NALSAR

FTS, Business Profits, Secondment and Turnkey Contracts

Key highlights

Oct 2022

CONTENTS

Background

Background - What is an EPC contract ?

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

Exposes the entire revenues to tax in India

Single composite contract

Indivisible contract (Sub-contracting arrangement can be explored)

Exposure of AOP if not structured properly

Consortium / Split contract*

Divisible contracts with a lead partner

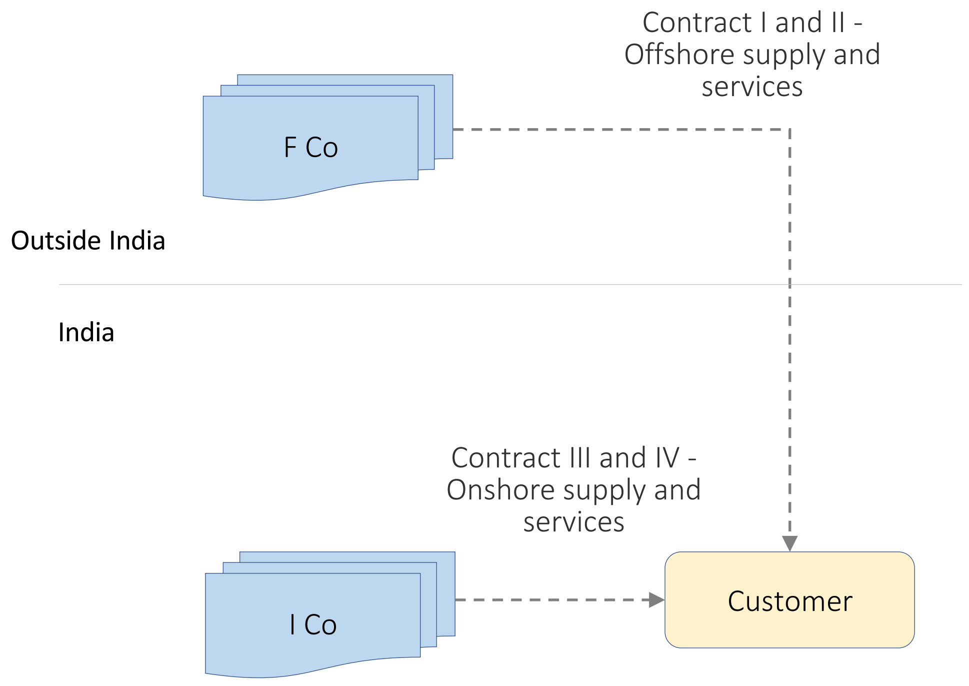
* Multiple contracts is a possible scenario, but practically not feasible

Background - Features of EPC contract

- 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
  - Certainty in tax impact, and optimization of taxes
  - Ease of implementation (viz., Lead partner providing the performance guarantee etc.)

- The key tax issues that arise in case of consortium contracts are:
  - Risk of Association of Persons (AOP)
  - Risk of Permanent establishment (PE)



Taxability of EPC contracts

Taxability of EPC contracts - Instruction No. 1829

CBDT has issued Instruction No.1829 w.r.t taxability of EPC contracts. The brief summary is given below for reference:

Instruction No. 1829

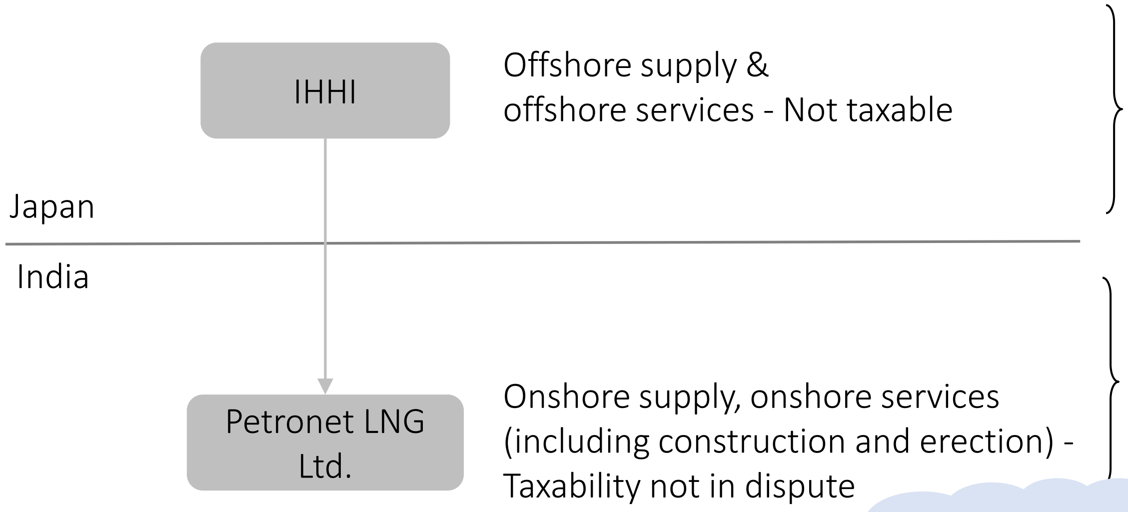
- Instruction No. 1829 of dated 21-9-1989 issued by the CBDT discusses about certain components of EPC contracts w.r.t Hydroelectric power projects
- One of the component being ‘Profits from sale of equipments and materials on FOB basis where the payments are also made outside India’
- Subsequently, 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

Taxability of EPC contracts - Judicial Precedents

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



Offshore supply - FOB vs CIF ? Refer **Annexure 1**

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:

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."*

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.

Taxability of EPC contracts - Judicial Precedents

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

IHHI

Offshore supply &
offshore services - Not taxable

Japan

India

Petronet LNG Ltd.

Onshore supply, onshore services (including construction and erection) - Taxability not in dispute

Amendment to section 9(1)(v)(vi)(vii) - For taxability, services need not be rendered in India. Also refer **Annexure 2**.

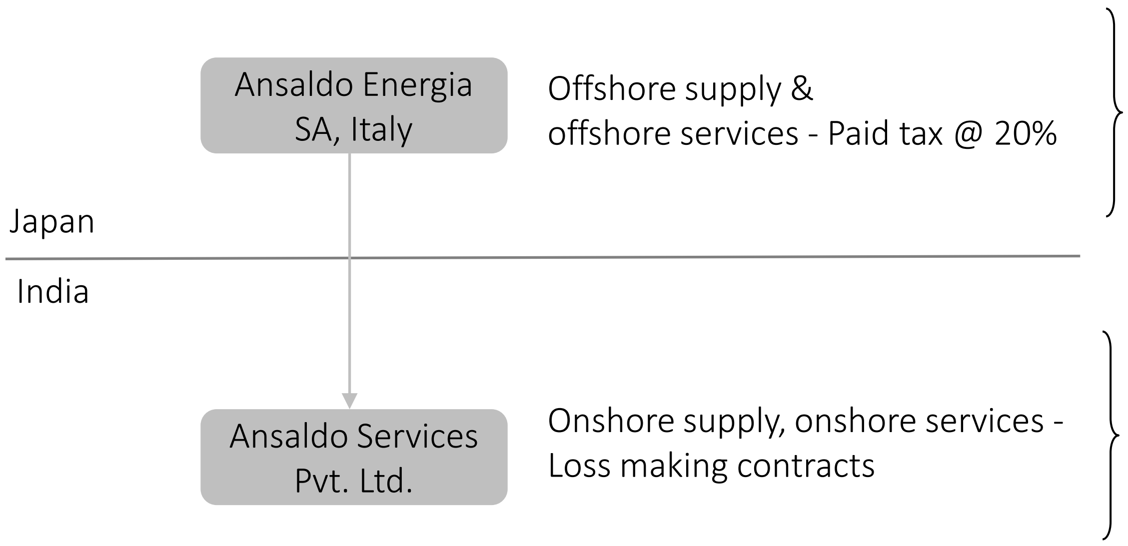
Key observations of SC:

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. Services to be rendered 'and' utilised in India under the Act
  - 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.

Taxability of EPC contracts - 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%

Taxability of EPC contracts - Judicial Precedents

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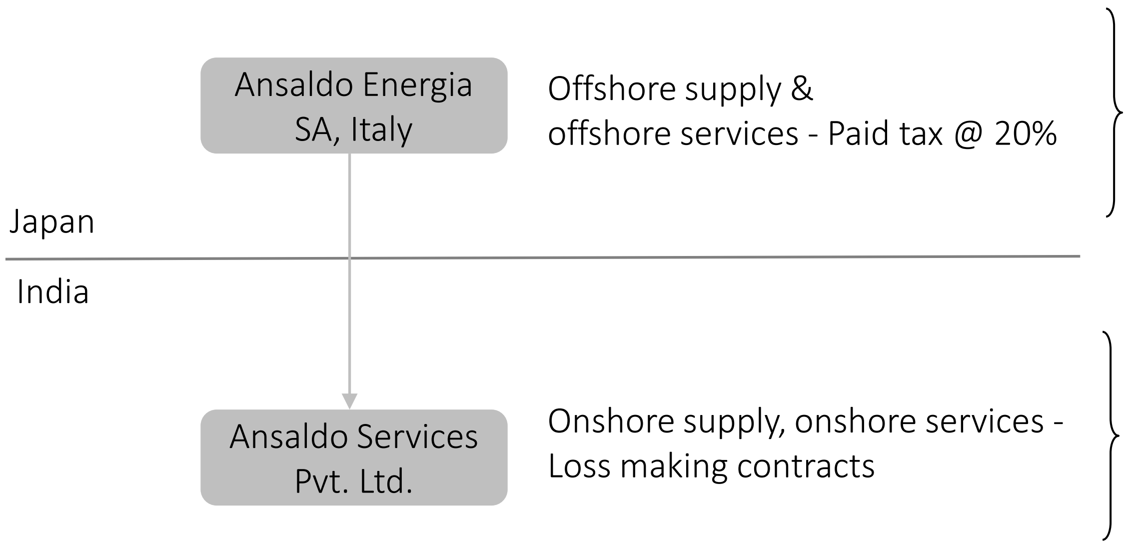


Ruling of the HC:

- 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.

Ruling of the HC:

- 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 price imbalance in the four contracts, and it was skewed in favour of the off-shore supply contract, nor was there any finding that the entity which executed the contracts for the on-shore supply and the on-shore services were mere facades.

Taxability of EPC contracts - Circular No. 7 of 2016

CBDT has issued couple of Instructions and Circular w.r.t taxability of EPC contracts. The brief summary is given below for reference:

Circular No. 7 of 2016

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

- 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.

Circular No. 7 of 2016.pdf

Taxability of EPC contracts - 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 @ 40 percent (plus surcharge and cess). Also refer **Annexure 3**. • 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

Taxability of EPC contracts - MLI Impact

Taxability of EPC contracts - MLI Impact

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 closely related enterprises for connected activities
- ✓ Subject to the condition that period(s) of time spent by enterprise and its closely related enterprises, each exceeds 30 days

- India has opted for Article 14 to apply to all its CTAs
- Contracting parties which have:
  - Opted to apply: New Zealand, Slovak Republic, Ukraine and Denmark
  - Opted to apply with reservation (Reservation made not to apply to exploration of / for natural resources): Netherlands, Australia, Norway, Russia, Serbia, Ireland and Lithuania
  - Opted not to apply: Canada, Cyprus, France, Singapore, UK, Luxembourg, Sweden, Japan, UAE, Austria, Belgium, Finland, Georgia, Poland, Slovenia and Iceland

Secondment vs FTS / PE

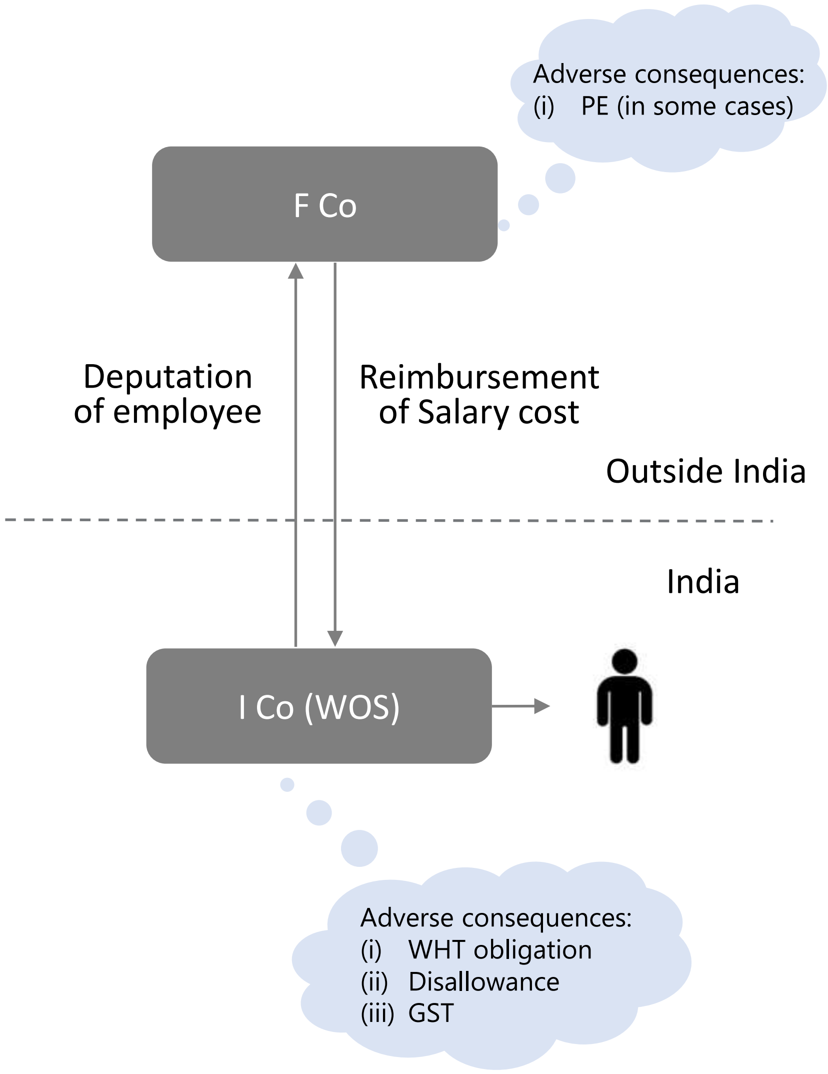
Secondment vs FTS / PE

Tax implications depend upon the terms of secondment arrangement:

- The Indian tax authorities have time and again sought to tax the reimbursements made to F Co by an associate entity in India (I Co) on the grounds that a secondment arrangement is essentially an arrangement for the provision of FTS by F Co to I Co effected through the seconded employees.

- In certain scenarios, the Indian tax authorities contend that the services provided by the secondees to I Co create a PE of the F Co in India.

#	Particulars	Whether taxable as FTS
1	I Co to qualify as an economic employer of employee. Salary cost re-charged at actuals by F Co. to I Co.	No. Also refer conditions laid down by the Judicial precedents
2	I Co to qualify as an economic employer of employee. Salary cost re-charged at mark-up by F Co. to I Co.	FTS
3	F Co. deputed employee for providing services to I Co. Cost re-charged by F Co at actuals.	FTS

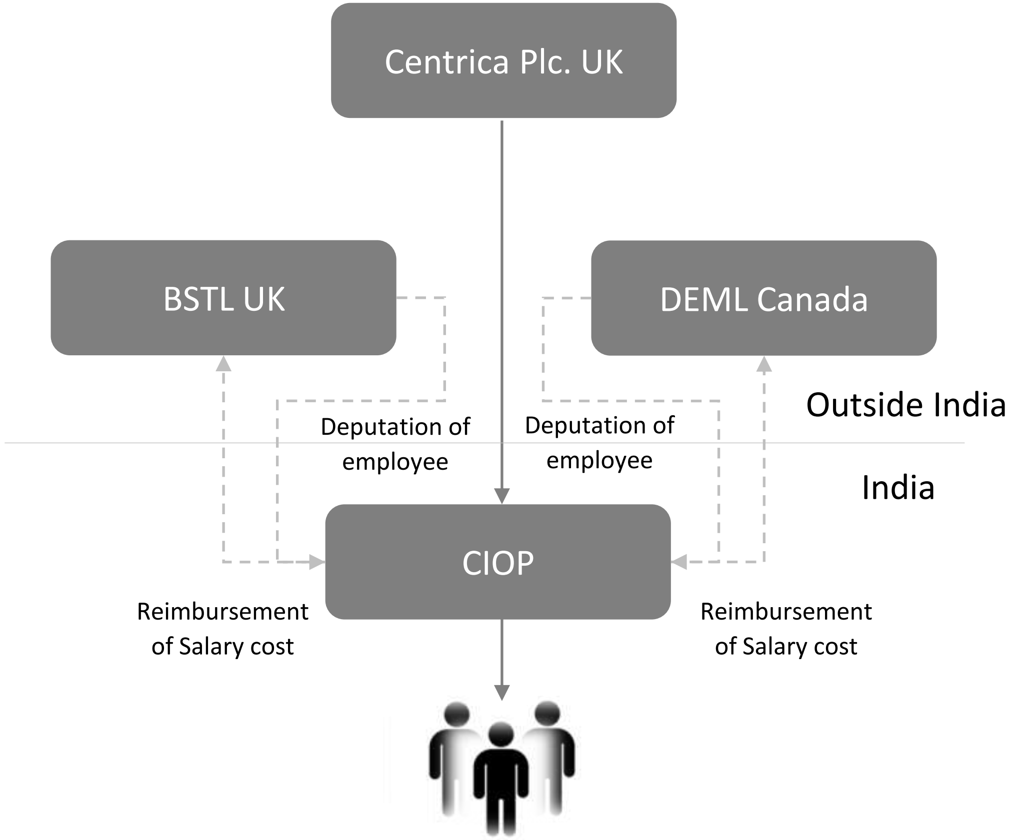


Secondment vs FTS / PE - Judicial precedents

Centrica India Offshore Pvt. Ltd. (2014) 44 taxmann.com 300 (Delhi), SLP rejected (2014) 51 taxmann.com 386 (SC)

Facts of the case:

- 'BSTL' and 'DEML' were in the business of supplying gas and electricity to consumers across the UK and Canada. These entities outsourced their back-office support functions (viz., debt collections/consumers' billings/monthly jobs etc.) to third party vendors in India.
- To ensure that the Indian vendors comply with quality guidelines, assessee was established in India to act as service provider to those overseas entities.
- To seek support during initial year of its operation, assessee sought some employees on 'secondment' from the overseas entities. For this purpose, it entered into an agreement with the overseas entities in which the latter seconded some employees for fixed tenure.
- In terms of the secondment agreement, the employees so seconded worked under CIOP's direct control and supervision.



Arguments of CIOP:

- there is no service PE, since assessee is the economic employer, whilst the overseas entities are only the legal employers
- the payment made by assessee to the overseas entities is only reimbursement
- that payment is not the income of the overseas entities on account of the doctrine of 'diversion of income by overriding title'.

Secondment vs FTS / PE - Judicial precedents

Centrica India Offshore Pvt. Ltd. (2014) 44 taxmann.com 300 (Delhi), SLP rejected (2014) 51 taxmann.com 386 (SC)

Ruling of the Delhi HC:

- The expression expressly ‘technical service’ includes the provision of the services of personnel. The nature of the services - cast as 'business support services' by assessee - as also clearly within the hold 'technical or consultancy’.
- In terms of India-Canada DTAA, the make-available test would be satisfied. The secondees are not only providing services to assessee, but rather tiding assessee through the initial period, and ensuring that going forward, the skill set of assessee's other employees is built and these services may be continued by them without assistance.
- In relation to the existence of PE:
  - Seconded employees retained <u>their entitlement to participate in the overseas entities' retirement and social security plans</u> and other benefits in terms of its applicable policies
  - Whilst CIOP was given the right to terminate the secondment, (in its agreement with the overseas entities) the services of the secondee vis-à-vis the overseas entities - <u>the original and subsisting employment relationship - could not be terminated</u>. Rather, that employment relationship remained independent, and beyond the control of COIP.
  - <u>Obligation to pay the salary rested with the overseas entities</u> and the right of the employee to claim it is only against the overseas entities.
  - The seconded employees in the present case, oversee quality control of the work of such vendors. This work <u>cannot be characterized as mere stewardship</u>.
  - The seconded employees are to be integrated into assessee, for the agreed period and are subject to its supervision and control. The overseas entities were not responsible for any errors or omissions of such seconded employees or for their work. These limited and sparse factors cannot displace the larger and established context of employment abroad.

Secondment vs FTS / PE - Judicial precedents

Northern Operating Systems, [2022] 138 taxmann.com 359 (19 May 2022)

Ruling of the SC:

- Where employees were seconded to assessee by group overseas entity, assessee was service recipient for manpower recruitment and supply services, and assessee would be liable to pay service tax.
- The SC observed the following:
  - Employees were under control of assessee, and worked under its direction
  - Overseas employer paid them their salaries and their terms of employment even during secondment were according to policy of overseas company
  - Employees would return to their overseas employer upon cessation of term of secondment and may be sent elsewhere on secondment
  - In case it was dissatisfied, assessee could only ask for return of the employee to her or his original position with the foreign employer.

Secondment vs FTS / PE - Judicial precedents

Flipkart Internet (P.) Ltd. vs DCIT [2022] 139 taxmann.com 595 (Karnataka) (24 June 2022)

Ruling of the Karnataka HC:

- What would be of significance is the relationship between the petitioner and the seconded employees during the period of secondment that has been lost sight of while passing the impugned order. Arter the period of secondment or its termination, the fact that 'Walmart Inc.' has the power to decide on the employees' continuance with 'Walmart Inc.' would not make any difference, as it would relate to a service condition post the period of secondment.
- Further, the mere payment by 'Walmart Inc.' to the seconded employees would not alter the relationship, as the petitioner only seeks to make payment to 'Walmart Inc.' of its payment to the seconded employee which is stated to be by way of reimbursement.
- It is not a case where the petitioner is merely acting as a back office for providing support service to the overseas entity, whereby the overseas entity could be treated as an employer. The petitioner issues the appointment letter, the employee reports to the petitioner, the petitioner has the power to terminate the services of the employee. For the purpose of a limited finding under section 195 on the basis of the available material, it could be concluded that the petitioner is the employer.
- The Apex Court in the particular facts of the case (Northern Operating Systems) had held that the Overseas Co., had a pool of highly skilled employees and having regard to their expertise were seconded to the assessee and upon cessation of the term of secondment would return to their overseas employees.
- It needs to be noted that the judgment rendered was in the context of service tax and the only question for determination was as to whether supply of manpower was covered under the taxable service and was to be treated as a service provided by a F Co to an I Co. But in the present case, the legal requirement requires a finding to be recorded to treat a service as 'FIS' which is "make available" to the I Co.
- Any conclusion on an interpretation of secondment as contained in the MSA to determine who the employer is would have no conclusive bearing on whether the payment made is for 'FIS' in light of the further requirement of "make available“.
- The agreement between assessee and 'W', if subjected to scrutiny as regards the aspect of secondment does not reveal the satisfaction of the requirement of 'make available' which is a sine qua non for being a 'FIS'. As the agreement does not support 'make available', further enquiry beyond that may not be called for, considering the nature and scope of proceedings.

Secondment vs FTS / PE - Judicial precedents

Morgan Stanley International Incorporated vs DDIT (2015) (53 taxmann.com 457) (Mumbai Tribunal)

Ruling of the Mumbai Tribunal:

- Para 6 of Article 12 makes it amply clear that taxability of 'royalty' and 'fees for included services' shall not apply, if the resident of the contracting state (USA) carries on the business in other contracting states (India) in which FIS arises through PE situated therein, then in such case the provisions of Article 7 i.e., "Business Profits“ shall apply. In other words, if there is a PE, then Royalty or FIS cannot be taxed under Article 12, albeit only under Article 7 of the DTAA.
- If the taxability of such payment has to be examined and determined on the basis of computation of business profit under Article 7, then the salary paid by the assessee would amount to cost to the assessee, which is to be allowed as deduction while computing the business profit of the PE in India.
- In our opinion, if logical conclusion of the decision of the Hon'ble Supreme Court in the case of *Morgan Stanley & Co* and the decision of *Hon'ble Delhi High Court in the case of Centrica India Offshore (P.) Ltd* is to be arrived at, then the seconded employees will constitute Service PE of the assessee in India and in that case any payment received on account of rendering of service of such employees will have to be governed under Article 7 as per unequivocal terms of para 6 of Article 12. Thus, the ratio laid down in the decision of Hon'ble Delhi High Court, will not help the case of the revenue in any manner because under the concept of PE, FIS cannot be taxed under Article 12, but only as a business profit under Article 7.
- It is very interesting to note that, similar provision is also embodied in the India-Canada DTAA in para 6 of Article 12, but this issue was neither raised or brought to the notice before the Hon'ble Delhi High Court nor it was contested by either parties. There is inherent contradiction in this concept, as in most of the treaties, exclusionary clause like Article 12(6) has been embodied, which makes the issue of taxability of FTS of FIS in such cases as non applicable and have to be viewed from the angle of Article 7.

Annexures

Annexure 1 - 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) - Assessee was doing business in Pakistan and India - It sold goods to buyers in Pakistan under C.I.F. contract with those buyers - Bills of lading was taken in names of buyers. Whether in general a seller appropriates goods by delivery of bill of lading in exchange for payment of price by which he shows that he does not intend to retain right of disposal of property in those goods - Held, yes - Whether, in instant case, sales caused by bills of lading in names of buyers took place outside India and, therefore, profits derived from said sales arose outside India - Held, yes

Points that merit 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

Annexure 2 - Offshore services

Taxability of offshore services in select instances:

- Services inextricably linked to supply of ‘goods’
  - Such services to not qualify as FTS under certain Indian tax treaties (viz. India-Israel, India-USA, India-Singapore)
- Technical services not linked to supply
  - 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 case of PE - taxable as business income if attributable to PE and not as FTS
- Non-technical services not linked to supply
  - Taxable in India to the extent it is attributable to business connection / PE of non-resident contractor in India

Annexure 3 - PE vs Subcontracting 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)

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