



Tax Flash News



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Mere situs of payer in India insufficient to tax non-resident's income in the absence of specific deeming provision or nexus with India

Executive summary



In the writ petitions filed by *Teva Pharmaceuticals USA* ('Teva USA') and *Teva Pharmaceuticals Industries Limited* ('Teva Israel') against the order of the Authority for Advance Rulings ('AAR'),¹ the Delhi High Court examined the taxability of payments made by an Indian pharmaceutical company pursuant to an arrangement relating to marketing rights for the generic drug in the USA market.

The High Court held that the receipts were not taxable in India as the underlying contractual rights, marketing rights, litigation, regulatory framework and economic activities generating the income were located outside India. Mere payment by an Indian resident to a non-resident does not, by itself, result in income accruing or arising in India.

The Court also observed that the AAR exceeded its statutory mandate by refusing to determine the taxability of the

¹ Batch of five writ petitions – *Teva Pharmaceuticals USA Inc v. DCIT* (W.P.(C) 10711/2017; W.P.(C) 10714/2017 & W.P.(C) 1295/2023); *Teva Pharmaceuticals Industries Limited v. ACIT* (W.P.(C) 4065/2022); *Teva Pharmaceuticals Industries Limited & Anr. v. DCIT* (W.P.(C) 12721/2019)

applicant (Teva Israel) and instead ruling that the income belonged to Teva USA, a non-applicant that was not before it. The AAR's jurisdiction is confined to the applicant, the transaction and the questions raised in the application, and it cannot assume an appellate role.

Further, having admitted the application, the AAR could not subsequently decline to decide the taxability issue by invoking allegations of tax avoidance without first identifying any Indian tax liability sought to be avoided. The Court also held that sweeping findings on collusion, sham arrangements and tax avoidance, based largely on conjecture, were untenable.

Facts of the case



Background of the transaction

Teva Israel was a pharmaceutical manufacturer in Israel, and Teva USA was its wholly owned subsidiary and distributor for the generic medicines in the USA market.

An Indian pharmaceutical company ('ICo') and its US subsidiary ('FCo') were also engaged in developing a generic version of the branded drugs.

Both Teva USA and FCo filed Abbreviated New Drug Applications ('ANDA') to market their respective generic versions of a drug in the USA market.

As the first successful ANDA filer, the Indian group was entitled to the 180-days of Sole First-to-File Exclusivity ('SFFE') from December 2011 to May 2012.

However, due to FDA² restrictions on its manufacturing facilities, there were concerns on the Indian group's ability to launch its product within the above period. Accordingly, the Indian group entered into an agreement with Teva USA in 2010.

Under the agreement, the Indian group would relinquish its exclusivity rights upon issuance of a valid 'Ready Date Notice' by Teva USA after the fulfilment of prescribed conditions, thereby enabling Teva USA to launch the generic drug.

In return, Teva USA agreed to share 50 per cent to 65 per cent of its profits earned during the exclusivity period. The agreement also included a '*No Challenge Provision*' under which the parties agreed not to challenge each other's SFFE rights relating to the ANDAs.

² Food and Drug Administration

In November 2011, Teva USA served the 'Ready Date Notice.' However, the Indian group disputed the notice on the ground that the prescribed conditions were not fulfilled and thereafter Teva USA filed a US court complaint against the Indian group.

The dispute was settled and the parties entered into an amended agreement effective from 30 November 2011. In the meanwhile, FCo obtained FDA approval.

Under the amended agreement, the Indian group manufactured and marketed the drug in the USA and agreed to pay Teva USA 50 per cent of its profits earned during the exclusivity period.

In March 2012, Teva USA assigned its rights under the agreement to Teva Israel. Accordingly, the payment was made by ICo to Teva Israel, after deducting tax at source ('TDS'). This payment was made from India in respect of products manufactured in the USA for the US market.

Teva Israel filed its India tax return declaring 'Nil' income and claimed refund of the tax deducted by ICo.

USA regulatory investigation

In 2014, the Office of the Attorney General of the State of New York ('OAG') observed that the arrangement between the Indian group and Teva USA was anti-competitive, particularly due to the "No Challenge Provision".

Teva USA and FCo paid the fine to settle the matter, *albeit* without admitting their guilt and undertook not to enforce the anti-compete clauses of the agreement.

AAR proceedings in India

Teva Israel filed an application before the AAR seeking a ruling on the taxability of the payment received from ICo.

It contended that this receipt was non-taxable business income in the absence of a Permanent Establishment in India and did not qualify as royalty or fees for technical services under the 1961 Act, read with the India-Israel tax treaty ('the Treaty').

The AAR declined to rule on taxability and instead held that the payment made by ICo did not belong to the applicant (i.e. Teva Israel) but to Teva USA. It further observed that the entire arrangement was *prima facie* designed for tax avoidance and the

payment was made in furtherance of an illegal transaction.

Consequently, reassessment proceedings³ were initiated against Teva USA, while a protective assessment⁴ was framed against Teva Israel.

Aggrieved, the Teva entities filed the writ petitions before the Delhi High Court challenging the reassessment notices and the AAR's order. Teva Israel also sought a refund of the taxes withheld by ICo, contending that no tax demand could be recovered pursuant to protective assessments.

Relevant provisions



Section 5(2)(b) restricts the scope of taxability of a non-resident in India to income that accrues, arises, or is deemed to accrue or arise in India.

Section 9 lays down the circumstances in which income is deemed to accrue or arise in India for tax purposes.

³ Under section 148 of the 1961 Act for the three FYs – 2011-12 to 2013-14

⁴ A protective assessment is made only in cases where there is uncertainty regarding the recipient of income or the person in whose hands the income should be assessed. A substantive assessment is made on the person whom the Revenue primarily considers liable, while a protective assessment is made in the name of the alternate person so that such income does not escape assessment upon expiry of the period of limitation.

Section 245R lays down the procedure to be followed by the AAR upon receipt of an application. The proviso to section 245R(2) provides that the AAR will not allow the application where the question raised in the application, *inter alia*, relates to a transaction or issue which is designed *prima facie* for the avoidance of income-tax.

Revenue's contentions



Assignment of income, not contract

The income originally belonged to Teva USA, which alone was a party to both the original and amended agreements with the Indian group. The assignment to Teva Israel transferred only the right to receive the payment, not the underlying contractual rights and obligations.

Entire transaction designed to avoid tax

The transaction was structured to achieve triple non-taxation, with the income escaping tax in India, the USA and Israel. Teva USA assigned the income to Teva Israel because Teva Israel enjoyed tax advantages in Israel, while both entities simultaneously denied taxability in India.

Illegal consideration

Reliance was also placed on the OAG proceedings and the 'No Challenge' provision, to characterise the payment by ICo towards illegal transaction.

Receipts taxable in India as per 'default source rule'

The basic source rule resides in section 5(2)(b), which has been further restated, expanded, modified, and explained in section 9 and its various sub-clauses.

Thus, any income accruing to a non-resident not falling within any of those specific sub-clauses would fall under the 'default' basic source rule, as articulated by the Supreme Court in *GVK Industries*,⁵ conferring upon India the right to tax non-resident on the basis that the payer of income is situated in India.

Relied on the decision in the case of *Malabar Industrial*⁶ to contend that compensation received on modification of a contract constitutes income from other sources, not business income. Since the original agreement had been modified, the payment made by ICo fell under the head "income from other sources" and was deemed to arise where the payer was located i.e., India.

⁵ *GVK Industries Ltd. v. ITO* [2015] 371 ITR 453 (SC)

⁶ *Malabar Industrial Co. Ltd. v. CIT* [2000] 243 ITR 83 (SC)

AAR's jurisdiction

The proviso to section 245R(2) empowered the AAR to reject applications relating to transactions designed *prima facie* for tax avoidance. The AAR had given detailed findings on collusion and commercial substance, which properly fell within its jurisdiction.

Reliance was placed on the Supreme Court's decision in *Tiger Global*.⁷

High court's decision



Proceedings against Teva USA set aside

The underlying contractual rights concerning marketing rights in the USA, the ANDA regime, the disputed 'Ready Date Notice', the signing of agreements, litigation and the alleged obligations of forbearance, the market generating the economic return – all were substantially held outside India. The Revenue failed to establish a nexus between India and the income-generating right or activity, so as to constitute accrual of income in India or alternatively bring the receipt within one of the statutory deeming provisions.

⁷ *AAR v. Tiger Global International II Holdings* [2026] 182 taxmann.com 375 (SC).

Accordingly, the jurisdictional foundation for issuance of reassessment notice and all consequential proceedings initiated thereunder were without jurisdiction and were, therefore, quashed and set aside.⁸

Other key observations of the High Court included:

Commercial and legal justification

Teva USA was only a marketing company, while manufacturing activities were carried out by Teva Israel, and therefore the amount receivable from ICo was assigned to Teva Israel. Even if the assignment had been made to obtain a tax benefit in Israel, this could not by itself give Indian tax authorities jurisdiction to bring the amount within the Indian taxation.

The Court rejected the Revenue's attempt to question the commercial rationale behind the settlement and observed that the prudence of business decisions cannot be evaluated by tax authorities.

An OAG opinion arising from anti-trust proceedings, without any accompanying admission of guilt, cannot be treated as a judicial finding of illegality for the purpose of invoking reassessment proceedings.

No nexus between India and the income-generating activity

The source of the payment could not be equated with the source of the income. The mere fact that ICo bore the payment and claimed a deduction of the expenditure in India was insufficient to establish that the income accrued in India.

The payment related to marketing rights of the generic drug in the USA and not to the manufacturing activities. Consequently, even if the products were manufactured in India, that fact alone did not establish the requisite nexus between India and the income in question.

The list of income in section 9 is exhaustive and deeming fiction can be invoked *qua* only those incomes.

Rejected the Revenue's 'default source rule' contention. The statutory scheme neither contains nor contemplates such a proposition; indeed, the enactment of specific deeming provisions in section 9 militates against acceptance of such an unqualified rule.

⁸ The issue relating to period of limitation for FY 2013-14 has not been covered in this Flash News.

The Revenue's reliance on *GVK Industries* ruling was misplaced as the observations therein arose in the context of the specific statutory regime governing fees for technical services.⁹ It merely affirms the parliament's competence to enact provisions founded upon an adequate territorial nexus with India and could not be read as establishing a broader rule that every payment by an Indian resident to a non-resident resulted in income accruing or arising in India.

The decisions in *Phra Phraison Salarak*¹⁰ and *Johnson Matthey Public Ltd.*¹¹ did not establish a universal 'payer-location' rule. The situs of accrual, therefore, had to be determined with reference to the true juridical and commercial source of the particular income.

In view of the above, the transaction did not fall within section 5(2)(b) or any of the deemed income provisions under section 9 of the 1961 Act.

AAR order quashed

The AAR not only exceeded its jurisdiction but also failed to exercise its jurisdiction bestowed under the Act. The Court quashed the AAR order for the following reasons:

- The AAR's jurisdiction is confined to the applicant, the transaction in question, and the issues raised in the application. As it does not exercise appellate jurisdiction, it could not travel beyond the matter before it. In the present case, rather than determining whether Teva Israel's income was taxable in India, the AAR *suo motu* held that the income belonged to Teva USA and not Teva Israel, without affording Teva USA an opportunity of being heard and despite Teva USA not being the applicant before it. Consequently, such findings could not be binding on Teva USA.
- Having concluded that the taxability of the income was required to be examined in the hands of Teva USA, the AAR ought to have held that the income was not taxable in the hands of Teva Israel.
- Having admitted the application in July 2015 and expressly declined to reconsider admissibility in September 2019, the AAR, in its final order, could

⁹ Under section 9(1)(vii)

¹⁰ *CIT v. Phra Phraison Salarak* [1928] 3 ITC 237 (Rangoon)

¹¹ *Johnson Matthey Public Ltd. Co. v. CIT* [2024] 162 taxmann.com 865 (Delhi)

not invoke the admission-stage restriction to hold that the transaction was *prima facie* designed for tax avoidance and dispose of the proceedings without ruling upon the taxability issue.

- While the AAR is not required to conclusively establish tax avoidance at the admission stage, it must at least identify that the impugned arrangement is *prima facie* designed to avoid the tax liability. In the absence of a finding that the income was taxable in India, any allegation of tax avoidance or evasion would be untenable.
- The AAR relied on conjectures about a possible understanding between the parties and conducted a roving inquiry into their commercial arrangements, including a contractual dispute governed by foreign law and arrived at a speculative conclusion that the arrangement was collusive, sham and designed to avoid tax.
- The AAR was not entitled to give its sweeping findings of collusion, tax avoidance and sham arrangements which could adversely affect both entities in future proceedings.
- Whether Teva USA or Teva Israel paid tax in their respective jurisdictions was irrelevant. The Indian tax authorities could not assume taxing jurisdiction

merely because the income may not have been taxed elsewhere.

- The decision in *Tiger Global* concerned denial of the India–Mauritius treaty benefits under GAAR¹² after source-based taxation had been established. Here, the issue is at the anterior stage as to whether the payment from ICo to Teva Israel constituted income accruing or arising in India at all.

TDS refund granted to Teva Israel

While the concept of protective assessment is recognised, there is no concept of protective recovery.

Having taken the plea that the amount paid by ICo accrued to Teva USA and not to Teva Israel, the Revenue could not withhold the refund of Teva Israel, merely because reassessment proceedings had been initiated against Teva USA. Although those proceedings have been quashed by this Court, even if this decision is disregarded, the refund due to Teva Israel cannot be withheld.

Accordingly, the Court directed that the entire TDS amount, along with applicable interest, should be granted to Teva Israel, subject to furnishing of corporate guarantees.

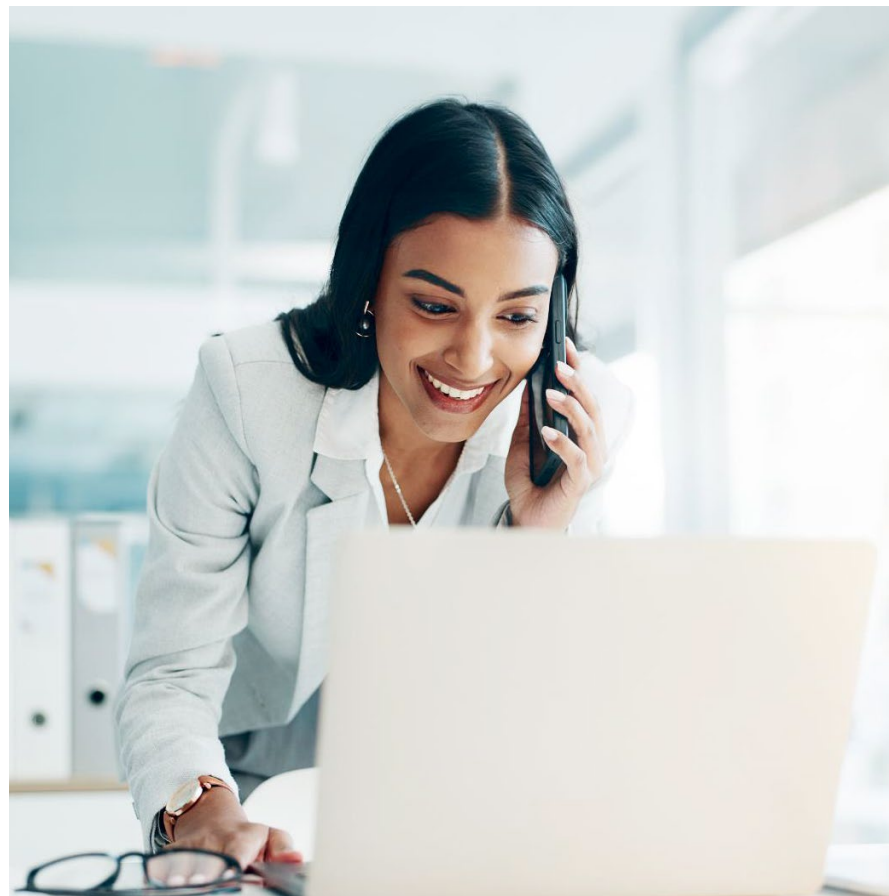
¹² General Anti-Avoidance Rules

Our comments



This ruling reaffirms the fundamental principle that Indian tax jurisdiction requires a nexus between India and the underlying income-generating rights, activities or transactions, and cannot be founded solely on the payer's location (in the absence of any deeming provision being applicable).

This ruling underscores that the AAR's jurisdiction is confined to determining the tax consequences of the transaction placed before it and cannot be expanded to adjudicate upon the tax liability of non-applicants or render broad findings on tax avoidance without first establishing a *prima facie* charge to tax in India.



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