

# EY Tax Alert

## Supreme Court upholds disallowance of expenses for freebies to medical practitioners in violation of MCI regulations

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### Executive summary

This Tax Alert summarizes a recent Supreme Court (SC) ruling in the case of Apex Laboratories Pvt. Ltd.<sup>1</sup> (Taxpayer) dated 22 February 2022 on the issue of tax deductibility of expenses incurred by the Taxpayer for providing freebies (such as hospitality, conference fees, gold coins, LCD TVs, fridges, laptops etc.) to medical practitioners to promote sales of a healthcare supplement.

The Tax Authority invoked the Explanation to Section (s.) 37(1) of the Indian Tax Laws (ITL) which disallows expenses incurred for any purpose, which is an offence or which is prohibited by law. The lower appellate authorities upheld such disallowance since the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (MCI Regulations) prohibited medical practitioners from accepting such freebies. The Taxpayer's principal argument against the disallowance was that MCI Regulations applied only to medical practitioners and not to pharma companies and, hence, it was not an offence or prohibited by law for pharma companies.

The Supreme Court (SC) dismissed the Taxpayer's appeal and upheld the disallowance on the ground that, since acceptance of such freebies by medical practitioners is in violation of MCI Regulations, the Taxpayer cannot be granted tax deduction. As per the SC, if accepting freebies is prohibited by law for the recipient, giving freebies is also impliedly prohibited by law for the payer. Further, the SC held that granting deduction of such expenses would undermine public policy.

<sup>1</sup> TS-104-SC-2022

## Background

- ▶ Section 37(1) of the ITL allows any expenditure laid out or expended wholly or exclusively for the purpose of business or profession. Explanation 1 to s.37(1) (Explanation) disallows expenses incurred for any purpose, which is an offence or, which is prohibited by law.
- ▶ Medical Council of India (MCI), erstwhile regulatory body constituted under Medical Council Act, 1956 (MCA), issued Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (MCI Regulations) specifying unethical practices forbidden for medical practitioners. The MCI Regulations provided for disciplinary action by MCI against erring medical practitioners for violation of such regulations<sup>2</sup>.
- ▶ On 14 December 2009, MCI Regulations were amended to specify additional unethical practices, whereby, a prohibition was imposed on medical practitioners from accepting, *inter alia*, gifts, travel, hospitality and cash grants, from pharma and allied health industry. Violation of such regulations had consequences of disciplinary action ranging from “censure” for incentives received up to INR 5,000 to removal from Indian Medical Register or State Medical Register for a period from three months to one year.
- ▶ The CBDT vide Circular No. 5/2012 dated 1 August 2012 (Circular) clarified that any expense incurred by pharma/allied health industry or other taxpayers in providing freebies, such as gifts, to medical practitioners in violation of MCI Regulations is disallowable under Explanation as an expense “prohibited by law”.
- ▶ The Himachal Pradesh High Court (HC) in the case of Confederation of Indian Pharmaceutical Industry v. CBDT<sup>3</sup> upheld the validity of the Circular. As per HC, sum and substance of the Circular is the same as the Explanation. The Himachal Pradesh HC also expressed concern about the increasing complaints that medical practitioners do not prescribe generic medicines and prescribe other branded medicines in consideration of freebies granted to them by some pharma industries and held that the MCI Regulations prohibiting such unethical practices is in the interest of patients and public. The HC also held that if a taxpayer satisfies tax authority that expense does not

violate the MCI Regulations, a deduction can be claimed.

- ▶ This gave rise to conflicting rulings of tribunal and courts on allowability of such expenditure in the light of MCI Regulations.
- ▶ Some tribunals/courts<sup>4</sup>, despite noting that acceptance of gifts by medical practitioners was violative of the MCI Regulations, granted deduction of expense incurred by pharma companies to provide such gifts, on the ground that the MCI Regulations are applicable only to the medical practitioners and not to the pharma companies. According to them, there is no violation of the MCI Regulations by the pharma companies.

However, other tribunals/courts<sup>5</sup> denied the deduction holding that, when acceptance of freebies by medical practitioners is prohibited by law, extension of these freebies by pharma companies also constitutes an expense for a purpose that is “prohibited by law”. Further, Punjab & Haryana HC in the case of Kap Scan<sup>6</sup> upheld the disallowance of commission for referring patients to diagnostic center on the ground that such payments are opposed to public policy and are unlawful consideration, and hence, are not cognizable for tax purposes.

Considering the judicial conflict on the subject, the Division Bench of Mumbai Tribunal in the case of Macleods Pharmaceuticals<sup>7</sup> referred the issue for constitution of Special Bench of Tribunal.

- ▶ Pending the outcome of Special Bench’s decision, the Finance Bill, 2022 (FB 2022) introduced in the Parliament on 1 February 2022 has proposed insertion of a new Explanation 3 to s.37(1) w. e. f. tax year 2021-22, which, *inter alia*, provides that, disallowance shall be deemed to have always applied to an expense incurred to provide any benefit or perquisite in any form to a person (whether or not carrying on a business or profession) if acceptance of such benefit or perquisite violates any law or rule or regulation or guideline governing the conduct of such person.

<sup>2</sup> In 2020, MCA was repealed and was dissolved. Consequently, National Medical Commission Act, 2019 has been enforced, and National Medical Commission has been constituted.

<sup>3</sup> (2013) 335 ITR 388 (HP), Refer EY Alert titled ‘Himachal Pradesh HC upholds validity of CBDT Circular on inadmissibility of unethical payments to doctors’ dated 25 February 2013

<sup>4</sup> Illustratively, PHL Pharma P. Ltd. [2017] 163 ITD 10 (Mumbai Tribunal)

<sup>5</sup> Illustratively, Macleods Pharmaceuticals Ltd. [2021] 131 taxmann.com 154 (Mumbai Tribunal) and Kap Scan and Diagnostic Centre (P.) Ltd. (2012) 344 ITR 476 (Punjab & Haryana HC)

<sup>6</sup> (2012) 344 ITR 476 (P&H HC)

<sup>7</sup> ITA Nos. 5168 & 5169/Mum/2018

## Facts of present case:

- ▶ For tax year 2009-10, the Taxpayer, a pharma formulations manufacturer, incurred selling expenses for freebies (such as hospitality, conference fees, gold coins, LCD TVs, fridges, laptops, etc.) to medical practitioners to promote sales of a nutritional health supplement.
- ▶ The tax authority disallowed such expenses by invoking the Explanation on the ground that such expenditure was in violation of MCI Regulations which restricted medical practitioners from accepting such freebies.
- ▶ The first appellate authority (FAA) granted partial relief to the Taxpayer and confirmed disallowance only for those expenses incurred after the MCI Regulations got amended, viz. after 14 December 2009, to expressly restrict the medical practitioners from accepting such freebies.
- ▶ On further appeal by the Taxpayer, the Chennai Tribunal<sup>8</sup> confirmed the decision of the FAA and held that the MCI Regulations applied only prospectively, from 14 December 2009. The Tribunal also held that the MCI Regulations prohibit distributing gifts not only by pharma companies but also by allied health sector companies such as the Taxpayer. The Tribunal also held that once the act of receiving such gifts is unethical, the act of giving such gifts to induce medical practitioners to violate the MCI Regulations would also be unethical.
- ▶ On further appeal by the Taxpayer, the Madras HC<sup>9</sup> approved the Tribunal's decision.
- ▶ Being aggrieved, the Taxpayer filed special leave petition (SLP)<sup>10</sup> against the Madras HC's decision in the SC. The SC admitted the SLP and decided the issue on merits.

## Taxpayer's contentions before SC

- ▶ MCI Regulations are only enforceable/binding on medical practitioners and not on pharma companies such as the Taxpayer. While MCI Regulations prohibit medical practitioners from accepting gifts; there is no corresponding prohibition on the Taxpayer from giving gifts.

- ▶ The Circular seeks to go beyond the statute in applying the MCI Regulations to pharma companies. In any case, such a circular can apply only prospectively from 1 August 2012, and not retrospectively from 14 December 2009.
- ▶ Explanatory Memorandum to Finance (No. 2) Bill, 1998 which inserted the Explanation clarifies that it disallows deduction of protection money, extortion, hafta, bribes etc., suggesting that Legislature intended to disallow only expenses on illegal activities that constituted an "offence" under law.
- ▶ The Madhya Pradesh HC in case of Khemchand Motilal Jain<sup>11</sup> allowed deduction of ransom money paid to kidnappers to secure an employee's release on the ground that though receiving ransom money is prohibited by law for the recipient (who commits the crime of kidnapping), the payment of ransom money to secure the release of the kidnapped employee was not prohibited.
- ▶ The ITL is not intended for social reform and needs to be interpreted strictly, devoid of moral considerations.

## Tax authority's contentions before SC

- ▶ While the act of pharma companies giving freebies to medical practitioners in violation of MCI Regulations cannot be regarded as "offence", it can certainly be regarded as "prohibited by law". Even though the pharma company cannot be punished, it cannot be allowed tax deduction for such expenses.
- ▶ Parliament's intent to disincentivise such expenditure, since it results in unethical practice of doctors prescribing expensive medicines instead of cheaper generic versions, is clear not only from the point of view of MCI Regulations but also from amendments to Prevention of Corruption Act, 1988 which is meant to prohibit government doctors from accepting any illegal gratification.
- ▶ Reliance was placed on CII and Kap Scan rulings in support of validity of the Circular and incurrence of such expenditure being against public policy.

<sup>8</sup> ITA No. 1153 & 1343/Mds/2014, decision dated 29 January 2018

<sup>9</sup> Tax Case Appeal No. 723 of 2018, decision dated 18 March 2019

<sup>10</sup> SLP No. 23207/2019

<sup>11</sup> 2011 (4) MPLJ 691

## SC's ruling

The SC dismissed the Taxpayer's appeal and held that provision of freebies to medical practitioners was clearly "prohibited by law" and attracted the Explanation. Further, the SC held that granting deduction would wholly undermine public policy. The SC's reasons are elaborated as under:

### Expenses for provision of freebies is for a purpose that is "prohibited by law":

- ▶ The terms used in the Explanation viz. "offence" and "prohibited by law", are not defined in the ITL. The General Clauses Act, 1897 defines "offence" as any act or omission made punishable by any law. The Indian Penal Code defines "illegal" as everything which is an offence or which is prohibited by law. Therefore, the Explanation covers all such activities which are illegal/prohibited by law and/or punishable by law.

In the present case, even if it is accepted that the MCI Regulations are inapplicable to pharma companies and, hence, the Taxpayer is not punishable by law, the acceptance of such freebies by the medical practitioners is still clearly an offence, punishable with varying consequences.

- ▶ It is but logical that, when acceptance of freebies is an offence for medical practitioners, the pharma companies cannot be granted the tax benefit for providing such freebies, and thereby (actively and with full knowledge) enabling the commission of such offence.
- ▶ Prevention of Corruption Act, 1988, prior to amendment in 2018, only punished the bribe taker (being a public servant) and not the bribe giver. The SC relied on an earlier decision<sup>12</sup> in this context, which held that, despite absence of a specific provision, the bribe giver is not automatically immune and can be prosecuted by the court.
- ▶ 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. Giving relief in this case would imply doing something "prohibited by law" or have the effect of defeating the law.

### Granting deduction for such expenses would undermine public policy:

- ▶ No court will aid a party in an immoral or illegal act. None should be allowed to profit from any wrongdoing. As doctors and pharmacists are complementary and supplementary to each other in the medical profession, a

comprehensive view must be adopted to regulate their conduct.

- ▶ Patients repose trust in their medical practitioners and provision of freebies pushes up price of medicines rendering them unaffordable for patients, which is against public policy. The Himachal Pradesh and Punjab and Haryana HCs have correctly upheld the disallowance on the grounds of public policy.
- ▶ As noted by the Punjab and Haryana HC, provision of freebies to medical practitioners to promote sales of medicines constitutes an unlawful consideration and an agreement to that effect between medical practitioners and pharma companies is violative of Indian Contract Act, 1872.
- ▶ Madhya Pradesh HC decision in the case of Khemchand Motilal Jain is inapplicable to the present case as in that case the taxpayer was not a wilful participant in the commission of an offence of kidnapping.

### Interpretation should discern and achieve social purpose subserved by a legislation:

- ▶ A strict interpretation of taxing statutes cannot sustain when it results in an absurdity, contrary to the legislative intent.
- ▶ 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. So viewed, the law has birthed implied limitations that are un-spelt but entirely logical and reasonable. 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.
- ▶ A narrow interpretation of the Explanation by Mumbai Tribunal in the case of PHL Pharma (*supra*) defeats the purpose of the Explanation i.e., to disallow a tax benefit for a taxpayer's participation in an illegal activity. Examples in the Explanatory Memorandum are only illustrative and not exhaustive of the Explanation's applicability. Also, the Circular being clarificatory, applied retrospectively from the date of implementation of amended Regulations i.e., 14 December 2009.

<sup>12</sup> P.V. Narasimha Rao (1998) 4 SCC 626

## Comments

The present SC ruling settles a contentious debate on tax deductibility of expenses for provision of freebies by pharma companies to medical practitioners in violation of MCI Regulations by rejecting the argument that giving of such freebies is not prohibited for a payer.

The SC ruling endorses the FB 2022 amendment that proposes to insert Explanation 3 to s.37(1) prospectively from 1 April 2022 insofar as the disallowance applies to an expense incurred to provide any benefit or perquisite to a person if acceptance of such benefit or perquisite violates any law, rule, regulation or guideline governing the conduct of such person. Therefore, the SC ruling, in effect, provides retrospective effect to the amendment insofar as it provides that the expenses need to be compliant of laws applicable to the payer as also the payee.

While SC ruling rejects the legal argument of expense not being prohibited for payer, the issue whether or not an expense is in violation of MCI Regulations is a mixed question of fact and law, and the SC was not directly concerned with this aspect in the present ruling.

Also, the issue whether the tax authority has jurisdiction to decide upon legality of a particular expenditure when the relevant regulator has not taken any disciplinary action either against the payer or recipient does not appear to be concluded by the SC in this ruling.

The ratio of the SC ruling and the proposed amendment by FB 2022 is applicable not only to pharma sector, but to all other sectors governed by similar regulations. Onus will be on the taxpayers to demonstrate that expense incurred is not in violation of any law from the perspective of both payer and recipient. If there is any ambiguity on any issue (e.g., whether small value gifts/tokens relevant for business/professional use is permitted), the relevant industry will need to engage with its sector regulator to get clarity and avoid further litigation. The judicial and legislative development calls for enhanced corporate governance for the entire industry to ensure compliance with laws from payees' perspective also.

On a separate note, the FB 2022 also proposes to introduce a new withholding requirement on the provision of business benefits or perquisites to residents with effect from 1 July 2022. The withholding applies regardless of whether the expenditure is disallowable in the hands of the payer on account of violation of any law, rule, regulation or guideline governing the conduct of the payee.

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