Supply of telecom equipment by overseas group company as a part of a turnkey project creates a PE

30 June 2014

In brief

The Delhi Income-tax Appellate Tribunal (Tribunal) has held that the Indian group company rendering pre and post-sale activities as a part of an indivisible contract, which was assigned to an Overseas Group Company, qualified as a Permanent Establishment (PE) for the latter. Also, profit on supply of equipment, which was part of a turnkey project, would be attributable to the PE in India.

In detail

Facts

- Nortel Networks India International Inc.[1] (Nortel Inc. or taxpayer), was a part of Nortel Group which was a leading supplier of hardware and software for GSM cellular radio telephones system.

- Nortel Networks India Private Limited (Nortel India), had entered into a contract with Reliance Infocomm (customer) for a composite agreement of supply and services, and had assigned the same to Nortel Inc. immediately, without any consideration. The equipment supplied was originally acquired from Nortel Network Limited (Nortel Canada), which was also part of the Nortel Group. Also, Nortel Canada had a liaison office (LO) in India. The performance of the contract was guaranteed by the group.

- During the course of assessment proceedings, the taxpayer's unaudited accounts were submitted, which reflected a gross loss and also very little general and administrative expenditure. Based on these, the tax officer (TO) observed that the taxpayer did not have any technical, financial or infrastructural capability to execute the contracts.

- Being a turnkey project, the contract was indivisible into supply and distinct services. Though Nortel India assigned the contract to the taxpayer, the responsibilities for negotiating, securing and executing the contract were given to Nortel India. Thus, there was a combined effort between the taxpayer and Nortel India for the project.

- The taxpayer argued that equipment sale and installation were separate contracts. As sales were completed before they reached India, the profit attributable to sale could not be taxed in India.

- The TO concluded that the taxpayer had a PE in India, for the following reasons:
  - Nortel India and Nortel Canada LO constituted a fixed place PE as per the treaty;
  - The premises of Nortel India were used by the Nortel Group as a sales outlet and for soliciting orders;
  - As Nortel India was involved in installation activity for the taxpayer, the same

[1] Nortel Networks India International Inc. *v.* DDIT [TS-355-ITAT-2014(DEL)]

constituted an Installation PE;

- Expatriates of various entities of the Nortel Group supervised the installation activity, hence creating a supervisory PE;
- As an expatriate employee stayed in India and rendered services for Nortel India for longer than the limit specified in the treaty, a service PE was created; and
- Nortel India had procured the orders and executed the same with the aid of the group companies. The accounts of Nortel India also reflected that it was performing agency functions for the taxpayer and was dependent on the group technically and financially

- For the purpose of attributing profits, the TO relied on the global accounts of the Nortel Group, which showed a gross margin of 42.6%, and allowed 5% for general expenditure.

Observations of CIT(A)

The Commissioner of Income-tax (Appeals) [CIT(A)] held that the activities of Nortel Inc. constituted a Fixed Place PE, Installation PE, Service PE and Dependent Agent PE.

- Nortel India and the place in which the equipment was assembled and installed constituted the taxpayer's fixed place PE. The CIT(A) rejected the taxpayer's contention that those were not at its disposal.
- Further emphasis was given to the admitted fact that:
  - Only Nortel India was involved in both pre-supply and installation activity.
  - Once the contract was signed, it was assigned to the taxpayer without any consideration.
  - Employees and other personnel from group companies were carrying out installation activity in India.
- The taxpayer's entire business in India had been taken care of by its associated enterprise, i.e. Nortel India, by getting the order, installing the equipment and performing after-sales services. Only supply of the equipment was done by the taxpayer, which could not be separated, as it was a part of the works contract.
- Also, when Nortel India assigned the contract to the taxpayer, the whole risk and responsibility also passed to the taxpayer. Hence, Nortel India was dependent on the taxpayer.
- The CIT (A) directed the TO to arrive at profit attribution based on 50% net profit margin after deduction of allowable expenditure, relying on rule 10. It was decided that attribution had to be made on a case-by-case basis and could not be compared with another case.

Issues before the Tribunal

- Whether supply of equipment by an overseas group company, incidental to installation activity in India, created a PE?
- Whether in the above case, 50% of profit from supply of equipment was attributable to the PE?

Taxpayer's contentions

Taxpayer constituting a PE in India

Business connection

- Nortel Inc. decided to be taxed under the treaty and hence, having a business connection in India would not have any impact on the taxation.
- Even under the Income-tax Act, 1961 (the Act), the taxpayer did not have any business connection, as it was involved only in the offshore supply of goods on a principal-to-principal basis, and the title and risk was passed to the customer outside India.
- Reliance was placed on CBDT circular 23 dated 23 July 1969, which clarified that no liability would arise to a non-resident if a sale was on a principal-to-principal basis.
- The acceptance test performed by the taxpayer was just to give assurance to the customer and was not indicative of conclusion of sale[2].
- Also, performance of acceptance test did not have any connection with payment of consideration, as a substantial portion of the consideration was received a while before the acceptance test.

No Fixed PE

- The taxpayer was involved only in supply of equipment, which was a part of the contract assigned in its favour by its Indian group company.
- Nortel India was held by a Mauritius group company

[2] DIT *v.* Ericsson Radio Systems A.B [2012] 343 ITR 470 (Delhi), DIT *v.* Nokia Networks Oy [2012] 25 taxmann.com 225 (Delhi)

and Nortel Canada LO was representing Nortel Canada's activities in India.

- Neither of them was at the disposal of the taxpayer nor could co-existence of both in India be construed as a PE.

No Dependent Agent PE

- Nortel India had all capabilities to take up such a contract by itself, and this was evident from the fact that it had earlier completed a similar order given by a state-run telecom major.
- Nortel India won the contract independently and did not enter into it on the taxpayer's behalf.
- Nortel India did not maintain stock of goods of the taxpayer, as it passed them on to the customer directly.
- Even assuming that Nortel India had authority to conclude contracts on behalf of the taxpayer, it was not habitual, as only one contract had been concluded.
- Nortel Canada LO could not perform any activities that were alleged to be performed by the revenue, because performance of such functions would be tantamount to violation of the terms on which approval was given by the Reserve Bank of India (RBI).

No Installation PE

- The taxpayer was only involved in supply of equipment, and the installation was done by Nortel India under an independent contract.
- Nortel India's taking assistance of group companies' personnel, could not lead to taxation of profit on sale of equipment.
- Relying on judicial precedents[3], even if the taxpayer constituted an installation PE, only income attributable to installation activity could be taxed in the taxpayer's hands, and not the income on sale of equipment, since supply was completed before installation.

No Service PE

The taxpayer did not have any employees based in India. Installation activity was carried out by Nortel India under a separate contract, in which personnel from group companies' were deputed.

No Shadow Company

The taxpayer put forth the following arguments against the TO's findings:

- The taxpayer was involved in trading activity and hence, there was no need for a manufacturing facility. The contract was entered into between group companies, and the taxpayer did not require any financial backup.
- The only activity carried on during the relevant period was the supply of equipment to the customer, and hence there was no need for any administrative or marketing expenditure.
- The taxpayer did not have audited accounts, as this was not required by regulations in the USA for foreign subsidiaries.
- The TO had failed to bring any evidence to substantiate the fact that it was created with the only motive of evading taxes.

Nortel Canada did not constitute a PE in India

- Nortel Canada LO was not engaged in any services, and performed only liaison activity which was well within its permissible activities.
- Nortel India utilised the services of Nortel Group's personnel by way of secondment, which included Nortel Canada's personnel. However, such personnel were entirely working under the control and supervision of Nortel India and they were duly compensated by Nortel India.
- Nortel India did not qualify as a dependent agent PE of Nortel Canada, as Nortel India concluded the contract on its own and did not act on behalf of Nortel Canada.
- Nortel India did not qualify as an installation PE of Nortel Canada, as installation activities were independently being done by Nortel India, and Nortel Canada's activity was restricted to supply of equipment.

Profit Attribution

The taxpayer:

- Contended that the equipment was sold outside India and its employees were not involved in installation activities. Hence, relying on the Apex Court's judgement in Ishikawajma Harima Heavy Industries Limited[4], profit on supply of equipment was not taxable.
- Relied on judicial precedents in which a lower profit had been attributed in the cases of companies engaged in the same industry

[3] Ishikawajma-Harima Heavy Industries Limited *v.* DIT. ([2007] 158 Taxman 259 (SC), CIT *v.* Hyundai Heavy Industries Co Limited [2007] 161 Taxman 191 (SC)

[4] Ishikawajma-Harima Heavy Industries Limited *v.* DIT ([2007] 158 Taxman 259 (SC)

Revenue's contentions

Business Connection

- The taxpayer's contention that it had no business relationship with Nortel India was not tenable, as the contract was assigned by Nortel India for 10 years with no consideration, which would have never happened between independent parties.

- On a reading of the Optical Equipment Agreement and General Terms and Conditions, it could be understood that the contract did not involve the customer importing equipment from the taxpayer, but a supply and delivery contract in which end-to-end functions were performed by Nortel India. In addition, the contract specified installation of a Test Bed Laboratory, which was also carried out by Nortel India.

- The fact that the sale had been concluded outside India and a substantial portion of the consideration was received outside India, itself could not lead to a conclusion that title of goods had passed outside India.

- Payment of substantial portion at an earlier stage was to reduce the financial burden[5] but the title passed only after the acceptance test was done in India.

- As per the Sale of Goods Act, 1930, title of goods passed when it was intended to pass. The intention of passage of title of equipment in India was explicitly brought out in the contract, which the taxpayer failed to bring out during earlier proceedings.

- The taxpayer had received payment on a milestone basis. If the taxpayer's responsibility was limited only to supply of equipment, it could have received the full amount immediately on supply. This was an additional fact to substantiate that the contract was a composite one and the title of goods passed in India.

Fixed Place PE

- The onus to prove that Nortel India and Nortel Canada LO were not PEs of the taxpayer lay with the taxpayer, and not with the TO.

- As per the contract, the taxpayer had to construct and maintain a test bed lab, service centre and a depot with tools and equipment, which was actually constructed and maintained by Nortel India. Hence, in addition to Nortel India being a PE, these places also qualified as the taxpayer's PE.

- Pre and post-supply activities, including maintenance, were carried out by Nortel India for nearly 10 years. Therefore, the taxpayer clearly used Nortel India's office for its business.

- The fact that Nortel Canada LO was approved by RBI and it could not perform any activities which were not permissible could not lead to the conclusion that it did not perform any support for the contract.

Dependent Agent

- Nortel India assigned such a huge contract to the taxpayer, on the same day, without any written agreement between the taxpayer and Nortel India.

- Nortel India negotiated the full contract and signed the contract by itself.

- Nortel India could not be held as independent because it did not sign the contract in the normal course of business, as its business was not to sign behalf of others.

- In performance of the contract, Nortel India performed the following activities:

  - Stored spare and repair parts, and undertook services warranty as required in the contract.

  - Activities ranging from clearing of goods at ports to post-sale services.

  - Received purchase orders raised by the customer on behalf of the taxpayer

- The taxpayer's contention that Nortel India secured only one order and it would not lead to habitually exercising authority to conclude contracts is an inappropriate claim.

- Commentary on Article 5 of the Organisation of Economic Co-operation and Development Model Convention required that an agent "habitually" exercise authority to conclude contracts. This could not be taken as such in this case, as the contract was a large one which involved substantial revenue and kept the taxpayer in business for ten years. Hence, the authority to conclude one such contract was enough to satisfy this condition.

Installation PE

Income from supply of equipment would be taxable once the Installation PE was established. Any further supply made after establishing Installation PE was taxable.

Service PE

Based on the facts specified in the CIT(A)'s order, a service PE also applied.

[5] Hindustan Shipyard *v.* State of Andhra Pradesh 6 SCC 579 (SC)

Shadow Company

- The assignment of the contract took place the very next day after the taxpayer was incorporated. The taxpayer did not have any capital, infrastructure or human resources. In fact, many obligations that had to be fulfilled by employees of the taxpayer, were done by Nortel India, as the taxpayer did not have any employees.

- The taxpayer-company was created as a shell company by the Nortel Group, to shift the profits out of India.

- Nortel India assigned the contract to the taxpayer without any consideration, which makes it clear that they are associated enterprises. The taxpayer also failed to comply with any income-tax filing and transfer pricing requirements, disregarding the provisions of the Act.

PE of Nortel Canada

- As the taxpayer did not object to the CIT(A)'s decision that for the purpose of the supply agreement, the taxpayer and Nortel Canada would be considered as the same entity, all arguments made against the taxpayer equally applied to Nortel Canada.

- As per the service arrangement, expatriates were seconded and they spent more than 30 days in India. As the services were rendered to Nortel India, it created a PE for Nortel Canada and any other group company which seconded its employees for the said purpose.

Profit Attribution

- The taxpayer's reliance on Ishikawajma Harima[4] was misplaced because the taxpayer's contention that title of goods passed outside India was factually wrong.

- Also, with respect to attribution, it was incorrect to compare preceding judgements, without looking into the functions performed in each case. In each case quoted by the taxpayer, the functions performed by the PE were minimal.

Tribunal's ruling

The Tribunal held that the taxpayer constituted a PE in India, based on the following observations:

- The contract was a turnkey contract and was indivisible. The taxpayer only performed the equipment supply portion of the contract, which was incidental to other activities.

- Nortel India performed negotiation, installation, product delivery and post-sale services. It was evident that Nortel India was used by the taxpayer for its functions.

- The LO performed all kinds of services for group companies, including the taxpayer, thereby making its place available to the taxpayer.

- The taxpayer's contention that the title of equipment passed to the customer outside India was incorrect, as equipment remained in the taxpayer's virtual possession until it was installed and an acceptance test carried out.

- Personnel from various group companies were deputed to India and worked under Nortel India, discharging functions relating to installation activity.

- Nortel India acted as a service provider to the taxpayer and also a sales outlet by carrying out various post-sale service activities.

With respect to profit attribution, the Tribunal upheld the order of the CIT(A) based on the fact that the taxpayer's PE had performed extensive functions in India and attribution was made taking this into consideration.

The takeaway

This ruling once again underlines the point that substance and facts of each case would determine existence of a PE and its attribution. Relying on past judicial precedents will not be of help where the factual matrix is different.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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