NALSAR

Business Profits and Turnkey Projects

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Section 1

Taxation of Business Income and Evolution

Concept of Virtual PE

ABB FZ LLC (83 taxmann.com 86) (2017) (Bangalore Tribunal)

- DTAA requires services to be rendered by its employees or other personnel for a period of 9 months within any 12 months period.
- In the present age of technology where services can be provided with various virtual modes (like email, internet, video conference, remote monitoring, remote access to desk-top, etc., through various software), the argument of fixed place of business raised by the assessee that three employees rendered services only for 25 days cannot be sustained, as the services can be rendered without the physical presence of employees of the assessee.
- However, the determination of this issue will only have any bearing on the issues under considerations if on examination of facts it is concluded that the activities of the assessee do not fall in any of the articles of DTAA.
- Consideration received for sharing or permitting to use special knowledge, expertise and experience was considered Royalty

Clifford Chance Pte. Ltd. vs. ACIT (60 taxmann.com 424) (2024) (Delhi Tribunal)

- Taxpayer a resident of Singapore rendered services in FY 2019-20 and 2020-21
- FY 2019-20 - [Business development 35 days, Vacation period 36 days, common days 5, Services rendered in India for 44 days.
- FY 2020-21 - Services rendered remotely. No employees visited India
- Article 5(6) of India-Singapore DTAA provides for a threshold of 90 days (30 days for AEs)
- Relied on Apex Court ruling in the case of E-Funds and held that the requirement of Service PE is that services must be rendered in India

Concept of Digital Service Tax (Equalisation Levy)

Google Asia Pacific Pte. Ltd. (2022) (137 taxmann.com 486) (Delhi HC)

Amazon Web Services India (P.) Ltd. (2023) (154 taxmann.com 230) (Delhi HC)

01 Apr 2016

EL on Advertisement Services (6%)

01 Apr 2020

EL on E-commerce Transactions (2%)

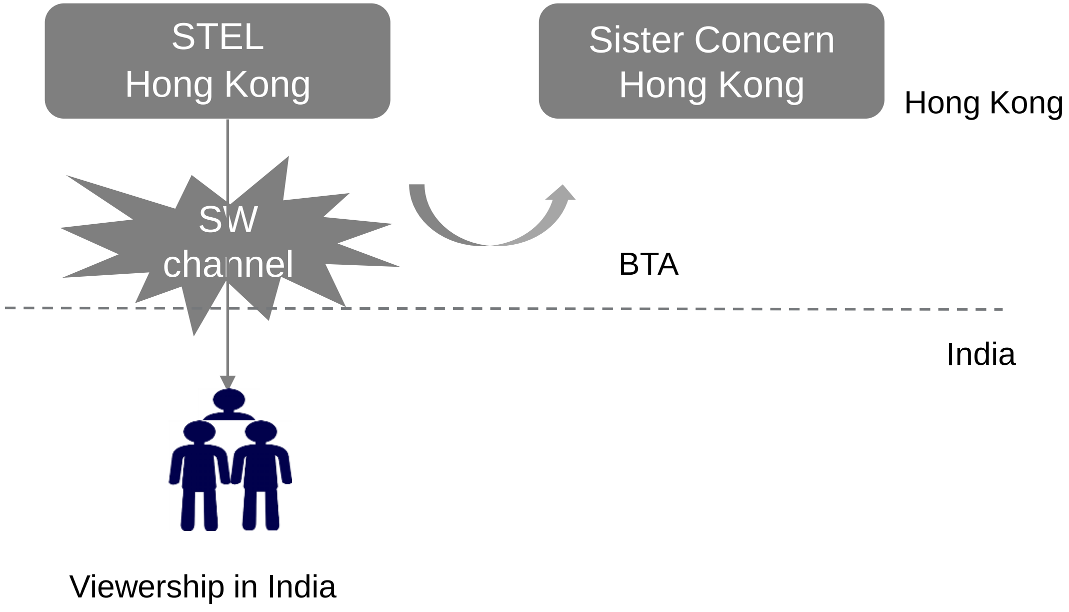
Abolished w.e.f. **01 Aug 2024**. This aligns with the country's global commitments under the OECD's Pillar Two framework.

BEPS 2.0 - Pillar One and Two

Pillar One	Pillar Two
Objective to allocate share of excess profits to Market jurisdictions and tax thereon	Identifies low tax jurisdictions and ensures a Minimum ETR of 15%

Case study 1 - Transfer of Intangibles outside India

- STEL, Hong Kong transferred SW channel vide a Business Transfer Agreement (BTA) to one of its sister concern based in Hong Kong
- STEL claims the transaction was undertaken between two non-residents and the underlying asset (i.e., channel) was not situated in India
- Tax authorities contend that transfer of the Channel would result in trigger of indirect transfer provisions and subject to short-term capital gains in India since:
  - The very nature of the asset and its ability to regularly generate income from India created a strong nexus and business connection with India.
  - Various elements of the asset being the brand name, logo, contents, permits, customer base (advertisements), substantial viewer base etc. located in India hence the situs of the channel was in India.
- Is STEL obligated to pay taxes in India ?



HUL - Tax notice

Section 2

Taxability of EPC Contracts

EPC Contract - Key Features

Project Owner / Customer

EPC Contract

Engineering:

- Preparation of designs, plans, & technical specifications
- Documentation of delivery schedules (w.r.t supply of equipments, instructions for erection, etc.) and preparation of performance standards

Onshore / Offshore

Procurement:

- Supply of equipments
- Arranging for freight and delivery
- Supply of spare parts

Onshore / Offshore

Construction:

- Construction (viz., installation / erection of equipment)
- Quality testing

Onshore

<u>Single composite contract</u>

Indivisible contract (Sub-contracting arrangement can be explored)

Exposure of AOP if not structured properly

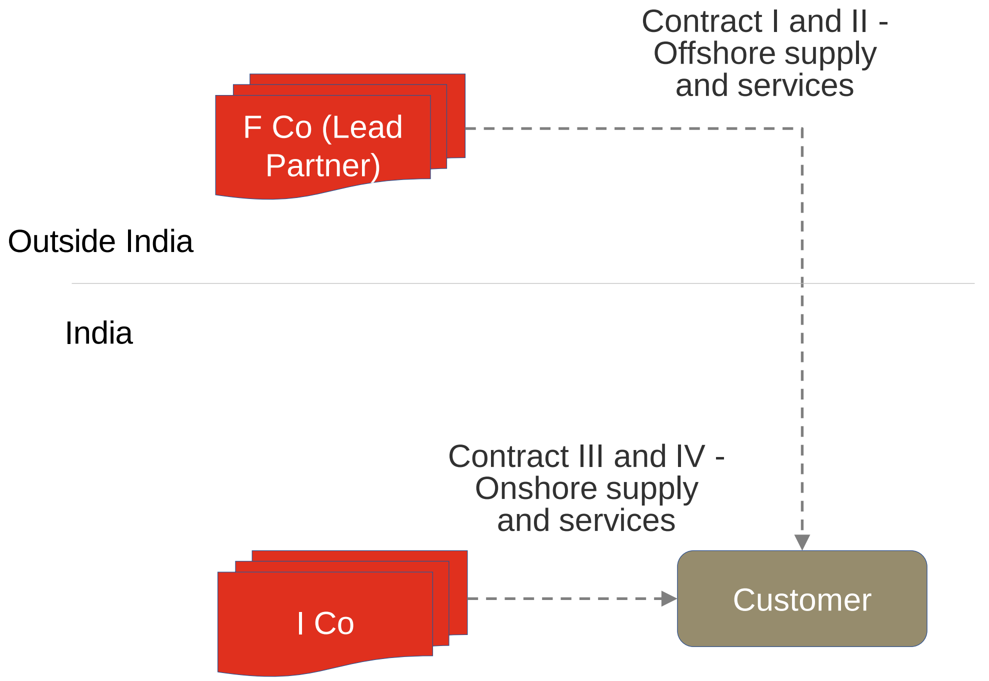
<u>Consortium / Split contract*</u>

Divisible contracts with a lead partner

* Multiple contracts is a possible scenario, but practically not feasible

EPC Contract - Tax perspective

- Significant tax inefficiencies arise from a single consolidated contract for the entire work and lump sum price
- The key objectives of entering a consortium contracts are given below:
  - Commercial imperatives
  - Ease of implementation (viz., Lead partner providing the performance guarantee etc.)
  - Certainty in tax impact, and optimization of taxes
- The key tax issues that arise in case of consortium contracts are:
  - Risk of Association of Persons (AOP)
  - Risk of Permanent establishment (PE)



EPC Contract - Taxability of offshore supply

‘Free On Board (FOB)’ vs. ‘Cost Insurance Freight’(CIF)? - whether place of accrual of income changes?

- FOB basis - Transfer of title at port of shipment
- CIF basis - Transfer of title at port of shipment along with freight and insurance

- **Siemens Aktiengesellschaft 34 SOT 16 (Mum Tribunal)** - Whether in case of CIF, though cost, insurance and freight, etc. is met by seller but property in goods gets transferred to buyer at port of shipment and buyer incurs all risks of loss of or damage to goods from port of shipment - Held, yes - Whether since assessee had delivered equipment to carrier at port of shipment, i.e., in Germany, it could be said that property in equipment passed on to BPL on port of Germany itself - Held, yes - Whether, therefore, no income accrued to assessee in India towards offshore supply of equipment to BPL.
- **Mahabir Commercial Company 86 ITR 417 (SC)** - Similar principles upheld

Points for consideration:

- Contract should be at arm’s length price
- Sale should be concluded outside India, i.e., title of goods should be transferred outside India (preferable to have sale terms on FOB Basis)
- Sales consideration should be received outside India i.e., bank account outside India
- PE of foreign company, if any, should not play any role to play in offshore supplies

EPC Contract - Instruction No. 1829

Summary of Instruction No.1829 issued by CBDT w.r.t taxability of EPC contracts:

Instruction No. 1829

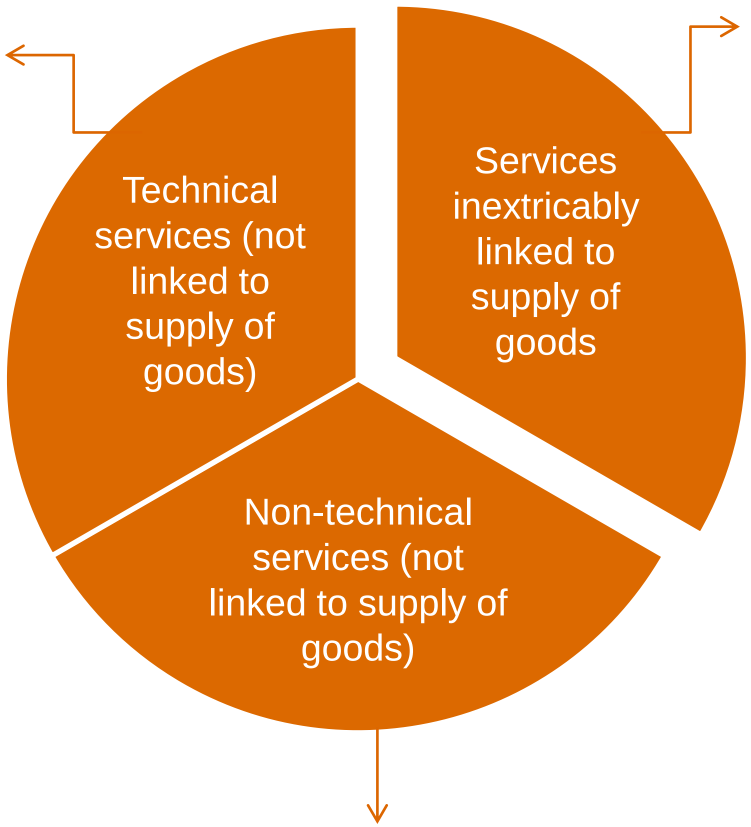
- Instruction No. 1829 of dated 21-9-1989 issued by the CBDT discusses about certain components of EPC contracts w.r.t Hydroelectric power projects
- One of the component being 'Profits from sale of equipments and materials on FOB basis where the payments are also made outside India'
- Subsequently, CBDT issued Instruction No. 5 of 2009 dated 20-7-2009 withdrawing the above instruction. One of the reason being 'It is noticed that most of the profit is loaded in the offshore supply and the payments for the Indian portion of the contracts barely meets the expenses resulting into either losses in India or very low profit'

Instruction No. 1829.pdf

Instruction No. 5 of 2009.pdf

EPC Contract - Taxability of offshore service

- Under the Act - Taxable as FTS if services utilized in India even though rendered from outside India; However, any construction, assembly, mining, or like project undertaken by recipient in India excluded from ambit of FTS.
- **Oil & Natural Gas Corporation Ltd. Vs. CIT (2015) (59 taxmann.com 1) (SC)**. Payment for providing various services in connection with prospecting, extraction or production of mineral oil, would be assessed under section 44BB.
- Under the tax treaty - FTS subject to 'make available' clause / 'most favored nation' clause if any under the tax treaty
- In PE exist - taxable as business income if attributable to PE (and not as FTS)

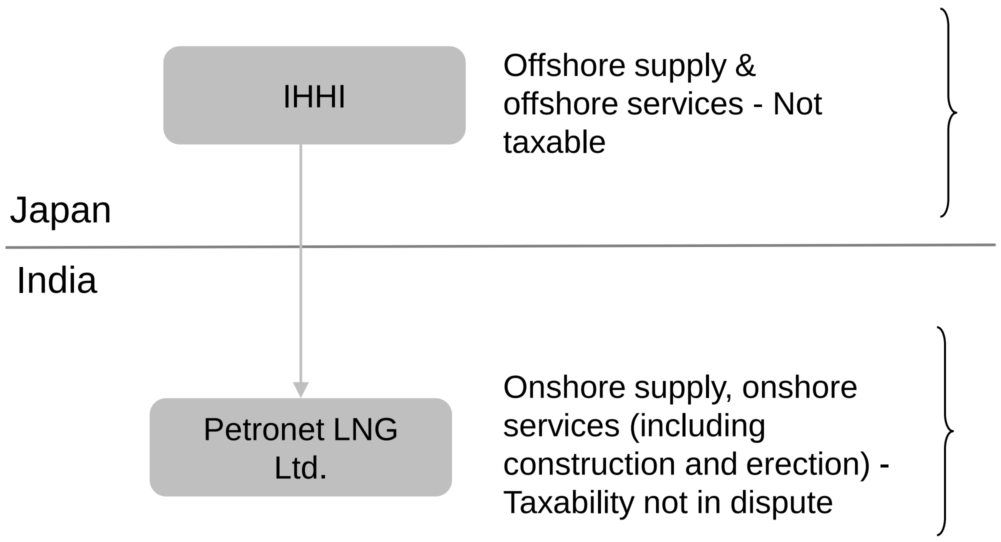


- Such services to not qualify as FTS under certain Indian tax treaties (viz. India-Israel, India-USA, India-Singapore)

- Taxable in India to the extent it is attributable to business connection / PE of non-resident contractor in India

EPC Contract - Judicial Precedents

Ishikawajima Harima Heavy Industries Ltd. (IHHI) v. DIT 288 ITR 408 (SC) Jan 2007



Key features of the arrangement:

- Consortium with 5 other enterprises (composite contracts) including an Indian entity for setting up a Liquified Natural Gas receiving storage and degasification facility at Dahej, Gujarat
- Contract signed in India; Role, responsibility and consideration of each specified

Key observations of SC w.r.t composite contract vs. Split contract::

- "Para 17. ……*The contract may also be a turnkey contract, but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events in execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under the contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the component of the contract is separate. Similarly offshore supply and offshore services have separately been dealt with. Prices in each of the segment are also different."*

EPC Contract - Judicial Precedents

Ishikawajima Harima Heavy Industries Ltd. (IHHI) v. DIT 288 ITR 408 (SC) Jan 2007

Key observations of SC:

Regarding Taxability of Offshore supplies :

- Only such part of the income, as is attributable to the operations carried out in India can be taxed in India.
- Since all parts of the transaction in question, i.e., the transfer of property in goods as well as the payment, were carried on outside the Indian soil, the transaction could not have been taxed in India.
- The fact that the contract was signed in India is of no material consequence, since all activities in connection with the offshore supply were outside India, and therefore cannot be deemed to accrue or arise in the country.

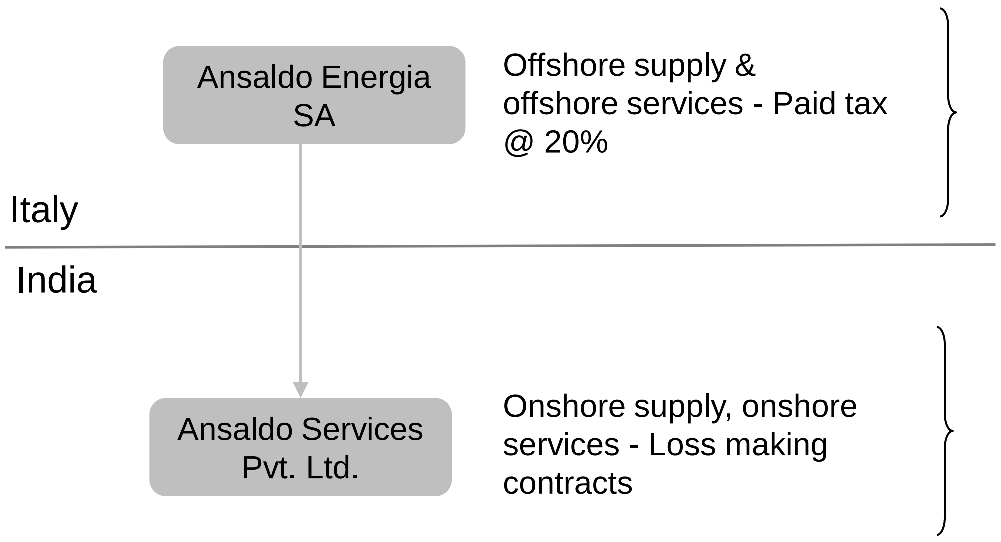
Regarding Taxability of Offshore services:

•Offshore services not taxable as the same are not attributable to Indian operations:

- Not FTS under 9(1)(vii) as services rendered outside India. Doctrine of territorial nexus applied. <u>Services to be rendered 'and' utilised in India under the Act</u>
- The terms 'effectively connected' and 'attributable to' are to be construed differently even if the offshore services and the permanent establishment were connected.
- The services have been rendered outside India, and have nothing to do with the PE, and can thus not be attributable to the PE and therefore not taxable in India.
- Offshore services inextricably linked to offshore supplies are part of supply and not taxable in India.

EPC Contract - Judicial Precedents

Ansaldo Energia vs. Income Tax (ITA No. 411.Mds/2006) (Madras High Court) (2007)



Findings of the Tribunal:

- *"Taking into consideration the entire conspectus of the case, we are of the opinion that ASPL was a facade created for the purpose of taxation ex consequent its corporate veil be lifted for consolidating the four contracts."*

Facts of the case:

- The assessee is a NR, and its business consists inter-alia of selling and setting of power plants.
- In 1995, with the necessary statutory approvals the assessee set up a company in India called Ansaldo Services Private Ltd. (ASPL hereafter).
- In 1997, the Neyveli Lignite Corporation(NLC in short) floated a single-bid tender for its expansion plan of setting up two thermal plants at Neyveli. The assessee applied for the bid in response to NLC's advertisement. It did so as a single bidder.
- The assessee assured NLC that it would take the overall responsibility of the entire turnkey contract in its capacity as a single bidder.
- Thereafter, the contract was divided into four contracts. Contracts which dealt with the on-shore supply and on-shore services were loss making contracts.
- Contracts w.r.t offshore supplies (designing and engineering) and offshore services (supervision of erection, testing and commissioning) were offered to tax @ 20%

EPC Contract - Judicial Precedents

Ansaldo Energia vs. Income Tax (ITA No. 411.Mds/2006) (Madras High Court) (2007)

Ruling of the HC:

- a) the foreign company and the activities rendered by it under contract No. I and the other three contracts are inextricably linked, and it was a composite contract, b) all responsibility from the beginning to the end rested on the assessee, c) there is an intimate, real and continuous relationship with the subsidiary company and d) that the price of the other contract was loaded on to Contract No. I.
- Assessee has a control over ASPL (including financial dependence). Onus is on the appellant to see that the entire contract is completed.
- Assessee requested NLC to separate the single contract into distinct contracts. NLC did not agree initially but did so only after making certain stipulations.
- ASPL came into the picture, at the instance of the assessee. ASPL is there only so that the single contract could be made into four, and for execution of contracts III and IV
- The NLC contract was with the Assessee alone, and thus a composite contract. The fact that separate price had been given to each of the contract would not make a difference.
- In IHHI also there is a clause which refers to the total price, yet the Supreme Court held that the price for each component was compartmentalized and so for the supplies made on high seas there was no tax liability. But, in IHHI, there was no factual finding that there was <u>price imbalance in the four contracts,</u> and it was skewed in favour of the off-shore supply contract, nor was there any finding that the <u>entity which executed the contracts for the on-shore supply and the on-shore services were mere facades</u>.

EPC Contract - Judicial Precedents

Linde A.G. Authority vs. DDIT [2014] 44 taxmann.com 244 (Delhi)

Facts of the case

- OPAL, an Indian Company floated a tender notice for carrying out all activities and services required for the design, engineering, procurement, construction, installation, commissioning and handing over of the plant on a lump sum turnkey basis for the Dual Feed Cracker and Associated Units of the Dahej Petrochemical Complex.
- Linde AG from Germany and Samsung from Korea through a MOU, decided to bid for this contract and work as a consortium. Subsequent to the MOU, both the parties entered into an Internal Consortium Agreement (ICA) which also clearly specified that the scope of work of 'L' and 'S' were separate and independent.
- Assessee’s application for Sec 197 certificate that offshore supply of equipment, supply of spares, and engineering services shall not be liable to tax in India was turned down. Applicant filed an AAR.

EPC Contract - Judicial Precedents

Linde A.G. Authority vs. DDIT [2014] 44 taxmann.com 244 (Delhi)

Ruling of AAR:

- AAR emphasized the Vodafone Case (adopting a 'Look at' approach) on to hold that a dissecting approach from the angle of taxation should not be adopted and the approach must be to understand the nature and object of the contract on looking at a transaction.
- AAR was of the view that it was impermissible to refer to internal documents namely, the memorandum of understanding and the Internal Consortium Agreement to interpret the contract or the tender document or the rights and obligations thereunder.
- In the AAR's view, an AOP had been formed by the Applicant and Samsung since the contract was awarded to the consortium. Since the contract may not be dissected to treat designing of the project and equipment as offshore transactions, the situs of the contract is in India and the payments are made by an Indian tax resident for work in India.

Ruling of High Court:

- Fact that contractual obligations of one of consortium member were not limited to merely supplying equipment, but were for due performance of entire contract, would not necessarily imply that entire income relatable to contract could be deemed to accrue or arise in India; only that portion of income which is reasonably attributable to operations carried on in India would fall within tax net in India
- Separate scope of work specified in the annexures to the Contract. OPAL recognised this.
- Separate invoices raised and payments received by concerned member. No arrangement of sharing of profits
- In absence of sufficient degree of joint action between consortium members in either execution or management of project, consortium would not be deemed as an AOP for purposes of Income-tax Act

Section

3

AOP exposure in EPC Contracts

‘What if’ Consortium is treated as AOP

Residential Status of the AOP in the Source Jurisdiction (i.e., India) as per Section 6

- Even if the Control and Management is partly in India, the said AOP would be considered as Resident
- Income generated world wide is exposed to Indian taxes

Residential Status of the AOP in the Home Jurisdiction

- AOP is an unregistered entity and the residential status would depend on the local laws
- When a consortium is treated as an AOP, the income earned by the consortium (foreign members' share of income may also be subject to tax in India) is taxed as a single entity. However, the taxes paid in India by the foreign member may not be available as a foreign tax credit outside India, resulting in double taxation.

EPC Contract - Circular No. 7 of 2016

Summary of Circular No.7 issued by CBDT w.r.t taxability of EPC contracts:

Circular No. 7 of 2016

- Consortium arrangement for executing EPC or Turnkey projects would having following attributes (Illustrative) would not be construed as AOP:
  - each member is <u>independently responsible</u> for executing its part of work through its own resources and also bears the risk of its scope of work
  - each member earns profit or incurs losses, based on performance of the contract falling strictly within its scope of work. However, consortium members <u>may share contract price at gross level only</u> to facilitate convenience in billing.
  - the <u>men and materials</u> used for any area of work are under the <u>risk and control of respective consortium members</u>;
  - the control and management of the consortium is <u>not unified, and common management</u> is only for the inter-se co-ordination between the consortium members for administrative convenience.

This Circular is not applicable where all or some of the members are AEs u/s 92A of the Act

Circular No. 7 of 2016.pdf

Section

4

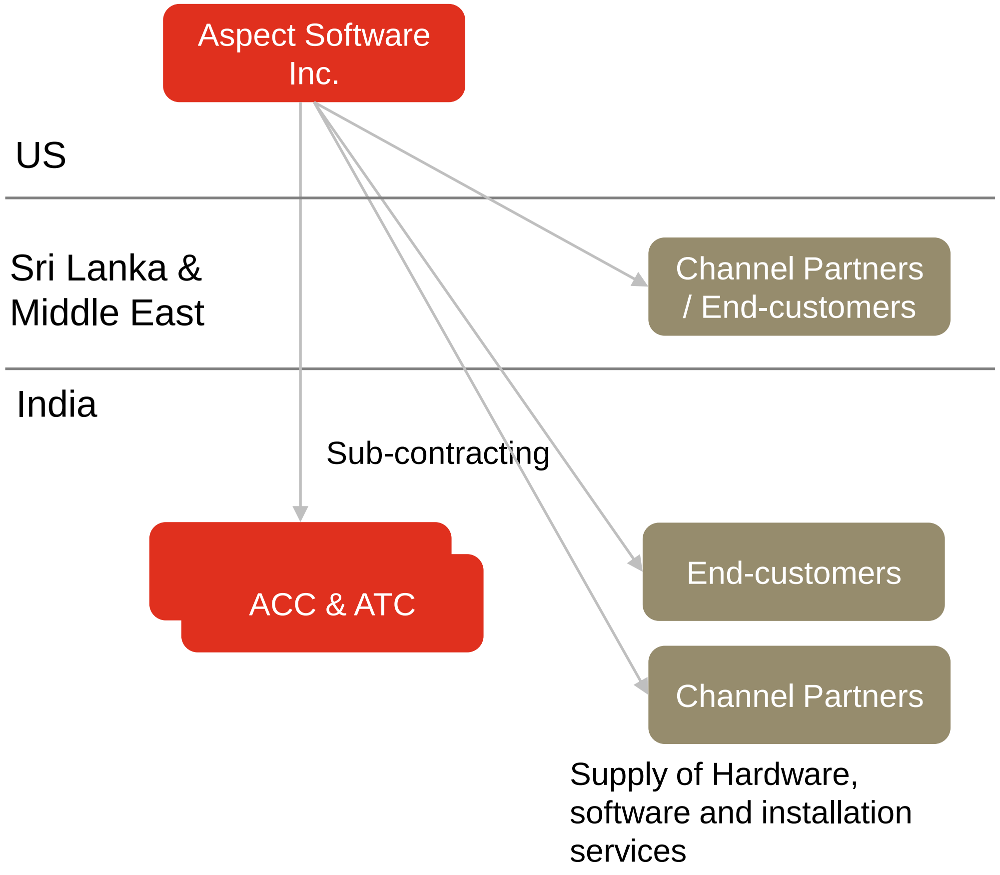
PE exposure in EPC Contracts

Installation PE - Software Implementation ?

Aspect Software Inc. In ITA no.1124 and 1125/Del/2014

Facts of the case:

- Aspect Software Inc. ('Aspect US) is in the business of provision of hardware, software and rendering of support services that enable call centre companies, to better manage customer interactions via voice, email, web and fax.
- Aspect US derives its revenue from supply of "contact solutions", software license and provision of services including, installation, maintenance and professional services. Aspect US also provided installation/ implementation and maintenance of the supplied hardware and software.
- Aspect US had two subsidiaries in India.
  - ACC - Installation and marketing support to Aspect US. (wherever customers request for on-site implementation)
  - ATC - R&D entity, which provides, testing, maintenance support to Aspect US (where customers request for on-site maintenance).
- The employees of Aspect US stayed in India during the FY for 157 days; AO held that the assessee has a PE in India in the form of Fixed Place, Installation as well as Dependent agent. ACC, the Indian Subsidiary of assessee, was held to be PE of the assessee in India.



Installation PE - Software Implementation ?

Aspect Software Inc. In ITA no.1124 and 1125/Del/2014

Ruling of the Tribunal:

- Payments for supply of Software and Hardware were not considered Royalty under Article 12 (even if the software is licensed separately) since its merely transfer of copyrighted article.
- Since the services implementation and maintenance services do not make available any technical knowledge, experience, skill, know-how or processes, were not considered as Fees for Included Services under Article 12
- For PE related aspects, the matter was remanded back to AO for further verification.
- Regarding Installation PE, the Tribunal held that Article 5(2)(k) should be read as a whole. The term ‘in connection therewith’ would apply for the entire preceding words viz., a ‘building site or construction, installation or assembly project or supervisory activities’. The term installation project cannot be read de-hors the words accompanying it. Thus, when the entire clause is read as a whole, the installation and supervisory activities should be in connection with the building site or construction.

(Clause (j): An installation or structure used for the exploration or exploitation of natural resources, but, only if so used for a period of more than 120 days in any twelve-month period;

Clause (k): A building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve-month period.

Aspect Software -
ıstallation PE - Pag

Installation PE - Sub-contracting arrangement

Whether time spent by subcontractor in India should be included for determining overall presence of main contractor in India?

(a) Para 54 of commentary to OECD MC Commentary on Article 5

“If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts all or parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project for purposes of determining whether a permanent establishment exists for the general contractor. In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period. The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.” -

(b) AAR in case of **Pintsch Bamag**, in re [2009] 318 ITR 190 (AAR) concluded that time spent by subcontractor in the source state should not be included in the overall time spent by the main contractor, if:

- Main contractor and sub-contractor deal on P2P basis and at arm’s length remuneration
- No control, supervision and interference exercised by main contractor w.r.t. scope of work of sub-contractor; and project not undertaken on conjoint basis

(c) Delhi High Court in **National Petroleum Construction Company** [2016] 383 ITR 648 (Delhi) held that time spent by subcontractor should not count towards duration of main contractor’s PE. This view is also endorsed in case of **HITT Holland Institute of Traffic Technology B.V.** vs. DDIT [2017] 186 TTJ 734 (Kolkata)

Installation or Service PE - Threshold computation

Multiple counting of employee on a single day has to be avoided. Also, vacation period, days involving business development activities to be excluded

Supreme Administrative court of Austria - IBFD Case No. 95/13/0137

Solar days vs. Man days for threshold computation

- Linklaters LLP vs. DCIT [2019] 106 taxmann.com 195 (Mumbai ITAT)
- Clifford Chance United Kingdom v. Dy. CIT [2002] 82 ITD 106 (Mumbai ITAT.)
- Clifford Chance PTE Ltd. vs ACIT [2024] (160 taxmann.com 424) (Delhi ITAT)

Period for threshold computation

#	Language in the Treaty	DTAA with	Relevant Judicial Precedence
1	Article 5(2)(j) - Furnishing of services, including consultancy services, through employees or other personnel for the same or a connected project for a period or periods aggregating to <u>more than 183 days</u>.	Thailand	Bangkok Glass Industry Co. Ltd vs. ACIT [2013] (34 taxmann.com 77) (Madras High Court)
2	Article 5(2)(k) - Furnishing of services including managerial services, other than those taxable under Article 13 (Royalties and fees for technical services), within a Contracting State by an enterprise through employees or other personnel, but only if activities of that nature continue within that State for a period or periods aggregating more than 90 days <u>within any twelve-month period</u> (30 days in case of AEs)	UK	Linklaters LLP vs. DCIT [2019] 106 taxmann.com 195 (Mumbai ITAT)

Section

5

Impact of MLI

Taxability of EPC Contracts - Impact of MLI

MLI Impact

Article 13 - Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions

Article 14 - Splitting-up of Contracts: Period of time spent by the enterprise for projects (such as building site, construction, installation or other specific project) to be determined by:

- ✓ Aggregating the time spent by the enterprise carrying on the activity with period of time spent by its <u>closely related enterprises for connected activities</u>
- ✓ Subject to the condition that <u>period(s) of time spent by enterprise and its closely related enterprises, each exceeds 30 days</u>

Taxability of EPC Contracts - Impact of MLI on CTAs with India

- Article 14 of the MLI applies “in place of or in the absence of” an existing provision.
- Article 14 is not a provision required to meet a minimum standard and therefore jurisdictions can opt out of this article entirely.

- As India has neither stated its reservation with respect to Article 14, nor do any of its treaties have existing language with respect to the splitting up on contracts, Article 14 should be applicable to all of India’s tax treaties where it’s relevant treaty partner has also not specified a reservation.
- In respect of India’s CTAs with Contracting Jurisdictions that have made a reservation, Article 14 would not have any impact (illustratively, France, Japan, Singapore and the United Kingdom).

EPC Contract - Summary

Offshore supply (NR)	Generally, not taxable (appropriate safeguards to be maintained)
Offshore services (NR)	• Taxability as FTS / PE to be analysed. Also, if services effectively connected with PE in India, net income taxable @ 35 percent (plus surcharge and cess). • If integral part of supply, possible to contend - Not taxable
Onshore supply (R)	Taxable in the hands of the supplier as Business profits
Onshore services (R)	Taxable in the hands of the service provider as Business profits

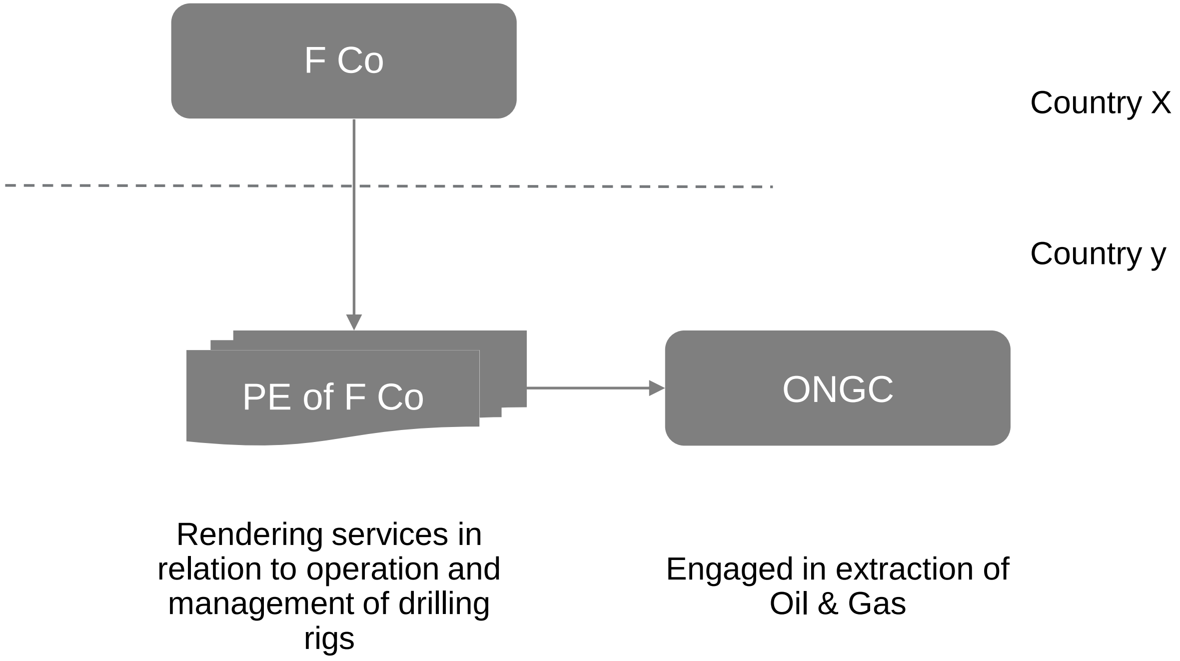
Section

6

Case Studies

Case study 2

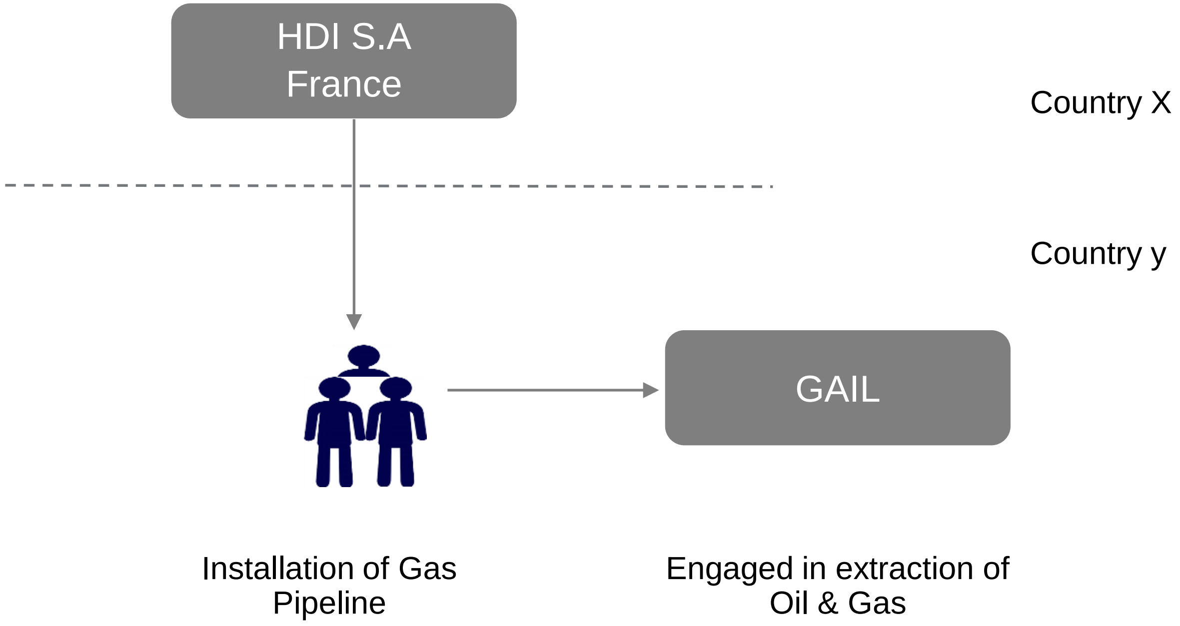
- Whether the payments made by ONGC for providing various services in connection with prospecting, extraction or production of mineral oil, would be assessed as FTS under section 9(1)(vii) of the IT Act?
- Section 44BB vs. Section 9(1)(vii)
- Impact of amendment made u/s 115JB w.r.t foreign companies having PE in India



ONGC - SC Judgement

Case study 3

- Horizontal Drilling International, France was awarded a contract by GAIL for installation of gas pipelines crossing under Yamuna River with optic fiber cable using horizontal drilling technique near Agra
- The work commenced with the import of the drilling rig on 20 Jan 1997 and the contract was completed on 04 March 1997
- GAIL approached the ITO for 'Nil' withholding since there is no PE (project completed within 6 months); However, ITO held the payments to be FTS
- Is GAIL obligated to withhold taxes?



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