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IN THE HIGH COURT OF JUDICATURE AT BOMBAY
ORDINARY ORIGINAL CIVIL JURISDICTION

INCOME TAX APPEAL NO.8 OF 2007

Zandu Pharmaceuticals Works Limited
70, Gokhale Road (South),
Dadar, Mumbai – 400 025. ....Appellant

.Versus.

The Commissioner of Income Tax
City-VII, Aayakar Bhavan, M.K. Road,
Mumbai – 400 020. ....Respondent

Ms.Asifa Khan for the Appellant.

Mr.Suresh Kumar for the Respondent.

CORAM : S.J. VAZIFDAR AND
M.S. SANKLECHA, JJ.
DATE : 12TH SEPTEMBER, 2012.

JUDGMENT (PER S.J. VAZIFDAR, J) :-

1. This is an appeal under section 260A of the Income Tax Act, 1961 against the order of the Income Tax Appellate Tribunal dated 1.8.2006 in a group of Income Tax Appeals pertaining to various assessment years. The present appeal is against the order insofar as it relates to ITA No.1964/M/1997 and pertains to the assessment year 1993-1994.

2. By an order dated 3.3.2008, the Division Bench admitted the appeal on the following substantial questions of law :-

1) Whether, on the facts and in the circumstances of the case and in law the ITAT was justified in confirming the allocation of Research and Development expenses incurred by the Head Office among the four manufacturing units on the presumption that the expenditure so incurred is for the benefit of these manufacturing units, when in fact such research conducted had no connection with the business of the said units, nor any benefit is received by them from the said research ?

2) Whether on the facts and in the circumstances of the case and in law the ITAT failed to consider the fact that the business of the four manufacturing units had no correlation with the expenses on the Research and Development incurred by the Head Office and that no benefit out of such expenses has been obtained by such units during the year ?"

3. The appellant carries on business inter-alia of manufacturing ayurvedic medicines and ointments. It has a head office and four units at Unnao in Uttar Pradesh, Vapi in Gujarat, Dadar in Mumbai and Sanjan, near Mumbai. The head office as well as the units carry on research and development (R & D) activities. The head office and each of the units have their own R & D

departments equipped with a laboratory.

4(A). On 16.12.1993, the appellant filed its return of income showing a total income of rupees nil. The return was taken up for scrutiny assessment. The same was processed under section 143(1)(a), determining the total income of Rs.5,28,084/-. For the said assessment year, the appellant claimed deductions of Rs.20,59,093/- and Rs.25,73,865/- under sections 80-I and 80HH respectively in respect of the Unnao unit and Rs.42,60,962/- under section 80-IA in respect of the Sanjan unit.

(B)(i). The appellant in the profit and loss account of the head office, claimed inter-alia Rs.38,70,000/- as R & D expenses in respect of the R & D work carried on in the head office. The details of the R & D projects undertaken by the head office during the assessment year in question were filed before the Tribunal. The R & D activities related to the development of new medicines and medical formulae.

(ii). The Assessing Officer allocated the said R & D expenses debited to the head office to the units proportionate to the turn over of the units. Accordingly he debited 7.56% and 23.76% of the R & D expenses of Rs.38,70,000/- to the Unnao unit and Sanjan unit on the basis of the proportionate turn-over of the said units to the appellant's total turn-over. Consequently the AO reduced the appellant's claim

for the said deductions under Chapter VI-A in respect of the said units.

(C). The Commissioner of Income Tax (Appeals) and the Tribunal upheld the assessment order.

The Tribunal held that the expenditure for the R & D work in the head office had been incurred for the benefit of the manufacturing units ; that the head office was maintained for the benefit of the manufacturing units only and therefore, the expenditure incurred in the head office was for the benefit of the manufacturing units ; that the head office itself does not have any income except the income of manufacturing units and that the R & D expenses incurred although for the development of new drugs were for the benefit of the assessee's manufacturing units. The Tribunal held that there was no justification for the claim that this expenditure ought not to be apportioned among the assessee's units. Incidentally, the CIT (A) had also observed that there was a composite fund of the assessee which comprised income from various units and expenditure even in respect of the units was incurred from this composite fund. Based on this the CIT (A) rejected the appellant's contention that the R & D expenses incurred by the head office had nothing to do with the units.

5. It is important to note and reiterate certain facts before

dealing with the rival contentions. As stated above, the head office and each of the units have their own separate R & D departments, including laboratories. The R & D work related to the development of new medicinal products. None of the units manufactured these products. The manufacturing activities carried on at the units did not pertain to the new drugs developed / to be developed by the said R & D activities. Drug research is a highly technical activity requiring contributions from the different faculties and scientists in various fields such as phytochemists, analytical chemists, pharmaceutical chemists, toxicologists, pharmacologists and clinicians. Each of these activities require specialized laboratory facilities.

6. The details of the R & D work in respect whereof the said expenditure of Rs.38,70,000/- was incurred were enumerated by the appellant as follows :-

1) To grow Glycyrrhiza roots in the country and to manufacture industrial medicinal and food products from Glycyrrhiza roots.
2) To develop Ayurvedic drug garden-cum-farm.
3) Evaluation of Safety and efficacy of an Ayurvedic antiarthritic formulation.
4) Evaluation of Safety and efficacy of an Ayurvedic antiarthritic formulation for periheral vascular disorders.
5) Safety studies, pharmacokinetic studies and clinical evaluation of Anti Parkinsonism activity of an Ayurvedic formulation HP 200.

6) Development of the diabetic food immunity and memory improving health/food tonic for the growing children."

7. The respondent has not established any co-relation or connection between the activities of any of the units with the above.

It is not the respondent's case that any of the units had benefited by the said R & D activities pertaining to the new drugs or had utilized the resultant benefit thereof, if any, in any manner whatsoever. It is not the respondent's case that the assessee manufactured the said new drugs through or even with the assistance of these units. Except on the basis of presumptions, as stated earlier, it is not even the respondent's case that the existing activities of any of the units in fact benefited from or could benefit from the said R & D activities. It is also important to note that each of the units manufactures different items and therefore, also carries out independent R & D work.

8. There is no dispute that the assessee is entitled to the benefits of the provisions of sections 80-HH, 80-I and 80-IA. Section 80-I provides that where the gross total income of an assessee includes any profits and gains derived from an industrial undertaking, there shall be allowed, in computing the total income of the assessee, a deduction from such profits and gains an amount equal to twenty per cent thereof. Section 80-IA provides that where the

gross total income of an assessee includes any profits and gains derived from any business of an industrial undertaking, there shall be allowed, in computing the total income of the assessee, a deduction from such profits and gains of an amount specified therein. Section 80-HH provides that whether the gross total income of an assessee includes any profits and gains derived from an industrial undertaking, there shall be in accordance with law and subject to the provisions of the section be allowed in computing the total income of the assessee a deduction from such profits and gains of an amount equal to 20% thereof.

9. While computing the profits and gains of the concerned undertaking, only expenses relating thereto can be deducted. In other words, the expenses must be incurred, for and on behalf of the concerned undertaking. The expenses attributable to any other unit or the head office expenses which have no relevance to the industrial undertaking, cannot be deducted in respect of the said undertaking while computing the profits and gains of the undertaking.

10. In *CIT vs. Sterling Foods, (1999) 4 SCC 98 = (1999) 237 ITR 579,* the following question was considered by the Supreme Court :-

> "Whether, on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the receipt from the sale of import entitlements could not be included in the income of the assessee for the

purpose of computing the relief under Section 80-HH of the Income Tax Act, 1961?"

The question therefore, was converse to the one before us. The Supreme Court held as under :-

"12. Crude petroleum is refined to produce raw naphtha. Raw naphtha is further refined, or cracked to produce the said products. This is not controverted. It seems to us to make no difference that the appellants buy the raw naphtha from others. The question is to be judged regardless of this, and the question is whether the intervention of the raw naphtha would justify the finding that the said products are not 'derived from refining of crude petroleum'. The refining of crude petroleum produces various products at different stages. Raw naphtha is one such stage. The further refining, or cracking, of raw naphtha results in the said products. The source of the said products is crude petroleum. The said products must, therefore, be held to have been derived from crude petroleum.

13. We do not think that the source of the import entitlements can be said to be the industrial undertaking of the assessee. The source of the import entitlements can, in the circumstances, only be said to be the Export Promotion Scheme of the Central Government whereunder the export entitlements become available. There must be, for the application of the words "derived from", a direct nexus between the profits and gains and the industrial undertaking. In the instant case the nexus is not direct but only incidental. The industrial undertaking exports processed seafood. By reason of such export, the Export Promotion Scheme applies. Thereunder, the assessee is entitled to import entitlements, which it can sell. The sale consideration therefrom cannot, in our view, be held to constitute a profit and gain derived from the assessee's industrial undertaking."

The Supreme Court held that there must be for the

application of the words “derived from” a direct nexus between the profits and gains and an industrial undertaking. Sections 80-I and 80-IA also use the expression “derived from”. If there must be a direct nexus between the profits and gains and an industrial undertaking, it must follow equally that there must be a direct nexus between an industrial undertaking and the expenses which are sought to be apportioned / attributable to it. Expenses which do not relate to an industrial undertaking / unit under consideration and they relate to other units or to the head office of the assessee, cannot be taken into consideration while computing the deduction under the said provisions.

11. Ms.Khan's reliance upon a judgment of the Division Bench of the Madras High Court in *Bush Boake Allen (India) Ltd. vs. Asst. CIT (Mad), (2005) 273 ITR 152* is well founded. In that case, the assessee claimed a deduction under sections 80-HH and 80-I. The Assessing Officer allocated certain expenditure on research and development pertaining to the Chittoor unit. It was submitted by the assessee that the amount so included did not pertain to the Chittoor unit inasmuch as the research and development undertaken at the Madras unit had no connection with the products manufactured in the Chittoor unit. The Chennai High Court held that the question had not been dealt with by the authorities. It was held that the apportionment

of the expenses on the activities of the research and development to the Chittoor unit merely on the presumption that the products manufactured at the Chittoor unit also had the benefit of the research made at the Chennai R & D department, was not proper. It was further held that the authorities had proceeded on the presumption that any technology about new flavours and essences would automatically be utilized in the Chittoor unit without examining whether R & D carried out in Chennai was of use to the unit at Chittoor. The matter was therefore, remanded to ascertain whether the R & D undertaken related to the products manufactured in the Chittoor unit.

12. We are in respectful agreement with the judgment, the basis of which is that unless the expenditure incurred on the R & D work relates to the undertaking / unit in question, the same cannot be apportioned to it.

13. Mr.Suresh Kumar submitted that any research and development activity carried out by the head office would automatically enure to the benefit of the units / industrial undertakings. He submitted that the head office itself does not manufacture any medicines, the benefit of the research and development would be utilized for manufacturing the products and the products would obviously be manufactured by the units.

14. The submissions proceeds on an erroneous basis and does not take into consideration the facts of the case at all. As we noted earlier, in the present case, the said R & D activities were in relation to the new drugs. There is nothing to indicate that in the event of the assessee deciding to commercially exploit the benefits of the R & D work, the products would be manufactured by the said units. The fallacy in the submissions proceeds on the hypothetical basis that the said products would be manufactured by each of the units or any one of them.

15. The fallacy also arises on account of an erroneous presumption that the benefit of any R & D activity can only be exploited by an enterprise utilizing the same in its manufacturing activities. That is not so. An enterprise can always assign the benefit thereof to a third party. It can always grant a licence in respect of any patent or design to a third party. In that event, the other units would not derive any benefit in respect thereof. The presumption of a nexus between the R & D activities and the units is not well founded.

16. In the circumstances, question (1) is answered in the negative and question (2) is answered in the affirmative. Thus both the questions are answered in favour of the assessee and against the department.

17. The appeal is therefore, allowed. There shall be, however, no order as to cost.

(M.S. SANKLECHA, J.) **(S.J. VAZIFDAR, J.)**