RECENT UPDATES ON MFN, THE CYPRUS TREATY AND TAXABILITY OF OFFSHORE SUPPLY

There have been a number of important tax developments and cases in India over the last couple of months. In this update, we provide snippets on the new India-Cyprus tax treaty and other key direct tax cases.

India-Cyprus Tax Treaty

The double taxation avoidance agreement between India and Cyprus has been revised on November 18, 2016 (the "**Revised DTAA**"). Among other things, the Revised DTAA provides for source based taxation of capital gains arising from the alienation of shares instead of the previous residence based taxation. The Revised DTAA expands the scope of "permanent establishment" and also reduces the tax rate on royalty to 10% from the earlier rate of 15%, which is in line with the tax rate prevalent under Indian tax law. Further, a grandfathering clause has been provided for investments made prior to April 1, 2017, so that capital gains will continue to be taxed in the country in which the taxpayer is a resident (Cyprus).

From the standpoint of the Indian government, the Revised DTAA will tackle the long pending complaint of suspected treaty abuse, preventing double non-taxation and round-tripping of funds, and improving transparency in tax matters. Additionally, the grandfathering provision for capital gains in the Revised DTAA up to April 1, 2017 will provide relief to existing structures.

It appears that India and Singapore will now enter into fresh discussions to renegotiate the India-Singapore double taxation avoidance agreement.

Permanent Establishment Issues

In a recent ruling in the case of a Swiss entity, Carpi Tech SA ("**CTS**"), the Chennai Income Tax Appellate Tribunal (the "**Chennai Tribunal**") adjudicated on the issue pertaining to a dependent agent and a fixed place permanent establishment ("**PE**") for CTS in India under the India-Switzerland double taxation avoidance agreement (the "**Swiss DTAA**"). CTS had undertaken a short duration project to provide geo-membrane water proofing work for an Indian entity. An Indian director of CTS' Indian subsidiary was given a specific power of attorney to undertake project work activities on behalf of CTS, as the project coordinator. Under the contractual documents, CTS' Indian subsidiary incurred all project-related expenses in India, which were later reimbursed by CTS. The Chennai Tribunal held that CTS had a fixed place PE in India at the residence-cum-office of the Indian director which was used for all official purposes in India, including for correspondence with Indian customers, participation in bids, signing and execution of contracts, etc. Further, as the director played a critical role in the Indian project of CTS from the stage of signing the contract until its execution, he was a dependent agent working almost exclusively for CTS. Accordingly, CTS was liable to pay tax on the profits attributable to its Indian operations. (*Carpi Tech SA* (TS-587-ITAT-2016.)

The existence of a PE in India continues to be a contentious tax issue for multinational enterprises doing business in India. The question "Is there a PE?" is probably the most frequent tax treaty query that our clients ask. Even though the concept has existed in tax treaties for several decades, the aggressive

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approach of the Indian tax authorities (coupled with a lack of adequate upfront safeguard measures on the part of clients) has made things tricky and vexed.

Interpreting the Most Favoured Nation Clause

An Indian company ("**ICO**") engaged in providing software development and IT-enabled services entered into a management services agreement with a French company ("**FCO**"), under which FCO provided corporate communication services, group marketing services, development services, etc. to ICO. Based on the most favoured nation ("**MFN**") clause in the double taxation avoidance agreement between India and France (the "**France DTAA**"), ICO (for the purposes of withholding tax) used the restrictive definition of the term "Fees for Technical Services" ("**FTS**") under the double taxation avoidance agreement between India and the UK (the "**UK DTAA**") and contended that "managerial service" was not covered under the definition of FTS mentioned in the UK DTAA. Therefore, the payment made by ICO to FCO for management services was not taxable in India. As usual, the Indian tax authorities did not agree and contended that to apply the restrictive definition of FTS under the UK DTAA into the France DTAA, a notification had to be issued by the Indian government to that effect, and that if a reference was made to another tax treaty, then the reference should cover both, the scope and the rate of tax. The Delhi High Court held that the MFN clause becomes automatically applicable, and there is no need for a separate notification incorporating the beneficial provisions of the UK DTAA into the France DTAA. (*Steria India Ltd. v. Commissioner of Income Tax and Anr* – W.P.(C) 4793/2014 & CM Appl. 9551/2014.)

The concept of the MFN clause is customary in international tax treaties, and it helps establish parity in the competitive opportunities that are present to investors in different foreign countries. India has a huge network of tax treaties entered into over a period spanning several decades, and many of the treaties (such as those with Spain, The Netherlands, France, Belgium, Sweden, etc.) contain MFN clauses. By virtue of the MFN clause in some tax treaties, beneficial tax rates and/or a restricted scope of tax that is available under certain country tax treaties can be applied to other tax treaties. The Delhi High Court has given a very assessee friendly, practical and good decision in this case.

Offshore Supply Taxable in India

A Singapore entity ("**SCO**") entered into a contract with an Indian company ("**ICO**") to construct the external and internal facades for piers, fixed link bridges and nodes. SCO had a project office in India which would oversee the installation work. SCO argued that the contract was for the offshore supply of goods and installation services, and that the offshore supply of goods should not be taxed in India because the title to the goods passed offshore to ICO and the payment was received by SCO in Singapore. Further, the project office was involved only in the installation work and had no connection with the offshore supplies. The tax officer contended that there was no separate/exclusive contract for offshore supply as there was one composite contract for the supply of goods and rendering of services. The tax officer relied on the *Ansaldo* case, wherein it was held that, "it is not just where the title passed, but also whether there was a crucial and intimate relation, whether there was an element of continuity between the business of the non-resident and the activity within the taxable territories." The Authority for Advance Rulings (the "**AAR**") observed that there was a composite contract without any bifurcation. Further, the customs clearance and payment of customs duty on the goods was done by the project office in India. Furthermore, the project office also carried out the installation activity in

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India. Therefore, the project office being a PE of the taxpayer in India was involved in the rendering of services and also the supply of goods. In addition, the risk and insurance of the goods was with the taxpayer until the completion of contract. The AAR held that the contract being a composite contract, the entire amount received by the taxpayer was taxable in India. (*MERO Asia Pacific Pte Ltd* (AAR No. 981 of 2010 (New Delhi)).)

The issue of taxability of “offshore supply” of goods was settled by India’s Supreme Court in the case of *Ishikawajima Harima* (288 ITR 408) wherein it was held that: (i) if the entire transaction was completed on the high seas, then the profit on sale did not arise in India; and (ii) where different severable parts of a composite contract were performed in different places, the principle of apportionment could be applied to determine which fiscal jurisdiction could tax that particular part of the transaction. However, in this ruling, based on the peculiar fact pattern, the AAR has held that a contract will be considered indivisible or composite for tax purposes if the scope of work is not mentioned separately for offshore supplies of goods and materials, and for onshore services.

This case is relevant to all international EPC contractors doing business in India. The key takeaway is that clear, separate contracts for offshore supply of goods and onshore services must be made, and the price for each component must be separately specified in the relevant contract. Further, the concerned party must pay appropriate taxes on the specific components of each contract.

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