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## Disallowance under section 14A not applicable to income of SEZ units eligible for tax holiday deductions

### In brief

The Mumbai Income-tax Appellate Tribunal (the Tribunal) in the case of Meditap Specialities Pvt. Ltd.<sup>1</sup> (the assessee) held the following:

- Disallowance under section 14A of the Income -tax Act, 1961 (the Act) not applicable to Special Economic Zone (SEZ) income eligible for deduction under sections 10AA and 80 IAB of the Act as disallowance under section 14A of the Act is contemplated in respect of exempt income and not on income eligible for 'deduction' under the Act.

- Rule 8D of the Income-tax Rules, 1962 (the Rules) applicable only from assessment year (AY) 2008-09. The Tribunal relied on the judgment of the Bombay High Court (HC) in the case of Godrej and Boyce Ltd. Mfg. Co.<sup>2</sup>

### Facts

- The assessee during the previous year 2006-07 earned dividend income from mutual funds and claimed it as exempt in its return of income.

<sup>1</sup> Meditap Specialities Pvt. Ltd. v. ACIT [TS-393-ITAT-2012 (Mum)]

<sup>2</sup> In the case of Godrej and Boyce Ltd. Mfg. Co. v. DCIT [2010] 328 ITR 81 (Bom), the Mumbai HC held that the provisions of Rule 8D of the Rules, which have been notified effective from 24 March, 2008 is applicable only from AY 2008-09 and onwards.

- The assessing officer (AO) observed that the dividend income was earned by virtue of investments made during the year in mutual funds.
- During the course of assessment, the AO computed disallowance under section 14A of the Act as per Rule 8D of the Rules<sup>3</sup> by allocating a portion of 'interest cost' to exempt income and 'other expenses' at half percentage of average investments in aggregate amounting to INR 5.215 millions.
- For computing disallowance, the AO considered investment in mutual funds and investment in SEZ.
- The Commissioner of Income-tax (Appeals) (CIT(A)) upheld the order of the AO.

## Issue

Whether, the AO was justified in making disallowance under section 14A of the Act by applying Rule 8D of the Rules?

## Revenue's contentions

- Disallowance under section 14A of the Act needs to be made according to Rule 8D of the Rules for expenses attributable to exempt income.
- The assessee has income from developing SEZ which is exempt as it falls under chapter III of the Act. Accordingly, disallowance under section 14A of the Act needs to be considered for SEZ income as well.

## Assessee's contentions

- No expense has been incurred for earning the exempt dividend income the issue of disallowance under section 14A of the Act does not arise.
- Investment in SEZ should not be considered for computing disallowance under section 14A of the Act.

## Tribunal ruling

- **Applicability of Rule 8D of the Rules:** Provisions of the Rule 8D of the Rules are applicable from AY 2008-09. Reliance placed on the jurisdictional Bombay HC ruling in the case of Godrej and Boyce Mfg. Co. Ltd. (above).
- **Disallowance under section 14 A of the Act for 'interest cost':** On perusal of the balance sheet and fund flow statement, it was observed that no fresh borrowings were made by the assessee in the relevant previous year for investing in mutual funds units. This clearly depicts that no interest bearing funds were utilised by the assessee. This negates the disallowance with respect to 'interest cost'.
- **Disallowance for other expenses:** As Rule 8D of the Rules is not applicable for the subject year, the AO is directed to compute the disallowance under section 14A of the Act for 'other expenses' on some reasonable basis.
- **Disallowance under section 14A of the Act for SEZ income:** The disallowance is not applicable to SEZ income. Even though, section 10AA of the Act falls in chapter III of the Act, it is a deduction and not an exemption. The Tribunal observed that the authorities below were not justified in placing the exemption provision and deduction provision on one platform; holding that investment or expenses incurred to earn income from SEZ do not merit reckoning in computing disallowance u/s 14A of the Act.

<sup>3</sup> Rule 8D of the Rules prescribes the methodology for computing disallowance of expenditure in relation to income which does not form a part of the total income.

### **PwC Comments:**

Assesseees will need to consider the decisions of the HC(s) where a contrary view on deduction versus exemption has been upheld:

- Decision of the Mumbai HC in the case of Black and Veatch Consulting Pvt. Ltd.<sup>4</sup> wherein it was held that the deduction under section 10A of the Act is to be allowed at business profit level before setting off brought forward losses; and
- Karnataka HC in the case of Yokogawa India Ltd.<sup>5</sup> wherein it was held that section 10A of the Act is in the nature of an exemption section and not a deduction section.
- More likely than not, litigation risk on disallowance under section 14A of the Act for 'SEZ investments/income' will continue.

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<sup>4</sup> CIT v. Black and Veatch Consulting Pvt. Ltd. [2012] 20 taxmann.com 727 (Bom.)

<sup>5</sup> CIT v. Yokogawa India Ltd. [2012] 341 ITR 385 (Kar.)

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