**No disallowance u/s 14A & Rule 8D can be made if the assessee does not have tax-free income & no claim for exemption is sought**

Section 14A has been inserted in Chapter IV of the Income tax Act by the Finance Act, 2001, with retrospective effect from 1-4-1962. This Section provides for disallowance of expenditure incurred in relation to income which is not included in the total income of the assessee (*i.e.* exempt income). The operative part of this Section reads as under:

*“For the purposes of computing the total income under this chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.”*

Proviso to the Section was added by the Finance Act, 2002 w.e.f. 11-5-2001. It provides that the A.O. cannot reopen the assessment u/s.147 for any assessment year prior to A.Y. 2001-02 for this purpose or pass any rectification order u/s.154 for prior years to disallow any such expenditure.

It has been a matter of discussion that **whether expenses should be disallowed in case the assessee has not earned any exempt income during the relevant assessment year.**

In a recent decision of Delhi High Court in the case of **M/s Holcim India P. Ltd. vs. CIT-IV ( ITA No. 486/2014 & ITA No. 299/2014) dated September 5, 2014 (Date of Publication Oct 17, 2014)**

**The High Court has held that no disallowance can be made u/s 14A if there is no exempt income in the relevant year.**

It has mentioned that

“There are three decisions of the different High Courts directly on the issue and against the Revenue;

* First decision is of the Punjab and Haryana High Court in **CIT vs. M/s. Lakhani Marketing Inc** made reference to two earlier decisions of the same Court in **CIT Vs. Hero Cycles Limited**, 323 ITR 518 and **CIT Vs. Winsome Textile Industries Ltd** 319 ITR 204 to hold that Section 14A cannot be invoked when no exempt income was earned.
* The second decision is of the Gujarat High Court in **CIT vs. Corrtech Energy (P.) Ltd**. [2014] 223 Taxmann 130 (Guj).
* The third decision is of the Allahabad High Court in **CIT vs. Shivam Motors (P) Ltd**;

Further it held that

1. Income exempt under Section 10 in a particular assessment year, may not have been exempt earlier and can become taxable in future years.
2. Further, whether income earned in a subsequent year would or would not be taxable, may depend upon the nature of transaction entered into in the subsequent assessment year. For example, long term capital gain on sale of shares is presently not taxable where security transaction tax has been paid, but a private sale of shares in an off market transaction attracts capital gains tax. It is an undisputed position that assessee is an investment company and had invested by purchasing a substantial number of shares and thereby securing right to management. Possibility of sale of shares by private placement etc. cannot be ruled out and is not an improbability. Dividend may or may not be declared. Dividend is declared by the company and strictly in legal sense, a shareholder has no control and cannot insist on payment of dividend. When declared, it is subjected to dividend distribution tax;
3. What is also noticeable is that the entire or whole expenditure has been disallowed as if there was no expenditure incurred by the assessee for conducting business. The CIT(A) has positively held that the business was set up and had commenced. The said finding is accepted. The assessee, therefore, had to incur expenditure for the business in the form of investment in shares of cement companies and to further expand and consolidate their business. Expenditure had to be also incurred to protect the investment made. The genuineness of the said expenditure and the fact that it was incurred for business activities was not doubted by the Assessing Officer and has also not been doubted by the CIT(A).

Recently in one more decision in the case of **Alliance infrastructure Projects Pvt. Ltd. vs. DCIT, ITAT Bangalore ITA Nos.220 & 1043(BNG.)/2013 dated September 12, 2014 (Date of Publication: Oct 17, 2014),** it has held that

***“****There is no dispute that the assessee had no exempt income during both the years involved. No doubt as mentioned by the DR, the Special Bench of this Tribunal in the case of* ***Cheminvest Ltd. vs. ITO*** *121 ITD 318, had held that disallowance under section 14A could be made even in an year in which no exempt income was earned or received by the assessee. This decision of Special Bench of the Tribunal has been, in our opinion, impliedly overruled by various decisions of different High Courts, namely,* ***CIT vs Shivam Motors P. Ltd****. (All HC),* ***CIT vs. Corrtech Energy Pvt. Ltd*** *(Guj HC),* ***CIT vs. Winsome Textile Industries Ltd*** *319 1TR 204 (P&H),* ***CIT Vs.Delite Enterprises*** *(Bom HC) &* ***CIT vs. Lakhani Marketing*** *(P&H HC). Therefore, unless and until there is receipt of exempted income for the concerned assessment years, s. 14A of the Act cannot be invoked. “*
CBDT has also issued a circular, **dated: 11th Feb, 2014** where it has clarified that expenditure incurred in relation to exempt income would be disallowed under Section 14A even if no such income has been earned in a particular year. It has been mentioned in the circular”

*“That the legislative intent is to allow only that expenditure which is relatable to earning of taxable income and it therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial year or not”*

Circular are binding on the Tax department but not on the assessee. In the case of **K.P.Varghese-vs- I.T.O. 131 ITR 597 SC, UCO Bank-vs-CIT 237 ITR 889 SC, C.B.Gautam-vs-UOI 199 ITR 530 SC (constitution Bench)**, the apex court has decided that circulars issued by the CBDT are binding on the tax authorities meant for execution of the Act even though such circulars tone down the rigour of law or deviate from or relax the provisions of the Act. Further such circulars are not binding on the assessee.

It looks from the above that after this circular, the Department is bound to follow the circular and will disallow the allowance u/s 14A but assessee is not bound to follow the circular.

In the above mentioned cases which has been held by Different High courts or ITAT in favour of the assessee, no reference has been made of this circulars. However, in **the case of ACIT, CC-1(2) vs. Mr. M. Baskaran (ITAT, Chennai Dated July 31st, 2014)** while putting its case revenue had mentioned the above circular but while giving its judgment in the favour of the assessee ITAT had not given any reference to this circular.

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