

AAR rules on the methodology of computation of threshold limit for construction PE in India in terms of India-Mauritius tax treaty

Recently, the Authority for Advance Ruling (AAR) in the case of Cal Dive Marine Construction (Mauritius) Ltd ruled on whether the taxpayer constituted a Permanent Establishment (PE) in India in terms of India-Mauritius tax treaty (the tax treaty). While deciding on the issue, the AAR analysed the clauses of the tax treaty on construction and assembly project and how the prescribed time for threshold limit of nine months should be computed.

The AAR while computing the time limit of nine months, considered the preparatory activities for starting the project, but it did not consider the purely preliminary activities such as visits for negotiations or taking soil samples. The AAR held that the fixed place rule under article 5(1) of the tax treaty should not be read as water tight compartment, but harmoniously with article 5(2) of the tax treaty as a part of the same concept. Accordingly, prescribed minimum period of nine months, in the case of formation of PE, should be read as per article 5(1) of the tax treaty i.e. fixed place rule.

The AAR held that since the activities of the taxpayer were carried on for less than nine months the income of the taxpayer was not taxable in India.

Facts of the case

- The taxpayer was a company incorporated in Mauritius. It entered into an agreement with Hindustan Oil Exploration Company Ltd, an Indian company for laying pipelines under the sea, constructing the structures and pre-commissioning of the pipelines for a fixed and lump sum consideration of USD 59.17 million. The contract for the services or facilities was executed both within and outside India.
- The work consists of transportation and installation engineering, pre-trenching, pipe laying, back filling, installation, pre-commissioning and surveys (pre-construction/pre-installation and post-installation), erection, construction, testing and handing over services.

- For the execution of the contract the taxpayer hired barges and tugs, it entered into contracts with resident/non-resident contractors for supply of equipment, labour and services. Employees were deputed to India either by the applicant or any other group entity in order to carry out the construction activity. The applicant compensated the group entity for such supply of personnel. The lump sum contract price was paid based on the progress of the work.

Issues before the AAR

- Whether the contract price receivable by the taxpayer for laying pipelines under the sea was liable to tax in India under the provisions of the Income-tax Act, 1961 (the Act) or under the tax treaty?
- If the answer to above was in affirmative, the extent to which the amounts reasonably attributable to the operations carried out in India and accordingly taxable in India?
- Whether the activities of taxpayer were covered within the scope of the provisions of section 44BB of the Act?

Contentions of the taxpayer

- The counting of the nine months period for the constitution of PE should be started from the date the installation/construction activity physically begins in India and not from the date of arrival of the dredger or equipment in India. The entire tenure of the work was only four months which was much less than nine months and therefore, PE was not constituted.
- As per the OECD commentary, the work involving assembling and laying of the pipelines under the sea, was a construction and assembling project and, hence, only the PE rule that provides for a time threshold, needs to be considered.

Contentions of the tax department

- 'Effective date' as defined in the contract should be taken as the starting point for calculation of the nine months period. The department also contended that an inclusive definition will only expand rather than restrict the meaning and amplitude of the preceding general expression in article 5(1) of the tax treaty. The scope of fixed place rule of PE cannot be cut down by referring to the terminology of the succeeding inclusive definition. Hence, the time threshold limit of nine months for construction PE should not be imported into the fixed place rule.
- The department also contended that the calculation of nine months period should commence from the date the preparatory activity in relation to installation/construction begins in India. Since the project team members arrived in India and started the preliminary activities of clearance and logistical formalities from November 2008. Hence, the taxpayer exceeded the nine months period and therefore, the income was taxable in India.

AAR Ruling

The AAR observed that

- Para 2 of article 5 of the tax treaty was complementary to the general concept of PE embodied in the opening paragraph of article 5 of the tax treaty. Para 2 serves the dual purpose of being explanatory and clarificatory of the concept of PE as contained in paragraph 1. By resorting to specific enumeration under article 5(2) of the tax treaty the framers of the treaty wanted to clear the possible doubts and to illustratively spell out various forms of PE. Further, certain qualifications or parameters were laid down, for example, in clause (i) of para 2, so that the general definition of PE is not unduly stretched or restricted.
- Formation of PE being a specific provision prevails over the other clauses of para 2 of article 5 of the tax treaty which are general in nature. The taxpayer having a project office or workshop to carry out the contract work will not bring the establishment within the other forms of PE.
- Para 1 of article 5 of the tax treaty (fixed place rule of PE) cannot be viewed as a water-tight compartment without taking colour from other forms of PE illustrated subsequently in article 5(2) of the tax treaty. If the fixed place rule was to be read on stand alone basis then the clause providing for construction of PE will be rendered ineffectual.
- Thus, these 2 clauses, providing for fixed place PE and construction PE should be read harmoniously, as part of the same concept. In relation to a building site and construction/assembly project, the prescribed minimum period should be read into expression. Accordingly, prescribed minimum period of nine months, in the case of formation of PE, should be read as per article 5(1) of the tax treaty i.e. fixed place rule.
- The AAR also observed that it would be too narrow view to take if the commencement of active phase of construction/installation was held to be the starting point. The preparatory stages leading to the actual commencement of the work such as gathering the equipment and arranging the infrastructure for carrying out the work in full swing should legitimately fall within the ambit of the project duration.
- However, the preparatory work for starting the project had to be distinguished from purely preliminary activities. Occasional short visits of contractor's personnel for negotiations or doing some paper work in connection with the project or for taking the soil samples will not trigger the start of the time-limit.
- Considering the facts of the present case, from any angle it was not possible to hold that the project continues for a period of more than 9 months. Therefore, the taxpayer cannot be said to have a PE in India under the tax treaty. Accordingly, no part of income of the taxpayer will be taxable in India, in view of the provisions of the tax treaty. It was also observed by the AAR that the technical services provided by the taxpayer were only integral to the performance of the project work and, hence, it cannot be taxed independently as fees for technical services.

Our Comments

The ruling analyses how the threshold limit of 9 months should be computed. According to the ruling, a company resident in Mauritius should not create a PE in India provided the construction and assembly project does not continue for a period of more than 9 months from the date the preparatory activity (excluding purely preliminary activities) commences.

Under the provisions of Article 7 of the tax treaty, where the Mauritius company does not have a PE in India, no part of its income will be taxable in India. The income will only be taxable in Mauritius at the tax rate of 15%. Where the Mauritius company holds a Category 1 Global Business Licence, the company will pay tax at a maximum effective tax rate of 3% on such income.



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