

Justifying arm's length for cost reimbursements - A two pronged test

Date : 8 September 2015



Ashutosh Mohan Rastogi
(Partner, Amicus Advocates
& Solicitors)



**Divya Ahuja (Senior
Associate, Amicus –
Advocates & Solicitors)**

The complexity of modern business inevitably gives rise to reimbursement transactions undertaken due to administrative convenience or practical exigency. Recent Court decisions have highlighted that even cost to cost reimbursements and allocations can pose a challenge and should not be taken lightly by tax management. In the backdrop of recent Court decisions, this article examines issues surrounding deductibility of reimbursement/allocation expenditure.

For reimbursement expenditure to be deductible, it must satisfy the two pronged test of arm's length justification [(quantitative test under Transfer Pricing Regulations (Section 92 of Indian Tax Code)] and 'benefit' test[(qualitative test under General Corporate Tax (Section 37 of Indian Tax Code)].

Quantitative Test- Arm's Length justification For Reimbursements (Section 92)

A reimbursement transaction typically entails a back-to-back arrangement between the taxpayer and its related party for the procurement of goods and services from a third party on a cost to cost basis. The associated enterprise first procures the good or service from the third party on (behalf of the taxpayer) and is subsequently reimbursed at cost by the taxpayer. The level of value addition by the associated enterprise is so insignificant that a mere cost to cost reimbursement without any mark-up suffices for arm's length compliance. However, proving that the transaction is at cost-to-cost is only the first limb of the two pronged test that such a transaction must satisfy. The taxpayer must additionally demonstrate that reimbursement expenditure has arisen out of a business need and is therefore an allowable expense.

Qualitative Test- Benefit Test (Section 37)

In order for any expense to be deductible, the taxpayer must demonstrate that it is '*wholly and exclusively*' connected with taxpayer's business.

In ***Commissioner of Income Tax- I vs. M/s Cushman & Wakefield (India) Pvt. Ltd (ITA 475/2012)***, the Delhi High Court held that the jurisdiction of Assessing officer under Section 37, and that of the Transfer Pricing Officer under Section 92CA of the Act, are distinct and separate. The Court ruled that the authority of Transfer Pricing Officer is to conduct a Transfer Pricing analysis to determine the ALP, and not to determine whether this is a service or not from which the taxpayer benefits. That aspect of the exercise is left to the Assessing officer under Section 37.

The High court held that it was not sufficient to merely state that a reimbursement expenditure to AE was at cost. The taxpayer must furnish evidence on following aspects:

1. Where the expenditure reimbursed is derived by allocating a part of total cost pool (incurred overseas), the taxpayer must be able to substantiate the overseas cost base;
2. The portion of total cost allocated to the taxpayer must be derived on a reasonable and scientific basis

say, by using a reasonable allocation key; and

3. Last but not the least, it must also be demonstrated what services or benefit has been received by the assessee by the incurring of such costs by AE.

The Court ruled that even after the Transfer Pricing Officer has examined a transaction, door was open for the Assessing officer to apply 'benefit test' under Section 37 of the Indian Tax Code. On the facts of the case, since taxpayer had failed to furnish evidence on above aspects, the High Court remanded the case to the Assessing officer to determine details of cost base and whether there was any benefit following to the assessee from the cost allocation.

The above ruling has been endorsed by the Delhi High Court in the celebrated Marketing Intangibles decision (***Sony Ericsson Mobile Communications India Pvt. Ltd vs. Commissioner of Income Tax- III (ITA No. 16/2014)***). The Delhi High Court has held that there is no conflict between the powers of Transfer pricing officer and the Assessing officer, qua the allowability of expense. While the Transfer pricing officer's jurisdiction is confined to determination of arm's length value, the Assessing Officer can (under Section 37) enquire whether or not the expenditure has been incurred '*wholly and exclusively*' for taxpayer's business.

Conclusion

Even where the Transfer Pricing Officer has given a clean chit on arm's length determination for a reimbursement transaction, the Assessing Officer can examine whether the expenditure claimed was for the 'benefit' of taxpayer's business. From a risk mitigation perspective, taxpayers are advised not only to keep back-up invoices to demonstrate cost to cost nature, but also maintain adequate documentation to demonstrate 'benefit test', qua the reimbursement/allocation transaction. For cost allocations, taxpayers must additionally maintain documentary evidence in the form of details of cost base and allocation keys used.