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Tax Flash News

5 December 2023

Income from offshore supply of equipments and services is not taxable in India under the Income-tax Act as well as under the India-Germany tax treaty

Executive Summary

The taxability of offshore supply and services has been a complex issue and much debated before the courts. Several courts and Tribunal have dealt with the taxability of offshore supplies and services and onshore supplies and services including designs, drawings, etc.

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of DSD Noell GMBH[1] (the taxpayer) held that the income from offshore supply of equipment was not taxable in India since plant and equipment supplied to the Indian company were designed and manufactured outside India and the title was duly passed outside India on FOB basis. Further, the consideration for such offshore supplies was also received outside India in foreign currency and all activities such as manufacturing, fabrication, designing, etc. of the plant and equipment were also undertaken outside India.

The Tribunal held that income from offshore services was also not taxable in India. The drawings and design supplied were inextricably linked with the plant and equipment supplied by the taxpayer and formed an integral part of the said supply. The dominant object of the contract was to supply a plant manufactured according to the designs developed, thus, the character of the offshore services was that of the supply of the equipment. The income from offshore services did not accrue or arise in India.

[1] DSD Noell GMBH v. DCIT (ITA No. 3186/Del/2016) – Taxsutra.com

Facts of the case

- The taxpayer, a German company, is engaged in the business of engineering, designing, manufacturing, and installing plants for the hydro-electric power projects.
- The taxpayer entered into an agreement with Hindustan Construction Company Ltd (HCC) for carrying out Hydro-Mechanical Works (HM Works) in relation to set up of Kishanganga hydro-electric power project in India.
- In terms of the contract, the taxpayer carried out offshore supply of hydro mechanical plant and equipment. It also provided offshore services including supply of drawings and design related to the plant and machinery.
- During the relevant assessment years[2], the taxpayer received consideration from HCC towards the offshore supply of plant and equipment as well as for offshore services. The taxpayer claimed that such consideration was not taxable in India under the provisions of the Income-tax Act, 1961 (the Act) as well as under the India-Germany tax treaty (tax treaty).
- The Assessing Officer (AO) and the Commissioner of Income-tax (Appeals) [CIT(A)] did not accept the contentions of the taxpayer and held that consideration for offshore supply of plant and equipment as well as for offshore services were taxable in India.

[2] Assessment Year 2011-12, 2012-13, 2014-15, 2015-16, 2016-17, 2017-18 and 2018-19

Tribunal's decision

Taxability of Offshore supply

- The taxpayer had supplied plant and equipment to HCC which were designed and manufactured outside India. The title to the said plant and equipment was duly passed on to the customer outside India on FOB basis. The consideration for such offshore supplies was also received outside India in foreign currency either through letter of credit or through bank transfer. All activities such as manufacturing, fabrication, designing etc. of plant and equipment were undertaken outside India.

- On perusal of the contract for offshore supply of plant and equipment, it was observed that though the custom clearance was the responsibility of the taxpayer, all the plant, machinery and materials received were absolute property of the owner and open for inspection at all time.

- Even though the taxpayer had taken the insurance for the plant and equipment but as per the terms of the agreement, the HCC was also the co-insurer in the insurance policy and terms of the agreement thereon specifies that plant and equipment shall remain absolute property of HCC.

- The scope of work under the onshore contract was under a separate agreement and for separate consideration. There was no justification to mix the consideration for the offshore and onshore contracts. Reference was made to the decision of LG Cables Ltd[3].

- The lower authorities had observed that full payment of consideration for supply of plant and equipment was not received by the taxpayer outside India and a part of the consideration was retained and would be paid only after satisfactory functional demonstration of equipment in India. The Tribunal observed that this is a normal clause which is incorporated in any contract. There would always be some portion of the retention amount of the contracted value that would be retained by the buyer/user of machinery.

- In the present case, under the contract for offshore supplies, the taxpayer received 95 per cent of contracted revenue at the time of shipment of plant, equipment and spares and only 5 per cent of the revenue was payable on successful commissioning of the plant. This aspect was also addressed by the High Court in the case of LG Cables Ltd.

- With regards to the Defects Liability Clause, the AO concluded that the ownership in the Plant and Equipment was transferred subsequent to the Defects Liability Period. The Tribunal observed that practically such clause would be incorporated in every contract to take care of a contingent event. This has no connection with the passing of title of the equipment.

- These observations were further fortified by the decision of the Supreme Court in the case of Ishikawajima-Harima Heavy Industries Limited[4]. Similar view is also expressed by the Jurisdictional High Court in the case of National Petroleum Construction[5].

- Therefore, the consideration received outside India does not accrue or arise in India under Section 9.

- Such consideration was in the nature of business income and in the absence of a PE in India it was not taxable under Article 5 read with Article 7 of the tax treaty.

Taxability of offshore services

- There was no dispute that the taxpayer had supplied offshore drawings and designs together with the supply of plant and equipment. The contract for offshore services and for offshore supply of plant and equipment were entered on the same date and were inextricably connected because the supply cannot be made without the drawings.

- The drawings and designs could not be utilised by HCC to get the manufacturing of plant from another manufacturer. The drawings and designs made by the taxpayer were tailor made to suit the requirements of the plant and equipment supplied by the taxpayer.

- Similar issue was addressed by the Jurisdictional High Court in the case of Linde AG[6] where it was held that if design and engineering is inextricably linked with the manufacture and fabrication of the material and equipment to be supplied from overseas, and forms an integral part of the said supply, then the services rendered would not be taxable as FTS.

- The Jurisdictional High Court in case of Linde AG[7] had considered the very same issue. Further, the decision of the Jurisdictional High Court is binding on this Tribunal.

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[3] DIT v. LG Cables Ltd [2011] 197 Taxman 100 (Del)

[4] Ishikawajima-Harima Heavy Industries Limited v. DIT [2007] 288 ITR 408 (SC)
[5] National Petroleum Construction v. DIT [2016] 66 taxmann.com 16 (Del)
[6] Linde AG, Linde Engineering Division v. DIT 365 ITR 1 (Del)
[7] Linde AG, Linde Engineering Division v. DIT 365 ITR 1 (Del)

- The dispute was squarely covered by the decision of the Delhi Tribunal in the case of SMS Concast AG[8], where it was held that since supply of drawings and designs were inextricably linked to sale and supply of equipment, it cannot be taxed as FTS.

- The dominant object of the contract entered by the taxpayer with HCC was to supply a plant manufactured according to the designs developed. Thus, even though the obligation to carry out the designs may be under a separate contract of same date and a separate consideration was mentioned therein, the character of the receipt must be that of a sale price for the supply of the equipment. The Supreme Court's decision in the case of ONGC[9] was relied upon.

- When supply of drawings and designs was coupled with supply of equipment, which is manufactured in accordance with the designs supply, amount received cannot be characterized as FTS.

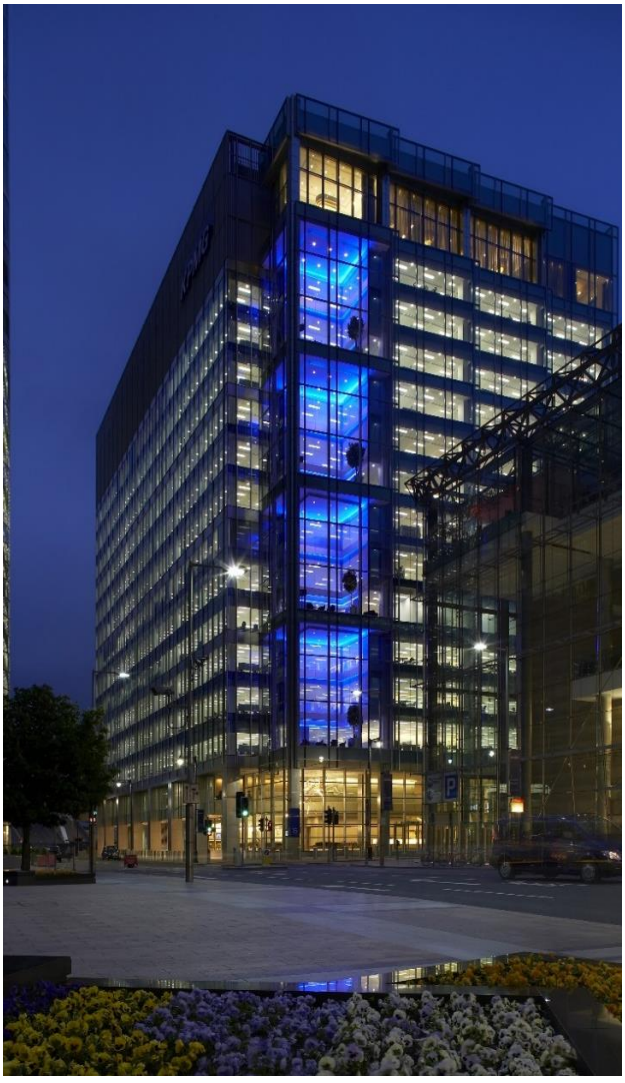
- When he entire work of preparing the designs and drawings was carried outside India, the question of bringing to tax any part of the consideration in accordance with Article 7 cannot be sustained. This aspect was concluded by the Supreme Court in the case of Ishikawajima-Harima Heavy Industry Ltd[10].

- Similar views were expressed by the Supreme Court in the case of Hyundai Heavy Industries Co. Ltd[11]. Further, as per the tax treaty, when technical services were rendered outside India, the consideration received thereon shall not be attributable to the PE in India.

- Accordingly, it was held that the offshore services that primarily involve offshore supply of drawings and designs were inextricably linked with the offshore supply of plant and equipment. Accordingly, the receipts from offshore services did not result into any income accruing or arising in India and therefore not taxable under the Act. Further, such consideration qualifies as business profits of the company under Article 7 of the tax treaty which cannot be attributed to India in the absence of a PE in India.

Our comments

The Tribunal in this decision analysed several aspects of offshore supply and services contract and made very important observations which can be helpful in similar cases. The Tribunal considered factors like the type of insurance, payment terms, defect liability clause, passing of title, etc. to conclude that the supply of plant and equipment was outside India and thus no income was accrued in India. With respect to services contract the importance was given to factors like the dominant object of the contract, the supply could not be made without the drawings, the drawings and designs were tailor made to suit the requirements of the plant and equipment, etc.to held that the service contract was inextricably linked with the offshore supply of plant and equipment.



[8] SMS Concast AG v. DDIT (ITA No. 1361/Del/2012) (Del)
[9] ONGC v. CIT 376 ITR 306 (SC)
[10] Ishikawajima-Harima Heavy Industries Limited v. DIT [2007] 288 ITR 408 (SC)
[11] CIT v. Hyundai Heavy Industries Co. Ltd 291 ITR 482 (SC)

KPMG in India addresses:

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

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

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

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

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

Mumbai
2nd Floor, Block T2 (B Wing),
Lodha Excellus, Apollo Mills Compound, N M
Joshi Marg, Mahalaxmi, Mumbai- 400011
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

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