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CASE LAW UPDATE

Compiled by CA Kewal Satra

Supreme Court's decision - Freebies provided by pharmaceutical companies not allowed as deduction

Apex Laboratories Pvt. Ltd. vs. Deputy Commissioner of Income Tax, Large Tax Payer Unit – II [SLP (Civil) No. 23207 of 2019]

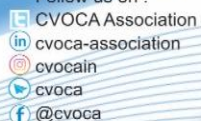
❖ Introduction:

A recent Supreme Court ruling (supra) dated 22 February 2022 has dismissed the taxpayer's appeal regarding disallowance of expenses incurred for providing freebies to medical practitioners to promote sales of its healthcare supplement, pursuant to the Explanation to section 37(1) of the Income Tax Act, 1961 ('IT Act')

❖ Brief background:

- W.e.f. 14.12.2009, the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 ('IMC Regulations') had prohibited medical practitioners from accepting emoluments, inter-alia, in the form of gifts, travel facilities, hospitality, cash or monetary grants and imposed strict penalties for any violation of such regulations.
- During AY 2010-11, M/s Apex Laboratories Pvt. Ltd. ('Appellant') had claimed deduction for expenses incurred towards gifting freebies hospitality services, conference fees, gold coins, LCD TVs, fridges, laptops etc. to medical practitioners for creating awareness about their health supplement.
- The CBDT vide Circular No. 5/2012 dated 01.08.2012 had specifically clarified that expenses incurred by pharmaceutical and allied health sector industries for distribution of incentives (i.e., "freebies") to medical practitioners are ineligible pursuant to Explanation 1 to Section 37(1), which denies the deduction of expenses incurred for any purpose which is an 'offence' or which is 'prohibited by law'.
- Pursuant to this Circular, the lower authorities and the Madras High Court had denied the deduction in respect of the expenditure incurred by the Appellant by way of gifts/freebies to doctors and medical practitioners.

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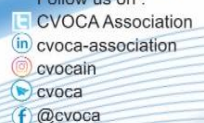
❖ Appellant's contentions:

- The Appellant placed reliance on rulings by different High Court to establish that the IMC Regulations are applicable only to the medical practitioners while accepting the freebies / gifts and are not binding on the donors i.e. pharmaceutical companies.
- There is no violation of the IMC Regulations as there is no corresponding prohibition on the pharmaceutical companies from giving gifts.
- The Memorandum Explaining the Provisions of the Finance (No. 2) Bill, 1998 stated that the introduction of Explanation 1 to Section 37(1) would disallow taxpayers from claiming "*protection money, extortion, hafta, bribes, etc.*" as business expenditures, and could be inferred as only 'illegal' activities were deigned as 'offences' under the relevant statute.
- The IT Act not being a social reform statute, needed to be interpreted strictly, and not in a wide manner so as to include in its scope an act by a pharmaceutical company not recognized as 'illegal' by any statute – doing so would be against the canons of public law.
- The Circular is ultra vires in applying the IMC Regulations to pharmaceutical companies, and in any case, can apply only prospectively from 01.08.2012, and not retrospectively from 14.12.2009.

❖ Revenue's contentions:

- The act of pharmaceutical companies gifting freebies to medical practitioners for promotion of their products may not be classified as an 'offence' under any statute, but will squarely be covered within the scope of Explanation 1 to Section 37(1) by use of the words "*prohibited by law*", as it was specifically prohibited by the IMC Regulations.
- Parliament's intention to disincentivize the practice of receiving extravagant freebies in exchange for prescribing expensive branded medication over its equally effective generic counterparts, thereby burdening patients with unnecessary costs, was apparent not only from the IMC Regulations, but also from the Prevention of Corruption Act, 1988 ('PC Act'). A government doctor receiving any illegal gratification amounting to malpractice or any other offence was liable to be charged under PC Act and the Indian Penal Code, 1860 ('IPC').

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- Reliance was placed on two High Court decisions, viz., (a) Commissioner of Income-Tax v. Kap Scan and Diagnostic Centre P. Ltd. [(2012) 344 ITR 476 (P&H HC)] and (b) Confederation of Indian Pharmaceutical Industry (SSI) v. Central Board of Direct Taxes [(2013) 353 ITR 388 (HP HC)], in support of the validity of the Circular, and that such expenditure is opposed to public policy, and the payments are unlawful consideration.
- ❖ **Findings and Decision:**
 - The IT Act does not define the terms 'offence' or 'prohibited by law' and the General Clauses Act, 1897 defines '**offence**' as "*any act or omission made punishable by any law for the time being in force*". Further, section 43 of the IPC defines '**illegal**' as being applicable to "*everything which is an offence or which is prohibited by law, or which furnishes ground for a civil action*". Therefore, Explanation 1 shall contain within its ambit all such activities which are illegal / prohibited by law and / or punishable, and acceptance of freebies given by pharmaceutical companies is clearly an offence on part of the medical practitioner, punishable with varying consequences under the IMC Regulations.
 - The CBDT circular being clarificatory in nature, would apply retrospectively from the date on which the Regulations were amended.
 - Relying upon the amendment to the PC Act making bribe-givers also a punishable offence, the Court observed that it is logical that when *acceptance* of freebies is punishable by the Medical Council of India, pharmaceutical companies cannot be granted the tax benefit for providing such freebies, and thereby (actively and with full knowledge) *enabling* the commission of the act which attracts such disapproval.
 - The Court observed that if a statute requires a thing be done in a certain manner, there is an implied prohibition on other forms of doing it. It is a known principle that, what cannot be done directly, cannot be achieved indirectly. Therefore, giving relief in this case would imply doing something "prohibited by law" or have the effect of defeating the law
 - There is no doubt that its actions fell within the purview of "prohibited by law" in Explanation 1 to Section 37(1). The well-established principle of interpretation of taxing statutes that they need to be interpreted strictly cannot sustain when it results in an absurdity contrary to the intentions of the Parliament, and doing so would wholly undermine public policy.



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- No court will aid a party in an immoral or illegal act. None should be allowed to profit from any wrongdoing. Given the express restriction in the Regulations on one hand, the Supreme Court held that one arm of the law cannot be utilised to defeat the other arm of law – doing so would bring the law into ridicule.
- Legal interpretation is not only to clarify the meaning of a provision but also to shed light and give shape to the legislative intent. Courts have a responsibility to discern the social purpose that a provision subserves. The continual refinement and assimilation of these concepts by courts into binding norms inject vitality and dynamism in the statute and avoid statute from turning irrelevant and stale.
- Lastly, the Supreme Court also considered the negative impact of such freebies on the increasing cost of healthcare and availability of medicine to public at large, and disallowed the tax deduction to the Appellant for a participation in an illegal activity.

❖ Key Takeaways

The Supreme Court has settled a significant controversial issue, regarding allowability of expenditure incurred by the pharma companies in providing freebies / incentives to doctors and other medical practitioners, in favour of Revenue. The said decision thus is understood to clarify the law since its inception, and the controversy as to the proposed amendment by the Finance Act, 2022, by way of insertion of a similar provision from 01.04.2022, vide Explanation 3 to section 37(1) would operate prospectively or retrospectively, also subsides. In effect, the said judgement provides a retrospective effect to the issue and any expenses incurred need to be compliant of laws applicable to the payer as well as the payee.

Akin to the pharmaceutical industry, similar irregular payments / freebies (directly / indirectly) as prevalent in other sectors could also be micro-probed by the tax authorities, and the onus will be on the taxpayers to demonstrate that expense incurred is not in prohibition of any law.

The Court hasn't delved upon the jurisdiction of tax authority to decide upon legality of a particular expenditure does not appear to be fully concluded. Nonetheless, the taxpayers / industry will be required to take serious stance and analyse the impact upon the amounts incurred previously, in light of the new reassessment provisions and proposed facility of filing an updated tax return. The taxpayers should also prepare for the documentation required to support and substantiate the legitimacy of their payments made in the past years, and plan for the state going forward.

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