Commissioner Of Income Tax, Meerut And ... vs Hyundai Heavy Industries Co. Ltd on 18 May, 2007

Equivalent citations: AIR 2007 SUPREME COURT 2445, 2007 (7) SCC 422, 2007 AIR SCW 4145, 2007 (5) ALL LJ 14, 2007 TAX. L. R. 703, 2007 (8) SCALE 222, (2007) 8 SCALE 222, (2007) 291 ITR 482

Bench: S.H. Kapadia, B. Sudershan Reddy

CASE NO.:
Appeal (civil) 2734 of 2007

PETITIONER:
Commissioner of Income Tax, Meerut and Anr.

RESPONDENT:
Hyundai Heavy Industries Co. Ltd.

DATE OF JUDGMENT: 18/05/2007

BENCH:
S.H. Kapadia & B. Sudershan Reddy

JUDGMENT:

JUDGMENT KAPADIA, J.

1. Leave granted.

2. These civil appeals filed by the Department concern computation of the profits of the Indian permanent establishment (for short, "PE") of the Korean company, M/s .Hyundai Heavy Industries Co. Ltd. (for short, `HHi'). Assesses is a non-resident foreign company incorporated in South Korea. On 12.3.85 it had entered into an agreement with oil and Natural Gas Company (for short, `ONGC') for designing, fabrication, hook-up and commissioning of South Basin field Central Complex facilities in Bombay High. In short the contract was in two parts, one was for fabrication of platform and the other was installation and commissioning of the said platform in South Basses in Field. In these civil appeals we are concerned with the assessment years 1987-88 and 1988-89. The assesses is incorporated under the laws of Republic of Korea. Its registered office is in Korea. As regards assessment year 1988-89, assesses filed its return of income on 3.8.1988. The return indicated `nil' income. In response to notices under Section 143(2) of the Income-tax Act, 1961 (for short `the Act'), the assesses stated that it did not have a PE in India and, therefore, it was not assessable to tax in India; that its Indian Operations consisting of installation and commissioning of the platform commenced in the taxable territory of India on 1.11.86 and got completed on 12.4.87 and, therefore, the duration of the Project was less than nine months; that it was entitled to exemption under Article 7 of the Convention for Avoidance of Double Taxation (for short, `CADT'); that in the

alternative it was liable to be assessed on the basis of the accounts annexed to the returns; that the accounts were based on the Completed Contract Method in its worldwide accounts; that the accounts of its PE can be accepted in the Completed Contract Method basis ; that it was maintaining income and expenditure account of its PE in India; that the above contract was divisible into two types of operations-one being fabrication in Korea and the other consisting of installation in India and , therefore, any income arising from the activity of fabrication in Korea was not assessable to tax in India and, therefore, any income arising from the activity of fabrication in Korea was not assessable to tax in India and to that extent the revenues receivable under the above contract in respect of the activity of fabrication should be excluded from the profit and loss account together with the expenditure relating to the activity of fabrication. It was further contended that the assesses had included the revenues relating to installation (Indian Activity) in the profit and loss account and the expenditure relating to that activity was debited on the Matching Principle Basis. It was further contended that the profit and loss account consisted of two parts-the Korean and the Indian part; that the Korean part recorded the entire revenue/income received in Korea as also the expenditure incurred in Korea relating to the Indian Project and debited to the Korean book of accounts. All the above contentions were rejected by the A.O. it was held that the duration of the Project consisting of installation and commissioning extended beyond nine months, that the project constituted a PE of the assessee in India in terms of Article 5(3) of CADT; that in any event the office of HHI in Bombay constituted a PE under Article 5(2)(c), and therefore, the claim of the assessee for exemption under Article 7 of the CADT was not maintainable. Therefore, the profits attributable to the PE were liable to be taxed in India in accordance with Article 7 of the CADT. The A.O. also rejected the Completed Contract Method as well as the accounts submitted by the assessee on the ground that the assessee had failed to produce the relevant books of accounts in respect of the profit and loss account; that they had refused to produce books of accounts maintained in Korea; and that they had failed to produced the accounting details pertaining to the activities/operations carried out by its PE in India. For the said reasons the accounts were rejected by the A.O. Therefore, the assessment was made for each of the two assessment years on receipt basis. On the question of quantum of assessment, the A.O. held that income from designing, fabrication, procurement of material etc. was partly attributable to the PE of the assessee in India on the ground that designing, fabrication and procurement of material were activities having nexus/linkage to the ultimate activity of installation and commissioning of platform in Bombay High and, therefore, income to that extent from the Korean Operations was taxable in India. According to the A.O., the contract was not divisible. According to the A.O., the contract was in respect of the Turnkey Project; that the consideration in the contract was of lump sum price; that even when the fabricated structure was delivered for transportation to the representative of ONGC the accounts between the parties remained to be settled; and since designing and fabrication of the platform had an application in Bombay High, (where the platform was to be come into operation), a part of the profits arising even from Korean operations was taxable in India as such portion of the profits was attributable to the work of installation and commissioning of the platform in Bombay High. Accordingly the A.O. estimated the net profit of the assessee under the contract at 20% of the gross receipts. Consequently, the A.O. taxed the entire revenue relatable to the Indian Operations and he taxed 2% of the contract revenue in respect of the Korean Operations.

3. Aggrieved by the foretasted decision the assessee carried the matter in CIT (A) who took the view that the assessee did not maintain separate books of accounts for each Project; that they were asked to submit and extract from the consolidated accounts and income and expenditure statement for the Indian Operations which they failed to submit; that the assessee had its PE in India as their Indian Operations extended beyond nine months and also in view of the fact that the they had a Project Office in Bombay; that such an office in Bombay had a close link with the operations, namely, installation and commissioning of the platform; that the Project was under Turnkey Contract consisting of drilling platform, process platform, accommodation platform and flare platform and that each of these platforms constituted the total project under the contract. It was further held by CIT (A) that the activity of designing and fabrication on one hand and the activity of installation and commissioning of the platforms on the other had constituted one integrated activity. He further found that the schedule in the contract indicated payment of lump sum price. Under the schedule, the assessee was to be paid U.S. $ 41.73 lakhs for Indian Operations. According to CIT (A), the contract was required to be read in entirety. It was a Turnkey Contract. It included designing, fabrication, installation and commissioning of the platform in Bombay High and on the reading of the entire contract it was clear that payment of lump sum amount was for the entire operations commencing from designing of platform right upto the work of commissioning of the platforms. Therefore, according to CIT (A), the contract was indivisible for the purposes of attributing the profits to the PE in India. Further, according to CIT(A), designing and fabrication of platforms, as an activity, did have an element of income embedded in the said activity of designing and fabrication which had nexus with the activity of installation and commissioning of the platform attributable to the PE in Bombay High. According to CIT (A), although the consideration paid by ONGC was a composite payment it cannot be said that no part of the income from the Korean Operations was at all attributable to the PE in Bombay High. For the foretasted reasons, the CIT(A) held that though the actual receipt on fabrication operations in Korea was not taxable under the Income-tax Act, the work of designing and engineering of platforms was taxable under the CADT read with Section 9(1) of the Act.

4. On the question of quantum of profits embedded in the Korean Operations, the A.O. was of the view that since the assessee had invoked Article 7 of the CADT, the assessee was not entitled to compute its income under Section 44BB or under Instruction No. 1767 dated 1.7.87 issued by CBDT as urged on behalf of the assessee. On this point, CIT(A) took the view that the operations, namely, installation and commissioning of platform in Bombay High gave rise to profits and, therefore, those profits were attributable to the PE of the assessee in India and they were taxable at the rate of 10% of the payments received by the assessee in respect of the Indian Operations from ONGC on the basis prescribed in Section 44 BB as also under Instruction NO. 1767. Consequently, the CIT(A) directed the A.O. to compute the profits of the assessee at the rate of 1% on receipts in respect of the Korean Operations and at 10% of the receipts relating to Indian Operations in terms of CBDT Instruction No. 1767.

5. Aggrieved by the aforestated decision the assessee carried the matter in appeal to the Tribunal. It was held that the Department was right in invoking best judgment assessment. It was held that the question as to whether the PE existed in India or not was not material as no part of the income attributable to the Korean Operations was required to be taxed. It was further held that the PE did

exist in India in terms of Article 5(3) of the CADT. On the point of computation of income regarding Indian Operations, it was held that Instruction No. 1767 was applicable. It was further held that Section 44 BB of the Act was also applicable and, therefore, the A.O. had erred in computing the income on the Indian Operations on only Accounting Principles without taking into account the provisions of Section 44BB as well as Instruction No. 1767. It was further held that profits from Indian Operations should be worked out at the rate of 3% and not at the rate of 10% as done by CIT(A). The Tribunal further held that the contract in question was divisible contract. According to the Tribunal, the work of fabrication in Korea was separate for from the work of installation and commissioning of platform in India; that the fabricated platform was handed over to ONGC in Korea in September 1987 and, therefore, before coming into existence of the PE of the assessee in India the work of fabrication was completed in Korea was not divisible. According to the Tribunal, the Installation PE came into existence only after the work in Korea got completed and, therefore, only the income from Indian Operations was attributable to the PE which was alone taxable in India. For the above reasons, the appeal filed by the assessee was allowed.

6. Aggrieved by the aforestated decisions of the ITAT, the matter was carried in appeal to the High Court under Section 260A of the Act WHICH APPEAL was summarily dismissed. Hence, these civil appeals are filed by the Department.

7. A short question which needs to be answered in the present case is what are the profits reasonable attributable to the assessee's PE in India. In order to answer the above question we are required to analyse the scheme of the Act. Under Section 4 of the Act it is the total income of every "person" which is taxable. A foreign company which is not wholly controlled or managed in India is a non-resident so far as its residential status is concerned. Section 5(2) of the Act lays down that as far as a non-resident assessee is concerned scope of total income of such an assessee is confined to an income which accrues or arises in India or is deemed to accrue or arise in India and which income is received or deemed to be received by such foreign company. Therefore, it is clear that under the Act, a taxable unit is a foreign company and not its branch or PE in India. A non-resident assessee may have several incomes accruing or arising to it in India or outside India but so far as taxability under Section 5(2) is concerned, it is restricted to income which accrue or arise or is deemed to accrue or arise in India. The scope of this deeming fiction is mentioned in Section 9 of the Act. Therefore, as far as the income accruing or arising in India, an income which accrues or arises to a foreign enterprise in India can be only such portion of income accruing or arising to such a foreign enterprise as is attributable to its business carried out in India. This business could be carried out through its branch(s) or through some other form of its presence in India such as office, project site, factory, sales outlet etc. (hereinafter called as "PE of foreign enterprise"). It is, therefore, important to note that under the Act, while the taxable subject is the foreign general enterprise (for short, "GE"), it is taxable only in respect of the income including business profits, which accrues or arises to that foreign GE in India. The Income-tax Act does not provide for taxation of PE of a foreign enterprise, except taxation on presumptive basis for certain types of income such as those mentioned under Section 44BB, 44BBA, 44BBB etc. Therefore, since there is no specific provision under the Act to compute profits accruing in India in the hands of the foreign entities, the profits attributable to the Indian PE of foreign enterprise are required to be computed under normal accounting principles and in terms of the general provisions of the Income-tax Act. Therefore,

ascertainment of a foreign enterprise's taxable business profits in India involves an artificial division between profits earned in India and profits earned outside India.

8. The Indian Income-tax Act, 1961 is concerned only with the profits earned in India and, therefore, a method is to be found out to ascertain the profits arising in India and the only way to do so is by treating the Indian PE as a separate profit centre vis- -vis the foreign enterprise (the Korean GE, in the present case). This demarcation is necessary in order to earmark the tax jurisdiction over the operations of a company. Unless the PE is treated as a separate profit centre, it is not possible to ascertain the profits of the PE which, in turn, constitutes profits arising to the foreign GE in India. The computation of profits in each PE (taxable jurisdiction) decides the quantum of income on which the source country can levy the tax. Therefore, it is necessary that the profits of the PE are computed as independent units. However, in a case where Government of India has entered into a tax treaty with a foreign county (Korea, in the present case) then in relation to an assessee on whom such tax treaty applies, the provisions of the Act shall apply only to the extent to which the provisions thereof are more beneficial to the assessee.

9. Now, coming to the present case, the main argument advanced on behalf of the Department was that the assessee was in receipt of consideration which formed part of execution of Turnkey Project with ONGC; that there was one integrated contract; that the contract was not divisible in terms of separate activities and, therefore, the Tribunal had erred in holding that profits accruing to the assessee from activities performed outside India were not chargeable to tax in India. According to the Department, the work of designing and fabrication under the Turnkey Project was totally interlinked with installation and commissioning and, therefore, there was no merit in the assessee's claim in respect of receipts attributable to the activates performed outside India as not chargeable to tax in India. According to the Department, the assessee was required to execute turnkey work, that is, to supply certain equipments and install the same in India. According to the Department, the supply of fabricated platform was essentially linked to installation of the platform in the Bombay High. Thus, according to the Department, there was a business connection and the supplies were linked to the Project in Bombay High. For this reason, according to the Department, the consideration received by the assessee for supplies form outside India were taxable in India in terms of Section 9(1) of the Act. On the other hand, the assessee placed reliance on Article 7 of the CADT and submitted that on completion of the work of fabricated of platforms the same were handed over to the Agents of the ONGC in Korea and, therefore, the assessee was not liable to be taxed in respect of the profits attributable to the operations of designing and fabrication in Korea. In this connection, the assessee placed reliance on Article 7 of CADT.

10. We quote hereinbelow Article 7 of CADT between Government of India and Government of Korea which reads as under:

> "ARTICLE 7 -Business profits-1. the profits of an enterprise of a contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent

establishment.

2. Subject to the provisions of paragraph (3), where and enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting Stat be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred whether in the State in which the permanent establishment is situated or elsewhere, which are allowed under the provisions of the domestic law of the Contracting State in which the permanent establishment is situated.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purpose of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by he same method year by year unless there is good and sufficient reason to the contrary.

6. Where income or profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article."

11. On reading Article 7 of the CADT, it is clear that the said Article is based on OECD Model Convention. Para (1) of Article 7 states the general rule that business profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on its business in the Other Contracting State through its PE. The said para 91) further lays down that only so much of the profits attributable to the PE is taxable. Para 91) of Article 7 further lays down that the attributable profit can be determined by the apportionment of the total profits of the assessee to its various parts OR on the basis of an assumption that the PE is a distinct and separate enterprise having its own profits and distinct from GE. Applying the above test to the facts of the present case, we find that profits earned by the Korean GE on supplies of fabricated platforms cannot be made attributable to its Indian PE as the installation PE came into existence only after the transaction stood materialized. The installation PE came into existence only on conclusion of the transaction giving rise to the supplies of the fabricated platforms. The Installation PE emerged only after the contract with ONGC stood concluded. It emerged only after the fabricated platform was delivered in Korea to the Agents of ONGC. Therefore, the profits on such supplies of fabricated platforms cannot be said to be attributable to the PE. There is one more reason for coming to the

aforestated conclusion. In terms of para (1) of Article 7, the profits to be taxed in the source country were not the real profits but hypothetical profits which the PE would have earned if it was wholly independent of the GE. Therefore, even if we assume that the supplies were necessary for the purposes of installation (activity of the PE in India) and even if we assume that the supplies were an integral part, still no part of profits on such supplies can be attributed to the independent PE unless it is established by the Department that the supplies were not at arm's length price. No such taxability can arise in the present case as the sales were directly billed to the Indian Customer (ONGC). No such taxability can also arise in the present case as there was no allegation made by the Department that the price at which billing was done for the supplies included any element for services rendered by the PE. In the light of our above discussion, we are of the view that the profits that accrued to the Korean GE for the Korean operations were not taxable in India.

12. There is one more aspect to be discussed. The attraction rule implies that when an enterprise (GE) sets up a PE in another country, it brings itself within the fiscal jurisdiction of that another country to such a degree that such another country can tax all profits that the GE derives from the sources country-whether though PE or not. It is the act of setting out a PE which triggers the taxability of transactions in the source State. Therefore, unless the PE is set up, the question of taxability does not arise-Whether the transactions are direct or they are through the PE. In the case of a Turnkey Project, the PE is set up at the installation stage while the entire Turnkey Project, including the sale of equipment, is finalized before the installation stage. The setting up of PE, in such a case, is a stage subsequent to the conclusion of the contract. It is as a result of the sale of equipment that the installation PE comes into existence. However, this is not an absolute rule. In the present case, there was no allegation made by the Department that the PE came into existence even before the sale took place outside India. Similarly, in the present case, there was no allegation made by the Department. that the price at which ONGC was billed/invoiced by the assessee for supply of fabricated platforms included any element for services rendered by the PE. In the present case, we are concerned with assessment years 1987-88 and 1988-89. Therefore, we are not inclined to remit the matter to the adjudicating authority. We reiterate, in the circumstances, not all the profits of the assessee company from its business connection in India (PE) would be taxable in India, but only so much of profits having economic nexus with PE in India would be taxable in India. To this extent, we find no infirmity in the impugned judgment of the Tribunal. Accordingly, we are of the view that the Tribunal was right in holding that profits attributable to the Korean Operations was not taxable in view of Article 7 of CADT.

13. Now coming to the question of the quantum of taxable profits attributable to the Indian PE of the assessee relating to the work of installation and commissioning of the platforms in Bombay High, we are of the view that, for the reasons mentioned hereinafter, profits arising from the activities of installation and commissioning were taxable at 10% of the payments relating to the said services/facilities carried out in Bombay High. Firstly, in the present case, it is important to note that the accounts submitted by the assessee were rejected and the A.O. had to invoke the provisions of the Act by way of best judgment assessment. Secondly, in the present case, the assessee themselves contended in the assessment proceedings that the A.O. should have computed the income relating to Indian Operations under Section 44BB or under Instruction No. 1967 issued by CBDT dated 1.7.87. Thirdly, it is important to note that Chapter IV of the Act contains provisions for

presumptive taxation of business income in certain cases as prescribed in Sections 44B, 44BB, 44BBA and 44BBB of the Act. In the scheme of presumptive taxation, the assessee is presumed to have earned income at the rate of a certain percentage of his total turnover or gross receipts. If the assessee agrees to be taxed on presumed income, he is not required to maintain books of accounts. If, however, he claims that his income is less than the presumed figure, he is required to support his claim by producing books of accounts. In the present, as indicated above, the A.O. has rejected the accounts submitted by the assessee. This has not be challenged. Moreover, the assessee appeared before the Department and submitted that its income from Indian Operations be computed under Section 44BB or under Instruction No. 1767 issued by CBDT. Under the said Instruction, in cases where the sales take place outside, as in this case, only 10% of the gross receipts in respect of the activates of installation, commissioning etc. performed in India will be taxable. In view of the stand taken by the assessee, we are of the view that the CIT (A) was right in computing the taxable profits at 10% of the gross receipts in respect of the activates of installation, commissioning etc. performed in India. In the present case, no reasons have been given by the Tribunal for reducing the rate from 10% to 3%. Fourthly, it is important to note the scope of Section 44BB of the act. Once that section applies then two conclusions follow. The first is that 10% of the receipts by the foreign resident is chargeable to tax and the other conclusion is that 90% of the receipts of that foreign resident as well as receipts/gains, other than those mentioned in Section 44BB, is also not chargeable to tax. Lastly, there is a concept in accounts which called as the concept of Contract Accounts. Under that concept, two methods exist for ascertaining profit for contracts, namely, "Completed Contract Method" and "Percentage of Completion Method". To know the result of his operations, the contractor prepares what is called as Contract Account which is debited with various costs and which is credited with revenue associated with a particular contract. However, the rules of recognition of costs and revenue depend on the method of accounting. Two methods are prescribed in Accounting Standard No. 7 They are- "Completed Contract Method" and "Percentage of Completion Method". In the present case, the A.O. has rejected the Completed Contract Method which is not challenged. Therefore, we have to fall back on Percentage of Completion Method under which reasonable profit is calculated on the basis of the value of the work certified and the profit attributable to the work certified. For example, if the value of the work certified is , or more but less than + of the contract price, then a certain percentage of the profit accruing to the certified work is taken to the profit and loss account.. In the present case, the assessee has not given these details, particularly, regarding the value of the work duly certified. If the contract is almost complete, then profit if normally estimated by charging the actual cost and the costs estimated for completing the remaining contract to the Contract account. This procedure is called as procedure of Contract costing. When the assessee does not given particulars above-mentioned then CIT (A) was right in estimating the profits of the assessee at 10% of the gross receipts in respect of the activities of installation, hook-up and commissioning performed by the Indian PE in Bombay High. To this extent we set aside the impugned decision of the Tribunal.

14. Before concluding, we may point out that the High Court had erred in holding that no substantial question of law arose in this case under section 260A of the act. In our view substantial questions of law did arise. We did not remit the matter to the High Court, particularly, when the appeal is in respect of the assessment years 1987-88 and 1988-89.

15. For the aforestated reasons, we hold as follows:

> (A) In the facts and circumstances of the case, profits, if any, form the Korean Operations (designing and fabrication) arose outside India, hence not taxable.
>
> (b) As regards the quantum of profits embedded in the Indian Operations attributable to the Indian PE of the assessee, we hold that the CIT (A) was right, in the facts and circumstances of this case, in attributing the profits to the Indian PE at 10% of the gross receipts in respect of its activities of installation, commissioning etc. performed in India. The same shall be taxable accordingly.

16. For aforestated reasons, civil appeals preferred by the Department are accordingly partly allowed with no order as to costs.