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Splitting of a project into a set of contracts for offshore and onshore components not to be disregarded

In brief

In a recent ruling in the case of Dongfang Electric Corporation[1] (the assessee), the Income-tax Appellate Tribunal (the Tribunal), Kolkata held that the assessing officer (AO) erred in coming to the conclusion that one integrated contract for 'offshore supplies' and 'onshore services and supplies' was artificially split into a set of contracts to avoid taxability of income in India. The Tribunal observed that the mere fact that the assessee has incurred a loss on onshore activities cannot be reason enough to show or even indicate that the value of the onshore activities was deliberately kept at a lower amount to avoid taxability in India.

Facts

- The assessee is a non-resident company domiciled in the People's Republic of China and has a project office in India. The assessee filed its return of income for assessment year (AY) 2007-08 disclosing a loss of about INR 671 million.

- During the course of assessment proceedings, the AO noticed that the assessee had entered into two contracts: one with West Bengal Power Development Corporation Ltd. for setting up Units 1 and 2 for the Sagardighi thermal power project and another with Durgapore Projects Ltd. for setting up Unit 7 for the Durgapur project power station.

[1] Dongfang Electric Corporation *v.* DDIT [TS-434-ITAT-2012(Kol)]

- Each of these contracts were divided into two parts: an 'offshore supplies contract' for supply of equipment (including spare parts, tools and tackles) outside India and an 'onshore services and supplies contract' for local supplies, design, engineering and construction, fabrication, erection, installation, testing and commissioning in India. The onshore activities were performed by the project office of the assessee in India.

- The consideration for offshore supplies was received outside India and consideration for onshore services and supplies was received in India.

- The AO noticed that in both the above cases the original tenders were for setting up of turnkey thermal power projects but the entire scope of work was split up into two contracts each under mutual agreement. The AO also noticed that there was a 'cross-fall breach clause' in the contracts which ensured that the performance of the entire contract was treated as a single-point responsibility of the assessee and non-performance of any portion of the contract was to be treated as a breach of the whole contract.

- The assessee did not take into account the income from offshore supply of equipment while computing its taxable income in India for AY 2007-08 considering it as not liable to tax in India.

- The AO held that for the purpose of taxation, the contract must be taken as one, for installation and commissioning of a project in India, and part of the transaction cannot be treated as a contract for offshore supply not liable to tax in India.

- The AO's order was confirmed by the Dispute Resolution Panel (DRP) and the assessee approached the Tribunal for relief.

Assessee's contentions

- Offshore supply cannot be brought to tax in India for the following reasons:

  (a) All the operations in connection with the offshore supply of equipments were carried out outside India.
  (b) Property in such goods was passed to the buyer outside India.
  (c) Invoices were raised directly from China to the Indian buyer.
  (d) Consideration for such offshore supply was received outside India.

- The assessee relied on the Supreme Court judgement in the case of Ishikawajima-Harima Heavy Industries Ltd.[2] in support of its contention that income from offshore supplies is not taxable in India.

- The assessee also explained that due to inordinate delays, the entire project had resulted in losses and there was no incentive for the assessee to assign lower values to the 'onshore services and supplies contract' as compared to the 'offshore supplies contract'.

Revenue's contentions

- The original contracts were for erection of power plants which were divided into separate parts solely to suit the assessee's purpose and manipulated in such a way that the assessee's activities in India would always result in losses. The prominent presence of the 'cross-fall breach clause' demonstrates that it is one integrated contract.

- The presence of the project office itself presupposes that it has to play some role in the overall execution of the contract. It is impossible to perceive that the project office did not play any role at all in the process of arrival of machinery

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

from China within the scope of the 'offshore supplies contract'. The revenue from offshore supply was not only for the price of equipment but also for each and every function performed on the goods sold.

- The decision in the case of Ishikawajima-Harima Heavy Industries Ltd. (above) relied on by the assessee is not applicable in the present case as the offshore supply of equipment is an ongoing process and the involvement of the project office in coordinating the supply and also providing information on actual site based requirements cannot be denied. The AO relied on the Madras High Court judgement in Ansaldo Energia SPA[3].

Tribunal Ruling

- The 'cross-fall breach clause' provides that a breach in one contract will automatically be classified as a breach of the other contract. While this undoubtedly gives an indication that the 'offshore supplies contract' and 'onshore services and supplies contract' are required to be viewed as an integrated contract, this fact by itself does not indicate that the onshore services and supplies contract is understated to avoid tax in India. That situation would arise when the offshore supplies show unreasonable profits and onshore services and supplies result in unreasonable losses.

- One may have legitimate issues as to whether the observations made by the Authority for Advance Ruling in the case of Alstom Transport SA[4] regarding 'looking at the transaction as a whole and not adopting a dissecting approach' can indeed be applied in all cases in which separate contracts are entered into for offshore supplies and onshore services. However, these observations are certainly applicable in the cases in which the values assigned to the onshore services are *prima facie* unreasonable *vis-à-vis* the values assigned to the offshore supplies which make no economic sense when viewed apart from the offshore supplies contract.

- In the present case, the assessee stated that all the activities, onshore as well as offshore, resulted in huge losses due to inordinate delays in the project. The audited accounts filed by the assessee also show losses in both the onshore and offshore segments.

- The DRP had taken note of the above submission but had not dealt with it. This is a very important aspect of the matter in as much as if the assessee had incurred a loss on its entire project, whether onshore or offshore. Mere fact that the assessee had incurred a loss on onshore activities cannot be reason enough to show or even indicate that the value of the onshore activities was deliberately kept at a lower amount to avoid taxability in India.

- Even if both the contracts are taken together, as the AO had suggested, and if there are no profits earned by the assessee from both the contracts taken together, there cannot be an occasion to tax income from these contracts in India.

- The AO has proceeded on the assumption that there were profits on offshore supplies, which were outside the ambit of taxation in India. However, in view of the assessee's claim that there are losses on the overall project and there cannot thus be any advantage by assigning lower value to onshore activities, what needs to be examined in the first place is the working of overall losses given by the assessee. In case the AO has no issues with this computation of overall losses, the very foundation of the AO's action ceases to hold good in law.

- The Tribunal remitted the case back to the AO for fresh adjudication to examine whether the assessee had incurred overall losses on the contracts.

[3] Ansaldo Energia SPA *v.* ITAT [2009] 310 ITR 237 (Mad)
[4] Alstom Transport SA *In re* [TS-387-AAR-2012]

Conclusion

The revenue authorities have been inclined to disregard the splitting up of contracts into offshore and onshore components and bring the entire revenue to tax in India. This ruling has come as a breather to taxpayers as it has emphasised that such an approach is justified only when the splitting up is done in an unfair and unreasonable manner to evade taxes in India.

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