



BMR & Associates

Tax and Regulatory

# EPC

- **Contract Formulation**
- **Change of Law, Tax Clauses & Tax Reimbursements**

**Conference on**

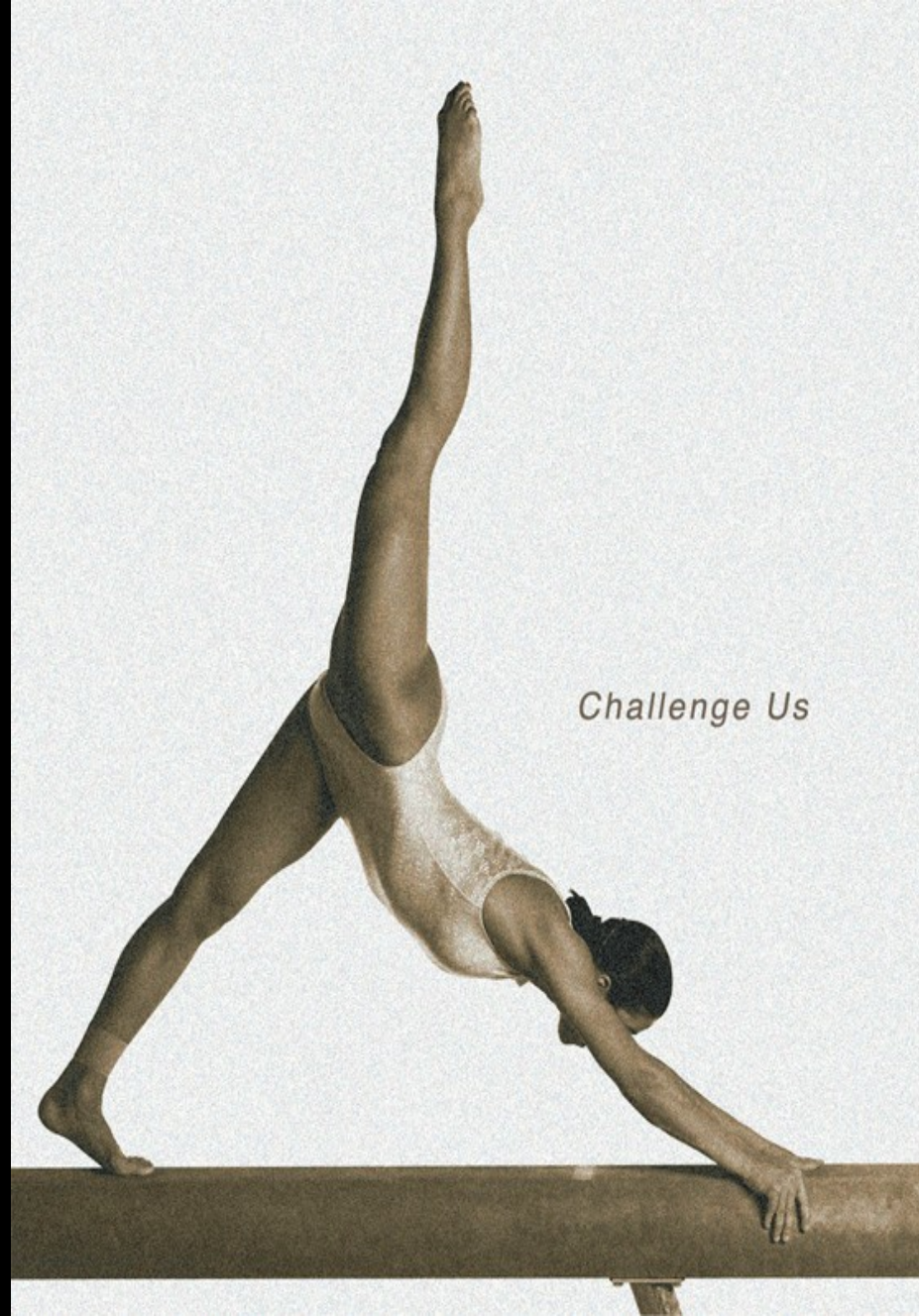
**EPC contracts Tax, Legal and Commercial Imperatives**

**8 - 9 June 2006 | Hotel Intercontinental The Grand | Sahar Airport Road | Mumbai | India**

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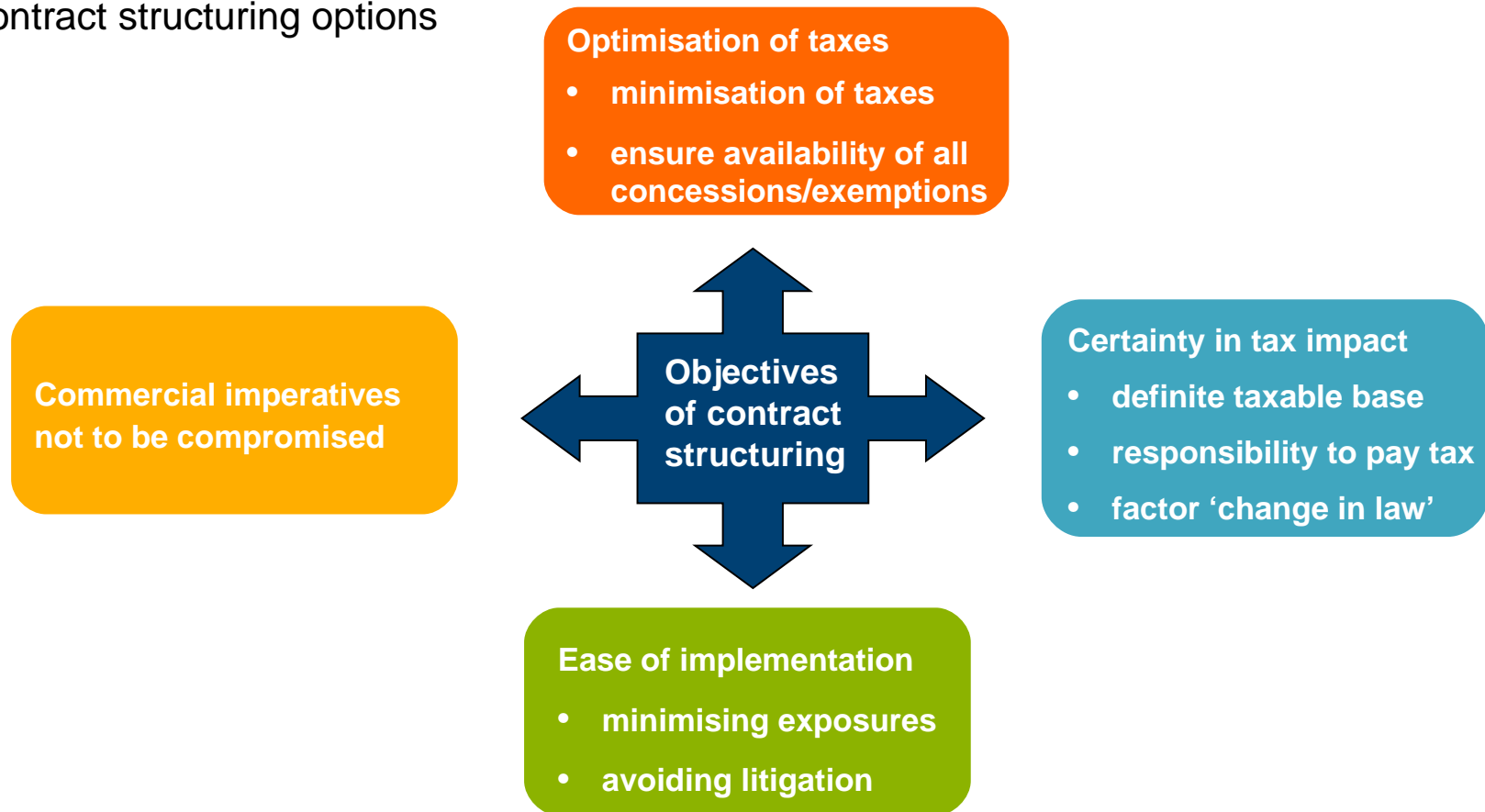
# CONTRACT STRUCTURING



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# OBJECTIVES OF CONTRACT STRUCTURING

In light of the significant tax inefficiencies arising from a single consolidated contract for the entire work and a lumpsum price, it becomes necessary to optimise taxes through efficient contract structuring options



# MULTIPLE CONTRACTS - FEATURES

Based on the Advance ruling in IHI Co Ltd case and notifications issued by Revenue authorities (including CBDT instruction no 1829), some broad guidelines for contract structuring are as follows:

- Execute separate contracts for:
  - Offshore supplies of equipment and materials

*versus*

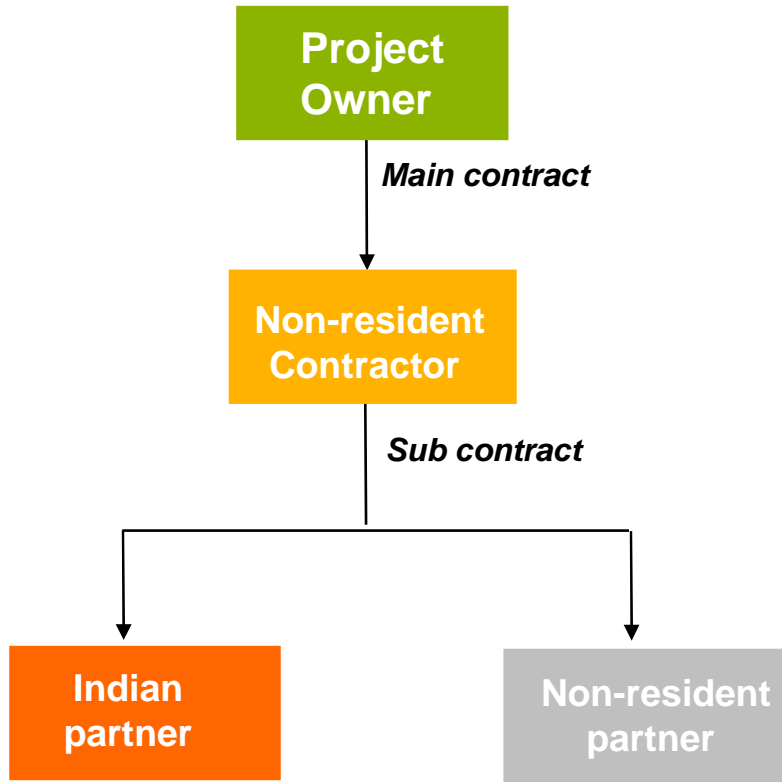
  - Offshore services in connection with planning and design of the project
  - Onshore supplies of equipment and materials
  - Onshore services for erection, testing and commissioning
- **Scope of work separately identified** for each work on stand-alone basis
- Obligation under each contract should be related to scope of work under that contract
- **No activities to be performed in India in connection with the offshore supplies**

# MULTIPLE CONTRACTS - WRAP AROUND AGREEMENT

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- Broad features of a co-ordination agreement are:
  - Entire scope of work to be performed by the contractors within prescribed time limits and according to specifications
  - Scope of work under each contract will be carried on and administered in a co-ordinated manner
  - No monetary consideration under the co-ordination agreement
  - The consortium leader to give guarantee to the project owner for the successful execution of the contract
  - The project owner would undertake not to set-off the dues of one contractor against payments due to the non-defaulting contractor

# SUB - CONTRACTING MODEL



## Mechanics

- The Contractor to enter into contract with the project owner
- The contractor to receive the contract revenues from the Project Owner and be liable for successful execution of the contract
- Contractor may sub-contract various scopes to other partners

# SUB - CONTRACTING MODEL (CONT)

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## Income tax implications

- All participants liable to tax in their individual capacity
- In case the main contractor is a non-resident, likely PE exposure

# IMPLICATIONS

## Indirect tax implications

- Onshore supplies could be subject to dual sales tax ie first on the procurement leg by Main Contractor from the local vendor and second on the supply leg from Main Contractor to the Project Owner
- To minimize this, in transit sales may be effected, which would enable Contractor to purchase the goods from vendors at 4% against Form C and supply the same to the Project Owner, free of sales tax
- Onshore services
  - Services procured by Main Contractor from local service provider would be subjected to Service tax at the rate of 12.24, provided the services are taxable in nature
  - Services rendered by Main contractor to Project Owner is likely to attract Service tax
  - However, Project Owner would be entitled to claim credit of the services tax charged by the local service providers and hence the net service tax cost would be restricted only on the margin of Main Contractor

# IMPLICATIONS

## Indirect tax implications

### ➤ Onshore services

- In the past, we have noticed that Project Owners have disputed the levy of service tax on turnkey single document contracts ( on the basis of Daelium)
- Consequently, there has been a commercial stand off interse between the parties with respect to whether or not service tax is payable on such contracts and whether or not the Project Owner must reimburse the contractor on such service tax
- Where the Contractor is forced to accept the above service tax position, the service tax charged by the subcontractors/vendors onto Main Contractor would become a cost to the project since, these cant be claimed as credit by either party ( ie Main Contractor as well as the project Owner) and hence would lead to inefficiency
- Indirect tax on Offshore supply and Offshore services would depend on the party that executes these activities and the manner in which that is carried out

# MULTIPLE CONTRACTS

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- Under this option, separate contracts can be executed with the Project Owner for –
  - Offshore supplies of equipment and materials
  - Offshore services in connection with planning and design of the project
  - Onshore supplies of equipment and materials
  - Onshore services for erection, testing and commissioning
- **Scope of work under each agreement to be clearly identified**
- Obligation under each contract should be related to scope of work under that contract and not any other
- Project Owner could enter into an **overall performance guarantee agreement** linking the separate agreements
- With regard to supply of equipment from outside of India, no activities to be performed in India

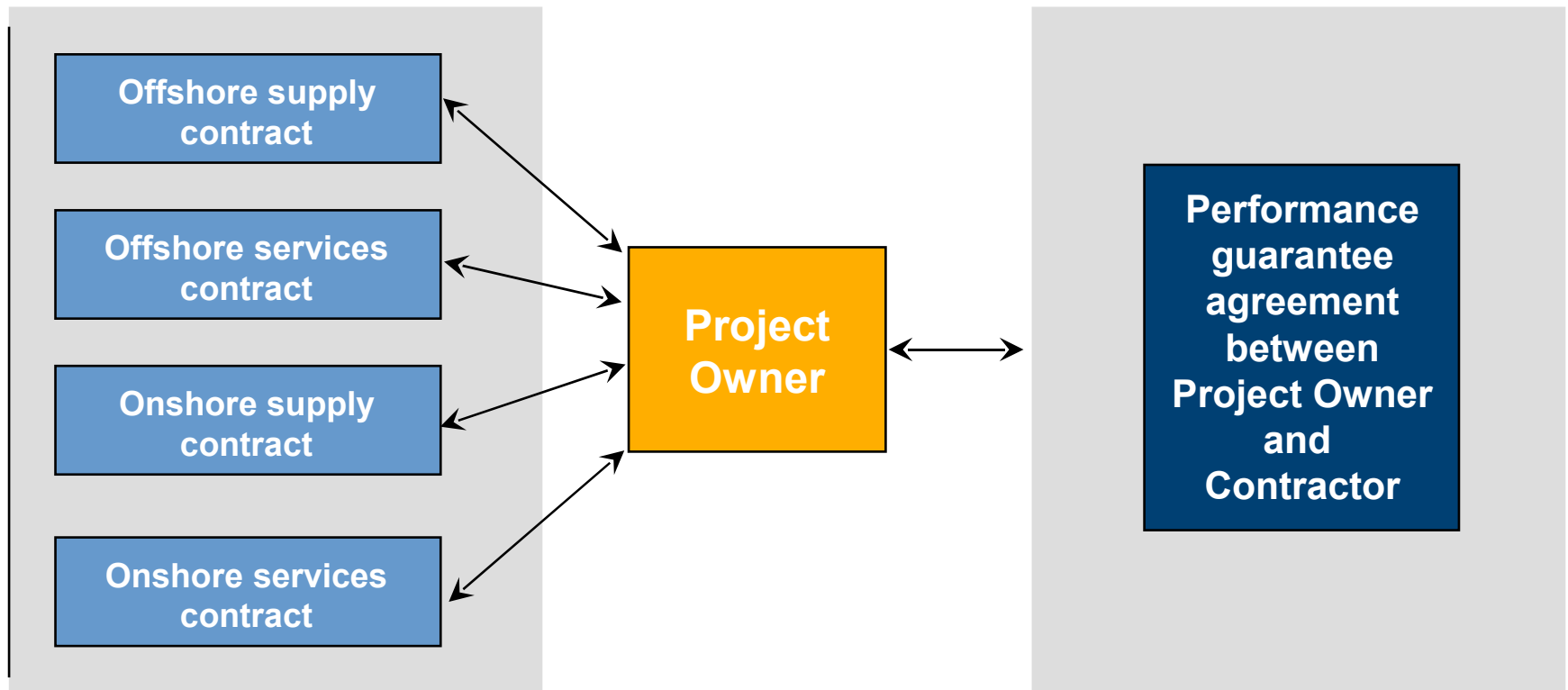
# MULTIPLE CONTRACTS

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- Project Owner may express concern over execution of multiple contracts and will be interested in preserving the turnkey nature of the project
- To address the Project Owner's concerns, a performance guarantee agreement may be executed
- Contractors agree, on a joint and several basis, to guarantee turnkey performance of contract
- Broad features of a Performance Guarantee agreement are as follows:
  - Entire scope of work to be performed by the contractors within prescribed time limits and according to specifications
  - Entire scope of work will be carried on and administered in a co-ordinated manner
  - The guarantors could guarantee the Project Owner against all damages under the main breached contract upto the contract price
  - Guarantors could undertake to put the Project Owner in funds, in the event of payment default by any of the contractor
  - Owner would undertake not to set-off the dues of one contractor against payments due to the non-defaulting contractor

# DIAGRAMATIC REPRESENTATION

Each contractor to execute multiple contracts for different scopes of work with the Project Owner



# EVALUATION OF THE MULTIPLE CONTRACT STRUCTURE

## Offshore supply contract

### *Features*

- Specific price
- Transfer of title outside India
- Payments outside India
- Imports by the owner

### *Implications*

- No income tax
- No sales tax/WCT
- Certain base for customs duty
- No exposure of denial of duty concessions
- No other tax exposure

## Offshore services contract

### *Features*

- Specific price
- Specific description of services
- No local presence
- Payments outside India

### *Implications*

- Certain nature and base for income tax
- Greater flexibility in firming up tax position under service tax
- Flexibility of treaty structuring
- No other tax exposure

# EVALUATION OF THE MULTIPLE CONTRACT STRUCTURE

## Onshore supply contract

### *Features*

- Specific price
- For goods only
- Payment anywhere

### *Implications*

- Certain nature and base for income tax
- Ability to adopt in-transit sales with ease, to reduce sale tax costs
- No Service Tax
- No other tax exposure

## Onshore services contract

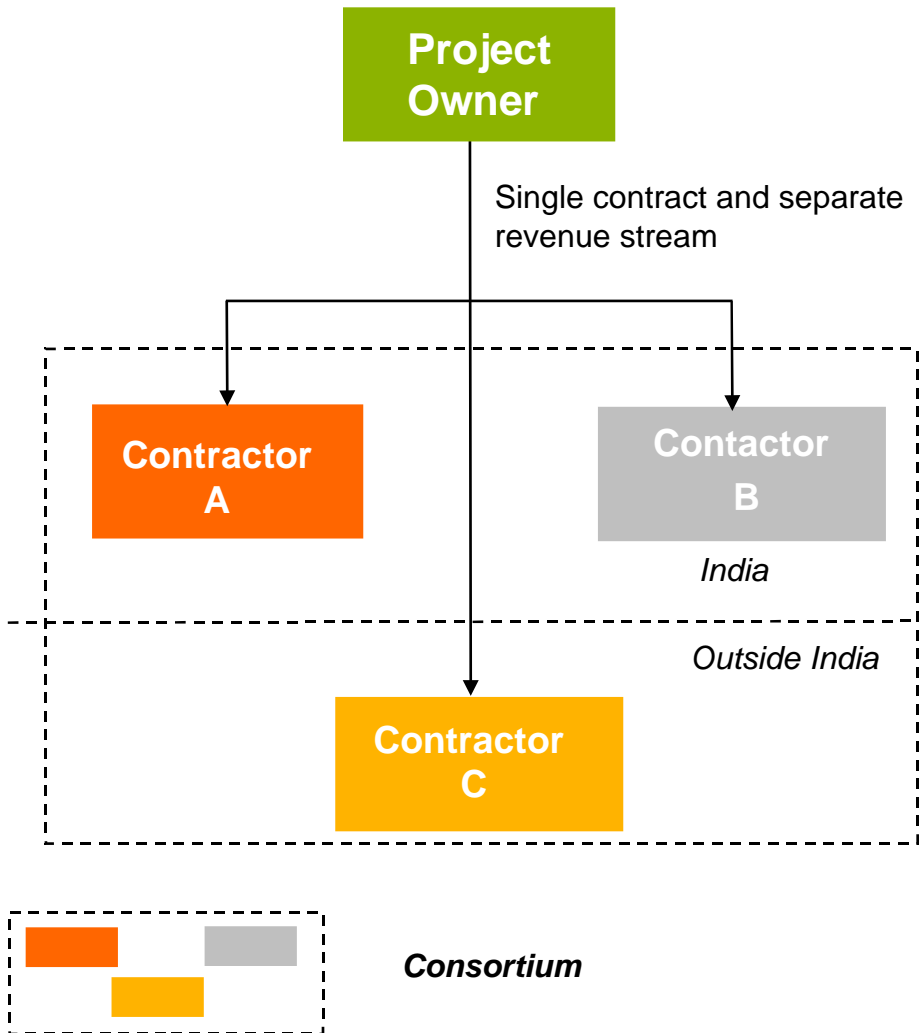
### *Features*

- Specific price
- Specific description of services
- Payment anywhere

### *Implications*

- Certain nature and base for income tax
- Certain Service Tax implications
- No sales tax/works contract tax
- No other tax

# CONSORTIUM MODEL



## Mechanics

- Contractors to bid for the tender in consortium with other participants
- The Project Owner to enter into a single contract with the consortium
- The scope of work as well as the corresponding fees for each of the consortium members would be clearly identified

# CONSORTIUM MODEL (CONT)

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## Income tax implications

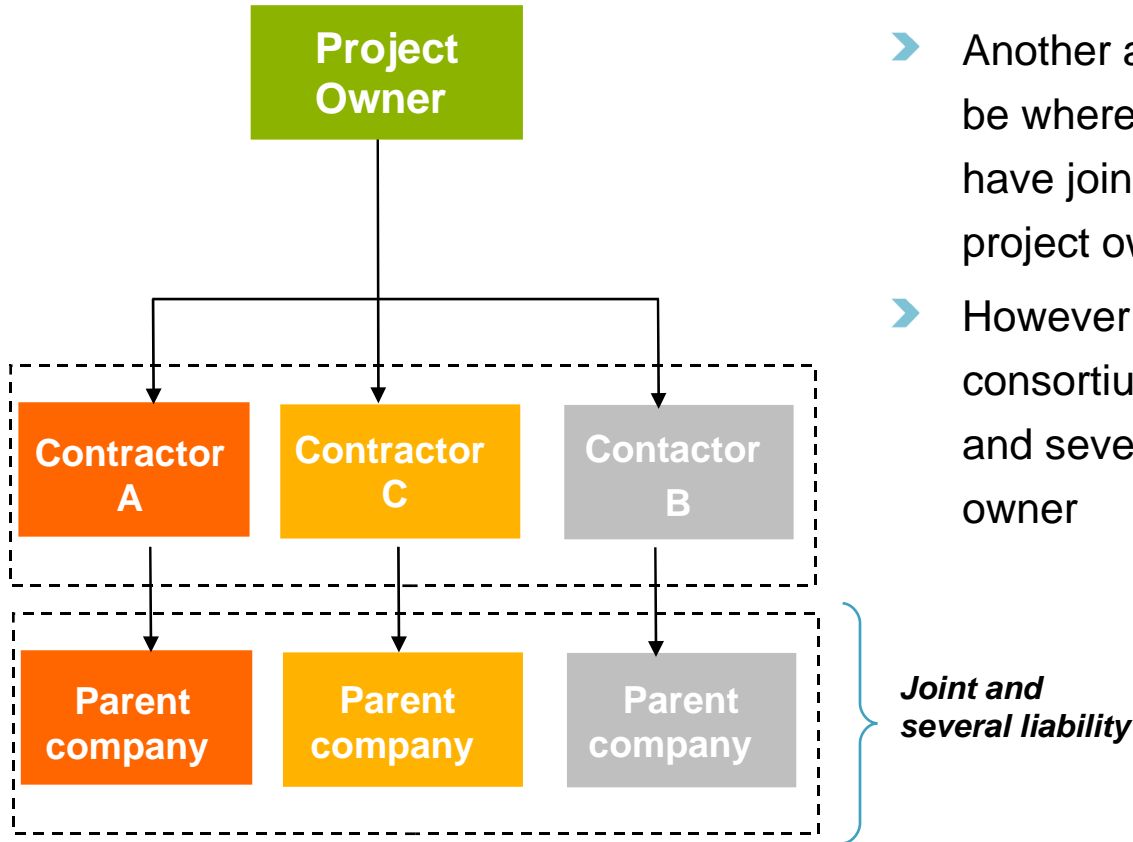
- Likely exposure that consortium could constitute an AOP for tax purpose
- Following safeguards could be built in the consortium model to mitigate the AOP exposure:
  - Separate scope of work
  - Independent payment stream for stand alone contract
  - Several liability for the consortium members

## Indirect tax implications

- Under Indirect taxes, each of the members of the consortium can be considered as independent contractors
- Thus taxability of the consortium members would depend on the specific scope performed by them. Largely similar to that applicable in the case of multiple contracts

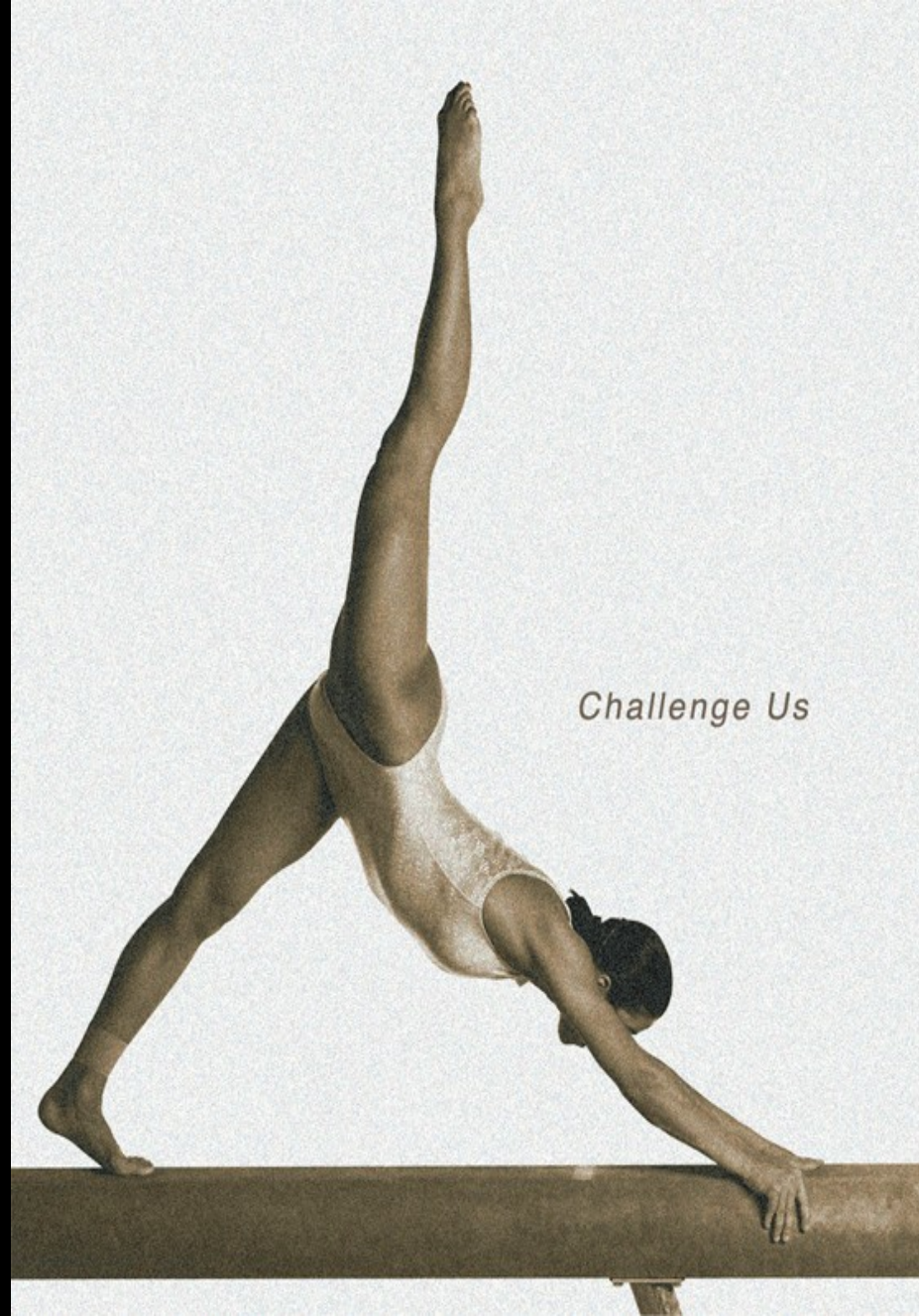
# CONSORTIUM MODEL (CONT)

## Alternate consortium model



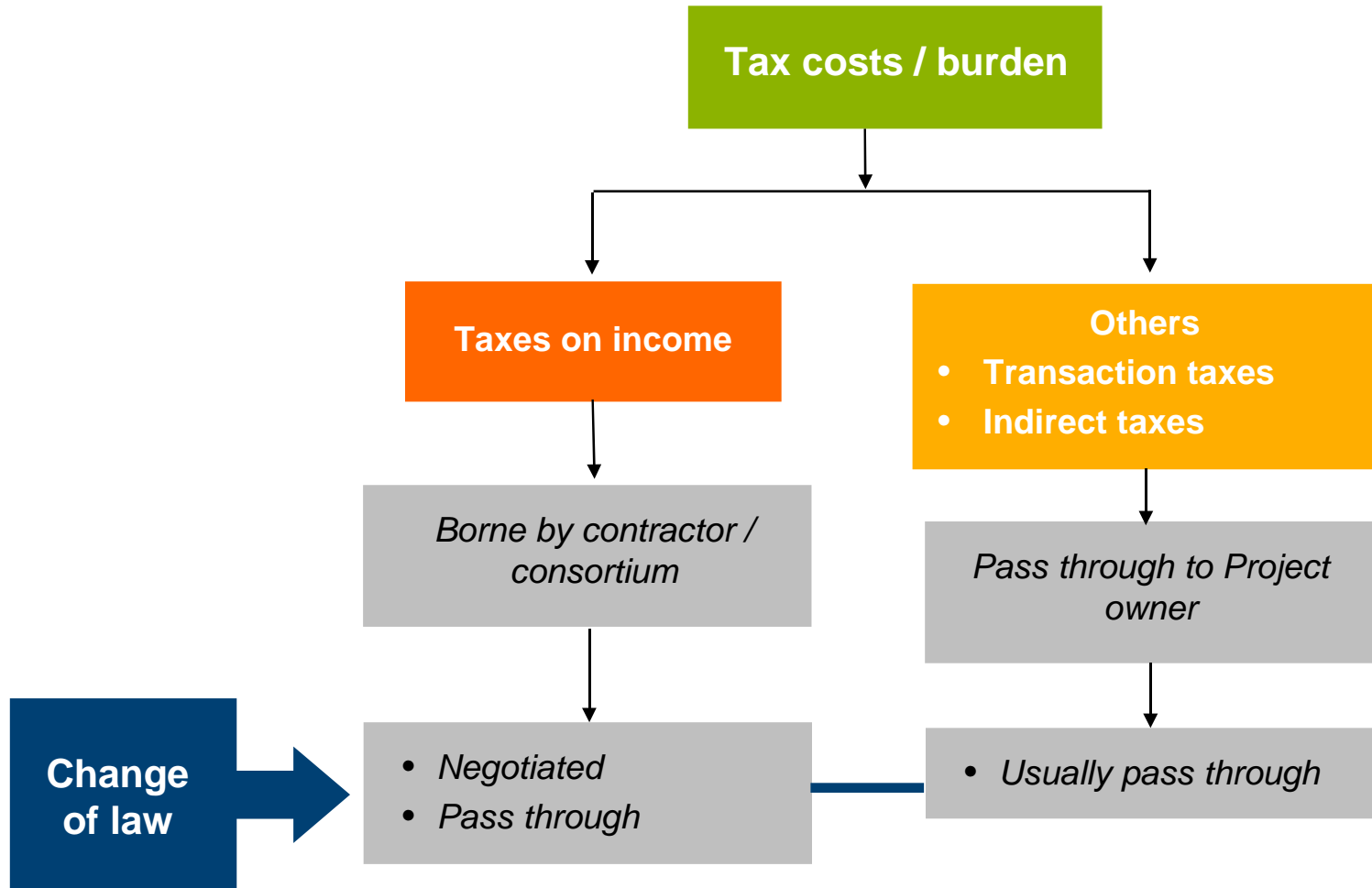
- Another alternate consortium model could be where the consortium partner does not have joint and several liability vis-à-vis the project owner
- However, the respective parent of the consortium members agree to bear the joint and several liability vis-à-vis the project owner

**CHANGE OF LAW,  
TAX CLAUSES &  
TAX REIMBURSEMENTS**

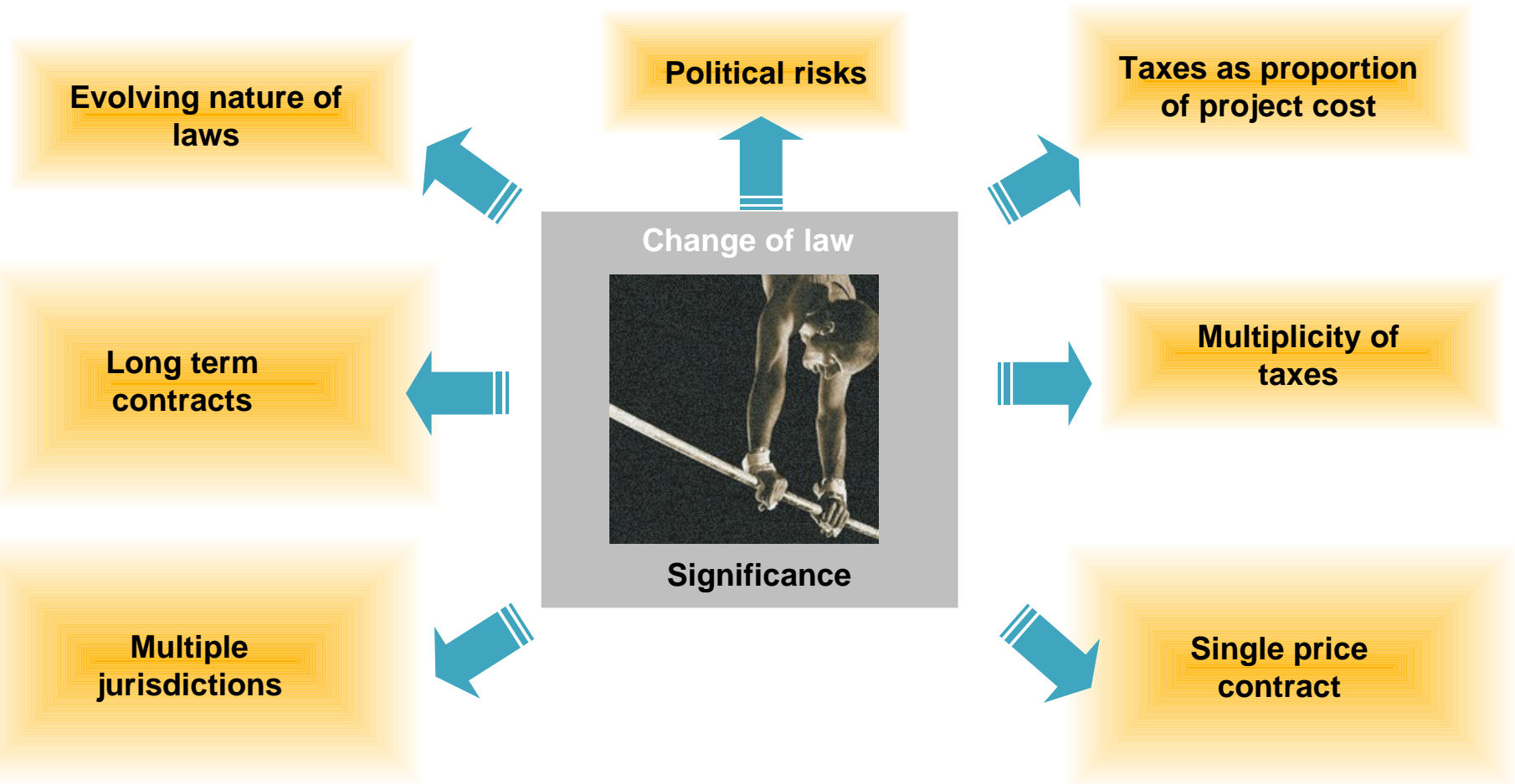


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# TAX COSTS – HOW THEY STACK UP



# CHANGE OF LAW



# TAX CLAUSES

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## Significance

- Certainty of tax outcomes / costs
- Arbitration
- Inefficiencies
- Respective rights and obligations
- Communication with Revenue authorities

## Key features

- Pass through
- Grossing-up
- Jurisdictions
- Tax withholding – certificates, information, documentation

# TAX REIMBURSEMENTS

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## Key features

- Reimbursements on actuals
- Gross basis
- Sub-contract ?
- Tax refund – mechanism of payments, unjust enrichment



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