

An aerial photograph showing a group of five people sitting around a circular table in a modern, brightly lit office space. The table is covered with documents and laptops. The room has a curved ceiling and large windows. The overall atmosphere is professional and collaborative.

## Tax Insights

22 June 2023

**Supply of drawings and design by a Swiss entity cannot be taxed in India as FTS since it is inextricably linked to offshore sale and supply of plant and equipment which itself is not liable to tax in India – Delhi bench of the Tribunal**

### In brief

The Delhi bench of the Income-tax Appellate Tribunal (Tribunal)<sup>1</sup> held that supply of drawings and designs by the appellant, which is inextricably linked to offshore sale and supply of plant and equipment, cannot be taxed as fees for technical services (FTS) in India. The Tribunal observed that offshore supply of plant and equipment was held as non-taxable in India by the Commissioner of Income-tax (Appeals) [CIT(A)], against which the Tax Officer (TO) has not filed an appeal. Therefore, supply of drawings and designs cannot be considered on a standalone basis, as the buyer could not have utilised such drawings and designs without supply of plant and equipment. Accordingly, the Tribunal held that consideration received by the appellant on account of supply of drawings and design would not be taxable in India as FTS.

On another issue, the Tribunal held that receipts from supervisory services relating to the erection and commissioning of the plant would be covered within the definition of FTS both under section 9(1)(vii) of the Income-tax Act, 1961 (the Act) as well as Article 12 of the India-Switzerland Double Taxation Avoidance Agreement (DTAA).

### In detail

#### Facts

- The appellant, a tax resident of Switzerland, was engaged in the business of manufacturing and supply of plant, equipment, drawings as well as rendering of services of the nature of supervision of erection and commissioning.
- During the year under consideration, the appellant entered into a separate contract with one customer for the following works –
  - a) Supply of plant and equipment from Switzerland;
  - b) Supply of drawings and designs in relation to such plant from Switzerland; and

<sup>1</sup> ITA No. 1361/Del/2012

- c) Supervision of erection and commissioning of the equipment supplied.

The appellant had also entered into a contract with another customer for the supply of electromagnetic stirrers. The scope of this contract also included supervision, erection and commissioning of plant and equipment.

- The appellant had filed its return of income in India declaring nil income. The appellant's case was selected for assessment proceedings. During the course of assessment proceedings, the TO requested the appellant to explain the reasons for not offering the income earned from the Indian entity on account of supply of plant, equipment, drawings and designs as well as receipts in respect of rendering of supervision services.
- The TO disregarded the submission of the appellant and was of the view that –
  - Receipts from supply of plant and equipment are taxable as business income.
  - Receipts from supply of drawings and designs are taxable as FTS.
  - Supervision of erection and commissioning of the equipment are taxable as FTS.

### Appellant's contentions

#### Taxability of supply of drawings and designs

- The appellant was required to supply drawings and designs along with plant and equipment, which is inextricably linked to the supply of plant and equipment for the same project.
- As per the contract, the appellant manufactured or fabricated the plants and equipment in its factory in Switzerland as per the specification provided by its customer and supplied them in India. Moreover, the drawing and design of such plant and equipment were also made in Switzerland and sold by the appellant outside India.
- The payments in respect of sale of plants and equipment as well as drawings and designs were received by the appellant outside India. Thus, transfer of the title, both in relation to drawings and designs as well as plants and equipment, have passed outside India.
- Supply of plant and equipment could not have been made, without the drawings and designs, as the customer could not have installed and commissioned the plant and machinery without drawings and designs.
- The drawings and designs are in the nature of 'as built drawings' and specifically with reference to the relevant plant and equipment. Thus, drawings and designs could not have been utilised by its customer to get the plant and equipment manufactured from another manufacturer.
- The appellant also contended that if it had been a case of supply of designs and drawings on standalone basis, for grant of right to use of commercial exploitation by the customer, the amount received could have been characterised, either as royalty or as FTS. However, when the supply of drawings and designs is coupled with the supply of equipment, which is manufactured as per the designs so supplied, the amount received can neither be characterised as royalty nor as FTS.
- Moreover, to ascertain the true nature of receipt, one must apply the test of pith and substance to determine what is the dominant object of the contract. If the dominant object of the contract was to supply a plant manufactured according to the designs developed, even though the obligation to carry out the designs may be under a separate contract and for a separate consideration, the character of the receipt must be that of sale price for the supply of equipment.
- In support of the above contentions, the appellant had, among others, relied on the decision of the jurisdictional High Court in case of Linde Engineering Division<sup>2</sup>.

<sup>2</sup> Linde Engineering Division v. DIT [365 ITR 1]

### Taxability of rendition of supervisory services

- As per the terms of the contract, the appellant was required to provide qualified technical personnel for supervisory work. The appellant argued that supervisory services, being incidental to the sale of the plant, would not be covered within the ambit of Article 12 of the DTAA dealing with taxation of royalty and FTS.
- Rendering supervisory services is an integral part of the contract of sale of plant to enable the supplier to ensure that the plant is properly erected and installed by the customer, keeping in view the performance guarantee obligation undertaken by the appellant. Thus, such receipts would be taxable as business profit.
- Moreover, it was argued that the tenure of providing supervisory services did not exceed the threshold limit of six months as required under the India-Switzerland DTAA, and therefore the appellant does not have a permanent establishment (PE) in India. In absence of business income, receipts from rendering services are not taxable as business income in India.

### Tribunal's observations and ruling

#### Taxability of supply of drawings and designs

- The Tribunal affirmed the contention of the appellant that receipts on account of supply of drawings and designs by the appellant to its customer would not be taxable in India as FTS. The Tribunal held that when the supply of plant and equipment was treated as a sale transaction completed outside India and hence are not taxable in India, the sale and supply of drawings and designs, being inextricably linked to sale and supply of such plant and equipment, has to be considered cumulatively and as a part of the sale and supply of plant and equipment.
- On perusal of details and schedule of drawings and designs, the Tribunal observed that the drawings and designs supplied by the appellant are specifically related to the supply of plant and equipment for the same project. It was also observed that though the contract for supply of plant and designs were executed separately, they were executed on the same date.
- The terms of the agreement for the supply of plant and equipment provided that if the seller is unable to deliver the equipment within 120 days, then the buyer could unilaterally terminate the contract for supply of plant and equipment, and also for the supply of drawing and designs. This fact further substantiates that both the contracts are inextricably linked to each other.
- The Tribunal further observed that the above issue had already been covered by the jurisdictional High Court in the case of Linde Engineering Division<sup>2</sup>, wherein it is held that in case design and engineering are inextricably linked with the manufacture and fabrication of the material and equipment to be supplied overseas and form an integral part of the supplies, then such services rendered would not be taxed under section 9(1)(vii) of the Act as FTS.

#### Taxability of rendition of supervisory services

- The Tribunal observed that qualified technical personnel deputed by the appellant have imparted technical services for the erection and commissioning of the plant and equipment. Therefore, the amount received by the appellant is clearly covered within the definition of FTS, both under the domestic law as well as under the DTAA provision, and once the receipts is covered within the definition of FTS, whether or not the appellant has PE in India becomes immaterial.
- The Tribunal upheld the decision of the TO to tax receipts on account of rendering service in the hands of the appellant.

### The takeaways

The Tribunal has once again upheld the principle of substance over form, and contracts or business arrangements need to be looked at in terms of their pith and substance. Even separate contracts (of even date) were read into one on account of the inextricableness of the contractual arrangements and convergence of end use at the buyer's end. Taxpayers need to be mindful of the ever-evolving principles of 'substance over form' while arranging their tax affairs.



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