

Of adhoc expenses and exempt income

Sunil M Lala & Pratik Kumar

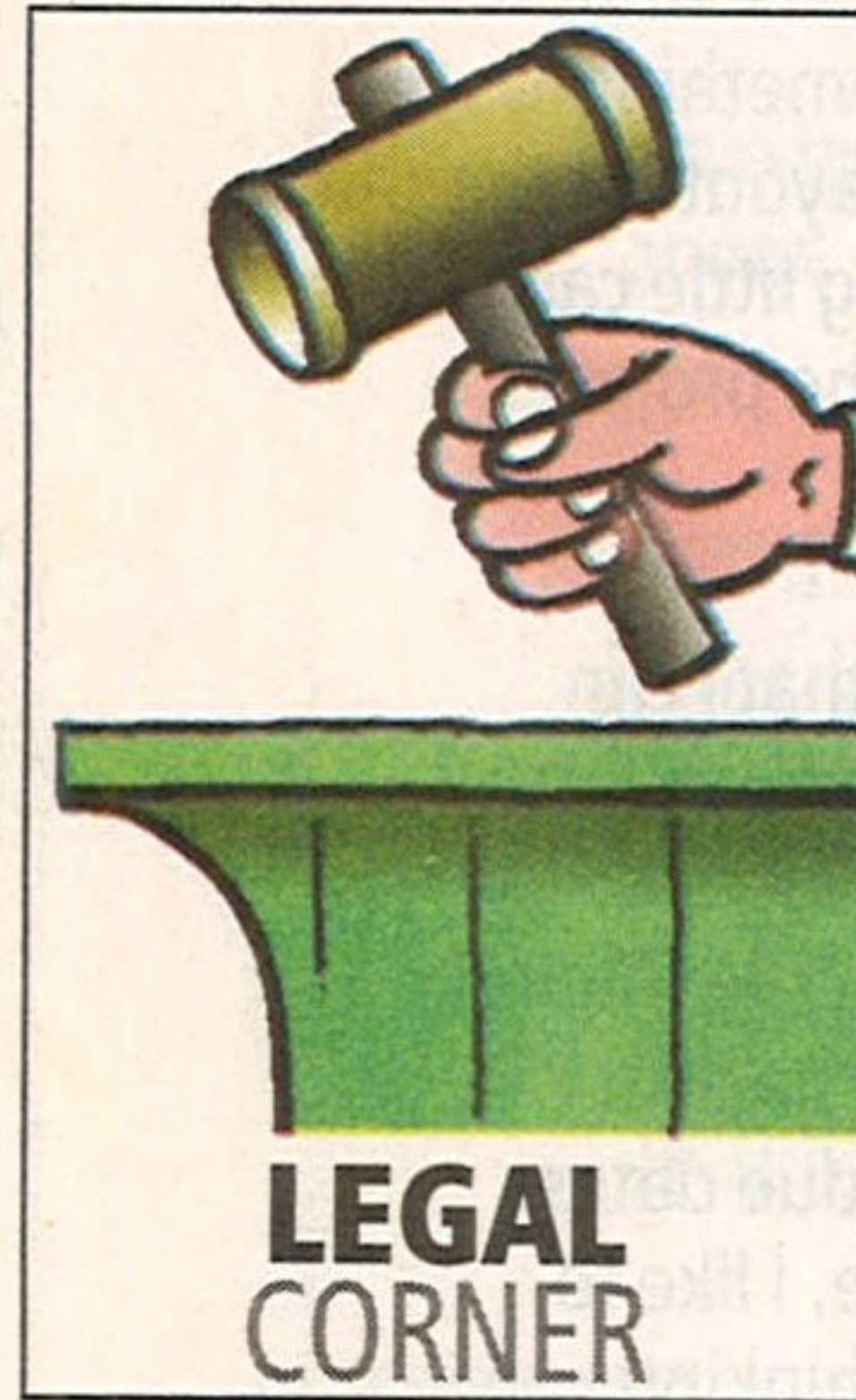
UNDER the Indian tax laws, certain incomes being exempt under various provisions of the Income Tax Act are not includible in computing the total income for levying income-tax.

A specific provision, Section 14A of the Income Tax Act, disentitles the taxpayer from claiming any deduction in respect of expenditure incurred in relation to such income that is exempt under the Act. However, it is usually experienced that revenue authorities, after inclusion of Section 14A, not only disallow the expenditure directly related to earning the exempt income, but also attempt to disallow proportionate indirect expenses like salary paid to staff, administrative and management expenses on the pretext that direct and proximate relation is not necessary for Section 14A.

The question therefore arises whether the revenue authorities are legally permitted to disallow even indirect expenses on estimate basis. This issue has in the recent past been subject matter of various judicial decisions and the view emerging is discussed as under.

The Mumbai tribunal in the case of Infomedia India Limited in ITA 1381/Mum/2005 had the occasion to consider the above controversy. The tribunal held that unless there is clinching evidence to show that the amount sought to be disallowed by the revenue under Section 14A proportionately is clearly related to investment, income of which is exempt, no disallowance could be made on estimate basis.

The tribunal followed the principle of law laid down by the Bombay High Court in the case of General Insurance Corporation of India (254 ITR 203). In this case, the court, though dealing with a different



Section (erstwhile section 80M - 'Deduction in respect of certain inter corporate dividends') held that the expenses incurred by the taxpayer on account of salary paid to staff, stamp duty and safe custody charges could not be said to be directly relatable to the earning of dividend income.

Similar interpretation, in context of Section 14A, has been adopted by the Delhi Tribunal in the case of Eicher Ltd. (101 TTJ 369). The tribunal held that the

provisions of Section 14A do not *ipso facto* authorise the assessing officer to assume that a part of the expenditure has been incurred by the assessee in relation to the exempted income and to proceed to disallow the same on estimate. The tribunal further noted that the assessing officer was still under the burden of proving, on the basis of evidence or material on record, that the assessee had in fact incurred expenditure that has relation to the exempted income.

This view has been affirmed by a Third Member decision of the Delhi Tribunal in the case of Wimco Seedlings Ltd. (2006) (107 ITD 267). The tribunal held that only expenditure that has been proved to be incurred in relation to the earning of tax free income can be disallowed and the Section can't be extended to disallow even expenditure that is 'assumed' to have been incurred for the purpose of earning the tax free income.

However, it may be noted that this position of law would hold good only till Assessment Year (AY) 2006-07.

The Finance Act 2006 has, with effect from AY 2007-08, amended Section 14A of the Act empowering the assessing officer to determine the amount of expenditure incurred in relation to the exempt income in accordance with such method as may be prescribed, if he is not satisfied with the correctness of the claim of the assessee.

It would be desirable that the CBDT comes out with appropriate rules soon. This would help mitigate the undue hardship to the taxpayers on account of unwarranted addition being made by the revenue authorities, under the garb of Section 14A of the Income Tax Act.

Lala is executive director and Kumar is associate director of PricewaterhouseCoopers — Tax Litigation Cell