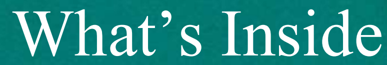
DMC GLOBAL

Judicial case update on section 14A read with Rule 8D of Income Tax Act, 1961 and Explanation regarding Calculation of Taxable/Non-Taxable Portion of interest on PF contribution

Editorial Note

It is with great pleasure and honor that DMC Global has issued its newsletter, Judicial case update on section 14A read with Rule 8D of Income Tax Act, 1961 (“the Act’’) and Explanation regarding Calculation of Taxable/Non Taxable Portion of interest on PF contribution. This newsletter seeks to provide analysis on the same. During the development of our newsletter, the team endeavored to provide all the relevant information required to keep oneself up to date with the changing scenario of the Indian economy. The focus has been made to serve the latest information gathered, interpreted & analyzed from the reliable sources some of which includes the official websites of Government Authorities.

Providing our readers crisp and concise content is the first & foremost priority of this newsletter established by DMC Global and its team. By this newsletter we look forward to provide you with apt information and requirements of readers.



1. DT Important Case law

Decision : In assessee's favour

Disallowance under section 14A-Expenditure against exempt income-Interest expenses under rule 8D(2)(ii)-Assessee having sufficient own funds

Facts: Assessee earned tax free dividend income on investments in shares. AO invoked section 14A read with rule 8D(1)(ii) and disallowed interest expenses. Assessee pleaded to have sufficient own funds.

Held: The interest-free funds of its own available with the assessee in the form of share capital and free reserves were substantially more than the corresponding investments made to earn interest free income and, therefore presumption could be drawn that investment in tax-free securities were made out of sufficient interest-free funds available with assessee and, therefore, interest disallowance under section 14A read with rule 8D(2)(ii) was not called for.

2. How to Calculate taxable/non taxable portion of interest on PF contribution?

1. About Provident funds
2. Types of Provident fund
3. Taxability of Provident fund
4. Amendment by the Finance Act, 2021
5. Method of computation of Taxable interest
6. Illustration

1. Analysis of Section 14A read with Rule 8D

IN THE ITAT, KOLKATA BENCH

P.M. JAGTAP, V.P. (KZ) & A.T. VARKEY, J.M.

DCIT v. Century Plyboards (I) Ltd.

ITA No. 2149/Kol/2019 and C.O. No. 22/Kol/2020 (in ITA No. 2149/Kol/2019)

4 November, 2020

Income Tax Act, 1961, Section 14A

Income Tax Rules, 1962, Rule 8D(2)(ii)

Disallowance under section 14A--Expenditure against exempt income--Interest expenses under rule 8D(2)(ii) Assessee having sufficient own funds

Conclusion: As investment in tax-free securities were made out of sufficient interest-free funds available with assessee, therefore, interest disallowance under section 14A read with rule 8D(2)(ii) was not called for.

Assessee earned tax free dividend income on investments in shares. AO invoked section 14A read with rule 8D(1)(ii) and disallowed interest expenses. Assessee pleaded to have sufficient own funds. Held: The interest-free funds of its own available with the assessee in the form of share capital and free reserves were substantially more than the corresponding investments made to earn interest free income and, therefore presumption could be drawn that investment in tax-free securities were made out of sufficient interest-free funds available with assessee and, therefore, interest disallowance under section 14A read with rule 8D(2)(ii) was not called for.

Decision: In assessee s favour.

Income Tax Act, 1961, Section 14A

Income Tax Rules, 1962, Rule 8D(2)(iii)

Disallowance under section 14A--Expenditure against exempt income--Administrative expenses under rule 8D(2)(iii)--AO made disallowance in excess of tax free income earned by assessee

Conclusion: Disallowance under section 14A read with rule 8D could not exceed tax free income earned by assessee. Therefore, AO was directed to restrict disallowance made on account of the common administrative expenses to the amount of exempt dividend income actually earned by the assessee during the year under consideration.

Assessee earned tax free dividend income on investments in shares. AO invoked section 14A read with rule 8D(2)(iii) and worked out disallowance in excess of tax free income earned by assessee. Held: Disallowance under section 14A read with rule 8D could not exceed tax free income earned by assessee. Therefore, AO was directed to restrict disallowance made on account of the common administrative expenses to the amount of exempt dividend income actually earned by the assessee during the year under consideration.

Decision: Partly in assessee s favour.

2. How to Calculate taxable portion of interest on PF contribution?

1. About Provident Funds

Provident Fund is a retirement saving plan in which both employee and employer contrib- ute a fixed sum every month. The amount ac- cumulated in the funds and interest earned thereon is paid to the employee on his re- tirement. However, an employee, in certain circumstances, is allowed to withdraw a sum from his provident fund account even before his retirement.

2. Types of Provident Fund

The provident funds can be categorized into the following types:

2.1 Statutory Provident Fund

This Fund is set up under the Provident Fund Act, 1925, which is meant only for employees working in Government or Semi-Government organizations, local authorities, universities, recognized educational institutions or railways.

2.2 Recognized Provident Fund

It is a provident fund which has been and continues to be recognized by the CIT in accordance with the rules contained in Part A of the Fourth Schedule to the Income-tax Act. It also includes a fund established un- der the Employees' Provident Fund Act, 1952. Such a fund is maintained in banks, insurance companies, factories and business houses in the private sector.

2.3 Unrecognized Provident Fund

These funds are those funds which have not been recognized by the CIT in accordance with the rules contained in Part A of the Fourth Schedule to the Income-tax Act. It can be maintained by any institution in private sector.

2.4 Public Provident Fund

Any resident individual can contribute in Public Provident Fund. Unlike EPF, contribution in PPF is voluntarily and it is only individual himself who can contribute to PPF.

3. Taxability of provident Fund

The tax implications in case of provident fund arise at the time of contribution, accrual of interest and withdrawal. The tax- ability can be explained with the help of the following table:

Treatment of	Recognised Provident Fund (RPF)	Statutory Provident Fund(SPF)	Unrecognised Provident Fund (UPF)	Public Provident Fund (PPF)
Employer's Contribution	Contribution up to 12% of basic salary + DA is exempt from tax. However, it shall be taxable in the following two scenarios:	-	Not Taxable	-
	(a) Any contribution above 12%; *(b)* Any contribution above Rs. 7,50,000.			
Employee's Contribution	Eligible for deduction under Section 80C	Eligible for deduction under Section 80C	Not eligible for deduction under Section 80C	Eligible for deduction under Section 80C
Interest earned on PF	Exempt from tax. However, it shall be taxable in the following two scenarios: *(a)* Interest above the notified rate; *(b)* Interest relating to the employee's contribution above Rs. 5 lakh, in case no contribution is made by employer; *(c)* Interest relating to the employee's contribution above Rs. 2.5 lakh, in case employer has also contributed to the fund.	Exempt from tax. However, it shall be taxable in the following scenarios: *(a)* Interest relating to the employee's contribution above Rs. 5 lakh, in case no contribution is made by employer; *(b)* Interest relating to the employee's contribution above Rs. 2.5 lakh, in case employer has also contributed to the fund.	Not taxable at the time of accrual	Exempt from tax
Withdrawal after 5 years	Exempt from tax	Exempt from tax	Aggregate of the following shall be taxable: *(a)* Employer's contribution; *(b)* Interest on employer's contribution; and *(c)* Interest on employee's contribution	Exempt from tax

4. Amendment by the Finance Act, 2021

As interest on the contribution made to statutory provident fund, recognised provident fund and the public provident fund is exempt from tax at the time of accrual as well as withdrawal, the Government noticed that some employees are contributing a huge amount to these funds. Thus, to curb this practice, the Finance Act, 2021 has amended Section 10(11) and Section 10(12) to provide that exemption shall not be available for the interest income accrued during the previous year on the recognised and statutory provident fund in the account of the person to the extent it relates to the contribution made by the employees in excess of Rs. 2,50,000 in a previous year. However, if such person has contributed in a fund in which there is no contribution by the employer, limit of Rs. 2,50,000 shall be increased to Rs. 5,00,000. The amount of such interest income shall be computed as per the prescribed rules.

5. Method of computation of taxable interest

The CBDT has notified2 Rule 9D for calculation of the taxable portion of interest pertaining to the contribution made to a statutory or a recognized provident fund in excess of threshold limit of Rs. 2.5 lakh or 5 lakhs as the case may be.

It provides that separate accounts within the provident fund account shall be maintained during the previous year 2021-22 and onwards for the taxable and non-taxable contribution made by the person.

5.1 Computation of Non-Taxable person

The non-taxable contribution to the provident fund account shall be computed in the following manner:

Particulars	Amount
Aggregate of the following:	
(a) Closing balance in account as on 31-03-2021	xxx
(b) Contribution by a person in financial year 2021-22 and onwards to the account (not being a taxable contribution)	xxx
(c) Interest accrued on (a) and (b) Above	xxx
Less: Amount withdrawn from the said account	(xxx)
Non-taxable contribution to account	**Xxx**

The interest accrued in the non-taxable contribution account shall continue to be exempt under Section 10(11) or Section 10(12).

5.2 Computation of Taxable person

The taxable contribution to the provident fund account shall be computed in the following manner-

Particulars	Amount
Aggregate of the following: *(a)* Contribution by a person in financial year 2021-22 and onwards to the account in excess of threshold limit (Rs. 2.5 lakhs/Rs. 5 lakhs) *(b)* Interest accrued on (a) above Less: Amount withdrawn from the said account	xxx xxx (xxx)
Taxable contribution to account	**xxx**

The interest accrued in the taxable contribution account shall be taxable under the head 'Income from other sources'.

6. Illustration

Mr. A is working in a software consultancy firm. He maintains an EPF account and his opening balance is Rs. 5,50,000. His annual CTC is Rs. 30 lakhs with break-up as under:

Particulars	Monthly	Annual
Basic salary	2,00,000	24,00,000
Special allowance	24,200	2,90,400
Employee's contribution to PF (12% of basic salary)	24,000	2,88,000
Employer's contribution to PF	1,800	21,600
Total CTC	2,50,000	30,00,000

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Computation of taxable and non-taxable contribution to PF:

Particulars	Non-taxable contribution	Taxable contribution
Opening balance	5,50,000	-
Contribution during the year: (a) Up to Rs. 2,50,000 (b) In excess of Rs. 2,50,000 (Rs. 2,88,000 less Rs. 2,50,000)	 2,50,000 -	 - 38,000
Total balance (before interest)	8,00,000	38,000
Interest for the financial year 2021-22 (assuming rate of interest 8.5%)	68,000	3,230
Interest income of Rs. 3,230 on taxable contribution to the provident fund shall be taxable in the hands of the employee in the assessment year 2022-23 under the head income from other sources. If the amount of interest exceeds the threshold limit prescribed under Section 194A (Rs. 5,000), the tax shall be de- ducted on the same. In such a case, the opening balance for the next year shall be computed by considering the interest amount after TDS.		

The excess contribution shall be taxable only if the aggregate amount of contribution made by the employer to the account of employee in a Recognised Provident Fund, National Pension Scheme and Superannuation Fund exceeds Rs. 7,50,000. In this situation, the excess amount so contributed is taxable as perquisite in the hands of employee.

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