

In-house R&D facility for manufacturing company eligible to claim such a deduction is required to be approved by the Secretary, Department of Scientific and Industrial Research ('DSIR'), Government of India ('GOI'). Companies having identifiable R&D infrastructure comprising analytical facilities, qualified manpower with well-defined R&D programs are considered for DSIR recognition.

Section 35(2AB) of the Act is loaded with a sunset clause whereby the expenditure incurred after March 31, 2017, would not be eligible for such a deduction. However, it has been observed that similar sunset clause has been extended in the past by the legislature by bringing an amendment in the statute through the Finance Act.

2. Approval Process

A two-step approval process has been prescribed for obtaining approval from the DSIR by the company having in-house R&D facility. Firstly, the facility has to be recognised or registered with the DSIR and, secondly, approval is required to be obtained.

Procedure for Obtaining Recognition

- a. Application as in the prescribed format¹ is to be made by the companies having identifiable R&D infrastructure comprising analytical facilities, qualified manpower with well-defined R&D programmes.
- b. The application is to be signed by the managing director/full-time director of the company and filed in eight sets along with the latest annual report, brief write-up on the past achievements, ongoing and future R&D projects/programmes of the in-house R&D facility. Photographs of some newly-developed products or application of the products/technologies along with a caption should also be enclosed. In addition, a company may enclose copies of bio-data of the key R&D personnel, major infrastructure available for research, product brochures/literature, certificates of merit or awards, etc., which may help DSIR appreciate the strengths of the R&D unit. A soft copy of the application along with the corporate presentation and a presentation on the R&D and a walk-in CD of the R&D facility should also be submitted.
- c. The application is scrutinised by the DSIR and circulated for comments among various administrative ministries/departments and

organisations. Thereafter, visits are made by an expert team (committee) comprising representatives of DSIR and outside agencies like administrative ministries, CSIR, etc. Discussions are held with the concerned key executives of the Company by the DSIR before granting the recognition.

The recognition is granted within 4 months (approx.) from the date of receipt of duly-completed application by the DSIR.

Procedure for Obtaining Approval

- d. An application in the prescribed form, i.e. Form No. 3CK, is required to be filed by the company with the Secretary, DSIR, for entering into an agreement with the DSIR for cooperation in, in-house research facility and audit of accounts maintained for the facility. The word cooperation shall, inter alia, mean that the assessee shall be willing to undertake projects of national importance, as may be assigned to it by the prescribed authority, on its own, or in association with laboratories of specified institution(s). The assessee would be free to exploit the results of such R&D projects, subject however, to any condition which may be imposed by the Government of India, in view of national security or in public interest.
- e. DSIR on satisfaction that the prescribed conditions are fulfilled, shall pass an order in writing in the prescribed form, i.e. Form No. 3CM.

The approval process takes approximately four to six months from the date of receipt of application. Generally, the approval is granted for three years and is renewable for a further period on application being made by the assessee three months before the expiry of the approval period. As per the prevailing DSIR guidelines, approval granted by the DSIR to a recognised R&D facility of the company runs from 1st April of the year in which the application is filed. Further, the approval granted is co-terminus with recognition granted by the DSIR.

3. Following the Code

As per the guidelines² issued by the DSIR (as on www.dsir.gov.in), the company to whom approval is granted, needs to abide by the following conditions:

- a. The company must spell out a long-term R&D policy which should be displayed prominently in the in-house R&D facility.

¹ Format can be accessed at www.dsirwebcsirhq.csir.res.in

² Refer DSIR guidelines at www.dsir.gov.in

The word *cooperation* shall, *inter alia*, mean that the assessee shall be willing to undertake projects of national importance, as may be assigned to it by the prescribed authority, on its own, or in association with laboratories of specified institution(s).

- b. The R&D facility should be exclusively used by the company to carry out a scientific research. Thus, no other work can be carried out in the facility apart from scientific research.
- c. The company needs to have well-defined R&D programs and the in-house R&D centre is required to be located in a separate earmarked area/building with an exclusive R&D manpower of its own.
- d. The R&D facility should not relate purely to market research, sales promotion, quality control, testing, commercial production, style changes, routine data collection or activities of a like nature.
- e. The company shall provide full cooperation to the DSIR in carrying out the R&D work.
- f. The company shall maintain separate accounts for both revenue and capital expenditure on scientific research including that on in-house R&D facility, which shall be annually audited by an accountant as defined in the Act.
- g. Get the accounts audited every year. A copy of the audit report as referred to the above has to be submitted with the DSIR by 31st October of each succeeding year. Further, annual progress report along with other prescribed information is required to be submitted to the DSIR for approval by 31st October of the following financial year.
- h. Assets acquired by the approved facility will be utilised only for the approved purpose. Thus, there cannot be any asset that may be used both for general business as well as in the in-house R&D facility. Further, such assets shall not be disposed of without the approval of the DSIR.

4. Expenditure Eligible for Deduction in Accordance with Provisions of the Act

Section 35(2AB) of the Act reads:

“(1) Where a company engaged in the business of bio-technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule incurs any expenditure on scientific research (not being expenditure in the nature of cost of any land or building) on in-house research and

development facility as approved by the prescribed authority, then, there shall be allowed a deduction of a sum equal to two times of the expenditure so incurred.

Explanation.—For the purposes of this clause, “expenditure on scientific research”, in relation to drugs and pharmaceuticals, shall include expenditure incurred on clinical drug trial, obtaining approval from any regulatory authority under any Central, State or Provincial Act and filing an application for a patent under the Patents Act, 1970 (39 of 1970).

Thus, the following emerge on a bare perusal of the above:

- Super deduction can be availed both in respect of capital as well as revenue expenditure. Expenditure incurred on acquisition of land and building is not an allowable expense for claiming 200% tax deduction.
- Such expenditure should be incurred for *scientific research*.
- Such scientific research expenditure should be incurred on approved in-house R&D facility.

5. Analysis of Section 35(2AB)

A. Expenditure should be on Scientific Research Activity

As per the Section 43(4) of the Act, the term ‘*scientific research*’ means, any activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries. References to expenditure incurred on scientific research include all expenditure incurred for the prosecution, or the provision of facilities for the prosecution, of scientific research, but do not include any expenditure incurred in the acquisition of rights in, or arising out of, scientific research. References to scientific research related to a business or class of business include any scientific research which may lead to or facilitate an extension of that business or, all businesses of that class and include any scientific research of a medical nature which has a special relation to the welfare of workers employed in that business or, all businesses of that class.”

As per the Rule 6(7A) of Income-tax Rules, 1962 (‘the Rules’), “the research and development facility should not relate purely to market research, sales promotion, quality control, testing, commercial production, style changes, routine data collection or activities of a like nature.”

Therefore, the company would need to demonstrate that the scientific research undertaken by it would result into some tangible results and not merely relate to the testing of existing machinery on a routine basis.

In a decision rendered by the Amritsar Bench of the Income Tax Appellate Tribunal ('ITAT' or 'Tribunal') in *DCIT vs. Daljit Singh Eye Hospital (P) Ltd. (2004) 90 ITD 235*, the Court upheld the claim of the assessee on expenditure incurred for purchasing a laser machine for development of laser delivery. This machine was used by the assessee for carrying out experiments on various patients for reducing plus and minus numbers. The experience led to gradual improvements in the technique and was accordingly, held as an extension of knowledge covered under the scope of 'Scientific research'.

Further, in the case of *Enem Nostrum Remedies (P) Ltd. vs. ACIT (2008) 314 ITR 47*, the Delhi Bench of the Tribunal analysing the meaning of *scientific research* cited an example that if the scientific research conducted by assessee would result in reducing the time taken by a medicine to cure a disease, such *scientific research* would lead to extension of business and accordingly would be covered within the ambit of Section 43(4) of the Act. The ITAT in this case also observed that it is nowhere contemplated in Section 43(4) of the Act that scientific research should lead to the growth of business in terms of more orders.

Thus, it is essential for any company to be able to demonstrate that scientific research carried out in separate facility results into something new and would not merely relate to testing of the existing product, machinery, quality control and commercial production.

Further, of late, the Courts while examining the claim of the assessee in the context of satisfying the test of *scientific expenditure* have ruled that there has to be a direct nexus between scientific research carried on by the assessee and the relationship of the research with its own business. For instance, in *Enem Nostrum Remedies (P) Ltd. Vs. ACIT [2008] 314 ITR 47*, the Mumbai Bench of the Tribunal held that provisions of 100% deduction (both capital and revenue expenditure)

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of expenditure on scientific research shall apply only in respect of in-house research expenditure of companies which are engaged in the manufacture of specified things. Where the only activity of the assessee was to undertake research and development work strictly in accordance with the orders placed by its parent company in USA and on the completion of the job it got compensated with the product development charges and the research work done by the assessee was not used in undertaking any manufacturing facility for itself, the assessee was not engaged in manufacture of specified things. Similar conclusion was reached by the Mumbai ITAT in the case of *Ciba India Pvt. Ltd. vs. ITO [2009] 318 ITR 71*.

Thus, it would also be important to demonstrate that the R&D activities carried out by the Indian company are used in its own business.

In addition to the above, it is important to note that the DSIR has laid down general principles on expenses incurred by the R&D facility which qualify for weighted deduction. These are:

- ▶ The weighted deduction is available on the 'net' expenditure. Sales realisations, grants/gifts, donations, presents, sponsorships for the R&D facility has to be set-off against the R&D expenditure.
- ▶ Capital expenditure except those on land and building incurred on the R&D account and revenue expenditures such as salary and wages of persons engaged in R&D, materials consumed for R&D, utilities consumed for R&D and any other revenue expenditure directly related to R&D, qualify for the purpose of deduction in case of the in-house R&D facility of manufacturing unit. However, expenditure on facilities that relate purely to market research, sales promotion, quality control, testing, commercial production, style changes, routine data collection or activities of a like nature do not qualify for deduction.
- ▶ Expenditure which is directly identifiable with the approved R&D facility only shall be eligible

In a decision rendered by the Amritsar Bench of the Income tax Appellate Tribunal ('ITAT' or 'Tribunal') in *DCIT vs. Daljit Singh Eye Hospital (P) Ltd. (2004) 90 ITD 235*, the Court upheld the claim of the assessee on expenditure incurred for purchasing a laser machine for development of laser delivery.

for weighted tax deduction. Expenditure in the R&D on utilities that are supplied from a common source which also services areas of the plant other than R&D may be admissible provided they are metered/ measured and subject to certification by a chartered accountant.

- ▶ Expenditure on manpower from departments other than R&D facility such as manufacture, quality control (QC), tool room, etc., on functions like attending meetings, providing advice/direction, customer survey on response to new product under development and other liaison work are not eligible.
- ▶ Expenditure of general nature such as expenditure on production, maintenance, QC departments, manufacturing overheads, depreciation, interest, and lease rentals on manufacturing/QC equipment, manpower expenditure in manufacturing/service department, head office expenditure, expenditure on security, guesthouse, canteen and other overheads of common nature are not eligible.

Thus, an assessee has to fall within the four corners of the law while conducting scientific research as well as observe the guidelines prescribed by the DSIR which is an approving authority. In case any question arises as to whether, and if so, to what extent, any activity constitutes or constituted, or any asset is or was being used for scientific research, a reference is required to be made to the prescribed authority whose decision would be final. In the case of *DCIT vs. Marsek (2012) 210 Taxman 432*, the Gujarat High Court, held that the Act provides for a reference to be made by the CBDT on such question namely, whether, and if so, to what extent, any activity constitutes or constituted, or any asset is or was being used for scientific research. The decision of the prescribed authority to whom the CBDT may make a reference would be final. Whenever any such question arises, the tax officer cannot decide the issue but must place the issue before the CBDT who would refer the question to the prescribed authority. The decision of the prescribed authority would be binding on the parties. Further, the Allahabad High Court in the case of *J.K. Synthetics*

Ltd. vs. ITO (105 ITR 864), held that if the assessing officer does not accept the claim of the assessee made under Section 35 of the Act on any grounds referred in the Act, he cannot outrightly reject the claim. He has to refer the matter to the CBDT, and it has to refer the question to the prescribed authority. Accordingly, the assessing officer has the powers to refer the matter to the CBDT which in turn will refer the matter to the Central Government/prescribed authority as the case may be and their decision will be final.

B. Expenditure should be Incurred on In-House Facility Approved by DSIR

The second main condition of the law provides emphasis on in-house research and development facility. The word in-house is not defined in the Act. In common parlance, it means something that is within the premises used by the assessee for its own business. The assessee has to apply separately for approval of each R&D facility. The approval is for each R&D facility. In common parlance, it means something that is within the premises used by the assessee for its own business.

Dictionary meaning of the term is:

“Conducted within, coming from, or being within an organisation or group: as in - an in-house computer system; in-house counsel; an in-house newsletter”/“within an organisation or group as in-house job the job was done in-house”.

Thus, the intention of the law is to provide the benefit to those companies that maintain in-house R&D facility to benefit their own manufacturing business. Therefore, if an R&D is conducted outside the R&D facility, the benefit of Section 35(2AB) may not be available on such R&D expenditure.

In this regard, it is important to note that in the case of *Cadila Healthcare Limited [2013] ITA NO. 752 of 2012*, wherein the assessee was engaged in the drugs



and pharmaceutical business, the Gujarat High Court held that testing charges incurred on trial runs outside the R&D facility is permissible on the ground that owing to the very nature of the business, the clinical trials may not always be possible to be conducted in the closed laboratory in similar in-house facility and if such narrow interpretation is given to the term expenditure incurred on in-house facility would defeat the purpose of the law.

As per the guidelines issued by the DSIR, an in-house R&D facility must satisfy the condition of having exclusive manpower of its own for eligibility to apply for approval of DSIR. Own resources may not necessarily mean employees but at least it indicates human resources having some sort of long term agreement for doing an R&D work for the entity. The guidelines also provide that the expenditure incurred on the outsourced R&D activities is not eligible for tax deduction. Also, the application form shows that the emphasis is on the in-house R&D facility having its own human resources to conduct R&D.

Thus, where the research work is done by the company with the support of a third party, it can be questioned that the company is not having a full-fledged in-house research to qualify for weighted deduction. Where the emphasis by the law is so overwhelmingly on identifying the physical location of the in-house R&D facility and expense incurred therein, it is unlikely that expenditure incurred in the form of payment to third parties for an R&D work in third party premises will be considered eligible for deduction under the Section 35(2AB). Hence, if an R&D facility is manned mainly by retainer R&D personnel, it is not likely to be approved by the DSIR. Further, if the facility does not have adequate resources to complete the entire chain of R&D process by its own human resources and on its own machinery and facility, the DSIR may not be convinced that it satisfies the condition of being a full-fledged in-house R&D centre and may deny the benefit of Section 35(2AB).

In the case of DCIT vs. Marsek (2012) 210 Taxman 432, Gujarat High Court, held that the Act provides for a reference to be made by the CBDT on such question namely, whether, and if so, to what extent, any activity constitutes or constituted, or any asset is or was being used for scientific research.



C. Assessee's Claim for Such Expenditure Needs to have Sanction of DSIR

It is pertinent to note that once the approval is granted by the DSIR, the assessee is required to abide with the guidelines issued by the DSIR. DSIR certifies the eligible expenditure in Form 3CL which helps the assessee in getting her/his Section 35(2AB) claim passed from the assessing officer.

Income-tax Act, 1961 and the Rules issued therein do not expressly provide that only such expenditure which has been certified by the DSIR shall be eligible for deduction under Section 35(2AB) of the Act. However, in a recent decision in the case of *Electronics Corporation of India Limited vs. ACIT (2011) ITA NO. 1106*, the Hyderabad Bench of ITAT held that the R&D expenditure which is approved by the DSIR only would be eligible for weighted deduction, the tax officer/appellate authorities cannot decide the same. It was observed that in terms of the provisions of the Act, if any question arises as to whether and if so to what extent any activities constitutes or constituted or any asset was used for scientific research, the matter should be referred to the appropriate authority (DSIR) whose decision will be final. Thus, it was held that once the DSIR has certified the quantum of eligible R&D expenditure for the purposes of weighted deduction under the Act, the figure cannot be tampered with by the Court. Even if the assessee is correct in that there is a mistake in the certificate issued by the DSIR, the same can only be rectified by DSIR and not by the Tribunal in appellate proceedings.

6. Concluding remarks

In the light of the above, it is recommended that the utmost care be exercised by an assessee while getting her/his R&D expenditure certified from the DSIR. Any inconsistency in the certification *vis-à-vis* the claim of R&D expenditure in the tax return may have a negative impact in term of getting her/his claim passed from the tax authorities, thereby leading to a prolonged litigation. ■