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Service fees payable to the subsidiary for product promotion services are not taxable as FTS

Background

Recently, the Authority for Advance Ruling (AAR) in the case of Dr. Reddy Laboratories Limited[1] (the applicant) held that payment of service fees for product promotion services cannot be categorised as Fees for Technical Services (FTS) either under the India-Russia tax treaty (tax treaty) or under the provisions of Section 9(1)(vii) of the Income-tax Act, 1961 (the Act). Accordingly, the said payments are not subject to withholding of tax under Section 195 of the Act.

The AAR relying on the decision of Supreme Court in the case of GVK Industries held that the term consultation entails deliberations, consideration, conferring with someone, conferring about or upon the matter. Further in the absence of any evidence to suggest that the applicant is consulting its subsidiary in pursuance of the agreement for product promotion, the subsidiary cannot be considered to be providing consultancy services to the applicant. The AAR also held that the role of the medical representatives was merely to meet the doctors and pharmacies and hence, such services cannot be categorised as managerial services managing the affairs of the applicant in Russia.

Facts of the case

- The applicant, a pharmaceutical company, entered into three separate agreements with its subsidiary DRL Russia:
  - Distribution agreement under which DRL Russia imports goods from the applicant and distributes the same in the Russian market.
  - Market research service agreement in respect of market research services on study of characteristics of the brand, identifying unsatisfied needs in relation to the brand, identifying the current perception of the image of the goods in a competitive environment.
  - Product promotion service agreement in respect of marketing services related to promotion of goods from the producer to the end-customer by way of meeting with medical and pharmaceuticals experts, participation in pharmaceutical circles, distribution of promotional materials to medical and pharmaceuticals experts.
- In consideration for the market research and product promotion services, the applicant was to remunerate DRL Russia on cost plus markup basis.

Issues before the AAR

- Whether the service fee payable for the product promotion services can be treated as FTS chargeable to tax in India as per provisions of Section 9(1)(vii) warranting withholding of tax at source under Section 195 of the Act?
- Whether the service fee payable for the product promotion services can be regarded as FTS under Article 12 of the India-Russia tax treaty, or is taxable under Article 7 or Article 22 of the tax treaty?

[1] Dr Reddy Laboratories Limited [A.A.R. No 1572 of 2014] taxsutra.com

Tax department's contentions

- Promotion of goods involving brand promotion and advertising etc. has been done by DRL Russia utilising the specialised knowledge of the dynamics of the Russian market and, therefore, services rendered by DRL Russia by utilising services of professionally qualified personnel were professional in nature.

- The reports of medical representatives of DRL Russia are sent to India which is being utilised by the applicant for the purpose of brand promotion in Russia.

- The marketing services for research agreement and marketing services for promotion of goods agreement are interconnected, and they together constitute marketing services.

Applicant's contentions

- The service fee received by DRL Russia was business income but in the absence of its Permanent Establishment (PE) in India, the income arising to DRL Russia was not chargeable to tax in India under the tax treaty.

- DRL Russia is a mere marketing and distribution arm for the applicant in Russia, and accordingly service fee could be considered as income arising through or from any business connection in India under the Act.

- The service fee paid did not fall within the ambit of the definition of FTS as these were not managerial, technical or consulting in nature.

- Since the service fee was business income, it was argued that such income could not be categorised as other income within the scope of Article 22 of the tax treaty.

- According to the principle of source rule, income of a recipient is chargeable to tax in the country where the source of payment is located, where service provider or payee is located and where services are rendered by non-resident. Since the export activity is fulfilled or concluded in Russia, the source of income cannot be said to be located in India.

AAR Ruling

- The medical representatives of DRL Russia merely promote the goods by way of meeting doctors and pharmacies and their activities are executory in nature since such services do not entail the rendering of advice to the applicant. Based on this fact it cannot be said that DRL Russia is providing any consultancy service to the applicant.

- There is no evidence to suggest that the reports prepared by medical representatives have been utilised by the applicant in respect of brand promotion for sale of goods in Russia. In order to establish that consultancy services have been provided based on work undertaken by medical representatives it is necessary that these services should be utilised by the applicant in India for brand promotion.

- The AAR relied on the decision of the Supreme Court in the case of GVK Industries[2] wherein it was held that consultation entails deliberations, consideration, conferring with someone, conferring about or upon the matter. Since there is no evidence to suggest that the applicant is consulting DRL Russia in pursuance of the agreement for promotion of goods, the AAR held that this agreement cannot be considered for providing consultancy services.

- The AAR distinguished reliance placed by the tax department on AAR ruling in case of International Hotel Licensing Company[3] wherein it was held that services provided in the form of advertising, marketing promotion, sales programme and special service and other programmes amounted to rendering of managerial and consultancy services. In the said case, based on the facts the AAR noted that the foreign company was providing such services within and outside India to the Indian

[2] GVK Industries v. ITO [2015] 54 taxmann.com 347 (SC)
[3] International Hotel Licensing Company [2006] 288 ITR 534) (AAR)

company. The AAR held that reports prepared by DRL Russia in respect of this agreement are merely statistical in nature and do not support this stand. Therefore, the services relating to promotion of goods cannot be categorised as consultancy services.

- Since the job of medical representatives is merely to meet doctors and pharmacies, the alternative argument of the tax department relating to services being managerial in nature is also far-fetched. The AAR in the case of Intertek Testing Services India Ltd[4] held that managerial services essentially includes controlling, directing or administering the business. Since all such elements are absent in this case, therefore, the services rendered pursuant to this agreement cannot be classified as managerial services either.

- The AAR also held that the service fee payable by the applicant to DRL Russia under the agreement for promotion of goods is not taxable either under Article 7 or Article 22 of the tax treaty.

Our comments

The issue as to whether a particular service constitutes FTS has been a subject matter of litigation before the Courts. The type and nature of services, arrangements between the parties and related facts of each case plays a pivotal role in determining whether the services can be categorised as FTS.

Courts have in various cases[5] held that fees paid for marketing, sales promotion, advertisement activities in a foreign country are not taxable as FTS either under provisions of Section 9(1)(vii) of the Act or under the Article on FTS under the respective tax treaties.

In the present ruling, the AAR, after analyzing the factual matrix of the arrangement between the applicant and the subsidiary, as well as the scope of services covered under the product promotion service agreement has held that said services cannot be classified as consultancy or managerial services. Thus, service fees cannot be taxed as FTS either under the provisions of the Act or under the tax treaty.

[4] Intertek Testing Services India Pvt. Ltd., [2008] 175 Taxman 375 (AAR)
[5] DIT v. Sheraton International Inc. [2009] 313 ITR 267 (Del); CIT v. Le Passage to India Tours & Travels (P.) Ltd. [2015] 54 taxmann.com 138 (Del)

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