सत्यमेव जयते

Report of the Comptroller and Auditor General of India

Assessment of Assessees in Pharmaceuticals Sector

Union Government
Department of Revenue - Direct Taxes
Report No. 5 of 2015

Report of the
Comptroller and Auditor General of India

for the year ended March 2014

Performance Audit
on
Assessment of Assessees in
Pharmaceuticals Sector

Union Government
Department of Revenue - Direct Taxes
Report No. 5 of 2015

Laid on the table of Lok Sabha / Rajya Sabha on .....

Table of Contents

Preface

This Report for the year ended March 2014 has been prepared for submission to the President under Article 151 of the Constitution of India.

The Report contains significant results of the performance audit of Assessment of Assessees in Pharmaceuticals Sector of the Department of Revenue – Direct Taxes of the Union Government.

The instances mentioned in this Report are those, which came to notice in the course of test audit for the period 2010 to 2014 conducted during June to September 2014.

The audit has been conducted in conformity with the Auditing Standards issued by the Comptroller and Auditor General of India.

Audit wishes to acknowledge the cooperation received from the Department of Revenue - Central Board of Direct Taxes at each stage of the audit process.

Executive Summary

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. Government 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. It is important to ensure that such fiscal incentives given to this sector under the Act are allowed as per prescribed conditions and seek assurance that proper machinery to exercise necessary checks/controls in the area of probable misuse of these provisions relating to tax concessions exists and operates effectively.

We conducted Performance Audit on "Assessment of Assessees 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 (c) the allowance of deduction of Research and Development expenditure to the assessees in Pharmaceuticals Sector has contributed to the growth in industry as well as in tax revenues.

The Performance Audit covered assessments completed during the period from 2010-11 to 2013-14 and up to the date of audit (September 2014) of assessees dealing in Pharmaceuticals sector. In case of major audit observations assessment records of previous assessment years were also checked/linked wherever found necessary. We held an entry conference with CBDT in July 2014 wherein we explained the audit objectives, scope and the main focus areas of audit examination.

We requisitioned 3,432 assessment records from the assessment units of the Income Tax Department (ITD) located all over India. However, the ITD produced and we audited 2,868 assessment records (83.57 *per cent*). This report contains 246 cases where we have pointed out deficiency in the system or in the compliance with the laid down provisions involving total tax effect of ₹ 1,348.44 crore.

We found that the 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 assessee in the Pharmaceuticals sector ignoring its importance for planning and decision making (Para 2.2 – 2.3).

We noticed in 22 cases in six states[1] 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 DSIR or from the website of DSIR who is the competent authority to grant approval of such claims. We further noticed 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. We further noticed that the assessees 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 (Para 2.4 - 2.6).

We pointed out in 17 cases involving tax effect of ₹ 8.51 crore where assessees 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. We also noticed that ITD does not have any mechanism to correlate & verify carried forward of losses/depreciation especially of the unit availing 80IC deductions. ITD also does not have any mechanism to correlate & verify the turnover declared in Income Tax returns with the turnover declared in Central Excise returns which is part of the same Ministry (Para 2.7 to 2.9).

We noticed in 36 cases involving tax effect of ₹ 55.10 crore in seven States[2] where the expenditure towards gifts/freebies to medical professionals were allowed despite being prohibited by law/not related to business (Para 3.1.1-3.1.4).

We also pointed out in 171 cases in 17 States[3] 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, irregularities pertaining to international transactions, arithmetical errors etc (Para 3.2).

With a view to streamline the assessment of assessees in the Pharmaceuticals sector, we have made recommendations relating to systemic issues, misuse of the ambiguities in the legal provisions / lacuna in the Act, lapses by the ITD which are placed under "Summary of Recommendations" and at the end of each chapter.

1 Maharashtra, Delhi, Tamil Nadu, Andhra Pradesh, Bihar, Karnataka

2 Andhra Pradesh, Gujarat, Karnataka, Maharashtra, New Delhi, Tamil Nadu and Uttaranchal

3 Andhra Pradesh, Assam, Goa, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Madhya Pradesh, New Delhi, Pudduchery, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, West Bengal.

Summary of Recommendations

With reference to Systemic issues relating to Pharmaceuticals Sector

1. CBDT may maintain the sector-wise data of assessees to which various tax incentives have been prescribed under the Act.

(Paragraph 2.3)

The Ministry stated (January 2015) that considering the large number of taxpayers availing various incentives under the Act, it may not be feasible to segregate/identify the data regarding various tax-incentives sector-wise in an accurate manner. The Ministry also stated that the data is mainly captured from the business code filled in the return by the assessees who are engaged in several businesses and there is possibility that the assessee may fill incorrect code. However, revision in the business code is under consideration.

Audit is of the view that the maintenance of sector wise data is necessary for tax planning and sector specific policy by the concerned Departments of Government of India. Hence, there is a need of evolving a system of sector wise data. For this purpose, DSIR and NPPA may be requested to capture PAN details to facilitate the linking with ITRs.

2. The Ministry may develop a mechanism so that the copy of Form 3CM/3CL duly approved by DSIR are invariably attached with the ITR. The Ministry may also prescribe the date of forwarding of approved Form 3CL by DSIR to DGIT (Exemptions) to precede the due date for filing the ITR.

(Paragraph 2.4)

The Ministry while explaining the system of approval of R&D expenditure by DSIR stated (January 2015) that the current scheme was designed in the pre computerised era and agreed to re-examine the issue.

Audit while agreeing with the reply of the Ministry, further suggested that approval of DSIR available with DGIT (Exemption) should be considered to be linked with ITR.

3. CBDT may 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.

(Paragraph 2.6)

The Ministry stated (January 2015) that implementation of C&AG suggestion would require legislative change in Section 194C as it is possible that some assessee may take advantage of the definition of work contract as defined in Section 194C. It further stated that a reference is being separately made to TPL Division for examination during budgetary exercise for 2015-16.

Audit is of the view that it is necessary to ensure that the Pharmaceutical Companies deduct the TDS on payments made to contract manufacturers. Ministry may, therefore decide to take appropriate decision to achieve this objective.

4. ITD may develop a mechanism to collect/receive information related to assessment available with other tax department and use it to deepen the tax base and bring the correct income to the tax-net. Alternatively the AIR in Form ER 4 should compulsory be called for from an assessee who is availing turnover based deductions under the provisions of the Act.

(Paragraph 2.9)

With reference to Compliance issues relating to Pharmaceuticals Sector

5. CBDT may issue instruction to clarify the nature of expenses to be treated as freebies including physician's samples. Further, a suitable mechanism may be devised for the assessees claiming deduction of such expenses, to provide details of expenses in the nature of freebies from the sales promotion expenses.

(Paragraphs 3.1.1-3.1.3)

The Ministry stated (January 2015) that what constitutes 'Freebies' is prescribed in guidelines of the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, as amended on 10th December, 2009, and therefore, any alteration/addition/deletion in the said guidelines can only be effected by that body. The Ministry further stated (January 2015) that in each case issue is decided by the AO on its merits and remedial action is available with AOs. The Ministry further stated that making details of expenses in the nature of freebies in ITR will make it bulky.

Audit is of the view that the AOs are taking divergent views due to lack of clarity in the CBDT instructions in this regard therefore, the Ministry may take appropriate action so that AOs take consistent action in future.

6. CBDT may clearly specify the effective date of disallowance of expenses towards freebies to put the disputed and varied interpretations in this regard to rest.

(Paragraph 3.1.1)

The Ministry stated that the circular of CBDT dated 01 August 2012 was merely clarificatory in nature and AOs make any disallowance of freebies on the basis of existing/amended guidelines of MCI and no intervention is required on this issue.

Audit is of the view that absence of effective date in the circular may lead to divergent views of the AOs and finally lead to litigation. Therefore, the date from which the instructions of the CBDT will be effective should be specifically mentioned in every instruction/circulars i.e. prospective or retrospective.

7. The Ministry may introduce a standard form, to be filed either with return or with the assessment records, indicating allocation of all common expenses or weighted deductions alongwith the basis and working of such allocation.

(Paragraph 3.2.1)

The Ministry stated (January 2015) that this is a compliance issue and is to be dealt with on case to case basis. AOs are empowered to call for all such details during the scrutiny assessments.

Audit is, however, still of the view that there is a need to indicate the basis of allocation of common expenses in the assessment records.

8. The Ministry may adhere with the conditions of the DSIR in general and submission of audited accounts of the R&D facility with the return filed by the assessee in particular at the time of assessment to see the eligibility of R&D expenses and quantification thereof.

(Paragraph 3.2.5)

The Ministry stated (January 2015) that DSIR would be consulted for revision of the existing format of audit certificate for capturing information like allocation of expenses etc from the view point of Income-tax proceedings. The Ministry further stated (January 2015) that the feasibility of e-enabling the audit certificate for filing will also be examined by the ITD.

Chapter I: Introduction

1.1 Introduction

Indian Pharmaceuticals Industry has witnessed a robust growth[4] 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. Globally, it ranks 4th in terms of generics production and 17th in terms of export value of bulk actives and dosage forms. Indian exports are destined to more than 200 countries around the globe including highly regulated markets of US, West Europe, Japan and Australia.

The annual turnover of the Indian Pharmaceutical Industry vis-a-vis share of export of Drugs, Pharmaceuticals and Fine Chemicals for the last four years ending 31 March 2013 is given below.

Table 1.1: Annual Turnover vis-a-vis Export

(₹ in crore)

Year	Total Turnover	Export	Percentage of Export over Turnover
2009-10	1,04,209	42,154	40.45
2010-11	1,04,944	47,551	45.31
2011-12	1,19,076	47,363	39.78
2012-13	1,21,016	55,693	46.02

Source: Annual Reports for the years 2010-11 to 2013-14, Government of India, Ministry of Chemical and Fertilizers and Department of Pharmaceuticals.

The 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 realized through the country's strengths in organic chemicals' synthesis and process engineering. Due to this, there is demand from both domestic as well as international markets. This has resulted in a robust growth since the beginning of the 11th Plan in 2007 from about ₹ 71,000 crore to over

4 Increase of turnover of approx. US $ 1 billion in 1990 to US $ 20 billion in 2010 of which the export turnover is approximately US $ 8 billion (as per reports of Department of Pharmaceuticals)

₹ 1,21,015 crore in 2012-13 comprising some ₹ 65,323 crore of domestic market and exports of over ₹ 55,692 crore[5], thereby making it a vital economic sector with corresponding potential for Government revenue.

1.2 Why we chose the topic

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, we 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.

Previously, we have conducted a performance evaluation on the working of companies in Pharmaceutical Sector in the year 2001[6] in which we had raised issues pertaining to compliance issues of the Act. However, Public Accounts Committee did not select this report for discussion. The present review was selected to seek assurance on compliance aspect of the Act as well as systemic issues relating to assessment of assessee of Pharmaceuticals Sector.

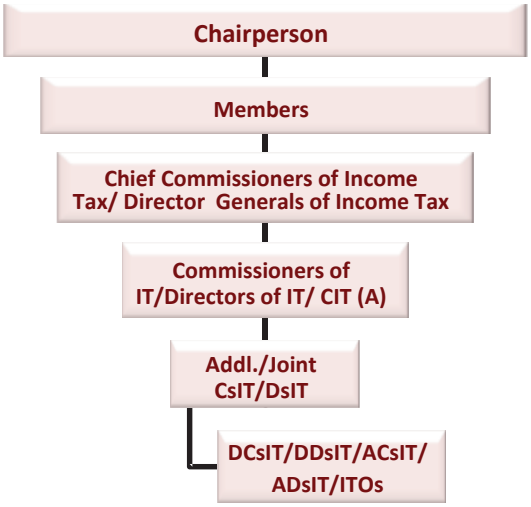
1.3 Organizational set up

Central Board of Direct Taxes (CBDT), as a part of Department of Revenue, Ministry of Finance, is the apex body charged with administration of Direct Taxes. CBDT is headed by the Chairperson and comprises of six Members. In addition to functions and responsibilities, the Chairperson and Members are responsible for exercising supervisory control over field offices of the CBDT, known as Zones. In scheme of reorganization Principal Chief Commissioner of Income Tax (PCCIT) is the Cadre Controlling Authority of each zone whose jurisdiction is generally co-terminus with state. Organogram of CBDT showing the hierarchy of various formations is shown in Graph 1.1

5 Planning Commission Working group on Drugs and Pharmaceuticals

6 Report of the Comptroller and Auditor General of India for the year 2001-02 (Report No.13 of 2003-Direct Taxes)

Graph 1.1 Organogram of CBDT



1.4 Legal Provisions

Pharmaceutical industry is mainly R&D oriented industry and many of its units are located in certain special category States. Also, there has been significant increase in the exports by the industry over the years. The assessees engaged in the Pharmaceuticals Sector are governed by all the provisions of the Act which are applicable to the assessees. However, these assessees are mainly availing deductions under Section 35(1)(iia), 35(2AB), 10B and 80IC which are briefly discussed in the table below:

Section 35(1)(iia)	A deduction of 125 *per cent* of any sum paid to a company to be used by it for scientific research subject to fulfilment of prescribed condition.
Section 35(2AB)	A deduction of 200 *per cent* of the expenditure incurred by the company engaged in the business of bio-technology or in any business of manufacture or production of any article or thing, not being an article or thing specified in the list of the Eleventh Schedule on scientific research (not being expenditure in the nature of cost of any land or building) on in-house research and development facility as approved by the Secretary, Department of Scientific & Industrial Research (DSIR), Government of India.
Section 10B	Deduction of profit and gain derived by a 100 *per cent* export oriented undertaking from the export of article or things or computer software subject to the fulfilment of prescribed condition.
Section 80IC	In computing the total income of the assessee, a deduction of profits and gains as specified in sub-Section (3) shall be allowed, where the gross total income of an assessee includes any profits and gains derived by an undertaking or an enterprise from any business referred to in sub-Section (2) in accordance with and subject to the provisions of this Section.

Assessees of Pharmaceuticals Sector apart being governed by the Act for tax purposes, are also regulated by bodies like Medical Council of India and National Pharmaceuticals Pricing Authority and Department of Scientific and Industrial Research. We have also correlated the guidelines/instructions issued by the above bodies/Department with instructions issued by CBDT in conducting the present Performance Audit.

1.5 Audit Objectives

The review is intended to focus on

a. Whether the exemptions and deductions allowable to Pharmaceuticals Sector have been allowed as per entitlement.

b. Whether the administrative and procedural adequacy for taxation of Pharmaceuticals Sector exists.

c. Whether the deduction of Research and Development (R&D) expenditure to the assessees in Pharmaceuticals Sector has contributed to the growth in industry as well as in tax revenues.

1.6 Audit Scope

The Performance Audit covered assessments completed during the period from 2010-11 to 2013-14 and up to the date of audit of (September 2014) assessees dealing in Pharmaceuticals sector. In case of major audit observations assessment records of previous assessment years were also checked/linked wherever found necessary.

1.7 Sample Size

We filtered and segregated data provided by Director General of Income Tax-(System) in respect of Pharmaceutical assessees and Demand & Collection Register (D&CR) of the selected assessing charge. Within the selected units, we selected all cases of scrutiny assessments pertaining to assessees in Pharmaceuticals sector for this Performance Audit. We requisitioned 3,432 assessment records from the assessment units of the Income Tax Department (ITD) located all over India. However, the ITD produced and we audited 2,868 (83.57 *per cent*) assessment records.

1.8 Audit Constraints

The ITD was not having separate database for identification of sector wise assessees. This hampered the selection of the assessment records of assessee engaged in the Pharmaceuticals Sector. As a result of this sample size was restricted to the extent of data available with the ITD and assessee identified by

the audit from Demand and Collection Register maintained by the respective Assessing Officer (AO) and data received from the DGIT (Systems) which was also not complete. Therefore, some of the significant cases related to the Pharmaceuticals Sector may remain out of coverage from the scope of audit in the absence of details.

1.9 Acknowledgement

We acknowledge the cooperation of ITD in facilitating the audit by providing necessary records and information in connection with the conduct of this Performance Audit. An entry conference with CBDT was held on 11 July 2014 wherein audit objectives, scope of audit and the main focus areas of audit examination were explained.

We issued draft report to the Ministry in December 2014 for their comments. After receipt of the Ministry's reply in January 2015, we held exit conference on 15 January 2015 to discuss our findings and recommendations vis-a-vis the Ministry's comments. We again issued draft report in January 2015 containing Ministry's views and audit stand thereon for their further comments. We received further comments from the Ministry on 29 January 2015 which has also been appropriately incorporated in the report together with audit comments thereon.

Chapter II: Systemic Issues and Internal Control

2.1 Introduction

Income Tax Act, 1961 (Act) provides for certain specific deductions relating to Pharmaceuticals Sector. We have come across cases where unintended benefits were given to the assessees due to certain provisions of the Act being deficient, unclear and ambiguous. The present chapter deals with systemic issues and internal control/monitoring mechanism by the ITD in dealing with assessees relating to Pharmaceuticals Sector.

ITD did not maintain data of incentives given to the Pharmaceutical Sector, hence audit is not able to assess the impact of revenue foregone in growth of the industry and finally in the fulfilment of objectives behind the incentive.

2.2 Impact of revenue foregone to the pharmaceuticals sector

The primary objective of any tax law and its administration is to raise revenue for the purpose of funding Government expenditure. The amount of revenue raised is dependent upon the collective tax base and the effective tax rates. The determinants of these two factors are a range of measures which include special tax rates, exemptions, deductions, rebates, deferrals and credits. These measures are collectively called as 'tax preferences' or 'tax expenditure'. They have an impact on Government revenues and also reflect a significant policy of the Government.

The receipt budget of Government of India includes a separate budget document titled "Statement of Revenue Foregone". This statement seeks to list the revenue impact of tax incentives or tax subsidies that are part of the tax system. We collected the information regarding the incentives given by the Government on account of revenue forgone by way of Deduction/Weighted deduction for expenditure on scientific research (Section 35 (1), (2AA) & (2AB), Deduction of profits of undertakings set-up in Sikkim, Uttarakhand, Himachal Pradesh (Section 80IC) to the assessees which is given in Table 2.1.

Table 2.1: Revenue forgone from 2006-07 to 2012-13

(₹ in crore)

Year	Revenue forgone under Section 35(1), (2AA) & (2AB) & 80IC	Increase in revenue forgone over the last year	Percentage increase from the last year
2006-07	4,877	--	--
2007-08	7,085	2,208	45.27
2008-09	8,055	970	13.69
2009-10	9,290	1,235	15.33
2010-11	12,354	3,064	32.98
2011-12	13,968	1,614	13.06
2012-13	14,708	741	5.30
2013-14 (projected)	16,443	1,735	11.80
Total	**86,781**		

Source: Receipt Budget for the years 2006-07 to 2012-13

As no information/data were available regarding total tax revenue and revenue forgone on Pharmaceuticals sector in the receipt budget, hence, the information regarding the revenue forgone due to deductions given to Pharmaceuticals sector, monitoring mechanism, impact analysis of the deduction allowed and sector-wise/state-wise data related to the assessee of Pharmaceuticals Sector were sought (August 2014) from CBDT/Department of Revenue.

CBDT has stated (September 2014) that this information pertains to Pharmaceutical industry and the concerned division of CBDT (TPL & ITA) do not maintain such record.

ITD does not have complete sector wise data of assessees of Pharmaceuticals Sector.

2.3 Sector wise data in the ITD

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 assessees but the same could not be provided by the ITD. In absence of jurisdiction wise database of assessees engaged in Pharmaceuticals Sector, audit had to rely on its historical knowledge to find out assessees of the Pharmaceuticals Sector. Audit also obtained data from the Assessment Information System (AIS) maintained by the DGIT (Systems) of the ITD of assessees filing the return under code *'0105- Drugs and Pharmaceuticals'*. Audit 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.

We sought information regarding data of assessees engaged in Pharmaceuticals sector (Manufacturer/Distributors/Stockists) from the Department of Pharmaceuticals under the Ministry of Science and Technology. We also sought (July 2014) to check whether the Directory of Pharmaceutical Manufacturing Units published by National Pharmaceutical Pricing Authority (NPPA) is updated. The reply of the Ministry is awaited (December 2014).

We also sought (August 2014) information regarding data of assessees engaged in Pharmaceuticals Sector from Office of the Drug Control Department (DCD). DCD stated (September 2014) that it is not having any data with respect to PAN, total income, total sales, total Export, Excise Registration number etc., with respect to licenses of Drug Manufacturer and Stockiest/Distributors of NCT of Delhi.

Thus, ITD along with Department of Pharmaceuticals and DCD did not maintain complete sector wise/industry wise data. 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.

ITD allowed weighted deduction on R&D under Section 35 (2AB) of the Act before receipt of approval from DSIR who is the approving authority.

2.4 Allowance of R&D expenditure awaiting approval from DSIR

Approval of expenditure incurred on in-house R&D facility by a company under Section 35 (2AB) includes that the prescribed authority shall submit its report in relation to the approval of expenditure by in-house R&D facility in Form 3CL to the Director General of Income Tax (Exemptions) within sixty days of its granting approval. It is also stipulated that the company shall maintain a separate account for each approved facility, which shall be audited annually and a copy thereof shall be furnished to the prescribed authority by 31 October of each succeeding year. Though DSIR is to submit the Form 3CL to DGIT (Exemption) within 60 days of its granting approval. But it is nowhere mentioned in the guidelines of DSIR that what is the time line to issue Form 3CL.

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 DSIR to 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 (see box 2.1).

Box 2.1: Illustrative cases on R&D expenditure claimed and allowed though approval of such expenditure was not given

Charge	**: CIT II, Delhi**
Assessee	**: Modi Mundipharma Pvt. Limited**
Assessment Year	**: 2011-12**
PAN	**: AAACM2303F**

The assessee claimed and ITD allowed weighted deduction under Section *35(2*AB) of ₹ 3.15 crore in AY 2011-12 completed in January 2014. We 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(2*AB)* before approval of DSIR. Reply is awaited (October 2014).

Thus the ITD allowed weighted deduction before approval of the DSIR. The date of forwarding of approved Form 3CL by DSIR to DGIT (Exemptions) should be prior to the due date of filing of ITR.

ITD allowed weighted deduction on R&D expenses under Section 35(2AB) of the Act without verifying the details of expenditure approved by Department of Scientific and Industrial Research in Form 3CL/3CM

2.5 Allowance of weighted deduction of R&D expenditure under Section 35(2AB)

Section 35 (2AB) provides for deduction of two times of the expenditure incurred on scientific research (excluding expenditure on purchase of land or building) by in-house R&D facility as approved by the Prescribed Authority[7]for a company engaged in the business of Biotechnology or of manufacture or production of any article or thing other than those specified in the list of the Eleventh Schedule of the Act. As per procedure prescribed under the Act, the assessee company furnishes application of agreement with Department of Scientific and Industrial Research (DSIR). After due process, DSIR grants approval of R&D facility in Form 3CM to the company and sends its report and details of approved expenditure in Form 3CL to Director General of Income Tax (Exemptions). DGIT (Exemptions) is to forward such reports (Form 3CM/3CL) to concern CCsIT/CsIT. Form 3CL contains the details of total cost of in-house research facility and also the annual production of eligible products of company during past 3 years. CCITs/CITs are to forward such reports to concerned jurisdictional AO who allows weighted deduction subject to the stipulated conditions.

7 Prescribed Authority is the Secretary, DSIR.

We observed that CCsIT/CsIT have not forwarded the copy of Form 3CL/3CM to the AOs for verification of the genuineness of deduction of R&D expenditure claimed by the assessees. ITD has allowed deduction without verifying the Form 3CL in which prescribed authority i.e. DSIR approve the expenditure incurred on in-house research. This resulted into loss (inclusive of potential loss) of ₹ 456.99 crore in 14 cases covering six states[8]. (see box 2.2).

Box 2.2: Illustrative cases on non-conformity of R& D figures with form 3CL

a.

Charge	**: CIT 1, Patna**
Assessee	**: Alkem Laboratories Limited**
Assessment Year	**: 2010-11**
PAN	**: AABCA9521E**

The assessee claimed weighted deduction under Section 35(2AB) of ₹ 67.91 crore which ITD allowed. However the DSIR, in response to the letter by AO with respect to scrutiny of subsequent AY 2011-12, replied (March 2014) that the assessee had violated conditions of DSIR guidelines by not submitting details of R&D expenses to DSIR and hence its approval was not extended beyond March 2009. Had the form 3CL been ensured by the ITD at the time of scrutiny of AY 2010-11 itself (March, 2013), such weighted deduction could have been disallowed. Omission to do so resulted in underassessment to the same extent with consequent short levy of tax of ₹ 23.08 crore. The ITD accepted the audit observation (July 2014).

b.

Charge	**: CIT I, Chennai**
Assessee	**: SPIC Limited**
Assessment Year	**: 2010-11**
PAN	: **AAACS4668K**

The assessee claimed ₹ 82.53 lakh as deduction under Section 35(2AB) against the actual expenses of ₹ 55.02 lakh. The claim of deduction had been allowed without the confirmation of approved expenditure in Form 3CL. This resulted in under assessment of income of ₹ 82.53 lakh involving potential tax effect of ₹ 24.76 lakh. Reply is awaited (October 2014).

8 Maharashtra, Delhi, Tamil Nadu, Andhra Pradesh, Bihar, Karnataka

c.	**Charge**	**: CIT-Central, Hyderabad**
	Assessee	**: Hetero Drugs Limited**
	Assessment Year	**: 2009-10**
	PAN	: **AAACH5071K**

The assessee claimed ₹ 22.93 crore towards R&D expenditure and ₹ 34.40 crore towards weighted deduction under Section 35(2AB) and ITD allowed the same without the confirmation of the expenditure in Form 3CL. Hence the assessee is not entitled to weighted deduction of ₹ 11.47 crore (₹ 34.40 crore - ₹ 22.93 crore). This resulted in short computation of income to that extent with a consequential short demand of ₹ 5.85 crore.

ITD replied (December 2014) that DSIR examined the information relating to AY 2009-10 to AY 2011-12 in July 2013 and granted renewal up to 31 March 2015 vide order dated 23 July 2013. It was, however, observed that the expenditure relating to AY 2010-11 to 2012-13 were only certified and any Form 3CL certifying the expenditure relating to AY 2009-10 was not produced to audit.

d.	**Charge**	**: CIT V, Delhi**
	Assessee	**: Ranbaxy Laboratories Limited**
	Assessment Year	**: 2008-09 to 2009-10**
	PAN	: **AAACR0127N**

The assessee claimed for AYs 2008-09 and 2009-10 weighted deduction on R&D expenditure under Section 35(2AB) of ₹ 670.80 crore and ₹ 645.50 crore respectively and ITD allowed the same. The claim of deduction had been allowed without the confirmation of approved expenditure in Form 3CL. The assessee has submitted the approval in Form 3CM of in-house research and development facility which is approval of recognition of R&D facility only. This resulted in under assessment of income to the same extent involving tax effect of ₹ 228 crore and ₹ 193.65 crore respectively. Reply is awaited (October 2014).

Thus R&D expenses have been allowed without the confirmation of approved expenditure in Form 3CL/3CM.

We further noticed in 6 other similar cases involving tax effect of ₹ 10.23 crore in Maharashtra that R&D figures depicted in DSIR website pertaining to assessee companies are not in conformity with the figures claimed as deductible under Section 35(2AB) (see box 2.3).

Box 2.3: Illustrative cases on non conformity of R & D figures as per DSIR website

Charge : CIT Central III, Mumbai
Assessee : Indoco Remedies Limited
Assessment Year : 2010-11 to 2011-12
PAN : **AAACI0380C**

Assessee claimed and ITD allowed weighted deduction on R&D expenditure under Section 35(2AB) of ₹ 40.50 crore. However, as per DSIR website the assessee was eligible for deduction of ₹ 13.43 crore only. This has resulted in excess allowance of weighted deduction of R&D expenditure amounting to ₹ 27.07 crore leading to underassessment of income to the same extent with consequent short levy of tax of ₹ 8.12 crore.

In reply the ITD forwarded the Form 3CL duly certified by the DSIR and stated that the same was submitted during the scrutiny assessment by the assessee. But the same was not available in the records provided to the audit by the ITD. However, as per the Form 3CL issued by the DSIR it was observed that the assessee for AYs 2010-11 and 2011-12 was eligible for weighted deduction of only ₹ 17.61 crore and ₹ 20.37 crore instead of ₹ 18.27 crore and ₹ 21.64 respectively claimed by the assessee. This has resulted into excess allowance of weighted deduction of ₹ 1.94 crore leading to under assessment of income to the same extent with consequent short levy of tax of ₹ 58.20 lakh.

We also noticed in two cases of an assessee in Maharashtra that assessee claimed the deduction of ₹ 344.55 crore involving tax effect of ₹ 103.37 crore under Section 35 (2AB) whereas their name did not appear in list of approved R&D expenditure in the Annual Report of DSIR (see box 2.4).

Box 2.4: Illustrative cases on R & D expenditure claimed and allowed though approval of such expenditure are not approved/pending with DSIR

Charge : CIT VII, Mumbai
Assessee : Piramal Life Science Limited
Assessment Year : 2009-10 and 2010-11
PAN : **AABCN8532E**

The assessee claimed and ITD allowed R&D expenditure of ₹ 344.55 crore to the assessee company without verification of documents or detailed scrutiny. In order to verify the genuineness/correctness of the deduction we searched DSIR website. Its name did not appear in the Annual Report of DSIR reflecting approved R&D expenditure of various assessees involving tax effect of ₹ 103.37 crore. Reply is awaited (October 2014).

Therefore, ITD allowed inadmissible R&D expenditure to the assessees without verifying the genuineness of the expenditure and approval of DSIR. ITD has also not prescribed any procedure to make Forms 3CL/3CM available to the AOs. ITD has also not made it mandatory to attach Forms 3CL/3CM along with ITR.

Pharmaceutical companies avoided deducting TDS on payments made to contract manufacturers by taking advantage of exclusion clause in Section 194C of the Act.

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

Section 194C of the Act provided for deduction of TDS at the rate of two *per cent* from the payment to the contractor for carrying out any work in pursuance of a contract between the contractor and an assessee. According to CBDT circular[9] read with exclusion clause in explanation to Section 194C of the Act, 'Work' included manufacturing of a product by a contractor according to the requirement/ specification of a customer by using material purchased from such customer but did not include such manufacturing in the purview of 'Work Contract' if the material was purchased from a person other than the customer.

We noticed 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.

Further, Karnataka High Court upheld ITD's view[10] that the contract entered by Pharmaceutical companies with a manufacturing company for preparation of products by a manufacturing company on above mentioned similar terms & conditions was a contract for work and not a contract for sale and thus attracted 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, we could not work out the amount of TDS deductible in the following case (see box 2.5).

9 CBDT Circular No 681 of 1994

10 CIT, Central circle V. Nova Nordisk Pharma India Ltd. (2012) 18 taxmann.com 285 (Kar)

Box 2.5 Illustrative case on non-deduction of TDS in respect of contract entered by assessee company with a manufacturing company for preparation of products

Charge	**: CIT VIII, Mumbai**
Assessee	**: Pfizer Limited**
Assessment Year	**: 2010-11**
PAN	: **AAACP3334M**

The assessee entered into an agreement for manufacturing its patented pharmaceutical products with manufacturers such as Snehal Foods & Feeds, Medibios Laboratories Pvt. Limited, Kemwell Pvt. Limited and Geno Pharmaceuticals Limited, 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 Limited on pre-determined prices. We 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 Limited 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.

Assessees take advantage of ambiguous provision related to salary and interest payment to Partners in the Firm to take undue benefit of 80IC deduction.

2.7 Allowance of excess deduction in respect of Partnership Firm

Sub-Section 10 of the Section 80IA read with sub-Section 7 of Section 80IC provides that where it appears to the AO that owing to the close connection between the assessee carrying on the eligible business and any other person or for any other reason profit is artificially increased, AO shall in computing, take the amount of profit as may be reasonably deemed to have been derived from the business. Section 40(b) provides that remuneration (salary) and interest are allowable to a Partner of a Firm if these are authorised by the partnership deed. Salary and interest are taxable in the hands of partners to whom these are payable.

We noticed in 13 cases in Haryana, Punjab and Himachal Pradesh that the Firm, enjoying tax deductions under Section 80IC, neither made provision for remuneration and interest in the partnership deed nor claimed the deduction of such expenditure. Thus, the Firm artificially increased the profit and thereby took undue benefit of deductions under Section 80IC leading to loss of revenue to exchequer amounting to ₹ 4.32 crore (see box 2.6).

Box 2.6: Illustrative cases on Non-payment of interest/ remuneration to Partners resulting in excess deduction

a. **Charge** **: Panchkula (Haryana)**
Assessee **: Admac Formulations**
Assessment Year **: 2009-10 to 2011-12**
PAN : **AAAAA5219Q**

The assessee Firm neither made a provision for remuneration of ₹ 2.55 crore and interest of ₹ 1.37 crore for such three AYs in the partnership deed nor offered such income for taxation in the hands of partners. This resulted in excess claim of deduction of ₹ 3.92 crore under Section 80IC resulting in short levy of tax of ₹ 1.27 crore. Reply is awaited (October 2014).

b. **Charge** **: Karnal, (Haryana)**
Assessee **: GMH Organics**
Assessment Year **: 2008-09 to 2010-11**
PAN : **AAGFG9690N**

The assessee Firm neither made a provision for remuneration of ₹ 2.43 crore and interest of ₹ 0.72 crore for such three AYs in the partnership deed nor offered such income for taxation in the hands of partners. This resulted in excess claim of deduction of ₹ 3.15 crore resulting in short levy of tax of ₹ 97.24 lakh. Reply is awaited (October 2014).

Thus the assessees do not provide for the interest/remuneration of the Partners and claimed excess deduction under Section 80IC.

We have raised the issue relating to payment of interest/remuneration of the Partners by the Firms availing exemptions/deductions under the Act in Report No. 7 of 2014 (Performance Audit of Assessment of Firms) laid on the table of Parliament on 18 July 2014 and gave recommendations to the Ministry in this regard.

ITD does not have any mechanism to correlate & verify carried forward losses / depreciation especially of losses / depreciation of the unit availing 80IC deduction.

2.8 Maintenance of data of brought forward loss or unabsorbed depreciation

Section 32 stipulates that unabsorbed depreciation relating to earlier AYs is allowed to be brought forward and set off against income of the assessee. Similarly unabsorbed business loss of the assessee is allowed to be carried forward for adjusting against the profit of following assessment years for the stipulated time period under the provisions of Section 72. The ITD is not maintaining any record of carry forward of loss (including depreciation) of the unit availing deduction under Section 80IC. Section 80IA(5) provides for set-off of losses of previous years of the eligible unit from its profit before claiming any

deduction. Further, CBDT has directed[11] AOs to carry out necessary verifications and correlation of claim of unabsorbed loss/depreciation with past records at the time of scrutiny to ensure correctness of the allowance of claims.

We observed in 4 cases of Delhi, Karnataka and Rajasthan that ITD allowed the set off of loss/unabsorbed depreciation without taking into consideration the changes effected due to revision of assessments resulting into incorrect set-off or excess carry forward of losses/depreciation to the tune of ₹ 13.09 crore with consequent short levy of tax of ₹ 4.19 crore (See box 2.7). We observed that ITD did not maintain the data of brought forward losses / unabsorbed depreciation properly.

Box 2.7: Illustrative cases on Non maintenance of data of brought forward loss/depreciation allowable to an assessee

a. **Charge : CIT I, Delhi**
Assessee : Akums Drugs & Pharmaceuticals Limited
Assessment Year : 2011-12
PAN : **AAECA7090B**

The assessee claimed and the ITD allowed deduction of ₹ 27.67 crore under Section 80IC which included deduction of ₹ 7.01 crore from one eligible unit (No.-III) after setting off its notional loss of ₹ 4.80 crore pertaining to AY 2010-11. However the losses of ₹ 3.83 crore and ₹ 24.73 crore respectively pertaining to AYs 2008-09 and 2009-10 were also required to be set off. After setting off such available losses, income should have been assessed at Nil for Unit III, instead of ₹ 7.01 crore. Omission to do so resulted in incorrect allowance of deduction under section 80IC of ₹ 7.01 crore with consequent short levy of tax of ₹ 2.17 crore. Reply is awaited (October 2014).

b. **Charge : CIT Central, Bangalore**
Assessee : The Himalaya Drug Company
Assessment Year : 2009-10
PAN : **AADFT3025B**

The assessee claimed and the ITD during scrutiny assessment for AY 2009-10 allowed (March 2013) set off of brought forward loss of ₹ 4.36 crore (pertaining to AY 2005-06). Whereas the said brought forward loss was already disallowed by the ITD during scrutiny assessment of AY 2005-06 (October, 2012), which was not considered during scrutiny assessment for AY 2009-10. Moreover, the ITD also failed to disallow the aforesaid brought forward loss at the time of giving effect to the order of CIT (Appeal) (August 2013). Thus the ITD did not consider the final treatment of the said loss despite the information being available with ITD. Omission to do so resulted in under assessment to the same extent with consequent short levy of tax of ₹ 1.48 crore. The ITD (October 2014) has stated that the remedial action has been taken by issue of notice under Section 148.

[11] CBDT Circular No 9 of 2007

The above cases imply that due to non maintenance of data of brought forward losses/depreciation of the previous years the carry forward/set off could not be co-related.

We have raised the issue of non-maintenance of the data of brought forward losses/depreciation of the previous years the carry forward/set off in Report No. 20 of 2014 (Performance Audit on Allowance of Depreciation and Amortisation) laid on the table of Parliament on 28 November 2014 and gave recommendations to the Ministry in this regard.

ITD does not have any mechanism to correlate & verify the turnover declared in Income Tax with turnover declared in Central Excise which is part of the same Ministry of Finance.

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

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 assessees 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.

We 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.

2.10 Recommendations

a. CBDT may maintain the sector-wise data of assessees to which various tax incentives have been prescribed under the Act.

The Ministry stated (January 2015) that considering the large number of taxpayers availing various incentives under the Act, it may not be feasible to segregate/identify the data regarding various tax-incentives sector-wise in an accurate manner. The Ministry also stated that the data is mainly captured from the business code filled in the return by the assessees who

are engaged in several businesses and there is possibility that the assessee may fill incorrect code. However, revision in the business code is under consideration.

Audit is of the view that the maintenance of sector wise data is necessary for tax planning and sector specific policy by the concerned Departments of Government of India. Hence, there is a need of evolving a system of sector wise data. For this purpose, DSIR and NPPA may be requested to capture PAN details to facilitate the linking with ITRs.

b. The Ministry may develop a mechanism so that the copy of Form 3CM/3CL duly approved by DSIR are invariably attach with ITR. The Ministry may also prescribe the date of forwarding of approved Form 3CL by DSIR to DGIT (Exemptions) to precede the due date for filing the ITR.

The Ministry while explaining the system of approval of R&D expenditure by DSIR stated (January 2015) that the current scheme was designed in the pre computerised era and agreed to re-examine the issue.

Audit while agreeing with the reply of the Ministry, further suggested that approval of DSIR available with DGIT (Exemption) should be considered to be linked with ITR.

c. CBDT may 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.

The Ministry stated (January 2015) that implementation of C&AG suggestion would require legislative change in Section 194C as it is possible that some assessee may take advantage of the definition of work contract as defined in Section 194C. It further stated that a reference is being separately made to TPL Division for examination during budgetary exercise for 2015-16.

Audit is of the view that it is necessary to ensure that the Pharmaceutical Companies deduct the TDS on payments made to contract manufacturers. Ministry may, therefore decide to take appropriate decision to achieve this objective.

d. ITD may develop a mechanism to collect/receive information related to assessment available with other tax department and use it to deepen the tax base and bring the correct income to the tax-net. Alternatively the AIR in Form ER 4 should compulsory be called for from an assessee who is availing turnover based deductions under the provisions of the Act.

CHAPTER III: Compliance Issues

3.1 Introduction

The Act prescribes the admissibility of expenditures, allowances/deductions to the assessees including assessees of Pharmaceuticals Sector. As per guidelines issued (May 2014) by Department of Scientific and Industrial Research (DSIR) for in-house Research & Development (R&D) centres, the Secretary of DSIR has been designated as Principal Authority for the purposes of Section 35 (2AB) of the Act. The Principal Authority approves the R&D Expenditure in Form 3CM/3CL prescribed by the Act. DSIR is required to send approval of R&D expenditure in Form 3CL to DGIT (Exemption) to help AOs in ascertaining the genuineness of the claim of assessees. Besides, there are regulatory bodies like Medical Council of India (MCI) and National Pharmaceuticals Pricing Authority (NPPA) who from time to time, issue instructions/guidelines to regulate the expenses related to Pharmaceuticals Sector like Freebies, Expenditure on Gifts, Physician samples etc.

During the Performance Audit, we came across compliance issue as follows:

Table 3.1 : Compliance issues with tax effects

(₹ in crore)

Issues	Cases	Tax Effect
Section A: Inadmissible expenses related to Pharmaceuticals Sector in compliance to the instructions/guidelines issued by DSIR and Bodies like MCI and NPPA.	36	55.10
Section B: Compliance issues in the Pharmaceuticals Sector	171	714.24
Total	**207**	**769.34**

Section – A

Inadmissible expenses related to Pharmaceuticals Sector

We noticed 36 cases, involving tax effect of ₹ 55.10 crore in seven States[12] relating to allowance of expenses where instructions/guidelines of regulatory bodies were not followed by AOs. In these cases, AOs did not disallow or partially disallowed expenditure towards gifts, freebies and physicians sample to medical professionals by companies in Pharmaceuticals sector despite these being made irregular by regulatory bodies or were not related to business. Table 3.2 shows summary of categories of mistakes in assessment and their tax effect. Details of these cases are dealt in this Chapter.

Table 3.2: Nature of mistakes with its tax effect

	Nature of Mistakes and Para Number of the Report	Cases	Tax effect (₹ in crore)
1.	Expenditure on gifts and other freebies to medical professionals (Para 3.1.1)	21	45.43
2.	Break up of expenditure on freebies / gifts not taken from sales promotion expenses (Para 3.1.2)	11	-
3.	Expenditure on physicians sample (Para 3.1.3)	3	1.57
4.	Penalty by National Pharmaceuticals Pricing Authority (Para 3.1.4)	1	8.10
	Total	**36**	**55.10**

AOs allowed expenditure on gifts, travel facilities, hospitality, cash or monetary grant despite being made irregular by the Act, Medical Council of India, CBDT/Judicial pronouncement.

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

As per explanation to Section 37(1) of the 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[13] 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

12 Andhra Pradesh, Gujarat, Karnataka, Maharashtra, New Delhi, Tamil Nadu and Uttaranchal
13 Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002

facilities, hospitality, cash or monetary grants etc. CBDT issued a circular[14] in 2012 and clarified that such expenses would not be allowable. Judicial pronouncement[15] also clarified that this circular had retrospective effect.

We noticed 21 cases in five states[16] 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 (see box 3.1).

Box 3.1: Illustrative cases of non/partial disallowance of expenses on freebies.

a. **Charge : CIT-VIII, Mumbai**
Assessee : Macleods Pharmaceuticals Limited
Assessment Year : 2009-10
PAN : AAACM4100C

We noticed that AO out of ₹ 58.71 crore spent on gifts, facilities etc. to medical practitioners, disallowed only ₹ 21.75 crore pertaining to period 9 December 2009 to 31 March 2010 considering that effective date for such disallowance would be date of amendment (viz. 9 December 2009) in the MCI Regulations. Stand of the AO was not proper as the said amendment was clarificatory in nature and hence expenses on such freebies being in the nature of offence and prohibited by law were fully disallowable for the earlier years as well, in terms of the explanation to Section 37(1) which is effective retrospectively from 01 April 1962. This omission resulted in under assessment of income of ₹ 36.96 crore involving potential tax effect of ₹ 11.09 crore. Reply is awaited (October 2014).

b. **Charge : CIT –IV, Ahmedabad**
Assessee : Troika Pharmaceuticals Limited
Assessment Year : 2010-11
PAN : AABCT0228K

We noticed that AO allowed ₹ 7.48 crore spent by assessee on Doctors travelling expenses along with spouse, gift articles distributed etc. which resulted in under assessment of income by the same extent with short levy of tax of ₹ 2.54 crore. Reply is awaited (October 2014).

14 No. 5/2012 [F. No. 225/142/2012-ITA.II], dated 01 Aug 2012
15 Confederation of Indian Pharmaceuticals Industry Vs. CBDT (Himachal Pradesh High Court)
16 Gujarat, Karnataka, Maharashtra, New Delhi, Tamil Nadu

c.	**Charge**	**: CIT-LTU, Mumbai**
	Assessee	**: IPCA Laboratories Limited**
	Assessment Year	**: 2009-10**
	PAN	**: AAACI1220M**

We noticed that the assessee incurred expenditure of ₹ 32.91 crore on Heart Touching Celebration, Sponsorship of Doctors and corporate /brand recall items. These expenses were not allowable being in the nature of freebies. This resulted in underassessment of income to the same extent involving tax effect of ₹ 11.19 crore. In the same charge in case of another assessee Wyeth Limited (AY 2008-09), the CIT(A) enhanced disallowances of expenses of this nature from one third to total such expenses. Reply is awaited (October 2014).

d.	**Charge**	**: CIT-Central, Bangalore**
	Assessee	**: Vascular Concepts Pvt. Limited**
	Assessment Year	**: 2008-09 to 2010-11**
	PAN	**: AAACM8353R**

The assessee debited sum of ₹ 4.73 crore, ₹ 6.21 crore and ₹ 7.49 crore for respective AYs totalling to ₹ 18.43 crore towards Doctor's domestic and foreign travelling expenses including hotel bookings, gifts. These expenses were not allowable being in the nature of freebies. However the AO allowed the same. This resulted in under assessment of income to the same extent involving tax effect of ₹ 6.26 crore. The ITD stated (October 2014) that the assessment under Section 153A is time barring in this case on 31 March 2015 and audit objection will be looked into during the course of assessment.

e.	**Charge**	**: CIT-Salem, Chennai**
	Assessee	**: B. Mohankumar**
	Assessment Year	**: 2009-10 to 2011-12**
	PAN	**: AIVPM2483C**

The assessee debited sum of ₹ 2.70 crore, ₹ 4.71 crore and ₹ 4.94 crore for respective AYs totalling to ₹ 12.35 crore towards interpretation charges/Doctor's fees visiting the hospital established by the assessee for promoting the usage of medicines to the patients. These expenses were not allowable in view of the judicial pronouncement in the case of Confederation of India Pharmaceuticals Industry Vs CBDT (Himachal Pradesh High Court 353 ITR 388 dated 26/12/2012). However, the AO allowed the same. This resulted in under assessment of income to the same extent involving tax effect of ₹ 4.11 crore.

f.	**Charge**	**: CIT-V, Delhi**
	Assessee	**: Ozone Pharmaceuticals Limited**
	Assessment Year	**: 2011-12**
	PAN	**: AAACO0056H**

The assessee debited an amount of ₹ 2.11 crore towards purchase of sales promotion material for Doctors as mentioned in the assessment order. These expenses were not allowable being in the nature of freebies. However, the AO allowed the same. This resulted in under assessment of income to the same extent involving tax effect of ₹ 70.17 lakh.

The ITD in reply (August 2014) stated that payments were made for material consisting of small Ayurvedic items like soaps, face wash gels etc. used for medical camps, blood donation camps, annual award functions, sales promotion meetings etc. held for promoting sales with the assessee company stockists.

The reply of the ITD was not acceptable as in the assessment order itself it was mentioned that assessee vide its reply dated 24 February 2014 stated that sales promotion products were purchased from Ozone Ayurvedics to be used as sales promotional material for Doctors which is in violation of provisions of Indian Medical Council Regulations 2002.

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.

AOs allowed the expenditure on sales promotion which included prohibited expenses on freebies

3.1.2 Break up of expenditure on freebies / gifts not taken from sales promotion expenses

Pharmaceuticals 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.

We 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 (see box 3.2).

Box 3.2: Illustrative cases of non disallowance of expenses on freebies due to not seeking break up of sales promotion expenses

a. **Charge : CIT– LTU, Mumbai**
Assessee : Glenmark Pharmaceuticals Limited
Assessment Year : 2009-10 and 2010-11
PAN : AAACG2207L

The assessee claimed and AO allowed expenditure on account of sales promotion of ₹ 55.66 crore and ₹ 91.96 crore for AY 2009-10 and 2010-11 respectively. The detailed breakup of these expenses was not available to verify the expenditure incurred on freebies. Reply is awaited (October 2014).

b. **Charge : CIT– LTU, Mumbai**
Assessee : IPCA Laboratories Limited
Assessment Year : 2007-08 and 2008-09
PAN : AAACI1220M

The assessee incurred sales and marketing expenses of ₹ 28.64 crore and ₹ 41.80 crore in AY 2007-08 and 2008-09 respectively but expenses of gift and other freebies given to Doctor was not identified. However, in the AY 2009-10, we noticed that out of ₹ 58.95 crore of sales and marketing expenses, ₹ 32.43 crore was spent on various freebies. Reply is awaited (October 2014).

c. **Charge : CIT Dehradun**
Assessee : Suncare Formulations Pvt. Limited
Assessment Year : 2009-10
PAN : AAICS9967M

The assessee debited ₹ 30.94 lakh in P&L Account as marketing and distribution expenses, besides advertising and travelling & conveyance expenses. The assessee accepted the fact that the marketing policy of the company included distribution of samples to Doctors and hospitals; however AO did not disallow the extent of prohibited expenses on freebies included in the above expense by ascertaining breakup of the same. Reply is awaited (October 2014).

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.

AOs did not disallow expenditure on physicians samples given free of cost to medical practitioners

3.1.3 Non / partial disallowance of expenditure towards physicians samples

As the physicians samples are given free to medical practitioners and it influences the decision of medical practitioners in prescribing medicines in favour of branded medicines instead of generic ones, hence it was in the nature of offence of law and therefore was disallowable.

We 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 (see box 3.3).

Box 3.3: Illustrative cases of non-disallowance of expenses on physicians samples

a.

Charge	**: CIT- VII, Mumbai**
Assessee	**: Solvay Pharma India Limited**
Assessment Year	**: 2008-09**
PAN	**: AABCD0322J**

The assessee incurred expenses of ₹ 2.24 crore on physicians sample given free of cost to medical practitioners which was not disallowed by the AO. This resulted in under assessment of income by the same extent involving tax effect of ₹ 76.18 lakh.

b.

Charge	**: CIT– X, Mumbai**
Assessee	**: Flamingo Pharmaceuticals Pvt. Limited**
Assessment Year	**: 2009-10 and 2010-11**
PAN	**: AAACF4211B**

The assessee incurred expenses of ₹ 1.45 crore and ₹ 92.46 lakh for AY 2009-10 and 2010-11 respectively on physicians sample given free of cost to medical practitioners which was not disallowed by the AO. This resulted in under assessment of income by the same extent involving tax effect of ₹ 49.39 lakh and ₹ 31.42 lakh respectively. In these cases our contention to treat the expenses on physicians sample as freebies and hence disallowable was supported by the CIT (A) – 19, Mumbai Order in the case of Dupen Laboratories Pvt. Limited for AY 2010-11 in the CIT Charge IX, Mumbai, wherein it was held that although the physicians sample is not specifically included in the list of expenses prohibited by MCI, it was in the nature of freebies only and hence disallowable. Reply is awaited in both the cases (October 2014).

The AOs did not disallow the expenditure on account of physicians samples, supplied free of cost to Doctors, which influence them to prescribe the branded medicines instead of generic ones and impedes their independent judgment.

AOs did not disallow expenditure towards penalties levied by National Pharmaceuticals Pricing Authority which is prohibited by law.

3.1.4 Non disallowance of expenditure towards penalty by National Pharmaceuticals Pricing Authority

As per Explanation to Section 37 of the Act, 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. We noticed one case in Andhra Pradesh in which the AO had allowed the expenses on the penalty levied by NPPA involving tax effect of ₹ 8.10 crore (see box 3.4).

Box 3.4: Illustrative case of non-disallowance of penalty by NPPA

Charge	**: CIT-I, Hyderabad**
Assessee	**: Dr. Reddy's Laboratories Limited**
Assessment Year	**: 2006-07**
PAN	**: AAACD7999Q**

We noticed in November 2011 that the AO allowed the expense of ₹ 15.43 crore paid by the assessee towards penalty levied by NPPA which was not allowable. In reply the ITD initially did not accept the objection (December 2012) stating that the amount was not a penalty but recovery of overcharge amount. However, subsequently remedial action was completed (March, 2014) in which entire claim was disallowed stating that the same is infraction of law. This involved under assessment to the same extent with short levy of tax of ₹ 8.10 crore. Reply is awaited (October 2014).

Section - B

Compliance issues in Pharmaceuticals sector

3.2 Introduction

In the assessment of assesses in Pharmaceuticals Sector, we noticed mistakes relating to administration of concessions/exemptions/deductions, quality of assessment, income escaping assessment, Transfer Pricing etc. The present chapter deals with audit issues relating to deficiencies in applying the provisions of the Act and relevant rules/judicial pronouncements by the AOs during assessments of assessees in Pharmaceuticals Sector**.** We noticed 171 cases, in 17 States[17] where the provisions of the Act were not followed correctly, with a tax effect of ₹ 714.24 crore. Table 3.3 shows summary of broad categories of mistakes in assessment and their tax effect. Details of these cases are dealt in this Chapter in subsequent paragraphs.

Table 3.3 : Nature of mistakes with its tax effect

Nature of Mistakes and Para Number of the Report	Cases	Tax effect (₹ in crore)
1. Allocation of R&D/common expenses (Para 3.2.1)	15	121.21
2. Allowance of concessions/exemptions/deductions / rebate/relief (Para 3.2.2)	26	158.89
3. Setting off of carried forward business loss/depreciation (Para 3.2.3)	28	27.77
4. Allowance of business expenditure (Para 3.2.4)	22	47.69
5. Allowance of R&D expenses (Para 3.2.5)	14	77.40
6. Allowance of expenses on which TDS was not deducted/deposited (Para 3.2.6)	7	5.91
7. Inconsistency in assessment (Para 3.2.7)	3	149.93
8. Arithmetical errors in computation of income and tax (Para 3.2.8)	15	14.65
9. Assessment of Income under special provisions (Para 3.2.9)	6	6.11
10. Assessment of Income under normal provisions (Para 3.2.10)	16	84.21
11. Classification and computation of capital gains (Para 3.2.11)	1	00.74
12. Irregularities in International Transactions (Para 3.2.12)	5	7.58
13. Others (Para 3.2.13)	13	12.15
Total	**171**	**714.24**

17 Andhra Pradesh, Assam, Goa, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Madhya Pradesh, New Delhi, Pudduchery, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh, West Bengal.

Research & Development and common expenditure are required to be allocated to the beneficiary units either on actual basis or on the basis of their sales turnover ratios. AOs allowed the same without ascertaining the proper allocation.

3.2.1 Allocation of R&D / other common expenses

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.

We 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 (see box 3.5).

Box 3.5: Non/partial allocation of R&D / other common expenses

a.	**Charge**	**: CIT-LTU, Mumbai**
	Assessee	**: Glenmark Generic Limited**
	Assessment Year	**: 2009-10**
	PAN	**: AACCG9820D**

The allocation of weighted deduction on expenses on R&D was to be done in sales turnover ratio among the units beneficiary of the R&D. Out of total weighted deduction of ₹ 212.73 crore on capital and revenue expenses on R&D, the assessee allocated weighted deduction of only ₹ 154.40 crore with respect to revenue expense under Section 35 (2AB) of the Act with ₹ 13.13 crore allocated to Goa unit (eligible for deduction) and ₹ 141.27 crore to other units (not eligible for deductions). However, as per sales turnover ratio ₹ 106.34 crore was required to be allocated to Goa unit. Omission to do so resulted in short allocation of ₹ 93.20 crore.

Further, remaining weighted deduction of ₹58.33 crore with respect to revenue expenses under Section 35(1)(i)} and capital expenses under Section 35(1)(iv) and 35(2AB) of the Act was not allocated at all which works out to ₹ 40.37 crore to Goa unit in the above mentioned ratio. Thus, the above resulted in underassessment of ₹ 133.57 crore (₹ 93.20 + ₹ 40.37) involving tax effect of ₹ 45.33 crore. Reply is awaited (October 2014).

b.	**Charge**	**: CIT Central, Hyderabad**
	Assessee	**: Hetero Drugs Limited**
	Assessment Year	**: 2009-10**
	PAN	**: AAACH5071K**

The assessee claimed corporate overhead expenditure of ₹ 98.19 crore which was not apportioned to all the units based on the turnover. The assessee allocated ₹ 81.36 lakh instead of ₹ 14.10 crore which resulted in excess claim of deduction under Section 80IC of ₹ 13.29 crore involving understatement of income to the same extent with consequential short levy of tax of ₹ 4.52 crore. The ITD did not accept the objection stating that there was no such provision in the Act for such allocation. The reply was not acceptable as nature of expense was common for both eligible and non eligible units. Moreover, this is a general principle that all the corporate overheads expenditure which are common to eligible and non eligible units are to be apportioned and no provision is required in the Act. Reply is awaited (October 2014).

c.	**Charge**	**: CIT LTU, Mumbai**
	Assessee	**: Glenmark Pharmaceuticals Limited**
	Assessment Year	**: 2007-08 to 2010-11**
	PAN	**: AAACG2207L**

The assessee used incorrect[18] sales turnover ratio for allocation of weighted deduction of R&D expenses, which was lesser than the correct one, and the AO accepted the same. The difference in the ratio during these years ranged from 0.93 *per cent* to 3.15 *per cent*. Owing to this, out of total weighted deductions of ₹ 319.15 crore, an amount of ₹ 156.96 crore was allocated to the eligible units (80IB unit at Goa and 80IC unit at Baddi) instead of ₹ 167.36 crore for the above years. The lesser allocation of weighted deduction for R&D expense, on account of lower turnover ratio, resulted in total under assessment of ₹ 10.40 crore for the above AYs, with consequential short levy of tax of ₹ 3.50 crore. Reply is awaited (October 2014).

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.

18 Instead of taking ratio between turnover of manufactured sales of individual unit and that of all the units, it used ratio between manufactured sales of individual unit and gross sales (inclusive of turnover of traded goods) of all the units. As the benefit of R&D was used only by manufactured goods and not the traded goods, the same was required to be excluded from working of ratio. The correct ratio would be higher than the incorrect one.

AOs allowed concessions/deductions/rebate/relief to assessees without verifying the conditions specified in the provisions of the Act.

3.2.2 Allowance of concessions/deduction/rebate/relief

Chapter VIA and Section 10 provide for certain deductions in computing total income of an assessee subject to fulfilment of certain conditions specified therein. Section 80IB/80IC provide for 100 *per cent* and 30 *per cent* deductions, respectively for first five AYs and next five AYs, in respect of profits and gains from undertaking under these Sections.

We noticed 26 cases in 13 states[19] in which the AO had allowed the concessions/deduction/rebate/relief without proper examination of the same involving tax effect of ₹158.89 crore (see box 3.6).

Box 3.6: Excess or irregular concession /exemption /Deduction/rebate /relief

a.

Charge	**: CIT-II Indore**
Assessee	**: Plethico Pharmaceuticals Limited**
Assessment Year	**: 2006-07 to 2009-10**
PAN	**: AABCP3063G**

We noticed that in the assessment completed under Section 143(3) /153A, the Auditor whose name was appearing on the accounts certification of assessee's eligible SEZ unit at Kandla, stated on oath that he had not audited the same. Hence exemption allowed to the assessee amounting to ₹ 68.03 crore, ₹ 80.88 crore, ₹ 121.46 crore and ₹ 127.50 crore for the AY 2006-07 to 2009-10 respectively was not in order as the report in form 56F furnished by the assessee was not given by that Accountant. Hence as per Section 10A(5) of the Act, exemption was required to be withdrawn which was not done. The omission to do so resulted in total underassessment of ₹ 397.87 crore with short levy of tax of ₹ 134.74 crore. Reply is awaited (October 2014).

b.

Charge	**: CIT-II Chandigarh**
Assessee	**: Venus Remedies Limited**
Assessment Year	**: 2011-12**
PAN	**: AAACV6524H**

The assessee commenced operations in October 2005 and initial AY was 2006-07. Hence, for the instant AY the assessee was eligible for deduction of ₹ 4.87 crore at 30 *per cent* of profit instead of ₹ 16.24 crore claimed at 100 *per cent* of profit. However, the ITD did not restrict the deduction claimed by the assessee resulting in excess allowance of deduction of ₹ 11.37 crore with under assessment to the same extent involving tax of ₹ 3.78 crore. Reply is awaited (October 2014).

19 Andhra Pradesh, Assam, Goa, Haryana, Himachal Pradesh, Karnataka, Maharashtra, Madhya Pradesh, New Delhi, Punjab, Tamil Nadu,, Uttar Pradesh, West Bengal

c.	**Charge**	**: CIT Central-III, Mumbai**
	Assessee	**: Indoco Remedies Limited**
	Assessment Year	**: 2010-11**
	PAN	**: AAACI0380C**

The AO during scrutiny assessment, incorrectly adopted profit of eligible unit (80IC unit) as ₹ 41.70 crore instead of ₹ 40.01 crore which resulted in excess deduction of ₹ 1.69 crore. Further while making allocation of weighted deduction[20] on R&D expenses between the eligible and ineligible units in the sales turnover ratio it allocated only ₹ 3.99 crore instead of ₹ 7.13 crore to eligible unit, resulting in excess deduction of ₹ 3.13 crore. Thus the AO computed allowable deduction of ₹ 35.31 crore and restricted to available profit of ₹ 34.62 crore. However, on the basis of above discussion admissible deduction was ₹ 30.69 crore only. This resulted in excess allowance of deduction of ₹ 3.93 crore (₹ 34.62 crore - ₹ 30.69 crore) involving tax effect of ₹ 1.18 crore. Reply is awaited (October 2014).

Thus, the ITD was not having a system of built in checks to ensure that deductions /concessions/exemptions/rebate/relief are thoroughly scrutinized before being allowed by the AOs.

AOs allowed setting off/carry forward of depreciation/business loss/capital loss in contravention of the provisions of the Act.

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

Section 72 provides for carry forward of loss for set-off in the following AYs where the loss is not wholly set off against income under any head of the relevant year to the extent it is not set off.

We noticed in 28 cases in 11 states[21] in which the AO had allowed business expenditure in contravention to the laid down provisions involving tax effect of ₹ 27.77 crore (see box 3.7).

20 The total weighted deduction available for allocation was of ₹ 18.27 crore. However, the AO allocated only ₹ 10.22 crore between eligible and ineligible units.

21 Andhra Pradesh, Goa, Gujarat, Karnataka, Kerala, Maharashtra, Madhya Pradesh, New Delhi, Rajasthan, Tamil Nadu and West Bengal

Box 3.7: Irregularities in allowing setting off of business loss and carry forward of depreciation and business / capital loss

a. **Charge : CIT-Central, Hyderabad**
Assessee : Gayatri Bio-organics Limited
Assessment Year : 2011-12
PAN : AAACG7384A

The AO allowed business loss of ₹ 12.09 crore pertaining to AY 1999-2000 to 2002-2003 to be carried forward even though the period of eight years were elapsed resulting in underassessment to the same extent involving potential tax effect of ₹ 3.63 crore. The ITD had not accepted the observation but passed order under Section 157 (July 2014).

b. **Charge : CIT I Delhi**
Assessee : Bausch & Lamb Eye care (India) Pvt. Limited
Assessment Year : 2009-10
PAN : AABCB7362G

The AO completed assessment in October 2013 determining an income of ₹ 19.96 crore after setting off brought forward business losses and unabsorbed depreciation of ₹ 11.70 crore (₹ 9.48 crore + ₹ 2.22 crore) for the assessment year 2007-08. We observed that the losses of ₹ 11.70 crore were not available to be set off as the assessee was assessed at an income in the AYs 2007-08 and 2008-09. Hence, no losses were available to be set off in the assessment year 2009-10. The mistake resulted in incorrect set off of losses of ₹ 11.70 crore involving short levy of tax effect of ₹ 3.98 crore. Reply is awaited (December 2014).

c. **Charge : CIT – Panaji**
Assessee : Wallace Pharmaceuticals Pvt. Limited
Assessment Year : 2009-10
PAN : AACW1667Q

The assessee was having profit of ₹ 14.43 crore from its 80IC unit and loss of ₹ 12.66 crore from its non 80IC unit. Thus the assessee computed its total income at ₹ 1.78 crore and the total taxable income as nil after allowing deduction of profit of the 80IC unit, restricted to total income.

However, the ITD made additions of ₹ 6.20 crore in the returned income and determined total taxable income at ₹ 6.20 crore and computed tax accordingly. Aggrieved by it, the assessee applied for rectification under Section 154 stating that 80IC deduction available being more than the assessed income, taxable income would be nil with no tax liability.

The AO rectified the order, but instead of determining total taxable income as *nil*, it determined loss of ₹ 6.45 crore by erroneously reducing ₹ 12.66 crore from the assessed income of ₹ 6.20 crore. This resulted in under assessment of ₹ 6.45 crore involving potential tax of ₹ 1.94 crore.

The ITD has accepted (October 2014) the objection and rectified the mistake under Section 154 on 14 October 2014.

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.

AOs allowed expenditure not related to the business in violation of the Act.

3.2.4 Allowance of business expenditure

Section 37 provides that any expenditure not related to business is not to be allowed as business expense. We noticed in 22 cases in nine states[22] in which the AO had allowed business expenditure in contravention to the laid down provisions involving tax effect of ₹ 47.69 crore (see box 3.8).

Box 3.8 Incorrect allowance of business expenditure

a.

Charge	**: CIT Central, Pune**
Assessee	**: Twilight Litaka Pharma Limited**
Assessment Year	**: 2012-13**
PAN	**: AAACL4246J**

The computation of income filed by the assessee revealed that its total business income was of ₹ 10.35 crore and the total taxable income was *nil* after allowing 80IC deduction of ₹ 34.25 crore, restricted to total income. The AO disallowed the 80IC deduction claimed by the assessee on the ground that the assessee during search and seizure in this case had himself submitted, that he was engaged in transactions which were mere book entries, circulating in nature and not genuine and accordingly the AO erroneously determined the taxable income at ₹ 34.25 crore instead of ₹ 10.35 crore.

Further we noticed that the AO had allowed write off of ₹ 51.61 crore debited in the profit and loss account without verifying the genuineness of the same, which consisted of (i) ₹ 15.03 crore on account of "Exceptional Item-Inventories written off" for which no further break up /details was available either in annual report or in the assessment records; and (ii) ₹ 36.58 crore on account of "Bad Debts written off" claimed by the assessee which was to be disallowed on the same ground that transactions were not genuine.

[22] Gujarat, Karnataka, Kerala, Maharashtra, New Delhi, Pudduchery, Tamil Nadu,, Uttar Pradesh, West Bengal

As per audit, keeping in view that 80IC deductions were disallowed by the AO, assessed income should have been ₹ 61.96 crore (₹ 10.35 + ₹ 51.61) instead of ₹ 34.25 crore. This resulted in under assessment of income by ₹27.71 crore involving tax effect of ₹ 8.99 crore. Reply is awaited (October 2014).

b. Charge : CIT-Puducherry
Assessee : DXN Herbal Manufacturing India (P) Limited
Assessment Year : 2008-09
PAN : AABCD4141M

The assessee had paid ₹ 2.97 crore as additional excise duty under protest during the previous year 2007-08 (AY 2008-09) and had claimed the same as deduction under Section 43B in the computation of income. However, the assessee had not claimed any expenditure in this regard in the books of accounts. As per Section 43B, the deduction is allowable only when the same has been incurred and actually paid by the assessee. As neither the liability has been incurred nor the same has been claimed as expenditure in profit and loss account, the same was required to be disallowed. This resulted in under assessment of income of ₹ 2.97 crore involving tax effect of ₹ 1.01 crore.

The ITD stated (November 2014) that even though the assessee made the payment under protest, it was served with a demand notice from the Excise Department. Hence it is a valid statutory liability which is allowable under Section 43B on payment before the due date of filing of return. The reply is not acceptable because the ITD has not produced the copy of demand notice from Excise department to substantiate that the liability is incurred.

Thus the AOs allowed business deductions which should not have been allowed as per provisions of the Act and Rules and CBDT instructions issued from time to time.

AOs allowed R&D expenditure without satisfying the conditions mentioned in the DSIR guidelines.

3.2.5 Allowance of R&D expenses

The DSIR guidelines, for approval of claim of weighted deduction under Section 35(2AB) of the Act delineates various conditions for eligibility of capital and revenue expenses on R&D. Any expense not satisfying the conditions mentioned therein are to be excluded before computing weighted deduction on R&D expenses.

We noticed in 14 cases in five states[23] in which the AO had allowed deductions on R&D expenses in contravention to the laid down provisions involving tax effect of ₹ 77.40 crore (see box 3.9).

[23] Andhra Pradesh,Gujarat, Karnataka, Maharashtra, New Delhi

Box 3.9 Incorrect allowance of R&D expenses

a. **Charge : CIT LTU, Mumbai**
Assessee : Glenmark Pharmaceuticals Limited
Assessment Year : 2009-10 to 2010-11
PAN : AAACG2207L

The DSIR guidelines, for approval of claim of weighted deduction under Section 35(2AB) of the Act, specifically provide to reduce *interalia* income from contract research from the total expenditure (excluding land and building) on the approved R&D centre.

The AO during scrutiny assessment allowed the weighted deduction, as claimed by the assessee under Section 35(2AB) of the Act, on expenditure on approved in house research and development facility. However, while computing net expenditure on R&D, instead of reducing "income from contract research", amounting respectively to ₹ 52.32 crore and ₹ 46.11 crore, from the gross R&D expenditure, it reduced the "*expenses* towards contract research" amounting to ₹ 36 crore and ₹ 31.07crore.

This resulted in excess claim of R&D expenditure of ₹ 16.32 crore and ₹ 15.04 crore and corresponding weighted deduction (at the rate of 150 *per cent*) of ₹ 24.47 crore and ₹ 22.56 crore respectively involving total tax effect of ₹ 15.99 crore. Reply is awaited (October 2014).

b. **Charge : CIT V Delhi**
Assessee : Ranbaxy Laboratories
Assessment Year : 2007-08
PAN : AAACR0127N

The assessee claimed weighted deduction on expenditure of ₹ 412.20 crore (₹ 374.31 crore + ₹ 37.89 crore) incurred on in house R&D at the rate of 150 *per cent* which comes to ₹ 618.30 crore under Section 35(2AB) in the computation of income. Further audit noticed that an amount of ₹ 42.35 crore incurred on Clinical Trial expenses conducted outside approved facilities (as per Form 3CL issued by DSIR) includes in the revenue R&D expenses for claiming deduction under Section 35(2AB). As the expenditure incurred on outside Clinical Trial of ₹ 42.35 crore was not an allowable expenditure under the provisions of Section 35(2AB). As such weighted portion of ₹ 21.17crore should have been disallowed. The mistake resulted in excess claim of weighted deduction to the tune of ₹ 21.17 crore resulting in under assessment of income to the same extent involving tax of ₹ 6.35 crore. Reply is awaited (December 2014).

Thus the ITD was not having an effective mechanism for examination of eligibility of R&D expenses and its correct value.

AOs allowed expenses on which either the Tax was not deducted at source or if deducted then not deposited before the specified due date.

3.2.6 Mistake in allowing expenses on which TDS was not deducted / deposited

As per Section 40(a)(ia), any interest, commission or brokerage (rent, royalty), fees for professional or technical services or amounts payable to a contractor or sub-contractor etc., as detailed therein, on which tax is deductible at source (TDS) and has not been deducted or, after deduction, has not been paid on or before the specified due date, such amounts shall not be allowed as expense in computing the income.

We noticed in seven cases in five states[24] in which the AO had allowed expenses on which TDS was either not deducted or deducted but not deposited violating the laid down provisions involving tax effect of ₹ 5.91 crore (see box 3.10).

Box 3.10 Mistake in allowing expenses on which TDS was not deducted /deposited

Charge	**: CIT-I, Guwahati**
Assessee	**: Candida Enterprise**
Assessment Year	**: 2010-11 to 2011-12**
PAN	**: AADFC9889N**

The assessee debited ₹ 1.01 crore & ₹ 1.24 crore respectively towards Service Charges in the P/L Accounts. However, no documentary evidence in support of deduction of TDS and payment thereof to the Government Account within the prescribed time limit was available in the Assessment Records. Therefore, as per the provision of Section 40(a)(ia) of the IT Act, the whole amount was not an allowable deduction. This resulted in under-assessment of total income of ₹ 2.25 crore involving tax of ₹ 95.66 lakh. Reply is awaited (October 2014).

This indicated that the provision for disallowance of expenses in cases where TDS has either not been deducted or deducted but not deposited is not being applied by the AOs properly.

24 Assam,Gujarat, Madhya Pradesh, Tamil Nadu, West Bengal

AOs did not maintain consistency in allowing or disallowing particular expenses in subsequent years.

3.2.7 Inconsistency in assessment

AOs are required to take a consistent stand in respect of allowance or disallowance with respect to certain aspect. Disallowance made in a particular AY must be sustained in the following AYs unless decided otherwise by the department.

We noticed in three cases of an assessee in Maharashtra that consistency in giving treatment of a particular disallowance was not observed by the AO involving tax effect of ₹ 149.93 crore (see box 3.11).

Box 3.11: Inconsistency in assessment

Charge	**: CIT Central-IV, Mumbai**
Assessee	**: Rajat Pharmachem Limited**
Assessment Year	**: 2006-07, 2008-09 and 2009-10**
PAN	**: AAACR6464N**

Section 68 of the Act provided for addition of the sum in the total taxable income, if that sum is found credited in the books of an assessee and the assessee either offers no explanation about the nature and source thereof or the explanation offered by him is not satisfactory in the opinion of the AO.

The AO completed scrutiny assessment (May 2011) of the assessee, *ex parte* under Section 144 read with Section 153A of the Act for the AYs 2003-04 to 2009-10. In this case, search and seizure was conducted in assessee's premises wherein it was observed that the books of accounts were not maintained in proper and correct manner as provided by law. It was manipulated and was not having evidences supporting transactions and hence the same was rejected. The assessee was asked to furnish year wise list of debtors and creditors with complete details including proof of creditworthiness of creditors, which the assessee had failed to provide. Hence the AO made additions, in the income, of amount of new sundry creditors shown. However such additions were made in respective AYs up to 2005-06 only and similar additions of new sundry creditors amounting to ₹ 99.02 crore, ₹ 98.56 crore and ₹ 186.34 crore were not done for AYs 2006-07, 2008-09 and 2009-10 respectively. Omission to do so, resulted in under assessment of ₹ 383.92 crore.

Further it was noticed that in the Balance Sheet with respect to AY 2008-09 (FY 2007-08), sundry creditors at the year end is shown as ₹ 198.12 crore, however in the balance sheet of the next FY viz. 2008-09, in the column reflecting details of the previous FY (viz. 2007-08) for comparison, the same has been shown as ₹ 256.26 crore instead of ₹ 198.12 crore. Owing to this inflated reflection, the differential amount of ₹ 58.14 crore was also required to be added in the income with respect to AY 2009-10. Thus, the total underassessment in this case was of ₹ 442.06 crore involving tax effect of ₹ 149.93 crore. Reply is awaited (October 2014).

AOs committed arithmetical errors in assessments despite provisions in the Act and CBDT's instructions in this regard.

3.2.8 Arithmetical errors in computation of income and tax

Section 143(3) provides that AOs have to determine and assess the income correctly. Different types of claims together with accounts, records and all documents enclosed with the return are required to be examined in detail in scrutiny assessments. CBDT has also issued instructions from time to time in this regard.

We noticed in 15 cases in nine states[25] in which the AO made arithmetical errors involving tax effect of ₹ 14.65 crore (see box 3.12).

Box 3.12: Arithmetical errors in computation of income and tax

a. **Charge : CIT –Central, Bangalore**
Assessee : The Himalaya Drug Company
Assessment Year : 2005-06
PAN : AADFT3025B

We noticed that the refund of ₹ 2.85 crore issued earlier was not added back while computing the total demand payable by the assessee resulting in short computation of demand of ₹ 4.00 crore. The ITD accepted the audit objection and the rectification order under Section 154 was passed in November 2013.

b. **Charge : CIT-III, Kolkata**
Assessee : Allied Resins & Chemicals Limited
Assessment Year : 2008-09
PAN : AACCA8557D

We noticed that AO in the assessment order made several disallowances amounting to ₹ 4.95 crore. The AO instead of adding the same amount deducted it from total income which resulted into under-assessment of income of ₹ 9.90 crore with consequential potential tax effect of ₹ 2.97 crore. The ITD rectified the mistake under Section 154 as pointed out by Audit (August 2014).

c. **Charge : CIT-I, Hyderabad**
Assessee : Dr. Reddy's Research Foundation Limited
Assessment Year : 2008-09
PAN : AABCR1733M

We noticed that during the assessment of the assessee company under Section 143(3) r.w.s. 147 of the Act on 10 March 2014, the refund issued of ₹ 1.69 crore under Section 154 of the Act on 25 April 2011 was not considered while computing the total demand payable by the assessee. This resulted in short demand of ₹ 2.11 crore including interest. The ITD has stated (July 2014) that audit objection is acceptable.

25 Andhra Pradesh, Gujarat, Karnataka, Maharashtra, Madhya Pradesh, New Delhi, Pujab, Rajasthan, West Bengal

This indicated that the quality of assessment, in many cases, suffered from arithmetical errors despite instructions of the CBDT from time to time.

Despite specific provisions in the Act the AOs did not assess the income under special provisions.

3.2.9 Assessment of Income under special provision

Section 115JB provides for levy of MAT at prescribed percentage of the book profit if the tax payable on total income under the normal provisions is less than such percentage of the book profit arrived at after certain additions and deletions as prescribed.

We noticed in six cases in five states[26] in which the AO had not assessed income under Section 115JB properly involving tax effect of ₹ 6.11 crore (see box 3.13).

Box 3.13 Income not assessed under special provision

a.

Charge	**: CIT I Delhi**
Assessee	**: Ayurvet Limited**
Assessment Year	**: 2009-10**
PAN	**: AAECA4056B**

The AO determined the income as *nil* under normal provisions. Hence the assessee had to pay tax on book profit of ₹ 5.86 crore under special provisions of the Act. Further audit noticed that an amount of ₹ 35.00 lakh in respect of provision for bad debts debited to the profit and loss account was also required to be added in book profit. Neither the assessee nor the AO determined the tax under Section 115JB. Omission to do so resulted in total under assessment of ₹ 6.21 crore involving tax effect of ₹ 70.40 lakh. Reply is awaited (December 2014).

b.

Charge	**: CIT LTU, Mumbai**
Assessee	**: IPCA Laboratories Limited**
Assessment Year	**: 2009-10**
PAN	**: AAACI1220M**

Income accrued or arising from any business carried by an entrepreneur in Special Economic Zone (SEZ) is not to be counted while computing book profit for the purpose of computation of Minimum Alternate Tax (MAT). Further as clarified by various court judgments[27] such income from SEZ is exempted under Section 10AA of the Act and hence shall not be considered as a part of computation of total income under normal provisions as well.

26 Gujarat, Maharashtra, Madhya Pradesh, New Delhi, West Bengal

27 (Scientific Atlanta vs. ACIT 129 TTJ 273 (Che)(SB), CIT vs. Yokogawa India Ltd. 341 ITR 385 (Kar), CIT vs. Black & Veatch Consulting 348 ITR 72 (Bom), CIT vs. TEI Technologies 78 DTR 225 (Del)and other judgements)

The assessee considered loss of ₹ 15.29 crore in its SEZ unit at Pithampur in computing book profit for the purpose of MAT and the AO allowed the same which was not allowable. This resulted in underassessment to the same extent involving tax effect of ₹ 1.73 crore. Further the assessee, in the computation of total income under normal provisions also, had considered the above mentioned loss and the AO accepted the same. As the tax payable by the assessee in this case was minimum alternate tax, the MAT credit available to the assessee was excess by the same amount of ₹ 1.73 crore.

Subsequently when the assessee makes further payment of ₹ 1.73 crore under MAT as pointed in audit, fresh MAT credit would not be available to the assessee, as he was already having excess credit to that extent. Reply is awaited (October 2014).

This indicated that in many cases, income under Section 115JB was not being assessed as per the provisions contained therein.

AOs did not assess the income of the assesses under normal provisions of the Act though the same was not specifically exempted.

3.2.10 Assessment of Income under normal provision

Section 5 provides that the total income of a person for any previous year includes all income from whatever source derived which is received or deemed to be received or which accrues or arises during such previous year unless specifically exempted from tax under the provisions of the Act.

We noticed in 16 cases in eight states[28] in which the AO had not assessed the income under normal provisions of Act involving tax effect of ₹ 84.21 crore (see box 3.14).

Box 3.14 Income not assessed under normal provision

a.

Charge	**: CIT II Vadodara**
Assessee	**: Sun Pharmaceutical Industries Limited (SPIL)**
Assessment Year	**: 2008-09 to 2010-11**
PAN	**: AADCS3124K**

The assessee company (SPIL) received ₹141.72 crore from the partnership firm Sun Pharmaceutical Industries (SPI) stating that it was remuneration from the firm and claimed exemption under Section 28(v) on this income stating that the firm has already added this amount to its income. We observed from the details of partnership deed that the income so received was in the nature of service charges for technical, marketing and distribution assistance and certain other functions performed on behalf of SPI (Firm).

28 Assam, Gujarat, Karnataka, Kerala, Maharashtra, Punjab, Rajasthan, West Bengal

Hence the above income of SPIL, not being in the nature of remuneration but a service charge was required to be taxed. Omission to do so resulted in under assessment of income of ₹ 141.72 crore involving tax effect of ₹ 48.17 crore. Reply is awaited (October 2014).

b. **Charge** **: CIT Central-III, Kolkata**
Assessee **: Nixil Pharmaceuticals Specialties Limited**
Assessment Year **: 2010-11**
PAN **: AABCN6977H**

The details of the investment in the Balance Sheet of assessee revealed that as on 31 March 2010 another company Basil International Limited had ₹24.33 crore invested in the assessee company. Whereas the investment details of Basil International Limited reflected only ₹ 9.44 crore in equity shares of the assessee. As there was no sale of shares reflected during the year in the accounts of the assessee, the excess amount so reflected was deemed to be an income from undisclosed source under Section 69. This resulted in under assessment of ₹ 14.89 crore involving tax effect of ₹ 4.24 crore. Reply is awaited (October 2014).

c. **Charge** **: CIT –LTU, Bangalore**
Assessee **: Biocon Limited**
Assessment Year **: 2010-11**
PAN **: AAACB7461R**

We observed that the AO, while computing the total income in the assessment, did not consider income from other sources of ₹ 8.83 crore. This resulted in short computation of income to the same extent involving a tax effect of ₹ 3 crore.

The ITD has stated (December 2014) that the case has been re-opened under Section 147 of the Act and notice under Section 148 dated 1.10.2014 has been issued to the assessee directing him to file a revised return.

This indicated that in many cases, income under normal provisions of the Act was not being assessed despite instructions of CBDT issued from time to time.

Assessing Officers made incorrect classification and computation of capital gains.

3.2.11 Classification and computation of capital gains

Section 45 of the Act provides that any profits or gains arising from the transfer of a capital asset be chargeable to income tax under the head capital gains.

Section 50B of the Act provides that any profits or gain arising from the slump sale shall be chargeable to income tax as capital gains arising from the transfer of long term capital asset.

We noticed in one case in Mumbai in which the AO had not assessed the income under capital gains properly involving tax effect of ₹ 0.74 crore (see box 3.15).

Box 3.15: Incorrect classification and computation of capital gains

a.	**Charge**	**: CIT LTU, Mumbai**
	Assessee	**: Glenmark Pharmaceuticals Limited**
	Assessment Year	**: 2009-10**
	PAN	**: AAACG2207L**

The assessee had sold two of its Generic units at Ankaleshwar and Goa on 01 April 2008 under Business Transfer Agreement for ₹ 750 crore. However while debiting cost of business from this sale consideration, to work out the long term capital gains, it considered book value of Capital Work-in-Progress (CWIP) of these units as ₹ 54.91 crore. Whereas the closing balance of CWIP, as on 31 March 2008 was ₹ 51.66 crore only, as reflected in the notes to fixed assets schedule in the Balance sheet. This resulted in under assessment of long term capital gains of ₹ 3.25 crore involving short levy of tax of ₹ 73.65 lakh. Reply is awaited (October 2014).

3.2.12 International Transactions

Section 92D read with 92E of the Act provided that every person who has entered into an International Transaction had to keep and maintain information and documents prescribed and to obtain and furnish a report in form 3CEB before the prescribed date, from an accountant in this regard. Further as per Section 271AA of the Act, failure to keep and maintain such information and or to report such transaction as required, or maintaining/furnishing incorrect information or document would attract penalty at the rate of two *percent* of the value of the international transaction entered into.

We noticed five cases in Maharashtra involving errors in the Transfer Pricing functions or in giving effect of the same by the ITD involving tax effect of ₹ 7.58 crore (see box 3.16).

Box 3.16: Irregularities in respect of Transfer Pricing

a.	**Charge**	**: CIT LTU, Mumbai**
	Assessee	**: Glenmark Generic Limited**
	Assessment Year	**: 2009-10**
	PAN	**: ACCG9820D**

Section 92D read with 92E of the Act provided that every person who has entered into an International Transaction had to keep and maintain information and documents prescribed and to obtain and furnish a report in form 3CEB before the prescribed date, from an accountant in this regard. Further as per Section 271AA of the Act, failure to keep and maintain such information and or to report such transaction as required, or maintaining/furnishing incorrect information or document would attract penalty at the rate of two *per cent* of the value of the international transaction entered into.

We noticed that the assessee had shown total international transaction of ₹ 111.11 crore in the Profit & Loss Account on account of payment towards the share of the company towards one time additional sales allowances given to customers by Glenmark Generics Inc., USA. The same was also certified by the Tax Audit Reporter in Form 3CD. However, the same was neither reported in Form No. 3CEB by the assessee nor Transfer Pricing Officer or AO took cognizance of the same. This resulted in non-reporting of international transaction in Form No. 3CEB by ₹ 111.11 crore attracting penalty at 2 *per cent* amounting to ₹ 2.22 crore. Reply is awaited (October 2014).

b. Charge : CIT-VIII Mumbai
Assessee : Pfizer Limited
Assessment Year : 2010-11
PAN : AAACE3334M

The AO allowed expenses of ₹ 18.38 crore debited to the profit and loss account, paid by the assessee to its associated enterprises. However, in Form 3CEB the accountant certified transactions with associated enterprises of ₹ 10.46 crore only. This resulted in excess claim of expenditure of ₹ 7.92 crore over and above what was certified by the accountant in form 3CEB, leading to under assessment of income to the same extent involving tax effect of ₹ 2.69 crore. Reply is awaited (October 2014).

3.2.13 Other cases

We also noticed 13 cases in five states[29] of miscellaneous nature such as allowance of provisional expenses, mistake in levy of interest, allowance of bogus purchase expenses etc. involving tax effect of ₹ 12.15 crore (see boxes 3.17-3.20).

Box 3.17: Illustrative cases on miscellaneous mistakes

Mistake in allowing provisions for expenses

As per Section 37, any expenditure (not being expenditure of the nature described in Sections 30 to 36 and not being in the nature of capital expenditure or personal expenses of the assessee), laid out or expended wholly and exclusively for the purposes of business or profession shall be allowed in computing the income chargeable under the head "Profits and gains of business or profession". Hence any provision made is not an allowable expenditure.

a. Charge : CIT LTU, Mumbai
Assessee : Glenmark Pharmaceuticals Limited
Assessment Year : 2008-09, 2009-10 & 2010-11
PAN : AAACG2207L

We noticed that the assessee has provided an amount of ₹ 2.03 crore for AY 2008-09, ₹ 4.58 crore for AY 2009-10 and ₹ 3.46 crore for AY 2010-11 on account of "Provision

29 Kerala, Punjab, Madhya Pradesh, Maharashtra, West Bengal

for Gratuity and Leave Encashment". As per Section 37 of the IT Act any provision made is not an allowable expenditure. Therefore, this should have been disallowed and added to the total income of the assessee while computing income under the normal provision of the Act. But neither the assessee nor the department has added this income. This resulted in under assessment of income to the extent of ₹ 10.08 crore with consequent short levy of tax of ₹ 3.43 crore. Reply is awaited (October 2014).

b. Charge : CIT Trivandrum
Assessee : Kerala Medical Service Corporation
Assessment Year : 2010-11
PAN : AADCK4029M

We noticed that provision for Income Tax amounting to ₹ 1.42 crore debited to P&L Account was not added back while computing total income. The mistake resulted in under assessment to the same extent involving short levy of tax of ₹ 48.11 lakh. The ITD accepted the objection.

Box 3.18: Illustrative cases on miscellaneous mistakes

Allowance of bogus purchase expenses

As per Section 37 any expenditure incurred by an assessee for any purpose which is an offence or which 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.

Sales Tax Department of State of Maharashtra, in the course of their investigation had unearthed a massive scam in which they had found that some dealers were issuing invoices without actual sales/purchase transaction, which is nothing but hawala transaction. Thereafter, they started publishing the list of such hawala dealers on the website of Sales Tax Department of the Government of Maharashtra. Purchases made from such bogus dealers are not admissible deduction for the assessees.

Charge : CIT-VIII, Mumbai
Assessee : Hiran Orgochem Limited
Assessment Year : 2009-10
PAN : AAACH0977J

The AO completed scrutiny assessment without verifying the name of one of the dealers viz. Utkantha Trading Pvt. Limited, from whom the assessee had shown purchases of ₹ 13.20 crore, appeared in the list of bogus dealers on the website of sales tax department of Government of Maharashtra and hence these expenses were not allowable. Omission to do so, resulted in under assessment to the same extent involving potential tax effect of ₹ 3.96 crore.

ITD in its reply did not accept the objection stating that audit had relied on third party information. Reply of the ITD was not acceptable as the name of the dealers appeared in the list of bogus dealers on the website of Sales Tax Department of Government of Maharashtra and the ITD itself uses information from this website for disallowances of purchases bogus in nature. Further it has been judicially held[30] that records maintained by various State / Central Government authorities are important piece of evidence.

Box 3.19: Illustrative cases on miscellaneous mistakes

Non deposition of tax

a. Charge : CIT-II Chandigarh
Assessee : Venus Remedies Limited
Assessment Year : 2011-12
PAN : AAACV6524H

The assessee company declared dividend of ₹ 2.74 crore for the AY 2011-12 on 30.09.2011. As per provisions of the Section 115(O), the additional tax of ₹ 44.16 lakh was required to be deposited before 15 October 2011. The assessee had not deposited the tax. This had resulted in the company becoming a defaulter with outstanding arrears of tax demand of ₹ 44.16 lakh. Reply is awaited (October 2014).

Mistake in levy of interest

b. Charge : CIT Central-IV, Mumbai
Assessee : Rajat Pharmachem Limited
Assessment Year : 2008-09
PAN : AAACR6464N

The AO completed scrutiny assessment *ex parte* under Section 144 read with Section 153A of the Act in May 2011. In this case, assessee neither filed return under Section 139(1) nor filed under Section 153A of the Act. The AO determined total income of the assessee at ₹ 283.98 crore on which tax was leviable of ₹96.52 crore. We noticed that interest under Section 234A leviable on @ of 1 *per cent* for 32 months (01.10.2008 to 31.05.2011) worked out to ₹ 30.89 crore, however, AO had levied only ₹ 29.92 crore. Hence, there was short levy of interest under Section 234A of ₹ 96.52 lakh. Reply is awaited (October 2014).

30 Motipur Sugar Factory(P) Ltd. vs. CIT (1974) 95 ITR 401-Pat (HC), Seetarama Mining Co. Vs CIT (1968)68 ITR1 (AP) HC

Box 3.20: Illustrative cases on miscellaneous mistakes

Excess or levy of interest on refunds

f.	**Charge**	**: CIT-IV, Kolkata**
	Assessee	**: Organon (India) Limited**
	Assessment Year	**: 2007-08**
	PAN	**: AAACI6949R**

The AO levied interest of ₹ 1.37 core instead of ₹ 16.78 lakh under Section 234D. The mistake resulted in excess levy of interest of ₹ 1.20 crore under Section 234D. The ITD rectified the mistake under Section 154 in September 2012. Reply is awaited (October 2014).

3.3 Conclusion

To evaluate the contribution in the tax revenue and existence of proper machinery/system to exercise necessary controls over the compliance of the provisions of the Act, we conducted the study on the assessees in Pharmaceuticals Sector. In addition to the system weaknesses like non-maintenance of sector wise data and non existence of mechanism for cross verification of turnover declared in the Income Tax Return and Excise Return, we pointed out non compliance of the instructions/guidelines of the regulatory bodies like Medical Council of India (MCI), National Pharmaceuticals Pricing Authority (NPPA) and Department of Scientific and Industrial research (DSIR).

In our Audit report we also suggested to bring clarity in instructions issued by the Central Board of Direct Taxes (CBDT) so that divergent view are not taken by the Assessing Officers and there is a consistency in the assessments and litigation is avoided.

3.4 Recommendations

a. CBDT may issue instruction to clarify the nature of expenses to be treated as freebies including physician's samples. Further, a suitable mechanism may be devised for the assessees claiming deduction of such expenses, to provide details of expenses in the nature of freebies from the sales promotion expenses

The Ministry stated (January 2015) that what constitutes 'Freebies' is prescribed in guidelines of the Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002, as amended on 10th December, 2009, and therefore, any alteration/addition/deletion in the

said guidelines can only be effected by that body. The Ministry further stated (January 2015) that in each case issue is decided by the AO on its merits and remedial action is available with AOs The Ministry further stated that making details of expenses in the nature of freebies in ITR will make it bulky.

Audit is of the view that the AOs are taking divergent views due to lack of clarity in the CBDT instructions in this regard therefore, the Ministry may take appropriate action so that AOs take consistent action in future.

b. CBDT may clearly specify the effective date of disallowance of expenses towards freebies to put the disputed and varied interpretations in this regard to rest.

The Ministry stated that the circular of CBDT dated 01 August 2012 was merely clarificatory in nature and AOs make any disallowance of freebies on the basis of existing/amended guidelines of MCI and no intervention is required on this issue.

Audit is of the view that absence of effective date in the circular may lead to divergent views of the AOs and finally lead to litigation. Therefore, the date from which the instructions of the CBDT will be effective should be specifically mentioned in every instruction/circulars i.e. prospective or retrospective.

c. The Ministry may introduce a standard form, to be filed either with return or with the assessment records, indicating allocation of all common expenses or weighted deductions alongwith the basis and working of such allocation.

The Ministry stated (January 2015) that this is a compliance issue and is to be dealt with on case to case basis. AOs are empowered to call for all such details during the scrutiny assessments.

Audit is, however, still of the view that there is a need to indicate the basis of allocation of common expenses in the assessment records.

d. The Ministry may adhere with the conditions of the DSIR in general and submission of audited accounts of the R&D facility with the return filed by the assessee in particular at the time of assessment to see the eligibility of R&D expenses and quantification thereof.

The Ministry stated (January 2015) that DSIR would be consulted for revision of the existing format of audit certificate for capturing information like allocation of expenses etc from the view point of Income-tax proceedings. The Ministry further stated (January 2015) that the feasibility of e-enabling the audit certificate for filing will also be examined by the ITD.

New Delhi **(MANISH KUMAR)**
Dated: 5 March 2015 **Principal Director (Direct Taxes)**

Countersigned

New Delhi **(SHASHI KANT SHARMA)**
Dated: 5 March 2015 **Comptroller and Auditor General of India**

Abbreviations

ACIT	Assistant Commissioner of Income Tax
Addl. CIT	Additional Commissioner of Income Tax
AO	Assessing Officer
AIR	Annual Information Report
AST	Assessment Information System
AY	Assessment Year
CBDT	Central Board of Direct Tax
CCIT	Chief Commissioner of Income Tax
CIT	Commissioner of Income Tax
CIT (A)	Commissioner of Income Tax (Appeal)
CWIP	Capital Work-in-Progress
DCIT	Deputy Commissioner of Income Tax
DGIT	Director General of Income Tax
DGIT (E)	Director General of Income Tax (Exemption)
DSIR	Department of Scientific and Industrial Research
FY	Financial Year
GMP	Good Manufacturing Practices
ITAT	Income Tax Appellate Tribunal
ITD	Income Tax Department
ITO	Income Tax Officer
JCIT	Joint Commissioner of Income Tax
LTU	Large Taxpayer Unit
MAT	Minimum Alternate Tax
MCI	Medical Council of India
MIS	Management Information System
NPPA	National Pharmaceutical Pricing Authority
PA	Performance Audit
PAN	Permanent Account Number
PCCIT	Principal Chief Commissioner of Income Tax
PCIT	Principal Commissioner of Income Tax
R&D	Research and Development
TCS	Tax Collected at Source
TDS	Tax Deducted at Source
TPO	Transfer Pricing Officer
VAT	Value Added Tax