

Disallowance of expenditure u/s 14A of the Income Tax Act, 1961

Introduction

Section 14A was introduced by the Finance Act, 2001 w.r.e.f. 1-4-1962 with the intention to disallow all expenses incurred by the assessee in relation to income which does not form part of total income under this Act. In other sense expenditure incurred to earn exempt income are not allowed. Although the section is effective retrospectively from 1.4.1962 but AO is not empowered to reopen/reassess u/s 147 or rectification u/s 154 for any assessment year before assessment year 2001-02.

Section 14A of the Income Tax Act.

14A. (1) 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.

(2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, if the Assessing Officer, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to income which does not form part of the total income under this Act.

(3) The provisions of sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act :

[**Provided** that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001.]

Analysis of the provisions of Section 14A

Section 14A is divided in three parts as follows:

1. Section 14A is applicable only if assessee has incurred any expenditure to earn income which does not form part of total income. It means if assessee has incurred any expenditure for making investments or maintaining investments are not covered under section 14A.
2. Section 14A is applicable if assessee claims that expenditure has been incurred and AO is not satisfied with the correctness of the claim of the assessee having regards to the accounts of the assessee.

3. Section 14A is applicable if assessee claims that no expenditure has been incurred.

Process of applying section 14A

1. Whether assessee has incurred any expenditure to earn income which does not form part of total income? If yes, section 14A is applicable and move on to sub-section 2 of section 14A, if not, section 14A is not applicable at all.
2. If section 14A is applicable as per point 1. Then sub-section 2 of section 14A is applicable where assessee claims the amount of expenditure incurred in relation to exempt income and sub-section 3 of section is applicable where assessee claims that no expenditure has been incurred in relation to exempt income.

Sub-section 2 of Section 14A

If assessee claims the amount of expenditure incurred by him in relation to exempt income then AO need to verify the correctness of the claim of the assessee having regards to the accounts of the assessee. It means AO should check the accounts of the assessee to verify the claim of the assessee.

If the AO is satisfied with the claim of the assessee then amount of expenditure as claimed by the assessee shall be disallowed by the AO u/s 14A.

If the AO is not satisfied with the claim of the assessee having regards to the accounts of the assessee then he should record his dissatisfaction before went on to apply the formula prescribed in rule 8D to determine the amount of expenditure to be disallowed u/s 14A.

Sub-section 3 of Section 14A

If assessee claims that no expenditure has been incurred then AO can directly apply formula prescribed in rule 8D to determine the amount of expenditure to be disallowed u/s 14A. The AO is not required to record the correctness of the claim of the assessee under sub-section 3 of Section 14A of the Income Tax Act.

Rule 8D of the Income Tax Rules

If rule 8D is applicable as analysed in earlier paragraphs then calculation of amount to be disallowed should be as per the formula and conditions mentioned in the rule. Rule 8D provided:

(1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with—

(a) the correctness of the claim of expenditure made by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred,

in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).

(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely :—

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee 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 following formula, namely :—

$$\frac{A \times B}{C}$$

Where A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year ;

B = the average of 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 assessee, on the first day and the last day of the previous year ;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year ;

(iii) an amount 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 assessee, on the first day and the last day of the previous year.

(3) For the purposes of this rule, the "total assets" shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.]

Analysis of the provisions of Rule 8D

The formula for calculating amount of expenditure to be disallowed is given in sub-rule 2, which is again divided into three parts as discussed under:

i) Clause i of sub-rule 2 disallows all direct expenses related to exempt income only. It means clause i is not applicable to any indirect expenses to exempt income.

- ii) Clause ii of sub-rule 2 disallows all indirect interest expenses as per formula. It means clause ii is not applicable to any interest expenses which are directly related to any income, i.e. exempt income as well as non exempt income. If interest expenses can not be segregated or can not be related directly to any income then only amount of disallowance be calculated as per formula given in clause ii. The formula embedded in Rule 8D(2)(ii) for variable "A" is only for interest expenses which is not directly attributable to any income i.e. tax free income as well as taxable income. It means that interest expenses if directly attributable to taxable income as well as tax free income should be excluded for the purpose of variable "A"
- iii) Clause iii of sub-rule 2 disallows an amount equal to 0.5% of average investment, income from which do not form part of total income. Clause iii aims to cover all expenses other than interest which are not directly attributable to exempt income. To cover the possibility of indirect expenses incurred by the assessee, statute has inserted clause iii. It means department can not disallow any indirect expenses separately on estimation basis other than the calculation provided in the clause iii.

The aggregate of amount calculated in clause (i), (ii) and (iii) are to be disallowed u/s 14A of the Income Tax Act.