



TAX FLASH NEWS

No disallowance under Section 14A of the Income-tax Act – The Bombay High Court

Background

Recently, the Bombay High Court (High Court) in the case of SBI DHFL Ltd.¹ (the taxpayer) dealt with a case under Section 14A of the Income-tax Act, 1961 (the Act) where investment in tax-free bonds has been made from a common pool of owned and borrowed funds. The High Court held that since the issue was fully covered in favour of the taxpayer, the tax department's appeal was dismissed.

Facts of the case

- The Assessing Officer (AO) held that the taxpayer kept all the funds in one common pool and in the absence of a separate cash flow statement maintained by the taxpayer, it was not possible to establish that the investment in the tax-free bonds was made only out of its owned funds.
- The AO applied an estimation and proceeded to hold that since the borrowed funds of the taxpayer at the relevant time were 69.9 per cent of the total funds, the utilisation of the borrowed funds for making tax-free bonds and the interest attributable to the said borrowed funds would have to be taken into account. The AO applied the average rate of interest for disallowance under Section 14A of the Act.
- The tax department claimed that the interest bearing borrowed funds were utilised by the taxpayer entirely for the purpose of its business and investment in tax-free bonds has been made by the taxpayer out of its own funds.

¹ CIT v. SBI DHFL Ltd. [2015] 376 ITR 296 (Bom)

- The Commissioner of Income-tax (Appeals) [CIT(A)] and the Income-tax Appellate Tribunal (the Tribunal) held that there was no warrant for such an estimation. The CIT(A) held that no interest expenditure can be allocated to the earning of tax-free income received by the taxpayer on tax-free bonds. The decision of the CIT(A) and the Tribunal is in consonance with the law laid down by the Bombay High Court in the case of Reliance Utilities and Power Ltd.²

High Court's ruling

- Merely because there is a common pool of funds, a presumption that the investment yielding tax-free returns is made by the taxpayer out of its own funds cannot be raised. Such a view of the Tribunal, therefore, does not raise any substantial question of law.
- The tax department relying on the decision of Godrej and Boyce³ contended that the matter should be remitted back to the AO for verification and scrutiny, particularly on the amount indicated in this decision. However, the High Court did not find a basis to grant the AO's request on account of the following reasons:
 - In the case of Godrej and Boyce, some material was produced so as to warrant a sending back of the matter to the AO.
 - In the case of Godrej and Boyce, the reference was made only to the reserves and there was no mention of interest-free funds. It was contended that the reserves shown on the liabilities side of the balance sheet and were represented by a variety of assets on the assets side.

² CIT v. Reliance Utilities and Power Ltd. [2009] 313 ITR 340 (Bom)

³ Godrej and Boyce Mfg. Co. Ltd. v. DCIT [2010] 328 ITR 81 (Bom)

- These assets can be fixed or non-liquid assets and hence, incapable of any investment. Therefore, the inquiry as to whether the interest-free funds were available on the assets side and in the absence of sufficient proof of such availability, the presumption could not be raised.
 - That was the inquiry which was warranted and that is why the matter was remitted and restored to the file of the AO.
 - An inquiry was made to find out whether the taxpayer had incurred any expenditure in relation to the earning of income which does not form part of the total income and question of the expenditure of disallowance.
- The High Court does not find that any such inquiry is necessary in the present case in the absence of any request in that behalf made to the Tribunal as well as the fact that the necessary materials have not been produced either before the Tribunal or the High Court.
 - Since the issue was fully covered in favour of the taxpayer, the tax department's appeal was dismissed.



Our comments

In the instant case, another decision of the Bombay High Court in the case of Reliance Utilities and Power Ltd was referred wherein it was held that since the taxpayer has his own funds as well as borrowed funds, a presumption can be made that the advances for non-business purposes have been made out of the owned funds and that the borrowed funds have not been used for this purpose. Accordingly, the disallowance of the interest on the borrowed funds was not justified.

In the case of Suzlon Energy Ltd⁴, the Gujarat High Court held that where the taxpayer had owned interest-free funds and there was no direct nexus between interest bearing borrowed funds and investment, no disallowance of interest expenditure could be made under Section 14A of the Act.

This decision is pertaining to Assessment Year 2003-04. Rule 8D has been introduced in the Income-tax Rules, 1962 (the Rules) with effect from 24 March 2008. It prescribes the method for determining the amount of expenditure in relation to income not includible in total income for the purpose of disallowance of the expenditure under Section 14A of the Act. It may be interesting to see how decisions similar to the instant case will apply post the introduction of Rule 8D of the Rules.

⁴ CIT v. Suzlon Energy Ltd [2013] 354 ITR 630 (Guj)

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