Off-shore supply of equipment and design and drawings not taxable in India

June 30, 2015

In brief

Recently the Kolkata bench of the Income-tax Appellate Tribunal (Tribunal), held in the case of a taxpayer or company, a German entity, that income earned from off-shore supply of equipment and from sale of designs and drawings was not subject to tax in India.

The Tribunal reached this conclusion on the basis that since the title to the equipment was transferred outside India, and no service was provided in India on account of supply of equipment, no income could be taxed in India as per the provisions of both, the Income-tax Act, 1961 (the Act) as well as the Double Taxation Avoidance Agreement (tax treaty) between India and Germany. The Tribunal also held that designs and drawings were supplied by outright sale. Furthermore, designs and drawings were used for internal business purposes of the Indian customers, and not for their commercial exploitation. Hence, the taxpayer's income from supply of designs and drawings did not constitute royalty and was thus not taxable in India.

In detail

Facts

The taxpayer[1] was a tax resident of Germany engaged in the business of providing innovative and environmentally sound solutions for a variety of customers in metal and mining processing industries. The taxpayer, during assessment year (AY) 2010-11, earned revenue from Indian customers through sale of equipment, supply of designs and drawings, and provision of supervisory services. It had supervisory Permanent Establishment (PE) for certain projects in India in terms of the tax treaty. In the income tax return filed, the taxpayer attributed 17.93% of the gross revenue earned from supervisory activities to the Indian supervisory PE. The income earned from sale of equipment and from supply of designs and drawings was not offered to tax in its return.

The Tax Officer (TO), in his draft assessment order, proposed to tax part of the income earned from sales of equipment to Indian customers. Further, the income earned from supply of designs and drawings was considered as taxable as royalty. In relation to income from supervisory services, the attribution percentage was enhanced to 27.5% of the gross revenue, from the 17.93% offered by the taxpayer. Additionally, interest under sections 234A and 234B were also proposed to be levied.

The taxpayer filed objections before the Dispute Resolution Panel (DRP) against the draft assessment order. The DRP confirmed the additions made by the TO on all issues, and the final assessment order was passed accordingly.

Aggrieved by the final assessment order, the taxpayer filed an appeal before the Tribunal.

Issues before the Tribunal

- Whether a part of the income earned from supply of equipment accrued or arose in India, and thus was taxable in India under the provisions of the Act read with the provisions of the tax treaty?

[1] TS-349-ITAT-2015 (Kolkata)

- Whether the net profit rate of 27.5% determined by the TO for attributing profits to Supervisory PE was justified, compared to the rate of 17.93% adopted by the taxpayer?
- Whether the supply of designs and drawings constituted outright sale and did not come within the meaning of royalty as per Article 12 (3) of the tax treaty as well as Explanation 2 to section 9(1)(vi) of the Act?
- Levy of interest under section 234A and 234B of the Act.

Taxpayer's Contentions

Sale of Equipment

- The title of equipment was transferred outside India and the consideration was also received outside India in foreign currency. As no operation in relation to sale of equipment was conducted in India, no income could be considered to accrue or arise in India. Reliance was placed on the decision of the Supreme Court (SC) in the case of Ishikawajima-Harima Heavy Industries Limited[2]. The taxpayer also relied on many other judgments.
- Clauses relating to 15% of the value of equipment payable on successful completion of various tests in India were only a commercial arrangement; it could not be construed that, for such clauses, the sale took place in India. Such clauses were in the nature of warranty provisions. The taxpayer relied on the Delhi High Court (HC) decision in the case of LG Cable Limited[3] and other HC and Tribunal judgments. It further contended that this 15% payment was merely a deferred payment that did not have any impact on the sale of goods. Reliance was placed on the definition of "sale" in section 2(g) of the Central Sales-tax Act, 1956.
- From the tax treaty perspective, the income earned from the sale of equipment was governed by Article 7 of the tax treaty and, as the taxpayer did not have a PE in connection with sale of equipment, no income was taxable. Reliance was also placed on the protocol [Item (a)] of the tax treaty to contend that income arising on delivery of equipment from outside India was not taxable in India.
- Income arising from the sale of equipment could not be attributed to the supervisory PE as only income arising on account of supervisory activities could be attributed to it.
- The taxpayer's alternative contention was that PE under the tax treaty had to be determined separately for each project. As per Article 5(2)(i) of the tax treaty, the taxpayer did not have Supervisory PE in India for all the projects. In such a situation, the question of attribution of income earned from sale of equipment to the projects for which the company did not have PE, did not arise at all. Reliance was placed on the decision of the Mumbai Tribunal in the case of M/s Krupp Udhe GmbH[4] where it had been held that supervisory PE had to be examined separately for each project.

Income from Supervisory Activities

- Net profit rate of 17.93% determined by the taxpayer was based on the average margin of comparable companies, but it was rejected by the TO without giving any cogent reasons.
- The TO applied the rate of 27.5% following the decision of Income-tax Settlement Commission (ITSC) in the taxpayer's own case for AYs 2008-09 and 2009-10. However, in those years, the margins of comparable companies were not available. Thus, the basis followed by ITSC could not be adopted in the current year.

Income from Supply of Designs and Drawings

- The designs and drawings supplied to Indian customers were in the nature of basic engineering, for which the entire work was done outside India, and the consideration was also received in foreign currency outside India. Air-way bills also supported the contention that the delivery of design and drawings for various projects had taken place outside India.
- Income earned from supply of designs and drawings was from outright sales and could not be taxed as royalty under Article 12(3) of the tax treaty read with section 9(1)(vi) of the Act. Reliance was placed on the principles laid down by SC in the case of Scientific Engineering House Private Limited[5] and by the Jaipur

[2] Ishikawajima-Harima Heavy Industries Ltd *v.* DIT [2007] 288 ITR 408 (SC)
[3] DIT *v.* LG Cable Ltd [2011] 237 CTR 438 (Delhi)
[4] M/s Krupp Udhe GmbH *v.* Addl CIT [2009] 28 SOT 254 (Mumbai-Trib)
[5] Scientific Engineering House Pvt Ltd *v.* CIT [1986] 157 ITR 86 (SC)

Tribunal in Modern Threads (I) Limited[6].

- The restriction on transfer of intellectual property in designs and drawings by the taxpayer did not change the character of the transaction from sale of goods to license.

- Designs and drawings sold were for internal business purposes of Indian customers to be used to set up plants, and not for any commercial exploitation. Accordingly, the payment for designs and drawings was for use of 'copyrighted article' rather than use of 'copyright'. Reliance was placed on the decision of Authority for Advance Rulings (AAR) in GeoQueste Systems B.V. *in re*[7], Dassault Systems K.K. *In re*[8] and also on various observations made in commentary on OECD model 2010 on Article 12.

- To support the contention that designs and drawings acquired for internal purposes would not constitute royalty, reliance was further placed on Commentary on the Double Taxation Convention by Klaus Vogel. As per Klaus Vogel, payment made for the purchase of software for personal or business purposes of the purchaser would constitute business income in accordance with Article 7 or 14 of tax treaties, and the restriction placed on the use by the purchaser was of no relevance.

Revenue's contentions

Sale of Equipment

- The Revenue contended that the sale was concluded in India for the following reasons:
  - The sale was subject to successful completion of various acceptance tests conducted in India;
  - 15% of the contract price was to be paid only after successful completion of the test; and
  - As the transfer of title of equipment had taken place in India, a part of the income earned from the sale of equipment was taxable in India.

- The contracts entered into between the taxpayer and the Indian customers were composite contracts; each contract could not be split into separate parts. Reliance was placed on the decision of AAR in the case of Alstom Transport SA, *In re*[9] where it was held that a contract for installation and commissioning could not be split into separate parts as consisting of independent supply of goods and for installation at the work site.

- As no separate compensation was mentioned in the agreement for a cold test, integrated test etc., which were performed in India, a reasonable view was that compensation for such activities was included in the cost of equipment. Accordingly, the payment for equipment should be segregated amongst sale *simplicitor* and the other host of services performed in India, based on robust transfer pricing methodology. As the taxpayer adopted no such policy, the TO had taken recourse to Rule 10 of the Income-tax Rules, in order to attribute profits to Indian PE.

- The taxpayer's reliance on the decisions of Ericsson A.B.[10], Nokia Networks OY[11] etc. were misplaced since, in those cases, the point for consideration was whether there would be taxability in India when the title of goods had passed outside India. However, in this case, the title in the property of the goods was passed in India, and thus reliance on these judgments was not relevant.

Income from Supervisory Activities

- Revenue applied the rate of 27.5% following the order of ITSC in the taxpayer's own case for AYs 2008-09 and 2009-10.

- On the issue of application of profit percentage based on margins earned by similar Indian comparable companies, revenue contended that the taxpayer failed to demonstrate functional similarity of the services of the comparable companies, and hence the profit percentage applied by the taxpayer could not be accepted.

Income from Supply of Designs and Drawings

The Revenue contended that consideration for supply of designs and drawings constituted royalty as per the Act, and also as per the provisions of the tax treaty. The arguments put forth in support of the contention were as follows:

[6] Modern Threads (I) Limited *v.* DCIT [1999] 69 ITD 115 (Jaipur-Trib)
[7] Geoquest Systems B.V. *In re* [2010] 327 ITR 1 (AAR)
[8] Dassault Systems K.K *In re* [2010] 322 ITR 125 (AAR)
[9] Alstom Transport SA, *In re* [2012] 251 CTR 193 (AAR)
[10] DIT *v.* Ericsson A.B., [2012] 343 ITR 470 (Delhi)
[11] DIT *v.* Nokia Networks OY [2013] 358 ITR 259 (Delhi)

- The supply of designs and drawings did not pertain to sale of goods, but took the characteristics of granting of a license allowing the Indian customers to use the designs and drawings. Reference was made to Design Act, 2000 and the decision in the case of The Wimco Limited *v.* Meena Match Industries[12] for reaching the conclusion that income constituted royalty.

- The confidentiality and secrecy clause in the agreement under which the designs and drawings were supplied could not justify the taxpayer's claim of it being an "outright sale".

- The taxpayer had granted a license to use its designs and drawings, which had enabled Indian customers not only to design and set up their plants, but also to commission, operate, test, and maintain the plant, and to manufacture products in the plant. Accordingly, the payment made to the taxpayer had to be considered as information concerning industrial, commercial or scientific experience, which alludes to the concept of know-how.

- Physical records of know-how such as drawings, designs, engineering/ manufacturing data, if imparted to another person, know-how was not lost and the owner continued to retain it for his own use. Hence the income arising from an agreement under which such record was parted could not be called a capital receipt and it instead fell within the ambit of "industrial, commercial, or scientific experience".

- Reference was made to Article 12 of the OECD MCC. Reliance was placed on the decision of Andhra Pradesh HC in the case of Klayman Porcelains Limited[13] to contend that the subject payment constituted royalty.

- The SC judgement in the case of Scientific Engineering[5] could not be relied upon by the taxpayer, as it dealt with capitalisation of assets in the purchaser's books, and had no applicability to the facts of the taxpayer's case.

- Reliance was placed on the decision of ITSC in the taxpayer's own case for earlier AYs, wherein it had been held that the consideration for supply of designs and drawings constituted royalty.

Tribunal's Ruling

Sale of Equipment

- The Tribunal concluded that the sale of equipment took place outside India, and hence no portion of the receipts from the sale could be taxed in India. This conclusion was reached based on the following facts:
  - All activities relating to design, fabrication and manufacturing of equipment took place outside India.
  - Sale of Equipment to unrelated Indian customers was done from outside India on a principal-to-principal basis at arm's length, and consideration was also received outside India.
  - The documents and clauses of the agreement clearly stated that the equipment was sold directly by the taxpayer on an export sale basis, and the title/ ownership of equipment was transferred outside India.
  - The Tribunal accepted the principle laid down in Ishikawajma-Harima Heavy Industries Limited[2] that if title was transferred outside India, no profit arose in India.
  - In connection with various acceptance tests, the Tribunal held that if the test failed, it could result only in payment of liquidated damages by the taxpayer, and hence the clause could be considered as a warranty provision. Reliance was placed on the desicisons of Delhi HC in LG Cable[3], Delhi Special Bench in Motorola Inc.[14] and of the AAR in Hyosung Corp, *In re*[15]. Deferred payment relating to an acceptance test did not have any impact on sale of goods, which was supported by the definition of "sale" mentioned under section 2(g) of the Central Sales-tax Act, 1956.

- Revenue's contention that the contract was a composite contract, and taxability could not be split into separate parts, was not accepted by the Tribunal based on the SC decision in Ishikawajma-Harima Heavy Industries Limited[2].

- Revenue's reliance on the AAR decision in Alstom Transport SA[9] was no longer valid as it had been overruled by the Delhi HC in Linde AG, Linde Engineering Division.[16]

- No PE of the taxpayer was created by sale of equipment.

[12] The Wimco Limited *v.* Meena Match Industries (AIR 1983 Delhi 537)

[13] CIT *v.* Klayman Porcelains Ltd [1998] 229 ITR 735 (Andhra Pradesh)

[14] Motorola Income. *v.* DCIT [2005] 95 ITD 269 (Delhi)(SB)

[15] Hyosung Corporation. *In re* (AAR) [2009] 314 ITR 343 (AAR)

[16] Linde AG, Engineering Division *v.* DDIT [2014] 365 ITR 1(Delhi)

Income earned from supervisory activities had been attributed to supervisory PE in India and had been considered taxable. Thus, income earned from sale of equipment was not taxable as per tax treaty provisions.

Income from Supervisory Activities

The ITSC, in the taxpayer's own case for earlier years, had held a profit rate of 27.5% applicable for attributing income from supervisory services. As no reason was provided by the taxpayer to deviate from this decision, the Tribunal had confirmed the rate of 27.5%.

Income from Supply of Design and Drawings

- Basic engineering packages sold by the taxpayer were largely designed on the basis of standard technologies available with it, and hence the consideration was for sale of products which were embedded in plants set up by Indian customers. Principles emerging from the decisions in Scientific Engineering House Private Limited[5] and Modern Threads (India) Limited[6] were accepted by the Tribunal and it was held that income from sale of designs and drawings would be considered as business income, and not royalty.

- The designs and drawings were used by Indian customers for internal business purposes and not for commercial exploitation. Thus, payments made by the Indian customers were for use of copyrighted articles rather than use of copyright. Hence the taxpayer's income could only be considered as business income and not as royalty.

- Retaining intellectual property in designs and drawings sold by the taxpayer was similar in nature to retaining patent rights in any goods/ machinery; it did not change the character of a transaction from sale of product to license/know-how.

- As the entire work in relation to designs and drawings was done outside India, sales were effected outside India, and consideration was also received outside India, the taxpayer's business income from sale of designs and drawings was not liable to tax in India under both, the Act and the tax treaty.

Interest under section 234A and 234B

- Charging of interest under section 234A and 234B was consequential in nature; the TO was directed to re-compute the interest charged.

The Tribunal had passed a consolidated order in this case wherein the appeal of the company for AY 2011-12 had also been decided. Further, the Tribunal had also passed an order in the case of a group company of the taxpayer, for the AY 2010-11. In both these appeals, the issues were broadly similar.

The takeaway

This is a very important decision affecting foreign EPC companies earning income from India. The most important outcome of the judgment is the Tribunal's observation and ruling on taxability of designs and drawings in India. The Tribunal has delivered this judgment based on specific sets of facts, and the decision cannot be uniformly applied to determine taxability of all offshore supply and designs and drawings in India. Before applying the decision, the facts of each case need to be carefully analysed. Further, the principle enunciated in the decision should not be construed as final as the chances of the Revenue appealing to the HC cannot be ruled out.

Let's talk

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

Tax & Regulatory Services – Direct Tax

Shyamal Mukherjee, *Gurgaon*
+91-124 330 6536
shyamal.mukherjee@in.pwc.com

Ketan Dalal, *Mumbai*
+91-22 6689 1422
ketan.dalal@in.pwc.com

Rahul Garg, *Gurgaon*
+91-124 330 6515
rahul.garg@in.pwc.com

Our offices

Ahmedabad

President Plaza
1st Floor Plot No 36
Opp Muktidham Derasar
Thaltej Cross Road, SG Highway
Ahmedabad, Gujarat 380054
+91-79 3091 7000

Bangalore

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bangalore 560 008
Phone +91-80 4079 7000

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai 600 006
+91 44 4228 5000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Andhra Pradesh
Phone +91-40 44246000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata - 700 091, West Bengal
+91-033 2357 9101/
4400 1111

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai - 400 050
+91-22 6689 1000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City, Gurgaon
Haryana -122002
+91-124 330 6000

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
+91-20 4100 4444

For more information

Contact us at
pwctrs.knowledgemanagement@in.pwc.com

About PwC

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in Assurance, Tax and Advisory services.

PwC India refers to the network of PwC firms in India, having offices in: Ahmedabad, Bangalore, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, please visit www.pwc.in.

*PwC refers to PwC India and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. Tell us what matters to you and find out more by visiting us at www.pwc.in