Supreme Court upholds applicability of section 14A to acquisition of shares - rejects dominant purpose test

March 26, 2018

In brief

In a recent decision[1] the Supreme Court (SC), in a batch of appeals, has held that the dominant object of investing in shares is irrelevant for interpreting the words 'in relation to' as contemplated in section 14A of the Income-tax Act, 1961 (Act). SC has assented that section 14A has been introduced to bifurcate the expenditure between taxable and non-taxable income and to disallow the expenditure relatable to exempt income. The SC has also held that Rule 8D of the Income-tax Rules, 1961 (Rules) is prospective in nature and be applied from assessment year (AY) 2008-09.

In detail

Facts

- Taxpayer 1 was *inter alia* engaged in the business of finance, investment and dealing in shares and securities held the shares in two portfolios: (a) as investment on capital account and (b) as trading assets for the purpose of acquiring/ retaining the controlling interest in other entities. Taxpayer 2 was a bank, which held the shares as stock in trade for its business of sale and purchase of securities.
- Taxpayers did not make disallowance under section 14A for any expenditure relatable to the investment in shares/ securities yielding tax-free income on the premise that dominant purpose of the investment was to acquire/ retain the controlling interest or to hold the securities as stock-in-trade but not to earn any exempt income.
- The tax officer (TO) made a pro-rata disallowance of expenditure and restricted it to the amount of exempt income for both the cases. On appeal, the Commissioner of Income-tax (Appeals) in these cases upheld the order of the TO, however, enhanced the disallowance upto the entire expenditure in the case of taxpayer 2. The taxpayers appealed before the Income-tax Appellate Tribunal (Tribunal).
- The Special Bench (SB) constituted[2] held that the investment representing controlling interest was on capital account. It was further held that a dominant and immediate connection between the expenditure and dividend income was a condition precedent due to the phrase 'in relation to' for invoking section 14A of the Act. The SB held that since the condition existed, the interest paid on loan utilised for investing in shares was disallowable under section 14A.
- In the case of taxpayer 2, the Tribunal deleted the disallowance on the basis that the shares were held as stock-in-trade.

[1] [2018] 91 taxmann.com 154 (SC)
[2] Constituted due to divergent views of various benches of Tribunal

- Further, in appeal the Delhi High Court (HC)[3] and the Punjab & Haryana HC[4] gave conflicting views.
- The Delhi HC relying on the SC judgement[5] observed that the intent of introducing section 14A was to provide for the theory of apportionment of expenses between taxable and exempt income. Further, the Delhi HC contended that the phrase 'in relation to' used in section 14A was synonymous with 'in connection with' or 'pertaining to' and had to be given expansive meaning. Thus, the Delhi HC held that section 14A was applicable regardless of the motive of making the investment and upheld the disallowance of expenditure in relation to exempt income.
- However, the Punjab and Haryana HC deleted the disallowance based on the Central Board of Direct Taxes circular that carves out a distinction between 'stock-in-trade' and 'investment' and provides that the motive of trading in securities, that is, to earn either profit or dividend, decides the classification as either stock-in-trade or investment, respectively. The Punjab & Haryana HC held that the objective of the purchase and sale of shares by the taxpayer 2 was to earn trading profits, not interest or dividend. Thus, the entire expenditure was incurred for earning trading profits, and no expenditure was incurred in relation to the exempt income.

Issue before the Supreme Court

Whether the dominant or main object of holding the shares would be a relevant consideration in determining as to whether an expenditure was incurred 'in relation to' the exempt income?

Supreme Court's decision

- The SC observed that if an expenditure incurred has no casual connection with the exempt income, the same would not be considered as related to exempt income and was allowable as a business expense.
- The SC held that the dominant purpose for which shares were held was not relevant for applicability of section 14A.
- The SC observed that as long as an exempt income was earned, the expenditure incurred as attributable to earning such exempt income, had to be disallowed under section 14A.
- The SC agreed with the view of the Delhi HC, that the intent behind the insertion of section 14A retrospectively was to incorporate the principle of apportionment of expenses between exempt income and taxable income. This was to ensure the taxpayer does not take double benefit by reducing the expenses incurred towards the exempt income against the taxable income and availing the exemption of the non-taxable income.
- The SC accepted the distinction between 'investment' and 'stock–in-trade' pointed out by the Circular relied upon by Punjab & Haryana HC, however, SC disregarded the dominant purpose test for section 14A.
- Further, the SC confirmed the view taken by the Tribunal and the Punjab & Haryana HC of restricting the disallowance to the quantum of exempt income, though the SC did not subscribe to dominant purpose theory.
- The SC held that irrespective of the objective of investment in shares (when the shares are held as stock-in-trade with a view to earn trading profits or as investment representing controlling interest) and the taxpayer earned an incidental exempt dividend income, section 14A was triggered which was based on the theory of apportionment of expenditure between taxable and exempt income.
- The SC held that before applying the theory of apportionment, the TO needs to record satisfaction that the *suo moto* disallowance made by the taxpayer was incorrect. While recording such satisfaction, the TO must also examine the nature of the loan taken by the taxpayer for purchasing the shares/ making the investment.
- The SC also held that Rule 8D is prospective in nature and could not be made applicable to cases prior to AY 2008–09.

The takeaways

- The ambiguity around applicability of section 14A in the hands of investors, who held shares either to acquire/ retain controlling interest in other entities or as stock in trade has been put to rest.
- The dominant purpose test for making the investment in shares is no longer a relevant criterion for applying section 14A.
- The expenditure in relation to even incidental exempt dividend income would attract section 14A.

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[3] [2011] 15 taxmann.com 390 (Delhi)

[4] PCIT *v.* State Bank of Patiala [2017] 78 taxmann.com 3 (Punjab & Haryana)

[5] CIT *v.* Walfort Share and Stock Brokers Private Limited [2010] 326 ITR 1 (SC)

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