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HO's allocation of R&D costs fully deductible, section 44C restriction inapplicable

In Brief

In a recent decision in the case of John Wyeth & Brother Ltd.¹ (the assessee), the Mumbai Income-tax Appellate Tribunal (the Tribunal) held that laboratory expenses incurred for pharmaceutical research and development (R&D) as allocated by the head office (HO) to its Indian branch is fully allowable. Such expenses are not 'executive' or 'general administrative' so as to attract the restriction on HO expenses deduction under section 44C of the Income-tax Act, 1961 (the Act).

Facts

- The assessee is a non-resident company and a branch of a foreign company with its HO in UK.
- Its business in UK, as well as in India, is that of manufacturing pharmaceutical products.
- It has a separate and independent establishment for its branch business in India.

¹ John Wyeth & Brother Ltd. v. ACIT [TS-567-ITAT-2012 (Mum)]

- Up to the assessment years (AYs) 1975-76 and 1976-77 the revenue authorities accepted the apportionment of laboratory expenses based on the percentage of gross sales of the Indian branch to total gross sales of the HO in UK.
- During the year under consideration, the assessing officer (AO) disallowed the claim of the assessee on the ground that laboratory expenses claimed are merely in the nature of executive and general administration expenditure. Therefore, according to the provisions of section 44C of the Act, they are not deductible.

Issue

Whether the laboratory expenses incurred outside India and attributable to the Indian branch would be treated as HO expenses for the purpose of disallowance under section 44C of the Act?

Assessee's contentions

- The assessee filed the certificate of auditors Arthur Andersen & Co, UK along with the details of R&D expenses and apportionment of total laboratory expenses.
- The high court (HC), in *John Wyeth & Brother Ltd.*² for the AYs 1980-81 and 1981-82, had examined the issue of the applicability of laboratory expenses in the light of section 44C of the Act. It was held that if the expenses incurred towards laboratory expenditure did not include any executive and general administration expenditure as indicated in section 44C of the Act, the expenditure claimed would be allowable.

Revenue's contentions

- R&D activities have been centralised under the HO in UK and the expenses are merely in the nature of executive and general administrative expenditure. The applicability of section 44C of the Act is inevitable.
- The claim of laboratory expense is restricted by section 44C of the Act and accordingly the claim of the assessee was not allowable.
- A portion of the expenditure is allowable in computing the assessee's income only if the result of the R&D has been utilised by the branch office in India.
- The Indian branch has not incurred any such expenditure on its own in UK.
- The assessee failed to produce the books of account, the relevant documents and the evidence that expenditure had not been allowed or proportionately disallowed in case of the HO in the income tax assessment in UK.

Tribunal ruling

- Reliance was placed on the judgement of the HC where it was held that expenses incurred towards laboratory expenditure would be allowable if it did not include any executive and general administration expenditure as indicated in section 44C of the Act.
- The assessee submitted the certificate from auditors justifying the claim of laboratory expenses and details of apportionment of the expenses based on the percentage of gross sales of the Indian branch to total gross sales by the HO.
- The assessee also submitted financial statements to show that the HO had shown executive and general administration expenditure as indicated in section 44C of the Act.

² *John Wyeth & Brother Ltd. v. CIT* [2009] 312 ITR 80 (Bom)

- It was proved beyond doubt that the expenses claimed on laboratory expenses did not include any executive and general administration expenses indicated in section 44C of the Act.

Conclusion

If the assessee is able to prove beyond doubt that expenses incurred are not in nature of executive and general administrative as per section 44C of the Act, then it would be allowable, irrespective of fact whether it is incurred by the branch or not.

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