Tax Review/Taxation

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The Development of Islamic Finance

by
*Davy Yun and Finsen Chan**

Recognizing the opportunities provided by the tremendous growth in Islamic financial products, Hong Kong has recently introduced a bill to amend its tax laws to provide a tax-neutral environment to promote the sector. This article looks at the proposed changes and the possibilities it could bring in positioning Hong Kong as an Islamic finance hub.

1. Introduction

The promotion of Islamic finance was articulated as a key policy initiative by the Hong Kong Chief Executive in 2007. After rounds of consultation and refinement, a 200-plus page legislative Bill amending both the Inland Revenue Ordinance and the Stamp Duty Ordinance was introduced and is due to be passed in 2013. The measures in the Bill are designed to provide a level playing field for Islamic finance from a Hong Kong tax perspective. Given Hong Kong's emphasis on maintaining its simple tax system, the scale of the proposed changes is remarkable.

This article looks at the proposed changes and explores Hong Kong's potential to become an Islamic finance hub from a tax perspective. The value of Islamic finance assets worldwide, estimated at USD 1.34 trillion in 2012, is growing at a compounded annual rate of 15% to 20%. During the global financial crisis, Islamic finance assets demonstrated their superior stability compared to traditional financial products due to their linkage with tangible assets (as compared to derivatives created under the conventional finance system). Recognizing the potential of the system, a number of countries have already taken steps to facilitate and promote Islamic finance and have become Islamic financial hubs. One approach, which has been adopted by countries such as Japan, Malaysia, Singapore and the United Kingdom, is to amend the domestic tax rules to make them conducive to an Islamic finance market.

As a reputable international financial centre, Hong Kong is well positioned to become a regional Islamic financial hub. Prior to analyzing the proposed legislative changes in Hong Kong, one should first look at what Islamic finance actually is.

2. What is Islamic Finance?

Very broadly speaking, the two fundamental characteristics of Islamic finance in which it differs from traditional are as follows:

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– Muslims may not invest in certain prohibited businesses, e.g. those related to alcohol, pork-related products, conventional financial services which involve the charging of "interest", gambling, tobacco, etc.;[1] and

– the charging or paying of "interest" is prohibited.

Although sharia law prohibits the charging or paying of interest, it does not preclude other forms of return on an investment such as rent or profits that the parties agree on at the time the contract is entered into.

3. Sharia-Compliant Products

Most discussion of Islamic finance concerns the various investment and bond arrangements arising from the prohibition of charging or paying. However, the prohibition on certain types of investment is no less important as it determines the types of investments Muslims can undertake. Jurisdictions without a large Muslim population can design products that will attract investment from Muslim jurisdictions. Accordingly, various jurisdictions have facilitated the setting up of funds encompassing investments that meet the "type of investment" criteria, and Hong Kong is no exception.

The Dow Jones Islamic Market China and Hong Kong Titans Index was set up in 2007, following the Chief Executive's policy speech in the same year, to track the performance of the 30 largest Hong Kong sharia-compliant listed companies with primary operations in Hong Kong and Mainland China. The Hang Seng Islamic China Index Fund is one of the funds that invest in such index constituent stocks (i.e. Hong Kong-listed shares, including "H shares"[2]). In short, Hong Kong has had mechanisms to attract investment from the Islamic population since 2007. Due to the rapid and continuing economic growth of China, more funds are investing directly into sharia-compliant Chinese companies listed on the Shanghai or Shenzhen stock exchanges through the Qualified Foreign Institutional Investor (QFII) programme, even though an Islamic tracking index has not yet been set up for "A shares".[3] The QFII programme, launched in 2002 in China, permits licensed foreign investors to buy and sell yuan-denominated A shares on the Shanghai and Shenzhen stock exchanges. From both Chinese and Hong Kong tax perspectives, it is advantageous to use a Hong Kong company as the vehicle investing in A shares under the QFII programme. One of the key benefits is the potential savings in

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[1] In addition to the categories of prohibited businesses, other criteria would include certain financial ratios that are intended to remove companies with specific debt and interest income levels in their balance sheets in accordance with Islamic law.

[2] "H" shares are shares of companies established in Mainland China that are traded on the Hong Kong stock exchange.

[3] "A" shares are shares of companies established in Mainland China denominated in renminbi currency that are traded on the Shanghai and Shenzhen stock exchanges. In general, A shares cannot be bought and sold by non-Chinese individual or companies unless through the QFII programme.

Chinese enterprise income tax under the China-Hong Kong tax arrangement when the Hong Kong company disposes of the shares of the Chinese company, provided (i) the Hong Kong company does not own 25% or more of the Chinese company at any time within the 12-month period before the date of disposal; and (ii) the Chinese company is not a landrich company.[1] Under the QFII programme, no single foreign investor is permitted to hold more than 10% of a Chinese company, so under the double taxation arrangement, such disposal gains may only be taxed in Hong Kong and may not be taxed in China. In Hong Kong, gains derived from the disposal of A shares traded only on a Chinese stock exchange are offshore-sourced and therefore non-taxable, which effectively means that such gains are potentially free of both Chinese and Hong Kong income taxes. However, it is not entirely certain that in these circumstances the Chinese tax authorities would accept the Hong Kong investment vehicle, which may simply be holding the investments on behalf of other investors, as the beneficial owner of the Chinese company whose shares are disposed of under Chinese tax law.

4. Investment Arrangements

Since the charging or payment of "interest" is prohibited under sharia law, alternative arrangements (i.e. investment arrangements) have to be deployed. Hong Kong's proposed legislation deals with the following types of arrangements:[2]

- *Ijarah (leaseback arrangements);*
- *Musharakah and Mudarabah (profit-sharing arrangements);*
- *Murabahah (purchase and sale arrangements); and*
- *Wahalah (agency arrangements).*

Under these arrangements, "interest" is replaced by another form of reward, such as rent or profits. Below are some examples demonstrating how these investment arrangements may work in practice.

In an *Ijarah* arrangement (see Diagram 1), the borrower may wish to borrow using its own property as collateral. To achieve this in a sharia-compliant manner, the lender would purchase the property and then lease it back to the borrower. After a number of years, the borrower would repurchase the property from the lender. The "rental payments" would, in substance, represent the interest element.

Diagram 1: *Ijarah* (leaseback arrangement)

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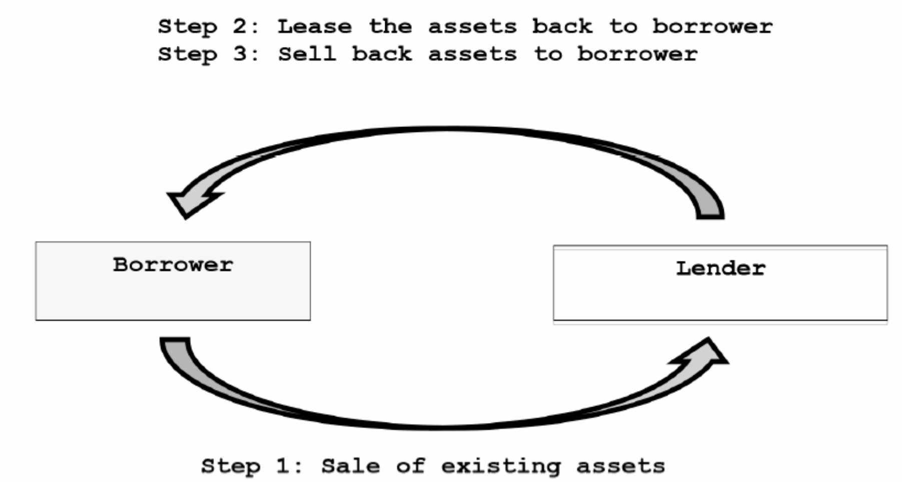
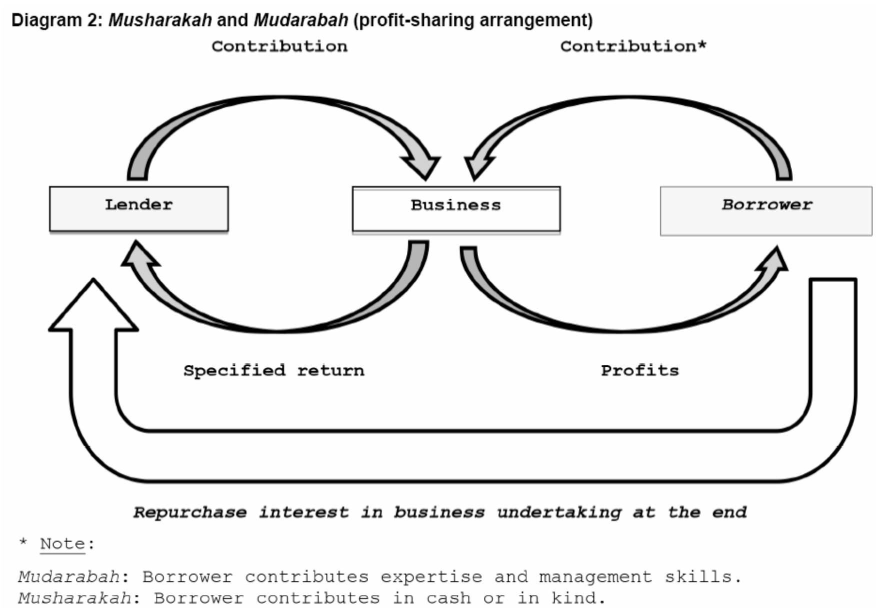
[1] More than 50% of the value of the Chinese company's assets comprise real estate located in China directly or indirectly.

[2] Other arrangements, such as Takaful (Insurance arrangements), which are commonly accepted in other countries are not covered by the proposed Hong Kong legislation.



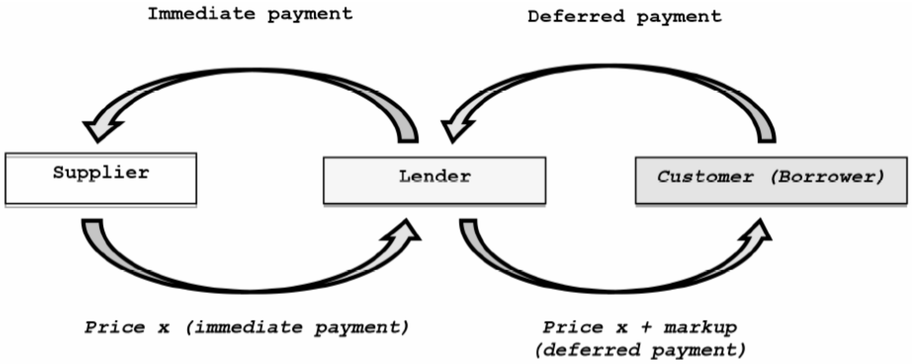
Under *Musharakah* and *Mudarabah* arrangements (see Diagram 2), the borrower wishes to borrow funds to embark on a new business. To comply with sharia law, the lender would enter into a business undertaking with the borrower under which the lender would contribute money and the borrower would make a cash or an in-kind contribution (*Musharakah*), or would contribute management or expertise and management skills (*Mudarabah*). The lender and the borrower would share the profits or losses arising from the undertaking. The return to the lender may be regarded as representing interest in certain cases.

Diagram 2: *Musharakah* and *Mudarabah* (profit-sharing arrangement)



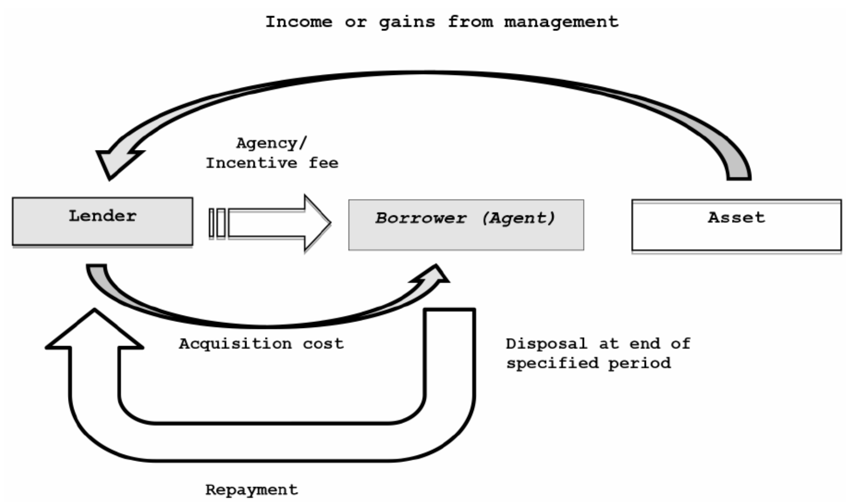
In a *Murabahah* arrangement (see Diagram 3), the borrower may wish to borrow to purchase trading stock. To comply with sharia law, the lender would first acquire the stock for an on-sale to the borrower at a markup. The borrower then would settle the purchase price on a deferred basis (e.g. after he had sold the stock). The markup may be regarded as representing the interest charge.

Diagram 3: *Murabahah* (purchase and sale arrangement)



In a *Wahalah* arrangement (see Diagram 4), the borrower seeks to borrow to purchase an asset to generate recurring income. To comply with sharia law, the lender would buy the asset and appoint the borrower as its agent in managing the asset. After a specified period, the lender would sell the asset to the borrower. During the interim period, the lender would receive income or gain from the management of the asset by the borrower acting as the lender's agent. The lender in turn would pay an agency/incentive fee to the borrower. The net return to the lender, being the difference between the income or gain and the agency/incentive fee expenses, may be regarded as representing the interest element.

Diagram 4: *Wahalah* (agency arrangement)



5. Bond Arrangements[1]

In addition to using their own equity, financial institutions can raise financing through the issuance of bonds. The ability of bondholders to redeem the bonds upon their expiry date means that there is no "interest" charge as such, although, in economic terms, the difference between the redemption price and the issuance price would closely resemble the "interest" element. Such a "bond arrangement" can involve unlisted or listed bonds on a local or foreign stock exchange.

While different jurisdictions accord different tax treatments to such bond arrangements and the investment arrangements discussed above, most take a "tax-neutral" approach, such that both the investment and bond arrangements receive the same tax treatment as in the case of conventional finance. For example, under an *Ijarah* arrangement (leaseback), the sale and repurchase transactions generally would be disregarded, with the rental income effectively being deemed to an interest expense and the purchase (or repurchase) amount a loan. An exemption would be granted from any transaction taxes, such as stamp duty, that otherwise would be charged on a sale and repurchase transaction. The same would apply to other investment arrangements, i.e. the transaction would be taxed as if it were a loan transaction involving an interest payment.

In addition to providing this tax-neutral treatment, some countries offer additional incentives to promote Islamic finance. For example, Malaysia grants a full tax exemption to Islamic banks on income derived from Islamic banking business conducted in international currencies from the year of assessment 2007 to 2016. Singapore reduces the income tax rate on Islamic finance activities to 12% (compared to the normal 17%) following the expiry of the 5% concessionary tax rate that applied from 1 April 2008 to 31 March 2013.

The proposed legislation in Hong Kong does not confer any additional tax incentives, but does grant tax-neutral treatment. Some of the conditions that must be satisfied to obtain tax-neutral treatment are unique:

(1) *Bond arrangements with investment arrangements*: Under the proposed legislation, if there was an investment arrangement, there would have to be a bond arrangement before tax relief could be granted. In other words, if a financial institution simply entered into an Ijarah with a borrower without issuing any bonds to finance the transaction, no tax relief would be available under the transaction. This is a different approach to approaches taken by other countries, such as Malaysia, Singapore, the United Kingdom, etc. This approach implies that the Hong Kong government's intention is probably not to implement Islamic finance on a "retail" scale, but rather on a

[1] This refers to *sukuk*, the Arabic name for financial certificates, also the Islamic equivalent of bonds.

"wholesale" scale (see also point (2) below). This also may prevent some taxpayers from using Ijarah to avoid the payment of stamp duty and profits tax in avoidance schemes involving property transactions.

(2) *Requirement that investment and debt arrangements be classified as "loans" from an accounting perspective*: This condition in Hong Kong's proposed rules would require that both investment and debt arrangements be treated as a financial liability in accordance with Hong Kong Financial Reporting Standards or International Financial Reporting Standards. From an accounting perspective, both the investment and debt arrangements would be classified as loan and interest transactions. This could pose problems for some sharia-compliant investment arrangements, such as *Musharakah* and *Mudarabah*, in which profits and losses are shared. In practice, many *Musharakah* and *Mudarabah*[1] have been structured as products with a fixed percentage of distribution on profits bench-marked at an interest rate.

(3) "*Hong Kong connection*": Bonds issued under the debt arrangement must be connected with Hong Kong in some way, i.e. they must be listed on the Hong Kong stock exchange or be issued in good faith and in the course of carrying on business in Hong Kong, or marketed in Hong Kong, or lodged with and cleared by the Central Moneymarkets Unit operated by the Monetary Authority.

There are other conditions relating to investment and debt arrangements, such as the "maximum term length", "bondissuer as conduit," etc. that must be satisfied for tax-neutral treatment to apply. Nevertheless, the above distinctive conditions provide a basic landscape as to how Islamic finance in Hong Kong will operate going forward.

6. Conclusion

China currently does not have any plans to offer tax-neutral treatment for Islamic finance, although the Ningxia Hui Autonomous Region, the region with the highest Muslim population in China, has been considered a hub for Islamic finance since 2008. Given Hong Kong's peripheral position, the new legislation should open the door for Islamic banking, though perhaps, at this stage, not as widely as that door has been opened in other countries.

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[1] For this reason, it is not surprising that some Islamic scholars have commented that current *sukuk* may not be sharia-compliant, since under sharia principles there should be no fixed rate of profit or guaranteed refund of capital.

Five zero-rated sectors: reduced rate facility of WHT at one percent misinterpreted

The facility of reduced rate of withholding tax at one percent provided by government to five zero-rated sectors has been misinterpreted by some field officers of Federal Board of Revenue (FBR), who have started recovery proceedings by misreading the contents of SRO.333(I)/2011.

Experts told here on Sunday that earlier through SRO 333(I)/2011, FBR has provided relief to business community in shape of introducing concessional rate of withholding tax on supplies and services provided to the taxpayers dealing in five zero rated sectors and standard rate of withholding tax at 3.5 percent and 6 percent respectively against supplies and services has been reduced into single rate of 1 per cent.

When contacted, a Lahore-based tax lawyer, Waheed Shahzad Butt, said that purpose behind the issuance of SRO 333(I)/2011 and induction of clause 45A of Part-IV of the Second Schedule to the Income Tax Ordinance, 2001 (Ordinance), to provide major tax relief to taxpayer falling in zero rated sectors including textile and articles thereof, carpets, leather and articles thereof including artificial leather footwear, surgical goods and sports goods.

Contrary to the factual position and without considering/examining the real intention of the government to facilitate taxpayers engaged with the business of textile and articles thereof, carpets, leather and articles thereof including artificial leather footwear, surgical goods and sports goods, recovery proceedings have been initiated by some filed formations simply be misinterpreting the law. The adamant attitude of field formations will not only create serious problems for the business community but also creating negative image of FBR among the taxpayers.

Tax lawyer further added no doubt FBR mainly relies on withholding tax for collection of taxes and share of withholding taxes in the overall budget target is quite significant. The field officers are not directly involved in direct tax collection because around 90 percent of the budget target of Regional Tax Offices has been met through withholding taxes. If policymakers compare the contribution of the field officers in the budgetary targets from other than withholding tax sources, with the operating expenditures incurred on the tax departments including salaries/benefits, it may lead to an alarming conclusion on their cost-benefit ratios.

Under SRO 333(I)/2011 and clause 45A of the Second Schedule to the Ordinance all taxpayers engaged with the business of textile and articles thereof, carpets, leather and articles thereof including artificial leather footwear, surgical goods and sports goods are obliged to deduct income tax at the rate of 1 per cent to facilitate the persons providing supplies and services to zero rated sectors of economy, however, some field officers treat it as a tool to harass the taxpayers. There are number of products and services, though utilised by zero rated sectors which are otherwise not zero rated like advertisement expenses and products used in indirect cost such as administrative and selling part of trading and profit/loss account, however, filed formation insisted that products supplied to zero rated sectors must be either textile, carpets, leather, surgical goods and sports goods and any other product/services can not avail the benefits of SRO 333(I)/2011.

Clause 45A of Part IV of the Second Schedule to Ordinance inducted through SRO 333(I)/2011, clearly provided facility of deduction of income tax for sales of goods and services rendered or provided to the taxpayers in the five zero rated sectors at reduced rate of 1 percent but filed formations exploiting the process of law by misinterpreting the provisions of clause 45A with sole intention to harass the taxpayers, this wrong practice needs to be curbed by the FBR authorities, Waheed added. – *Courtesy Business Recorder*

Serious ambiguities detected in customs rules

M/s Pak-Afghan Trader Group (Regd) Peshawar has pointed out serious ambiguities in the customs rules during transportation of transit goods by bonded carriers to Afghanistan through land route of Pakistan under Afghan-Pakistan Transit Trade Agreement, (APTTA) 2010.

Sources in the Directorate of Transit Trade Peshawar told here on Thursday that the M/s Pak-Afghan Trader Group (Regd) Peshawar has conveyed its objections on the Customs Rules to the Directorate of Transit Trade Peshawar. The M/s Pak-Afghan Trader Group (Regd) Peshawar, in their representation, raised the following issues: Firstly, according to Customs Rules bonded carrier has been made responsible for payment of all duty/taxes.

Secondly, customs rules are silent about cost of goods transported by the bonded carriers. Thirdly, no responsibility of tracking contractor has been defined in the rules. Fourthly, agent has no role in transportation of goods. Fifthly, it will be difficult for them (clearing agents) to continue their business if the issue of recovery of cost of goods is not resolved. Sixthly, lacuna in the rules will encourage the bonded carrier to join hands with miscreant to earn millions at the cost of few lakhs by paying leviable duties/taxes, M/s Pak-Afghan Trader Group (Regd) Peshawar added. – *Courtesy Business Recorder*

Income tax returns: FBR will not accept without filing wealth statements

The Federal Board of Revenue (FBR) will not process and accept the income tax returns of all public/private sector employees, including politicians members of National Assembly, Senate, Federal/Provincial cabinets employees, without filing of wealth statements for the period ending June 30, 2013 ie, period relevant to Tax Year 2013.

Sources told that all employees drawing annual salary of Rs 500,000/- are legally obliged to submit their annual income tax return along with wealth statements and wealth reconciliation statement (explanation of sources to generate wealth) electronically for the Tax Year 2013 under the provisions of Income Tax Ordinance, 2001.

Sources further stated that electronic filing of income tax returns and wealth statement by salaried persons through eFBR web portal devised by PRAL has been made mandatory through Finance Act, 2009. The proviso to sub section (1) of section 115 has been substituted to provide that where salary income for the tax year is Rs 500,000 or more, the taxpayer shall file return electronically on the prescribed form as well as wealth statement as required u/s 116 of the Income Tax Ordinance 2001.

Sources said that the government and private sector employees including parliamentarians would have to file both the income tax returns and wealth statements. It would cover all government employees including politicians. Those having annual gross salary income of Rs 500,000 or above including taxable perquisites and allowances have to file income tax return and wealth statement electronically through eFBR web portal.

Sources stated that FBR has decided income tax return form would be considered as incomplete for individual taxpayers, who would not file their mandatory wealth statements along with the income tax returns. The system would not accept the income tax return forms until the mandatory wealth statements have also been filed as required under the provisions of section 116 of the Income Tax Ordinance, 2001. All taxpayers who are liable to file income tax returns electronically have to file wealth statement electronically through the eFBR web portal. Otherwise, income tax return would not be accepted by the FBR. Such income tax returns would not be accepted by the FBR's system.

As per law the date of electronic filing of returns by salaried persons is August 31, 2013. The new proposed income tax return form and wealth statements have been aligned with the amendments made in the Finance Act, 2013, sources said. The new income tax return form and wealth statement would incorporate changes to ensure 0.5 percent collection of Income Support Levy. FBR has made it mandatory for the salaried individuals deriving salary income above Rs 400,000 to file a return of income along with wealth statement and wealth reconciliation statement. Furthermore, the concept of treatment of an 'employer's certificate or an Annual Statement of deduction of income tax from salary filed by the employer as a return on behalf of the taxpayer has been abolished to make it compulsory for the salaried individuals deriving salary income above Rs 400,000/- to file income tax return along with wealth statement and wealth reconciliation statement: sources added. – *Courtesy Business Recorder*

APTTA-2010: recovery of cost of transit goods outside purview of FBR

Directorate of Transit Trade Federal Board of Revenue (FBR) has categorically said that the recovery of cost of transit goods under Afghan-Pakistan Transit Trade Agreement, (APTTA) 2010 is outside the purview of FBR, as there is no provision of recovery of cost of goods under APTTA-2010 and transit rules under SRO 601(I)/2011.

An official of Directorate General of Transit Trade Karachi told on Thursday that the Directorate of Transit Trade Peshawar has informed the FBR about the legal/technical issues arising after misplacement of transit cargo under the of FBR, as there is no provision of recovery of cost of goods under APTTA-2010 and Afghanistan-Pakistan Transit Trade Rules.

In case, there is any pilferage of goods en-route ie Karachi to Torkham/Chaman & vice versa, the bonded carrier is liable to pay the leviable duties/taxes. Directorate of Transit Trade suggested the FBR that Afghan importer may like to insure the goods, providing protection and coverage in case the goods are lost or damaged en-route to its destination to Afghanistan.

In this regard, the Directorate of Transit Trade Peshawar has written a letter to the Directorate General of Transit Trade Karachi. Directorate of Transit Trade has further said that there is no provision of recovery of cost of goods under Afghan-Pakistan Transit Trade Agreement, (APTTA) 2010 and Transit rules notified by FBR under SRO 601(I)/2011 dated 13.06.2011. The issue of recovery of cost of goods is therefore outside the purview of FBR as the transaction to transport the transit cargo is between two private parties, ie, Bonded Carrier and Afghan Importer through his clearing agent. However, it may be suggested to M/s Pak Afghan Trader (Regd) Peshawar that the clearing agent at office of departure, while entrusting transit goods to bonded carrier, may like to include an appropriate provision in their agreement holding bonded carrier responsible for payment of cost of goods in case of damage/pilferage/theft etc.

Directorate of Transit Trade highlighted the responsibilities of bonded carrier/transport operators under the APTTA-2010 and Transit rules under SRO 601(I)/2011. According to rule 641(I) & (2) of Afghanistan-Pakistan Transit Trade Rules notified vide SRO.601(I)/2011 dated 13.06.2011 the transport operator shall be responsible and is bound to carry the goods to its destination without any delay and with utmost haste. While according to Rule 639(b) of the said SRO the bonded carrier has to deposit revolving guarantee of Rs 5 million with the licensing authority in order to cover the amount of duties/taxes involved in transportation of transit goods, Directorate of Transit Trade said.

In case, there is any pilferage of goods en-route ie Karachi to Torkham/Chaman & vice versa, the bonded carrier is liable to pay the leviable duties/taxes which are covered by revolving insurance guarantee deposited with licensing authority under rule 639(b) of SRO.601(I)/2011 dated 13.06.2011.

Under established business practices, the transported goods are insured to cover risk of damage/loss etc. It is also suggested that the Afghan importer may like to insure the goods, providing protection and coverage in case the goods are lost or damaged en-route to its destination to Afghanistan, transit goods, Directorate of Transit Trade added.

About the responsibilities of tracking company, Directorate of Transit Trade observed that the Rule-30 of SRO.413(I)2012 dated 25.04.2012, (Tracking And Mentoring Of Cargo Rules-2012) which deal with liabilities of the licensee - the licensee ie TPL Tracker shall liable to deposit duties and taxes along with surcharges and penalties under rules wherein it is established that the licensee has colluded with bonded carrier resulting in loose/pilferage of goods.

Highlighting the role of Agent in transportation of goods, Directorate of Transit Trade stated that the clearing agent has no direct role in transportation which is done by duly licensed approved bonded carrier, however, the role of bonded carrier, clearing agent or importer has been defined in Customs Act 1969 and rule made thereunder.

The rules have explicitly mentioned the role of bonded carrier as envisaged in rule 639 & 641 of SRO. 601/2011, Directorate of Transit Trade added. Background of issue revealed that Peshawar Regional Control Room of M/s TPL Trackers Limited verbally informed Additional Director, Transit Peshawar that vehicle No C-1031, loaded with container No BSIU-9078049 out-of-charged/gate-out vide GD No KPTT-AT-115 has a long stay at Chamkani on GT Road, Peshawar and may be looked into. Accordingly, the Mobile Enforcement Unit (MEU) was sent by Model Customs Collectorate, Peshawar to the pointed location along with representatives of M/s TPL Tracker Company but they were unable to locate the vehicle. Meanwhile, M/s Shadab Logistics, the bonded carrier in this case, informed that they have lodged an FIR with Police Station Chamkani and local police has recovered the empty container along with vehicle (Reg.No C-1031).

Directorate of Transit Trade has send an incident report to the Collector (Preventive) MCC, Custom House, Karachi, being Project Director of Tracking of Monitoring Project, to enquire into why M/s TPL Tracker Company failed to generate alert when the vehicle went away from the designated route and also failed to immobilise engine. A report was also sent to Directorate General of Transit/Trade Karachi regarding the incident of pilferage of transit goods.

According to annexure to Afghanistan-Pakistan Transit Trade Rules (SRO.601(I)/2011 dated 13.06.20112) there is only route for transportation of Afghan Transit Cargo, ie, Indus Highway Karachi - Sukkar - D I Khan - Kohat Ring Road Peshawar - Landi Kotal - Torkham. However, according to TPL, the said vehicle has gone to Chamkani which is about 25 kms in the opposite direction to the east on G.T Road. M/s TPL, are therefore to explain why they failed to generate an alert and to immobilise the engine of the vehicle, when it was deviating from the assigned co-ordinates.

The said vehicle stayed for about two days in the said area, why they failed to generate alert for undue stoppage well in time so that the remedial steps may have been taken on time. A letter was sent to Director, Directorate of Transit Trade Custom House Karachi, with copy to licensing authority of bonded carrier, indicating that the bonded carrier failed to fulfil his responsibilities and warranted necessary action under rule 641 of SRO.601(I)/2011 dated 13.06.2011. The directorate has forwarded contravention report to Collectorate of Customs (Adjudication), Islamabad (Camp Office Peshawar), for initiation of legal proceedings under Customs Act,1969 and rules made thereunder. – *Courtesy Business Recorder*

F.No.1(1)Jurisdiction/2012-Vol-II/102743-R

Islamabad, the 29th July, 2013

ORDER

In exercise of the powers conferred by Sub-Section (1) of Section 209 of the Income Tax Ordinance, 2001, Sections 30 and 31 of the Sales Tax Act, 1990 and Section 29 of the Federal Excise Act, 2005, Federal Board of Revenue is pleased to transfer the jurisdiction over the case of M/s Blessed Textiles Limited, NTN 0698032-5 and M/s Faisal Spinning Mills Limited, NTN 0676741-9, from Chief Commissioner IR, RTO, Karachi to Chief Commissioner Inland Revenue, LTU, Karachi.

2. This order shall take immediate effect.

Karachi, the 5th August, 2013

SECP CIRCULAR NO. 14/2013

Subject: **Clarification on the Directive on Anti-money Laundering and Counter the Financing of Terrorism (AML/CFT) vide SRO 20(I)/2012 dated January 11, 2012.**

The Securities Exchange Commission of Pakistan (SECP), taking cognizance of the concerned raised by the insurance companies and, after undertaking extensive deliberations with the relevant Authorities and stakeholders, deem it appropriate and expedient to issue certain clarification, in order to remove the difficulties faced by the insurers in complying with the SECP's Directive issued vide SRO 20(I)/2012dated January 11, 2012 on Anti-money laundering and Combating the Financing of Terrorism (AML/CFT).

2. Therefore, the SECP in exercise of the powers conferred under Section 40B of the Securities and Exchange Commission of Pakistan Act, 1997 is pleased to issue the following clarifications in respect of the Customer Due Diligence/Know Your Customer (CDD/KYC) and risk profiling of existing and new policyholders, as mandated in the subject Directive:

a. For the purposes of establishing the identity and proof of address of a potential policyholder consistent with the risk profile by the insurers, while the procurement of the CNIC of policyholder shall remain the bare minimum mandatory requirement, other documents as mentioned in the Annexure-I of the subject Directive may be construed as indicative. It is clarified that no further documentation is necessary for proof of residence where the document of identity submitted also gives the proof of residence. However, an additional document for proof of address/residence is required in case the address mentioned on NIC is not the actual/present address. Moreover, the requirement of procuring NTN shall not be applicable in-case of non-tax paying policyholders.

b. to promote the delivery of insurance products, especially microinsurance, through innovative, technology-based and alternate distribution channels, the minimum threshold amount for the applicability of Clause 4(i)(VIII) of the subject Directive shall be the annual/one time premium of Rs. 200,000 (Rupees Two Hundred Thousand only).

3. It is the responsibility of the insurers to ensure compliance with the provisions of Anti-money Laundering Act, 2010 and the rules and regulations made thereunder. The assumption of lower vulnerability of the insurance business towards AML/CFT activities and minimum documents requirement does not absolve the insurers from their obligations under these laws including the KYC/CDD and the Suspicious Transactions Report (STR) reporting.

4. Insurers are strongly encouraged to refer to the Guidance Paper No. 5 on AML/CFT issued by the International Association of Insurance Supervisors (IAIS) to ensure effective AML/CFT compliance.

2013 TRI 1397 (Trib. Ind.)

INCOME TAX APPELLATE TRIBUNAL
DELHI "G" BENCH, NEW DELHI

G.E. Veerabhadrappa, President and A.D. Jain, Judicial Member

FACTS/HELD

Section 14A: Onus is on AO to show expenditure is incurred to earn tax-free income

1. For AY 2006-07, the assessee earned dividend of Rs. 17 lakhs and LTCG of Rs. 12 crores. The assessee claimed that it had incurred no expense to earn the tax-free income and so no s. 14A disallowance was permissible. However, the AO disallowed Rs. 2 crores under Rule 8D towards interest and admin expenditure. The CIT (A) accepted that no interest was incurred and deleted that disallowance. He also reduced the admin expenditure disallowance. On appeal to the Tribunal, HELD:

   (i) The contention of the Revenue that some expenditure, directly or indirectly, is always incurred for earning tax-free income cannot be accepted. **The burden is on the AO to establish the nexus of the expenditure incurred with the earning of exempt income** before making any disallowance u/s 14A (Hero Cycles 323 ITR 518 (P&H), Jindal Photo followed)

   (ii) As regards interest, the **AO has to show the nexus** between the borrowed funds and the tax free investments. If that is not done, disallowance of interest is not permissible (K. Raheja Corporation (Bom) followed)

   (iii) As regards admin expenses, s. 14A disallowance cannot be made on an **ad-hoc basis**. It is the **department's responsibility** to bring material on record to show that **expenditure was incurred** for earning the exempt income. If this is not done, disallowance is not permissible (Wimco Seedlings followed)

Order accordingly.

ITA No. 2431(Del)2010 (Assessment year: 2006-07) & C.O. No.349 (Del)2010 (In ITA 2431(Del)2010) (Assessment year: 2006-07).

Decided on: 4th May, 2012.

Present at hearing: S. Mohanty, DR, for Appellant. Ajay Vohra, Advocate, Rohit Jain, CA & Janpriya Rooprai, Advocate, for Respondent in ITA No. 2431(Del)2010. Ajay Vohra, Advocate, Rohit Jain, CA & Janpriya Rooprai, Advocate, for Appellant. S. Mohanty, DR, for Respondent in C.O. No.349 (Del)2010.

JUDGMENT

Per A.D. Jain:– (Judicial Member)

These are Department's appeal and the assessee's cross objections against the order dated 4.2.2010 passed by the CIT(A), XI, New Delhi. The following grounds have been taken by the Department:-

1. *"Ld. Commissioner of Income Tax (Appeals) erred, in law and on the facts and circumstances of the case, in restricting the disallowance of Rs. 2,08,83,181/- made by the AO u/s 14A of the I.T. Act to Rs. 16,54,531/-*
2. *Ld. Commissioner of Income Tax (Appeals) erred, in law and on the facts and circumstances of the case, in deleting the disallowance of Rs. 5,000/- made by the AO on account of fines & penalties.*
3. *Ld. Commissioner of Income Tax (Appeals) erred, in law and on the facts and circumstances of the case, in directing the AO as under:–*
   i) *To verify the claim of the assessee and exclude interest income from UTI from income after due verification.*
   ii) *To allow the balance 50% of additional depreciation after verifying the contention of the assessee that 50% of additional depreciation was claimed and allowed in immediately preceding year i.e. A.Y. 2005-06.*
   iii) *Verify the claim of the assessee and allow credit of the TDS.*

   Since the CIT(A), as per the provisions of section 251 (1)(a) of the I.T. Act, may confirm, reduce, enhance or annul the assessment and the above directions of the CIT(A) amount to setting aside the grounds of appeal."

2. The assessee has raised the following cross objections:–

1. *"That the CIT(A) erred on facts and in law in confirming the disallowance of expenditure amounting to Rs. 16,54,525/- under section 14A Income-tax Act, 1961 (the Act), alleged to have been incurred for earning tax free dividend income.*

That the CIT(A) erred on facts and in law in not holding that disallowance under section 14A of the Act, could not have been worked out as per the method provided in Rule 8D of the Income-tax Rules, 1962 ('the Rules') since the same was prospective in operation and was not applicable to the year under consideration.

2. *That the CIT(A) erred on facts and in law in not directing the assessing officer to allow deduction under section 801A/80IB of the Act in respect of the three units of the appellant.*

2.1 *That the CIT(A) erred on facts and in law in not appreciating that deduction under section 80IA/80IB of the Act was not allowed in respect of the profits of the three units for the period 01.04.2005 to 30.06.2005 to the appellant as well as the resulting company."*

3. Apropos ground No.1 of the Department's Appeal & Cross Objection No.1 of the assessee, as per the assessment order, the AO noticed that the assessee had earned dividend income of Rs. 17,32,701/- and long term capital gain of Rs. 12,15,93,111/-, against which, no expenses had been claimed to have been incurred. The AO asked the assessee to explain as to why disallowance u/s 14A of the I.T. Act be not made in respect of expenses attributable to income exempt u/s 10 of the Act. The assessee submitted that no expenses had been incurred to earn the exempt income. The AO, however, disagreed with the stand taken by the assessee. It was observed that the assessee had an opening balance of investment of Rs. 88,85,47,596/- and a closing balance of Rs. 1,00,47,31,991/-, from which, the assessee had earned the exempt income; that as available from the assessee's Profit and Loss Account, the assessee had incurred an interest cost of Rs. 3,22,99,963/- during the year; that the assessee company had been carrying on the business of manufacture of yarn, which had been transferred to Sutlej Textiles and Industries Ltd. ('STIL', for short), with effect from 1.7.2007, as per the scheme of arrangement sanctioned by the Hon'ble Rajasthan High Court; that the assessee company had retained the investment business; that as such, 50% of the expenses on account of interest were being treated as incurred for investment business, from which, the assessee had earned income in the form of dividend and capital gains; and that it was clear that the assessee had earned exempt income at the costs debited to the Profit and Loss Account. The AO further held that following the Special Bench decision of the Tribunal in "ITO, Mumbai v. Daga Capital Management Pvt. Ltd.", 2008 – TIOL – 509-Mumbai-(SB), Rule 8 D of the I.T. Rules read with Sections 14A(2) & (3) of the Act are applicable with retrospective effect. Holding so, the AO worked out the disallowance u/s 14 A of the Act as follows:–

A) Direct cost	
(50% of Interest)	1,61,49,981/-
B) Indirect cost	
Opening balance of Investment	88,85,47,596/-
Closing balance of Investment	100,47,31,991/-
	189,32,79,587/-
	94,66,39,793/-
	47,33,200/-
Total disallowance u/s 14A (A+B)	2,08,83,181/-

4. Before the ld. CIT(A), the assessee contended that as per the Scheme of demerger, the entire interest bearing liabilities, namely, secured and unsecured loans, belonging to the assessee company as on 30.6.05, the date preceding the date of demerger, were relatable to the demerged Textile Division and were transferred to the resulting company, i.e., STIL, as part of the demerger. The assessee supported such contention with documentary evidence, i.e., Schedule of assets and liabilities in respect of the residual undertaking forming part of the Scheme of demerger, the Profit and Loss Account of the Company for the period from 1.7.2005 to 31.3.2006, wherein nil interest expenses had been debited and comparative Profit and Loss Account for the demerger period and for the complete year, showing that the entire interest expenditure related to the pre-demerger period from 1.4.2005 to 30.6.2005. The assessee thus contended that there was no interest expenditure actually related to the investment activity and so, no part of interest expenditure was disallowable u/s 14A of the Act. It was submitted that during the post demerger period, the assessee only had investment activity; that expenses of only Rs. 9,26,788/- had been claimed as deduction towards remuneration to Director, Audit Fee, etc., which also could not be said to be related to the earning of exempt income; that during the pre-demerger period, disallowance, if any called for, could be of only Rs. 7,27,743/-, since the rest of the expenditure related to Haridwar Holiday Home and Dehradun Holiday Home, which had also demerged with the Textile business; and that Rule 8D of the I.T. Rules was applicable only prospectively and not retrospectively.

5. The ld. CIT(A) asked for a remand report from the AO. In the remand report, the AO stated that interest expenditure also related to the investment activity and that the assessee was wrong in contending that no expenses related to the dividend income.

6. So far as regards the applicability of Rule 8D of the Income Tax Rules, the ld. CIT(A) confirmed the AO's view of the said Rule being retrospectively applicable. In doing so, the ld. CIT(A) also went by "Daga Capital Management"(supra).

7. So far as regards the merits of the disallowance, the ld. CIT(A) observed that the disallowance had been made on account of interest expenditure and other administrative and operative expenses. Concerning the interest expenditure, the ld. CIT(A) had asked the assessee to file the audited financial statements of STIL, i.e., the resulting company, as on 31.3.2006. There-from, the ld. CIT(A) observed that the entire loan, on which the interest expenditure had been incurred, actually stood transferred from the assessee company to STIL, pursuant to the scheme of demerger sanctioned by the Hon'ble Rajasthan High Court. The ld. CIT(A) observed that it stood established that the entire interest expenditure actually related to the earning of taxable income from the Textile Division and not to the earning of any exempt income. It was held that therefore, no part of the interest expenditure was disallowable u/s 14A of the Act read with Rule 8D of the Rules.

8. Regarding the disallowance of Rs. 47,33,200/- out of administrative and operative expenses, the ld. CIT(A) observed that the entire expenditure during the pre-demerger period, excepting Rs. 12,99,537/- related to the demerged Textile Division; that for the post-demerger period, the total expenditure was of Rs. 21,06,266/-, out of which, the assessee had itself disallowed Rs. 11,79,478/- and had claimed only the balance of Rs. 9,26,788/-; and that thus, the total pre-demerger and post-demerger expenses, from which, disallowance could be made, aggregated to Rs. 22,26,325/-. The ld. CIT(A) observed that the disallowance of Rs. 47,33,000/-, as made by the AO u/s 14A of the Act read with Rule 8D of the Rules could not be sustained, since such disallowance had to be restricted to the actual expenditure incurred. The ld. CIT(A) further observed that, on the other hand, the contention of the assessee that no part of the expenditure of Rs. 22,26,000/- was disallowable, was also not acceptable; and that the assessee had actually earned exempt dividend income, due to which, the expenditure incurred in relation to such income needed to be disallowed in terms of section 14A of the Act. Observing that the expenditure of Rs. 5,71,794/- related to Haridwar Holiday Home and Dehradun Holiday Home, which also stood demerged as part of the Textile Division, the ld. CIT(A) reduced this amount from the amount of Rs. 22,26,000/- and held the entire balance expenditure of Rs. 16,54,531/- to be relating to the investment activity of the assessee company. It is this amount of Rs. 16,54,531/-, to which the disallowance of Rs. 2,08,83,181/-, as determined by the AO, was restricted by the ld. CIT(A).

9. The Department has raised ground No.1 of its appeal against this action of the ld. CIT(A), seeking confirmation of the entire disallowance of Rs. 2,08,83,181/-, as made by the AO. The assessee, on the other hand, has taken Cross Objection No.1, requesting for the deletion of the entire disallowance as against that restricted by the ld. CIT(A) to Rs. 16,54,531/-.

10. The learned counsel for the assessee has made oral arguments and a chart of issues had been filed as well. It has been contended that the provisions of section 14A of the Act are applicable only to expenditure incurred in relation to income not forming part of the total income. Reliance in this regard has been placed on "CIT v. Walfort Share and Stock Brokers", 326 ITR 1(SC) and "Godrej & Boyce Manufacturing Co. Ltd., Bombay v. DCIT", 328 ITR 81(Bom). It has been contended that in the present case, during the year, no expense, having either any direct or any indirect relation with the earning of exempt income, was incurred by the assessee; that no part of the interest expenditure actually related to the investment division, as also noted by the ld. CIT(A), since the entire loan on which the interest had been paid, had been transferred to STIL, the resulting company, pursuant to the scheme of demerger, with effect from 1.7.05. The learned counsel for the assessee has drawn attention to a copy of the scheme of demerger [pages 1 to 20 of the Assessee's Paper Book ('APB' for short)]. Reference has, then, been made to the Schedule of assets and liabilities in respect of the residual undertaking of the assessee company (APB 21 to 76). Further, the Profit and Loss Account of the residual company for the period from 1.7.05 to 31.3.06 (APB 78), the comparative Profit and Loss Account for the segregated period from 1.4.05 to 30.6.05, of the consolidated company and that for the year ending 31.3.06 (APB 79 to 80) have also been referred to. It has been contended that if no nexus is shown between the borrowed funds and the tax free investment, no disallowance of interest on the borrowed funds can be made. For this proposition, reliance has been placed on the following case laws:–

1. "*CIT v. Hero Cycles*", 323 ITR 518(P&H);
2. "*CIT v. K. Raheja Corporation Pvt. Ltd.*", decision dated 8.8.11 in ITA No. 1260/2009, rendered by the Hon'ble Bombay High Court (Copy at pages 31 to 33 of the Case Laws Paper Book filed by the assessee, "CLPB" for short);
3. "*DCIT v. Jindal Photo Ltd.*", authored by one of us, the J.M., on 22.12.10, in ITA No. 4539(Del)2010 (copy at CLPB 39 to 45);
4. "*Maruti Udyog Ltd. v. DCIT*", 92 ITD 119(Del);
5. "*ACIT v. Eicher Ltd.*", 101 TTJ 369(Del); and
6. "*DCIT v. Maharashtra Seamless Ltd.*", 138 TTJ 244(Del).

11. Apropos the administrative expenditure, it has been contended on behalf of the assessee that firstly, no part of the administrative expenditure related to the investment division; that the AO did not bring anything on record to show that expenditure to have been incurred for earning exempt income; that the disallowance u/s 14A of the Act was made on an entirely adhoc basis, without discharging the onus of justifying the disallowance of such expenditure; and that this is impermissible in law, as laid down in–

1. "*Chemical and Metallurgical Design Co. Ltd.*", ITA No. 803/2008 …..?
2. "*PTC India Ltd. v. DCIT*", ITA Nos. 580 & 581(Del)09(Del) …?
3. "*Wimco Seedlings Ltd. v. DCIT*", 107 ITD 267(Del)(TM); and
4. "*CIT v. Ms. Sushma Kapur*", 319 ITR 299(Del).

12. It has been further contended that even otherwise, the provisions of sections 14A(2) and (3) of the Act and Rule 8D of the Rules are prospective and cannot be applied for any assessment year prior to assessment year 2008-09. For this, reliance has been placed on–

1. "*Godrej & Boyce Manufacturing Co. Ltd. v. DCIT*", 328 ITR 81(Bom);
2. "*Godrej Agrovet Ltd. v. ACIT*", 326 ITR 81(Bom); and
3. "*Continental Carriers (P)Ltd. v. ACIT*", 138 TTJ 249(Del).

13. Explaining the administrative expenditure actually incurred by the assessee, it has been contended that so far as regards the pre-demerger expenditure, the total expenditure was of Rs. 12,99,537/-. Reference in this regard had been made to APB 82 to 87. It has been submitted that this entire expenditure related to activities other than the activities of the Textile Division; that an amount of Rs. 11,76,500/- out of the said expenditure of Rs. 12,99,537/- was debited as "miscellaneous expenditure"; that out of this expenditure, expenditure of Rs. 5,71,794/- related to Haridwar Holiday Home and Dehradun Holiday Home, which were also demerged under the scheme, (with regard to which, APB 199 has been referred to); and that therefore, only the balance expenditure of Rs. 7,27,743/- was incurred during the three months period from 1.4.05 to 30.6.05, under the head of "miscellaneous expenditure". Referring to the post-demerger expenditure from 1.7.05 to 31.3.06, the learned counsel for the assessee has argued that the total expenditure during this period amounted to Rs. 21,06,266/- (APB 81 referred to); that this expenditure primarily comprised of a restructuring/demerger expenditure of Rs. 14,74,347/- and balance other expenses, with regard to which, our attention has been drawn to APB 78 to 80; that in the revised return of income, out of the demerger expenses of Rs. 14,74,347/-, an amount of Rs. 2,94,869/- had been claimed u/s 35 DD of the Act, whereas the balance expenditure of Rs. 11,79,478/- was disallowed in the return (reference made to APB 283); that therefore, a total expenditure of only Rs. 16,54,531/- had been claimed and disallowance, if at all, could have been made only out of the said expenditure of Rs. 16,54,531/-; that so, the ld. CIT(A) went wrong in disallowing the entire expenditure, particularly when there is no evidence available to suggest that even any part of such expenditure was incurred to earn exempt income; and that further more, this expenditure includes expenditure towards remuneration of Director and Audit Fees, which expenditure had to be *incurred*, irrespective of

exempt income being received or not and these expenses also could not be held to be related to the earning of exempt income.

14. The learned DR, on the other hand, has contended that the ld. CIT(A) has erred in restricting the disallowance of Rs. 2,08,83,181/- made by the AO u/s 14A of the Act to Rs. 16,54,531/-; that while doing so, the ld. CIT(A) has failed to take into consideration that the assessee had an opening balance of investment of Rs. 88,85,47,596/- and a closing balance of Rs. 1,00,47,31,991/-; that it was therefrom that the assessee had earned exempt income; that during the year, the assessee had incurred interest cost of Rs. 3,22,99,963/-, as available from the Profit and Loss Account; that the assessee had earned exempt income at the costs debited to the Profit and Loss Account; that undisputedly, a loan had been taken, on which, interest was being paid; that as such, the AO was right in holding 50% of the interest expenditure to be directly relatable to the earning of exempt income; that as such, the AO was correct in making the disallowance accordingly; that even though agreeing with the AO to the applicability of formula as per Rule 8D of the Rules, the ld. CIT(A) erred in restricting the disallowance made by the AO at Rs. 47,33,000/- being 0.5% of the average investment, to Rs. 22,26,000/-; that the ld. CIT(A) further erred in reducing a sum of Rs. 5,71,794/- and thereby restricting the disallowance to only Rs. 16,54,531/-; that even otherwise, the matter needs to be remitted to the AO to examine the expenses regarding the exempt income in the light of "Godrej & Boyce"(supra), as per which, even if the assessee has utilized its own funds for making investments which have resulted in income which does not form part of the total income under the Act, the expenditure which is incurred in the earning of that income would have to be disallowed, which expenditure is what the AO has to determine.

15. We have heard the parties and have perused the material on record with regard to this issue. The assessee is a limited company and is in the business of making investments, besides other business. Earlier, it was carrying on the activity of manufacturing and dealing in Textiles. The Textile Division of the assessee, however, got demerged into the resulting company, STIL, with effect from 1.7.05. The AO made disallowance of interest expenditure of Rs. 1,61,49,987/- and of other administrative and operative expenses of Rs. 47,33,200/-, total amounting to Rs. 2,08,83,181/-. The ld. CIT(A), apropos the interest expenditure, held that the entire loan on which the interest expenditure had been paid actually stood transferred from the assessee company to STIL, the resulting company, pursuant to the scheme of demerger. This fact, as found by the ld. CIT(A), has remained established. Nothing to the contrary has been brought out . It remains undisputed that in the audited financial statement of STIL, as on 31.3.2006, this loan stood transferred pursuant to the scheme of demerger, from the assessee company to STIL. This was in accordance with the scheme of demerger as approved by the

Hon'ble Rajasthan High Court. A copy of the said scheme of demerger is at APB 1 to 20. As per this scheme, the liabilities, duties and obligations of the assessee company relating to the demerged Textile Division were to be transferred to the resulting company, STIL. Then, as per the Schedule of assets and liabilities in respect of the residual undertaking forming part of the scheme of demerger, the relevant portion whereof is at APB 62 to 64, after the demerger, the books of the assessee do not show any outstanding loans, signifying that all the loans pertaining to the demerged Textile Division stood transferred. APB 64, states, inter alia,:–

Secured loans - Nil

Unsecured loans - Nil

APB 62 to 64 constitute the statement of assets and liabilities in respect of the residual undertaking of SIL (the assessee) as on the date immediately preceding the appointed date. Further, the details of Profit and Loss Account of SIL (the assessee), from July, 2005 to March, 2006 (APB 78) gives the details of the expenditure, as per which, the total expenditure was of Rs. 21,06,266/-. The comparative Profit and Loss Account for the segregated period, i.e., from 1.4.05 to 30.6.05, of the consolidated company, and for the year ending 31.3.06, are at APB 79 to 80. Therein, no interest expenditure stands shown as relating to the period from 1.7.05 to 31.3.06, i.e., the period during which the assessee company was only an investment company. It was only to the three months period prior to the said period, i.e., from 1.4.05 to 30.6.05, that the total interest expenditure pertained. This clearly shows that the expenditure on interest concerned the demerged Textile Division of the assessee Company and not its investment activity. 16. As such, no nexus was brought by the AO between the borrowed funds and the tax free investment. That being so, disallowance of interest on borrowed funds was entirely uncalled for.

17. In "K. Raheja Corporation Pvt. Ltd." (supra), it was held by the Hon'ble Bombay High Court that in the absence of any material or basis to hold that the interest expenditure directly or indirectly was attributable for earning the dividend income, the decision of the Tribunal in deleting the disallowance of interest made u/s 14A of the Act could not be faulted. In the facts of the present case, as discussed, "K. Raheja Corporation Pvt. Ltd." (supra), is squarely applicable.

18. In "*CIT v. Hero Cycles*" (supra), it was held by the Hon'ble Punjab & Haryana High Court, inter alia, that the contention of the Revenue that directly or indirectly some expenditure was always incurred, which must be disallowed u/s 14A of the Act and the impact of the expenditure so incurred could not be allowed to be set off against the business income which may nullify the mandate of section 14A, could not be accepted; and that the disallowance u/s 14A required a finding of incurring of expenditure and where it was found that for earning exempted income,

no expenditure had been incurred, disallowance u/s 14A could not stand. In the present case, as seen, the AO has not established any nexus whatsoever between the borrowed funds and the investment made. Therefore, "Hero Cycles" (supra), is applicable.

19. In "ACIT v. Eicher Ltd." (supra), it has been held that the burden is on the AO to establish the nexus of the expenditure incurred with the earning of exempt income, before making any disallowance u/s 14A of the Act.

20. In "Maruti Udyog"(supra), it has been held that before making any disallowance u/s 14A of the Act, the onus to establish the nexus of the same with the exempt income, is on the Revenue.

21. In "Jindal Photo"(supra), following "Hero Cycles"(supra), "Eicher Ltd."(supra), "Maruti Udyog"(supra) and other decisions, we have held as follows:–

> *"18. Now, as per section 14A(2) of the Act, if the AO, having regard the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of expenditure incurred in relation to income which does not form part of the assessee's total income under the Act, the AO shall determine the amount incurred in relation to such income, in accordance with such method as may be prescribed, i.e. under Rule 8D of the I.T. Rules. However, in the present case the assessment order does not evince any such satisfaction of the AO regarding the correctness of the claim of the assessee. As such, Rule 8D of the Rules was not appropriately applied by the AO as correctly held by the CIT (A). It has not been done by the AO that any expenditure had been incurred by the assessee for earning its dividend income. Merely, an ad hoc disallowance was made. The onus was on the AO to establish any such expenditure. This onus has not been discharged. In "CIT vs. Hero Cycles: (P & H) 323 ITR 518, under similar circumstances, it was held that the disallowance u/s 14A of the Act requires a clear finding of incurring of expenditure and that no disallowance can be made on the basis of presumptions. In "ACIT vs. Eicher Ltd.", 101 TTJ (Del.) 369, that it was held that the burden is on the AO to establish nexus of expenses incurred with the earning of exempt income, before making any disallowance u./s 14A of the Act. In "Maruti Udyog vs. DCIT, 92 ITD 119 (Del.), it has been held that before making any disallowance u/s 14A of the Act, the onus to establish the nexus of the same with the exempt income, is on the revenue. In "Wimco Seedlings Limited vs. DCIT", 107 ITD 267 (Del.) ™, it has been held that there can be no presumption that the assessee must have incurred expenditure to earn tax free income. Similar are the decisions in:*

1. "Punjab National Bank vs. DCIT", 103 TTJ 908 (Del.);

2. "Vidyut Investment Ltd." 10 SOT 284 (Del.) ; and

3. "D.J. Mehta vs. ITO", 290 ITR 238 (Mum.) (AT).

19. In view of the above, finding no error with the order of the CIT(A) on the point at issue , the same is hereby confirmed. Ground No. 3 is thus rejected."

22. Moreover, as rightly contended, the finding of fact recorded by the ld. CIT(A), to the effect that no part of the interest expenditure actually related to the investment activity, has not been challenged by the Department.

23. Therefore, we hold that the ld. CIT(A) has correctly deleted the disallowance of the interest expenditure of Rs. 1,61,49,987/-.

24. Further, the AO made disallowance of Rs. 4,77,33,200/- out of administrative and operative expenses at 0.5% of the average investment of the assessee company, under the formula given in Rule 8D(2)(iii) of the Rules. The ld. CIT(A) observed that the entire expenditure incurred during the pre-demerger period related to the demerged Textile Division, but for Rs. 12,99,537/-. It was also noticed that the total expenditure for the post demerger period was of Rs. 21,06,266/-. Out of this amount, the assessee had itself disallowed Rs. 11,79,478/- and had claimed only the balance expenses of Rs. 9,26,788/-. The total expenses pre-demerger and post-demerger thus amounted to Rs. 22,26,325/-. The ld. CIT(A) observead that it was out of this amount that the disallowance could be made. The CIT(A) agreed in principle with the argument of the assessee that just since the AO had worked out the disallowance of Rs. 47,33,000/- u/s 14A of the Act, being 0.5% of the average investment under Rule 8D of the Rules, and this amount exceeded the total expenditure incurred in connection with the earning of the exempt income, the expenditure as worked out as per the Rules, could not be disallowed. The ld. CIT(A) was of the view that the disallowance was to be restricted to the total expenditure of Rs. 22,26,325/- (rounded off to the figure of Rs. 22,26,000/-), lest the disallowance exceeded even the actual expenditure incurred. However, the assessee's stand that no part of the expenditure determined at Rs. 22,26,000/- was disallowable, was not accepted by the ld. CIT(A), observing that the assessee had actually earned exempt income by way of dividend and in terms of section 14A of the Act, the expenditure incurred in relation to that income was required to be disallowed. As such, out of the expenditure determined at Rs. 22,26,000/-, the ld. CIT(A) subtracted the amount of Rs. 5,71,794/- representing expenditure relating to Haridwar Holiday Home and Dehradun Holiday Home, which were found to be demerged under the Demerger Scheme, and arrived at the figure of Rs. 16,54,531/-. The ld. CIT(A) held this amount to relate to the investment activity of the assessee company and disallowed it as against the disallowance of Rs. 47,33,200/- made by the AO.

25. The assessee maintains that the ld. CIT(A) has erred in disallowing the sum of Rs. 16,54,531/- also, as according to the assessee, no part of the administrative expenditure related to the investment division of the assessee. This contention of the assessee, it is seen, carries force. To start with, it cannot be gainsaid that the disallowance u/s 14A of the Act cannot be made on an ad-hoc basis and it is the Department's responsibility to justify any such disallowance by bringing material on record to show that any expenditure was incurred for earning the exempt income. Reference in this regard has correctly been made to "Wimco Seedlings Ltd. v. DCIT"(supra), wherein it has been held that there can be no presumption that the assessee must have incurred expenditure to earn tax free income. "Wimco Seedlings Ltd." (supra) was followed by us in "Jindal Photo" (supra). 26. In "Ms. Sushma Kapur" (supra), it has been held by the Tribunal that to the extent it could be proved that the investment was made from borrowed funds, the expenses had been disallowed u/s 14A. This finding of fact recorded by the Tribunal was upheld by the Hon'ble jurisdictional High Court.

27. In the present case, the AO did not bring any evidence on record to establish that any expenditure had been incurred by the assessee company for earning the exempt income. In the absence of such evidence, it was wrong on the part of the AO to proceed to compute disallowance of the expenses u/s 14A of the Act by merely applying Rule 8D(2)(iii) of the Rules.

28. Apropos the assessee's contention regarding the applicability of the provisions of Sections 14A(2) and (3) of the Act and Rule 8D of the Rules being prospective with effect from assessment year 2008-09, such contention is supported by "Godrej & Boyce"(supra) and "Godrej Agrovet Ltd."(supra). It is, however, well established, as held in "Continental Carriers P.Ltd. v. ACIT", 138 TTJ 249(Del), that even prior to assessment year 2008-09, when Rule 8D of the Rules was not applicable, the AO was duty bound to determine the expenditure incurred in relation to income not forming part of the total income, by adopting a reasonable basis. Therefore, nothing stopped the AO from determining the expenditure incurred in relation to the exempt income earned by the assessee. But for doing so, a "reasonable basis" had to be adopted. And the most reasonable basis, rather, the first reasonable basis for such determination can be none else than the nexus between the expenditure incurred and the exempt income earned. Now, evidently, the AO did not establish any such nexus between the expenditure incurred and the exempt income earned by the assessee Company.

29. Even the ld. CIT(A), though he restricted the disallowance from Rs. 47,33,200/- to Rs. 16,54,531/-, did not establish any such nexus and it was merely observed that this amount related to the investment activity of the assessee Company, without clarifying as to how it was found to be so.

30. We find that apropos the pre-demerger expenditure incurred during the period from 1.4.05 to 30.6.06, the total expenditure relating to the activities other than those of the Textile Division of the assessee Company, as available from the consolidated Profit and Loss Account for the year ended 31.3.06 of STIL (copy at APB 83 to 87), was Rs. 12,99,537/-, as follows:-

		Rs.
1.	Salary, wages, bonus etc.	61,353/-
2.	Employees' contribution to PF	2,792/-
3.	Rates and Taxes	3,440/-
4.	Insurance Premium(Net)	50,000/-
5.	Misc. expenses	11,76,500/-
	Total:	12,99,537/-

Out of the above expenditure of Rs. 12,99,537/-, it is seen, an amount of Rs. 11,76,500/- stands debited as misc.expenditure. The break up of these misc.expenses, as appended at APB 82, is as follows:–

Particulars	2005-06	3 Months	9 Months
*Detail of M/s. Expenses			
-Filing Fee	4000	0	4000
-General Expenses	12361	12361	0
-Postage & Telegram	118478	4929	113549
-Printing and Stationery	231675	469	231206
-Bank Commission	135	135	0
-Books and Periodicals	2497	2497	0
-Traveling Expenses	38696	38696	0
-Trunk & Telephone Exp.	1888	1888	0
-Haridwar Holiday Home	171231	171231	0
-Legal & Professional	80407	80407	0
-Electricity charges	2769	2769	0
-Water charges	425	425	0
-Advertisement	77570	77570	0
-Listing Fee	84250	58000	26250
-Maintenance Charges	3940	3940	0
-Directors Traveling	668018	178511	489507
-conveyance Charges	620	620	0
-Depository Fees	44080	44080	0

-Demat Expenses	46653	0	46653
-Dehradun Holiday Home Exp.	400563	400563	0
-Motor Car Exp.	80910	80910	0
-Press Conference Exp.	16500	16500	0
	2087666	1176501	911165

31. As noted above, an amount of Rs. 5,71,794/- was expenditure related to Haridwar Holiday Home (Rs. 1,71,231/-) and Dehradun Holiday Home (Rs. 4,00,563/-). These properties, pertinently, were shown in the Schedule forming part of the Balance Sheet as on 31.3.06 (copy at APB 199), as fixed assets of the company. Both these Holiday Homes, undeniably, were demerged under the Demerger Scheme and so, the ld. CIT(A) rightly did not disallow the expenditure on these Holiday Homes.

32. So, what remained as balance under the head of misc.expenditure incurred during the three months period from 1.4.2005 to 30.6.2005, was the amount of Rs. 7,27,743/-. Even this part of the expenditure has not been correlated by the Authorities below to the exempt income earned by the assessee Company.

33. So far as regards the post-demerger expenditure incurred by the assessee from 1.7.05 to 31.3.06, as available from the details of expenses in the Profit and Loss Account in March, 2006 and June, 2005, i.e., for the year ended 31.3.06 and for the period ended 30.6.05 (copy at APB 81), that is, the difference of expenses in the Profit and Loss Account for the period from 1.4.05 to 30.6.05 and 1.7.05 to 31.3.06, i.e., to say, the pre-demerger and the post-demerger periods, during the post-demerger period, the assessee had only investment activity and there was no activity of manufacture of Textiles, the Textile Division having been demerged. The total expenditure incurred during this period was of Rs. 21,06,266/-. This comprised of (as available from the copy of the details of the Profit and Loss Account of the assessee Company from July 2005 to March, 2006, at APB 78), of operative and other expenses of Rs. 14,78,766/- and Director's fees and commission of Rs. 6,27,500/-. The operative and other expenses of Rs. 14,78,766/- constituted, mainly, restructuring/demerger expenses of Rs. 14,74,347/- (APB 79). The balance operating and other expenses were of Rs. 4,419/-. A revised computation of income for the assessment year 2006-07 (copy at APB 283 to 286) was filed by the assessee before the AO along with letter dated 27.11.06 (copy at APB 287 to 292). In the revised return of income, out of the demerger expenses of Rs. 14,74,347/-, the assessee claimed an amount of Rs. 2,94,869/- as being allowable u/s 35 DD of the I.T. Act, being 1/5th of the said amount of Rs. 14,74,347/-. The balance expenditure of Rs. 11,79,478/- was disallowed. The revised computation (APB 283), in this regard, reads as follows:–

A. <u>Income from Business</u>

Adjustments in accordance with sections 28 to 44

……………………………………

7. Expenditure on account of demerger	Rs. 14,74,347/-
Less: Allowable u/s 35DD (1/5th of Rs. 14,74,347/-)	Rs. 2,94,869/-
	Rs. 11,79, 478/-

As such, it is evident that the assessee had claimed expenditure only of Rs. 16,54,531/-. The ld. CIT(A) has duly taken this into consideration. No doubt, the disallowance, if any, could have been made out of this amount only. However, in order to validate such a disallowance, as discussed hereinabove, what was required to be established was the nexus of the expenditure with the earning of the exempt income. The ld. CIT(A), in this regard, has merely observed that the entire balance expenditure of Rs. 16,54,531/- relates to the investment activity of the assessee Company. There is, however, nothing in the impugned order as to how this finding has been arrived at by the ld. CIT(A). It cannot be gain-said that the onus to prove the nexus between the expenditure incurred and the earning of income not forming part of the total income is squarely on the Department. In the absence of discharging this onus, no disallowance in this regard can be made, much less sustained, as has been done by the ld. CIT(A). There is absolutely nothing on record to show that any part of the expenditure was incurred to earn the exempt income. And not only this, as rightly canvassed, this expenditure of Rs. 16,54,531/- even included expenditure towards remuneration to Director and Audit Fees. Now this kind of expenditure, irrespective of the fact whether or not income not forming part of the total income is earned, has to be incurred. Therefore also, these expenses cannot, in any manner, be said to be relatable to earning of exempt income by the assessee company.

34. Thus, looked at from any angle, the ld. CIT(A), in our considered opinion, was not at all justified in holding the entire balance expenditure of Rs. 16,54,531/- incurred by the assessee company as liable to disallowance u/s 14A of the Act. The grievance of the assessee in this regard is, therefore, found to be justified and is accepted as such. The grouse of the Department, on the other hand, is found to be baseless and ground No. 1 raised by the Department is, hence, rejected, whereas Cross Objection No. 1 taken by the assessee is accepted.

35. Turning to ground No.2 raised by the Department, it has been contended that the ld. CIT(A) has erred in deleting the disallowance of Rs. 5,000/- made by the AO on account of fines and penalties. The AO, it is seen, made disallowance of the expenditure of Rs. 5,000/- incurred by the assessee Company on account of fines towards traffic violation. Before the ld. CIT(A), the assessee contended that a similar amount had been allowed as a deduction in the case of the assessee for the assessment year 1990-91 by the Tribunal in ITA No. 2856(Del)93. The ld. CIT(A) deleted the disallowance following the said order of the Tribunal. Before us, the

assessee has again pressed into service the Tribunal's order (supra) for the assessment year 1990-91 (copy at APB 225 to 228)in response to the ld. DR's argument that the payment for fines towards traffic violation and the AO had correctly made the disallowance.

36. The facts remaining the same for the year under consideration, as those for the assessment year 1990-91 and following the Tribunal order, the action of the ld. CIT(A) in deleting the disallowance is confirmed, rejecting Ground No.2 taken by the Department.

37. Turning to ground No.3, the Department contends that the ld. CIT(A) has erred in directing the AO to verify the claim of the assessee and exclude interest income from UTI from income after due verification and to allow the balance 50% of the additional depreciation after verifying the contention of the assessee that 50% additional depreciation was claimed and allowed in the immediately preceding year, i.e., in the assessment year 2005-06 and to verify the claim of the assessee and to allow credit of TDS.

38. In this regard, it is seen that the AO refused to allow additional depreciation @ 7.5% in respect of addition of plant and machinery during the immediately preceding assessment year, i.e., assessment year 2005-06. Before the ld. CIT(A), the assessee contended that in the assessment year 2005-06, the assessee had claimed additional depreciation @ 7.5%, being 50% of additional depreciation of 15%, amounting to Rs. 5,32,65,467/-, in respect of new plant and machinery, installed at the new eligible industrial undertaking of the Company, i.e., Unit No.8, Kathua, u/s 32 (iia) of the Act, since the machinery had been put to use for a period of less than 180 days in that previous year; that the depreciation claimed in the return of income for the assessment year 2005-06 was allowed; that in the return of income for the year under consideration, the assessee had claimed the balance 50% of additional depreciation of 15% of the value of the plant and machinery installed in the immediately preceding assessment year; that this was done through Notes to Accounts appended to the return of income; that this claim was computed at Rs. 1,32,79,884/-, by apportioning 50% of the gross amount of additional depreciation of Rs. 5,32,65,467/- in the ratio of 91 days to the total period; and that however, the AO had not considered this claim made by the assessee.

39. The ld. CIT(A), in the impugned order, observed as follows:–

> *"8.2 Since the appellant is stated to be admittedly eligible for deduction of additional depreciation as 50% of the same has already been duly allowed by the AO in the immediately preceding assessment year 2005-06, there is nothing on record to indicate that the appellant should not be allowed deduction of the balance 50% of deduction in the current assessment year 2006-07. Accordingly, the ld. AO is directed to verify the*

contention of the appellant that 50% of additional depreciation was claimed and allowed in the immediately preceding assessment year 2005-06 and if this fact is found to be factually correct, the AO is directed to allow the balance 50% of additional depreciation during the year under consideration. This ground of appeal is accordingly treated as allowed for statistical purposes."

40. There is nothing on record to show that the directions given by the ld. CIT(A) are not proper. The eligibility for deduction of additional depreciation stands admitted, since 50% thereof had already been allowed by the AO in the assessment year 2005-06, i.e., the immediately preceding assessment year. Therefore, obviously, the balance 50% of the deduction is to be allowed in the current year, i.e., assessment year 2006-07. The ld. CIT(A) has merely directed the verification of the contentions of the assessee and to allow the balance additional depreciation after such factual verification. Accordingly, finding no merit therein, ground No. 3 raised by the Department is rejected.

41. Now the only issue remaining is that comprising Cross Objection No. 2 raised by the assessee, which is to the effect that the ld. CIT(A) has erred in not directing the AO in allowing deduction to the assessee under sections 80 IA/80 IB of the Act in respect of the three units of the assessee.

42. The AO refused to allow deduction under sections 80 IA/80 IB regarding the assessee's three units which stood demerged pursuant to the Demerger Scheme approved by the Hon'ble Rajasthan High Court. This demerger came about 1.7.05, as noted hereinabove. The disallowance was ordered by the AO as per the provisions of section 80 IA(12) read with section 80 IB of the Act.

43. Before the ld. CIT(A), the main contention on behalf of the assessee Company was that deduction u/s 80 IB of the Act had not been allowed for the pre-demerger period from 1.4.05 to 30.6.05, either to the assessee Company or to the resulting Company after the demerger.

44. The ld. CIT(A) held the action of the AO to be correct in view of the provisions of section 80 IA(12), as per which, where the eligible undertaking stands transferred in a Scheme of Amalgamation or Demerger, the deduction is allowable only to the resulting Company.

45. Before us, it has been contended on behalf of the assessee that undisputedly, the deduction under sections 80 IA/80 IB of the Act had been claimed with respect to the profit of certain eligible units of the assessee Company; that these units had been part of the assessee company during the pre-demerger period from 1.4.05 to 30.5.05; that these units had been transferred under the Demerger Scheme with effect from 1.7.05; that the deduction claimed was only with respect to the profits earned by these undertakings for the said pre-demerger period only and such deduction had not been claimed in the computation of

income but by way of Notes appended to the return of income filed, the said Notes forming an integral part of the return of income; and that prior to the introduction of section 80 IA(12), CBDT Circular No. 15/5/63 – IT(A-I) dated 13.12.63 clarified that deductions under sections 80 IA and 80 IB of the Act were related to the eligible undertaking and accordingly, they got transferred with the undertaking, notwithstanding the ownership thereof. The learned counsel for the assessee has placed reliance on the following case laws in this regard:–

1. "*CIT v. P.K. Engg.& Forging Pvt. Ltd.*", 87 Taxmann 101(Cal);
2. "*A.G.S. Timber & Chemical Industries Pvt. Ltd. v. CIT*", 233 ITR 207(Mad);
3. "*ITO v. Hindustan Petroleum Corpn. Ltd.*", 25 TTJ (Bom)28;
4. "*Shah Granites Pvt. Ltd. v. ITO*", 28 TTJ 83(Bom);
5. "*ITO v. SLM Maneklal Industries Ltd.*", 17 ITD 515(Ahd.);
6. "*ACIT v. IIS Infotech Ltd.*", 82 TTJ 174(Del);
7. "*Tech Books Electronics Services (P)Ltd. v. ACIT*", 100 ITD 125(Del);
8. "*ACIT v. Prisma Electronics*" – ITA Nos. 3378(Del)2009 & 500(Del)2010(Del); and
9. "*ITO v. Advance Valves Global*" – ITA No. 2096(Del)2008(Del).

45. It has thus been contended that as such, the profits of the undertaking earned by the respective companies, i.e., the respective units, for the period the undertaking was owned by the respective companies, are eligible for deduction under sections 80 IA/80 IB of the Act; that the provisions of section 80 IA(12) merely facilitates the grant of deduction under sections 80 IA/80 IB of the Act to the resulting companies also, in the year of transfer/merger; that while bringing into the Statute Book, the said section 80 IA(12); that the Explanatory Note provides that these provisions have been introduced to make the Corporate Reorganizations tax neutral; that by virtue of the provisions of sections 80 IA/80 IB(12) of the Act, benefit of deduction under the profits earned by the demerger companies, for part of the period cannot, and so, ought not, be denied. It has further been contended that the provisions of the Act which are beneficial to the assessee must be liberally construed, as has been well settled in "*Bajaj Tempo v. CIT*", 194 ITR 188(SC), "*CIT v. Strawboard Manufacturing Co. Ltd.*", 177 ITR 431(SC) and "*P.R. Prabhakar v. CIT*", 284 ITR 548(SC). The learned counsel has then contended that as such, the provisions of sections 80 IA(12) and 80 IB(12) of the Act, being provisions beneficial to the assessee, require to be construed liberally; that deduction under the said sections is allowable to the demerged and resulting company in respect of the profits earned by both the companies for the respective period of ownership of the eligible undertaking in the year of demerger; that the AO has factually erred in

observing that no audit report in form No. 10 CCB, as provided under sections 80 IA(12) and 80 IB(12) of the Act was filed; that actually, the audit reports for the respective units were duly filed in the assessment proceedings vide letter dated 7.11.08 by the assessee; that the details of deduction under sections 80 IA(12) and 80 IB(12) of the Act were also given in the tax audit reports, certifying such deduction; that the AO has also wrongly observed that since the deduction was not claimed in the computation of income, it could not be allowed, in view of "Goetze India v. CIT", 284 ITR 323(SC); that in fact, it remains undisputed that the deduction in question was claimed by way of a Note appended to the original return of income; that in "CIT v. Sain Processing and Weaving Mill Pvt. Ltd.", 325 ITR 565(Del), it has been held that the net profit cannot be determined, without taking into account the information disclosed in the Notes appended to the accounts, which Notes form part of the accounts of the assessee Company.

46. The ld. DR, on the other hand, has strongly supported the impugned order in this regard, submitting that it remains undisputed that under the provisions of section 80 IA(12) of the Act, in a case where the eligible undertaking stands transferred in a Scheme of Amalgamation and Demerger, deduction is allowable only to the resulting company and so, the assessee/demerged company is not at all eligible for deduction under sections 80 IA/80 IB of the Act, as has rightly been held by both the Authorities below concurrently. It has further been contended that it would be wrong to canvass, as has been done in the case of the assessee, that the provisions of section 80 IA of the Act require to be read beneficially to the assessee; that the factual findings of the ld. CIT(A) in this regard are abundantly clear and nothing has been brought on record to dislodge them; that moreover, the AO has categorically observed in the assessment order that no report in form No. 10 CCB was filed by the assessee and it is only by way of an alibi that the assessee now contends to have done the needful in this regard before the AO during the assessment proceedings.

47. On this issue, we find that indeed, as per Circular No. 15/5/63 – IT(A-I) dated 13.12.63 (supra) it has been clarified that deduction under sections 80 IA/80 IB of the Act relates to the eligible undertaking and, accordingly, it transfers with that undertaking, notwithstanding the ownership of such undertaking. The Circular relates that the Board agreed that the benefit of section 84 attached to the undertaking and not to the owner thereof and that the successor would be entitled to the benefit of the unexpired period of 5 years, provided the undertaking was taken over as a running concern. The case laws relied on by the assessee are to a similar effect.

48. In "Advance Valves" (supra), following, inter alia, "P.K. Engg. & Forging" (supra) and "A.G.S Timber" (supra), "Prisma Electronics" (supra) and the CBDT Circular (supra) it has been held that it is the

successor on demerger, which would be entitled to the benefit for the unexpired period of 5 years, provided the undertaking was taken over as a running concern.

49. So far as regards the claim made by the assessee, it is on record that the assessee had duly filed the audit report in form No. 10 CCB vide letter dated 7.11.08 before the AO, in which audit report, deductions under sections 80 IA(12)/80 IB(12) of the Act were duly certified to have been claimed by the assessee. It is undisputed that the claim was made by way of a Note appended to the original return of income. It cannot be gain-said that the Note to the return of income formed an integral part of the return. That being the position, obviously, it cannot be held that the deduction was not claimed in the return of income. In this regard, in "Sain Processing" (supra), it has been held that net profit cannot be determined without taking into account the information disclosed in the Notes appended to the Accounts which formed part of the Accounts of the assessee Company.

50. In view of the above, we hold that the AO erred in denying the deduction under sections 80 IA(12)/80 IB(12) of the Act to the assessee and the ld. CIT(A) erred in confirming such disallowance. The grievance of the assessee in this regard is well justified, and Cross Objection No. 2 raised by the assessee is thus accepted.

51. In the result, whereas the appeal filed by the department is dismissed, the Cross Objection filed by the assessee is allowed.

Order pronounced in the open court on 04.05.2012.