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Expenditure incurred outside the R&D facility eligible for benefit of weighted deduction

In brief

Recently, in the case of Cadila Healthcare Ltd.¹ (the assessee), the Ahmedabad Bench of the Income-tax Appellate Tribunal (Tribunal) held that the benefit of section 35(2AB) of the Income-tax Act, 1961 (the Act) would be available to expenditure mentioned in Explanation to the section even though they were not incurred within the in-house research and development (R&D) facility.

Facts

- The assessee, claimed weighted deduction for certain expenditure incurred on scientific research under section 35(2AB) of the Act. This included expenditure incurred on clinical trial activities and bio-equivalence studies conducted outside the research facility.
- The assessing officer (AO) disallowed the weighted deduction stating that the expenditure for the purposes mentioned in section 35(2AB) should be incurred within the research facility and any expenditure on scientific research conducted outside the research facility was not eligible.

¹Cadila Healthcare Ltd v Addl CIT [2013] 29 taxmann.com 229 (Ahd)

- The Dispute Resolution Panel (DRP) confirmed the view of the AO. Aggrieved by the order, the assessee appealed before the Tribunal.

Issue before the Tribunal

- Whether the weighted deduction under section 35(2AB) is available for expenditure mentioned under the Explanation even when these activities are conducted outside the research facility.

Assessee's contentions

- Similar issue was covered in the assessee's own case for earlier year, where the Ahmedabad Bench of the Tribunal decided in favour of the assessee.
- Reliance was placed on the decision of Bharat Biotech International (P.) Ltd² where the Tribunal held that expenditure on clinical trials conducted outside the approved facility would also be eligible for weighted deduction.

Revenue's contentions

- Revenue contended that there are diverse decisions on the same issue and pointed out the case of Concept Pharmaceuticals Ltd³ where the Mumbai Tribunal held that the expenditure incurred on clinical trials conducted outside the in-house research facility would not be eligible for weighted deduction under section 35(2AB) of the Act. Hence, given the diverse views at Tribunal level, the matter should be referred to a Special Bench.
- Revenue also placed its reliance on the decision of Gujarat High Court (HC) in the case of Claris Lifesciences Ltd.⁴, where it had ruled in favour of the Revenue on similar matter, based on the following reasoning;

- The phrase used in the Explanation to section 35(2AB) of the Act is expenditure incurred 'on in-house research and development facility' and not 'by in-house research and development facility.'
- the assessee's reliance on circular 763 of 1998 and 14 of 2002 was disregarded by the Tribunal, stating that these circulars only explain that a new sub section to section 35 has been inserted allowing weighted deduction to companies having in-house R&D facility engaged in the business of drugs, pharmaceuticals etc. There is no mention in the circular that expenditure incurred outside the in-house facility is eligible for deduction.

Tribunal ruling

- The section 35(2AB) read with Explanation allows for weighted deduction for expenditure incurred not only on clinical trials but also on other expenses (such as expenses incurred in obtaining approval from regulatory authority and filing of application for a patent). It is evident that activities such as obtaining regulatory approvals or patents cannot be conducted in-house.
- The Tribunal discussed the process of conducting clinical drug trials, which is in two stages. In the first stage of the trial, volunteers are enrolled in small pilot studies. On its successful completion, a larger scale is involved. Carrying out such drug trials is essential for product approvals and marketability and they are generally carried out in more than one country.
- The tribunal distinguished the precedents relied on by the Revenue (i.e Concept Pharma (above) and Claris Lifesciences (above)) on following grounds:
 - Explanation to section 35(2AB) provides for certain expenses which cannot be incurred within the in-house R&D facility. The Tribunal in the above cases had decided in favour of Revenue without considering those aspects.

² ACIT v. Bharat Bio Tech International Pvt. Ltd. [ITA no. 560-636/Hyd/2007]

³ Concept Pharmaceuticals Ltd v ACIT [2011] 43 SOT 423 (Mum)

⁴ CIT v. Claris Lifesciences Ltd [2010] 326 ITR 251 (Guj)

- Just like it is not possible to incur regulatory and approval related expenses in-house, it is not possible to carry out all the clinical drug trial activities in the in- house facility.
- These rulings are not binding precedent, as it cannot lay down an impossible condition of incurring the expenditure within the in-house R&D facility, when it is not possible to do so.
- It held that all the expenses as mentioned in the Explanation to section 35(2AB) of the Act, whether incurred inside or outside the in-house research facility should be eligible for weighted deduction under section 35(2AB) of the Act.

Conclusion

This ruling provides some clarity on the issue of eligibility of weighted deduction on expenses incurred outside the R&D facility.

This ruling distinguishes other rulings on the subject in a logical manner and would provide some succour to pharma companies incurring expenses on clinical trials and other regulatory approvals outside the R&D facility.

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