

Circular No. 5/2014

Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes

North Block, New Delhi
dated the 11th of February, 2014

Subject: - Clarification regarding disallowance of expenses under section 14A of the Income-tax Act in cases where corresponding exempt income has not been earned during the FY –regarding.

Section 14A of the Income-tax Act, 1961 ('Act') provides for disallowance of expenditure in relation to income not "includible" in total income.

2. A controversy has arisen in certain cases as to whether disallowance can be made by invoking section 14A of the Act even in those cases where no income has been earned by an assessee which has been claimed as exempt during the financial-year.

3. The matter has been examined in the Board. It is pertinent to mention that section 14A of the Act was introduced by the Finance Act, 2001 with retrospective effect from 01.04.1962. The purpose for introduction of section 14A with retrospective effect since inception of the Act was clarified vide Circular No. 14 of 2001 as under:

"Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect means that the tax incentive given by way of exemptions to certain categories of income is being used to reduce also the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income. This is against the basic principles of taxation whereby only the net income, i.e., gross income minus the expenditure, is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income".

Thus, legislative intent is to allow only that expenditure which is relatable to earning of income and it therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial-year or not.

4. The above position is further clarified by the usage of term '*includible*' in the Heading to section 14A of the Act and also the Heading to Rule 8D of I.T.Rules, 1962 which indicates that it is not necessary that exempt income should necessarily be included in a particular year's income, for disallowance to be triggered. Also, section 14A of the Act does not use the word "*income of the year*" but "*income under the Act*". This also indicates that for invoking disallowance under section 14A, it is not material that assessee should have earned such exempt income during the financial year under consideration.

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5. The above position is further substantiated by the language used in Rule 8D(2)(ii) & 8D(2)(iii) of I.T.Rules which are extracted below:

"(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:-

$A*B/C$

Where.....

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;

(iii) an amount equal to one-half percent 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."

(Emphasis added)

6. Thus, in light of above, Central Board of Direct Taxes, in exercise of its powers under section 119 of the Act hereby clarifies that Rule 8D read with section 14A of the Act provides for disallowance of the expenditure even where taxpayer in a particular year has not earned any exempt income.

7. This may be brought to the notice of all concerned.

8. Hindi version to follow.

(Rohit Garg)

Deputy Secretary to the Government of India

(F.No:225/182/2013-ITA.II)

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Deputy Secretary to the Government of India