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IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCHES **"A"** BENCH: HYDERABAD

BEFORE SHRI D. MANMOHAN, VICE PRESIDENT AND
SHRI S. RIFAUR RAHMAN, ACCOUNTANT MEMBER

ITA. Nos.1844 to 1846/Hyd/2017
Assessment Years:2008-09 to 2010-11

Dr. Reddy's Laboratories Limited, Hyderabad. PAN: AAACD7999Q	vs.	DCIT, Circle-17(1), Hyderabad.
(Appellant)		(Respondent)

For Assessee:	Shri S.P. Chidambaram
For Revenue :	Shri J. Siri Kumar, CIT-DR

Date of Hearing :	23.05.2018
Date of Pronouncement :	08.06.2018

ORDER

PER BENCH:

These three appeals, filed at the instance of the assessee-company, are directed against the consolidated order passed by Ld. CIT(A)-5, Hyderabad. Since the issues involved in all the appeals are identical, we proceed to dispose of these appeals by a combined order, for the sake of convenience.

2. For the sake of understanding the issue, we refer to facts emanating from the Assessment Year 2008-2009. Assessee-company is admittedly engaged in the business of manufacture and sale of bulk drugs, APIs, Formulations and other pharmaceutical products. For the year under consideration, it declared total income of Rs. 192.96 Crs, after claiming deductions under sections 10B, 80IB and 80IC etc. Along with the return of income, the assessee-company placed a copy of balance sheet, trading account and P & L Account. The case was

selected for scrutiny under CASS. During the course of scrutiny assessment proceedings, the Assessing Officer called upon the assessee to furnish details with regard to the claim of deduction u/s 10A / 10AA / 10B / 10BA by stating that the claim of deduction is not proper. The Authorised Representative of the assessee appeared on 21st June, 2011 and furnished all the details.

3. It was noticed that certain Transfer Pricing adjustments were required to be made in the instant case. It was also noticed that the claim of expenditure on ESOPs is not proper since it is notional and capital in nature. Assessee was also called upon to furnish details of Research and Development (R & D) expenses in connection with the claim of weighted deduction. Accordingly, the assessee furnished the details of R & D expenditure. Pages 97 & 98 of the paper book refers to the explanation offered by the assessee with regard to the show-cause notice issued by the Assessing Officer. After obtaining the details of R & D Expenses etc., the Assessing Officer completed the assessment on a total income of Rs. 320.65 Crs, vide order dated 30.11.2012 passed u/s 143(3) r.w.s 144C(5) of the Act. While passing the said assessment order, A.O. admittedly apportioned the indirect expenses such as corporate overheads etc., to various units on the basis of turnover of units, based on the conclusion reached by the ITAT, Hyderabad Bench in the assessee's own case for the assessment year 2003-04.

4. The assessment made on 30.11.2012 was sought to be reopened by the Assessing Officer u/s 147 of the Act, on the ground that the assessee booked loss of Rs. 3.88 Crs as business loss from the 100% generic EOU which was not reported earlier. According to the Assessing Officer, unreported loss needs to be adjusted against the exempted income of that year.

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5. Besides, it was observed that certain expenditure like R & D expenditure and ESOP, claimed in the computation of income, were not apportioned to the special units of the assessee in respect of which deductions u/s 10B, 80IB and 80IC were claimed. This non-apportionment has resulted in huge anomaly in the percentage of the profit ratio, which has the effect of enhancing the exempt income and reducing the taxable profits. According to the Assessing Officer, the above factors are the basis of reopening the assessment. In otherwords, the A.O. has 'reason to believe' that the income chargeable to tax has escaped assessment within the meaning of section 147 of the Act.

6. At this stage, it deserves to be noticed that in respect of Financial Year ending 31.03.2008 the assessee filed return on 30.09.2008, which was revised on 31.03.2010. The assessment was completed on 30.11.2012. Four years time limit, for issuance of notice u/s 148, elapsed on 31.03.2013, whereas the A.O. issued a notice u/s 148 on 30.03.2015, which is clearly beyond the period of four years from the end of the assessment year.

7. Therefore, the assessee-company raised an objection with regard to re-opening of assessment. Thought it has requested the Assessing Officer to treat the revised return of income filed on 31.03.2010 as a return filed in response to notice u/s 148, vide assessee's letter dated 30.04.2015 it was contended that the notice merely mentions that A.O. has reasons to believe that income chargeable to tax has escaped assessment but it does not bring out any reasons based on which he had come to the conclusion that there is an escapement of income. It was also submitted that during the course of scrutiny assessment proceedings, the assessee furnished all material facts and disclosed true and fair taxable income. Since the details called for by the A.O, from time-to-time, were furnished, based on the said material, the assessment was completed. In fact upon receipt of direction of DRP AO

passed a final assessment order u/s 143(3) r.w.s 144C of the Act. Therefore, no action can be taken at this stage since it is beyond the period of four years from the end of the assessment year.

8. Assessing Officer observed that reopening of assessment is very much within the time limit since notice was issued after obtaining prior approval of the Principal Commissioner of Income Tax and he further stated that the plea of the assessee that all necessary information was furnished as required by the A.O. from time-to-time, does not have any merit for the reason that the information furnished by the assessee does not specifically contain the bifurcation of expenditure on R & D with regard to exempted and non-exempt units. It was also stated that the annual report and other documentation did not specifically indicate the R & D expenditure incurred by the assessee for the exempted and non-exempt units. The A.O therefore concluded that there was failure on the part of the assessee in not disclosing fully and truly the information before the Assessing Officer. Therefore, he proceeded to complete the re-assessment proceedings on merits. At this stage, the assessee contended that as per proviso to section 147, reopening is not permissible since the assessee produced books of account and other evidence before the Assessing Officer during original assessment proceedings from which the Assessing Officer would have duly considered the issue. The Assessing Officer rejected the contention of the assessee. According to him, the material required in connection with R & D was not furnished and therefore proceeded to reopen the assessment.

9. At this stage, it may be noticed, originally the assessment was stated to be reopened on the ground that the assessee booked a loss of Rs. 3.88 Crs which was not reported whereas during re-assessment proceedings it was noticed that by virtue of mixing of computation of total income, profits of all business units falling under the same head

are aggregated first, irrespective of the fact whether they are eligible units or not. In reply, it was submitted that Schedule 10A to the return of income does not accept the negative profit of one 10B unit to aggregate with positive profit of the other unit. This plea of the assessee found acceptance of the Assessing Officer. In otherwords, the main basis on which the assessment was sought to be reopened, was found to be wrong.

10. As regards the non-apportionment of R & D expenditure, the Assessing Officer called upon the assessee to submit R & D expenditure product-wise and unit-wise. The assessee submitted that it is not possible for them to quantify R & D expenditure product-wise. It was clearly stated that R & D expenses spent on formulation products should not be allocated to special units. It was also contended that the R & D expenditure has no connection whatsoever with the units from where the assessee is deriving exempt income. It was also stated that exemption can be claimed only on income "derived from such undertaking" and in order to arrive at the income derived, the "expenditure directly attributable to it" has to be taken into consideration and from that angle spreading over of the expenditure pertaining to special unit is not in accordance with Law.

11. During the year, the assessee-company claimed to have incurred R & D expenditure aggregating to Rs. 322 Crs to develop branded formulations, generic drugs etc., in addition to niche products such as bio-similar and new chemical entities. Therefore, the assessee objected to the allocation of R & D expenditure to special units. A.O. observed that the work done by the R & D unit is a continuous process and it is for the benefit of all the units of the assessee. Just because one unit did not manufacture any of the products developed by the R & D unit during the year it does not mean that the expenditure incurred in connection with R & D is not attributable to exempt units of the

assessee. He was therefore of the opinion that the expenditure incurred on R & D as well as the ESOP should be treated as an indirect expenditure, which has to be apportioned for determining the correct income of special units. In the assessee's own case for the assessment year 2003-04, the Tribunal held that the Assessing Officer should apportion indirect expenditure on the basis of total turnover of various units. Keeping in mind the decision cited (supra), Assessing Officer was of the opinion that the expenditure not apportioned to non-exempt units has to be apportioned against all the units, including taxable unit. Accordingly, assessment was completed on a total income Rs. 363.90 Crs.

12. It may be noticed that in respect of AYs 2009-10 and 2010-11, the only reason mentioned for issuing a notice u/s 148 was the non-apportionment of R & D expenditure and ESOPs to special units of the assessee wherein deduction u/s 10B, 80IB and 80IC was claimed resulting in huge anomaly in the percentage of profit ratio returned. According to the Assessing Officer, this anomaly has the effect of enhancing the exempt income and reducing the taxable profits. A.O. also accepted that R & D expenditure and ESOPs are indirect expenses. In his opinion, the same has to be apportioned to special units. In respect of A.Y. 2009-10 and 2010-11, the returns of income were filed on 30.09.2009 and 04.10.2010 respectively and the assessments were completed on 26.12.2013 and 23.02.2015 whereas the notices were issued u/s 148 of the Act on 31.03.2014 and 31.03.2015 which is beyond the period of four years from the end of relevant assessment years. As noticed in the order for the A.Y. 2008-09, in these two years also the assessee raised similar objections with regard to jurisdiction of the A.O. to reopen the assessment but the A.O. brushed aside the contentions and proceeded to allocate the R & D expenditure and ESOP expenditure to special units.

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13. Aggrieved, assessee contended before the Ld. CIT(A) that during the proceedings u/s 143(3) r.w.s 144C(5) of the Act, the assessee furnished all the relevant information and hence there is no fresh material in possession of the Assessing Officer to reopen the assessment and it cannot be said that the assessee has not furnished true and correct particulars of income so as to enable the Assessing Officer to invoke the provisions of section 147.

14. Without prejudice, it was contended that the A.O. erred in allocating R & D expenditure and ESOP to the exempt units overlooking the fact that tax incentives restrict the scope of deduction only to the income 'derived from such undertaking'; when the deduction is restricted only to the income derived, the same logic has to be applied with regard to expenditure also while computing the deductions. In otherwords, the A.O. erred in travelling beyond the scope of sections 10B, 80IB and 80IC while allocating the ESOP cost and R & D expenditure to the said units.

15. During the course of hearing, Learned Counsel for the Assessee relied upon a decision of the Apex Court in the case of ITO vs. L.M. Das (103 ITR 437) which was also reiterated in the case of Parashuram Pottery Works Co. Ltd vs. ITO (160 ITR 1) to contend that in order to invoke the provisions of section 147 read with section 148, essentially two conditions have to be satisfied ie., (a) there should be a reason to believe that income has escaped assessment and (b) such escapement of income should be on account of omission or failure on the part of the assessee to disclose fully and truly all material facts. Learned Counsel for the Assessee submitted that both the conditions were not fulfilled in the instant case. In respect of A.Y. 2008-09, the first reason given was that one of the units eligible for deduction u/s 10B had reported loss but the assessee had not made adjustments to exempt income in that year, whereas the fact remains that the loss of one unit had been set off

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against the profits of the other units, as per section 70, in line with the CBDT circular. In fact the Assessing Officer accepted the contention of the assessee and dropped this observation and did not proceed for reassessment on this ground. It can thus be seen that the A.O. has no reason to believe that income has escaped assessment, on this aspect.

16. The second reason given was that certain expenditure like R & D expenditure, ESOPs etc., are not apportioned to special units which resulted in huge anomaly in the percentage of profit ratio. In this regard, Learned Counsel for the Assessee submits that in the scrutiny assessment proceedings, the assessee furnished all the necessary documents pertaining to deduction claimed under sections 10B, 80IB and 80IC of the Act. The assessee also furnished Form No. 3CM and 3CL pertaining to claim of expenditure on R & D and after considering the record, the A.O. completed the assessment u/s 143(3) of the Act. Under these circumstances, if an assessment has to be reopened beyond four years, it is the duty of the Assessing Officer to prove that there is some new material available on record or there was omission or failure on the part of the assessee so as to issue a notice for reassessment.

17. It was contended that both the conditions are conspicuously absent. The A.O. has not invoked the condition of “omission or failure on the part of the assessee” either deliberately or by sheer omission arising out of inadvertence. In either case, it renders the whole re-assessment proceedings null and void in the eyes of Law as it is a defect which cannot be cured since it is required to be explicitly stated and it is a condition precedent for the assumption of jurisdiction. In fact, para 4 of the CIT (A)’s order contains the detailed submissions of the assessee challenging the reopening of assessment wherein it was stated that the primary facts necessary for assessment having been considered by the A.O. at the time of original assessment, he is not entitled, on a change

of opinion, to commence re-assessment proceedings, without even proving that there was failure or omission on the part of the assessee to furnish details at the time of original assessment. Assessee also relied upon several case law in this regard.

18. On merits, it was contended that there is no need to allocate R & D and ESOP cost to tax holiday units. Detailed submissions of the assessee are stated in para 7 of the order of CIT (A) which finds place from pages 32 to 39 in the CIT (A) order.

19. The case of the assessee was that the company is carrying on R & D activities under three business segments i.e., Finished Dosage Formulations (FDF), Biologics and Proprietary Products. R & D of a product would be initiated in a common location namely Integrated Product Development Organisation (IPDO). Expenditure incurred on this unit cannot be attributed to any specific plant. When the product reaches to a development phase, the company applies to regulatory authorities for an approval to launch the product. Depending on the geographical location, where the product is intended to be launched, exhibit batches of the product would be produced from that manufacturing plant, either new or old and the expenditure incurred at this stage is debited to the manufacturing plant where the exhibit batches are to be produced. In otherwords, there is no nexus between R & D expenditure and the existing units wherein there is production of Finished Dosage Formulations, Biologics and Active Ingredients.

20. In this regard, it was stated that the products manufactured from special units are different from the products, on which R & D expenditure has been incurred. In fact, the R & D carried out in the IPDO may or may not see the light of the day. Thus there is no direct link / nexus between R & D work carried out in the IPDO and the products manufactured in the other unit, so as to apportion the R & D

expenditure. Assessee relied upon a decision of the Hon'ble Bombay High Court in the case of Zandu Pharmaceutical Works Ltd (350 ITR 366) wherein the Court accepted a similar contention. In this regard, the Court observed that unless the expenditure incurred on R & D works relates to the undertaking / unit in question, the same cannot be apportioned. Reliance was also placed upon a decision of the ITAT Mumbai Bench in the case of Wockhard Ltd (ITA No.6323/Mumbai/2010, dated 13.04.2012).

21. It was also stated that the allocation of R & D expenditure to special units on a presumptive basis, on the ground that the profits of these units were skewed is fallacious. Profit percentage of each unit is independent, based on the type of product produced, targeted market of the product, product mix etc. Hence the A.O. is not right in proceeding with the allocation of expenditure on such a presumptive basis.

22. Even hypothetically assuming that new products do emanate on account of R & D work in the IPDO, there is no guarantee that these products will be manufactured in the existing production unit or even by the company at all. Therefore, the conclusion of the A.O that any R & D activity carried out in the IPDO would automatically endure to the benefit of the existing units and that benefit of R & D would be utilised for manufacturing the products in the same units is fallacious. It was also highlighted that there is nothing on record to indicate that assessee has set up separate R & D unit to commercially exploit the benefits of R & D work in the existing units; Thus apportionment of expenditure is not based on a logical reasoning. The fallacy is on account of erroneous presumption that the benefit of any R & D activity can only be exploited by an enterprise, by utilising the same in its manufacturing activity, whereas the fact remains that the development from R & D unit can always be assigned to a third party and can always grant a license

in respect of any patent or design to an outsider which implies that the other units, which are in existence as of now or which are not directly connected to the assessee, may not derive any benefit out of R & D activity carried out by the assessee. Therefore, the conclusion of the A.O that it has to be spread over to the existing units is logically incorrect.

23. The assessee also highlighted the expression "profit derived" under the provisions of sections 10B, 80IB and 80IC of the Act to submit that if benefit is given to the assessee only in respect of the profits directly attributable to the said unit, on the same lines expenditure also should be directly attributable to the special units as otherwise the same cannot be set off against the profits of that unit.

24. With regard to the validity of reopening of assessment, the Ld. CIT(A) considered this issue in para 5 of his order wherein he observed that the changes made to section 147 w.e.f 1.4.1989 widens the scope of powers of the A.O. in respect of re-assessment subject to only restriction i.e., "reason to believe". In otherwords, expression "reason to believe" refers to the belief which prompts the Assessing Officer to apply section 147, depending on the facts of each case so long as the belief is based on reasonable grounds; the AO is required to act, not on suspicion but on direct and circumstantial evidence. The word "reason to believe" does not mean a subjective satisfaction on the part of the Assessing Officer but if the AO has a cause or justification to think or suppose, he can initiate proceedings.

25. Ld. CIT(A) observed that the justification of his belief is not to be judged from the standards of proof required for coming to a final decision. A belief, though justified for the purpose of initiation of proceedings u/s 147, may ultimately stand altered after hearing the assessee or on the basis of intervening enquiry. In otherwords, the

Assessing Officer is not required to base his belief on any final adjudication of the matter. According to the Ld. CIT(A), the case law relied upon by the assessee are distinguishable since, in the instant case there is a reason to believe that income has escaped assessment.

26. The next issue is with regard to fulfilling the second condition i.e., whether there is failure to disclose fully and truly all material facts so as to enable the Assessing Officer to issue a notice u/s 148 of the Act.

27. Ld. CIT(A) observed that the narration of the Assessing Officer with regard to non-reporting of the loss would be sufficient to reopen the assessment. The relevant portion of the assessment order in this regard is reproduced by the Ld. CIT(A) in para 5.7 as under:

> "*02. During the assessment proceedings for the A.Y. 2011-12, it was found that the assessee had booked a loss of Rs. 3.88 Crs as business from 100% generic EOU situated at Hyderabad and that the assessee had not reported the said loss. The assessee's computation of income for A.Y. 2008-09 submitted during the assessment proceedings was not reflecting the loss from EOU. Hence, the unreported loss needs to be adjusted against the exempted income of the year.*
>
> *Besides, it was observed that certain expenditure like R & D expenditure and ESOP claimed in the computation of income were not apportioned to the Special Units by the assessee in respect of which deductions u/s 10B, 80IB and 80IC were claimed. This non-apportionment of expenses to the special units has resulted in huge anomaly in the percentage of profit ratio returned. This anomaly has effect of enhancing the exempt income and reducing the taxable profits during the previous year 2007-08 relevant to the AY 2008-09. In the instant case, the R & D Expenditure and ESOP is also an indirect expenditure. But as seen from the computation of total income, the assessee has not apportioned any expenditure to special units in this regard.*
>
> *Therefore, the Assessing Officer had reason to believe that the income chargeable to tax has escaped assessment within the meaning of section 147 of the Income Tax Act, 1961, for the A.Y. 2008-09. In view of this, the assessment for the A.Y. 2008-09 was reopened after obtaining the sanction of the Pr. CIT -5, Hyderabad on 30.03.2015 and a notice u/s 148 of the Income Tax Act, 1961, dated 30.03.2015 was issued and duly served on the assessee."*

28. Ld. CIT(A) also noted that though the assessee challenged the jurisdiction of the A.O. in issuing notice u/s 148, during the course of assessment proceedings the assessee did not file any objections which

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implies that the assessee did not have any objection to the reopening. He also observed that the sufficiency of reasons for forming a belief is not for the Courts to judge as held by the Apex Court in the case of L.M. Das (103 ITR 437) wherein the court observed that there should be an appropriate reason for reopening the assessment and it should be on account of failure or omission to disclose fully and truly all material facts and once there exists reasonable ground for the A.O. to form a belief, that would be sufficient to cloth him with jurisdiction to issue notice though the reasons may not be adequate.

29. With regard to the change of opinion, the Ld. CIT(A) observed that in the instant case there is no discussion on the issue in the original assessment order and no details were called for by the Assessing Officer or filed by the assessee on the issue. Thus, there is no question of change of opinion which contemplates formation of some opinion at an earlier stage. A wrong application of Law cannot be held as permissible view and that can always be changed for appreciating correct legal position. In his opinion, cases of excess deduction / exemption would warrant formation of requisite belief to initiate proceedings even in a case where full disclosure was made. Though the document / claims were supported by Form No. 10CCB, but the Assessing Officer having not called for any details of R & D expenditure, except with regard to claim of weighted deduction, it cannot be held that the Assessing Officer has applied his mind to the issue. It was only during the re-assessment proceedings, the assessee was asked to explain as to why the R & D expenditure was not apportioned to special unit. He also observed that with regard to the ESOP and corporate overheads in the assessee's own case for the earlier year, the matter was considered by the Tribunal which in turn was applied by the Assessing Officer wherein it was held that in the absence of identification of expenditure the same can be apportioned to various units. Thus, in the instant case also passing an

order by the A.O. u/s 143(3), overlooking the issue of apportionment of R & D expenditure to various exempt units would be sufficient for reopening of assessment since it would amount to escapement of income. He thus justified the action of the Assessing Officer for reopening the assessment.

30. As regards the stand taken by the Assessing Officer that R & D expenditure and ESOP expenses ought to have been apportioned to all eligible undertakings wherein assessee availed tax incentives, the Ld. CIT(A) observed that huge profits (43% for the A.Y. 2008-09) have been returned in the special units on which assessee claimed exemption and profit ratio returned in the taxable zone is very low compared to the profit ratio in the special units. He further observed that the obvious reason for the above anomaly is due to the fact that common expenditure like R & D and ESOP etc., are not apportioned to special units. He went on to observe that R & D expenditure is common in nature and to curb the practice of claiming deduction of the expenses incurred in relation to exempt income, against the taxable income, as well as on the principles of equity, the expenditure has to be apportioned both amongst taxable units as well as exempted units.

31. He relied upon the decision of the ITAT in the assessee's own case, with regard to corporate overheads to highlight that even R & D expenditure is also utilised and / or will be utilised in future by all the units and therefore, it has to be treated as a common expenditure which needs to be apportioned to all the units, irrespective of the fact whether they are exempted or taxable units.

32. The contention of the assessee was that computation of profits and gains of eligible business undertakings are governed by special provisions i.e., 80IB and 80IC etc., which are Code by themselves and therefore, any expenditure which is not directly attributable cannot be

taken into consideration; he observed that section 80IC, among other similar provisions, speaks of allowing deduction in respect of profits and gains “derived” by certain undertakings or enterprises. In otherwords, the assessee is under legal obligation to compute “profits and gains of eligible undertakings” separately and that of the others separately.

33. Ld. CIT(A) rejected the contention on the ground that profits and gains of eligible undertaking implies that profit has to be arrived at after deducting all the expenses, both direct and indirect, among all the operating units. Further, the devices adopted to reduce or inflate the profits of eligible business should be rejected in view of the overriding provisions of section 80IA(5) of the Act.

34. All direct expenses have to be adjusted from the profits and gains of eligible business and while computing the profits and gains of an eligible business, the Assessing Officer has to compute as if such eligible business were the only source of income of the assessee which implies that common or head office expenditure should be assumed to have incurred for such eligible business as if it is only a source of income of the assessee. Reliance was placed upon a decision of the ITAT Delhi Bench in the case of DCIT vs. Eastern Medikit Ltd (100 TTJ 382) wherein the Bench observed that any allocation of the expenditure of the head office has to be done to all the units which are operating under the head office, unless there are valid reasons to exclude any particular unit. Ld. CIT(A) extended the same logic to R & D expenses also though the claim of the assessee was that it was not a common expenditure but exclusively incurred for separate unit i.e., Integrated Product Development Organisation (IPDO). In otherwords, IPDO is a separate unit which is meant for carrying on R & D and any available formulation / product arising out of it, may or may not be utilised in the existing special units and the assessee can also sell the same in the open market. This argument of the assessee was rejected by the Ld. CIT(A).

ITAT, Delhi Bench (supra) clearly mentioned that only common expenditure has to be apportioned.

35. He mainly proceeded on the ground that sections 80IA & 80IC provide for disclosure of excessive profits in respect of eligible profits and if such possibility is inevitable (in his opinion the indirect expenses were booked only against taxable profits and not against tax free profits) such computation of excessive profits is against the provisions of section 80IC of the Act and the only method to correct the same is to distribute the R & D expenditure amongst the exempt units. He has also exhaustively reproduced the contentions of the assessee but concluded that he is not in agreement with the contention of the AR that the products manufactured from the New Chemical Entities (NCE) are different from the products manufactured by the special units and therefore, does not call for apportionment. He thus concluded that both R & D and ESOP expenditure has to be apportioned between taxable and exempted units except for the R & D expenditure attributable to Biologics.

36. Further aggrieved, assessee-company preferred appeals before the Tribunal contending *inter alia* that the procedure followed for reopening the assessment is bad in law and consequently the assessment made therein does not stand and it was also contended that the A.O. as well as the CIT (A) erred in allocating ESOP and R & D expenditure to the units eligible for deduction u/s 10B, 80IA and 80IC of the Act by not considering the fact that the said units are self-sustaining units and such allocation is not required in terms of sections 10B, 80IB and 80IC of the Act. In respect of Assessment Years 2008-09 and 2010-11, it was also contended that no R & D expenditure was incurred, during the previous years relevant to the assessment years under consideration, on products manufactured from these undertakings. With regard to ESOP, connected to R & D, similar plea was raised before us.

37. At the time of hearing, Learned Counsel for the Assessee elaborately contested the validity of reopening of assessment as well as the validity of apportionment of R & D expenditure as well as ESOP to the exempted units and thereafter placed before us summary of his arguments which is extracted for immediate reference:-

Summary of Arguments

S. No	**Particulars**	**AY 2008-09**	**AY 2009-10**	**AY 2010-11**
		ITA No.1844/H/2017	**ITA No. No.1845/H/2017**	**ITA No. No.1844/H/2017**
1	Financial year ending	31.03.2008	31.03.2009	31.03.2010
2	Date of filing of ROI	30.09.2008	30.09.2009	04.10.2010
3	Date of filing of revised ROI	31.3.2010	31.03.2011	NA
4	Relevant submission with respect to R&D expenses filed before the AO on	19.12.2011 (PB 97 to 147)	15.02.2013 (PB 107-177)	03.02.2014 (PB 240-244)
5	Date of regular assessment proceedings u/s 143(3)	30.11.2012 (PA178-198)	26.12.2013 (PB 178 - 193)	23.02.2015 (PB 245-265)
6	Four year time limit for issue of notice u/s 148 elapsed on	31.03.2013	31.03.2014	31.03.2015
7	Notice for reassessment u/s 148 issued on	30.03.2015 PB 199	03.03.2016 PB 194	03.03.2016 PB 266
8	Objections for re-assessment u/s 148 filed before the AO on	30.04.2015 (PB 200-202)	07.04.2016 (PB 195-197)	07.04.2016 (PB 267 - 269)
9	Reasons for re-assessment issued by the AO on	15.06.2015 (PB 203)	27.06.2016 (PB 198-199)	27.06.2016 (PB 270-271)

1.1 We submit that the AO has issued notice under section 148 of the Income-tax Act, 1961("the Act") after the completion of 4 years from the end of Assessment year in all the cases on the reason that certain R&D expenditure, corporate overheads and other expenditure has not been allocated to special units (tax holiday units).

1.2 It may however be noted that the Appellant has submitted all the details with respect to R&D and ESOP expenses before the AO during the regular assessment proceedings itself. Further, the AO has specifically examined the details of R&D expenditure and ESOP expenditure at the time of regular assessment. Apart from the above, the AO has specifically applied his mind to the issue that corporate overheads will have to be allocated to tax holiday units and reduced the quantum of deduction at the time of regular assessment. Accordingly, all the issues have been examined and considered at the time of regular assessment. Even in the reassessment proceedings, the AO has not alleged or indicated that the same is based on new material or information he is

proposing to reopen the assessment. It is based on existing information already available on record at the time regular assessment. Therefore, the reassessment is purely on the basis of change of opinion. Further, the AO has not proved failure on the part of the Appellant to disclose fully and truly all necessary information and as such the reassessment beyond 4 years is barred by limitation.

1.3 From the above, it may be noted that there is no fresh material available on the record for the AO to re-open the assessment, reassessment beyond 4 years is barred by limitation and the allocation of R&D expenses to special units is a mere change of opinion. Hence, the proceedings u/s 148 of the Act are void ab initio and deserves to be quashed.

1.4 In this regard, we rely on various case laws as referred to in the case law compendium. Without prejudice to the above. on merits we submit as under:-

Without prejudice to the above, on merits we submit as under:-

2.1 The Appellant Company is engaged in the manufacture and trading in formulations, Generics, Active Pharmaceuticals Ingredients (APls), Bio-Technology and Custom pharmaceutical services in its various units. The company also carries out its research and development work (R&D) in a specified unit namely Integrated Product Development Organization (IPDO). The Appellant has incurred most of R&D expenses to develop branded formulations, generic drugs and niche products such as bio similar and new chemical entities. The Appellant has also incurred ESOP expenses during the years under consideration.

2.2 During the re-assessment proceedings, u/s 148 of the Act, AO is of the opinion that R&D expenditure and ESOP expenses are general in nature and hence the same needs to be allocated to special units. The AO has allocated the R&D expenses and ESOP expenses to special units & other units based on the turnover of the units.

Reasons for non-allocation of R&D expenses and ESOP expenses:-

2.3 Section 801C/801B/10B of the Act contemplates that only profits and gains "derived" from undertaking is eligible for deduction. The 80IC/801C/10B unit is independently functional and there is no direct nexus between products being developed in R&D units and products being manufactured in special units. The profits and gains of each unit are computed and audited separately and then aggregated to determine the gross total income. In the case of the exempted units, necessary audit certificates as per statutory norms are also being prepared and submitted. In such circumstances, it is crystal clear that the profits and gains being derived from each individual unit are not encompassing any expenditure or income pertaining to other units, be they eligible units or otherwise. Hence, there is no question of allocation of the R&D expenditure & ESOP expenses to the exempted units. Therefore, expenses which are not directly related to the undertaking should not be allocated on ad hoc basis.

2.4 The above view is squarely covered in favor of the Appellant in the following cases:-

• Madras HC decision in the case of CIT Vs Hindustan Unilever Ltd. [2014] 42 taxmann.com 132 (Mad)

• AAR in National Fertilizers Ltd., In Re (142 Taxman 5) has held that when other income cannot be considered as derived from 801 unit similarly other corporate office expenditure should also not be allocated to 801 unit.

• CIT Vs Kanmani Metals & Alloys Ltd 183 ITR 327 (Bom) it was held in the context of Section 80J that for the purpose of deduction only liability pertaining to the unit should be considered and not the overall liability of the Appellant

• Tide Water Oil Co (India) Ltd Vs CIT 353 ITR 300 (Cal) held that no expenditure at the corporate level which is remotely or indirectly related should be taken in to account while computing the deduction u/s.80IC

2.5 Further, with respect to allocation to R&D expenses, we wish to submit that the Company's research and development activities can be classified in to the following business segments namely Global Generics, formulations, Biologics Pharmaceutical services and active ingredients (PSAI) and Proprietary Products details of which are enunciated below:

• Finished Dosage Formulations (FDF), where our Research and Development activities are directed at the development of product formulations, process validation, bioequivalence testing and other data needed to prepare a growing list of drugs that are equivalent to numerous brand name products for sale in the highly regulated markets of the United States and Europe and emerging markets such as Russia, India etc.,

• Biologics: Research and development activities are directed at the development of biologics products for the emerging as well as highly regulated markets. Unlike traditional "small-molecule" drugs, biologic drugs cannot be manufactured synthetically, but typically must be produced from living plant or animal microorganisms.

• Pharmaceutical Services and Active Ingredients (API) Research and Development activities concentrate on development of chemical processes for the synthesis of active pharmaceutical ingredients and intermediates ("API") for use in our Global Generics segment and for sales in the emerging and developed markets to third parties. Our research and development activities also support our custom pharmaceutical line of business, where we continue to leverage the strength of our process chemistry and finished dosage development expertise to target innovator as well as emerging pharmaceutical companies. The research and development is directed toward providing services to support the entire pharmaceutical value chain, from discovery all the way to the market

• Proprietary Products, where we focus on the research, development, and manufacture of differentiated formulations and new chemical entities ("NCEs"). These novel products fall within the dermatology and neurology therapeutic areas.

2.6. During the years under consideration, the appellant has the following special units:

Sl No.	Name of the Unit	Nature of business	Section
1	Dr. Reddy's Laboratories Limited, Villager Khol, Dist: Solan, Baddi Himachal Pradesh (Hereinafter as Baddi Unit)	Manufacture and Sale of Pharmaceuticals Formulations in India Market	80 IC
2.	Dr. Reddy's Laboratories Limited, Adavipolam, Yanam, Pondicherry. (hereinafter referred as Yanam Unit)	Manufacture and sale of Pharmaceuticals Formulations	80 IB

3,	Dr. Reddy's Laboratories Limited, Export Ori9ented Unit. Bulk Active Division, Pydibheemavaram (hereinafter referred as BD 9 Unit	Manufacture and Export sale of Bulk Drugs	10B

2.7. The following is the abstract of the business wise R & D expenditure incurred:-

Sl No.	Particulars of R & D	Remark	AY 2008-09	AY 2009-10	AY 2010-11
1	Finished Dosage Formulations	R & D is incurred for generics for US markets and formulations	135	179	169
2	Pharmaceutical Services and Active Ingredients (PSAI)	Active Pharmaceuticals Ingredient	71	72	85
3	Biologics	R & D is for new products based on bio-similar (for biological products based on living organism) which does not manufacture any of the special units	29	34	23
4	Proprietary Products (NCE / Speciality)	Innovative products (Not generics in nature & creating the product for the 1st time)	87	100	87
	Total		322	385	364

2.8 Further, we wish to inform that there is no nexus between the products manufactured and sold from these special units and products on which R&D expenditure was incurred during the years under consideration. The products manufactured from these special units are different from the products on which R&D expenditure has been incurred. The Appellant Company manufactures Formulations, Generics, and APIs etc., in its various units with the R&D activity of the Appellant Company being carried out separately in an independent unit (IPDO). The Appellant Company also exports some of the products to regulated markets like the US, Europe and semi regulated markets like Russia for which mandatory approvals are obtained from US FDA and respective regulatory authorities for such units. Lack of such approvals prohibits the sale in these geographical locations. The R&D carried out in the IPDO has no nexus with any of these products which are under manufacture in the other units including the special units as it is geared for the development of new products which may or may not see the light of day.

2.9 Therefore, in the absence of any direct link or nexus between the R&D work carried out in the IPDO and the products manufactured in the other units, the question of apportioning the R&D expenditure to these units does not arise. In this regard, we rely on the following cases:

• Zandu Pharmaceuticals Works Limited vs. CIT (350 ITR 366) held that only expenditure directly relating to such eligible activity would be deductible. R&D expenses of the head office cannot by itself be understood as proportionately deductible, unless there is evidence to show nexus as between the eligible activity and such research.

• Bush Boake Allen (India) Pvt Ltd vs. ACIT (2005) 273 ITR 152 (Mad) held that for the purpose of determining as to whether at all there was R&D undertaken regarding the product manufactured in the tax holiday unit, the matter was

> remitted to the Tribunal. If it did pertain to the product manufactured at tax holiday unit, only then would the allocation of the expense to the tax holiday unit be justified.
>
> In view of the above, we pray before your honors that the re-assessment proceedings u/ 148 of the Act initiated by the AO beyond 4 years need to quashed. Without prejudice to re-assessment u/s 148, we pray before your honors that since, the R&D expenses and ESOP expenses are not derived/linked from special units and not having a direct nexus between products manufactured in special units and products being developed in R&D units, the addition made towards allocation of R&D expenses and ESOP need to be deleted."

38. On the other hand, Learned Departmental Representative relied upon the orders passed by the Tax Authorities.

39. We have carefully considered the rival submissions and perused the record. We have also carefully analysed the cases referred to by A.O. as well as CIT (A).

40. We shall first deal with the justification of issuing notice u/s 148 of the Act since the assessee challenged the very basis for reopening of assessment. As per section 147 of the Act, Assessing Officer should furnish reasons which prompted him to reopen the assessment. The expression "reason to believe" was subject matter of consideration by various Courts. The words 'reason to believe' is distinct from 'reason to suspect'. In otherwords, reopening should be based on 'objective satisfaction' and not on the subjective inferences purely on surmises and suspicion.

41. If no action has been taken within four years, from the end of the relevant assessment year, thereafter mere escapement of income is not sufficient to reopen the assessment but it has to be shown that the escapement of income was on account of the failure on the part of the assessee to make a return u/s 139 or to disclose fully and truly all material facts necessary for assessment. Explanation-1 thereof states that production before the Assessing Officer all account books or evidence from which material evidence could, with due diligence, be discovered will not necessarily amount to disclosure. However, if the

material is subject matter of consideration in the first stage, on mere change of opinion, proceedings cannot be initiated.

42. In the instant case, the assessee submits that it has not only furnished complete details but they were also considered by the Assessing Officer during the course of original assessment proceedings. This fact can be noticed from the original assessment order wherein the Assessing Officer called for the details of R & D expenditure for the purpose of considering the claim of weighted deduction and, allocation of expenditure to exempt and non-exempt units was also considered vide para XV of his order wherein the Assessing Officer followed decision of the ITAT and held that corporate overheads have to be apportioned between taxable / non-taxable units. In fact the assessee gave a detailed note with regard to R & D expenditure. Page 27 (Schedule-20) refers to the note on R & D expenditure which reads as under:-

> *"Revenue expenditure on research and development is expensed as incurred. Capital expenditure incurred on research and development is capitalised as fixed assets and depreciated in accordance with the depreciation policy of the Company."*

Similarly, details of ESOP were also furnished (see page 45 of the paper book).

43. In the case of Tecumseh Products India (P.) Ltd vs. ACIT (361 ITR 429) the Hon'ble High Court of Andhra Pradesh, while considering a material pertaining to Assessment Year 2005-06 observed that the Assessing Officer has to show that there is 'reason to believe' that income liable to be taxed has escaped assessment and it is on account of failure on the part of the assessee by not disclosing material facts. In the case of Sirpur Paper Mills Limited (113 ITR 393) the Court observed that if the Assessing Officer subsequently feels that he arrived at an erroneous conclusion earlier, the same cannot be a reason for reopening of assessment so long as primary facts are disclosed to the Assessing Officer during the course of original assessment proceedings. In

otherwords, while initiating proceedings u/s 147 of the Act, Assessing Officer has to take an appropriate decision as to whether there is a reason to believe that income escaped assessment and it is on account of non-disclosure of true and correct particulars of income. The reasons recorded by the Assessing Officer, as could be noticed from page 203 of the paper book is as under:-

> *"With reference to the A.Y. 2008-2009 the reasons for reopening assessment u/s 147 of the IT Act is communicated as under:*
>
> *It was found during the assessment proceedings for the A.Y. 2011-12 that this assessee has booked a loss of Rs. 3.88 Crores as business loss from the 100% generic EOU situated at Hyderabad. During the course of assessment proceedings for A.Y. 2011-12, it is found that the assessee had not reported the said loss. The assessee's computation of income for A.Y. 2008-2009, submitted during the assessment proceedings is not reflecting the loss from EOU.*
>
> *From the above, it is very clear that it is failure on the part of the assessee not to disclose fully and truly the loss incurred to the assessee of Rs. 3.88 Crs during the assessment proceedings before the Assessing Officer. This unreported loss needs to be adjusted against the exempted income of that year.*
>
> *It is also found that certain expenditures like R & D expenditure, corporate overheads, and other expenditure claimed in the computation are not apportioned to the special units. Thus it is found that this non-apportionment of expenses to special units has resulted in huge anomaly in the percentage of the profit ratio returned. It is noted that this anomaly has effect of reducing the taxable profits returned."*

44. A plain reading of the reasons recorded by the AO speaks of failure on the part of the assessee in not disclosing fully and truly the loss incurred by the assessee of Rs. 3.88 Crs. It was later dropped because the allegation that the assessee has not fully and truly disclosed the loss was found to be incorrect. The other reason mentioned in the notice was that the expenditure like R & D, corporate overheads and other expenditure claimed in the computation are not apportioned to special units. It deserves to be noticed that the issue of corporate overheads was already considered in the assessment made u/s 143(3) and with regard to the R & D expenditure etc., **it is not the case of the Assessing Officer that it was on account of non-disclosure – fully**

and truly – of the particulars of income or material facts; rather it was based on the apprehension that non-apportionment of expenses to special units has resulted in huge anomaly in the percentage of profit ratio which has the effect of reducing the taxable profits. We fail to understand as to whether such reason can be an appropriate reason, without recording that the failure was on account of non-disclosure of material facts.

45. Even the first appellate authority has emphasised the fact that if an assessee had excess taxable profit, non-allocation of expenses to the exempted units would result in huge anomaly in the percentage of profit ratio which can form the basis for reopening of assessment. In otherwords, there is no live link between the reasons recorded and the factual matrix of the case.

46. In our considered opinion, reopening should not be based on any prejudiced apprehension that the assessee might have purposely followed the practice of claiming deduction of expenses incurred in relation to exempted units against the taxable income. In fact, the CIT (A) also mentioned that even on the principle of equity, the expenditure has to be apportioned both amongst taxable units as well as exempted units, overlooking the fact that equity and taxation are strangers and one has to go by strict interpretation of provisions. Merely because the assessee claimed exemption on certain units it should not have been assumed that expenditure claimed against taxable income is attributable to the exempt units. Ld CIT (A) also observed, vide para 5.13, that "***cases of excess deduction / exemption of income chargeable to tax would warrant formation of requisite belief to initiate proceedings where full disclosure were made and yet an income chargeable to tax had escaped from being included in the assessment order".*** In our humble opinion, Ld CIT (A) has considered the issue from a prejudiced point of view overlooking the fact that it is

a duty of the Assessing Officer to assume jurisdiction only upon arriving at a reasonable belief that income has escaped assessment and it is as a result of non-furnishing of material facts. In the instant case, the notice itself does not indicate that the assessee has not furnished all material facts with regard to R & D expenditure. The notice also speaks of "corporate overheads" which was already considered by the Assessing Officer at the stage of original assessment proceedings and this indicates lack of application of mind on the part of the Assessing Officer while issuing a notice u/s 148 of the Act. In otherwords, as rightly pointed out by the Learned Counsel for the assessee the notice issued u/s 148 is based on information already available on record at the time of original assessment and therefore, re-assessment proceedings are purely based on change of opinion and not attributable to the failure on the part of the assessee to disclose fully and truly all material information. Therefore, even under the amended provisions, we are of the firm opinion that the notice issued by the Assessing Officer cannot be said to have been based on "reasons to believe that income chargeable to tax has escaped assessment"; He has proceeded mainly on the ground that there is a "huge anomaly in the percentage of profit ratio apportioned" which implies that there is a subjective approach and not objective approach on the part of the Assessing Officer. We are of the view that the Assessing Officer has not satisfied the pre-conditions specified in section 147 of the Act, in order to assume jurisdiction for reopening of assessment, and accordingly the notice issued u/s 148 of the Act deserves to be quashed and, we hold accordingly.

47. Though the assessee has relied upon several case-law before the Ld CIT (A), it is not necessary for us to consider those decisions at this stage since factually the notice issued by the Assessing Officer speaks of "reasons to suspect" rather than "reasons to believe" which fact was impliedly accepted by the Learned Commissioner wherein he has

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attributed the issuance of notice on the ground that "excessive deduction claimed may be sufficient for formation of requisite belief to initiate proceedings u/s 147 of the Act". Under these circumstances, we are of the view that re-assessment proceedings are not valid and consequently the additions / disallowance made therein do not stand in the eye of Law.

48. Since elaborate arguments were advanced on merits of the case i.e., with regard to correctness of apportionment of R & D expenditure and ESOP cost between taxable and exempted units and also in view of the fact that it is a recurring issue, we proceed to consider this issue also on merits.

49. The case of the assessee, all through, was that R & D expenditure was incurred by the assessee in a separate unit known as 'IPDO', which is meant for carrying on R & D. It is also not in dispute that formulations / products arising out of it may or may not be utilised in the special units wherein the assessee is eligible for deduction / exemption. It is not controverted that formulations / products arising out of it can be sold in the open market and need not necessarily be utilised in the existing special units. The Hon'ble Bombay High Court in the case of Zandu Pharmaceuticals Limited (350 ITR 366) considered an identical issue wherein the assessee carried on business of manufacture of Ayurvedic medicines which had four units in Uttar Pradesh and Head Office separately. Each of the units had their own R & D unit equipped with laboratory. The Head Office also had their own R & D Department. The AO allocated R & D expenditure, debited to the Head Office, to the units proportionate to the turnover of the units. The Revenue could not prove that any of the units were benefited by the R & D activities pertaining to new drugs. Only on the presumption the AO sought to allocate R & D expenses to all the units, irrespective of whether there is any existing activity connected to R & D, in any of the

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units. Under these facts and circumstances, the Court observed that R & D activities were in relation to new products and there is nothing to indicate that in the event of assessee commercially exploiting the benefits of R & D works, the products would be manufactured by the said units. Since the Revenue's stand is based on hypothetical basis that the said products would be manufactured by each of them or any one of them, the Court concluded that it is an erroneous presumption that the benefit of any R & D activity can be exploited by an enterprise, by utilising the same in its manufacturing activity. The Court also noted that an enterprise can always assign the benefit thereof to a third party. It can grant a license in respect of any patent or design to a third party in which event the other units would not derive any benefit and thus there can be no nexus between R & D units and the units wherein the assessee is carrying on activity with regard to the existing products. Similar view was taken by the Hon'ble Madras High Court in the case of Bush Boake Allen (India) Pvt Ltd vs. ACIT (273 ITR 152) wherein the Court observed that there cannot be any presumption that any technology about new flavours or essence will automatically be utilised in other units.

50. In the case on hand, it was stated by the assessee, all through, that the expenditure incurred on R & D and ESOP cost have no nexus with the products manufactured in the exempted units, unlike Head Office overheads. It cannot be disputed that without Head Office, the Branch units also cannot run and hence overheads have to be necessarily allocated to the exempt as well as non-exempt units. Similar view was taken by the Tribunal in the assessee's own case for the earlier year. However, with regard to R & D expenses and ESOP cost, both AO as well as CIT (A) have proceeded on presumption that R & D expenses will benefit the exempted units in the long run overlooking the fact that there is nothing on record to show that all the R & D

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inventions / patents were never sold in outside market but only captively utilised in the exempted units. Under these circumstances, by respectfully following the decision of the Hon'ble Bombay High Court (cited supra), we are of the view that the Revenue has not made out a case for apportionment of R & D expenditure and ESOP cost to the exempt units. In the result, we hold that the Tax Authorities were not justified in apportioning R & D expenditure and ESOP cost to the units which claimed exemption u/s 10B, 80IB and 80IC of the Act.

51. In the result, appeals filed by the assessee are allowed.

Order pronounced in the open court on 08th June, 2018.

Sd/-

(S. RIFAUR RAHMAN)
ACCOUNTANT MEMBER

Sd/-

(D. MANMOHAN)
VICE PRESIDENT

Hyderabad, Dated: 08th June, 2018.

OKK, Sr.PS

Copy to

1.	Dr. Reddy's Laboratories Limited, 8-2-337, Road No.3, Banjara Hills, Hyderabad-500034.
2.	Asst. Commissioner of Income Tax, Circle-17(1), 9th Floor, Signature Towers, Opp. Botanical Garden, Kothaguda, Kondapur, Hyderabad-500084.
3.	CIT (A)-5, Hyderabad.
4.	Pr. CIT-5, Hydeabad.
5.	DR, ITAT, Hyderabad.
6.	Guard File