KPMG

TAX FLASH NEWS

19 January 2018

Payment for offshore supply of an equipment is not taxable in India, whereas, supervisory services for installation of such equipment are taxable in India

Background

Recently, the Authority for Advance Rulings (AAR) in the case of Michelin Tamil Nadu Tyres Pvt Ltd.[1] (the applicant) held that the payment for offshore supply of an equipment to a French company under the umbrella agreement is not taxable in India. The AAR observed that that the delivery of the equipment took place outside India on Free on Board (FOB) basis. Further, the title of equipment was transferred outside India. It was clear case of offshore equipment supply contract. The entire flow of business shows that offshore supply of equipment and onshore services of supervision have been provided by French company, whereas installation of equipment is done by unconnected third parties and technicians on specific terms and conditions which are well documented and samples of which have been furnished. Thus, neither can the project be called turnkey, nor can the two separate contracts be read together as a composite contract.

However, supervision services provided by the French company in India at the factory site where the plant has been set up, are chargeable to tax in India as the income arising therefrom can be said to have arisen or accrued in India. Income earned in India through such services would be covered by Section 9 of the Income-tax Act, 1961 (the Act), as a business connection clearly exists between these supervisory services and the business of French company of assisting in setting up of manufacturing units in the field of bus and truck tyres. Further a service Permanent Establishment (PE) under India-France tax treaty (the tax treaty) is also formed since the French company is carrying on its supervisory activities through its personnel at the fixed place that is the factory premises, and the income from supervisory services can be attributable to this PE.

Facts of the case

- The applicant is Chennai-based resident company and it is a subsidiary of a French company.
- From the year 2009-10, it started taking steps to set up a factory for production of bus and truck tyres and also a manufacturing facility for mixtures and semi-finished products necessary for the production of tyres.
- For this purpose it entered into an umbrella agreement as an 'Equipment Purchase Contract' on 1 April 2011 with Manufacture Francaise des Pneumatiques Michelin (MFPM), a closely associated group company, for design, engineering, manufacturing, inspection and packing, forwarding and dispatch from outside India of machinery and equipment for setting up its new manufacturing facility in India.
- MFPM is a company incorporated under the laws of France. MFPM would supply the equipment in three phases.
- As regards Phase I, the total price for the equipment is stated as EURO 9,31,90,452 (approx. INR580 crore) and the purchase of the same was completed upto February 2013. Further, supply of equipment under Phase II and Phase III have not yet started.
- Subsequently it also entered into a Services Agreement on 1 February 2013, for providing supervisory services during installation i.e. after the supply of machinery and equipment was completed and after installation work had commenced. These installation services were rendered by different third party suppliers.

[1] Michelin Tamil Nadu Tyres Pvt Ltd (AAR No.1218 of 2011) - Taxsutra

- The applicant sought a ruling for taxability and withholding obligations on the payments as per the above agreements. It has taken support from various cases to argue that on the facts of the case, the payments made to MFPM towards offshore supply of equipment cannot be taxed in India.

- The tax department contended that the supply of equipment as well as the services rendered outside India i.e. design engineering and also the supervision services which are rendered in India constituted a composite contract. As the supply of the equipment and its installation in India was in three phases over a period of seven years, the supplying foreign company can be said to have a PE in India under the tax treaty. The income arising to MFPM from supply of the equipment and their installation in India was also taxable under Section 9(1)(i) of the Act.

AAR's ruling

Offshore supply of equipment and onshore supervisory services – whether composite contract and taxable in India

- From a perusal of the Ocean Bill of Lading issued by transporting container company, in the name of the applicant, describing the equipment being shipped from Shanghai to the applicant and a copy of the Bill of Entry issued by Indian Customs in favour of the applicant describing equipment imported from MFPM, it is clear that the title in the property was transferred outside India.

- The sample copies of Bill of Lading, Purchase order and Invoice also show that the delivery of the equipment took place outside India on FOB basis. The consideration for supply of plant and equipment was paid by the applicant to MFPM in Euros to a bank outside India. All the custom duties and other charges levied at the port of importation were borne by the applicant. Further, MFPM obtained transit insurance policy for supply of equipment till the port of Chennai on behalf of the applicant, and also the risk and rewards were transferred to the applicant at the port of shipment.

- The Transfer Pricing Officer (TPO) has accepted that the payment for such import of equipment from MFPM is at arm's length in the Transfer Pricing assessments. This is clearly indicative that the price paid is only for the equipment, and cost and services related to such manufacture, prior to shipment, and is not for installation or any services post shipment or other than those covered by the umbrella agreement, as alleged by the tax department.

- The second agreement is the Service Agreement, which as per its terms, was to supervise the installation services at the factory premises, and to coordinate the start-up and ramp-up services rendered by those suppliers. But there is no mention in this agreement also regarding any installation services to be provided to the applicant by the MFPM personnel. In the absence of any evidence being brought on record, it cannot be assumed that the personnel sent by MFPM under this Agreement were involved in installation work. The tax department's submission that the installation would have been done only by MFPM personnel to whom payment would have been made as part of the administrative expenses, is also merely an assumption and bereft of any evidence whatsoever.

- 'Schedule II - Price List' of the Equipment Purchase Contract 2011, gives the details of the equipment purchased from MFPM. It is seen that most of these are not huge and complex machines that require manufacturing personnel to install. Most appear to be pre-fabricated, shipped as such in plywood cartons (as the invoices suggest) and ready to use. These were fabricated and assembled in France itself or other places through third party suppliers of MFPM, and for which the applicant has been billed, being within the scope of 'Schedule 1 – Price Computation' of the umbrella agreement.

- The cost worked out as incurred by MFPM for being charged to the applicant is mentioned in the agreement itself, and includes full engineering costs, full production and external purchase costs of the equipment, designing, project steering, transportation, administrative costs relating to production and sales, supervision and short term financing, etc. That is, cost involved in their production and till the time of shipment.

- There is no mention of any installation cost included or charged with the price, nor has any evidence been brought on record, to this effect.

- Some of the third parties with whom service agreement is entered into are in the business of manufacturing and supplying machineries and equipment. The service provider shall be responsible for installing the machinery and equipment at the factory of the applicant as per its lay out plan, and shall also provide technical training to the applicant's

employees. Another Equipment and Machinery Installation Agreement was entered into with Spain entity. This company was in the business of installing machineries, and had the requisite expertise in this field. And it also had the responsibility of installing machineries at the factory of the applicant, as per its master plan.

- As regards the qualifications of the 169 Indian employees and 79 Expats involvement in installation and commissioning. The tax department's questioning their competence is rather sweeping. Such evaluation can only be done by a technical person at the factory. Most of the personnel are Engineers, and the rest are mostly Managers. The expats employed by the applicant on a long term basis are mostly Engineers, technical persons, maintenance personnel, and quality managers etc. who have been employed from inception to assist in the installation stage and later in production, as stated by the applicant.

- They are specialists drawn from different countries, such as from U.K., U.S.A., Italy, Netherlands, Germany, Romania, Canada, France, Poland, Hungary, Spain etc. No material brought on record to suggest that all these technical people did not do installation work or that they were not qualified enough. Only a broad assumption has been drawn by the tax department, which appears not to be accurate and is bereft of any evidence.

- On the other hand, 33 technicians visited India for short durations and the applicant paid an amount of about INR9.95 crore to MFPM in respect of services of supervision rendered by them, as per the Service Agreement. The tax department has not brought on record anything to establish that they were involved in installation or were paid for that purpose, nor do the agreements show this. Considering the large scale of the project spread over 100 acres, it is highly improbable that the work could have been completed by just 33 technicians from MFPM, when they have stayed for very short periods. There is no evidence also to show that more such MFPM technicians had visited India, or payment made for more personnel. It appears therefore, that installation was done by the third parties, local technicians and expats employed by the applicant on long term basis only, trained at a high cost, under the supervision of the 33 MFPM specialist technicians who were paid Rs 9.95 crore for the same.

- Activities of equipment purchase and the services of supervision, respectively, were carried out as per the two clearly demarcated agreements, with different periods of execution, clearly stipulated terms of payment, including a schedule to the umbrella Agreement showing item wise pricing of equipment supplied by MFPM, one for offshore supply and the other for on shore services. There is no material to suggest that MFPM had dealt with the applicant on a turnkey basis, for supply, installation, commissioning and supervision of the setting up of the plant in India, as argued by the tax department.

- Also, the two had transacted on a principal to principal basis, as found by the TPO while assessing the payments for purchase of equipment, and it cannot be said that merely because the applicant and MFPM were closely associated or under the ultimate holding company, they had colluded to transact in a manner that was akin to tax avoidance or that this automatically created a PE in India.

- Citing of the decision in the case of Vodafone International Holdings B.V. by the tax department looks out of place in the instant case, as the overall transaction was not designed for tax avoidance, but for genuine business of setting up a plant for manufacture of tyres, with the help of MFPM and other third parties who are genuine, and should be 'looked at' from that point of view.

- The entire flow of business shows that off shore supply of equipment and onshore services of supervision have been provided by MFPM, whereas installation of equipment is done by unconnected third parties and technicians on specific terms and conditions which are well documented and samples of which have been furnished. Thus, neither can the project be called turnkey, nor can the two separate contracts be read together as a composite contract.

- The tax department has based all its arguments on the assumption that installation was done by MFPM and being closely associated companies, and that it has been designed to look as separate contracts. This view cannot be accepted on the factual position narrated above.

- The tax department argued that since MFPM had earlier carried out a feasibility study for which the applicant had paid INR5.52 crore, its PE was established then itself. The AAR observed that the feasibility study was carried out even before the signing of the umbrella Agreement and supply of equipment at the behest of the applicant, and for which the amount was paid on arm's length basis, as assessed by the TPO. This study of preparatory and auxiliary nature carried out for a short and one off period, even before the business commenced could not be said to have established a business connection at that point in time, or fixed place of business through which its business was carried on, or merely for the reason that they were closely associated entities.

- The decisions relied on by the tax department were distinguished on the basis of facts of the case.

- The applicant has made payments of about INR580 crore for the off shore supply of equipment under the umbrella Agreement. There is no way that it can be contended that since MFPM had a role in the supervision of setting up the same, the transfer of the property extended beyond the shores of France such as to have income arisen or accrued in India. The point at which the property is passed to the applicant, on the shore of the supplier country, the taxable event in respect of such supply of equipment is over, there itself. Business connection through supervision on the Indian premises later has no connection with this supply, and there is no justification to mix up the considerations received by MFPM from its offshore supplies and onshore services, as held by the Delhi High Court in the case of LG Cable[2].

- In the instant case, there is no such point of contact in these two acts of supply and services that make it difficult for us to set apart the non-taxable and taxable events, i.e. Offshore supply, onshore supply and installation and on shore supervision, each being clearly demarcated.

- In the present case, the sale of goods, simplicitor, outside India would not give rise to any taxable income in India even though the said goods are to be utilized within India. Hence, no part of the income from the off shore supply of equipment can be brought to tax in India, on the facts of this case.

- In both the cases of Ishikawajima Harima Heavy Industries Ltd[3] as well as Linde AG[4], which followed Ishikawajima Harima, there was a single composite contract but the project was undertaken by several different parties coming together on turnkey basis. The instant case is actually on a better footing in that here there are only two parties, apart from the third parties engaged in manufacture, supply and installation, there are two clearly demarcated contracts, the events from which income emanates are distinguishable, one is for off shore supply and the other for on shore services, there is no overlap or haziness about the activities undertaken such that make apportionment of income difficult.

- In view of this position, respectfully following the decision in the case of Ishikawajima Harima, it is clear that no income arising in the hands of MFPM from the off shore supply of equipment can be held to be chargeable to tax in India, under the Act. The AAR observed that it is not necessary to deal with this issue under the India-France tax treaty.

[2] DIT v. LG Cable Ltd [2011] 237 CTR 438. (Del)

Taxability of supervisory services

- While examining provisions of Section 9 of the Act, reasons have been given why the income from off shore supply could not be brought to tax in India. By the same reasoning under this provision, the AAR held that income derived from the discharging of its obligations by MFPM, namely provision of services of supervision in India at the factory site where the plant has been set up, is chargeable to tax in India as the income arising therefrom can be said to have arisen or accrued in India. There is a direct and real nexus between the terms of the contract, the activities of supervision undertaken at the site, and hence the income earned in India through the provision of the services and would be covered by Section 9, as a business connection clearly exists between these supervisory services and the business of MFPM of assisting in setting up of manufacturing units in the field of bus and truck tyres.

- In fact, a service PE is also formed since the MFPM is carrying on its supervisory activities through its personnel at the fixed place that is the factory premises, and this income can be fastened to this PE. Hence, the payments made by the applicant to MFPM's 33 supervisory staff and engineers, amounting to INR9.95 crore, would be chargeable to tax in India, and would also attract the provisions of section 195 of the Act.

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 and Hyundai Heavy Industries Company Ltd.[5]

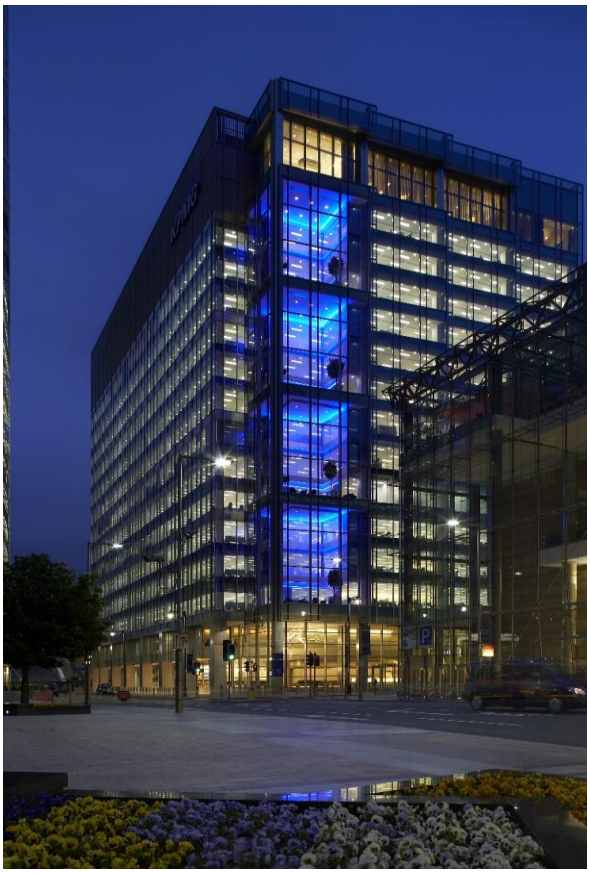
The Delhi High Court in the case of Nokia Networks OY[6] following the decision of Ishikawajima-Harima Heavy Industries Ltd has held that in case of one composite contract, supply has to be segregated from the installation and only then the question of apportionment arises under the Act. The High Court held that since the property in goods had passed on to the buyer outside India, said agreement would not be taxable in India.

[3] Ishikawajma-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)
[4] Linde A.G. (AAR No. 962 of 2010) (AAR)
[5] CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC)
[6] DIT v. Nokia Networks OY [2012] 25 taxmann.com 225 (Del)

The Mumbai Tribunal in the case of Atomstroy Export[7] held that income from offshore supply contract was not taxable in India under Section 9(1) of the Act and under 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[8], Roxar Maximum Reservoir Performance WLL[9] and Linde A.G.[10], the AAR relying on Vodafone International Holding B.V.[11] applied 'look at' approach and held that composite contract for installation and commissioning of 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.

The AAR in the instant case has held that payment for offshore supply of an equipment to a French company under the umbrella agreement is not taxable in India. However, supervision services in India at the factory site where the plant has been set up, is chargeable to tax in India as the income arising therefrom can be said to have arisen or accrued in India.



[7] Atomstroy Export v. DDIT [2017] 80 taxmann.com 178 (Mum)
[8] Alstom Transport SA [2012-TII-28-ARA-INTL]
[9] Roxar Maximum Reservoir Performance WLL (AAR No. 977 of 2010) (AAR)
[10] Linde A.G. (AAR No. 962 of 2010) (AAR)
[11] 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
KRM Tower, Ground Floor,
No 1, Harrington Road
Chetpet, Chennai – 600 031
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
Salarpuria Knowledge City,
ORWELL, 6th Floor, Unit 3, Phase
III, Sy No. 83/1, Plot No 2,
Serilingampally Mandal, Raidurg
Ranga Reddy District,
Hyderabad, Telangana – 500081
Tel: +91 40 6111 6000
Fax: +91 40 6111 6799

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