Tax Alert - Supreme Court upholds disallowance of expenditure under Section 14A on strategic investments in subsidiaries and shares held as 'stock-in-trade'

Tax Alert
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Dear All,

Recently, the Supreme Court in a batch of appeals[1] has upheld that the provisions of Section 14A of the Income-tax Act, 1961 ("the Act") would apply regardless of the motive behind making the investment. The Court held that expenditure attributable to earning exempt income has to be disallowed and cannot be treated as business expenditure. The 'dominant purpose test' is not a relevant criteria to be considered for applicability of provisions of Section 14A of the Act in the following scenarios (a) where the main purpose for investing in shares was to gain control over the investee company; and (b) where the shares of investee company were held by the assessees as stock-in-trade (i.e. as a business activity) and not as investment to earn dividends. As dividend is earned in both the scenarios, even though incidentally, it results in exempt income and triggers applicability of Section 14A of the Act. The Court also reiterated the theory of apportionment of expenditure between 'taxable' and 'non-taxable income'.

Taking into consideration the facts and views expressed by Delhi High Court in the case of Maxopp Investment Ltd. v. CIT [2] and Punjab and Haryana High Court in the case of Principal CIT v. State Bank of Patiala[3], the Supreme Court decision is as under:

DECISION OF SUPREME COURT:

(A) With respect to shares held as investment in the shares of investee company for the purpose of acquiring and retaining a controlling interest

1. As per Section 14A(1) of the Act, if an expenditure incurred has no causal connection with the exempted income, then such an expenditure would obviously be treated as not related to the exempt income, and accordingly such expenditure would be allowed as business expenditure.

2. The key dispute is in the interpretation of the term 'in relation to' in the given scenario, viz. where the dividend income on the shares is earned, though the dominant purpose for subscribing those shares of the investee company was not to earn dividend. Interpretation of the word 'in relation to' the income that does not form part of total income has to be made keeping in view the objective[4] behind insertion of Section14A of the Act which is as under:

   'Certain incomes are not includable 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.'

3. Even though investment is made in the subsidiary in order to gain control of the investee company, the dominant purpose for which the investment into shares is made by an assessee may not be relevant factor in determining the disallowance under Section 14A. The fact remains that such dividend income is non-taxable and if expenditure is incurred on earning the dividend income that much of expenditure which is attributable to the dividend income has to be disallowed and cannot be treated as business expenditure.

[1] Maxopp Investment Ltd. v. Commissioner of Income-tax, New Delhi [2018] 91 taxmann.com 154 (SC)
[2] [2011] 203 Taxmann 364 (Delhi High Court)
[3] [2017] 391 ITR 218 (Punjab & Haryana High Court)
[4] Memorandum explaining the provisions of the Finance Bill 2001

4. The Bench accepted that the principle of apportionment of expenses is engrained in Section 14A of the Act, which was laid down by Supreme Court in the case of CIT v. Walfort Share and Stock Brokers P Ltd[5].

5. The Bench agreed with the view of Delhi High Court in the case of Maxopp Investment Ltd. v. CIT (supra), wherein the Court had held that principle of apportionment of expenditure was made available only where the business was divisible and in case of composite or indivisible business which had elements of both taxable and non-taxable income, the entire expenditure in respect of said business was deductible. Accordingly, those cases were dismissed where the shares were purchased by the assessees to have controlling interest in the investee companies.

(B) With respect to shares held as 'stock-in-trade'

6. Where the shares of Investee Company were held by the assessees as stock-in-trade, the Supreme Court accepted the distinction made between 'stock-in-trade' and 'investment' by the Punjab and Haryana High Courts in the case Principal CIT v. State Bank of Patiala (supra). If the motive behind purchase and sale of shares is to earn profit, then the same would be treated as trading profit and if the object is to derive income by way of dividend then the profit would be said to have accrued from investment.

7. The Bench held that when the shares are held as 'stock-in-trade', whether dividend is earned or not becomes immaterial as the main purpose is to liquidate those shares whenever the share price goes up in order to earn profits. However, when dividend is earned, though incidentally, such dividend is also an income and by virtue of Section 10(34) of the Act, this dividend income is not to be included in the total income and is exempt from tax. This triggers the applicability of Section 14A of the Act which is based on the theory of apportionment of expenditure between taxable and non-taxable income as held in the case of Walfort Share and Stock Brokers P Ltd. (supra). Therefore, to that extent, depending upon the facts of each case, the expenditure incurred in acquiring those shares will have to be apportioned.

8. Lastly, relying on the Supreme Court ruling in the case of Essar Teleholdings Ltd.[6], it was held that Rule 8D was held to be prospective in nature and is not applicable in respect of the Assessment Years prior to 2007 when this Rule was inserted.

ELP COMMENTS:

The Supreme Court ruling has now provided clarity by holding that when there is an income in the nature of dividend earned from strategic investments made in subsidiaries or by the investments made and held as 'stock-in-trade', disallowance under Section 14A will still come into operation with respect to the expenditure especially incurred in relation to the exempt income.

The Supreme Court has rejected 'the dominant purpose test' for disallowance under Section 14A. However, it has accepted the 'theory of apportionment' according to which if an expenditure is incurred which has no connection with the exempted income, then such expenditure would be allowed as business expenditure and would not be treated as related to exempt income. Going forward, it would be very critical to maintain a robust documentation in order to justify this classification of expenditure incurred.

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[5] [2010] 326 ITR 1 (SC)

[6] TS-35-SC-2018