

8 August 2011

EY Tax Alert

AAR rules on taxability of income from offshore supplies



Executive summary

This Tax Alert summarizes a recent ruling of the Authority for Advance Rulings (AAR) [AAR No. 858-861 of 2009] in the case of LS Cable Ltd. (Applicant) on the issue of taxability of income from offshore supplies. Based on the terms of the contract as well as the documents submitted, the AAR held that the transaction for sale was concluded outside India. Therefore, no income from offshore supplies is liable to tax in India under the Indian Tax Laws (ITL). The AAR also ruled that even if the Applicant is said to have a permanent establishment (PE) in India, the same cannot be said to have any connection with offshore supplies. Consequently, no part of income from offshore supplies is taxable in India.

Background and facts

- ▶ The Applicant, a company incorporated in Korea, is engaged in the business of manufacturing electric wires and cables for power distribution.
- ▶ The Applicant was a successful bidder in the bids invited by an Indian company (ICo) for four different projects which involved supplying, laying, jointing, testing and commissioning of power cables.
- ▶ With respect to the above projects, the Applicant entered into three separate contracts with ICo:
 - ▶ Contract no. 1: Offshore supplies contract-for supply of equipment and materials, including mandatory spares on Cost, Insurance and Freight (CIF) basis

- ▶ Contract no. 2: Onshore supplies contract
- ▶ Contract no. 3: Onshore services contract

- ▶ The Applicant sought a ruling from the AAR on whether the consideration received/ receivable from ICo under Contract no. 1 for 'offshore supplies' is taxable in India under the provisions of the ITL and also under the India-Korea Double Taxation Avoidance Agreement (DTAA).

Applicant's contentions

- ▶ The title to the equipment and material was passed outside India and the payment for offshore supplies, too, was received in foreign currency outside India. Therefore, no income accrues or arises in India in respect of the offshore supplies contract. On this aspect, reliance was placed on the decision of the Supreme Court (SC) in the case of Ishikawajima-Harima Heavy Industries Ltd.^[1], which supports its view.

Tax Authority's contentions

- ▶ The Tax Authority had already filed a special leave petition (SLP) to appeal before the SC against an adverse order from the Delhi High Court on the issue of taxability of offshore supplies in the Applicant's own case, though, in respect of a

^[1] [288 ITR 408]

different contract. Therefore, it was proposed that the hearing in this case be deferred till the SC pronounced its order.

- ▶ The consideration for offshore supply of equipment is taxable in India under the provisions of the ITL, for the following reasons:
 - ▶ The separate contracts entered into are, in effect, 'composite contracts' and none of the contracts can exist without the other as breach of one is deemed to be a breach of the other contracts. Furthermore, offshore supplies were on CIF basis and all the contracts were signed on the same date. In the event of breach of any of the contracts, ICo (the employer) had a right to terminate the other contracts at the risk and cost of the Applicant.
 - ▶ The award of separate contracts does not, in any way, dilute the responsibility of the Applicant for successful completion of the overall project. Furthermore, the entire activity of offshore supplies and onshore supplies/services was to be rendered by the Applicant itself. The insurance requirements of the offshore supplies require that the Applicant would take out insurance of cargo, installation, worker compensation etc. Therefore, from the facts of the present case, the offshore supplies cannot be considered as a sale simpliciter. The project is for providing both offshore as well as onshore supplies/services. The Applicant had merely entered into different contracts and this would not extinguish its tax liability on independent consideration of each contract.
 - ▶ The delivery of equipment would not be complete till the same is commissioned on the site of ICo. Furthermore, full payments against offshore supplies were payable only after satisfactory demonstration of the equipment. Therefore,

under such circumstances, passing of title outside India is of little significance as far as the issue of taxability of income earned in the transaction is concerned. It cannot, therefore, be accepted that the offshore and onshore contracts were totally isolated and independent of the other. The Applicant has, rather, entered into a turnkey contract and, therefore, has a PE in India. Reliance was placed on the decision of the Madras High Court (Madras HC) in the case of Ansaldo Energia SPA ^[2].

AAR ruling

- ▶ Merely on the basis of filing the SLP before the SC, the application filed by the Applicant cannot be kept pending, especially when the question stands concluded by an earlier decision of the SC.
- ▶ Reliance is placed on the binding SC decision in the case of Ishikawajima (*supra*) and an earlier decision of the AAR in the case of Hyosung Corporation^[3] to support that offshore supplies are not taxable in India.
- ▶ The clauses in the offshore supplies contract regarding transfer of ownership, the payment mechanism in the form of letter of credit etc., established that the transaction of sale took place outside India. The transit risk borne by the Applicant till the goods reached the site in India

was not necessarily inconsistent with the sale of goods taking place outside India. The parties may decide between themselves as to when the title of the goods should pass. As the consideration for the offshore supplies had been separately defined in the contract, it could well be separated from the whole of the project consideration.

- ▶ The Madras HC decision in the case of Ansaldo (*supra*), relied on by the Tax Authority, wherein the contract for offshore supplies was held to be a 'composite contract' is distinguishable. In that case, the turnkey project, as a whole, was awarded to the applicant and, thereafter, the contract was split. It was found by the Tribunal that there was a façade created for the purpose of avoiding tax and that there was a price imbalance in the contracts which was skewed in favour of the offshore supplies contract, in order to minimize the tax liability. Subsequently, it was held that consideration for offshore supplies was taxable in India. However, facts of the present case are distinguishable. Nothing in law prevents the parties from entering into a contract which provides for sale of equipment for a specified consideration, although they were meant to be utilized in the fabrication and installation of a complete plant.
- ▶ Even if a PE is said to have existed in India for the Applicant, under Article 5 of the DTAA, the same would be for the purpose of carrying out the contract for onshore supplies/services and the same would have no role to play in offshore supplies. Even though the PE is involved in carrying on some incidental activities such as clearance from the port and transportation, it

cannot be said that the PE is involved with the offshore supplies.

- ▶ Accordingly, the Applicant is not liable to tax in respect of offshore supplies.

Comments

A ruling by the AAR is binding only on the Applicant, in respect of transaction in relation to which the ruling is sought and on the Tax Authority, in respect of the Applicant and the said transaction. However, it does have persuasive value and the Courts in India, the Tax Authority and the appellate authorities do recognize the principles and ratio laid down by the AAR, in deciding comparable cases.

This AAR ruling has reiterated the principle that income from offshore supply of equipment is not taxable in India, where essential conditions, such as passing of title in the goods, payment received outside India and conclusion of sale outside India are met.

^[2] [310 ITR 237]

^[3] [314 ITR 343]

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
HITECH City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi

9th Floor, Abad Nucleus
NH-49, Maradu PO
Kochi -682304
Tel: +91 484 3044000
Fax: +91 484 2705393

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby,
Dadar, Mumbai - 400 028.
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000

6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E), Mumbai - 400 063.
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

Ernst & Young Pvt. Ltd.

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit

www.ey.com/india

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young Private Limited is one of the Indian client serving member firms of Ernst & Young Global Limited.

Ernst & Young Pvt. Ltd is a company registered under the Companies Act, 1956 having its registered office at 22, Camac Street, Block C, 3rd Floor, Kolkata- 700016

© 2011 Ernst & Young Pvt. Ltd.
All Rights Reserved.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young Pvt. Ltd. accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.