

Cost-To-Cost Reimbursement Held to Be Taxable in Absence of Documentary Evidence

Article By:
Muqet Drabu
Morvi Chaturvedi

- The Mumbai bench of Income Tax Appellate Tribunal (“ITAT”) has held that reimbursement of service-related fee on a cost-to-cost basis will be taxable as ‘fees for technical services’ upon failure to provide sufficient documentary evidence establishing basis of cost allocation;
- It has also clarified that there cannot be any presumption as to reimbursement; first, the taxpayer is required to prove that the cost allocations are falling under the category of reimbursement, and only then can it claim the costs as being exempt from taxation.

Background

There has been a recent trend, evidenced by several decisions, that reimbursements made to associated enterprises (“AE”) on a cost-to-cost basis without any markup should not be taxed as fees for technical services (“FTS”) in India. For instance, based on a reading of section 9(1)(vii) of the Income-tax Act, 1961 (“ITA”) and Article 12(4)(b) of India-US tax treaty, the Mumbai bench of Income Tax Appellate Tribunal (“ITAT”)¹ held that transactions between the assessee in question and its AE were not FTS. This was owing to such transactions being in the nature of reimbursement of salary cost (for seconded employees) without any mark-up.

While the above decision is in context of reimbursement of salary cost, the Mumbai bench of ITAT, in the case of *Kraft Foods Group Brands LLC (“Taxpayer”) v. ACIT (International Taxation)*², has developed the jurisprudence by providing a ruling in context of reimbursement of cost of support services provided by the Taxpayer to its AE.

Decision

The Taxpayer, a company incorporated in USA, is a tax resident of USA holding a valid tax residency certificate in India. The Taxpayer, *inter alia*, entered into a service agreement with Heinz India Private Limited (now Zydus Wellness Products Limited) (“Heinz India”), an AE to the Taxpayer, to provide support services in the areas of general management, internal audit, communications, human resources, finance and treasury, legal and other related areas. During the year under consideration, the Taxpayer received ₹8,81,94,650/- from Heinz India, as below:

Income Head	Amount (₹)	Tax Treatment in Return of Income
Royalty for Trademark	96,715	Taxable
Support Services	3,62,36,081	Taxable
Cost Allocation of Support Services [on a cost-to-cost basis]	5,18,61,854	Non-taxable; reimbursement on a cost-to-cost basis without any markup / profit element

The Taxpayer issued a single consolidated invoice for the support services receipts, of which it declared ₹3,63,32,796/- as taxable income and other portion of ₹5,18,61,854/- as exempt. The Taxpayer placed reliance on a general clause³ of the service agreement for claiming the amount of cost allocation as exempt. No further documentary evidence, details, or reasonable basis of allocation for classification, of the various support service charges collected from Heinz India was submitted by the Taxpayer.

In the absence of appropriate classification (including basis of classification) of costs and documentation, the Mumbai bench of ITAT held against the Taxpayer’s selective claim of cost recovery as being towards reimbursement, and not support services. The Mumbai bench of ITAT held that the Taxpayer cannot collect consolidated support service charges and offer to tax only a portion of it (*in this case*, ₹3,62,36,081/-), while treating the rest (₹5,18,61,854) as reimbursement of allocated costs, by simply relying on general clauses of the service agreement. As such, the contention of the Taxpayer was rejected, and the entire cost allocation was taxed as FTS.

Analysis

In this decision, the Mumbai bench of ITAT has maintained the legal position that reimbursement of expenditure is not taxable as there is no profit element embedded in such expenses. The decision, however, casts an obligation on the taxpayer to first establish, with appropriate documentary evidence, that the sums claimed as not chargeable to tax were in fact in the nature of ‘reimbursements’. Absent appropriate evidence, there cannot be a presumption as to reimbursement. It is also important to bifurcate the costs in the documentary evidence based on a reasonable cost allocation method.

While this decision casts an obligation on the taxpayer, the Mumbai bench of ITAT in the case of *BASF India Ltd.*⁴ has held that there is a corresponding responsibility on the revenue authorities to examine all necessary documents before concluding that the remittances were in the nature of FTS, which would be taxable in the hands of a taxpayer.

This decision adds to the growing jurisprudence on determining the taxability of reimbursements. While cost-to-cost reimbursements are generally non-taxable, due regard is placed on the nature of the transaction, the underlying documentary evidence, the basis of cost allocation, as well as the intention of the transacting entities. It therefore becomes essential to appropriately structure cross-border inter-company transactions with all relevant documents and agreements in place.

Footnotes

[1] Morgan Stanley International Incorporated vs. DDIT (ITA No. 5985/Mum/2012) (TS-217-ITAT-2023(Mum)-TP)

[2] Kraft Foods Group Brands LLC (ITA NO. 2495/MUM/2022) [TS-577-ITAT-2023(Mum)]

[3] The clause relied upon by the Taxpayer to support its contention (Article 5, Section 5.2 of the subject matter service agreement) read as below:

“a) For each relevant cost center, a cost accounting method consistent with GAAP and the Company’s accounting policies will be

used to identify all direct and indirect costs including but not limited to any and all compensation costs, depreciation of equipment, expenses paid to third parties, and overhead expenses.

b) For each relevant cost center, the aggregate amount of such costs shall not include costs which are related to the provision of Special Services and stewardship activities.

c) An Allocation Factor shall be determined for each relevant cost center based on reasonable estimates provided by the relevant cost center related to the Support Services performed during the Accounting Period. The expenses attributed to Recipient under this Agreement shall be the sum of the amounts determined for each relevant cost center.

d) The parties agree that a mark-up of 0% shall be applied to costs of performing Support Services under this Agreement unless a different mark-up is required under U.S. transfer pricing rules based on the nature of the Support Services performed." (Capitalised terms in the extract above are as defined in the subject matter agreement)

[4] BASF India Ltd. vs. DCIT (IT), Circle 3(2), Mumbai (IT APPEAL NOS. 4754 & 4755 (MUM.) OF 20) ([2019] 102 taxmann.com 133 (Mumbai - Trib.))

Nishith Desai Associates 2024. All rights reserved.

National Law Review, Volumess XIV, Number 59

Source URL: <https://www.natlawreview.com/article/cost-cost-reimbursement-held-be-taxable-absence-documentary-evidence>