Life Sciences

Tax Newsletter

About the newsletter

Life Sciences Tax newsletter is our initiative to share informative tax insights, important developments and interesting interviews with business leaders focusing on the ever-evolving field of life sciences.

Foreword by Santosh Dalvi

Foreign Direct Investment inflows in the pharmaceutical sector have significantly improved in the recent years - INR12,097 crore in the FY 2021-22 and INR8,081 crore during the period Apr 2022 to Sep 2022[1], in pharmaceuticals and medical devices segment. The potential upside of the sector is significant, especially in the emerging biotechnology-derived field. In the given trend, Indian pharma can go beyond the generics and biosimilars segments, graduating to new drug discovery, including genetic therapies given the new focus of the industry in emerging areas. Besides the potential growth of the sector and the increasing trend of tax collections in the recent times there is a soaring responsibility on the government to ensure maximum governance in the sector. In this regard, regulatory authorities are resorting to strict measures wherever necessary, including the attempt to nail the so called 'freebies culture' prevailing in this sector, increased GST audits, enhanced transfer pricing scrutiny on IP ownership, tangible goods and services pricing, drive against fake GST registrations, Significant Economic Presence (tracking of non-residents carrying on business in India), Stringent TRC requirement for availing treaty benefits, bilateral exchange of data between regulatory authorities, etc. Owing to the said developments, in this third edition of the newsletter, we have captured the impact of key amendment in the Finance Act, 2023 on FDI inflows together with recent insights on the implications of section 194R, specific to the life sciences sector.

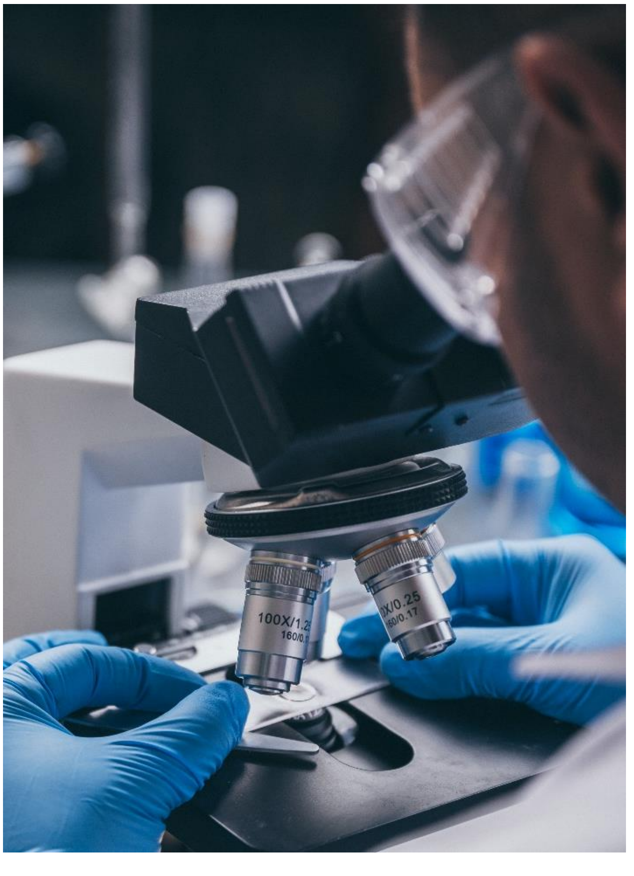
1. Press information Bureau, Ministry of Chemicals and Fertilizers, 22 December 2022.

Extension of 'angel tax' to foreign investors – potential impact on fund raising and M&A deals

Finance Act, 2023 has widened the net cast by 'angel tax' provisions (under section 56(2)(viib) of the Income-tax Act, 1961 (the 'Act')), to include issue of shares to non-residents. The mischief of these provisions is attracted if a closely held company issues shares at premium and the consideration received is in excess of the prescribed fair value of shares. In such a case, the excess of consideration over such fair value is taxed as income in the hands of the issuing company. Prior to the amendment, these provisions were only applicable if shares were issued to residents.

Background

Angel tax provisions were introduced in 2012 to prevent circulation of unaccounted money. Time and again, tax authorities have questioned valuation for fund raise undertaken by companies where shares have been issued to residents, even if the same valuation was adopted for issue of shares to non-resident investors. The only relaxations available were if shares were issued to Venture Capital Fund or Category I or II Alternative Investment Fund (AIF) or if issuing company was an eligible start-up.



Post budget notifications

Recently, Central Board of Direct Taxes (CBDT) notified exemption from angel tax provisions with respect to issue of shares to Government/ Government related investors and banks or insurance companies which are regulated in host jurisdiction. Further, following specified class of investors would also be subject to exemption if they are a resident of specified countries[2] – Category I Foreign Portfolio Investors (Cat-I FPI), endowment funds, pension funds and broad-based pooled investment vehicle or fund (number of investors > 50, excluding hedge fund).

Further, CBDT also released draft rules for amending valuation norms for unquoted equity shares for public comments. Broadly, the draft rules envisage the following:

a. In addition to adjusted book value and discounted cash flow, five new valuation methodologies prescribed for investment by non-residents

b. Price-matching concept introduced whereby issuance to exempted entities (under the Act or notification) can be used as benchmark for future issue, capped to fund raise amount from such exempt entities amount within 90 days

c. Safe harbour introduced for pricing up to 10 per cent of valuation

d. Validity of valuation report : Up to 90 days prior to share issuance.

2. Specified countries: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom and United States

Potential impact on fund raising and deal activity

Historically, Indian companies have been raising funds from non-resident investors based on commercially negotiated terms at a valuation which may be higher than the fair value derived as per an asset or income-based valuation model. Foreign exchange regulations (FEMA) allow issuance of shares to non-residents at a price which is equal to or more than the fair value, thereby allowing Indian companies (especially early-stage companies) to raise capital at negotiated fair value. With applicability of angel tax provisions imposing fair value ceiling on issue price, fund-raise would need to be undertaken at a valuation, which exactly matches the fair value as per independent valuation report. This would reduce the flexibility of structuring instruments with anti-dilution rights / down-round adjustments. While proposed rules provide for safe harbour and price matching for unquoted equity shares, these relaxations are not provided for valuing convertible preference shares, which are more commonly used instruments for structuring investor rights.

Further, in situations where there is a disagreement in valuation between the promoters and the investor, convertible instruments are typically issued with variable conversion terms allowing the investor to finalise conversion price based on certain futuristic benchmarks or parameters. For example, say convertible preference shares are issued specifying conversion price of equity shares at INR100 (1:1), subject to meeting of agreed conditions and INR80 (0.8:1) if such conditions are not met. For regulatory (FEMA) purposes, fair valuation of INR80 would need to be justified. In such cases, tax authorities may seek to tax INR20 per share as income in the hands of the company since base issue price is INR100 and fair value per share is INR80.

There may be practical challenges in case shares are purchased from existing shareholders alongside a fund raise in the company and valuation for share purchase is lower than the fund raise valuation. For example, if a foreign investor is undertaking share subscription at a price of INR100 per share and at the same time, purchasing shares from existing foreign shareholder at a price of INR80 per share, tax authorities may question the valuation for share subscription and seek to invoke angel tax provisions.

Moreover, angel tax provisions would not only impact future fund raises but also historical fund raises that were done through convertible instruments. For example, if convertible preference shares were issued to non-residents at a premium prior to 1 April 2023, while angel tax provisions would not apply on the date of issuance, they may still need to be tested on the date of conversion and company may need to justify the valuation.

Sector POV: Life sciences

The Indian healthcare sector continues to be a lucrative sector for foreign investors and a significant part of the growth may be driven from foreign capital. The wider angel tax provisions should be kept in mind while structuring foreign capital inflows in healthcare companies as well as multinational corporate reorganisations. While the angel tax provisions may have been intended to target circulation of unaccounted money, unintended tax consequences may arise even for genuine transactions if not structured cautiously.

The exemptions provided by CBDT do offer relief for foreign investment by certain entities; however, there are concerns such as leaving out several FATF compliant countries from the notified list, like Luxembourg, Mauritius, the Netherlands, Singapore, etc. which contribute significantly to foreign investment inflow in India. It is also expected that industry representations with respect to valuation concerns (such as with respect to preference shares) will be considered by the Government before finalising the valuation norms.

Freebies and other benefits - the year gone by and the tax impact which it has created

In August 2012, the Central Board of Direct Taxes issued a circular stating that expenses incurred in violation of Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (as amended in 2009) (herein referred to as MCI Regulations) shall be inadmissible under section 37(1) of the Income-tax Act, 1961 as these are for a purpose which is either an offence or prohibited by law. The circular created ripple effect and became one of the most controversial tax matters for this industry – the key claim of the pharmaceutical companies being that MCI Regulations are not applicable to them.

To address this, on 1 Feb 2023, the Government proposed an amendment vide the Finance Bill 2023 to *inter alia* disallow any expenditure incurred to provide any benefit/perquisite to a person, acceptance of which is in violation of any law or rule. While the impact of this proposal was still being deliberated, the Hon'ble Supreme Court (herein referred to as SC) in case of Apex Laboratories[3] held that when acceptance of freebies is punishable by the MCI regulations, pharmaceutical companies cannot be granted the tax benefit for providing such freebies, and thereby (actively and with full knowledge) enabling the commission of the act which attracts such opprobrium.

Rulings in last one year following Apex Laboratories

The Apex Lab ruling of SC lays to rest the legal standing of interplay between MCI regulations and corporate taxation for pharmaceutical companies. Centering around this ruling, over the year, there have been various rulings which have, based on fact, decided the matter accordingly:

Peerless Hospitex Hospital and Research Center Limited (Calcutta HC, April 2022)

Referral fees paid to doctors for referring patients is not allowable in the light of MCI regulations.

AstraZeneca Pharma India Limited (Bangalore ITAT, October 2022)

Directs examination of each expenditure and accordingly decide the allowability of such expenditure.

Merk Limited (Mumbai ITAT, December 2022)
Providing samples of pharmaceutical products is not prohibited under MCI regulations and allowable, whereas travel expenses of doctors and gifts were not allowable.

Abbott India Limited (Bombay HC, February 2023)

CBDT circular on freebies to doctors can only be applied effective 14 December 2009, i.e., effective of the date when the MCI regulations were implemented.

Boston Scientific India Private Limited (Delhi ITAT, March 2023)

TDS cannot give credence that incentives received by doctors is in fact a deductible expense and it cannot legalise the payments which are in contravention with the law.

Galderma India Private Limited (Mumbai ITAT, April 2023)

Directs examination of the nature of expenditure on account of providing free samples to the doctors and determine whether the said expenditure violates MCI regulations.

The above rulings assert that factual nature of the expenditure, as well as its effective demonstration before the authorities, is an essential element in stating if a particular expenditure is covered by the MCI regulations and consequentially allowable in the facts of its case.

3. Tax sutra, 104-Supreme Court, 2022

TDS on perquisite and benefits has a cascading effect

Another important element in claiming deduction of expense, otherwise allowable under section 37, is application of TDS provisions. Section 194R, as introduced w.e.f. July 2022, warrants a person to ensure TDS at 10 per cent is deducted and/or paid before providing any benefit or perquisite, whether convertible into money or not, arising from business or the exercise of a profession. Thereafter, guidelines were issued in June 2022 and additional guidelines issued in September 2022 to arguably 'remove difficulty' arising in giving effect to section 194R. Some of the matters covered in the guidelines, *inter alia*, include:

- For the trigger of section 194R, benefit or perquisite could be provided either in cash or in kind or in both. Further, taxability of such benefit or perquisite in the hands of the recipient of such benefit or perquisite need not be assessed
- In case of reimbursements, one would need to examine whether the expenditure being reimbursed was in capacity of 'pure agent' (a concept that of the GST law). If the invoice is not in the name of the one who is reimbursing the amount, the same is to be treated as a benefit or perquisite
- Valuation of the benefit would be fair market value, unless cost is actually incurred, in which case it shall be such cost incurred (for manufacturing or purchase, as the case may be)
- Dealer/business conference held with the prime objective to educate dealers/customers about new product, etc. shall not be treated as a benefit or perquisite. However, it would be treated as benefit/perquisite if conference is for select dealers/customers based on targets achieved, or expenditure on leisure trip, expenditure incurred for family members, for stay beyond the conference dates, etc.

If one were to examine these guidelines itself, they do seem to have characteristics of increasing the very scope of the provision. The SC in one of its rulings held that guidelines issued for 'removal of difficulty' cannot exceed the power conferred by the Act[4]. Similarly, in another ruling it held that "In no case, can it, under the guise of removing a difficulty, change the scheme and essential provisions of the Act"[5]. Removal of difficulty clause cannot be used as a substitute for rule making power[6]. Considering this, one could assess the legal validity of these guidelines.

While the coming times may test the validity and applicability of these guidelines in the judiciary, it is important to note that vide Finance Act 2023, even the penal provisions have been amended and made applicable to section 194R. Under the provisions of section 271C, the penalty could be 100 per cent of the amount of tax, which was failed to be deducted or paid. Further, under the provisions of section 276B, such person shall be punishable with rigorous imprisonment for a term which shall not be less than three months, but which may extend to seven years and with fine.

4. AIR 1968 SC 579
5. AIR 1975 SC 797
6. AIR 1988 Pat 9 (FB)

The impact for the un-initiated

Let us assume for a particular promotional scheme an expense of INR100 crore has been incurred by a company. The said company believes that the subject scheme is permissible under the MCI regulations and does not warrant any TDS. If the tax officer is to conclude that the said scheme is not permissible under the MCI regulations, the potential consequences could be as under:

Sr No	Particulars	Amount
1	Disallowance under section 37	INR25 crore [INR100 crore * 25% tax rate assumed]
2	Penalty under section 270A for underreporting or misreporting of income	INR50 crore [maximum penal rate of 200% assumed]
3	TDS liability under section 201	INR10 crore
4	Penalty under section 271C for TDS non-payment	INR10 crore
	Total potential outflow	**INR95 crore**

Additionally, considering that the proceedings would take two to three years to conclude, there would be interest liability payable. Needless to add, the possibility of prosecution proceedings being initiated.

Further, there could be disallowances of input tax credit even under the GST law, as input credit arising on the expenditure incurred in the promotional scheme could be challenged by the authorities.

The impact of these provisions cannot be undermined. The introduction has increased the compliance burden of pharmaceutical companies and has also impacted their sales promotion and marketing strategies. It is essential for companies to be aware of the provisions of the law and ensure compliance to avoid any penalties or interest.

Client Interview

- Vinod Kothari (Life Cell International)

Q1. Your views on major trends in pharma industry in 2023?

A. Year of Turnaround and Consolidation. You will see that companies will focus more on the domestic market as well other international markets apart from US which has been the major focus for India.

Q2. What are some of the larger challenges and opportunities for pharma Sector in the near future?

A. Larger challenges

1. Removal of fiscal incentives has reduced export competitiveness
2. Strategic initiatives like PLI scheme have to reach wider and importance should be given to existing players who can play a larger role/harness the same for achieving the desired result.

B. Opportunities

1. India has been emerging as an alternative source for companies who were importing from China and Europe.
2. Healthcare expenditure per capita is expected to grow substantially, thereby opening a bigger opportunity for the domestic market.
3. With the available talent pool tagged with more impetus on R&D shall help drug discovery

Q3. Performance Linked Incentive Scheme for pharma sector – hits and misses.

A. Hits

The intention was good to reduce import dependency and create alternative source of procurement.

B. Misses

1. Existing players should have been given due weightage to ensure that the right candidates are able to maximise the objective for implementing the scheme
2. Actual implementation of committed investment by applicants.

Q4. Your suggestions for start-ups / fast-growing pharma companies of India.

1. To ensure focus on quality and maintaining the highest regulatory standard
2. To focus on R&D as part of its growth strategy
3. To avail fiscal benefits by engaging the right advisors.

Q5. Your view on steps to be taken by government for making India a global pharmacy?

1. Atmosphere for R&D incubation
2. Seamless single window online clearance
3. To develop logistics infrastructure for hassle-free transportation

Q6. Your view on Union Budget 2022-23 from the perspective of pharma industry

1. Compliance must be a part of business and the same should be simplified rather than causing undue hardships for doing business. For example: Ambiguity on applicability of 194R in certain scenarios
2. Clarity on deductions to be claimed for business promotions activities.

Q7. Where do you see Indian pharma industry in the next five years?

Third in terms of value and first in terms of volume

Did you know?

The drink Coca-Cola was invented in 1886, by an Atlanta pharmacist, John S. Pemberton, at his Pemberton Chemical Company. Pemberton originally touted his drink as a tonic for most common ailments, the drink was based on cocaine from the cocoa leaf and caffeinated extracts from a kola nut – hence the name, Coca-Cola. Later, cocaine was removed from the recipes in 1903.

Happy Reading!

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