

Cross-Border Reimbursement Dilemma Continues



With the globalization of businesses, interdependence amongst group companies has increased substantially. Transactions are frequently undertaken to achieve cost efficiency and not necessarily with the intention of making a profit. Some of the prevalent practices include allocation of common costs such as those related to information technology and procurement, cross-charge of personnel and other types of cost sharing arrangements.

Taxability of reimbursement has been a matter of considerable debate in India from the perspectives of both direct tax and indirect tax. Where there are inter-group transactions, it is normally the intention of the companies to achieve a tax neutral position on these transactions, especially in the absence of the profit element. On the other hand, the tax authorities generally contend that such payments are taxable for a variety of reasons.

The term 'reimbursement' has not been defined in the Income-tax Act, 1961 ('Act'). However, it has been defined in various dictionaries, as given below:

Black's Law Dictionary: To pay back; to make return or restoration of an equivalent for something paid, expended or lost; to indemnify or make whole.

Oxford Dictionary: Repay (a sum of money spent); repay or compensate

According to these dictionary meanings, reimbursement can be described as repayment of what has already been spent or incurred. Therefore, it should not be considered a reward or compensation for a service rendered.

The Hon'ble Income-tax Appellate Tribunal, Bangalore Bench in the case of Bovis Lend Lease (I) Pvt Ltd vs ITO noted the following conditions which need to be cumulatively satisfied for a certain payment to be characterized as 'reimbursement':

- (i) actual liability should be of the person reimbursing the money to the original payer;
- (ii) the liability should be definite and not an estimation or an appropriate amount;
- (iii) the liability should be crystalized;
- (iv) there should exist a 'clear ascertainable relationship between the paying and the reimbursing parties';
- (v) the payment should first be made by a person, who did not have the liability to pay it and such person should be reimbursed to 'square off the account', and
- (vi) there should be three parties to such transaction- the payer, the payee and the reimbursor.



Taxability under the Act

The Act seeks to levy income-tax in respect of the 'income' of every person. The term 'income' has been exhaustively defined to include various types of gains, accretion, value addition, etc. In the absence of any profit related element, a receipt cannot be classified as income and therefore, should not be subject to income-tax.



In the landmark judgement, *Hon'ble Supreme Court of India, in the case of GE India Technology Center Pvt. Ltd.*, held that the obligation to withhold tax should be limited to the appropriate proportion of such income chargeable to income-tax under the Act. According to the Court, it cannot be said that the obligation to withhold tax arises the moment there is a remittance. If we were to accept such a contention it would mean that on mere payment income would be said to accrue or arise in India. Such an interpretation would mean obliteration of the expression 'sum chargeable under the provisions of the Act'.

Therefore, plain reimbursement to a non-resident is not chargeable to tax under the Act, and consequently, should not attract withholding tax provisions. However, one needs to evaluate the facts and circumstances in every circumstance.

Let's analyze the taxability of reimbursement in few circumstances, as given below:

Cost sharing arrangement

Cost sharing arrangement generally refers to an arrangement between a number of companies, generally a part of one group of companies, wherein certain functions such as finance, HR, IT and R&D are carried out centrally by one entity but all other entities are the beneficiaries of such functions. The lead entity then cross charges the beneficiaries, based on certain predetermined criteria such as usage or the benefits they derive from the central functions.

The issue in these kinds of arrangements that arise is whether payment made under cost sharing arrangement is taxable in the hands of the recipient. *Hon'ble Supreme Court in the case of DIT v A.P Moller Maersk A S*, while analyzing the cost sharing arrangement between the foreign company and its Indian agents, held that once the character of payment was found to be in the nature of reimbursement of the expenses, it cannot be income chargeable to tax in India. In this case, the foreign company had submitted the calculation of total costs and their pro-rata allocation among agents (without any mark-up). Moreover, the transfer pricing officer had also accepted that the payment was at arm's length price.

Reimbursement of cost vs service rendered at cost

There is a very thin line of distinction between reimbursement of cost vs services rendered at cost. For example, services of technical nature may be rendered without any markup or profit element i.e. at cost. Where the services are of technical nature taxability arise irrespective of the fact that no profit element was included in the consideration. The Authority for Advance Ruling ('AAR') in the case of [Danfoss Industries Pvt. Ltd.](#) and [Timken India Ltd.](#) held that the element of profits is not an essential ingredient of a receipt to be taxable as income.

Reimbursement of cost of salary in secondment arrangements

In a typical secondment agreement, the employees on the payroll of the overseas entities are seconded or deputed to Indian subsidiary enabling the latter to utilize the skills and experience of the global talent pool. In such case, control and supervision of the work rests with the Indian company while right to terminate the employment of the employees under such agreement is retained by the overseas entities. Also, for administrative convenience, the salary to such employees are paid in their home country by the overseas entities, and which is later reimbursed by the Indian company by way of cross charge. It is important to note that for all practical purposes, the Indian company becomes the economic employer of the employees and responsible for payment of salary as well as withholding tax compliances.

However, such presence of employees in India of the overseas entities may also trigger permanent establishment related exposure to the overseas entities and/or the receipt by the overseas entities may be taxed as fees for technical services ('FTS'). In the landmark judgment in the case of [Centrica India Offshore Pvt. Ltd.](#), Hon'ble High Court of Delhi held that reimbursement of salary costs to the overseas entity is liable to tax to tax as 'FTS', since by seconding its employees to Indian company it is providing technical knowledge and skills assisting the Indian Company in its quality and management functions. The Court held that payment in essence was for the managerial services provided. Right to terminate the employment was considered as an important aspect by the Court. It is important to note that the special leave petition by the tax payer in this case was summarily dismissed by the Hon'ble Supreme Court.

The dispute surrounding the taxability of reimbursement of salary costs in the secondment agreement has been continuing.



Robust Documentation

However, such presence of employees in India of the overseas entities may also trigger permanent establishment. As is apparent from the above, the issue about taxability of reimbursement is highly contentious and litigative. Since companies often take a tax neutral position on reimbursements, it is imperative that proper documentation to substantiate the true nature of the transactions or the arrangement. The importance of documentation cannot be ignored in the case of reimbursement of expenses. In the absence of proper documentation, the reimbursement of software maintenance charges was treated as royalty by the Hon'ble ITAT in the case of [SMS Iron Technology Pvt. Ltd.](#)

Some examples of the documents to be considered in the context of transactions or arrangement involving reimbursements are listed below:

- Written agreement between the parties
- Agreement entered into by the foreign company with the third party and invoices raised by the third party in case of allocation of expenses or cost sharing arrangements including basis of allocation of expenses
- An accountant or auditor certificate to substantiate that no profit element is included in the amount recharged by the foreign company
- Agreement between Indian company and foreign company to facilitate payment of salary to the seconded employees, salary slips of the seconded employees and proof of withholding tax compliances,
- Debit notes issued by the foreign company on the Indian company for cross charges.

Conclusion

There is no fixed formula for determining the taxability of reimbursements in India. The solution lies in maintaining robust documentation that records the intention of the parties and the purpose and nature of the expenditures incurred.

1. *ITA 636,637 & 665/Bang/2008*
2. *327 ITR 456 (2010)*
3. *81 Taxmann.com 479 (2017)*
4. *268 ITR 1 (2004)*
5. *273 ITR 67 (2005)*
6. *364 ITR 336 (2014)*
7. *88 Taxmann.com 277 (2017)*



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