

# TAX FLASH NEWS

13 May 2021

## The Tribunal permits reduction of foreign taxpayer's taxable income in India basis APA signed by taxpayer's Indian Associated Enterprise

### Executive Summary

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Gemological Institute of America Inc.<sup>1</sup> (foreign taxpayer) has dealt with the issue of allowing corresponding adjustments to the taxable income of foreign taxpayer in consequence of an Advance Pricing Agreement (APA) signed by its Indian associated enterprise (AE) with the Central Board of Direct Taxes (CBDT).

The Tribunal ruled in favour of the foreign taxpayer and noted that the amount previously booked as an income but subsequently refunded in a 'bonafide' capacity pursuant to a specific condition of the Indian AE's APA cannot be considered as a taxable income of the foreign taxpayer. Tribunal emphasized on considering the 'real income' as opposed to the 'hypothetical or notional income' for taxation purposes.

### Facts of the case<sup>2</sup>

- The foreign taxpayer had received royalty income from its Indian AE for Assessment Years (AYs) 2011-12 to 2016-17.
- Royalty amount received by it was offered to tax in India under Article 12(2) of India-USA Double tax treaty (tax treaty) @ 15% on a gross basis. However, the case was under dispute before the Tribunal as revenue was alleging establishment of a Permanent Establishment in India and thereby taxation of royalty on a net basis under Article 7 of the India-USA tax treaty.

- In the meanwhile, the Indian AE concluded a unilateral APA with the CBDT, covering international transaction of payment of royalty to the foreign taxpayer.
- One of the critical assumptions of the APA required that Indian AE shall raise an invoice on the foreign taxpayer and recover the excess amount in case payment of royalty exceeded the arm's length price determined as per the APA. Subsequently, this income will be offered to tax by the Indian AE as additional income in its modified returns of respective years.

### Primary issue before the Tribunal

The main issue under adjudication before the Tribunal was whether or not the quantification of taxable royalty income in the hands of foreign taxpayer will stand reduced by the refund granted to its Indian AE consistent with the terms of the APA to which the foreign taxpayer is not even a party.

### Tribunal's Decision

The Tribunal has adjudicated that that once the excess royalty paid by the Indian AE has been recovered from the foreign taxpayer through invoicing/ book entries, taxing such amount (already refunded) in the hands of the foreign taxpayer would result in taxing notional income. The Tribunal has made certain pertinent observations while adjudicating the issue in favour of the foreign taxpayer.

- The foreign taxpayer cannot be taxed in respect of the amount which it has refunded and hence, income to be taxed must be the real income.
- On Revenue's argument that the foreign taxpayer cannot benefit from the terms of APA signed by the Indian AE, the Tribunal tagged this contention as "superficial" and observed that it is not the 'content' of the APA, but the 'impact' of the APA that is relevant for the foreign taxpayer.

<sup>1</sup> Gemological Institute of America Inc. v. ACIT (ITA No. 386/Mum/2016, 1836 and 7174/Mum/2017, 53,7739 and 7740/Mum/19) (Mum)

<sup>2</sup> Discussion on admissibility of additional grounds before Tribunal has not been covered in this Flash News

- Disregarding Revenue's reliance on second proviso to Section 92C(4) of the Act which prohibits an entity from getting corresponding benefit of arm's length adjustment made in hands of its AE, the Tribunal stated that the modification in quantum of the royalty is not because of determination of ALP but because of the actual, even if partial, refund of the royalty due to a bonafide claim in consequence to the APA.
- Adjudicating Revenue's argument with respect to distinction between the period prior and post introduction of provisions pertaining to secondary adjustment, the Tribunal noted that secondary adjustment provisions in any case, have nothing to do with taxability of correct income in the hands of foreign taxpayer. Tribunal has further states that applicability or non-applicability of these provisions cannot be seen as a bar on repatriating back excess royalty amount received (i.e. actual received minus the arm's length amount).
- The Tribunal has also acknowledged the bilateral nature of secondary adjustment, whether pursuant to an APA or otherwise. The Tribunal noted that every invoice raised by the Indian AE here has to be accounted for in the books of foreign company as well and accordingly a corresponding expense/revenue reduction is bound to happen.

## Our comments

This is a welcome decision by the Tribunal which carries significant relevance for foreign taxpayers. The Tribunal has recognised the principal factual position and rightly upheld corresponding argument of the foreign taxpayer for reducing its taxable royalty income (that was already offered to tax in its tax return) as the differential amount was required to be (and has been) refunded by it to its Indian AE.

Within the broad similarity of facts, several other foreign taxpayers may consider (subject to applicable provisions) initiating proceedings to seek a refund of the excess taxes deducted/ paid based on their Indian AE's APA or Secondary Adjustment by exploring alternatives available such as revision of tax return, claims during ongoing tax assessment or any ongoing appellate proceeding, invoking Mutual Agreement Process (MAP) based on the relevant tax treaty, etc. All of these will eventually have to stand the test of time. Foreign taxpayers may continue to face resistance or rejection on any tax refunds in case the Revenue chooses to contest this matter in appeal at High Court and (if required) Supreme Court.



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