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Royalty income of a non-resident taxable on receipt basis under the tax treaty

In brief

Recently, in the case of Johnson and Johnson USA[1], the Mumbai Income-tax Appellate Tribunal (the Tribunal) held that the income earned on account of royalty is taxable on receipt basis as per the provisions of the Double Taxation Avoidance Agreement (the tax treaty).

Facts

- The appellant, Johnson and Johnson, (the company or the assessee) a tax resident of USA, received royalty income from its Indian associated enterprises, *viz*. Johnson and Johnson India (J&J India) and NR Jet.

- The appellant submitted its tax return for assessment year (AY) 2004-05 declaring royalty income of INR 71 million taxable at 15% (withholding tax (WHT) INR 10.7 million) as per the provisions of the tax treaty between India and USA. The appellant consistently followed cash basis of accounting and offered to tax the royalty income on receipt basis.

- The return of income was scrutinised. The appellant placed on record WHT certificates amounting to INR 78 million (on royalty income INR 520 million accrued in the books of Indian associated enterprises) along with a note stating that the royalty income has been offered to tax on receipt basis (INR 71 million received) and credit of corresponding WHT (INR 10.7 million) has been claimed. The balance credit of WHT shall be claimed in the year in which the royalty is received by the company. An order under section 143(3) of the Income-tax Act, 1961 (the Act) was passed accepting the return of income.

[1] Johnson & Johnson *v.* ADIT(IT) [TS-39-ITAT-2013(Mum)]

- Subsequently, the appellant's case was re-opened under section 148 of the Act for the following reasons:

  - The appellant has offered lower income to tax. The accrued income on account of royalty is INR 520 million and not INR 71 million as declared by the appellant.

  - The rate of tax as per the agreement and the Act is 20% and not 15% as considered by the appellant.

- The assessing officer (AO) passed a draft assessment order taxing INR 520 million as royalty income at 20%. Also, credit of corresponding WHT (i.e INR 78 million on income of INR 520 million) was not given by the AO.

- The Dispute Resolution Panel (DRP) confirmed the draft order and consequently a tax demand was raised along with interest under section 234B of the Act.

- The assessee filed an appeal before the Tribunal.

Issue

- Whether the AO was justified in re-opening the assessment under section 147 of the Act.

- Whether the AO erred in making arbitrary additions to the royalty income on the basis of the income reflected in the WHT certificates and by not accepting the cash basis of accounting followed by the assessee on a consistent basis.

- Whether the AO had erred in levying interest under section 234B of the Act.

Assessee's contentions

- All material records relevant to the royalty income had been submitted to the AO during the scrutiny assessment proceeding for AY 2004-05 and the tax position was accepted by the AO. In such circumstances, the reassessment proceedings were a result of a change in opinion by the AO and hence not valid.

- The appellant has been following the cash basis of accounting for more than 13 years which had been accepted by the Commissioner of Income-tax (Appeals) (CIT(A)) for AY 2003-04.

- As the provisions of the India-US tax treaty are more beneficial, the royalty income should be taxed at 15% and not 20%.

- The appellant, being a non-resident and its entire income being subjected to WHT in India, provisions relating to levy of interest under section 234B of the Act was not applicable.

Revenue's contentions

- As per the WHT certificates filed by the appellant, the amount of royalty income of the appellant is INR 520 million.

- The appellant failed to prove that the royalty accrued in the books by J&J India for the year ending 31 March 2004 has been paid to the appellant during the subsequent years 2006 and 2007.

- If the cash basis taxation of royalty is accepted, it will lead to an anomalous situation wherein, the recipients of income will not offer the same to tax in the year of accrual and the payers will not withhold tax on such amounts as it will not be taxable in the hands of the recipient in the year of accrual. As a result, such income will not be taxed at all.

Tribunal ruling

- Regarding validity of the reassessment proceedings, the Tribunal held that all facts relating to the royalty income had been disclosed during the assessment proceedings. The order of the CIT(A) for AY 2003-04 accepting cash basis of

taxation of royalty income was received before the issuance of the notice under section 147 of the Act for the current AY. Hence, the issuance of notice under section 147 of the Act is bad in law.

- Since the words used in the India-US tax treaty are *'paid to a resident of a contracting state'* and *'payment of any kind received'*, the royalty income is taxable only on receipt basis. The Tribunal relied on the decision of the Bombay High Court (HC) in the case of Siemens Aktiengesellschaft[2].

- The appellant had consistently offered royalty income to tax as and when it received the same.

- The Tribunal referred to the legal provisions, which requires payers to withhold tax on accrual basis to claim a deduction of the expense. Hence, it held that the anomalous situation visualised by the revenue department does not arise at all.

- The Tribunal also pointed out that the credit of WHT was not granted to the appellant in spite of enclosing all WHT certificates. If WHT credit is given, there would not have been any demand and consequential interest under section 234B of the Act.

- The Tribunal also commented that DRP failed in its statutory duty by not examining the factual aspects of the case and by not passing a speaking order.

Conclusion

- The decision reaffirms the principle laid down by the HC in the case of Siemens Aktiengesellschaft (above) that royalty income of a non-resident is taxable on cash basis as per the provisions of the India-Germany tax treaty.

- This is a welcome ruling and comes as a relief for non-resident companies offering its income to tax on receipt basis as per the tax treaty provisions.

[2] DIT *v.* Siemens Aktiengesellschaft [TS-795-HC-2012(BOM)]

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