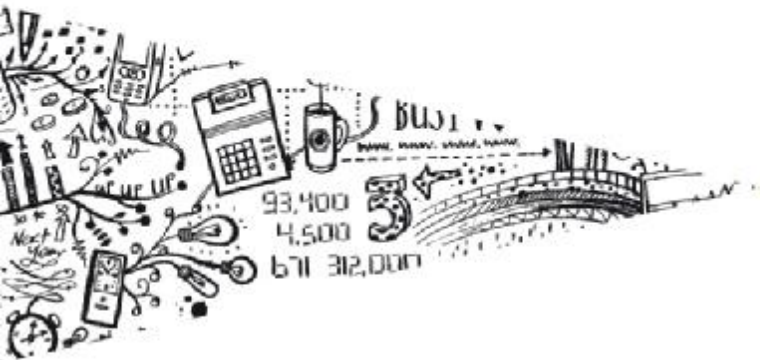


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EY Tax Alert

Delhi ITAT ruling on whether a project office constitutes a permanent establishment



Executive summary

This Tax Alert summarizes a recent ruling of the Delhi Income Tax Appellate Tribunal (ITAT) [ITA No. 5237/Del/2010]^[1] in the case of Samsung Heavy Industries Co. Ltd. (Taxpayer). The issue before the ITAT was whether, in the facts of the case, the project office (PO), which was not restricted in terms of regulatory approval from the conduct of commercial activities, constituted a permanent establishment (PE) in terms of Article 5 of the India-Korea Double Taxation Avoidance Agreement (DTAA). The ITAT held that the installation PE clause of the DTAA is not to be read in isolation and the same extends to the scope of PE, as envisaged under Article 5(1) of the DTAA. The ITAT held that, in the facts of the case, the Supreme Court (SC) decision in the case of Hyundai Heavy Industries^[2] is not applicable as the SC was concerned with execution of divisible contract, involving two components of supply and installation, whereas the Taxpayer, in the present case, was concerned with execution of composite turnkey contract.

Background and facts

- ▶ The appeal under reference related to the tax year 2006-07. The Taxpayer, along with another Indian company, entered into a turnkey contract with Oil and Natural Gas Corporation (ONGC) in February 2006 for the purposes of survey (pre-

engineering, pre-construction/pre-installation and post-construction), design, engineering, fabrication and installation of the facilities. In terms of the mandate of the contract, an application was filed with the Reserve Bank of India (RBI) for setting up a PO in Mumbai, India.

- ▶ The Board of Directors' resolution (Board resolution) indicated that the PO was set up for coordination and execution of the project in India. The RBI approval was received in May 2006, which did not place any restrictions on the PO's activities.
- ▶ The fabrication work relating to the contract was given to an unrelated entity in Malaysia. The fabricated equipment was received in the subsequent tax year.
- ▶ The Taxpayer filed its tax return declaring a loss in respect of its India operations. Such loss was reduced in tax assessment on account of certain adjustments.
- ▶ In respect of its offshore operations, the Taxpayer had claimed that it did not trigger any tax liability in India. Accordingly, no amount of income was returned in respect of offshore operations. However, the Tax Authority attributed 25% of its revenue, related to outside India activity, as income attributable to the PE in India. The order was passed by the Tax Authority pursuant to directions received from the Dispute Resolution Panel. Aggrieved, the Taxpayer filed a direct appeal before the ITAT challenging the tax assessment.

Tax Authority's contentions

- ▶ Reliance was placed on the Board resolution and the RBI approval for setting up the PO and, based on the reading of the terms of the contract, the Tax Authority argued that the PO constituted a fixed place of business of the Taxpayer and, consequently, a PE in terms of Article 5 of the DTAA.
- ▶ The PO was actively involved in the bidding process, pre-bid meetings, negotiations and submissions of the tender documents/process of award of contract and, therefore, the PO was involved in execution of the core functions of the Taxpayer. As the title to the goods passed to ONGC only after the completion of the project and successful acceptance by ONGC in India, it was observed that the entire project was carried out in India. The consideration was for the full contract to be executed in India and, therefore, income earned by the Taxpayer, with respect to activities carried on outside India, should also be liable to tax in India.
- ▶ The very fact that the Taxpayer furnished tax return, declaring income from activities carried on within India, indicates that the Taxpayer had no doubt about the existence of a PE.
- ▶ To constitute a PE under Article 5(1) of the DTAA, there should be a fixed place of business and the business of the enterprise should be wholly/partly carried on through such fixed place. In the

^[1] Source: <http://www.itatonline.org/>

^[2] [291 ITR 482]

present case, the first condition was satisfied as the PO was a fixed place having an address in India. Furthermore, contemporaneous documents and the Board resolution support the fact that the PO was set up for coordination and execution of the project and, therefore, the second condition was also fulfilled. Thus, the PO constituted a fixed place of business for the Taxpayer and, consequently, a PE under Article 5(1) of the DTAA.

- ▶ The Taxpayer's contention that no material evidence was placed by the Tax Authority, with respect to any commercial activity carried on by the PO, should not be accepted for the reason that the Board resolution was a positive evidence to show that the PO was established for coordination and execution of the contract with ONGC. In view of such positive evidence, which amounts to self-admission on the part of the Taxpayer, no further evidence would need to be furnished by the Tax Authority. Onus lies on the Taxpayer to prove that no part of its income was taxable in India despite the existence of a PE in India.
- ▶ According to the scheme of Article 5, fixed place PE under Article 5(1) is the primary form of PE which comes into existence if the above twin conditions are fulfilled. Such fixed place PE is based on a 'permanence test', irrespective of the nature of business carried on. To take care of situations where the permanence test is not likely to be met, Article 5(3) lays down a 'duration test', in respect of installation projects, for a PE to exist. However, Article 5(3) does not preclude application of Article 5(1) of the DTAA and, thus,

it cannot be argued that there exists no fixed place PE in case of installation project mentioned in Article 5(3). Therefore, provisions of Article 5(3) cannot override the provisions of Article 5(1) of the DTAA.

- ▶ The terms of the contract and the contemporaneous Board resolution etc., clearly indicate that ONGC had to continuously coordinate with the Taxpayer and, for this very purpose, the Taxpayer set up a PO in India. Such activity carried on by the PO is a vital part of the contract and, therefore, cannot be said to be 'preparatory' or 'auxiliary', as required for exemption in terms of Article 5(4) of the DTAA.
- ▶ Various clauses of the contract show that the contract is indivisible and that the contract was taxable in India, right from the beginning, to the extent of profit which can be attributable to the PE in India.
- ▶ The SC decision in the case of Hyundai Heavy Industries (*supra*) cannot be applied to the present case as there is a material difference in the facts of the case.
- ▶ In the facts of the case, the Taxpayer is liable to pay tax on the revenue received or receivable in respect of the project to the extent of profit which is attributable to the PE in India, irrespective of the fact that the activities are carried out either in India or outside India.

Taxpayer's contentions

- ▶ The consideration received was with respect to 'offshore supply' and 'offshore services' as well as for the sale of supplies effected outside India and, therefore, no portion of the offshore consideration is taxable in India. Furthermore, the requirement to perform certain services in India, such as unloading, port clearance, transportation of the equipment supplied, is not taxable as the consideration thereof was embedded in the consideration for 'offshore supply'. Reliance was placed on the SC decision in the case of Hyundai Heavy Industries (*supra*) to state that offshore supply and services cannot be taxed in India.
- ▶ As per Article 7(1) of the DTAA, India can tax profits only if the business is carried on through a PE situated in India. Thus, existence of a PE is an essential element for taxability. This is also subject to the satisfaction of the condition that the business should be carried on through such a PE. Furthermore, activities carried out through a fixed place would not constitute a PE if the same are in the nature of 'preparatory' or 'auxiliary'.
- ▶ The project was awarded in February 2006 and an approval for setting up the PO was obtained, later on, in May 2006. The PO was not involved in pre-contract meetings which were carried out prior to setting up of the PO.
- ▶ The PO employed non-technical personnel to act as a communication channel between the Taxpayer and ONGC. The Tax Authority had also not placed any evidence on record to suggest that

the PO had undertaken anything apart from acting as an interface between the Taxpayer and ONGC. The books of account maintained and the level and nature of expenditure incurred clearly suggest that the PO had no role in carrying on the core business activities in India. The activities of the PO were 'preparatory' or 'auxiliary' in nature *vis-à-vis* the scope of the overall project of designing, engineering, fabrication and installation and, consequently, the PO cannot be said to have constituted a PE in India under Article 5(1) of the DTAA.

- ▶ Article 5(3) of the DTAA deals with installation PE, which comes into existence only if the time threshold of nine months has elapsed. As the Taxpayer was engaged in executing installation projects in India, the activities carried out were clearly covered within the specific provision and, therefore, the provisions of Article 5(3) should have an overriding effect over the general provisions under Article 5(1)/(2) of the DTAA. Reliance was also placed on the Delhi ITAT decision in the case of Hyundai Heavy Industries^[3] to support that mere existence of a PO cannot constitute a PE, given the nature of the contract which was predominantly in the nature of installation project.
- ▶ The contract of the Taxpayer is divisible in two parts viz., the supply of fabricated platform to be deported from Malaysia and a separate component of installation. The supply of fabricated platform cannot be attributed to installation PE which came into existence only at

a later point of time.

- ▶ The onus of proving that the PO was in existence for carrying out revenue generation activity is on the Tax Authority.

ITAT's ruling

Composite vis-à-vis divisible contract

- ▶ The facts of the case suggest that the project was a composite one which commenced with survey activity and comprised pre-engineering, pre-construction/pre-installation and post-construction activities, including design, engineering, procurement, fabrication, installation, testing etc.
- ▶ Existence of PO was a condition precedent to the commencement of the composite contract. The terms of the contract made it clear that the installment of payments became due only after the performance guarantees were furnished and the RBI permission for setting up the PO was available.
- ▶ The consideration for all the activities was a fixed price without any possibility of revision on account of escalation. Also, the payments were released on provisional basis as advance, depending on the milestone of the payment schedule provided in the contract. The payment schedule did not indicate components to which the consideration related to.

- ▶ In the facts of the case, the contract was a composite contract which was expected to last for more than two years.

PO and its relevance to the emergence of PE

- ▶ The contemporaneous documents in the form of Board resolution, RBI application and approval etc. make it clear that the PO was not restricted from carrying on any business activity. In fact, the Board resolution made it clear that the PO was for coordination and execution of the project in India.
- ▶ The PO constituted a fixed place of business of the Taxpayer in India. The documents on record indicate that all activities to be carried out in respect of the project were routed through the PO. Thus, the PO constituted a PE in terms of Article 5(1) of the DTAA.

Non-applicability of the SC decision in Hyundai Heavy Industries (supra)

- ▶ The SC decision in the case of Hyundai Heavy Industries (*supra*) was concerned with the contract which was divisible into two parts viz., fabrication and installation. Also, in that case, the taxpayer merely had a liaison office (LO) in India. Admittedly, there was no other place of business which the taxpayer had in India, prior to fabrication work which was completed outside India. As a result, the SC held that the fabrication work did not relate to a PE in India.
- ▶ As against that, in the present case, admittedly, the PO was set up for coordination and execution

^[3] [31 SOT 482]

of the project and, hence, constituted a fixed place PE. Furthermore, the Taxpayer, wholly or partly, carried on its business activities in India and, hence, satisfied the conditions for the emergence of a PE.

Interplay of Article 5(1)/5(2) and 5(3)

- ▶ Article 5(1) defines the term 'PE' to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. Furthermore, Article 5(2) provides an illustrative list (branch, office, factory, workshop etc.) which would constitute a PE. Thus, Article 5(2) has enlarged the meaning of the term 'PE' in addition to what has been provided in Article 5(1). Furthermore, Article 5(3) uses the words 'likewise encompasses' and these items are a building site, a construction, assembly or installation project or supervisory activity in connection therewith, but only in a case where such site/project or activity continues for a period of more than nine months. This provision has further enhanced the term 'PE' to such activities as well. Therefore, it may not be appropriate to suggest that Article 5(3) is an exclusionary clause, restricting the scope of Article 5(1)/(2) of the DTAA. Article 5(3), therefore, cannot be read in isolation. If a PE exists in terms of Article 5(1)/(2), it is not necessary to trigger installation PE under Article 5(3) as a condition to trigger tax liability.
- ▶ Reliance placed on the Delhi ITAT decision in the case of Hyundai Heavy Industries (*supra*) is incorrect as, in that case, only the LO was permitted to be set up and the taxpayer was not allowed to carry out any business activity.

Exclusion with respect to 'preparatory' or 'auxiliary' activities

- ▶ The terms of the contract and the manner in which the work was carried out clearly suggest that the PO was involved in all the activities carried out by the Taxpayer. Thus, the benefit of exclusion with respect to 'preparatory' or 'auxiliary' activities is not available.
- ▶ The accounts and the nature of expenditure reflected in the accounts do not conclusively determine the character of the PE or the role played by the PE.
- ▶ The onus is on the Taxpayer to prove that, despite the clear terms of the contract, the PO had limited responsibilities in the matter of execution of the contract.

Profit attribution

- ▶ The Tax Authority is not justified in attributing 25% of the offshore income to the PE in India. The profit attribution is required to be done, having regard to the extent of the activities of business carried on by the Taxpayer through such a PE.
- ▶ The matter is restored back to the Tax Authority to determine the income which can be attributed after considering the relevant material and after granting appropriate opportunity of hearing to the Taxpayer.

Comments

There has been a spate of litigation on taxability of turnkey contracts. This decision, however, has not dealt with taxability under the provisions of the Indian Tax Laws but has considered the taxability on account of the PO constituting a PE in India in terms of Article 5 of the DTAA. Determination of existence of a PE is a fact-based exercise.

The present decision appears to be on the peculiar facts of the case. The ITAT itself has opined that its earlier ruling in case of Hyundai Heavy Industries (*supra*) was not applicable to the present case.

Furthermore, the aspect of whether or not the composite contracts and the responsibilities need to be evaluated from a tax perspective, having regard to the territorial nexus as elaborated by the SC in the case of Ishikawajima Harima Heavy Industries^[4], has not been evaluated and applied by the ITAT.

As regards attribution, only profits properly attributable to the functions performed through the PO, taking into account the assets used and the risks assumed, are to be attributed to such a PE. If the PE is not involved in any of the activities carried on directly by its head office, no profits should be attributed to such a PE. This aspect seems to have been recognized by the Taxpayer.

^[4] [288 ITR 408]

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