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TAX FLASH NEWS

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Freebies given by pharmaceutical companies to medical practitioners are not allowed as business expenditure – Supreme Court

Background

Recently, the Supreme Court, in the case of Apex Laboratories Pvt. Ltd.[1] (the taxpayer), dealt with the allowability of expenditure incurred by pharmaceutical and allied health sector industries for distribution of incentives to medical practitioners under Section 37(1) of the Income-tax Act, 1961 (the Act). The Supreme Court held that gifting of freebies to doctors, etc., is 'prohibited by law', and cannot be allowed as a business deduction under Section 37(1). The Supreme Court observed that the freebies given by the taxpayer company to the doctors may lead to a ban on their practice of medicine. Since the medical practitioners are forbidden from accepting freebies, it is not less than a prohibition on the part of their giver or donor. Further denial of such tax benefit cannot be construed as penalising the taxpayer pharmaceutical company. Only its participation in what is plainly an action prohibited by law, precludes the taxpayer from claiming it as a deductible expenditure

Facts of the case

During Assessment Year 2010-11, the taxpayer claimed expenditure incurred for the purpose of gifting freebies such as hospitality, conference fees, gold coins, LCD TVs, fridges, laptops, etc., to medical practitioners for creating awareness about the health supplement 'Zincovit'.

On 1 August 2012, the Central Board of Direct Taxes (CBDT) issued a Circular[2] where it was clarified that the expenditure incurred by pharmaceutical and allied health sector industries for distribution of incentives (freebies) to medical practitioners are not eligible as business deduction under Section 37(1).

Subsequent to the CBDT Circular, the Assessing Officer (AO) issued a notice under Section 142(1) asking clarification on deductibility of freebies expenditure. The taxpayer contended that while medical practitioners were prohibited from accepting freebies, no corresponding prohibition in the form of any binding norm was imposed on the pharmaceutical companies gifting them. In the absence of any express prohibition by law, the taxpayer could not be denied the benefit of expenditure incurred on the supply of such freebies under Section 37(1).

The Assessing Officer (AO) partially allowed the expenditure since the amendment to the Medical Council Act, 1956 through the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (IMC Regulations), published in the Official Gazette on 14 December 2009 prohibits medical practitioners from accepting emoluments in the form of gifts, travel facilities, hospitality, cash or monetary grants, etc. Therefore, only the expenditure incurred till 14 December 2009 were eligible for the benefit of Section 37(1) and not for the entirety of the Assessment Year 2010-2011. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. Subsequently, the Tribunal and the High Court upheld the order of the lower authorities.

Supreme Court's decision

Acceptance of freebies given by pharmaceutical companies is clearly an offence on the part of the medical practitioner, punishable with varying consequences. Section 37 contains within its ambit all such activities which are illegal/prohibited by law and/or punishable.

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[1] Apex Laboratories Pvt. Ltd. v. DCIT (Special Leave Petition No. 23207 of 2019) – Taxsutra.com

[2] CBDT Circular No. 5/2012, dated 1 August 2012

Further, CBDT Circular clarified that the claim of any expenditure incurred in providing freebies in violation of the provisions of the IMC Regulations shall be inadmissible under Section 37(1), being an expenditure prohibited by the law. This disallowance shall be made in the hands of such pharmaceutical or allied health sector industries who have provided such freebees and claimed it as a deductible expenditure in its books of accounts.

The CBDT Circular, being clarificatory in nature, was in effect from the date of implementation of IMC Regulations, i.e., from 14 December 2009. The Mumbai Bench of the Income-tax Appellate Tribunal in the case of PHL Pharma P. Ltd.[3] reiterated principles laid down in Max Hospital's[4] decision that the IMC Regulations were inapplicable to pharmaceutical companies, and in the absence of requisite jurisdiction, it could not be said that the pharmaceutical companies had violated any law or regulation. Further, it was held that there was no enabling provision to allow the CBDT to bring pharmaceutical companies within the fold of the Regulations, and even if such an act were to be permitted, it could only be done so prospectively.

In the case of PHL Pharma, the Tribunal discussed the Punjab and Haryana High Court's decision in the case of Kap Scan and Confederation[5] and held that even though they were decided against the taxpayer, they did not lay down a blanket ban on pharmaceutical companies claiming tax benefit under Section 37(1), and it is subject to the satisfaction of the AO on a case-to-case basis. Subsequent decisions by the Tribunal relied on PHL Pharma to grant relief to the taxpayer pharmaceutical companies.

The Supreme Court observed that such a narrow interpretation of Explanation 1 to Section 37(1) defeats the purpose for which it was introduced, i.e., to disallow the taxpayer from claiming a tax benefit for its participation in illegal activity. Though the Memorandum to the Finance Bill, 1998 elucidated the ambit of Explanation 1 to include 'protection money, extortion, hafta, bribes, etc.', yet, by no means is the embargo envisaged restricted to those examples. It is but logical that when acceptance of freebies is punishable by the Medical Council of India (MCI), 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 contempt.

The illogicality and completely misconceived nature of such an interpretation by the Tribunal was dealt with in a similar interpretation of the provisions of Prevention of Corruption Act, 1988 (PC Act), by a Constitution Bench of Supreme Court in the case of P.V. Narasimha Rao v. State (CBI/SPE)[6]. In that case, the Supreme Court held that the Parliament has the power not only to punish its members for an offence committed by them but also to punish others who had conspired with them to have the offence committed.

In view of the above, even if the taxpayer's contention were to be accepted that it did not indulge in any illegal activity by committing an offence, taxpayers' actions will fall within the purview of 'prohibited by law' in Explanation 1 to Section 37(1).

If the statutory limitations imposed by the IMC Regulations are kept in mind, what is discernible is 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. Reference was made to the decision of the Supreme Court in the case of Jamal Uddin Ahmad v. Abu Saleh Najmuddin & Anr[7]. It is also a settled principle of law that no Court will lend its aid to a party that roots its cause of action in an immoral or illegal act meaning that none should be allowed to profit from any wrongdoing coupled with the fact that statutory regimes should be coherent and not self-defeating.

Doctors and pharmacists being complementary and supplementary to each other in the medical profession, a comprehensive view must be adopted to regulate their conduct in view of the contemporary statutory regimes and regulations. Therefore, denial of the tax benefit cannot be construed as penalising the taxpayer pharmaceutical company. Only its participation in what is plainly an action prohibited by law, precludes the taxpayer from claiming it as deductible expenditure.

The Supreme Court observed that medical practitioners have a quasi-fiduciary relationship with their patients. A doctor's prescription is considered the final word on the medication to be availed by the patient, even if the cost of such medication is unaffordable or barely within the economic reach of the patient. Such is the level of the trust reposed in doctors. Therefore, it is a matter of great public importance and concern, when it is demonstrated that a doctor's prescription can be manipulated and driven by the motive to avail the freebies offered to them by pharmaceutical companies, ranging from gifts such as gold coins, fridge and LCD TV to funding international trips for vacations or to attend medical conferences. These freebies are technically not 'free'. The cost of supplying such freebies is usually factored into the drug, driving prices up, thus creating a perpetual publicly injurious cycle.

[3] DCIT v. PHL Pharma P. Ltd [2017] 163 ITD 10 (Mum)
[4] Max Hospital Pitampura v. Medical Council of India ILR (2014) 1 Delhi 620
[5] CIT v. Kap Scan and Confederation [2012] 344 ITR 476 (P&H)
[6] P.V. Narasimha Rao v. State (CBI/SPE) (1998) 4 SCC 626
[7] Jamal Uddin Ahmad v. Abu Saleh Najmuddin & Anr (2003) 4 SCC 257

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[8].

The taxpayer repeatedly relied on T.A. Quereshi[9], K.M. Jain and Pt. Vishwanath Sharma[10], however, these decisions were distinguishable on the facts of the present case.

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. Reference was made to the decision of C.W.S. (India) Ltd[11].

It is also a known principle that what cannot be done directly, cannot be achieved indirectly. Reference was made to the decision of Fox v. Bishop of Chester[12]. Further, the Supreme Court, in an appeal arising from action for specific performance, in the case of G.T. Girish[13] held that giving the relief would imply doing something prohibited by law (bar against conveyance, for a specific period) it had the effect of defeating the provisions of the law.

In the present case also, the incentives (or freebies) given by the taxpayer, to the doctors, had a direct result of exposing the recipients to the odium of sanctions, leading to a ban on their practice of medicine. Those sanctions were mandated by law, as they are embodied in the code of conduct and ethics, which are normative, and have legally binding effect. The conceded participation of the taxpayer (donor) was plainly prohibited, as far as their receipt by the medical practitioners were concerned.

Thus, pharmaceutical companies' gifting freebies to doctors, etc. is clearly 'prohibited by law', and not allowed to be claimed as a deduction under Section 37(1).

Our comments

Expenditure incurred by pharmaceutical companies on freebies like gifts, free samples of medicines, sponsorship of seminars, travel and stay provided to medical practitioners, etc. have been often challenged by the tax department by treating the same in violation of MCI regulations and thus sought to be disallowed under Explanation 1 to Section 37(1).

Gifting of freebies by pharmaceutical companies though not specifically prohibited under any statute, it is prohibited for medical practitioners under the MCI Regulations. In 2012, CBDT had issued a Circular clarifying that expenditure incurred by pharmaceutical and allied health sector industries for distribution of incentives to medical practitioners are not allowable as business expenditure. This issue was a subject matter of litigation before the Courts/Tribunal.

The Mumbai Tribunal, in the case of PHL Pharma P. Ltd., held that the IMC Regulations were inapplicable to pharmaceutical companies, and in the absence of requisite jurisdiction, it could not be said that the pharmaceutical companies had violated any law or regulation. Further, it was held that there was no enabling provision to allow the CBDT to bring pharmaceutical companies within the fold of the Regulations, and even if such an act were to be permitted, it could only be done so prospectively.

On the other hand, the Himachal Pradesh High Court, in the case of Confederation of Indian Pharmaceutical Industry[14], while upholding the validity of the CBDT Circular, held that if the taxpayer satisfies the AO that the expenditure is not in violation of the regulations framed by the Medical Council, then it can legitimately claim a deduction.

The Supreme Court has put to rest this controversy and held that gifting of freebies to doctors, etc. is 'prohibited by law' and not allowed to be claimed as business expenditure under Section 37(1). While interpreting the term 'prohibited under the law', the Supreme Court observed that when the medical practitioners are forbidden from accepting freebies, it is not less than a prohibition on the part of their donor i.e. pharmaceutical companies.

[8] Biharilal Jaiswal v. CIT (1996) 1 SCC 443
[9] T.A. Quereshi v. CIT (2007) 2 SCC 759, Khemchand Motilal Jain 2011 (4) MPLJ 691
[10] CIT v. Pt. Vishwanath Sharma (ITR No. 27 of 1999, Allahabad HC, dated 21 February 2008)
[11] C.W.S. (India) Ltd. v. CIT 1994 Supp (2) SCC 296.
[12] Fox v. Bishop of Chester (1824) 2 B & C 635, quoted and applied in Jagir Singh v. Ranbir Singh & Ors. 1979 (2) SCR 282
[13] G.T. Girish v. Y. Subba Raju (D) by L. Rs & Ors 2022 SCC Online SC 60.
[14] Confederation of Indian Pharmaceutical Industry (SSI) v. Central Board of Direct Taxes [2013] 353 ITR 388 (HP)

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