

INTRODUCTION

Income-tax is not a tax on receipts but on income. Income is taxed on a net basis *i.e.* net of expenses. It goes without saying that the exemption in respect of income should also be claimed on a net basis. However, assessee's offset against taxable income expenses incurred in earning tax-free incomes and reduce their tax liabilities. To obviate this, section 14A was inserted in the Income-tax Act, 1961 (hereinafter referred to as 'the Act').

It is axiomatic that if an item of income is exempt and gets excluded at the very outset from entering into computation of total income, any expenditure incurred in relation to such income shall also meet with the same fate. Such expense will also not come within the ambit of consideration zone as to its deductibility or otherwise. Business expenses go hand in hand with the business income as legal spouse. Both are to be viewed together and not divorced from each other. Business income can be determined after deducting business expenses. If we compartmentalize business income and expenses into taxable and exempt parts, it is but natural that only that much of the business expenditure can be allowed as deduction from the taxable income as has been incurred in relation to such taxable income. Business expenditure incurred for earning the exempt business income shall call for deduction only against the exempt business income. It is quite elementary that, unless expressly provided otherwise, exemption is always in respect of income and not the gross receipt. It is the excess of gross receipt over the expenditure for earning such income, which qualifies for exemption. The crux is that if any business income is exempt from taxation under the Act, the expenditure incurred in relation to such income shall also stand to qualify for reduction against the exempt income and not any taxable income. Neither such exempt income

nor any expenditure incurred in relation to such exempt income shall enter into the computation of taxable income.—*State Bank of Mauritius Ltd. v. Dy. DIT*[2012] 25 taxmann.com 555 (Mum. - Trib.)

Conditions to be satisfied to trigger disallowance of expenditure u/s 14A

- ◆ Expenditure has been actually incurred by the assessee.
- ◆ Such expenditure is in relation to income which does not form part of total income under the Act.
- ◆ Such expenditure has actually been claimed by the assessee as deduction in computing total income.
- ◆ If all the above conditions are satisfied, such expenditure shall be disallowed *i.e.* 'no deduction shall be allowed' in respect of such expenditure.

Expenditure has been actually incurred by the assessee.	<p>1. Section 14A applies to expenditure, not to loss.</p> <p>2. Section 14A applies to expenditure, not to allowance like depreciation.</p> <p>3. Disallowance can't be on notional basis. Disallowance can only be of actual expenditure incurred.</p>
Such expenditure is in relation to income which does not form part of total income under the Act	<p>1. Section 14A applies to expenditure incurred in relation to incomes which are not part of total income.</p> <p>2. Section 14A has no application to expenditure incurred in relation to incomes taxable at concessional rates of tax.</p> <p>3. Section 14A has no application to expenditure incurred in relation to incomes includible in total income in the first instance and then deductible under Chapter VIA.</p>
Such expenditure has actually been claimed by the assessee as deduction in computing total income	<p>Wordings in section 14A is 'no deduction shall be allowed'. Unlike section 69C, it does not use the words 'deemed to be income'. Further Rule 8D clarifies that disallowance can't exceed amount actually claimed as deduction.</p>

If all the above conditions are satisfied, such expenditure shall be disallowed i.e. 'no deduction shall be allowed' in respect of such expenditure claimed by the assessee.	AO to follow the approach outlined in sub-sections (2) and (3) of section 14A.
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If assessee himself determines expenditure incurred in relation to taxable income and disallows the same in computing total income:

- ◆ Having regard to the accounts of the assessee, AO shall satisfy himself as regards the correctness of assessee's claim as to amount of such expenditure.

If satisfied with assessee's claim?

- ◆ If satisfied, AO shall accept assessee's working of disallowance and matter ends there.

If not satisfied with assessee's claim?

- ◆ If not satisfied, then AO shall determine the amount of expenditure liable to be disallowed in accordance with prescribed method *i.e.* Rule 8D
- ◆ The amount of disallowance computed as per Rule 8D shall not exceed the actual amount of such expenditure claimed by the assessee as deduction.

If assessee determines expenditure incurred in relation to tax-exempt income as NIL and claims that no expenditure incurred by him in relation to tax-exempt income:

- ◆ Having regard to the accounts of the assessee, AO shall satisfy himself as regards the correctness of assessee's claim that no such expenditure incurred.

If satisfied with assessee's claim

- ◆ If satisfied, AO shall accept assessee's claim and matter ends there.

If not satisfied with assessee's claim

- ◆ If not satisfied, then AO shall determine the amount of expenditure liable to be disallowed in accordance with prescribed method *i.e.* Rule 8D.
- ◆ The amount of disallowance computed as per Rule 8D shall not exceed the actual amount of such expenditure claimed by the assessee.