Tax - Heads Up

16 May 2014

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Centrica India Offshore Pvt. Ltd. (Delhi HC)
Writ Petition No. 6807 of 2012

Context: With globalization, India has witnessed a significant increase in secondment of employees from global parent. For the sake of convenience, salary to such employees is continued to be paid by the entity outside India and thereafter, the same is reimbursed by the Indian entity. These reimbursements have been a matter of extensive debate with Indian tax authorities. While such payments have often been classified as FTS, the AAR had in the case of this Taxpayer held earliier that it would also form a Service PE in India, of the global entity.

In the instant case, Centrica UK and Centrica Canada (or "overseas entities") had outsourced their back office support to Indian vendors. Centrica India Offshore Pvt. Ltd. (CIOPL) was formed to act as an interface between the Indian vendors and the overseas entities. For this work, CIOPL was reimbursed on full cost plus mark-up of 15%.. To enable CIOPL to fulfill its role, managerial employees were seconded to CIOPL from the overseas entities under a secondment agreement according to which the employees would work under the control and supervision of CIOPL. However, the employees continued to be on the payroll of the overseas entities which used to pay salaries, which was reimbursed at cost by CIOPL.

The AAR,had ruled in past that:

› Payments by CIOPL were not FTS as they were for 'managerial services' which are excluded from the definition of FTS in India-UK DTAA.

› Since the employees of overseas entities were rendering services to CIOPL, it would give rise to Service PE as per the tax treaty with UK and Canada.

Aggrieved by the ruling, CIOPL approached the HC, which held as follows:

A. FTS

› The overseas entities, through the seconded employees, provide 'technical services' to CIOPL, especially since FTS includes provision of services of personnel.

› The seconded employees transmits their technical ability (i.e. knowledge possessed) to regular employees, thereby 'making available' their know-how to CIOPL for future consumption.

› Hence, payments to overseas entities were in the nature of FTS.

B. Service PE

› The overseas entities were the employers, and not CIOPL due to following reasons:

- The right of termination vests with overseas entities and not with CIOPL.
- Obligation to pay salary rested with overseas entities and right of employees to claim the same, is only against overseas entities.
- Employees continued to have lien on their jobs with overseas entities.

› The Court placed reliance on the decision of the Supreme Court in the case of **Morgan Stanley** and OECD commentary on Article 15, to substantiate the existence of Service PE.

› Accordingly, the Court upheld the ruling of AAR as regards the existence of Service PE.

Judicial Updates

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Centrica India Offshore Pvt. Ltd. (Delhi HC)

C. Payments were not reimbursements

- The nomenclature of payments as 'reimbursements' or absence of mark-up thereon, are not determinative factors to decide the nature of transaction.
- The nature of activity undertaken by the seconded employees is such that it cannot be termed as 'stewardship' (as used in the decision of the Supreme Court in the case of **Morgan Stanley**).
- The payments made to overseas entities could not be construed as diversion of income by overriding title. The overseas entities may or may not utilize such payments to discharge their obligations to the seconded employees.

Heads Up's Views:

There is no doubt that the subject decision will encourage the tax authorities to question secondment arrangements entered into by global enterprises. While there are several favorable rulings / decisions which can be relied upon by the Taxpayer as guidance / precedents, the confusion pursuant to this decision is certainly a dampener.

Further, we believe that the concept of 'legal vs. economic employer' has not been discussed in appropriate detail in this ruling. The HC also appears to have missed an important (and settled) aspect that services of the nature of FTS or Royalty are excluded from the definition of Service PE.

As a way forward, this decision creates an immediate need for taxpayers that have entered into secondment arrangements, to review such arrangements, in order to ensure that the clauses pertaining to employment, rights and duties, termination, etc. are appropriately worded / drafted to avoid any unintended interpretations.

Also, such taxpayers may consider making payment of salaries to the seconded personnel directly from the Indian entity (instead of payment by their overseas group companies), especially after relaxation of RBI norms in this regard.

Judicial Updates

Linde AG (Delhi High Court)
Writ Petition No. 3914 OF 2012

Context: It is common for participants in turnkey contracts, to approach the AAR to obtain certainty as regards their taxability. In past, the AAR held in several such cases that any such part of an EPC contract (particularly, 'Offshore Supplies' which generally constitute the most significant part of the total contract price) that is executed outside India and is not attributable to Indian business activities of these companies, is not taxable in India.

However, in some of its recent rulings, the AAR altered its position and held that due to the decision of the Supreme Court in the case of **Vodafone International Holdings BV**, its not possible anymore, to divide a single turnkey contract into various parts and determine their taxability separately. Consequently, its recent position has been that EPC arrangments are indivisible contracts and their entire income is taxable in India.

In this case, Linde AG (Germany) and Samsung Engineering Company Ltd. (Korea) formed a Consortium, to bid in response to a tender notice from ONGC Petro Additions Ltd. (OPAL), and thereafter, to enter into a contract with it.

The AAR, in response to an application in this regard, ruled that:

- The Consortium of Linde and Samsung constituted an Association of Persons (AOP); and
- The turnkey contract was an indivisible one. Therefore, income therefrom (including income from offshore supply of equipment, as well as from drawings and designs) was taxable in India.

Aggrieved by the ruling, Linde AG approached the High Court. The Court analyzed the subject issue in detail, and held as follows.

Turnkey Contracts

A. Taxability of the Consortium as an AOP

- The responsibilities of each Consortium member (w.r.t. execution of the contract) were separate and independent.
- Only area of cooperation and management between them, was in respect of sharing of information and material, to enable the other to perform its work.
- Such cooperation is necessary for execution of any project, even where multiple (unrelated) agencies are involved.
- Whether or not consortium members form an AOP, should be determined by the level of association / collaboration agreed between them. Desire of a 3rd party to deal with such members as one consortium cannot be the determinative factor in this regard.
- In light of the above, the Consortium did not constitue an AOP.

B. Taxability of offshore supplies

- Following the decision of the Apex Court in case of **Ishikawajima-Harima Heavy Industries**, the contract cannot be considered a composite one.
- Principle of apportionment of income on the basis of territorial nexus is embodied in the Act.

Judicial Updates

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Linde AG (Delhi High Court)

- Where the equipment and material was manufactured and procured outside India, the income from offshore supply could not be attributable and taxed in India, as the same did not arises through / from a business connection in India.
- The AAR has read the principles applied by the Supreme Court in **Vodafone International Holdings BV** completely out of context.

C. Taxability of offshore services (supply of drawings and designs)

- Taxability of offshore services would depend upon whether or not Linde AG had a PE in India at the time when offshore services were being rendered, which were attributable to the PE – in which case the same would be taxed as Business Profits.
- The AAR had not examined the mixed question of law and fact as regards the stage at which the PE of Linde AG came into existence.
- The Court set aside the matter to the AAR to proceed in accordance with its views (as outlined above) and to decide the issue afresh.

In conclusion, the decision of the High Court brought releief to Linde AG and Samsung.

Heads Up's Views:

While the global infrastructure majors are lining up in India to bid for turnkey contracts, taxation of such contract revenues has remained a pain-point – particularly because of the complex structures of EPC contracts and their high financial stakes.

The persistence of tax authorities in prolonging litigation on these issues, particularly when there already exist several praiseworthy precedents from the Apex Court on the subject matter, is disturbing.

Given that India is nowhere close in infrastructural development, to some of its economic competitors, its important that litigation on these issues be discouraged – in order to instill confidence in the participants in our growth story.

Judicial Updates

Parle Biscuits Private Limited (ITAT Mumbai)
ITA No. 9010/Mum/2010

Context: Applicability of TP provisions to issue of shares by Indian subsidiaries has been a contentious issue in recent past. The Indian Revenue authorities have argued that such a transaction is an international transaction and is subject to examination by the TPO. This case examines the reverse situation wherein an Indian parent invests in overseas subsidiary and there is a time lag in payment and allotment of shares.

In this case, the Taxpayer invested in shares of its overseas subsidiary by remitting share application money to its subsidiary. However, there was a lag in allotment of shares, after the payment of share application money. Consequently, for the period of delay, the TPO treated the share application money as loan by the Taxpayer to its subsidiary and added imputed interest on the same to the income of the Taxpayer. The DRP in its decision went ahead with the approach of the TPO but reduced the rate for imputing interest income.

The ITAT, on an appeal by the Taxpayer, relied on decision of the Delhi bench of the ITAT in the case of **Bharati Airtel Limited** and concurred with the view that there is no deeming fiction in Transfer Pricing regulations which allows the TPO to treat share application money as loan on account of delay in allotment of shares and impute interest thereon. Consequently, the ITAT held that the approach adopted by the TPO was wrong and no interest can be imputed on share application money due to delay in allotment.

The ITAT also held that since the TPO had not brought on record anything to show that an unrelated share applicant was to be paid any interest for period of delay in allotment, the very basis of making addition was not legally sustainable.

Heads Up's Views:

The decision emphasizes the imperative principle that Revenue cannot presume benefits being provided to a related party, where none exist. The Tribunal has laid down a precedent that may serve as a reminder to TP authorities that making addition on transactions of capital nature without giving any adequate rationale will not stand scrutiny of higher appellate authorities.

Judicial Updates

Kone Elevators India Pvt Ltd
(SC Constitutional Bench)

Context: In a significant judgement delivered on 6 May 2014, the Constitution Bench (5 Member Bench) of the Apex Court has held that a contract for the erection, installation and commissioning of Lifts is a 'Works Contract' and not a 'Contract of Sale'. In case of a sale of goods contract, the entire sale consideration attract sales or value added tax, while in a works contract, no sales or value added tax would be charged on the 'service element' i.e. the labour and other costs in installing the lift.

The Constitution Bench of the SC heard the writ petitions in great detail in the month of January, 2014 and held that the contract of erection and commissioning of lifts / elevators is works contracts; and after the 46th Constitutional Amendment, VAT / Sales Tax can be levied only on the goods component involved in execution of such contracts and not on the total value of the contract.

The decision has come as a great relief to the elevator industry as significant demands were raised by the State Tax Department on the entire contract value without allowing deduction of the service element on which Service Tax had already been paid to the Central Government, leading to double taxation.

The decision is also of importance to other industries generally in as much as the decision lay down the fundamental principle for the determination of a contract as works contract and consequently the liability of the companies to Sales Tax under the State value added tax legislations under the Works Contract category.

Heads Up's Views:

This judgment distinguishes the earlier judgment passed in the case of Kone Elevators in 2005, and It will impact all kind of ‘works contracts’. This decision will play a vital role to resolve a large number of cases, that were pending on similar lines.

Judicial Updates

M/s Hero Motors Ltd. (Delhi CESTAT)
2014-TIOL-574

Context: It has been generally observed that the tax authorities often make taxpayers submit undertakings whereby the taxpayer has to forgo its statutory rights. Such undertakings are generally taken under duress of granting of refund, clearance of imports / exports, etc. The question which came before the Tribunal in this case, was whether principle of estoppel shall apply in such cases i.e. whether or not the taxpayer should be allowed to go against his undertaking.

In the instant case the Taxpayer claimed refund of accumulated credit under Rule 5 of the Cenvat credit rules and interest for delayed payment of refund. The Taxpayer gave an undertaking to the adjudication authority that it would not claim any interest on such credit for the period of delay in sanction of the refund claims. However, after getting the refund, the taxpayer claimed such interest in the course of the appeallate proceedings. The Revenue denied such claim on the basis of the undertaking given by the taxpayer in past.

The CESTAT observed that:

- The Revenue sought to deny the interest on the basis of the undertaking given to the Jurisdictional AO and held that such decision of the Commissioner (Appeals) was absolutely incorrect and contrary to the Law laid down by the Apex Court in the case of **Dunlop India Ltd.** and **Madras Rubber Factory Vs. UoI** wherein the Apex Court had held that there is no estoppel in law against an assessee in taxation matters.
- The CESTAT further observed that the Apex Court in case of **UoI Vs. Madhumilan Syntex Ltd.** has held that right conferred under the statute cannot be given up on the basis of concession made by any party.

- The ratio of the above judgments of the Apex Court are squarely applicable to the facts of this case.
- Just because the Taxpayer, by way of certain letters addressed to the Jurisdictional AO, had given up its claim for interest on the amount of refund for the period of delay in sanction of the refund claims – there would not be any estoppel against him, to debar him from challenging the denial of interest and claiming the same, when he is entitled for the same under the express provisions of the statute.

Heads Up's Views:

This decision is a dent on the regular practice of the tax officers to avoid payment of interest to taxpayers. The rights of taxpayers cannot be frustrated by forcibly obtaining such undertakings.

Further, such an attitude of the Revenue is leading to frivolous and unnecessary litigation wasting the precious time of taxpayers and the Courts, which could have been used for more productive pursuits.

Other Updates

RBI revises norms for rescheduling ECBs

The RBI has recently revised the norms for rescheduling of ECBs and has allowed one-time rescheduling for the same. The authority to approve any changes / modifications in the drawdown / repayment schedule of the ECBs already availed (both under approval and automatic routes) has been delegated to ADs, where such re-schedulement is due to changes in draw-down schedule and / or repayment schedule.

This is subject to the following conditions:

- Changes, if any, in all-in-cost (AIC) is only on account of the change in average maturity period (AMP) due to re-schedulement of ECB and post re-schedulement, the AIC and the AMP are in conformity with applicable guidelines. There should not be any increase in the rate of interest and no additional cost (in foreign currency/Indian Rupees) should be involved.
- The re-schedulement is allowed only once, before the maturity of the ECB.
- If the lender is an overseas branch of a domestic bank, the prudential norms applicable on account of re-schedulement should be complied with.
- The changes on account of re-schedulement should be reported to DSIM.
- The ECB should be in compliance with all applicable guidelines related to eligible borrower, recognised lender, AIC, AMP, end-uses, etc.
- The borrower should not be in the default / caution list of RBI and should not be under the investigation of Directorate of Enforcement.

Heads Up – Who are we

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Heads-up : hedzʌp / hedz-uhp / [Business English];

n. a short statement giving information on how a situation is developing; a piece of advice about something so that you are prepared for it.

adj. alert; perceptive; resourceful; quick to grasp a situation.

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Standard Abbreviations

AAR	Authority for Advance Rulings
AD	Authorized Dealers
AY	Assessment Year
AOP	Association of Persons
AO / Tax Officer	Assessing Officer
BAS	Business Auxiliary Service
BPO	Business Process Outsourcing
CESTAT/ Tribunal	Customs Excise Service Tax Appellate Tribunal
DRP	Dispute Resolution Panel
DSIM	Department of Statistics and Information Management
DTAA	Double Taxation Avoidance Agreement
ECB	External Commercial Borrowings
EPC	Engineering, Procurement & Construction contracts
FTS	Fees for Technical services
HC	High Court
INR	Indian Rupees
ITAT / Bench / Tribunal	The Income Tax Appellate Tribunal
OECD	Organization for Economic Co-operation and Development
PE	Permanent Establishment
RBI	The Reserve Bank of India
SC	The Supreme Court
Sec.	Section
TPO	Transfer Pricing Officer
TP	Transfer Pricing
Tax Year / PY	Previous Year