



Income pertaining to separately identifiable segment in a composite contract, is not taxable in India if the activities pertaining to the contract are carried out outside India

Recently, the Hyderabad bench of Income-tax Appellate Tribunal (the Tribunal) has given its ruling on the taxability of the composite contract. The Tribunal in the case of Andhra Pradesh Power Generation Corporation Ltd.¹ held that though the contracts were of composite in nature, tax was required to be deducted only on income attributable to the identifiable segment of the composite contract which was carried out in India.

Facts of the case

- The taxpayer, a State Government Undertaking, was in the business of generation of power. It entered into two separate agreement with Chinese company, National Machinery and Equipment Import and Export Corporation (CMEC) for
 - The design, manufacture, supply of six units electric generators i.e. supply contract
 - Erection and commissioning of generators i.e. erection service contract.
- The taxpayer filed an application before the Income-tax department for determining the tax withholding rate in respect of payments to be made to CMEC under the erection service contracts. The taxpayer contended that it was not liable to deduct tax in respect of supply contract, since no part of income was taxable in India.

¹ ACIT v. Andhra Pradesh Power Generation Corporation Ltd. (2009-TIOL-346-ITAT-HYD)

- The Assessing Officer (AO), after considering the tender documents and other papers concluded that both the contracts were of composite nature and therefore, it cannot be said that the sale of equipment took place outside India.
- The AO also held that the CMEC had a Permanent Establishment (PE) in India as the employees were present on the site in India for at least 30 months and residential colony was found to have been constructed for CMEC employees. Thus, the AO determined the income at 10 percent of the gross value of the contract by applying the section 44BBB of the Income-tax Act, 1961 (the Act).
- The Commissioner of Income Tax (Appeals) (CIT[A]) found that though two contracts were of composite in nature it had two different identifiable segments, one relating to the supply of equipment and the second relating to erection, testing and other related services. Accordingly, the CIT(A) after considering the various facts held that since the income from erection and commissioning contract was attributable to India its income was chargeable in India.

Issue before the Tribunal

Whether the taxpayer was liable to deduct tax in respect of the income arising outside India under the composite contract?

Contentions of the taxpayer

- The taxpayer entered into a Free On Board (FOB) contract with CBEC for the supply of equipment outside India. Therefore, income arises from the supply contract was not chargeable in India.
- Even if the two contracts are considered to be one, 90 percent of the total contract value was for the supply contract and the contract value to erection service contract was only 9 percent.
- The taxpayer further contended that the contract carried out was pure sale contract and not a works contract especially when majority of the work relating to the plant and equipment was carried out outside India.

Contention of the tax department

- The employees of the CMEC were present at the site for at least 30 months for erection service contract and CMEC had also taken two warehouses on hire from the taxpayer. Therefore, CMEC had a permanent establishment (PE) in India.
- Since the contracts entered by the taxpayer were of composite in nature and since the CMEC had PE, entire contract amount was taxable in India.

Tribunal's Ruling

The Income-tax Appellate Tribunal after relying on the Special Bench judgment in case of Motorola Inc² observed that

- Since both the contracts were with the same party it would not be wrong to consider both the contracts as a composite contract. Although the contracts were composite in nature, they were two separately identifiable contract of the overall turnkey project.
- If the parties had entered into the contract on FOB terms, wherein the title of the goods was passed outside India, the AO cannot change the commercial intent of the parties to the contract and the intention of the parties to the contract was just to pass the title of the equipment outside India, and the conduct of neither party was contrary to the above intention.
- The taxpayer as an owner was entitled to submit grievances as per the terms of the contract if any defect was found on commissioning the equipment, as CMEC had no title of the equipment in India.
- As per article 7 of the India-China tax treaty, no profit was taxable in India, if no activities were carried out in India. Accordingly, as no activity with regard to the manufacture of the generators supplied to the taxpayer had been carried out in India by the CMEC, no part of the income related to supply contract was chargeable to tax in India.
- However, the Tribunal held that the income from erection service contract was taxable and the income was to be determined at the rate of 10 percent as per the provision of section 44BBB of the Act.

Our Comment

Taxability of turnkey contracts has been a matter of debate from a long time. In the case of an identifiable segment of a composite contract with a non-resident, the income pertaining to activities carried out in India can only be attributed to the Indian operations for the Indian tax purposes. In other words, the offshore supply contract does not attract tax liability in India. It is to be noted that the Tribunal has not made a reference to the decision of the Supreme Court in the case of Ishikawajima-Harima Heavy Industries Ltd³ which had similar facts as the present case.

² Motorola Inc. v. DCIT [2005] 95 ITD 269 (Delhi) (SB)

³ Ishikawajima Harima Heavy Industries Ltd v. Director of Income-tax (2007) 288 ITR 408 (SC)

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