Substantiating cost essential for deduction under cost allocation arrangements

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In brief

Recently, the Delhi Income-tax Appellate Tribunal (Tribunal), in the case of BG International Limited (BGIL or the taxpayer), held that while computing the taxable income, costs incurred were not deductible, without substantiating common expenses and basis of allocation. Furthermore, the income was held to be taxable on presumptive basis under section 44BB of the Income-tax Act, 1961 (the Act).

In detail

Facts

The taxpayer[1], a company incorporated, and tax resident, in the UK, was engaged in the business of exploration and production activities in the oil and gas sector. The taxpayer provided requisite services/ support to its group entities and incurred certain expenditure/ costs, which were then cross charged to such group entities without any mark-up.

BG Exploration and Production India Limited (BGEPIL) is a limited liability company incorporated in the Cayman Islands, and an Associated Enterprise of the taxpayer within the meaning of section 92A of the Act. BGEPIL, along with Oil and Natural Gas Commission and Reliance Industries Limited, had entered into a production sharing contract (PSC) with the Government of India, for exploration and production of oil and gas hydrocarbons in India. BGEPIL has set up a project office in India to execute this PSC.

BGIL had rendered various services to BGEIPL on a cost-to-cost basis, and had received reimbursement of INR 972,898,465 towards such cross charge/ cost allocation. The taxpayer filed its return of income for assessment year (AY) 2007-08 declaring an income of INR 159,520 (being interest received from income tax). The income element in the receipts of INR 972,898,465 was considered to be at NIL as an amount equal to INR 972,898,465 was claimed as deduction towards expenditure incurred.

In course of the assessment proceedings, the Tax Officer (TO) disallowed the expenses in the hands of BGIL and computed the income at INR 972,898,465 by holding the following:

- The taxpayer failed to provide any worthwhile evidence to substantiate expenses incurred;
- There was no evidence of actual rendering of services;
- The taxpayer did not give any explanation as to how BGEIPL was charging the amount of accrual overhead to the taxpayer, as BGEIPL was supposed to charge this to its parent and not to the taxpayer.

Aggrieved, the taxpayer filed an application before the Dispute Resolution Panel (DRP). The DRP concurred with the TO's view. However, it directed him to provide deduction on account of expenditure in respect of which third party evidence was submitted. As such, the DRP granted a relief of INR 88,365,531.

Aggrieved with the DRP's decision, the taxpayer filed an appeal before the Tribunal.

[1] BG International Ltd *v.* ADIT [TS-120-ITAT-2015(Delhi-Tribunal)]

Issues before the Tribunal:

- Whether the receipts from BGEIPL could be considered to be pure reimbursement of expenses, and therefore not liable to tax in India?
- Without prejudice to the above, whether the taxpayer's income should be computed in accordance with section 44BB of the Act?

Taxpayer's contentions:

- Principle of *res judicata* did not operate in income tax proceedings. Accordingly, the fact that in the AYs 2003-04, 2004-05 and 2005-06, the income was assessed under section 44BB of the Act should not be considered as precedent for all the years.
- Reliance was placed on the Tribunal order for AY 2006-07 on the same issue where the issue had been decided in the taxpayer's favour, based on the material produced.
- Reliance was placed on the Global Allocation Policy of the taxpayer, which pointed out that the allocation of the overhead costs was made on a cost-to-cost basis. It was mentioned that the cost allocation policy was quite reasonable, and that the policy had been validated by two independent consultants.
- In view of the nature of the taxpayer's business, a one-to-one nexus between the services rendered and the expenditure allocated for such services was not possible.
- Reliance was placed on the decision of High Court in the case of Enron Oil and Gas Limited[2], wherein it had been held that the taxability of income of each member of PSC had to be determined in terms of section 42, which overrode other provisions of the Act. As per section 42, in addition to the allowances admissible under the Act, allowances specified in the agreement with the Central Government also had to be allowed.

Revenue's contentions:

- The evidence produced by the taxpayer was insufficient to prove that the expenses had been incurred for rendering the services in the arrangement;
- With regard to the decision of Tribunal in AY 2006-07, the Revenue pointed that the taxpayer had produced invoices, and therefore its appeal had been dismissed. However, in the present year, the TO as well as the DRP has brought on record that there was no evidence of expenses being incurred by BGIL, for which reimbursement was taken from BGEIPL;
- Regarding the taxpayer's without prejudice contention that the assessment should be made under section 44BB, the Revenue argued that the taxpayer's profits were taxable under Article 7 of the India-UK tax treaty on a net basis;
- With respect to the taxpayer's contention regarding the allocation being in line with BGIL's global cost allocation policy as certified by independent consultants, the Revenue argued that the report of independent consultants only mentioned that the overhead cost allocation and time writing policy of the group has been adhered to. It was argued that the report of independent consultants did not certify cost allocation to businesses and benefits.

Tribunal ruling:

- The taxpayer's reliance on the Tribunal's judgement for AY 2006-07 could not be accepted, as the decision was in light of the finding that the taxpayer had provided invoices and supportings to substantiate the expenditure. However, in the concerned AY, the taxpayer had not produced any documents before the TO;
- The taxpayer had failed to substantiate its claim regarding the allocation of expenses incurred by it for the services rendered to BGEIPL. The taxpayer has not been able to substantiate the common expenditure incurred, the basis of allocation of the same, and why those had to be allowed as deduction from its Indian operations. It was a well-established principle that unless the taxpayer was able to substantiate its claim, deduction could not be allowed;
- As demonstrated by the Revenue in his submissions and arguments, the taxpayer had not been able to substantiate its claim. The matter would not be restored to the TO for re-examination, as the taxpayer had clearly stated that it would not be possible to have a one-to-one nexus of the expenses with the services rendered;
- In the light of the facts, and the limitation that the taxpayer was not in a position to substantiate expenses incurred, taxing the income under section 44BB of the Act was the only possible recourse, as done in previous years.

The takeaways

- In pure cost reimbursement arrangements, it is critical to establish costs allocated, benefits and basis of allocation.
- Submission of a global policy for cost allocation and an external consultant's report may not be adequate to defend a claim for deduction.

[2] CIT *v.* Enron Oil & Gas India Limited [2008] 305 ITR 68 (Uttaranchal)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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