Indian Income-Tax Appellate Tribunal Permits Reduction of US Company's Royalty Income Based on APA Signed by Indian AEWHT

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The Indian Income-tax Appellate Tribunal (ITAT) accepts the assessee [Gemological Institute of America Inc]'s contention that the royalty amount refunded to its Indian AE [GIA India Laboratory Pvt Ltd or GIA-India] on the basis of an advance pricing agreement (APA) signed by GIA India, cannot be treated as income in the hands of GIA US.

ITAT decides the issue on first principles in favour of the assessee and orders a reduction of GIA US's taxable royalty income for the years covered by the APA after due verification of the quantum calculations. For assessment years 2011/12 to 2016/17 (equivalent to Financial Years 2010/11 to 2015/16), GIA US had received royalty amounts from GIA India that were offered to tax in India on a gross basis under article 12 of the India-US DTAA.

While the finalization of its tax liability was still pending in view of the Revenue's contention to tax the royalty income on a net basis under article 7 of the India-US DTAA, GIA India approached the Indian tax administration for an APA with respect to the above-mentioned royalty transaction.

The APA was signed in May 2018 and covered the financial period ended 31 March 2014, 2015, 2016 and 2017, and rollback period of 4 years i.e. financial periods ended 31 March 2010, 2011, 2012 and 2013. One critical assumption of the APA was that where payment of royalty to GIA US exceeds the ALP determined under the APA, the same shall be recovered by way of invoices raised by GIA India and subsequently, be offered to tax by GIA India as additional income in the modified returns of respective years.

The net result of the APA was that royalties received by GIA US from GIA India were required to be partially refunded to GIA India. Accepting the assessee's contentions, ITAT observes that one of the fundamental assumptions of the APA was the partial recovery of royalty from GIA US and hence the bona fide nature of the adjustments made in the quantum of royalty by GIA US cannot be questioned.

ITAT notes that royalty recoveries and royalty refunds cannot be seen as standalone events but in conjunction with the whole transaction with GIA India where the excess royalty refunded by GIA US has been offered to tax by GIA India.

It also observes that on the basis of well-established legal principles, GIA US can only be taxed on its "real income" and not hypothetical income which has been refunded to the payer of royalty. ITAT dismisses Revenue's contentions that considering this issue is beyond the powers of the ITAT, which may, after granting both the parties an appeal to an opportunity of being heard, “pass such orders thereon as it thinks fit.” ITAT treats Revenue's contention that "where the computation of income on the basis of arm’s length price results in a reduction of taxable income or increase of loss, the provisions Computation of income from international transaction will not apply" to be a wholly irrelevant observation and superficial. ITAT brushes off Revenue's contention that GIA US cannot benefit from the terms of APA signed by CBDT with GIA India as "very superficial". It observes that "Whether it happened on account of APA, or it was to happen otherwise, the fact remains that there is a reduction of royalty income in the hands of the assessee (GIA US). And, if there is a reduction in royalty income, what should be brought to tax is only the actual, i.e. reduced, royalty income". ITAT discusses the scope and impact of provisions pertaining to secondary adjustments in detail and observes that "It is thus not correct to say that, in principle… no refund of taxes could be claimed or allowed on account of secondary adjustments- even if, for example, as in this case, such secondary adjustments end up reducing the income of the foreign AE assesses as a result of partial repatriation of income".

Comments from Indian tax experts on this decision:

Rahul K Mitra (Senior Advisor with M/s Nangia Andersen)

"… The Mumbai Tribunal demonstrated an extremely high level of judiciousness, pragmatism and positive approach in allowing the claim of Gemological US, by holding that under the real income theory, the balance sum of USD 20 (as an example) no longer remained an income of Gemological US, upon its refund in favour of GIA India in order to honour the conditions imposed by the APA Authorities of India in the APA signed between GIA India and the Government of India. The ruling of the Mumbai Tribunal is extremely welcome, as it addresses similar distresses faced by other non-resident taxpayers in flipside issues emanating from the conclusion of APAs in the hands of their Indian related parties.

While the judiciary, namely the esteemed institution of the Tax Tribunal, has played its role and part in addressing the unforeseen hardship of non-resident taxpayers under the circumstances referred to above, it is now upon the Government of India to legislate on similar lines, since the judiciary may not be able to provide relief in all such cases, for various reasons ..."

Vijay Iyer (National Leader, Transfer Pricing, EY India)

"… This is a very welcome ruling and gives a strong message to the international community and multinational investors that Indian transfer pricing recognizes the issue of real income and that the Indian tax courts give due importance of not taxing the same income twice in the hands of two taxpayers of the same group in India in certain circumstances.

However, given the complexity and importance of the issue involved, the Tax Department may likely file an appeal against this judgment before higher courts. Thus, while the ruling may not be the last word on this issue, it should certainly give guidance to taxpayers and Tax Administrations to follow.

Also, while in this case, the taxpayer's appeals were pending with the Tribunal, the taxpayers whose appeals are not pending with appellate fora may not be able to take benefit from this ruling and would need to explore other alternatives."

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Vishweshwar Mudigonda (Partner, Deloitte Haskins & Sells LLP)

"... The current ruling observed that no secondary adjustment under section 92CE can anyway be unilateral in nature. It is, therefore, not correct to say that when an APA requires an assessee to raise debit notes or invoices on its AE abroad, it is open to the AE abroad to ignore those invoices or debit notes and continue with computation of its income *dehors* these invoices or debit notes, because the said AE is not a party to the APA. The AE may not be party to the APA, yet the impact of the terms of the APA must be taken note of when these terms affect the AE.

This ruling has in a nutshell revamped the way provisions relating to corresponding adjustments are to be interpreted under an APA."