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Deciphering the Tax Landscape of EPC Contracts: A Comprehensive Analysis

CA Shivam Sharma

A A S S & Associates, Chartered Accountants, Amritsar, India

Abstract
This document aims to elucidate the tax implications of Engineering, Procurement, and Construction (EPC) contracts within the Indian jurisdiction, offering clarity to stakeholders involved. In recent times, there has been a noticeable surge in Income-tax notices targeting foreign companies engaged in EPC contracts in India, with a central focus on the taxability of offshore supplies.

1. Introduction
The issue at hand has persisted over time, with judgments from the Hon'ble Supreme Court spanning several decades, from the late 70s to the 80s, and into the early 2000s and 2010s, grappling with the question of whether a business connection is established in such cases. This ongoing debate has led to divergent judicial interpretations, with some rulings favoring taxpayers, deeming offshore supplies as non-taxable in India, while others align with the Revenue's stance, subjecting such supplies to taxation.
This uncertainty has left foreign companies uncertain about their tax liabilities in India concerning segments of their projects involving offshore supplies. Drawing upon a comprehensive array of sources, including Indian judicial judgments, the Indian Income Tax Act, tax treaties, OECD Commentaries, and OECD Text on MLI, this research seeks to provide insights. Additionally, it integrates findings from online research and information sourced from reputable websites.
It is hoped that this research will contribute to enhancing the understanding of readers connected to this issue, enabling them to navigate their particular cases or situations with greater clarity and insight.

A. What does EPC Stand for?
EPC stands for Engineering, Procurement, and Construction. It refers to a contractual arrangement where a single entity is responsible for the design, procurement of materials and equipment, and project construction. In an EPC contract, the contractor typically assumes full responsibility for delivering the project on time and within budget, often taking on significant risks in the process. In India, EPC Contracts are also known as **"Turnkey Projects".**
This type of contract is commonly used in large-scale infrastructure projects such as power plants, refineries, pipelines, and industrial facilities.

B. Position of EPC Contracts in India:
The India power EPC (Engineering, Procurement, and Construction) market size was estimated at USD 13.8 billion in 2022. During the forecast period between 2023 and 2029, the size of India's power EPC market is projected to grow at a CAGR of 21.94% reaching a value of USD 45.36 billion by 2029.
Major growth drivers for the Indian power EPC market include the growing industrial operations and the increasing number of government initiatives focused on providing electricity to every citizen in the country.

Also, India's power EPC market is further expected to be primarily influenced by the conventional thermal segment, encompassing coal, natural gas, and oil-based power generation, constituting approximately 62.2% of the nation's total energy capacity.

Illustration 1:

2. Foreign Companies Operating in the Indian EPC Market*:

- Isolux Corsan
- ITD Cementation India Limited
- Samsung Engineering India Pvt Ltd
- Linde Engineering India Pvt. Ltd
- Hyundai E&A LLP
- J.M. Voith Paper India
- UK Grid Solutions/Alstom India
- TechnipFMC plc
- McDermott International, Inc.
- Saipem
- KBR Inc.
- Chemie-Tech
- Jakson
- WorleyParsons
- IJM(India) Infrastructure Limited
- Leighton
- ACS Construction Group Ltd.
- Vinci Construction

**source: Construction Placements*

3. General Scope of the EPC Project:

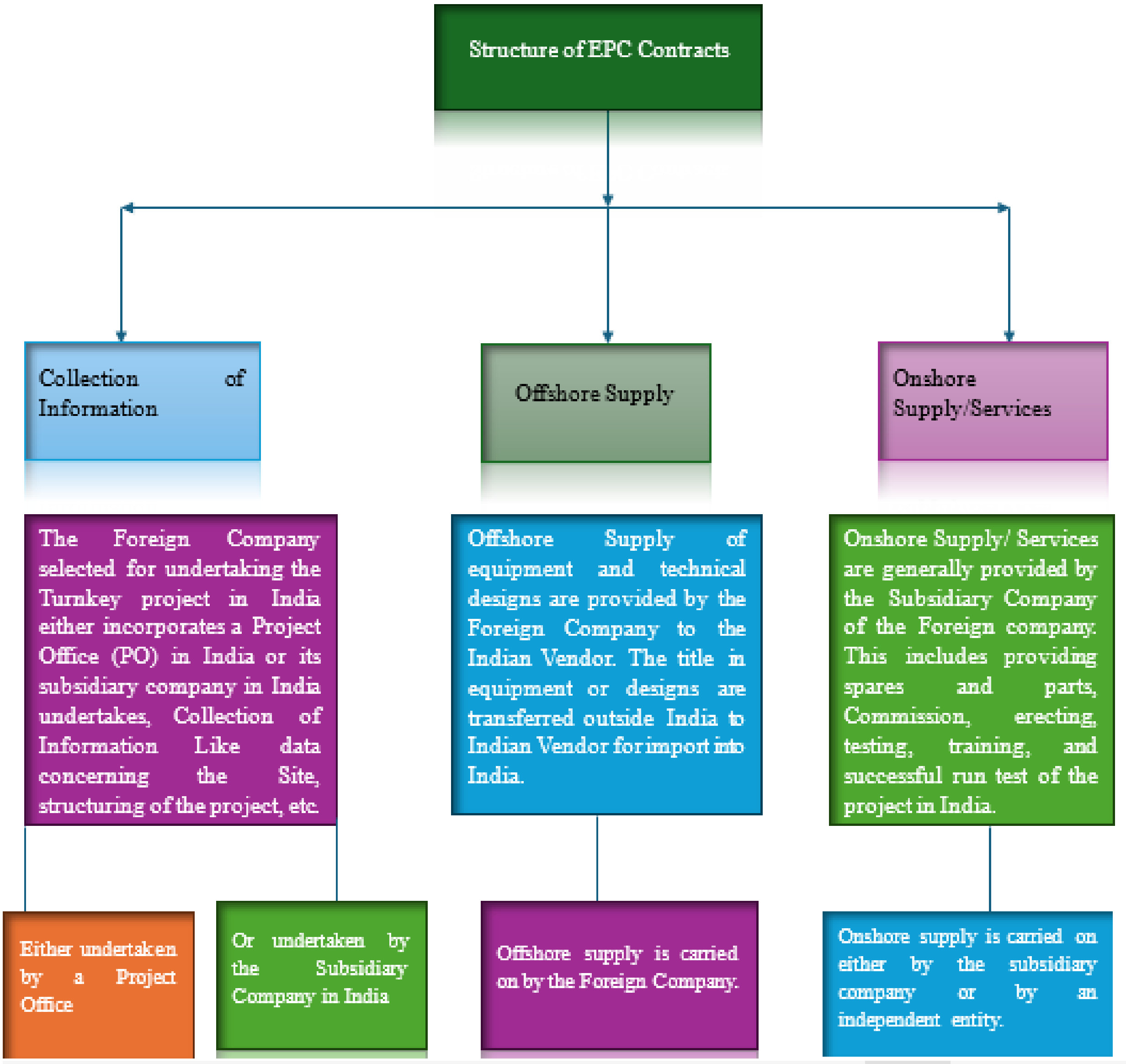
The EPC projects are **"Composite Contracts"** under which the Indian Company while raising the tenders outlines the whole of the responsibility of the project which includes **"Supply of Plant & Machinery & Equipment"**, **Installation and Successful commissioning**. However, certain bidding contracts necessitate the Inclusion of an Indian Associate i.e. Subsidiary company in a separate contract for undertaking the **"Onshore Activities".**

EPC Projects are undertaken with due care at each step which are classified into the following:

1. Visit of the Planned site by the team of Engineers and Architects to formulate the Structure and Planning of Project Initiation
2. Based on the Plans, the technical engineering departments do the necessary designing and engineering.
3. Production of equipment/machines including testing before commissioning as per the designs supplied.
4. Supply of equipment/machines along with the tools, spares, computer hardware and software, etc.
5. Installation of such equipment/machine in the planned site and successful test run.

4. Structure of EPC Contracts Awarded to Foreign Companies:

Illustration 2:



Foreign Companies commonly use this structure in the case of EPC Contracts, which is discussed in detail afterward with the help of a practical case study.

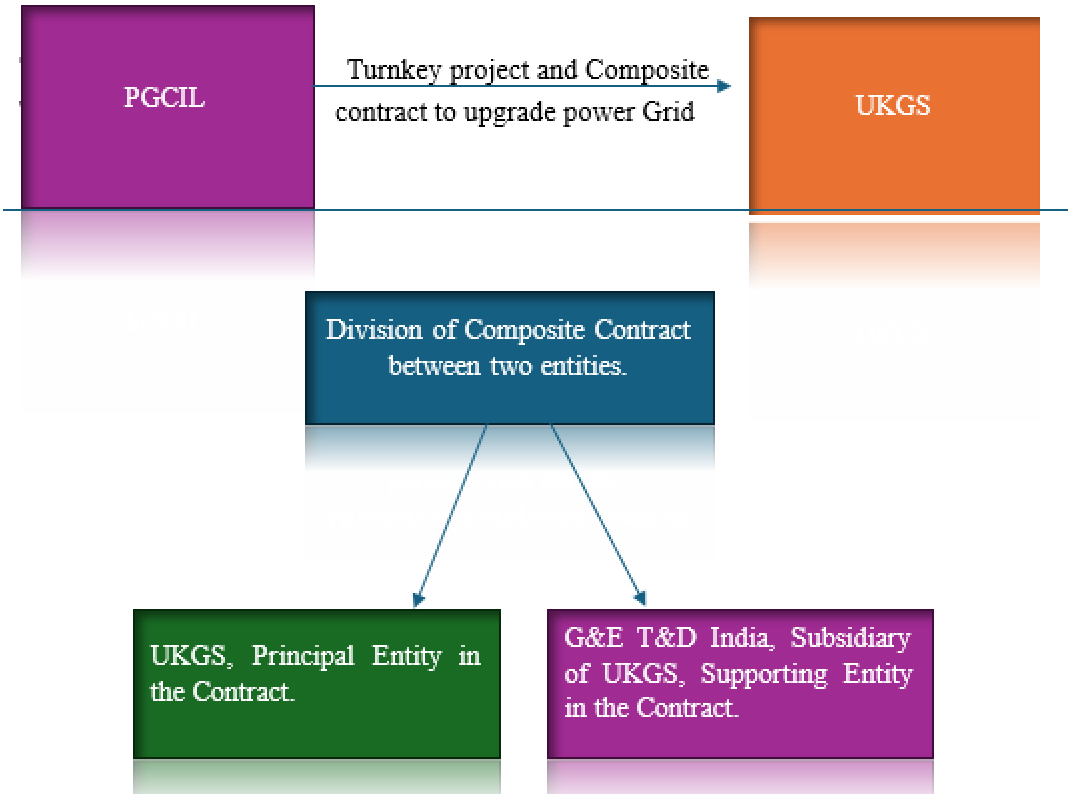
Case Study: Complex Turnkey Power Project Contract between UK Grid Solutions Limited and PGCIL

Background:

UK Grid Solutions Limited (UKGS) based in the UK and Power Grid Corporation of India Limited (PGCIL) have embarked on a comprehensive agreement for the execution of a turnkey power project. This endeavor aims to implement a high-voltage direct current (HVDC) terminal package associated with the Western/Northern Region Interconnector for IPP Projects in Chhattisgarh under the "National Grid Improvement Project.

Contract Structure:

Illustration 3:



What activities were involved in each of the three contracts:

The contract is structured into three distinct categories to manage the project's diverse aspects efficiently:

A. Off-shore Contract: The offshore contract was fulfilled by the UK Grid Limited based in the UK.

a) Covers the Production and supply of plant and equipment, including spares, sourced from locations outside India.

b) Responsibilities include procurement, quality assurance, and transportation of equipment to the project site. In all cases, the ownership is transferred outside India to the contractee.

B. On-shore Supply Contract: The onshore supply contract was fulfilled by the Indian Subsidiary of the UK Grid, i.e. G&E T&D India Ltd.

a) Encompasses the supply of plant and equipment, including certain spares, and testing activities within India.

b) Involves coordination with local suppliers, compliance with regulatory standards, and on-site testing procedures.

C. On-shore Service Contract: The onshore service contract was fulfilled by the Indian Subsidiary of the UK Grid, i.e. G&E T&D India Ltd.

a) Includes all services, civil work, testing, commissioning, and personnel training conducted within India.
b) Responsibilities entail project management, civil construction, commissioning activities, and training of local personnel.

Summary: The Composite contract for the Supply of Power Grid equipment along with its installation and successful commissioning was awarded to UK Grid Limited, an entity based in the UK. The UK Grid split this composite contract of equipment and installation with its Indian Subsidiary, where the equipment was supplied offshore by the UK Grid. Installation and commissioning Services were performed by the Indian Entity, G&E T&D India Ltd.

5. Outlining the Taxation Enigma:

The Enigma:

The legal dispute between the foreign companies and the tax authorities lies in the **"Taxability of offshore supplies"** in India. The general rule of taxation dictates that taxation in the source country/state arises where income is effectively connected to activities carried out within that jurisdiction.

The principal legal consideration for the tax authorities revolves around the notice issued concerning "**Offshore Supplies**" that are carried out in countries other than in the Source Country, would such supply be liable to tax in the Source Country i.e. India?

To answer the above question, the whole issue is divided into two sub-categories as per the following:

Category 1: A project office is established by a Foreign Company in India and the Composite Contract is split into different contracts, where the onshore supplies are undertaken by the subsidiary company!

Category 2: No project office is established, but the Composite Contract is split into different contracts, where the onshore supplies are undertaken by the subsidiary company!

Note: The ensuing conclusion takes into account all pertinent legal provisions applicable or anticipated for future application. These include considerations of Business Connection in India (Section 9), Presumptive Taxation for companies involved in turnkey projects (Section 44BBB), Permanent Establishment Provisions as outlined in tax treaties of specific countries, accompanying protocols of such tax treaties, relevant judicial precedents, and specific articles of Multilateral Instruments covering Anti-fragmentation rules.

Comprehensive Examination of Category 1:

A project office is established by a Foreign Company in India and the Composite Contract is split into different contracts, where the onshore supplies are undertaken by the Subsidiary company

In this scenario, numerous foreign companies entering the Indian market for the first time or lacking well-established subsidiaries with substantial experience in undertaking projects in India have employed a particular strategy. This strategy involves setting up project offices in India to conduct work for **"Offshore supplies"** and compensating these offices at arm's length for their services during a limited period. Some companies have utilized this approach as a means of tax avoidance, aiming to evade taxes on the funds received for these offshore supplies.

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In Engineering, Procurement, and Construction (EPC) contracts, a significant portion of the income arises from the **"supply of Plant & Machinery/Equipment"**, typically **comprising 60% to 70% of the total contract value.** This becomes particularly noteworthy when these supplies are sourced offshore, as such income has historically not been subject to taxation in India. This aspect has drawn attention from the Indian Revenue Department due to its potential implications for tax revenue and the need to ensure fairness and compliance within the tax framework.

In the context of **"Onshore supplies"**, two primary modes of operation emerge: either the subsidiary company manages the work, or an independent entity forms a consortium with Indian EPC companies such as L&T. Within this framework, the division of responsibilities is clear: the foreign company retains oversight of offshore activities, while the Indian entity assumes responsibility for onshore operations within the consortium. Tax liabilities associated with **"Onshore supplies"** are fulfilled either by the subsidiary or by the Indian company participating in the consortium, depending on the specific contractual arrangements and tax structures established.

Denouement: This delineation of roles and tax obligations underscores the complexity of multinational operations within the Indian EPC sector, contributing to significant tax revenue loss for the source country, India, on composite EPC contracts.

A. The Start of Conflict between the foreign companies and the Indian Income tax department:

The EPC Conflict got its limelight from two Judgments by the Hon'ble Supreme Court of India. In the case of **"Ishikawajma Harima 288 ITR 408",** a turnkey project was awarded to the consortium of 5 members which included the assessee also. The assessee was responsible for undertaking **"Offshore Supplies of certain equipment"**, **"Offshore Services"** in the form of designing and engineering, and **"Onshore Services"** like Installation and commissioning. It was held that the **"Offshore supplies"** are not taxable in India as no activities in relation to such were undertaken in India and **"Offshore Services"** are not taxable in India due to no territorial nexus with India as such services were not rendered in India.

In the case of **"Hyundai Heavy Industries Co. Ltd. SCC 422, 2007",** a turnkey project was awarded for designing, fabrication, hook-up, and commissioning of South Basin field Central Complex facilities in Bombay High Sea. Two separate contracts were entered. One was for the fabrication of the platform and the other was for installation and commissioning. A liaison office was established in Bombay to oversee the project. It was argued by the Assessing officer (AO) that a Permanent Establishment (PE) was established in India, and hence the payment received for **"fabrication of platform"** is taxable in India. It was also argued that both contracts were inextricably linked to each other, where the second contract was undertaken by an Installation PE. However, it was held that the liaison office did not have permission to engage in commercial activities, and was performing services that were preparatory, and auxiliary, and the Installation PE came into existence after the completion of the First Contract. Hence, the Payment received for **"fabrication of platform"** was not taxable in India.

B. Recent Trends of Judicial Conflicts:

The recent trend reflects that the Assessing officers are issuing notices to multiple foreign companies undertaking the EPC Project in India. The Authority for Advance Ruling (AAR) in the case of "**M/s Technip France S.A.S AAR No. 1413 of 2012",** a Turnkey Contract was awarded by ONGC Petro Additions Limited (OPAL) for the Installation of Butene-1 Plant at its premises. The Contract had a clear overview and price distinction for the **"Offshore Work"**, and **"Onshore Work"**. The Offshore work consisted of two activities **"Offshore Supply of Equipment",** and **"Offshore Design and Engineering Services".** Technip France undertook the offshore work, and the Project Office (PO) of Technip France

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undertook the onshore work. AAR held that the **"Offshore Supply of Equipment"** is not taxable in India, following the Judgment of **"Ishikawajma Harima",** and for the **"Offshore Design and Engineering Services",** will be taxable in India, as the designs and engineering services directly related to the Activities undertaken by the PO for setting up the Betune-1 Plant.

Note: However, in my perspective, this judgment lacks validity. Once it's determined that the offshore services bear a territorial nexus with India and are inherently linked to the installation contract, it logically follows that the "Offshore Supply of Equipment" should be subject to taxation in India.

In the case of **M/S. Voith Paper Gmbh, New Delhi vs. DDIT, ITA No.1077/Del/2014, dated February 21, 2020**, it was ruled that when an assessee engages in a composite agreement for a turnkey project in India, encompassing both the B and the **"Installation of Such Machines"** at a location like M/s Century Textiles, it is not treated as separate agreements. Instead, it is regarded as a singular turnkey project executed within India. Additionally, since the assessee had a Service PE due to its employees being present in India to supervise the contract, the profits from the **"Offshore Supply of Machines"** are attributed to the Permanent Establishment of the Assessee.

C. Key Arguments Presented by Foreign Companies:

This paragraph contains the Summary of Key Arguments that are raised by the foreign companies before the Indian Judicial Authorities to support their contention for the Non-taxability of Offshore Supplies**:**

"Technical operations for offshore supplies take place outside of India, clearly delineating them from Indian territory. The transfer of ownership for machinery and equipment to the Contractee on CIF/FOB terms underscores the transactions' extraterritorial character. Furthermore, project offices mainly handle preparatory and auxiliary tasks, supporting project execution without directly involving themselves in core operational activities within India."

D. Key Arguments Presented by Revenue:

This paragraph contains the Summary of Key Arguments that are raised by the revenue department before the Indian Judicial Authorities to support their contention for the taxability of Offshore Supplies**:**

"The offshore supply cannot be viewed in isolation; it is part of a composite contract rather than separate agreements. The offshore and onshore components are intricately interconnected. PEs Played an important role in executing the turnkey project. Consequently, turnkey projects completed within India fall under Indian taxation jurisdiction.

Comprehensive Examination of Category 2:

No project office is established, but the Composite Contract is split into different contracts, where the onshore supplies are undertaken by the subsidiary company!

In India, companies such as Linde Engineering, Hyundai Engineering, and Samsung Engineering establish subsidiary companies to autonomously undertake various projects within the country. These subsidiaries, equipped with skilled local workforces, facilitate the execution of Engineering, Procurement, and Construction (EPC) projects independently. This strategic approach not only ensures compliance with regulations but also minimizes reliance on foreign labor, thereby mitigating the risk of creating a Service Permanent Establishment (PE) for tax purposes.

Certain Bidding agreements/tender applications require the inclusion of Indian Companies in the contract to undertake the **"Onshore Work"** of the Project by such Indian Entity. This Entity can either be the related entity of the Foreign company or any other Indian Entity having experience Like L&T etc.

For Instance, Samsung Engineering entered into an agreement with L&T India, to undertake the EPC Project in India. As per the agreement, the L&T was entrusted to certain Onshore work like the Installation and Commissioning of certain plants and machinery in the premises of the ONGC.

This arrangement is commonly known as a **"Consortium Agreement,"** wherein a Consortium is established between a Foreign Entity and an Indian Entity, be it a Subsidiary Company or a other Independent Entity. Its primary objective is to effectively execute the turnkey project.

A. Trends of Judicial Conflicts:

In the case of **"Ansaldo Energia Spa vs ADIT, Tax Case No.1303 of 2007",** before the **Hon'ble Madras High Court**, a tax appeal was followed by the assessee for the ITAT judgment that was against the assessee in which it was held that the **"Offshore Supplies"** made by the assessee should be liable to be taxed in India. The Assessee was awarded an EPC Contract by M/s Neyveli Lignite Corporation(NLC) for installing thermal plants in India. The assessee entered into a **"Consortium Agreement"** with its Subsidiary Namely Ansaldo Services Private Ltd. (ASPL), under which the contract was split into 4 contracts namely, Contract I was related to **"Offshore Supply of Equipment"**, Contract II was related to **"Offshore Supply of Services",** Contract III was related to **"Onshore Supply of Equipment"**, and Contract IV was related to **"Erection and Installation"**. Contracts I & II were undertaken by the Assessee, and Contracts III & IV were undertaken by the Subsidiary Company. The Assessee had taken a plea that the Judgments of **"Ishikawajma Harima"** and **"Hyundai Heavy Industries"** are squarely applicable to the Assessee's case.

However, the Madras High Court has held that both judgments are not applicable in this case, as in the case of **"Ishikwajma Harima",** No Permanent establishment was involved and the transaction was just for the **"Offshore Supply of Equipment"**. As far as **"Hyundai Heavy Industries"** is concerned, there were two separate contracts and each of the contracts was undertaken in **"High Sea"**, and the PE in the Form of Installation PE came in a later stage. In the case of the assessee, it was using the Site office owned by its subsidiary including the project managers were the Employees of the assessee who were overseeing the project from its initiation and helped the subsidiary company in the installation and commissioning of plants.

Hence assessee had a Fixed Place PE in India, and each of the contracts was inextricably linked to each other which was carried out through that PE. So, taxable in India.

Note: From my standpoint, the judgment rendered by the Madras High Court appears comprehensive, taking into account pertinent rulings from the apex court and other legal statutes. It serves as a primary reference for the Revenue Department in presenting their cases before the Judiciary.

In the case of "**UK Grid Solutions vs DCIT ITA Nos. 2239,884, 885 & 2240/Del/2023",** before the Delhi ITAT, the assessee was awarded an EPC Contract from PGCIL to upgrade the Power Grid. As per the tender applications, it was required to have an Indian Associate for undertaking the **"On-shore Supply Contract",** and **"On-shore Services".** The Assessee employed its Indian Associated Enterprise Namely G&E T&D India Ltd. It was argued by the AO that a Composite Contract is divided into three contracts and for each contract, the assessee was solely responsible, hence whole of the composite contract was taxable in India. On the other hand, the assessee held that it had not played any role in the execution of contracts of Indian Associates and no employees of the Assessee were present in India for executing the Contract. Meetings which were undertaken by employees of both Companies were just for contract negotiations. The Indian Associate was not a **Dependent Agent PE (DAPE)** of the Assessee as it had an independent source of Income for projects it undertook Independently.

Based on the above Facts, the ITAT held that it was not a composite contract rather it was different contracts for **"Offshore Work"**, and **"Onshore Work".** The assessee did not participate in the Onshore Work, and it did not have any PE in India. As such split of the contract was a mandatory term in the bidding application and was not carried on to avoid taxes on **"Offshore Supplies"** and the business prudence of such a split can not be questioned.
Note: This judgment suggests that without foreign company involvement in onshore activities, proving the taxability of offshore supplies becomes challenging for the revenue department.

Indian Income-tax Perspective
Exploring 'Business Connections' alongside the 'Presumptive Taxation Scheme
A. Business Connection:
Section 9 of the Income-tax Act states that the income of Non-resident (Foreign Companies) shall be deemed to accrue or arise in India. The following is Contained in the Section:
9. (1) The following incomes shall be deemed to accrue or arise in India:—
(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.
Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—
(a)has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts by that non-resident and the contracts are—
(i) in the name of the non-resident; or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
(iii) for the provision of services by the non-resident; or
(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or
(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident
The Hon'ble Supreme Court in the case of "**CIT vs. R.D. Aggarwal & Co."** has explained the term **"Business Connection".** This case dealt with the interpretation of the term **"business connection"** under the Income Tax Act, of 1961. The Supreme Court held that a business connection exists when there is a **real and intimate connection between the business of a non-resident and the activities carried out in India**. This case further elaborated on the concept of business connection, emphasizing that it involves a **continuous activity of a non-resident's business in India through a fixed place of business, dependent agents,** or any other factors that establish a real and intimate connection.
The Hon'ble Supreme Court in the case of **"Formula One World Championship Ltd. vs. CIT",** has explained that the **presence of a non-resident in India through a liaison office or an agent** may create a **business connection** if there is a **significant economic presence and a real and intimate connection** with the income earned in India.
Denouement: Above can be concluded that the Foreign Companies undertaking the EPC Projects in India may be liable for tax in India on income deemed to accrue or arise to them from the business connection

in India. As defined by the Hon'ble Supreme Court of India for the term **"Business Connection"** in India, where Foreign companies either through the Project office or the subsidiary carry on Work like Pre designing, Pre Engineering surveys or participate directly or indirectly in Onshore activities like Installation, Commissioning etc, would establish the "business connection" in India of the Foreign Companies.

It would be held in the above cases that the non-resident i.e. Foreign companies activities are continuously carried out either by the Project Office or the Subsidiary Company and there exists a significant economic presence of the foreign company in India.

Note: It must be noted that without the existence of PE, no Income can be taxed in India, as the tax treaties override the Domestic Legislation. However, the existence of Business connections can lead to the existence of PE in India. As seen in the case of Formula One, Where the Fixed Place PE was established along with the existence of a business connection in India.

B. Future Prospect: A Deemed Business Connection

The addition of Explanation 2A to the definition of "Business Connection" means that offshore transactions of machines or equipment by foreign companies, exceeding INR 20 million, now create a fictional business connection in India for those companies. This provision is applicable from 1st April 2022. Following is Explanation 2A and its rule 11UD:

Explanation 2A.—For the removal of doubts, it is hereby declared that the significant economic presence of a non-resident in India shall constitute a "business connection" in India, and "significant economic presence" for this purpose, shall mean—

(*a*) transaction in respect of any goods, services, or property carried out by a non-resident with any person in India including provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds such amount as may be prescribed; or

(*b*) systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, as may be prescribed:

Provided that the transactions or activities shall constitute a significant economic presence in India, whether or not—

(*i*) the agreement for such transactions or activities is entered in India; or

(*ii*) the non-resident has a residence or place of business in India; or

(*iii*) the non-resident renders services in India

11UD. (1) For the purposes of clause (a) of Explanation 2A to clause (i) of sub-section (1) of section 9, the amount of aggregate of payments arising from transaction or transactions in respect of any goods, services or property carried out by a non-resident with any person in India, including the provision of download of data or software in India during the previous year, shall be two crore rupees.

(2) For the purposes of clause (b) of Explanation 2A to clause (i) of sub-section (1) of section 9, the number of users with whom systematic and continuous business activities are solicited or who are engaged in interaction shall be three lakhs.]

Denouement: Introduction of Explanation 2A facilitates the revenue department in issuing notices to numerous foreign companies, as the fictional creation of a Business Connection becomes more straightforward. Nonetheless, the revenue department bears the responsibility of demonstrating the existence of Permanent Establishments (PE) for these foreign companies, through which activities are conducted in India, to tax receipts from offshore supplies.

C. Presumptive Taxation:

The presumptive taxation scheme is contained in Section 44BBB of the act:

44BBB. (1) Notwithstanding anything to the contrary contained in sections 28 to 44AA, in the case of an assessee, being a foreign company, engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof, in connection with a turnkey power project approved by the Central Government in this behalf, a sum equal to ten percent of the amount paid or payable (whether in or out of India) to the said assessee or to any person on his behalf on account of such civil construction, erection, testing or commissioning shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession".

(2) Notwithstanding anything contained in sub-section (1), an assessee may claim lower profits and gains than the profits and gains specified in that sub-section, if he keeps and maintains such books of account and other documents as required under sub-section (2) of section 44AA and gets his accounts audited and furnishes a report of such audit as required under section 44AB, and thereupon the Assessing Officer shall proceed to make an assessment of the total income or loss of the assessee under sub-section (3) of section 143 and determine the sum payable by, or refundable to, the assessee.

Following sub-section (3) shall be inserted after sub-section (2) of section 44BBB by the Finance Act, 2023, w.e.f. 1-4-2024:

(3) Notwithstanding anything contained in sub-section (2) of section 32 and sub-section (1) of section 72, where an assessee declares profits and gains of business for any previous year in accordance with the provisions of sub-section (1), no set off of unabsorbed depreciation and brought forward loss shall be allowed to the assessee for such previous year.

The presumptive taxation scheme assesses the profits of a foreign company based on the total receipt received for a turnkey project. Under this scheme, 10% of the total amount received is deemed as the profits of the foreign company, subject to a tax rate of 40% plus applicable cess and surcharge. However, this scheme is applicable when the foreign company either has a Permanent Establishment (PE) in India or when its business connection is deemed as the PE in India.

However, numerous foreign companies have contested that deeming 10% of total receipts as business profits under Rule 10 of the Income-tax rules is unjustified. Globally, the specific division related to Engineering, Procurement, and Construction (EPC) projects typically earns profits ranging from 3% to 5%. This contention finds support in the judgment of **"J.M. Voith SE & Co. KG vs DCIT ITA No. 4862/Del/2019"** before the Delhi Income Tax Appellate Tribunal (ITAT).

Tax treaties Perspective

Delve into Fixed Place PE, Installation PE, Service PE, and Protocols:

A. Fixed Place PE:

Article 5(1) of the Tax Treaties **(also referred to as Double Taxation Avoidance Agreements "DTAAs")** refers to the concept of Fixed Place PE. Further Article 5(2) & Article 5(3) illustrate the Fixed Place PE in different Structures. Generally, Fixed Place PE refers to any place through which the business is carried on by the Non-resident and such place is at the **disposal of the Non-resident**.

In the landmark case of **"Formula One World Championship Ltd. vs. CIT,"** the Hon'ble Supreme Court of India addressed the crucial concept of Fixed Place Permanent Establishment (PE) in the context of international taxation. The case pertained to Formula One, a non-resident entity that organized a Moto Race at the Buddh International Circuit (BIC) in Noida, India. Under the agreement between Formula One and BIC, Formula One exercised substantial control over the venue where the race took place. The Supreme Court determined that the BIC was effectively at the disposal of Formula One during the race events.

This key finding led to the conclusion that a Fixed Place PE was constituted in India by Formula One's control and use of the BIC facilities. As a result of this ruling, the profits derived by Formula One from organizing the Moto Race at the BIC were deemed taxable in India due to the existence of the Fixed Place PE.

This was a very key ruling for Fixed Place PE, which was subsequently followed by more rulings like E Funds Solutions, and Morgan Stanley Judgment which were ruled in favor of Assessee.

Category 1: Fixed Place PE:

When a foreign company establishes a Project Office in India, it depends on whether commercial activities are carried out from a Project Office or not. As in the case of **"Samsung Heavy Industries Co. Ltd vs ADIT, ITA No.5237/Del/2010"** before Delhi ITAT, the assessee had a Project Office in India, which was set up as a channel of communication between the Assessee and the Contractee. RBI approved the opening of the Project Office in India and it was not restricted to carrying on the commercial activities in India. Based on the facts and the board meetings of Samsung, it was held that the Project office was involved in executing the Project, and hence the assessee had a Fixed Place PE in India. The argument that the Project Office undertook **"Preparatory and Auxilary Activities"** can not be substantiated without providing evidence, as the onus to prove such a claim is on the assessee.

Category 2: Fixed Place PE:

As per the DTAAs, generally, a subsidiary company is not treated as a PE of the Non-resident. However, there are certain exceptions to it. In the case of **Daikin Industries v ACIT ITA No 1623 of 2015, before Delhi ITAT**, in such case the subsidiary company of Japan's Daikin was held to have a **Dependent Agent PE (DAPE)** in India, as contracts of Holding Company were negotiated and finalized by the Subsidiary company. Even in the Case of **"Ansaldo",** which was discussed earlier, in such a case where the Site Office of a Subsidiary company was available to the Assessee and the employees of the Assessee were working as a project manager it was held that the Assessee had a Fixed Place PE and Service PE in India, and hence EPC contract as a whole was taxable in India.

So, in general, the subsidiary would escape the legal warmth of being held as a PE, but the outcome can change if the facts discussed above are present in the case, which can lead to the creation of a Subsidiary company as a PE.

B. Installation PE:

India-US DTAA:

(k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project, or activities (together with other such sites, projects, or activities, if any) continue for a period of more than 120 days in any twelve-month period:

India-UK DTAA:

(j) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project, or supervisory activity continues for a period of more than six months, or where such project or supervisory activity, being incidental to the sale or machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or supervisory. activity exceed 10 per cent of the sale price of the machinery and equipment;

India-Germany DTAA:
(i) a building site or construction, installation, or assembly project or supervisory activities in connection therewith, where such site, project or activities continue for a period exceeding six months.
India-France DTAA:
3. A building site or construction, installation, or assembly project constitutes a permanent establishment only where such site or project continues for a period of more than six months.
Denouement: If a foreign company carries out installation work through its Liaison or Project Office in India for durations specified and highlighted in the respective Double Taxation Avoidance Agreements (DTAA), it will establish a Permanent Establishment (PE) in India. Notably, the US treaty imposes stricter criteria regarding project tenure, where any continuous 12-month period within the specified duration is considered sufficient to establish the existence of a PE in India.
C. Service PE:
India-US DTAA:
(l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:
(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period.
India-UK DTAA:
(k) the furnishing of services including managerial services, other than those taxable under Article 13 (Royalties and fees for technical services), within a Contracting State by an enterprise through employees or other personnel, but only if:
(i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period.
India-Germany DTAA & India-France DTAA:
For each of the respective Countries, the DTAA doesn't contain the provisions of Service PE.
Denouement: In instances where foreign companies engage their employees or other personnel to carry out projects in India, their presence for the duration of the contract execution is taken into account for Permanent Establishment (PE) assessment. Notably, only employees seconded or deputed to India are considered for PE determination, aligning with the precedent set by the Hon'ble Supreme Court in the Morgan Stanley case. It's important to exclude days when such employees are on personal leisure or travel from the calculation.
D. Protocols of Some DTAAs:
Some Protocols of the Indian treaties contain provisions that guide the determination of Installation PE, Service PE, and taxability of "offshore supplies" by Head Office to Permanent establishment.
India-USA Protocol:
AD ARTICLE 5 - It is understood that where an enterprise of a Contracting State has a permanent establishment in the other Contracting State in accordance with the provisions of paragraph 2(j), 2(k) or 2(l) of Article 5 (Permanent Establishment), and the time period referred to in that paragraph extends over two taxable years, a permanent establishment shall not be deemed to exist in a year, if any, in which the use, site, project or activity, as the case may be, continues for a period or periods aggregating less than 30 days in that taxable year. A permanent establishment will exist in the other taxable year, and the enterprise

will be subject to tax in that other Contracting State in accordance with the provisions of Article 7 (Business Profits), but only on income arising during that other taxable year.

Denouement: Where the period of 120 days stretches to two taxable years, the liability to pay tax arises in the year in which the activity continues for more than 30 days.

India-UK Protocol:

that, in applying sub-paragraph (j) of paragraph 2 of Article 5, for the purpose of determining whether a building site or construction installation or assembly project or supervisory activity in connection therewith has continued for a period of more than six months, the Contracting States shall :

1. take no account of time previously spent by employees of the enterprise on other sites or projects which have no connection with the site or project in question ;
2. apply for more than six months test separately to each site or project which has no connection with any other site or project and to each group of connected sites or projects; and
3. regard a building site as a single site, even if several contracts have been entered into for the work being done, provided that if forms a coherent whole commercially and geographically;

Denouement: The calculation of the six-month period shall exclude any time attributed to a project or site that operates independently from another project. This exclusion encompasses the duration spent by employees on said separate project or site, as well as any time allocated to other independent projects.

India-Germany Protocol:

In the determination of the profits of a building site or construction, assembly or installation project there shall be attributed to that permanent establishment in the Contracting State in which the permanent establishment is situated only the profits resulting from the activities of the permanent establishment as such. If machinery or equipment is delivered from the head office or another permanent establishment of the enterprise (situated outside that Contracting State) or a third person (situated outside the Contracting State) in connection with those activities or independently therefrom there shall not be attributed to the profits of the building site or construction, assembly or installation project the value of such deliveries.

Denouement: The Supply of machinery and equipment, by the Head office to the PE or the Indian Contractee will not be attributed to the profits of the Permanent establishment. For German cases, the **"Offshore Supplies"** would be held exempt by this protocol, subject to the "**Applicability of tax treaty".**

India-France Protocol:

In the India-France Protocol, it is provided that the Protocols of India-UK & India-Germany Protocols will apply in the India-France DTAA.

Preparatory and Auxiliary Including the Effect of MLI:

MLI stands for Multilateral Instruments, by which the tax treaties of Signatory Countries can be ratified in an effective and fastest way. **"Preparatory and auxiliary"** covered by Article 5(4) of treaties, refers to activities or services that support and facilitate the main business operations of a company but are considered ancillary to those operations. These activities are typically considered to be of secondary importance or directly related to the main business activities without constituting the core revenue-generating functions. If an enterprise does the **"Preparatory and auxiliary activities"** in the Source state, then such enterprises fall under the exclusion of being held to be a PE in India.

Previously multiple MNE companies divided their business activities into small operations in the Source Country so that each operation automatically falls under the exclusion of being held as a PE in India, which in turn avoids payment of taxes in India. This was called as **“Fragmentation of business activities”.**

The OECD's stance on Preparatory and Auxiliary activities is as follows:

“Depending on the circumstances, activities previously considered to be merely preparatory, or auxiliary may nowadays correspond to core business activities. To ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a ‘preparatory or auxiliary’ character. … “BEPS concerns related to Art. 5(4) also arise from what is typically referred to as the **‘fragmentation of activities**. **Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, it is important to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations** in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Art. 5(4). The **anti-fragmentation** rule proposed will address these BEPS concerns”.

A. Article 13(4) of MLI:

“Cohesive business operation” is referred to as the Core Business activities that are crucial to generating business income for an entity. In EPC contracts, we have seen that business activities like Pre-engineering and designing surveys are carried on by the Project Office, and other works like installation, and commissioning are divided with the Subsidiary company. This leads to the dividing of **“Cohesive Business Operation”** into project offices and subsidiaries, which in turn avoids paying taxes in India.

Article 13(4) of the MLI serves the purpose of avoiding the tax through this strategy. The following is contained in Article 13(4):

“A provision of a Covered Tax Agreement (as it may be modified by paragraph 2 or 3) that lists specific activities deemed not to constitute a permanent establishment shall not apply to a fixed place of business that is used or maintained by **an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or another place** in the same Contracting Jurisdiction and:

a) **that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a permanent establishment; or**

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same operation” by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, **constitute complementary functions that are part of a cohesive business operation”.**

The article contains two provisions, one in the case where a PE is situated in the source state and the second case where there’s no PE situated but a Closely related company (which Includes the Subsidiary Company). In simple terms, Paragraph 4 aims to prevent enterprises from splitting a cohesive business into smaller units to claim they are only engaged in preparatory or auxiliary activities. Under this paragraph, the exceptions in paragraph 4 don't apply to a place of business if its activities, along with those of related enterprises in the same state, form complementary functions of a unified business operation. For Para 4 to apply, at least one of these places must be a permanent establishment or the combined activities must exceed preparatory or auxiliary functions.

The following Countries have notified the Applicability of Article 13(4) to their tax treaties with India.

a) Australia

b) UK
c) Netherlands
d) France
e) Japan

The Following Countries have not applied Article 13(4) to their tax treaties with India:

a) Germany
b) South Korea

The US has not been a signatory member of MLI, hence no part of the India-US treaty is amended to give effect to any provisions of MLI.

B. Pakistan's Legislative Amendment:

The recent changes to Pakistan's tax laws by the Finance Act 2018, are all about making sure that businesses operating across borders pay their fair share of taxes. They've updated the rules to cover what they call **"Cohesive business operations"** (CBO), which are when companies do a bunch of things like supplying goods, doing installations, or supervising projects, mostly in Pakistan, but maybe some elsewhere.

Before, there was some confusion about whether these kinds of operations should be taxed in Pakistan. Now, the law says they should be.

However, this change has stirred up some debate. In the past, courts sometimes said that if goods were sold outside of Pakistan, they shouldn't be taxed here. But now, with these new rules, those sales might get taxed after all, which could cause more arguments.

Also, if a bunch of different companies team up to do a project, it might not count as a cohesive business operation under these rules. It's also important to remember that tax treaties between countries still have a big say in how this all works out.

These changes mean that companies doing business across borders might end up paying more taxes in Pakistan than before. Even if they were able to avoid taxes before because of certain international agreements, these new rules could change that.

Deciding Factor- Contract/Bidding Document:

This paragraph outlines the important factors of the "Contract/Bidding Document" which helps in ascertaining whether the "Offshore Supply" would be taxable in India or not. These factors are derived from the various findings as discussed in earlier parts:

1. **Single Contract vs Multiple Contract:** In the case where an EPC Contract is a composite contract, the artificial division of such contract into multiple contracts leads to a conclusion by Indian Judicial Authorities that such was to avoid taxes in India, and each of the Contract is Inextricably linked to each other, and hence such artificial split is not allowed and whole of EPC contract is taxable (Such was held in the Case by **AAR in case of Alstom Ltd.)**

   However, as seen in the case of the **UK Grid case**, where the bidding application required to have an Indian associate and multiple contracts, it was held that each contract was different and "Offshore supplies" would not be taxable in India.
2. **Price Apportionment vs Total Contract Price:** As in the case of **Ishikajwama**, where the price for **"Offshore Supply"** and **"Other Services"** was apportioned in the contract, it was held by the Hon'ble Supreme Court that each of the contracts was different.

However, it was seen in the case of **Mitsui Engineering**, the contract had a total contract price and it was not apportioned, hence in such a case that it was a composite contract.

3. **High Sea Contract vs Onshore Contract:** Where the foreign company undertakes the EPC project in the High Sea, such a contract would not be taxable in India, as no activities are to be undertaken in India. This was held in the case of **Hyundai Heavy Industries**.
4. **Division of Responsibility vs No Division of Responsibility:** This scenario is particularly pertinent in cases involving multiple contracts, where it's crucial to discern whether the segmentation of contracts was merely a strategy to evade taxes or if each contract clearly outlines the respective responsibilities of the involved parties. This could be justified in the case of the **UK Grid,** where the responsibilities of each party to the contract were outlined in the Contract.
   This principle was also held in the case of **Ansaldo SA,** that for a contract to be independent, it must demonstrate the responsibility of each party to the contract and such are fulfilled by each of the parties to the contract.
5. **Clearing by PE/Subsidiary vs Clearing by Contractee:** In the case of **Ansaldo SA**, the equipment was cleared in the name of its subsidiary, as a clearing agent. This was a conclusive evidence that the equipment was handed over to the assessee not offshore, but once such equipment was installed by the assessee at the premises of the assessee, and hence the offshore supply will be taxable in India.
   As far as **Hyundai Heavy Industries** are concerned, the offshore supply was handed over in Korea to the Agents of ONGC, and hence such offshore supply would not be taxable in India, as the title to goods was passed outside India, and the EPC contract was not a composite contract.
6. **Arms Length Transaction**: The supply of equipment/plant and machinery offshore shall meet the Arm's length criteria, which justifies that the transaction is not overpriced as to avoid paying tax in India.

This list was inclusive, and many other circumstances can be included to determine the taxability of offshore contracts. However, the circumstances as discussed above are of utmost importance when considering the taxability of EPC Contracts.

Way Forward/Conclusion:

This research paper delves into the intricate challenges encountered by foreign companies embarking on EPC Projects in India. As previously discussed, the contentious issue often revolves around the offshore supply of equipment/plant&machinery, sparking disputes between foreign entities and the Income Tax department. These disputes undergo scrutiny at various judicial levels, ranging from ITAT to High Courts, and ultimately to the Hon'ble Supreme Court of India. While matters such as Software Taxation as royalty have been conclusively addressed by the Hon'ble Supreme Court, the EPC matter remains highly litigious, with evolving strategies prompting fresh conflicts between foreign entities and the Income Tax department.

To navigate such complexities, there exist strategies to streamline EPC contracts, establishing the business prudence of dividing composite contracts before the Indian Income Tax department or Judicial Authorities. Foreign companies contemplating EPC projects in India must meticulously analyze bidding documents and contracts in their entirety to ascertain the applicability of tax planning strategies. The introduction of MLI introduces further complexities, nullifying attempts to segregate cohesive business operations to evade source state taxation, particularly for foreign countries that have adopted Article 13(4) to amend treaties with India.

Moving forward, beyond examining bidding documents and contracts, thorough consideration of tax treaties and protocols is imperative to grasp the tax implications and interpret provisions accurately. India could also consider legislative amendments akin to those implemented by Pakistan, specifically taxing offshore supplies and supporting the deeming fiction of business connections introduced from April 1, 2022.

About the Author

Since June 2022, the author, CA Shivam Sharma has been refining their skills as a Chartered Accountant, specializing in various areas such as International Taxation, Transfer Pricing, US and Canadian Taxation, FEMA, and NRI Transaction Advisory. Their expertise extends to the establishment of US LLCs tailored to Digital Nomads, optimizing their tax efficiency. Engaged in the meticulous preparation and thorough review of Transfer Pricing study reports, the author caters to clients across the Manufacturing, ITES, and Software sectors. Offering strategic counsel to Non-resident clients on Inbound investments into India, they address pertinent issues concerning Permanent establishment in the country. Furthermore, the author crafts tax strategies for NRIs navigating property disposal in India, aiming to curtail their tax burden by up to 5% in both India and the USA/Canada.
In addition to their professional endeavors, the author is actively involved in knowledge dissemination. They are indulged in writing articles and sharing views on tax laws through video presentations. This commitment to education and information sharing reflects their dedication not only to their clients but also to the broader community of professionals and individuals seeking clarity and insight into complex tax matters. By leveraging various mediums of communication, the author strives to empower others with the knowledge and understanding necessary to navigate the intricacies of tax regulations effectively.

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