

No sec. 35 deduction if assessee failed to prove that exp. incurred on scientific research was for own business

Summary – The Mumbai ITAT in a recent case of SI Group India Ltd., (the Assessee) held that where assessee failed to prove that scientific research in relation to which capital expenditure was incurred was carried on for its own business, it could not be allowed deduction under section 35(1)(iv)

Facts

- The assessee-company was engaged in the business of manufacture and sale of organic chemicals. For the relevant assessment year, assessee filed its return of income declaring loss under normal provisions. The assessment was completed under section 143(3) read with section 144(c).
- After examining the assessment records of the assessee, the Commissioner (LTU) was of view that the assessment order passed was erroneous and prejudicial to the interest of the revenue on account of allowance of assessee's claim of deduction of capital expenditure of Rs. 1.24 crore under section 35(1)(iv) and thus, issued show cause notice.
- In response to show cause notice, though, the assessee accepted that the revenue expenditure was incurred on Research and Development (R & D) activities were on behalf of its parent company in US and had been reimbursed by them, however, as the capital expenditure was concerned, it was claimed that such expenditure was related to assessee's own business. Hence, deduction claimed was allowable.
- The Commissioner after considering the submissions of the assessee observed that as per assessee's own admission it has conducted R&D activities on behalf of foreign clients and income earned on account of such activities are credited to the profit and loss account. From the copies of the monthly reports filed before him by the assessee, Commissioner found that the process of R & D activities has been continuing regularly and were done for the benefit of foreign clients/associates enterprises abroad. The Commissioner was of the view that for claiming the deduction under section 35(1)(iv), the R&D activity must be connected with the business of the assessee. Since, the capital expenditure claimed by the assessee was in connection with the R&D activities carried on for the benefit of other entities, Commissioner held that the assessee is not eligible to claim deduction under section 35(1)(iv). Since, the Assessing Officer had allowed assessee's claim under section 35(1)(iv), Commissioner holding the assessment order passed by the Assessing Officer to be erroneous and prejudicial to the interests of the revenues set it aside with a direction to disallow assessee's claim of deduction under section 35(1)(iv) in respect of the capital expenditure incurred of Rs. 1,24,87,065.

Held

- Nothing has been brought on record to demonstrate that in course of the assessment proceedings the Assessing Officer has either examined or enquired into the issue relating to claim of deduction

under section 35(1)(iv). At least, no documentary evidence have been brought to indicate that the Assessing Officer has either raised any query or in any other manner has enquired into the deduction claimed under section 35(1)(iv). Notably, the assessee itself in its accounts has not claimed revenue expenditure relating to the R&D activities, since, such expenditure was reimbursed to the assessee by the parent company as it was incurred for the business of the parent company. Thus, when the revenue expenditure relating to R&D activity was not claimed as deduction since it was incurred on behalf of the parent company and related to the business of the parent company, it should have triggered an enquiry by the Assessing Officer to verify whether the capital expenditure claimed as deduction under section 35(1)(iv) relates to assessee's own business or was incurred on behalf of the parent company. Absence of any enquiry by the Assessing Officer to ascertain the veracity of assessee's claim in respect of capital expenditure on R&D activities certainly has made the assessment order erroneous and prejudicial to the interest of the revenue. In view of the aforesaid facts, Commissioner was justified in exercising power under section 263 as both the conditions enshrined in the said provision are fulfilled.

- It is very much clear from the audit financial statements of the assessee, it has not claimed any deduction on account of revenue expenditure on R&D in respect of its own business. Whereas, the entire capital expenditure on R&D activities has been claimed as deduction under section 35(1)(iv) on the plea that it relates to its own business. Assessee had entered into a research and development agreement with US company which is engaged in the development and manufacture of chemical products. For developing new products and enhancing quality continuous R&D activity is required. Since, the assessee has the facilities for research and development of new and enhanced chemical products, SI Group US entered into a research and development agreement. As it appears from the terms of the said agreement, the assessee is to render research and development services to US company for the purpose of enhancing the chemical products and creating new chemical products. As per the terms of the agreement assessee shall provide US company with detailed written quarterly reports on the research and development work carried out. The assessee is also required to inform US company of any cost over runs as compared to the budget. It is also provided, US company may at any time require the assessee to alter the R&D project and its implementation.
- It is not clear how the assessee incurs only capital expenditure on R&D relating to its own business without incurring any revenue expenditure on R&D. Therefore, when the assessee accepts that the revenue expenditure on R&D is relating to the business of the parent company logically it must follow that the capital expenditure on R&D also belongs to the parent company. The assessee cannot blow hot and cold at the same time by claiming capital expenditure on R&D on its own account and revenue expenditure on R&D in the account of its parent company. In any case of the matter, the assessee has not brought any evidence to conclusively prove that the capital expenditure claimed as deduction under section 35(1)(iv) is related to R&D activities carried on for assessee's own business. In that view of the matter, one of the conditions of the section 35(1)(iv) is not fulfilled. In other words, the assessee has failed to prove that the scientific research in relation

to which capital expenditure was incurred is carried on for assessee's own business. That being the case, the assessee is not eligible to claim deduction under section 35(1)(iv). Resultantly the Assessing Officer was in error while allowing deduction claimed under section 35(1)(iv) which has caused prejudice to the revenue. Therefore, Commissioner was justified in revising the assessment order by invoking his powers under section 263.

- In the result assessee's appeal is dismissed.