



## Supreme Court upholds applicability of Section 14A to dividend income

The Supreme Court (SC) in the case of Godrej & Boyce Manufacturing Company Limited upheld the decision of Bombay High Court on the applicability of section 14A disallowance in respect of dividend income. The SC, *inter-alia*, held that dividend constitutes a 'tax-free' income notwithstanding the fact that Dividend Distribution Tax (DDT) is paid by the company. It therefore held that disallowance under section 14A of the Income-tax Act, 1961 (Act) would get attracted if an expenditure to earn such dividend income has been incurred by the taxpayer.

### Facts of the case:

- The issue in the present appeal relates to Assessment Year (AY) 2002-03 wherein the taxpayer had earned dividend income from its group companies and mutual funds.
- No fresh investments were made by the taxpayer during AY 2002-03 and the earlier investments were made with interest free funds possessed by the taxpayer.
- The Assessing Officer (AO) had disallowed interest expenditure for AY 2002-03 on a notional basis in the ratio of the cost of the investment in shares and units of mutual funds to cost of the total assets appearing in the balance sheet.
- The order of the AO was reversed by the Commissioner of Income Tax (Appeals) as well as by the Income-tax Appellate Tribunal (ITAT) on the ground that the AO failed to show any nexus between investments in shares/mutual funds and borrowed funds. However, the ITAT remanded the matter back to the AO for fresh examination in light of amendments made to section 14A of the Act which, *inter-alia*, prescribed Rule 8D of Income-tax Rules, 1962 for computing the quantum of disallowance under section 14A.
- On appeal, the High Court held that the aforesaid amendment to section 14A applies prospectively (i.e. from AY 2008-09 and onwards) and hence cannot be made applicable to AY 2002-03. The High Court also held that on a plain grammatical construction of the



section, the provisions of section 14A also applies to dividend income even if the same has been subjected to DDT as such dividend income is not includible in the total income of the recipient taxpayer.

### **Issues before the SC:**

The following questions were raised by the taxpayer before the SC:

1. Whether the phrase *'income which does not form part of the income under this Act'* appearing in Section 14A includes within its scope dividend income from shares or mutual funds in respect of which tax is paid under the relevant provision of the Act?
2. On facts, whether the provisions of Section 14A are applicable in the case of the taxpayer?

### **Key Conclusions:**

The SC held that disallowance under Section 14A would get attracted in respect of dividend income from shares and mutual funds even if tax is payable under section 115-O and 115-R of the Act by the company distributing the same.

Based on a strict grammatical construction of the provision, the SC held that since the dividend income is not includible in the total income of the recipient, disallowance under section 14A would be attracted if the AO has reached a satisfaction that the taxpayer has incurred an expenditure to earn such exempt income.

The key reasons laid down by the SC are summarised below:

- The additional income-tax paid under section 115-O by the dividend paying company cannot assume the character of tax paid on dividend income by the shareholder.
- This is further fortified by the fact that provisions of section 199 of the Act do not provide for any credit of DDT in the hands of the shareholder.
- A plain reading of section 14A of the Act suggests that once an income is not includible in the total income of the taxpayer, the expenditure incurred in earning the said income cannot be deducted.
- The SC upheld the principle of literal interpretation as the words of the statute (section 14A in this case) were clear and unambiguous and hence the SC did not feel any need to apply any other principles of interpretation.
- The fact that the provision exempting dividend income in the hands of shareholder [section 10(33)] and provision pertaining to payment of DDT by the distributing company [section 115-O] were brought in together, deleted and re-introduced later in a composite manner would countenance a situation that so long as the dividend income is taxable in the hands of the dividend paying company, the same is not includible in the total income of the recipient taxpayer.



On facts of the case, the SC held that the issue stood concluded in favour of the taxpayer in earlier years. The SC held that the law postulates a requirement that the AO must reach a satisfaction as regards the correctness of claim of the taxpayer with respect to expenditure incurred by it on earning exempt income. It is only when the AO is not satisfied with the claim of the taxpayer, that the AO can proceed to determine the quantum of disallowance.

In the facts of the case, as the AO was not able to establish any nexus between the disallowed expenditure and the exempt income, the disallowance under section 14A was deleted by the SC.

Interestingly, the SC did not rule on whether the amended provisions of section 14A (viz, insertion of Rule 8D, etc) have a retrospective effect as the said issue was pending as a separate appeal before the SC.

### **Comments:**

The controversy on whether section 14A disallowance would be attracted on income on which DDT is paid has been put to rest by the SC. The SC has also upheld the preponderant view that the AO must reach a satisfaction regarding the correctness of the claim of the taxpayer before adopting a formulary approach prescribed in Rule 8D. However, on the aspect of retrospective application of Rule 8D, the matter remains sub-judice.



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