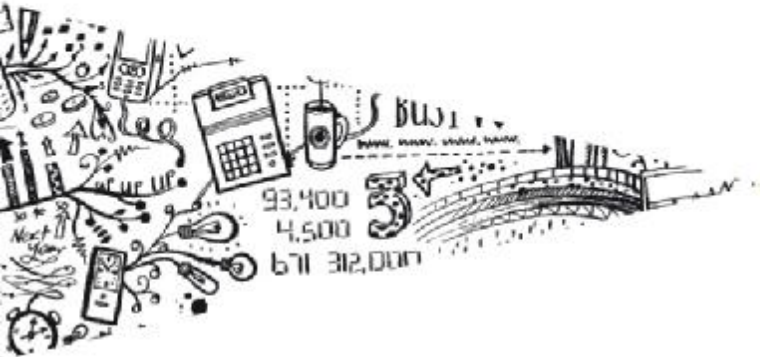


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EY Tax Alert

Uttarakhand HC rules no Construction PE if specified time threshold is not exceeded



Executive summary

This Tax Alert summarizes a recent ruling of the Uttarakhand High Court (HC) in the case of BKI/HAM VOF (Taxpayer). The issue before the HC was whether the dredging activities carried on by the Taxpayer for a period of less than six months in India constituted a permanent establishment (PE) in terms of Article 5 of the India-Netherlands Double Taxation Avoidance Agreement (DTAA). The HC, based on the facts, held that the Taxpayer did not constitute a Construction PE under the DTAA as the contract carried on by the Taxpayer did not exceed the threshold provided under the DTAA, i.e., six months. The HC also held that the Construction PE rule is more specific and takes precedence over the Basic PE rule under the DTAA.

Background and facts

- ▶ Under the DTAA, income in the nature of business profits of a non-resident is taxable in India only if the non-resident has a PE in India.
- ▶ Under the DTAA, 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 (Basic PE). Furthermore, Article 5(2) provides an illustrative list (branch, office, factory, workshop etc.) which could prime facie be regarded as a PE under Basic PE rule. Additionally, Article 5(3) provides that a building site or construction, installation or assembly project would constitute a PE only where such site or project continues for a period of more than six months (Construction PE).

- ▶ The appeal under reference related to tax year 1993-94. The Taxpayer, a partnership firm, organized under the laws of Netherlands, entered into a sub-contract agreement in India for dredging activities (contract) which commenced in India on 27 December 1993. The contract was completed on 12 June 1994. It is pertinent to note that the contract was spread over to two tax years, but the total duration of the contract did not exceed six months. Furthermore, the Taxpayer had an office in India.^[1]
- ▶ The Taxpayer contended that dredging activities fell within the scope of Construction PE rule of the DTAA. Since the contract was carried on for a period lesser than six months, it did not constitute a Construction PE under the DTAA and, hence, income was not taxable in India.
- ▶ However, the Tax Authority passed an order wherein it held that the office of the Taxpayer in India constituted a PE under the Basic PE rule of the DTAA and the Construction PE rule of the DTAA was immaterial. Accordingly, the income of the Taxpayer was taxable in India.
- ▶ The First Appellate Authority ruled in Taxpayer's favor and held that the contract executed came within the purview of the Construction PE rule and the same was not taxable as the duration of the contract did not exceed six months. Furthermore,

^[1] However, the HC decision does not throw any light on the time period for which the office existed and whether the office was set up in relation to the contract. The Tribunal order [70 TTJ (Del) 480] for tax year 1994-95 provides that the office in India carried out work in the nature of preparatory and auxiliary character in relation to the contract in India.

the First Appellate Authority held that the Construction PE rule is more specific and takes precedence over the Basic PE rule. Also, since the contract extended over two tax years, i.e., 1993-94 and 1994-95, the First Appellate Authority relied on the Second Appellate Authority's order for tax year 1994-95, wherein, based on the facts, it was held that the Taxpayer did not constitute a Construction PE under the DTAA.

- ▶ The Second Appellate Authority dismissed the Tax Authority's appeal.
- ▶ Aggrieved, the Tax Authority filed an appeal before the HC.

Ruling of the HC

- ▶ The Construction PE rule of the DTAA provides that in order to constitute a PE, the site or project should continue for a period of more than six months. Such site or project as used in the Construction PE is provided under the Basic PE rule of the DTAA and, therefore, it should continue for a period of more than six months in order to constitute a PE.
- ▶ Furthermore, based on the facts provided by lower appellate authorities that the contract was for less than six months, the Taxpayer did not constitute a Construction PE in India under the DTAA and, hence, the income from dredging activities is not taxable.

- ▶ The HC also held that, the Construction PE rule provides a specific provision which would prevail over the general provision of the Basic PE rule and, hence, the Taxpayer did not constitute a PE in India.

Comments

Explicit time threshold requirements apply to the construction site aspects of the PE definition in both the OECD and UN Model conventions (although the time periods differ). Similar explicit time threshold has been incorporated in India's DTAA's. Such time thresholds provide certainty for taxpayers and tax authorities. The HC's affirmation that the specific time-threshold of the Construction PE rule would prevail over the Basic PE rule, which provides a fact-and-circumstances approach, is, therefore, welcome. The ruling also confirms that an office set up in connection with a construction or installation project would not, by itself, constitute a PE if the conditions for constituting a Construction PE are not satisfied.

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

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