Tax Hotline

June 06, 2007

'ECONOMIC NEXUS' NECESSARY FOR TAXING FOREIGN COMPANY'S PROFITS IN INDIA

The Supreme Court of India has recently held, in the case of M/s Hyundai Heavy Industries Co Ltd ("**Taxpayer**") that income from offshore design and fabrication activities would not be taxable in Indiamerely because such activities are rendered in relation to a turnkey project situated in India . Even though there was a permanent establishment ("**PE**") in India in the form of project office, income was held to be taxable only to the extent it was attributable to the activities carried on by the PE in India .

The Taxpayer, a non-resident foreign company incorporated in South Korea , had entered into an agreement with the Oil and Natural Gas Corporation ("**ONGC**") in relation to the installation of certain facilities in the Bombay High region in India . The agreement between the Taxpayer and ONGC was a composite agreement for a) designing and fabrication of platform and b) installation of the platform on ground in India . The installation activities in India took place over a period of about nine months.

The issue in dispute was with regard to what portion of the Taxpayer's income could be brought to tax in India , taking into consideration that the consideration for the entire agreement was received in a lump sum which included consideration for activities carried on outside India as well as in India .

The Hon'ble Supreme Court of India considered the issue in detail, and held that an artificial division between profits earned in India and profits earned outside India is necessary for the ascertainment of a foreign enterprise's taxable business profits in India . It was also held that, as per the Income tax Act, 1961 ("**ITA**"), the taxable unit is the foreign company and not its branch or PE in India, and as per section 5(2) such entity would be taxable only in respect of income that accrues or arises or is deemed to accrue or arise in India.

For the purpose of determining what income may be said to arise in India , it was held that the PE in India should be treated as a separate profit center vis-a-vis the foreign enterprise, "in order to earmark the tax jurisdiction over the operations of a company". It was further stated that it is not the "hypothetical profits" of the PE, which are taxable in the source country but the "real profits", which the PE would have earned if it were wholly independent of the foreign enterprise.
Applying these principles to the instant case, it was held that the installation activities took place subsequent to a transaction where fabricated platforms were delivered to agents of ONGC outside India . Thus, the PE came into existence subsequent to the transaction involving supply of fabricated platforms. The Supreme Court also discussed the applicability of the "force of attraction" principle contained in the double taxation avoidance agreement between India and Korea, and held that as the fabrication activities took place prior to the existence of the PE, the profits from such activities could not be taxable in India. Therefore, it was held that payments made towards fabricated platforms could not be attributable to the PE, and that such payments towards fabrication activities carried on in Korea would not be taxable in India in the absence of economic nexus of such payments with the PE in India.

This ruling follows quick on the heels of the ruling of the Apex Court in the case of *Ishikawajma Harima Heavy Industries Ltd. v. DIT*[1], wherein it was held that the concept of territorial nexus was fundamental in determining taxability of any income in India, and that income from offshore supply of equipment and services by the foreign company outside India, would not be taxable in India merely because the equipment was supplied in relation to a turnkey project in India.

These rulings provide much needed clarity with respect to taxation in India of foreign entities engaged in the business of providing cross border services. By reiterating the importance of establishing "economic nexus" for the purpose of bringing income to tax in India , they assume great significance in times when states are unsure of the extent of their jurisdiction to tax cross border services, and revenue authorities, aggressive. It may be noted that the ruling of the Supreme Court in the case of Morgan Stanley, which is on the issue of PE determination in case of outsourcing industry and profit attribution to the PE, is still awaited.

- **Shreya Rao** & **Shefali Goradia**

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[1] Appeal (civil) 9 of 2007 (SC)

Source: Commissioner of Income Tax and Another versus M/s. Hyundai Heavy Industries Co Ltd. Civil Appeal No. 2735 of 2007 (arising out of SLP (C) No. 4839 of 2007

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