

Short Note on “Section 14A r.w. Rule 8D : Current situation”

Section 14A r.w Rule 8D under normal provisions of the Act: Situation post Maxopp SC & Vireet ITAT-SB judgments

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(The following short note reflects the current position as of June 2021 w.r.t S.14A r.w. Rule 8D)
Section 14A of the Income Tax Act, 1962 was introduced by the Finance Act, 2001 and has been given effect from 1st April, 1962. It deals with expenses incurred by an individual to earn exempt income such as dividend income. It provides that no deduction on expenditure incurred by assessee in relation to exempt income (income not forming part of the total income) shall be allowed.

Section 14A(2) provides that if the Assessing Officer, having regard to the accounts of the assessee, is not satisfied with the correctness of assessee's claim for the expenditure incurred in relation to exempt income, then in such a case the Assessing Officer has to determine the quantum of disallowance as per the method prescribed i.e. in accordance to Rule 8D of the IT Rules.

Under normal provisions of the Act, Rule 8D is now watered down to be calculated as follows:
(Prior to 2-6-2016 amendment)

1. **Rule 8D(2)(i):** Under this first limb, all direct expenditure which have been incurred for earning tax exempt income are disallowed. For example, if salary is paid (direct expenditure) to a staff member who works to earn exempt income for the company, in that case the company shall disallow this amount itself in the return.
2. **Rule 8D(2)(ii):** Under the second limb, interest expenditure with respect to monies borrowed for making investments to earn dividend income is disallowed.

The taxpayer should show that loans borrowed were used for specific purposes (say, purchase of machinery or term loans with specific directions) and thereby can reduce the interest expenditure considered under this limb. If there is no nexus between borrowed funds and earning exempt income, there can be no interest disallowance. Also, most importantly, under this limb no disallowance can be made if it can be demonstrated that the assessee has sufficient funds in its Balance sheet (reserves & surplus) to make the investments which have yielded dividend income. This is rationale of *Commissioner of Income-tax v. Reliance Utilities & Power Ltd*[1].

3. **Rule 8D(2)(iii):** Under the third limb, investments w.r.t exempted income earned is to be disallowed. If an investment has yielded exempt income in a particular year, only then it will need to be used in the computation of 0.5% of average value of investments for the purposes of rule 8D(2)(iii).

In *Maxopp Investment Ltd. v. Commissioner of Income Tax, New Delhi* [2] the Supreme Court ruled that investments in subsidiaries is also to be included but when it is read along with *ACIT, Circle 17(1), New Delhi v. Vireet Investment (P.) Ltd.*[3] which said that only investments earning dividend income have to be considered, this limb is significantly watered down.

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(2016 amendment) The Central Board of Direct Taxes (CBDT) vide notification no. 43/2016 dated 2 June, 2016, has amended Rule 8D. As per the amendment, Rule 8D is as follows:

1. **Rule 8D(2)(i):** No change was observed, therefore, all direct expenditure which have been incurred for earning tax exempt income are disallowed.
2. **Rule 8D(2)(ii):** The amended rule provides for the annual average of **monthly averages** of value of investments instead of the previous annual average value of investments. The amended rule also changed the presumptive expenditure to **1%** of the annual average of monthly averages of values of investments, from the previous 0.5% of average value of investment. The amendment also added a proviso, providing that disallowance amount as computed under Rule 8D shall not exceed total expenditure claimed by the taxpayer.

Some other aspects of S.14A r.w. Rule 8D disallowance are as follows:

- **Dividend Income from investments in foreign companies** is taxable under the Act and hence these investments do not require to be included under Rule 8D computation as they do not form part of exempt income yielding investments.
- **In case of no exempt income:** Corollary to the above judgements, and as enshrined in a catena of judgements recently, if you don't have any exempt income in the given year^[4], you cannot have Rule 8D disallowance in that specific year.
- **Rule 8D disallowance cannot exceed exempt income:** The other corollary now enshrined in law is that the amount of Rule 8D disallowance cannot exceed the exempt income earned in that year (*see Marg Ltd. V. CIT Madras HC[5]*), because Rule 8D is in itself for calculating the expenditure incurred towards earning exempted income.
- **Satisfaction to be recorded:** The AO has to record satisfaction as to why Rule 8D is to be invoked and how the assessee's computation and disallowance if any is insufficient. In absence of this, Rule 8D disallowance cannot stand (*see Pr CIT vs. Vedanta Ltd., Delhi HC[6]*)
- **Exempt income earned through RTGS/NEFT:** In *Canara Bank Vs ACIT Karnataka HC[7]* [2014] 99 DTR 36 (Karn), the HC held that when dividend income was being credited to the assessee's account by way of a bank transfer. (NEFT/RTFS), it involves no human agency and thus assessee does not need to incur any expenditure to earn such exempt income and hence S.14A r.w. Rule 8D disallowance was not warranted.

Conclusion: So, the assessee should prepare a computation keeping in mind the above rulings. The assessee should calculate Rule 8D(2) while making sure they restrict computation to include only investments yielding dividend income and exclude foreign investments which are taxable under the Act. It would also be prudent for the assessee to disallow salary of a manager or staff in terms of direct expenditure for the first limb of Rule 8D(2)

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[1] [2009] 313 ITR 340 (Bombay).

[2] 2018] 402 ITR 640 (SC).

[3] [2017] 58 ITR(T) 313 (Delhi - Trib.) (SB).

[4] Supra.

[5] 2020 SCC OnLine Mad 2667.

[6] ITA No.1467/2018 dated 18.12.2018, Delhi HC

[7] [2014] 99 DTR 36 (Karnataka HC)