

Reimbursement of lease line charges to AE not taxable as “royalty” under tax treaty; TPO’s acceptance of nature of expense binding

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In brief

In a recent decision,¹ the Pune bench of the Income-tax Appellate Tribunal (Tribunal) has held that reimbursement of lease line charges to US parent could not be characterised as “royalty” as per the India-USA Double Taxation Avoidance Agreement (tax treaty). It rejects the Revenue’s contention that the taxpayer routed payments to a third party service provider through its associated enterprise (AE) to avoid withholding tax obligations. In light of the fact that the reimbursement was on cost without a mark-up the same was not subject to withholding tax.

It has further been held that the determination of nature of international transaction as “reimbursement” by the Transfer Pricing Officer (TPO) was binding on the Tax Officer (TO).

In detail

Facts

- The taxpayer was an Indian company. It claimed expenditure on account of reimbursement of expenses to its US parent.
- The parent company had entered into an agreement with a third party service provider (A Limited) for providing lease line services and the parent company in turn, provided such services to its subsidiaries (including the taxpayer) against reimbursement on cost-to-cost basis.
- The TPO accepted the transaction to be at arm’s length price (ALP) and as “reimbursement” of expenses.
- The TO held that the payment was not reimbursement of expenses to the parent company but was payment made to A Limited through the parent company, for use of “process,” and accordingly, such remittance was taxable in India as “Royalty” (considering the retrospective amendment of the provisions of the Act). The payments were disallowed in the hands of the taxpayer for non-withholding of tax.

- On appeal, the Commissioner of Income-tax (Appeals) upheld the TO’s order.

Issue before the Tribunal

- Whether payment made by the taxpayer to its parent company against of lease line services was in the nature of “Royalty” as per the tax treaty?
- Whether tax was required to be withheld on such payments for lease line charges?

Taxpayer’s contentions

- The taxpayer contended that the withholding tax provisions would not apply

¹ ITA No. 826/ PUN/ 2015

on reimbursement of expenses having no embedded profit element.

- The TPO had accepted the transaction as reimbursement of expenses.
- Relying on judicial precedents² and contending that even post amendment, the payment for lease line charges was not taxable in India, in accordance with the beneficial provisions of the tax treaty.
- The taxpayer relied on the Supreme Court's decisions³ to contend that withholding tax liability arose only when the remittance was chargeable to tax in the hands of a non-resident Indian.

Revenue's contentions

- The Revenue contended that the payment was routed to A Limited through its parent company. If the amount were paid to A Limited directly then it would have attracted withholding tax provisions.
- Where the parent company had not provided any services, it could not be a case of reimbursement of expenses.
- The payment made to the parent company was in the nature of Royalty as per the

amended provisions of the Act.

Tribunal's decision

- On whether lease line charges may be taxed as "royalty," the Tribunal relied upon the Delhi High Court ruling in case of New Skies and Shin Satellite² to hold that beneficial provisions of the tax treaty overrides the provisions of the Act and the definition of "royalty" not having been amended the taxpayer was not liable to withhold tax on the lease line charges paid by it.
- On the issue of taxability of reimbursement, the Tribunal held as follows:
 - The basic principle is that where the reimbursement of expenses does not include any income element, the same is not subject to tax in India.
 - The privity of contract was between A Limited and the parent company, which received services and in turn passed it on to various group entities.
 - The taxpayer had substantiated based on extensive evidence that it was charged by its parent company on cost, and in absence of any income

element, the taxpayer was not liable to withhold tax.

- In relation to the contention of the taxpayer that the TO could not change the character of transaction determined by the TPO, the Tribunal held that -
 - Once the transaction had been accepted by the TPO as reimbursement of expenses and was accepted to be at ALP, its order was binding on the TO, not only in respect of determination of ALP but also with regard to the nature of transactions.

The takeaways

- In order to establish that a transaction is in the nature of pure "reimbursement," one needs to substantiate the same based on documentation entered between the AE and the third party as well as within the group.
- The TPO's acceptance of the nature of expense is binding on the TO.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

² DIT v. (1) New Skies Satellite BV (2) Shin Satellite Public Co. Limited [2016] 382 ITR 114 (Delhi);

DIT v. Nokia Networks OY [2013] 358 ITR 259 (Del);
Asia Satellite Telecommunications Co. Limited v. DIT [2011] 332 ITR 340 (Del)

³ GE Indian Technology Cen (P.) Limited v. CIT [2010] 327 ITR 456 (SC);
DIT v. A.P. Moller Maersk A S [2017] 392 ITR 186 (SC)

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