

Preparatory activities performed prior to entering into contract cannot be included to compute duration for determining installation PE

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In brief

In a recent ruling, the Delhi bench of the Income-tax Appellate Tribunal (Tribunal)¹ has held that activities carried out by the taxpayer's employee in India before the execution of the installation contract could not be considered to determine the threshold for installation permanent establishment (PE), as provided in Article 5(2)(g) of the Double Taxation Avoidance Agreement (tax treaty) between India and Cyprus.

The Tribunal also held that the activities which were auxiliary and preparatory in nature, like, tendering purposes, carried out before initiation of work at the project site (before entering into the contract) could not be construed as carrying out any activity of installation or construction in India.

Furthermore, the Tribunal held that, for the purpose to determine threshold period in case of installation PE, the date of commencement should have been reckoned from the effective commencement date provided in the contract (the date when the activity commenced), and the date mentioned in the completion certificate should have been reckoned as the date of completion as all the activities connected to the project were completed by then.

In detail

Facts

- The taxpayer was a Cyprus based company engaged in the business of dredging and pipeline related services for oil and gas installations.
- The taxpayer was awarded a contract (by a main contractor) for placement of rocks in the seabed in Indian waters for protection of gas pipelines and sub-sea

structures in the oil and gas field.

- Before entering the contract, an employee of the taxpayer visited India to collect data and information necessary for tendering purposes.

Before the tax officer (TO) the taxpayer claimed that it did not meet the 12 months threshold provided for installation PE as per Article 5(2)(g) of the India-Cyprus tax treaty. The

period between the effective date of commencement (i.e. date provided in the contract) and date of completion (i.e. date of issuance of completion certificate) did not exceed 12 months.

- The TO, after examining the scope of work of the main contractor, concluded that the taxpayer was responsible for multifarious functions. Thus, it could not be said that the role of the

¹ ITA no. 5759/ Del/ 2011

taxpayer was limited only to rock placements, to be covered under the ambit of Article 5(2)(g) (installation PE clause) of the India-Cyprus tax treaty.

- Furthermore, the TO held that even assuming that the activities were covered under the installation PE clause, the taxpayer was carrying on such activities for more than 12 months as the commencement should have been reckoned from the date of arrival of the employee of the taxpayer in India for preparatory work. Therefore, the TO concluded that the taxpayer constituted an installation PE in India as per Article 5(2)(g) of the tax treaty.
- The Dispute Resolution Panel (DRP) confirmed the TO's action regarding the establishment of installation PE.
- Aggrieved by the above, the taxpayer filed an appeal before the Tribunal.

Issue before the Tribunal

Whether the date of visit of the employee for collection of data and information for tendering of the contract be considered as the date of commencement to compute the threshold period of an installation PE as per Article 5(2)(g) of the tax treaty?

Taxpayer's contentions

- In relation to the threshold period for installation PE, the contract itself provided for the relevant duration to be considered, as it mentioned both the effective date of commencement and the completion date.
- Even if the period of actual activity was to be considered as the duration, the payment

schedule and its break-up in the contract provide that the activities of mobilisation and demobilisation did not exceed the threshold of 12 months for constituting an installation PE as per the tax treaty.

- In relation to the allegation that the date of commencement should have been reckoned from the date of visit of the employee, the taxpayer submitted that the activities performed by such employee was not for any kind of installation activity but was necessary for tendering purposes.
- Such activities could not be treated as part of installation activity, as stipulated in Article 5(2)(g) of the tax treaty and reliance in this regard was placed on the judgement of the Delhi High Court (HC)².

Revenue's contentions

- The date of commencement should not have been reckoned from the effective date of the contract because the contract only indicated that the taxpayer's personnel were required to visit India and such visit did take place prior to the effective date of the contract.
- Furthermore, the date of arrival of vessel/ barge should not have been taken as date of commencement of activities as the entire activity *qua* the contract had to be considered. Reliance in this regard was placed on various clauses of the contract and it was highlighted that the taxpayer's responsibilities included various activities such as pre-installation activities and obtaining various permits and authorisations.

- Accordingly, the Revenue contended that the taxpayer exceeded the threshold period of 12 months and constituted an installation PE.

Tribunal's ruling

- After perusing the various agreements, the Tribunal observed that the scope of work noted by the TO was that of the main contractor. Thus, the inference of the same by the TO was incorrect, as the taxpayer's scope was different and more limited.
- In respect to date of commencement, the Tribunal observed that the duration of 12 months provided in clause 5(2)(g) of the tax treaty *per se* was activity specific in relation to the site, construction, assembly or installation project.
- The Tribunal placed reliance on the ratio laid down by the judgment of the Delhi HC² relied by the taxpayer and noted that the building site or construction, or assembly project, would commence on the commencement of activities relating to the project or site.
- An activity that may be related or incidental to the project but which was not carried out at the site would clearly not be construed as a PE. The Tribunal observed that preparatory work at the site itself could be counted for the purpose of determining the duration for PE, but that was not the issue to be dealt with in the present case.
- The Tribunal, in the present case, noted that the employee of the taxpayer who visited India for conducting pre-survey engineering,

² National Petroleum Construction Company v. DIT [2016] 383 ITR 648 (Delhi)

investigation of site, etc., for tendering purposes had performed preparatory activities without actually entering into the contract.

- Therefore, the Tribunal held that activity of the taxpayer was without any economic substance or active work *qua* the project, and could not be construed as carrying out any activity of installation or construction. Accordingly, the Tribunal held that the activities performed by the employee of the taxpayer could not be considered while determining the duration for determining installation PE.
- Thus, the Tribunal held that period of commencement was to be reckoned from the date

from which the enterprise started performing its activities in connection with the installation project and not any date prior to that.

- In relation to the date of completion, the Tribunal observed that the activity *qua* the project ends when the work was completed and the responsibility of the contractor with respect to that activity came to an end.
- Accordingly, in view of the facts and material, and in consonance of the principle laid down by the Delhi HC², the Tribunal held that the threshold period of 12 months was not exceeded in the present case. Consequently, no installation PE was held to be established as per Article

5(2)(g) of the tax treaty.

The takeaways

- This is an important ruling for non-resident taxpayers as the Tribunal reaffirms that preparatory activities performed in India prior to obtaining the actual contract will not be considered while determining the project period for an installation PE.
- This ruling also reaffirms that the project period ends when the work is actually completed and the responsibility of the contractor comes to an end.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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