

**ASSESSMENT OF ASSESSEES IN
PHARMACEUTICAL SECTOR**

MINISTRY OF FINANCE (DEPARTMENT OF REVENUE)

**PUBLIC ACCOUNTS COMMITTEE
(2018-19)**

ONE HUNDRED AND THIRTY SIXTH REPORT

SIXTEENTH LOK SABHA



**LOK SABHA SECRETARIAT
NEW DELHI**

PAC NO. 2175

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MINISTRY OF FINANCE (DEPARTMENT OF REVENUE)



Presented to Lok Sabha on:

Laid in Rajya Sabha on:

**LOK SABHA SECRETARIAT
NEW DELHI**

February 2019/ Magha 1940 (Saka)

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- I. Minutes of the Second sitting of Sub-Committee - III (Direct and Indirect Taxes) of the Public Accounts Committee (2017-18) held on 08-06-2017.
- II. Minutes of the Twentieth sitting of the Public Accounts Committee (2018-19) held on 05-12-2018.
- III. Minutes of the Twenty-third sitting of the Public Accounts Committee (2018-19) held on 07-01-2019.

* Not appended

**COMPOSITION OF THE SUB COMMITTEE - III (DIRECT AND INDIRECT TAXES) OF
THE PUBLIC ACCOUNTS COMMITTEE (2017-18)**

Convenor	:	1.	Shri Nishikant Dubey
Alternate Convenor	:	2.	Shri Satyavrat Chaturvedi
Members	:	3.	Shri Shivkumar C. Udasi
		4.	Shri Bhupender Yadav
		5.	Shri Sukhendu Sekhar Roy ¹
		6.	Shri Ajay Sancheti

¹ ceased to be a Member of Committee consequent upon his retirement from Rajya Sabha on 18 August, 2017.

COMPOSITION OF THE PUBLIC ACCOUNTS COMMITTEE
(2018-19)

Shri Mallikarjun Kharge - Chairperson

M E M B E R S

L O K S A B H A

2. Shri Subhash Chandra Baheria
3. Shri Sudip Bandyopadhyay
4. Shri Prem Singh Chandumajra
5. Shri Gajanan Chandrakant Kirtikar
6. Shri Bhartruhari Mahtab
7. Smt. Riti Pathak
8. Shri Ramesh Pokhriyal "Nishank"
9. Shri Janardan Singh Sigriwal
10. Shri Abhishek Singh
11. Shri Gopal Shetty
12. Dr. Kirit Somaiya
13. Shri Anurag Singh Thakur
14. Shri Shivkumar Chanabasappa Udasi
15. Dr. Ponnusamy Venugopal

R A J Y A S A B H A

16. Prof. M. V. Rajeev Gowda
17. Shri Bhubaneswar Kalita
18. Shri Shwait Malik
19. Shri Narayan Lal Panchariya
20. Shri Sukhendu Sekhar Roy
21. Shri C. M. Ramesh²
22. Shri Bhupender Yadav²

SECRETARIAT

1. Shri Abhijit Kumar - Additional Secretary
2. Shri T. Jayakumar - Director
3. Smt Anju Kukreja - Under Secretary

² Elected w.e.f. 6 August, 2018 for filling vacancies.

INTRODUCTION

I, the Chairman, Public Accounts Committee (2018-19) having been authorised by the Committee, do present this One Hundred and Thirty-sixth Report (Sixteenth Lok Sabha) on '**Assessment of Assesseees in Pharmaceutical Sector**' based on C&AG Report No.5 of 2015 related to the Ministry of Finance (Department of Revenue).

2. The above-mentioned Report of the Comptroller and Auditor General of India was laid on the Table of the House on 20th March, 2015.

3. The Sub-Committee - III (Direct and Indirect Taxes) of the Public Accounts Committee (2017-18) took up the subject for detailed examination and report. The Sub-Committee took evidence of the representatives of the Ministry of Finance (Department of Revenue) on the subject at their sitting held on 8th June, 2017. Further, the Main Committee also took evidence of the representatives of the aforesaid Ministry on 5th December, 2018. Accordingly, a Draft Report was prepared and placed before the Public Accounts Committee (2018-19) for their consideration. The Committee considered and adopted this Draft Report at their sitting held on 7th January, 2019. The Minutes of the Sittings are appended to the Report.

4. For facility of reference and convenience, the Observations and Recommendations of the Committee have been printed in thick type and form Part- II of the Report.

5. The Committee thank their predecessor Sub-Committee for taking oral evidence and obtaining information on the subject.

6. The Committee would like to express their thanks to the representatives of the Ministry of Finance (Department of Revenue) for tendering evidence before them and furnishing the requisite information to the Sub-Committee/Main Committee in connection with the examination of the subject.

7. The Committee place on record their appreciation of the assistance rendered to them in the matter by the Office of the Comptroller and Auditor General of India.

NEW DELHI;
February, 2019
Magha, 1940 (*Saka*)

MALLIKARJUN KHARGE
Chairperson,
Public Accounts Committee

REPORT

I. INTRODUCTORY

1. This Report is based on C&AG Report No.5 of 2015 on the subject "Assessment of Assesseees in Pharmaceuticals Sector", pertaining to the Ministry of Finance (Department of Revenue).

2. The Sub-Committee - III (Direct and Indirect Taxes) of the Public Accounts Committee (2017-18) considered the subject for detailed examination, took oral evidence of the representatives of Ministry of Finance (Department of Revenue) and obtained written replies on the same. Based on the oral evidence and written replies, the Sub-Committee examined the subject in detail. Further, the Public Accounts Committee (2018-19) took oral evidence of the representatives of the Ministry of Finance (Department of Revenue) on the subject and obtained oral as well as written replies.

3. Indian Pharmaceuticals industry has witnessed robust growth in last five-six years, taking its turnover from ₹ 71,000 crore in 2007 to ₹ 1,21,015 crore in 2013 and thereby making it a vital economic sector with corresponding potential for the Government revenue. India ranks 4th in terms of generics production and 17th in terms of export value of bulk actives and dosage forms. Indian exports are going to more than 200 countries around the globe including highly regulated markets like US, West Europe, Japan and Australia. Indian Pharmaceutical industry has developed excellent Good Manufacturing Practices (GMP) compliant facilities for the production of different dosage forms. The strength of the industry is in developing cost effective technologies in the shortest possible time for drug intermediates and bulk activities without compromising on quality. This is realised through country's strength in organic chemical's synthesis and provides support to this sector by way of various area based tax exemptions, weighted deductions on expenses towards Research and Development (R&D) and other deductions against business profits in the Income Tax Act 1961 (Act), concessional rate of excise duties, State VAT etc.

II. Audit objectives

4. Audit conducted Performance Audit on "Assessment of Assesseees in Pharmaceuticals Sector" with the objectives to focus on whether (a) the exemptions and deductions allowable to Pharmaceutical Sector have been allowed as per entitlement; (b) the administrative and procedural adequacy for taxation of pharmaceutical sector exists;

and (c) the allowance of deduction of Research and Development expenditure to the assesseees in Pharmaceuticals Sector has contributed to the growth in industry as well as in tax revenues.

5. In their Report, C&AG pointed out the following irregularities in the assessment of assesseees in Pharmaceutical sector:

III. Systemic issues and internal control

Sector-wise data in the Income Tax Department

6. The Committee found from Audit Report that a list of manufacturing units engaged in Pharmaceuticals sector published by National Pharmaceutical Pricing Authority (NPPA), Department of Pharmaceutical containing names, addresses, telephone numbers was referred to the ITD for providing PAN and jurisdiction charge of the assesseees but the same could not be provided to Audit by the ITD. In absence of jurisdiction-wise database of assesseees engaged in Pharmaceutical Sector, Audit had to rely on its historical knowledge to find out assesseees of the Pharmaceutical Sector. Audit also obtained data from the Assessment Information System (AIS) maintained by the DGIT (Systems) of the ITD of assesseees filing the return under code '0105- Drugs and Pharmaceuticals'. It was observed that data provided by the DGIT (Systems) was incomplete as many Pharmaceutical manufacturing units indicated in the Directory of Pharmaceutical Manufacturing Units in India did not exist in the database. Thus, ITD along with Department of Pharmaceuticals and Drug Control Department (DCD) did not maintain complete sector wise/industry-wise data of assesseees engaged in Pharmaceuticals sector. In absence of sector/trade wise data, it would not be able to analyse the various aspects relating to policy formation, revenue foregone on particular sector/trade, contribution of such sector in tax revenue and the contribution of such sector is in tune with their growth etc.

7. When asked about the reasons for not maintaining complete sector-wise/industry-wise database of Pharmaceutical Sector, the Ministry of Finance (Department of Revenue) in their written replies submitted as under:

"The Sector-wise data can be obtained using 'nature of business code available in the respective Income Tax return (ITR). The business code for 'Drugs and Pharmaceutical Industries' is 0105. However, in case of an entity having diversified businesses, it becomes difficult to capture sector wise data since the Income Tax Return captures a consolidated Profit and Loss statement and a Consolidated Balance Sheet and it may not be possible to fully isolate only the

P&L A/c and Balance Sheet for a Pharmaceutical division/unit/line in a diversified company.

Further, the Revenue forgone statement of each year's budget document (referred to as Statement of Revenue Impact of Tax Incentives under the Central Tax System in Budget), does contain sector wise data relating to revenue impact of direct tax incentives in respect of various sectors such as telecommunication, power, infrastructure, mineral oil & natural gas, housing, food processing etc.

Appendix to Statement also enlists the effective direct tax rate in more than 70 sectors. As per the Statement of Revenue Impact of Tax Incentives under the Central Tax System 2015-16, the effective tax rate in the manufacturing of drugs and pharmaceuticals sector is 19.47%."

8. The Committee sought to know as to how in the absence of such a database, the Department of Revenue could monitor the assessee engaged in Pharmaceutical sector. In response, the Ministry replied that the assessing officers/field formations monitor the advance tax payment of big taxpayers in their charge which also include entities from Pharmaceutical sector.

9. As regards the steps taken by the Ministry for instituting a mechanism for compilation of sector-wise data, the Ministry stated that sector specific data is captured in the ITR Form subject to constraints and capturing further data would lead to complexity in Return Forms and shall hamper ease of doing business.

10. In their reply to a query raised by the Members on this issue during evidence, Secretary, Department of Revenue deposed before the Committee that "If it is specifically required, we can find it out but generally we do not maintain such data."

11. In this regard, Chairperson, CBDT in his deposition before the Committee stated that "we are starting a new project called insight, which is exclusively for data mining. This is under preparation. We are going to start that project for data mining from next year onwards."

IV Allowance of R&D expenditure without approval from DSIR

12. The due date for filing return of income under the Act is 30th September in respect of company not having international transactions. Thus, companies claim R&D expenditure in its return of income before getting approval of DSIR. The reason being that the due date for filing return of income of such assessee companies precedes the date of forwarding of approved Form 3CL report, i.e. 31st December by Department of Scientific and Industrial Research (DSIR) to Director General of Income Tax (DGIT) (Exemptions). Therefore, R&D expenditure are claimed by assessee companies and allowed by the ITD in summary processing, before such expenditure is being approved

by DSIR. In CIT-II Delhi Charge , the assessee M/s Modi Mundipharma Pvt. Ltd claimed and ITD allowed weighted deduction under Section 35(2AB) of ₹ Rs. 3.15 crore in AY 2011-12 completed in January 2014. Audit observed that AO allowed the claim without verifying the form 3CL as Form 3CL was issued by DSIR in April 2014. Thus, the ITD allowed weighted deduction under Section 35(2AB) before approval of DSIR. Reply was awaited (October 2014). The date of forwarding of approved Form 3CL by DSIR to DGIT (Exemptions) should be prior to the due date of filing of ITR.

13. The Committee desired to know about the steps being taken by the Ministry to devise a mechanism wherein the copy of Form 3CM/3CL duly approved by the DSIR is invariably attached with the Income Tax Return to verify the genuineness of the expenditure. In their written reply, the Ministry submitted as follows:

"With effect from 01.07.2016, CBDT has made substantial changes in Rule 6 of Income-tax Rules, 1962 so that possibility of recurrence of lapses as pointed out by the Audit is minimized. The amended Rule would enable the Department to keep a track on claim of weighted deduction by the concerned taxpayer and whether the conditions subject to which approval was allowed to it, are being fulfilled or not. These can be summarized as under:

i. The Prescribed Authority i.e. Secretary, DSIR is required to submit its report in Form No. 3CL electronically to the concerned jurisdictional Pr.CCIT/CCIT/Pr.DGIT/DGIT. Earlier, in all cases, report of DSIR was to be submitted manually to the Principal DGIT(Exemptions) who was not the jurisdictional Income-tax Authority in many of such cases and hence, there was a possibility that these reports/approvals did not reach the correct jurisdiction. The new provision, therefore, ensures proper transmission of the report to enable verification of claim of weighted deduction, if required, under section 35(2AB) of the Income-tax Act made by the taxpayer in the return of income.

ii. Post approval of DSIR, the concerned taxpayer is required to submit a duly audited report, electronically, in Form No. 3CLA to the Secretary, DSIR within the timeframe prescribed under the Act for filing return of income under section 139(1) of the Act, unlike earlier, when a manual report was to be submitted to the Secretary, DSIR by 31st October of each year. This change would enable DSIR to keep a track of compliance requirements being fulfilled by the concerned taxpayer. In case of possible infringement, the same would also get reported to the Income-tax Department quickly in electronic mode."

14. On being asked as to whether the Ministry have examined the possibility of linking of the approval of the DSIR, available with DGIT (Exemption with the Income Tax Return), the Ministry submitted as follows:

"Earlier, in all cases, report of DSIR was to be submitted manually to the Principal DGIT(Exemptions) who was not the jurisdictional Income-tax Authority in many of such cases and hence, there was a possibility that this reports/approval did not reach the correct jurisdiction. The new provision, therefore, ensures proper

transmission of the report to enable verification of claim of weighted deduction, if required, under section 35(2AB) of the Income-tax Act made by the taxpayer in the return of income."

15. In this regard, Chairperson, CBDT in his deposition before the Committee stated that "After many consultation with the DSIR, we have changed the Rule 6 altogether, we have changed the formats and within 120 days, this will come, and after that, the suspension will take place. So, henceforth, there is no chance of allowing any deduction like this before getting the DSIR report".

16. The Committee further desired to know about the tax incentive in case of R&D and why the industrialists are keen to take tax incentives in case of R&D sector. In response, representatives of the Ministry replied during evidence as follows:

"We have to Phase out those deductions. From this year, it will be 150 percent and from 2021 it will be actual expenditure, which is done on that particular item."

V Deduction of TDS in respect of contract entered by assessee company with a manufacturing company for manufacture of products.

17. The Committee found that the Pharmaceutical companies, by just not supplying raw materials directly to the contract manufacturers, treated such contracts as supply contracts and did not pay TDS taking advantage of exclusion clause of Section 194C. But they made binding conditions for contractors about source and price of raw materials to be purchased, rights of inspection and control over production process, controlled final price and exclusive buying rights etc. On termination of such contracts, the contract manufacturer were required to return technical know-how and all papers, documents, data etc. back to the Pharmaceutical company. Thus entire control of manufacturing process remained with the Pharmaceutical companies which made it akin to works contract only, attracting TDS. Thus, the relevant amount of tax was not collected in advance from such manufacturers through the deductors. In absence of the individual contract details, Audit could not work out the amount of TDS deductible. In CIT-VIII, Mumbai Charge for the Assessment Year 2010-11 the assessee M/s Pfizer Ltd. entered into an agreement for manufacturing its patented pharmaceutical products with manufacturers such as Snehal Foods & Feeds, Medibios Laboratories Pvt. Ltd., Kemwell Pvt. Ltd. and Geno Pharmaceuticals Ltd., in Maharashtra. There were conditions in the agreement of procurement of raw material from the list of approved sources, selling of specific quantities of products as ordered by the Pfizer Ltd. on pre-determined prices. Audit observed that the manufacturer neither had the liberty to procure the materials from

other suppliers nor had the freedom to sell the manufactured products to other customers or to determine price himself. However, Pfizer Ltd. was not deducting TDS on value of works done by the manufacturer by treating these contracts as sell contracts. Due to non availability of the exact details under assessment/tax effect could not be quantified.

18. The Committee sought to know as to how the Department ensure that the Pharmaceutical companies deduct the TDS on payments made to contract manufacturers and whether any action has been initiated in this regard. The Ministry in their written replies submitted as under:

"It is to state that with effect from 1.10.2009, a distinction has been made in 'work contracts' and 'sale contracts' on the basis of who is supplying the material for manufacturing. The C&AG have recommended that instructions may be issued by CBDT to include such contracts within the definition of 'work contract' where the entire control of the manufacturing process vests with the assessee/customer. The C&AG has relied on only one case law, which relates to AY 1997-98 apart from its own findings on facts during the audit process.

It is submitted that the recommendations of the C&AG, as contained in point No.3 of the Draft report, are not acceptable for the following reasons:

- (i) There is lack of adequate material to warrant introduction of another criterion for distinguishing work contract from sale contract.
- (ii) The legal ambiguity that existed before 2009 has already been addressed by the 2009 amendment;
- (iii) Implementation of the C&AG's suggestions would require legislative change in Section 194C.

In view of the facts stated above, no Instruction as recommended in the Report can be issued by the CBDT."

VI Mechanism for cross verification of turnover declared in Income Tax Return with the turnover declared in Excise Return

19. Manufacturers paying more than one crore rupees as Central Excise duty are required to file annual information in Form ER 4 under rule 12(2)(a) of the Central Excise Rules, 2002. This form contained details of quantity & value of raw materials as well as of quantity & value of finished goods. As the Central Excise and ITD both belong to the Ministry of Finance, ITD should have correlated/link the turnover of the assessee claiming exemptions /deductions as declared in Income Tax records (viz. 10CEB) with that of ER-4 for deepening the tax base. Such correlation/linking was easily possible in case of Large Taxpayer Unit (LTU) which is a single window clearance point for three

taxes i.e. Income Tax, Central Excise & Service Tax and thereby data to be correlated/linked was readily available to the AOs.

20. Audit test checked in 14 States and observed that there was no mechanism with the ITD to cross-verify the turnover declared in ITR with the turnover declared in Central Excise Return. In absence of such cross-verification of turnover, possibility of revenue leakage in the form of incorrect deduction claimed under the provisions of the Act cannot be ruled out.

21. On being asked about the steps taken by the Ministry to develop a mechanism to cross verify the turnover declared by a company in the ITR with the turnover declared in Central Excise Return, the Ministry stated as follows:

"As regards creating a mechanism for compulsory obtaining Form ER 4 from the assessee in order to compare the turnover declared under Central Excise and Income tax it may be submitted that, under the Income-tax Act, 1961 under section 142(1) the assessing officer is authorised to obtain information during the course of assessment. Further, under section 133 such information may be obtained from the other agency (CBEC) during pendency of any proceedings. Thus, already a mechanism exists for obtaining all information including Form ER-4.

Further, compulsory furnishing such forms by assessee will only increase -the compliance burden of the assessee which will increase compliance cost and it will create unnecessary hurdles for voluntary compliance and ease of doing business. It is the endeavour of the department to minimize compliance burden and increase tax base thereby. As a balance needs to be struck between compliance burden and revenue leakages, suitable safe guards are already provided under section 142(1) and 133 of the Income-tax Act, 1961 to obtain information wherever necessary.

Further, under section 44AB of Income-Tax Act, every year, taxpayers whose income exceeds the monetary limit prescribed therein or those who are not engaged in businesses specified therein are required to get their books of accounts compulsorily audited. Such a report of audit is required to be filed electronically with the Income-Tax Department within the time frame prescribed under section 139(1) of the IT Act. Therefore, the turnover declared by the taxpayer before the Central Excise Department is by and large captured satisfactorily in such reports of audit. Since books of accounts are common, the figure of turnover gets similarly reported before both the authorities while filing respective returns.

In cases under scrutiny, the Assessing Officer, depending on specific requirements of the case can also call for such information from the concerned assessee or may verify it independently from the concerned Excise authorities.

It may be further mentioned that in Income-Tax return, the taxpayers are required to file a statement of all taxes paid or payable to the Government. Thus, the

turnover, so declared in Central Excise, gets captured, indirectly, in Income Tax also.

However in view of the Audit observation, an MOU was entered into with CBEC on 30.11.2015 on exchange of information. The details of ER-4 are now being obtained from CBEC. Wherever required the Excise turnover as per ER-4 and turnover as per profit & loss account of Income-tax return are being compared."

Chapter 3 - Compliance Issues

Section A - Inadmissible expenses related to Pharmaceutical Sector

VII Allowance of expenditure towards gifts, freebies etc. to Medical Professionals

22. As per explanation to Section 37(1) of the Income Tax Act, any expenditure for a purpose which is an offence or which is prohibited by law is not an allowable business expense. MCI vide its regulations of 2002 provided that medical practitioners should prescribe generic drugs as far as possible. It inter-alia prohibited them to solicit or receive any commission, gifts etc. for any approval or recommendation, endorsement of any medicine or drug for advertisement purpose or for referring or recommending any patient any medical, surgical or other treatment. Vide amendment dated 10 December 2009, Pharmaceutical companies were specifically prohibited to give any consideration in the nature of gifts, travel facilities, hospitality, cash or monetary grants etc. CBDT issued a circular in 2012 and clarified that such expenses would not be allowable. Judicial pronouncement also clarified that this circular had retrospective effect. Thus, the AOs have not adopted uniform approach in disallowance against freebies given to doctors and uniform treatment for effective date from which such payments, as prohibited against law or not related to business, were disallowable. Audit noticed 36 cases in 07 States in which the AO had allowed the expenses which were in the nature of freebies given to Doctors involving tax effect of ₹ 55.10 crore.

23. When asked about the reasons for allowing expenses which were in the nature of freebies given to doctors in 36 cases in seven States, involving tax effect of ₹ 55.10 crore, the Ministry replied as under:

"As per the clarificatory circular of CBDT No. 5/2012 dated 01.08.2012, any expenditure incurred by an entity engaged in pharmaceuticals business in providing gifts, travel facilities, hospitality, cash or monetary grant (termed as freebies) which is prohibited by The Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations 2002 as amended on 10.12.2009 (the MCI guidelines) is not an allowable business expenditure under the Act. The AOs

are required to duly take into consideration the above position of law. Therefore, from policy perspective, no specific intervention is required. However, if any lapse has occurred on the part of the AO, adequate provisions exist for taking necessary remedial measures. In specific cases pointed out by the C&AG the action is being taken separately."

24. In regard to the action initiated against the concerned Assessing Officers who have violated the CBDT circular of 2012, the Ministry stated that directions have been issued to the Chief Commissioners of Income Tax to issue advisory to the officers concerned in suitable cases.

VIII Breakup of expenditure on freebies/gifts not taken from sales promotion expenses

25. Pharmaceutical companies routinely incur expenses on freebies and gifts to the medical professionals. Hence, during scrutiny assessment proceedings, the AOs seek break up of sales promotion expenses, identify expenses on freebies and disallow the same. By not doing so, such expenses are allowed as a part of sales promotion expenses. Despite the fact that such prohibited expenses by Pharmaceuticals companies to Doctors are a routine industry practice, the AOs did not disallow expenses on freebies by seeking details of such expenses under the head sales promotion expenses. Audit noticed 11 cases in Uttaranchal and Maharashtra in which the AOs had allowed the expenses on freebies given to Doctors included in sales promotion without examination of the detailed breakup.

26. As regards the steps taken to evolve a mechanism for the assesseees to provide details of expenditure in the nature of freebies under sales promotion expenses for claiming the deduction, the Ministry in their written replies stated as under:

"The assesseees are reporting such expenses in their Profit & Loss account under the head "Sales Promotion" which is a part of the mandatory Audit Report attached with the Return of income filed. During the course of scrutiny proceedings detailed examination of these expenses is carried out, and if any expenditure is not in accordance with the MCI guidelines the same is disallowed and added back to the taxable income of the taxpayer."

Section - B - Compliance issues in Pharmaceutical Sector

IX Allocation of R&D/other common expenses

27. Section 37 of the Act provides for the deduction of business expenses from the income of the assessee, to arrive at the gross profit. Depending upon the benefit accrued

from any expense to a specific unit or more than one unit or all the units of the assessee, the particular expense is required to be allocated to the beneficiary unit(s) either on actual basis or on the basis of their sales turnover ratios. Audit noticed 15 cases in Andhra Pradesh, Maharashtra and Tamil Nadu in which the AOs had allowed the allocation of common and R&D expenses without proper examination of the same involving tax effect of ₹ 121.21 crore. This indicated that the ITD has not put in place a foolproof system to ensure that common expenses or weighted deductions from R&D, which the exempted / non exempted units and multi locational units benefit from, were allocated properly to all the beneficiary units and undue exemptions/deductions /concessions were not claimed.

28. On being asked as to how the Ministry will ensure that allocation of all common expenses or weighted deduction has been done correctly and what mechanism has been evolved to avoid such incidents in future, the Ministry stated as follows:

"With effect from 01.07.2016, CBDT has made substantial changes in Rule 6 of Income-tax Rules, 1962 so that possibilities of recurrence of lapses as pointed out by the Audit are minimized. The amended Rule would enable the Department to keep a track on claim of weighted deduction by the concerned taxpayer and whether the conditions subject to which approval was allowed to it are being fulfilled or not. These can be summarized as under:

i. The Prescribed Authority i.e. Secretary, DSIR is required to submit its report in Form No. 3CL electronically to the concerned jurisdictional Pr.CCIT/CCIT/Pr.DGIT/DGIT. Earlier, in all cases, report of DSIR was to be submitted manually to the Principal DGIT(Exemptions) who was not the jurisdictional Income-tax Authority in many of such cases and hence, there was a possibility that these reports/approval did not reach the correct jurisdiction. The new provision, therefore, ensures proper transmission of the report to enable verification of claim of weighted deduction, if required, under section 35(2AB) of the Income-tax Act made by the taxpayer in the return of income.

ii. Post approval of DSIR, the concerned taxpayer is required to submit a duly audited report, electronically, in Form No. 3CLA to the Secretary, DSIR within the timeframe prescribed under the Act for filing return of income under section 139(1) of the Act, unlike earlier, when a manual report was to be submitted to the Secretary, DSIR by 31st October of each year. This change would enable DSIR to keep a proper track of compliance requirements being fulfilled by the concerned taxpayer. In case of possible infringement, the same would also get reported to the Income-tax Department quickly in electronic mode."

29. As regards the steps initiated to indicate the basis of allocation of common expenses in the assessment records, the Ministry stated as under:

"As per Rule 6 in the Income Tax Rules, the Secretary DSIR is the prescribed Authority, who shall furnish the certificate in Form 3CL regarding R&D expenses, on the basis of which these expenses shall be allowed in the assessments. This

form is to be sent by the Secretary DSIR electronically within a prescribed limit to the jurisdictional authority."

X Allowance of concessions/deductions/rebates/relief

30. Audit noticed 26 cases in 13 States in which the AO had allowed the concessions/deductions/rebates/relief without proper examination of the same involving tax effect of ₹158.89 crore. Thus, the ITD was not having a system of inbuilt checks to ensure that deductions /concessions/exemptions/rebates/relief are thoroughly scrutinized before being allowed by the AOs.

31. Apprising the Committee about the specific reasons for such mistakes, the Ministry submitted that:

"The mistakes are unintentional, due to oversight, heavy pressure of work, and time limitation of completing large number of assessments. The mistakes are corrected through appropriate remedial actions as soon as they come to the notice of concerned assessing officer."

32. In order to avoid such lapses in future, the Ministry stated that:

"The assessing officers are imparted training regularly where they are sensitized on such issues. Regular courses are conducted by the National Academy of Direct Taxes, Nagpur, and the Regional Training Institutes to the assessing officers, wherein all issues on assessments are exhaustively covered. Recently CBDT has also initiated the exercise to revise all the existing Manuals on different subjects, including Audit Manual 2011. The Committee for Review of Audit Manual has to submit its report by 31.01.2018."

XI Setting off/carry forward of depreciation/business loss/capital loss

33. Audit noticed in 28 cases in 11 States in which the AO had allowed business expenditure in contravention to the laid down provisions involving tax effect of ₹ 27.77 crore. This indicated that the AOs allowed setting off/carry forward of depreciation/business loss/capital loss without doing proper scrutiny of the details available / required for the purpose, which was in contravention of the provisions of the Act.

34. While furnishing their justification in this regard, the Ministry stated as follows:

"The carry forward/set-off of earlier year business losses/depreciation losses is allowed after verification from earlier years records. Sometimes, the earlier years records are not readily available, as they are sent in appeal proceedings, and in such situations the losses claimed by the assessee are likely to be allowed. This has to be avoided. Also due to excessive workload or as a result of oversight such mistakes do take place. The same are rectified the moment they are brought to the notice of the Department."

PART II

OBSERVATIONS AND RECOMMENDATIONS

1. Indian Pharmaceuticals Industry has witnessed a robust growth over the past few years. The industry ranks 3rd in terms of volume and is 14th in terms of value globally thereby accounting for around 10 per cent of world's production by volume and 1.5 per cent by value. It has shown tremendous progress in terms of infrastructure development, technology base creation and a wide range of products. It has established its presence and determination to flourish in the changing environment. The industry now produces bulk drugs belonging to all major therapeutic groups requiring complicated manufacturing technologies. This has resulted in a robust growth since the beginning of the 11th Plan in 2007 from about ₹ 71,000 crore to over ₹ 1,21,015 crore in 2012-13 comprising some ₹ 65,323 crore of domestic market and exports of over ₹ 55,692 crore , thereby making it a vital economic sector with corresponding potential for Government revenue. Considering the robust growth in pharmaceutical industry in the last four years and the Government support in the form of fiscal incentives i.e. deduction against business profits in the Income Tax Act and concessional rate of excise duties and State VAT, Audit felt it appropriate to select Pharmaceutical sector for performance evaluation to seek assurance that exemptions and deductions allowable to Pharmaceuticals Sector under Income Tax Act, 1961 (Act) have been allowed as per entitlement and there exists a proper machinery to exercise necessary checks/controls in the area of probable misuse of the provisions relating to tax concessions.

2. The performance Audit Report No. 5 of 2015 of C&AG on "Assessment of Assesseees in Pharmaceuticals Sector" and the Committee's examination of the issues have revealed plethora of deficiencies in systemic issues as well as compliance issues relating to assessment of assesseees in Pharmaceuticals sector. It contains (i) ITD did not maintain data of incentives given to the Pharmaceuticals Sector and hence the impact of such incentives could not be assessed. The ITD also did not maintain database of the assesseees in the Pharmaceuticals sector ignoring its importance for planning and decision making. Hence, the Audit could not assess the impact of revenue foregone in growth of the industry; (ii) In 22 cases in six States involving tax effect of ₹ 570.59 crore where

weighted deduction on expenses towards R&D was allowed without verifying the claims from the form 3CL/3CM issued by Department of Scientific & Industrial Research (DSIR) or from the website of DSIR who is the competent authority to grant approval of such claims; (iii) The assesseees have not paid TDS by taking advantage of exclusion clause of Section 194C in respect of contract manufacturers by treating these contracts as supply contracts; (iv) In 17 cases involving tax effect of ₹ 8.51 crore where assesseees took advantage of ambiguous provisions related to salary and interest payment to its partners by not providing the same in the partnership deed and thereby taking undue benefit of Section 80IC deduction; (v) ITD does not have any mechanism to correlate and verify, carried forward of losses/depreciation especially of the unit availing 80IC deductions. ITD also does not have any mechanism to correlate and verify the turnover declared in Income Tax returns with the turnover declared in Central Excise returns which is part of the same Ministry; (vi) In 36 cases involving tax effect of ₹ 55.10 crore in seven States where the expenditure towards gifts/freebies to medical professionals were allowed despite being prohibited by law/not related to business; (vii) In 171 cases in 17 States involving tax effect of ₹ 714.24 crore, of general nature, which included mistakes in allowing business expenditure, R&D expenses, and allocation of such expenses among the units benefitting from such research and development, inconsistency in assessments, arithmetical errors etc; and (viii) There are systemic issues such as need for evolving a system of sector-wise data for tax planning, misuse of the ambiguities in the legal provisions/lacunae in the Act, lapses by the ITD. These irregularities involving tax effect of hundreds of crore of rupees have been examined by the Committee in detail in the succeeding Paragraphs.

Non-maintenance of Sector-wise/Industry-wise data

3. The Committee are constrained to observe that ITD did not maintain sector-wise/industry-wise data of assesseees engaged in Pharmaceuticals sector. Thus, in absence of sector/trade wise data, the Committee would not be able to analyse the various aspects relating to policy formation, revenue foregone in this sector, contribution of such sector in tax revenue and whether the contribution of such sector is in tune with their growth etc. In this regard the Committee have been informed by the Ministry that the sector-wise data can be obtained using nature of business code available in the respective Income Tax Return (ITR). The Ministry

have further informed that it may not be possible to fully isolate only the Profit and Loss (P&L) account and Balance sheet for a pharmaceutical division/unit/line in a diversified company. They further informed that the assessing officers/field formations monitor the advance tax payment of big tax payers in their charge which also include entities from Pharmaceuticals sector. The Ministry submitted that sector specific data is captured in the ITR Form subject to certain constraints and capturing further data would lead to complexity in Return Forms and shall hamper ease of doing business. The Committee view seriously of the scant attention paid by the Income Tax authorities in the compilation of such vital data having large repercussion and loss in the collection of tax from Pharmaceutical sector. It is astonishing that such an important area involving substantial revenue to the national exchequer was left ignored by non-maintenance of reliable data of tax payers in this sector. During evidence Secretary revenue stated that "if it is specifically required we can find it out". The Committee have further been informed during evidence that the Ministry are starting a new project called 'insight' from next year, which is exclusively meant for data mining. The Committee would like to be apprised of the present status of commissioning of this project and recommend that henceforth a comprehensive data of Pharmaceuticals sector be maintained not only for helping in tax planning and making sector specific policy but also for proper accounting and collection of the taxes from this sector. The Committee, also desire the Department of Scientific and Industrial Research and National Pharmaceutical Pricing Authority to capture PAN details of the sector to facilitate its linking with ITRs.

Allowance of R&D expenditure without approval from Department of Scientific and Industrial Research (DSIR)

4. The Committee find 22 cases in six States involving tax effect of ₹ 570.59 crore where weighted deduction on expenses towards R&D was allowed without verifying the claims from the Form 3C/3CM issued by Department of Scientific and Industrial Research (DSIR) who is the competent authority to grant approval of such claims. The Committee further notice that due to date of filing of return preceding the date of approval of R&D expenditure, as claimed in the return, by DSIR, such claims are allowed by the ITD before/without its approval. In this regard, the Committee have been apprised that with effect from 01.07.2016, CBDT has made substantial changes in Rule 6 of Income-Tax Rules, 1962 which would

enable the Department of Revenue to keep a track on claim of weighted deduction by the concerned tax payer and whether the conditions subject to which approval was allowed to it, are being fulfilled or not. The new provision also ensures proper transmission of the report to enable verification of claim of weighted deduction, if required, under section 35 (2AB) of the Income-Tax Act made by the taxpayers in the return of income. So, henceforth, there is no chance of allowing any deduction like this before getting the DSIR Report. On being asked as to why the industrialists are keen to take tax incentives in case of R&D sector, the representative of the Ministry replied during evidence that they have to phase out those deductions and from 2021 it would be actual expenditure, which is done on that particular item. The Committee trust that Government would make an in-depth study before phasing out these deductions from 2021 and take further measures, legal or procedural as might be necessary to effectively deal with this issue. The Committee would also like to be apprised of the action taken against the assessing officers who allowed weighted deduction on expenses towards R&D without verifying the claims from the Form 3CL/3CM issued by DSIR in the aforesaid 22 cases resulting in loss to the exchequer to the tune of ₹ 570.59 crore.

Deduction of TDS in respect of contract entered by assessee company with a manufacturing company for manufacture of products

5. Section 194C of the Act provided for deduction of TDS at the rate of two percent from the payment to the contractor for carrying out any work in pursuance of a contract between the contractor and an assessee. The Committee are constrained to observe that the Pharmaceutical companies, by just not supplying raw materials directly to the contract manufacturers, treated such contracts as supply contracts and did not pay TDS taking advantage of exclusion clause of Section 194C. Since entire control of manufacturing process remained with the Pharmaceutical companies which made it akin to works contract only, attracting TDS, the Audit recommended that the CBDT should consider issuing instructions to bring under the ambit of section 194C of the Act such work contracts where the entire control of manufacturing process vests with the assessee companies. In reply thereto, the Ministry stated (January 2015) that implementation of C&AG suggestion would require legislative change in Section 194C as it is possible that some assessees may take advantage of the definition of work contract as defined in Section 194C. The Committee are surprised at this complacent approach of the

CBDT. The Committee are distressed to note that despite being pointed out the issue by the C&AG way back in 2015, no concrete steps have been taken thus far by the Ministry in this direction. Since a large number of potential tax payers can be identified in the Pharmaceutical sector, non-deduction of TDS in these cases resulted into huge revenue loss to the exchequer. Since the case pointed out by the Audit are only test checked and only tip of the iceberg, the net tax effect would be much detailed audit examination is done. The Committee, therefore, recommend that the Ministry should take legal advice on the matter and amend the Section 194C of the IT Act, if required, at the earliest besides issuing clear instructions to ensure that the Pharmaceutical companies deduct the TDS on payments to contract manufacturers.

Mechanism for cross verification of turnover declared in Income Tax Return with the turnover declared in Excise Return

6. Manufacturers paying more than one crore rupees as Central Excise duty are required to file annual information in Form ER4 under Rule 12 (2)(a) of the Central Excise Rules, 2002. As the Central Excise and ITD both belong to the Ministry of Finance, ITD should have correlated/link the turnover of the assessee claiming exemptions/deductions as declared in Income Tax records (viz 10CEB) with that of ER-4 for deepening the tax base. However, the Committee are shocked to note that in 14 States there was no mechanism with the ITD to cross-verify the turnover declared in ITR with the turnover declared in Central Excise Return. The Committee are, therefore, of the view that in the absence of such cross-verification of turnover, possibility of revenue leakage in the form of incorrect deduction claimed under the provisions of the Act cannot be ruled out. In this regard, the Committee have been informed that in cases under scrutiny, the Assessing Officer, depending on specific requirements of the case can also call such information from the concerned assessee or may verify it independently from the concerned Excise authorities. The Ministry have further stated that compulsory furnishing such forms by assessee will only increase the compliance burden of the assessee which will increase compliance cost and create unnecessary hurdles for voluntary compliance and ease of doing business. The Committee are dismayed at this unfortunate state of affairs in the Department entrusted with the responsibility of collecting due tax revenue from the assessee. However, the Committee have been apprised that an MOU was entered into with CBEC on

30.11.2015 on exchange of information. The details of ER-4 are now being obtained from CBEC, wherever required the Excise turnover as per ER-4 and turnover as per profit and loss account of Income-Tax return are being compared. While welcoming the steps taken in this direction by the Ministry, the Committee hope that these steps will ensure in deepening the tax base of pharmaceutical sector. The Committee would like to be apprised of the outcome of such steps initiated by the IT Department way back in the year 2015.

Allowance of expenditure towards gifts, freebies etc to Medical Professionals

7. The Committee observe that as per explanation to Section 37 (I) of the Income Tax Act, any expenditure for a purpose which is an offence or which is prohibited by law is not an allowable business expense. Medical Council of India (MCI) vide its regulations of 2002 provided that medical practitioners should prescribe generic drugs as far as possible. It, inter-alia, prohibited them to solicit or receive any commission, gifts etc. for any approval or recommendation, endorsement of any medicine or drug for advertisement purpose or for referring or recommending any patient any medical, surgical or other treatment. Further, vide amendment dated 10 December 2009, Pharmaceutical companies were specifically prohibited to give any consideration in the nature of gifts, travel facilities, hospitality, cash or monetary grants etc. CBDT issued a circular in 2012 and disallowed such expenses. The Committee are constrained to observe that in 36 cases, involving tax effect of ₹ 55.10 crore in seven States where the expenditure towards gifts/freebies to medical professionals were allowed despite being made irregular by the Income Tax Act, Medical Council of India regulations, CBDT/Judicial pronouncement etc. Out of 36 cases, the Committee find 21 cases in five States (Gujarat, Karnataka, Maharashtra, New Delhi, Tamil Nadu) in which the AO had allowed the expenses which were in the nature of freebies given to doctors involving tax effect of ₹ 45.43 crore. Further, in 11 cases in Uttaranchal and Maharashtra the AOs had allowed the expenses on freebies given to doctors included in sales promotion without examination of the detailed breakup. The Committee also noticed three cases in Maharashtra in which the AO had allowed the expenses on Physician samples given free to doctors involving tax effect of ₹ 1.57 crore. Again, in one case in Andhra Pradesh the AO had allowed the expenses on the penalty levied by National Pharmaceutical Pricing Authority (NPPA)

involving tax effect of ₹ 8.10 crore. The Committee are failed to find any specific reasons for allowing such expenses for tax deduction. The Committee have been informed that directions have been issued to the Chief Commissioners of Income Tax to issue advisory to the officers concerned in suitable cases. However, the Committee find that no penal action was initiated against any of these officers who have failed in their duty. From the information made available to the Committee it is seen that the disciplinary actions are proposed to be taken against the AOs only. The Ministry have not offered any explanation on the role of delinquent senior officers. The Committee desire that the Ministry should initiate exemplary disciplinary action against the junior as well as senior officers connected with the lapses so that the principles of accountability and responsibility are applied in letter and spirit. Further, the Committee are of the opinion that the assesseees would not have succeeded in their efforts in defrauding the Government without the connivance of certain departmental officers. While deploring such an unhealthy practice in the Income Tax Department, the Committee recommend that not only the cases highlighted by the Audit but also similar such cases in the field should be thoroughly inquired into so as to find out as to how and why such lapses occurred, to what extent they were bonafide mistakes and exemplary stern action taken against the officers concerned. The Committee are perturbed to note that the AOs are taking divergent views for disallowance of expenses in the nature of freebies as CBDT has not clearly specified in its circular the effective date of disallowance of such expenses. Since the failure to mention the effective date in the circular by the CBDT led to divergent views of the AOs on a same issue result in litigation and finally to loss of revenue, the Committee desire that the Ministry should take immediate corrective action in this regard.

Compliance issues in Pharmaceutical Sector

8. The Committee observe the deficiencies in applying the provisions of the Income-Tax Act and relevant rules/judicial pronouncements by the AOs during assessment of assesseees in Pharmaceuticals sector. The Committee noticed 171 cases, in 17 States where the provisions of the Act were not followed correctly results in a tax effect of ₹ 714.24 crore. Broad categories of mistakes in assessment included allocation of R&D/Common expenses, allowance of concessions/exemptions/deductions/rebate/relief, setting off of carry forward business loss/depreciation, allowance of business expenditure/R&D expenses,

allowance of expenses on which TDS was not deducted/deposited, inconsistency in assessment, arithmetical errors in computation of income and tax, assessment of income under special/normal provisions, classification and computation of capital gains and irregularities in International Transactions. According to the Ministry the mistakes are unintentional, due to oversight, heavy pressure of work and time limitation of completing large number of assessments and the same are rectified the moment they are brought to the notice of the Department. The Committee have further been apprised that the assessing officers are imparted training regularly where they are sensitized on such issues. Besides, CBDT has also initiated the exercise to revise all the existing Manuals on different subject, including Audit Manual 2011. The Ministry while attributing several reasons for irregularities in the aforesaid cases, have not explained the lapse on the part of Internal Audit Wing in not having detected these cases themselves. The Committee exhort the Ministry to look into the reasons for failure on the part of the Internal Audit Wing for detecting such lapses leading to huge revenue loss to the exchequer and take suitable steps so as to ensure that this Wing perform efficiently in exercising effective control to find out mistakes in assessment and thereby to prevent leakage of revenue. The Committee would, therefore, like to be apprised of the action taken by the Ministry in this regard within 6 months of the presentation of this report.

NEW DELHI;
February, 2019
Magha, 1940 (*Saka*)

MALLIKARJUN KHARGE
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