

IN THE INCOME TAX APPELLATE TRIBUNAL, SURAT BENCH, SURAT
BEFORE SHRI PAWAN SINGH, JUDICIAL MEMBER AND
DR. ARJUN LAL SAINI, ACCOUNTANT MEMBER
ITA No.2571/AHD/2015 (AY 2011-12)
(Hearing in Virtual Court)

Surat Rough Diamond Sourcing (India) Limited, C-401/403, Diamond World, Mini Bazar, Varachha Road, Surat – 395006. PAN: AAOCS 9292 D	Vs	The Income Tax Officer, Ward-4(3), Surat.
Assessee / appellant		Revenue / respondent

Assessee by	Sh. Tushar P. Hemani Senior Advocate with P. S. Parmar Advocate
Revenue by	Shri Deependra Kumar – Sr.DR
Date of hearing	29/10/2021
Date of pronouncement	13/12/2021

Order under section 254(1) of Income Tax Act

PER PAWAN SINGH, JUDICIAL MEMBER:

1. This appeal by assessee is directed against the order of ld. Commissioner of Income Tax (Appeals)-2, Surat dated 14.07.2015 for the Assessment Year 2011-12. The assessee raised the following grounds of appeal:

“1. The learned CIT(A) has erred both in law and on the facts of the case in confirming the action of AO in disallowing business expenditure of Rs.1,02,96,954/- while simultaneously contradicting the factual findings of the AO on whether the business was set up during the year under consideration.

2. The learned CIT(A) has erred both in law and on the facts of the case in confirming the action of learned AO but by taking a completely different view of the facts and holding that the business was set up but the business expenditures incurred by the appellant were for a Illegal Business.

3. *Without prejudice to the above, the benefit of netting off of interest income against interest or other expenditure ought to have been granted.*

4. *Both the lower authorities have passed the orders without properly appreciating the fact and that they further erred in grossly ignoring various submissions, explanations and information submitted by the appellant from time to time which ought to have been considered before passing the impugned order. This action of the lower authorities is in clear breach of law and Principles of Natural Justice and therefore deserves to be quashed.*

5. *The learned CIT(A) has erred in law and on facts of the case in confirming action of the ld. AO in levying interest u/s 234A/B/C/D of the Act.*

6. *The learned CIT(A) has erred in law and on facts of the case in confirming action of the ld. AO in initiating penalty u/s 271(l)(c) of the Act.*

The appellant craves leave to add, amend, alter, edit, delete, modify or change all or any of the grounds of appeal at the time of or before the hearing of the appeal.”

2. Brief facts of the case are that the assessee is a company engaged in the sourcing of rough diamonds, filed its return of income for the A.Y. 2011-12 on 27.09.2011 declaring loss of Rs.3,09,035/-. The assessee claimed carry forward on unabsorbed depreciation of Rs.3,71,250/- and thereby declared business loss. The case was selected for scrutiny. During the assessment, the Assessing Officer (AO) noted that in the computation of income, the assessee has debited administrative expenses Rs.53,41,267/-, preliminary and pre-operative expenses of Rs.23,96,344/-, financial expenses of Rs.25,06,453/- and depreciation of Rs.52,890/- thereby claimed total expenses of Rs.1,02,96,954/- (1.03 Crore). The AO took his view that

assessee came into existence during the previous year as it was incorporated only on 03.11.2010, and there is no business receipt credited to the Profit and Loss Account and not a single transaction of sale or purchase made during the year. Accordingly, the AO issued show cause notice dated 24.12.2013 as to why the expenses of Rs.1.03 crore should not be disallowed as there is no business.

3. In response to the notice, the assessee filed its reply on 31.01.2014. Along with the reply, the assessee furnished the copy of memo of undertaking (MoU) dated 21.10.2010 with Zimbabwe. The assessee also furnished articles of assessment and Memorandum of Association (MoA) of Assessee Company. The assessee also furnished the details of brake up of pre-operative and preliminary expenses incurred in the month of October to January and also furnished business consultation charges paid to RSM Astute Consulting (Gujarat) Pvt. Ltd., and M/s. Kanga & Co. Mumbai. The assessee explained that all the expenses were incurred in accordance with the memorandum of articles of the assessee as the assessee are in the stage of setting up its business. The reply of assessee was considered by the AO, but the same was not found favourable to him. The AO was of the view that

assessee has not commenced any business activities and the expenses are not as per the provisions of Income Tax Act.

4. The AO recorded that in response to the show cause notice, against proposing various disallowance, the assessee requested for making a reference under section 144A of the Act to Additional Commissioner of Income- tax (Range Head). The Addl.CIT vide his order dated 27.03.2014, disposed off the application of assessee and no relief was given to the assessee. The relevant part of order of Addl.CIT is extracted on page 5 of the assessment order. The AO on receipt of direction of Addl.CIT, Range-4, examined the activities of assessee undertaken from 30.09.2010 till 31.03.2011 as recorded on page no.10 to 15 of the assessment order. On the basis of observation of all the activities allegedly undertaken by the assessee, the AO was of the view that business of assessee was not setup during the Financial Year 2010-11, therefore, the expenses debited to Profit and Loss Account including Depreciation cannot be allowed as deduction for the year under consideration. The AO accordingly disallowed the entire expenses of Rs.1.03 crore.
5. Aggrieved by the additions, the assessee filed an appeal before the Id.CIT(A). Before the Id.CIT(A), the assessee filed detailed written

submissions. The submission assessee is recorded in para 5 of order of ld. CIT(A). The assessee in its submission submitted that assessee is a Special Purpose Vehicle Company and is set up is to provide best quality of rough diamonds to all business man in this trade, even to the small businessman through tenders, auctions and other transportation modes and giving them bargaining power vis-à-vis mining giants of the world. The assessee also gave date wise event undertaken by the assessee company.

6. The assessee explained that on 03.09.2010 Meeting and Interactive Session with the Ministry of Mines and Zimbabwe Companies was held, on 05.10.2010 bank account was open with HSBC Bank, on 12.10.2010 and 13.10.2010 Mines and Market Seminar 2010 organised by Diamond and Jewellery Export Promotion Council of India, and Export Promotion Agency under the Ministry of Commerce. This event is attended the Hon'ble Minister of State for Commerce and Minister of Mines of Zimbabwe as key note speaker. On 14.10.2010 visit of Zimbabwe delegation in Surat, photographs of Zimbabwe delegation led by Minister of Mines was furnished. The Minister is welcomed in a poised manner by the assessee and a huge procession taken in his Honour on the Roads of Surat and Minister perched on Elephant. On 21.10.2010 MoU with Zimbabwe Mines and

Mineral Corporation for sourcing of rough diamonds was executed. On 25.10.2010 launch of website of assessee (SRDSIL). On 21.12.2010, Certificate of commencement of business issued by Ministry of Corporate Affairs. On 21.01.2011 purchase of rough diamonds of C. D. Jewels on behalf of assessee. On 01.02.2011 opening of wholly own subsidiary (DSRDSIL FZE) in Dubai and remittance of equity and loan funds to subsidiary company for procurement of rough diamonds. On 03.02.2011 advances for purchase of rough diamonds by SRDSIL FZE. The assessee also furnished funds infused in the assessee company during the assessment year. The assessee further explained that funds lying in the assessee's bank account were used to advance loan to wholly own subsidiary in UAE. The subsidiary of assessee in UAE ropes in C.D. Jewels for procurement of Zimbabwe rough diamonds and managed logistic for supply, insurance etc., Zimbabwe Mineral Corporation and Mbada Diamond invoices, C. D. Jewels for rough diamonds on 20.01.2011. However, C.D. Jewels and assessee could not lift the goods from Harare since International Airlines and insurers under United State and European Union pressure, refused to carry and insure the goods. The goods kept lying in Harare in safety vault and deemed custody of C.D. Jewels and assessee. The goods finally arrived in Dubai on

20.11.2011 and reached in India in end November 2011. All the aforesaid imports were duly accompanied and supported by relevant legal documents, such as bill of entry, K.P. Certificate, Invoices etc.

7. The assessee further explained that at the time of execution of agreement, there was no ban of sourcing of rough diamonds from Zimbabwe. Even the article news print dated 15.10.2010 takes note of this fact. This article states that all the Kimberly Process (KP) approved the sale of portion of Marange goods in August and September, which of which went to Indian Buyer. However, further sales have been withheld pending K.P. review machine reported to be discussed at the organisations plenary, to be held in Jerusalem during November. Further, the notifications/circular issued by Ministry of Finance during the relevant period clearly stated that import of K.P. Certificate Zimbabwe rough diamonds were legally very much permissible. The copy of Government Circular was furnished. The assessee also explained that as per Foreign Trade Policy - 2009-14 it has been stated that import of rough diamonds shall be permitted once the same is accompanied by K.P. Certificates. The rough diamonds are mined in different parts of world in Australia, Rulkia and Botswana, Zimbabwe, Ongola, Kanade in South Africa. The rough diamonds sold through traders and direct sales at

major global trading heads such Antwerp, Dubai and in India. The rough diamonds purchased by assessee are of mixed origin which could be from Zimbabwe or from Australia.

8. The Id. CIT(A), after considering the submission of assessee dismissed the appeal of assessee by taking view that assessee has debited expenses of Rs.1.03 crore under the head of Administrative Expenses, Preliminary Expenses, Financial Expenses and Depreciation. The assessee-company was incorporated on 03.11.2010 and no sale or purchase was made. The assessee made application under section 144A of the Act before Addl.CIT- Range-4, Surat for appropriate direction. Direction under section 144A was issued as reproduced in para 8 of the assessment order. The Id. CIT(A) further held that on perusal of details, it is revealed that assessee has not indulged into sale or purchase transaction. During the period, in financial year 2010-11, it was not possible for any Indian Company to source any diamond from Zimbabwe due to ban imposed by United Nation Organisation and India was one of the signatories. The Act of assessee is of welcoming Zimbabwe Delegation holding seminar at the best is a public relation exercise, further as the embargo on Zimbabwe rough diamond would not have made it possible to have any import from Zimbabwe. The office space was hired on

08.02.2011 and staff was recruited later. There is no fixed asset in the balance sheet of assessee. The reliance of office memorandum issued by Ministry of Commerce dated 24.11.2011 is misplaced and does not help the assessee. The Id. CIT(A) further note that during the appellate proceedings, Directorate of Revenue Intelligence (DRI), Ahmedabad conducted a search on 30.11.2011 to verify the source of the rough diamonds imported by assessee company and these rough diamonds were kept in the safe of Blue Star Diamonds. The DRI seized the rough diamonds as the country of origin was not ascertainable. The assessee was asked the status of DRI case. The assessee submitted that goods were released after obtaining indemnity bond for the value of Rs. 5.00 crore and the case is still under the investigation. As per the Panchnama draft by DRI 30.11.2011, the diamonds were seized as exact mining area in Zimbabwe could not be ascertained, nor any proof could be submitted. The contention of assessee that DRI has released its consignments as it was found to be explained, is misplaced and devoid of facts. The seized stock has been released against the bank guarantee and case of DRI is under progress. The Id.CIT(A) further held that the claim of assessee company about starting of business activity and making advance payments to C.D. Jewels in February, 2011 to show that assessee has started

his business is not supported with proper documentation and evidence. During the Financial year 2010-11, relevant to the current Assessment Year, Zimbabwe diamonds were under UNA embargo. During this period, the assessee claimed that it has brought Zimbabwe Diamond through C.D. Jewels through its subsidiaries SRDSILF ZE for US 15millions amounts to illegal business transaction.

9. The Id CIT(A) further held that the explanation of section 37 laid down the condition that any expenditure incurred for any purpose which is an offence or it is prohibited by law shall not be deemed to have been incurred for the purpose of business or profession, no deduction or allowance shall be made in respect of such expenditure. In fraction of law under any provisions cannot be allowed and no addition can be given to the infraction of law to the law breaker. The expenditure which can be allowed should be legitimate and not illegal. Further aggrieved, the assessee has filed present appeal before this Tribunal.
10. We have heard the submission of Sh. Tushar Himani, learned Senior Counsel for the assessee and learned Senior Departmental Representative (.Sr. DR) of the Revenue and have gone through the orders of Lower Authorities carefully. The Id. Senior Counsel for the assessee submits that

AO disallowed expenses consisting of administrative, preliminary, financial expenses and depreciation aggregating of Rs.1.03 crore. The Id. CIT(A) confirmed the disallowance of one additional count that the expenses was incurred by the assessee for an illegal business and hence, in view of Explanation to section 37, such expenses are not allowable. The Id. Senior Counsel submits that Assessee Company is dealing in rough diamonds and has come into existence with the principal object of providing best quality of rough diamonds to all small, middle and other business houses engaged in the business of diamonds by way of tender, auction on other transaction mode and give them bargaining power vis-à-vis mining giants in the world. The details of activities carried out by the assessee during the period under consideration were furnished to the Lower Authorities.

11. The learned Senior Counsel for the assessee further submits that note on certain vital facts is furnished in writing to the Hon'ble Bench. In the said note, the assessee has explained that the assessee was looking forward for purchase of rough diamonds from Zimbabwe and put in strenuous efforts in such direction. However, during the period under consideration, a ban was imposed from 17.11.2010 which were later on lifted on 24.11.2011 on import of rough diamonds from Zimbabwe by United Nation Organization

under the Kimberly Process certification and since India was one of the signatories of Kimberley Process, the International Law was applicable to India as well. Dubai was one of the major centres for trading rough diamond and was the first country to allow dealings with Zimbabwe, hence, the assessee open wholly owned subsidiary namely SRDSIL FZE in United Arab Emirates (UAE). The assessee advanced loan to its UAE subsidiaries out of funds lying in its bank account in accordance of the procedure prescribed by RBI as is evident from the bank statement of assessee. Copy of which is placed at page no.78 of paper book. The assessee's subsidiary in turn placed an order for purchase of diamonds from C. D. Jewels and also made payment against the same have been received from the assessee. The ledger account of C. D. Jewels and bank statement of assessee's subsidiary and annual account of assessee's subsidiary in Dubai is placed on record. C. D. Jewels, in turn procured diamonds from MBABDA Diamonds Private Limited through Mineral Metal Trading Corporation of Zimbabwe. Copy of invoices of MBABDA is also placed on record. Ultimately, such diamonds purchased by C. D. Jewels was received by assessee's subsidiary in Dubai and in turn the same was imported by assessee in Nov, 2011 i.e. immediately succeeding year.

12. The Id. Senior Counsel submits that CESTAT passed order on 12.03.2020 wherein the transaction relation to procurement of diamonds through assessee's subsidiary have been discussed in length and found to be legal and permissible, copy of the same is placed on record. The Id. Senior Counsel further submitted that AO and Ld. CIT(A) have been carried away by the fact that assessee had not indulgent into any transaction as to purchase or sale during the year under consideration.
13. The mere fact that no purchase or sale transaction took place during the year under consideration cannot be sale barometer for determining as to whether business was setup or not. The assessee undertook various activities which need to be taken by the Lower Authorities. The Lower Authorities have brushed aside the factum of business being setup and also the activities carried out by the assessee during the period under consideration that the Lower Authorities have not at all disputed the fact that such kind of activities were actually carried out by the assessee. The Id. Senior Counsel submits that transaction of assessee with its subsidiary are genuine and in accordance with law as evident from the order of Hon CESTAT dated 12.03.2020. The Id. Senior Counsel submits that Hon'ble Gujarat High Court Sardar Sarovar Narmada Nigam Limited (2014) (364 ITR 477

Gujarat)/ (2013) 37 taxmann.com 344 (Gujarat)/ 263 CTR 591 (Gujarat), while referring the object clause of the said assessee held that the object could not be achieved without contemplating different stages of completion and it would be wholly wrong to uphold the contention of the Revenue that only on completion of work of entire canal, the assessee's business can be said to have taken up. In the project like Sardar Sarovar, they are bound to be different stage, where different activities takes place and those activities being integral parts of the business and when they are set up phase vice, and the assessee cannot be deprived of benefits of fiscal legislation in disregarded to well settled principles on the issue by adopting over technical approach.

14. The Id. Senior Counsel further submits that the AO and Id. CIT(A) cannot sit in the chair of businessmen so as to discharge as to which activities are essential in the business and how such activities are to be carried out by the businessmen. To support his submission, the Id. Senior Counsel for the assessee relied upon the decision of Hon'ble Apex Court on S. A. Builders 288 ITR 1 (SC). The Id. Senior Counsel further submits that Id.CIT(A) erroneously held that expenses were incurred by the assessee for an illegal business particularly in view of ban on sale of rough diamonds from

Zimbabwe imposed by UNA under Kimberly Process. The learned Senior Counsel submits that it is an undisputed fact that during the year under consideration, the assessee has not purchased any diamonds worth a single rupee. The expenses claimed by assessee were on account of administrative expenses, preliminary and pre-operative expenses, written off, financial expenses and depreciation. The expenses such as organising Gala dinners for Zimbabwe Authorities and others giving Gifts etc., have been incurred broadly for developing relation with person in Zimbabwe anticipating that the same would bring business to assessee in future, such activities are neither an offence, nor prohibited by law, hence, the explanation under section 37 cannot be invoked in case of assessee to disallow expenses for such activities. There is no prohibition on inviting foreign guests, organising dinner for guests, giving gifts and perks to dignitaries so as to develop better business relation which in turn might be helpful to the business in further, hence such expenditure would not be covered by explanation to section 73. The explanation to section 37 is concerned with “nature of expenditure” and not “nature of business”. In the present case nature of expenditure is such that same cannot be said to be either an offence or prohibited by law, hence, Explanation to section 37 is inapplicable to the expenses in question. The ld.

Senior Counsel for the assessee reiterated that during the year under consideration no expenditure has been incurred on purchase of diamonds from Zimbabwe, therefore explanation to section 37 cannot be invoked. The ld. Senior Counsel for the assessee further submits that it is an undisputed fact that for the year under consideration of assessee has not purchased any diamond worth of single rupee as per para 6.1.3 of ld.CIT(A) order, thus, the whole issue at best, is academic and not at all relevant for determining the controversy on hand. As a matter of fact, immediately after ban, on Zimbabwe diamond was lifted in November, 2011, the assessee imported diamonds and also such imports were duly accompanied and supported by legal document, invoice, bill of entry, K. P. Certificate etc, after following the due process of law. Under such circumstances, the aspect that business was duly setup during the year under consideration and such business was very much legal, have become crystal clear.

15. In without prejudice submission, the ld. Senior Counsel for the assessee submits that even if a view is taken that assessee did not commence its business during the year under consideration, then benefit of netting of Rs.25,84,398/- against the interest and other expenses incurred by assessee must be granted.

16. On the other hand, the Id.Sr.DR for the Revenue supported the order of AO and Id. CIT(A). The Id.Sr.DR further submits that the assessee was only incorporated only on 03.11.2010 and during the year, no sale or purchase was made. The assessee moved application for reference under section 144A before Additional CIT, Range-4. The direction under section 144A of the Act was issued. The direction of Range Head was included in the assessment order. The AO before disallowing the expenses clearly held that assessee was hired office completing only on 08.02.2011 and the staff was deputed at the end of relevant assessment year. The AO clearly held that opening of bank account making same correspondence with bank and MBADA Diamond Private Limited of Zimbabwe was not sufficient for claiming exorbitant expenses.

17. We have considered the rival submission of both the parties and have gone through the orders of Lower Authorities carefully. The short controversy for our adjudication is whether the assessee is entitled for pre-operative administrative expenses, preliminary expenses, financial expenses and depreciation or not. It is an undisputed fact that during the period under consideration, the assessee has not imported a single piece of diamond, nor made any payment thereof, therefore, the invocation of explanation to

section 37 by Id. CIT(A) is uncalled for. The assessee has placed on record the copy of Memorandum of Association (MOA) of Assessee Company. The assessee is a Special Purpose Vehicle company formed and registered in India as a Public Limited Company, engage in business of sourcing of rough diamonds globally. The assessee is to carry out its business as per MOA, for procuring, cleaving, sawing, cutting, polishing, processing, manufacturing, sorting, grading, buying, selling, handling, supplying, transporting, distributing, warehousing, trading, auctioning, tendering, bidding, importing, exporting, marketing or otherwise dealing or disposing any diamonds, sapphire, ruby topaz, garnet, emerald, pearl, precious or semiprecious or natural stones, aquatic, marine or other such articles, gold, silver, platinum, titanium, bullion or any other precious / semi-precious metals or alloys thereof, in any form whatsoever, and jewelleryes, ornaments, articles, decorative and art materials goods or things made of all or any of such things or a combination thereof and to act as broker, auctioneer, importer, exporter, distributor, agent, wholesaler, merchant, goldsmith, silversmith, jewellers, manufacturer, polishers, processors in relation to all or any of the above and to take up all such incidental acts and things necessary for attainment of the above objects.

18. In pursuance of its object, the assessee incurred various expenses. We find that nature of expenses was not examined. The AO, disallowed the expenses by taking view that business of assessee was not setup during the year under consideration. The ld. CIT(A) confirmed the action of AO on similar lines. The ld. CIT(A) also confirmed the disallowance of additional ground that the expenses were incurred by assessee for illegal business. We may note that we have already held that invocation of explanation to section 37 is uncalled for as the assessee has not made any expenses for purchase of diamonds rather entire expenses are in the nature of preoperative business expenses. The various expenses incurred by the assessee are not at all prohibited by law. All expenses were incurred in anticipation of business. It is a settled law that the AO cannot sit in the chair of businessmen so as to decide what activities are essential in the business should be activities are to be carried out by the businessmen. It has been held so by Hon'ble Apex Court in S.A. Builders (supra).

19. We further find that the Hon'ble High Court in CIT Vs Sardar Sarovar Narmada Nigam Limited (supra) while considering the question of law whether Special Bench of Tribunal is right in holding that assessee's business had setup w.e.f. 21.02.2001 which is to flow drinking water as a

construction work of canal project was still under progress. The Hon'ble High Court while referring its earlier decision in CIT Vs Sarabhai Sons (P.) Ltd., [1973] 90 ITR 318, (Guj); and in CIT Vs Saurashtra Cement and Chemicals Industry [91 ITR 170 (Guj)] held that when business can be said to have been setup, the Court observed that when each one of the activities essential and vital and combined together constitute business of the assessee and things being a continuous process, all activities which go to make a business need not be started simultaneously of entire term business without proceeding other activities, no fault can be found. On the finding of the Tribunal, it held the businesses have to be setup without same being commenced and ultimately dismissed the appeal of the Revenue.

20. At the cost of repetition that the quantum of expenses has not been examined nor been disputed nor the legitimacy of the expenses were disputed. The assessee has incurred expenses for the purpose of business. Thus, in view of the aforesaid factual and legal discussion, we are of the view that the disallowance of expenses of Rs. 1.03 Crore incurred by assessee on various preoperative expenses is not justified. Hence, we direct the AO to allow the entire business expenditure claimed by the assessee. In the result, grounds No. 1 to 2 of appeal raised by the assessee are allowed.

21. Considering the fact that we have allowed the substantial ground of appeal, therefore, adjudication of Ground No.3 raised in alternative and without prejudice and on the submissions made therein by learned Senior Counsel of the assessee have become academic.

22. Ground No. 4 is general and need no specific adjudication. Ground No. 5, which relates to levy of interest under section 234A/B/C/D is consequential and Ground No. 6 relates to initiation of penalty under section 271(1)(c) is premature and therefore dismissed.

23. In the result, appeal of the assessee is allowed.

Order announced on 13 December, 2021 in open court and the result was placed on the notice board.

Sd/-
(Dr ARJUN LAL SAINI)
ACCOUNTANT MEMBER

Surat Dated: 13/12/2021 /SGR*

Copy to:

1. Appellant
2. Respondent
3. CIT(A)
4. CIT
5. DR
6. Guard File

Sd/-
(PAWAN SINGH)
JUDICIAL MEMBER

By order

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Sr. Pvt. Secretary, ITAT, Surat