Article

Reimbursement of Expenses-Whether an RPT?

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Related Party Transactions (RPTs) are a usual phenomenon in corporate sector. Section 188 of Companies Act, 2013 ('Act, 2013') is more exhaustive and procedural as compared to Section 297 of Companies Act, 1956. Under the Act, 2013, hierarchy of approvals required for RPTs has been made more intricate and complex. Similarly, Regulation 23 of SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015 ('LODR') foisted a vast coverage of RPTs and consequent approval and disclosure requirements. The meaning of RPTs under LODR is very wide as compared to Act, 2013 and includes any transfer of resources, obligations or services. However, even after more than two years of enforcing sections of Act, 2013, there are remnants of several unresolved issues.

This article intends to analyze:

"Whether reimbursement of expenses incurred for related parties tantamount to an RPT or not?"

Current scenario

It is a common practice amongst group companies to share resources instead of each owing one. They may share a common office space, common office infrastructure, common facilities, sometimes even common staff or key managerial personnel. In turn, such group companies sharing such common facilities, reimburse their respective costs to the company who bears the cost of sharing.

Having said the above, it would be relevant to refer to some questions in relation to applicability of the above referred provisions of Act, 2013 and LODR, and compliance requirements thereunder. Following are some line of items encountered in the field of practice which may need our attention:

Deputation or Secondment of employees

It is no wonder that deputation or secondment of employees has emerged as a popular practice for businesses in recent times. The term "secondment" covers a situation whereby an employee or a group of employees are assigned or transferred, on a temporary basis to work for another organisation or a different part of the orgasnisation of their current employer. This transfer could be a complete transfer or a partial transfer; that is to say, the seconded employee could be exclusively working for the transferee company for a specified period or could be partially working for both the transferor and the transferee company. A secondment job can be full-time, part-time or job share. In case of secondment of employee, the secondment agreement plays a pivotal role. Hence, secondment should be preferably subject to an agreement entered into between the parties for the purpose of sharing of service and/or facility.

There are generally three parties to a secondment agreement:
(a) the original employer referred to as the "Seconder";
(b) the seconded employee referred to as the "Secondee" and
(c) the organization to which the secondee is to render service referred to as the "Host".

Secondment of employee without any remuneration

It is quite common for a company to depute its employees in other companies. Even in certain circumstances, a person who is a related party of the company, by virtue of Section 2(76) of the Act is deputed by the Company to another Company. In such a case, where related party of a company is being considered to be appointed in subsidiary company or associate company, this will falls within the ambit of Section 188 (1) (f) of the Act, 2013 which pertains to appointment to "office or place of profit". The intent behind such a concept is that, every such service rendered by a related party by virtue of his appointment to the subsidiary company or associate company, will be taken to be a RPT, provided the person so appointed is remunerated for the same. In case the person is only appointed in the other company but is not remunerated for the same, the provisions of section 188(1)(f) of Act, 2013 will not be applicable on both the companies. Also, the remuneration paid to the person remains same as it was before such deputation. Hence, in the absence of any separate remuneration for such deputation, the question of holding office of place of profit does not arise and the provisions of Section 188 will not be applicable for such deputation.

Apart from section 188 (1)(f) we should also consider if section 188 (1) (d) of Act, 2013 i.e. "availing or rendering of services" gets attracted for such deputation.

Meaning of 'Service'

Before getting into the intricacies of Section 188 (1) (d) i.e. "availing or rendering of services", we will have to understand the meaning of the term 'Service'. The concept of service is very wide. How it should be interpreted and what it means depends in the context in which it has been used in an enactment. The "Service" has been defined in few judgments delivered by the Hon'ble Supreme Court. The Hon'ble Supreme Court in the case of *Union of India & Ors. v. M/s. Martin Lottery Agencies Ltd.*, noticed the dictionary meaning of the word 'Service', inter alia, meaning as "*work done or duty performed for another or others; a serving; as, professional services, repair service, a life devoted to public utility service*".

As per Service Tax Act/Rules
Sub-section 44 of section 65B of Chapter V of the Finance Act 1994 defines the word "service" as follows :-

*"Service" means any activity carried out by a person for another **for consideration**, and includes a declared service, but shall not include—*
(a) an activity which constitutes merely,—
(i) a transfer of title in goods or immovable property, by way of sale, gift or in any other manner; or
(ii) a transaction in money or actionable claim;
(b) a provision of service by an employee to the employer in the course of or in relation to his employment;
(c) fees taken in any Court or tribunal established under any law for the time being in force.
[Emphasis supplied]

In the light of above provisions of law, it may be construed that for levying service tax on a transaction it must first qualify to be a service, wherein, there must be an activity taking place from one person to another for a **"consideration".** Since the aforesaid deputation is an arrangement whereby the company is deputing or seconding its paid employee to its subsidiary or associate company, **without any consideration** this is certainly not amenable to the definition of service and hence in view of the author it will not attract the provisions of Service tax.

However, in case the Seconder deputes its paid employee to the host, without any consideration, it implies that the Seconder bears the burden for the benefit derived by the host from availing the services of the Secondee. This arrangement of secondment between the Seconder and the host leads to a transaction that is not at arms' length basis. Therefore, such transactions which are not at arms' length basis are certainly amenable to an RPT and hence, comes under the purview of 188 (1) (d) of Act, 2013.

Now the next question which comes to mind is how to proceed with an RPT which is not at arms' length basis and how to determine arms' length price:

- **Approval of RPTs- not at Arms' length basis:**

In accordance with the provisions of Section 177 of the Act, 2013 and Regulation 23 of LODR, one of the important duties of Audit Committee is to pay sufficient attention to approval of RPTs. Since the Audit Committees are responsible for the first level scrutiny of RPTs, it has to satisfy itself about the fairness and arms-length nature of the RPTs. Hence, there is no question of Audit Committee granting approval to RPTs which is not on arm's length. Therefore, in view of the author RPTs which are not at arms' length basis should not be approved by the Audit Committee and be recommended to the Board for appropriate action.

- **Determination of Arms' Length Price**

Having discussed the above, it is pertinent to note that while there is a discussion on arms' length price, no method has currently been prescribed under the Act, 2013 or the Rules framed thereunder. As a result, one will have to take guidance from the benchmarking methodologies prescribed under the OECD Transfer Pricing Guidelines, UN Transfer Pricing Manual and the Income Tax Act. The arms' length price has been defined under the transfer pricing provisions under the Income Tax Act as '*a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions'*. Several methods are permitted to be applied, under the provisions of the Income tax Act which can serve as a useful tool for determining arms' length price of transactions with related parties.

Secondment of employee on reimbursement basis

Some Seconders follow the practice of being reimbursed for the expenses incurred on behalf of the Host. Continuing the situation discussed above, if the fact is that the Seconder is suitably compensated by the Host with respect to the time spent by the Secondee in the exact proportion, there is no transaction which may fall within the meaning of RPT.
The question therefore arises:

"What is a transaction and what is the meaning of the term reimbursement?"

Meaning of 'Transaction'

Transaction occurs when there is benefit or burden or results in some expenditure or income. As per Black's Law dictionary, a transaction or compromise is an agreement between two or more persons, who, for preventing or putting an end to a lawsuit, adjust their differences by mutual consent, in the manner which they agree on, and which every one of them prefers to the hope of gaining, balanced by the danger of losing. This contract must be reduced into writing.

In common law, the term transaction means whatever may be done by one person which affects another's rights, and out of which a cause of action may arise. "Transaction" is a broader term than "contract." A contract is a transaction, but a transaction is not necessarily a contract.

Meaning of 'Reimbursement'

The term "reimbursement" has the following meaning/connotations as provided in the Black's Law Dictionary: "*Reimburse: To pay back, to make restoration to repay that expended; to indemnify, or make whole*".

Reimbursement of actual expenses does not have an element of income embedded in it. It is mere recovery of expenditure incurred at a common place and is merely a matter of logistic convenience. Hence, reimbursements cannot be regarded as a transaction at all.

As already discussed above that the provisions of Section 188 (1)(f) gets attracted only in case where a related party renders services by virtue of his appointment to the subsidiary company or associate company, provided the person so appointed is remunerated for the same.

Now the question arises:

"Whether reimbursement of expenses falls within the ambit of the meaning of the term 'remuneration'?"

'Reimbursement' Vs. 'Remuneration'

Section 2 (78) of the Act, 2013 defines remuneration as *'any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income-tax Act, 1961*'.

Mere reimbursement of expenses does not come within the meaning of 'remuneration' as per section 2 (78) of the Act, 2013. As can be seen, the reimbursement of expenses is neither paid for the services provided and nor does it fall under the definition of perquisites. It is mere reimbursement of the actual expenses incurred by the Seconder. The dividing line between reimbursement and remuneration/income can be drawn by seeing the ruling in the case of *M/S Kalyani Steels Ltd., Bellary vs Department of Income Tax,* where the ITAT-Bangalore held that where reimbursement is on cost to cost basis, then the payment does not comprise income and hence not liable to tax u/s 194J.

There has to be reimbursement from the Host for the time devoted by Secondee in the Host. Seconder cannot bear the burden for the benefit derived by the Secondee. This will otherwise result in RPTs – not on arm's length basis. In the present case, amount paid by the Seconder for the services rendered by the Secondee is reimbursed fully by the Host. Thus, if the aforesaid is ensured, Section 188 (1) (d) and (f) of Act, 2013 will not get attracted.
Now we will examine:

"Whether reimbursement of expenses will tantamount to Service for the purpose of levy of service tax?

Section 67 of the Service Tax Act, 1994, where in the Explanation, for clause (a) as amended by budget 2015, the word "consideration" provides that:

(a) "consideration" includes–

(i) Any amount that is payable for the taxable services provided or to be provided;
(ii) any reimbursable expenditure or cost incurred by the service provider and charged, ***in the course of providing or agreeing to provide a taxable service,*** *except in such circumstances, and subject to such conditions, as may be prescribed;*
(iii) any amount retained by the lottery distributor or selling agent from gross sale amount of lottery ticket in addition to the fee or commission, if any, or, as the case may be, the discount received, that is to say, the difference in the face value of lottery ticket and the price at which the distributor or selling agent gets such ticket.'.

Further in terms of Rule 5(2) of the valuation rules, *expenditure or cost that service provider incurs, as pure agent on behalf of the client, shall be* ***excluded from the value****, if service provider fulfill prescribed conditions:*

i) the service provider acts as a pure agent of the recipient of service when he makes payment to third party for the goods or services procured;
(ii) the recipient of service receives and uses the goods or services so procured by the service provider in his capacity as pure agent of the recipient of service;
(iii) the recipient of service is liable to make payment to the third party;
(iv) the recipient of service authorises the service provider to make payment on his behalf;
(v) the recipient of service knows that the goods and services for which payment has been made by the service provider shall be provided by the third party;
(vi) the payment made by the service provider on behalf of the recipient of service has been separately indicated in the invoice issued by the service provider to the recipient of service;
(vii) the service provider recovers from the recipient of service only such amount as has been paid by him to the third part y; ands
(viii) the goods or services procured by the service provider from the third party as a pure agent of the recipient of service are in addition to the services he provides on his own account.

Explanation 1. – For the purposes of sub-rule (2), "pure agent" means a person who –
(a) enters into a contractual agreement with the recipient of service to act as his pure agent to incur expenditure or costs in the course of providing taxable service;
(b) neither intends to hold nor holds any title to the goods or services so procured or provided as pure agent of the recipient of service;
(c) does not use such goods or services so procured; and
(d) receives only the actual amount incurred to procure such goods or services. -

On reading of the above definition, it is clear that only such reimbursement are included in consideration which are received or receivable in the course of providing or agreeing to provide a

taxable service. Therefore, any transaction taking place in the nature of pure reimbursements, without any intent of service, and the receipts from such transactions will not fall within the purview of definition of "consideration".

Scenario before Finance Act, 2015:

Before the amendments were made vide Finance Act, 2015, on plain reading of Section 66 and Section 67 (1) (i) together and harmoniously, it seems quite clear that only the amount of consideration paid as quid pro quo for the services shall be considered in the valuation of the taxable service and hence shall be brought to charge. Therefore, there is no doubt that Rule 5 (1) of the Rules ran counter and was repugnant to Sections 66 and 67 of the Act and to that extent it was ultra vires. Rules 5 (1) includes in the valuation of the taxable service the other expenditure and costs also which are incurred by the service provider "in the course of providing taxable service". Hence, by including the expenditure and costs, Rule 5(1) goes far beyond the charging provisions. It has been well settled law that sub-ordinate legislation cannot overrule the statue.

Keeping in view the same, Hon'ble Delhi High Court in the case of *Intercontinental Consultants & Technocrats Pvt. Ltd. v. Union of India 2013 (29) STR 9 (Del.)*, stroke down the provisions of Rule 5(1) of the Rules and held the following:

- Rule 5 (1) of the Rules is ultra vires section 66 and section 67 of the Finance Act, 1994 since it travels beyond the scope of the aforesaid sections.

- The expenditure or costs incurred by the service provider in the course of providing the taxable service can never be considered as part of the gross amount charged by the service provider for the services provided.

- The reimbursement of expenses for air travel tickets, train, hotel, etc. may also lead to double taxation.

Therefore, the above judgment is in contrary to the intent of the law makers. The intent has always been to include reimbursable expenditure in the value of taxable service except pure reimbursable expenses. However, the judgment in this case was tilted in favour of assesse. Accordingly, changes made through Finance Act, 2015 could be seen as a desperate attempt by the government to make good for this legal faux pas. By this amendment the intention of legislature is being specifically stated and taxability of reimbursement has reached some finality. Henceforth, any reimbursable expenditure or cost incurred by the service provider and charged, in the course of providing or agreeing to provide a taxable service, be chargeable to service tax.

Sharing of office infrastructure

Sharing of infrastructure is another common practice amongst group companies. Many companies may, for practical reasons, share a common office space, common office infrastructure, common facilities etc. In common parlance the space or infrastructures are owned by one company and shared with one or more group companies and in turns the group companies reimburse the

expenses incurred by the owner company on behalf of them. Similarly when office infrastructures are shared between two entities it would be quite difficult to identify who is using and to what extent the same is being used by either entity. Hence, in such a case, companies usually enter into a facility sharing agreement, called by whatever name for the purpose of sharing of space and/or facility.

As far as eligibility of service tax on sharing of expenses is concerned, the best course of action would be to look at whether the expenses recovered can be attributed towards rendering of a service and that too, a taxable service. In other words, whether the entity recovering the expenses, can be regarded as stepping into the shoes of a service provider? If the answer to this is in affirmative then the said entity should discharge the service tax liability on the amount so recovered. If the said entity cannot step into the shoes of a service provider but merely recovers the amount, then no question of taxability arises.

For instance, a holding company takes 20,000 sq. feet of office space on rent and allows its subsidiary to use 5000 sq. feet of office space and thereby the holding company recovers rent in respect of 5000 sq. feet of office space. In this case, the holding company by allowing its subsidiary to use the office space falls under the definition of renting of immovable property services and accordingly, the recovery of expense would be liable to service tax in the hands of the holding company. On the other hand, holding company makes payment in respect of security guards employed for the entire building and then recovers the amount in respect of security guards then obviously the holding company has not rendered security services to the subsidiary. Consequently, in the absence of service provider-service recipient relationship levy of service tax would not hold good.

Margin on cost

The core purpose of sharing infrastructure or facility is to provide operational convenience to the other entity. The intent of sharing is mere providing mutual facilitation. The idea is not to get into the business of renting or leasing, or to make proper use of surplus resources, or to minimize costs. The sharing is done only because of the reasons of practicality.

However, the key issue arises when the company starts charging any margin on its cost incurred for either sharing of infrastructure, facility or on sharing of employees. In such a case it will amount to a business transaction and being a transaction with related parties the provisions of Section 188 will need to be studied.

Further note that the definition of the term pure agent clearly states that ‘Pure agent’ is a person who:

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(d) receives only the actual amount incurred to procure such goods or services.

On reading the above text it is clear that in order to avail the benefit of the provisions of Rule 5 (2) of Service Tax Valuations Rules, 2006, the reimbursement shall be the actual amount incurred by the service provider to produce such goods or service. Therefore, if the reimbursement is not a pure reimbursement and the service provider is charging some margin on actual cost, it will amount to a service and consequently will be chargeable to service tax.

Conclusion

From the discussion above, it is clear that expenses incurred on behalf of a related party and purely reimbursed by the other party would not said to be a transaction with related party. Reimbursement of expenses does not result in any transaction as it does not lead to any burden or benefit. The company is simply restored to the previous position. There is no transfer of resource happening as the company receives the amount from another party. This arises only for operational convenience and does not have any economic rationale. Therefore, in view of the author the same will not fall within the purview of Section 188 of the Act, 2013 and Regulation 23 of LODR Regulations, 2015. However, in case the reimbursement is being made with some margin on cost, the same will result into a transaction and hence provisions of Act, 2013 and LODR will get attracted.

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