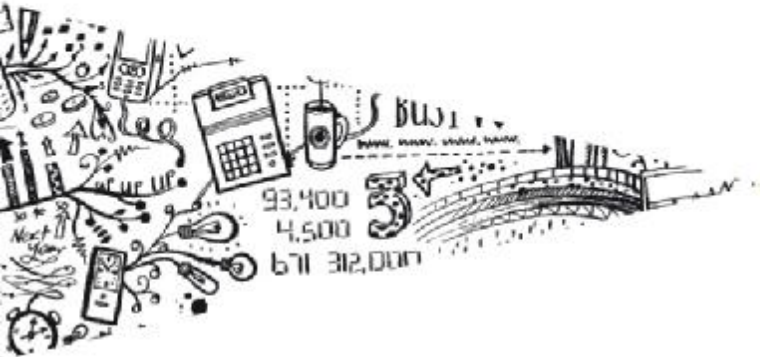


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EY Tax Alert

Delhi HC rules on disallowance of expenditure incurred in relation to exempt dividend income from shares held as 'trading assets'



Executive summary

This Tax Alert summarizes a recent decision of the Delhi High Court (Delhi HC) in the case of Maxopp Investment Ltd. (Taxpayer) & Others v. CIT^[1] on the issue of disallowance of expenditure incurred in relation to exempt income by way of dividend on shares held as 'trading assets'.

The Delhi HC held that the term 'in relation to' employed in Section 14A (Section) of the Income Tax Act (ITA) means 'in connection with' or 'pertaining to' and, thus, it needs to be construed widely. The disallowance under this provision is attracted in all cases even where the investment in shares is not with the main object of earning dividend income. It further held that the disallowance should be restricted to actual expenditure and, thus, there can be no disallowance where no expenditure is incurred in relation to exempt income. Lastly, it also held that the provisions of Section 14A(2) and 14A(3) (procedural provisions) and Rule 8D, providing for normative methodology of computation of disallowance, are prospective in nature and apply from tax year 2007-08 onwards.

Background

- ▶ The Finance Act, 2001 inserted the Section in the ITA, with retrospective effect from 1 April 1962 i.e., from the date of inception of the current ITA. The Section provides that, for the purposes of

computing total income under Chapter IV of the ITA, no deduction shall be allowed in respect of expenditure incurred by a taxpayer, in relation to the exempt income.

- ▶ The Finance Act, 2006 inserted the procedural provisions, with effect from 1 April 2007, to provide that the amount of disallowance will be computed as per prescribed methodology where the Tax Authority is not satisfied with the claim of a taxpayer or where the taxpayer claims that no expenditure has been incurred by it in relation to exempt income. The Central Board of Direct Taxes (CBDT) prescribed the methodology by Rule 8D which was inserted in the Income Tax Rules with effect from 24 March 2008.
- ▶ Rule 8D prescribes computation of disallowance under three limbs viz., (a) Direct expenditure (b) Indirect interest expenditure computed on pro rata basis in proportion of average value of investments to the total assets and (c) 0.5% of the average value of investments.

Facts

- ▶ The Taxpayer is in the business of finance, investment and dealing in shares and securities. It held shares and securities, partly as investments on 'capital account' and partly as 'trading shares'. The Taxpayer offered income from sale of shares on capital account as capital gains income and sale of trading shares as business income.
- ▶ For tax year 2001-02, the Taxpayer received dividend income of INR4.99m from trading

shares. The Taxpayer claimed exemption with reference to the entire dividend income of INR4.99m.

- ▶ For the year under reference, the Taxpayer incurred interest expenditure of INR16.12m. The Taxpayer contended that no part of this expenditure was incurred for earning dividend income from trading shares since investment in trading shares was not made with the intention of earning dividend income.
- ▶ The Tax Authority disallowed part of the interest expenditure worked out on pro rata basis by taking the proportion of investment in shares to the total assets, by invoking the Section. However, in view of dividend income being lower than such proportionate working, the Tax Authority restricted the disallowance to the extent of dividend income only.
- ▶ The First Appellate Authority confirmed the disallowance. On the Taxpayer's further appeal to the Income Tax Appellate Tribunal (Tribunal), the matter was referred to the same Special Bench (SB) of the Mumbai Tribunal already constituted in the case of Daga Capital Management Pvt. Ltd. & Others^[2]. The SB held that the Section is applicable even where the shares are held as stock-in-trade or trading assets and earning of dividend income is not the main object. It further held that the procedural provisions and Rule 8D were clarificatory in nature and applied with retrospective effect from the date of insertion of the Section in the ITA i.e., 1 April 1962.

^[1] Source: www.itatonline.org

^[2] [117 ITD 169 (Mum)]

- ▶ Aggrieved by the SB ruling, the Taxpayer appealed further to the Delhi HC.

Taxpayer's contentions

- ▶ The intention behind acquiring trading shares is not to earn dividend, which is merely incidental. Interest paid for acquiring trading shares is allowable as business expenditure.
- ▶ The use of the term 'in relation to' indicates that there must be direct and proximate nexus between the expenditure and exempt income. Furthermore, only actual expenditure incurred, which is made directly and with the object of earning exempt income, can be disallowed.
- ▶ The procedural provisions and Rule 8D are not retrospective and have no application to the tax year under reference viz., 2001-02. They are substantive provisions and cannot be regarded as clarificatory in nature.

Tax Authority's contentions

- ▶ The term 'in relation to' cannot be construed narrowly to restrict the disallowance only to expenditure which has direct and proximate nexus with exempt income.
- ▶ The procedural provisions and Rule 8D merely lay down the machinery for quantification of the expenditure which is disallowable as per the

Section. Therefore, they are clarificatory in nature and apply from the same date from which the Section was inserted in the ITA.

HC's ruling

On applicability of the Section to dividend income on trading shares

- ▶ The Section was introduced to overcome a series of Supreme Court (SC) rulings which held that, where a taxpayer has an indivisible business giving rise to both exempt and taxable incomes, the expenditure incurred in such indivisible business cannot be apportioned between the two types of incomes. As held by the SC in the case of CIT v. Walfort Share and Stock Pvt. Ltd.,^[3] the Section widens the scope of apportionment of expenditure between the exempt income and taxable income.
- ▶ Reference to three SC rulings^[4] explaining the term 'relating to' or 'in relation to' makes it clear that the term requires contextual interpretation. Ordinarily, the term indicates wide import unless the context suggests otherwise. In the context of the Section, having regard to its retrospective insertion and the basic principle of taxing only net income i.e., gross income minus expenditure which should equally apply to exempt income, the term cannot be ascribed a narrow or constricted

^[3] [326 ITR 1]

^[4] Madhav Rao Scindia v. UOI [AIR 1971 SC 530], Doypack Systems Pvt. Ltd. v. UOI [AIR 1988 SC 782] and Navin Chemicals Manufacturing and Trading Co. Ltd. v. CCE [1993 (68) ELT 3(SC)]

meaning. It simply means 'in connection with' or 'pertaining to'. Accordingly, the disallowance under the Section is attracted even in a case where the main object of incurrance of the expenditure is not to earn exempt income.

- ▶ However, the disallowance should be restricted only to actual expenditure and not to any notional expenditure. Accordingly, if no expenditure is incurred in connection with or pertaining to exempt income, no disallowance can be made under the Section.

On the scope of procedural provisions and Rule 8D

- ▶ The procedural provisions and Rule 8D can be invoked by the Tax Authority only if it is not satisfied with a taxpayer's quantification of disallowance.
- ▶ The Tax Authority must record such finding and also provide cogent reasons for the same.

On retrospective application of procedural provisions and Rule 8D

- ▶ While the Section was inserted with retrospective effect, the procedural provisions are specifically made applicable from tax year 2006-07. Furthermore, the procedural provisions are ineffective without prescribed method of disallowance which is provided in Rule 8D. Rule 8D has been inserted with effect from 24 March 2008.
- ▶ The ITA provides the CBDT with the power to make rules with retrospective effect other than those which prejudicially affect the interests of

the taxpayers. Nothing prevented the CBDT from making Rule 8D applicable from retrospective effect. The fact that the CBDT notified Rule 8D only from 24 March 2008 reflects that the intent was to make it effective from tax year 2007-08 only. This is also supported by the Bombay HC ruling in the case of *Godrej & Boyce Mfg. Co. Ltd. v. DCIT*^[5].

- ▶ For earlier years, the Tax Authority has to apply a reasonable and acceptable method of apportionment for quantifying the expenditure on the basis of objective criteria and after giving the taxpayer a reasonable opportunity before rejecting the taxpayer's claim. The Tax Authority should also state the reasons for rejecting the taxpayer's claim.

The present ruling concurs with the Bombay HC ruling in the case of *Godrej & Boyce (supra)* on the procedural provisions and Rule 8D not being retrospective in nature.

In view of this ruling, it will be significant for the taxpayers to consider the disallowance even where shares are held as stock-in-trade and justify the quantification of the disallowable expenditure by robust documentation and sound principles of apportionment. Where the Tax Authority is not satisfied with the taxpayer's claim, it would need to follow the directions of the Delhi HC of giving reasonable opportunity to the taxpayer and making disallowance only after taking into account all the relevant facts and circumstances and recording reasons for its non-satisfaction.

Comments

This Delhi HC ruling confirms the SB ruling on the proposition that the disallowance under the Section can apply even to shares held as stock-in-trade and even where expenditure is not incurred with the main object of earning exempt dividend income. The Kerala HC, in the case of *CIT v. Leena Ramachandran*^[6], held that, where the shares are held as stock-in-trade, interest expenditure is allowable as per specific provisions of the ITA.

^[5] [328 ITR 81]

^[6] [45 DTR 372]

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