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TAX ALERT
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DISALLOWANCE OF EXPENDITURE ON DIVIDEND INCOME ON WHICH TAX IS PAID

Introduction

In a major move the Supreme Court ("**SC**") has laid to rest the debate surrounding the applicability of Section 14A disallowance on dividend income on which Dividend Distribution Tax is payable by the distributor company under Section 115O. Ruling against the taxpayer in the case of ***Godrej & Boyce Manufacturing Company Ltd. v. DCIT*[1]*,*** the SC held that Section 14A disallowance is applicable to dividend income which has been taxed under Section 115O and explained that earning the species of dividend income on which tax is paid under Section 115O is tax free in the hands of the recipient taxpayer. In the ensuing paragraphs we have summarized and discussed the decision of the SC.

Facts

The taxpayer is engaged in the business of manufacture of steel furniture, electrical equipments, etc. It is also a promoter of various other companies and invests funds into these companies to maintain control over them.

For Assessment Year 2002-2003, taxpayer filed its return of income declaring a total loss of INR 45.90 crores. It has shown its dividend income and income from units of mutual funds worth INR 34.34 crores. Dividend income to the extent of 98% was contributed by the Godrej group of companies. Substantial part of taxpayer's investment in group companies was in form of bonus shares without any fresh capital investment. Also, the taxpayer had not made any fresh investments during relevant year and the value of investments had reduced.

The Assessing Officer ("**AO**") disallowed the interest expenditure of INR 6.92 crores holding the same to be attributable to earning the dividend income. CIT(A) reversed the order of the AO. However, the ITAT taking a different view, held that sub-sections (2) and (3) of Section 14A were applicable with retrospective effect and hence the matter should be remanded back to the AO for recording his findings in light of the said sub-sections.

In appeal the Hon'ble Bombay High Court held that "*Section 14A of the Act has to be construed on a plain grammatical construction thereof and the said provision is attracted in respect of dividend income referred to in Section115O as such income is not includible in the total income of the shareholder. Sub-sections (2) and (3) of Section 14A of the Act and rule 8D of the Income-tax Rules, 1962 (hereinafter referred to as "the Rules") would, however, not apply to the AY 2002-03 as the said provisions do not have retrospective effect."* It must be noted that the High Court also held that tax paid under Section 115O is an additional tax on that component of the profits of the dividend distributing company which is distributed by way of dividends and that the same is not a tax on dividend income of the taxpayer.

Aggrieved, the taxpayer filed an appeal in the SC.

Issues for consideration before the SC

(a) Irrespective of the findings in case of taxpayer, whether the phrase *"income which does not form part of total income under this Act"* appearing in Section 14A includes within its scope dividend income on shares in respect of which tax is payable under Section 115O and income on units of mutual funds on which tax is payable under Section 115R.

1. TS-176-SC-2017

(b) Whatever be the view on the legal aspects, whether on the facts and in the circumstances of the Appellant's case and bearing in mind the unanimous findings of the lower authorities over a considerable period of time (which were accepted by the Revenue) there could at all be any question of the provisions of Section 14A in the case of the taxpayer.

Arguments of the parties

Taxpayer argued that Section 14A applies only in situations where income is tax free; non-taxable and there is no incidence of tax *per se*. However, dividend on shares is subjected to tax under Section 115O, whereas returns of units or mutual funds are subjected to tax under Section 115R. The fact that the tax on such dividend is paid by the dividend paying company and not by the recipient of the dividends, makes no difference as the person paying tax is not relevant.

Further the taxpayer argued that Section 10(33) (which exempts dividend income) and 115O are interlinked and they constitute a composite scheme as they were inserted together in the Income Tax Act, 1961 ("**IT Act**"), were removed together and were later re-introduced together. Thus, it was argued that legislative policy is clear that dividend though to be taxed in hands of the distributing company, is not to be included in the total income of recipient taxpayer.

On the other hand, Indian Revenue Authority ("**Revenue**") argued that Section 14A was inserted in the IT Act to offset several judicial pronouncements holding that in case of a taxpayer earning income which is both includible and non-includible in the total income, the entire expenses would be permissible as deduction, including, expenses pertaining to income not includible in the total income. In other words, legislative intent behind enactment of Section 14A and sub-sections (2) and (3) thereof was to combat situations where tax incentives given by way of non-inclusion of different categories of income under the head *"Income which do not form part of the total income"* was actually used to reduce the tax payable on the total income.

The Revenue also contended that even though income from dividend falls under the head "Income from Other Sources" specifically provided for under Section 56 of the IT Act, dividend income referred to in Section 115O of the IT Act is excluded from the provisions of deductions contained in Section 57 inasmuch as such income does not form a part of the total income in view of Section 10(33) of the IT Act. Section 14A reiterates a fundamental principle enshrined under the IT Act that expenses are allowable only to the extent that they have a nexus to the earning of taxable income or income which forms a part of the total income.

Moreover, pointing to the provisions of Section 115O(5) it was argued that under the said provisions a shareholder cannot claim deduction in respect of the dividend received by it/him from a dividend paying company on which tax has been paid by the said company under Section 115O(1) of the IT Act. Thus in such a situation, expenditure incurred for earning such dividend income cannot be allowed.

Decision

SC observed that the object of introducing Section 14A is clear and unambiguous. The legislature intended to check the claim of allowance of expenditure incurred towards earning exempted income in a situation where a taxpayer has both exempted and non-exempted income or includible or non-includible income. Deduction under Section 14A would not be permissible merely on the ground that the tax on the dividend received by the taxpayer has been paid by the dividend paying company and not by the recipient taxpayer, when under Section 10(33) of the IT Act such income by way of dividend is not a part of the total income of the recipient taxpayer. A plain reading of Section 14A would go to show that the income must not be includible in the total income of the taxpayer.

Rejecting the reliance of the taxpayer on the case of *K. P. Varghese v. ITO, Ernakulam and Anr.*[2], the SC stated that literal meaning of Section 14A, far from giving rise to any absurdity, appears to be wholly consistent with the scheme of the IT Act and the object of levy of tax on income. Further the SC referred to the case of *CIT v. Calcutta Knitwears, Ludhiana*[3] wherein it was held that *"the language of a taxing statute should ordinarily be read and understood in the sense in which it is harmonious with the object of the statute to effectuate the legislative animation. A taxing statute should be strictly construed; common sense approach, equity, logic, ethics and morality have no role to play. Nothing is to be read in, nothing is to be implied; one can only look fairly at the language used and nothing more and nothing less."*

Holding Section 14A applicable in case of dividend income on which tax is paid the SC stated that so far as the species of dividend income on which tax is payable under Section 115O of the IT Act is concerned, the earning of the said dividend is tax free in the hands of the taxpayer and not includible in the total income of the said taxpayer. In that case the operation of Section 14A of the IT Act to such dividend income cannot be foreclosed. The fact that Section 10(33) and Section 115O of the IT Act were brought in together; deleted and reintroduced later in a composite manner, also, does not assist the taxpayer.

The SC held that the no material difference to the applicability of Section 14A would arise even if it is assumed that additional income tax under Section 115O is on the dividend and not on the distributed profits of the dividend paying company. It further stated that in fact, if the argument that tax paid by the dividend

2. (1981) 131 ITR 597 (SC)
3. (2014) 6 SCC 444

paying company under Section 115O is to be understood to be on behalf of the recipient taxpayer, the provisions of Section 57 should enable the taxpayer to claim deduction of expenditure incurred to earn the income on which such tax is paid. Such a position in law would be wholly incongruous in view of Section 10(33) of the IT Act.

Dealing with the second issue at hand the SC holding in favour of the taxpayer, relied on the case of *Radhasoami Satsang v. CIT*[4] and observed that *"while it is true that the principle of res judicata would not apply to assessment proceedings under the Act, the need for consistency and certainty and existence of strong and compelling reasons for a departure from a settled position has to be spelt out which conspicuously is absent in the present case."*

Conclusion

It is a significant decision of the Apex Court which will settle the position on the disallowance of expenditure incurred in earning a tax exempt income. Dividend income is exempt in the hands of the recipient and so the SC has rightly held that such income shall not be considered as a taxable income just because dividend distribution tax is paid on the same by the distributing company under Section 115O.

It has now been clarified that such dividend income is taxable in the hands of the distributing company and thus the benefit of claiming any deductions in computation of total income by way of expenditure incurred in respect of earning such dividend income cannot be extended to the recipient taxpayer, as this dividend income is exempt in his hands.

Thus the species of dividend income on which tax is paid under Section 115O will be liable to disallowance under Section 14A.

However, it must be noted that the SC has also held in the particular facts of the present case that for sake of consistency and certainty, if there are unanimous findings of the lower authorities over a considerable period of time (which were accepted by the Revenue), the same should not be departed from unless strong and compelling reasons are spelt out for the same.

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4. (1992) 193 ITR (SC) 321