

Supreme Court denies the deductibility of freebies expense incurred by pharmaceutical companies under section 37 of the Act

Snapshot

Hon'ble Supreme Court has given a landmark ruling in the context of claiming deduction of expenditure incurred towards freebies granted by pharmaceutical companies and other allied healthcare sector industries to medical practitioners. Court has held that even if the regulations of Indian Medical Council are not directly applicable to pharmaceutical companies, expenditure by way of freebies would still be subject to disallowance under section 37 of the Act as the same is prohibited by the law. This judgement has put to rest all prolonged litigations and conflicting rulings given by the judiciary in this regard.

Historic background

Deduction of an expenditure incurred by pharmaceutical companies on freebies (such as gifts, travel facilities, hospitalities, cash, monetary grants etc.) under section 37 of the Income-tax Act, 1961 ('the Act') was a matter of prolonged litigation and judiciary has given contrary rulings on the same.

To start with, it has been brought to the notice of Central Board of Direct Tax ('CBDT') that some pharmaceutical and allied health sector Industries are providing freebies to medical practitioners and their professional associations in violation of the regulations issued by Indian Medical Council.

To address the same, CBDT had issued a circular (No. 5/2012) on 01 August 2012 to clarify that the Indian Medical Council, in exercise of its statutory powers, amended the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 on 10 December 2009, imposing a prohibition on the medical practitioner and their professional associations from taking any Gift, Travel facility, Hospitality, Cash or monetary grant from the pharmaceutical and allied health sector Industries.

In view of this prohibition imposed by the Indian Medical Council by virtue of its regulations, CBDT had clarified that any claim of expense incurred towards above mentioned or similar benefits in violation of provisions of Indian Medical Council regulations, shall be inadmissible for deduction under section 37(1) of the Act as the same was prohibited under the regulation. Hence, it was directed by CBDT to make disallowance of such expenditure in the hands of pharmaceutical companies which provided these kinds of benefits and claimed the same as allowable deduction.

The circular issued by CBDT was also challenged in the Hon'ble Himachal Pradesh High Court in the case of **Confederation of Indian Pharmaceutical Industry Vs Central Board of Direct Taxes [(2013) 335 ITR 388 (HP)]**, wherein the Hon'ble High Court rejected the petition on the ground that circular issued by CBDT was in line with the provisions of section 37 of the Act and cannot be said to be illegal.

Post this, there has been plethora of rulings wherein the Tribunals and Courts have given contrary judgements on applicability of provisions of section 37 of the Act to pharmaceutical companies giving freebies to medical professionals.

Recent Supreme Court Ruling

While section 37 of the Act is proposed to be amended by Budget 2022, recently Hon'ble Supreme Court in case of **M/S. Apex Laboratories Private Limited v. DCIT [SLP (Civil) No. 23207 of 2019]** has held that expenditure incurred by pharmaceutical companies in providing freebies is not allowed as deductible expense under section 37(1) of the Act. This is a landmark ruling given by the Hon'ble Supreme Court, clarifying the intention of the legislature, in a matter which was subject to prolonged litigation. The brief facts of the case, contention of the parties and judgement given by the Court is as follows:

Facts of the case

The Taxpayer has incurred expenditure towards freebies such as hospitality, freebies, gold coins, LCD TVs, fridges, laptop etc. for medical practitioners for creating awareness about the health supplement 'Zincovit'.

Revenue has issued a notice to the taxpayer proposing for disallowance of above expenditure on the ground that pursuant to circular issued by CBDT, expenditure incurred by taxpayer toward freebies ought to have been disallowed under section 37 of the Act as the same is prohibited by the regulations.

Court room exchange

Taxpayer's contentions

Taxpayer argued that regulations amended by the Indian Medical Council were neither applicable nor binding on pharmaceutical companies and the said regulations expressly prohibited only medical practitioner from accepting such gifts. However, no such corresponding binding norm was imposed in case of pharmaceutical companies sponsoring or giving

such freebies to medical practitioners. In absence of any express prohibition under any law, expenditure towards freebies incurred by pharmaceutical companies should not be disallowed under section 37 of the Act.

Taxpayer has placed reliance on various favorable judicial precedents wherein the Tribunals / Courts have held that regulations of Indian Medical Council are not applicable to pharmaceutical companies and the same is enforced only against the medical practitioners.

Taxpayer has also relied upon the judicial precedents wherein it was held that it is not open for revenue to deny the tax benefit based on 'nature' of expense incurred. The fact of the case has to be decided keeping in mind the provisions of legal law and not based on one's moral views.

Further, Taxpayer has also emphasized in the Memorandum explaining Finance Bill (No. 2) of 1998 which provides that introduction of Explanation 1 to section 37 of the Act would disallow the expense in the nature of protection money, extortion, hafta, bribes etc. as business expenditure. This means the intention of legislature is to bring within its ambit only illegal activities which were designated as 'offence' under the relevant statute.

However, covering the activities carried out by the pharmaceutical companies within the ambit of Explanation 1 to section 37 of the Act is against the canon of public law. Further, it was also submitted by the taxpayer that as far as applicability of any CBDT circular is concerned, beneficial circulars are having retrospective applicability and oppressive circulars could be applied prospectively only.

Revenue's contentions

Revenue has submitted that even if the act of giving freebies may not be termed as offence under any law or regulations, it will still fall within the ambit of Explanation 1 to section 37 of the Act for the reason that Explanation 1 to section 37 also prohibits deduction of expense which is '**prohibited by law**'.

Indian Medical Council Regulation has specifically imposed a prohibition on accepting such freebies.

Revenue has also submitted that it was always the intention of the parliament to disincentivize the practice of receiving freebies in exchange for prescribing expensive and branded medication over its equally effective generic counterparts and thereby burdening the patients with extra cost. This intention is very clearly coming from amended medical council regulations as well as Prevention of Corruption Act, 1988. Further, doctors receiving any illegal gratification amounting to malpractices and the same is liable for punishment under Prevention of Corruption Act, 1988 and Indian Penal Code, 1860.

In the present case, giving various types of gifts to medical practitioners for creating awareness of health supplement 'Zincovit' is clearly tantamount to professional misconduct on the part of medical practitioners. These kinds of instances would be squarely covered under the prohibition imposed by amending regulations of Indian Medical Council.

Revenue has also placed reliance on judicial precedents where it was held that any expenditure incurred, which is against the public policy, and which is in the nature of unlawful consideration is not allowed as deduction under section 37 of the Act. It was further held that businessmen are not allowed to conduct their business in the manner which is contrary to the law.

Revenue has also placed reliance on the judgement of Hon'ble Himachal Pradesh High Court in the case of **Confederation of Indian Pharmaceutical Industry Vs Central Board of Direct Taxes (Supra)**, wherein the Court has categorically mentioned that once accepting freebies and other gifts by medical practitioners is expressly prohibited under regulations, section 37 of the Act will come into play.

Hence, expenditure incurred by Taxpayer towards granting of various freebies is liable to be disallowed under section 37 of the Act as the same is prohibited under the regulations issued by Indian Medical Council.

Supreme Court's Ruling

Hon'ble Court has explained the provisions of section 37 of the Act and also analyzed various provisions of General Clauses Act, 1897 and Indian Penal Code, 1860 to ascertain the meaning of the term 'offence' as used in Explanation 1 to section 37 of the Act. It was held that Explanation 1 to section 37 of the Act covers within its ambit all such expenditure which are illegal / prohibited by law / punishable.

The Court has also taken a note of amended regulations of Indian Medical Council and held that said regulations clearly provides for action or sanction which can be taken against or imposed upon the medical practitioners for violation of each stipulation mentioned in the said regulation. Hence, it is clear that accepting freebies from pharmaceutical companies is an offence on the part of medical practitioners and liable for punishment with various other consequences.

Court has also held that Mumbai ITAT, in the case of **PHL Pharma Private Limited v DCIT [ITA No. 4605/Mum/2014 dated 12 January 2017]** has given a very narrow interpretation to the provisions of section 37 of the Act by concluding that regulations of Indian Medical Council is not putting an express ban or bar on pharmaceutical companies from giving freebies to medical practitioner and hence, the said expenditure should be allowed as deduction under section 37 of the Act.

Such narrow interpretation would defeat the purpose of the legislature to disallow the Taxpayer from participating in an illegal activity. Further, Court has also held that though Memorandum explaining Finance Bill (No. 2) of 1998 has given some specific examples for attracting disallowance under section 37 of the Act, by no stretch of imagination it could be held that freebies is outside the ambit of section 37 of the Act despite the same being prohibited by regulations of Indian Medical Council.

Court has also held that even if the Taxpayer is not indulging himself in any activity which is violation under any law or which is punishable under any law, still giving freebies would be covered within the ambit of section 37 of the Act due to the reason that the same is *prohibited by law*.

The Court has also relied upon the report issued by the Parliamentary Standing Committee on Health and Family Welfare in which clear observation was made by such committee that Government of India should take parallel action through DCGI and Income Tax Department to penalize those companies that violates regulations of Indian Medical Council by cancelling drug manufacturing license and / or disallowing expenses on unethical activities.

Court has also held that once accepting such freebies by the medical practitioner is prohibited by the law, giving such freebies would also be tantamount to violating of regulations of Indian Medical Council. Thus, one arm of the law cannot be utilized to defeat the other arm of the law. Doing so would be opposed to the public policy.

Court has also taken a note of agreement between pharmaceutical companies and medical practitioners in gifting freebies for boosting sales of prescription drugs and the same is also violative to the provisions of section 23 of the Contract Act, 1872. In the said section, it is clearly mentioned that any agreement of which the object or consideration is unlawful, is void.

The Court has also distinguished the case laws relied upon by the Taxpayer by holding that in such case laws, Taxpayer was not a willful participant in commissioning of the offence or activity prohibited by the law, which is not the case at all in present facts.

Court has also relied upon the judicial precedent wherein it was held that taxing statute has to be interpreted strictly, and any interpretation cannot sustain when it is contrary to the intention of legislature or parliament.

It is very well settled principle that what cannot be done directly cannot be achieved indirectly as well. Also, no relief can be granted in any situation where it results into defeating the provisions of any law.

Coming to present facts of the case, when accepting freebies is clearly prohibited for medical practitioners under the regulations applicable to them, the same regulation shall also apply to the person sponsoring such freebies.

Hence, it was held that expenditure incurred by the Taxpayer by way of freebies was clearly an expenditure prohibited by the law and cannot be allowed as deduction under section 37 of the Act.

Hence, Supreme Court has dismissed the appeal filed of Taxpayer as well as any other pending application.

Budget 2022 announcement

In order to remove the doubts and to clear the intention of the legislature, Budget 2022 proposed to amend the provisions of section 37 of the Act by providing that any expenditure incurred for providing benefits or perquisites, which is prohibited by any law or regulations shall not be allowed as deduction.

As per the Memorandum explaining Finance Bill 2022, it seems that this amendment is applicable from 01 April 2022. On the other hand, in the statute book, this amendment is brought in by way of Explanation. Hence, possibility of revenue taking a plea that this amendment has a retrospective application cannot be ruled out.

Key takeaways

- This is a landmark ruling given by the Supreme Court by clarifying that freebies expenditure incurred by the pharmaceutical companies cannot be allowed as deduction under section 37 of the Act as the same is prohibited by the law or regulations.
- The Supreme Court has clearly brought out the intention of the legislature for not allowing the deduction of any expenditure which is prohibited under any law or regulations.
- Supreme Court has not commented anything on the amendment proposed by the Budget 2022.
- Though Budget 2022 proposed to amend the provisions of section 37 of the Act, this judgement may have an adverse impact on pending adjudications on this matter, if amendment proposed by Budget 2022 is said to be applicable prospectively (from 01 April 2022).
- On the contrary, one may also seek to explore a possibility that Budget amendment in section 37 of the Act is applicable with prospective effect and hence, legislature intended for not disallowing any expenditure by way of freebies incurred prior to 01 April 2022. Had legislature intended to disallow the expenditure with retrospective effect, the same would have been clearly mentioned in the Budget 2022.

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