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## **Weighted deduction available for R&D expenditure incurred outside the approved facility;**

## **Profit of tax holiday unit computed by considering 'actual' sale price and costs attributable thereof, including HO costs allocation**

### **In brief**

In a recent ruling in the case of Cadila Healthcare Ltd. (assessee or company), the Ahmedabad Income-tax Appellate Tribunal (the Tribunal) has held, among other things, the following:

- Weighted deduction under section 35(2AB) of the Income-tax Act, 1961 (the Act) is available on the expenditure incurred by the assessee on clinical trials and the bio-equivalence study conducted outside the approved Research and Development (R&D) facility.

- Deduction under section 80-IB and section 80-IC of the Act is available on the profit earned by the eligible unit from the overall activity, and the assessing officer (AO) cannot segregate manufacturing and sale activity for the purpose of computing deduction under respective sections.

### **Facts**

- The assessee was engaged in the business of manufacturing and trading of pharmaceuticals goods, diagnostic kits, medical instruments etc. The assessee was having a unit at Baddi, Himachal Pradesh, for which it was claiming a

deduction under section 80-IC of the Act. Further, the assessee also has a unit at Goa, for which the assessee was claiming deduction under section 80-IB of the Act.

- During the course of assessment proceedings, the AO proposed the following adjustments to the total income in his draft assessment order passed under section 143(3) of the Act read with 144C of the Act:
  - Disallowance of weighted deduction under section 35(2AB) of the Act claimed by the company with respect to expenditure incurred on clinical

trials and the bio-equivalence study conducted outside the approved R&D facility.

- Curtailment of amount of deduction claimed by the company under sections 80-IC and 80-IB of the Act with respect to its Goa and Baddi units respectively.
- The disallowances proposed by the AO were upheld by the Dispute Resolution Panel (DRP). Aggrieved with the order of the DRP, the assessee preferred an appeal before the Tribunal.

### Contentions and ruling

Issue	Assessee's contentions	Revenue's contentions	Tribunal's ruling
Whether weighted deduction is available under section 35(2AB) of the Act for expenditure incurred on clinical trials and the bio- equivalence study conducted outside the approved facility.	<ul style="list-style-type: none"> <li>• Clinical drug trial is an integral part of the ongoing scientific research carried on by pharmaceutical companies.</li> <li>• A bioequivalence study is a highly specialised clinical trial research study, which is integrally connected with the scientific research.</li> <li>• Such trials are mandatory for obtaining the approval for any drug from the regulatory authority.</li> <li>• The scope of section 35(2AB) of the Act is expanded by the explanation to the</li> </ul>	<ul style="list-style-type: none"> <li>• The clinical trials have to be conducted in-house to become eligible for weighted deduction under section 35(2AB) of the Act.</li> <li>• Since the expenditure on clinical trials was incurred outside the facility approved by the DSIR, the same is not eligible for a weighted deduction under section 35(2AB) of the Act.</li> <li>• The revenue authorities relied on decision of the Plantation Corporation of Kerala<sup>2</sup>.</li> </ul>	<ul style="list-style-type: none"> <li>• As per the explanation to section 35(2AB) of the Act, a clinical drug trial is to be considered a part of research and is eligible for a weighted deduction.</li> <li>• Weighted deduction is available for an expenditure incurred in relation to the in-house R&amp;D facility.</li> <li>• It is not necessary to incur the expenditure inside the R&amp;D facility.</li> <li>• In the decision of Claris Life Sciences<sup>3</sup>, the Gujarat High Court has clarified that once the scientific research facility is approved,</li> </ul>

<sup>2</sup> Commissioner of Agricultural Income-tax v. Plantation Corporation of Kerala [2000] 247 ITR 155 (SC)

<sup>3</sup> CIT v. Claris Life Sciences [2008] 221 CTR 301 (Guj)

Issue	Assessee's contentions	Revenue's contentions	Tribunal's ruling
	<p>section to allow weighted deduction for expenses on clinical trials and expenses for obtaining regulatory approvals.</p> <ul style="list-style-type: none"> <li>The said explanation does not restrict the allowability of weighted deduction only to expenses incurred in-house.</li> <li>Since the expenditure incurred on clinical trials and for getting regulatory approvals is an integral part of the R&amp;D facility approved by Department of Scientific and Industrial Research (DSIR), the expenditure incurred on the same is eligible for weighted deduction under section 35(2AB) of the Act.</li> <li>The assessee relied upon various decisions<sup>1</sup> in support of its arguments.</li> </ul>	<ul style="list-style-type: none"> <li>The revenue authorities also contested that bio-equivalence studies constitute neither clinical trials nor scientific research.</li> </ul>	<p>the expenditure incurred on the R&amp;D facility is eligible for weighted deduction under section 35(2AB) of the Act.</p> <ul style="list-style-type: none"> <li>In light of the above, the expenditure incurred by the assessee on clinical trials and bio-equivalence studies is eligible for weighted deduction under section 35(2AB) of the Act.</li> </ul>
<p>Whether deduction under sections 80-IB and 80-IC of the Act is available on the activities of the Baddi and Goa units, being units enjoying tax holiday.</p>	<ul style="list-style-type: none"> <li>The assessee contended that the AO should not disturb the computation of deduction of the eligible unit on the ground that the profit earned by other units is lower than the profits earned by the eligible unit. In this regard, the decision of Delhi Press Patra Prakashan<sup>4</sup> was relied upon.</li> </ul>	<ul style="list-style-type: none"> <li>The AO contended that the Baddi unit of the company was earning abnormally high profits. Deduction under section 80-IC of the Act was claimed on such abnormally high profits.</li> <li>The profit of Baddi unit was computed after deducting manufacturing expenses and depreciation. No indirect costs such</li> </ul>	<ul style="list-style-type: none"> <li>Profit is the difference between sale price and the cost of production along with cost of bringing the product to market such as marketing expenses, corporate expenses and interest.</li> <li>The Baddi unit has computed profit as per the above accounting principle (i.e., after allocating head office expenses).</li> </ul>

<sup>1</sup> a) ACIT v. Bharat Biotech International Ltd. (ITA No. 1327/Hyd/2008)  
b) CIT v. Claris Life Science [2008] 221 CTR 301 (Guj.)  
c) Radhaswami Satsang v. CIT [1992] 193 ITR 321 (SC)

d) Taraben Ramabai Patel v. ITO [1995] 215 ITR 323 (Guj)  
e) CIT v. Neo Poly Pack (P) Ltd. 245 [2000] ITR 492 (Del.)  
f) CIT v. JH Golta [1985] 156 ITR 323 (SC)

<sup>4</sup>ACIT vs. Delhi Press Patra Prakashan [2006]103 TTJ 578 (Del)

Issue	Assessee's contentions	Revenue's contentions	Tribunal's ruling
	<ul style="list-style-type: none"> <li>• Section 80-IA(5) of the Act requires computation of profits of the undertaking on the assumption that the eligible business is the only source of income for the assessee. Eligible business means the overall activity, i.e. the manufacturing of a product along with the marketing activity.</li> <li>• There are no provisions in the Act that provide for the segregation of profits of the eligible unit with regard to various operations like manufacturing, marketing etc.</li> <li>• As per the provisions of section 80-IC of the Act, profits and gains derived by an eligible undertaking are eligible for deduction. Accordingly, the profits and gains of an eligible undertaking include not only the manufacturing gains but also ancillary gains having direct nexus with manufacturing activity.</li> <li>• Sourcing of raw materials by the Baddi unit from other plants was at arm's length price as required by section 80IA(8) of the Act.</li> <li>• In light of the above, the entire profits of</li> </ul>	<ul style="list-style-type: none"> <li>as marketing expenses, research and development expenses, corporate expenses and interest were allocated. Accordingly, the profit of the unit is inflated.</li> <li>• As per the provisions of section 80-IC(7) read with section 80IA(5) of the Act, profits of eligible business are to be computed on the assumption that the said business is the only source of business.</li> <li>• According to the AO, the Baddi unit carried out manufacturing activity and transferred the goods to the marketing division in the head office, and therefore should have been entitled to remuneration of its cost and a reasonable profit.</li> <li>• The AO therefore proposed to compute profits attributable to the manufacturing activity alone.</li> <li>• Earlier, from the sale of products which were purchased from third party contract manufacturers, the assessee was earning gross margin of 80%. However, after the manufacture of these</li> </ul>	<ul style="list-style-type: none"> <li>• As separate books of accounts were maintained and no defect in working of the profit with respect to Baddi unit has been pointed out, the AO cannot disturb the computation of profit of Baddi unit.</li> <li>• The decision of Roll Royce PLC<sup>4</sup> relied upon by the revenue authorities can be distinguished as in the case of the assessee, the segregation between 80% and 6% is not on account of any evidence through which it could be established that the major portion of the profit could be attributed to the assessee company and rest of the profit could only be attributed to the Baddi unit.</li> <li>• Section 80-IA of the Act does not suggest that the eligible profit should be computed first by transferring the product at an imaginary sale price to the head office and then the head office should sell the product in the open market. There is no such concept of segregation of profit.</li> <li>• Profit of an undertaking is always computed by taking into account the sale price of the product in the market.</li> </ul>

<sup>4</sup> Roll Royce PLC v. DDIT [2008] 19 SOT 42

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	<p>the Baddi and Goa units were eligible for deduction under sections 80-IC of the Act and 80-IB of the Act, respectively.</p>	<p>products commenced in Baddi unit, the gross margin of the assessee increased up to 86%. Accordingly, the AO contended that it is only the additional profits of 6% which represented profits from manufacturing activity. The balance profit was earned by exploiting the brand and marketing network.</p> <ul style="list-style-type: none"> <li>• Accordingly, the deduction for Baddi unit was restricted to 6% of its turnover {The AO relied on the decision of Roll Royce PLC (above)}.</li> <li>• Following the same analogy, the deduction for Goa unit was restricted to 6% of its turnover.</li> </ul>	<ul style="list-style-type: none"> <li>• In light of the above, deduction under sections 80-IB and 80-IC of the Act is required to be computed on the entire profit of the unit including marketing activities.</li> </ul>

### PwC Comments

This decision is relevant for pharmaceutical companies where some part of the R&D process is carried outside the approved facility.

Further, in relation to tax holiday claim, the following principles have been laid out:

- To compute a price for transfer of goods or services from a unit enjoying tax holiday to the non-eligible unit of the assessee, an "actual" transfer is a pre-condition.
- Where the sale from the unit enjoying tax holiday is the only source of income, the profit of the unit should be computed by considering the sale price of goods or services and costs attributable to effect such sale (including allocation of head office costs).

Effective financial year 2012-13, transfer pricing provisions will apply to transactions of transfer of goods and services undertaken by units enjoying tax holiday with non-eligible units of the assessee. Accordingly, the above principles laid down by the Tribunal would need to be followed in consonance with the transfer pricing regulations.

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