

TAX ALERT



SECTION 14A APPLICABLE TO DIVIDEND INCOME DESPITE LIABLE TO DIVIDEND DISTRIBUTION TAX

Background

Section 14A of the Income-tax Act, 1961 (the Act) provides for disallowance of expenditure incurred to earn exempt income. There has been a spate of litigation on application of this section as to what constitutes exempt income. The Supreme Court dealt with the issue as to whether dividend income that suffers dividend distribution tax can, in essence, be construed as exempt income so as to attract disallowance under section 14A. We, at BDO, have summarized latest Supreme Court ruling on this and other related issues regarding disallowance under section 14A.

Facts of The Case

- Godrej & Boyce Manufacturing Company Limited ('taxpayer') is engaged in the business of manufacture of steel, furniture, security equipment, etc. The taxpayer is a promoter of various other companies and invests its funds in sister concerns and other companies in order to maintain control.
- For the fiscal year 2001-02, the taxpayer had earned dividend income from companies and income from mutual funds as exempt income (not includible in taxable income) under section 10(33) of the Act. A major portion (98%) of this dividend came from taxpayer's own group companies, representing investment in form of bonus shares. It did not involve any fresh investment. Further, as substantiated from the balance sheet figures, the taxpayer had sufficient interest free funds for making such investments.
- Similar to this year, the taxpayer had earned dividend income in previous fiscal years, claimed as exempt. The tax officer notionally allocated interest expenditure as relating to earning of dividend income and disallowed the same. However, the disallowance was reversed by appellate authorities, in the absence of any nexus between borrowed funds and investment.
- For fiscal year 2001-02, the first appellate authority ruled in favour of taxpayer on similar disallowance, as in case of earlier years. However, the tax tribunal took a view that matter should be remanded to the tax officer for recording his satisfaction/finding in light of retrospective effect of section 14A(2) and (3) of the Act¹. These provisions state that where tax officer is not satisfied with correctness of taxpayer's claim with respect to expenses in relation to exempt income, officer shall determine the amount of expenditure as per prescribed methods.

¹ Inserted by Finance Act 2006

High Court Ruling

The High Court upheld the remand by tax tribunal, notwithstanding holding that section 14A(2) and (3) do not have retrospective effect. It held that section 14A has to be construed on plain grammatical construction. These provisions are attracted in respect of dividend income, on which dividend distribution tax² (DDT) is payable under section 115-O and 115R of the Act, since such income is not includible in taxable income. The DDT is additional tax on the profits distributed by way of dividend and it is not a tax on dividend income of recipient.

Question Before the Supreme Court

The taxpayer preferred an appeal before the Supreme Court raising following two questions:

- Whether dividend income in respect of which DDT is payable is covered under the scope of phrase in section 14A - 'income which does not form part of the total income'
- Whether there could be any question of provisions of section 14A considering the facts and circumstances in present case and bearing in mind the unanimous findings of the lower authorities over a considerable period of time?

Contentions Before the Supreme Court

Contentions of the Taxpayer

- Section 14A of the Act applies only in situations where income is tax free, non-taxable and there is no incidence of tax per se. The fact that tax on such dividend is paid by dividend paying company and not recipient, is of no consequence. Such dividend income, really, is not tax-free.
- Both the sections i.e. relating to exempting the dividend income and mandating payment of DDT [sections 10(33) and 115-O/115R of the Act] constitute a composite scheme for taxation of dividend income. Mere fact that amount is not includible in taxable income of recipient, would not attract section 14A as the cardinal test is whether dividend income is tax-free or not. The person paying the tax is not relevant.
- In counter-affidavit of tax authorities, it is admitted that exemption of dividend is consequent upon collection of tax on dividend income from dividend distributing company. Therefore, a literal interpretation of section 14A must be avoided³.

Contentions of the Tax Authorities

- Section 14A in the Act was inserted to offset several judicial decisions, whereby entire expenses were permissible as deduction, including those pertaining to income not includible in taxable income⁴.
- The legislative intent behind section 14A and sub-sections therein, was to combat situations where tax-incentives given by providing various categories of exempt income, were actually used to reduce the tax payable on the total income.
- Section 14A of the Act reiterates a fundamental principle that expenses are allowable only to the extent that they have a nexus to the earning of taxable income⁵
- Section 115-O/115R of the Act levies an additional income-tax on the profits of the company, declared and distributed to its shareholders as dividend. No credit of same is available either to the company or the shareholders.
- The relevant provisions of the Act⁶ dealing with "collection and recovery of tax at source" specially provide that no deduction shall be made in respect of dividend referred to in section 115-O/115R of the Act. Hence, it is clear that additional income-tax paid under section 115-O/115R by the dividend paying company cannot assume the character of tax paid on dividend income by the taxpayer-shareholder.
- The Tax Tribunal and High Court were justified in remanding the matter to the tax officer for a *de novo* consideration in light of section 14A(2) and (3). Though in earlier years no disallowance was made, each fiscal year has to be reckoned separately.

²Section 115-O of the Act mandates domestic companies to pay DDT on dividend declared/distributed

³K. P. Varghese 131 ITR 597 (SC)

⁴Reference made to Memorandum to Finance Bill, 2001 and CBDT Circular No 14

⁵Walfort Share & Stock Brokers P. Ltd 326 ITR 1 (SC)

⁶Sections 194 (dividend), 195 (other sums to non-resident) , 196C (income from foreign currency bonds or shares of Indian company) and 199 (credit for tax deducted)

The Supreme Court Ruling

Regarding the first question, the Supreme Court held that section 14A of the Act would apply to dividend income on which tax is payable under section 115-O/115R of the Act, on following reasoning:

- The object behind introduction of section 14A of the Act is clear and unambiguous. The plain reading of section would show that income must not be includible in taxable income. Once this condition is satisfied, expenditure incurred in earning the income cannot be allowed to be deducted. The literal meaning of section 14A appears to be wholly consistent with scheme of the Act and therefore, recourse cannot be made to principles of interpretation other than literal view⁷.
- Referring to scheme of both the sections - 10(33) and 115-O/115R of the Act, it fortifies the situation that section 14A of the Act would operate to disallow deduction of all expenditure incurred in earning the dividend income under section 115-O/115R, that is not includible in taxable income.
- If tax paid by the dividend paying company is on behalf of recipient, provisions of section 57 (deductions under income from other sources) should enable the taxpayer to claim deduction of expenditure incurred to earn the income on which tax is paid. Such a position in law would be wholly incongruous in view of section 10(33) of the Act.

The Supreme Court answered the second question in favour of taxpayer by holding that taxpayer is entitled to full benefit of exemption of dividend income without any deductions. While holding so, it observed that:

- Finding of High Court order that section 14A(2) and (3) is retrospective has been challenged in another appeal, therefore that question need not be gone into. Irrespective of that, the requirement for attracting provisions of section 14A is proof of the fact that expenditure sought to be disallowed/deducted had actually been incurred in earning the dividend income.
- In earlier fiscal years, revenue authorities had failed to establish any nexus between expenditure disallowed and earning of dividend income. The question was specifically looked from requirements of section 14A(2) and (3) and findings were recorded that expenditure had no relation to earning of dividend income and therefore, taxpayer was entitled to full exemption of dividend. A different view could not be taken in fiscal year under consideration.
- The law postulates a requirement of satisfaction of tax officer that having regard to accounts of the taxpayer, it is not possible to generate requisite satisfaction regarding correctness of claim of taxpayer. Only thereafter, provisions of section 14A(2) and (3) read with Rule 8D would be applicable.
- There is no mention of the reasons that prevailed upon the tax officer to hold that claim of taxpayer that no expenditure was incurred to earn dividend income cannot be accepted and why orders of tax tribunal for earlier years were not acceptable, specifically in the absence of any new facts or change of circumstances. No basis has been disclosed establishing a reasonable nexus between expenditure disallowed and dividend income received. It has not been proved that any part of the borrowings of taxpayer has been diverted to earn tax-free income despite availability of surplus or interest-free funds.
- While the principle of res judicata would not apply in tax assessment proceedings, the need for consistency and certainty and existence of strong/compelling reasons for departure from a settled position has not been spelt out in present case.

BDO Comments

The provisions of Section 14A have been highly litigated at judicial forums and thus this ruling comes as a binding rule of law going forward on the questions dealt with. The ruling has negated the economic taxation principle and upheld Section 14A disallowance on dividend income subjected to DDT. However, the Supreme Court has also highlighted the importance of consistency in court decisions, by allowing the entire expenditure to the taxpayer owing to its case history.

The important observations and principles laid down by the Supreme Court such as recording satisfaction by tax officer to invoke disallowance as per prescribed methods, establishing nexus of funds with investments are noteworthy and favorable to the taxpayer. In such cases, it is imperative that taxpayers maintain robust documentation to prove nexus of interest free funds in making investments.

There have also been earlier rulings by High Courts rejecting Section 14A disallowance in case of strategic investments. However, the Supreme Court has not commented on this issue in the present case.

⁷Calcutta Knitweaves (2014) 6 SCC 444, Tata Agencies (2007) 292 ITR 444 (SC) ¹ Calcutta Knitweaves (2014) 6 SCC 444, Tata Agencies (2007) 292 ITR 444 (SC)

For any content related queries, you may please write to the respective service line experts at:

taxadvisory@bdo.in

BDO Offices

Bengaluru

Floor 6, Prestige Khoday Tower
Near Raj Bhavan
Bengaluru 560011, INDIA
Tel: +91 80 4656 1300

Chennai - Office 1

117/54, Floor 2, Citadel Building,
Dr Radha Krishnan Salai, Mylapore
Chennai 600 004, INDIA
Tel: + 91 44 3001 0200

Chennai - Office 2

Floor 1, Tower C Tek Meadows
No. 51 Sholinganallur
Chennai 600119, INDIA
Tel: +91 3001 0200

Hyderabad

Manbhumi Jade Towers, II Floor
6-3-1090/A/12 & 13 Somajiguda,
Hyderabad 500082, INDIA
Tel: +91 40 3024 2999

Kolkata

Floor 4, Duckback House,
41, Shakespeare Sarani,
Kolkata 700017, INDIA
Tel: +91 33 4600 3505

Mumbai - Office 1

The Ruby, Level 9, North West Wing,
Senapati Bapat Marg, Dadar (W),
Mumbai - 400028, INDIA
Tel: +91 22 3332 1600

Mumbai - Office 2

Floor 2, Enterprise Centre
Nehru Road, Near Domestic Airport,
Vile Parle (E), Mumbai - 400099, INDIA
Tel: +91 22 3358 9700

New Delhi - Gurgaon

The Palm Springs Plaza
Office No. 1501-08, Sector-54,
Golf Course Road, Gurgaon-122001, INDIA
Tel: +91 124 281 9000

Pune

Floor 6, Building # 1
Cerebrum IT Park, Kalyani Nagar
Pune 411014, INDIA
Tel: +91 20 3006 4700

Note: This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO India LLP to discuss these matters in the context of your particular circumstances. BDO India LLP and each BDO member firm in India, their partners and/or directors, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

BDO India LLP, a limited liability partnership, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the international BDO network and for each of the BDO Member Firms.

Copyright ©2017 BDO India LLP. All rights reserved.

Visit us at www.bdo.in
