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Offshore sale of equipment is not taxable in India. Sale of designs and drawings for setting up a plant does not result into royalty income in India. Work relating to such designs and drawings and its sale has taken place outside India and therefore not taxable in India

Background

Recently, the Kolkata Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Outotec GmbH[1] (the taxpayer) held that income from offshore sale of equipment cannot be taxed in India either under the Income-tax Act, 1961(the Act) or under the India-Germany tax treaty (tax treaty) since all the activities relating to designing, fabrication, manufacturing and the sale of equipment took place outside India on a principal to principal basis. The consideration was also received outside India in foreign currency. Further, Indian customers were independent parties who made purchases on their own account and the transaction was made at arm's length.

The Tribunal held that sale of designs and drawings for setting up a plant amounts to the use of copyrighted article rather than use of a copyright and therefore, it is in the nature of business income. The designs and drawings sold by the taxpayer were used by Indian customers for internal business purposes for setting up of their plants and not for any commercial exploitation. Since the work relating to designs and drawings was done outside India and sale took place outside India, such income was not taxable either under the provisions of the Act or under the tax treaty.

Facts of the case

Taxability of supply of equipment

- The taxpayer is a tax resident of Germany, engaged in the business of providing innovative and environmentally sound solutions for a variety of customers in the metals and minerals processing industry.
- During the Assessment Year (AY) 2010-11, the taxpayer earned revenue from offshore supply of equipment to seven Indian companies (relating to the steel industry).
- The Assessing Officer (AO) held that the income earned by the taxpayer from offshore sale of equipment accrues or arises in India and was taxable under the Act and the tax treaty. The AO calculated a profit at 10 per cent of consideration from offshore sale of equipment and held that it was chargeable to tax.
- The Dispute Resolution Panel (DRP) upheld the order of the AO.

Taxability of supply of designs and drawings

- The taxpayer provided drawings, designs and engineering documents relating to steel industry in India to the customers for the operation and maintenance of the plant.
- The DRP and the AO held that the income earned from supply of drawings and designs was taxable in India.

Attribution of profits from supervisory services

- During the year under consideration the taxpayer had provided supervisory services in India. The taxpayer was engaged by its customers for supervising the detailed engineering, installation and commissioning activity undertaken independently by the customer/third party vendors appointed by the customers.

[1] Outotec GmbH v. DDIT (ITA No. 431/Kol/2014) (Kol) – www.taxsutra.com

- The taxpayer had a supervisory Permanent Establishment (PE) in India for supervisory services rendered on standalone basis. The taxpayer for the purpose of computation of profit for the AY under consideration computed the average profit margin earned by the comparable Indian companies, which worked out to 17.93 per cent of sales.
- However, the AO disregarded such comparable companies and applied the net profit percentage at 27.5 as held by the Settlement Commission for Financial Years (FYs) 2007-08 and 2008-09.

Tribunal's ruling

Taxability of supply of equipment

- The designing, procurement of material, fabrication and manufacturing of equipment were undertaken outside India. The company was not involved in the manufacturing of equipment and such equipment were sourced from third party vendors based outside India.
- On perusal of the agreements and documents it was clear that the equipment was directly sold by the taxpayer on export sale basis and the title/ownership of the equipment was transferred outside India i.e. before the equipment reached India.
- Even the consideration for sale of equipment was received outside India in foreign currency and majority of the payment (80 to 85 per cent including 10 per cent advance) for each and every part of shipment becomes payable upon delivery of equipment on Free on Board (FOB) basis on foreign port once shipping and other documents are sent to the customer.
- Such payments are made through irrevocable letter of credit. From the documents and evidence it is clear that the buyers were Indian customers who were independent and unrelated parties and purchased the equipment from the taxpayer on their own account.
- The contracts for the sale of equipment were concluded on a 'principal to principal' basis. Under the contracts, customers' inspection of the equipment was to be taken place outside India and the taxpayer did not have any office or place of business in India.
- The Tribunal relied on various decisions[2] wherein it was held that offshore supply of equipment was not taxable in India. In view of this, it was clear that no portion of receipts from sale of equipment can be taxed in India both under the provisions of the Act and under the tax treaty since all the activities relating to designing, fabrication and manufacturing took place outside India. The sale of equipment also took place outside India on a principal to principal basis and Indian customers were independent parties who made purchases on their own account. Further, the transaction was at arm's length and the consideration was also received outside India in foreign currency.

Acceptance test criteria for taxability of sale of equipment

- With reference to the clauses of agreement relating to acceptance tests, it was clear that they are part of normal commercial arrangements generally agreed in common trade parlance and partake the character of trade warranties.
- Besides, on delivery of equipment on a foreign port, generally 85 per cent (including advance payment) of the total contract price for each and every part of the shipment becomes due to the taxpayer from the customer and merely 15 per cent of contract price is receivable by the taxpayer upon completion of the above mentioned tests.
- In case acceptance tests were not successful, the vendor is entitled to claim liquidated damages from the taxpayer upto 35 per cent of the contract price. Accordingly, this 15 per cent payment is merely a deferred payment and the acceptance tests clauses mentioned under the contract were merely in the nature of warranty provisions and cannot be construed to mean that the acceptance of goods by the customer has taken place in India and any portion from sale of equipment can be taxed in India.
- Deferred payment does not have any impact on the sale of goods which is also supported by the relevant portion of definition of 'sale' mentioned under Section 2(g) of the Central Sales Tax Act, 1956.

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[2] Ishikawajma-Harima Heavy Industries Ltd. v. DIT [2007] 288 ITR 408 (SC), CIT v. Hyundai Heavy Industries Co. Ltd. [2007] 291 ITR 482 (SC), DIT v. Ericsson A.B. New Delhi [2012] 343 ITR 470 (Del), DIT v. Nokia Network OY [2012] 253 CTR 417 (Del), DIT v. LG Cable Ltd. [2011] 237 CTR 438 (Del), Joint Stock Company Foreign Economic Association [2010] 322 ITR 409 (AAR), Hyosung Corpn. [2009] 314 ITR 343(AAR), DCIT v. Roxon Oy [2007] 291 ITR 275 (Mum)

- Similarly, the clauses relating to liquidated damages mentioned in the agreement clearly indicate that when the performance tests do not provide the desired output, the taxpayer is liable to pay liquidated damages. This is also a normal commercial arrangement agreed in common parlance in the industrial world.
- This cannot be construed to mean all the contracts should be clubbed together or that the title in equipment did not pass outside India. For this proposition the Tribunal relied on the decisions in the cases of LG Cable Ltd., Motorola Inc.[3] and Nokia Networks OY where it was held that income from offshore supply of equipment cannot be taxed in India despite the fact that such clauses existed in the agreement entered into for sale of equipment.
- Accordingly, it was clear that the acceptance tests are merely in the nature of warranty provisions. The Delhi High Court in the case of Nokia Networks OY also clarified that breach of warranty could result in payment of damages and does not by itself mean the property/title in the goods did not pass to a buyer outside India.
- The clause of acceptance tests and liquidated damages are nothing but merely in the nature of warranty provision and its remedial measures. Hence, undue importance cannot be given to such clauses and the same cannot be construed to mean that any portion from the sale of equipment can be taxed in India.

Attribution of profits from supply of equipment to a Supervisory PE

- As far as sale of equipment was concerned, no PE of the taxpayer was constituted in India for any of the projects and hence there cannot be any question of attribution of profits to a PE. This position has also been accepted by the Settlement Commission in the order passed for FYs 2007-08 and 2008-09.
- Further, majority of the projects of the taxpayer do not have a supervisory PE in India under Article 5(2)(i) of the tax treaty since the said work has been awarded by the customer to Outotec (India) Private Limited and in some projects the supervisory services had not commenced till the end of the Financial Year.
- Since there is no supervisory PE in India for the said projects, the question of any attribution being made for supply of equipment to the supervisory PE does not arise at all.
- The PE of the taxpayer is determined separately for each of the project which is evident from the wording of Article 5(2)(i)[4] of the tax treaty. The words 'such project, project or activities' mentioned under Article 5(2)(i) of the tax treaty clearly indicates that the supervisory PE has to be examined separately for each of the project.
- The above legal position has also been confirmed by the Mumbai Tribunal in the case of Krupp Udhe GmbH[5] under the India-Germany tax treaty.
- In view of above, it was held that the sale of equipment was concluded outside India because all work relating to manufacturing, designing, fabrication, etc. of equipment was done outside India and sold to the taxpayer directly on export sale basis.
- The reliance placed by the DRP on the case of Authority for Advance Rulings (AAR) of Alstom Transport SA[6] to hold that the contract for installation and commissioning of a project cannot be split up into separate parts cannot be supported since the DRP relied on the decision of Linde AG[7] of AAR but the said decision was overruled by Delhi High Court[8].
- Accordingly, it was held that the profit arising to the taxpayer from offshore sale of equipment was not taxable in India.

Taxability of supply of designs and drawings

- From the clauses of the contract and sample copies of the airway bill it was clear that the entire work relating to designs and drawings was done outside the territory of India. Sale was affected outside India and the consideration was also received outside India in foreign currency.
- Since the taxpayer supplied the designs and drawings for setting up plants in India, in light of the decision of the Supreme Court in the case of Scientific Engineering House P. Ltd.[9], such designs and drawings partake the character of a product and accordingly, the income arising from supply of such designs and drawings was in the nature of business income.
- The designs and drawings sold by the taxpayer amounted to the use of a 'copyrighted article' rather than use of a 'copyright' and was therefore in the nature of business income. The Tribunal

[3] Motorola Inc. v. DCIT [2005] 95 ITD 269 (Del) (SB)

[4] The term 'permanent establishment' includes especially, - (i) a building site ors construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities continue for a period exceeding six months.

[5] Krupp Udhe GmbH v. ACIT [2009] 28 SOT 254 (Mum)

[6] Alstom Transport SA [2012] 349 ITR 292 (AAR)

[7] Linde AG [2012] 349 ITR 172 (AAR)

[8] Linde AG, Linde Engineering Division v. DDIT [2014] 365 ITR 1 (Del)

[9] Scientific Engineering House P. Ltd. v. CIT [1986] 157 ITR 86 (SC)

relied on Commentary on Double Tax Conventions by Klaus Vogel and various observations made in the OECD Model convention of 2010 on Article 12 dealing with Royalties and Fee for Technical Services.

- The AAR in the case of Geoquest Systems B.V.[10] dealing with the non-taxability of payment for software held that payments would not constitute as 'royalty' since the licenced product could not be commercially exploited by the licensee/customer. The principle of licence and copyright was also discussed by the AAR in the case of Dassault Systems K.K.[11]
- In view of the above judicial precedents, it was clear that the restriction on intellectual property would not make any difference since the designs and drawings sold by the taxpayer were used by the Indian customers for their internal purpose of setting up plants and not for commercial exploitation.
- The basic engineering packages sold by the taxpayer to the Indian customers have been largely designed on the basis of standard technologies available with them. Since the work was done outside India and sale took place outside India, such income was not taxable either under the provisions of the Act or under the tax treaty.
- Retaining intellectual property in designs and drawings is similar in nature to retaining of patented rights in any goods/machinery. Restriction on intellectual property in designs and drawings sold by the taxpayer for the purpose of setting up a plant in India does not change the character of the transaction from sale of the product to the use of a licence/know-how.
- Accordingly, the designs and drawings sold by the taxpayer tantamounts to the use of copyrighted article rather than use of a copyright and therefore it was in the nature of business income.

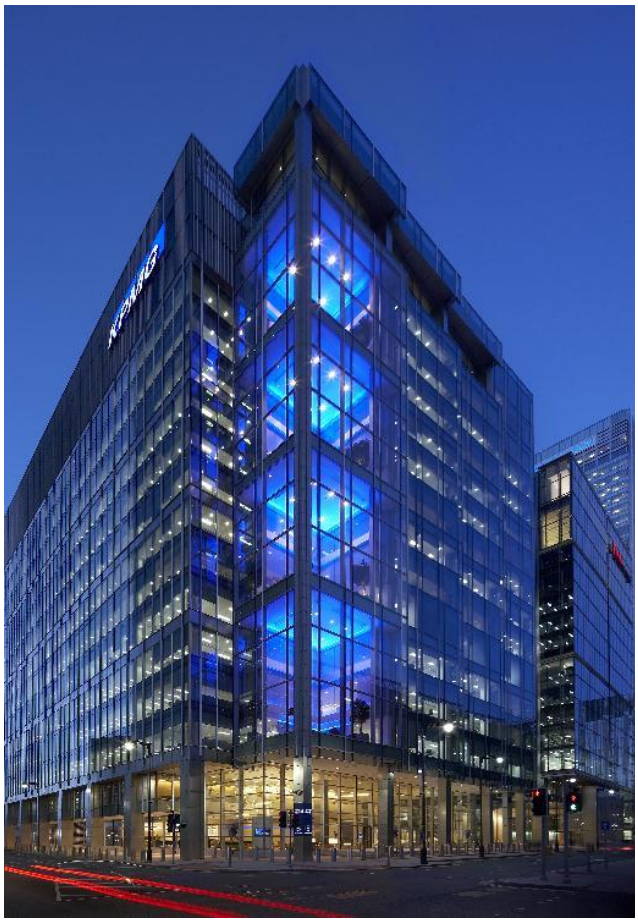
Attribution of profits from supervisory services

- For AYs 2008-09 and 2009-10 before the Settlement Commission and during the AY under consideration, the taxpayer admitted to have a PE in India to which the supervisory services were effectively connected, but no books of accounts were maintained for the same.
- In such circumstances, the factual finding of the Settlement Commission towards attribution of profits to the extent of 27.50 per cent on the revenue earned from supervisory activities in India cannot be faulted with and for the very same reason, the action of the AO in attributing profits at 27.50 per cent cannot be faulted with.

Our comments

This is a welcome ruling from the Kolkata Tribunal where it has been held that offshore sale of equipment cannot be taxed in India either under the Act or under the tax treaty since all the activities relating to designing, fabrication, manufacturing and the sale of equipment took place outside India on a principal to principal basis. The Tribunal observed that Indian customers were independent parties who made purchases on their own account and the transaction was made at arm's length.

With respect to the issue of taxability of income from designs and drawings for setting up a plant, it was held that such sale of designs and drawings amounts to the use of copyrighted article rather than use of a copyright and therefore, it was in the nature of business income. The designs and drawings sold by the taxpayer were used by Indian customers for internal business purposes of setting up their plants and not for commercial exploitation. Since the work related to designs and drawings was done outside India and the sale took place outside India, such income was not taxable either under the provisions of the Act or under the tax treaty.



[10] Geoquest Systems B.V. [2010] 327 ITR 1 (AAR)
[11] Dassault Systems K.K. [2010] 322 ITR 125 (AAR)

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