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Tax Insights

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Tribunal denies taxability of offshore supplies and services inextricably linked with offshore supplies – Delhi bench of the Tribunal

In brief

The Delhi bench of the Income-tax Appellate Tribunal[1] (Tribunal) was of the view that no part of the consideration received outside India by a non-resident entity for offshore supplies of plant and equipment can be deemed to accrue or arise in India as per section 9 of the Income tax Act, 1961 (the Act). Moreover, such consideration would only be in the nature of business profits not attributable to a permanent establishment (PE) in India; hence, it is not taxable as per the provisions of the India-Germany double taxation avoidance agreement (DTAA). In addition, receipts from offshore services that primarily involve offshore supply of drawings and designs, which are inextricably linked with the offshore supply of plant and equipment, do not give rise to any income accruing or arising in India; therefore, they are not taxable under the Act. Moreover, as the designs and drawings were prepared outside India, the question of bringing to tax any part of the consideration in accordance with Article 7 of the DTAA cannot be sustained.

In detail

Facts

- The taxpayer, a non-resident corporate entity incorporated under the laws of Germany, was engaged in the business of engineering, designing, manufacturing and installing plants for hydroelectric power projects.
- The taxpayer entered into an agreement(s) with an Indian entity for the following scope of work:
  - Offshore supply of hydromechanical plant and equipment
  - Offshore services primarily involving supply of drawings and designs related to the hydromechanical plant and machinery
  - Onshore activities involving supply of indigenous parts, etc. and rendering of onshore services
- The taxpayer had supplied plant and equipment designed and manufactured outside India. Titles of the said plant and equipment were duly passed on to the customer outside India on a free-on-board basis.
- All activities such as manufacture, fabrication, design, etc. of the plant and equipment were undertaken

[1] ITA No. 3186/Del/2016 & Ors.

outside India. Consideration for such offshore supplies was also received outside India in foreign currency through either a letter of credit or bank transfer.

- Considering the nature, size and specific purpose of the plant and equipment to be supplied, it was necessary for the taxpayer to (a) prepare the drawing and design of the plant and equipment to be manufactured or fabricated; and (b) get the same approved by the customer.
- The consideration received by the taxpayer towards offshore supply of plant and equipment and for offshore services (involving supply of related drawings and design) were claimed as non-taxable in India under both the provisions of the Act and the relevant articles of the India-Germany DTAA.

Issues before the Tribunal

- Whether the amount received by the taxpayer under the contract for offshore supply of plant and equipment is chargeable to tax in India as per the provisions of the Act and the India-Germany DTAA?
- Whether the amount received under the contract for offshore services is chargeable to tax as per the provisions of the Act and the India-Germany DTAA?

Tribunal's observations and ruling

Taxability of offshore supply of plant and equipment

- The Tribunal has perused the contract for offshore supply of plant and equipment entered into by the taxpayer and found the following:
  - Although the custom clearances will be the responsibility of the taxpayer, all plant, machinery and materials received will remain the Indian entity's absolute property and be open at all times for inspection.
  - Several machines were supplied at different points of time from outside India. For all machines supplied, the title was transferred outside India.
  - The Tribunal has relied on a judgement of the Supreme Court[2]. The Supreme Court had held that where the property in respect of goods is transferred to the buyer outside India, sale of such goods must be regarded as having been completed outside the taxable territories of India. Hence, income from such sale is not liable to tax in India.
  - The Tribunal has relied on various other judicial precedents. Accordingly, it concluded that no part of the consideration received outside India for offshore supplies of plant could be deemed to accrue or arise in India as per section 9 of the Act. Moreover, such consideration would only be in the nature of business profits not attributable to a PE in India; hence, it is not taxable under Article 5 read with Article 7 of the India-Germany DTAA.

Taxability of offshore services

- The Tribunal observes that the contracts for offshore services and offshore supply of plant and equipment were entered into on the same date and are irretrievably connected, because supply cannot be made without the drawings. Moreover, designs could not be used by the Indian entity for manufacturing the plant using another manufacturer.
- The offshore services contract primarily involves preparation and supply of drawings and designs for imported plant and equipment. Thus, it is inextricably linked with the offshore supply of plant and equipment.
- The Tribunal has observed that the dominant objective of the contract entered into by the taxpayer with the Indian entity was to supply a plant manufactured according to the designs developed. Then, even though the obligation to carry out the designs may be under a separate contract of the same date and a separate consideration is mentioned therein, the character of the receipt must be that of a sale price for the supply of equipment.

[2] Ishikawajima-Harima Heavy Industries Limited *v.* DCIT [2007] 288 ITR 408 (SC)

- The Tribunal has relied on the case of a jurisdictional High Court decision[3] which is binding on the current case. The High Court had held that if design and engineering are inextricably linked with the manufacture and fabrication of the material and equipment to be supplied from overseas, and they form an integral part of the said supply, then the services rendered would not be amenable to tax as fees for technical services (FTS).
- Accordingly, The Tribunal concluded that when the supply of drawings and designs is coupled with the supply of equipment, which is manufactured in accordance with the designs supplied, the amount received cannot be characterised as FTS. Additionally, as the entire work of preparing the designs and drawings is carried out outside India, the question of bringing to tax any part of the consideration in accordance with Article 7 of the India-Germany DTAA cannot be sustained.

The takeaways

This is a relevant ruling for taxpayers providing offshore supply of plant and machinery as well as various offshore services such as drawing and designing, which are inextricably linked with such offshore supply of plant. The Tribunal has clarified that where the dominant objective of the contract is to supply a plant manufactured according to the designs developed, even if the obligation to carry out the designs may be under a separate contract and separate consideration, the character of the receipt from the supply of equipment would not change.

[3] Linde AG, Linde Engineering Division *v.* Dy. DIT [2014] 365 ITR 1 (Delhi)

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