

**IN THE HIGH COURT OF GUJARAT AT AHMEDABAD**

**TAX APPEAL No.242 of 2000  
With  
TAX APPEAL No.243 of 2000  
With  
TAX APPEAL No.263 of 2000**

**For Approval and Signature:**

**HONOURABLE MR. JUSTICE AKIL KURESHI  
HONOURABLE MS. JUSTICE HARSHA DEVANI**

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1 Whether Reporters of Local Papers may be allowed to see the judgment?

2 To be referred to the Reporter or not?

3 Whether their Lordships wish to see the fair copy of the judgment?

4 Whether this case involves a substantial question of law as to the interpretation of the constitution of India, 1950 or any order made thereunder?

5 Whether it is to be circulated to the civil judge?

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**THE DEPUTY CIT (ASSTT) - Appellant(s)**

**Versus**

**MASTEK LIMITED - Opponent(s)**

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**Appearance:**

MR MR BHATT, SR. COUNSEL with MRS MAUNA M BHATT for Appellant(s): 1,  
MR BANDISH SOPARKAR for MR SN SOPARKAR for Opponent(s): 1,

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**CORAM : HONOURABLE MR. JUSTICE AKIL KURESHI**

**and**

**HONOURABLE MS. JUSTICE HARSHA DEVANI**

**Date : 21/08/2012 & 28/08/2012**

**COMMON ORAL JUDGMENT  
(Per : HONOURABLE MR. JUSTICE AKIL KURESHI)**

**Date: 21/08/2012**

1. These three tax appeals involve the same assessee and give rise to similar questions of law. We have heard them together and propose to dispose them off by this common judgment.

2. While admitting these appeals by common order dated 22-11-2000, the court framed following two substantial questions of law:-

- A. Whether, the Appellate Tribunal is right in law and on facts in holding that the activities carried out by the assessee constituted research activity in terms of section 43(4) and therefore the assessee was entitled to deduction of expenditure incurred, capital as well as revenue, Pune centre under section 35(1)?
- B. Whether, before permitting deduction under Section 35(1) of the Act to the assessee, the Tribunal ought to have obtained the opinion of the Central Board of Direct Taxes on the question whether the expenditure incurred by the assessee on its project at Pune was for research activities?

3. We may notice facts in brief. The respondent assessee M/s. Mastek Ltd. is a company registered under the Companies Act and is regularly assessed to tax. For the assessment years 1992-93, 1993-94 and 1994-95, the assessee claimed certain expenditure, revenue as well as capital, by way of deduction under section 35 of the Income

Tax Act, 1961 ('the Act', for short) expended on scientific research. The case of the assessee was that the assessee incurred expenditure of Rs.31,58,882/- in the previous year relevant to the assessment year 1992-93 in setting up a Product Development Centre at Pune. The new product developed at this centre was marketed in the name and style of a package called MAMIS during the financial year 1993-94. On such expenditure, the assessee claimed deduction under section 35 of the Act. In support of such a claim, the assessee produced advice of the Expert Advisory Committee of the Institute of Chartered Accountants.

4. The Assessing Officer, however, was of the opinion that such claim was not sustainable. He was of the opinion that such product MAMIS was already developed in the year 1989. The basic features of the package projected to be produced and one ultimately produced were substantially similar. He was, therefore, of the opinion that no new product was developed and there was only modification in the existing product to suit the requirements of the prospective buyers. On such basis, the Assessing Officer disallowed the claim of deduction under section 35 of the Act.

5. The assessee carried the matter in appeal. Before the Commissioner (Appeals), the assessee contended that the Research and Development Centre at Pune had developed a new software program. That such R&D Centre was established for developing sophisticated versatile software products. One such product developed was MAMIS. Expenditure incurred in developing such product should be held allowable deduction under section 35(1) of the Act. The assessee also raised an

alternative contention before the Commissioner that substantial portion of this expenditure of Rs.31,58,882/- was a revenue expenditure. The same, therefore, in any case, was allowable deduction under section 37(1) of the Act.

6. Commissioner (Appeals) considered the contentions. The Commissioner was of the opinion that the assessee was not entitled to deduction under section 35 of the Act since no scientific research was done and no new product was developed. It was a case of simple modifications of an existing software program. He, however, upheld the assessee's contention that a sum of Rs.31,58,882/- was revenue expenditure.

7. Revenue carried the matter in appeal before the Tribunal since the assessee was granted benefit under section 37 of the Act. The assessee also carried a separate appeal contending that the Commissioner erred in holding that in absence of any scientific research, deduction under section 35 of the Act was not allowable.

8. The Tribunal disposed of both the appeals by a common judgment dated 25-11-1999. The Tribunal noted that the assessee had produced opinion of three experts in the field namely of one Dr. D.B. Pathak, Professor of Computer Science & Dean, Resource Development, Indian Institute of Technology, Powai, of Shri P. Sadanandan, Associate Director, Head, Software Engineering Division, National Centre of Software Technology, Bangalore and Appraisal note prepared by Technology Development & Information Company of India Ltd. who had evaluated the product MAMIS before entering into any

financial arrangement supporting such product. The Tribunal was of the opinion that such reports suggested that there were salient features of the product MAMIS which would achieve a major breakthrough in the field of software technology. Such program would provide a complete solution to the medium-sized manufacturing companies. Before the Tribunal, the assessee contended that such reliable evidence of the experts' opinion could not have been discarded by the revenue authorities. If the Assessing Officer had any doubt about the nature of activity carried on and whether the same amounted to scientific research or not, he ought to have taken recourse to the provisions of section 35(3) of the Act by making a reference to the Board requesting for an opinion of the prescribed authority on the issue.

9. The Tribunal was of the opinion that the expression "scientific research" defined under section 43(4) was of wide amplitude. The Tribunal was of the opinion that the Legislature had provided incentive for providing deduction of capital and revenue expenditure incurred for the research and developmental activities. Such provision should, therefore, be liberally construed. The Tribunal accepted the assessee's contention that the product MAMIS would ensure reduction of the process time substantially. This could be treated as a major breakthrough in the field of software processing. The Tribunal concluded that the assessee had carried out scientific research in the process of developing such software. The Tribunal rejected the revenue's contention that MAMIS had already been developed in the year 1989. The Tribunal upheld the assessee's claim for deduction under section 35 of the Act on the entire amount and allowed the assessee's appeal. The

revenue's appeal was dismissed, however, without expressing any opinion on the question whether the Commissioner's finding that in any case, the expenditure was revenue in nature.

10. Against such judgment of the Tribunal, revenue filed two appeals before this court being Tax Appeal No.243/2000 and 251/2000. Tax Appeal No.243/2000 came to be admitted by an order dated 22-11-2000 framing the above noted two questions. Tax Appeal No.251/2000 was not entertained by a separate order also passed on 22-11-2000. A perusal of the appeal memo reveals that here also, the revenue had proposed a question regarding the assessee's claim for deduction under section 35(1) of the Act read with section 43(4). Presumably, however, this appeal was filed with an intention of questioning the assessee's stand that the expenditure was in any case revenue in nature. Be that as it may, this appeal has not been admitted by the court and the issue rests there.

11. For subsequent two assessment years namely, 1993-94 and assessment year 1994-95, facts are very similar. The assessee had raised similar claims of deduction under section 35 of the Act both on revenue as well as capital expenditures for development of product MAMIS. Here also, the Assessing Officer disallowed such claim. In assessee's appeal, the Commissioner adopting the logic in the earlier year, allowed the deduction as a revenue expenditure under section 37(1) of the Act but held that there was no scientific research and the claim could not be sustained under section 35(1) of the Act. On further appeals, the Tribunal accepted the assessee's claim for deduction under section 35(1) and

dismissed the revenue's appeals without touching the question of applicability or otherwise of section 37(1) of the Act. Here also, the court entertained only one appeal each framing identical questions and did not entertain two further appeals of the revenue arising out of the counter appeals before the Tribunal pertaining to same assessment years.

12. In view of the above facts, counsel for the revenue submitted that the Tribunal erred in granting benefit of section 35 of the Act to the assessee. Any development of software per se would not amount to scientific research, in the present case all the more so since all that the assessee had done was to modify its existing product to suit the requirements of individual buyers. No scientific research was needed, none carried out, no deduction under section 35(1) of the Act was available to the assessee.

13. Counsel further submitted that the Tribunal without examining highly technical and complicated aspects came to the conclusion that the assessee had carried out scientific research.

14. Counsel further submitted that the question whether the activity carried out by the assessee amounted to scientific research or not could be decided having regard to section 35(3) of the Act for which purpose the assessee ought to have made a reference to the Board for the opinion of the prescribed authority. This not having been done, the Tribunal erred in granting benefit of the provisions of section 35(1) of the Act.

Date: 28/08/2012

He, in fact, suggested that the question can be stated to have arisen only once, the Assessing Officer during the course of framing the assessment takes a decision to disallow the claim of an assessee regarding deduction of expenditure incurred for scientific research. At that stage, according to the counsel, the onus would be on the assessee to make a reference to the Board as envisaged in section 35(3) of the Act.

15. In support of his contentions, the counsel relied on the following decisions:-

- (1) In case of **Commissioner of Income-Tax vs. Engineering Innovation Ltd.** reported in 327 ITR Page 392 wherein the Himachal Pradesh High Court referring to section 35(3) of the Act observed that the said section only empowers the Board to refer the matter to the prescribed authority. Under the Act, the Assessing Officer or the Commissioner (Appeals) or the Tribunal has no power to directly refer the matter to the Board. It was recorded that the counsel for the revenue failed to bring to the notice of the court any provision under the Act or the Rules which empowers the Assessing Officer or other tax authorities to refer the matter to the Board. It was concluded that once the matter was before the Assessing Officer, he must decide the same.
- (2) In case of **M/s. Bishwanath Prasad Radhey Shyam vs. Hindustan Metal Industries** reported in (1979) 2

SCC Page 511 wherein the Apex Court in the context of the question whether an invention is patentable under the Patents and Designs Act, 1911 observed that grant of patent is for manner of new manufacture and the invention must involve inventive step having novelty and utility.

16. On the other hand, learned counsel Shri Bandish Soparkar for the respondent assessee opposed the appeal contending that the assessee had carried out scientific research in developing a new software known as MAMIS. Expenditure incurred for development of such scientific research was, therefore, an allowable deduction.

16.1 He submitted that there was sufficient evidence produced by the assessee before the Assessing Officer in support of this case. Opinions of experts in the field and having credibility were produced. The Assessing Officer without appreciating such materials erroneously held that no scientific research was carried out.

16.2 Counsel submitted that the term 'scientific research' has wide amplitude. Such term cannot be equated with a scientific invention. He referred to section 43(3) of the Act where the term scientific research has been defined.

16.3 Counsel further submitted that the Assessing Officer ought to have accepted the claim of the assessee on the basis of material already produced. The question of reference by the Board under section 35(3) of the Act would arise in exceptional cases involving a class of assesseees and such provision is not

required to be resorted to in individual cases.

16.4 The counsel for our consideration brought to our notice following decisions with respect to the question of reference by the Board under section 35(3) of the Act:-

- (1) In case of **J.K. Synthetics Ltd. vs. O.S. Bajpai, Income-Tax Officer, Central Circle V, Kanpur and Another** reported in 105 ITR 864 (All.) wherein the Allahabad High Court referring to section 35(3) of the Act expressed an opinion that if the Income Tax Officer does not accept the claim of the assessee under section 35, he has to refer the matter to the Board and the Board in turn will make a reference to the prescribed authority. Neither the Income Tax Officer nor the Board was competent to take a final decision on any such controversy.

This decision of Allahabad High Court in case of J.K. Synthetics Ltd. (supra) was followed by the same High Court in a later decision in the case of **Union of India and Another vs. J.K. Synthetics Ltd.** reported in 199 ITR Page 14

- (2) In case of **Commissioner of Income-Tax vs. F.C.S. International Marketing P. Ltd.** reported in 283 ITR 32 wherein the Punjab & Haryana High Court held that if any question arises under section 35(3) as to whether and to what extent any activity constituted or any asset was being used for scientific research, the Assessing Officer would be duty bound to strictly comply with the statutory provisions.

16.5 Our attention was also drawn to the decision of Delhi High Court in the case of **Commissioner of Income-Tax vs. Deltron Ltd.** reported in 297 ITR 426 wherein referring to section 35(3) of the Act, it was held that the prescribed authority was not the Assessing Officer and he could not determine whether the machinery used by the petitioner was for research and development purpose or not. Further, noticing that the Commissioner (Appeals) had passed an order to the effect that the Assessing Officer was not competent to decide whether the machinery was being used for research and development purpose or for manufacturing activity, the court observed that soon thereafter, the revenue could have made an attempt to find out the actual use of the machine but it did not do so. Under such circumstances, the court rejected the prayer of the revenue to remand the matter for a fresh determination.

17. In order to decide the questions, we may first notice the statutory provisions. Section 35 of the Act pertains to expenditure on scientific research. Sub-section (1) of section 35 of the Act provides for deduction in respect of expenditure on scientific research. Sub-section (3) of section 35 provides that if any question arises under the said 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, the Board shall refer the question to the prescribed authority whose decision shall be final.

18. Section 35 as it stood at the relevant time to the extent it is relevant for our purpose reads as under:-

35. (1) In respect of expenditure on scientific research, the following deductions shall be allowed -

- (i) any expenditure (not being in the nature of capital expenditure) laid out or expended on scientific research related to the business.

[*Explanation.*-Where any such expenditure has been laid out or expended before the commencement of the business (not being expenditure laid out or expended before the 1<sup>st</sup> day of April, 1973) on payment of any salary (as defined in *Explanation 2* below sub-section (5) of section 40A) to an employee engaged in such scientific research or on the purchase of materials used in such scientific research, the aggregate of the expenditure so laid out or expended within the three years immediately preceding the commencement of the business shall, to the extent it is certified by the prescribed authority to have been laid out or expended on such scientific research, be deemed to have been laid out or expended in the previous year in which the business is commenced;]

- (iv) in respect of any expenditure of a capital nature on scientific research related to the business carried on by the assessee, such deduction as may be admissible under the provisions of sub-section (2).

(3) 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, the Board shall refer the question to the prescribed authority, whose decision shall be final.

19. The term 'scientific research' has been defined in section 43(4) which reads as under:-

43. In sections 28 to 41 and in this section, unless the context otherwise requires -

- (4) [(i) "scientific research" means any activities

for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries;]

(ii) references to expenditure incurred on scientific research include all expenditure incurred for the prosecution, or the provision of facilities for the prosecution, of scientific research, but do not include any expenditure incurred in the acquisition of rights in, or arising out of, scientific research;

(iii) references to scientific research related to a business or class of business include -

- (a) any scientific research which may lead to or facilitate an extension of that business or, as the case may be, all businesses of that class;
- (b) any scientific research of a medical nature which has a special relation to the welfare of workers employed in that business or, as the case may be, all businesses of that class;

20. From the above statutory provisions, it can be seen that deduction as provided under section 35(1) of the Act is made available on expenditure on scientific research whether the nature of such expenditure is revenue or capital in character. The question whether a particular expenditure was, therefore, incurred for the purpose of expenditure on scientific research, would as in the present case, become important. Sub-section (3) of section 35, therefore, provides for a reference to be made by the Board on such question namely, whether, and if so, to what extent, any activity constitutes or constituted, or any asset is or was being used for scientific research. The decision of the prescribed authority to whom the Board may make a reference would be final.

21. The term 'scientific research' as we already noted is

defined in section 43(4) of the Act as to mean any activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries.

22. The term 'research' per se has a wide amplitude. In the Advanced Law Lexicon by P. Ramanathan Iyer, 3<sup>rd</sup> Edition, it is explained as to mean study or scientific investigation of any biological reference or technological application for use to biological systems, living organisms or derivatives thereof to make or modify products or processes of any use. Original and planned investigation undertaken with the prospect of gaining new scientific or technological knowledge or understanding. An investigation directed to the discovery of some fact; careful study of a subject.

23. The term 'scientific research' has been explained as to mean any activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries. Research and development, if any, of the sciences or in technology. Any activities in the fields of knowledge or applied science for the extension of knowledge.

24. The terms 'research' and 'scientific research' respectively thus have a wide scope. It does not necessarily mean only invention. The term 'invention' on the other hand has somewhat narrower meaning and is explained as: "An invention is the finding out; the contriving; the creating of something which did not exist and was not known before and which can be made useful and advantageous in the pursuance of business, or can add to the enjoyment of mankind." In common parlance, thus, the terms 'research' and 'scientific

research' respectively are understood to include wide variety of activities relatable to scientific study. We do not even need to fall back on such general principles since the term 'scientific research' has been defined under section 43(4) to mean any activities for the extension of knowledge in the fields of natural or applied science including agriculture, animal husbandry or fisheries. Thus, scientific research need not be equated with a scientific invention. Even the term 'invention' as defined in the Patent Act is wider than understood in pure science where distinction is made between invention and discovery. The Patent Act thus recognises not only the product pattern where a new product has been invented through scientific research, but also recognises a process pattern where an existing product may be manufactured through an innovative process which was hitherto unknown.

25. It can thus be seen that the term scientific research in the context of the deduction allowable under section 35(1) of the Act would include wide variety of activities. It can also be appreciated that every scientific research need not necessarily result into the ultimate goal with which it may have been undertaken. Often times in the field of research and invention, the efforts undertaken may or may not yield fruitful results. What is to be ascertained is whether any scientific research was undertaken and not whether such scientific research resulted into the ultimate aim for which such research was undertaken. It can be easily envisaged that the scientific research undertaken often times would completely fail to achieve desired results. That by itself does not mean that no scientific research was undertaken. What the Legislature desired to encourage by granting deduction under section

35(1) of the Act was a scientific research and not necessarily only the successful scientific research undertaken by an assessee.

26. With above clarity in mind, if we revert back to the case on hand, the Tribunal allowed the assessee's appeal primarily on two grounds. Firstly, the Tribunal was of the opinion that the assessee had placed sufficient material to establish that a new product was developed through scientific research. The expenditure incurred for such purpose was, therefore, allowable deduction under section 35(1) of the Act. The second ground on which the Tribunal accepted the assessee's case was that under section 35(1) of the Act, the Assessing Officer could not have rejected such a claim without making a reference to the Board.

27. Insofar as the first aspect of the matter is concerned, we are of the opinion that the Tribunal without discussing full materials on record, came to such conclusion which, in our opinion, ought not to have been done. These are matters of extreme scientific complexities. What was the nature of the research undertaken, what was the improvement in the existing software aimed at or desired, whether ultimately the product which was launched by the assessee after undertaking such so called scientific research, was a new product substantially different from the existing one or not were some of the issues on which the Tribunal, in our humble opinion, without bestowing sufficient attention ruled in favour of the assessee. We may caution that such issues of extreme scientific complexities, should not be decided without referring to the full materials on record and appreciating the

complexities of the issue on hand. In our opinion, simply accepting one view over the other without fully grasping the complexities would be hazardous in a given situation.

28. We are, however, of the opinion that insofar as the second aspect of the matter is concerned, the Tribunal was perfectly justified in holding in favour of the assessee. Section 35(3) of the Act as noticed requires a reference to be made by the Board to the prescribed authority when a question arises 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. The decision of the prescribed authority on such a question would be final. In our opinion, therefore, whenever any such question arises, the Assessing Officer cannot decide the issue but must place the issue before the Board who, in terms of section 35(3) of the Act, would refer the question to the prescribed authority. The decision of the prescribed authority would govern the parties. Therefore, if an assessee puts forth a claim of deduction under section 35(1) for expenditure incurred on scientific research and if the Assessing Officer is not inclined to accept such a claim, the question can be stated to have arisen. In such a situation, the Assessing Officer cannot take a decision but must seek the opinion of the prescribed authority, We may hasten to add that only when such a question arises that the reference would be competent. For example, if in a given case, the assessee lodges a claim without any supporting material, it cannot be stated that the question has arisen which would require a reference by the Board. Similarly, if the Assessing Officer accepts the claim of the assessee, no such question can be stated to have arisen. We are, however, unable to accept Shri Bhatt's contention that

such a question would arise only when the assessment is finally framed and that thereafter the onus would be on the assessee to seek a reference. No such intention is emerging from section 35(3) of the Act. Whenever an Assessing Officer is not inclined to accept the assessee's case for deduction, we fail to see how at that very stage, the question cannot be stated to have arisen.

29. In the view that we have taken, we are supported by the decisions of three High Courts namely, the decision of Allahabad High Court in the case of J.K. Synthetics Ltd. vs. O.S. Bajpai, Income-Tax Officer, Central Circle V, Kanpur and Another (supra), Punjab & Haryana High Court in the case of Commissioner of Income-Tax vs. F.C.S. International Marketing P. Ltd. (supra) and Delhi High Court in the case of Commissioner of Income-Tax vs. Deltron Ltd. (supra). We are conscious that the Himachal Pradesh High Court in the case of Commissioner of Income-Tax vs. Engineering Innovation Ltd. (supra) has taken a somewhat different view. We are unable to persuade ourselves to accept the reasoning of the Himachal Pradesh High Court. The High Court was of the opinion that neither section 35(3) of the Act nor any other provision under the Act or the rules empowers the revenue authorities to refer the matter to the Board. We are of the opinion that the very scheme of section 35(3) of the Act would require a revenue authority whenever a question arises as to whether the expenditure was incurred for scientific research or not before the Board who, as provided under section 35(3) of the Act, would have to refer the issue for the decision of the prescribed authority. In such a case, the revenue authority is not making a reference to the Board but is only placing the issue at the

disposal of the Board to act in terms of section 35(3) of the Act to make a reference to the prescribed authority. It is undoubtedly true that the power of making such a reference lies with the Board and not with the revenue authorities, however, the act of the revenue authorities to place such an issue before the Board for making a reference cannot be seen as a reference made directly by the revenue authority.

30. The Assessing Officer not having obtained such a decision of the prescribed authority though a serious question in the present case had arisen, in our opinion, was not justified in rejecting the assessee's claim for deduction of expenditure incurred for scientific research. The Tribunal in this regard, in our view, came to a correct conclusion.

31. The last question that survives is whether at this stage should we permit the revenue to seek such a reference and the opinion of the prescribed authority. In the facts of the present case, we are not inclined to accept any such request for the following reasons. Firstly, at no stage, right up to the Tribunal and even during the pendency of these appeals before the High Court, any such attempt was made by the revenue. Secondly, in the meantime, more than 20 years have passed since the assessee incurred the expenditure. Expecting the assessee to now produce minute details of the research activity undertaken would be unreasonable. Thirdly, that the Commissioner held that a substantial portion of such expenditure was in any case of revenue nature and in respect of the provision of section 37(1) of the Act, the assessee was entitled to claim full deduction thereof. We have noticed that such conclusion of the Commissioner was not disturbed by the

Tribunal though the revenue had specifically preferred an appeal in this respect. Against non-entertaining of such appeal, further appeals by the revenue also came to be dismissed by this court. No useful purpose would, therefore, be served in permitting reopening of the entire issue at this distant point of time.

32. In the result, we answer the question No.A by holding that the Tribunal itself ought not to have decided this question without the opinion of the prescribed authority, particularly without full discussion on the materials on record. The question No.B is answered by holding that the reference ought to have been sought by the revenue before the Board to the prescribed authority and not having done so, the Tribunal was justified in reversing the orders of the revenue authorities rejecting the assessee's claim for deduction.

33. In the result, all appeals are dismissed.

THE HIGH COURT  
OF GUJARAT

( Akil Kureshi, J. )

( Harsha Devani, J. )

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