IN THE HIGH COURT OF KARNATAKA AT BENGALURU

DATED THIS THE 11TH DAY OF MARCH, 2016

PRESENT

THE HON'BLE MR. JUSTICE JAYANT PATEL

AND

THE HON'BLE MRS. JUSTICE B.V.NAGARATHNA

INCOME TAX APPEAL NO.471/2015

BETWEEN:

1. THE COMMISSIONER OF INCOME-TAX,
LTU, JSS TOWERS,
BSK III STAGE,
BANGALORE – 560 085.

2. THE DEPUTY COMMISSIONER OF INCOME-TAX,
LTU, JSS TOWERS,
BSK III STAGE,
BANGALORE – 560 085. ... APPELLANTS

(BY SRI: K.V. ARAVIND, ADVOCATE)

AND:

M/S. MICROLABS LTD.,
NO.27, K.C.N. TOWERS,
RACE COURSE ROAD,
BANGALORE.
PAN: AABCM2131N. ... RESPONDENT

*****

THIS ITA IS FILED UNDER SEC.260-A OF INCOME TAX ACT 1961, ARISING OUT OF ORDER DATED:05/03/2015 PASSED IN ITA NO.1412/BANG/2013, FOR THE ASSESSMENT YEAR 2009-2010.

THIS APPEAL COMING ON FOR ADMISSION THIS DAY, ***JAYANT PATEL J.,*** DELIVERED THE FOLLOWING:-

J U D G M E N T

The appellant has preferred the present appeal by raising two main substantial questions of law, which are as under:

i) *"Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in setting aside the computation made by the assessing authority in respect of claim for deduction under Section 35(2AB) of I.T.Act even when the assessing authority rightly adopted the net expenditure for allowing the weighted deduction and same was done on the basis of DSIR guidelines wherein it was stated that the receipts to the in-house R&D centre needs to be reduced from gross expenditure and in accordance with parameters of the provision?*

ii) *Whether on the facts and the circumstances of the case, the Tribunal was corrected in law in deleting the addition made under Section 14A computed under Rule 8D(2)(ii) amounting to Rs.49,42,473/- even when the assessing authority rightly quantified*

the aforesaid disallowance under Section 14A as per Rule 8D?

2. We have heard Mr. Aravind, learned counsel appearing for the appellant - Revenue.

3. On the first question, the observations made by the Tribunal in the impugned order from paragraph Nos.12 to 17 are as under:

"12. We have heard the submissions of the ld. DR and the ld. counsel for the assessee and also perused the documents filed in paperbook. As we have already seen, the assessee carries on scientific research. It is in the business of manufacture of drugs and pharmaceuticals. It incurred expenditure on scientific research and the quantum of such expenditure on scientific research, which is a sum of Rs.7,80,52,805, is not in dispute. The weighted deduction u/s. 35(2AB) at 150% was claimed by the assessee at a sum of Rs.12,57,00,920. What is now to be examined is the guidelines of DSIR, which the prescribed authority u/s.35(2AB)(3) & (4) of the Act, has to follow before granting approval of the scientific research carried out by the assessee as eligible for deduction u/s.35 (2AB). A copy of the guidelines of DSIR is at pages 27 to 33 of assessee's paperbook.

Guidelines 5(vii) is relevant for the present case and it reads as follows:

> *"(vii)* ***Assets acquired and products, if any emanating out of R&D work done in approved facility, shall not be disposed off without approval of the Secretary, DSIR.*** *Sales realization arising out of the assets sold shall be offset against the R&D expenditure of the R&D Centre claimed under section 35(2AB) for the year in which such sales realization accrues under section 35(2AB) of IT Act, 1961. Expenditure claimed for deduction under the subsection shall be reduced to that extent."*

13. The CIT(A) in his order passed u/s. 154 of the Act has not quoted the first sentence of the guideline 5(vii) (given above in bold letters), which in our opinion, is very material. The above guideline only means that in the process of carrying out the R&D work, if the assessee acquires any assets or products that should not be disposed of without the approval of Secretary, DSIR. If such assets are sold, the sales realization arising therefrom are to be setoff against the R&D expenditure of the R&D centre which is claimed as decuction u/s.

*35(2AB). It is evident from the above guideline that it is only sales realization arising out of the **assets sold** that should be offset against R&D expenditure. In respect of sale of products acquired emanating out of R&D work done in an approved facility, the sale proceeds need not be reduced from the R&D expenditure. In our view, the reason for not including sales realization arising out of products emanating out of R&D work done and sold is because such sales would be reflected as receipts by the assessee in its books of account and income from business would be computed treating such sale as part of business receipts. The receipts arising out of sale of products will not go to reduce the expenditure on R&D, whereas the assets acquired in the process of carrying out the R&D if they are sold, such sales realization would go to reduce the expenditure on scientific research and that is why sales realization arising out of assets sold is required to be offset against R&D expenditure. The above explanation will be sufficient to hold that the order passed by the CIT(A) u/s. 154 of the Act is unsustainable. Nevertheless, we will also examine as to what is the exact nature of receipts from sale of products.*

14. A copy of license and supply agreement which was filed by the assessee before the AO as well as CIT(A) is at pages 5 to 26 of the assessee's paperbook. The sale of products is nothing but the sale of Dossiers by the assessee to persons not associated with the assessee or its directors. In the course of carrying out the scientific research, the assessee prepares elaborate documents regarding the products that would emanate from carrying out scientific research. This would also include the requirement of health authorities for grant of license to approve the products for human use. The assessee gives the Dossiers so prepared to entities outside India, who are interested in getting the marketing authorization for the product in a particular territory. They pay to the assessee the Dossier charges and apply for license to market the products for human use in their respective territories. On getting the license, they get marketing authorization from the assessee. The person who takes the Dossier (knowhow) takes it for the limited purpose of registration of product in other countries and after registration sale of the products in their country. If they get any order M/s. Micro Labs will manufacture and sell them at agreed price. So the knowhow given to them is only for

limited purpose of registering with the drug control authorities for approval for human consumption. The foreign entities who get the dossiers will get rights to market the assessee's products in their territory and the actual manufacture in course of time will be done by M/s. Micro Labs Limited i.e., the Assessee.

15. All intellectual property rights, title and interest of any kind whatsoever in and/or to the Dossier and the Products shall be the exclusive property of MICRO LABS (the Assessee). MICRO LABS i.e., the Assessee may sell the Dossier to any third party, including its clients without the consent of foreign entity buying the dossier. However, MICRO LABS (the Assessee) shall notify the person acquiring the dossier of the transfer or sale of the Dossier to such third party and shall undertake that such third party respect the terms and conditions of the agreement with the other third party who buys dossier from the Assessee.

16. DSIR guidelines no. vii has specifically provided that assets acquired if any out of R & D work shall be disposed with approval of DSIR. The assessee has been submitting yearly audit reports & accounts of approved R

& D sanction to DSIR. The R & D accounts have been separately maintained and separate P & L Account prepared and the dossier sales have been credited to P & L Account of R & D because these sales are part of normal sales.

17. It is clear from the sample copy of the license and supply agreement filed before us that the product development charges received by the assessee will not be covered under clause 5(vii) of the DSIR guidelines. As we have already seen, these receipts are credited to profit & loss account are part of normal sales. They are, therefore, not to be reduced from the expenditure incurred by the assessee on carrying out scientific research on which deduction u/s. 35(2AB) has to be allowed. We are, therefore, of the view that there is no merit in ground No.2 raised by the revenue and that the order passed by the CIT(A) DATED 9.4.2014 U/S. 154 of the Act cannot be sustained and the same is hereby reversed. Thus, ITA No.764/B/14 by the assessee is allowed, while ground No.2 raised by the revenue is dismissed."

The aforesaid paragraphs show that the Tribunal has proceeded on the premise that when the regular work is in the nature of R&D work done and sold, it becomes a

business income and chargeable as business income. It is only when the assets acquired in the process of carrying on R&D work, if they are sold, such realization would go to reduce the expenditure of scientific research.

4. In our view, the approach to the issue considered by the Tribunal is appropriate. In any case, no substantial question of law would arise for consideration as canvassed.

5. For the second question, the observations made by the Tribunal in the impugned order reads as under:

> *"32. Ground No.2 raised by the assessee reads as follows:-*
>
> *"2. The learned Commissioner of Income Tax (Appeals) has erred in sustaining the additions made by the assessing officer u/s. 14A read with rule 8D on the ground that the appellant has not produced the evidentiary support in relation to dispersal of loan and utilization of loan. Whereas the appellant has produced the evidence that the amount invested was out of positive bank balance and no borrowings were utilized for the purpose of investment."*

33. The assessee earned dividend income of Rs.38,75,857. It quantified a sum of Rs.3,22,426 as expenditure incurred in earning tax free income dividend income which does not form part of the total income and which is to be disallowed u/s. 14A of the Act.

34. The break-up of the sum of Rs.3,22,426 is not specifically given, but is stated to be relating to management fee, legal & professional charges, security transaction charges and NSDL charges. It is thus clear that the assessee by implication had claimed that there was no expenditure incurred by way of interest, either directly or indirectly, which is attributable to the borrowed funds which were used for the purpose of investment which yielded tax free income.

35. The AO observed that Schedule G to the Financial Statements of the assessee had shown investment to the tune of Rs.28,45,29,937 in shares mutual funds of various companies. He was of the view that such investments cannot be made routinely. No prudent businessman would make any investment without applying the resources wisely. Obviously this entails expenditure, direct as well as indirect. He thereafter

proceeded to make disallowance u/s. 14A of the Act, which is given as annexure to the assessment order and enclosed as ***ANNEXURE-II to this order.***

36. Aggrieved by the assessment order, the assessee preferred appeal before the CIT(Appeals).

37. Before CIT(A), the assessee submitted that interest bearing loans were borrowed for specific purposes and not for investment purposes and in support of the above contention, the Assessee filed copies of balance sheets as on 31.03.2003 upto 31.03.2009 to show that the various loans availed from banks were all taken for specific purposes and could not have been utilized for making any investments out of which exempt income was earned. These loans include short term loans from IDBI Bank, Exim Bank, Barclays Bank and Standard Chartered Bank in respect of which it was explained that the loans could not have been used for making any long term investment. Copies of some communications from banks regarding sanction of the loans were also filed before me to substantiate the nature of the loan. In respect of IDBI loan, it was submitted that the same

had been returned back before the year end, thus bringing the balance to Nil.

38. On consideration of the above submissions and on perusal of the relevant documents, the CIT(A) was of the view that the claim of the Assessee was not evidenced from the documents submitted in view of the loans and other sources of funds being mixed up in the common pool of funds. The CIT(A) further held that the burden of proof in this matter clearly continues to rest with the Assessee and that it was not enough to merely show that surplus funds were available or that bank loans had been availed for specific purposes including short term reasons. A one-to-one correlation must also be established to prove that the loans were absolutely utilized for the purpose for which they were claimed. The CIT(A) also held that there was no utilization certificate from the bank filed before the AO nor was such evidence furnished before the CIT(A). The CIT(A) also held that the documents submitted from the bank during the course of appeal only refer to the disbursal of the loan and even these specify certain conditions required to be met. The date-wise actual disbursal and utilization is not proved from the ledger copies as submitted. The CIT(A) also referred to the decision of Mumbai

ITAT in the case of Hercules Hoists Ltd. (ITA No.7944, 7946, 2255 & 7943/mum/2011), wherein it was held that with the introduction of Rule 8D the burden of proof on the assessee has become "more stringent, so that rather than showing existence of sufficient capital, the matter would be required to be examined from the stand point of utilization of the borrowed interest bearing funds." In the absence of categorical utilization certificate from the bank, the CIT(A) was of the view that there was no evidentiary support of the assessee's claim. Hence, the disallowance u/s.14A of the Act as made by the AO was upheld by the CIT(A).

39. Aggrieved by the order of CIT(A), the assessee has raised ground No.2.

*40. We have heard the rival submissions. A copy of the availability of funds and investments made was filed before us which is at pages 38 to 42 of the assessee's paperbook and the same is enclosed as **ANNEXURE-III to this order**. It is clear from the said statement that the availability of profit, share capital and reserves & surplus was much more than investments made by the assessee which could yield tax free income.*

41. The Hon'ble Bombay High Court in Reliance Utilities & Power Ltd. 313 ITR 340 (Bom) has held that where the interest free funds far exceed the value of investments, it should be considered that investments have been made out of interest free funds and no disallowance u/s. 14A towards any interest expenditure can be made. This view was again confirmed by the Hon'ble Bombay High Court in CIT v. HDFC Bank Ltd., ITA No.330 of 2012, judgment dated 23.7.14, wherein it was held that when investments are made out of common pool of funds and non-interest bearing funds were more than the investments in tax free securities, no disallowance of interest expenditure u/s. 14A can be made.

42. In the light of above said decisions, we are of the view that disallowance of interest expenses in the present case of Rs.49,42,473 made under Rule 8D(2)(ii) of the I.T. Rules should be deleted. We order accordingly."

The aforesaid shows that the Tribunal has followed a decision of the Bombay High Court in the case of ***CIT v. HDFC Bank Ltd., (ITA No.330/2012 disposed of on 23/7/2014)***. When the issue is already covered by a decision of the High Court of Bombay with which we

concur, we do not find any substantial question of law would arise for consideration as canvassed.

6. In view of the above observations, the appeal is dismissed.

Sd/-
JUDGE

Sd/-
JUDGE

*S**