21 December 2015

Income from EPC related offshore services is neither taxable as fees for technical services nor as business income under the India-Japan tax treaty

Background

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of IHI Corporation[1] (the taxpayer) held that the income from offshore services related to the Engineering, Procurement, Construction (EPC) and commissioning contracts in India, is taxable as Fees for Technical Services (FTS) under Section 9(1)(vii) of the Income-tax Act, 1961 (the Act). However, such services are neither taxable as FTS nor as business income under the India-Japan tax treaty (the tax treaty).

Facts of the case

- The taxpayer, a company, incorporated in and a tax resident of Japan, was engaged in the manufacturing of heavy machinery, providing technology oriented products and services. The taxpayer was awarded three EPC and commissioning contracts by Petronet LNG Limited in India.

- The contract consideration under these agreements is segregated into an offshore and onshore portion. The onshore portion comprises of onshore supply of equipment and services in India while the offshore portion comprises of the offshore supply of equipment and services from outside India. For the purposes of the execution of this contract the taxpayer set-up a project office in India.

- In the return of income, the taxpayer offered the income received from onshore activities to tax in India with a claim of the applicability of the tax treaty or the domestic law, whichever is beneficial to it. The taxpayer did not offer to tax the income from offshore supply offshore services by claiming that it did not accrue or arise in India. In support of its contention, the taxpayer relied on the Supreme Court decision in its own case[2].

- The taxpayer claimed an exemption of income from offshore services from tax by stating that its project office in India had no role to play in respect of the offshore services rendered.

- The Assessing Officer (AO) as well as the Dispute Resolution Penal (DRP) opined that the Supreme Court's decision in the taxpayer's own case was rendered prior to the retrospective amendment carried out to Section 9(1)(vii) of the Act. Also, the amount was liable to be considered as FTS under Article 12 of the tax treaty. Resultantly, the gross sum received by the taxpayer towards offshore services was subjected to tax at 10.5575 per cent.

Tribunal's ruling

Taxation under the Act

- The Finance Act, 2010 has substituted the Explanation below Section 9(2) of the Act, whereby the income from FTS shall be deemed to accrue or arise in India to a non-resident whether or not, inter alia, the non-resident has rendered services in India.

[1] IHI Corporation v. ADIT [2015] 63 taxmann.com 100 (Mum)

[2] Ishikawajima-Harima Heavy Industries Ltd. v. DIT [2007] 288 ITR 408 (SC)

- The substitution of this Explanation has diluted the twin conditions formulated by the Supreme Court in the taxpayer's own case, being the rendering of services and the utilisation of such services in India as a pre-requisite for attracting Section 9(1)(vii) of the Act. With this substitution, the rendering of services even outside India would be a good case for bringing the income of non-residents from FTS within the purview of Section 9(1)(vii) of the Act, if such services are utilised in India.

- In view of above, income from offshore services rendered outside India would fall within the domain of Section 9(1)(vii) of the Act.

Taxation under the tax treaty

- Article 12(5) of the tax treaty is a center of controversy between the assessee and the tax department, which contended that the case of the taxpayer cannot be considered under Article 12(5) because the fees for offshore services cannot be considered as 'effectively connected' with the Permanent Establishment (PE).

- The taxpayer contended that the offshore services were rendered because of the composite 'contract', whose remaining parts are effectively connected with the PE in India. It was submitted that if the effective connection of the FTS and the PE is established, then the income goes back to Article 7 instead of staying in Article 12 of the tax treaty.

- The Supreme Court in the taxpayer's own case held that:

  - For Section 9(1)(vii) of the Act to be applicable, it is necessary that the services not only be utilised within India but also be rendered in India or have such a 'live link' with India that the entire income from fees as envisaged in Article 12 of the tax treaty becomes taxable in India.

  - The terms 'effectively connected' and 'attributable to' are to be construed differently, even if the offshore services and the PE were connected.

  - Article 7 of the tax treaty is applicable in this case, and it limits the tax on business profits to that arising from the operations of the PE. In this case, the entire services have been rendered outside India, and have nothing to do with the PE; thus, it cannot be attributable to the PE and therefore not taxable in India.

- The Supreme Court has rendered a positive decision on this aspect by holding that Article 7 of the tax treaty is applicable in this case insofar as the income from offshore services is concerned. It has further been held that since the entire service was rendered outside India having nothing to do with the PE, this amount cannot be taxed in India

- Further, the offshore services are inextricably linked to the supply of goods, so it must be considered in the same manner. In view of the enunciation of law by the Supreme Court in the taxpayer's own case, it becomes vivid that the income from identical services rendered by the taxpayer in respect of the contract under consideration cannot be characterised differently.

- In the Assessment Year (AY) 2003-04, the jurisdictional High Court noted that the Supreme Court in the taxpayer's own case had held that apart from the non-applicability of Section 9(1)(vii) of the Act, Article 7 of the tax treaty is also applicable and hence the income arising on account of offshore services would not be taxable.

- The Supreme Court in the case of P.V.A.L. Kulandagan Chettiar[3] held that the provisions of Sections 4 and 5 are subject to the contrary provision, if any, in the tax treaty. The crux of the matter is that the provision of the Act or that of the tax treaty, whichever is more beneficial to the taxpayer, shall apply.

- Accordingly, it was held that the income from offshore services, albeit chargeable under Section 9(1)(vii) but exempt under the tax treaty, cannot be charged to tax in the light of Section 90(2) of the Act.

Our comments

This is an interesting decision of the Mumbai Tribunal dealing with EPC related offshore services and examining taxability under the Act as well as under Article 7 and 12 of the tax treaty. The Tribunal held that in the case of an EPC contract, offshore services (i.e. technical services rendered overseas) are effectively connected with the PE in India as per Article 12(5) of the treaty and hence would be governed by Article 7 of the tax treaty. Under Article 7 of the tax treaty, no income is attributable to the PE and hence not taxable in India.

The Supreme Court in the case of Ishikawajima-Harima Heavy Industries Ltd. held that the terms 'effectively connected' and 'attributable to' are to be construed differently even if the offshore services and the PE were connected. The Supreme Court held that the entire service was rendered outside India and has nothing to do with the PE in India. Therefore, no income can be attributable to the PE in India.

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[3] CIT v. P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)

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