



# Flash News

## DSIR amends guidelines for approval of in-house R&D centres and submission of report under Section 35(2AB) of the Income-tax Act

### Background

As per Section 35(2AB) of the Income-tax Act, 1961 (the Act) where a company is engaged in the business of bio-technology or in any business of manufacture or production of any article or thing<sup>1</sup>, 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 (R&D) facility as approved by the Department of Scientific and Industrial Research (DSIR), then, a sum equal to two times of the expenditure so incurred shall be allowed as weighted deduction.

In April 2016, the Central Board of Direct Taxes (CBDT) vide Notification<sup>2</sup> amended Rule 6 of the Income-tax Rules, 1962 (the Rules) as well as specified forms with respect to expenditure on scientific research under Section 35 of the Act. The amended rules come into effect from 1 July 2016.

The Finance Act, 2016 has amended Section 35(2AB) of the Act where it has been provided that the weighted deduction shall be reduced under Section 35(2AB) from 200 per cent to 150 per cent effective from 1 April 2017 till 31 March 2020. Thereafter, it will be phased out to 100 per cent only.

Recently, the DSIR has amended the existing guidelines<sup>3</sup> for approval of in-house R&D centres and submission of the prescribed report. The key amendments to the guidelines are as follows:

### Amended guidelines

- Expenditure incurred on manpower engaged in non-R&D activities such as attending consultation meetings shall not qualify for the weighted deduction.
- Expenditure reported as CWIP will not be eligible for weighted deduction. Company to submit a list of capital equipments, with the date of purchase/installation and cost. Further vehicles purchased for reference and testing purpose will not be admissible for weighted deduction.
- Expenditure incurred on manpower under the category of trainees and manpower on contract (may include trainees based on employment status) will not be admissible for a weighted tax deduction.
- The pre-amended guidelines provide that the expenditure eligible should necessarily be reported in the audited financial statement prepared for the purpose of the published annual report as well as for the purpose of income tax returns.

<sup>1</sup> Not being an article or thing specified in the list of the [Eleventh Schedule]

<sup>2</sup> CBDT Notification No. 29/2016, dated 28 April 2016

<sup>3</sup> Source - <http://www.dsir.gov.in/>

As per the new guidelines, it should be reported in the audited financial statement prepared for the purpose of the published annual report or to be filed with the Registrar (RoC) as per Companies Act 2013.

- As per the guidelines, where a company has incurred INR10 million by way of capital expenditure<sup>4</sup> on R&D centres are eligible to claim a weighted deduction in the preceding financial year of application for approval under Section 35(2AB) of the Act. Such companies are either not having DSIR recognised R&D centres but applied for approval under Section 35(2AB) of the Act or having R&D centres already recognised by DSIR, but have applied for approval under Section 35(2AB) of the Act. The amended guidelines provide that for claiming benefit on capital expenditure, companies should:
  - Submit the request for a claim of such expenditure in the covering letter at the time of application in Form 3CK for approval under Section 35(2AB) of the Act.
  - Provide complete breakup and details of capital equipment investment on R&D of more than INR1 crore excluding expenditure on land and building, in the financial year preceding the year in which the firm applied to DSIR for the approval.
- In line with an amendment to the rules, similar forms have been incorporated in the amended guidelines issued by DSIR. Under the amended guidelines, the DSIR has asked for additional information under Annexure I for each R&D centre.

## Our comments

### Approach of DSIR

The approach of DSIR on the eligibility of expenditure on an R&D centre is restricted to expenditure which are directly identifiable with the approved R&D facility. Expenditure on activities/department other than R&D are generally not eligible. In the amended guidelines, DSIR has restricted the eligibility of certain additional expenditure for e.g., expenditure incurred on manpower engaged in non-R&D activities, expenditure on manpower under the category of the trainee, vehicles purchased for reference and testing purpose, etc.

<sup>4</sup> Excluding expenditure on land and building

### Capital Work-in-Progress

The amended guidelines provide that expenditure reported as CWIP will not be eligible for weighted deduction. The Karnataka High Court in the case of Tejas Networks Limited<sup>5</sup> held that where the DSIR has certified product development expenditure (i.e., CWIP) under Section 35(2AB) of the Act, the Assessing Officer (AO) would be out of bounds to examine whether such expenditure as certified by DSIR can be allowed or disallowed under Section 35 of the Act. The allowability or otherwise of such expenditure cannot be the subject matter of scrutiny by the AO.

It seems that the amended guidelines negate this decision by restricting the eligibility of CWIP. Whether the DSIR has the authority to declare such expenditure as ineligible for the purpose of weighted deduction.

### **Whether DSIR has the authority to decide quantum of R&D expenditure entitled to weighted deduction under Section 35(2AB) of the Act**

The issue with respect to whether DSIR has the authority to decide the quantum of R&D expenditure entitled to a weighted deduction under Section 35(2AB) of the Act has been a matter of debate before the courts. Some of the courts/Tribunal<sup>6</sup> have held that DSIR has the authority to decide the quantum of R&D expenditure entitled to a weighted deduction under Section 35(2AB) of the Act. Further, the AO/Appellate Authorities do not have the authority to modify viz. enhance or reduce the quantum of R&D expenditure as determined by DSIR which is eligible for deduction. However, some of the courts/Tribunal<sup>7</sup> have held that DSIR is not the authority to decide the quantum of R&D expenditure which are entitled to benefit of Section 35(2AB) of the Act. It is the taxpayer who has a right to claim any expenditure incurred on scientific research on in-house R&D facilities as per Section 35(2AB) of the Act read with Rule 6 of the Rules. Therefore, it is the AO who has the right and jurisdiction to decide the quantum of R&D expenditure.

<sup>5</sup> Tejas Networks Limited v. DCIT [2015] 60 taxmann.com 309 (Kar)

<sup>6</sup> Electronics Corporation of India Ltd. v. ACIT (ITA No. 1106/Hyd/2011), DCIT v. Mastek Limited [2013] 263 CTR 671 (Guj), Tejas Networks Limited v. v. DCIT [2015] 60 taxmann.com 309 (Kar)

<sup>7</sup> Wockhardt Limited (2010-TIOL-606-ITAT-MUM), CIT v. Cadila Healthcare Ltd [2013] 31 taxmann.com 300 (Guj)

In April 2016, the CBDT issued a notification amending Rule 6 of the Rules to provide that the DSIR shall furnish electronically its report in relation to the approval of in-house R&D facility, quantifying the expenditure incurred on in-house R&D facility by the company during the previous year and eligible for weighted deduction under Section 35(2AB) of the Act in Form No 3CL.

A bare reading of provisions of Section 35(2AB)(1) of the Act suggests that the in-house R&D facility should be approved by DSIR. It seems that Section 35(2AB)(1) does not provide that the approval from DSIR is required in respect of the expenditure eligible for weighted deduction. Further Section 35(2AB)(1) refers to 'any' expenditure, therefore, the weighted deduction is to be allowed on expenditure 'so incurred'. Section 35(3) of the Act provides that if any question arises under this section 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, CBDT shall refer the question to DSIR, whose decision shall be final. It seems that Section 35(3) does not provide the scope for referring to DSIR for determining the amount of expenditure eligible for deduction. The language of the section is not clear whether the DSIR has the authority to decide the eligible expenditure.

After the amendment to Rule 6, the tax department may take a view that the rules reflect the intention of the Legislature inferred from the provisions of Section 35(2AB) of the Act. Accordingly, the DSIR may have the power to stipulate and approve scientific expenditure that is eligible for weighted deduction.

Generally, the Rules cannot override the Act. However, if the language of the Act is not clear, a court may refer to the Rules to find out the intention of the law or precise meaning of the underlying provisions. Whether the Rules which are prescribed under a delegated legislation can deal with the nature and the quantum of expenditure.

### **Additional requirements**

The amended guidelines provide that for claiming benefit on capital expenditure, companies should submit the request for claim of such expenditure in the covering letter at the time of application in Form 3CK for approval under Section 35(2AB) of Act and provide complete break up and details of capital equipment investment on R&D of more than INR1 crore excluding expenditure on land and building, in the financial year preceding the year in which the firm applied to DSIR for the approval.

The guidelines, as well as the Rules, already provide to submit various details. The requirement of these additional details will create an unnecessary burden on the taxpayers.

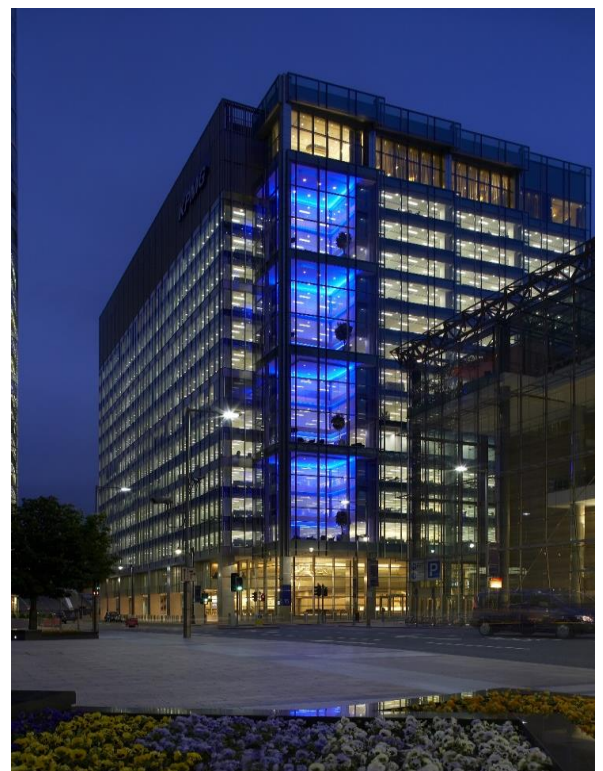
### **Phase-out of deductions**

The Finance Act, 2016, with a view to phase out weighted deduction under Section 35(2AB) of the Act, restricted the allowability of expenditure incurred on scientific research (other than expenditure in the nature of cost of any land or building) on in-house R&D facility incurred from 1 April 2017 to 31 March 2020 to 150 per cent and from 1 April 2020 to 100 per cent from the existing 200 per cent.

With a view to achieve a growth rate of 8 per cent and put India on the growth trajectory and to ensure having a robust R&D database, the weighted deduction under Section 35(2AB) of the Act should be extended for a further period of 10 years. This would enable the country to be on par with developed nations which have robust R&D centres fuelling growth in the economy.

### **Effective date of guidelines**

The updated guidelines are silent on the effective date for its applicability. It is not clear whether it will apply to Assessment Year 2017-18 (Financial Year 2016-17). Appropriate clarification on this issue is required from the authorities.



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