

## TAX FLASH NEWS

### Loss on sale of mutual fund units is allowed as a business loss. The provisions of Section 14A of the Income-tax Act are not attracted

#### Background

Recently, the Madras High Court (High Court) in the case of Patco Investment & Consultancy Services (P.) Ltd.<sup>1</sup> (the taxpayer) held that the taxpayer is entitled to claim the business loss on the sale of mutual fund units. The transaction would not attract the provisions of Section 14A<sup>2</sup> of the Income-tax Act, 1961 (the Act).

The High Court has placed reliance on the decision of the Supreme Court in the case of Walfort Shares & Stock Brokers (P) Ltd.<sup>3</sup>, where it has been held that a deduction for expenditure or loss which is not within the prohibition must be allowed if it is a proper debit item to be charged against the incomings of the business in ascertaining the true profits. For attracting Section 14A of the Act, there has to be a proximate cause for disallowance, which is its relationship with the tax-exempt income.

The Supreme Court observed that a return of investment cannot be construed to mean 'expenditure' and even if it is construed so, the expenditure was not of a nature which can be claimed as an 'allowance' under Sections 30 to 37 of the Act. Accordingly, the High Court has struck down the contention of the tax department and held that the transaction would not attract Section 14A of the Act.

#### Facts of the case

- The taxpayer is engaged in the business of trading in stocks and shares. During the year under consideration, the taxpayer accepted a loan of INR20 million from Kotak Mahindra Finance Ltd. The taxpayer executed a power of attorney in favour of Kotak Mahindra Finance Ltd., enabling the latter to subscribe mutual fund units, to pay monies due on application, to make an application for redemption, to receive dividend and to receive consideration consequent on sale.
- Kotak Mahindra Finance Ltd. purchased 1,149,425 units of a mutual fund on the record date at INR17.40 for a total consideration of INR20 million. Kotak Mahindra Finance Ltd. directly paid the purchase consideration to the mutual fund. A dividend at INR3.50 per unit amounting to INR4.02 million was to be received by Kotak Mahindra Finance Ltd.
- The units were purchased with a dividend reinvestment option; hence the dividend of INR4.02 million was reinvested at INR13.60 per unit equivalent to 295,807 units. Immediately one day after the record date, all the units were redeemed at INR13.44 per unit. On redemption, Kotak Mahindra Finance Ltd. received INR15.40 million (excluding dividend) directly from the mutual fund. Thus, the mutual fund units were purchased-cum-dividend at INR17.40 and redeemed at an ex-dividend at INR13.44. In this transaction, Kotak Mahindra Finance Ltd. incurred a loss of INR3.96 per unit. This loss was claimed by the taxpayer as its trading loss.

<sup>1</sup> Patco Investment & Consultancy Services (P.) Ltd. v. ACIT [2015] 59 taxmann.com 266 (Mad)

<sup>2</sup> Deduction in respect of expenditure in relation to income not includible in total income

<sup>3</sup> CIT v. Walfort Share & Stock Brokers (P.) Ltd. [2010] 326 ITR 1 (SC)

- The loan account with Kotak Mahindra Finance Ltd. was squared up by the taxpayer by paying the balance due. The taxpayer received an incentive of INR2,70,000 from Kotak Securities for making the alleged investment. The taxpayer claims to have paid an interest of INR28,110 towards the loan.
- The taxpayer neither received cash of INR20 million nor the redemption amount of INR15.4 million excluding dividend. Though the taxpayer was not involved in the transaction, it claimed to have received a dividend of INR4.02 million. The taxpayer also claimed the expenditure/loss of INR 4.36 million as being part of its trading operations.
- During the Assessment Year (AY) 2001-02, the taxpayer filed its return of income declaring a loss. In the return, the taxpayer claimed dividend as exempt under Section 10(33) of the Act.
- This claim of expenditure/loss in the purchase and sale of units was disallowed by the Assessing Officer (AO). The Commissioner of Income-tax (Appeals) and the Income-tax Appellate Tribunal (the Tribunal) upheld the order of the AO.
- The purport of insertion of Section 94(7) of the Act is only to curb dividend stripping, which is used as a colourable device. This section having come into effect from 1 April 2002, the same would have been enforceable only from the AY 2002-03 onwards. In the present case, the AY pertains to 2001-02. Therefore, it was clear that Section 94(7) of the Act would not be applicable to the present case.
- With respect to the tax department's contention of applicability of Section 14A of the Act, the High Court relied on the decision of the Supreme Court in the case of Walfort Share and Stock Brokers (P.) Ltd. wherein the Supreme Court held as follows:
  - The basic principle of taxation is to tax the net income i.e. gross income minus the expenditure. On the same analogy, the exemption is also in respect of the net income.
  - The theory of apportionment of expenditure between taxable and non-taxable has in principle, been now widened under Section 14A of the Act. On a perusal of Section 14 of the Act in juxtaposition with Sections 15 to 59 of the Act, it is clear that the words 'expenditure incurred' in Section 14A of the Act refers to expenditure on rent, taxes, salaries, interest, etc. in respect of which allowances are provided for.
  - These allowances are admissible to qualified deductions. These deductions are for debits in the real sense. Every pay-out is not entitled to allowances for deduction. A pay-back does not constitute an 'expenditure incurred' in terms of Section 14A of the Act.
  - Applying the principles of accountancy, a pay-back in the strict sense does not constitute an 'expenditure' as it does not impact the profit and loss account. Pay-back or return of investment will impact the balance sheet whereas a return on investment will impact the profit and loss account. The cost of acquisition of an asset impacts the balance sheet. Return of investment brings down the cost. It will not increase the expenditure.
  - Hence, expenditure, return on investment, return of investment and cost of acquisition are distinct concepts. Therefore, one needs to read the words 'expenditure incurred' in Section 14A of the Act in the context of the scheme of the Act and, if so read, it is clear that it disallows certain expenditure incurred to earn exempt income from being deducted from other income which is includible in the 'total income' for the purpose of chargeability to tax.

### Taxpayer's contentions

- The taxpayer contended that in the view of the new provisions of Section 94(7) of the Act, the decision of the Supreme Court in the case of Walfort Share & Stock Brokers (P.) Ltd. is applicable to the facts of the present case.
- The taxpayer relying on the decision of Supreme Court contended that buying and selling of units resulting in an inflow of dividends and at the same time business loss on sale of the units after the record date, could not be equated to the transaction in terms of Section 94(7) of the Act, which came into effect from 1 April 2002 and the AY pertaining to the present case was 2001-02.

### Tax department's contention

- The tax department relying on the order of the lower authorities contended that the transaction in the current case would fall under Section 14A of the Act.

### High Court's ruling

- Section 94(7) of the Act was inserted vide the Finance Act, 2001, with effect from 1 April 2002. On a perusal of the said section, it is clear that Section 94(7) of the Act was inserted to clarify the position as to how the computation of income is to be made for the purpose of charging tax in the case of purchase and sale of securities or units within a specified period.

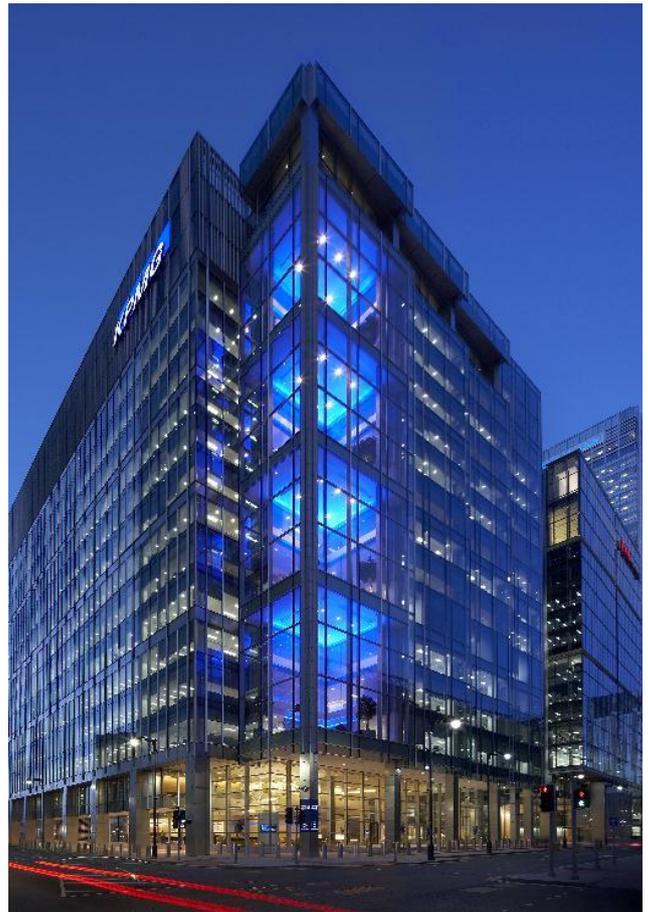
- The scheme of Sections 30 to 37 of the Act is that profits and gains must be computed subject to certain allowances for deductions/expenditure. The charge is not on gross receipts; it is on profits and gains. Profits have to be computed after deducting expenses and losses incurred in the business.
- A deduction of expenditure or loss which is not within the prohibition must be allowed if it is on the facts of the case a proper debit item to be charged against the incomings of the business in ascertaining the true profits.
- A return of investment or pay-back is not as such a debit item and hence, it is not 'expenditure incurred' in terms of Section 14A of the Act. Expenditure is a pay-out. It relates to disbursement.
- For attracting Section 14A of the Act, there has to be a proximate cause for disallowance, which is its relationship with the tax-exempt income. Pay-back or a return of investment is not such a proximate cause; hence, Section 14A of the Act was not applicable in the present case.
- Accordingly, a return of investment cannot be construed to mean 'expenditure' and if it is construed to mean 'expenditure' in the sense of physical spending still the expenditure was not such as could be claimed as an 'allowance' against the profits of the relevant accounting year under Sections 30 to 37 of the Act and, therefore, Section 14A cannot be invoked. Hence, the two asset theory is not applicable in this case as there is no expenditure incurred in terms of Section 14A of the Act.
- The Supreme Court, in the above decision, further fortified this issue stating that such a transaction was curbed by the introduction of Section 94(7) in the Finance Act, 2001, with effect from 1 April 2002, relevant to the AY 2002-03.
- Accordingly, in view of the aforesaid decision of the Supreme Court, the contention of the tax department that the transaction would attract Section 14A of the Act fails and the High Court held that the taxpayer is entitled to claim the amount as business loss during the AY in question.

## Our comments

This is a welcome ruling of the Madras High Court where it has been held that the taxpayer is entitled to claim business loss on sale of mutual fund units which is not to be disallowed under Section 14A of the Act.

The High Court has also held that since Section 94(7) of the Act has come into effect from 1 April 2002, the same will be enforceable only from the AY 2002-03 onwards and since the present case pertains to the AY 2001-02, it was clear that Section 94(7) would not be applicable to the present case.

The High Court has relied on the decision of the Supreme Court where it has been held that for attracting Section 14A of the Act, there has to be a proximate cause for disallowance, which is its relationship with tax-exempt income.



**Ahmedabad**

Commerce House V, 9th Floor,  
902 & 903, Near Vodafone House,  
Corporate Road,  
Prahlad Nagar,  
Ahmedabad – 380 051  
Tel: +91 79 4040 2200  
Fax: +91 79 4040 2244

**Bengaluru**

Maruthi Info-Tech Centre  
11-12/1, Inner Ring Road  
Koramangala, Bangalore 560 071  
Tel: +91 80 3980 6000  
Fax: +91 80 3980 6999

**Chandigarh**

SCO 22-23 (1st Floor)  
Sector 8C, Madhya Marg  
Chandigarh 160 009  
Tel: +91 172 393 5777/781  
Fax: +91 172 393 5780

**Chennai**

No.10, Mahatma Gandhi Road  
Nungambakkam  
Chennai 600 034  
Tel: +91 44 3914 5000  
Fax: +91 44 3914 5999

**Delhi**

Building No.10, 8th Floor  
DLF Cyber City, Phase II  
Gurgaon, Haryana 122 002  
Tel: +91 124 307 4000  
Fax: +91 124 254 9101

**Hyderabad**

8-2-618/2  
Reliance Humsafar, 4th Floor  
Road No.11, Banjara Hills  
Hyderabad 500 034  
Tel: +91 40 3046 5000  
Fax: +91 40 3046 5299

**Kochi**

Syama Business Center  
3rd Floor, NH By Pass Road,  
Vytilla, Kochi – 682019  
Tel: +91 484 302 7000  
Fax: +91 484 302 7001

**Kolkata**

Unit No. 603 – 604,  
6th Floor, Tower – 1,  
Godrej Waterside,  
Sector – V, Salt Lake,  
Kolkata 700 091  
Tel: +91 33 44034000  
Fax: +91 33 44034199

**Mumbai**

Lodha Excelus, Apollo Mills  
N. M. Joshi Marg  
Mahalaxmi, Mumbai 400 011  
Tel: +91 22 3989 6000  
Fax: +91 22 3983 6000

**Noida**

6th Floor, Tower A  
Advant Navis Business Park  
Plot No. 07, Sector 142  
Noida Express Way  
Noida 201 305  
Tel: +91 0120 386 8000  
Fax: +91 0120 386 8999

**Pune**

703, Godrej Castlemaine  
Bund Garden  
Pune 411 001  
Tel: +91 20 3050 4000  
Fax: +91 20 3050 4010

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