TRANSFER PRICING

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Case Law Update

- Reduction in foreign companies' Royalty income permissible basis Unilateral APA signed by India Associated Enterprise - **Gemological Institute of America Inc [TS-201-ITAT-2021(Mum)-TP]**

Facts:

- The Assessee is a foreign company earning Royalty income from its Indian Associated Enterprise ('AE') which was subject to withholding tax at 15 percent in India.
- Indian AE has signed Unilateral APA with CBDT in respect of the royalty payment as a covered transaction.
- One critical assumption of the Unilateral APA was that in case where payment of royalty by Indian entity exceeds the ALP determined under the APA, the same shall be recovered by way of invoices raised by Indian entity and subsequently, be offered to tax by the Indian entity as additional income in the modified returns of respective years.
- Thus, the result of the APA was that royalty which were received by the Assessee were required to be partially refunded to Indian AE.
- Pursuant to this, the Assessee before the Hon'ble Tribunal either through additional Grounds in pending appeals or original Grounds of Appeal claimed that the amounts so refunded by the Assessee to its Indian AE, be reduced from the computation of its income from the royalties.

Tribunal's Ruling:

- The Hon'ble Tribunal ruling in favour of the Assessee noted that the amount previously booked as an income but subsequently refunded in a 'bonafide' capacity pursuant to the Indian entity's APA cannot be considered as a taxable income of the Assessee.
- The Hon'ble Tribunal observed that where the 'excess royalty' paid by the Indian AE was recovered from the Assessee through invoicing / book entries, taxing such amount (already refunded) in the hands of the Assessee would result in taxing notional income.
- Negating the Revenue's contention that the Assessee cannot benefit from the terms of APA signed by the Indian AE as "very superficial", the Hon'ble Tribunal emphasized on considering the 'real income' of the non-resident taxpayer as opposed to the 'hypothetical or notional income' for taxation purposes.
- The Tribunal further negated Revenue's contention that second proviso to section 92C(4) prohibits an entity from getting corresponding benefit of ALP and such reduction is not permissible as per Secondary adjustment provision. The Tribunal noted that the reduction in royalty is not because of determination of ALP during TP audit but due to refund pursuant to APA.

- When payments are accepted at arm's length by the TPO, then the AO cannot hold such expenditure as unreasonable and invoke the provisions of Section 40A(2) of the Act. - **Lifestyle International (P) Limited [TS-185-ITAT-2021(Bang)-TP]**

Facts:

- The Assessee has paid professional fees to its AE which was considered by the Assessee as an international transaction in its transfer pricing study and also disclosed in Form no. 3CEB.
- The TPO during the TP assessment proceedings accepted the said transaction of payment of professional fess to be at arm's length.
- However, the AO went ahead and disallowed the professional fees paid under Section 40A(2) of the Act citing it as excessive and unreasonable.
- Alternatively, the AO also alleged for disallowance under Section 37 of the Act, concluding the payments to be not incurred exclusively for the purpose of business.
- CIT(A) deleted the adjustment made by the AO. Aggrieved by the order of the CIT(A), the Revenue filed an appeal before the Tribunal

Tribunal's Ruling:

Upholding the order of CIT(A) and dismissing the grounds raised by Revenue, Hon'ble Tribunal observed as under:

- The AO is required to compute the total income of the Assessee having regard to the arm's length price determined by the TPO.
- When payments are already accepted at arm's length by the TPO, then there was no justification on the part of the AO to hold that the expenditure is unreasonable and invoke the provisions of Section 40A(2) of the Act. Moreover, the AO has not compared the reasonableness of payment with respect to fair market value of services provided by the AE vis-à-vis third parties.
- Further Hon'ble Tribunal noted that the AO was also not correct in disallowing the expenditure under Section 37 of the Act. Hon'ble Tribunal remarked *"The A.O. has nowhere doubted the genuineness of the agreement, the retention of services as well as the fact of actual payment of professional fees. The A.O. has disallowed the payment merely because he considered that there was no necessity of incurring such expenses by stating that the assessee had full-fledged management team and well-equipped resources. The A.O. cannot take a place of the management of the company and decide from its own point of view, whether an expense has to be incurred or not."*

  - Accepts tested party as the non-eligible unit under CUP as done by the Assessee for benchmarking inter unit power transfer. Accordingly, deletes the adjustment on **SDT - Balarampur Chini Mills Ltd [TS-200-ITAT-2021(Kol)-TP]**

Facts:

- The Assessee was claiming deduction under Section 80IA of the Act for generation and distribution of power in its Return of Income.
- The Assessee had considered rate of electricity at Rs. 8.30 per Kwh for transferring the same to other units (manufacturing units) of the Assessee. The said rate was considered as per tariff orders issued by Uttar Pradesh Electricity Regulatory Commission for sale of electricity in that area. The transaction were reported as Specified Domestic Transaction ('SDT') and considered to be at arm's length.
- The TPO did not agree to the contention of the Assessee and determined the TP-adjustment at INR 41.65 crores by considering the rate of electricity at INR 4.90 per Kwh. The rate adopted by the TPO was the rate at which the eligible unit of the Assessee had sold electricity under Power Purchase Agreement (PPA) to the distribution companies.
- CIT(A) agreed with Assessee's contention and granted relief. Aggrieved by the order of the CIT(A), the Revenue filed an appeal before the Tribunal

Tribunal's Ruling:

Upholding the order of CIT(A) and dismissing the grounds raised by Revenue, Hon'ble Tribunal observed as under:

- Explanation to Section 80IA(8) of the Act inserted by the Finance Act, 2012 w.e.f. 01.04.2013 gives an option for determination of "Market Value" as the ALP under the transfer pricing provisions OR as the price of such goods and services as, that it would fetch in the open market.
- There is no dispute that CUP is the Most Appropriate Method. The ICAI in Guidance note that the tested party has to be identified even when under CUP analysis.
- In this case the Assessee has taken that the tested party as the non-eligible unit and whereas the TPO has taken the tested party as the eligible unit. Taking the manufacturing unit as tested party for the purpose of determination of ALP under CUP, cannot be found fault with as the profit of the non-eligible unit also had to be properly determined.
- The rate under PPA as adopted by the TPO cannot be considered as the *"market value" or "uncontrolled transaction"* as PPA is a 20 year agreement with regulated price needing statutory clearances and approval.
- ITAT concluded that *"Thus while determining the ALP under transfer pricing provisions, in our view the assessee has correctly identified the manufacturing unit as the tested party and CUP as the MAM and the purchase price of electricity in the open market from the State Electricity Board to the manufacturing units in uncontrolled conditions as the ALP."*

  - ITAT upholds DRP's action of directing 1% adjustment to the average margin to be provided towards risk adjustment - **NTT Data Global Delivery Services Pvt Ltd [TS-180-ITAT-2021(Bang)-TP]**

Hon'ble Tribunal appreciating the difference in the risk profile of a captive cost plus entity and the comparable companies upheld the DRP directions to give 1% risk adjustment to the average margin of comparable companies. The relevant extract from the Tribunal order is as under:

"6.4 The DRP had restored the issue to TPO and directed him to give 1% adjustment to the average margin for the risk differentials. The DRP in the above said directions, had relied on various orders of the Tribunal. In view of the above orders of the Tribunal (cited by the DRP), we hold that the DRP is justified in the aforesaid directions. It is ordered accordingly."

Gemological Institute of America Inc Vs ACIT {ITA 386, 7174, 1836- Mumbai ITAT}

Mumbai ITAT accepted Gemological Institute of America Inc's ("assessee") contention that royalty amount refunded to GIA India Laboratory Pvt Ltd ("GIA-India") on the basis of an APA signed by GIA India, cannot be treated as income in the hands of GIA US.

Brief facts of the case:

GIA US had received royalty amounts from GIA India which were offered to tax in India @15% on gross basis under Article 12 of the India-US DTAA. While the finalisation of its tax liability was still pending in view of the Tax Authority's contention to tax the royalty income on a net basis under Article 7 of the India-US DTAA, GIA India approached CBDT for an APA with respect to the above-mentioned `royalty transaction. The APA was signed in May 2018 and covered the financial period ended 31st March 2014, 2105, 2016,and 2017, and rollback period of four years i.e. financial periods ended 31st March 2010, 2011,2012 and 2013. One critical assumption of the APA was that in case 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 additonal income in the modified returns of respective years. The net result of the APA was that royalties which were received by GIA US from GIA India were required to be partially refunded to GIA India. Accepting assessee's contentions, ITAT observed that one of the fundamental assumptions of the APA was partial recovery of royalty from GIA US and hence the bonafides of the adjustments made in the quantum of royalty by GIA US cannot be questioned. Notes that royalty recoveries and royalty refunds cannot be seen as standalone events but in conjunction to the whole transaction with GIA India where the excess royalty refunded by GIA US has been offered to tax by GIA India. It was also noted that basis well-established legal princples, GIA US can only be taxed on its "real income" and not hypothetical income which has been refunded to the payer of royalty. The ITAT rejected Tax authority's contention that GIA US cannot benefit from the terms of APA signed by CBDT with GIA India as "very superficial". It also observed 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. And, if there is a reduction in royalty income, what should be brought to tax is only the actual, i.e., reduced, royalty income.". It discussed the scope and impact of Section 92CE qua secondary adjustments in detail and observed that "It is thus not correct to say that, in principle, in terms of the provisions of section 92CE, 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."