



Preference shares which have not yielded any exempt income have to be considered for disallowance under Section 14A of the Income-tax Act when the taxpayer is having exempt income from other investments

Background

Recently, the Kolkata Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of West Bengal Infrastructure Development¹ (the taxpayer) dealt with the disallowance of expenditure under Section 14A of the Income-tax Act, 1961 (the Act) read with Rule 8D(2)(iii) of the Income-tax Rules, 1962 (the Rules) with respect to preference shares which have not yielded any tax-free income so far. The Tribunal observed that the taxpayer received exempt income from other investments during the year, and, therefore, provisions of Section 14A of the Act would apply. The Tribunal held that the preference shares have to be considered to determine the average value of investment under Rule 8D(2)(iii) of the Rules even though no tax-free income has been earned so far from preference shares.

The Tribunal also held that the disallowance under Section 14A of the Act cannot be in excess of the tax-free income earned by the taxpayer during the previous year.

¹ West Bengal Infrastructure Development v. ACIT (ITA No.388/Kol/2008) – Taxsutra.com

Facts of the case

- The taxpayer is wholly owned by the Government of West Bengal. The taxpayer is engaged in the business of providing finance for infrastructural development in the State of West Bengal. For this purpose, the taxpayer was required to follow the suggestions made by the state government from time to time.
- During the year under consideration, the taxpayer has made investment amounting to INR1946.20 million at 1 per cent cumulative preference shares of Haldia Petrochemicals Ltd (HPL) and INR 41.81 million in Equity Shares of the Calcutta Stock Exchange Association Ltd (CSEAL), pursuant to the directions of the Government of West Bengal.
- The taxpayer had also granted unsecured loans for the purpose of laying a gas pipe line and other infrastructural activities to the extent of INR1750 million at an interest rate of 16 per cent to HPL.
- The taxpayer also had investments in mutual funds. During the year, the taxpayer earned the exempt dividend of INR4.1 million from investments in mutual funds during the financial year 2007-08.

- Up to February 2002, the taxpayer accounted for interest income to the extent of INR196.2 million. However, the said interest could not be realised from HPL, and the said loan had become doubtful of recovery.
- The taxpayer at the instruction of the Government of West Bengal realigned the outstanding loan and accrued interest into preference shares of HPL which otherwise had been doubtful of recovery.
- Subsequent to the conversion of unsecured loan into preference shares, till date the taxpayer had not received any amount as a dividend on such preference shares. Accordingly, investments in preference shares of HPL had not been considered by the taxpayer for the purpose of Rule 8D of the Rules i.e. while computing the quantum of disallowance under Section 14A of the Act.
- The taxpayer argued that since no dividend was received on preference shares the investment in preference shares should not be considered for the purpose of determining the average value of investments under Rule 8D(2)(iii) of the rules. The Tribunal is unable to agree with such a proposition.
- The decisions relied upon by the taxpayer do not lay down such proposition of breaking up individual investments and see whether those investments yielded tax-free income and exclude those investments for the purpose of working out the average value of investments under Rule 8D(2)(iii) of the Rules.
- It has also been observed that the disallowance under Section 14A of the Act cannot be in excess of the tax-free income earned by the taxpayer during the previous year. Accordingly, it has been held that the disallowance under Section 14A of the Act is restricted to the tax-free income earned by the taxpayer.

Tribunal ruling

- Preference shares have to be considered to determine the average value of investments is not in dispute. The fact that a loan was converted into preference shares consequent to the direction of the state government can be no ground not to treat preference share as an investment which is likely to yield tax-free income.
- The proposition laid down in various decisions² is that in the absence of the existence of tax-free income there can be no disallowance under Section 14A of the Act. In the present case, however, the taxpayer had received exempt income and therefore provisions of Section 14A of the Act have to be applied.

Our comments

The Kolkata Tribunal in the instant case dealt with the issue whether the investment in preference shares on which the taxpayer has not yielded any exempt income shall be considered for the purpose of calculating average value of investment under Rule 8D(2)(iii) of the Rules for making disallowance under Section 14A of the Act. The Tribunal held that the taxpayer has earned exempt income on other investments and, therefore, the taxpayer cannot break individual investments and see whether those investments yielded tax-free income and exclude the same for the purpose of working out the average value of investments under Rule 8D(2)(iii) of the Rules.

² Alliance Infrastructure Projects Pvt. Ltd. (ITA No.220,2324, 1043 and 1217/Bang/2013), CIT v. Holcim India Pvt. Ltd. [2014] 57 Taxmann.com 28 (Del), CIT v. Delite Enterprise (ITA No. 110 of 2009, 26 February 2009), CIT v. Winsome Textile Industries Ltd. [2009] 319 ITR 204 (P&H), CIT v. Corrtch Energy (P) Ltd. [2015] 372 ITR 97 (Guj), CIT v. Shivam Motors Pvt. Ltd. [2014] 545 Taxmann.com 262 (All)

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