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Direct Tax Alert

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Supreme Court denies deduction in respect of incentives / freebies offered to medical practitioners

The Hon'ble Supreme Court, in a recent ruling in case of *M/s. Apex Laboratories Pvt. Ltd.*[1] ('the taxpayer') denied deduction in respect of expenses incurred by pharmaceutical and allied health sector industries for grant of incentives / freebies to medical practitioners.

Background and facts of the case

- Section 37 of the Income-Tax Act, 1961 ('the Act') deals with general deductions in computing profits and gains from business and profession. Explanation 1 to section 37 of the Act was inserted in year 1998, with retrospective effect from April 1, 1962, to deny deduction in respect of expenditure incurred *for any purpose which is an offence or which is prohibited by law*.
- The Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 ('the Regulations'), notified on December 14, 2009, prohibited the medical practitioners from accepting emoluments, inter-alia, in the form of gifts, travel facilities, hospitality, cash or monetary grants and imposed strict penalties and repercussions on them for any violation of the regulations The relevant extract from the Regulations is reproduced in the **Annexure.**

[1] Special Leave Petition (Civil) No. 23207 of 2019

- The Central Board of Direct Taxes ('CBDT') issued a Circular (viz, Circular No. 5/2012 dated August 1, 2012) ('the Circular') and clarified that with effect from December 14, 2009, i.e. date of publication of the Regulations, any claim of any expense incurred in providing the aforementioned or similar freebies in violation of the Regulations shall be inadmissible under section 37(1) of the Act, being an expense prohibited by law. As per the Circular, disallowance in this regard will be made in hands of such pharmaceutical or allied health sector industries or any other assessee which provides the aforesaid freebees.
- Pursuant to this Circular, the taxpayer was denied deduction in respect of sales promotion expenditure incurred by way of gifts/freebies to doctors and medical practitioners.
- The taxpayer, aggrieved by the orders of the lower authorities and also of the Madras High Court which upheld the disallowance, filed an appeal before the Supreme Court with a plea to admit the appeal and allow deduction of such expense as business expenditure. The Supreme Court has dismissed the appeal of the Assessee.

Contention of the Taxpayer

- The Regulations are enforceable only against medical practitioners and not against the providers, i.e., pharmaceutical companies. While the regulations expressly restrict medical practitioners from accepting freebies, no corresponding prohibition in the form of any binding norm was imposed on the pharmaceutical companies giving them.
- It was not open for the Revenue to deny a tax claim on the 'nature' of expenses incurred. The intention of the Parliament was to only deny deduction for expenditure which is illegal in nature such as protection money, extortion, hafta, bribes, etc. as the same are considered as 'offences' under the relevant statutes. The 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.
- The Circular enlarged the scope of the Regulations and made it operable to pharmaceutical companies and allied health sector industries, which, in the absence of any enabling provision, was outside its dominion.
- Even if, the CBDT circular had to be brought into effect, it could be done so only 'prospectively', and not 'retrospectively', i.e., from the date of publication of the CBDT circular (which is August 1, 2012) and not the date of publication of the Regulations (which is December 14, 2009).

Contention of the Revenue

- The act of pharmaceutical companies giving freebies to medical practitioners for promotion of their products was squarely covered within the scope of Explanation 1 to Section 37(1) by use of the words

'*prohibited by law*', as such an act was specifically prohibited by the Regulations.

- The menace of prescribing expensive branded medication as a *quid pro quo* arrangement had a direct bearing on public policy, which was implicit in the Regulations itself.
- The consideration or object of the agreement between the taxpayer and private doctors are unlawful, and the arrangement between them is therefore void, as it is opposed to public policy.

Ruling of the Supreme Court

- The Supreme Court held that whilst acceptance of freebies by medical practitioners is punishable by the Medical Council of India, pharmaceutical companies cannot be granted tax benefit for providing such freebies. This would tantamount to enabling the commission of the act which attracts such opprobrium.
- The Supreme Court further held that an act which cannot be done directly, cannot be achieved indirectly. The Supreme Court laid greater emphasis on this aspect by holding that the statutory regime requiring that a thing be done in a certain manner, also implies (even in the absence of any express terms), that the other forms of doing it are impermissible.
- 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 be opposed to public policy and bring the law into ridicule.
- The agreement between the pharmaceutical companies and the medical practitioners in giving freebies for boosting sales of prescription drugs, being against public policy, is also violative of Section 23 of the Contract Act, 1872.
- The act of pharmaceutical companies' gifting freebies to doctors, etc. is clearly "prohibited by law", and therefore any expenditure incurred for the same is not allowable as a deduction under Section 37(1). Allowing such an expenditure for tax purposes would wholly undermine the public policy. The Court also observed that the pharma companies have misused a legislative gap to actively perpetuate the commission of an offence.
- The Supreme Court also observed that doctors and pharmacists being complementary and supplementary to each other, a comprehensive view must be adopted to regulate their conduct in view of the contemporary statutory regimes and regulations.
- The CBDT circular being clarificatory in nature, would apply retrospectively from the date on which the Regulations were amended.

Dhruva Comments

- Pharmaceutical companies and allied healthcare sector industries have been providing varying types of benefits to doctors and medical professionals. These cover educational support of varying forms, travel, lodging and boarding for such continuing medical education

programs, assistance to the medical practitioners in upgrading their infrastructure with a view to increase penetration of healthcare awareness, gifts and freebees with a view to push medical prescriptions for the companies. Allowability of expenditure incurred by the pharma companies in providing freebies / incentives to doctors and other medical practitioners has been a vexed issue with conflicting jurisprudence on both the sides. The Supreme Court has put the controversy to rest by deciding the issue in favour of the Revenue. It is important to note that the Finance Bill, 2022 has proposed to make a clarificatory amendment in section 37 which would now disentitle a taxpayer to claim such expenditure incurred in nature of freebies if it violates any law or regulation by which the recipient is governed. There were widespread concerns and controversy on whether such proposed amendment would operate prospectively or retrospectively. However, given the decision of Supreme Court, this debate is now academic in nature.

- Given that the Supreme Court decision is understood to clarify the law since its inception, there are several areas which companies may want to assess and analyse further. Few key areas which merit consideration are discussed below:

Impact on concluded assessments

- Interesting issues would arise on whether the Revenue can now seek to reopen the assessments of the past years which have already stood concluded. Whilst there is jurisprudence available to contend that a subsequent ruling of the Supreme Court which changes the legal position is not a valid ground for reassessment, it may be noted that such jurisprudence is in the context of the erstwhile reassessment regime. The new reassessment provisions as applicable from April 1, 2021 have modified several contours on when and how reassessment proceedings can be initiated. As per the new reassessment provisions, the Revenue has the powers to initiate reassessment if there is "information" with the tax officer that income chargeable to tax has escaped assessment. There could be issues on whether a Supreme Court ruling can qualify as "information" so as to warrant a reassessment. The new reassessment provisions also define "information" to include information which may get flagged as per the risk management strategy of the CBDT. Given the broad scope of the new reassessment provisions, it will be interesting to analyse whether the old principles governing reassessment provisions can still be made applicable under the new regime.
- Further, the Finance Bill 2022 has also expanded the scope of extended time limit of 10 years in cases where income escaping assessment is represented, inter-alia, by an entry or entries in books of accounts. It needs to be seen whether the department can resort to the extended time limit even for cases which are

concluded and do not involve any concealment of any material facts on part of the taxpayer.

Impact on ongoing assessments and positions to be taken in tax returns

- The taxpayers may face disallowances in respect of proceedings which may be presently pending at any level. However, the taxpayer should be able to defend any potential penalty implications if the claim is bona fide and made basis the favorable rulings. Also, the taxpayer could face challenges in defending any interest liability which arguably is consequential in nature.
- Furthermore, the taxpayers would also need to reassess their advance tax liability of the current year such that any interest exposure is minimized to the extent possible.
- Companies should also consider whether there is any need to revise the tax returns of the earlier years. The facility of filing an updated tax return as proposed by Finance Bill, 2022 can also be explored in order to optimize the tax costs.

Rectification of past orders

- A legal position pronounced by the Supreme Court which is in variance to the position adopted by the taxpayer, or the Revenue typically constitutes a mistake apparent from record and therefore eligible for rectification. Therefore, the plausible action of the Revenue to rectify its earlier orders within the prescribed time limits needs to be assessed and examined in detail.

Way forward:

- Pharmaceutical companies have worked closely with medical practitioners to promote and facilitate healthcare awareness which in a country like India has been historically very low. This has taken various forms, some of which may be legitimate and some that may not be so. Given that this has been an industry wide practice, companies will need to closely examine which of the payments and facilities provided to the doctors would be hit by the Regulations, the documentation required for defending the legitimate payments made in the past years and how the situation needs to evolve for the future.
- Companies will also need to suitably plan for the deduction of tax at source which has been proposed in the Finance Bill through section 194R.
- In light of this decision, the taxpayers may also be required to account for additional tax provision in the books of accounts.

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For any queries in relation to this tax alert, please feel free to reach out.

Annexure - Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002

"6.8 Code of conduct for doctors and professional association of doctors in their relationship with pharmaceutical and allied health sector industry.

6.8.1 In dealing with Pharmaceutical and allied health sector industry, a medical practitioner shall follow and adhere to the stipulations given below:-

a) Gifts: A medical practitioner shall not receive any gift from any pharmaceutical or allied health care industry and their sales people or representatives.

b) Travel facilities: A medical practitioner shall not accept any travel facility inside the country or outside, including rail, air, ship, cruise tickets, paid vacations etc. from any pharmaceutical or allied healthcare industry or their representatives for self and family members for vacation or for attending conferences, seminars, workshops, CME programme etc as a delegate.

c) Hospitality: A medical practitioner shall not accept individually any hospitality like hotel accommodation for self and family members under any pretext.

d) Cash or monetary grants: A medical practitioner shall not receive any cash or monetary grants from any pharmaceutical and allied healthcare industry for individual purpose in individual capacity under any pretext. Funding for medical research, study etc. can only be received through approved institutions by modalities laid down by law / rules / guidelines adopted by such approved institutions, in a transparent manner. It shall always be fully disclosed.

e) Medical Research: A medical practitioner may carry out, participate in, work in research projects funded by pharmaceutical and allied healthcare industries. A medical practitioner is obliged to know that the fulfillment of the following items (i) to (vii) will be an imperative for undertaking any research assignment / project funded by industry – for being proper and ethical. Thus, in accepting such a position a medical practitioner shall:-

(i) Ensure that the particular research proposal(s) has the due permission from the competent concerned authorities.

(ii) Ensure that such a research project(s) has the clearance of national/ state / institutional ethics committees / bodies.

(iii) Ensure that it fulfils all the legal requirements prescribed for medical research.

(iv) Ensure that the source and amount of funding is publicly disclosed at the beginning itself.

(v) Ensure that proper care and facilities are provided to human volunteers, if they are necessary for the research project(s).

(vi) Ensure that undue animal experimentations are not done and when these are necessary they are done in a scientific and a humane way.

(vii) Ensure that while accepting such an assignment a medical practitioner shall have the freedom to publish the results of the research in the greater interest of the society by inserting such a clause in the MoU or any other document / agreement for any such assignment.

f) Maintaining Professional Autonomy: In dealing with pharmaceutical and allied healthcare industry a medical practitioner shall always ensure that there shall never be any compromise either with his / her own professional autonomy and / or with the autonomy and freedom of the medical institution.

g) Affiliation: A medical practitioner may work for pharmaceutical and allied healthcare industries in advisory capacities, as consultants, as researchers, as treating doctors or in any other professional capacity. In doing so, a medical practitioner shall always:

(i) Ensure that his professional integrity and freedom are maintained.

(ii) Ensure that patients interest are not compromised in any way.

(iii) Ensure that such affiliations are within the law.

(iv) Ensure that such affiliations / employments are fully transparent and disclosed.

h) *Endorsement: A medical practitioner shall not endorse any drug or product of the industry publicly. Any study conducted on the efficacy or otherwise of such products shall be presented to and / or through appropriate scientific bodies or published in appropriate scientific journals in a proper way".*

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