

Tax Hotline

June 22, 2004

REIMBURSEMENT OF EXPENSES BASED ON ALLOCATION HELD SUBJECT TO WITHHOLDING TAX IN INDIA

The Authority for Advance Rulings ("AAR") has ruled that reimbursement of expenses if based on allocation is subject to withholding tax under Section 195 of the Income Tax Act ("ITA"). Under Section 195 any person responsible for paying to a non-resident any sum chargeable under the provisions of the ITA is required to withhold tax at source.

The ruling was given in the case of M/s. Danfoss Industries Private Limited ("DIPL"), Chennai, which was a member of the Danfoss Group of companies. Danfoss Singapore ("DS") was another company in the group, (incorporated in Singapore) which was to provide certain services such as market research, public promotion, and recommendations on improvement of management and business activities, budgeting and long-term financial planning etc. to DIPL. The consideration for the service was based on the allocation key, which was determined on a proportional percentage of budget turnover weighted by growth rate and market maturity of the group company availing the services. In case of any increase or shortfall in the actual turnover would proportionately increase or decrease the portion of cost to be absorbed by the group company, which avails services from DS.

The issue that arose for determination was whether the fee paid to DS was in the nature of a reimbursement for expenses incurred by DS or did it also contain the element of profit and if so would they fall in the ambit of Section 195 of the ITA and be subject to a withholding tax?

The AAR held that the amount paid by DIPL to DS was not based on the actual expenses incurred, because the method of calculating the fee payable had no relation to the costs borne by DS, in providing these services. The payment at the very least partook the nature of income, and relying on the judgment of the Supreme Court in the case of Transmission Corporation of A.P. Ltd. & Another v. Commissioner of Income-tax (239 ITR 587), the AAR held that the said sum would be chargeable to tax and could be assessed to tax under the ITA. The AAR further ruled that the scheme of tax deduction at source applied not only to amount paid which would wholly bear income character such as salaries, dividend, interest on securities, etc. but also to gross sums, the whole of which might not be income or profit of the recipient. Therefore, if any income is embedded in a payment it is subject to withholding tax. Another point taken into consideration by the AAR was that the reimbursement was based on an allocation, and there was no evidence that the expenses were actually incurred for and on behalf of DS. The AAR further held that when the expenses claimed were of such a kind, they were subject to the provisions of Section 195 of the ITA.

Advance rulings are as much private rulings and are binding only in the case of the applicant. They are fact specific and do not have any persuasive value where the facts and circumstances are different.

Source: The Authority for Advance Rulings, May 14, 2004.

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