Re-Charge Without Markup is NOT Reimbursement

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The taxability of reimbursements has always been a contentious issue in India. However, before the taxability of reimbursements is discussed, it is important to understand when an amount constitutes reimbursement. The term reimbursement is not defined in the Income-tax Act, 1961 (**'ITA'**), however, the same has been explained by the Indian courts.

Meaning of reimbursement

Reimburse means and imply to pay back or refund, reimbursement has to mean and implies the restoration of an equivalent for something paid or expended, and reimbursement pre-supposes previous payment.[1] To qualify as reimbursement, the following conditions should be satisfied cumulatively:[2]

a The actual liability to pay should be of the person who reimburses the money to the original payer.

b The liability ought to have been clearly determined. It should not be an approximate or varying amount.

c The liability ought to have crystallized. In other words, payments which were never required to be done, but were done just to avoid a potential problem may not qualify.

d There should be a clear ascertainable relationship between the paying and reimbursing parties. Thus, an alleged reimbursement by an unconnected person may not qualify.

e The payment should first be made by somebody else whose liability it never was and the repayment should then follow to that person to square off the account.

f There should be clearly three parties existing - the payer, the payee and the reimbursor.

It can, therefore, be said that wherever the above conditions are satisfied, the payment of money will qualify as reimbursement. Once the payment qualifies as reimbursement, the taxability will not arise in the hands of the person to whom the amount is reimbursed.

Recoupment vis-à-vis reimbursement

Reimbursement, however, needs to be distinguished from recoupment i.e., in cases where no markup is added by the recipient, the transaction does not automatically qualify as reimbursement. Once it is established that there was a provision of services and payment is made towards such service only, the fact that no markup is charged over the cost does not change the nature of services and does not affect taxability. Reference in this regard can be made to the decision of ***Centrica India Offshore (P) Ltd.***[3], wherein it was held that the fact that there was no markup on the amount reimbursed does not automatically make the transaction non-taxable. It is also imperative to note here that the name which the parties give to the transaction which is the source of receipt and the characterization of the receipt by them are of little importance and the true nature and character of the transaction have to be ascertained from the covenants of the contract in the light of the surrounding circumstances.[4]

Having understood the difference between reimbursement and recoupment (recharge without markup), let us now evaluate the real character of the payment.

a. Out of Pocket Expense - consideration for services or reimbursement?

We often witness situations where the service agreements include a provision towards the out-of-pocket expense. It is claimed that the amount charged towards the out-of-pocket expense qualifies as 'reimbursement' and accordingly, the same should not attract tax deduction at source.

It is important to understand that once a service provider agrees to render certain services then it is implicit that (s)he will assume responsibility of all incidental things and necessary infrastructure for rendering the said services including incurring necessary incidental expenses. For example, if an engineer is called for repair, then the travel expenses by an engineer for arriving at the relevant venue have to be incurred by the engineer as his own expense necessary and incidental for the services. If, in addition to the fee charges for repair (s)he also demands the recoupment of certain expenses like travel, which but for a special agreement is his/her own responsibility, then the total consideration agreed is comprised of two things viz. base fee and recoupment of travel expenses. This understanding can be gleaned from section 2(d) of The Indian Contract Act, 1872 (**'Contract Act'**) as deliberated hereunder.

Section 2(d) defines **Consideration** as "*When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise*". A perusal of the definition shows that 'Consideration' is a very wide term and is not restricted to monetary benefit. Consideration does not necessarily mean money in return for money or money in lieu of goods or services. Any benefit or detriment of some value can be a consideration.[5]

Thus, if a service provider asks its client to pay the professional fee and in addition bear, the cost of his/her travel and stay for rendering the service, then the consideration would be the sum total of monetary fee and value of travel and stay. Accordingly, it can be said that the out-of-pocket expense necessary for rendering the service would not qualify as 'reimbursement'. Once the same does not qualify as reimbursement, tax on the same needs to be deducted under the appropriate section (e.g., 194J).

b. Income taxable on a gross basis under 115A

Often there are situations wherein certain expenses are incurred towards technology (e.g., software /technology) etc. by the overseas group company and a part of the same (to the extent apportionable to India) is recovered without markup from the Indian group entity. It is claimed that since there is no markup i.e., only the cost is recovered, the same qualifies as 'reimbursement' and thus, there is no requirement to deduct tax. Attention is invited to the recent decision of the Karnataka High Court in the case of ***Flipkart Internet (P.) Ltd***.[6] wherein the services were held to be in the nature of fees for technical services (**'FTS'**) under the ITA.[7] While addressing one of the questions regarding the deduction of tax on a gross basis in the case of FTS, the High Court held that since there is no profit element, tax is not deductible under Section 195 of the ITA. It was held that *The DCIT has grossly erred while concluding that where the payment is made for the services rendered, then whether the charge for the services rendered is equivalent to the cost or not becomes irrelevant. The finding that the services rendered fall within the description of services as in Explanation-2 in Section 9(1)(vi) and that the element of profit is not an essential ingredient of receipt, to make it taxable is erroneous*.

Reference is made to Section 195 (1) of the ITA which interalia provides that any person responsible for paying to a non-resident not being a company, or to a foreign company any other sum chargeable under the provisions of the Income Tax Act shall at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.

Section 115A (1) of the ITA provides for taxation of passive income such as royalty, FTS etc. in the case of non-residents. Further, Section 115A (3) provides that no deduction in respect of any expenditure or allowance shall be allowed to the assessee under sections 28 to 44C and section 57 in computing his/her or its income referred to in Section 115A (1). In other words, it can be said that once the income is taxable under Section 115A, the same needs to be taxed on a gross basis i.e., without any deduction towards the cost. In contrast, where the non-resident has a permanent establishment and royalty or FTS is effectively connected with such a permanent establishment, Section 44DA (1) provides for taxation on net income.

In light of the above, it can be said that where the income of the non-resident is taxable under section 115A, tax is deductible on the gross amount under section 195(1). However, where the income is taxable under section 44DA, tax is deductible on the net amount i.e., after deduction of cost, under Section 195(1). **It seems that the provisions of Section 115A (supra) were not brought to the attention of the Hon'ble Karnataka High Court.**

It can, accordingly, be concluded that once the income is taxable under Section 115A, the said income needs to be taxed on a gross basis i.e., without any deduction towards the cost and the fact that no markup is charged would not affect the taxability of such income nor affect the withholding obligations on the gross sum.

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[1] TISCO vs Union of India [2001] 2 SCC 41

[2] Bovis Lend Lease (India) (P.) Ltd v. ITO [TS-5508-ITAT-2009(BANGALORE)-O]

[3] Centrica India Offshore (P) Ltd. v. CIT [TS-237-HC-2014(DEL)]. SLP dismissed vide order reported at [TS-5037-SC-2014-O]

[4] National Cement Mines Industries v. CIT [TS-5-SC-1961-O]

[5] K.S.Bakshi v. State and another [2008] 146 DLT 125; Suresh Chadra Goyal v. Amit Singhal [2015] 3 BC 649

[6] Flipkart Internet (P.) Ltd. v. DCIT (International Tax), [TS-503-HC-2022(KAR)]

[7] The same was held as not taxable due to non-satisfaction of the 'make available' condition present in Article 12 of the India-USA DTAA