

Structuring of EPC Contracts – Tax and Other Issues

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1. INTRODUCTION

- 1.1. Infrastructure investment is pivotal to any country's economic and social well being. Absence or shortage of such investment impedes a nation's growth as well as its global competitiveness. Limitations in funding such inevitable investment have been a big spoil sport. The dilatory tactics of the contractors and the regulators are also contributory to a performance far from being satisfactory. As a result of all these, complex infrastructure projects appear to suffer from high levels of unmanageability. Despite ever growing technical expertise and know-how, these projects are plagued by cost and time over runs.
- 1.2. The steady increase in scale and complexity of capital projects yearns for a secure, seamless integrated management and hassle free completion of the project. A large project invariably involves interplay of a large number of suppliers to co-ordinate the timing, technology, logistics and finances. This necessitates that the project is divided into various phases from project initialisation to ultimate handover. Technical interfaces have to be integrated; project and management planned. Quality is to be uncompromised. To achieve this measures are defined; costs are estimated. With so many tasks to be executed and so much to be achieved, doing the entire project all by oneself has become almost impossible. EPC contracts (or sometimes called turnkey contracts) offer a solution to this 'complexity matrix'.
- 1.3. A turnkey is a type of project where the contractor or provider undertakes the entire responsibility from design through completion and commissioning. It is sold to the buyer as a 'completed' project. The turnkey model offers a balanced management of risk, price and value addition. In principle, it is a contract undertaken to fully design, construct and equip a manufacturing/ business/ service facility and handover the project to the purchaser when it is ready for operation. One such variant of turnkey contract is 'EPC contract'.
- 1.4. There is a philosophy that turnkey contract differs from EPC contracts in certain aspects. The first difference is in terms of the depth of the project – while EPC gets involved right from basic engineering plans and procedures; turnkey project entails more of technical procedures and performance. The second dissimilarity lies in EPC contract going a little further when compared with turnkey projects. While turnkey projects are generally involve responsibility for setting up of plant, EPC contracts



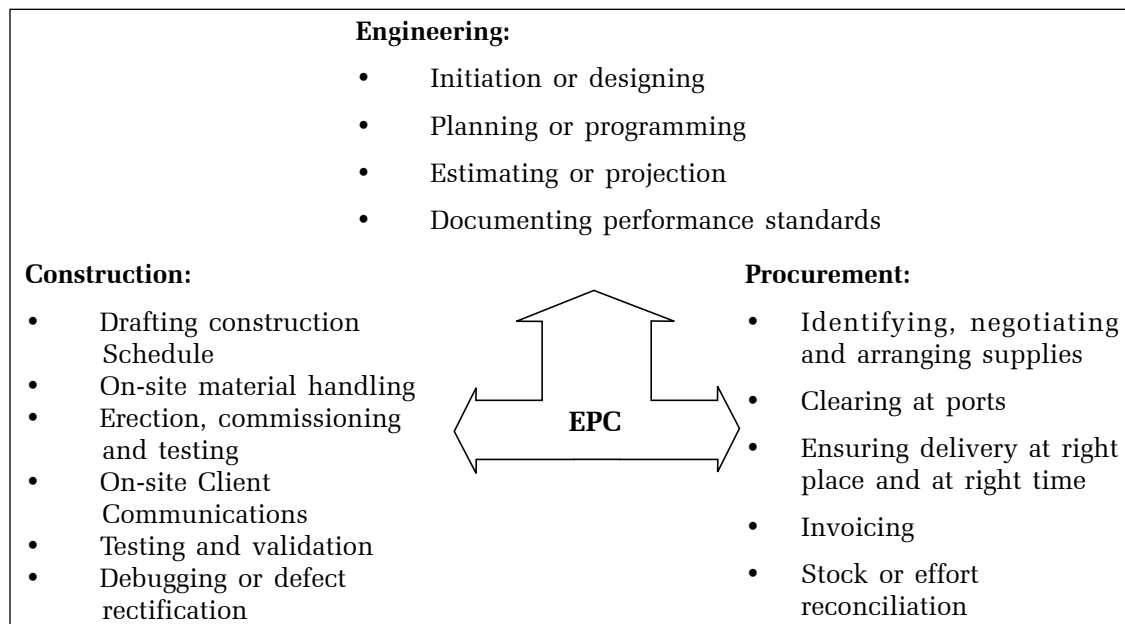
assume total responsibility as well as liability of commissioning the project, along with services which include project monitoring and skilled expertise in project execution.

- 1.5. This write-up presumes EPC as a variant of turnkey without harping on the subtle distinction between the two. This write-up deliberates on the various facets of EPC contract and income-tax implications thereon. Implications of indirect taxes in EPC are not dealt with although they are equally important and critical in decision making & execution procedures.

2. EPC CONTRACT – MEANING & CONTENTS

What is an EPC Contract?

- 2.1. EPC is an acronym for Engineering, Procurement and Construction. It is a contract involving combination of these three tasks. It is also called as ‘design and build’ arrangement. These arrangements involve placing the entire responsibility of design to construction/ installation on one person. This person is often addressed as the ‘contractor’. The responsibility assumed by the contractor is of such extent and nature that it reduces the role of project owner to contract administration.
- 2.2. Under an EPC contract, the contractor designs the installation, procures the necessary materials builds/ constructs the project, either directly or by outsourcing the work, along with associated touches of installation/ inspection/ quality control etc. The meaning of the three terms (ie, engineering, procurement and construction) has been defined and detailed in various literatures. Instead of picking these definitions or reiterating them, the scope of these three expressions in the present context has been pictorially depicted below:





2.3. Study of individual components of EPC when viewed on a standalone basis does not throw up any unique challenges from an income-tax stand-point. The challenges arise when components of the EPC contract are clubbed or when one component in the EPC is split. The peculiarity of EPC taxation lies in the flexibility available with the parties to contract to design the arrangement in a manner that suits them. Every new combination or split of these components results in distinct tax treatments. This write-up articulates those pressure points that one needs to be mindful of when structuring contracts and actions. This paper in no manner provides any guidance on structuring the transaction - for we abstain from travelling this formidable path. Further, time and size constraints have conditioned the approach of this write-up. The constituents of an EPC contract, the composition thereof, the work flow, commercial semantics, manner of securing them have not been detailed. What is being attempted is the outlining of a few topics and the principles attached thereto. As is the objective of the RRC, the attempt is to take the “thought process forward”.

Need for EPC contracts: (Single vs. multiple contracts)

- 2.4. At the initial stages of a project, a contract plan is chalked out that best suits the project objectives. Contract plan entails selecting the appropriate (organizational and contractual) policies required for the execution of a specific project. One such policy decision is to finalize on whether the organization wants a number of contractors to fulfill the various tasks in the project or whether to place the onus in the hands of a single project contractor. One may opt for the former if the organization wants to:
- (a) Decide which tasks to be carried out by whom (and whether certain portions of the project can be done in-house) – thereby take advantage of specialization and execute complex jobs through use of skilled personnel/ field experts;
 - (b) Enter into individual contracts and bargain with the respective contractors to achieve cost efficiency;
 - (c) Have a greater control over the quality of the deliverables and competence of the contractors.
- 2.5. This would mean that the project owner will need to:
- (a) provide the co-ordination and interface between various contractors/ sub-contractors;
 - (b) have the necessary skills and experience to undertake such co-ordination;
 - (c) invest substantial time in monitoring the proceedings of the project; and
 - (d) assume responsibility for project co-ordination and successful/ timely execution.
- 2.6. A project owner, who cannot afford to invest as aforesaid, would opt to deal with a single project contractor. This would place the responsibility for the entire project in the hands of the contractor. There is a shift in the project co-ordination as well as control from project owner to contractor. In other words, the onus of designing, procurement, installation, construction and commissioning is on the project contractor. The project contractor assumes responsibility of the entire project from planning to execution and handover the deliverable in a ‘ready to operate’ condition. This fastens



a huge importance on the project tender process. For, post commencement, the reins are handed over to the project contractor.

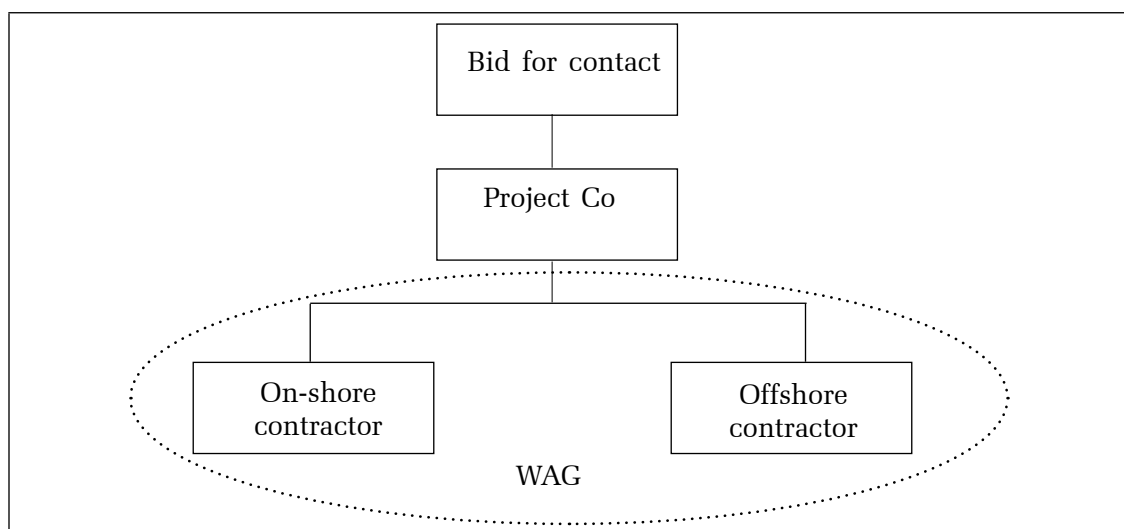
- 2.7. A project owner will have to be mindful of the feasibility, profitability, resource mobilization, cost-benefit analysis to carry out a project. Engaging a project contractor requires the owner to rely substantially or wholly on the integrity, acumen, and competence of the contractor. The cost and effort estimates are often preliminary and the variations invariably emerge. Handover of responsibility hence is often afflicted with uncertainty. The benefit of ‘single-point responsibility’ is nevertheless alluring for a project owner.

Contract Splitting

- 2.8. With the onset of modernization and globalization, business has transformed manifold. Commercial transactions are no more in-house. Import and export of goods or service is omnipresent. EPC contracts have also “travelled abroad”. Project owners are now seen reaching out to overseas contractors. Contracts which straddle several countries or jurisdictions are often accompanied by a multitude of problems owing their origin to the geographical diversity. This multi-locale presence induces enterprises to follow the ‘split approach’. There could be many reasons for such split. Some of the commercial reasons are as under:
- (a) Presence of various independent parties;
 - (b) Each party may have his/ its own bargaining or contract terms;
 - (c) The various contracts may be entered into at different point in time;
 - (d) Presence of parties with specialization at various locations (sometimes across borders);
 - (e) Restrictions and exemptions on procurement of goods/ services in certain cases.
- 2.9. The much larger and germane reason for splitting a cross border EPC contracts is often to mitigate or negate taxes on offshore receipts. Where there are restrictions on movement of capital from the host country, a further reason for employing the split EPC structure is to simplify profit repatriation. Splitting and customizing the project (and the players) paves way for an efficient and desirable structuring. This possibility along with a presence of variety of tax and fiscal incentives, help quantify the “tax costs” and mitigate outflows.
- 2.10. Under the classic split, an EPC contract is divided into two separate contracts - an ‘Onshore Contract’ and an ‘Offshore Contract’. This split is based on the locale and is called **‘Locational split’**
- 2.11. The responsibilities of the Offshore Contractor typically comprise of the supply of design and engineering services ‘offshore’ (i.e., outside the country) and the supply of offshore plant, equipment and materials (‘Equipment’). The responsibilities of the Onshore Contractor would typically include:
- a. the supply of equipment sourced from within the host country;
 - b. the installation of the above offshore equipment once that equipment has come ‘onshore’; and



- c. construction, testing, commissioning and other onsite activities (including some onshore design and engineering services) associated with the works.
- 2.12. There could also be a **‘functional split’**, wherein the entire EPC contract is dissected into supply; installation & erection; supervision; technical service and post sale service. Such split could be undertaken to avail the functional specialization, decentralization and segment wise taxation. Such functional split is often incentivised by benefits under the indirect tax regime.
- 2.13. An EPC contract is essentially a tool to allocate risks between the project company and the contractors. Project contractor being the face of the arrangement provides some sense of security to the project owner by providing a ‘one-point contact’ and ‘single point responsibility’. A ‘split EPC’ structure has the potential of diluting the ‘single point responsibility’ of the contract. This is because, with the splitting of contract, the responsibility is also distributed among the concerned contractors. This ‘responsibility sharing’ undermines the single point of responsibility for the delivery of the ‘turnkey’ project. Splitting the contracts also causes difficulty in fixing accountability (which would have otherwise rested with Project contractor).
- 2.14. In order to allay the fears of ‘non-accountability’ and fix the responsibility, split EPC structures have lead to the emergence of ‘Co-ordination Agreement’ or ‘Wrap Around Guarantee’ (WAG). A WAG is entered into between the contractors and the Project Company. It articulates the workscope of all the contractors involved; co-ordination of efforts; delivery time-lines; guarantee of successful accomplishment to the project owner (by the project leader/ contractor); etc. A WAG imposes a positive and direct obligation on contractors (both onshore and off-shore) to co-ordinate the execution of the works. The leader of the consortium usually also provides a warranty and representation that the separate scope of work in the split contracts when added together, constitutes the totality of the scope of the project. Under a WAG, liquidated damages are payable by the leader irrespective of the contractor in default. Any caps in liability in the split contracts are made subject to the overall cap in the wrap-around agreement. A typical arrangement very generically could be depicted as below:





3. CONCERNS FROM AN INCOME-TAX STANDPOINT

3.1. Having regard to the operational mechanics of EPC, the ensuing paragraphs provide an insight into the various concerns which the industry grapples with. The concerns discussed in this write-up are as under:

- (a) Contract splitting;
- (b) Obscurity in nature of income & variation in modus operandi;
- (c) Outsourcing in EPC arrangement;
- (d) Identity crisis;
- (e) Interplay of ICDS with Income-tax statute;
- (f) Relevance of presumptive basis of taxation;
- (g) Claiming relief under tax treaties:
 - Treaty eligibility;
 - Permanent establishment exposure
 - Profit attribution
 - Fees for technical service
 - Foreign tax credit
- (h) Tax withholding

CONCERN I: CONTRACT SPLITTING

Contract splitting – Tax concerns

- 3.2. In the context of EPC contract, a project owner may approach ‘one contractor’ or ‘multiple contractors’ or ‘group of contractors represented by an enterprise/entity’. One may enter into multiple contracts with the same contractor (for instance, designing contract, construction contract, supply and installation contract etc.) or a single arrangement with multiple contractors (being parties to one universal contract encompassing all the project activities). Contract(s) may assume various forms. They are primarily driven by commercial consideration but often conditioned by the tax implications. In nutshell, the goal of EPC contract is one; ways of attaining it are many.
- 3.3. The array of business mechanics is an index of ‘business freedom’. Indian Constitution bestows every citizen the freedom to do business as a matter of right. Undeterred freedom is however tempered with public interest. Globally also, lawmakers have struggled to balance between empowering contracting parties to enter into mutually beneficial arrangements and the need to fight against the possible misuse. Experience over time has driven and conditioned the regulators to view business structuring with a suspicious eye. The assessee or the businessman is thus left to opt between ‘regulatory peace in contractual simplicity’ and ‘potential gain from structural complexity’.
- 3.4. The challenges which spring from this multidirectional possibilities are as under:
- (a) Should the variation in routes (whether split approach or unified WAG arrangement or hybrid mechanics) to this goal (EPC project) have unique tax consequences?



- (b) Will an alteration in the methodology make an assessee better off (by mitigating tax exposure) or worse off (to demonstrate the bonafides)?
- 3.5. From an income-tax standpoint, splitting of contracts or creation of WAG arrangement poses unique challenges both for the assessee and the Revenue authorities. The concept of splitting of contracts pre-supposes ‘singularity’ or ‘unity’ of certain portions of the project or division of one contract into phases or stages. It is undisputed that if the split intends to circumvent or evade legal and procedural requirements, then such split ought to be ignored. An arrangement devoid of commercial purpose is often branded as a “make believe arrangement” undertaken to defraud revenue authorities. The *achilles heel* is deciphering such intent. The questions therefore which glare at us are:
- (a) Whether one would resort to **evidence and documentation** to separate wheat from the chaff or stay away from the modalities to view the matter holistically?
- (b) Do **judicial precedents** on this matter provide a unified view?
- (c) Is this yet another **battle between substance and form**?
- 3.6. **Documentation, substance or intent of parties – importance**
- 3.6.1. It is trite to state that documents of any transaction are critical. Documents serve as the proof to decipher the intent of any transaction. The documents have to be interpreted based on the intention of the parties as captured therein.
- 3.6.2. The importance of documentation and intention of parties has been given supremacy by courts on various occasions [*CIT vs. Motors & General Stores (1967) 66 ITR 692 (SC)*; *CIT vs. M. Sreedharan (1991) 190 ITR 604 (Ker)*; *W T Suren & Co. vs. CIT (1971) 80 ITR 602 (Bom)* and many others].
- 3.6.3. The Apex Court in the case of *Ishikawajima-Harima Heavy Industries Ltd. vs. DIT (2007) 288 ITR 408 (SC)* at para 60 had commented on interpretation of documents. It held:
- “In construing a contract, the terms and conditions thereof are to be read as a whole. A contract must be construed keeping in view the intention of the parties. No doubt, the applicability of the tax laws would depend upon the nature of the contract, but the same should not be construed keeping in view the taxing provisions.”*
- 3.6.4. The divisibility of contracts can be inferred from the various documents/information that evidence the EPC contracts. An indicative list is as under:
- Existence of separate agreements
 - Separate consideration agreed for each components
 - Invoicing
 - Minutes of the meeting/ board resolution
 - Custom duty documentation
 - CA certificate in Form 15CB
 - Pricing of the various components



- Bid/ offer documents
- Risk/ responsibility matrix of the arrangement
- General conditions of the contract including critical clauses such as “cross fall breach clause”¹

3.6.5. The decision to categorise the EPC contract (as one or multiple) is a collective study of all the relevant documents, information and surrounding facts thereto. None of the above documents or conduct could guide a decision on a standalone basis. Whether one resorts to documentation, substance of the matter or intent of parties; all these tests rely on the paper work and evidences that exist on ground. Their importance has been briefly highlighted below:

- (a) Agreements: These are primary sources of ascertaining the nature of transaction. The nomenclature used in the agreements is critical (whether supply agreement, service agreement etc.). The details of consideration involved have to be examined (whether a lump sum amount is prescribed or component-wise break-up is provided). The dates of agreement have a bearing in understanding whether such arrangements are an afterthought or a fall out of a strategy.
- (b) Bid/ offer documents & Invoice: The bid or offer documents spell out the expectation of the buyer or service recipient. Description in invoices reflect what is sought to be delivered by the supplier or service provider.
- (c) Minutes of the meeting/ board resolution: These documents provide a peep into the board room sentiments. It enables one to understand the objective behind the contracts entered into.
- (d) CA certificate in Form 15CB and custom documentation: These are documents which specify the nature of transaction and outline the characterization of income earned. It provides an opinion from an independent, qualified and external expert on the matter.
- (e) Pricing of the various components: Pricing mechanics have a significant bearing on the question whether it is a uno or multiple transaction arrangement. If the contract involves consideration being fixed for various components, it would usually indicate a split EPC contract; although such conclusion is not fool proof or sacrosanct.
- (f) Terms of the contract: A contract is reflective of the intent of the parties. The risk and responsibility matrix in the contracts define the role of each party to the contract. They act as evidence of the essence of the contract.
- (g) FAR analysis: A pricing model is reflective of the functions performed, assets owned/ used and risk shouldered or undertaken. These are facets which control the prospects of any business. What are the performed functions or assumed risks has to be unravelled. The identity of functions is critical for deciphering contract severability. Risk which is a consequence

1. Breach in one contract will automatically be classified as breach of the other contract.



of function has always remained *private and thus elusive*. It is neither evident nor inferred from the financial statements or contracts. The operative facets which control the pecuniary prospects of business are seldom disclosed in *public*. The absence of data on these operational secrets would leave the documentation analysis incomplete and in a limbo.

3.6.6. The importance of documentation, information and other surrounding circumstances are undisputed. However, some issues which arise are:

- (a) Documents serves as a record of facts or facts are aligned to the documents?
- (b) Whether documents constitute evidence?
- (c) Whether documents persuade (nay, dictate) the dictum of the judiciary?
- (d) Are documents (like the agreements) records of what ought to have been done or is it presumed that an agreement has been strictly adhered to?

3.7. Judicial precedents – on (in)divisibility of contracts

3.7.1. Judicial precedents have been often considered to be the source of law. Their role gets elevated in the absence of statutory guidance on a particular matter. The rules to separate or club contracts are not explicit in the Act. The obvious recourse in such an event is to traverse through the dictum of judiciary. However, precedents have not been uniform and consistent. Some of them are discussed below:

3.7.2. Para 17 of the Apex Court's decision in *Ishikawajma-Harima Heavy Industries Ltd. vs. DIT (2007) 288 ITR 408 (SC)* has become a *locus classicus* which reads as under:

“The fact that it has been fashioned as a turnkey contract by itself may not be of much significance. The project is a turnkey project. The contract may also be a turnkey contract, but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events in execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under the contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the component of the contract is separate. Similarly offshore supply and offshore services have separately been dealt with. Prices in each of the segment are also different.

18. *The very fact that in the contract, the supply segment and service segment have been specified in different parts of the contract is a pointer to show that the liability of the appellant thereunder would also be different.*

.....

70. *We would in the aforementioned context consider the question of division of taxable income of offshore services. Parties were ad idem that there existed a distinction between onshore supply and offshore supply. The intention of the parties, thus, must be judged from different types of services, different*



types of prices, as also different currencies in which the prices are to be paid.”(emphasis supplied)

- 3.7.3. The Supreme Court in the aforesaid case relied on the ‘obligations’ of the parties involved. Mention of supply and service agreement in different parts of the contract was held as an ‘indicator’ of contracts being divisible. The question is whether such divisibility based on ‘obligations’ of the parties is appropriate? Would the dictum have been different if there was a WAG along with the facts outlined in this case?
- 3.7.4. In *Ansaldo Energia SPA vs. ITAT, Chennai (2009) 310 ITR 237 (Mad.)*, the Madras High Court adjudged the contracts to be indivisible and distinguished the dictum of *Ishikawajima Harima* case on facts. In this case, Ansaldo Energia SPA was an Italian company which had an Indian subsidiary. The Indian subsidiary did not execute the onshore contract. A single contract was awarded to the Italian parent and was later on split into four contracts. The High Court observed that there was price imbalance in the four contracts entered into. It was skewed in favour of the off-shore supply contract and the onshore services were concluded to be facades. It was concluded to be a composite contract in spite of apparent demarcation of separate parts.
- 3.7.5. In the case of *CIT vs. Best and Co. P. Ltd (1966) 60 ITR 11 (SC)*, the Hon’ble Court ruled that when a composite consideration may have to be split although such splitting may pose difficulties. The Apex Court observed:
- “The next questions whether the compensation paid is severable. If the compensation paid was in respect of two distinct matters, one taking the character of a capital receipt and the other of revenue receipt, we do not see any principle which prevents the apportionment of the income between the two matters. The difficulty in apportionment cannot be a ground for rejecting the claim either of the revenue or of the assessee. Such an apportionment was sanctioned by courts in *Wales v. Tilley*, *Carter v. Wadman* and *T. Sadasivan v. Commissioner of Income-tax*. In the present case apportionment of the compensation has to be made on a reasonable basis between the loss of the agency in the usual course of business and the restrictive covenant. The manner of such apportionment has perforce to be left to the assessing authorities.”*
- 3.7.6. In *State of Uttar Pradesh & Anr vs. Union of India & Anr. (2004) 190 CTR 569 (SC)* it was observed – “37. Having given our anxious consideration to the submissions made in regard to the composite contract of service of goods and the classification above referred, we are of the view that they will not apply to the present case. Here the service of telephone connection cannot be artificially split into various categories supply of instruments and accompaniment on the one hand and supply of telegraphic line/connection on the other, to name the former as “sale” and the latter as “service”. The analogy of composite contract will apply where “sale” and “service” are two different independent objects.”
- 3.7.7. The Special bench of Delhi Tribunal in the case of *L.G. Electronics India (P) Ltd. vs. ACIT (2013) 29 taxmann.com 300 (Delhi - Trib) (SB)* quoted the *ILjin Automotive (P.) Ltd vs. ACIT [2011] 16 taxmann.com 225 (Chennai)* wherein



having regard to the OECD Transfer Pricing Guidelines it was observed - *The basic thesis is that transfer pricing legislation is to treat each of the individual members of a commonly controlled group as a separate entity, the transactions between whom are taxable events to be conformed to the economic realities obtaining between independent entities entering into similar and identical transactions, at arm's length.*

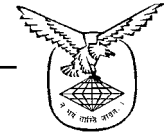
- 3.7.8. Without further outlining a catalogue of judgments in this matter, it may be relevant to mention some of the instances in the statute which club or split or apportion transactions. The term 'transaction' has been defined in Rule 10A(d) to include a number of closely linked transactions. Thus, the law recognizes that one transaction can be a repository of and represent various closely linked and entwined transactions. While dealing with income deemed to accrue in India, explanation 1(a) to section 9(1)(i) requires splitting of contract on the basis of operations in and outside India. Section 98 which deals with consequences of impermissible avoidance arrangement, *inter alia* provides that an arrangement may be disregarded, combined or recharacterised. Thus, the law provides for splitting or clubbing of transactions in certain circumstances. Are these evidences sufficient to argue that an arrangement/ agreement can be unbundled to ensure taxation of correct proportion of income in India? Does that mean a contract is always subject to 'wait and watch' strategy to ascertain whether the assessee's arrangement is agreed to by the Revenue authorities? Could there be some tests, checks and balances that may come to the aid of the parties? Participants may deliberate.
- 3.7.9. Judicial precedents have relied on certain factors to adjudge contracts as divisible or indivisible. Weightage given to each of the factors have differed. These weights have usually been based on their perceived criticality. Non-consideration of even a single yardstick could make the entire decision disputable. The question is whether it is possible to state with conviction that a decision while construing an arrangement to be divisible or indivisible has exhausted all the materials which is placed before and which can be called for by the court? Is the taxation of EPC desperately yearning for a comprehensive guideline to demarcate or merge contracts?
- 3.7.10. There is a divide on whether the contract is divisible or indivisible. The answer to this puzzle is probably the destination. The challenge is the route that a court will have to take to reach this destination. Will it respect the contracts entered into between the parties or take a holistic view of the matter by staying away? Or will it take a plunge into the contract mechanics to raid and question the contents and read through the contracts?

3.8. Judicial precedents – 'look through vs. look at'

- 3.8.1. Innovative tax mitigation techniques have encouraged Revenue authorities to step out of the conventional tax assessment methods. If contracts are pre-designed, their authenticity is examined; if actions are an afterthought, their commercial basis is verified. A divorce between thought or action and contract is always an invitation for piercing the 'gap'. This is how the controversy of 'look through' and 'look at' emerged.



- 3.8.2. The Apex Court in the case of *CIT vs. Motors & General Stores (1967) 66 ITR 692 (SC)* quoting the case of Lord Russell of Killowen in *IRC vs. Duke of Westminster* held that it is not open to the income-tax authorities to deduce the nature of the document from the purported intention by going behind the documents or to consider the substance of the matter or to accept it in part and reject it in part or to re-write the document merely to suit the purpose of revenue.
- 3.8.3. The Apex Court in *Ishikawajma-Harima Heavy Industries Ltd. vs. DIT (2007) 288 ITR 408 (SC)* observed that where different and severable parts of a composite contract are performed at different places, the principle of apportionment can be applied to determine which fiscal jurisdiction can tax that particular part of the transaction. The principle advocated was ‘apportionment of income in case of severable composite contracts’. Thus, a composite contract was dissected by the Apex Court.
- 3.8.4. The Pune Tribunal in the case of *Dhariwal Industries Ltd. vs. ACIT (2008) 111 ITD 379 (Pune)* acknowledged the concept of look through. It observed – Courts have time and again declined to be bound by labels and have always tried to look through it and reach to the substance. The Mumbai Tribunal in the case of *ACIT vs. Asea Brown Boveri Ltd. (2007) 110 TTJ 502 (Mum)* also chose this approach.
- 3.8.5. However, the Apex Court in the case of *Vodafone International Holdings B.V. vs. Union of India (2012) 341 ITR 1 (SC)* gave a new perspective to this subject. The Court on the consideration of the ‘look at’ versus the ‘look through’ doctrine held - “If government intends to tax such transaction, it must be reflected clearly in the provisions and tax treaties. It is important for the tax administration, as well as the Courts, to ‘look at’ the legal nature of the transaction, in its entirety and holistically.”
- 3.8.6. Such ‘look at’ approach has been upheld in the case of *Roxar Maximum Reservoir WLL (2012) 349 ITR 189; WT Ramsay Limited vs. IRC (1981) 1 All ER 865*. Thus, there appears to be divergent principles emerging from the judicial dictums.
- 3.8.7. The gospel that the substance of transaction, rather than mere form, controls the tax incidence is undisputed. If the real nature of a transaction is masked by formalisms which exist solely to alter or negate tax liabilities, it is impossible for the tax administrators to leave them scot free. The doctrine of ‘**look through**’ approach advocates intrusion and invites an insight into the transaction to uncover the essential essence. It is an attempt to unravel the cautiously pre-arranged form to disguise the underlying transaction. Having accepted all this, it is equally true that the task of the Revenue is to ascertain the legal nature of the transaction and, while doing so, it has to look at the **entire transaction holistically and not to adopt a dissecting approach**.
- 3.8.8. The Apex Court in *Vodafone International Holdings B.V.’s* case held that the onus is on the Revenue to identify a scheme and its dominant purpose. Thus, the Revenue needs to demonstrate that the transaction in essence deviates from the form. Such demonstration would entail persistent vigilance and deep drilling investigation. Although an onerous task, it cannot cause harassment and browbeating of honest taxpayer. This however, does not absolve the taxpayer of



his ardent duty to discharge the appropriate tax liability without by-passing the contours of law.

3.9. Judicial precedents – intent of parties

3.9.1. Actions always speak louder than words. The contracts, agreements or arrangements may record the intended course of action; but the evidence of actual acts (of parties) spell the true character of any transaction. Actions are often a reflection of the intent of parties. These provide the clinching evidence to conclude on the nature of transaction.

3.9.2. In the case of *Fuzhakkal Kuttappu vs. C. Bhargavi & Ors* reported in [AIR 1977 SC 105], it has been observed that the nomenclature given to a document by the writer or even by the parties is not always conclusive. In construing a document, it is necessary to find out the intention of the parties executing such document. Such intention has to be gathered from the recital, the terms in the document and from surrounding circumstances. When there is a document of a composite character disclosing features of mortgage and lease, the Court will have to find out the **pre-dominant intention of the parties executing the document** viewed from the essential aspect of the reality of the transaction. The Supreme Court in **Faqir Chand Gulati 10 SCC 345** held that the “essence” of the contract is supreme.

3.9.3. The role of documents and intent of parties are thus critical in deciphering the real essence of the transaction. There could be various commercial and contractual reasons and compulsions to consolidate or split the contracts. When such split or consolidation is backed up with genuine and satisfactory reasoning, their acceptance and recognition becomes smoother. A ‘tax evasive mentality’ can raise suspicion and result in rejection of the arrangement.

3.9.4. The deluge of judicial precedents which often provide contradictory dictums and rely on evidences furnished before the judges may not always serve as reliable guide. Even otherwise, a proposition which stands on the edifice of judicial precedents will be on a shaky ground. This is because, such theory is always susceptible to challenge by distinguishing the judicial dictum on facts or law involved; evidences before the court; arguments deliberated etc. It may be appropriate to recollect the words of Lord Denning in the matter of applying precedents which has become a *locus classicus*:

“Each case depends on its own facts and a close similarity between one case and another is not enough because even a single significant detail may alter the entire aspect, in deciding such cases, one should avoid the temptation to decide cases (as said by Cardozo) by matching the colour of one case against the colour of another. To decide therefore, on which side of the line a case falls, the broad resemblance to another case is not at all decisive.”.....

Precedent should be followed only so far as it marks the path of justice, but you must cut the dead wood and trim off the side branches else you will find yourself lost in thickets and branches. My plea is to keep the path to justice clear of obstructions which could impede it.”



3.9.5. The Supreme Court in *CIT vs. Sun Engineering Works P. Ltd.* 198 ITR 297 held as under:

“It is neither desirable nor permissible to pick out a word or a sentence from the judgment of this Court, divorced from the context of the question under consideration and treat it to be the complete ‘law’ declared by this Court. The judgment must be read as a whole and the observations from the judgment have to be considered in the light of the questions which were before this Court. A decision of this Court takes its colour from the questions involved in the case in which it is rendered and while applying the decision to a latter case, the Courts must carefully try to ascertain the true principle laid down by the decision of this Court and not to pick out words or sentences from the judgment, divorced from the context of the questions under consideration by this Court, to support their reasonings. In H.H. Maharajadhiraja Madhav Rao Jiwaji Rao Scindia Bahadur vs. Union of India [1971] 3 SCR 9 this Court cautioned:

“It is not proper to regard a word, a clause or a sentence occurring in a judgment of the Supreme Court, divorced from its context, as containing a full exposition of the law on a question when the question did not even fall to be answered in that judgment.”

3.9.6. Not adhering to the stated path, could lead to sliding into a quagmire of judicial precedents. To avoid or stay away from judicial sermons, one would have to focus on the ‘on-ground’ actions that constitute EPC contracts. In a life cycle of EPC contract there are various activities that contribute towards its successful accomplishment. If these were spread over a timeline, a possible view would be as under:

Project ← initialization	Negotiation & procurement	Manufacture/ construction	Testing & trial runs	Delivery or installation / erection	Supervision & technical certification	Final sale & product delivery	Post sale assistance →
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3.9.7. It is possible that each of the activities is handled by the same person, different persons or two or more activities are undertaken by one person. Thus, there are many combinations that are possible.

3.9.8. The reasons which persuade splitting of contracts could also result in clubbing of phases/ contracts. Who is the person carrying out each the various stages; what is the locale of executing such phases; what is the documentation evidencing such phases would go to determine the aggregation as also taxability (more of this later). An ‘aerial’ view of EPC contract could thus be bisected into ‘taxable’ and ‘non-taxable’ phases. If most of the phases in relation to a particular EPC contract fall within the ‘non-taxable’ bucket, then a natural ‘attempt’ by the assessee would be to condition and submerge the taxable component into the non-taxable one. Any attempt to unnaturally alter the substance of transaction (through clubbing or splitting of contracts) is always viewed by the Revenue authorities with a suspicious eye. Thus, “**clubbing of contracts**” is also an equally troubled area from an income-tax standpoint.



- 3.9.9. In the background of the foregoing discussion, the following issues emerge for consideration:
- (a) Whether judicial precedents on ‘look at’ and ‘look through’ approach are advocating contradictory sermons?
 - (b) Should each of the criterion – documentation, intent of parties and substance of transaction be viewed distinctly or a collective impact should be judged?
 - (c) If multiple contracts are wrapped into an overall agreement, should such arrangement be viewed as a single contract or multiple contracts?
- 3.10. Can the threat of splitting or clubbing of contracts by the Revenue authorities be mitigated by upfront functional and monetary bifurcation? To illustrate, a supply contract may involve operations such as supervision, installation and support services. They are generally carried on at the site of delivery of supply. An overseas supplier can outsource to or earmark the concerned enterprise to be engaged in such activity. The consideration may be contractually fixed. In such cases, can these activities be safely concluded to be divorced from the core supply agreement? Does upfront submission before the Revenue authorities with regard to the functional and revenue split mitigate the ‘re-arrangement’ by the taxman? Can the Revenue continue to question the pricing of these components? Can an allegation be made that the numbers are favourably skewed?
- 3.11. **EPC taxation is fraught with various issues. Defence of the taxpayer and allegation of the Revenue authorities remain unresolved. The two are often at loggerheads. It is possibly time to rise above the doctrines of ‘look through’ and ‘look at’ and adopt a ‘look ahead’ approach which is progressive and deters the use of subterfuges. Participants may deliberate on the above.**

CONCERN II: OBSCURITY IN NATURE OF INCOME & VARIATION IN MODUS OPERANDI

Taxability of EPC contracts

- 3.12. An EPC contract owner may adopt various means of accomplishing the project. An enterprise/ entity which requires a project to be accomplished may –
- (a) do it all by itself;
 - (b) do it through its fictional legal extensions such as the branch, project office;
 - (c) achieve it through its associated enterprises (could be subsidiary, holding or group companies);
 - (d) outsource the project to third parties/ invite such third parties to join; or
 - (e) explore the right combination of any of the above.

Each of these options would have an impact on the quantum as also characterization of income chargeable to tax in India.

- 3.13. The write-up proceeds to discuss the tax implications in case a non-resident executes the EPC contract himself followed by variations in tax treatment if the works is partially or wholly outsourced to its extensions, associated enterprises or third parties.



The write-up excludes contracts entered into between domestic entities. Taxation of non-residents invariably involve interplay of domestic and tax treaty provisions.

Domestic tax provisions – Briefly

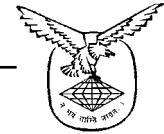
3.14. The scope of income chargeable to tax in India in case of non-residents is dealt in section 5(2) of the Act. As per the said sub-section, a non-resident is chargeable to tax in respect of the following categories of income:

- income received in India;
- income deemed to be received in India;
- income accruing or arising in India; and
- Income deemed to accrue or arise in India.

3.15. It is obvious to state that an income received in India is chargeable to tax in India. If it is assumed that such payment is not received in India, then one may have to examine whether it is deemed to be received in India. Income which is deemed to be received in India is set out in sections 7 and 198 of the Act. Sections governing presumptive basis of non-resident taxation – being, 44B, 44BB and 44BBA also deal with deemed receipt. Section 7 or 198 is generally not applicable. The presumptive taxation provisions enlisted above deal with specific industry segments (i.e, operation of aircraft or ships or oil exploration). In the generic background of the topic under discussion, the implications of specific provisions have not been detailed. Suffice it to conclude, that payments made under EPC may not generally constitute income deemed to be received in India.

3.16. Section 5(2)(b) provides that income ‘accruing or arising’ or ‘deemed to accrue or arise’ **in India** shall be chargeable to tax in India. The situs of income accrual has to be in India. Section 5, proceeds on the assumption that accrual of income has a situs; though there is no indication as to how the situs is to be determined. Defining the situs of accrual of income has been an eternal challenge. The situs of accrual depends upon the nature of transaction (whether trading, service, manufacture etc.).

3.17. ‘Accrual’ as a legal concept refers to the right to receive. It represents a situation where the relationship of a debtor and creditor emerges. Such a relationship could be traced to a contract, asset, activity or utility. These actually are instrumentality of income. They give rise to the accrual, but by themselves are not synonymous with accrual. Judicial precedents have however traced the accrual of income to the situs of these attributes. Irrespective of the instrumentality, the locale or situs of accrual must be found in India. In a case where such instruments of accrual are scattered across nations, distributive locations of accrual would be in evidence. This phenomenon was recognised in the early years by the Apex Court in the case of *The Anglo-French Textile Company Ltd. vs. CIT (1954) 25 ITR 27 (SC)*. The situs of accrual could vary based on the nature of the transaction. EPC contract is often a combination of supply and service arrangements. These are offered as a package to suit the project requirement of the customer. If the components of EPC projects are unbundled, separate accrual and situs principles could become applicable to supply transactions as well as service transactions. If one form (service or supply) of transaction gets subsumed into another, the place of accrual has to be determined on the basis of the dominant part of the



transaction. A supply transaction may accordingly be characterized as ‘service’ (for instance, supply contract involving works) depending on the domination of service or vice versa (i.e., works contract involving material). As held by the Hon’ble Supreme Court in the case of *State of Himachal Pradesh & Ors. vs. Associated Hotels of India Ltd 29 STC 474 (SC)*, in the case of a composite contract, one has to find out the primary object of the transactions and the intention of the parties while entering into it. Circular 681 dated 8.3.1994 (although now withdrawn) clarified that in case of doubt, whether a particular contract is a contract for work and labour or for sale, the matter should be decided in the light of the principles laid down by the Supreme Court in *Associated Hotels of India Ltd. case* (referred supra).

- 3.18. **Service transactions:** As per the judicial trend, income from work done or services performed or rendered, accrue at the place **where the work is done or services are performed**. Relevant extracts of some decisions in this connection are as follows.

- (i) *Shoorji Vallabhdas and Co. vs. CIT [1960] 39 ITR 775 (SC)*

“Normally the commission payable to the managing agents accrued at the place where the business was actually done, i.e., where the services of the managing agents were performed. As in this case, the assessee practically performed all the services in British India, the commission which it earned in respect of the two shipping companies, though computed on the percentage of freight or passage money, accrued or arose in British India.”

- (ii) *Performing Right Society Ltd. vs. CIT [1977] 106 ITR 11 (SC)*

“In the case before us the High Court and the Income-tax authorities considered it a hard matter of fact that the income derived from broadcast of copyright music from the stations of All India Radio arose in India. In our opinion, this was the correct view to take and we find no reason to differ from it.”

- (iii) *CIT vs. Anamallais Timber Trust Ltd. [1950] 18 ITR 333 (Mad.)*

“If income accrues or arises as a result of work done or services performed under a contract of service, then the place where the services are performed would be the place where the income accrues or arises.”

- 3.19. **Supply transactions:** The right to receive income from sale of goods is available at a place where sales are effected [Refer *Pushlal vs. CIT 66 ITR 159*, *Singarani vs CIT 21 ITR 375*, *Mysore Sugar vs. CIT 31 ITR 760*]. In words of the Supreme Court in *Keshav Mills Limited vs. CIT 23 ITR 230 (SC)* *“when goods are sold the profit or the loss on any particular transaction arises out of the sale, for until there is a sale, there can be no profit. If goods are sold in the taxable territories, the profits or a portion of them arise there”*. (emphasis supplied). The Apex Court recognised that partial taxability of profits (as they have partially accrued) is possible in supply transactions. It is therefore not necessary that the whole of the transaction has to be taxed in one jurisdiction. This is statutorily recognised by explanation 1(a) to section 9 and confirmed by Article 7 of DTAA [more of this later].

- 3.20. Sales are effected at a place where property in goods passes on payment of a price is made [Refer *Pudukottah Co Ltd. vs. CIT 47 ITR 352*, *Mysore Glass vs. CIT 47 ITR 841*]. In the context of manufacturing concerns, the Apex Court held that that the *place*



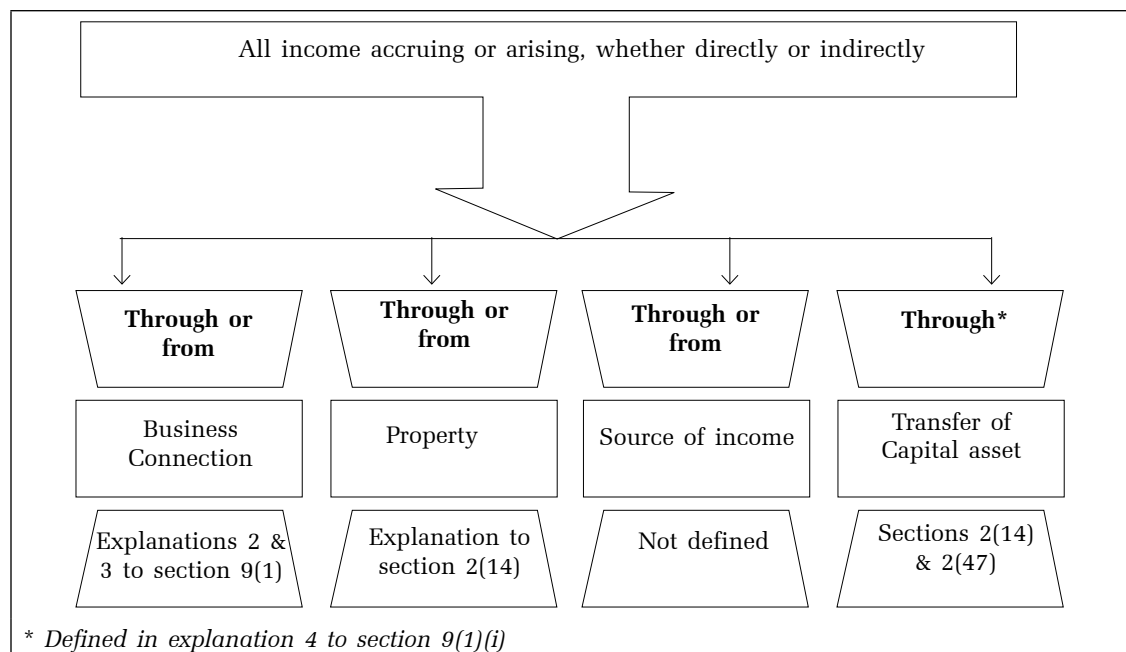
where operations of manufacture, standardization and testing takes place is the place of accrual of income (Refer *CIT vs. Ahmedbhai Umarbhai & Co. (1950) 18 ITR 472 (SC)*).

- 3.21. EPC contract is a combination of supply and service transactions. They are either separable or one get subsumed into another. If the transaction is construed as a supply transaction, then the place where sale is effected becomes the cynosure. It is in these circumstances that ‘passing of title and the associated risks and rewards’ assume importance. What earmarks the place of sale? Would documentation or contracts dictate the taxation by indicating the place of sale? Whether the sales are effected – (a) at the locale of seller? (b) locale of purchaser/ payer? (c) at the place where purchase agreement is executed? (d) at place where erection or installation is effectuated? (e) at place where monies are agreed to become due? Would the terms of contract (whether on FOB or CIF basis) make a difference? Whether the timing of passing title and risk have a bearing – especially if the title and risk pass at different point in time or to independent parties?
- 3.22. If the transaction is construed to be a ‘service transaction’ or ‘service component is separated from the supply arrangement’, the place of accrual (of such service income) would usually be the place where services are rendered. Is this an undisputed proposition? Can a service transaction having a ‘live-link’ with the supply transaction have different place of accrual vis-à-vis the supply arrangement? Can place of accrual of service income be controlled or altered by agreements or contracts?
- 3.23. The determination of the place of accrual in the context of EPC would not be a straitjacket exercise. The interplay of supply and service transactions in a EPC arrangement gives birth to the following further questions:
- (a) Are accrual of income and divisibility of contracts interdependent?
 - (b) Would the principles of income accrual have to be ignored or given a go-by or conditioned when one transaction (supply or service transaction) gets subsumed into the other superior element?
- 3.24. **Apportionment of income accrual between supply and service arrangement:** The presence of supply and service component in EPC contract poses the issue of divisibility and place of accrual. The supply and service components of these contracts may not be fully executed in one contracting State. For instance, manufacture of machine may happen outside India but assembly and installation (which mark the completion of machine delivery) could happen in India. In the context of services, inspection and trial runs may happen outside India but supervision and post sale maintenance services may be rendered in India. Thus, offshore supply and service agreements can have spill over in India. Assuming all these variants are covered within one umbrella agreement with a single consideration, the question would be on apportionment of income. In other words, how can income be apportioned as income accruing in India and outside India?
- 3.25. The term ‘accrual’ connotes *legal right to receive*. It is the enforcement of right to receive (from recipient standpoint) with a corresponding obligation to pay (from payer’s perspective) [Refer *CIT vs. Excel Industries Ltd. (2013) 358 ITR 295 (SC)*]. The Act is silent on the definition of what constitutes accrual; although the Income Computation & Disclosure Standards (ICDS) have provided a definition therein (more of this later).



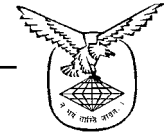
Section 5 which outlines the scope of total income to include income accruing in and outside India (as the context requires), does not specify the place of accrual. The place of accrual as discussed above is discerned from the judicial precedents. Section 9 provides guidance on the locale of accrual albeit through a fiction. Section 5 has to be therefore read along with section 9. The enigma around income accrual of a cross border EPC contract can be possibly be cleared only with a combined reading of sections 5 and 9.

- 3.26. In the background of this theorem (of interplay between sections 5 and 9) the following questions emerge:
- Whether section 5 concurs with attribution and apportionment principles embedded in section 9?
 - If yes, wouldn't this amount to reading words in the statute (which are forbidden)?
 - Whether section 9, being a deeming provision, be extended to interfere into the operation of section 5 by conferring exemptions under particular circumstances?
- 3.27. **Deemed accrual:** Section 9 deals with incomes that are deemed to accrue in India. Section 9 creates a fiction. The fiction embodied in section 9 operates to shift the locale of accrual of income. Based on the nature of income, one may need to traverse through the various clauses of section 9 to determine whether any of those are attracted to the non-resident payee.
- 3.28. As per section 9(1)(i), all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property **in India**, or through or from any asset or source of income **in India**, or through the transfer of a capital asset situated in India is deemed to accrue or arise **in India**. A flow chart depiction of section 9(1)(i) is as below:





- 3.29. It can be discerned that all the limbs of section 9(1)(i) use the phrase ‘through or from’ except capital gains – which only uses ‘through’. The implication of ‘from’ missing in the capital asset limb was viewed as a means of bypassing indirect transfer of shares.
- 3.30. Indirect transfer of capital assets was not covered within the gamut of section 9(1)(i) until Finance Act, 2012 inserted Explanations 4 and 5. The term ‘through’ is defined as under in Explanation 4: “For the removal of doubts, it is hereby clarified that the expression “through” shall mean and include and shall be deemed to have always meant and included “by means of”, “in consequence of” or “by reason of”.
- 3.31. Although the objective of this amendment was to plug tax leakage on account of indirect transfers, the language employed in Explanation 4 could have far reaching ramifications. By defining “through” to mean among other, ‘in consequence of’, it could potentially attach every transaction which may owe a remote nexus to the supply arrangement in a EPC. In the chart at para 3.28 above, the word “through” is visible in all the four segments. In each of these segments, the understanding of the said term would have to be as defined in Explanation 4.
- 3.32. **Business connection:** The first limb of the above clause refers to income arising from any business connection in India. The expression ‘business connection’ under section 9(1)(i) connotes carrying of some business activity in India. Explanation 2 to section 9(1)(i) defines ‘business connection’ in an inclusive manner. “Business connection” shall include any business activity carried out through a person is acting on behalf of the non-resident and satisfies certain conditions outlined. Explanation 2 does not define business connection *per se*. It includes any business activity carried out through a person.
- 3.33. A business could have various operations. Some could be carried out in India and some outside India. Only incomes attributable to ‘operations’ carried out in India are taxable under the Act. This is the mandate of Explanations 1(a) and (3) to section 9(1). If it can be established that there are no ‘operations’ carried out in India, then the non-resident would not be taxable in India [Refer *CIT vs. Toshoku Limited (1980) 125 ITR 525 (SC)*].
- 3.34. The Supreme Court in the case of *Anglo-French Textile Company Ltd vs. CIT (1953) 23 ITR 101 (SC)* held that the expression ‘operations’ does not mean isolated transactions. It was adjudged that systematic and regular activity represents operations. The term has to be given meaning as understood in trade parlance. The Court observed-
“it is not every business activity of a manufacturer that comes within the expression “operation” to which the provisions of section 42(3) are attracted. These provisions have no application unless according to the known and accepted business notions and usages the particular activity is regarded as a well defined business operation.”
- 3.35. **Income from ‘property’ or ‘asset’ or ‘source’ in India** - An EPC contract in its offshore segment may involve acquisition of an asset outside India. In such a situation, the payment would not be made in relation to any property or asset in India. Thus, the underlying income cannot be said to have accrued through or from any property or asset in India. Contrastingly, an onsite supply contract in India could invite levy of tax for the foreign EPC contractor. An onsite supply in India deepens the link of the overseas contractor with India. It not only amounts to a contract with India but becomes a connection or operation in India.



3.36. The conviction in denying or preventing accrual of income in India on the tests of 'property' or 'asset' in India may not be associated while dealing with source of income in India. This is due to the nebulous nature of the expression 'source'. The absence of a precise definition of source has left the judiciary grappling with the connotation of this term. Some attempt has been made to outline its contours. "Source" is not a legal concept, but something which a practical man would regard as a real source of income. [*Rhodesia vs. Comr of Taxes* 9 ITR Suppl. 45, 52 (PC); *CIT vs. Kanchan Bai* 77 ITR 123, 126 (SC); *Amrit Kunwar vs. CIT* 14 ITR 561, 582 (FB); *Vijaykuverba vs. CIT* 49 ITR 594, 605; *Sterling Foods vs. CIT* 150 ITR 292, 298; *Shiva Prasad vs. CIT* 84 ITR 15]. In *Seth Shiv Prasad vs. CIT* [1972] 84 ITR 15 (All), it was held:

"A source of income may be described as the spring or fount from which a clearly defined channel of income flows. It is that which by its nature and incidents constitutes a distinct and separate origin of income capable of consideration as such in isolation from other sources of income and which by the manner of dealing adopted by the assessee can be treated so."

3.37. Source refers to origin. It is a start point. This theory is undisputed. The question is what constitutes 'source'? Should source be tangible or definite? Is source an action or an intention? Everything owes its birth to a root or origin. In fiscal matters, there could be many claimants for being regarded the source. No decisive principle has yet evolved to resolve the dispute of what constitutes "source". Thus, one keeps wondering as to where does the journey to 'start point' stop? The journey is on-going. A successful culmination of the discovery of the "start" is still far away. The journey is littered with judicial interpretations which have made the path only slippery.

3.38. **"Business connection" is wide enough to engulf "properties or assets"**: "Business connection" is mentioned in section 9(1)(i). Being more specific, as also wider it should prevail over the general concept of income from any "asset or source in India". Therefore, an "asset or source in India" would have relevance only to incomes not referable to a business activity that a non-resident undertakes/ performs. If the words "assets in India" is held to have an unmitigated role, then the income from the business of EPC contracts would be taxable even in the absence of a business connection. Further, if the tax liability is fastened because of "assets in India", then the benefit of Explanation 1(a) would not be available to an assessee.

3.39. Even otherwise, it is arguable that business is a conglomerate of various properties, assets, like plant, stock, employees etc. A business has various constituents or elements. A cumulative and coherent whole of these elements constitutes business. No vivisection should be possible of these elements. A constituent or element on a standalone basis does not constitute a business nor a business connection. Elements like property or assets gets subsumed into it. The occasion to examine separately, the characterization of income from the elements, independent of or *de hors* the business should not arise. "Asset" in India, would be one of the factors that will help in determining whether there is a "business connection" in India. The role of assets would stop there. Whether a business connection exists would depend on a multitude of other factors.

3.40. Section 14 warrants income chargeable to tax being classified into 5 heads of income. Under each head there may be various sources of income. A business could be



a source of income under the head “Profits and gains of business or profession”. A “source” of income should not be disintegrated into its constituents, unless the constituents are complete in themselves to form a different and independent source of income. A “business connection” is wide enough to engulf “properties or assets”. They are therefore not to be evaluated separately.

- 3.41. Having regard to the context, the last limb of section 9(1)(i) which deals with transfer of capital asset has not been dealt with in this write-up. As repeatedly mentioned, EPC is a blend of supply and service contracts. While income from supply contracts are enveloped within section 9(1)(i), service segment would be dealt by section 9(1)(vii) dealing with fees for technical services.
- 3.42. **Fees for technical services:** EPC contracts involve rendition of services. Taxability of services in a cross border transaction could be governed by the provisions of section 9(1)(vii) [save certain exceptions]. As per section 9(1)(vii), income by way of fees for technical services is deemed to accrue or arise in India. Explanation 2 to section 9(1)(vii) defines the expression ‘fees for technical services’.
- 3.43. Rendering of managerial, technical or consultancy services (including the provision of services of technical or other personnel), for a consideration is regarded as ‘fees for technical services’ (“FTS”). The terms ‘*managerial, technical and consultancy*’ employed in the definition of ‘*fees for technical services*’ have not been defined in the section 9(1)(vii). In the absence of definition of the terms one needs to understand the meaning thereof in their natural sense.
- 3.44. The Word Web defines these terms as follows:

Managerial = *Of or relating to the function or responsibility or activity of management.*

Technical = *1. Of or relating to technique, 2. Characterizing or showing skill in or specialized knowledge of applied arts and sciences, 3. Of or relating to proficiency in a practical skill, 4. Of or relating to a practical subject that is organized according to scientific principles, 5. Resulting from or dependent on market factors rather than fundamental economic considerations, 6. (of production of chemicals) made for commercial purposes especially on a large scale.*

Consultancy = *The practice of giving expert advice within a particular field.*

The Shorter Oxford English Dictionary defines these terms as follows:

Managerial = *of, pertaining to, or characteristic of a manager, esp. a professional manager of or within an organization, business, establishment etc.,*

Manager = *1. A person who manages something, 2. 3. A skilled in managing household affairs, money etc., 4. A person whose office it is to manage an organization, business establishment, or public institution or part of one; a person with a primarily executive or supervisory function within an organization etc.; a person controlling the activities of a person or team in sports, entertainment, etc; the dictionary has used the term ‘manager’ along with prefix such as “bank manager, factory manager, floor manager, football manager, hotel manager, personnel manager, stage manager, team manager, theatre manager, etc.,”*



Technical = 1. having knowledge of or expertise in a particular art, science, or other subject, 2. Pertaining to, involving or characteristic of a particular art, science, profession or occupation or the applied arts and science generally; 3. using or dealing with terms that belong to a particular subject or field; requiring specialist knowledge to be understood; treating a subject in a specialist way;

Consultancy = the work or position of a consultant; a department of consultants;

Consultant = A person who gives professional advice or services in a specialist field; the dictionary has used the term ‘consulting’ along with prefix such as “consulting architect, consulting engineer, consulting physician”.

- 3.45. Clause (b) to section 9(1)(vii) provides that income by way of fees for technical services is deemed to accrue or arise in India when the amount is payable by a resident (save certain exceptions - discussed below). Clause (c) provides that amount payable by a non-resident is deemed to accrue or arise in India if it payable in respect of services utilized in India or for the purposes of making or earning any income from any source in India.

Exclusions to section 9(1)(vii)(b)

- 3.46. Section 9(1)(vii)(b) reads - a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India.
- 3.47. Clause (b) houses twin exclusions. It is manifest from the above that if – technical services/ royalties are utilized (i) in a [or for the purposes of - as in royalty] business or profession carried on by a resident outside India; or (ii) for the purposes of making or earning any income from any source outside India, then the payment even though covered under the definition of “royalty” or “FTS” would be outside the scope of section 9(1)(vii).
- 3.48. The former exception deals with fee/amount payable ‘in respect of’ royalties/ technical services utilized in/for ‘business carried on outside India’. The latter deals with royalties/ fee payable and utilized for ‘the purpose of’ making or earning any income from any ‘source’ outside India.
- 3.49. The element of ‘**utilization**’ is common to both these exceptions. The term ‘utilize’ has not been defined in the Act. The term ‘utilize’ as per Word Web means ‘Put into service; make work or employ for a particular purpose or for its inherent or natural purpose’. As per Shorter Oxford English Dictionary, ‘utilize’ means ‘make practical use of’, ‘use effectively’, ‘turn to account’.
- 3.50. Interestingly, section 9(1)(vii)(b) uses the phrase ‘utilized in’ whereas 9(1)(vi)(b) [dealing with taxability of royalty income] uses ‘utilized for’. The word “in” is used as a preposition after the term “utilized” in section 9(1)(vii). It has a narrow meaning and signifies inclusion or position within limits of space, time or circumstance. Contrastingly, the phrase ‘utilised for’ is wider in its scope and ambit. This difference in terminologies could have consequent tax implications while determining the chargeability of royalty/ FTS in India. The exception under ‘royalty’ would encompass a wider range of activities than that under ‘fees for technical services’.



3.51. Although the extent of utilization could possibly vary (depending upon whether the language is ‘utilized in’ or ‘utilized for’), the existence of element of ‘utilization’ is a must. This indicates the importance of utilization to satisfy the exceptions in either of the sections. Clauses (vi) and (vii) were inserted into the statute by Finance Act, 1976. Interestingly, the term ‘utilization’ is absent in circular no. 202 dated 5.7.1976 which explained the insertion of these provisions into the statute. The relevant portion of the circular is as under:

“The Finance Act, 1976 has inserted a new clause (vi) in section 9(1) clearly specifying the circumstances in which the royalty income will be deemed to accrue or arise in India and also defining the term “royalty”.

15.3 Under the new provision, royalty income of the following types will be deemed to accrue or arise in India:

- (a) royalty payable by the Central Government or any State Government;*
- (b) royalty payable by a resident, except where the payment **is relatable to** a business or profession carried on by him outside India or to any other source of his income outside India ; and*
- (c) royalty payable by a non-resident if the payment **is relatable to** a business or profession carried on by him in India or to any other source of his income in India.*

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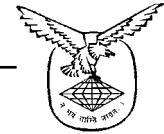
16.1 As in the case of royalty, the Finance Act, 1976 has amended the Income-tax Act clearly specifying the circumstances in which income by way of “fees for technical services” will be deemed to accrue or arise in India and also defining the expression “fees for technical services”. For this purpose, a new clause (vii) has been inserted in section 9(1).

16.2 Under the new provision, income by way of “fees for technical services” of the following types will be deemed to accrue or arise in India:

- (a) fees for technical services payable by the Central Government or any State Government;*
- (b) fees for technical services payable by a resident, except where the payment **is relatable to** a business or profession carried on by him outside India or to any other source of his income outside India ; and*
- (c) fees for technical services payable by a non-resident if the payment **is relatable to** a business or profession carried on by him in India or to any other source of his income in India.”(emphasis supplied)*

‘Utilized’ vs. ‘Relatable to’

3.52. The circular uses the phrase ‘is relatable to’ as compared to or contrasted with ‘utilized’ in the Act. Circular 229 dated 9.8.1977 [which explained the amendments made by Finance Act, 1977] also uses the phrase ‘relatable to’. Ordinarily ‘relatable to’ would mean ‘is connected with’ or “have reference to”. If this meaning were to be adopted in the context of section 9(1)(vii), it would mean that if the payment towards FTS



is linked (however remote!) to overseas business, then such payment would not be deemed to accrue or arise in India. Consequently, actual utilization in such overseas business would never be a criterion. Whether the import and impact of the statutory language has been diluted by the above referred circulars? Whether in the view of the language in the circulars, is it arguable that a lesser intensity of relationship with business carried on outside India would help the non-resident in escaping the deeming fiction in 9(1)(vi) and (vii)? On the other hand, whether such 'lesser intensity' of relationship make payments made by non-resident to another non-resident deemed to accrue or arise in India? The interpretation adopted [by applying the phrase 'relatable to' instead of 'utilized'] could have equal and opposite implications under clauses (b) and (c) of section 9(1)(vi) and 9(1)(vii).

Exception I - utilization of services in 'business carried on outside India'

- 3.53. This exception has certain key words. They form the crux of interpretation of this exception. The term 'business' which is one of the key words is defined in section 2(13) of the Act. As per the said definition, business includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. The term 'business' is of wide and indefinite import. In a fiscal statute, it generally must be construed in a broad rather than a restricted sense unless the context otherwise requires - *Mazagaon Dock Ltd. vs. CIT/CEPT [1958] 34 ITR 368 (SC)*, *CIT vs. Calcutta National Bank Ltd. [1959] 37 ITR 171 (SC)*, *Sole Trustee, Loka Shikshana Trust vs. CIT [1975] 101 ITR 234 (SC)*, *S.G. Mercantile Corpn. (P) Ltd. vs. CIT [1972] 83 ITR 700 (SC)*; *Continental Construction Ltd. vs. CIT [1992] 195 ITR 81 (SC)*
- 3.54. The language employed in section 9(1)(vii)(b) is '...fees are payable **in respect of** services utilised in a business'. The phrase 'in respect of' means 'attributable to' or if it is given a wider meaning, "relating to or with reference to" [Refer *Asher vs. Seoford Court Estates Ltd. [1950 A.C. 508, 5261]*; *Tolaram Relumal vs. State of Bombay [1955] 1 SCR 158 at P. 165: (AIR 1954 466 at p.499)*; *CIT vs. Synopsis International Old Ltd. (2012) 212 Taxman 454 (Kar)*].
- 3.55. The usage of the phrase 'in respect of' broadens the scope of the exception. It would exclude payments for services attributable or referable to a business outside India from being deemed to accrue or arise in India. Such an understanding, would be in accord with the sentiments expressed in Circular no.202.
- 3.56. The words '**carried on**' are indicative of continuum, frequency or regularity. According to the Stroud's Judicial Dictionary, the phrase 'carried on' - "implies a repetition or series of acts." In *Smith vs. Anderson, 15.CH.D 247, 277-278*, the observation of Brett L.J. were as under:-
- "The expression 'carrying on' implies a repetition of acts, and excludes the case of an association formed for doing one particular act which is never to be repeated". In Kirkwood vs. Gadd (1910) AC 422, at page 423, Lord Loveburn also said: "what is carrying on business? It imports a series of repetition of acts". [Refer Golf in Dubai LLC vs. DIT [2008] 306 ITR 374].*
- 3.57. The words "carrying on business" require something more than merely selling or buying, etc. Whether a person "carries on a business" in a particular commodity



must depend upon the volume, frequency, continuity and regularity of transactions of purchase and sale in a class of goods and the transactions must ordinarily be entered into with a profit motive (*Board of Revenue vs. A. M. Ansari [1976] 38 STC 577 (SC); [1976] 3 SCC 512*).

- 3.58. It is to be borne in mind that section 9 attempts to charge income to tax in India by enacting a deeming fiction. A deeming section is to be construed and interpreted strictly [*CIT vs. Amarchand N. Shroff (1963) 48 ITR 59 (SC); CIT vs. Mother India Refrigeration Industries (1985) 155 ITR 711 (SC), CIT vs. Khimji Menshi (1992) 194 ITR 192 (Mum.) and other cases*]. Logically therefore, the exception to the deeming section is to be liberally construed.

Exception II – utilized of services for the purpose of making or earning any income from any source outside India

- 3.59. The term ‘source’ has not been defined. Judicial precedents (as discussed earlier) have attempted to ascribe a meaning to source as a start point or origin. For the purposes of section 9(1)(vii)(b), the source of such income should be outside India.
- 3.60. The provision does not intend that the payments should be ‘exclusively’ for the purpose of earning any income from source outside India. If the condition of foreign sourced income is satisfied, the second exception is triggered.
- 3.61. On a perusal of the twin conditions, it is evident that the intention is (i) to carve out those transactions which do not have sufficient territorial nexus with India and (ii) exclude such transactions from the ambit of taxation in India [*Refer International Tire Engineering Resources LLC, In re (2009) 319 ITR 228*].
- 3.62. The “source of income” as a cause of exception is mentioned along with a business carried on outside India. One way of interpreting the same would be to regard the two as mutually exclusive. Proceeding further on this line of reasoning, a person involved in a business should have no occasion to invoke the rule of “source outside India” in securing an exemption.
- 3.63. The wordings of the exemption are “**making or earning any income** from a source outside India”. The underlined words find a mention in section 57, dealing with “Income from other sources”. Can it be therefore argued that the exception is intended to deal with non-business incomes? Can one contend source of income outside India and carrying on business in India co-exist? Is it possible to refer the AAR decision in the case of Dell International Services India (P) Ltd. (2008) 305 ITR 37 (AAR) which observed - In *Dell International Services India (P) Ltd. vs. CIT (2008) 305 ITR 0037 (AAR)* it was observed:

“No doubt, the factum of the applicant carrying on business in India does not come in the way of getting the benefit of the exception. It is possible to visualize the situations in which the business is carried on principally in India whereas a particular source of income is wholly outside India”.

- 3.64. **Payer - as a source of income:** The Delhi High Court in the case of *CIT vs. Havells India Ltd. (2013) 352 ITR 376 (Del)* held that the customer cannot be considered as source of the income though he is the source of the monies received. However, a



contrary view was expressed by the Apex Court in the case of *GVK Industries Ltd. vs. ITO [2015] 371 ITR 453 (SC)*. The Supreme Court held that ‘payer’ is the source of income in the context of section 9(1)(vii)(b) at para 22 of the judgment which reads as under:

*“22. The principal provision is Clause (b) of Section 9(1)(vii) of the Act. The said provision carves out an exception. The exception carved out in the latter part of clause (b) applies to a situation when fee is payable in respect of services utilized for business or profession carried out by an Indian payer outside India or for the purpose of making or earning of income by the Indian assessee i.e. the payer, for the purpose of making or earning any income from a source outside India. On a studied scrutiny of the said Clause, it becomes clear that it lays down the principle what is basically known as the “source rule”, that is, income of the recipient to be charged or chargeable in the country where the source of payment is located, **to clarify, where the payer is located**. The Clause further mandates and requires that the services should be utilized in India.”* (emphasis supplied)

- 3.65. The Apex Court has clarified that payer could be the source of income. Does this decision effectively override the Delhi High Court judgment in the case of *CIT v Havells India Ltd.* which held that customer cannot be considered as source of income though he is the source of the monies received? Can the same rule be applied in context of section 9(1)(vii)(c) in respect of payments made by non-residents? The Apex Court calls this statement ‘clarificatory’. Does that mean that this definition of source is applicable retrospectively? Participants may deliberate on the above.
- 3.66. The role of the twin exceptions is significant as they would (for a non-resident payee) withdraw the entire transaction from the charge of tax in India. Appropriate interpretation of the language employed therefore becomes critical. **Participants may deliberate on the following issues enlisted along with Case study below:**

<i>Name of the project owner:</i>	<i>India Co</i>									
<i>Name of the project contractor:</i>	<i>FCo1</i>									
<i>Name of the project sub-contractor</i>	<i>FCo2</i>									
<i>EPC Project description:</i>	<i>Off shore supply and on-site services</i>									
<i>Other facts:</i>										
<ul style="list-style-type: none"> • <i>Project value:</i> <table style="width: 100%; border: none;"> <tr> <td style="padding-left: 20px;"><i>Total contract value</i></td> <td style="padding-left: 20px;">---</td> <td style="text-align: right;"><i>US \$ 1000 mn</i></td> </tr> <tr> <td style="padding-left: 20px;"><i>Off shore supply value</i></td> <td style="padding-left: 20px;">---</td> <td style="text-align: right;"><i>US \$ 700 mn</i></td> </tr> <tr> <td style="padding-left: 20px;"><i>On-site supply</i></td> <td style="padding-left: 20px;">---</td> <td style="text-align: right;"><i>US \$ 300 mn</i></td> </tr> </table> • <i>Onsite supply portion sub-contracted entirely by FCo1 to FCo2 for US \$ 250 mn</i> • <i>Onsite services work performed by FCo2 under supervision of FCo1</i> • <i>The payment by FCo1 to FCo2 is at ALP</i> 		<i>Total contract value</i>	---	<i>US \$ 1000 mn</i>	<i>Off shore supply value</i>	---	<i>US \$ 700 mn</i>	<i>On-site supply</i>	---	<i>US \$ 300 mn</i>
<i>Total contract value</i>	---	<i>US \$ 1000 mn</i>								
<i>Off shore supply value</i>	---	<i>US \$ 700 mn</i>								
<i>On-site supply</i>	---	<i>US \$ 300 mn</i>								
<i>Queries:</i>										
<ul style="list-style-type: none"> • <i>Examine the characterization and taxability of the offshore supply value of US \$ 700mn</i> • <i>Examine the characterization and taxability of the onsite service value of US \$ 300mn</i> 										



- 3.67. Explanation below section 9(2) provides that income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1), whether or not –
- (i) the non-resident has a residence or place of business or business connection in India; or
 - (ii) the non-resident has rendered services in India.
- 3.68. Irrespective of whether the non-resident has residence, place of business or business connection in India income from fees for technical services is deemed to accrue in India. Place of rendering services is also irrelevant. The focus is on the payer. If the payer is resident, fee for technical services is automatically deemed to accrue or arise in India (subject to two exceptions). If the payer is a non-resident then the utilization of services should happen in India to deem such income as accruing in India. It is important to note that explanation below 9(2) does not obliterate the exception to section 9(1)(vii)(b). This was confirmed by the Delhi High Court in the case of *DIT vs. Lufthansa Cargo India (Delhi) (2015) 375 ITR 85 (Del.)*. The Delhi High Court after placing reliance on GVK Industries case reported in 371 ITR 453 observed – *“Explanation is deemed to be clarificatory and for a good measure retrospective at that, nevertheless there is nothing in its wording which overrides the exclusion of payments made under section 9(1)(vii)(b).”*
- 3.69. Explanation 2 to section 9(1)(vii) defines the expression ‘fees for technical services’ as under:
- “For the purposes of this clause, “fees for technical services” means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head “Salaries”.*
- 3.70. The latter part of the definition states that any consideration for any technical service for construction, assembly, mining or like project undertaken by the recipient is excluded. It also excludes incomes which are chargeable under the head ‘salaries’. Payments for such services would not constitute fees for technical services.
- 3.71. To exclude an activity/ payment from the ambit of FTS definition, the following conditions need to be cumulatively satisfied:
- (a) The income earned is towards the ‘actual construction/ mining/ assembly activity’ or the like project; and
 - (b) The activity is ‘undertaken by the recipient’ of the income.
- 3.72. The reasoning for exclusion of the construction, assembly, mining or the like project from the ambit of Explanation 2 can be gathered from CBDT circular No. 202 dated 5.7.1976 (105 ITR St 25). This circular explains the changes brought out by the Finance Act, 1976. The CBDT clarifies that the consideration from such projects has been excluded from the definition on the ground that such activities virtually amount to



carrying on business in India. The legislature possibly perceived that carrying on of construction activity would be for substantial duration; it would involve the presence of the parties at the place of work. These attributes would attract the ‘business connection’ clause. There was therefore a need to exclude this activity from the FTS ambit. Further, construction activity would involve the incurrence of huge expenditure, making it unfair to tax the same on gross basis. Relevant excerpts from the circular are as below:

“...Such consideration has been excluded from the definition on the ground that such activities virtually amount to carrying on business in India for which considerable expenditure will have to be incurred by a non-resident and, accordingly, it will not be fair to tax such consideration in the hands of a foreign company on gross basis or to restrict the expenditure incurred for earning the same to 20 per cent of the gross amount as provided in new section 44D. Consideration for any construction, assembly, mining or like project will, therefore, be chargeable to tax on net basis, i.e., after allowing deduction in respect of costs and expenditure incurred for earning the same and charged to tax at the rates applicable to the ordinary income of non-resident as specified in the relevant Finance Act.”

- 3.73. The phraseology used (in the definition of FTS) is “but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient”.
- 3.74. In order to come under the exemption, the non-resident should have entered into a contract for the construction, assembly or mining. The activities have to be carried out necessarily by the recipient of income. In other words, the exclusion would be applicable only to those who have taken up construction as the core activity and not to those who render technical or consultancy services to the enterprise promoting the main project.
- 3.75. The Income Tax Tribunal Hyderabad in the case *ITO vs. National Mineral Development Corporation Ltd.* 42 ITD 570 (Hyd.) had occasion to consider whether supply, assembly and erecting of conveyor belts was a construction activity. It also examined whether this activity was undertaken by the non-resident recipient of income to justify the exclusion under section 9(1)(vii). The Tribunal observed -
- 3.76. *“From the facts and circumstances before us it cannot be said that the non resident simply agreed to provide service of its technical personnel only. It had undertaken to complete erection, commissioning and maintenance. Erecting a conveyor belt is a form of construction..”* (emphasis supplied)
- 3.77. The Mumbai Tribunal decision in the case of *Aditya Birla Nuvo Limited vs. ADIT* [ITA Nos. 7674/75, 7526/27/Mum/ 2007] addressed the interpretation of the exclusion clause of FTS definition in the Act and clarified as follows:

“The technical services must be for providing managerial, technical or consultancy services and these managerial, technical or consultancy services should not be for construction, assembly etc..... These two technicians are there only to supervise the erection and giving technical advice in connection with the erection. We agreed with the learned DR in that case that technical fee is for technical advice in connection with



erection and the actual erection was done by others.and the payment of technical fee is only for giving technical advice in connection with the erection and not for undertaking the erection by the NR, we disagree with the CIT(A) when she held that the amount payable was in connection with construction, assembly etc.”(emphasis supplied)

3.78. Thus, to avail the exemption, both the conditions need to be satisfied - the activity should be the actual construction activity and the same needs to be carried on by the assessee receiving income in consideration of such activity.

3.79. In a typical EPC contract, there would be construction or assembly activities. In case the payment is made towards these activities, the same is excluded from the definition of fees for technical services. There may however be challenges when there is one lump sum consideration payable for executing the entire EPC contract and the consideration attributable to services is not ascertainable. In such a situation, the question is whether the exclusion clause in explanation 2 applicable? How would one attribute and quantify the service related income?

3.79.1. An attached issue which crops up for consideration is the characterisation of the exclusions from definition of FTS. To elucidate, construction, assembly, mining or like projects are jettisoned from the FTS purview. The phrase like projects leaves the exclusions open ended. In this context it may be relevant to refer Instruction No. 1862, dated 22.10.1990 which reads as under:

Instruction: No. 1862, dated 22-10-1990

1. The expression “fees for technical services” has been defined in Explanation 2 to section 9(1)(vii) of the Income-tax Act, 1961 as under :

“Explanation 2: For the purpose of this clause, fees for technical services means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining, or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head Salaries.”

2. The question whether prospecting for, or extraction or production of, mineral oil can be termed as mining operations, was referred to the Attorney General of India for his opinion. The Attorney General has opined that such operations are mining operations and the expressions mining project or like project occurring in Explanation 2 to section 9(1)(vii) of the Income-tax Act would cover rendering of services like imparting of training and carrying out drilling operations for exploration or exploitation of oil and natural gas.

3. In view of the above opinion, the consideration for such services will not be treated as fees for technical services for the purpose of Explanation 2 to section 9(1)(vii) of the Income-tax Act, 1961. Payments for such services to a foreign company, therefore, will be income chargeable to tax under the provisions of section 44BB of the Income-tax Act, 1961 and not under the special provision for the taxation of



fees for technical services contained in section 115A, read with section 44D of the Income-tax Act, 1961.” (emphasis supplied)

- 3.80. Instances of like projects are referred in the notification. It mentions training activities and drilling operations as like projects. Does this notification give scope for some more activities to be excluded? When training in relation to these activities are excluded, does that mean other forms of training would invariably constitute fees for technical services? Participants may deliberate.
- 3.81. If income from these activities is not FTS, the question is what would be the characterization of these incomes? Would they constitute ‘business income’? Will taxability of these incomes be governed by section 9(1)(i) wherein business connection test assumes primacy?
- 3.82. **Proportion of income chargeable to tax in India:** EPC contract involves various stages from project initialization till post sale activities. In a cross border transaction, some stages of the transaction may be undertaken in India and some outside India. The issue regarding division of contracts as off-shore and on-shore is already discussed. However, whether recognition of income would follow this split or would be ‘apportioned’ on the basis of definitive criteria is a question EPC contractors regularly face.
- 3.83. The rule of proportionality has been enunciated by section 9 which mandates that only income proportionate to ‘operations’ in India is taxable. Rule 10 of Income-tax Rules, 1962 provides that if the assessing officer is of the opinion that the actual amount of income chargeable to tax in India cannot be definitely ascertained, taxable income may be computed in one of the three methods provided therein. The three methods are:
- Income estimated as a percentage of turnover as considered reasonable by the officer;
 - Income estimated as the same proportion of the total profits (global profits) as the total turnover in India bears to the global turnover;
 - On any other method which the officer finds reasonable.
- 3.84. Thus, there are two apportionment theories available in the statute. One is on the basis of operations in India. If the proportion cannot be determined on such basis, then turnover method can be resorted to. It is interesting to observe that ‘operations’ based apportionment is limited to income chargeable to tax due to the presence of business connection in India. This apportionment theory does not apply to clause (vii) [which deals with fees for technical services]. This is because gross basis taxation is envisaged for income by way of FTS unless such FTS is effectively connected to a PE in India.
- 3.85. Thus, payment made by resident for services in or outside India would be chargeable to tax in India as far as they are not ‘utilized’ for a business outside India. Utilization is a positive condition. Therefore, payment made by a resident to a non-resident overseas contractor for the services rendered by him is always chargeable to tax unless such resident payer utilizes such services for its business outside India.
- 3.86. It may be relevant to peruse Instruction: No. 1767, dated 1-7-1987 which deals with computation of income of foreign contractors engaged in the business of exploration



and exploitation of oil and natural gas in India. The circular provides guidance on working out the percentage of profits pertaining to work outside India. Instruction no. 1829 of 1989 contained guidelines regarding taxability of non-residents engaged in the execution of power projects of turnkey basis. The instruction lays down the basis of taxation with regard to the four activities listed therein, namely, Planning, design and engineering services, Supply of permanent equipment, civil works and erection, testing and commissioning of electrical and mechanical equipment. With regard to the activity relating to profits from sale of equipments and materials on FOB basis, delivered at a port outside India, where the payments are also made outside India, it instructed that on the given facts no part of the income will be deemed to accrue or arise in India. It was observed that this instruction was misused by the assesseees to their advantage. Accordingly, the instruction was withdrawn by instruction no.5 of 2009 dated 20.7.2009. The relevant extract of instruction 5 of 2009 is as under:

- “3. In practice, however, the assesseees rely on the instruction for not only the power projects but other projects as well. Further, a single project is split into various components like offshore supply of equipments/services, onshore supply equipments and onshore services. Sometimes, the contract is split even when only one contractor/supplier bid for the project. In such cases the contract is split into various components to be executed by the bidder and its associate concerns. Thus consortium of foreign companies is not in existence but is created to take advantage of the instruction. This is not the same case as “consortium of foreign companies” envisaged in the instruction.*
 - 4. It is also noticed that most of the profit is loaded in the offshore supply and the payments for the Indian portion of the contracts barely meets the expenses resulting into either losses in India or very low profit. The Assessing Officers attempt to apportion profit correctly into various components of the overall project on the basis of functions, risks and assets is often resisted by the assessee taking recourse to the instruction. Further, even if it is proved that a part of the operations relating to supplies have taken place in India or the permanent establishment of the assessee had a role in offshore supply, the profit from offshore supply is claimed to be exempt under the instruction.*
 - 5. Thus the instruction which was originally intended for only a particular type of turnkey power project, for a given situation, is being relied upon by assesseees in all cases, in all situations, to align their business operation in a manner to avoid payment of taxes in India. This was never the purpose of issuance of this instruction. Accordingly, the Central Board of Direct Taxes hereby withdraws the Instruction No. 1829, dated September 21, 1989 with immediate effect.”*
- 3.87. Was there a misuse that instruction no. 5 of 2009 to prevent? Does this prevent an assessee from apportioning profits between offshore and onshore activities to their advantage? Does instruction no. 5 display a skeptical approach of Revenue towards foreign company consortium? – Participants may deliberate.



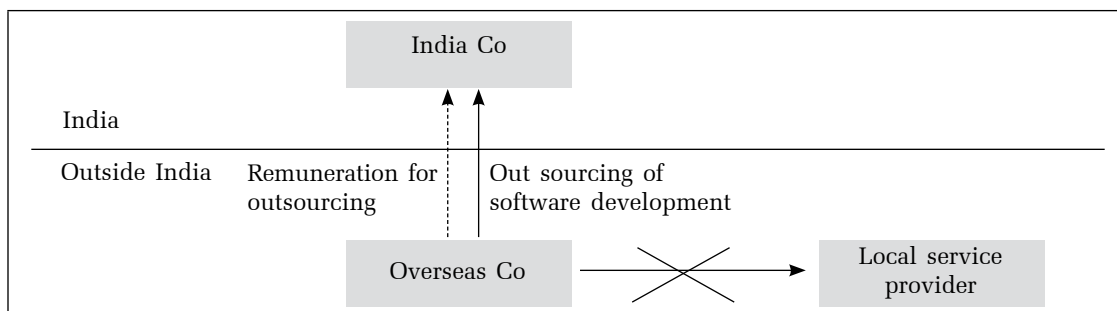
CONCERN III: OUTSOURCING IN EPC ARRANGEMENT

- 3.88. As mentioned earlier, an EPC contract may be carried out by an enterprise in association with its own legal extensions in other contracting states, its associated enterprises or third parties.
- 3.89. **Legal extension:** A non-resident contractor could have its extensions in India in the form of branch, project office or a permanent establishment. If the entity is a branch office or project office, it will serve as a place through which the non-resident carries out its operations. The presence in India becomes tangible as compared to the non-resident rendering services through employees. The income attribution principles discussed above will be applicable to these legal extensions along with computation aspects envisaged in section 44C and 44DA. Taxability of such legal extensions under tax treaty has paved way for many questions - more of this later.
- 3.90. **Associated enterprises:** Due to the magnanimity of work involved in a typical EPC contract, an enterprise could involve its group entities to execute a part of the contract. One could choose to have a conglomerate of group entities to take advantage of the synergy between the entities. Co-ordination within the group is easier. Engaging group entities would certainly be commercially and operationally a better option. The challenge lies in the tax implications that may arise on account of the joint effort of the group companies or associated enterprises.
- 3.91. Any transaction with an independent party would generally be transacted in a manner which is mutually beneficial and commercially viable. However, involvement of group entities may indicate an element of 'sacrifice' by one entity for another in the interest of the group. Such "sacrifice" may be conditioned by tax reasons. The risks and rewards of each entity engaged in the EPC arrangement and the identification of the profitability separately may get distorted. Entity wise income quantification and cost appropriation has always been a challenge in a consortium consisting of associated enterprises. This hazy picture of the internal arrangement is sought to be addressed by transfer pricing analysis. Transfer pricing provisions have only added on to the all round tax challenges faced by EPC contract - some of them being:
- (a) Can transaction between the entities in EPC contract be compared with an uncontrolled entity? Is FAR analysis possible in such cases?
 - (b) Would the comparables be chosen from the service industry or manufacturing segment or trading or construction?
 - (c) Will a TP study at the conglomerate level and entity level differ?
 - (d) Which method would be more appropriate – Profit Split Method or Transaction Net Margin Method or any other method?
 - (e) Can the uniqueness of every EPC be adjusted and factored in the transfer pricing study?
- 3.92. Increasing participation of multi-national groups in economic activities in India has given rise to new and complex issues emerging from transactions entered into between them. In a cross border EPC contract, there could be a number of foreign companies and their domestic counterparts who collectively engage in execution of the contract.



The work is divided among them. They complement each other to ensure seamless progress of the contract. At the commencement or during the course of the contract there may be a need to re-arrange the work distribution within the consortium. Such re-arrangement often paves way for assignment of contracts. The assignee steps into the shoes of the assignor. Whether an assignment amounts to a novation of the contract is not within the domain of this write-up.

- 3.93. From a tax angle, assignment of contracts between the group companies triggers transfer pricing issues [Refer *Tellabs India Private Limited vs. ACIT ITA Nos. 1037 & 1038/ Bang/ 2008*]. One may have to deliberate on whether:
- (a) Assignment of contracts is an international transaction?
 - (b) If yes, what is the Arm's Length Price of the assignment?
 - (c) If yes, what would be an appropriate comparable to benchmark such transactions?
- 3.94. **Third party or independent entities:** Outsourcing of contracts to independent or unassociated enterprises does not create any unique tax implications by itself. The interplay and involvement of multiple parties creates uncertainty about person who is subjected to tax, the timing and the quantum thereof.
- 3.95. **Outsourcing to another non-resident:** It is often seen that EPC contract of a non-resident could be partially outsourced to another non-resident. If the contract is for supply of materials, then the non-resident (contractee) is not subject to tax in India in the absence of business connection (operations) in India. However, if services are rendered by one non-resident to another, the same could be subject to tax in India if the services are 'utilized for the purposes of business carried on in India' [presuming the services satisfy the definition of 'fees for technical services' as per explanation 2 to section 9(1)(vii)].
- 3.96. **Location saving:** There could be several reasons why companies outsource work. The primary reason is pecuniary savings. Many service providers can offer to get the work done at lower costs, as they have fewer/ lower overhead expenses and perhaps operate in a different economical environment. When a company outsources peripheral work, it is able to concentrate on core business issues. Outsourcing is an excellent option to a company that plans to expand geographically. The company can start its operations in a different country more economically than doing it itself or through a local provider. Thus, there is a location saving that is inherent in an outsourcing exercise. This is better explained through an illustration below:





- 3.97. In the aforesaid diagram, there is an overseas company which outsources certain portion of its contract to India Co. Overseas Co opts to outsource the work to India Co due to the cost efficiency achieved. Overseas Co would remunerate the India Co for its efforts. Overseas Co leverages on the lower cost of service and thereby makes a notional gain. If this were to be the fact pattern, various questions arise in the context of these location savings (which are notional).
- (a) Can location savings made by outsourcing part of EPC project to Indian entities be subjected to tax in India?
 - (b) Can India Co be subjected to tax on this notional income by deeming such income to be received/ receivable by India Co?
 - (c) Would the locational savings be taxed in the hands of Overseas Co despite it being demonstrated that the profit margins or price of India Co are at arm's length?
- 3.98. **Secondment issue - a fall out of outsourcing:** As mentioned above, an overseas contractor could execute onsite portion of contract through outsourcing to its associated enterprises or third parties in India. Such outsourcing could be followed by secondment of the contractor's employees to supervise, sometimes execute or assist the actions in India. This movement of employees into India could give rise to challenges in the secondment space.
- 3.99. One of the attached or consequent implications of business outsourcing is employee deputation or secondment for carrying out the services/ tasks outsourced.
- 3.100. The movement abroad may be under a "deputation" or a "secondment". Deputation means "appointment, assignment to an officer, function". It refers to persons appointed on a particular mission. It is an appointment as a substitute, representative or deputy.
- 3.101. "Secondment" as per the dictionary means "a temporary transfer to another position or employment". It means support, backup, assistance.
- 3.102. The dictionary meaning of "deputation" and "secondment" generally rely on the duration test. Secondment is defined to be a temporary transfer. Deputation by inference is believed to be for a longer duration. Corporate world, in their relationship not only take into account the duration test but also the aspect of control. In both eventualities, the control of the employee is ceded to the organization where the employee is sent. Deputation as well as secondment is generally evidenced by a tripartite agreement. Additionally, the organization to which the employee is deputed may enter into a separate contractual arrangement.
- 3.103. The determination who exercises control, determines the person for whom or on whose behalf the services are rendered. This also determines who shall bear the salary and the need if any, for a cross charge of the salary. The **nature of control** (and the consequential question for whom the services are rendered) would determine whether the employee constitutes an extension of the deputing organization and leads to its presence (service PE) in the foreign soil. This aspect of employee secondment thus includes its own heaps of tax consequences, implications and unresolved issues.



- 3.104. The Apex Court in the case of *DIT vs. Morgan Stanley and Co. Inc. (2007) 292 ITR 416 (SC)* observed that when an employee of one company [legal employer] is deputed to another, such person does not become the employee of the company [economic employer] where he is sent. As long as the **lien** remains with the legal employer, it retains control over the deputationist's terms and employment. Where the activities of the multinational enterprise entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a service PE would emerge.
- 3.105. Tribunals in many cases, notably *IDS Software Solutions India (P) Ltd. vs. ITO (2009) 122 TTJ 410 (Bangalore)*; *M/s. Abbey Business Services (India) Private Limited vs. DCIT 1141/Bang/2010/2005-06* have laid down various tests to determine who the employer (legal employer or economic employer) is as under:
- a. For ascertaining whether a person is a servant a rough and ready test is whether under the terms of the employment, the employer exercises a **supervisory control** in respect of the work entrusted to him;
 - b. The nature of employment can be determined by the Articles of Association of the company and/or the agreement, if any, under which a **contractual relationship** between him and the company is brought about;
 - c. Control need not necessarily be of one who tells him what to do from day to day, nor is it necessary that the company's supervision over him should be a continuous exercise of power to oversee or superintend the work to be done;
 - d. Control and supervision is exercised and is exercisable in terms of the employee contract;
 - e. The employee not only receives instructions from his employer but is also subject to the right of the employer to control the manner in which he should carry out such instructions, a significant feature of employer-employee relationship being 'control and command';
 - f. When rights such as the right to hire or accept the secondment, right to control and supervise, right to instruct, right to terminate from secondment are satisfied, the employer-employee relationship is satisfied.
- 3.106. It may be relevant to quote the observations of the Delhi High Court in the case of *Centrica India Offshore (P) Ltd. vs. CIT (2011) 364 ITR 336 (Delhi)* wherein primacy was given to social security and other emoluments paid by the overseas entity to establish the link of overseas employer with the employees. In this case, employees of the overseas entity were seconded to Indian counterpart for carrying out certain services. It was not disputed that – (i) the employees were subject to control and supervision of the Indian entity; (ii) The rules, regulations, policies and other practices of Indian entity for its employees were applicable to the seconded overseas employees too; (iii) The seconded employee's duties and functions were dictated by the instructions and directions of the Indian entity; (iv) Indian entity bore all risks in relation to the work of the seconded employees, and reaped the benefit from the output; (v) Indian entity bore the cost of monthly remuneration and reimbursement of cost to the



seconded employees. In spite of all these facts, the Delhi High Court ruled that the overseas entity has a lien over the seconded employees. It observed:

“crucially, these seconded employees retained their entitlement to participate in the overseas entities, retirement and social security plans and other benefits in terms of its applicable policies, and the salary was properly payable by the overseas entities, which claimed the money from CIOP [Indian entity]. There was no purported employment relationship between CIOP [Indian entity] and the secondees. None of the documents, including the attachment to the secondment agreements placed on record (between the secondees and CIOP [Indian entity]) reveal that the latter can terminate the secondment arrangement ; there is no entitlement or obligation, clearly spelt out, whereby CIOP [Indian entity] has to bear the salary cost of these employees. The secondees cannot in fact sue the CIOP [Indian entity] for default in payment of their salary-no obligation is spelt out vis-a-vis the petitioner. All direct costs of such seconded employee’s basic salary and other compensation, cost of participation in overseas entities’ retirement and social security plans and other benefits in accordance with its applicable policies and other costs were ultimately paid by the overseas entity...

Today, CIOP [Indian entity] attempts to cast that employment relationship as a tenuous link because, for the duration of the secondment, CIOP [Indian entity] pays the salary of these. Even here, the salary is ultimately paid through the overseas entity, which is not a mere conduit. Crucially, the social security, emoluments, additional benefits etc. provided by the overseas entity to the secondee, and more generally, its employees, still govern the secondee in its relationship with CIOP. It would be incongruous to wish away the employment relationship, as CIOP [Indian entity] seeks to do today, in the face of such strong linkages. Whilst CIOP may have operational control over these persons in terms of the daily work, and may be responsible (in terms of the agreement) for their failures, these limited and sparse factors cannot displace the larger and established context of employment abroad.”[words in the brackets supplied by us].

- 3.107. It is important to observe that the Delhi High Court chose to give prominence to salary disbursement responsibility and ‘employment link’. Although, the control over the seconded employees rested with the Indian entity, the overseas entity was declared as the employer. The question is whether Centrica case has followed the dictum of Morgan Stanley? Whether the person who bears the salary cost is always the employer? Consequently, whether decisions such as *Morgan Stanley International Incorporated vs. DDIT [2015] 153 ITD 403 (Mumbai - Trib.)* [Wherein Centrica decision was relied upon to conclude presence of service PE in India] would provide the correct principles? Participants may deliberate.

CONCERN IV: IDENTITY CRISIS UNDER EPC ARRANGEMENT

- 3.108. From an income-tax perspective, it is elementary to establish the person/ assessee who would be subject to tax. Under a typical EPC arrangement there are number of players who come together to make the project possible. Will each of the parties reckon the tax liabilities separately on the basis of their portion of rewards? Or can the inherent unity in EPC give birth to a consortium or a separate taxable entity?
- 3.109. Section 4 levies a charge of income-tax on total income of every person. Section 2(31) of the Act defines “person” in an inclusive manner. The definition being inclusive,



it has to be given a broad meaning. Eight categories of persons are mentioned in section 2(31). These are natural as well as juristic persons. If each party to the EPC contracts were to be assessed separately for income-tax purposes, their taxation would be governed by their respective status. However, if 'collective entity' approach is considered, AOP and BOI [appearing in clause (v) of section 2(31)] are the alternatives. The involvement of persons who are not individuals (which is generally the case) would render BOI irrelevant. One may have to therefore examine whether the various parties participating in an EPC arrangement constitute an AOP?

What is AOP?

- 3.110. Section 2(31) includes AOP to be a form of person. The term "AOP" has not been defined in the Act. A combination of persons (from any of the seven listed in the provision) who are engaged jointly for the purpose of earning profit may be considered to be an AOP. A unified approach to define AOP has been elusive. One may therefore traverse through various judicial precedents on this matter. Some of the landmark judgments have been listed here –
- 3.111. In *CIT vs. Indira Balakrishna (1960) 39 ITR 546 (SC)*, the Apex Court held that - "*the real test is the existence of a common source of income in which two or more persons are interested as owner or otherwise and it is immaterial whether their shares are specific and definite or whether there is any scheme of management or not. He has submitted that if the persons so interested come to an arrangement, express or tacit, by which they divide the income at a point of time before it emanates from the source, then the association ceases; otherwise it continues to be an association.*"
- 3.112. The meaning of "an association of persons" was also examined by Supreme Court in the case of *G. Murugesan & Brothers vs. CIT (1973) 88 ITR 432 (SC)*. It was held in that case that an association of persons could be formed only when two or more individuals voluntarily combined together for certain purposes. **Volition on the part of the members** of the association was an essential ingredient. These observations were reaffirmed by the Apex Court in *CIT vs. Govindbhai Mamaiya [2014] 367 ITR 498 (SC)*.
- 3.113. In *N. V. Shanmughan & Co vs. CIT (1971) 81 ITR 310 (SC)*, unity of control amongst the members of AOP was given due weightage. It was observed - "The existence of specific or defined interest in the profits did not make the earning any the less by an "association of persons." Liability to tax depends upon the earning of profits by a unit and not upon the ultimate division of the profits."
- 3.114. The Authority of Advance Ruling in the case of *Van Oord ACZ BV, In re (2001) 248 ITR 399 (AAR)* had an occasion to decipher whether the arrangement impugned was an AOP. The AAR ruled that it was not an AOP. It observed that there is no sharing of profits or loss. The agreement provided that each party will bear its own loss and retain its profits as and when such profits or loss arise. The association by the assessee in the said case was not with the object of earning income but was for coordination in executing the contract so that it could make its own profit. The assessee's work and income arising therefrom was separate and independent of the applicant's work and income.



3.115.AAR in the case of Rotem Co., In re (2005) 279 ITR 165 held that the assessee did not constitute an Association of Persons on the basis of following aspects:

- The nature of work undertaken and capable or being executed by each consortium member was different and the scope of work of one member could not be undertaken by the other;
- Each consortium member had a different skill set.
- Overseeing of each other's work, by the consortium members was not possible.
- Each consortium member had independently determined the prices (by way of agreeing to separate discounts).
- The consortium agreements specifically recorded that nothing in the agreement would be construed as creating a partnership, joint venture or any other legal entity with the other parties to the said agreements.
- The profit and losses were borne by individual members and there was no common expenditure incurred by the members jointly

3.116. It may be observed that judicial precedents consistently have laid thrust on importance of earning profits. If there was no common motive to earn profits, the association was not recognised as AOP. This requirement was discontinued by the legislature. Finance Act 2002 amended section 2(31) by inserting an explanation thereto which reads as under:

Explanation.— For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains”.

3.117. Profit earning motive is no more essential for constitution of an AOP for the purposes of section 2(31). The objective of this amendment can be inferred from circular 8 of 2002 dated 7.8.2002 which reads as under:

“5.1 Under the existing provision contained in clause (31) of section 2, the expression “person” includes an individual, a Hindu undivided family, a company, a firm, an association of persons or a body of individuals, whether incorporated or not, a local authority and every other artificial juridical person, not falling within any of the above definitions. Although, the definition of “person” is inclusive and starts with the qualifying words “unless the context otherwise requires”, in some cases, a claim has been made that certain bodies do not fall within any of the definition of “person” provided in clause (31) of section 2 due to sole reason that they are not supposed to have any income or profits and gains.

5.2 To clarify the correct legal position, an Explanation in clause (31) of section 2 has been inserted through Finance Act, 2002 so as to provide that an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not, such person or body or authority or juridical person, was formed or established or incorporated with the object of deriving income, profits or gains.” (emphasis supplied).



- 3.118. One may trace back to the Calcutta High Court decision in the case of *B. N. Elias And Others, In Re.* (1935) 3 ITR 408 (Cal) wherein his Lordship Costello J observed as under:

“I have no doubt whatever that Mr. Banerji was perfectly justified and correct in inviting us to take the view that this was not a partnership but it seems to me bearing in mind the juxtaposition which I have mentioned, that although these four persons did not constitute a body which was the same as partnership it was in many respects similar to a partnership and was approximate to a partnership and it may well be that the intention of the legislature was to hit combinations of individuals who were engaged together in some joint enterprise but did not in law constitute partnership....”

When we find, as we do find in this case, that there is a combination of persons formed for the promotion of a joint enterprise banded together if I may so put it, co-adventurers to use an expression then I think no difficulty whenever arises in the way saying that in this particular case these four persons did constitute an “association of individuals” within the meaning of both Section 3 and Section 55 of the Indian Income-tax Act, 1922.”

- 3.119. In the case of *Linde AG, Linde Engineering Division vs. DDIT (2014) 365 ITR 1 (Del)*, Linde and Samsung entered into a Memorandum of Understanding whereby both the parties agreed to form a Consortium for jointly submitting a bid to secure the contract for execution of a project. The consortium was formed to avoid competition between them and secure the bid. The High Court observed that an AOP should have the trappings or shades of a partnership to qualify as AOP and observed as under:

“It is, thus, essential that an Association of Persons has the trappings of a partnership for conducting the joint enterprise which makes it amenable to be treated as a separate taxable entity. A person carrying on business may in the usual course cooperate with others for a common purpose. In many instances, the test of common purpose and common action, if literally applied, may also hold true. However, treating every instance of such cooperation between two or more persons as resulting in an Association of Persons would militate against the purpose of considering an association as a separate tax entity. Whether an arrangement or collaborative exercise between two or more persons results in constituting an Association of Persons as a separate taxable entity would depend on the facts of each case including the nature and the extent of collaboration between them.”

- 3.120. AOP is an association of persons which has shades of partnership. It need not be constituted for profits or gains. If two or more persons join hands to carry on an activity (whether for profits or otherwise) but do not constitute a partnership they may be assessed as an AOP. There has to be a concerted action by all the persons in association. An AOP however does not mean any and every combination of persons. It emerges only when they combine to carry out an activity in association. The activity carried on must be pursuant to the combined will of the persons constituting the association that an AOP may emerge. If there is no common design and desire, there is no association.

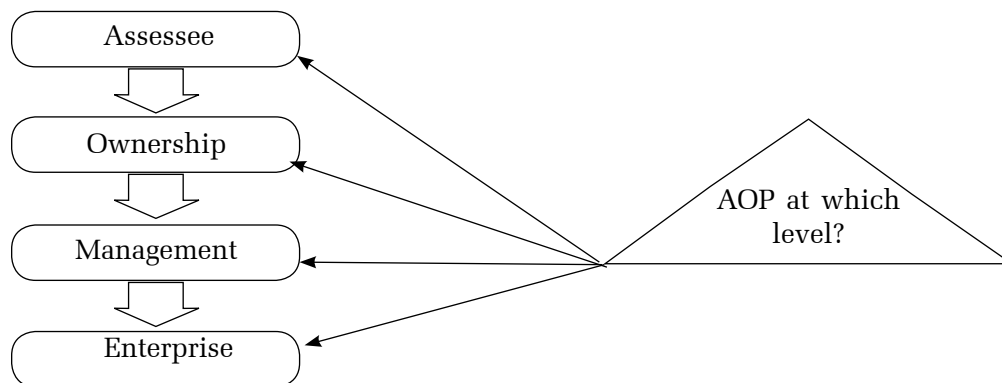


3.121. **Is it AOP or AOE?** - The Delhi High Court in Linde's case above observed that members must join as an enterprise to constitute an AOP. The relevant observations of the High Court are:

"...the Association of Persons is one in which two or more persons join together for a common purpose or common action and there is a joint management or joint action by the said two or more persons. In order to treat persons as an association, it is necessary that the members must have a common intention and must act jointly for fulfilling the object of their joint enterprise."

3.122. The High Court advocates that the joining or coming together should happen at the enterprise level. It is therefore interesting to understand that to constitute AOP the blending should be of two or more enterprises. It may not be at the assessee level. Could we now say that AOP has been redefined to mean association of enterprises rather than association of persons? Or can we say it is just use of different semantics because the enterprise (although in section 92F) is defined enterprise to mean person?

3.123. The aforesaid issue can be better appreciated through the chart below:



3.124. There are many combinations which fall in the negative list (ie, they are not AOP). For instance, mere joint receipt of income; common management; co-ownership may not constitute AOP. The Andhra Pradesh High Court in the case of *Bolla Tirapanna & Sons vs. CIT (1969) 71 ITR 209 (AP)* observed that merely because the parties entered into a single lease instead of seven separate agreements of lease, the status of the assessee cannot be determined as an association of persons.

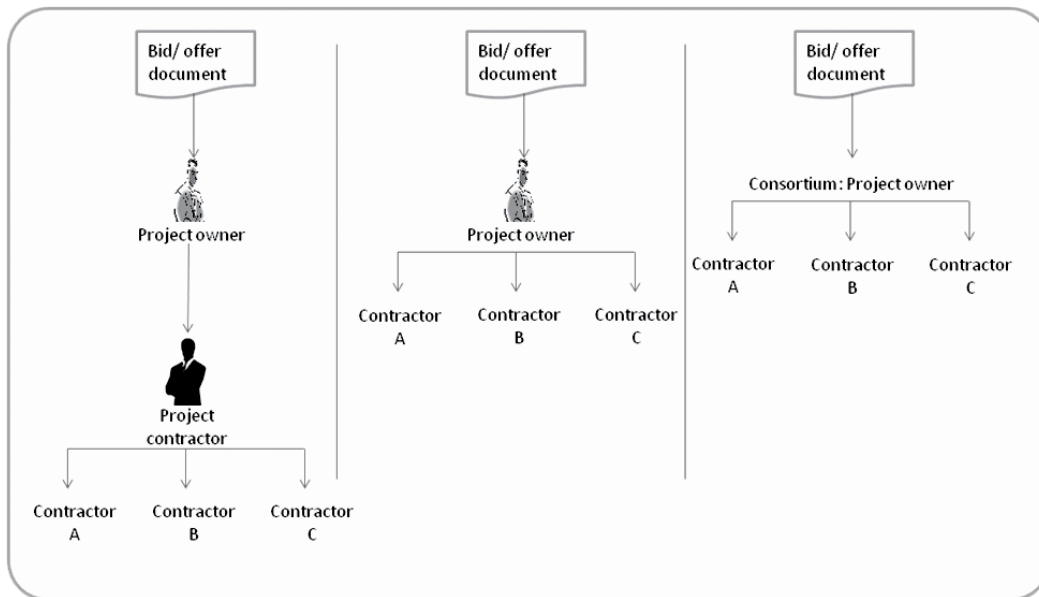
3.125. Mere fact that a work may be undertaken jointly cannot lead to the inference of AOP. This was confirmed in *Hyosung Corporation In re (2009) 314 ITR 343 (AAR)* wherein it was found that a non-resident was associating with a resident only for the offshore activities without being responsible for Indian activities. It was concluded that there cannot be an inference of AOP in the absence of risk sharing.

3.126. In an EPC contract, there would be a project owner who seeks to execute a project. He could either carry out the project himself or could mate with other persons to carry out the project. In some arrangements, the parties to the EPC contract may agree to share 'receipts at source'. This is also called as top-line sharing. Each of the parties share income at the 'gross level'. Contrastingly, parties to the EPC contract may share



income after deduction of expenses. Expenses are then common to all participants. This is sharing at the net level or bottom line sharing. The level at which the profits are shared could have a bearing on the characterization as AOP. A gross level split indicates the independence of each of the parties. Right from the source, the stream of income is channelized to one of the constituents of EPC. There is no overlap. There is therefore no need to compute, bifurcate and apportion the net income among the EPC players. Alternatively, income could be collected in a common pool and distributed among the EPC participants after reducing the associated or attached outflows (for instance, expenses, taxes etc). This *modus operandi* would involve sharing of expenses/ outflows; agreeing on a share from the common pool in some ratio; timing of withdrawal of money from the pool etc. The second alternative would have various mutual arrangements and agreements for ensuring the accomplishment of the task in its entirety as well economic returns (for the efforts) for the individual participants in EPC.

3.127. There could be various modes of entering and executing EPC contract. Some of the variants are displayed below:



3.128. Thus, there can be various formations that can be evidenced in a EPC structure. In the first case above, the project owner contacts a project contractor who would team up with other or associated contractors to render the requisitioned works. In this case, an AOP (if any) can occur at the project contractor stage. In the second case, the project owner is possibly a person who is conversant and capable of achieving a portion of the requisitioned work. He therefore associates and gathers contractors to accomplish the task. Under this scenario, AOP can possibly be formulated at the project owner stage. The third variant is where two or more contractors come together under one banner and make a joint bid. An AOP under this fact pattern emerges due to the coming together of different contractors with a unified objective. To decipher the correct relationship, it is imperative to scan the arrangements in evidence minutely.



Every term/ condition; the risk and reward matrix; communication between the parties, other details along with the surrounding circumstances etc would help unravel the true story and relationship. It is the *inter se* relationship between the parties which is more important than the relationship of the consortium with the project owner. If the project owner is also a party to the consortium, view of the third parties with whom the consortium deals does not matter. There has to be consensus ad idem at the participant's level within the EPC arrangement. Molecular density of a matter decides whether it is a solid, liquid or gas. In the same manner, the bonding within the participants of EPC determines whether it is AOP or not.

3.129. Having regard to the various principles discussed above, the following questions emerge for consideration:

- (a) Do participants of EPC contract invariably constitute AOP?
- (b) Should they have the traits of a partnership in them?
- (c) Should the determination whether the EPC arrangement is AOP or not be finalized at the commencement of the project or can the characterization change in the course of the project execution?
- (d) Is the 'top line' sharing and 'bottom line' sharing still a relevant criterion having regard to explanation to section 2(31) which states that an AOP need not be formed with an object of earning income?

3.130. **A case study on this matter is below:**

<i>Name of the project owner:</i>	<i>Mumbai Metro (Aamchi Mumbai)</i>
<i>Name of the consortium members:</i>	<i>Rhundai Ltd, Korea</i> <i>Takanishi Ltd, Japan</i> <i>Hindustan Machinery Ltd., India</i>
<i>Consortium leader:</i>	<i>Hindustan Machinery Ltd., India</i>
<i>Other facts:</i>	<ul style="list-style-type: none"> • <i>Consortium members to design and deliver 150 metro cars to be used from 1.1.2018, being the scheduled date of metro commencing its services</i> • <i>Wrap Around agreement (WAG) entered into.</i> • <i>Invoices raised and payments to be made: 60% in dollar & 40% in rupees.</i> • <i>Payments are made to the consortium leader which in turn disburses the aliquot portion to the consortium members in accordance with the consortium agreement</i> • <i>Expenses for the respective portion of work to be borne by the consortium members</i>



Queries:

- *Whether the arrangement constitutes an AOP?*
- *If there is no AOP; (i) what would be the nature and character of payment to the various constituents? and (ii) what would be the withholding obligation and by whom will it be discharged?*
- *If there is an AOP, what would be –*
 - (i) its residential status;*
 - (ii) scope of income chargeable to tax;*
 - (iii) the rate of tax on its total income;*
 - (iv) what would be the MAT implications?*
- *What would be the advise from a precautionary angle to the consortium leader:*
 - (i) during the period the EPC work continues; (ii) after the end of the EPC work.*

- 3.131. **Residential status of AOP:** Section 6(2) of the Act provides that AOP is said to be resident in India if its control and management is wholly or partially in India. Therefore, if EPC arrangement is concluded to be an AOP, partial presence of its control and management in India would make the “arrangement” resident in India. Alternatively, the EPC castle may be opened up. Individual participants may be viewed on a stand-alone basis. The corporate participants therein would then respectively stand exposed to the POEM test in section 6(3).
- 3.132. From foreign companies’ perspective, this has been a paradigm shift in residential status determination. Under the hitherto legislation, the foreign companies were held to be ‘resident’ in India if during that year, the control and management of its affairs was situated wholly in India. There were various aspects that one had to be mindful of to reckon the residential status of a foreign company. Some of these were:
- (a) Identify the **control and management** of the company;
 - (b) Such control and management has to be in relation to **affairs** of the company;
 - (c) **Locale or situation** of control and management should be **wholly** in India.
- 3.133. Control and management was the fulcrum of this entire provision. The presence of both ‘control’ and ‘management’ was imperative. POEM departs from the above understanding. The rule of residential status determination is that the place of effective management (POEM) in that year should be in India. With this shift one has to evaluate whether a WAG/ consolidated arrangement would invite global tax on the income from EPC contract? Would WAG influence be now more pronounced than otherwise? Participants may deliberate.
- 3.134. **Computation of income from AOP (in the hands of members):** Section 67A deals with the method of computation of members’ share in the income of AOP. Section 86 provides for inclusion and chargeability of share in the income of and tax payable thereon. It provides exemption in the hands of the members under certain circumstances. Whenever a company participated in an AOP, the question was whether



income therefrom would be subject to MAT? In the case of a partner of a firm, the share in the profits of the firm is exempt in the hands of the partner as per section 10(2A) of the Act and no MAT is payable by the partner on such profits. There was no specific exemption from MAT for members of AOP.

3.135. Finance Act 2015 has amended section 115JB so as to provide that the share of a member of an AOP on which no income-tax is payable as per section 86 of the Act, should be excluded from MAT liability (in the hands of the members). This is captioned as a rationalization measure. It provides the much needed relief to the EPC participants. The question is whether sans this provision, the income was chargeable to tax in the participant's hands? Participants may deliberate.

CONCERN V: INTERPLAY OF ICDS WITH INCOME-TAX STATUTE

3.136. Vide notification no. 32 of 2015 dated 31.3.2015 'Income computation and disclosure standards' under section 145 have been notified. Sub-section (2) to section 145 has made compliance with ICDS mandatory. It may be relevant to traverse some of the relevant portions of the ICDS. We would abstain from making any comment or observation on the validity of the notification itself or the binding impact it has on the assessee. The ensuing paragraphs highlight some of the conflicts that an assessee may encounter in complying with the requirements of the ICDS.

3.137. ICDS IV deals with revenue recognition. It provides separate revenue recognition mechanism for sale of goods and provision of services. In relation to sale of goods, it provides that revenue shall be recognised when the seller has transferred the property in the goods to the buyer for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership. In a situation, where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership, revenue in such a situation shall be recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

3.138. Para 6 of ICDS IV deals with recognition of income from services. It prescribes revenue recognition on "percentage completion method". It requires matching of revenue from service transactions with relevant costs incurred at the particular stage of completion. The quantum of income to be recognised would depend upon the costs that are incurred in achieving the desired milestone. Thus, income is to be recognised on 'matching principle'.

3.139. There is no guidance available on when the income should be recognised in case of composite contracts. There is no special or specific computation prescribed for EPC or turnkey projects. In this background, it becomes relevant to deliberate on the following issues:

- (a) Whether income recognition would be for the contract as a whole or for each segment of the EPC contract?
- (b) If the Revenue authorities disregard the supply contract and adjudge the same to be service contract (or vice-versa), would the income recognition principles be altered?



- (c) In the absence of specific guidance in ICDS, should one fall back on the known principles under the Act?
- 3.140. ICDS I [dealing with accounting policies] recognizes ‘accrual’ as one of the fundamental accounting assumption. It defines ‘accrual’ as under:
- “Accrual” refers to the assumption that revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the previous year to which they relate.”*
- 3.141. ICDS I requires revenues to be recognized as and when it is earned. It clarifies that revenues should not be recognized as money is received or paid. In other words, cash system of accounting is not permissible under ICDS. Incomes are said to accrue when they are ‘earned’ and ‘recorded’ in the previous year to which they relate. The presence of ‘earning’ and ‘recording’ of income connote crystallization of right to receive the income in favour of the assessee.
- 3.142. The definition of accrual under ICDS is different from the traditional understanding of the term under section 5. Under section 5, earning is the cause of accrual. Accrual is a stage post the event of earning. It emerges when the earning translates into a right to receive. Salary for example is earned everyday on the bestowing of labour. The right to receive (accrual) however happens at defined intervals. It is therefore critical to examine as to what constitutes ‘accrual’ in the context of EPC contract? Can one have resort to ICDS I and conclude that income should be recognised as and when it is earned and recorded? Or could one state that income accrues when the right to receive fructifies? In the case of retention monies, should the accrual be associated with the factum of earning or the dictum of right to receive?
- 3.143. It is equally relevant to analyse whether ICDS III [Construction contracts] covers EPC contracts. Para 1 of ICDS III states the Standard should be applied in determination of income for a construction contract of a contractor. The term contractor is not defined by the standard. The expression construction contract has been defined as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. Thus, construction of technology related assets and related services are also envisaged in ICDS III. Could one thus argue that EPC contracts are also covered within the standard? Participants may deliberate.
- 3.144. ICDS III (at para 7) provides that a group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
- (a) the group of contracts is negotiated as a single package;
 - (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (c) the contracts are performed concurrently or in a continuous sequence.
- 3.145. Para 7 of ICDS III covers a situation where a group of contracts is to be treated as a single contract. The conditions which are required to be fulfilled for treating a group of contracts into a single contract are outlined therein. The fact that the contractor has negotiated the said group of contract with a single customer or with several customers



is irrelevant if the conditions are cumulatively satisfied. The first condition requires an enquiry being made to determine whether the group of contracts has been negotiated as a single package. The second condition requires a determination whether the contracts are closely interrelated with each other having an impact on the overall profit margin of the contractor. The interdependence could be in relation to design, function or use of the assets covered under different contracts. The third condition is that the contracts are performed concurrently or in sequential manner.

3.146. All the three conditions referred to hereinabove would have to be satisfied. To illustrate:

- (a) A contractor (say RP & Co) enters into two separate contracts with a customer (say PP Ltd) one for preparing the technical designs of a power plant and another for civil construction of the said plant.
- (b) The civil construction work is based on the technical design.
- (c) Negotiations are conducted for the two agreements and for sequential delivery of the assets in a span of 18 months. The decision is taken on pricing of contracts by PP Ltd after considering the value of bids made by RP & Co. RP & Co negotiates the contracts as a single package. In substance, the nature of tasks to be performed under both the contracts is interrelated in terms of technology, function and use. This is despite the fact that there are two separate contracts for the two distinct jobs. The contracts would be performed in sequence.

3.147. In the said illustration, all the three conditions of Para 7 of ICDS III would be satisfied to combine the two contracts [contract for technical designing and civil construction] into a single contract. RP & Co would therefore be required to recognize revenues and costs for both the contracts as one single contract.

3.148. In this background, the questions which emerge for deliberation are as under:

- (a) Could these parameters also be adopted to decide on the severability of contracts?
- (b) Are these conditions invariably to be applied in every circumstance?
- (c) When viewed negatively, if any of the conditions are not satisfied, could it be accepted that the contracts are divisible?

CONCERN VI: RELEVANCE OF PRESUMPTIVE BASIS OF TAXATION

Presumptive basis of taxation prescribed for Government approved turnkey power projects

3.149. Section 44BBB contains special provision for computing profits and gains of foreign companies engaged in the business of civil construction, etc. in Government approved turnkey power projects. It determines the income at a sum equal to 10% of the amount paid or payable on account of such civil construction or the business of erection of plant or machinery or testing or commissioning thereof, as the profits and gains of such business chargeable to tax under the head "Profits & gains from business or profession". Can this concessional rate be jeopardized by MAT regime?

3.150. To illustrate, a foreign company is chargeable to tax at 40%. Tax on a presumptive income of 10% would make the company liable to tax at a concessional rate of



4% [10% of 40%]. However, these companies are not outside the ambit of MAT computation. Book profit computed under section 115JB is liable to tax at 18.5%. Thus, a foreign company which is otherwise liable to be taxed at a rate of 4% could get exposed to hefty tax at 18.5%. Wouldn't this taxation through the backdoor entry render the concessional tax regime inane?

3.151. Section 44BBB is a specific section dealing with foreign companies engaged in turnkey power projects. Its scope and operation is limited. We have therefore not detailed into the other nuances attached to this section.

CONCERN VII: CLAIMING RELIEF UNDER TAX TREATIES

Relief under the Double Taxation Avoidance Agreements

3.152. Double Taxation Avoidance Agreement ("Tax treaty" or "DTAA") is designed to provide relief in case of double taxation of the same income. Section 90(2) confirms that the provisions of the Act would apply to the extent they are beneficial as compared to the Tax treaty. Each treaty is unique in its content and import. For the sake of easy understanding, Articles of India-US DTAA has been adopted to discuss the treaty provisions save certain variations in other treaties highlighted at the appropriate places.

CONCERN VII(A): TREATY ELIGIBILITY

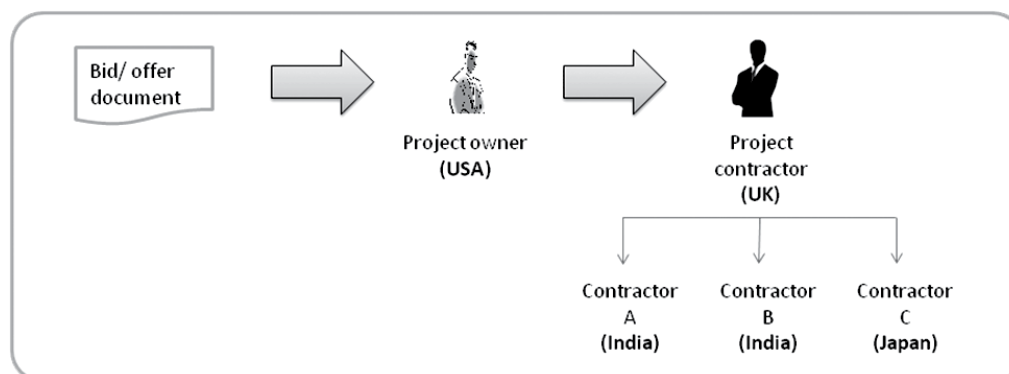
3.153. Article 1 of the Indo-US treaty clarifies that the Convention shall apply to "persons" who are residents of one or both of the Contracting States, except as otherwise provided in the Convention. The term "persons" has been defined to include an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity. If the EPC arrangement is an AOP, it could be classified as 'body of persons'. However, such person is required to be a resident of one or both the contracting states. Under the Indian tax laws [section 6(2)], an AOP is treated as resident if the control and management is even partially in India. This could result in its global income being taxable in India. Presence of various overseas entities in the AOP could result in the consortium being resident in the other country as well. This could result in denial of tax treaty benefits. This happens especially when the two contracting states are countries like India and USA. Under Indo-US treaty, it is clarified that the tax treaty benefits for non individuals are not available if the assessee is resident in both the countries. Treaty eligibility determination is far more easier when the parties involved in EPC contract hail from two countries. The involvement of many parties in the consortium who owe their origin to different countries could create challenges around identification of the applicable treaties.

3.154. If the consortium is unbundled into different parties, each of them would have to satisfy the test of Article 1. This would mean that separate study of residential status would have to be done for each of the participants to the EPC contract. As we are aware, a foreign company is resident in India only if its place of effective management is in India. Would this mean that presence of a project contractor (who is the actual manager of the entire project) in India could render the foreign enterprise a resident in India?



3.155. In addition to the above, the following questions also pose challenge:

- (a) How does one determine the control and management in case of AOP? Does it depend on the locale of project contractor, the offshore or onshore contractor?
- (b) Multinational EPC arrangements: As indicated above, the participants in EPC could be residents of different countries. An instance is captured in the figure below:



3.156. In the figure above, it is assumed that a consortium is created at the Project contractor level. This consortium consists of participants from UK, India and Japan. The question of which country is the AOP a resident?

CONCERN VII(B): PERMANENT ESTABLISHMENT EXPOSURE

3.157. Under the Double tax convention regime, right of the contracting states to tax business income of an enterprise of other contracting state arises only if the enterprise carries on its business in the first mentioned state through a Permanent Establishment. Permanent Establishment has emerged as one of the most debated (nay most feared) aspects of international law. It is analogous to the concept of 'business connection'. It is a mechanism by which a foreign enterprise's profits are taxed in the country where the activities are performed. A PE may take various forms. The ones relevant for the present discussion are as under:

(a) Fixed place PE

3.158. In terms of Article 5(1), i.e. the basic rule, a PE is said to exist in the other contracting state when an enterprise of one of the contracting states has a fixed place of business, in the other contracting state, through which business is carried out – wholly or partly.

3.159. There are three criteria embedded in this definition - (i) physical criterion i.e. existence of physical location, (ii) subjective criterion i.e. right to use that place and (iii) functionality criterion i.e. carrying out of business through that place. It is only when these conditions are satisfied, a PE under the basic rule can be said to have come into existence [Refer *Airlines Rotables Ltd. vs. JDIT* [2010] 131 TJJ 385 (Mumbai)]. The physical test, i.e., place of business test, requires that there should be a physical



location at which the business is carried out. However, mere existence of a physical location is not enough. This location should also be at the disposal of the foreign enterprise and it must be used for the business of foreign enterprise as well. A place of business should be “*at the disposal*” of the foreign enterprise for the purpose of its own business activities [Disposal test]. Disposal test is satisfied when a specific earmarked premise is visited frequently, without any restrictions on the access for carrying out operations of its business. The test is met when the use of place cannot be prevented without the enterprise’s consent.

- 3.160. In this context, it may be relevant to refer the decision of Delhi ITAT in the case of Samsung Heavy Industries Co Limited (TS-498-ITAT-2011(Del) wherein it was concluded that a ‘Project office’ involved in co-ordination and execution of turnkey project constituted a fixed place PE in India. The project office in this case did not render preparatory or auxiliary services; in which case, it would have been bailed out of the clutches of PE definition.
- 3.161. Some of the countries recognise the fixed place PE concept in the domestic law itself. For instance, the tax laws of Algeria regarding tax of foreign companies performing EPC contracts state that foreign companies performing EPC activities are deemed to have a fixed place of business (or PE) in Algeria².

(b) Installation PE

- 3.162. For an EPC contractor, the existence of a PE may depend on whether it is performing its services as part of the construction or installation of a project inside the project country. Article 5(2)(j) of the Indo-US treaty deals with installation PE. It reads as under –

“a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve-month period”

- 3.163. The paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. The term – building site or construction or installation project includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging.
- 3.164. The term is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. An EPC contract involving installation of machinery which spans a period exceeding 120 days could trigger an installation PE. Some of the issues which emerge in this context are as under:

- (a) The threshold of 120 days applies to each individual site or machine or project?

2. Source: The Report: Algeria 2007 by Oxford Business Group



- (b) Whether the timeline would factor in time previously spent by the contractor on other sites or projects unconnected with such installation?
 - (c) The period to be tested is the time span during which the construction or installation exists. What would indicate the commencement and completion of installation?
 - (d) Whether temporary shut downs should be excluded from the time frame computed in the said context?
 - (e) The test is examined at the level of consortium or entity which performs the installation or at the level of the actual personnel engaged in execution (such as the partners or employees)?
 - (f) If an EPC contractor, which has undertaken a general contractor role in a project, sub-contracts parts of the project to one or more sub-contractors, whether the time spent by each sub-contractor working on the construction site will be counted for purposes of determining whether the general contractor has an installation PE?
- 3.165. Whenever countries have treated 'supervision activity' as a separate PE on a standalone basis, they have created a separate line item to enforce PE on account of supervision activities. For instance, one may refer to Articles 5(2)(h) and (i) of Indo-Kenya treaty which reads as under:
- (h) *a building site or construction or assembly project which exists for more than six months;*
 - (i) *the provision of supervisory activities for more than six months on a building site or construction or assembly project.*
- (a) Could this mean that supervisory activities by themselves are capable of creating a PE?
 - (b) Should such supervision be in connection with the installation carried on by the assessee only?
 - (c) If supervision is carried on in connection with one's own building site, would the assessee constitute two separate PE(s)?
- 3.166. It may also be interesting to quote the decision of Jabalpur Bench of ITAT in the case of *Birla Corporation Ltd. vs. ACIT (2015) 53 taxmann.com 1 (Jabalpur-Trib.)*. In this case, the Tribunal concluded that though construction, installation and assembly activities are *de facto* in the nature of technical services, the consideration thereof will not be assessable under Article 12 [as fees for technical services] but will only be assessable under Article 7 if an "Installation PE" is created under Article 5. Article 5 is a specific provision for installation etc, which prevails over Article 12. Would this decision hold its ground in every situation? Participants may deliberate.
- 3.167. A reading of the tax treaties India has entered into with various countries provides some interesting variants of construction/ installation PE. Some of them are tabulated below:



Language employed in various treaties	Possible inference
<p>Belgium – “a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than six months, or where such project or supervisory activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory activity exceed 10 per cent of the sale price of the machinery and equipment.”</p>	<p>Project or supervisory activity would constitute a PE if it continues for a period of 6 months and the charges therefor exceed 10% of the sale price of machinery/ equipment in relation to which they are rendered. Thus, the article visualizes two forms of cap – one is on the timeline and the other on the quantum. The question is whether each of the activities should exceed 10% of sale price or all the consideration towards all the activities should cumulatively exceed such threshold?</p>
<p>Brazil – a building site or construction or assembly project which exists for more than six months;</p>	<p>In this case, installation and supervisory activity does not constitute PE. Further, the treaty employs the phrase ‘exists’ (vis-a-vis the term ‘continues’ in other treaties). Would the use of the term ‘exists’ pave way for a different interpretation of such PE?</p>
<p>UK – a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than six months, or where such project or supervisory activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory activity exceed 10 per cent of the sale price of the machinery and equipment</p>	<p>It provides that any project or supervisory activity if incidental to sale of machinery or equipment, it should continue for a period of 6 months and the quantum of charges should exceed 10% of total sale price. The treaty provides specific stipulation for project and supervisory activities in relation to machinery or plant. Does that mean that machinery and equipment are otherwise not covered within the contours of installation PE?</p>

(c) Service PE

3.168. The existence of Permanent Establishment is essentially determined based on the level of economic engagement or footprint required to justify source taxation of business profits. Presence of employees of a foreign enterprise in another country could constitute a permanent establishment for the foreign enterprise. The relevant article of the Permanent Establishment is generally as follows –



“the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

- (i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or*
- (ii) the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of Article 9 (Associated Enterprises)].*

3.169. There are two possibilities of creating a PE by movement of employees from one contracting state to another contracting state. One is when the stay of the employees [in the course of performing services] exceeds the stipulated thresholds. The second is when such services are performed for a related enterprise [irrespective of the span of stay]. The primary condition is that the employees should furnish services (other than FTS). Such activities (i.e., furnishing of service) should continue within that country for the stipulated time frame of say 90 days (in 12 months). A service PE is thus created if the following conditions are satisfied:

- (a) The services are furnished within the source state;
- (b) The services are furnished by the foreign enterprise through employees or other personnel;
- (c) The period of furnishing of services exceeds the specified threshold period.

3.170. The treaty states that the activities of that nature should continue within that state. ‘Activities of that nature’ means furnishing of services other than included services. The point is silent on the manner of rendering such services. It does not require that the employees only have to render services for more than 90 days. To elucidate, the language employed in ‘activities of that nature’; it does not state ‘in the same manner’. There is no reference made to the mode of furnishing service. Whether therefore rendering of services online without their physical presence in India, a service PE could be created in India? Or the absence of a reference to employees in the rendering of services is to cover a case where other personnel (like consultants or sub-contractors) provide such services?

3.171. An alternate condition is rendering of service for associated enterprises. There is no time limit for performance of services in relation to AE(s). A single day of service would be sufficient to trigger a PE.

3.172. An EPC Contract wherein the contractor agrees to install the machinery (and supervise the installation) would invariably involve employees being sent to the installation site. Presence of employees engaged in such activity could trigger the risk of a service PE.

(d) Agency PE

3.173. An agent is a person who performs or acts on behalf of another. A foreign enterprise may opt to perform a business activity through another person rather than performing it itself. That other person may constitute an agent for the former. It would be too easy to circumvent taxation if the PE fiction is held inapplicable when an agency is involved. An agency PE is based on the relationship between the agent and principal



along with the nature of service rendered by the agent. Article 5(4) of the Indo-US treaty (which deals with Agency PE) reads as under:

“4. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 5 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State, if :

- (a) he has and habitually exercises in the first-mentioned State an **authority to conclude on behalf of the enterprise**, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph ;*
- (b) he has no such authority but **habitually maintains in the first-mentioned State a stock of goods or merchandise** from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in the State on behalf of the enterprise have contributed to the sale of the goods or merchandise ; or*
- (c) he **habitually secures orders** in the first-mentioned State, wholly or almost wholly for the enterprise.”*

3.174. The Article deals with 3 variants of Agency PE – (a) agent having authority to conclude contract on behalf of the enterprise; (b) agent who habitually maintains stock or merchandise or (c) habitually secures orders. There are more variants to Agency PE in other treaties. Treaties with countries like Italy and Kuwait provide that when the agent in the course of so acting manufactures or processes goods or merchandise belonging to the enterprise, it creates an Agency PE. These agents exclude those who operate in an independent status and do not carry on the activities captured in the negative list of the PE definition.

CONCERN VII(C): PROFIT ATTRIBUTION

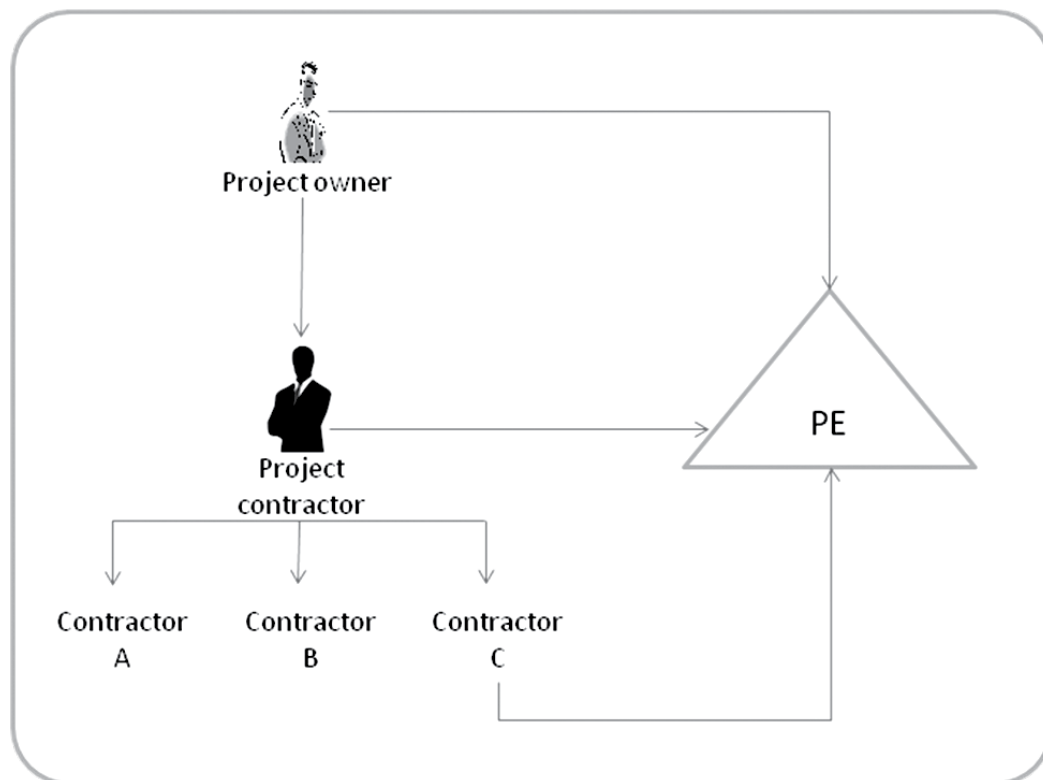
3.175. Article 7(1) does not allow a host country to tax the profits of an enterprise of the other Contracting State unless the enterprise carries on business in the host country through a PE situated in that country. Where the non-resident enterprise carries on business in the host country through a PE situated in that country, Article 7(1) permits the host country to tax the profits that are “attributable to” the PE in accordance with Article 7(2). In other words, the right to tax does not extend to profits that the enterprise may derive from a State otherwise than through the PE (save force of attraction rule).

3.176. As per the interpretation of Article 7(2) under the authorised OECD approach, a two-step analysis is required. First, a functional and factual analysis is carried out to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each segment undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Secondly, income from transactions with the hypothesised enterprises is determined by applying the transfer pricing norms having regard to functions performed, assets used and risk



assumed by the hypothesised enterprises. The result of these two steps will be to arrive at the profits (or losses) of the PE from all its activities, representing transactions with other unrelated enterprises, transactions with related enterprises and dealings with other parts of the enterprise. The hypothesis by which a PE is treated as a functionally separate and independent enterprise is a fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7.

- 3.177. Paragraph (3) to Article 7 deals with expenses which can/ cannot be claimed as a deduction while computing income attributable to a particular PE. Thus, paragraph 3 provides a computational rule for determination of profits of a PE. Paragraph (2) is subject to the computation under paragraph (3). Paragraph (2) requires that the profits determined under paragraph (3) correspond to the profits that a separate and independent enterprise would have made.
- 3.178. Profit attribution is an art of carving out profits relating to a hypothetical entity – namely, PE. It is well known that attribution of profits carries the weight of numerous questions. The quantum, manner, basis and timing of attribution have always been a matter of debate. These contributory but often divergent factors gives rise to an “attribution maze” when analyzed in the context of EPC. This is because the attribution exercise has to not only separate profits of PE from one source but from multiple sources and multiple contributories. A depiction of such ‘maze’ is provided below:



- 3.179. In the figure above, it is discernible that income attributable to PE (installation PE) has some portions coming from the project owner, some from the project contractor and



balance from the second tier contractors (such as Contractor C). Therefore the income referable to PE would involve incomes and expenditure to be carved out from these three sources. Post this, an ALP test will have to be run. The existence of multiple parties makes the computation complex.

- 3.180. Section 44C imposes a cap on quantum of head office expenditure which can be claimed as a deduction. Some treaties incorporate the limitations of the domestic law for attributing income of a PE.

CONCERN VII(D): INTERPRETATION OF FEES FOR TECHNICAL SERVICES

3.181. Composite or split contracts in EPC arena could involve rendering of technical support and assistance. Under the domestic tax law provisions, rendering of technical services by non-resident would be chargeable to tax in India if the same is received from a resident or if the services are utilized for the purposes of carrying on business in India or for earning any source of income in India. The intricacies of section 9(1)(vii) and the exceptions thereto have already been dealt with. What remains to be discussed are the implications under the treaty.

3.182. As mentioned earlier, each treaty is unique for its terms and content. There are treaties (a) where a make-available clause is incorporated; (b) where the language is similar to the domestic tax provisions; (c) where the fees for technical services article is absent. In an EPC contract, there could be service elements such as the supervision services, test run services, performance guarantee certification, post sale or transfer maintenance etc. whether each of such services constitutes FTS would be a preliminary exercise. Thereafter, the peculiarities of each treaty would have to be examined whether the preliminary conclusion if as FTS, is sustained. Depending on the above, each treaty could have different ramifications hidden within in it. Interpretation of FTS article poses a number of questions. Some of them are:

- (a) As mentioned earlier, Article 5 provides for a specific clause on construction, installation and supervision. In the presence of such specific clause in Article 5, are installation and supervision services always to be governed by Article 5 and not by the Article on FTS?
- (b) If the supervision or installation activity is absent in the installation/ construction PE clause, then should one examine the FTS clause or can one take a plea of 'no-PE; no tax'?
- (c) Can a service in relation to construction activity which is excluded from the definition of FTS under section 9(1)(vii) be examined as FTS in the treaty? In short, is 'hop-in; hop-out' possible? Can one adopt the definition of FTS under the Act but the rate under the treaty or vice versa?

3.183. There could be further twists in a FTS article when one has to deal with treaties such as Indo-China treaty. Article 12 of the India-China treaty deals with "fees for technical services"; relevant portion of which is as under:

"4. The term "fees for technical services" as used in this Article means any payment for the provision of services of managerial, technical or consultancy nature by a resident of a Contracting State in the other Contracting State, but does not include



payment for activities mentioned in paragraph 2(k) of Article 5 and Article 15 of the Agreement.”(emphasis supplied)

- 3.184. The first part of the above definition provides that fees for technical services means payment for provision of services of managerial, technical or consultancy nature. To this extent, the definition is similar to the definition in explanation 2 to section 9(1) (vii). However, the fact that payment is for managerial, technical, consulting services alone would not result in characterization of such payment as ‘fees for technical services’ under the Treaty. The other requirement is that the services of managerial, technical or consultancy should be provided by the resident of a contracting state in the other contracting state. The expression ‘in the contracting state’ mandates the rendering or provision of services by a resident in the other contracting state.
- 3.185. Under Article 12(4) of the Treaty between India - China, the place of rendering of services is thus important. Payment for technical services to a resident of China would be chargeable to tax in India only if such services are rendered in India. If such services are rendered outside India, the payment would not be in the nature of ‘fees for technical services’ under Article 12(4) of the Treaty. A contrary view has however been taken by the Mumbai Tribunal in the case of Ashapura Minichem (2010) 40 SOT 220 (Mum).
- 3.186. The Mumbai Tribunal differentiated the phrase ‘provision for services’ from ‘provision for rendering of services’. The relevant extract of the Tribunal decision is as follows – **the expression ‘provision for services’ is much wider in scope that the expression ‘provision for rendering of services’ and will cover the services even when these are not rendered in the other Contracting State, as long as these services are used in the other Contracting State.**
- 3.187. The Mumbai Tribunal in Ashapura case has connoted ‘provision’ with ‘utilization’. However, both these terms are different and have opposite connotations. As per Shorter Oxford English Dictionary, ‘utilize’ means ‘make practical use of’, ‘use effectively’, ‘turn to account’; whereas, ‘provision’ means ‘act of providing something’, ‘supply of materials etc.. Thus, utilize connotes use of something. Provision implies providing with something. Provision is from a service provider’s standpoint, while utilize from service recipient’s perspective. Both can never coincide or rest with the same person.
- 3.188. There are other interesting variations in the definition of fees for technical services. For instance, Article 12(b) of Indo-Ireland treaty defines FTS as *payment of any kind in consideration for the rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel but does not include payments for services mentioned in Articles 14 and 15 of this Convention.* Thus, the definition excludes independent and dependent personnel services. Treaty with France excludes payments for independent personal services only when made to individuals. Article 13(4) of Indo-Italy treaty defines FTS to mean *payments of any amount to any person other than payments to an employee of the person making payments, in consideration for the services of a managerial, technical or consultancy nature, including the provisions of services of technical or other personnel.* Similar sentiments are seen in Article 13(3) of Indo-Israel treaty which excludes only dependent personal services (and



not independent personal services). The following tables would provide a snapshot of this discussion:

Treaty country	Inclusions	Exclusions	
		Dependant personal service	Independent personal service
Ireland	Rendering of any managerial, technical or consultancy services including the provision of services by technical or other personnel	Excluded	Excluded
France	Same as above	Excluded	Excluded (only if payee is an individual)
Israel/ Italy	Same as above	Excluded	Included

3.189. Fee for technical services has been an area of eternal dispute. In the context of various Indian tax treaties, it may be noticed that this article has a number of variants. There is variation in the scope of coverage of FTS. There is lack of clarity due to the language employed. The act of service has been referred to or described as furnish, render or provide. It sometimes excludes certain services while other treaties provide a wide definition to encompass larger genre of services. An attempt by the assessee to wriggle out of the definition and counter attempts by the Revenue to fix him into the FTS box has lead to multifarious interpretations.

3.190. Interplay of PE and FTS can sometime pose puzzling questions. **One such case study is as under:**

<i>Case study</i>	
<i>Name of the project owner:</i>	<i>India Co</i>
<i>Name of the project contractor:</i>	<i>FCo1</i>
<i>EPC Project description:</i>	<i>Offshore supply and service and on-site supply & services</i>
<i>Other facts:</i>	
• <i>Project value:</i>	
<i>Off shore supply value</i>	<i>--- US \$ 300mn</i>
<i>Off shore service value</i>	<i>--- US \$ 300mn</i>
<i>On-site supply</i>	<i>--- US \$ 100mn</i>
<i>On-site service</i>	<i>--- US \$ 100mn</i>
• <i>The contract is secured due to the effort, persuasion and on the basis of the term negotiated by FCo2.</i>	



Queries

- *What would be the quantum and character of profits chargeable to tax in India of the off-shore supply; off-shore services; on-site supply and on-site services?*
- *Would any of the answers above change if FCo2 is held to constitute DAPE of FCo1?*
- *Would any of the answers above change if FCo2 is not compensated at arm's length?*

CONCERN VII(E): FOREIGN TAX CREDIT

3.191. Foreign tax credit is a mechanism to mitigate potential double taxation. It involves interplay of taxation of the same income in different countries. Credit is generally limited to taxes of a nature similar to the tax against which the credit is allowed. Challenges arise due to distinct and unique tax norms in each country. To elucidate, the class of entities who are subject to tax (for instances domestic laws of certain countries do not levy income-tax on individuals) class of income (many nations do not levy capital gains tax), timing of recognition of income (receipt basis or accrual basis), differential treatment for the different forms of income (some are taxed special rates or some at slab rates), deductions or reliefs available (some available are upfront while other can be availed on satisfaction of certain conditions) etc. It would not be an exaggeration to state that taxation of no two countries can be identical. This differential results in various forms of mismatches creating in difficulties in claiming tax credit. Some and prominent mismatches are highlighted below:

(A) Income mismatch

3.192. A single income may suffer tax deduction in the source country on gross income. The same income may be burdened with tax on net income basis in the home country. Thus, there is a mismatch in the quantum of taxable income. This paves way for the issue regarding the quantum of tax that is eligible for credit. Should one restrict the tax credit only to the income which is actually taxed twice or should widen the scope to accommodate the entire income which is subject to income-tax in the two countries?

(B) Participant mismatch

3.193. In a plain vanilla case, tax credit is available to the person whose income is being taxed twice. However, challenges could arise when the same entity is a pass-through or transparent entity in one country while it is taxable entity in the other. The profits and losses of the business pass through to its owners, who report them in their personal tax returns. There is thus a mismatch in the tax systems of the two countries as regards the entities which are chargeable to tax.

(C) Timing mismatch

3.194. The third reason of mismatch is the difference in timing of recognising income by the two contracting countries. For instance, royalty may become payable by an overseas company to an Indian resident. Such royalty would be chargeable to tax the moment such income accrues to the Indian resident. However, the overseas domestic law may levy tax on such royalty on actual payment basis. The two events of accrual and



receipt may occur in different fiscal years. In such a situation, the question is which year would the Indian resident get credit for taxes paid in the overseas soil? This is an example of timing mismatch.

3.195. These issues are not unique to EPC arrangements. However, EPC regime evidence high quantum payments. A cross border transaction would generally be subject to double taxation making the relief under tax treaty critical to the success of the venture. This being the case, these mismatches have the potential of causing damage to the participants.

CONCERN VIII: TAX WITHHOLDING ON PAYMENTS IN EPC SET-UP

3.196. Section 195 of the Act imposes a statutory obligation on any person responsible for paying to a non-resident any interest or any other sum chargeable to tax under the provisions of the Act, to deduct income-tax at specified rates. Taxes would have to be deducted at source in accordance with the provisions of section 195 or the provisions of the relevant Treaty whichever is beneficial to the assessee. The tax withholding provisions (“TDS”) would apply, if any payment comprises (a) income chargeable to tax in India under the Act; and (b) such conclusion is sustained, also under the Treaty.

3.197. The rate of deduction prescribed in the Indian tax law (in section 195 context) is housed in Part II of First Schedule to the relevant Finance Act. The rates would vary on the basis of the nature of payment made. It is imperative for the payer to reckon the nature of payment before deducting the tax. For the reasons already discussed the nature of transaction (whether supply or service agreement) has always been debatable. There is always a possibility that the Revenue authorities may/ may not concur with the understanding of the contracting parties. One possible view on this matter could be that the deductor has to focus on the ‘objective of the payment’ and not the treatment of his payment in the books of payee. The deductor needs to ask – ‘what is the payment made for?’ The answer to this question should spell out the nature of transaction. How will the deductor reckon the nature of transaction wherein the supply and service elements are inextricably linked?

3.198. Section 194C(3) provides that deduction of tax at source has to be carried out only on ‘work’ carried out by the payee. It permits exclusion of material costs provided the quantum of such costs is specifically mentioned in the invoice. It permits bifurcation between material and service. Such dissection mechanic is missing in section 195. The question therefore is:

- (a) whether the deductor can bifurcate between the payments relating to supply and service arrangements?
- (b) In case the characterization is altered by the Revenue, would the deductor be called as an ‘assessee in default’ to the extent of short deduction (if any)?

3.199. The payer or deductor may interact and conclude contracts with the EPC contractor, being the representative of the consortium. Would the deductee necessarily be the contractor or the entity which may have been formed for this project or individual contractors? Would the deductee and payee necessarily be the same from the deductor’s standpoint?



- 3.200. To ward off the uncertainty in the tax deduction, one could take recourse to alternative routes provided by the legislation. Sub-section (2) to section 195 empowers a person responsible for deducting tax under section 195(1) to apply to the Assessing Officer for an order determining the amount on which the tax has to be deducted. An application under section 195(2) can be made if the person responsible for deducting tax 'considers' that the whole amount payable does not constitute income in the hands of the non-resident and requires the Assessing Officer to make the determination of the income component, on which the obligation to deduct tax at source would attach. Alternatively, an application under sub-section (3) can be made by the recipient of income. While sub-section (2) is *qua* the payer; sub-section (3) is from the recipient standpoint. Third alternative being an application under section 197 allowing an assessee to make payment to non-residents without deduction of tax at source. One could also seek ruling from the Authority of Advance Ruling. Although the statute provided multiple forums for obtaining relief, they have not been efficacious either on account of lethargic decision making or contradictory dictums.
- 3.201. The opening portion of section 195 abundantly clarifies that only income 'chargeable' to tax is subject to tax withholding. Sub-section (6) of the section was amended by Finance Act, 2015 to read as under:
- “(6) The person responsible for paying to a non-resident, not being a company, or to a foreign company, any sum, whether or not chargeable under the provisions of this Act, shall furnish the information relating to payment of such sum, in such form and manner, as may be prescribed.”*
- 3.202. The objective of this provision is explained in memorandum to Finance Bill, 2015. The relevant extracts of the memorandum is as under:
- “The mechanism of obtaining of information in respect of remittances fulfils twin objectives of ensuring deduction of tax at appropriate rate from taxable remittances as well as identifying the remittances on which the tax was deductible but the payer has failed to deduct the tax. Therefore, obtaining of information only in respect of remittances which the remitter declared as taxable defeats one of the main principles of obtaining information for foreign remittances i.e. to identify the taxable remittances on which tax was deductible but was not deducted. In view of this, it is proposed to amend the provisions of section 195 of the Act to provide that the person responsible for paying any sum, whether chargeable to tax or not, to a non-resident, not being a company, or to a foreign company, shall be required to furnish the information of the prescribed sum in such form and manner as may be prescribed.”*
- 3.203. It is critical to decipher the objective of this amendment. The legislature wanted an account of those payments which were subject to tax but was declared by remitter as 'non-taxable'. To achieve this, the scope of sub-section (6) has been widened. Every payment to non-resident or foreign company which is chargeable to tax or not has to comply with information reporting requirements. The legislature has indicated that certain guidelines would be issued in this regard. No guidelines have been yet issued. As it stands today, every cross border payment has to mechanically pass through the information reporting process. Is this a step in the right direction? Is it fair to scrutinize every transaction without any filter by the remitter? Does it enable



identification of all taxable transactions or is it only going to enhance the burden on Revenue to scan through every transaction?

4. Concluding thoughts

The world today is a global village. Urbanisation has lured herds of people to opt for metropolis emigration. This has placed considerable strain on infrastructure around the world. Developing world has a herculean task of creating new and at the same time expanding the existing transportation, communication, power and fuel networks to meet the galloping demand. With infrastructure gaining momentum in India it is imperative to provide a proper and pervasive approach to address the various concerns.

The number of EPC has only grown over the years. Increasing market response to major EPC contracts have boosted their relevance. These contracts have several facets requiring the contractor(s) to perform a wide spectrum of diverse yet integrated activities. This has given a propensity to structuring the contract to the extent of creating the unreal. Pernicious actions of a few have invited burdensome scrutiny (by the taxman) to the rest. In the present circumstances and milieu, clarity on EPC taxation is the need of the hour. Guidelines and norms for a healthy compliance would ease the bottlenecks. Taxation of EPC today lies obscure with glaring questions – the attempt of this write-up to unearth these concerns and find possible solutions.

Reference material:

- (i) <http://www.kslaw.com/library/newsletters/EnergyNewsletter/2012/April/article4.html>
- (ii) http://www.gulfconstructionworldwide.com/news/160035_Key-issues-in-split-EPC-contracts.html
- (iii) <https://www.dlapiper.com/~media/Files/Insights/Publications/2012/02/EPC%20contracts%20in%20the%20power%20sector/Files/epccontractsinthepowersector/FileAttachment/epccontractsinthepowersector.pdf>
- (iv) International Taxation journal - Volume 9 (October 2013)
- (v) Understanding and Negotiating Turnkey and EPC contracts by Joseph A Huse [Second edition]
- (vi) Law of Income Tax by Sampath Iyengar



ANNEXURE

Scope of total income

5. (1) Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which—
- (a) is received or is deemed to be received in India in such year by or on behalf of such person ; or
 - (b) accrues or arises or is deemed to accrue or arise to him in India during such year ; or
 - (c) accrues or arises to him outside India during such year :
- Provided** that, in the case of a person not ordinarily resident in India within the meaning of sub-section (6) of section 6, the income which accrues or arises to him outside India shall not be so included unless it is derived from a business controlled in or a profession set up in India.
- (2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which—
- (a) is received or is deemed to be received in India in such year by or on behalf of such person ; or
 - (b) accrues or arises or is deemed to accrue or arise to him in India during such year.

Explanation 1.—Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Explanation 2.—For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

Income deemed to accrue or arise in India

9. (1) The following incomes shall be deemed to accrue or arise in India :—
- 30(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

Explanation 1.—For the purposes of this clause—

- (a) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India ;



- (b) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export ;
- (c) in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India ;
- (d) in the case of a non-resident, being—
 - (1) an individual who is not a citizen of India ; or
 - (2) a firm which does not have any partner who is a citizen of India or who is resident in India ; or
 - (3) a company which does not have any shareholder who is a citizen of India or who is resident in India,

no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India.

Explanation 2.— For the removal of doubts, it is hereby declared that “business connection” shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

- (a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or
- (b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
- (c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.



Explanation 3.— Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India.

Explanation 4.— For the removal of doubts, it is hereby clarified that the expression “through” shall mean and include and shall be deemed to have always meant and included “by means of”, “in consequence of” or “by reason of”.

Explanation 5.— For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India;

Explanation 6.— For the purposes of this clause, it is hereby declared that—

- (a) *the share or interest, referred to in Explanation 5, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets—*
 - (i) *exceeds the amount of ten crore rupees; and*
 - (ii) *represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;*
- (b) *the value of an asset shall be the fair market value as on the specified date, of such asset without reduction of liabilities, if any, in respect of the asset, determined in such manner as may be prescribed;*
- (c) *“accounting period” means each period of twelve months ending with the 31st day of March;*
- (d) *“specified date” means the—*
 - (i) *date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest; or*
 - (ii) *date of transfer, if the book value of the assets of the company or, as the case may be, the entity on the date of transfer exceeds the book value of the assets as on the date referred to in sub-clause (i), by fifteen per cent :*

**Provided that where a company or an entity, referred to in Explanation 5, regularly adopts a period of twelve months ending on a day other than the 31st day of March for the purpose of—*

- (i) *complying with the provisions of the tax laws of the territory, of which it is a resident, for tax purposes; or*
- (ii) *reporting to persons holding the share or interest,*

then, the period of twelve months ending with the other day shall be the accounting period of the company or, as the case may be, the entity:



Provided further that the first accounting period of the company or, as the case may be, the entity shall begin from the date of its registration or incorporation and end with the 31st day of March or such other day, as the case may be, following the date of such registration or incorporation, and the later accounting period shall be the successive periods of twelve months:

Provided also that if the company or the entity ceases to exist before the end of accounting period, as aforesaid, then, the accounting period shall end immediately before the company or, as the case may be, the entity, ceases to exist;

Explanation 7.— For the purposes of this clause,—

- (a) no income shall be deemed to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, referred to in the Explanation 5,—
 - (i) if such company or entity directly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of such company or entity; or
 - (ii) if such company or entity indirectly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds any right in, or in relation to, such company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India, nor holds such percentage of voting power or share capital or interest in such company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;
- (b) in a case where all the assets owned, directly or indirectly, by a company or, as the case may be, an entity referred to in the Explanation 5, are not located in India, the income of the non-resident transferor, from transfer outside India of a share of, or interest in, such company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in such manner as may be prescribed;
- (c) “associated enterprise” shall have the meaning assigned to it in section 92A;



(ii) *income which falls under the head “Salaries”, if it is earned in India.*

Explanation.—For the removal of doubts, it is hereby declared that the income of the nature referred to in this clause payable for—

- (a) service rendered in India; and
- (b) the rest period or leave period which is preceded and succeeded by services rendered in India and forms part of the service contract of employment,

shall be regarded as income earned in India ;

(iii) income chargeable under the head “Salaries” payable by the Government to a citizen of India for service outside India ;

(iv) a dividend paid by an Indian company outside India ;

(v) income by way of interest payable by—

- (a) the Government ; or
- (b) a person who is a resident, except where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or
- (c) a person who is a non-resident, where the interest is payable in respect of any debt incurred, or moneys borrowed and used, for the purposes of a business or profession carried on by such person in India ;

Explanation.— For the purposes of this clause,—

(a) *it is hereby declared that in the case of a non-resident, being a person engaged in the business of banking, any interest payable by the permanent establishment in India of such non-resident to the head office or any permanent establishment or any other part of such non-resident outside India shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the permanent establishment in India and the permanent establishment in India shall be deemed to be a person separate and independent of the non-resident person of which it is a permanent establishment and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly;*

(b) *“permanent establishment” shall have the meaning assigned to it in clause (iiia) of section 92F.*



- (vi) income by way of royalty payable by—
- (a) the Government ; or
 - (b) a person who is a resident, except where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or
 - (c) a person who is a non-resident, where the royalty is payable in respect of any right, property or information used or services utilised for the purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India :

Provided that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property, if such income is payable in pursuance of an agreement made before the 1st day of April, 1976, and the agreement is approved by the Central Government :

Provided further that nothing contained in this clause shall apply in relation to so much of the income by way of royalty as consists of lump sum payment made by a person, who is a resident, for the transfer of all or any rights (including the granting of a licence) in respect of computer software supplied by a non-resident manufacturer along with a computer or computer-based equipment under any scheme approved under the Policy on Computer Software Export, Software Development and Training, 1986 of the Government of India.

Explanation 1.—For the purposes of the first proviso, an agreement made on or after the 1st day of April, 1976, shall be deemed to have been made before that date if the agreement is made in accordance with proposals approved by the Central Government before that date; so, however, that, where the recipient of the income by way of royalty is a foreign company, the agreement shall not be deemed to have been made before that date unless, before the expiry of the time allowed under sub-section (1) or sub-section (2) of section 139 (whether fixed originally or on extension) for furnishing the return of income for the assessment year commencing on the 1st day of April, 1977, or the assessment year in respect of which such income first becomes chargeable to tax under this Act, whichever assessment year is later, the company exercises an option by furnishing a declaration in writing to the Assessing Officer (such option being final for that assessment year and for every subsequent assessment year) that the agreement may be regarded as an agreement made before the 1st day of April, 1976.



Explanation 2.—For the purposes of this clause, “royalty” means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head “Capital gains”) for—

- (i) the transfer of all or any rights (including the granting of a licence) in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (ii) the imparting of any information concerning the working of, or the use of, a patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (iii) the use of any patent, invention, model, design, secret formula or process or trade mark or similar property ;
- (iv) the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill ;
- (iva) the use or right to use any industrial, commercial or scientific equipment but not including the amounts referred to in **section 44BB**;
- (v) the transfer of all or any rights (including the granting of a licence) in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting, but not including consideration for the sale, distribution or exhibition of cinematographic films; or
- (vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v).

Explanation 3.— For the purposes of this clause, “computer software” means any computer programme recorded on any disc, tape, perforated media or other information storage device and includes any such programme or any customized electronic data.

Explanation 4.— For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred.

Explanation 5.— For the removal of doubts, it is hereby clarified that the royalty includes and has always included consideration in respect of any right, property or information, whether or not—

- (a) the possession or control of such right, property or information is with the payer;
- (b) such right, property or information is used directly by the payer;
- (c) the location of such right, property or information is in India.



Explanation 6.— For the removal of doubts, it is hereby clarified that the expression “process” includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret;

- (vii) income by way of fees for technical services payable by—
- (a) the Government ; or
 - (b) a person who is a resident, except where the fees are payable in respect of services utilised in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India ; or
 - (c) a person who is a non-resident, where the fees are payable in respect of services utilised in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India :

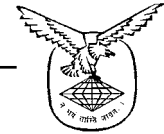
Provided that nothing contained in this clause shall apply in relation to any income by way of fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government.

Explanation 1.— For the purposes of the foregoing proviso, an agreement made on or after the 1st day of April, 1976, shall be deemed to have been made before that date if the agreement is made in accordance with proposals approved by the Central Government before that date.

Explanation 2.— For the purposes of this clause, “fees for technical services” means any consideration (including any lump sum consideration) for the rendering of any managerial, technical or consultancy services (including the provision of services of technical or other personnel) but does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head “Salaries”.

- (2) Notwithstanding anything contained in sub-section (1), any pension payable outside India to a person residing permanently outside India shall not be deemed to accrue or arise in India, if the pension is payable to a person referred to in Article 314 of the Constitution or to a person who, having been appointed before the 15th day of August, 1947, to be a Judge of the Federal Court or of a High Court within the meaning of the Government of India Act, 1935, continues to serve on or after the commencement of the Constitution as a Judge in India.

Explanation.— For the removal of doubts, it is hereby declared that for the purposes of this section, income of a non-resident shall be deemed to accrue or arise in India under clause (v) or clause (vi) or clause (vii) of sub-section (1) and shall be included in the total income of the non-resident, whether or not,—



- (i) the non-resident has a residence or place of business or business connection in India; or
- (ii) the non-resident has rendered services in India.

Instruction: No. 1767, dated 1-7-1987.

Date: 01/07/1987

1. The question of taxability of the income of non-resident contractors engaged by resident organisations like ONGC carrying on the business of oil exploration and production in India, for the execution of turnkey projects involving work to be carried out in India as well as outside India, for a lump sum consideration, has been examined by the CBDT in consultation with the Ministry of Law.
2. It has been seen that most of the agreements entered into by these non-resident contractors relate to fabrication and installation of various facilities like offshore platforms and pipelines, terminals, treatment plants onshore, rigs, etc. for exploration and production of Oil and/or Natural Gas. In these contracts the equipment by way of platform, rig or any other facility is fabricated by the foreign contractor as per specific requirement of the Indian company organisation engaged in such exploration or production. The major part of the work, namely design, engineering, procurement and fabrication is performed abroad by the foreign contractor. In certain cases, ownership in the facilities is also seen to have been transferred abroad. Because of the size and complicated nature of the platform etc., it is fabricated and transported in modules for example jacket, piles, deck, topside equipment modules etc., to the actual offshore site where these are then installed. The transport and installation of the facilities is at times undertaken by the same contractor who had done the engineering, procurement and fabrication and in certain cases by another enterprises. After installation, the work on hook-up and commissioning is generally done by the fabrication contractor himself because that is invariably an essential part of the satisfactory completion of the contract itself.
3. On these facts, it is clear that income accruing or arising to the non-resident contractor should be apportioned between the various activities carried on by it, some of which would be within India and some outside. Where the ownership in the platform, terminal, treatment plant or other facilities passes outside India, the non-resident will be taxable only in respect of the activities performed in India by way of installation, hook-up and commissioning etc., of the facilities acquired by the Indian enterprises engaged in oil exploration or production. Where, however, the sale has taken place in India, there will be two elements of income that should be brought to tax. One would relate to the proportion of the profits on the entire value of the contract which can be said to be attributable to the activity of the sale itself and the other would be in respect of the activities like installation, hook-up, commissioning etc., actually performed in India as part of the total work contract.
4. The question of determining a reasonable percentage of gross receipts as profits/income was discussed, *inter alia*, with the Ministry of Petroleum, in the light of the importance of the oil sector to the Indian economy and taking into account the fact that oil industry is now passing through a very difficult period, resulting in idle capacity all



round. Taking all these factors into account, it has been decided to adopt 10 per cent of the gross receipts from the contract as the net income of the contractor. It has also been decided that out of the income so computed, 10 per cent (i.e. 1% of the gross receipt) would be attributable to the activity of sale itself and that the balance would be attributable to the other manufacturing etc., (i.e. other than sales) activities.

5. On this basis, where the sale takes place outside India, only 10 per cent of the gross receipts in respect of the activities of installation, hook-up, commissioning etc., performed in India will be taxable here. Where, however, the sale takes place within the country, apart from the 10 per cent in respect of gross receipts for activities by way of installation etc. performed in India, the income arising from the activity of sale itself will have to be brought to tax. This will be done by estimating the income from such sale at one per cent (10% of 10%) of the gross receipts in respect of all activities performed outside India. The activities performed in India are excluded for this purpose because, the entire income from such activities would already have been included as indicated in the preceding sentence.
6. A hypothetical example is given below to clarify the matter. For this purpose it is assumed that the gross payment for fabrication and including installation, commissioning etc. is awarded to a non-resident for a total consideration of \$ 10M. It is further assumed that \$ 8M relates to fabrication etc., done abroad and \$ 2M to work done in India (on or off-shore). In such a case, if the sale is in India, taxable income will be calculated as under :

I. Income in respect of work done in India - 10% of \$ 2 M. :\$ 2,00,000

II. Total consideration for work done abroad: \$ 8 M

Therefore, profit on that at 10 per cent: \$ 0.8 M (\$ 8,00,000)

Income attributable to activity of sale in India at 10% of above: \$ 80,000

III. Income assessable in India (I+II) : \$ 2,80,000

If, in this example, the sale is also outside India, only \$ 2,00,000 would be taxable in India.

7. Hook-up, commissioning etc. would not amount to rendering of technical services as defined in Explanation 2 to section 9(1)(vii) of the Income-tax Act, 1961. Assessing Officers may, however, examine the contracts and see whether the non-resident contractors have been paid fees for technical services. Fees for technical services, if any, paid under above-mentioned contracts will not be covered by the above guidelines. Such fees will be taxable as per the rates specified in the relevant D.T.S. Agreement or in the Income-tax Act.
8. The above guidelines will be applicable to all such contracts for a period of 3 years, beginning from assessment year 1987-88 and for earlier assessment years where proceedings are “open” at any stage.
9. These guidelines will be applicable only if the non-resident company agrees to taxation on this basis and does not dispute it in any manner whatsoever. In cases where tax has already been deducted on a different basis, the non-resident company may file a



return of income disclosing income calculated on the basis of the guidelines discussed above. In such cases assessment may be completed expeditiously and refund granted.

Instruction : No. 1829, dated 21-9-1989.

Date: 21/09/1989

1. The taxability of income arising to non-residents who will be entering into agreements with resident organisations/public sector companies for the execution of power projects on turnkey basis involving activities to be carried out in India as well as outside India has been examined by the CBDT.
2. Turnkey execution of hydroelectric power projects mainly involve the following work packages:
 - i. Planning, design and engineering services,
 - ii. Supply of permanent equipment,
 - iii. Civil works, and
 - iv. Erection, testing and commissioning of electrical and mechanical equipment.
3. The concept of the turnkey execution of the project involves total and complete responsibilities of the persons undertaking the contracts for commissioning the project and they are accordingly required to furnish performance guarantees for timely completion.
4. Some of these hydroelectric power projects are likely to be undertaken by a consortium of foreign companies. The public sector companies in India will be entering into separate agreements with one or more of these foreign companies for the following purposes :
 - a. for supply of equipment and materials on FOB at ports outside India;
 - b. for planning, design and engineering services. These services would include preparation of designs, technical specification and drawings for the project as well as for the equipment model studies and rendering of advice on various technical aspects during construction as well as planning of the entire work schedule etc;
 - c. for execution of civil works at the project site like construction of dams, tunnels, power houses etc. and for transportation of equipment and materials to India by air/sea;
 - d. for erection, testing and commissioning of the machinery and equipment purchased outside India on FOB basis as well as equipment purchased in India, and for transportation of equipment and materials to India, by air/sea.

The items of work mentioned at a, b, c, d above may be entrusted to one or more foreign companies. But the suppliers referred to at (a) above need not be the contractor(s) for civil works mentioned at (c) above.

5. Apart from the separate contracts for the jobs mentioned in para 4 above, there would be an overall co-ordination agreement between the public sector company on the



one hand and the foreign contracting parties referred to in para 4 on the other hand to ensure guaranteed performance of all the contracts in a co-ordinated manner and within an agreed timeframe and for undertaking to meet necessary liabilities and responsibilities including payments of liquidated damages for delays etc. One of the companies would for this purpose act as leader to ensure supervision and co-ordination of inter-related tasks.

6. With facts and circumstances stated above, nothing contained in the overall agreement will be intended to create a joint venture or partnership or association of persons between the contracting parties. The Indian concern will not be making any payments whatsoever to any foreign company under this overall agreement.
7. On the basis of these broad facts the issues which arise for consideration and the taxability of the various items of income have been discussed below:
 - (a) The status of the consortium for tax purposes – As mentioned above there will be an overall agreement between the public sector company on the one hand and the various foreign companies referred to in para 4 on the other. This will be only for ensuring the guaranteed performance of all the contracts in a co-ordinated manner within the agreed time and for ensuring acceptance of liabilities and responsibilities thereof including payment of liquidated damages for delays in execution etc. Further no payment is to be made under the overall agreement to any of the contracting parties. In view of these facts the foreign companies forming the consortium will not constitute an association of persons under the I.T. Act. Each foreign company will be individually liable for taxation as a separate entity.
 - (b) Profits from sale of equipments and materials on fob basis where the payments are also made outside India – Profits from such sale of equipments would not be deemed to accrue or arise in India under section 9(1)(i) of the I.T. Act as the title of the goods will pass outside India will be so even if there is an overall agreement as mentioned above. As already indicated no payments will be made under the overall agreement nor technical services abroad for doing the civil works at the site or for installation, erection, testing etc. Therefore, in respect of these sales no part of the income will be deemed to accrue or arise in India.
 - (c) Payments for planning, design and engineering services – These services rendered in India or abroad are of the nature of technical services and the fees payable in respect of such services will not partake the character of royalty. In the absence of a double taxation avoidance agreement with the country concerned the gross fees paid to the foreign company will be subjected to tax at the rate of 30 per cent, under section 115A of the I.T. Act, 1961. If the foreign company is a resident of a country with which India has a double taxation avoidance agreement then such Agreement will govern the taxation of the fees for technical services.
 - (d) Profits in respect of civil work contracts executed in India and contracts for erection, testing or commissioning of plant or machinery – In this connection, attention is invited to the provisions of section 44BB inserted by the Finance Act with effect from 1-4-1990. Under the provisions of this section, a sum equal to



10% of the gross amounts paid or payable to the foreign company on account of such civil construction, erection, testing or commissioning will be treated as the profits and gains of such business chargeable to tax in India provided other conditions mentioned in the section are satisfied. It may be added that the erection of plant or machinery or testing or commissioning thereof will also include laying of transmission lines.

- (e) Chargeability of receipts on account of transportation of equipment and material to India by air/sea – In respect of these payments the provisions of section 44B and section 44BBA of the I.T. Act relating to the computation of profits and gains of business of operation of ships or aircraft, as the case may be will be applicable. These provisions may be applied only if the charges payable for such transportation are clearly distinguishable in the agreements.
- 8. For the removal of doubts, it is clarified that in spite of the existence of the overall agreement between the public sector company and the foreign companies covering the completing scope of work etc. as mentioned in para 5 above each contracting foreign company should be treated as a separate entity. Further various contracts should not be clubbed together unless they are undertaken by the same foreign company.
- 9. These guidelines will be applicable in the cases of the contracts entered into after 1-4-1989.

Instruction No. 5/2009, dated 20-7-2009

Date: 20/07/2009

1. Instruction No 1829, dated September 21, 1989 (hereinafter called “the instruction”) issued by the Central Board of Direct Taxes deals with the taxability of income arising to non-residents from the execution of power projects on turnkey basis involving activities to be carried out in India as well as outside India. The instruction analyses a hypothetical situation and taxability thereof. The instruction lays down the basis of taxation with regard to the four activities listed therein. With regard to the activity relating to profits from sale of equipments and materials on FOB basis, delivered at port outside India, where the payments are also made outside India, it instructs that on the given facts no part of the income will be deemed to accrue or arise in India.
2. This instruction was issued in 1989 with regard to execution of power projects on turnkey basis with certain specified features. Further, the instruction quite clearly covers a specific situation in which there is actually a consortium of foreign companies.
3. In practice, however, the assesseees rely on the instruction for not only the power projects but other projects as well. Further, a single project is split into various components like offshore supply of equipments/services, onshore supply equipments and onshore services. Sometimes, the contract is split even when only one contractor/supplier bid for the project. In such cases the contract is split into various components to be executed by the bidder and its associate concerns. Thus consortium of foreign companies is not in existence but is created to take advantage of the instruction. This is not the same case as “consortium of foreign companies” envisaged in the instruction.



4. It is also noticed that most of the profit is loaded in the offshore supply and the payments for the Indian portion of the contracts barely meets the expenses resulting into either losses in India or very low profit. The Assessing Officers attempt to apportion profit correctly into various components of the overall project on the basis of functions, risks and assets is often resisted by the assessee taking recourse to the instruction. Further, even if it is proved that a part of the operations relating to supplies have taken place in India or the permanent establishment of the assessee had a role in offshore supply, the profit from offshore supply is claimed to be exempt under the instruction.
5. Thus the instruction which was originally intended for only a particular type of turnkey power project, for a given situation, is being relied upon by assessees in all cases, in all situations, to align their business operation in a manner to avoid payment of taxes in India. This was never the purpose of issuance of this instruction. Accordingly, the Central Board of Direct Taxes hereby withdraws the Instruction No. 1829, dated September 21, 1989 with immediate effect.
6. It is clarified that the withdrawal of instruction will not in any way prejudice the plea of the Income-tax Department, in any appeal, reference or petition, that the Instruction No. 1829 does not apply to a particular case on the given facts even though it was in force at the time of making the assessment.
7. This may be brought to the knowledge of all officers within your region.

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