



ERGO

Analysing developments impacting business

SUPREME COURT RULES THAT PROJECT OFFICE UNDERTAKING ONLY LIAISING ACTIVITIES DOES NOT CONSTITUTE A TAXABLE PRESENCE IN INDIA

30 July 2020

The Supreme Court of India (SC) in *Director of Income Tax-II (International Taxation) v M/S Samsung Heavy Industries Co. Ltd.* (Civil Appeal No. 12183 of 2016) has held that the Project Office (PO) set up by Samsung Heavy Industries Co. Ltd. (Taxpayer) in India did not constitute its permanent establishment (PE) in India.

Background

The Taxpayer was a company incorporated in South Korea. In 2006, Oil and Natural Gas Company (ONGC) awarded a "turnkey" contract to a consortium comprising of the Taxpayer and Larsen & Toubro Limited, for carrying out work comprising of, *inter alia*, surveys, design, engineering, procurement, fabrication, installation, start-up and commissioning of entire facilities covered under the 'Vasai East Development Project' (Project).

In the same year, the Taxpayer set up a PO in Mumbai, India to act as "a communication channel" between the Taxpayer and ONGC in respect of the Project. During 2006, designing, engineering and material procurement activities were undertaken by the Taxpayer outside India (Offshore Activities). From November 2007, the platforms were brought in India for installation at the Project site.

In relation to the Taxpayer's assessment for the financial year 2006-07 (Relevant FY), the Assessing Officer (AO) held that the India PO constituted the Taxpayer's fixed place PE under Article 5(1) of the India-Korea Tax Treaty (Tax Treaty). Basis this conclusion, the AO held that profits from Offshore Activities were associated with the PE in India and attributed 25% of the revenues earned from Offshore Activities to the PE and brought to tax.

The Taxpayer appealed against the AO's order before the Dispute Resolution Panel (akin to the first appellate authority) and the Income Tax Appellate Tribunal (the second appellate authority). However, both these appellate authorities rejected the Taxpayer's contentions and upheld the AO's order. The main reasons flowing from the AO's order as well as the appellate orders are briefly summarized below:

- based on the application submitted by the Taxpayer to the Reserve Bank of India (RBI) for opening the Project Office and the Taxpayer's board minutes, it was held that no restrictions were placed by the RBI or the Taxpayer's board of

directors on the PO's activities and that the PO was therefore entitled to carry on business activities in India;

- a board resolution of the Taxpayer in 2006 stated, *inter alia*, that the Taxpayer was opening a PO in India for *coordination and execution* of the project, thereby making it clear that all the Project activities were to be routed through the PO only;
- the Taxpayer had contended that the contract with ONGC was divisible in terms of activities to be performed inside and outside India, and therefore, profit arising to the Taxpayer from Offshore Activities was not chargeable to tax in India. However, on a detailed reading of the contract terms, it was held that the Project was an indivisible project and accordingly, Project revenues earned by the Taxpayer outside India would be considered as *income accruing in India* and therefore taxable in India to the extent attributable to the Taxpayers' PE; and
- the Taxpayer had contended that the accounts of the PO showed that no expenditure relating to the execution of the contract was incurred by it. The Tribunal rejected this argument, stating that as accounts were in the hands of the Taxpayer, the mere mode of maintaining accounts alone cannot determine the character of the PE.

Aggrieved, the Taxpayer appealed before the Uttarakhand High Court (HC). While the HC's order is not elaborate on how the PO constituted the Taxpayer's PE in India under the Tax Treaty, the HC held that the profits attributable to the PE from Offshore Activities (held to be 25% of revenues by the AO) was without any basis and therefore struck down the Tribunal's order.

Aggrieved by the HC's order, the tax authorities filed an appeal before the SC.

Ruling

The SC held that the PO did not constitute the Taxpayer's PE in India within the meaning of Article 5(1) of the Tax Treaty during the Relevant FY.

SC laid emphasis on the fact that under the Tax Treaty, profits of a foreign enterprise are taxable in India only where the enterprise carries on its *core business* through a PE in India.

Referring to the documents relied upon by the lower appellate authorities, the SC held that the board resolution of 2006, when read in entirety, showed that the PO was established to coordinate and execute '*delivery documents in connection with construction of offshore platform modification of existing facilities for ONGC*', and not coordinate and execute the Project in its entirety. Thus, the SC set aside the Tribunal's finding that PO was involved in core activities relating to Project execution.

The SC also set aside the Tribunal's finding relating to the Taxpayer's accounts being inconclusive of the scope of activities carried on by the PO.

Relying on its own judgment in *E-Funds IT Solution Inc. (2018) 13 SCC 294*, the SC also set aside the ITAT's finding and held that the initial onus to show that the PO constituted a PE was on the Tax authorities and not the Taxpayer.

Finally, considering that there were only two people working in the PO, with neither of being qualified to perform any core activity of the Taxpayer, the SC held that it was clear that no fixed place PE was constituted under Article 5(1) of the Tax Treaty as the PO could not be said to be a fixed place of business through which core business of the

Taxpayer was wholly or partly carried on. Therefore, the SC held that it was unnecessary to go into any of the other questions argued before the SC (such as whether the Project contract was a divisible contract or a composite contract).

The SC also held that the PO would fall within Article 5(4)(e) of the Tax Treaty, as the office was solely carrying out auxiliary activity that was meant to act as a liaison office between the Taxpayer and ONGC (the aforesaid article of the Tax Treaty provides that PE does not include a fixed place of business that is maintained solely for the purpose of carrying on any activity of a preparatory or auxiliary character).

Comments

The taxability of income earned by foreign entities from Engineering, Procurement and Construction (EPC) contracts carried out on turnkey basis has seen significant litigation in India, especially in the context of a foreign entities' PO being alleged as a PE of a foreign entity.

It is a settled position that determination of PE is a mixed question of facts and law. The ruling reiterates this principle by calling out the lack of factual basis in answering the question on PE. It is, therefore, critical to evaluate the scope of activities *actually* carried out in India, and not the activities that *could have been* carried out under the applicable contractual / legal framework.

SC in this ruling has emphasized a very important principle that unless 'core business activities' are carried on in India by the PO, it cannot be regarded as a fixed place PE in India to attract taxation in India.

This ruling also reiterates an important principle that burden of proving that a foreign entity has a PE in India is initially on the Tax Authorities.

Additionally, in relation to tax treaties to which the provisions of the Multilateral Instrument (MLI) regarding specific activity-based exemption apply, it will be important to examine whether a particular activity in the exclusion clause of PE (advertising, storage, delivery, etc) is indeed 'preparatory or auxiliary' in nature.

Lastly, one cannot overemphasize the importance for the Taxpayer to maintain adequate and accurate documentation on an ongoing basis in order to substantiate its position against any future challenges from the Tax Authorities.

- Jimmy Bhatt (Principal Associate) and Jugal Mundra (Associate)

For any queries please contact: editors@khaitanco.com

We have updated our [Privacy Policy](#), which provides details of how we process your personal data and apply security measures. We will continue to communicate with you based on the information available with us. You may choose to unsubscribe from our communications at any time by clicking [here](#).

For private circulation only

The contents of this email are for informational purposes only and for the reader's personal non-commercial use. The views expressed are not the professional views of Khaitan & Co and do not constitute legal advice. The contents are intended, but not guaranteed, to be correct, complete, or up to date. Khaitan & Co disclaims all liability to any person for any loss or damage caused by errors or omissions, whether arising from negligence, accident or any other cause.

© 2020 Khaitan & Co. All rights reserved.

Mumbai

One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi

Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru

Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata

Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com