Chapter - 1

Introduction

Expenditure means a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond the period.

There are two kinds of provisions wrt expenditure in Income Tax Act, i.e.,

- **Allowable Expenditure** - Those expenses which are allowed/ deducted while computing the taxable income under the head "Profits and Gains from Business or Profession".
- **Disallowed Expenditure** - Those expenses which are not allowed/ cannot be deducted while computing the taxable income under the head "Profits and Gains from Business or Profession". It means such expenses will be added to the income on which tax needs to be remitted.

The provisions of disallowance of expenditure should be applied first as they are overriding provisions.

While determining whether a particular expenditure is deductible or not, the first requirement must be to enquire whether the deduction is expressly prohibited under any other provision of the Income Tax Act. If the same is not prohibited, then such expenditure can be claimed while computing the taxable income. If any expenditure is not allowable due to any provisions, then that expenditure is not allowable. There are specific as well as general provisions which do not allow the expenditures.

No income can be earned without expenses

That business cannot be done without incurring any expenditure. Since the expenses are backed by evidence. Businesses must incur expenses to earn revenue, such as paying salaries, purchasing inventory, and paying rent. Net income is only what is left after deducting all expenses from revenue.

Types of expenditure in Income-tax

The Income Tax Act does not recognize deferred revenue expenditure. In Income Tax only three types of expenditure are recognized, viz. -

(i) Capital expenditure

(ii) Revenue expenditure

(iii) Personal expenditure

Required

(a) The expenditure has nexus with the business

(b) The expenditure is genuine

The broad proposition that once there is tax audit u/s 44AB, the ITO should not insist upon production of records or vouchers or details cannot be laid down. - [*Goodyear India Ltd. v. CIT (2000) 112 Taxman 419 (Del.)*]

For allowing loss, expenditure must be connected with or related to business carried on by assessee and profits and gains therein; expenditure incurred for giving support services to holding company by assessee could not be allowed as revenue expenditure in assessee's hands

Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of (Expenses for holding company) - Assessee-company was incorporated for carrying on business of consultants and advisors for supply of industrial computer software systems for use in oil, gas, water pipelines, etc. It disclosed loss of certain amount for relevant assessment year towards salaries, travelling expenses, rent, printing and stationary, postage, telegrams and telephone charges and other administrative expenses, etc. Assessing Officer disallowed expenses taking view that assessee-company did not carry on business activity during year, but helped its parent company in completing projects of parent company. Holding company and subsidiary company are separate entities and expenditure pertaining to one entity cannot be claimed or allowed in hands of other. Further for allowing loss, expenditure must be connected with or related to business carried on by assessee and profits and gains therein and since in instant case, expenses incurred were for purpose of giving support services to holding company and assessee did not derive any profit and gain from such expenditure, amount incurred by assessee-company could not be considered as revenue expenditure of assessee-company and thus, not eligible for deduction under section 37(1). [In favour of revenue] (Related Assessment year : 1999-2000) – [*Pipelic Energy Software India (P) Ltd. v. DCIT (2024) 166 taxmann.com 179 (Telangana)*]

While considering the allowability of any expenditure claimed by the assessee commercial expediency has to be viewed in the light of requirement of business. - [*Commissioner of Excess Profits v. N.M. Rayaloo Iyer & Sons, AIR 1961 (SC) 692 : (1961) 41 ITR 671 (SC)*]

Onus

Where an assessee claims a deduction the onus is on him to bring all material facts on record to substantiate his claim. - [*L.H. Sugar Factory & Oil Mills (P) Ltd. v. CIT (1980) 125 ITR 293 (SC)*]

If an expenditure is partly deductible and partly not deductible it is for the assessee to show which part is deductible, and if he fails, the whole of the expenditure should be disallowed. - [*Sabalgarh Industries Ltd. v. CIT (1962) 46 ITR 978 (All.)*]

Sections dealing with disallowance of expenses

S. No.	*Section*	*Corresponding to the Income-tax Act, 1961*	*Description*
1.	14	14A	Disallowance of Expenditure incurred in relation to income exempt from tax
2.	32(1)(b)	36(1)(iii)	Interest on borrowed capital
3.	34	37(1)	General conditions for allowable deductions
4.	34(2)(a)	*Explanation* 1 to Section 37(1)	Expenses for any purpose which is an offence or is prohibited by law
5.	34(2)(b)	*Explanation* 2 to Section 37(1)	Disallowance of Corporate Social Responsibility (CSR) Expenditure
6.	34(2)(c)	37(2B)	Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like published by a political party
7.	35(a)	40(a)(ii) & 40(a)(iia)	Any sum paid on account of any rate or tax levied on the profits and gains of business or profession
8.	35(b)(i)	40(ia)	Disallowance on account of non-deduction of TDS
9.	35(b)(ii)	40(a)(i)	Any sum (other than salary) payable outside India or to a non-resident
10.	35(b)(iii)	40(a)(iv)	Payment to provident fund or other funds established for the benefit of employees of the assessee
11.	35(c)	40(a)(iii)	Salary payable outside India (or in India to a non-resident) without tax deduction
12.	35(d)	40(a)(ib)	Any sum is paid or payable to a non-resident for a specified service on which equalisation levy is deductible
13.	35(e)	40(a)(iib)	Amount paid by way of royalty, license fee, service fee, privilege fee, service charge or any other fee or charge
14.	35(f)	40(b)	Disallowance of remuneration and interest paid by firm to partners
15.	35(g)	40(ba)	Payment of interest, salary, etc. made by AOP or BOI to its members
16.	36(2) & (3)	40A(2)	Excessive and unreasonable payments to any specified person
17.	36(4)	40A(3)	Disallowance for cash payments exceeding prescribed limit

18.	36(5)	40A(3A)	Cash payments exceeding the prescribed limits under Section 36(4) but later convert these transactions into non-cash modes
19.	37	43B	Certain deductions allowed on actual payment basis only

The Gujarat High Court in *CIT v. Navsari Cotton & Silk Mills Ltd. (1982) 135 ITR 546 (Guj.)* has evolved some positive and negative tests on first principles to claim deduction of an expenditure as business expenditure.

A. POSITIVE TESTS

If the expenditure is incurred:

(i) with a view to bring profits or monetary advantage today or tomorrow;

(ii) to render the assessee immune from impending or reasonably apprehended litigation;

(iii) in order to save losses in foreseeable future;

(iv) for effecting economy in working which may pay dividends today or tomorrow;

(v) for increasing efficiency in working;

(vi) for removing inefficiency in the working;

(vii) where the expenditure incurred is such as a wise, prudent,pragmatic and ethical man of the world of business would conscientiously incur with an eye on promoting his business prospects subjects to the expenditure being genuine and within reasonable limits;

(viii) where it is incurred solely by way of a civil duty owed by the assessee to the society having regard to the nature of his business which brings him profits but results in some detriment to the public at large either by way of health hazard or ecological pollution or serious inconvenience to the citizens with a view to mitigate the aforesaid evil consequences and consequences of a like nature, subject to its being genuine and within reasonable limits.

B. NEGATIVE TESTS

If the expenditure is incurred:

(i) for a mere altruistic consideration;

(ii) mainly in order to satisfy his philanthropic urges;

(iii) mainly in order to win applause or public appreciation;

(iv) for illegal, immoral or corrupt purposes or by any such means or for any such reasons;

(v) mainly in order to oblige a relative or an official;

(vi) to earn the goodwill of a political party or a politician;

(vii) to show off or impress others with his affluence or for ostentatious purposes;

(viii) apparently for a factor listed as a positive factor but in reality for one of the obnoxious purpose listed as a negative factor;

(ix) on a nebulous plea or pretext but really for one or the other of the purposes listed as negative tests;

(x) it must not be a bogus, fictitious or sham transaction;

(xi) it must not be unreasonable and out of proportion;

(xii) it must not be an expenditure merely with a view to avoid tax liability without any genuine purpose or reason in good faith; and

(xiii) the advantage to be secured by incurring the expenditure must not be of the nature of a remote possible advantage depending on "ifs" and "buts" and, if at all, to be secured at an uncertain future date which may be considered too remote.

Quantum of expenditure cannot be reduced, unless provided so under law

Unless there is a limitation put by the law on the amount of expenditure,a lesser amount than the amount expended cannot be allowed merely because the assessing authority thinks that the assessee could have managed by paying a lesser amount as a prudent businessman. - [*Jamshedpur Motor Accessories Stores v. CIT (1974) 95 Taxman 664 (Pat)*]

Quantum of expenditure is not relevant factor

Whether the money paid is a revenue expenditure or capital expenditure depends not so much upon the facts as to whether the amount paid is large or small or whether it has been paid in lump sum or by instalments, as it does upon the purpose for which the payment has been made and expenditure has been incurred. It is the real nature and quality of the payment and not the quantum or the manner of the payment which would prove decisive. - [*M.K. Bros. (P) Ltd. v. CIT (1972) 86 ITR 38 (SC)*]

If expenditure is incurred as owner-cum-trader, it must be really incidental to carrying on of business

The test adopted by the Supreme Court in *Travancore Titanium ProductLtd. v. CIT (1966) 60 ITR 277*, that to be a permissible deduction, there must be a direct and intimate connection between the expenditure and the business,i.e., between the expenditure and the character of the assessee as a trader, and not as owner of assets, even if they are assets of the business, needs to be qualified by stating that if the expenditure is laid out by the assessee as owner cum-trader, and the expenditure is really incidental to the carrying on of his business, it must be treated to have been laid out by him as a trader and as incidental to his business.—[*Indian Aluminium Co. Ltd. v. CIT (1972) 84 ITR 735(SC)*]

To be a permissible allowance, the expenditure must be for the purpose of carrying on the business

Where accounts are maintained on the mercantile system and liability to make the payment has arisen during the time the business is carried on, it may appropriately be regarded as an expenditure. But where the liability is during the whole of the period that the business is carried on, it cannot fallwithin the expression 'expenditure laid out or expended wholly and exclusively'for the purpose of the business. – [*CIT v. Gemini Cashew Sales Corpn. (1967) 65 ITR 643 (SC)*]

'Expenditure' need not involve actual parting with money or property

A mere liability to satisfy an obligation by an assessee is undoubtedly not 'expenditure'; it is only when he satisfies the obligation by delivery of cash or property or by settlement of accounts that there is expenditure. But expenditure does not necessarily involve actual delivery of or parting with money or property. A mere forbearance to realise a claim is not expenditure. - [*CIT v. Nainital Bank Ltd. (1966) 62 ITR 638 (SC)*]

Expenditure must be directly and intimately connected with character of assessee as trader, and not as owner of assets

To be a permissible deduction, there must be a direct and intimate connection between the expenditure and the character of the assessee as a trader, and not as owner of assets, even if they are assets of the business. - [*Travancore Titanium Product Ltd. v. CIT (1966) 60 ITR 277 (SC)*]

'Expenditure' means something which is gone irretrievably

'Expenditure' is what is 'paid out or away' and is something which is gone irretrievably. - [*Indian Molasses Co. (P) Ltd. v. CIT (1959) 37 ITR 66 (SC)*]

Connected documents as well as surrounding circumstances must be looked into

There is no single test of universal application –The Court has to look not only into the documents but also at the surrounding circumstances so as to arrive at a decision as to what was the real nature of the transaction from the commercial point of view. No single test of universal application can be discovered for a solution of the question. The name which the parties may give to the transaction which is the source of the receipt and the characterization of the receipt by them are of little consequence. - [*Travancore Sugars & Chemicals Ltd. v. CIT (1966) 62 ITR 566 (SC)*]

Relevance of book entries

Failure to make book entries is no bar to allow deduction

If an assessee under some misapprehension or mistake fails to make an entry in the books of account and if under the law, a deduction must be allowed by the ITO, the assessee will not lose the right of claiming or will not be debarred from being allowed that deduction. Whether the assessee is entitled to a particular deduction or not will depend on the provision of

law relating thereto and not on the view which the assessee might take of his rights nor can theexistence or absence of entries in the books of account be decisive or conclusive in the matter. - [*Kedarnath Jute Mfg. Co. Ltd. v. CIT (1971) 82 ITR 363 (SC); Sutlej Cotton Mills Ltd. v. CIT (1979) 116 ITR 1 (SC); CIT v. Sri Rama Sugar Mills Ltd.(1952) 21 ITR 191 (Mad)*]

The Supreme Court in the case of *CIT v. Kalyanji Mavji & Co.,* has observed (at page 53) that on accepted commercial practice and trading principles an item of business expenditure must be deducted in order to arrive at the true figure of profits and gains for the tax purposes. - [*CIT v. Kalyanji Mavji & Co. (1980) 122 ITR 49 (SC)*]

It was held that in deciding whether a payment of money is a deductible expenditure one has to take into consideration questions of commercial expediency and the principles of ordinary commercial trading. If the payment or expenditure is incurred for the purpose of the trade of the assessee it does not matter that the payment may incur to the benefit of a third party. - [*CIT v. Chandulal Keshavlal & Co. (1960) 38 ITR 601 (SC)*]

It was held that if the know-how acquired relates to the process of manufacture, then any payment made for this purpose would have to be considered as a revenue expenditure since the acquirer does not obtain any asset of an enduring nature it is more in the nature of a payment for consultancy. - [*Gannon Norton Metal Diamond Dies Ltd. v. CIT (1987) 163 ITR 606 (Bom.)*]

Decision of fact-finding authority about adequacy of proof is conclusive and final

It cannot be said that even if the taxpayer does not produce any evidence in support of the claim for allowance, the ITO himself independently is to collect evidence and decide that the allowance claimed is baseless having regard to the legitimate business needs of the assessee. It is for the taxpayer to establish by evidence that a particular allowance is justified. The law does not prescribe any quantitative test to find out whether the onus in a particular case has been duly discharged. A decision of the final fact-finding authority is conclusive and binding. - [*Assam Pesticides & Agro Chemicals v. CIT (1997) 227 ITR 846 (Gau.)*]

The broad proposition that once there is tax audit under section 44AB,the ITO should not insist upon production of records or vouchers or details cannot be laid down. - [*Goodyear India Ltd. v. CIT (2000) 246 ITR 116: 112 Taxman 419 (Del.)*]

Mere fact that payment is capital receipt in payee's hands is not relevant

The fact that a certain payment constitutes incomes or capital receipt in the hands of the recipient is not material in determining whether the payment is revenue or capital disbursement *qua* the payer. Whether it is capital expenditure or revenue expenditure would have to be determined

having regard to the nature of the transaction and other relevant factors. - [*Empire Jute Co. Ltd. v. CIT (1980) 124 ITR 1 (SC)*]

Advantage must be in a commercial sense, and in the capital field

It would not be enough to merely ascertain whether a particular expenditure has resulted in any advantage of an enduring character. The advantage must be in a commercial sense and, further, it must be in the capital field. If there is a payment made on the ground of commercial expediency and if such payment does not result in the acquisition of any capital asset or an enduring benefit, merely because such payment is made to get rid of the liability which is much larger, the outgoing amount cannot be considered as capital in nature. - [*CIT v. Pioneer Engg. Syndicate (1989) 175 ITR 93 : (1988) 38 Taxman 151 (Mad)*]

Department cannot dictate the circumstances in which expenditure is to be incurred

It is not open to the department to prescribe what expenditure an assessee should incur and in what circumstances he should incur that expenditure.Every businessman knows his interest best. - [*CIT v. Dhanrajgirji Raja Narasingirji (1973) 91 ITR 544 (SC)*]

The Assessing Officer can only decide whether the expenditure is real,whether it relates to the business and is wholly spent for that purpose. - [*Ramanand Sagar v. DCIT (2002) 255 ITR 134 (Bom.)*]

Business Expenditure - Payment to Ex-Employees

Amount paid by assessee to an ex-employee at the time of leaving the service as per settlement is allowable as deduction but not the amount which has already been claimed as deduction on account of provident fund in the year to which relates.- [*Tulip Hotels (P) Ltd. v. DCIT (2010) 132 TTJ 633: 37 SOT 77 (ITAT Mumbai)(TM)*]

Chapter - 2

Reasons for disallowance of Expenditure

Expenditure refers to a cost associated with an accounting period's operations, the revenue earned during the period, or the benefits of which do not extend beyond the period. The Income Tax Act, 2025 defines two types of expenses: allowable and disallowed. Allowable expenses are those that can be deducted when calculating taxable income under the heading "Income from Business or Profession," whereas disallowed expenses cannot be deducted and the amount is added to the income that must be taxed.

There are various reasons why expenditure will be disallowed. Few of them are mentioned below:

[1] Non-Compliance with the provisions of law

- Expenditure on which TDS should have been deducted and paid, has not been deducted and paid.
- Incurring cash payments exceeding Rs.10,000
- Certain expenditure are allowed on payment basis
- Interest on delay in payment of TDS
- Delay in remitting ESI and PF contributions to the government

[2] Personal expenses cannot be claimed as business expenses

- No proper maintenance of documents like vouchers, invoices for the expenses incurred.

  Implications:
- If a particular expense is disallowed, then such amount shall be treated as income and will be taxed @ 30% + Surcharge + Cess.
- This becomes an additional burden for Assessee. Therefore, it will be the duty of the Assessee to comply with the provisions of the law and make sure that he can claim the expenses.

[3] If the expenditure is prohibited, it cannot be deducted from taxable income

The provisions for disallowance of expenses are overriding and must be applied first. The first requirement in determining whether a particular expenditure is deductible or not is to determine whether the deduction is expressly prohibited under any other provision of the Income Tax Act. If the expenditure is not prohibited, it can be deducted from taxable income. However, if any expenditure is not allowable due to any provisions, it cannot be claimed. Certain expenses are prohibited by specific and general provisions.

Chapter - 3

Expenditure - Meaning and Connotation

The word 'expenditure' is not defined in the Income Tax Act, 2025. The word 'expenditure' is, therefore, required to be understood in the context in which it is used. Section 34 enjoins that any expenditure not being expenditure of the nature described in sections 28 to 33, 44 to 49, 51 and 52 laid out or expended wholly and exclusively for the purpose of the business, shall be allowed in computing the income chargeable under the head 'profits and gains of business or profession'.

In these sections, the expression 'expenses incurred' as well as 'allowances and depreciation' have also been used. For example, depreciation and allowances are dealt with in section 33. Therefore, the Parliament has used the expression 'any expenditure' in section 34 to cover both. Therefore, the expression 'expenditure' as used in section 34 may, in the circumstances of a particular case, cover an amount which is really a 'loss', even though said amount has not gone out from the pocket of the assessee.

Principles of a fundamental character

There are certain principles of a fundamental character. The first is that capital expenditure cannot be attributed to revenue and *vice versa*. Secondly, it is equally clear that a payment in a lump sum does not necessarily make the payment a capital one. It may still possess revenue character in the same way as a series of payments. Thirdly, if there is a lump sum payment but there is no possibility of a recurrence, it is probably of a capital nature, though this is by no means a decisive test. Fourthly, if the payment of a lump sum closes the liability to make repeated and periodic payments in the future, it may generally be regarded as a payment of a revenue character and lastly, if the ownership of the money whether in point of fact or by a resulting trust be still in the taxpayer, then there is acquisition of a capital asset and not an expenditure of a revenue character.

Side by side with these principles, there are others which are also fundamental. The income-tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. The money may be expended on grounds of commercial expediency but not of necessity. The test of necessity is whether the intention was to earn trading receipts or to avoid future recurring payments of a revenue character. Expenditure in this sense is equal to disbursement which, to use a homely phrase, means something which comes out of the trader's pocket.

Legitimacy or necessity for expenditure cannot be probed into

Once the conditions laid down in section 37(1) are found satisfied, it is not proper on the part of the taxing authorities to probe into the question as to whether the expenditure is legitimate or necessary, etc. This type of inquiry is neither contemplated nor called for. It is only when the Assessing Officer finds that the claim made is bogus or false or not incurred as a fact, it can be disallowed, otherwise not. - [*Hemraj Nebhomal Sons v. CIT (2005) 278 ITR 345 : 146 Taxman 345 (MP)*]

Liability

'Expenditure' is not necessarily confined to the money which has been actually paid out. It covers a liability which has accrued or which has been incurred although it may have to be discharged at a future date. - [*Madras Industrial Investment Corporation Ltd. v. CIT (1997) 91 Taxman 340 (SC)*]

In finding out what profits there be, the normal accountancy practice may be to allow as expense any sum in respect of liabilities which have accrued over the accounting period and to deduct such sums from profits. But the income-tax laws do not take every such allowance as legitimate for purposes of tax. A distinction is made between an actual liability *in-praesenti* and a liability *de futuro* which, for the time being, is only contingent. The former is deductible but not the latter. - [*Indian Molasses Co. (P) Ltd. v. CIT (1959) 37 ITR 66 (SC)*]

The recurring liability of pension which is compressed into a lump payment should itself be a legal obligation, and that, if contingent, the present value of the future payments should be fairly estimable. If the pension itself be not payable as an obligation, and if there be a possibility that no such payment may be necessary in the future, the whole of the amount cannot be deducted but only the present value of the future liability, if it can be estimated.

Assessing authorities are empowered to enquire and investigate whether expenditure incurred for business/profession or not

There can hardly be any dispute on the proposition that the businessman is the best judge to determine the business expediency and, therefore, when he claims to have incurred a certain expenditure for business expediency his version should ordinarily be accepted. This principle, however, does not debar the assessing authorities to enquire and investigate as to whether such expenditure was actually incurred by the businessman and if incurred whether the same was incurred wholly and exclusively for business consideration. – [*Jaipur Electro (P) Ltd. v. CIT (1996) 89 Taxman 644 (Raj.)*]

Payments made by assessee for purchase of goods were covered by word 'expenditure' occurring in section 40A(3)

While scrutinising the return for the relevant assessment year the ITO noticed that the assessee-firm had paid against purchase of goods certain

amounts exceeding Rs. 2,500 but payments were not made either by crossed cheques or demand drafts. He, therefore, made addition of the amounts so paid to the total income of the assessee. On second appeal, the Tribunal held that the payments were covered by the term 'expenditure' occurring in section 40A(3) and, thus, upheld the addition so made by the ITO. On reference:

Held : The purpose of enacting section 40A(3) was clearly to prevent use of unaccounted money in carrying on business by purchases of stock-in-trade or raw materials or any payment of overhead expenses. The payments made for purchases would be covered by the word 'expenditure' occurring in section 40A(3) and such payments would be disallowed if they were made in cash, if the sum so paid exceeded Rs. 2,500 or more. There was no reason why the word 'expenditure' should be given a restricted meaning so as to refer to only overhead expenses enumerated in sections 30 to 43A. If the provisions of section 40A(3) are not held to apply to payments made for purchases of stock-in-trade or raw materials, then it would be defeating the intention of the Legislature as the purpose of preventing unaccounted money being used for clandestine transactions would be frustrated. In the instant case, the payments made by the assessee were undeniably made in respect of purchase of goods. Even if the payments were made by way of advances and were ultimately treated as discharging the liability to pay the price of the goods purchased, the payments so made must be considered to fall within the expression 'expenditure' incurred for payment of price of goods.

No exceptional or unavoidable circumstances were disclosed to exist by the assessee on account of which payments could be made in respect of the purchases in question by crossed cheques or bank drafts. The addition so made was beyond challenge and the order of the Tribunal was, therefore, justified in upholding the addition so made by the ITO. [In favour of revenue] - [*Kejriwal Iron Stores v. CIT (1988) 169 ITR 12 : (1987) 62 CTR 227: 31 Taxman 311 (Raj.)*]

Connection between expenditure and purpose must be real

All expenditure incurred by the assessee, though voluntary, i.e., not obligatory, which is ultimately designed to further the objects and purposes of the assessee can be treated as business expenditure so long as the connection between the expenditure and the object is real and not remote and illusory. - [*CIT v. Heath & Co. (Calcutta) (P) Ltd. (1978) 114 ITR 605 (Cal.); CIT v. Vazir Sultan Tobacco Co. Ltd. (1987) 35 Taxman 294 (AP)*]

Quantum of expenditure cannot be reduced unless provided so

Unless there is a limitation put by the law on the amount of expenditure, a lesser amount than the amount expended cannot be allowed merely because the assessing authority thinks that the assessee could have managed by paying a lesser amount as a prudent businessman. - [*Jamshedpur Motor Accessories Stores v. CIT (1974) 95 Taxman 664 (Pat.)*]

Actual delivery or parting with money is not required

The expression 'expenditure' denotes 'spending' or 'paying out or away', i.e., something that goes out of the coffers of the assessee. A mere liability to satisfy an obligation by an assessee is undoubtedly not an 'expenditure': it is only when he satisfies the obligation by delivery of cash or property or by settlement of accounts, there is 'expenditure'. But 'expenditure' does not necessarily involve actual delivery of or parting with money or property. If there are cross-claims - one by the assessee against a stranger and the other by the stranger against the assessee - and as a result of accounting the balance due only is paid, the amount which is debited against the assessee in the settlement of accounts may appropriately be termed 'expenditure' - [*CIT v. Nainital Bank Ltd. (1966) 62 ITR 638 (SC)*]

The word 'expenditure' has been interpreted by their Lordships of the Supreme Court with reference to the provisions of section 10(2)(xv) of the Indian Income-tax Act, 1922 in *Indian Molasses Co. (P) Ltd. v. CIT*. In the aforesaid case their Lordships observed that the idea of 'spending' in the sense of paying out or away of money is the primary meaning of 'expenditure'. 'Expenditure' is what is paid out or away and is something which is gone irretrievably. Therefore, for an amount to be an expenditure, it should be something which has gone out of the hands of the assessee irretrievably. For claiming deduction as 'expenditure', the amount should have been spent by the assessee as an amount paid out or paid away. To be a payment which is made irrevocably, there should not be any possibility of the money forming once again a part of the funds of the assessee. If this condition is not fulfilled and there is a possibility of there being a resulting trust in favour of the assessee, the money cannot be considered to have been spent by the assessee. The assessee cannot claim that he had spent out or away the amount which he seeks to get deduction of. - [*Indian Molasses Co. (P) Ltd. v. CIT (1959) 37 ITR 66 (SC)*]

Chapter - 4

Disallowance of Expenditure incurred in relation to Income exempt from Tax

[Section 14]

{Corresponding to Section 14A of the Income Tax Act, 1961}

Section 14 of the Income Tax Act, 2025 is a disallowance provision. This section provides that while computing the total income of any assessee, no deduction will be permitted in respect of any expense incurred in relation to any income which is exempt from income-tax.

Background

Section 14A of the Income Tax Act, 1961 was introduced to overcome the judgement of Supreme Court in *Rajasthan State Warehousing Corporation v. CIT (2000) 242 ITR 450 (SC)* wherein it was held that in case of an indivisible business, some income wherefrom is taxable while some exempt, entire expenditure would be permissible deduction and the principle of apportionment would apply only for an indivisible business.

The assessee was a State Government corporation who derived its income from interest, letting out of warehouse and administration charges for procurement of foodgrains. It claimed deduction of expenditure amounting to Rs. 38.13 lakhs under section 37 of the Income Tax Act, 1961. The ITO allowed only so much of the expenditure as could be allocated to the taxable income and disallowed the rest of it which was referable to the non-taxable income, being exempt under section 10(29) of the Income Tax Act, 1961. The Tribunal and the High Court confirmed the disallowance. Supreme Court laid down following principles:

(i) if the income of an assessee is derived from various heads of income, he is entitled to claim deduction permissible under the respective head, whether or not computation under each head results in taxable income;

(ii) if the income of an assessee arises under any of the heads of income but from different items, e.g., different house properties or different securities, etc., and income from one or more items alone is taxable whereas income from the other item is exempt under the Act, the entire permissible expenditure in earning the income from that head is deductible; and

(iii) in computing the "profits and gains of business or profession" when an assessee is carrying on business in various ventures and some among them yield taxable income and the others

do not, the question of allowability of the expenditure under section 37 of the Income-tax Act, 1961, will depend on:

(a) fulfilment of requirements of that provision; and

(b) on the facts whether all the ventures carried on by him constituted one indivisible business; if they do the entire expenditure will be a permissible deduction but if they do not, the principle of apportionment of the expenditure will apply, because there will be no nexus between the expenditure attributable to the venture not forming an integral part of the business and the expenditure sought to be deducted as the business expenditure of the assessee. - [*Rajasthan State Warehousing Corporation v. CIT (2000) 242 ITR 450 : 159 CTR 132 : 109 TAXMAN 145 (SC)*]

Memorandum Explaining the Introduction of Section 14A

Inserted by Finance Act, 2001, w.r.e.f. 01.04.1962

"………exemptions to certain categories of income are used to reduce also the tax payable on non-exempt income by debiting expenses incurred to earn the exempt income against taxable income. This is against the basic principle of taxation whereby only net income is taxed."

The intention of the legislature is not to allow the expenses which are incurred to earn the income exempt from tax.

Objective behind insertion of section 14A

The object behind the insertion of section 14A in the said Act is apparent from the Memorandum explaining the provisions of the Finance Bill, 2001 which is to the following effect:—

Explanatory memorandum of Finance Bill, 2001 whereby object behind section 14A was presented, as under:

"Certain incomes are not includible while computing the total income as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect means that the tax incentive given by way of exemptions to certain categories of income is being used to reduce also the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income. This is against the basic principles of taxation whereby only the net income, i.e., gross income minus the expenditure is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

It is proposed to insert a new section 14A so as to clarify the intention of the Legislature since the inception of the Income-tax Act, 1961, that no deduction shall be made in respect of any expenditure incurred by the assessee

in relation to income which does not form part of the total income under the Income-tax Act.

The proposed amendment will take effect retrospectively from April 1, 1962 and will accordingly, apply in relation to the assessment year 1962-63 and subsequent assessment years."

Objective behind insertion of section 14A with retrospective effect

The basic principle of taxation is to tax the net income, i.e., gross income minus the expenditure and on the same analogy the exemption, if any, is also in respect of net income. In other words, where the gross income did not form part of total income, its associated or related expenditure also, could not be permitted to be debited against other taxable income.

The stated intention of the Parliament, while introducing section 14A, was that it should appear in the statute book, right from its inception that, expenditure incurred in connection with income, which does not form part of total income is not intended to be allowed as a deduction. It can be said that the insertion of section 14A with retrospective effect reflects a serious attempt on the part of the Parliament not to allow deduction in respect of any expenditure incurred by the assessee in relation to income, which does not form part of the total income under the Act against the taxable income.

It is understood that in the case of an income like agricultural income which does not form part of the total income, any expenditure/deduction relatable to such (exempt or non-taxable) income, even if it is of the nature specified in sections 15 to 59 cannot be allowed against any other income which is includible in the total income.

The purpose for introduction of section 14A

Section 14A of the Act was inserted by the Finance Act, 2001 with retrospective effect from 01.04.1962. The purpose for introduction of section 14A of the Act with retrospective effect since inception of the Act was clarified vide Board Circular No. 14 of 2001 as under:

"Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect means that the tax incentive given by way of exemptions to certain categories of income is being used to reduce also the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income. This is against the basic principles of taxation whereby only the net income, i.e., gross income minus the expenditure, is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income".

The purpose of introducing this Circular [No. 14 of 2001] was explained by the Board in the Circular No. 5/2014—

"Thus, legislative intent is to allow only that expenditure which is relatable to earning of income and it therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial year or not."

Though the purpose of issuing this Circular No. 5/2014 was stated at para. 4 of Circular as "for invoking disallowance under section 14A, it is not material that assessee should have earned such exempt income during the financial year under consideration" the purpose for which amendment was made to section 14A of the Income-tax Act by the earlier Circular No.14 of 2001 as explained in para.1 above, nowhere mentioned that disallowance of interest is mandatory/compulsory even though no payment of interest can be attributed to exempt income. It is to be noted that the above referred circular was issued in 2014 after amendment to section 14A of the Income-tax Act with effect from assessment by clause 7 of memorandum explaining the provisions in the Finance Bill, 2006 as under:—

"Clause 7 of the Bill seeks to amend section 14A of the Income-tax Act relating to expenditure incurred in relation to income not includible in total income. The proposed amendment seeks to insert a new sub-section (2) in the said section so as to provide that where, having regard to the accounts of the assessee, the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to income which does not form part of the total income under the Act, the Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income, in accordance with such method as may be prescribed. It is proposed to confer power upon the Central Board of Direct Taxes to make rules to lay down the method for determining the amount of expenditure incurred in relation to such income which does not form part of the total income under the Act, for the purposes of the said section."

Accordingly Rule 8D was inserted by the IT (Fifth Amendment) Rules, 2008, with effect from 24.03.2008 wherein the formula to be adopted for working disallowance in appropriate cases was spelt out.

Text of Section 14 of the Income Tax Act, 2025

"14. Income not forming part of total income and expenditure in relation to such income

(1) Irrespective of anything to the contrary contained in this Act, for the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income.

(2) Where the Assessing Officer, having regard to the accounts of the assessee, is not satisfied with—

(a) the correctness of the claim of expenditure incurred by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under this Act, he shall determine such amount of expenditure in accordance with any method, as prescribed.

(3) Irrespective of anything to the contrary contained in this Act, the provisions of this section shall apply in a case where any expenditure has been incurred during any tax year in relation to income which does not form part of the total income under this Act, but such income has not accrued or arisen or has not been received during that tax year."

Text of Rule 14 of the Income Tax Rules, 2026

"14. Method for determining amount of expenditure in relation to income not includible in total income.

(1) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts:—

(a) the amount of expenditure directly relating to income which does not form part of total income; and

(b) an amount equal to 1% of the annual average of the monthly averages of the opening and closing balances of the value of investment, income from which does not or shall not form part of total income.

(2) The amount referred to in sub-rule (1) shall not exceed the total expenditure claimed by the assessee."

Scope of Rule 14 of the Income Tax Rules, 2026:

The amount of expenditure relating to income that does not form part of total income shall be the sum of:

(a) The expenditure directly relating to such exempt income; and

(b) An amount equal to 1% of the annual average of the monthly averages of the opening and closing balances of the value of the investments the income from which is exempt under the Act.

Limit:

The total of the direct expenditure (1(a)) and the 1% calculation (1(b)) shall not exceed the total expenditure claimed by the assessee for the tax year.

Practical Meaning

- When computing deductions linked to exempt income (such as dividends exempt from tax or other exempt receipts), Rule 14 provides a formulaic method to determine how much of your business or investment expenses can be attributed to that exempt income.
- Instead of arbitrary allocation, the rule creates a consistent calculation using investment values and a standardized percentage (1%).

Evolution of Section 14A of the Income Tax Act, 1961 & Rule 8D of the Income Tax Rules, 1962

The sequence of insertion of section 14A of the Income Tax Act, 1961 and issuance of allied Circulars/Notifications since its inception:

S. No.	*Amending Act/Rule*	*Amendment*	*Impact*
1.	Finance Act, 2001	Finance Act, 2001 has inserted section 14A in the Income Tax Act, 1961, with retrospective effect from 01.04.1962.	Provided for disallowance for expenses incurred in relation to income exempt from income-tax
2.	C B D T Circular No . 11/2001, dated 23.07.2001	PAST ASSESSMENT NOT TO BE REOPENED CBDT Circular No. 11/2001 was issued dated, 23.07.2001 regarding Clarification, regarding restriction on re-opening of completed assessments on account of provisions of section 14A.	In *V Uppalaiah v. DCIT (2005) 96 TTJ 706 (ITAT Hyderabad) and in Paul John Delicious Cashew Co v. ITO (2005) 94 ITD 13 (ITAT Cochin)*, the ITAT followed the said circular No. 11 of 2011 and held that reopening was invalid.
3.	Finance Act, 2002	A proviso to section 14A was inserted by the Finance Act, 2002 with retrospective effect from 11.05.2001.	Clarification that section 14A cannot be used to reopen/rectify completed assessment.
4.	Finance Act, 2006	Finance Act, 2006 revamped Section 14A inserting sub-sections (2) and (3) to section 14A with effect from 01.04.2007 thereby enabling to notify the method to compute the amount of disallowance under section 14A	Provided the methodology for computing the disallowance under section 14A
5.	IT (Fifth Amendment) Rules, 2008	Inserted Rule 8D by the IT (Fifth Amendment) Rules, 2008 vide Notification No. 45/2008, dated 24.03.2008 with effect from 24.03.2008 providing the formula for apportioning expenses related to exempt income.	Prescribes the mechanics for allocating expenses to exempt income

6.	CBDT Circular No. 5/2014, dated 11.02.2014	The CBDT issued Circular No. 5/2014, dated 11.02.2014, through which it has taken a view that disallowance of expenditure for earning exempt in come under section 14A read with Rule 8D would be attracted even if the corresponding exempt income has not been earned during the financial year, thereby superseding a few decisions rendered in this regard.	CBDT clarifies that disallowance under section 14A will be attracted even if no exempt income is earned during the financial year.
7.	IT (Fourteenth Amendment) Rules, 2016	Rule 8D(2) substituted by the Income–tax (Fourteenth Amendment) Rules, 2016, vide Notification No . 43/2016, dated 02.06.2016.	Whereby disallowance is restricted to 1% of the average monthly value of investments yielding exempt income, but not exceeding the actual expenditure claimed.

Definition of the term 'expenditure' and 'incurred'

The term 'expenditure' as used in the section means what is paid out or away, something which is gone irretrievably. Expenditure means something that a trader pays out from his pocket.

Expense has many forms, namely; accrued expense, administrative expense, business expense, capital expense, current expense, deferred expense, educational expense, entertainment expense, extraordinary expense, fixed expense, general administrative expense and medical expense, moving expense, operating expense, ordinary and necessary expense, organizational expense, put-of-pocket expense, prepaid expense, travel expense. The term "expenditure" as mentioned in Section 14A would take within its ambit not only direct expenditure but also all forms of expenditure regardless of whether they are fixed, variable, direct, indirect, administrative, managerial or financial.

The term "incur" has been defined at page 771. Black's Law dictionary, 7th edition as follows: "incur", "To suffer or bring on oneself (a liability or expense)".

Nexus between the income earned and the expense occurred

It is not sufficient if it is shown that there was an expense. It is necessary to establish that there is a nexus between the income earned and the expense occurred.

Expenditure incurred in relation to exempt income

Under this segment of issue, the following three points should be considered:—

(i) Section 14 talks of the relation between the expenditure and the exempt income.

(ii) Unless there is a direct and proximate connection between the exempt income and the expenditure, section 14 will not apply.

(iii) Section 14 has no application on the incidental exempt income.

Applicability of Section 14

Section 14A applies in the following cases:

(i) The assessee claims that there is no expenditure incurred for earning such exempted income.

(ii) The assessee has incurred the expenses to earn the exempted income, and such expenses are disallowed by the taxpayer.

(iii) The Assessing Officer is not satisfied with the correctness of the amount claimed for expenditure incurred.

(iv) The assessee has invested to earn exempted income.

Expenditure to be incurred actually and not notionally

The words 'in relation to income which is exempt under the Act', no doubt, appear to be broad at first impression, but on deeper examination, and read in conjunction with the word 'incurred', it seems that these are respective words, restricting the power of the Assessing Officer to estimate a part of the expenditure incurred by the assessee as relatable to the exempted income. It seems that implicit in the expression 'in relation to' is the concept that the Assessing Officer should be in a position to pinpoint, with an acceptable degree of accuracy, the expenditure which was incurred by the assessee to produce non-taxable income.

CBDT Circular No. 5/2014, dated : 11.02.2014

Subject: *Clarification regarding disallowance of expenses under section 14A of the Income-tax Act in cases where corresponding exempt income has not been earned during the Financial Year - Regarding*

Section 14A of the Income-tax Act, 1961 ('Act') provides for disallowance of expenditure in relation to income not "includible" in total income.

2. A controversy has arisen in certain cases as to whether disallowance can be made by invoking section 14A of the Act even in those cases where no income has been earned by an assessee which has been claimed as exempt during the financial-year.

3. The matter has been examined in the Board. It is pertinent to mention that section 14A of the Act was introduced by the Finance Act, 2001 with retrospective effect from 01.04.1962. The purpose for introduction of section