

Sharing insights

News Alert
20 July, 2012



Bad debts not a factor relevant to determination of arm's length price for royalty

In Brief

In a recent ruling in the case of CA Computer Associates India Pvt. Ltd ¹ (the taxpayer), the Mumbai High Court (HC), ruled in favour of the taxpayer and confirmed the decision of the Mumbai Income-tax Appellate Tribunal (the tribunal) in relation to disallowance of royalty on sales to third parties which were subsequently written off as bad-debts. The HC held as follows:

- Section 92C of the Income-tax Act, 1961 (the Act) does not either expressly or impliedly consider bad debts to be a relevant factor in determining arm's

length price (ALP) for royalty. Also, in the absence of any statutory provision, bad debts cannot be a factor relevant to determination of ALP of the royalty transaction.

- Once it is accepted by the revenue authorities that the rate of royalty was not under dispute, there can be no reduction in the value of royalty on account of bad debts.
- Unless there was an agreement to the contrary, the vendor or licensor is not concerned with recovery of sale price from third parties. The two are distinct, unconnected transactions. The purchaser's/licensee's obligation to pay royalty is not dependent upon recovery of its sale price from customers.

¹ CIT v. CA Computer Associates India Pvt. Ltd. [ITA No. 20 of 2011]

- The transactions, either between the taxpayer and its associated enterprise or the taxpayer and its customers, are not colourable.

Facts

- The taxpayer had entered into a Software Distribution Agreement with CA Management Inc. (CAMI), where under the taxpayer was appointed as a distributor of CAMI's products (software) to third parties in India. Under the agreement, the taxpayer was liable to pay an annual royalty on all amounts invoiced, at a rate of 30%.
- There was no dispute regarding the rate of royalty. However, royalty on sales written off as bad-debts was disallowed by the transfer pricing officer (TPO)/assessing officer (AO). The amount of bad-debts included even those bad debts which arose on sales where the software had not worked at all or where there were complaints regarding the quality of the products. Thus, it was held that such cases should be dealt with on the basis that no sales had been made, and therefore, royalty need not be paid to that extent.
- Aggrieved, the taxpayer appealed before the Commissioner of Income-tax (Appeals) (CIT(A)), who rejected the taxpayer's appeal, and made similar observations as those made by the TPO/AO. Aggrieved with the CIT(A)'s decision, the taxpayer appealed before the Tribunal.

Tribunal Ruling

The Tribunal concluded that non-recovery of sales value from third party customers does not impact determination of the ALP in respect of the transaction of royalty.

High Court Ruling

Aggrieved with the Tribunal's decision, the Revenue appealed before the HC, and raised the following substantial question of law, i.e., whether on the facts and circumstances of the case and in law, the Tribunal was justified in deleting the disallowance made of royalty paid by the assessee to CAMI for distribution of software products in India without appreciating that the royalty had been paid on the amount of bad debts even where the software had not worked at all. The HC held as follows:

- Section 92C of the Act does not either expressly or impliedly consider failure of the taxpayer's customers to pay for the products sold to them by the taxpayer to be a relevant factor in determining ALP for royalty. Further, in the absence of any statutory provision, refusal by third parties to pay for sales made by the taxpayer cannot be a factor relevant to determination of ALP of the royalty transaction.
- Once it is accepted by the revenue authorities that the rate of royalty was not under dispute, there can be no reduction in the value of royalty on account of bad debts.
- Unless there was an agreement to the contrary, the vendor or the licensor is not concerned with whether its purchaser/licensee recovers its price from its clients to which it has in turn sold/licensed such products. The two are distinct, unconnected transactions. The purchaser's/licensee's obligation to pay the consideration under its transaction with its vendor/licensor is not dependent upon its recovering the price of the products from its clients.
- It was not suggested that the transactions in this case, either between the taxpayer and CAMI, or the taxpayer and its clients, are colourable.

In light of the above, the HC answered the question of law in the affirmative, in favour of the taxpayer.

PwC observations

In a first of its kind ruling, for various reasons, the HC has made a clear distinction between the transaction of royalty and the recovery or not of sales on which the royalty is computed. The HC has held ALP determination for the transaction of royalty to be independent of the recovery of those sales, which have been used as a base to compute the royalty. Although not articulated by the HC as a reason, however, even from an accounting perspective, bad debts relate to 'trade debtors', which in turn arise from sales. The transaction of sales is recorded as it occurs and

cannot be changed. On the other hand, 'trade debtors' refer to a balance which changes as and when sales occur and also when recoveries are made or bad debts are written off. Therefore, 'recovery' and 'bad debt' are in the context of the outstanding balance of 'trade debtors' and not of sales.

Our Offices

For private circulation only

Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	Bangalore 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	Bhubaneswar IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	Chennai PwC Center, 2nd Floor 32, Khader Nawaz Khan Road Nungambakkam Chennai 600 006 Phone +91-44 4228 5000	Hyderabad #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata South City Pinnacle, 4th Floor, Plot – XI/1, Block EP, Sector V Salt Lake Electronic Complex Bidhan Nagar Kolkata 700 091 Phone +91-33 4404 6000 / 44048225	Mumbai PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	Gurgaon Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	Pune GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

The above information is a summary of recent developments and is not intended to be advice on any particular matter. PricewaterhouseCoopers expressly disclaims liability to any person in respect of anything done in reliance of the contents of these publications. Professional advice should be sought before taking action on any of the information contained in it. Without prior permission of PricewaterhouseCoopers, this Alert may not be quoted in whole or in part or otherwise referred to in any documents

©2012 PricewaterhouseCoopers. All rights reserved. "PwC", a registered trademark, refers to PricewaterhouseCoopers Private Limited (a limited company in India) or, as the context requires, other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.