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TAX FLASH NEWS

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Equipment and service contracts are treated as a composite contract and from off-shore supply 35 per cent of profits are attributed to a PE in India

Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Voith Paper GmbH[1] (the taxpayer) dealt with the taxability of income from contracts of equipment supply and services to bring such equipment in an operating stage.

The Tribunal observed that the supply and service contracts are in the nature of a composite contract. Both contracts cannot be seen independently. The artificial division of composite contract into supply and service may be on paper but the conduct of the parties and terms and condition of the contract manifest that in substance, it was a composite contract.

The supply of equipment is connected with a Permanent Establishment (PE) in India under the India-Austria tax treaty (the tax treaty). Further, the taxpayer had a business connection in India under the provisions of the Income-tax Act, 1961 (the Act). In addition to the marketing activities or engineering survey pre or post awarding of the contract, the Service PE had played a role in assembling and bringing the equipment to deliverable state as agreed under the supply agreement. Accordingly, the Tribunal attributed 35 per cent of profits accruing from off-shore supplies to a PE in India.

Facts of the case

The taxpayer, a foreign company, is one of the market leaders in concept, technology, project planning, sale, engineering, etc. of ‘board and packaging paper machines’. The taxpayer entered into two contracts with an Indian company for equipment supply and service for commissioning. The supply contract includes engineering, designing, manufacturing, drawing and supplying of machinery for 620 TPD multilayer packaging coated board plant. The Service contract includes supervision of erection, start-up, training, commissioning and performance test of said machinery.

The taxpayer earned income from the supply of components of machinery. The personnel of the taxpayer had visited for the supervision of the erection, start up, training, commissioning and performance test of the plant. The taxpayer contended that the sale of machinery was made outside India and the payment was also received outside India and thus, no part of off-shore supply was taxable in India.

The Assessing Officer (AO) observed that the contract of supply and service in relation to the commission of the plant was a composite contract. Income from the composite contract was taxable under Section 9(1) of the Act. It was also taxable in India under the tax treaty. The taxpayer had a fixed place PE in India, in the form of a project office. AO held that sale of equipment was concluded in India and the PE had played a role in marketing and thus part of profits of supply of machinery of the plant is directly attributable to the PE. AO computed profits attributable to the PE at 35 per cent from the operation of supply of machinery.

Tribunal’s decision

Composite contract

The Tribunal observed that both the contracts could not be read independently. On perusal of various clauses of the agreement, it indicates that the dominant purpose or intention of the buyer from the very beginning was the installation of a plant under the supervision of the taxpayer. As the taxpayer was also specialised in the manufacturing of equipment required for setting up of the plant, the taxpayer was involved in the supply of the same. The plant in itself was not a set of machinery only, but the contractor was required to construct a facility of manufacturing the products of the buyer.

[1] Voith Paper GmbH v. DDIT (ITA No. 1077/Del/2014) – Taxsutra.com

The service contract had a provision of a termination clause in case of failure of performance and return of machinery supplied under the supply contract and refund of money. All these terms made it clear that both the supply and service contracts were intrinsically linked and not severable.

The artificial division of composite contract into supply and service may be on paper but the conduct of the parties and terms and condition of the contract manifest that in substance, it was a composite contract. The accounting practice followed for recognising of revenue from service on completion of the project also supports the intention of the parties to treat the erection of the plant as a composite project.

All the terms and conditions of the contract when read together bring out the real nature and essence of both the contracts as a part of one composite and turnkey works contract.

The decision in the case of Ishikawajima-Harima heavy industries Ltd[2] was distinguishable on the facts of the present case since the supply obligation and service obligation were interlinked and complemented to each other. The arrival of the goods and arrival of the person of the taxpayer coincide and run concurrently. Thus, Tribunal held that the supply and service contracts represent a single, composite turnkey work contract.

Business connection

Relying on the decision of Ishikawajma-harima Heavy Industries ltd and Ericson AB[3], it was observed that signing of the contract in India was of no relevance while determining the taxability of off-shore supply of equipment. Further, the Tribunal observed that the decision in the case of Ericson AB is distinguishable on facts of the present case. The High Court in the cases of Ericson AB held that acceptance test was not a material event for the passing of the title and risk in the equipment supplied and if the system did not conform to the specifications, the only consequence was that the taxpayer had to cure the defect. There was a caveat attached to the finding that the position might have been different if the buyer had the right to reject the equipment on the failure of the acceptance test carried out in India. In the instant case, the said clause of repayment on the return of machinery on the failure of the acceptance test was available. Further, in the present case, the transit insurance of goods had been arranged by the taxpayer at its own cost from the warehouse of the supplier to the warehouse of the purchaser, which means the risk in case of damage of goods during transit remained with the supplier.

[2] Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC)
[3] DIT v. Ericson AB [2012] 343 ITR 470 (Del)

The decision of Nokia Networks OY[4] was distinguishable on facts of the case since the taxpayer had not provided details of marketing activities or negotiation of the contract to the AO despite repeated requests and thus, the decision was not helpful to the taxpayer. Accordingly, it was held that the taxpayer had supplied parts of goods by way of invoices raised, which have further been assembled in India to bring them in deliverable state and thus property in goods was passed in India and part of the consideration of supply agreement for off-shore supply was taxable in India.

Since, in the present case, the part of the operations of the supply agreement was carried out in India and sale of goods was in continuation of the process of erection of the plant, the conditions of the business connection exits. It was not the case of isolated sale of the 'off the self-goods' or stray transaction, in view of the fact that the taxpayer has rendered supervision of the erection/commission of the plant. Thus, the taxpayer was doing business activities in India which were not isolated instances but represented a real and intimate relationship between activities of the taxpayer done outside India and those done within India. Accordingly, the income was deemed to accrue or arise in India in terms of Section 9(1)(i) of the Act from the off-shore supply of goods.

Permanent Establishment and attribution of profits

The existence of a service PE in India was not denied by the taxpayer. The employees of the taxpayer were in India at the time of the entry of the part of the machinery on the Indian soil. Those employees were instrumental in supervising the entire activity of inspection of a part of the machinery imported into India and assembling of those machinery to bring into the deliverable state mentioned in the supply agreement. Such PE has also played a role in completing the supply agreement between the taxpayer and the buyer. Though the part of the equipment or the machinery needed for the erection or commissioning of the plant was manufactured in Austria, the same were utilised for the creation of plant in India. Part of the operations of supply agreement was carried out in India by the PE of the taxpayer and for which part of the profit from the supply agreement also needs to be taxed in India under the India-Austria tax treaty.

There was close proximity or connection between the PE and the taxpayer. A substantial part of the business activity of the taxpayer of manufacturing and commissioning of the plant was carried out in the taxable territory of India and supply of parts of machinery for the plant was incidental to a service contract and for this reason also a part of the profit was directly attributable to the PE in India.

[4] DIT v. Nokia Networks OY [2012] 25 taxmann.com 225 (Del)

The taxpayer had not provided any detail in respect of the marketing or pre-tendering activities or even post tendering activity. In absence of any such details, it was difficult for the AO to quantify the role related to marketing activity played by the PE. However, as far as an assembly of fabrications of the machines, the service PE had played a significant role and no part of the profit out of the supply agreement had been assigned by the taxpayer towards the Service PE.

In the supply agreement, the taxpayer had supplied mainly parts or the components of the machines and those machines or sections of the plants have been assembled in India. For all practical purposes, the property in goods transferred in India and thus PE had played a role in supply agreement other than design, build and manufacturing of the components of the machines. Therefore, the significant part of the profit on the off-shore supply of equipment under the supply agreement should be attributed to PE in India. In the case of Rolls Royce PLC[5], the High Court had taken into consideration the rate of 50 per cent towards manufacturing activity and 15 per cent towards the research and development activity and balance 35 per cent was considered to the marketing activity.

In the instant case, in addition to the marketing activities or engineering survey pre or post awarding of contract (for which no information was filed by the taxpayer), the Service PE had played a role in assembling and bringing the equipment to deliverable state as agreed under the supply agreement. Accordingly, the Tribunal attributed 35 per cent of profits accruing from off-shore supplies to a PE in India.

Our comments

The issue with respect to taxability of income from off-shore supply of equipment under a composite contract has been a matter of debate before the Courts including the Supreme Court[6].

The Delhi High Court in the case of Nokia Networks OY[7] following the decision of Ishikawajima-Harima Heavy Industries Ltd 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 the agreement would not be taxable in India.

The Mumbai Tribunal in the case of Atomstroy Export[8] held that income from off-shore supply contract was not taxable in India under Section 9(1) of the Act and under India-Russia tax treaty since the 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[9], Roxar Maximum Reservoir Performance WLL[10], Michelin Tamil Nadu Tyres Pvt Ltd[11] and Linde A.G.[12], the AAR relying on Vodafone International Holding B.V.[13] 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 off-shore supply and services was taxable in India.

The Tribunal in the present case on the basis of the facts of the case held that the supply of equipment and service contracts are in the nature of a composite contract. Both contracts cannot be seen independently. Further supply of equipment is connected with the PE in India under the India-Austria tax treaty and also had a business connection in India under the provisions of the Act. Accordingly, the Tribunal attributed 35 per cent of profits accruing from off-shore supplies to PE in India.

A committee formed by the Central Board of Direct Taxes (CBDT) examined the existing scheme of profit attribution to PE and recommended changes in current domestic tax law. The Committee recommends a mixed approach that allocated profits partly to the jurisdiction where the consumers are located and partly to the jurisdiction where supply activities are undertaken. The Committee recommends a fractional apportionment approach that determines profit attribution based on a three-factor method, assigning equal weights to sales (representing demand), manpower and assets (representing supply including marketing activities). Further, in cases of profit attribution for Significant Economic Presence, the Committee has recommended a four-factor approach wherein 'Users' be considered as the fourth factor.

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[5] Rolls Royce PLC v. DIT [2011] 339 ITR 146 (Del)
[6] Ishikawajima-Harima Heavy Industries Ltd v. DIT [2007] 288 ITR 408 (SC); CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC)
[7] DIT v. Nokia Networks OY [2012] 25 taxmann.com 225 (Del)
[8] Atomstroy Export v. DDIT [2017] 80 taxmann.com 178 (Mum)

[9] Alstom Transport SA [2012-TII-28-ARA-INTL]
[10] Roxar Maximum Reservoir Performance WLL (AAR No. 977 of 2010) (AAR)
[11] Michelin Tamil Nadu Tyres Pvt Ltd (AAR No.1218 of 2011)
[12] Linde A.G. (AAR No. 962 of 2010) (AAR)
[13] Vodafone International Holdings B.V. v. UOI [2012] 341 ITR 1 (SC)

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