

Tax Hotline

January 10, 2007

OFFSHORE SUPPLY OF EQUIPMENT AND SERVICES NOT TAXABLE IN INDIA - HOLDS SUPREME COURT, OVERRULING ADVANCE RULING

The Supreme Court of India ("SC") has recently held, in the case of Ishikawajima-Harima Heavy Industries Ltd ("Applicant") that the income from offshore supply of equipment and services by the Applicant outside India, would not be taxable in India merely because the equipment was supplied in relation to a turnkey project situated in India.

In the instant case the Applicant entered into a contract for the setting up of a turnkey project, which contract involved a) offshore supply of equipment and services and b) onshore supply of equipment and services.

The Applicant filed an appeal before the Supreme Court against a ruling by the Authority for Advance Rulings ("AAR"), which held that the income of the Applicant from offshore supply of equipment and material was taxable in India. In arriving at this conclusion, the AAR applied the twin tests of

- whether the 'offshore' and 'onshore' elements of the contract are so inextricably linked that the breach of the 'offshore' element would result in the breach of the whole contract and
- whether the dominant object of the contract is the execution of a turnkey project and whether the title to the goods supplied passes offshore or within India

The AAR relied on the protocol in the India- Japan tax treaty, with reference to paragraph (1) of Article 7, wherein both parties to the treaty understood that by using the term "directly or indirectly attributable to that permanent establishment", profits arising from transactions in which the permanent establishment ("PE") has been involved shall be regarded attributable to the PE, to the extent appropriate to the part played by the PE in those transactions.

Reversing the decision of the AAR, the SC drew a distinction between business connection and permanent establishment ("PE"), to hold *inter alia* that, as the offshore supply of equipment was outside India, the fact that the contract was signed in India was of no material consequence, since all activities in connection with the offshore supply were outside India. The SC reaffirmed that the concept of territorial nexus was fundamental to determine taxability and the "location of the source of income within India would not render sufficient nexus to tax the income from that source". Thus, with regard to rendering of offshore services, it was observed that as the services were rendered outside India and income from the same could not be said to be attributable to a PE in India, it would not be taxable in India. The SC examined both section 9(1)(vii) and Article 12 of the India Japan DTAA (dealing with Fees for technical Services) to hold that for taxability under these provisions the services not only must be utilised within India but also rendered in India or have a "live link". The SC further held that Section 9(1)(vii)(c) would only apply if the income derived by the non-resident company were utilised in India.

The SC also said that the above referred paragraph of the protocol was not applicable because, for the profits to be "attributable directly or indirectly", the PE must be involved in the activity giving rise to the profits.

Author's note:

This is a very important ruling, laying down the law of the land with respect to large EPC and infrastructure related contracts. The clarity accorded by it would give the required certainty to the foreign entities which are involved in large infrastructure projects in India.

The judgment of the SC may also lend clarity to taxability of income earned by non-residents which though remotely linked to sources in India, may be brought within the widely worded Section 9(1)(vii)(c) of the Indian Income Tax Act. This is of particular interest to the Fund Industry; where in the recent past offshore fund managers have been receiving tax notices for the income earned from the management of offshore funds making investments into India.

- Jitender Tanikella & Daksha Baxi

Source: Order arising out of SLP (Civil) No.5318 of 2005

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