Cost sharing by companies and Service Tax

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Background

A group company could procure resources such as server space, software licenses, office space and various other facilities from vendors. When a company say Co A of Karnataka procures such resources, the same are not only used by such company but also by its group companies, ie Company B of Chennai, Co C of Mumbai or Co D of Pune. The expenses incurred could be recovered by company A from its group company which uses the resource. In this backdrop, question arises whether cost sharing is liable to service tax.

In this article the paper writers have sought to examine service tax implications of cost sharing done between Indian entities under service tax and recent developments in this regard.

Mutuality and cost sharing

Under under negative list based taxation, service tax is levied on the services provided by one person to another for a consideration. Two persons are required to constitute a taxable service, namely a service provider and a service receiver. This is based on the mutuality principle which says that a person cannot provide service to self.

Mutuality is not a form of organization. The concept of mutuality has been extended to defined groups of people who contribute to a common fund, controlled by the group, for a common benefit. The contributories and the beneficiaries would be the same. Members' clubs are an example of a mutual undertaking; but, where a club extends facilities to non-members, to that extent the element of mutuality is wanting.

In the decisions of Ranchi Sports Club 2012(26) STR 401(Jharkhand) the Jharkhand High Court(appeal admitted before SC) and Gujarat Sports Club 2013-TIOL-528-HC-AHM-ST where though the entities were constituted as a body corporate, yet mutuality was upheld on the basis that every member was shareholder and club open to members' only. The validity of this view could need further judicial review confirmation at the highest level of judiciary.

Further based on facts and circumstances the implications could be different. A body corporate could not be providing or procuring resources to its members/shareholders. However it is procuring resources such as server space, software to other entities which are not the company's shareholders nor its members and it debits other group companies for the use of common resources. When the group companies are distinct legal entities, having a perpetual

existence and common seal mutuality concept may not be applicable to said transaction of recoveries done by a company.

Cost sharing and reimbursement of expenses

Section 67(1) of the Finance Act 1994, levies service tax on **gross amount charged for taxable service,** when the service is provided for consideration in money. In other words, what is sought to be taxed under Service Tax law, is the **amount which is attributable to the taxable service alone.** Whether this precludes **a scenario where purely expenses are reimbursed, without any services having been provided?**

It maybe noted that with effect from 19.04.2006, with the introduction of Service Tax (Determination of Value) Rules 2006, even reimbursements of expenses during the course of providing services are being subjected to service tax. It could have been to cover situations where service providers were deliberately bifurcating the expenses incurred to provide the service itself to undervalue their services. Exclusion has been provided for expenses incurred by the service provider as a pure agent of the service receiver.

There has been a doubt on taxing under service tax of real reimbursements [unrelated to the service per se] where the concept of "pure agent" has not been followed by the service provider and no margins exist.

In *Intercontinental Consultants And Technocrats Pvt Ltd vs. UOI &Anr* [2012-TIOL-966-HC-Del-ST] there had been a demand of service tax on the reimbursed expenses on the ground that those are essential expenses for providing the taxable services of consulting engineers.

The H'ble High Court of Delhi allowed the writ holding that what is brought to charge under the relevant Sections is only the consideration for the taxable service. By including the expenditure and costs, Rule 5(1) goes far beyond the charging provisions and cannot be upheld.

Consequently in FA 2015, an explanation inserted in Section 67 clause (a) (ii) the term consideration, includes the value of re-imbursement of expenses claimed in the provision of output service. Effective date is from 14.5.2015. This amendment is to overcome the decision of Hon'ble Delhi High Court in Intercontinental Consultants mentioned at supra.

There is no change in the basic valuation provisions, which levies service tax on gross amount charged for service as set out in earlier service tax law in Section 67. Same was continued under negative list based taxation.

Further Rule 5(2) also continues and not quashed. Therefore, in the normal course, the proposition of exclusion as pure agent [subject to fulfillment of conditions] in relation to expenses reimbursed would have to continue.

It would be important for entity to identify what is reimbursement and what is not. Merely **calling it as reimbursement in the bills would not make it reimbursements.** To claim exclusion of expenses incurred as pure agent, It should be clear from the terms of agreement that there was an obligation upon the service receiver to incur such expenditure and instead the service provider incurs such expenditure, and the same would be reimbursed by the service receiver to service provider. Further reimbursement means it should be at actuals and supported by sufficient documentary evidence.

Though legally possible practically the fact remains that revenue could insist on evidence and agreements for all these payments made. It could question basis on which amount was arrived at which may lead to disputes.

Therefore it would be responsibility of the entity to have sufficient documentary support to prove whether exclusions made claiming it to be reimbursements are in fact reimbursements and not separation or artificial splitting of consideration by calling it as reimbursements.

Concept of Pure agent

Pure agent" as per explanation (1) to Rule 5(2) of Service Tax (Determination of Value) Rules 2006, means a person who –

i. 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

ii. 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

iii. Does not use such goods or services so procured and

iv. Receives only the actual amount incurred to procure such goods or services

The conditions to be satisfied in this regard as per Rule 5(2) are as follows –

i. Service provider to act as a pure agent of the recipient of service while making payment to third party for the goods or services procured

ii. Service receiver to receive and use the goods or services procured by the service provider on his behalf

iii. Service receiver to be liable to make payment to the third party

iv. Service receiver to authorise the service provider to make payment on his behalf

v. Service receiver to know 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 is to be 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 party

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

Service tax on Cost sharing vs Cost Allocation

Cost sharing needs to be distinguished from scenario where the costs incurred are allocated between various group entities based on turnover or other criteria. Then it cannot be treated as a reimbursement of expense as it may not be possible to prove that the expenses incurred on behalf of such group companies to meet their obligation are being reimbursed to procuring company based on actual consumption of such resources by the group companies.

The revenue could take a view that the expenses incurred could be treated as incurred towards input services used for providing services to the service receiver group company and liable to service tax in hands of service provider company. Therefore, in such scenario in order to avoid litigation, it maybe advisable that the service tax liability be discharged.

Recent decisions

In Reliance Ada Group Pvt Ltd Vs CST, Mumbai IV (2016-TIOL-603-CESTAT-MUM) appellant has entered into contractual agreements with its participating group companies to procure certain services on their behalf so as to share the cost among the participating Group Companies. Such procurement includes provision of aircraft hiring services, branding services, professional services, custodian services etc. The expenses/cost incurred in procuring the specified services on behalf of the participating group companies are separately charged to and reimbursed by the participating group companies.

Held no taxable service is provided and, in absence of rendition of such service by the appellant to the participating group companies, the demand of service tax cannot sustain. Pure agent conditions satisfied as amount recovered is precisely the same as has been paid to the third party vendors.

In a related development, another decision in Franco Indian Pharmaceutical Pvt Ltd Vs CST, Mumbai (2016-TIOL-885-CESTAT-MUM) where a pharma company was sharing its marketing network with group companies. Recoveries made towards the cost attributable to

salary, wages, bonus, demand and incidental expenses of the employees who were deputed to the work of marketing of the group companies.

Held if indeed the intention to render service, the employer company which takes the trouble of hiring an employee in its own rolls would have insisted on some markup or margin being given to it, over and above the actual cost. In the absence of such a markup/margin, the payments received against debit notes by one employer company upon the other employer companies, will not partake the character of consideration for any service, but will merely represent reimbursement of shared costs. No ST payable appeal allowed.

Conclusion

Coming to the various categories of expenses incurred and shared by the various entities concerned, the question of levy of service tax would arise only where the service provider-service receiver relationship comes into play between company and entities bearing their share of expenses. In view of paper writers, mere sharing of expenses would not result in constituting the entities concerned as service provider and service receiver. Further the sharing of resources cannot be considered as services provided for a valuable consideration. The business entities have to be very clear on when it is mere sharing of expense[not liable] and when is it treated as taxable service liable to service tax.

When such expenses incurred are excluded from service tax, advisable entity intimates jurisdictional range by RPAD letter why it is not liable and seek confirmation to ensure there are no future sustainable demands for extended periods.

In this article paper writers sought to examine the implications of cost sharing arrangement.

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