

## Bombay High Court ruling on section 14A and Rule 8D

The Finance Act 2001 had introduced section 14A in the Income-tax Act, 1961 ("the Act") to disallow deduction of any expenditure incurred in relation to earning exempt income. This section was introduced retrospectively from April 1, 1962, i.e., from the commencement of the Act. The section was further amended to empower the Assessing Officer ("AO") to determine the amount of expenditure to be disallowed under a prescribed method. In this regard, in 2008, Rule 8D was introduced which prescribed the method to be adopted by the AO in determining the expenditure to be disallowed under section 14A of the Act.

The Bombay High Court ("Bombay HC") has delivered an important judgment in the case of Godrej and Boyce Manufacturing Company Limited ("the Company" or "the taxpayer") v DCIT [being the lead matter challenging the judgment of the Special Bench of the Income Tax Appellate Tribunal ("the Tribunal") in the case of ITO v. Daga Capital Management Private Limited].

### Facts of the case

The taxpayer was carrying on the business of manufacturing steel furniture, security equipment, typewriters, electronic equipment, machine tools, etc. During the year in question, it had earned dividend income and claimed the entire dividend income as exempt. During the assessment proceedings, the AO attributed certain amount of the interest/expenditure incurred by it towards dividend receipts and disallowed the same under section 14A of the Act.

On appeal, the Commissioner (Appeals) followed the decision in the taxpayer's own case in earlier years and since facts had not changed, deleted the addition made by the AO and held that no expenditure was attributable to the earning of dividend income.

On further appeal, the Tribunal following its decision in the case of Daga Capital Management Private Limited held that section 14A(2) and section 14A(3) of the Act were procedural in nature and had to be given retrospective effect. The Tribunal

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noted that the AO had not examined the correctness of the claim of the taxpayer and therefore, remanded the matter back to the AO for a fresh examination on the basis of the provisions of section 14A(2) of the Act.

The taxpayer had appealed against the decision of the Tribunal to the Bombay HC.

### **Key Contentions of the taxpayer before the Bombay HC**

- The expression “income which does not form part of the total income under the Act” should be interpreted to mean income which is exempt from tax. Section 14A of the Act cannot be invoked in respect of dividend income from shares and income from mutual funds as they are charged to tax under sections 115O and 115R on the declaration of the dividend by the Company or the Mutual fund and cannot be treated as exempt income
- A literal interpretation of section 14A of the Act would give effect to unintended and absurd consequences and therefore has to be disregarded
- The provisions of section 14A(2), section 14A(3) of the Act and Rule 8D were arbitrary and violative of Article 14 of the Constitution
- Rule 8D was not a procedural rule, but it was a measure to determine the income which was chargeable to tax. Since the amendment specifically provided that the Rules shall come into force from the date of their notification in the official gazette, they cannot be regarded as being retrospective in nature and therefore the provisions of Rule 8D cannot have any application to the year in question which was prior to 2008

### **Contentions of the revenue authorities before the Bombay HC**

- The intention of section 14A of the Act was to disallow all expenses relating to exempt income and all that was required was to show that there is a ‘proximate cause’ between the expenditure incurred (even indirect expenditure) and the exempt income
- Rule 8D was in conformity with the principle contained in section 14A (1) of the Act. The uniform method is to be adopted by the AO only if he is not satisfied with the correctness of the claim of the assessee. Rule 8D only provides a machinery or method to measure and attribute expenditure in relation to exempt income
- On the adhoc disallowance under Rule 8D(2)(iii), it was contended that the Rule prescribes a mechanism for attributing part of the administrative/managerial expenses to the tax exempt investment income and the same was reasonable
- The provisions of section 14A (2) and Rule 8D are procedural in nature. Where the machinery provisions implement a charging section or where they prescribe

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the circumstances in which the charging power can be exercised, they should be given a retrospective effect which is co-terminus with the period of operation of the main charging provision

### **Order of the Bombay HC**

The Bombay HC held that section 14A(2), section 14A(3) and Rule 8D are constitutionally valid. It agreed with the contention of the Revenue authorities that expenditure incurred (whether direct or indirect) in relation to earning exempt income should be disallowed. However, it has held that Rule 8D is prospective in its operation and can be applied only from the financial year 2006-2007 onwards. The important observations of the Bombay HC in delivering the above judgment are as follows:

- Tax under section 115O is not a tax on the dividend income, but it is a charge on the component of the profits of the company represented by the profits declared, distributed or paid. Such tax is not paid by the company on behalf of the shareholders and the company is not an agent of the shareholder while paying such tax. Since, income from dividend is exempt under section 10(34) of the Act, expenditure incurred in relation to earning such income cannot be allowed as a deduction
- Section 14A of the Act requires the apportionment of expenditure to taxable and non-taxable income and no expenditure in relation to income which does not form part of the total income can be allowed as a deduction. It is mandatory on the part of the AO to first examine the correctness of the claim of the taxpayer and give him an opportunity to support his claim before applying Rule 8D
- The legislature is open to adopt diverse methods to achieve the desired results and so long as the measure adopted by the legislature had nexus with the object sought to be achieved, it was constitutionally valid. Since section 14A(2) and section 14A(3) contain adequate safeguards to ensure reasonable exercise of power by the AO and considering the fact that the method has been prescribed to curb the disputes that had occurred between the revenue authorities and the taxpayers in the past, Rule 8D was not arbitrary or oppressive
- The Bombay HC took cognizance of the fact that the law with respect to the disallowance of expenditure came into effect on different dates and noted that the memorandum explaining the provisions of the Finance Bill of 2006 which inserted section 14(A)(2) and section 14A(3) of the Act provided that the amendment would apply in relation to the FY 2006-07 onwards. Considering this fact, the Bombay HC held that Rule 8D is prospective in its application
- Even in the absence of section 14A(2), section 14A(3) and Rule 8D, the AO could make an apportionment of expenditure incurred by the assessee on a reasonable basis between taxable and exempt income

## BMR comments and analysis

This is an important decision on the validity of the provisions and the retrospective applicability of section 14A (2), section 14A (3) of the Act and Rule 8D. While on the constitutional validity of section 14A(2), section 14A(3) and Rule 8D, the Bombay HC has ruled against the taxpayer, it has nevertheless held that the power of the AO to apply Rule 8D is not automatic and the AO is bound to give an opportunity to the taxpayer to prove the correctness of his claim. It is only where the AO is not satisfied with the claim of the taxpayer can he apply Rule 8D after recording reasons. This decision is welcome in so far as retrospective applicability of Rule 8D is concerned as it overrides the decision of the Special Bench of the Tribunal in the case of Daga Capital Management Private Limited, which held that Rule 8D was applicable retrospectively.

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