Taxability of Income from Offshore Supply of Goods to India in a Turnkey Contract

The last time this topic was discussed in the CA Journal was in May 2011 under the heading 'Taxation of EPC Contracts – A treatise'. However, since then, there have been developments on the said subject and it is felt that the said Article published in May 2011 requires an updation. The Authority for Advance Rulings – Income tax, in back to back decisions, have held that income received by a non-resident assessee from offshore supply of goods to India under a turnkey contract accrues or arises in India under Section 5(2)(b). An effort is made through this article to examine the taxability of the said income under the provisions of the Income-tax Act, 1961, in the light of the findings of the Advance Rulings with regard to 'look at' test and 'dissecting approach'.

One of the first fallouts of the findings of the landmark decision of the Supreme Court of India in the case of *Vodafone International Holdings BV vs Union of India and Anr* (345 ITR 1) has been seen on the *'income from offshore supply of goods to India in a composite/ turnkey/works contracts'* which are now held to be taxable in India. The Authority for Advance Rulings - Income tax (AAR), in back to back decisions, rendered in the case of *Alstom Transport SA, in Re (251 CTR 193), Roxar Maximum Reservoir Performance WLL, in Re (71 DTR 108)* and *ABC, in Re (70 DTR 49),* have all, after relying on the observations of Vodafone International Holdings BV's case (*supra*), held that income received by non-resident assessees from offshore supply of goods to India under a composite/ turnkey/works contract [hereinafter referred to as 'turnkey contract'] accrues or arises in India and, therefore, shall be subject to tax in India.

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It is well settled that income can be held to accrue or arise only when the person acquires a right to receive that income. The right to receive an income is generally determined, based on the contractual obligations entered into by the parties. While the AAR appreciates in the aforesaid referred decisions that in a case of contract for offshore sale of goods, the right to receive the income is created outside India, but it disputes the said conclusion in case of turnkey contracts.

The taxability of the subject under consideration prior to the aforesaid decisions, was rather found to be settled in favour of the non-resident assessees with both AAR and other judicial forums,[1] upholding the contention of the assessee that income from offshore supply of goods to India under a turnkey contract cannot be said to be taxable under the provisions of the Income-tax Act, 1961 ('the Act') and/or respective Double Taxation Avoidance Agreements ('DTAA'), which India has entered into with other countries.

The fact patterns which one generally comes across in a turnkey arrangement entered into between the transacting parties, are as under:

1. The parties to the turnkey contracts enter into a *single contract*, which deals with offshore supply of goods and services and onshore supply of goods and services; or
2. The parties to the contract enter into *separate contract* on individual basis for offshore supply of goods, offshore services, onshore supply of goods and onshore services; or
3. In certain cases, even though *single contract* is entered for the composite work, the Contractor who is awarded the contract assigns/sub-contracts a particular scope of work to the non-resident and/or resident assessee, viz, the Contractor assigns the scope of work relating to onshore supply of goods and onshore services to a resident assessee; or
4. In certain cases, since the nature of work to be undertaken is complicated, therefore a Consortium is formed among non-resident and/or resident Contractors to undertake composite work and contract is entered into by the opposite party with the Consortium for the scope of work; or
5. In certain cases, even though a Consortium is formed to undertake the composite work, but the contracts are entered into, individually by the Opposite party with each consortium member for their respective scope of work.

The aforesaid arrangements are further sub-classified, based on the nature of consideration entered into by the Contracting parties for the respective scope of work:

- Separate consideration is earmarked for different scope of work undertaken, viz, offshore supply of goods, offshore services, onshore supply of goods and onshore services; or
- A lumpsum consideration is decided, for undertaking all the works under the turnkey contract;

The aforesaid fact patterns as entered into between the transacting parties are not exhaustive in nature and they may take different forms and arrangements depending upon the requirements and agreement among the parties. The fact pattern which was the subject matter of consideration before the aforesaid AAR rulings was largely in the nature described at *point no. 1 and 4 above*. However, if the findings of the aforesaid AAR decisions are something to go by, then it may be possible to contend that income under consideration shall be taxable in India irrespective of the fact patterns discussed above.

Further, it would be necessary to highlight that even though specific questions were raised before the AAR in the cases of *ABC, in Re* (*supra*) and *Alstom Transport SA*, *in Re (supra*) as regards to taxability of such income in the context of respective DTAAs, the AAR neither provided any findings nor discussed any articles of the DTAA in order to determine the taxability under the respective DTAAs. However, it has instead, in the conclusions, held that income under consideration shall also be subject to tax under the respective DTAAs.

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[1] *Ishikawajma – Harima Heavy Industries Ltd vs DIT (288 ITR 408)(SC);*
Sutron Corporation, in Re (268 ITR 156) (AAR);
Deepak Cables (India) Ltd, in Re (337 ITR 127) (AAR);
Sepco III Electric Power Construction Corporation, in Re (2012)(66 DTR 511) (AAR);
CTCI Overseas Corporation Ltd, in Re (2012)(66 DTR 506)(AAR);
Hyosung Corporation, in Re (314 ITR 343)(AAR);
L.S.Cables Ltd, in Re (337 ITR 35)(AAR);
Joint Stock Foreign Economic Association "Technopromexport", in Re; (322 ITR 409) (AAR);
DIT (International Taxation) vs Xelo Pty Ltd. (203 Taxman 475) (Bom.);
DIT vs Ericsson A.B. (66 DTR 1)(Del); and
DIT vs LG Cable Ltd. (2011) (50 DTR 1)(Del).

Section 4, Section 5 read with Section 9 of the Act determines the taxability of income of a non- resident in India. Section 4 provides for charging a particular rate of tax, as enacted by the Central Government, to the total income of a non-resident person in the previous year. Section 5(2) determines the scope of total income with respect to a non-resident. Section 5(2)(b), subject to other provisions of the Act, provides for the following incomes as the total income of a non-resident, irrespective from whatever source derived:

- Income is received in India;
- Income is deemed to be received in India [Section 7];
- Income accrues or arises in India; and
- Income is deemed to accrue or arise in India [Section 9].

Generally, the income under consideration is neither received in India nor deemed to be received in India. The AAR also in the recent decisions as referred above, have consistently held that income from offshore supply of goods to India under a turnkey contract shall accrue or arise in India and no dispute or findings are found that claim income under consideration is regarded as received in India or deemed to be received in India.

Further, Section 9 gathers in one place, various types of incomes, which are distinct and independent of the other, and their requirements thereof, for such income to be said to be deemed to accrue or arise in India. Section 9(1)(i) generally provides the requirements for taxability of income under consideration, as the turnkey contract normally envisages the existence of business connection in India on account of rendering of onshore supply of goods and services in India alongwith offshore supply of goods and services. Section 9(1)(i) read with Explanation 1(a) provides for apportionment of profits and subjects to tax only those incomes of business, which can be reasonably attributable to operations carried out in India. In other words, those incomes of business viz, income from offshore supply of goods to India, which are not attributable to operations carried out in India, cannot be taxed in India. However, the AAR in the aforesaid decisions has provided no findings as regards to the non-resident assessee undertaking turnkey contracts in India of having any business connection in India and has restricted its conclusions to income that accrues or arises in India under Section 5(2)(b) of the Act.

It is well settled that income can be held to accrue or arise only when the person acquires a right to receive that income. The right to receive an income is generally determined, based on the contractual obligations entered into by the parties. While the AAR appreciates in the aforesaid referred decisions that in a case of contract for offshore sale of goods, the right to receive the income is created outside India, but it disputes the said conclusion in case of turnkey contracts. The AAR explains that in a turnkey contract, the intention among the transacting parties is completion of the work which typically involves supply of goods as well as providing labour and services in India. Therefore, the AAR holds that in a turnkey contract, the right to receive the income is not created until the completion of work and since the work is concluded in India, therefore, the right to receive the income is created in India.

The AAR after perusing the turnkey agreements, holds that the transfer of title to the goods cannot be said to be transferred until the work is completed and accepted. The AAR does not appreciate and recognise the individual obligations and performances as agreed among the transacting parties under the turnkey contracts for offshore supply of goods and services and onshore supply of goods and services. In order to negate the said arguments and favourable legal precedents as referred in earlier paragraphs, the AAR takes recourse to the findings of the Apex Court in the case of *Vodafone International Holdings BV (supra)* of 'look at' test to ascertain the true legal nature of the transaction.

The AAR, by relying on the said test, holds that the dissecting approach as claimed by the applicants with respect to taxability of offshore supply of goods and services and onshore supply of goods and services cannot be accepted and the true legal nature of the transaction is required to be looked into, which envisages for a composite works contract and

In summary, the AAR has, therefore, for want of following broad reasons, held that income from offshore supply of goods to India under a turnkey contract are chargeable to tax in India: '*Situs* of a turnkey contract is in India and therefore, income accrues or arises in India'; and 'The Apex Court decision of Three Member Bench in the case of Vodafone International Holdings BV (supra) impliedly overrules the decision of Apex Court of Two Member Bench in the case of Ishikawajma – Harima Heavy Industries Ltd (288 ITR 408) with respect to findings on dissecting approach.'

On going through the findings of the AAR to hold the income from offshore supply of goods under turnkey contract as taxable in India, one is reminded of the litigation under the Sales tax laws of the various states, wherein similar reasoning's were provided to tax the turnkey contracts involving sale of goods. In order to address the said litigation, the Legislature had to amend the Constitution of India and vide 46th Amendment, Article 366(29A) was inserted which held that the sale of goods involved in execution of a works contract as deemed to be a sale of those goods.

therefore, the entire income from the works contract shall accrue or arise in India.

In summary, the AAR has, therefore, for want of following broad reasons, held that income from offshore supply of goods to India under a turnkey contract are chargeable to tax in India:

- *Situs* of a turnkey contract is in India and therefore, income accrues or arises in India; and
- The Apex Court decision of Three Member Bench in the case of *Vodafone International Holdings BV (supra)* impliedly overrules the decision of Apex Court of Two Member Bench in the case of *Ishikawajma – Harima Heavy Industries Ltd (288 ITR 408)* with respect to findings on dissecting approach.

The 'look at' test as referred above, which negates the dissecting approach, was enunciated by the House of Lords, UK in the case of *W. T. Ramsay Vs. IRC* (1981) (1 ALL ER 865) [5 Member Bench]. The following important principles were laid down by the said decision:

- It is the task of the Revenue and Court to ascertain the true legal nature of any transaction;
- On ascertaining the legal nature of the transaction, if one finds that the said transaction is a part of a series or combination of transactions ('a scheme'), then it is the scheme rather than the individual transaction to which regard should be had;
- Upon ascertainment of legal nature of the scheme, if one finds that the object of the scheme was to avoid tax and it produced neither a gain nor a loss, then even though the individual transactions of the scheme are genuine, the scheme could be treated as a nullity for tax purposes;
- As regards to the limitations of the Court to go behind a document or transaction which is genuine, it was held that the said principle cannot be overstated or over-extended; and
- If it can be seen that the transactions or document was intended to have effect as a part of nexus or series of transactions, then Courts have the right to go back and determine the true legal nature of the transaction.

The said 'look at' test which is also popularly referred to as Ramsay's principle was considered in a number of judicial decisions[2], not only restricted to English Courts. The following important observations were made in context of the said principle:

- The Ramsay decision (*supra*) did not discard the principle laid down in the *IRC Vs. His Grace the Duke of Westminster* (1935) (ALL ER 259) decision ['popularly called as Westminster principle'] but read it in the proper context by which 'device' which was colourable in nature had to be ignored as fiscal nullity;
- The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device, but that, it should apply the 'look at' test to ascertain its true legal nature;
- Ramsay was dealing with readymade schemes, where it was concerned with a series of self cancelling transactions;
- Ramsay approach does not require or permit an examination of the commercial nature of the transaction. Rather it requires a consideration of the legal effect of what was done; and
- The Ramsay decision did not decide on whether a transaction entered into with the motive of minimising the subject's burden of tax, is for that reason, to be ignored or struck down. Further, nor did it decide whether the Court is entitled to attribute a legal effect which the subject did not have, when it entered into a genuine transaction.

[2] *MacNiven vs Westmoreland Investments Ltd (2003) (1 AC 311); (255 ITR 612)(HL);*
Craven vs White (1988) (3 ALL ER 495);
Furniss (Inspector of Taxes) vs Dawson (1984) (1 ALL ER 530);
IRC vs Burmah Oil Co. Ltd (1982) (54 Tax Cases 200);
Vodafone International Holdings BV vs UOI (supra);
UOI vs Azadi Bachao Andolan (263 ITR 706) (SC) ; and
M. V. Valliappan vs CIT (170 ITR 238) (Mad).

Also, there are decisions[3] which have raised questions on the Ramsay's principle for want of various reasons.

The question which then needs to be answered, is whether the AAR was reasonable to apply the 'look at' test to the turnkey contracts and tax income from offshore supply of goods. Some of the arguments which can be considered for non-applicability of 'look at' test for the transaction under consideration are as under:

- Supply of goods in a works contract involves transfer of title in goods, which is accepted and recognised in law under the Articles of Constitution of India[4];
- Offshore supply of goods in a works contract is not a self cancelling transaction and is a genuine transaction;
- The Ramsay principle as discussed above did not opine on whether a transaction entered into with the motive of minimising the subject's burden of tax, is for that reason, to be ignored or struck down. However, for the sake of completeness, it would be relevant to mention that the CBDT as well as Judicial authorities[5] in India have opined to tax income from offshore supply of goods, where intention of the transacting parties were manifest solely to avoid tax by shifting profits from onshore supply of goods and services to offshore supply of goods; and
- On ascertainment of turnkey contract as a whole, if one finds that there was no intention to evade taxes, and profits and losses from the works contract were duly offered for tax, based on the provisions of the Act, then the offshore supply of goods under a turnkey contract could not be considered as nullity for tax purposes.

For want of aforesaid decisions, one may want to argue that the applicability of 'look at' test by the AAR for determining the taxability of income may require reconsideration.

On going through the findings of the AAR to hold the income from offshore supply of goods under turnkey contract as taxable in India, one is reminded of the litigation under the Sales tax laws of the various states, wherein similar reasons were provided to tax the turnkey contracts involving sale of goods. In order to address the said litigation, the Legislature had to amend the Constitution of India ('COI') and vide 46th Amendment, Article 366(29A) was inserted, which held that the sale of goods involved in execution of a works contract as deemed to be a sale of those goods. The findings of the Apex Court in the case of *BSNL vs UOI* (2006) (2 STR 161) would be relevant to understand the said 46th amendment of COI:

> *"Of all the different kinds of composite transactions, the drafters of the 46th Amendment chose three specific situations, a works contract, a hire purchase contract and a catering contract to bring within the fiction of deemed sale. Of these three, the first and third involve a kind of service and sale at the same time. Apart from these two cases where splitting of the service and supply has been constitutionally permitted…., there is no other service which has been permitted to be so split……."*

One of the arguments of AAR to hold otherwise, was that the title in the goods cannot be separately transferred, until the completion and acceptance of works contract in India. However, Article 366(29A) of COI specifically recognises transfer of title in goods in the execution of works contract and provides for splitting of consideration between supply of goods and services. Based on the aforesaid discussions, one may argue that income from offshore supply of goods in the course of works contract could be transferred apart from transfer of works contract. In the offshore supply of goods, the title in the goods is transferred outside India and therefore, income will not be said to accrue or arise in India.

The next question which arises for consideration is whether the decision of *Ishikawajma-Harima Heavy Industries* (*supra*) actually supported the dissecting approach as claimed by the AAR. The relevant findings of the said decision are as under:

- In construing a contract, the terms and conditions thereof are to be read as a whole. A contract must be construed, keeping in view the intention of the parties;

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[3] *Furniss (Inspector of Taxes vs Dawson) (supra) Lord Scarman, LJ – (the test of form v/s substance could help in determining the tax consequences in composite transactions); and MacNiven vs Westmoreland Investments Ltd (supra) – (in context of 'real' nature of transaction vis-à-vis 'commercial aspect' of the transaction)*

[4] *Article 366(29A) of the Constitution of India defines sale of goods in the course of works contracts as deemed sale for the purpose of tax on the sale or purchase of goods.*

[5] *Instruction No. 5 of 2009 dated 20th July, 2009 withdrawing the favourable Instruction No. 1829 dated 21st September, 1989 on taxability of turnkey power projects, had also given tax evasion has one of reasons for withdrawal of said instruction;*
Ansaldo Energia SPA vs ITAT & Ors. (310 ITR 237) (Mad.); and
Donfang Electric Corporation vs DDIT (International Taxation) (2012) (52 SOT 496)(Kol.)

- The applicability of the tax laws would depend upon the nature of the contract, but the same should not be construed keeping in view the tax provisions;
- The contract may be a turnkey contract, but that by itself would not mean that even for the purpose of taxability, the entire contract must be considered to be an integrated one;
- Obligations under the contract are different ones. Supply obligation is distinct and separate from service obligation. Price of each of the component of the contract is separate; and
- The very fact that in the contract, the supply segment and service segment have been specified in different parts of the contract is a pointer to show that the liability of the appellant thereunder is different.

After going through the said findings, one would appreciate that the said decision did not advocate the dissecting approach theory but instead, required the contract to be construed as a whole to determine taxability thereof, after respecting the terms and conditions of the contract as entered in by the transacting parties. The said principles are even otherwise recognised by the Constitution of India under Article 366(29A) for works contracts.

In addition to the above, this Article may be incomplete if the recent favourable decisions on the subject are not incorporated, wherein the following judicial authorities, while opining on the taxability of income under consideration in context of respective DTAAs applicable, have upheld the contention of the taxpayers that income from offshore supply of goods in a turnkey contract shall not be taxable in India:

- *DIT vs M/s. Nokia Networks OY and Others* (Del HC) (ITA No. 512 of 2007) dated 7th September 2012; and
- *M/s National Petroleum Construction Co. vs Addl DIT* (ITA No. 5168/Del/2010) dated 5th October 2012;

Based on the aforesaid discussions, it may be possible to conclude that, generally, income from offshore supply of goods to India under a turnkey/ composite/works contract is not taxable in India and the findings based on which the AAR has ruled otherwise respectfully may require reconsideration. ■