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TAX FLASH NEWS

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Project office for installation of petroleum platforms and submarine pipelines does not constitute a PE in India

Background

Recently, the Delhi High Court (the High Court) in the case of National Petroleum Construction Company[1] (the taxpayer) held that since the activities of the taxpayer's Project Office (PO) are falling within the exclusionary clause of Article 5(3)(e) of the India-UAE tax treaty (tax treaty), it does not constitute a Permanent Establishment (PE) under the tax treaty. Since the duration of the project activities in India was less than nine months, the taxpayer was not having installation PE in India under Article 5(2)(h) of the tax treaty. The consultant appointed by the taxpayer was an agent of independent status and therefore, it does not form a Dependent Agent Permanent Establishment (DAPE) of the taxpayer in India. Therefore, no income can be attributed to the taxpayer in India.

Facts of the case

- The taxpayer is a company incorporated in the UAE, engaged in fabrication of petroleum platforms, pipelines and other equipment. The taxpayer undertakes contracts for installation of petroleum platforms, submarine pipelines and pipeline coating at various sites. In the course of its business, the taxpayer entered into contracts with ONGC for installation of petroleum platforms and submarine pipelines.

- The taxpayer was awarded a contract pursuant to a global tender floated by ONGC in July 2005. The said contracts included various activities. Whilst the activities relating to survey, installation and commissioning were done entirely in India, the platforms were designed, engineered and fabricated overseas.

- The taxpayer computed its income on a presumptive basis by taxing the gross receipts pertaining to its activities in India less verifiable expenses at the rate of 10 per cent and the receipts pertaining to activities outside India at the rate of 1 per cent.

- The Assessing Officer (AO) held that the taxpayer had a fixed place PE in India in the form of a PO. It was held that Arcadia Shipping Ltd. (ASL), a consultant, constituted a DAPE of the taxpayer in India. The AO held that the taxpayer also had an installation/construction PE in India. The contract was a turnkey and a composite contract and was not divisible as claimed by the taxpayer. Accordingly, the AO held that the entire contractual receipts including the activities performed outside India were taxable in India. The AO held that the consideration received by the taxpayer for

[1] National Petroleum Construction Company v. DIT (ITA No. 143/2013, 533/2013, 144/2013, 795/2014) (Del) – Taxsutra.com

design and engineering was held to be Fees for Technical Services (FTS). Since the taxpayer had not maintained separate books pertaining to the contract, the AO estimated the taxpayer's profit to be 25 per cent of the consideration received from ONGC.

- The Dispute Resolution Panel (DRP) and the Income-tax Appellate Tribunal (the Tribunal) upheld the order of the AO.

High Court's ruling

Interplay of Article 5(1), 5(2) and 5(3) of the tax treaty

- Article 5(1) of the tax treaty provides an overarching general definition of the expression PE. On perusal of the said definition, it indicates that the expression PE entails (a) a fixed place of business; and (b) business of the enterprise being carried on wholly or partially through the said fixed place of business. These two conditions must necessarily be satisfied for the existence of a PE.

- In addition, the word 'permanent' in the term PE indicates that there should be some degree of permanency attached to the fixed place of business before the same can be construed as a PE of an enterprise. The word 'permanent' does not imply for all times to come but merely indicates a place which is not temporary, interim, short-lived or transitory.

- In the case of P. No. 24 of 1996[2] the AAR referred to Baker's 'Double Taxation Conventions and International Tax Law, Second Edition', wherein the author had cited the decision in Henriksen[3] and explained that the expression 'permanent' is relative and not synonymous with 'everlasting'. The AAR ruled that it was used only in 'contradistinction to something fleeting, transitory, temporary or casual'.

- Article 5(2) of the tax treaty provides for an inclusive definition of PE and specifically lists out the places of business that fall within the meaning of that expression. The use of the word 'especially' underscores the intention of the authors of the tax treaty to remove any doubts that the places listed in sub-paras (a) to (i) fall within the definition of PE.

- Normally an inclusive definition is used to expand the width of the term sought to be defined. However, that does not appear to be the principal intent in drafting paragraph 2 of Article 5 of the tax treaty. Read in the context of the other provisions of Article 5, paragraph 2 clearly indicates that it has been used as an explanatory provision to specifically include the species of places of business that would constitute the PE of an enterprise.

- Article 5(1) and 5(2) of the tax treaty complement each other. Thus, all classes of PEs as specified in various subparas of paragraph 2 of Article 5 of the tax treaty would be construed as a PE subject to the essential conditions of paragraph 1 of Article 5 being met.

- Insofar as sub-paras (h) and (i) of Article 5(2) of the tax treaty are concerned, the test of permanence as required under Article 5(1) of the tax treaty is substituted by a specified minimum period of nine months. Thus, places of business as specified under sub-paras (h) and (i) of Article 5(2) of the tax treaty cannot be construed as the PE of an enterprise, unless it exists for a period of atleast nine months.

- Paragraph 3 of Article 5 of the tax treaty is an exclusionary clause and is intended to exclude certain places of business from the scope of the expression PE. Paragraph 3 begins with a *non-obstante* clause. Thus, the exclusions provided under paragraph 3 would override the provisions of paragraph 1 and 2 of Article 5 of the tax treaty.

- In other words, even if a place of business squarely falls within the definition of Article 5(1) and is specifically listed in 5(2) of the said Article, the same would, nonetheless, not be construed as the PE of an enterprise, if it falls

[2] P. No. 24 of 1996 [1999] 237 ITR 798 (AAR)
[3] Henriksen v. Grafton Hotel Limited [1943] 11 ITR (E.C.) 10 (CA)

within any of the exclusionary clauses contained in sub-paras (a) to (e) of paragraph 3 of Article 5 of the tax treaty.

- Thus, even though the taxpayer's PO established in India falls within the definition of PE in terms of paragraph 1 and 2 of Article 5 of the tax treaty, it would still have to be seen whether it stands excluded under paragraph 3 of Article 5 of the tax treaty.

- Article 5(4) of the tax treaty provides for a legal fiction to include an agent (other than an agent of an independent status) to be a PE of the principal enterprise. Paragraph 4 also begins with a *non-obstante* clause. Thus, even though an agent may not *stricto senso* fall within the definition of a PE as defined in paragraph 1 and/or paragraph 2 of Article 5 of the tax treaty, yet it would be deemed that a PE of an enterprise exists if the business of an enterprise is carried out through an agent as described in Article 5(4) of the tax treaty.

- It is also not disputed that the taxpayer did carry out part of its business through its PO. In these circumstances, the conditions as spelt out in paragraph 1 and paragraph 2(c) of Article 5 of the tax treaty are satisfied. However, the matter does not rest here, and it is required to be seen whether any of the exclusionary clauses of Article 5(3) of the tax treaty are applicable.

- The observations made by the DRP and the Tribunal with regard to the employees of the PO being present at the meeting cannot be sustained. Similarly, there is also no material that the employees of the PO had participated in the review of the engineering documents done in Mumbai or had participated in the discussions or approval of the designs submitted to ONGC. In the absence of any material evidence to controvert the taxpayer's claim that its PO was only used as a communication channel, the same has to be accepted.

- The language of Article 5(3)(e) of the tax treaty is similar to the language of Article 5(4)(e) of the Model Conventions framed by the OECD, United Nations as well as the U.S. The rationale for excluding a fixed place of business maintained solely for the purposes of carrying out an activity of a preparatory or auxiliary character has been explained by Professor Dr. Klaus Vogel. Further, the High Court relied on the decision of Morgan Stanley & Company Inc[4] and the UAE Exchange Centre Limited[5].

- The Black's Law Dictionary defines the word 'auxiliary' to mean as 'aiding or supporting, subsidiary'. The word 'auxiliary' owes its origin to the Latin word 'auxiliarius'. The Oxford Dictionary defines the word 'auxiliary' to mean 'providing supplementary or additional help and support'.

- In the context of Article 5(3)(e) of the tax treaty, the expression would necessarily mean carrying on activities, other than the main business functions, that aid and support the tax treaty. In the context of the contracts in question, where the main business is fabrication and installation of platforms, acting as a communication channel would clearly qualify as an activity of auxiliary character - an activity which aids and supports the taxpayer in carrying out its main business.

- In view of the above, the activity of the taxpayer's PO in India would clearly fall within the exclusionary clause of Article 5(3)(e) of the tax treaty, and it cannot be construed as a PE in India.

Installation PE

- Exclusionary clause of Article 5(3)(e) of the tax treaty would equally apply to a place of business falling within Article 5(2)(h) of the tax treaty as it would be an office falling within the scope of Article 5(2)(c) of the tax treaty. Thus, the taxpayer also cannot be stated to have a PE under Article 5(2)(h) of the tax treaty.

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[4] DIT v. Morgan Stanley & Company Inc [2007] 292 ITR 416 (SC)
[5] UAE Exchange Centre Limited v. UOI [2009] 313 ITR 94 (Del)

- In terms of clause (h) of paragraph 2 of Article 5 of the tax treaty, ‘a building site or a construction or assembly project or supervisory activities in connection therewith’ would also constitute a PE of an enterprise subject to that site, project or activity continuing for a period of atleast nine months. Clearly, the purpose of the said clause is also to include a building site or construction or an assembly project as a PE by itself.

- On perusal of clause (h) of paragraph 2 of Article 5(2)(h) of the tax treaty, it indicates that a PE constituted by a building site or a construction or an assembly project would commence on the commencement of activities relating to the project or site. The said clause is also to be read harmoniously with Article 5(1) of the tax treaty which necessarily entails a fixed place of business from which the business of an enterprise is carried on. Thus, a building site or an assembly project could be construed as a fixed place of business only when an enterprise commences its activity at the project site.

- An activity which may be related or incidental to the project but which is not carried out at the site in the source country would clearly not be construed as a PE as it would not comply with the essential conditions as stated in Article 5(1) of the tax treaty.

- It is necessary to understand that a building site or a construction assembly project does not necessarily require an attendant office. The site or the attendant office in respect of the site/project itself would constitute a fixed place of business once the taxpayer commences work at a site.

- Thus, in order to apply Article 5(2)(h) of the tax treaty, it is essential that the work at a site or the project commences. It is not relevant whether the work relates to planning or actual execution of construction works or assembly activities.

- On perusal of the commentary by Klaus Vogel on ‘Double Taxation Conventions, Third Edition’ it clearly indicates that the duration of a PE would commence with the performance of business activities in connection with the building site or assembly project.

- In the present case, the taxpayer claims that the survey was conducted by an independent third party and that too for a period of nine days in one instance and 27 days in another. The taxpayer commenced its activities at a site when the barges entered into the Indian Territory on 19 November 2006 and such activities relating to the installation, testing and commissioning of the platforms continued till 27 April 2007. Thus, the taxpayer's activity at a site would indisputably commence on 19 November 2006 and continue till 20 April 2007, that is, for a period of less than nine months.

- The initial activities at the site were carried out by an independent subcontractor appointed by the taxpayer. If the commencement of the activities of the sub-contractor is considered, the same commenced on 27 February 2006 and were concluded by 21 May 2006.

- An interruption in the normal course of activities such as a weekly day off would undoubtedly be included in the duration of the PE but in cases where the interruption exceeds substantial periods which represent cessation of the activities at site, it would be difficult to accept that the building/project site continues to represent the fixed place of business of an enterprise. A reference to the commentary by Klaus Vogel on Double Taxation Conventions on this aspect is also instructive.

- In the facts of the present case, where the taxpayer did not have access to the site from the period starting 21 May 2006 till 19 November 2006, the same cannot be construed as its PE under Article 5(2)(h) of the tax treaty. If the period during which the taxpayer did not have access to the site in question is excluded, the aggregate period would be less than nine months, and this would exclude the applicability of Article 5(2)(h) of the tax treaty.

- In the facts, where an enterprise is not granted access to the site for a long duration and carries out no activity at the site during that period, the site could hardly be construed as the fixed place of business of a taxpayer during that period. In the present case, the installation activities lasted from 19 November 2006 till 27 April 2007, which is much less than the minimum period of nine months.

- Even if the time spent by ASL in conducting the pre-engineering and predesign survey is included, the duration of the project activities in India would not exceed nine months. The taxpayer's PO is inextricably linked to the project. Therefore, if the duration of the project activities in India was less than nine months, it cannot be held that the taxpayer had a PE in India under Article 5(2)(h) of the tax treaty.

DAPE

- On perusal of the director's report and the final accounts of ASL for the financial year ended 31 March 2007, it indicates that ASL's activities were not limited to providing services to the taxpayer but extended to various other activities. ASL also provided logistics and consultancy support to various companies other than the taxpayer. The director's report also clearly indicates that the activity of providing offshore marketing/technical consultancy and offshore fabrication and installation work were amongst the regular activities carried out by ASL.

- It is clear from the above that ASL had agreed to act as a 'sole and exclusive' consultant for the taxpayer in India and had further agreed not to represent any competitor of the taxpayer or act in a manner detrimental to the taxpayer's interest. The recital to the agreement also indicates that the taxpayer was desirous to undertake offshore contract work in India and had, therefore, appointed ASL as its sole and exclusive consultant in India.

- The consultancy agreement did not fetter ASL to carry out its regular activities including providing consultancy services to persons other than the taxpayer's competitors. The financial accounts of ASL also clearly indicate that it had earned substantial income other than the remuneration received/receivable from the taxpayer.

- In view of the above, the Tribunal's conclusion that ASL was working 'wholly and exclusively' for the taxpayer, is clearly not sustainable. The consultancy agreement clearly indicates that ASL was engaged to (a) provide assistance in gathering relevant market information; (b) assistance in obtaining works; (c) active representation and promotion of the taxpayer's activities in India; and (d) provide assistance in obtaining services and facilities in India.

- The consultancy agreement clearly indicates that the contracts would be tendered for and executed by the taxpayer. The taxpayer had also duly disclosed ASL to be its agent involved in the contract as well as the remuneration payable to ASL.

- The representatives of ASL were present at the pre-bid meeting held with ONGC as well as at the kick-off meeting. The presence of ASL at such a meeting was clearly in pursuance of the services agreed to be rendered by them. However, this by itself cannot lead to an inference that ASL constituted a DAPE of the taxpayer in India.

- By virtue of paragraph 5 of Article 5 of the tax treaty an independent agent who acts outside its ordinary course of business would fall outside the scope of Article 5(5) of the tax treaty. Therefore, in order to consider whether an agent of an enterprise falls within the ambit of Article 5(5) of the tax treaty, it is necessary to consider whether (a) the agent is one of an independent status and (b) whether he/she is acting on behalf of the enterprise in the ordinary course of its business.

- Applying the aforesaid tests in the facts of the present case, it is clear that ASL has acted on behalf of the taxpayer in its normal course of business. This is evident from the director's report which indicates that regular activities of ASL include offshore marketing/technical consultancy and ASL in its regular course of business provides logistics and consultancy support to various entities including the taxpayer.

- It is also apparent from the final accounts of ASL for the year 2006-07 that it carries on substantial business other than the services provided to the taxpayer. The agreement entered into between the taxpayer and ASL is also on a principal-to-principal basis. Even otherwise, there is material to support the view that the taxpayer would bid and execute contracts in its name. The consultancy agreement does not authorise ASL to conclude contracts on behalf of the taxpayer.

- Although the correspondence between the taxpayer and ASL indicated that ASL was involved in the project since the pre-bid meeting and had also acted on behalf of the taxpayer, it cannot be concluded that ASL was habitually authorised to conclude contracts on behalf of the taxpayer.

- In view of the above, ASL cannot but be considered as an agent of independent status to whom Article 5(5) of the tax treaty applies. In this view, ASL would not constitute a DAPE of the taxpayer in India.

In view of the conclusion that the taxpayer did not have a PE in India, the question of attributing any income of the taxpayer to the PE does not arise.

Section 44BB of the Act

- Although the taxpayer had claimed that Section 44BB of the Income-tax Act, 1961 (the Act) and the CBDT Instruction No.1767 provided the legal basis for the method of computation of taxable income adopted by the taxpayer, the same is clearly erroneous.

- Section 44BB of the Act provides for levying tax on a presumptive basis, and 10 per cent of the receipts are presumed to be the profits of a foreign company rendering the services specified therein. There is no scope for allowing any deduction while computing tax on a presumptive basis. The method of computation as adopted by the taxpayer is also not supported by the CBDT Instruction No. 1767 referred to by the taxpayer.

Taxability of incomes attributable to design, procurement of material and fabrication of platforms

- On perusal of Article 7 of the tax treaty, it indicates that only such income as is attributable to the taxpayer's PE in India can be taxed. In Hyundai Heavy Industries[6] the Supreme Court had explained that the only way to ascertain the profits arising in India would be by treating the taxpayer's PE in India as a separate profit centre viz-a-viz its foreign enterprise.

- In the present case, the consideration of various activities has been specified in the contracts. The contract price schedule and rental rates schedule specifically assign values to various activities. It is also not disputed that the invoices raised by the taxpayer specifically mention the work done outside as well as in India.

- Thus, even though the contracts may be turnkey contracts, the value of the work done outside India is ascertainable. There is no dispute that the values ascribed to the activities under the contracts are not at arm's length. There is also no material evidence to indicate that the work done outside India included any input from the taxpayer's PE in India.

- The Tribunal had considered the contract and in view of the fact that the consideration for various activities such as design and engineering, material procurement, fabrication, transportation, installation and commissioning

[6] CIT & Anr. v. Hyundai Heavy Industries [2007] 291 ITR 482 (SC)

had been separately specified, the Tribunal rightly held that the consideration for the activities carried out overseas could not be attributed to the taxpayer's PE in India.

- In view of the conclusion that the taxpayer did not have a PE in India during the Assessment Years (AYs) 2007-08 and 2008-09, no income of the taxpayer from the projects in question can be attributed to the taxpayer's PE.

Our comments

The issue with respect to the formation of a PE under Article 5(2) of the tax treaty independent of Article 5(1) of the tax treaty has been a matter of debate before the courts. In some of the cases, it has been held that the PE cannot be constituted under Article 5(2) unless the conditions specified in Article 5(1) are met with. However, in a few cases, it has been held that Article 5(2) of the Act is independent of Article 5(1). The High Court in the instant case observed that Article 5(1) and 5(2) of the tax treaty complement each other. Thus, all classes of PEs as specified in Article 5(2) of the tax treaty can be construed as a PE subject to the essential conditions of Article 5(1) of the tax treaty being met with. The High Court also observed that the exclusions provided in Article 5(3) of the tax treaty would override the provisions of Article 5(1) and (2) of the tax treaty.

The High Court observed that the activities of the PO of the taxpayer were auxiliary and preparatory in nature, and therefore, it could not be construed as the taxpayer's PE in India. Also, the PO is inextricably linked to the project, and the duration of the project activities in India was less than the threshold period of nine months, therefore, the taxpayer did not have an installation PE in India. Further, the consultant appointed by the taxpayer was an agent of independent status and therefore, it does not form a DAPE in India. Since the taxpayer did not have a PE in India, no income can be attributed to the taxpayer in India.

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