

# No disallowance of proportionate interest expenditure under Section 14A where taxpayer had sufficient interest-free funds: Supreme Court

22 September 2021



## Summary

The Supreme Court (SC) has held that where interest-free funds available with the taxpayer were larger than investments made in tax-free securities, proportionate disallowance of interest expenditure could not be made under Section 14A of the Income-tax Act, 1961 (Act) on the ground that separate accounts were not maintained by the taxpayer for investments and other expenditures incurred for earning tax-free income.

## Facts of the case

- The taxpayer<sup>1</sup> is a scheduled bank and is engaged in the business of investments in bonds, securities and shares.
- It earned interests from securities and bonds as also dividend income on investments made in shares of companies and from units of UTI etc., which are tax-free.
- The taxpayer did not maintain separate accounts for investment in bonds, securities and shares, wherefrom the tax-free income is earned so that disallowances could be limited to the actual expenditure incurred.
- In absence of separate accounts, the tax officer made proportionate disallowance of interest attributable to the funds invested to earn tax-free income. The Commissioner (Appeals) [CIT(A)] upheld the order of the tax officer.
- Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Income Tax Appellate Tribunal (ITAT). The ITAT held that since taxpayer is having surplus funds and reserves from which investments are made, it can be accepted that investments were not made out of interest-bearing funds alone. Accordingly, in absence of clear identity of funds, disallowance under Section 14A of the Act is not warranted.
- Further, the ITAT observed that considering the nature of business of the taxpayer and since the taxpayer has indivisible business, the investments made in tax-free bonds and in shares would, therefore, be in nature of stock-in-trade.
- The decision of ITAT was reversed by the High Court (HC).
- Aggrieved by the order of HC, the taxpayer filed an appeal before the SC.

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<sup>1</sup> M/s. South Indian Bank Ltd.

- Before the SC, the taxpayer contended that the investments made in bonds and shares should be considered to have been made from interest-free funds, which are substantially more than the investment made. Therefore, the interest paid by the taxpayer on its deposits and other borrowings, should not be considered as expenditure incurred in relation to tax-free income on bonds and shares.

### SC's observation and order

- The SC held that in a situation where the taxpayer has mixed funds (made up partly of interest-free funds and partly of interest-bearing funds) and tax-free investment is made from such mixed funds, the tax-free investment must be considered to be made from interest-free funds. In this regard, the SC held that the taxpayer has the right of appropriation of mixed funds and also the right to assert from what part of the fund a particular investment is made. It is not permissible for the tax authority to make an estimation of a proportionate figure. In this regard, the SC approved similar ratio laid down in earlier rulings.<sup>2</sup>
- The SC distinguished the rulings<sup>3</sup> relied by the tax department on the grounds that in

those cases, loans were extended to sister concerns while in the present case, funds have been invested in bonds/securities.

- The SC also held that the tax department failed to justify/refer to any statutory provision which obligated the taxpayer to maintain separate accounts, which might justify proportionate disallowance. In this regard, the SC held that there is no statutory compulsion on taxpayer to maintain separate accounts for different types of funds.
- Further, placing reliance on certain decisions<sup>4</sup>, the SC held that disallowance cannot be made in respect of tax-free investments which are held as stock-in-trade since such investment is made to earn taxable business profits from trading and not to earn exempt dividend income. For attracting provisions of Section 14A of the Act, the proof of fact regarding such expenditure being incurred for earning exempt income is necessary.
- Further, the SC referred to Circular no. 18, dated 2 November 2015, issued by the Central Board of Direct Taxes (CBDT), wherein it was clarified that all the shares and securities held by a bank which are not bought to maintain Statutory Liquidity Ratio

<sup>2</sup> in the cases of PCIT v. Bombay Dyeing and Mfg. Co Ltd (I.T.A. No.1225 of 2015), CIT v. Reliance Industries Ltd [2019] 410 ITR 466 (SC) and other HC rulings [2016] 383 ITR 529 (Bom), [2013] 354 ITR 630 (Guj), [2016] 383 ITR 490 (Karn), [2016] 388 ITR 81 (P&H)

<sup>3</sup> of S.A. Builders vs CIT [2007] 1 SSC 781 and Addl CIT vs Tulip Star Hotels Ltd SLP (C) No. 14729 of 2012

<sup>4</sup> Maxopp Investments Ltd. v. CIT [2018] 402 ITR 640 (SC) and Godrej & Boyce Manufacturing Co Ltd. v. DCIT [2017] 7 SSC 421

(SLR) constitute stock-in-trade and all income received on such shares and securities must be considered as business income. As no argument was made by the tax department that the taxpayer had held the securities for maintaining SLR, the SC held that no tax implications would arise against the taxpayer from the said circular.

- The SC, while quoting a renowned economist<sup>5</sup>, stated that in a taxation regime, there is no room for presumption and nothing can be taken to be implied. The tax that an individual or a corporate is required to pay is a matter of planning for a taxpayer and the government should endeavour to

keep it convenient and simple to achieve maximum compliance. Just as the government does not wish for avoidance of tax, similarly, it is the responsibility of the regime to design a tax regime for which a taxpayer can budget and plan taxes. If proper balance is achieved between these, unnecessary litigation can be avoided without compromising on generation of revenue.

## Our comments

The decision of the SC is welcomed by taxpayers as it settles the controversy on disallowance of interest expenditure in case of availability of mixed funds (partly interest-free and partly interest bearing) under the Act.

It is relevant to note that from Financial Year 2020-21, dividend income is taxable in the hands of the shareholders and hence, disallowance under Section 14A of the Act should not be applicable on such dividend income.

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<sup>5</sup> Adam Smith: "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of

payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person."

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