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Article

Business expenses of pharma companies – A regulatory hurdle

By **Sumeet Khurana**

Background

Pharmaceutical companies incur huge expenses in launching and promoting their products by way of gifts to medical professionals, holding conferences and distribution of promotional material. Tax deductibility of such expenses has been a contentious issue in certain recent tribunal decisions. Revenue authorities contend that these expenses are in contravention of law and not allowable as deduction in view of the Explanation 1 to Section 37. This article seeks to trace the jurisprudence governing the matter and apply it to this burning issue.

General principles governing such deductions

In first place, every revenue expense incurred wholly and exclusively for the purposes of business is deductible and it is not for the Revenue Authorities to dictate as the nature and quantum of expense that shall be deductible in arriving at taxable business profits[1, 2]. However, an expenditure involving infraction of law cannot be said to be incurred for the purposes of business as violation of law is not a normal incidence of business; even on grounds of public policy it cannot be said to be a commercial expense[3]. No distinction can be drawn between penalties payable on infraction of law and payments in furtherance of illegal transactions. An illegal transaction which is not visited with a penalty, will none the less remain an illegal transaction and it would equally be against public policy to treat the payments made in pursuance of, or in furtherance of such illegal transaction as commercial expenses[4]. It is against public policy to allow the benefit of deduction under one statute, of any expenditure incurred in violation of the provisions of another statute [4]. Distinction is however necessary between an expense tainted with illegality incurred for furthering *lawful* business and expenses incurred in an *illegal* business. In latter, the denial of all expenses on the ground of illegality will result in taxation of gross receipts which is impermissible as taxman can only tax profits arrived at after deducting incidental expenses[5].

Legislative background of specific provisions governing the matter

Section 37 of the Income tax Act is a residuary provision permitting deduction of all revenue expenses. Promotional expenses by pharma companies were held as allowable under this section in several rulings[6].

In the year 1997 Mumbai Bench of Income Tax Appellate Tribunal[7] faced an issue pertaining to deductibility of protection money. The Tribunal took notice of the vulnerable situation of builders and allowed the deduction. With a view to

[1] CIT v. Dhanrajgiri [1973] 91 ITR 544 (SC)
[2] CIT v. Walchand [1967] 65 ITR 381 (SC)
[3] Haji Aziz v. CIT [1961] 41 ITR 350 (SC)
[4] CIT v. Maddi Venkataraman [1983] 144 ITR 373 (Mad) approved in 229 ITR 534 (SC)
[5] CIT vs. S.C. Kothari [1971] 82 ITR 794 (SC) followed in CIT v. Piara Singh 124 ITR 40 (SC) 3JB
[6] Life Sight Surgicals Pvt. Ltd. v. DCIT [2010] 133 TTJ 27 (Ahd) ; Samir Surgitech (P) Ltd. in ITA No. 4560/Ahd/2003
[7] Pranav Construction v. ACIT [1997] 61 TTJ 145 (Mum)

overrule this decision and deny deduction of payments towards protection money, extortion, hafta, bribes, etc. as business expenditure[8] an explanation was added to Section 37 which reads as under:

> "For the removal of doubts, it is hereby declared that any expenditure incurred by an assessee for any purpose which is an *offence* or *which is prohibited by law* shall not be deemed to have been incurred for the purpose of business or profession and no deduction or allowance shall be made in respect of such expenditure."
> [emphasis supplied]

On 10 December 2009, Medical Council of India (MCI) issued a notification exercising its powers under Section 33 of Medical Council Act, 1956 ('MCA') amending the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 ('the Regulations') and inserted clause 6.8 therein. That clause prohibited medical practitioners from receiving any gift, travel facility for vacations or for attending conferences, hospitality from pharma industry or endorsing publicly any drug. By inserting such a provision medical practitioners became exposed to adverse action by MCI for deviations. Such disciplinary actions were to be decided on case to case basis. *Vide* Notification dated 28 January 2016 MCI provided for punishments in case of specified deviations. This ensured uniformity in disciplinary action as against a case to case decision.

CBDT issued a Circular No. 5 in year 2012 ('the Circular') clarifying that expense on freebies in violation of the provisions of the Regulations shall be inadmissible under Section 37(1) of the Income Tax Act, 1961 being an expense prohibited by the law. Himachal Pradesh High Court[9] upheld the validity of this Circular holding that:

- The Circular does not go beyond the Explanation;
- In sum and substance both the Explanation and the Circular have same effect; and
- It is for the taxpayer to satisfy the assessing officer that the expense is not in violation of the Regulations

Analysis of the decisions rendered in the context of Pharma sector

The Hyderabad Bench[10] of the ITAT dealt with deductibility of expenses on travel, stay, participation fee in pharmaceutical conferences and following its earlier orders remanded the matter to the AO for examining as to whether the expenses are incurred for the purpose of business of the assessee without clearly expressing its views on infraction of the Regulations and its consequences. The Panaji Bench[11] allowed the claim of the taxpayer as the revenue authorities failed to pin-point as to how the expenses incurred by taxpayer were covered by CBDT Circular. Mumbai Bench in the case of *Syncom*[12] held that CBDT Circular is prospective in nature and will not apply to AY 2011-12. Without much discussion on contravention of Regulations it allowed the deduction holding that small gifts bearing company logo are mere advertisement expenses and hospitality expenses for medical conferences is to help doctors in gaining contemporary knowledge. This has been followed in the case of UCB[13] wherein expenses on gift of pens, watches,

[8] CBDT Circular 772 dated 23 December 1998 explaining the provisions of Finance (No.) Act 1998

[9] Confederation of Indian Pharmaceutical Industry (SSI) v. CBDT CWP No. 10793 of 2012-J.

[10] Dr. Reddy's Laboratories v. ACIT ITA.No.294/Hyd/2014

[11] ACIT v. Geno Pharmaceuticals Ltd. ITA No. 12/PNJ/2014

[12] Syncom Formulations India Ltd. v. DCIT ITA No.6429&6428/Mum/2012

[13] UCB India Pvt. Ltd. v. ITO I.TA No. 6681/Mum/2013

household appliances and sponsoring doctors meet overseas has been allowed for AY 2004-05.

In the case of *PHL Pharma*[14] the Tribunal allowed deduction of freebies placing heavy emphasis on the point that the Regulations govern only medical practitioners and have no bearing on the conduct of pharmaceutical companies i.e. it does not impose 'prohibition' on pharmaceutical companies[15]. It opined that only when payment constitutes an offence by the taxpayer the deduction can be denied and CBDT transgressed its authority by issuing the said Circular. It also held that articles like free samples[16]; diaries, pen sets, calendars, paper weights, injection boxes etc. embossed with bold logo of brand name of the company do not constitute 'gift' for the purpose of the Regulation. The bench considered HP HC case of *Confederation* v. *CBDT* and opined that the same does not suggest an absolute denial to deduction of such expenses.

Delhi Bench held the distribution of free samples to be out of the Explanation 1 to Section 37 as well as CBDT Circular especially when the same were given based on specific requests of medical practitioners[17].

Chennai Bench recently denied deduction of expenses on laptops, LCDs, TVs, etc., gifted to doctors[18] holding the same to be in contravention of the Regulations disagreeing to the theory that Regulations do not apply to pharma companies. In the case of *Vishwanatha Sharma*[19] commission to private doctors for prescribing specific medicines was allowed by tax authorities and disallowance was restricted to commission paid to government doctors. Issue before HC confined to the latter and disallowance was upheld by applying the retrospective Explanation.

Author's analysis of the issues involved

Relevance of payer's perspective

The reason that pharma companies are not prohibited from giving gifts and incurring other specified expenses is not supported by the text of the section. Language of the section is not confined to "payments / expenditure *prohibited* by law" rather it extends to "expenditure for any '*purpose*' which is prohibited by law. If, what is achieved by the expenditure is prohibited by law then the same is not allowable. Clearly the purpose of the Regulations is to prevent receipt of such gratifications by doctors. Even the Explanatory Memorandum of the Budget and Explanatory Circular by CBDT[8] on Finance Act introducing Explanation suggest that payment of protection money will be disallowed as per amended law. Thus, the legislative intent is also clear to cover those cases where the payer cannot be charged with an offence. Punjab & Haryana High Court in *KAP Scan*[20] held both payer and recipient to be privies to a wrong and denied deduction on the ground of public policy. It held that payments opposed to public policy being unlawful consideration as per section 23 of Indian Contract Act cannot be allowed to be deducted for ascertaining taxable profits. A payment to achieve a purpose which defeats or contravenes a law was held to be disallowable even in year 1961 by Punjab High Court[21]. It held that an expense having proximate connection with an act which is an infringement of law cannot be allowed as deduction. Delhi High Court[22] has held that an expense to defeat government policy cannot be allowed as deduction. Therefore, in

[14] DCIT v. PHL Pharma Ltd. ITA No.4605/Mum/2014

[15] Relying on Max Hospital v. Medical Council of India W.P.(C) 1334/2013 though rendered in different context

[16] Relied on Eskayef (Now SmithklineBeecham) Pharmaceuticals (I) Ltd v. CIT (2000) 111 Taxman 561(SC)

[17] Eli Lilly & Co. v. ACIT ITA No.788/Del./2015

[18] Apex Laboratories v. ACIT 80 Taxmann.com 236 (Chennai)

[19] CIT v. Pt. Vishwanatha Sharma [2008] 316 ITR 419 (All)

[20] CIT v. KAP Scan (2012) 344 ITR 476 (P&H)

[21] Raj Woolen Industries v. CIT [1961] 43 ITR 36 (Punjab)

[22] CIT v. Orissa Cement [2002] 258 ITR 365 (Del)

Author's view this argument may not pass muster with higher appellate authorities.

Even if one were to believe that the prohibition has to be on payer, the payment will still be opposed to public policy because its receipt is prohibited by law. Even before introduction of the Explanation, the law was well settled by Apex Court[3] that expenses opposed to public policy cannot be allowed. The Karnataka High Court[23] has gone to the extent of saying that expenses tainted with immorality should not be allowed. It justified its statement by drawing support from illustration (j) to Section 23 of Indian Contract Act holding that immorality in certain cases coincides with illegality and a gratification to non-government officials seeking their undue influence is hit by that provision and disallowable being an unlawful consideration. Certainly, one needs to develop stronger arguments to support the deductibility.

Retrospectivity of the Circular

As the Circular does not go beyond the scope of enactment[24] there is no gainsaying that it is prospective. It merely clarifies the enactment. The disallowance therefore can operate qua any expense incurred after 10 December 2009.

Scope of disallowance

Free samples help the doctor in ascertaining the efficacy of the medicine. Diaries, pen sets, calendars, paper weights, injection boxes etc. embossed with bold logo of brand name of the company ensure brand promotion. It can also be argued that expenses on arranging conference for promoting the product and sharing field developments cannot be said to be a gift or perquisite

Considering their essential characteristic and predominant function, these expenses cannot be said to impair the independence of a medical practitioner. However gifting household items, travel, stay etc., could well be in breach of the Regulations. A distinguishing line between the two categories may be difficult to draw but must be drawn.

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Notification

Revised Safe Harbour Rules notified

The CBDT has announced the revised Safe Harbour Rules provided in Sub-rule 2A of Rule 10TD, as are applicable from 1-4-2017 and for three succeeding assessment years. Assessees may however opt for application of the rules prior to the revision (sub-rule 2 of Rule 10D) or the revised rules whichever is beneficial to them. *(Please refer to Tax Track No.5 for details)*

23 J.K. Panthaki v. ITO [2012] 344 ITR 329 (Kar)

24 Confederation of Indian Pharmaceutical Industry (SSI) v. CBDT CWP No. 10793 of 2012-J

Ratio Decidendi

Payment for sharing of SOPs is taxable as royalty under India-Germany DTAA

The assessee made certain payments to a German entity to ensure that they used the Standard Operating Procedures developed by the entity pertaining to clinical trial procedure and was also allowed access to email server, database, etc. As per the agreement the assessee could view such information as regards SOP preparation, numbering, data management, investigator site audit etc., but could not make any changes to the SOP. The assessee stated that it would take seven to ten years to develop its own SOPs which would be acceptable to regulatory authorities. It argued that access to computer systems and viewing of information could not come under the purview of royalty. However, the ITAT held that it was obvious from the invoice raised for payment that the consideration pertained to transfer of knowhow and in terms of Article 13(3) of the India-Germany DTAA, information concerning industrial, commercial or scientific experience had been shared by the German entity. Thus, it held that the payment was taxable as royalty and the assessee should have deducted TDS on the same. [*Oncology Services India (P) Ltd* v. *ADIT (IT)* - [2017] 82 taxmann.com, 42 (Ahmedabad-Trib.)]

Marked to market loss on forward contracts which are not stock in trade not allowable

The assesse entered into forward contracts with a bank to safeguard any losses in sales invoices raised in respect of export of certain services to its Associated Enterprise, on account of exchange fluctuation in foreign currency.

The assessee re-measured its forward contracts at prevalent forward market exchange rate and debited the loss to profit and loss account under the head “exchange difference” and claimed these losses as “marked to market” losses under section 37(1) of the Income Tax Act, 1961 (‘Act’). This was disallowed by the Assessing Officer. The Hon’ble ITAT noted that the assessee instead of measuring the receivables on balance sheet date at foreign exchange rate contracted, measured the pending forward contracts on balance sheet date at a value of foreign currency in the forward market. It noted that at relevant point of time assessee was evidently not dealing in forward contract and those contracts were not part of a stock in trade, these transactions were in not on account of the trading and, therefore, there was no trading liability.

The Tribunal held that since the assessee had entered into hedging forward contract transactions and settled all the forward contract by way of export receivables, therefore, it was immune from any fluctuation in the foreign exchange rate. Thus, no liability could arise on account of such fluctuation in foreign exchange on maturity of contract and the possibility of such liability on the balance sheet date also cannot arise. [*Bechtel India Pvt. Ltd.* v. *ACIT,* ITA No. 1224/Del/2017 - ITAT Delhi, Order dated 29-5-2017]

Non-inclusion of certain intangible may not affect character of slump sale

Assessee sold its edible oil manufacturing unit through Business Transaction Agreement (BTA) on slump sale basis. In the revisionary proceedings, the Pr. CIT rejected assessee's claim holding the transaction to be one of itemised sale. One of his objections was that since the assessee had not sold the rights trademark, logo etc., and also that post the slump sale the entity continued to be a going concern, therefore the requirements of slump sale had not been satisfied. The ITAT held as regards the initiation under Section 263 of the Income-tax Act, 1961 that all the records were furnished before the AO and the action of AO in accepting the claim of assessee that the transaction in question was a slump sale after detailed enquiry was one plausible view. It held that the edible oil unit had been transferred as an entire undertaking on going concern basis and satisfied the requirement of slump sale. It also held that non-inclusion of intangibles in the list of assets sold would not affect the character of slump sale. The buyer entity did not want to use the seller's brandname and hence chose not to buy the trademark, logo etc. Observing that the clauses of the agreement cannot be read in isolation and the contract must be read as a whole, the Tribunal quashed the order passed under Section 263. [*Ambo Agro Products Ltd*. v. *Pr.CIT* - ITAT Kolkata, decided on 19-5-17]

Payment of export commission not Royalty or FTS

The assessee entered into a Licence & Technical Assistance Agreement (LTAA) with its AE (Associated Enterprise) in 1984 which was later renewed in 1995 & 2004. A separate Export Agreement (EA) was entered to export specific two wheelers to specific countries on payment of export commission of 5%, which were earlier supplied by the AE or its other affiliates. Assessing officer treated this commission as royalty reasoning that under the LTAA dated 2nd June, 2004, there was a specific bar (in the form of a negative covenant) that prevented the Assessee from using the know-how to manufacture vehicles for export outside India and that the EA was only a method to monetise the negative covenant. The Court rejected the contention of the department that the EA was nothing but an extension of the LTAA itself. It was held that LTAA was continued in 1995 and then in 2004 and that EA entered on 21st June, 2004 could not be contemporaneous to LTAA. It was also noted that the assessee did not pay for using the existing distribution & sales network in those countries, and that payment under LTAA was itself treated royalty by the assessee and was in effect paid on export consignment also. Thus, the High Court held that the export commission was not in nature of royalty or FTS. [*CIT* v. *Hero Motocorp Ltd*. - ITA No. 923/2015, Delhi High Court]

News Nuggets

Draft Notification on special provisions relating to foreign company said to be resident in India on account of PoEM

On 15-6-2017 the CBDT issued a draft notification providing for exception, modification, and adaptation of certain provisions relating to computation of total income, treatment of unabsorbed depreciation, brought forward losses, special provisions relating to tax avoidance in respect of foreign company said to be resident in India on account of PoEM for the first time, when the said company has never been a resident in India before. Comments and suggestions have been invited and can be sent electronically upto 23-6-2017. Some of the notable points pertain to Written Down Value of assets which would be as per the tax record in the foreign country on the 1st day of the previous year if the foreign company is assessed to tax. And if it is not assessed to tax in the foreign jurisdiction, the WDV would be as appearing in the books of account maintained in accordance with the applicable laws. Set-off of brought forward loss or unabsorbed depreciation will be allowed and in cases where the accounting year does not end on March 31, the foreign company would be required to prepare the profit and loss account and Balance sheet on that basis till the year the foreign company remains resident in India. The rate of tax in case of foreign company shall be rate of income-tax applicable to the foreign company though the residency status of the foreign company changes from non-resident to resident on the basis of PoEM.

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