

Tax Hotline

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REIMBURSEMENT BY INDIAN COMPANY TO OFFSHORE COMPANY FOR OBLIGATED EXPENSES IN RELATION TO EXPATRIATES NOT FTS: AAR

- Reimbursement held not to be fees for technical services as there was employer-employee relationship between the Indian company and expatriate personnel.
- Payments made to reimburse obligated expenses such as social security contributions, insurance and relocation expenses held to be reimbursement since they do not accrue to the offshore company.

The Mumbai bench of the Authority for Advance Rulings ("AAR"), held that reimbursement made by an Indian company, to a foreign company for certain obligatory payments made to expatriate personnel ("Personnel") on behalf of the Indian company, would not be taxable as fees for technical services ("FTS").¹ In doing so, the AAR distinguished from the Delhi High Court's ("Delhi HC") ruling in *Centrica Offshore v. CIT*.²

BACKGROUND

CTBT Pvt. Ltd. ("Applicant"), a company incorporated in India was a wholly owned subsidiary of PMK (Swiss Company). The Applicant had entered into a memorandum of understanding with one of the State government for establishing a manufacturing plant. In order to ensure consistent application of quality and safety standard, the Applicant requested KRP, another wholly owned subsidiary of PMK (Swiss Company), to supply experienced Personnel in order to run a manufacturing plant in India.

The Applicant entered into an intercompany agreement ("Agreement") with KRP for disbursing social security contribution, insurance and relocation expenses in the home country of the Personnel. The Applicant stated that the arrangement of KRP making part payment of salary to the Personnel, on behalf of the Applicant, was only facilitative in nature and to facilitate the Personnel to meet their financial commitments in their home countries. The Applicant reimbursed KRP for these expenses and paid an additional administrative fee to KRP for managing the disbursements. The Applicant paid the Personnel the substantive part of the salary directly. This salary was subjected to tax in India in the hands of the Personnel. The Applicant withheld tax under section 192 of the Income-tax Act, 1961 ("ITA") on the entire amount paid by the Applicant which was inclusive of the reimbursement payment to KRP. The Applicant also withheld tax under section 195 of the ITA on the administration fee paid to KRP.

The Agreement between the Applicant and KRP laid down the rights the Applicant had vis-a-vis the Personnel.

- The Applicant was wholly responsible for the Personnel and gave them instructions for execution of their duties to be carried out locally and supervised their activities;
- The Applicant had sole liability for every act or failure of the Personnel during the period of appointment;
- KRP discharged the Personnel of all obligations and rights including any lien on employment, and from all actions, claims and demands towards KRP, while they were working as employees of the Applicant during the assignment;
- KRP could not recall any of the Personnel without obtaining the prior consent of the Applicant;
- The Personnel while on assignment to the company were not regarded as employees of KRP and were also not in any way be subject to any kind of instructions or control of KRP;
- The Personnel were not permitted to embark or engage, whether directly or indirectly in any outside activity, business undertaking or employment without the consent of the Applicant and
- While on assignment with the Applicant, the Personnel would not be regarded as employees of KRP.

RULING

- The AAR observed that there was an employer-employee relationship between the Applicant and the Personnel since the Applicant exercised full operational control over them. Further, KRP was not making any performance related payments to the Personnel. The AAR characterized the payments made by KRP on behalf of the Applicant as "obligated payments" that the Personnel were liable to make in their home country. On this basis, the AAR held that the amount paid by the Applicant to KRP was in the nature of reimbursement and not FTS.
- The AAR distinguished the facts of the present case from that of *Centrica* as well as the Bengaluru Tribunal's ruling in *Flughafen Zurich v. DDIT*.³ In *Centrica (supra)*, the entire salary of the expatriate personnel was paid by the overseas companies and reimbursed by the Indian entity. Further, the reimbursement amount accrued to the overseas entities and it was up to them whether to apply it for payment to the expatriate personnel or not. In *Flughafen (supra)*, the entire remuneration was paid by the foreign company in the home countries of the

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expatriate personnel and subsequently reimbursed by the Indian company. In the present case, as noted by the AAR, the reimbursement amounts were a small fraction of the salary of the Personnel, and no other payments took place outside India except for the minimal obligated payments. Further, the payments never accrued to KRP but were mandatorily paid to the respective accounts of the Personnel.

- Based on the above observations, the AAR held that the Applicant had no useful purpose to cloak a small fraction of obligated payments by routing them through an offshore company, as it had already paid the bulk of the salary in India. Since the substantive salary was paid and taxed in India, the AAR held that the present case could be considered a camouflage of the provision of services or Personnel through a secondment agreement.
- Further, the AAR held that the administrative fee paid by the Applicant to KRP for managing the disbursements would constitute fees for technical services. On this finding, the AAR took into account the fact that the Applicant had admitted that the payments were subject to tax deduction under section 195 of the Income Tax Act, 1961.

ANALYSIS

The issue of whether reimbursements to offshore companies, for payments made to expatriate personnel, should be considered FTS has been a litigated issue. Whereas the Delhi HC in *Centrica (supra)* held the reimbursement to be taxable as FTS, the Bombay High Court in *DIT v. Marks and Spencer*⁴ held that the deputation of expatriate personnel did not amount to rendering a service. The ITAT rulings in *Faurecia v. DCIT*⁵ as well as *AT&T v. DCIT*⁶ distinguished from *Centrica (supra)*, but on separate grounds. In *Faurecia (supra)*, it was held that the reimbursement was not FTS as the amount did not accrue to the offshore company, while in *AT&T (supra)* the same conclusion was reached on the basis that the expatriate personnel were effectively under the control of the Indian company. Two other ITAT rulings – *Nippon Paint v. DCIT*⁷ and *Flughafen Zurich (supra)* – relied on *Centrica (supra)* and held that the payment was FTS on the basis that the expatriate personnel were still on the payroll of the offshore company. What is clear from these decisions is that whether the payment qualifies as FTS or not depends on the facts of each case and the relationship between the employee, the Indian company and offshore company.

The AAR ruling identified certain important principles which could be applied to distinguish between reimbursement and FTS in situations involving secondment of expatriate personnel.

- **No Lien over Employment:** In *DIT v. Morgan Stanley and Co.*⁸, the Supreme Court held that expatriate personnel deputed by an offshore company do not become employees of the Indian company for as long as the offshore company has lien over the employment. The Delhi HC relied on this decision by the Supreme Court in *Centrica (supra)*. However, it acknowledged that the situation would be different if the employee worked exclusively for the enterprise in the state of employment and was released for the period in question from the state of residence.

Although previous rulings such as *Faurecia (supra)* and *AT&T (supra)* identified that the Personnel were employed by the Indian company through the secondment agreement, they did not discuss the issue of lien.

The AAR relied on the Agreement between the Applicant and KRP and observed that the Agreement explicitly provided that KRP had no lien over employment. The Agreement specifically provided that KRP discharged the Personnel of all obligations and rights including any lien on employment, and from all actions, claims and demands towards KRP, while they were working as employees of the Applicant during the assignment. The Agreement also provided that while the Personnel were in India on assignment, KRP shall not enforce any kind of contractual obligations that the Personnel have had as employee of KRP. It was on this basis that the AAR concluded that there is no lien on employment of the seconded employees with the Applicant. The AAR also held that the Applicant is exercising full operational control and the employee is required to abide by policy regulations and guidelines of the Applicant.

- **Accrual of Payment:** In *Centrica (supra)*, the payment made by the Indian company accrued to the offshore company. The offshore company was in a position to decide whether or not to apply this amount to pay the seconded employees. However, such a situation did not exist in the present case as the payments never accrued to KRP for it to decide its application. They were mandatorily paid to the respective accounts for social security, insurance, and relocation commitments. The AAR characterized the payments as "obligated payments" which had to be made in the Personnel's home country and which could not accrue to KRP. Hence, the point of accrual as well as the nature of the payment would be relevant in deciding whether an Indian company is reimbursing an offshore company for payments made on its behalf, or whether it is paying consideration to the offshore company for services rendered.

- **Useful Purpose:** The AAR acknowledged that secondment agreements could be used to camouflage provision of services and manipulate receipts. Since the reimbursed amount in the present case was a mere fraction of the total salary, the AAR observed that no useful purpose had been served even if the companies intended to cloak payments as reimbursement. The AAR also noted that the substantive part of the salary was paid and taxed in India. It used this point to distinguish from *Flughafen Zurich (supra)* wherein the salary was paid by the offshore company in the home countries of the expatriate personnel.

The 'useful purpose test' may be used to substantiate the payment of certain non-substantive portions of salary to expatriate personnel, as the companies would gain little benefit from cloaking the nature of payment.

However, the useful purpose test should not be reduced to a 'substantive salary' test. Reimbursements to the offshore company should not be classified as FTS merely because they involved payment of substantive salary. The AAR's emphasis on who pays the bulk of the salary might be misplaced, given that in *AT&T (supra)* as well as *Faurecia (supra)*, the reimbursement was for a substantive part of the salary, and it was held to be a reimbursement and not FTS. Hence, the focus of useful purpose test should be on how much tax was finally paid in India and what is the nature of the payment being made to the offshore company, as opposed to the how much of the salary was paid offshore.

The AAR ruling indicates the importance of the nature of employment and accrual of payment, in order to determine whether a payment for seconded employees is mere reimbursement or FTS. It might be prudent to draft the secondment agreements carefully to correctly capture the nature and intent of payments being made, relationship with the seconded employees etc. This decision by the AAR is welcome and seems to be in the right direction which

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You can direct your queries or comments to the authors

1 AAR No 1366 of 2012

2 (2014) 8 HCC Del 714

3 (International Taxation) [2017] 79 taxmann.com 199.

4 2017 SCC OnLine Bom 1432.

5 2019 SCC OnLine ITAT 15829.

6 ITA Nos. 354/Del/2017 and 1653/Del/201.

7 2019 SCC OnLine ITAT 6475.

8 (2007) 7 SCC 1.

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