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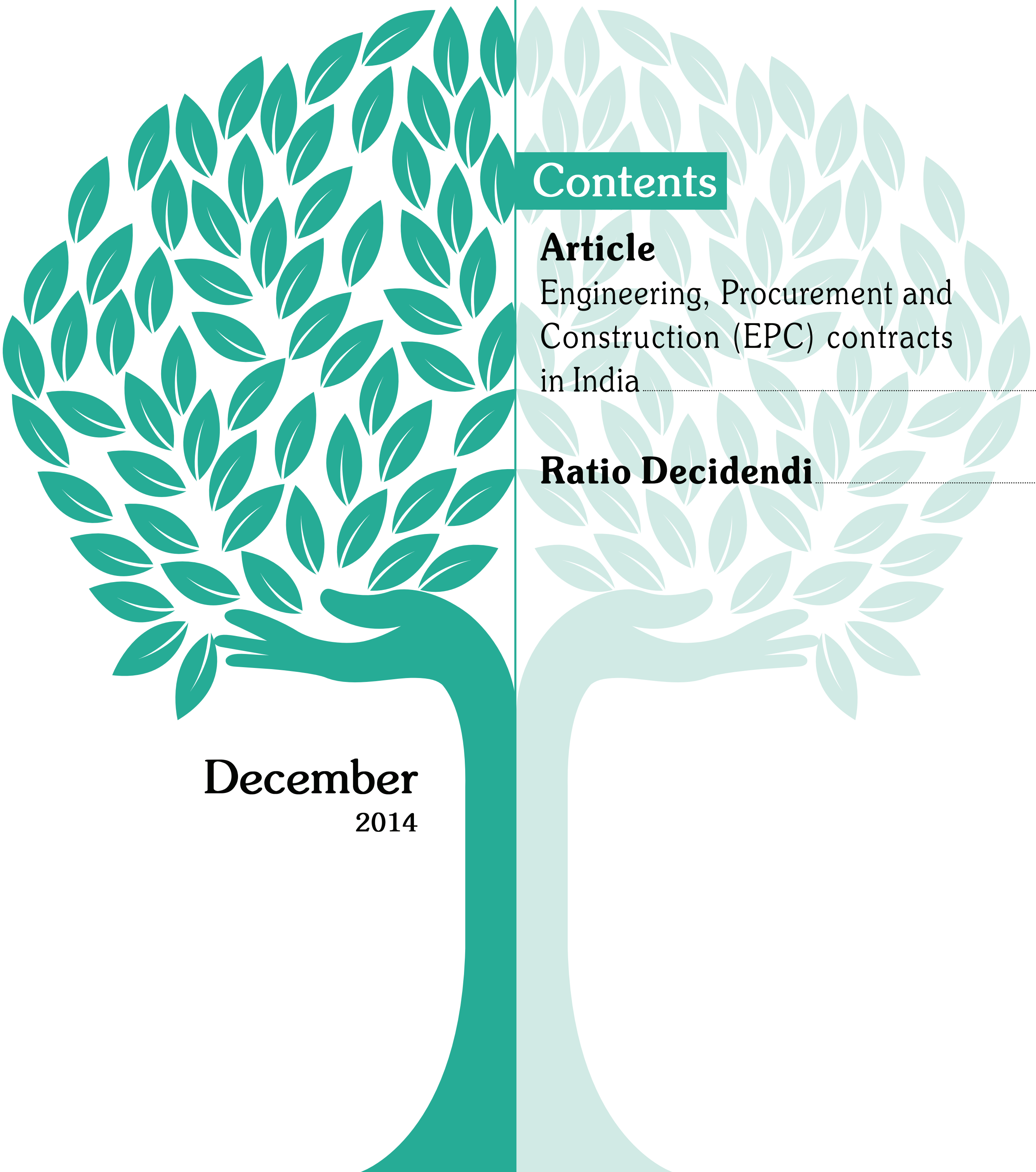

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Engineering, Procurement and Construction (EPC) contracts in India

By **Ashish Karundia**

The economic growth that India witnessed in last two decades has attracted Multinational Enterprises ('MNEs') to increase their business presence manifold in India. Many MNEs have won projects involving Engineering, Procurement and Construction ('EPC') to be undertaken on turnkey basis. An EPC contract generally involves supply of goods and services, both offshore and onshore. Such contracts may, either be a composite contract i.e. without any breakup of consideration towards goods and services, or on the other hand provide split up of the consideration. The present article aims at highlighting income tax issues that generally arise in relation to such projects.

India follows a blend of residence based and source based taxation. The treaty framework restricts taxability of MNEs with respect to profits from their unincorporated Indian ventures only to those cases where a Permanent Establishment is created in India or where the income is in the nature of 'fees for technical services'.

Existence of Permanent Establishment ('PE')

Presence of PE can attract tax on the income attributable to the PE at the rate of 40% as against regular corporate tax rate of 30%. Generally the MNEs maintain *project office* in India in order to efficiently execute the EPC contract. Indian courts have in some cases held a permanent establishment of a foreign enterprise to have resulted because of the project office in India observing that the activities of installation etc were routed through such office.[1]

Generally time threshold of 6 months is required to invoke Installation / Supervisory PE and time threshold for each project is taken individually. Unless properly structured the tax authorities may find that multiple projects are interconnected and apply an aggregate approach for determining whether PE threshold is met. Many Indian treaties have specific clauses for *installation and supervisory* PE. Depending on the treaty language and facts of a particular case, mere performance of supervision without undertaking installation, construction, etc., can in some cases create a PE.

Some of the Indian treaties recognize furnishing of services (beyond a specific threshold) also as a PE creating activity. The tax authorities tend to invoke Service PE clause where they are not able to justify existence of Installation / Supervisory PE. They allege that the visit of technical personnel for rendering onshore services in respect of the EPC contract gives rise to Service PE. The exception is where the services rendered constitute 'technical services' *(infra)* which itself may be taxable in India as source country both under its domestic law and treaty.

[1] Samsung Heavy Industries Co. Ltd. v. ADIT, ITA No. 5237/Del/2010 (ITAT Delhi).

Commencement of PE

The point of time at which the PE is said to have been set-up is also an aspect that requires due attention. In certain cases, attempt has been made by the tax authorities to justify that PE comes into existence from the time when first activity was undertaken by the foreign enterprise even though at that point of time the activity may only have been preparatory or auxiliary in nature. Maintenance of robust documentation corroborating the real nature of activities is extremely essential to mitigate such exposure.

Offshore supply

Supplies made offshore, conceptually should not give rise to tax implication in India[2]. The contracts at times indicate that the supply is complete and title over goods pass only after satisfaction of certain conditions in India. In such cases, tax authorities have at times endeavoured to tax the offshore supply. This happens especially when there is a composite price[3] for the contract. In exceptional cases tax authorities have observed that consideration towards non-taxable offshore supplies is inflated so as to reduce the tax impact on taxable onshore activities[4]. A justification of price break-up (on the lines of a transfer pricing study) is imperative in such cases.

Offshore services such as design, drawings, documentation etc. constitute inextricable part of offshore supply and usually entitled for similar treatment. A detailed examination of the facts and documents in some cases has revealed that what is ostensibly a payment for assignment of design is in law a payment in the nature of fees for technical services and taxable under source rule.

Offshore services - Fees for technical services (FTS)?

Indian domestic law provides for source based taxation on consideration for services which are in the nature of managerial, technical or consultancy. Some of the Indian treaties also contain similar provision. It is pertinent to note that FTS is taxable in India on gross basis at the rate of 25%[5] or at the rate provided in relevant Double Tax Conventions ('DTC')[6], whichever is lower. Such services are usually excluded from the purview of Service PE but can be taxed as PE profits if the contract generating FTS is effectively connected with the PE. Some treaties, however, provide for a narrow definition of FTS and in such cases the consideration may not attract tax either as PE profit or as FTS.

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2 Ishikawajima-harima Heavy Industries Ltd. reported at [2007] 288 ITR 408 (Supreme Court), CIT v. Hyundai Heavy Industries Co. Limited [2007] 291 ITR 482 (Supreme Court), DIT v. LG Cable Ltd. 237 CTR 438 (Delhi High Court), DIT v. Nokia Networks OY [2012] 253 CTR 417 (Delhi High Court), Joint Stock Company Foreign Economic Association 'Technopromexport', In re, 322 ITR 40 (Authority for Advance Rulings), Hyosung Corporation, In re, 314 ITR 343 (Authority for Advance Rulings), DCIT v. Roxon Oy. 291 ITR (T) 275 (ITAT Mumbai), Toshiba Plant Systems & Services Corp., Japan, In re, 332 ITR 456 (Authority for Advance Rulings).

3 Linde AG, In re, [2012] 349 ITR 172 (Authority for Advance Rulings), Alstom Transport SA [2012] 349 ITR 292(Authority for Advance Rulings), Roxar Maximum Reservoir Performance WLL, In re, [2012] 349 ITR 189 (Authority for Advance Rulings).

4 Ansaldo Energia SPA.

5 Section 115A of the Income Tax Act, 1961.

6 0% to 25%.

Conclusion

As EPC projects involve huge amount of investment, MNEs need to be cautious in respect of the tax exposure and take necessary safeguards to optimize the tax cost. Careful drafting of the contracts, meticulous planning and diligent conformity of the conduct with the contract are key factors for keeping taxmen at bay.

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Ratio decidendi

Mutual arrangements are also subject to Transfer Pricing

The taxpayer entered into an arrangement to secure 'Call Options' in a disinvestment scheme, for a consideration. The taxpayer contended that the transaction would not be subject to transfer pricing as it did not result in a transfer of shares. The Tribunal held that the mutual understanding and arrangement was an action in concert between the parties for securing the option rights against consideration, which would certainly have a bearing on the profits, income, losses or asset of the associated enterprises. The Tribunal thus held that the transaction would be subject to transfer pricing, though it did not result in transfer of underlying shares. [*Vodafone India Services (P.) Ltd* v. *ACIT*, ITA 7514/Mum/2013, ITAT Mumbai, Order dated 10-12-2014]

Entity level approach for determining ALP would lead to cross subsidization of unconnected transactions and hence cannot be adopted

The taxpayer had entered into a series of international transactions including licensing of technology, import of raw materials, import of service spare, export of finished goods, export of service spares, etc. The taxpayer sought to determine Arm's Length Price (ALP) for all the transactions on a combined basis, adopting Transaction Net Margin Method at entity level. The Tribunal however held that adopting entity level approach for unconnected transaction would lead to cross subsidization of the international transactions, which was impermissible under the Income-tax Act [*LG Electronics India (P.) Ltd* v. *ACIT*, ITA 5140/Del/2011, ITAT Delhi, Order dated 8-12-2014]

JDA with conditional possession constitutes taxable 'transfer'.

The taxpayer, a land owner, entered into a joint development agreement (JDA) with a developer wherein, in lieu of giving possession of the land to the developer, he was entitled to 50% of the total constructed area. The taxpayer agitated that only conditional possession was given which is restricted to development of land and further that, it was mere promise to exchange assets and 'transfer' would thus crystallize only upon receiving the constructed area. The Tribunal held that the year in which the constructed area would be received is immaterial and the moment possession of land is handed over, a right to receive the constructed area would accrue on account of transfer of land. [*Sri N. S. Nagaraj*, ITA 676/Bang/2011, ITAT Bangalore, Order dated 1-12-2014]

Premature payment of deferred sales tax is not a remission of trading liability

The taxpayer, entitled to defer the sales tax liability under the deferral scheme, paid prematurely the amount of deferred sales tax at net present value and credited the balance to capital reserve which the Income Tax Department sought to tax under Section 41(1) of the Act. The High Court held that Section 41(1) applies only if the taxpayer has obtained any amount or benefit in respect of such loss or expenditure, which in present set of facts has not been fulfilled. Further, there is no remission or cessation of liability which may be trading one and thus, the said sum is not chargeable to tax. [*Sulzer India Limited* v. *CIT*, ITA 762 of 2013, Bombay High Court, Judgment dated 5-12-2014]

Transfer of rights in immovable property is a transfer of a capital asset

The taxpayer, a telecom network services provider, was allotted land on lease cum sale basis by Karnataka Industrial Development Board. Subsequently, it entered into the consortium agreement with third party wherein it agreed to transfer rights in the property. The taxpayer relying on Section 2(47)(vi) of the Act, agitated that there is no immovable property which is being transferred and further that there is no transferable right and thus no capital asset. Tribunal held that the property under consideration need not necessarily be an immovable property. The taxpayer certainly had rights in immovable property which have been transferred to the consortium, by which, the consortium has taken approvals and constructed buildings, hence there is a capital asset which is transferred within the definition of Section 2(47) of Act and thus chargeable to tax. [*Andhra Networks Limited* v. *DCIT,* ITA 966/Hyd/2013, ITAT Hyderabad, Order dated 26-11-2014]

Premium paid for buying back shares to ensure smooth running of business is deductible

Certain petitions were filed before the Company Law Board (CLB) against the taxpayer for oppression and mismanagement by shareholders. Complying with of the CLB's directions, the taxpayer settled the disputes by buying back shares from such shareholders at a premium. This amount of premium was claimed as revenue expenditure on the ground that it is the extinguishment of shareholdings of the recalcitrant shareholders with a motive to smoothen the running of taxpayer's business. The Income Tax Department disallowed it being on capital count. The Tribunal held that it was an expenditure incurred out of business expediency and the resultant share capital reduction was only consequential and therefore the entire premium is on revenue count. [*DCIT* v. *Brahma Corp. Hotels & Resorts Ltd.*, ITA No. 772/PN/2013, ITAT Pune, Order dated 2-12-2014]

Sale of SIM cards to distributors is a sale of 'right to service' and lacks principal-agency relationship

The taxpayer, a telecommunication services provider sells service products viz. starter kits (SIM cards) and recharge coupons to channel partners/ distributors. The Income Tax Department observed that these distributors are the commission agents of the taxpayer and thus treated the difference between MRP and the selling price as commission liable to TDS under Section 194H. The High Court referred to certain clauses in the agreements and held that there exists no relationship of principal and agency, further, the distributor has to pay consideration for the products provided and it was treated as sale consideration and furthermore, after such sale of products the distributors could not return them to the taxpayer and the ownership risks also vests with them. Thus Section 194H of the Act was held inapplicable as only a discount as opposed to commission was provided by the taxpayer and the sale of coupons or SIM cards only tantamount to sale of 'right to service'. [*Bharti Airtel Limited* v. *DCIT*, ITA Nos. 637-644 of 2013, Karnataka High Court, Judgment dated 14-8-2014]

'Genuine hardship' to be construed liberally for condoning of delay in filing of returns

The taxpayer, filed an application before CBDT for condoning delay in filing of return under Section 119(2)(b) of the Income-tax Act, since at that relevant time the office of the taxpayer was shifted and certain records were misplaced. The CBDT rejected this plea observing that the taxpayer was a habitual late filer. The High Court observed that the explanation offered by the taxpayer was not counterfeit or bogus, and it didn't obtain any undue advantage out of delay in filing of returns and therefore held that the expression 'genuine hardship' in Section 119(2)(b) of the Act should be construed liberally. [*Artist Tree Pvt. Ltd.* v. *Central Board of Direct Taxes*, W.P No. 3087 of 2006, Bombay High Court, Order dated 3-12-2014]