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Tax sparing credit is allowed on the interest income under the India-Cyprus tax treaty. Payment for clinical trials is not taxable as FTS under the India-USA tax treaty. Post-merger, weighted deduction on scientific research expenditure is allowed to the merged entity

Background

Recently, the Hyderabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Dr. Reddy's Laboratories Ltd.[1] (the taxpayer) held as follows:

- The expenditure approved by the Department of Scientific and Industrial Research (DSIR) includes a sum on account of Perlecan Pharma Pvt. Ltd. (Perlecan Pharma). By virtue of the merger of Perlecan Pharma with the taxpayer, all its activities are also the activities of the taxpayer. Therefore, the deduction under Section 35(2AB) of the Income-tax Act, 1961 (the Act) is allowable even on the expenditure incurred on Perlecan Pharma after the date of its merger.

- Since there is no technical skill, knowledge, expertise, plans, or designs are made available, the payments made to the Contract Research Organisations (CROs) in the U.S. for conducting clinical trials to comply with the regulations, did not fall under Article 12 of the India-USA tax treaty. Amounts paid are considered as business receipts and since CROs do not have any Permanent Establishment (PE) in India, there is no need to deduct tax at source.

- The process of research includes a trial run of a new drug. The taxpayer's experiments on a new drug cannot be said to be a new line of business, and therefore, the expenditure towards the Cyto products is allowable as revenue expenditure.

- The Tribunal has remanded the issue of grant of the tax credit on the interest income earned from the Cyprus subsidiary to the Assessing Officer (AO) to verify whether the taxpayer has paid tax on the interest income in India. If such tax is paid, the deduction of the tax admitted to have been paid in Cyprus under Article 25 of the India-Cyprus tax treaty should be allowed.

Facts of the case

- The taxpayer, engaged in the business of manufacture and trading of pharmaceutical products filed its return of income for the Assessment Year (AY) 2007-08.

- The taxpayer incurred a sum towards the trial run expenses pertaining to the cancer drugs, which was debited to pre-operative expenses and taken to the balance sheet in the books of account for the A.Y 2007-08. However, for tax purposes, the said amount was claimed as revenue expenditure under Section 37 of the Act. The AO however, observed that the expenditure is not incurred for improving the present project, but is incurred for a new project which did not materialise therefore, it is capital in nature and not allowable.

- By virtue of a High Court order, Perlecan Pharma got merged with the taxpayer with effect from 1 January 2006. The taxpayer claimed the weighted deduction of 150 percent under Section 35(2AB) in respect of expenditure on scientific research incurred by Perlecan Pharma. The AO observed that before the merger, Perlecan Pharma was a separate undertaking and each R&D undertaking

[1] Dr. Reddy's Laboratories Ltd. v. ACIT [ITA Nos.2229/Hyd/2011, 85/Hyd/2013 - Assessment Years: 2007-08 & 2008-09] – Taxsutra.com. In the present case, the Tribunal has given decision on some other issues, which have not been considered in this Flash news

needs to be approved by the DSIR in Form 3CL format for getting the benefit for the weighted deduction. Observing that Perlecan Pharma did not have such an approval, the AO disallowed the claim on R&D expenditure.

- The AO held that some payments to the foreign companies by the taxpayer for the technical services were made without deducting tax under Section 195 of the Act. Under Articles 12 and 15 of the India-USA tax treaty, such payments are taxable in the source country and therefore, tax withholding under Section 195 was to be done.

- The taxpayer granted a loan to its subsidiary in Cyprus, and the subsidiary paid interest to the taxpayer. As per Article 11 of the India-Cyprus tax treaty, 10 percent of the gross amount of interest is chargeable to tax in Cyprus. The taxpayer submitted that the domestic law at Cyprus provides the tax incentives for the promotion of economic development in Cyprus and therefore, there was no withholding of tax on interest amount remitted to the taxpayer in India. Article 25 of the India-Cyprus tax treaty provides for the tax credit in India with respect to taxes withheld/levied in Cyprus on the interest amount, and not withstanding that no tax has in fact, been withheld as mentioned above. Accordingly, the taxpayer claimed a tax credit at 10 percent of the gross amount received from Cyprus. The Dispute Resolution Panel (DRP) observed that Cyprus did not levy any tax and therefore, the claim for credit of tax payable in Cyprus was rejected.

The Tribunal's ruling

Trial run expenditure

- The taxpayer is in the business of research development and manufacture of pharmaceuticals. The process of research includes the trial run of a new drug. Therefore, the taxpayer's experiments on a new drug cannot be said to be a new line of business.

- In the case of Glaxo Smith Kline Consumer Healthcare Ltd.[2] the Chandigarh Tribunal held that the new products relate to the same line of business that the taxpayer has been carrying on. Therefore, the expenditure incurred for introducing and developing new products are revenue expenditure.

- Following the above decision, it is held that the expenditure incurred by the taxpayer towards Cyto products is allowable as revenue expenditure.

Weighted deduction on scientific research

- The in-house R&D facility of the taxpayer is approved by the DSIR as provided under Section 35(2AB). The expenditure approved by the DSIR includes a sum on account of Perlecan Pharma. By virtue of the merger, all the activities of the Perlecan are also the activities of the taxpayer. As the facility and also the expenditure has already been approved by the relevant authority, post-merger the said expenditure cannot be reduced while allowing the deduction under Section 35(2AB) of the Act. Therefore, the deduction under Section 35(2AB) is allowable even on the expenditure incurred on Perlecan Pharma after the date of its merger.

Payment to foreign companies for rendering technical services

- In the taxpayer's case[3] for the AYs 2003-04 and 2004-05, the Tribunal held that the payments were made by way of 'fee for technical services' as per Article 12 of the tax treaty, however, the same is taxable in the source country only if such services make available any technical knowledge, expertise, etc. or there is a transfer of a technical plan or design.

- The taxpayer was conducting clinical trials through the CROs in the U.S. to comply with the regulations therein, and the CROs who are experts in this field were only conducting studies and submitting the reports in relation to it. There was neither transfer of a technical plan or technical design nor making available of technical knowledge, experience or know-how by the CROs to the taxpayer company.

- The taxpayer company did not get any benefit out of the said services in the USA, and the taxpayer was only getting a report in respect of the field study on its behalf, which would help it in getting registered with the Regulatory Authority.

[2] Glaxo Smith Kline Consumer Healthcare Ltd. v. ACIT [2007] 112 TTJ 94 (Chandigarh)

[3] DCIT v. Dr. Reddy's Laboratories Ltd. [2013] 35 taxmann.com 339 (Hyd)

- Since there is no making available of technical skill, knowledge, expertise, plans, or designs in the present case, the amounts paid by the taxpayer does not fall under Article 12 of the tax treaty, but comes within the purview of Article 7 of the tax treaty. Therefore, the amounts paid are to be considered as business receipts of the said CROs, and since they do not have any PE in India, there is no need to deduct tax at source.

- A similar issue was analysed and considered by the AAR in the case of Anapharm Inc.[4], which is one of the recipients in the taxpayer's case also.

- The facts and circumstances in the present case are similar to the above decisions, and therefore, following the decision of the Coordinate Bench in the taxpayer's case, it is held that payments for technical services to the foreign companies are not liable for tax withholding.

Tax credit on interest income

- The DRP in relation to AY 2008-09 held that the AO has to compute the tax on interest income and allow the tax attributable to interest income under the India-Cyprus tax treaty. The AO is directed to verify whether the taxpayer has paid tax on interest income, and if the tax is paid then allows the deduction for tax deemed to have been paid.

- The Tribunal held that since the facts in the above case are similar to that in the present case, the issue is remanded to the file of the AO to verify whether the taxpayer has paid tax on interest income in India, and if so, to allow the deduction of the tax admitted to have been paid under Article 25(2) read with Article 25(4) of the tax treaty.

Our comments

In order to attract capital and investment, countries give concessions e.g. in India units located in Free Trade Zones are exempt from tax. If a tax credit is restricted to the tax paid, this incentive given to the investor from the resident state is lost. To keep this benefit, the resident state agrees to give credit not only of tax paid but that which would have been payable in the absence of such incentives. Thus, the 'tax sparing' method goes beyond the pure tax credit method and takes into account the potential tax, which would have been payable.

In the present case, Cyprus subsidiary paid interest to the taxpayer. The taxpayer offered the same to tax in India. The taxpayer claimed and the Tribunal allowed the tax sparing credit as per Article 25 of the India-Cyprus tax treaty, in spite of the fact that there was no tax withholding by Cyprus subsidiary.

In June 2016, CBDT issued a Notification[5] introducing Foreign Tax Credit (FTC) rules in the Income-tax Rules, 1962, which will come into effect from 1 April 2017. Even though many Indian tax treaties provide for a tax sparing clause, the FTC Rules do not deal with such instances.

Recently, the Bangalore Tribunal in the case of Stempeutics Research (P.) Ltd.[6] held that the payment by an Indian pharma company to its Malaysian subsidiary for carrying out clinical trials and R&D pursuant to a product development agreement, the service being of a technical nature, constituted FTS under the India-Malaysia tax treaty. Since Article 13(3) of the tax treaty did not contain the 'make available' clause, such payments were held to be taxable in India.

However, in the present case, no technical skill, knowledge, etc. were made available with respect to payments to the CROs in the USA. Therefore, it was held that such payments do not fall under Article 12 of the India-USA tax treaty.

[4] Anapharm Inc., In re [2008] 305 ITR 394 (AAR)

[5] Notification No. 54/2016, dated 27 June 2016

[6] Stempeutics Research (P.) Ltd. v. JDIT [2016] 75 taxmann.com 240 (Bang)

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