

No disallowance under Section 14A since investments are made out of own funds and the tax officer has not given cogent reason for invoking Rule 8D

13 March 2015



Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Subramanya Constructions & Development Co. Ltd.¹ (the taxpayer) held that the taxpayer had made investments out of interest free funds and therefore, disallowance of interest expenditure under Rule 8D(2)(ii)² of the Income-tax Rules, 1962 (the Rules) cannot be made. Further, the Assessing Officer (AO) is not justified in invoking Rule 8D(2)(iii)³ of the Rules for disallowance of indirect expenditure unless he/she has recorded his/her dissatisfaction of the claim. It is essential for the AO to record his/her dissatisfaction with cogent reasons before invoking Section 14A of the Income-tax Act, 1961 (the Act).

¹ DCIT v. Subramanya Constructions & Development Co. Ltd. (ITA No. 404/2013) – Taxsutra.com

² The expenditure in relation to income which does not form part of total income shall be in a case where the taxpayer has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the formula specified therein

³ The expenditure in relation to income which does not form part of total income shall be an amount of equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the taxpayer, on the first day and the last day of the previous year

Facts of the case

- The taxpayer is a builder and had investments of INR634.93 million in equity shares. During the Assessment Year (AY) 2009-10 it had earned a dividend income amounting to INR33,600 which was claimed as exempt. The taxpayer charged it in its Profit and Loss Account interest of INR339.31 million.
- The AO disallowed expenditure attributable to investments. In response, the taxpayer claimed that all the investments were made out of general reserves and interest free deposits from tenants apart from its capital. Therefore, disallowance under Section 14A of the Act could not be made.
- The AO applied Rule 8D(2)(ii) of the Rules on the interest claim of INR339.31 million and computed the disallowance of INR46.41 million. Further, for the disallowance under Rule 8D(2)(iii) of the Rules, the AO applied 0.5 per cent of the average value of investments.

- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the taxpayer had interest free funds which satisfied the requirement of the investments made by it and therefore, disallowance under Rule 8D(2)(ii) of the Rules could not be made. However, confirming the disallowance made under Rule 8D(2)(iii) of the Rules, it was held that no investment could stand together for years without any expenditure.

Tribunal's ruling

- The tax department has not rebutted the contention of the taxpayer that rental deposits carried no interest. Therefore, interest free funds were available with the taxpayer which was substantially higher than the investments made by it.
- It was not necessary to draw a one to one nexus between investments and interest free funds. When the funds had gone out of a common pool and the taxpayer had interest free funds in excess of the investments, it could take a valid plea that such investments were made out of interest free funds.
- While taking the aforesaid view, the Tribunal placed reliance on the decision of the Gujarat High Court in the case of Gujarat Industrial Development Corporation Ltd.⁴ and the decision of the Punjab and Haryana High Court in the case of Deepak Metal⁵.
- With respect to the disallowance made under Rule 8D(2)(iii) of the Rules, the taxpayer had stated that there was nothing which called for a disallowance under Section 14A of the Act relating to the investment portfolio. Though, nothing specific has been mentioned about non-incurring of any indirect expenditure, it is clear that major part of the investments were done in Financial Year 2005-06.
- Under Section 14A of the Act, once the taxpayer has taken a stand that it had not incurred any expenditure under Section 14A of the Act, the AO is not justified in invoking Rule 8D(2)(iii) of the Rules for a disallowance of indirect expenditure unless he/she recorded his/her dissatisfaction of claim.
- It is essential for the AO to record his/her dissatisfaction with cogent reasons before invoking Section 14A of the Act. Doctrine of satisfaction no doubt, does not mean that an AO should presume what was in the mind of the taxpayer and express his/her approval or disapproval, thereon. However, once the taxpayer says that it had not incurred any expenditure covered by Section 14A of the Act, the AO has to verify this claim.
- Accordingly, it has been held that the CIT(A) was justified in deleting the disallowances made under Rule 8D(2)(ii) of the Rules. However, the disallowance under Rule 8D(2)(iii) was not sustainable. Accordingly, the disallowance under Rule 8D(2)(iii) was deleted.

⁴ CIT v. Gujarat Industrial Development Corporation Ltd. [2013] 218 Taxman 142 (Guj)

⁵ CIT v. Deepak Metal [2014] 361 ITR 131 (P&H)

Our comments

Prior to the introduction of Rule 8D of the Rules, the Bombay High Court in the case of HDFC Bank Limited⁶ held that the disallowance under Section 14A cannot be made in respect of interest paid on borrowing if the taxpayer's own funds and non-interest bearing funds exceed investment in tax-free securities. Further, the Gujarat High Court in the case of Torrent Power Ltd⁷ held that, where the taxpayer had sufficient funds for making investments and it had not used borrowed funds for such purpose, disallowance under Section 14A cannot be made.

This is a welcome decision of the Bangalore Tribunal where the Tribunal while dealing with Rule 8D held that since the taxpayer had sufficient interest free funds to make an investment, disallowance of interest expenditure cannot be made.

Various Courts/Tribunals⁸ have held that disallowance under Section 14A cannot be made if the AO has not recorded his/her satisfaction about the claim of expenditure made by the taxpayer. The Tribunal in the present case has held that it is essential for the AO to record his/her dissatisfaction with cogent reasons before invoking Section 14A of the Act. Accordingly, the disallowance under Rule 8D(2)(iii) was deleted.



⁶ CIT v. HDFC Bank Limited [2014] 366 ITR 505 (Bom)

⁷ CIT v. Torrent Power Ltd [2014] 363 ITR 474 (Guj)

⁸ Maxopp Investment Ltd. v. CIT [2012] 347 ITR 272 (Del), REI Agro Ltd. v. DCIT [2013] 144 ITD 141 (Kol), ACIT v. Magarpatta Township Development & Construction Co. Ltd [2015] 152 ITD 469 (Pune)

www.kpmg.com/in

Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2015 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name, logo and “cutting through complexity” are registered trademarks of KPMG International Cooperative (“KPMG International”), a Swiss entity.