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Tax and Regulatory

# EPC CONTRACTS IN INDIA – Direct taxes



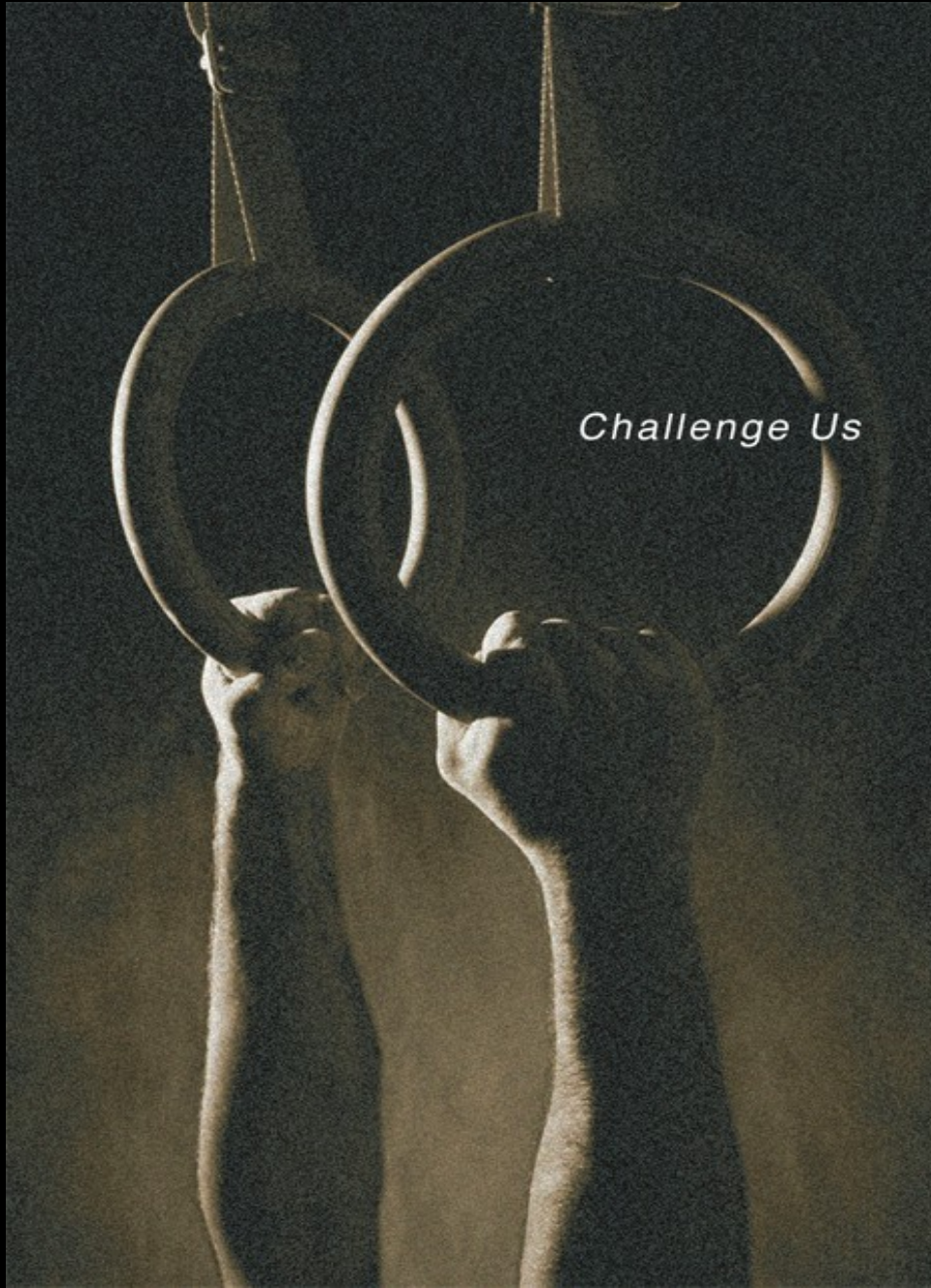
**Conference on**

**EPC Contracts Tax & Legal Imperatives**

18 -19 May 2007 | Hotel Imperial | Janpath | New Delhi | India

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# TAXES ON CONTRACTS – A SNAPSHOT



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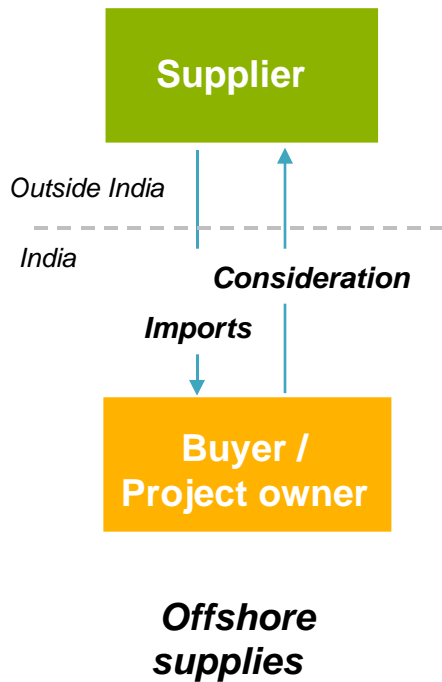
- Whole gamut of taxes, both direct and indirect applicable to contracts
- Contracts may be for supply / sale of goods, installation, services, works contract, engineering, designing, or combination of the above
- Some of the major taxes both at the central and the state level include:

Central taxes / levies	State taxes / levies
Income Tax	Local Sales Tax / VAT
Custom Duty	Entry Tax
Central Excise Duty	Octroi
Service Tax	<del>State Excise</del>
Works Contract Tax	Local Area Development Tax
Central Sales Tax	<del>Stamp Duty</del>
R&D cess	<del>Land Revenue</del>
<del>Stamp Duty</del>	<del>Luxury Tax</del>

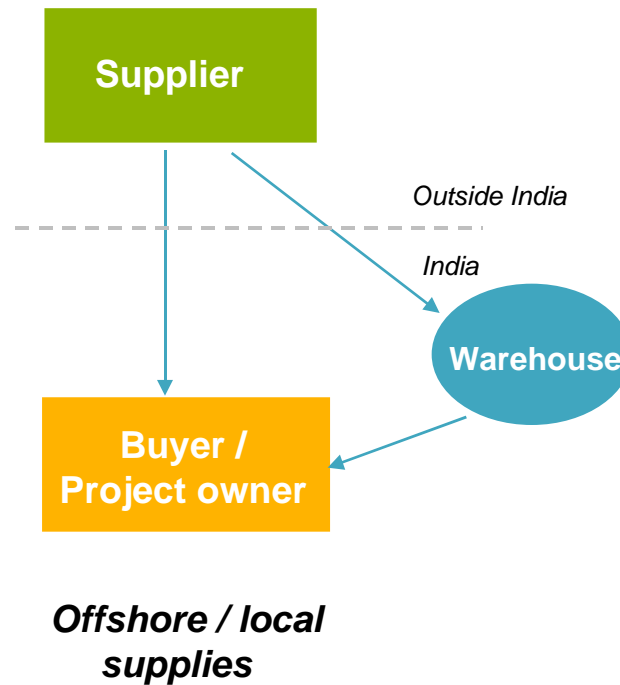
*Interplay of some of the major taxes in some typical contracts follows...*

# SUPPLY OF GOODS

## Structure 1



## Structure 2



## Mechanics

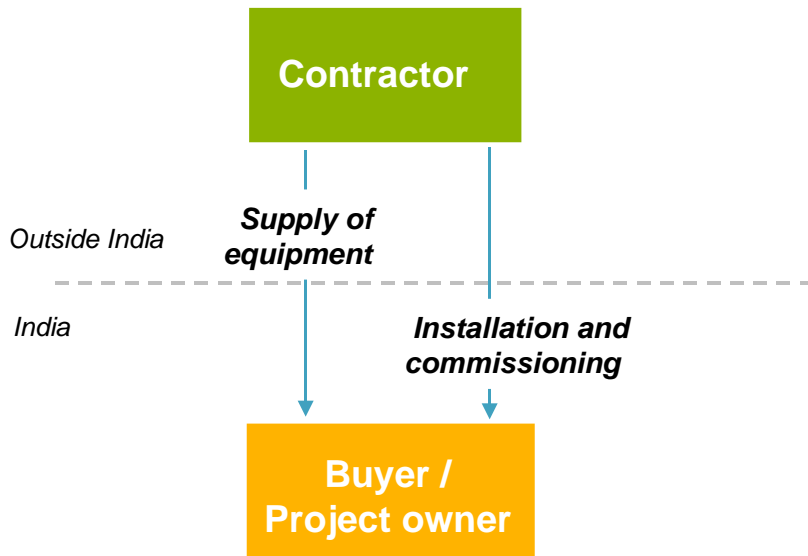
- Sale of goods by Supplier to Project Owner
- Direct imports (Structure 1) or through local warehouse (Structure 2)

## Tax outcomes

Income tax

Circular 23

# COMPOSITE SUPPLY AND INSTALLATION



## Mechanics

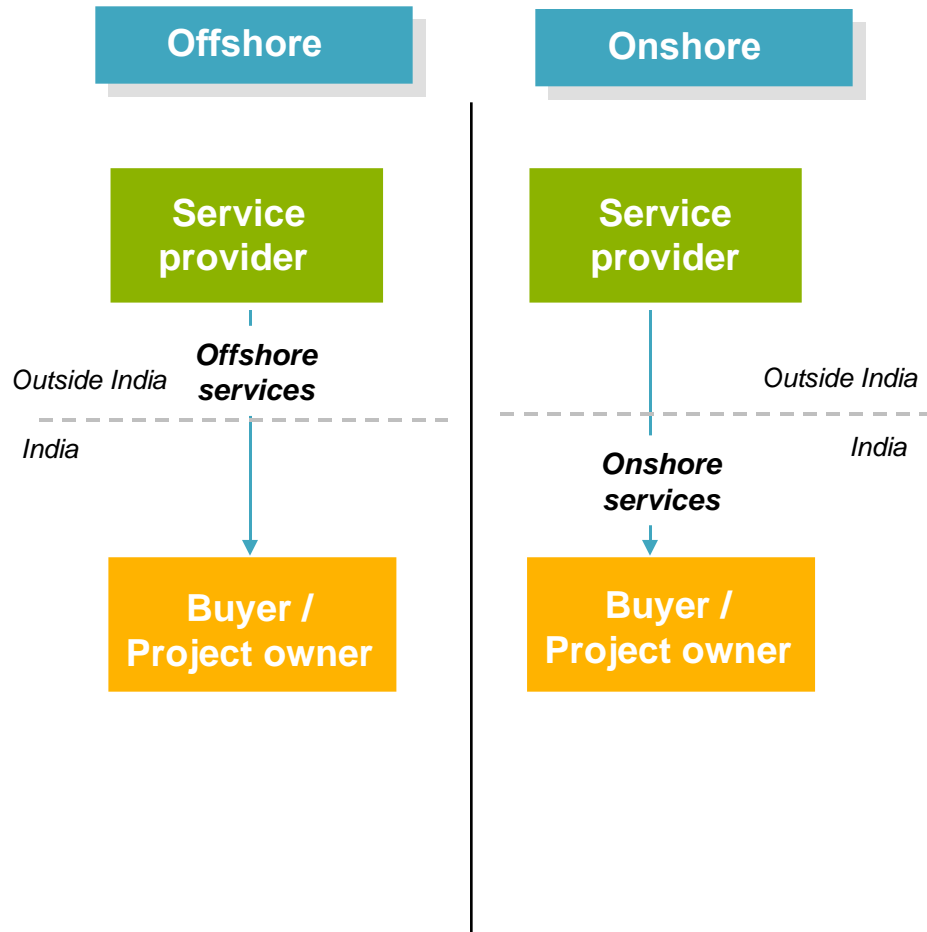
- Composite contract for supply of goods and installation / commissioning

## Income tax

- Installation - PE exposure
- Attribution of profits to PE
- Risk to offshore supplies
- No PE – FTS / no tax

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# SERVICES



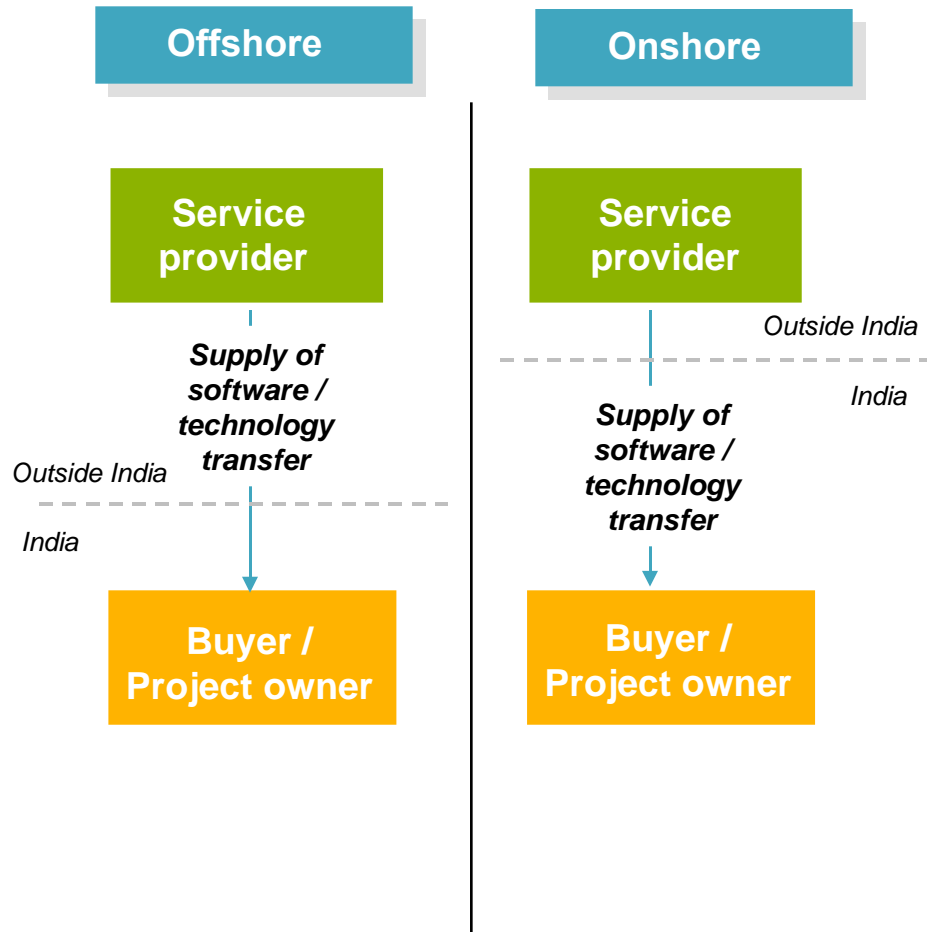
## Mechanics

- Contract for services
- Services may be offshore or onshore

## Income tax

- Fee for Technical Services
- “Make-available” and “Technical drawings”
- Withholding taxes
- PE exposure – **service / fixed place PE**
- Work vs service 
- Attribution of profits to PE

# SOFTWARE / TECHNOLOGY TRANSFER



## Mechanics

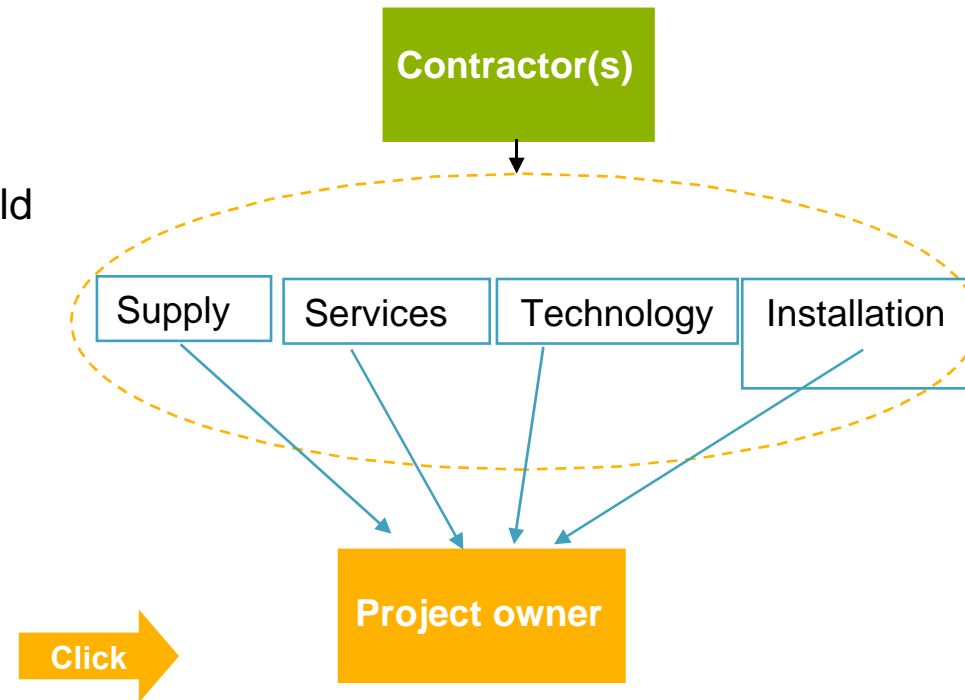
- Sale of software
- Transfer of technology

## Income tax

- Supply of software – royalty or sale of goods
- Recent rulings on software taxability [Click](#)
- Technology transfer - royalty

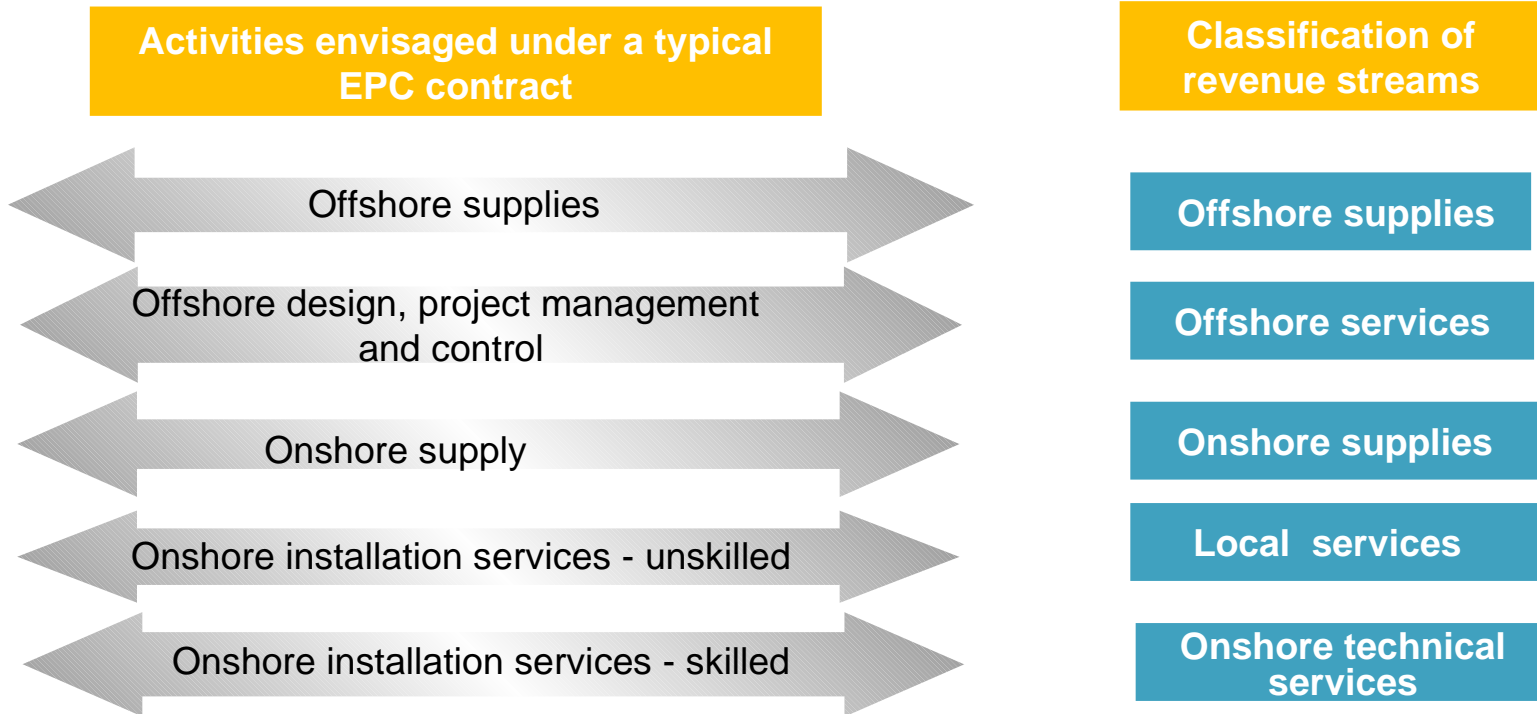
# COMPOSITE CONTRACT - EPC

- Where all the above scopes present in a single project, typically referred to as an **EPC contract**
- The outcomes discussed above would hold so long as:
  - Scopes of work clearly and distinctly defined
  - Separate consideration for each scope of work
  - Contractors individually liable for their scope
  - Wrap-around agreement for co-ordination
- AOP exposure for multi-party contractors












*Activity break-up of a typical EPC contract and broad tax outcomes follow...*

# EPC - ACTIVITIES AND REVENUE STREAMS



# INCOME TAX IMPLICATIONS

Classification of Revenue streams	No PE in India (eg short term contract)	PE in India	Broad Taxability
Offshore supplies		?	Not taxable (supply not connected to PE)
Offshore services			Taxable on gross basis* (however, if PE is established in India, taxable on net basis at the rate of 42.23%)
Onshore supplies			Taxable at 42.23 % on net income basis
Onshore technical services			Taxable on gross basis* (however, if PE is established in India, taxable on net basis at the rate of 42.23%)
Local services			Taxable at 42.23% on net income basis

\* If the payment for offshore services classify as 'Fee for technical services' and PE is not constituted, such payments would be liable to tax at the rate of 10.56% or the rate under DTA between India and the country of foreign company, whichever is lower

# INDIRECT TAX IMPLICATIONS

## Classification of Revenue streams

Offshore supplies

Offshore services

Onshore supply

Onshore technical services

Local services

## Indirect tax implications

- Custom duty on imports leviable – Project Imports
- Design fees relatable to imported equipment would be added to the total value of equipment for custom' s valuation

- Service tax net & recent amendments
- R&D Cess leviable on import of designs - are they foreign collaborations?

- Sales tax leviable on procurement
- VAT/CST chargeable on supply leg
- Excise duty cost on procurement leg – Cenvat credit can pass to Owner

- Service tax leviable
- R&D Cess if deputation from abroad – are they foreign collaborations?

- Levy of WCT/VAT if contract involves transfer of property in goods
- Service tax
- Cenvat if on-site activities tantamount to manufacture

# SINGLE CONTRACT – SINGLE CONSIDERATION

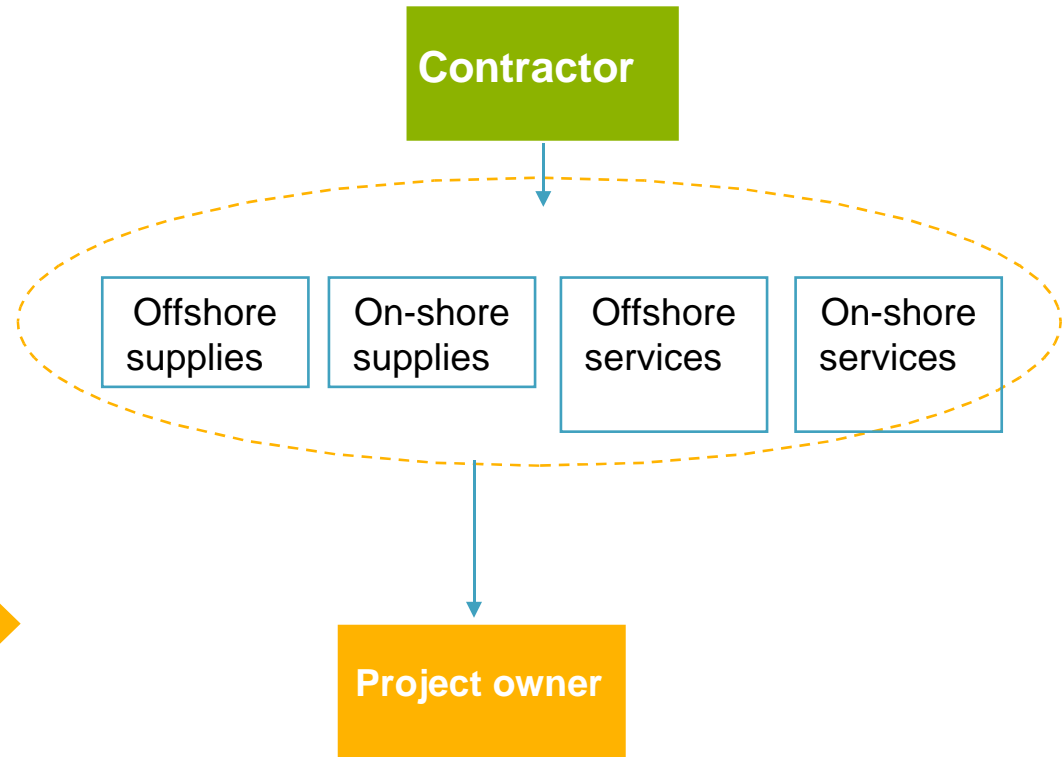
## ➤ Features

- Single contract
- Consolidated consideration
- Single point responsibility / liability

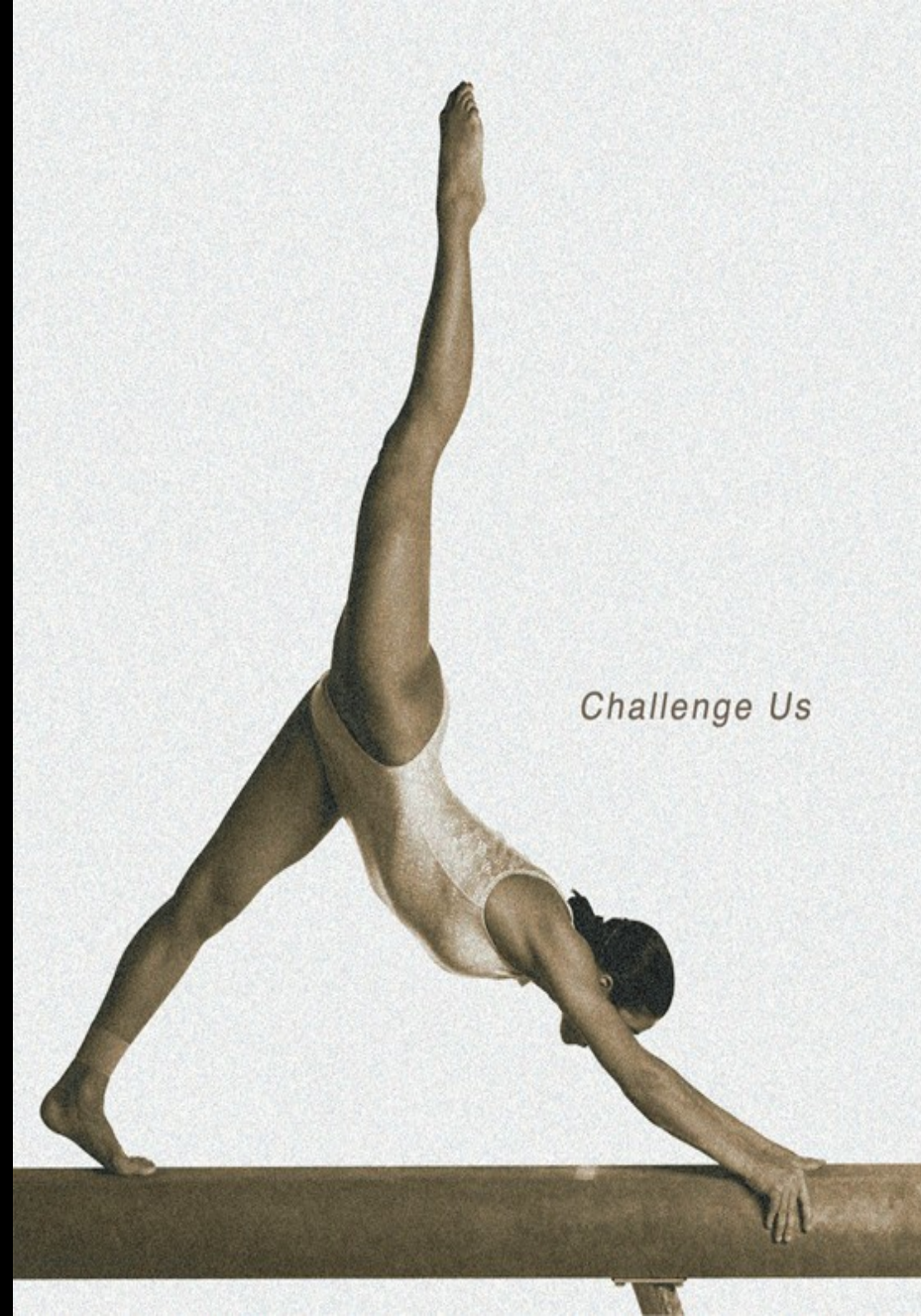
## ➤ Outcomes

- PE exposure
- Attribution of profits to PE
- Taxability of offshore supplies
- Tax inefficiencies

IHI Ruling



# EPC CONTRACTS FOR OILFIELD SERVICES



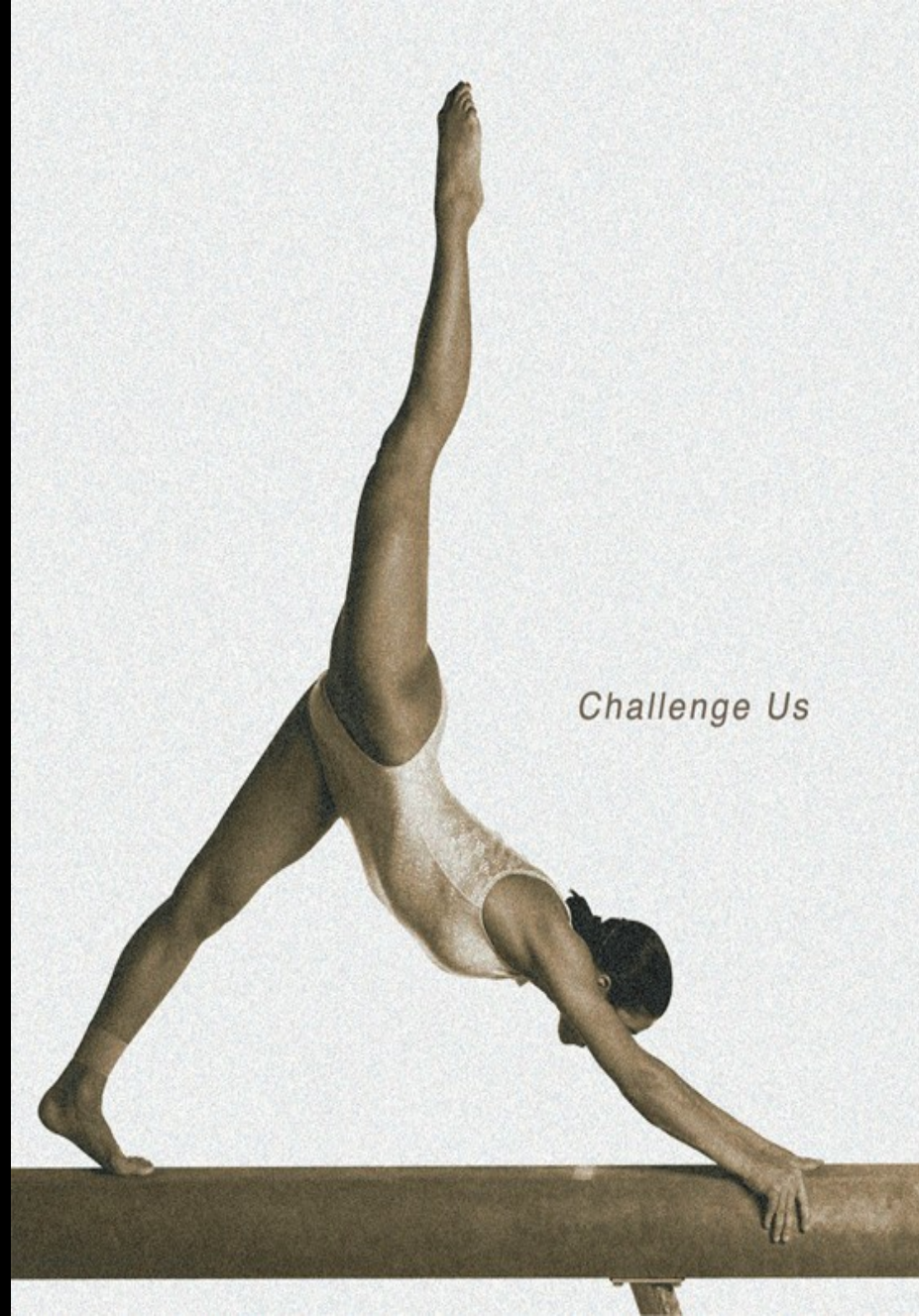
# EPC CONTRACTS FOR OIL FIELD SERVICES

- Income of non-resident oil field service contractors are taxable under section 44BB of the Income tax Act, 1961
- **10 percent** of the gross contract revenue of oil field service contractor deemed as the taxable business income
- Payments for onshore supplies will be liable to tax under section 44BB

## **CBDT Instruction No 1767**

- Relaxed the ambit of taxation under section 44BB of the Act
- Where the sale takes place outside India the taxable profits is:
  - Only **Ten percent** of the gross receipts in respect of services performed in India
- Where the sale takes place in India the taxable profits is:
  - **Ten percent** of the gross receipts in respect of services performed in India, and
  - **One percent** of the gross receipt in respect of all activities performed outside India

# EPC CONTRACTS FOR POWER PROJECTS



*Challenge Us*

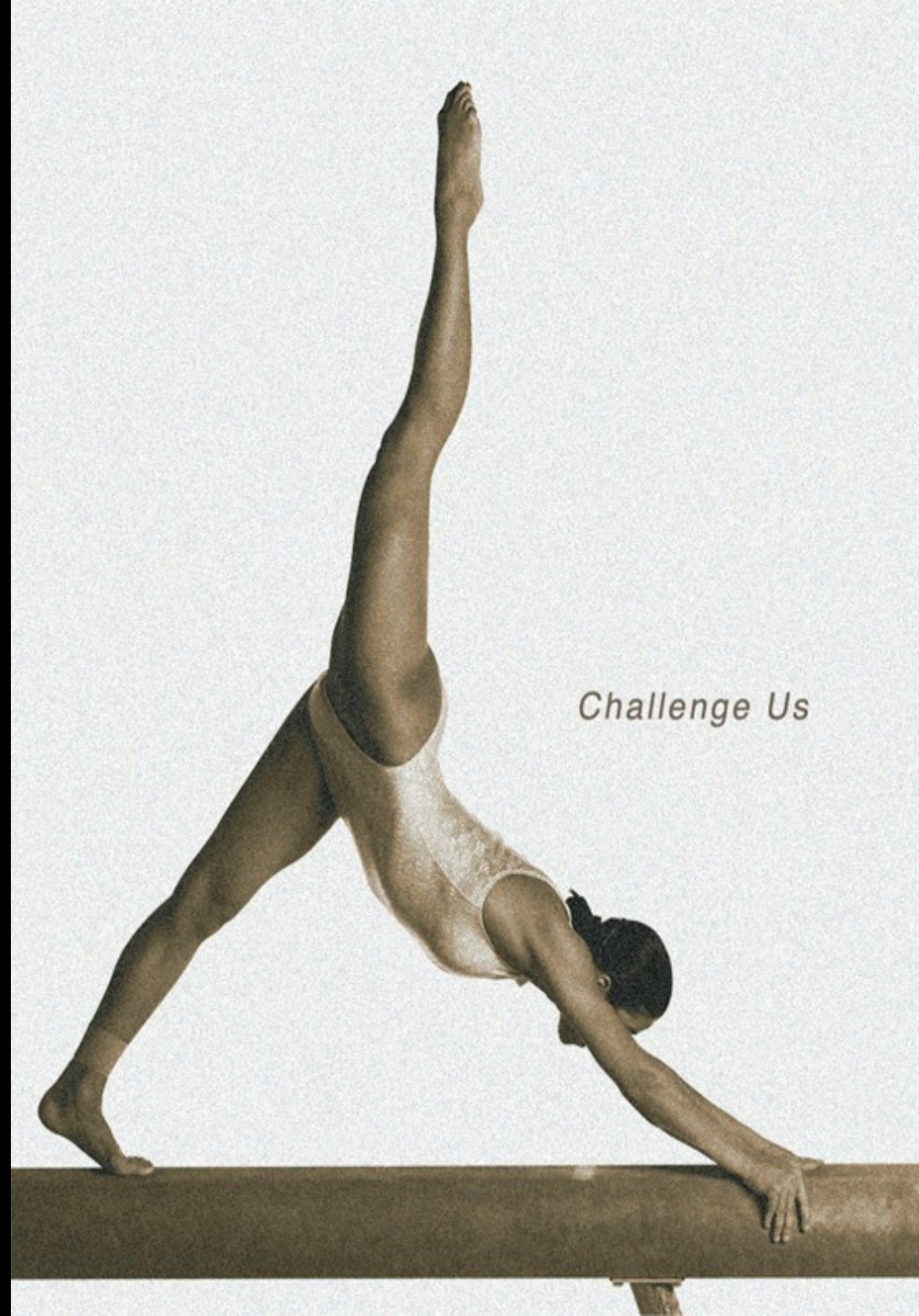
# EPC CONTRACTS FOR POWER PROJECTS

- In case of a foreign company engaged in the business of civil construction or turnkey power project approved by Central Government, **10 percent** of the gross receipts under the contract is deemed as taxable profits
- **Instruction No 1829** - Guidelines to ensure AOP not constituted

*“Apart from the separate contracts from the jobs mentioned in Para 4 above, there would be an **overall co-ordination agreement** between the public sector company on the one hand and the foreign contracting parties referred to in Paragraph 4 on the other hand to ensure guaranteed performance of all the contracts in a coordinated manner..”*



*“...Nothing contained in the overall agreement will be intended to create a joint venture or partnership or **association of persons** between the contracting parties. The Indian concern will not be making any payments whatsoever to any foreign company under this overall agreement.”*

# INFRASTRUCTURE STATUS TO PIPELINES



*Challenge Us*

# INFRASTRUCTURE STATUS TO PIPELINES

- Tax holiday benefits extended to undertakings “**carrying on the business of laying and operating a cross-country natural gas distribution network, including pipelines and storage facilities being an integral part of such network**” 
- Deduction available:
  - 100 percent of the profits for a period of 10 consecutive years out of 15 years beginning from the year the undertaking lays and begins to operate distribution network
- Eligibility conditions:
  - Undertaking should be owned by a company registered in India; or by a consortium of such companies; or by an authority or a board or a corporation established or constituted under any Central or State Act;
  - It has been approved by the Petroleum and Natural Gas Regulatory Board
  - 1/3 of the undertaking’s total pipeline capacity to be available for use on common carrier basis by person other than the assessee or an “associated person” 
  - The undertaking has started or starts operation on or after 1<sup>st</sup> April, 2007; and
  - Any other condition which may be prescribed from time to time



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# TAXABILITY OF OFFSHORE SUPPLIES

## Circular 23 of 1969

- Taxability of offshore supplies one of the most debated issue
- CBDT sought to end the debate by issuing Circular 23
- As per circular, income from **offshore supplies** can be claimed tax exempt provided:
  - **Transfer of title** (ie risk and ownership) in the equipment and materials passes to buyer outside India
  - Entire **sale consideration** is received outside India by the seller
  - Sale is at **arms length**
  - Contract for supply of equipment is **executed** outside India
- Critical to build safeguards in **contract documentation**
- Revenue authorities taking contrary view in some cases



# INSTALLATION PE – SOME EXAMPLES

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## ➤ Installation PE under India – France treaty

*“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”*

*“an installation or structure used for the exploration of natural resources provided that the activities continue for more than 183 days”*

## • Installation PE under India – UK treaty

*“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 of the 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 or equipment”*



# WORK VS SERVICE

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Based on circulars and judicial precedents, following principles emerge:

- The rendering of a service is different from carrying out a work
- The two words “**work**” and “**service**” convey different ideas:
  - In the former, the activity is predominantly **physical** and **tangible**. Certainly, “work” also involves intellectual exercise, to some extent. But the physical (tangible) aspect is more dominant than the intellectual aspect
  - In “services”, the dominant feature of the activity is **intellectual**, or at least, mental



# TAXABILITY OF SOFTWARE

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## Recent rulings

### Samsung Electronics Co Ltd

- Revenue authorities contending supply of shrink-wrap software liable to tax as royalty
- Bangalore Tribunal held supply of shrink wrap software not taxable provided conditions of circular 23 satisfied
- Transaction to be treated as outright sale of goods and not 'royalty'

### Ericsson, Motorola, Nokia

- Issue was whether payment made for software embedded in hardware constitutes 'Royalty'
- Special bench relied on the judgment of Supreme Court in case of Tata Consultancy Services wherein it was held that sale of software is sale of 'goods'



# AOP EXPOSURE

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- Business imperatives and project owner's concerns for successful execution of the project may require a single consolidated contract for the entire work and a lumpsum price
- This may require contractors to bid in a consortium for the entire scope of work instead of entering into contracts for each component of EPC contract on stand-alone basis
- Consortium – AOP exposure
- Tax inefficiencies in AOP taxation

# TAXABILITY OF AOP

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- Separate taxable entity
- 'AOP' not defined
- Based on various judicial precedents, following characteristics of an AOP can be identified:
  - Common scope of work
  - Joint and several liability
  - Common stream of payment
  - Joint venture for profit
- Condition of '**joint venture for profit**' has been diluted
- The above are only indicative and not sacrosanct determinant

# TAXABILITY OF AOP (CONT)

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## Taxable income

- Net basis of taxation

## Tax depreciation

- A deduction is allowed to the assessee in respect of depreciation in respect of owned (wholly or partly) assets
- In case, the assets used in the project are owned by one of the consortium members, claim tax depreciation by the consortium may create issues

# TAXABILITY OF AOP (CONT)

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## Tax rate

- If the revenue / profit shares of AOP participants is determinate, each member's share in AOP income subject to tax at the respective rate applicable to the member
- If the shares revenue / profit shares of AOP participants is indeterminate, the entire revenues of the AOP will be subject to tax at the highest tax rate applicable to any of the members

## Specific disallowance of certain expenditure

- Bonus, commission, interest, salary, remuneration etc paid to member is not deductible
- However, if AOP member also pays interest to the AOP, only net amount of interest paid to members is not allowed as deduction in computing taxable income of AOP

**In view of the above inefficiencies of an AOP constitution, it will be imperative that the EPC contract be appropriately structured**



# IHI RULING

## Facts

- Applicant, a Japanese company entered into a turnkey contract
- Scope of work included development, design, engineering, procurement of equipment / materials for erection, construction, commissioning of LNG storage tanks
- Scope of work under the contract included offshore supply and offshore services
- Title to goods for offshore supply transferred outside India

## Issue

- Whether amounts received / receivable for offshore supply would be taxable in India

## Held

- Only such part of the income as is attributable to the operations carried out in India can be taxed in India
- The fact that the contract was signed in India is of no material consequence
- As all activities in connection with the offshore supply were outside India, income cannot be deemed to accrue or arise in the country

 Back

# INFRASTRUCTURE STATUS TO PIPELINES

- For the purposes of this clause, an “**associated person**” in relation to an assessee means a person (Budget 2007-08)
  - a. who participates directly or indirectly or through one or more intermediaries in the management or control or capital of the assessee;
  - b. who holds directly or indirectly, shares carrying not less than twenty six percent of the voting power in the assessee;
  - c. Who appoints more than half of the Board of directors or members of the governing board, or one or more executive directors or executive members of the governing board of the assessee; or
  - d. Who guarantees not less than ten percent of the total borrowings of the assessee
- “**Cross-country natural gas distribution network**” not defined under Income tax Act
- P&NGRB Act defines “**city or local natural gas distribution network**”
  - as an inter-connected network of gas pipelines and the associated equipment used for transporting natural gas from a bulk supply high pressure transmission main to the medium pressure distribution grid and subsequently to the service pipes supplying natural gas to domestic, industrial or commercial premises and CNG stations situated in a specified geographical area

