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Offshore supplies held to be taxable in India

The Delhi Bench of the Indian Income-tax Appellate Tribunal (ITAT) gave its decision that considering the facts of the case, income from offshore supplies was taxable in India

Facts of the case:

- Voith Paper GmbH (the taxpayer)¹ is a company incorporated under the laws of Austria. The taxpayer is one of the market leaders in concept, technology, project planning, sale, engineering, processing, sourcing and marketing of board and packaging paper machines.
- The taxpayer entered into two contracts with an Indian customer, the Century Pulp and Paper Company (the buyer), for equipment supply and service for commissioning of '620 TPD' multilayer packaging coated board plant (the packaging plant). The supply included engineering, designing, manufacturing, drawing and supplying of machinery for the packaging plant, whereas services included supervision, erection, start-up, training, commissioning, and performance test of the packaging plant.
- The taxpayer had filed its income-tax return on the following basis:
 - The income in respect of offshore supply of equipment was not taxable in India under the Income-tax Act, 1961 (ITA) as well as the India-Austria tax treaty;
 - The activity of supervision of erection of machines (supplied from outside India) exceeded six months. Thus, as per the India-Austria tax treaty the taxpayer had a deemed Permanent Establishment (PE) in India in respect of said service activity. The income from supervision services was offered to tax under the completed contract method.
- The taxpayer's income-tax return was selected for audit and the Assessing officer (AO) in the draft assessment order held that offshore supply was taxable as per Section 9(1)(i) of the ITA as well as per the provisions of Article 5 read with Article 7 of the India-Austria tax treaty on the following basis:
 - Both the supply and service contracts constituted a single composite contract;
 - The income from composite contract was deemed to accrue or arise in India because of the business connection in India;
 - The sale of equipment / machines was concluded in India and the PE in India played a role in the marketing. Thus, part of profit of supply of machinery of packaging plant is directly attributable to the PE of the taxpayer in India;
 - In the absence of standalone financials, the AO assumed a profit of 9.75% of the taxpayer company on supply, and attributed 35% of the profits related to supply to the PE in India.
- The Dispute Resolution Panel (DRP) upheld the AO's draft order.
- Aggrieved by the AO's final order, the taxpayer filed an appeal before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

¹ 116 taxmann.com 127 (Delhi ITAT)

Provisions relevant for the case under consideration, in brief:

- As per the provisions of Section 9(1)(i) of the ITA, income accruing or arising through or from any business connection in India is deemed to accrue or arise in India.
- As per Article 5(1) of the India-Austria tax treaty, PE means a fixed place through which the business of an enterprise is wholly or partly carried on.
- As per Article 7(1) of the India-Austria tax treaty, if an Austrian enterprise carries on business through a PE situated in India, then profit attributable to the PE is taxable in India.

Decision of the ITAT:

- The ITAT noted that the following four issues had emerged in the case under consideration:
 - Whether the supply contract and the service contract constitute a single composite contract?
 - Whether the income of the taxpayer was deemed to accrue or arise in India because of the business connection in India?
 - Whether the taxpayer had a PE in India relating to the supply of equipment?
 - Attribution of profits to the PE.

Issue 1 – Whether the supply contract and the service contract constitute a single composite contract?

- The ITAT noted the following facts which were relevant for the case under consideration:
 - The dominant purpose or intention of the parties was installation of the packaging plant under taxpayer's supervision.
 - The taxpayer specialised in manufacturing of equipment (such as 'Press section', 'Press rolls', 'Wire section', 'Coating section', 'Dryer section') required for setting up the packaging plant, and hence was involved in supply of the equipment.
 - The final acceptance of the equipment was dependent on the success of performance warranty test. Further, the service contract also had a provision of termination clause in case of failure of performance; return of machinery supplied under the supply contract; and refund of money.
 - It was not possible for the buyer to assemble or erect the packaging plant from any other contractor without the supervision of the taxpayer.
 - The equipment imported into India could be used only for the custom-made packaging plant and could not be used for any other customer.
- The ITAT held that the ratio in the case of Ishikawajima-Harima² was not applicable in the case under consideration, since:
 - In the case of Ishikawajima-Harima, two different parties had supplied and erected the plant;
 - In the case under consideration, a single party viz. the taxpayer was required to supply and erect the packaging plant. It was not possible for the buyer to erect the packaging plant without the supervision of the taxpayer. Further, the supply obligation and service obligation complemented each other and were interlinked.

² Ishikawajima-Harima Heavy Industries Ltd. vs DIT [2007] 158 Taxman 259/288 ITR 408 (SC)

- Considering the above, the conduct of the parties and the terms of the contracts, the ITAT held that both the supply and service contracts were intrinsically linked, not severable and composite. Further, the ITAT held that the taxpayer's accounting practice to recognise service revenue only on completion of the project, also supported the intention of the parties to treat the erection of the packaging plant as a composite project.
- The ITAT affirmed the cases³ relied upon by the Revenue authorities and held that the supply contract and the service contract represented a single, composite turnkey works contract.

Issue 2- Whether the income of the taxpayer was deemed to accrue or arise in India because of the business connection in India?

Whether the sale of goods / equipment took place outside India?

- The ITAT relying on the cases of Ishikawajima-Harima⁴ and Ericsson AB⁵:
 - Held that the fact that contracts were signed in India was not a relevant factor to determine the taxability of offshore supply of plant / equipment; and
 - Noted that offshore supply will not be taxable in India if the property and risk in the equipment passed outside India.
- With respect to the contention of the taxpayers that sale of the equipment took place outside India, the ITAT held that the title in property and risk to buyer passes only when parties to contract intend to transfer. The ITAT noted that in the current case:
 - Real intention of the buyer was to install the packaging plant;
 - Purchaser's scope of supply was related to the packaging plant as a whole;
 - Under the supply agreement:
 - The taxpayer had warranted performance of the packaging plant;
 - Warranty was with respect to the date of commissioning of the packaging plant;
 - Final acceptance of the machinery was subject to the final acceptance test;
 - On termination, the taxpayer was bound to return the price already paid;
 - The service contract also provided for return of equipment on termination which showed that both the supply contract and service contract are interconnected and composite;
 - The transit insurance was arranged by the taxpayer till the buyer's warehouse which meant that the risk during transit remained with the taxpayer. Thus, the transfer of ownership and risk to the buyer outside India remained on paper and was not acted upon;
 - The equipment were manufactured outside but they were not brought in a deliverable state in India as per the supply agreement;
 - Unlike in case of Ericsson AB⁵, the supply and supervision of installation or commissioning of the packaging plant was done by the taxpayer only.
- In view of the above, the ITAT held that the taxpayer had supplied parts of goods manufactured outside India which were further assembled in India to bring them in a deliverable state as per the supply agreement. Thus the property in the equipment sold, had passed in India and part of the consideration for offshore supply was taxable in India.

³ Indure Ltd. vs CTO [2010] 3 taxmann.com 542; State of Karnataka vs Bangalore Soft Drinks (P.) Ltd. 1998 taxmann.com 2005; Shanghai Electric Group Co. Ltd. vs Dy. CIT [2017] 84 taxmann.com 44/(Delhi ITAT); Roxar Maximum Reservoir Performance WLL, In re [2012] 21 taxmann.com 128

⁴ Ishikawajima-Harima Heavy Industries Ltd. vs DIT [2007] 158 Taxman 259/288 ITR 408 (SC)

⁵ DIT vs Ericsson AB [2011] 16 taxmann.com 371

Whether the taxpayer had a business connection in India?

- The ITAT relying on various cases⁶, noted that the following parameters were relevant for a business connection to exist in India:
 - Existence of a real and intimate relation between the activities carried on outside India by a non-resident and the activities carried out in India;
 - The relation contributes directly and indirectly to the earning of business income for the non-resident; and
 - An element of continuity between the business of the non-resident and the activity in India i.e. a stray or an isolated transaction would normally not be regarded as a business connection.
- The ITAT held that in the current case a business connection of the taxpayer existed in India on the following basis:
 - The part of the operations of the supply agreement were carried out in India and sale of goods was in continuation to the process of erection of the packaging plant;
 - There was an element of continuity from supply to successful supervision of the commissioning of the packaging plant. It was not a case of sale of off-the-shelf goods or a stray transaction;
 - The business operation done in India was a revenue generating activity.
- In view of the above, the ITAT held that the income of the taxpayer from offshore supply of equipment was deemed to accrue or arise in India as per Section 9(1)(i) of the ITA.

Issue 3 - Whether the taxpayer had a PE in India relating to the supply of equipment?

- The ITAT noted that:
 - The buyer had not ordered an off-the-shelf machinery but had ordered installation of the packaging plant;
 - The taxpayer was a manufacturer of the components of the packaging plant which were required to be assembled at the site in India;
 - The manufacturing and commissioning of the packaging plant was carried out in India and the supply of the equipment was only incidental to commissioning of the packaging plant;
 - The taxpayer's employees were present in India at the time of entry of the part of the machinery in India. These employees were instrumental in supervising the part of goods manufactured outside India, further assembling in India in order to bring them into a deliverable state as per the supply agreement;
 - The taxpayer had admitted existence of a service PE in India for supervisory activity under the service contract.
- In view of the above, the ITAT held that since the taxpayer's PE in India carried out part of the supply operations as per the supply agreement, a part of the profit from the supply agreement was taxable in India as per the India-Austria tax treaty.

⁶ CIT vs R.D. Agarwal & Co. [1965] 56 ITR 20 (SC); CIT vs Hindustan Shipyard Ltd. [1977] 109 ITR 158 (AP); CIT vs Atlas Steel Co. Ltd. [1986] 28 Taxman 462 (Cal); CIT vs Gulf Oil (Great Britain) Ltd. [1977] 108 ITR 874(Bom)

Issue 4 – Attribution of profits to the PE

- The ITAT held that in addition to the marketing activities or engineering survey pre or post awarding of contract (for which no information was filed by the taxpayer), the service PE had played a role in assembling and bringing the equipment to a deliverable state as per the supply agreement. Accordingly, relying on the case of Rolls Royce Plc⁷, the ITAT affirmed the Revenue's claim of profit attribution to the extent of 35%.

Comments:

- The issue of separate or composite contracts and taxability of offshore supply of goods has been a litigative issue. This ruling lays down key factors for treatment of contracts as a single composite contract or separate contracts, and taxability of goods sold from outside India.
- Taxpayers undertaking sale of goods from outside India may want to evaluate the impact of the said ruling on their arrangements.

⁷ Rolls Royce Plc vs DIT [2011] 13 taxmann.com 233



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