

Tax Hotline

March 23, 2018

SUPREME COURT RULING: ONLY EXPENSES PROPORTIONATE TO TAXABLE INCOME DEDUCTIBLE

- Dominant purpose or intention behind borrowing funds irrelevant under Section 14A of the Income Tax Act, 1961.
- The Supreme Court of India rules that when shares are acquired to obtain a controlling interest in a company, the rule of apportionment shall be followed.
- In case shares are held as stock-in-trade, the income earned should be regarded as business income and any exempt income, such as dividend earned, shall be immaterial.

Recently, the Supreme Court of India (the “**Supreme Court**”) in the case of *Maxopp Investment Ltd. v. Commissioner of Income Tax, New Delhi*¹, laid down a bright-line test on whether interest payments made on funds borrowed to make investments into shares of company could be a deductible expense or not, particularly in the context of Section 14A of the Income Tax Act, 1961.

To sum up, according to the Supreme Court, in case a taxpayer acquires shares of an investee company to gain / retain controlling interest over the same and earns exempt income, the portion of the expenditure which may be attributable to such exempt income should be disallowed under Section 14A of the Income Tax Act, 1961 (the “**ITA**”)². On the contrary, if the taxpayer holds the shares as stock-in-trade, then any income earned shall be its trading profit / business income and thereby, the expenditure incurred in relation to such income shall be deductible as business expenditure, irrespective of whether exempt income is earned or not.

FACTS

Maxopp Investment Limited (the “**Assessee**”), had claimed a deduction of the entire interest amount (payable towards the loan borrowed) against the taxable income earned which was disallowed by the Assessee under Section 14A of the ITA since it had also earned exempt income in the form of dividends. The Assessee contended that the shares of Max India were acquired to retain controlling interest over Max India and not to earn any income in the form of dividend and thus, Section 14A should not be applicable. The AO and CIT(A) ruled against the Assessee and disallowed the expenditure. On appeal before Income Tax Appellate Tribunal (the “**Tribunal**”), a Special Bench wherein the Assessee’s appeal was tagged along with *ITO v. Daga Capital Management (Pvt.) Ltd*³ case, also disallowed the expenditure. On further appeal by the Assessee, the Delhi High Court (“**Delhi HC**”) upheld the decision of the Tribunal. On the contrary, Punjab and Haryana High Court (“**P&H HC**”), while dealing with the issue of application of Section 14A to a banking concern, in the case of *Principal Commissioner of Income Tax v. State Bank of Patiala*⁴ held in favour of the taxpayer allowing for the deduction of entire interest expenditure incurred in relation to the investments made in the investee companies.

Therefore, the Supreme Court, considering the conflicting opinions of various High Courts on the same issue, clubbed the appeals filed in different cases by the taxpayers and the revenue authorities.

ISSUES

1. Whether holding of investment in group companies representing controlling interest amounts to carrying on business?
2. Whether dividend income received on shares held as stock-in-trade or shares purchased for acquiring / retaining controlling interest can be considered to be in the nature of business income?

JUDGMENT

The Supreme Court, to render its judgment, discussed the judgments of Delhi HC in *Maxopp Investment Ltd. v. CIT, New Delhi*⁵ and P&H HC in *State Bank of Patiala*⁶ case. While in the case of *Maxopp Investment Ltd.*, the Delhi HC ruled that if the expenditure incurred has a relation or connection with or pertains to an exempt income, it shall be disallowed even if it otherwise qualifies under the other provisions of the ITA, in the case of *PCIT v. State Bank of Patiala*, the P&H HC held that since the dividend and interest income were earned out of the securities held by the taxpayer as stock-in-trade and the purpose of acquiring of such securities by the taxpayer was to earn profits by way of trading, Section 14A shall not be applicable.

With respect to the scope of Section 14A, the Supreme Court observed that the expenditure that is incurred in relation to the exempt income alone should only be disallowed. In case, expenditure incurred has no causal connection with the exempted income, then such expenditure should be treated as business expenditure.

Additionally, the Supreme Court analysed the expression “in relation to” from two perspectives / aspects, viz.,

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I. Shares held to gain control over the investee company

The Supreme Court held that even though the Assessee may have acquired shares in order to gain control over the investee company, the portion of the expenditure that is attributable to the dividend income earned out of such investment should be disallowed under Section 14A. Thus, the “principle of apportionment” ought to be applied for the purposes of interpretation of the expression “in relation to” used under Section 14A.

Moreover, the Supreme Court also placed reliance on its own decision in the case of *CIT v. Walfort Share and Stock Brokers (P.) Ltd.*⁷ wherein the Supreme Court had observed “the *theory of apportionment of expenditure between taxable non-taxable has, in principle, been now widened under Section 14A*”.

Therefore, the Supreme Court agreed with the Delhi HC judgment in the case of *Maxopp Investment Ltd.*⁸ and rejected P&H HC’s decision in *State Bank of Patiala case* to the extent P&H HC had applied the “dominant intention test”.

II. Shares held as stock-in-trade and not to earn dividend

The Supreme Court agreed on the view taken by P&H HC in *State Bank of Patiala case* to the extent it relied on the CBDT Circular, dated 02.11.2015⁹ (the “**Circular**”) and stated that if the motive behind purchase and sale of shares is to earn profit, then the income earned would be treated as trading profit, however, if the object is to earn dividend income, then the taxpayer would be considered to have made an investment into the investee company.

The Supreme Court ruled that where shares are held as stock-in-trade, it becomes a business activity of the taxpayer and receipt of any dividend income is immaterial. Hence, any expenditure incurred with respect to earning such business income shall be allowed for deduction.

In addition to the above, the Supreme Court also held that in case the taxpayer itself disallows certain expenditure under Section 14A and the AO finds it incorrect, it should record satisfaction to such effect before applying the theory of apportionment. Further, while recording such satisfaction, nature of loan taken by the taxpayer for purchasing the shares / making the investment in shares should be examined by the AO.

ANALYSIS

The Memorandum explaining the Provisions of the Finance Bill, 2001 (the “**Memorandum**”) states that the provision of Section 14A is based on the fundamental principle of taxation law which states that only net income, i.e., gross income less expenditure, is taxed. Since, the ITA taxes the net income of a taxpayer, it is clearly understood that the exemptions provided with respect to certain incomes are also with respect to the net income, and hence, any expenditure incurred in relation to earning of such exempt income should be disallowed.

The Supreme Court, in the present case, referred to the Calcutta High Court (“**Calcutta HC**”) judgment in the case of *Dhanuka and Sons v. CIT*¹⁰ wherein the HC observed that Section 14A was introduced into the ITA with an objective to disallow the direct and indirect expenditure incurred in relation to an exempt income and to overcome the judicial pronouncements of the Supreme Court in the cases of *CIT v. Maharashtra Sugar Mills Ltd.*¹¹ and *Rajasthan State Warehousing Corporation v. CIT*¹², wherein the Supreme Court had held that in case of an indivisible business out of which the taxpayer earns taxable as well as exempt income, the entire expenditure incurred in relation to the business should be allowed.

The Supreme Court, by rightly retaining the spirit of Section 14A and without making any distinction between a divisible and an indivisible business, has clarified that in case of shares held as stock-in-trade, any expenditure incurred shall be an allowable expenditure, since, the dividend income is merely an incidental receipt which the taxpayer may or may not receive, contingent upon the sale of shares by the taxpayer. On the other hand, in case a taxpayer subscribes to the shares of the investee company to acquire / retain control over the same, the taxpayer should be considered to be aware of the fact (at the time of acquiring such shares) that such an investment may generate dividend income which shall be earned by the taxpayer alone. Hence, in such cases, interest expenditure needs to be apportioned between the dividend income (as and when received) and the taxable income.

This rule should have a positive impact on the taxpayers, since it clarifies the position that is required to be taken by the revenue authorities regarding the application of Section 14A with respect to expenditures incurred in relation to earning of trading profits and / or capital profits.

However, it is also likely to have an impact on the pending matters before the lower courts and tax authorities wherein similar issues have been raised, wherein it may not be beneficial to the taxpayers in some cases. Further, though a logical implication suggests that the said ruling should apply to majority as well as minority shareholders of a company, there remains uncertainty regarding the application of this ruling in the case of the latter, i.e. where the shares are not subscribed with an intention to acquire / retain a controlling interest over the investee company but are nevertheless held as capital assets.

In any case the said judgment should provide the required clarity for businesses going forward in terms of the conditions that are required to me to be eligible for interest deductibility and allow them to structure transactions and commercials accordingly. It will also prevent the tax department from questioning transactions based on a nebulous intention or dominant purpose test, which would have been a subjective factual finding.

– **Prakhar Dua & Meyyappan Nagappan**

You can direct your queries or comments to the authors

¹ Civil Appeal Nos. 104-109 of 2015

² “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...”

³ 312 ITR (AT) 1.

⁴ (2017) 391 ITR 218 (P&H).

⁵ [2012] 347 ITR 272 (Delhi).

⁶ *supra*.

⁷ 326 ITR 1 (SC).

⁸ *supra*.

⁹ CBDT Circular No. 18/2015, available at https://www.incometaxindia.gov.in/communications/circular/circular18_2015.pdf

¹⁰ (2011) 339 ITR 319 (Cal).

¹¹ [1971] 82 ITR 452.

¹² [2000] 242 ITR 450/109 Taxman 145.

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