KPMG

TAX FLASH NEWS

22 August 2017

Profits from offshore and onshore services are taxable in India, and it is attributable to the supervisory PE in India

Background

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Shanghai Electric Group Co. Ltd.[1] (the taxpayer) held that the taxpayer is having a supervisory Permanent Establishment (PE) in India. The Tribunal observed that Indian clients contracted the taxpayer to carry out the work of supply, supervision, erection, installation and successful commissioning of plants. The taxpayer was directly involved in the entire supervisory work carried out in India and was responsible for the successful functioning of the projects in India under each and every contract.

The Tribunal observed that the agreements entered into by the taxpayer with its clients in India are in the nature of a composite contract since agreements are inextricably linked with each other. None of the agreements are executed exclusively for sale of equipments. The taxpayer was specialised in manufacturing of equipments required for setting up of the power plant, and it was also involved in the supply of the same. The transfer of title to the equipments has taken place in India. Further, the contracts are negotiated and concluded in India. The expatriates come to India to provide technical support services to PE in India. All these activities go on to establish that the taxpayer has a business connection in India within the meaning of Section 9(1)(i) of the Income-tax Act, 1961 (the Act). Splitting of this transaction under supply and services will be wholly artificial and neither will it have a rational basis, nor can it be recognised for the purposes of computation of profits attributable to the PE.

The Tribunal held that profits relating to services rendered by the taxpayer, whether rendered in India or outside India, in respect of Indian projects are taxable in India, and are attributable to the supervisory PE of the taxpayer in India since they are effectively connected with each other.

[1] Shanghai Electric Group Co. Ltd. v. DCIT [2017] 84 taxmann.com 44 (Del)

Facts of the case

- The taxpayer is a Chinese company engaged in the business of supply of Boiler, Turbine, and Generator (BTG) equipments to various companies for setting up of power plants in India. During the Assessment Year (AY) 2010-11[2], the taxpayer executed contracts with various parties for provisions of supervisory services for erection/commissioning of BTG equipments.

- The taxpayer is carrying out all the drawings, design and engineering along with supervising the commissioning and erection of BTG equipments. There are offshore supply and onshore services.

- During the year under consideration, the taxpayer filed its return of income for onshore supervisory services rendered in India. The taxpayer had offered to tax the remuneration arising from supervisory services under the provisions of Section 44BBB[3] of the Act. No portions of income arising from offshore supplies were offered to tax since the sale of BTG equipments was concluded outside India.

- The taxpayer claimed that income from offshore supplies is not taxable in India. It was contended that the income derived in respect of supervisory activities cannot be treated as Fees for Technical Services (FTS) under the Act. Section 44BBB of the Act is applicable to a non-resident, who is engaged in business in connection with a turnkey power project.

[2] Facts of the case were similar for AY 2007-08, 2008-09, 2009-10, 2010-11, 2011-12, 2012-13, 2013-14

[3] Special provisions for computing profits and gains of foreign companies engaged in the business of civil construction, etc., in certain turnkey power projects

- The Assessing Officer (AO) issued a show cause notice asking him why income from supervisory services should not be taxed as FTS. The AO held that it was not a simple case of supply of goods where some services were required to be carried on by the taxpayer, incidental to sale. Designing, manufacturing and supervision, erection and commissioning of BTG equipments were complete responsibility of the taxpayer under the same contract. The AO has attributed profits from offshore supply to the supervisory PE of the taxpayer in India. The AO thus concluded that the supervisory PE of the taxpayer in India was directly involved in supervision and supply of BTG equipments, needed to set up a fully functional power plant. The AO passed draft order computing profits at 8.1 per cent, on the basis of global profit and loss account and attributed such profit to Indian operations (supervisory PE) at 25 per cent.

- The Dispute Resolution Panel (DRP) upheld the attribution at 25 per cent to the PE in India, in respect of the offshore supply of BTG equipments.

Tribunal's decision

Analysis of the agreement

- On reference to the clauses of the agreement, it indicates that along with a supply of equipment, the taxpayer is required to perform such additional or incidental items as may be required. The taxpayer is also required to provide the performance guarantee and warranties and to supply the equipment and make the equipment operable and capable of performing as specified in the specifications or as otherwise necessary in order to comply with the requirements of this contract.

- The agreement also provides that any royalties and fees for patents covering materials, articles, characters, devices, equipment or processes used in the equipment shall be deemed to have been included in the contract price. The taxpayer shall indemnify the owner against any infringement of any patents involved in and in case of an award of damages, the taxpayer shall pay all sums as may be required under such award in respect of the equipments.

- The taxpayer continues to have control over the equipments while in transit, and there is no actual custody of the equipments by the buyer from the supplier outside India. The taxpayer is solely responsible for delivery of the equipments to the territory of India each time they are loaded on the ship. The payments are linked with each other at different stages of design, drawing, supply, and commissioning of the entire project. Therefore, it has been held that activities rendered by the taxpayer are inextricably linked with each other, and all the responsibility from supply till successful commissioning of projects rested on the taxpayer.

- On the basis of above analysis in respect of each contract, the argument of the taxpayer is to be rejected that the agreements entered into by taxpayer with the project owners were essentially a contract for the supply of goods, where some work is required to be done as incidental to sale. The decisions in the case of Motorola Inc.[4] and POSCO[5] are distinguishable on facts of the present case.

- None of the contracts specifies clear intention of parties to transfer the title and the goods outside India. In fact, the taxpayer was having complete control over the goods inclusive of risk while in transit as well as once equipments reaches the respective site. The delivery of shipment has taken place on Cost and Freight (CFR) basis, would imply that the taxpayer was responsible to deliver the goods to the buyer at the port in India and the risk of any damage/loss would shift to the buyer only on the goods reaching the port of India. Thus, title in the goods did not get transferred to the buyer outside India.

Composite contract

- The agreements entered into by the taxpayer with its clients in India is in the nature of a composite contract. On perusal of various clauses of agreements, it is clear that the dominant intention of the parties was to set up a power plant in India at various locations under the supervision of the taxpayer.

- Since the taxpayer was also specialised in manufacturing of equipments required for setting up of the power plant, the taxpayer was involved in the supply of the same. The parties had agreed to construct power plants of a certain capacity. None of the agreements are executed exclusively for sale of BTG equipments.

- Under one project, the taxpayer has entered into two agreements, one for supply and another for supervision. On a co-joint reading of these agreements, it appears that payments are linked with each other at different stages of design, drawing, supply, and commissioning of the entire project. Thus, applying 'dominant nature test' applied by the Supreme Court in the case of Bharat Sanchar Nigam Ltd.[6], and the ratio of substance over form that has been considered by the AAR in the case of Roxar Maximum Reservoir Performance WLL[7] the Tribunal do not have any hesitation in holding that the transfer of title to the equipments has taken place in India.

---

[4] Motorola Inc. v. DCIT [2005] 95 ITD 2691 (Del) (SB)
[5] POSCO Engineering and Constructions Company Ltd. v. ADIT [2014] Taxmnn.com 500 (Del)
[6] Bharat Sanchar Nigam Ltd. v. Union of India [2006] 3 STT 245 (SC)
[7] Roxar Maximum Reservoir Performance WLL [2012] 349 ITR 189 (AAR)

- It has been observed that the taxpayer has trained personnel regarding the functioning/handling/ maintenance of BTG equipments. By and large, the taxpayer has not been separately compensated for providing training have expressly agreed that cost of training would be included in the total contract price. It does not help the taxpayer in any case, as training given to owners personal is finally consumed in India.

- Whether the payment is made separately or not, and whether it has been given in India and or China, does not change the situs of consumption of such services rendered by the taxpayer. This leads to the conclusion that the training cost is included in the sale price charged for the supply of BTG equipments.

- Further, the taxpayer is responsible to incur expenditure towards tests and inspection at project sites in India, conduct repair during defect liability period which is again in India, etc. This again indicates that the cost so incurred is subsumed in the supply cost of the equipments, which cannot be ruled out.

- The property in BTG equipments will pass only when it reached the project site and is successfully put to function without any defect. It is for that reason the taxpayer gives performance bank guarantee and advance bank guarantee to owners of the project, much before any payment is made to the taxpayer. If that not be the case, then there would have been no question of retaining effective control by the taxpayer over the equipments till it reached the project sites, and further while erection/installation activities are carried on irrespective of whether the erection/installation activities are carried on by the taxpayer or by any other party under the supervision of taxpayer.

- In a typical case like that of the taxpayer, view has to be taken on the basis of agreements and terms of the contract entered into by the taxpayer as has been observed by the Delhi High Court[8] in order to come to a conclusion of transfer of title as well as continuance of taxpayer's responsibility from supply to erection and successful functioning of the plant at various sites agreed to have been constructed under taxpayer's supervision in India. Therefore, the agreements are composite nature for providing services. On reference to the work and responsibilities of the taxpayer, it indicates that contract is one. The taxpayer was responsible for the successful functioning of the projects in India under each and every contract, which is discernable on a careful reading of the contracts. The case of the taxpayer is different from the facts of the case of Delhi High Court in Nortel Networks[9].

Business connection

- There is an element of continuity between the businesses by the taxpayer from supply to successful commissioning of the plants. It is not a case of a mere stray or isolated transaction, when the taxpayer has agreed to render technical/supervisory co-operation for construction, erection of power plant at various locations.

- A careful reading of Section 9, together with the Explanations thereto, makes it clear that the statutory test for determining the place of accrual of income is not the place where these services are rendered but where those services are utilised. The crux of the provision insofar as is relevant to the facts of the present case is that the taxpayer is liable to tax if it earns business income from the operations carried out in India.

- The taxpayer is supplying BTG equipments to customers in India and is wholly responsible for erection/installation/successful commissioning of equipments. The contracts are negotiated and concluded in India by a team consisting of persons from PE in India and the taxpayer in China. The expatriates from Shanghai China come to India to provide technical support services to PE in India. All these activities go on to establish that the taxpayer has a business connection in India within the meaning of Section 9(1)(i) of the Act.

- The taxpayer is doing business activities in India which are not isolated instances rather these represent the real and intimate relationship between activities of the taxpayer done outside India and these done inside India. The business operations being done in India by the taxpayer are revenue generating as these operations are required to earn the contract and to meet with contractual obligations. Therefore, all the parameters of business connection as prescribed by various judicial authorities as mentioned supra are satisfied.

Existence of Supervisory PE

- On a combined reading of Article 3(a)(b) of UN Model Convention and Article 5(2) of the India-China tax treaty (tax treaty), it indicates that a building site or construction or installation project constitutes a PE only if it lasts more than twelve months. Any of those items which do not meet this condition does not by itself constitute a PE, even if there is within it an installation.

[8] Linde AG v. DIT [2014] 365 ITR 1 (Del)
[9] Nortel Networks India International Inc. Ltd v. DIT [2016] 386 ITR 353 (Del)

- Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in a paragraph, it will be considered a PE if the conditions of the article are otherwise met even if one of the projects involved, lasts for more than 12 months. Thus, on the question of the existence of PE, to the facts of the present case, the contentions of the taxpayer is to be rejected for the following reasons:

  - Article 5(2) provides for specific instances over and above the general provisions contained in Article 5(1), e.g., duration of the construction contract, furnishing of services other than technical services, etc. It is a well-accepted principle that specific provisions prevail over the general provisions. Therefore, if the conditions provided in Article 5(2) are satisfied, it will amount to a PE, irrespective of the fact whether the general provisions of Article 5(1) cover such a situation or not.

  - The PE under Article 5(2)(j), encompasses a building site, a construction, assembly or installation project or supervisory activities in connection therewith, only if such site, project or activities last more than six months, which is an admitted position in all the contracts entered into by the taxpayer in the previous years, relevant to AYs under consideration.

  - Thus, the supervisory PE of the taxpayer existed in India from the time Indian clients contracted with the taxpayer to carry out the work of supply, supervision, erection, installation and successful commissioning of plants. Thus, splitting of this transaction under supply and services will be wholly artificial and neither will it have a rational basis, nor can it be recognised for the purposes of computation of profits attributable to the PE.

Attribution of profits

- In the present case, the taxpayer has entered into a composite contract which is relatable to the operations carried out in India and partly to outside India a proportionate part of income which is so relatable to the operations carried out in India has to be charged to tax. The extension of taxability of profits of PE by including profits directly or indirectly attributable is akin to the provisions of Article 7(1)(b) and 7(1)(c) of the UN Model Convention[10].

- The connotations of 'profits indirectly attributable to PE will extend to these two categories. These categories clearly incorporate a force of attraction rule. The basic philosophy underlying the force of attraction rule is that when an enterprise sets up a PE in another country, it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can properly tax all profits that the enterprise derives from that country whether the transactions are routed and performed through the PE or not.

- The provisions of Article 7(1) of the tax treaty, include same results as sought to be achieved by Article 7(1)(c) of UN Model Convention. Therefore, the connotations of 'profits indirectly attributable to PE' do indeed extend to the incorporation of the force of attraction rule being embedded in Article 7(1) of the tax treaty. In addition to taxability of income in respect of services rendered by the PE in India, any income in respect of the services rendered to an Indian project, which is similar to the services rendered by the PE, is also to be taxed in India in the hands of the taxpayer, irrespective of the fact whether, such services are rendered through the PE, or directly by the general enterprise.

- There cannot be any professional services rendered in India which are not, at least indirectly, attributable to carrying out professional work in India. This indirect attribution, in view of the specific provisions of the tax treaty, is enough to bring the income from such services within the ambit of taxability in India. Thus, the twin conditions are to be satisfied for taxability of related profits are:

  - The services should be relatable to the services rendered by the PE in India; and

  - The services should be 'directly or indirectly attributable to the Indian PE', i.e., rendered to a project or client in India.

  To the facts of the present case, both these conditions stand satisfied.

- In effect, profits relating to services rendered by the taxpayer, whether rendered in India or outside India, in respect of Indian projects are taxable in India, and are attributable to the supervisory PE of the taxpayer in India, as they are effectively connected with each other.

[10] UN Model Convention provides that in addition to the 'profits attributable to the PE, the taxability of PE profits will also extend to (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment

Our comments

The issue with respect to taxability of offshore supply of equipments and services rendered under a composite contract has been a matter of debate before the Courts including the Supreme Court of India in the case of Ishikawajima-Harima Heavy Industries Ltd.[11] and Hyundai Heavy Industries Company Ltd.[12]

The Delhi Tribunal in the instant case has observed that splitting of the transaction under supply and services is wholly artificial and neither it has a rational basis, nor can it be recognised for the purposes of computation of profits attributable to the PE. The agreements entered into by the taxpayer is in the nature of a composite contract since agreements are inextricably linked with each other. It was held that profits from offshore and onshore services in respect of Indian projects are attributable to the supervisory PE of the taxpayer in India since they are effectively connected with each other.

The Delhi High Court in the case of Nokia Networks OY[13] following the decision of Ishikawajimajima Harima Heavy Industries Ltd[14] has held that in case of one composite contract, supply has to be segregated from the installation and only then the question of apportionment arises under the Act. The High Court held that since the property in goods had passed on to the buyer outside India, the said agreement would not be taxable in India.

Recently, the Mumbai Tribunal in the case of Atomstroy Export[15] held that income from offshore supply contract was not taxable in India under Section 9(1) of the Act and India-Russia tax treaty since title in goods passed outside India, payments were in foreign currency and deliveries were on 'FOB' basis.

However, in the cases of Alstom Transport SA[16], Roxar Maximum Reservoir Performance WLL and Linde A.G.[17], the AAR relying on Vodafone International Holding B.V.[18] applied[18] 'look at' approach and held that composite contract for installation and commissioning of the project in India cannot be dissected for the purpose of taxability of the contract. Accordingly, income from offshore supply and services was taxable in India.

While dealing with turnkey contracts, it would be important to evaluate the fairness of divisibility of the contract and of assigning values to offshore and onshore activities.

---

[11] Ishikawajma-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)
[12] CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC)
[13] DIT v. Nokia Networks OY [2012] 25 taxmann.com 225 (Del)
[14] Ishikawajma-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)
[15] Atomstroy Export v. DDIT [2017] 80 taxmann.com 178 (Mum)
[16] Alstom Transport SA [2012-TII-28-ARA-INTL]
[17] Linde A.G. (AAR No. 962 of 2010) (AAR)
[18] Vodafone International Holdings B.V. v. UOI [2012] 341 ITR 1 (SC)

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala,
Bengaluru – 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh – 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai – 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Gurugram
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurugram, Haryana – 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
Reliance Humsafar, 4th Floor
8-2-618/2, Road No.11, Banjara Hills
Hyderabad – 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Jaipur
Regus Radiant Centres Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road
Jaipur, Rajasthan, 302018.
Tel: +91 141 - 7103224

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091
Tel: +91 33 4403 4000
Fax: +91 33 4403 4199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai – 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park
Tower-B, Plot# 7, Sector 142,
Expressway Noida, Gautam Budh Nagar,
Noida – 201305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex, Mundhwa Road,
Ghorpadi, Pune – 411001
Tel: +91 20 6747 7000
Fax: +91 20 6747 7100

Vadodara
iPlex India Private Limited,
1st floor office space, No. 1004,
Vadodara Hyper, Dr. V S Marg
Alkapuri, Vadodara – 390 007
Tel: +91 0265 235 1085/232 2607/232 2672