

-आयकर अपीलीय अधिकरण, अहमदाबाद न्यायपीठ - अहमदाबाद।

IN THE INCOME TAX APPELLATE TRIBUNAL
AHMEDABAD – BENCH ‘A’
[Conducted Through Virtual Court]

**BEFORE SHRI RAJPAL YADAV, VICE-PRESIDENT
AND
SHRI AMARJIT SINGH, ACCOUNTANT MEMBER**

ITA No.1735/Ahd/2019
निर्धारण वर्ष/ Asstt.Year: **2013-14**

Harsha Engineers Ltd. Sarkhej Bavla Road Changodar Ahmedabad 382 213. PAN : AAACH 4828 C	Vs.	DCIT, Cir.2(1)(1) Ahmedabad.
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(Applicant)		(Responent)
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Assessee by :	Shri Tushar Hemani, AR
Revenue by :	Shri L.P. Jain, Sr.DR

सुनवाई की तारीख/Date of Hearing : 10/09/2020

घोषणा की तारीख /Date of Pronouncement: 05/10/2020

आदेश/O R D E R

PER RAJPAL YADAV, VICE-PRESIDENT

Assessee is in appeal before the Tribunal against order of the ld.CIT(A)-2, Ahmedabad dated 24.10.2019 passed for the Asstt.Year 2013-14.

2. Assessee has taken seven grounds of appeal, wherein issues agitated by it revolve around two aspects. In ground no.1, the assessee has challenged reopening of the assessment by issuance of notice under section 148 of the Income Tax Act, 1961. However, at the time of hearing, no arguments were advanced by the ld.counsel for the assessee,

and therefore, we do not deem it necessary to comment on this issue. This ground is rejected.

3. Under ground no.2 to 4, the assessee has challenged disallowance of alleged R&D expenditure amounting to Rs.10,42,41,078/-.

4. Brief facts of the case are that the assessee has filed its original return of income on 31.8.2013 declaring total income at Rs.27,37,55,058/-.. An assessment order under section 143(3) was passed on 11.2.2016 wherein the income was assessed at Rs.28,28,48,150/-. The AO thereafter harboured a belief that the assessee has claimed expenditure of Rs.11,65,15,1456/- on R&D, but capitalized a sum of Rs.1,22,74,378/-. He was of the view that the revenue expenditure amounting to Rs.10,42,41,078/- claimed by the assessee as revenue expenditure ought to have been capitalized, and thus by making claim of this amount as revenue expenditure on R&D, income has escaped assessment. The AO, therefore, reopened the assessment and issued notice under section 148 on 30.3.2018. In response to the notice, the assessee has filed return and declared total income at Rs.27,39,79,540/-. The assessee has raised objection for reopening of the assessment, and this was rejected by the AO. He issued notice under section 143(2) as well as 142(1) of the Act. The AO has issued detailed show cause notice on 23.10.2018 which has been reproduced in paragraph-3 of the assessment order. Relevant part of this notice reads as under:

“6. It is relevant to mention here that the case of the assessee was reopened on findings that the assessee company has made total expenditure of Rs. 11,65,15,456/- on R&D and out of said total

expenditure, Rs. 1,22,74,378/- was shown as capital expenditure and remaining Rs. 10,42,41,078/- was claimed as recurring expenditure. It remains self established that recurring expenditure on R&D results in generating enduring benefits which was required to be capitalized. It was further noticed from computation of income that recurring expenditure of Rs. 10,42,41,078/- on R&D was not capitalized while arriving taxable income. Further, on this issue, the assessee has not fully and truly disclosed the material facts necessary for its assessment for the year under consideration. Moreover, the issue under consideration was never examined by the AO during the course of assessment proceedings and the material facts relevant for the assessment on this issue were not filed during the course of assessment proceedings. Thus, income of Rs. 10,42,41,078/- has escaped assessment.

7. Vide, above stated notice, relevant details has been called for to finalize the assessment proceedings. However, assessee has been failed to submit the details despite sufficient opportunities and time have been given. In view of the noting in above paragraphs and time barring nature of proceedings i.e. time barred on 31.12.2018, it can be construed that the assessee willfully tried to make delay in proceedings in its case to left insufficient time with the undersigned to do thorough investigation and verification which is required in assessee case.”

5. In response to this notice, the assessee has filed a detailed reply which has been reproduced by the AO, and we deem it necessary to take note of this reply in order to appreciate the stand of the assessee. It reads as under:

“4. In response, the assessee has submitted its reply. The undersigned, keep in mind issue in question, has carefully examined and verified the submission filed by the assessee and found not acceptable. Gist of assessee's submission is herein under;

We are engaged in the activity of manufacturing bearing cages with steel, brass and polyamide material and stamped auto components with steel material. We are a core engineering

company. These cages are being of specified measurement and are to be manufactured with the specified tools only. Both tools and cage size differs from customer to customer and order to order of various customers.

The customers provide us with the drawing and specifications at the time of each quotation/development to manufacture required bearing cages and stamped auto components. To manufacture such parts/cages, we have to evaluate various kinds of needs viz. need of material, technology, equipments, tools etc. After considering all above requirements and making them available, a sample is- being prepared which is sent to customers for their approval.

Further, the company have a dedicated development and innovation center at changodar plant and state of art tool manufacturing unit and changodar. These primary activities are being carried out to catch the emerging trends such as supply of very clean bearing to reduce noise by supplying clean cages, to develop right geometry of cage to reduce energy loss due to friction and allow bearings to consider extra load carrying capacity, increasing line production speed to make product most cost competitive so as to provide high quality product at a lesser price.

We had incurred expenditure on R&D aggregating to Rs. 11,65,15,456/- out of which, Rs. 1,22,74,378/- was capital expenditure and Rs. 10,42,41,078/-was recurring expenditure. The said fact is evident from the annual report. The company have not claimed any amount of deduction u/s. 35(2AB) of the Income Tax Act, 1961 during the year under consideration.

The assessee further stated that there is no specific head of "R&D expenses" in the profit and loss account under which, the underlying expenses have been debited. The said expenses were debited in eight different expenses head i.e. Raw material, Stores, Power & Fuel, Operative expenses, Salary & Wages, Administrative expenses, Depreciation and Selling & Packing Expenses. Such expenses have been incurred in the course of normal business activities and the same are revenue in nature. However, while preparing the Annual report, we have suo-motto classified a portion of such expenses towards R&D activities for the purpose of disclosure and compliance as per the companies

act. The following table shows the total of such eight expenses and the portion that has been classified as R&D expenses (though it is a production expenses);

(Rs. In Lakhs)

S.No.	Particular	Total Expenses	R&D expenses	Proportion of R&D exps. (%)
1	Raw material	13258.98	100.43	0.76
2	Stores	1358.74	74.79	5.50
3	Power & fuel	816.4	58.34	7.15
4	Operative exps	689.4	103.14	14.96
5	Salary & Wages	2746.85	524.36	19.09
6	Administrative exps	2139.09	32.43	1.52
7	Depreciation	1473.42	146.59	9.95
8	Selling & Packing exps.	785.59	2.34	0.3
	Total	23268.47	1042.41	4.48

The said eight different expenses are very much revenue in nature and forms miniscule part of above stated eight different expenses head. Further, when the larger part of the concerned type of expenditure is accepted, question of disallowing miniscule part of the same does not arise merely on the count that the same has been shown as R&D in the director's report.

In our case, all the criteria prescribed under section 37 of the Act are fulfilled as these expenses are not covered by section 30 to 36 of the Act. Further these expenses are not in capital in nature since neither any capital asset has come into existence consequent to incurring such expenses nor any enduring benefit has accrued to us for a period of more than one year. Further, the expenses are not at all out personal expenses. Further, these expenses have undoubtedly been incurred wholly and exclusively for our business.

Thus, the expenses in question are very much revenue in nature and hence, no disallowance is called for in respect of the same by treating it as capital expenses.”

6. The Id.AO thereafter gone through submissions of the assessee. He rejected contentions of the assessee and recorded a finding that the expenditure of Rs.10,42,41,078/- was incurred for development of new product range as well as valued engineering of existing product ranges and same resulted into enduring benefit to the assessee. He accordingly disallowed the claim of the assessee for revenue expenditure, and treated this expenditure as capital in nature. However, in spite of that, he did not allow depreciation to the assessee. Dissatisfied with the order of the AO, the assessee carried the matter in appeal before the Id.CIT(A). The Id.CIT(A) rejected the contentions of the assessee and affirmed the finding of the Id.AO.

7. Before us, while impugning the order of the AO, the Id.counsel for the assessee appraised us business activities of the assessee. He filed a note as Annexure-A. He submitted that these activities were explained to the AO and also pleaded in the reply filed in response to the notice under section 142(1). For buttressing his contentions, he took us through the pleading made in the reply reproduced in paragraph-4 at page no.4 & 5 of the assessment extracted (supra). The note submitted by the Id.counsel for the assessee reads as under:

“Assessee is engaged in the activity of manufacturing bearing cages with steel, brass and polymide material and stamped auto components with steel material. Assessee is a core engineering company. Assessee consistently focuses on continuous learning experience to produce world class products. Since inception in 1972, assessee has leveraged continuous customer engagement to embed world class manufacturing practices thriving on an ecosystem of precision engineering.

Assessee manufactures products as per "specific requirements of customers". Broadly, the following activities are being carried out by the assessee:

- *Customers provide drawings and specifications required for bearing cages and stamped auto components;*
- *To manufacture the same, assessee needs to evaluate various kinds of needs viz. need of material, technology, equipment, etc.;*
- *Assessee also needs to gauge the tolerance requirement by doing feasibility study, define flow of the process and prepare tool drawings;*
- *Assessee also needs to resort to simulation and trial runs;*
- *Eventually, a sample is prepared and sent to customer for approval;*
- *Based on feedback, internal as well as external, final flow of process is decided and required automation is done for mass production;*

In order to carry out the aforesaid activities, the assessee herein has following three Departments:

- *Designing and Engineering Department;*
- *Tool Room Department;*
- *Product Development Cell department;*

Details of activities being carried out in the aforesaid three Departments were explained to AO vide letter dated 11.10.18 (Pgs.83-96 @ 85-87 of P/B);

Assessee has dedicated development and innovation centre at Changodar plant and state of art tool manufacturing facilities at Changodar. "R & D activities" are being out to capitalize on emerging trends such as very clean bearing to reduce noise by supplying clean cages, to develop right geometry of cage to reduce energy loss due to friction and allowing bearing for extra load carrying capacity, increasing line production speed to make product most cost competitive for new product development and process improvement in different types of bearing cages.

Efforts put in for R & D has helped the assessee to meet the customer needs in accordance with delivery schedules. With assessee's expertise in design and manufacturing complex tooling components in house, assessee has engaged with its customers, developing and manufacturing many products to meet their changing requirements."

8. The Id.counsel for the assessee raised two fold submissions. In his first fold of contentions, he pleaded that this expenditure deserves to be allowed as revenue expenditure to the assessee. The AO failed to appreciate the contentions of the assessee while presuming that incurrence of this expenditure would bring in new product range/process improvement and cost effectiveness in existing products. The Id.counsel for the assessee while repelling the reasons of the AO, submitted that the assessee manufactures customized cages based on specific requirement of the customers as against uniform products. Therefore, no new product which has an independent market was ever developed by the assessee as such. Similarly, as far as process improvement and cost effectiveness in existing product is concerned, the expenditure were incurred keeping in mind the quality of existing products of the assessee, and the same cannot be treated as capital in nature. For buttressing his contentions he relied upon judgment of the Hon'ble Gujarat High Court in the case of CIT Vs. Arvind Products Ltd., 93 taxmann.com 454 (Guj). He placed on record copy of the judgment.

9. In the alternative contention, he submitted that under section 35 of the Income Tax Act, even this expenditure is being treated as capital in nature, then also it is allowable. On the other hand, the Id.DR relied upon orders of the Revenue authorities.

10. We have duly considered rival contentions and gone through the record carefully. It is pertinent to observe that in order to claim expenditure under section 37(1) of the Income tax Act, the assessee is required to fulfill certain conditions viz. (a) there must be expenditure,

(b) such expenditure must not be of the nature described in sections 30 to 36, (c) the expenditure must not be in the nature of capital expenditure or personal expenditure of the assessee, and (d) expenditure must be laid out or expended wholly and exclusively for the purpose of business or profession. The expression “wholly” employed in section 37 refers to quantification of expenditure while expression “exclusively” refers to the motive, objective and purpose of the expenditure. A particular expenditure, whether revenue or capital in nature, must be determined on consideration of all the facts and circumstances, and by the application of principles of commercial needs, and must be viewed in the larger context of business necessity or expediency. If the expenditure is so related to the carrying on or conduct of the business, that may be regarded as an integral part of the profit-earning process and not for acquisition of an asset or an asset of a permanent character, the expenditure may be regarded as revenue expenditure, otherwise, such expenditure which creates an enduring advantage to the assessee would be in the nature of capital expenditure and not an allowable.

11. In the light of the above, let us evaluate the product manufactured by the assessee or its business activity. The assessee has emphasised before the AO that it is engaged in the manufacturing of bearing cages with steel, brass and plymide material and stamped auto components with steel material. According to the assessee, it is a core engineering company. These cages are being of specified measurement, and are to be manufactured with specified tools only. Both tools and cages differ from customer to customer and order to order of various customers. In other words, the customer gives drawings and specification requirement

for manufacturing of bearing cages and stamped auto components. The assessee would evaluate various kinds of needs i.e. material, technology, equipment etc. Thereafter, it will prepare a sample product, and if finalized by the customer, then the product will be manufactured as per requirement of the customers. Now, while evaluating this manufacturing activity of the assessee, the Id.AO took a very simplistic view. He analysed breakup of the expenditure which has been tabulated in the reply of the assessee and extracted by us in the upper part of this order. He was of the view that the assessee had itself segregated certain expenditure amounting to Rs.104.41 lakhs but debited this R&D Expenditure as revenue expenditure. He was of the view that it would give enduring benefit to the assessee, and therefore, this should be capitalized. According to us, Id.AO lost sight in appreciating the business activity of the assessee particularly product made by the assessee for a particular customer. In that exercise, the assessee would need material, technology, equipment and tools. It may have to design certain dies, certain tools and that exercise would call for deployment of material, fuel, tangible and intangible technical knowhow etc. It is not necessary that a particular bearing cages or stamped auto tool manufactured by the assessee for a particular customer will be uniformly required by others. Auto part design for a particular model of a particular auto design/program may not be of any use for other customers. Therefore, we are of the view that the AO has generalized the activities while treating this expenditure as a capital in nature. In the past also, there was no such disallowance. It is also pertinent to mention that during the course of hearing, the Id.counsel for the assessee relied upon following the judgments, viz. Empire Jute Co. Ltd. Vs. CIT, 3

taxmann 69 (SC); CIT Vs. Coal Shipments P.Ltd., 82 ITR 902 (SC) and Devidas Vithaldas & Co Vs. CIT, 84 ITR 277 (SC) and contended that every expenditure which has resulted into some of sort of enduring benefit cannot be straight away treated as expenditure, which is capital in nature.

12. Apart from the above, the assessee has demonstrated that it has not created any specified head of R&D expenditure in the P&L account. It has demarcated all these expenditure under various heads which are tabulated in its reply and reproduced in the assessment order. Out of that, assessee itself has pointed out that only 4.48% expenditure at the most could be debited to R&D would be exhausted according to the finalization of specification and design of the product by a customer. It is also pertinent to note that as far as genuineness of incurrence of expenditure is concerned, that has not been doubted by the AO. Any expenditure incurred by an assessee for the purpose of business, wholly and exclusively is to be reimbursed either by allowing as revenue or by depreciation, which will recoup the cost over a period of time. But in the present case, the AO has not even granted depreciation. Therefore, overall analysis of the record would indicate that the assessee has incurred this expenditure for fulfilling the requirement of a specified product required to be supplied to a particular customer. The raw-material, tools designs ultimately determined by the assessee and used for manufacture of customised products were not meant for uniform application for other customers also, and therefore the expenditure incurred for development of customized products and manufactured and sold by the assessee need not to be capitalized. These are to be treated

as revenue expenditure and deserve to be allowed under section 37 of the Income Tax Act.

13. Alternative argument has been raised by the assessee even in that case the expenditure is allowable under section 35 of the Act. The ld.counsel for the assessee took us through section 35(1)(iv) and 35(2)(ia) as well as judgments of Hon'ble Gujarat High Court in the case of CIT Vs. Gujarat Aluminium Extrusions, 263 ITR 453 (Guj). On the other hand, the ld.DR submitted that no such plea was raised before the AO, and the issue was not examined by the AO with the above angle.

14. We have duly considered rival submissions and gone through the record carefully. We deem it take note of the relevant provisions, which reads as under:

Section 35(1)

.....

(iv) in respect of any expenditure of a capital nature on scientific research related to the business carried on by the assessee, such deduction as may be admissible under the provisions of sub-section (2) :

Section 35(2)(ia)

.....

(ia) in a case where such capital expenditure is incurred after the 31st day of March, 1967, the whole of such capital expenditure incurred in any previous year shall be deducted for that previous year :

15. A bare perusal of the above provision would indicate that if an assessee has incurred expenditure on R&D and its capital in nature, then also it is to be allowed under these provisions. At the time of hearing,

judgment of Hon'ble Gujarat High Court cited before us and the relevant part of the same reads as under:

"18. We have heard the learned advocates at length and have considered the judgments cited before this, court.

19. The object behind the enactment of Section 35 of the Act is to encourage research and development activities by the assessee. As an incentive, the Legislature has given this benefit by way of deduction in respect of the capital expenditure incurred by the assessee. This is a provision for the benefit of the assessee and if the assessee incurs capital expenditure for the purpose of research and development during the relevant previous year, in our opinion, the Revenue should not deprive the assessee of the benefit of deduction under the provisions of Section 35 of the Act even if the asset is not put to use for research and development. It is a settled legal position that the provision for exemption or relief should be construed liberally and in favour of the assessee. If the section is interpreted in the manner suggested by standing counsel for the Revenue, in our opinion, we would be depriving the assessee of the benefit which the Legislature desires to give to the assessee.

20. It is also pertinent to refer to Circular No. 5-P (LXXVI-63) of 1967 dated October 9, 1967, issued by the Department. The relevant extract of the said circular reads as under :

“(ii) The amount of capital expenditure incurred by an assessee after March 31, 1967, on scientific research related to his business will be allowed to be deducted in full in computing his business profits of the year in which such expenditure is incurred.”

21. From the provisions of the above referred to circular also, the intention of the Revenue is patent. The intention is to give benefit to the assessee who incurs expenditure on scientific research related to his business. Even the circular issued by the Department does not make use of the capital asset a condition precedent for claiming deduction under the provisions of Section 35 of the Act.

22. In our opinion, both the appellate authorities have rightly considered the spirit with which Section 35 of the Act has been enacted by the Legislature and the circular referred to hereinabove while

allowing deduction to the assessee under the provisions of Section 35 of the Act.

23. We are of the view that when the Legislature has not expected the assessee to put the asset to actual use, it would not be open to the Revenue to deprive the assessee of the benefit of deduction under the provisions of Section 35 of the Act if the asset is not used in the previous year in which the capital expenditure is incurred.

24. It is also relevant to note that the deduction is given not on the count of user. Had it been so, the assessee would have been given benefit in the nature of depreciation. It cannot be disputed that depreciation is allowed when the asset is used by the assessee and when he suffers loss on account of wear and tear of the asset. Had the intention of the Legislature been to grant additional depreciation, we would have agreed with the submissions made by standing counsel appearing for the Revenue but the position is different in the instant case. Here, the Legislature wants the assessee to spend more amount for scientific research and it also wants the assessee to get the benefit immediately in the year in which he incurs the expenditure in the nature of revenue or capital for scientific research and therefore the Legislature refers to incurring of the expenditure and not the using of the asset.

25. Once it is established that the expenditure was incurred for the purpose of scientific research and the conditions incorporated in Section 35 of the Act are fulfilled, in our opinion, the Revenue cannot expect the assessee to start using the asset immediately. In a given case the assessee might have to go on incurring expenditure for several years before putting the asset to actual use. If the interpretation advanced by standing counsel for the Revenue is accepted, we are afraid, the assessee would not be in a position to avail of the deduction under Section 35 of the Act to the extent to which the Legislature intends to give to the assessee.

26. It is also pertinent to note that the deduction under the provisions of Section 35 of the Act is given only during the previous year in which the expenditure is incurred. If the assessee has taken several years to construct or acquire a particular asset, the assessee would be deprived of the benefit of Section 35 of the Act because he can put the asset to use only when construction of the asset is completed and it would not be open to him to claim deduction in respect of the expenditure incurred during the earlier previous years because looking to the

provisions of Section 35 of the Act, the assessee can avail of the benefit of deduction of the amount of expenditure incurred only during the previous year and not for the earlier period unless his case is covered under the provisions of an exception to Section 35(2)(ia) of the Act.”

16. If we analysis the nature of the expenditure noted by the AO in the reply of the assessee reproduced on page no.5 and extracted (supra) then it would indicate that these are the expenditure which were incurred by the assessee for preparing pro-type or preparing a product specifically required by its customers. In other words, it has incurred certain expenditure for development on a mechanism which can help it to produce a product specifically demanded by a specific customer, and according to the needs of that customer. If any amount is being incurred towards R&D for the purpose of business for manufacturing customized products, then that can be considered under R&D which can be allowed under section 35(1)(iv) r.w.s. 35(2)(ia) of the Act. In view of the above discussion, we are of the view that the claim of the assessee deserves to be allowed, and delete disallowance of Rs.10,42,41,078/-.

17. Ground no.7 is general ground, which does not call for recording of any finding, hence rejected.

18. In ground no.5 the assessee has challenged levy of interest under section 234A, 234B and 234C of the Act. It is consequential in nature, and hence rejected.

19. In ground no.6, the assessee has challenged initiation of penalty under section 271(1)(c) of the Act. It is premature at this stage. Assessee will get a fresh opportunity to adjudicate whether penalty is to

be imposed upon the assessee or not. Hence, this ground of appeal is also rejected.

20. In the result, appeal of the assessee is partly allowed.

Order pronounced in the Court on 5th October, 2020 at Ahmedabad.

**Sd/-
(AMARJIT SINGH)
ACCOUNTANT MEMBER**

**Sd/-
(RAJPAL YADAV)
VICE-PRESIDENT**