

Taxation Of Permanent Establishments In Epc Contracts The Emerging Trends, Rulings, And The Way Forward- Issues Arising And Judicial Views Under Direct Taxes -An Indian Perspective

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Abstract: The importance of taxation of EPC contracts is critical from the point of view of both the Indian economy, for the contribution it makes to economic growth and development. An EPC contract is composed of two parts Activities done outside the country and Onsite- performed within the country. It involves the participation of many international players, who bring different skill sets, with a separate specific scope, woven into an umbrella contract for the final delivery of a project to the customer, there is a tendency for the taxman to try and tax the contract – treating it mainly as a single, turnkey contract, while the taxpayer tries to reduce the outcome of taxable income. The various motives involved on the part of the taxpayer to reduce the obligations on tax liability to a minimum level, using different arrangements, structures, sub-contracts, split contracts to subsidiaries, and third-party entities in developing countries are carefully thought out using special tax counsel. The study is exploratory and also examines the past studies in motives, key factors influencing the structure of entity to sub-contract, and rulings by the judiciary at various forums like ITAT, High Court, and Supreme Court and examines the various factors which had determined the decision, as to how it will influence the future of taxation of EPC contracts, with post-BEPS effects and the economy going digital too. The cases involving EPC contracts, the different types of PEs arising in the process, motives to save taxes, reasons for employing SPV structures, the role played by governance, tax counsel and then examine the court cases in the Indian scenario, and draw conclusions as to how it will be going forward in future.

Keywords: Offshore, On-site, Supply of equipment. Permanent establishment, Attribution of profits, Engineering Procurement Construction Contracts, Tax Planning, Tax avoidance

1. Introduction

One of the most important tax concepts is a permanent establishment (PE), which limits tax liability to the portion of income or profits generated by the establishment that originates in the nation and does not apply to the entire profits generated for the entity. The issue of profit allocation is forced into the spotlight as a result, and the Indian Income-tax Law offers some practical solutions. According to publicly available court decisions, certain variables are taken into account for allocating earnings to the PE. A "Permanent Establishment" is a significant, enduring, or long-term element of a foreign enterprise in another country that may be linked to a permanent place of business there. Only the portion of a profit that may legitimately be attributed to operations carried out in India is taxable.

A key fact is what percentage of earnings were produced or originated in India. According to explanation 1(a) of section 9(1) of the IT Act, what is primarily attributable to operations carried out in India alone may be considered the revenue of business assumed to originate or accrue in India. The provisions of a Tax treaty (DTA) would take precedence over those of the IT Act if they are more advantageous to the taxpayer, according to S-90

of the IT Act. in compliance with DTA Article 7(2). The direct accounting method makes the assumption that the PE earned, what it would have if it were a different and separate entity operating under identical or comparable conditions and acting entirely independently.

The different types of contracts are Composite contracts, Turnkey contracts, LSTK, Split contracts, etc. using special SPV structures, tax planning, tax avoidance, etc. Different motives also exist in the way of setting up contracts, and interests of investors who fund these projects. These can be revealed by looking at past studies in this regard.

2. Review Of Literature

In relation to Permanent establishment, the various aspects of corporate governance, tax planning, avoidance, changing tax laws related, uncertainty, and SPV structures, can be said to have an impact on the possible desire to reduce the taxability arising on account of Permanent establishments in the country of execution of the project, and hence the following reviews would be more relevant, in this context.

Wanyana Ogutu, A. (2009), mentions that a tax treaty is a legal agreement that specifies how two nations will tax their respective citizens' income. Tax treaties are typically drafted using a specific model, and they generally adhere to their prescriptive articles' rules. The profits of a business inside a contracting state are generally only subject to taxation there unless the business also conducts business in another contracting state through a permanent establishment (or "PE") there. Only the gains attributed to a PE are taxable if one exists. The importance of a PE thus lies in the fact that, even though it has no independent legal existence, it grants the nation in which it is located (the source country) the authority to tax its profits. Garbarino, C. (2019), mentions that the view from the investment's country of destination indicates significant BEPS effects on tax treaties, most notably that the avoidance of the PE status is now subject to additional restrictions. Before 2017, one planned strategy involved non-resident investors engaging in activities in the source country to avoid the so-called "PE status," which would have required them to pay taxes in the source country. The new aspects of operating through a PE in the source country are the focus of this chapter, which also examines the tax PE threshold, the tests to identify a PE, BEPS changes about preparatory/auxiliary activities, the anti-fragmentation rule, and finally, structures in shipping and air transport, and discusses how to safeguard the PE operation using the non-discrimination clause, as well as more conventional treaty responses to issues like the PE's force of attraction and the separate handling of isolated types of income. Ftouhi, K., Ayed, A., & Zemzem, A., the study aims to determine if corporate tax preparation practices boost business value in a European setting. Tax savings and the Effective Tax Rate (ETR) in the financial statements disclosures of tax reduction determine how tax planning affects a company's worth, this study makes the case that tax planning harms a firm's worth due to higher agency charges. The permanent differences portion of tax savings can also be used to explain this link, as firm value is believed to be adversely correlated with permanent differences. Also, the corporate ETRs are lower than the statutory tax rate. Expanding the gap between the effective tax rate and the statutory tax rate results in greater tax savings. In this situation, tax planning can be defined as the actions taxpayers take to lower their tax obligations to benefit from tax savings. Ariffin, Z. Z. (2013), mentions studies on corporate tax planning have been conducted for some time in the setting of developed markets, but there is little to no study on corporate tax planning for businesses in developing nations, with tax avoidance and business tax planning going hand in hand. Companies involved in worldwide business can use international tax planning. This study aims to investigate how corporate tax planning is impacted by businesses that engage in international operations, using a cross-sectional-time series valuation employing panel data analyses—also known as Tobit estimations—used to examine the link and shows a connection between businesses operating internationally and corporate tax structuring in emerging markets. Saragih, A. H., & Hendrawan, A. (2021), find evidence changes in tax laws create uncertainty for businesses, which may lead them to engage in more aggressive tax planning. and proactive tax planning may result in tax evasion. This study examines the relationship between managerial aptitude, firm size, and firm size and managerial aptitude on corporate tax avoidance strategies. According to this study, managerial skill, firm size, and their interactions all significantly affect corporate tax avoidance. (Feng, M., Gramlich, J. D., & Gupta, S. (2009), mention strong corporate governance tends to reduce the use of special purpose vehicles (SPVs), according to Tobit regressions of the factors that influence their use, except for those SPVs founded primarily for economic, tax, or other reasons.

(Otusanya, O. J. (2011), talks about tax avoidance and evasion reduce the government's taxable income. This causes substantial harm to the infrastructure, public services, and public utility supply. Multinational corporations (MNCs) in the oil, gas, and industrial sectors have employed a variety of tax avoidance strategies to avoid paying taxes in Nigeria, including using offshore intermediary businesses, claiming recharges, royalties, or technical fees, and under-reporting earnings.

2.1 Research Gap

One of the most crucial elements involves a PE's taxability in the context of EPC contracts. Large contracts, which are essential for the economic development of nations, are valued since they require a variety of stakeholders to collaborate to build up the project, such as in infrastructure, machinery and equipment, power generation equipment, etc. Another aspect of how the PE is developing is added by the DTA between the two nations (countries) concerned. Past studies have focussed on the significance, applicability, types, and varieties of PEs that may arise, but little work has been done in the context of linking the structures, factors, and motives that go on to make a PE taxable. The taxability of digital PEs, in the future post the BEPs are likely to be handled by various nations is unclear. Because the EPC contracts, which are the basis of foreign investors' interest in Indian EPC projects, were not covered in previous studies, this opens the door for further research based on major contracts and engineering procuring contracts. In this study, it is proposed to look at how PEs arise in EPC contracts, their factors, motives, structures, and judicial case outcomes.

2.2 Data Source

The study is exploratory and draws on secondary data from a variety of government reports, historical studies, publications from the CBDT, the OECD, Deloitte, PWC KPMG, Itatonline.org, the Chartered Accountant Journal, the Bombay Chartered Accountant Journal, the High Court, the Supreme Court, and the AAR, among other sources. Also, the authors examined significant court cases, specifically how they were decided at different levels at the ITAT, AAR, HC, and SC levels mainly from 2007-08, to 2023

3. Objectives Of Study

1. To study the types of contracts falling under EPC contracts
2. To examine the factors, and elements, which influence the structure of EPC contracts.
3. To study the importance of Tax planning, tax avoidance, and contract splits in the formation of EPC contracts- using select cases and trends.

4. Methodology

The author proposes to examine past studies in this regard to the different factors that are instrumental in the creation of PE. The formation of PE is defined differently based on the OECD, UN model convention, and Indian Income Tax laws. The different rulings given by the courts, and the factors going into the reasons for the same, further throw light on reasons as to why the court construes a PE has arisen or otherwise. The study is exploratory, and considers reports of Professional consultants like Deloitte, KPMG, E&Y, etc., with reflections on current trends in industry practice being advised and recommended. The study examines the theoretical aspects of PE arising which then gives rise to the taxability of Income and the different cases which are decided by the different courts.

5. Discussion:

- a) Study the types of contracts falling under EPC contracts

The different types of contracts falling under EPC contracts can be a composite contract, Split contract, Turn-key contract, Umbrella contract, Fixed price contract, Lump-sum Turnkey contract, etc. While the nomenclature varies, they represent the same EPC contract. Again because the contracts are large, need various competencies and skills, cannot be executed by one single party, and will have to be executed jointly in connection with other players and involve equipment design, fabrication, and manufacture of equipment. These are later delivered to the site where the project gets executed and final assembly at the site happens. Hence typically they comprise two parts i) offshore -work done outside the country and ii) onsite- work done at the situs of the project. The formation of PE therefore can happen mostly in onsite work done, but if the project structure or documentation

is not appropriate may also be invoking some part of offshore services, to taxation in India, however in certain specific cases. The understanding as to the break-up of activities in offshore and onsite, therefore needs to be crucially discussed with a good tax counsel as well as the project team to enable frame an appropriate design of contract. The importance of having the right split and the activities that should go under each category – should be set in such a manner as not to invite a judicial review at a later date, by the tax-man, and the judiciary.

- b) Examine the factors, and elements which influence the structure of EPC contracts and motives concerning tax planning and avoidance

As already examined in the past studies and reviews certain factors are critically relevant and influence the direction of how EPC contracts are getting structured. In line with the past literature, studies, and aspects the certain factors appear to be quite relevant and useful for structuring contracts. EPC contracts are high value and they involve different players in the execution and delivery of these contracts, as well as significant investment by investors both national and international institutions. They tend to protect their interests and do not want to expose themselves to tax risk arising due to PE formation by housing all their projects in one basket. Further, they would like to evaluate the performance of the main EPC contractor, and its managers and hence like to have separate SPVs to enable them to either carry on the business effectively, (monitor using KPI/KRA) or if not dispose of the entity as a going concern undertaking without taking a higher hair-cut. Further risks is reduced in such cases for investors.

Certain factors can be commonly laid out based on past studies-summarised as below:-

SLno	Factors	LR Reference/Rationale/Basis
A	Contract structure & split contracts are common in EPC contract design	Industry practice
1	EPC contract is the most efficient type when involving large projects with multiple vendors/contractors	Industry practice
2	Split contracts help mitigate tax risks and add commercial value	Industry practice
3	Shifting of major portion of work to the offshore entity can lower tax risk	Global Industry practice
B	Entities and subsidiaries, Structures	
1	The structure of participating entities plays an important role in mitigating tax risk	Structuring is an industry practice
2	Subsidiary as a structure for local execution of contracts is an accepted commercial practice	Industry practice
C	Court approaches and judiciary	
1	Courts look through the contract, in its entirety while issuing the final ruling on taxability	Past judgements
2	Courts look at the prime commercial purpose behind the contract	GAAR provisions, past judgments
3	Split contracts and documentation and the acts of parties while executing contracts to determine the role of parties, are examined by courts -for possible tax implications	Donfang Electric Corporation V Dy. CIT (2012 74 DTR 25) GE Energy Parts Inc V CIT TS-765-HC 2018- Dependent PE
D	Corporate process for managing tax risk	
1	Boards of Entities have a formal process for reviewing EPC tax risk in projects	Industry and corporate practice
2	Project structure decisions are mainly based on the advice of reputed local tax advisors in India	Industry and corporate practice
3	Good CG helps Boards take a safe position, based on tax risk assessment- in certain cases if there are conflicting rulings of authorities	Industry and corporate practice

4	The structuring of contracts has an impact on tax risk.	Industry and corporate practice
D	Tax avoidance, governance mechanisms	
1	Aggressive tax authority may lead to aggressive taxpayers	Penno, M. (2020)
2	Firms with lower cash effective tax rates bear significantly greater tax uncertainty	Dyrenge, S. D., Hanlon, M., et al (2019)
3	Large firms, multinationals, and Institutional owners are likely to be practicing tax avoidance	Wang, F., Xu, S. et al (2020)
E	Role of External tax counsel	
1	External Tax advisors are more confident of a structure when they recommend it to entity	Fallan, Hammervold, et al, (1995)
2	External Tax Advisers advise corporates against venturing into grey areas in tax matters	Industry practice - Chyz, J. A., Gal-Or, R., et al. (2017)
3	Board of entities generally go by the decision of the tax counsel only	Industry practice

These factors can significantly influence the outcome of arising of a PE or otherwise in tax cases before the various forums -e.g. CIT(A), ITAT, HC, SC, etc. It is therefore becoming a crucial aspect of planning for EPC contracts in such a way that liability due to PE arising is kept to a minimum level.

C) The importance of tax planning, avoidance, and contract splits in the formation of EPC contracts, cannot be overemphasized. Several studies have in the past brought out the differences between Tax planning and Tax avoidance, and it is interesting to know that the courts have also taken note of the same. While Tax planning is accepted and upheld by the judiciary, tax avoidance has not been finding favor. (see below)

Case Laws on PEs

SLNo	Case law	Citation-Authority	Decision favour of	Decision and Rationale
1.	RD Aggarwal & Co	1965 56ITR 20 (SC)	A -	Mere sales do not result in Business connection – No PE- Relationship between trading activity outside the taxable territory and contribution of earning income in the trading activity must exist.
2.	Ishikawajima Harima Heavy Industries Co. Ltd	2007 288 ITR 409(SC)	A-TP	Transactions carried outside India are not taxable in India. Only a portion of income attributable to operations carried out in India can be taxable -No PE for the offshore part
3.	Hyosung Corporation	(2009) 3134 ITR 343(AAR)	A-TP	The offshore contract was separate – not taxable in India- No PE
4.	Commissioner of IT V Fried Krupp Indus	(1981) 128 ITR 27	A-TP	No operations were conducted in India attributed to a foreign company which could give rise to profits earned in India – hence not taxable -supply of equipment and spares were FOB terms, and erection by Indian company personnel – Hence no PE
5.	Dong Feng Electric Corpn-V-DDIT	(TS -434-ITAT-2012(Kol)	A-TP	Held that AO had erroneously concluded that one integrated contract was artificially split into a set of contracts to avoid taxability of Income in India. Loss incurred on onshore activities cannot be reason to show that onshore activities

				were deliberately kept at a low value to avoid taxability in India - No PE
6.	Ansaldo Energia SPA-V- ITO	(2009) 310 ITR 237(Mad)	D- TA	Four contracts were inextricably linked and it was a composite contract. The Assessee did not disclose certain information and ITAT confirmed 75% of contracts in contract -I as taxable- matter remitted back to ITAT to decide on correct profits to be taxable. – the break up of contracts was a façade hence taxable income arose – PE arises
7.	SEPCO III Electric power const.Corp	(2012)18 taxmann.com 144 AAR	A-TP	The offshore contract was separate – not taxable in India- No PE
8.	Vodafone International BV-V- UOI	(2012) 341 ITR 1 (SC)	A-TP	“Look at” approach rather than “Look through” approach adopted by the SC -No PE
9	Durr Systems AG, Chennai-V- DCIT(Intl tax)	[TS-5398-ITAT-2023(CHENNAI)-O	D-TA	It was decided that the German company's income from equipment supply, supervision, and installation is taxable in India because it is integrally related to and a component of the same turnkey project. The ITAT cited an earlier ruling in the Taxpayer's case that had upheld the Indian tax authorities' claim that the three components of the turnkey contract—offshore supply, supervision fees, and installation and commissioning of the project—were not naturally divided into two separate parts but had instead been artificially divided. As a result, it was determined that the contract was composite and that the supplies were taxable in India.

A= Assessee D = Department TP=Tax Planning TA =Tax Avoidance

6, Limitations Of The Study

The study is exploratory and does not consider the behavioral attitudes and litigation nature for cases, for the taxpayer and the department attitude in such cases, and tax morale in economies like India, and is not an empirical study.

7. Conclusion

The authors conclude that the taxation of EPC contracts is one of the most vexatious and complex aspects of large contracts, with a variety of structures and with offshore and onsite parts separately being performed and delivered in India for the final customer, the tax outcomes should be made known to the project sponsor or investor, failing which there will be considerable uncertainty and loss of trust. This in turn will affect FDI flows and possibly make India a costly destination for major projects, which are crucial for economic development. In reality, also we see considerable delays in projects, which happen due to cost and time escalation and this forces the contract value to a higher level. The project sponsor needs to get the agreement with the funder and investor and tax policies in this regard are crucial. Certainty of legal outcomes in the area of taxation in EPC contracts is a *sin qua non* for the effective development of the economy at affordable costs. In the future, due to digital transformation, we can expect the major portion of work to be shifted offshore, which will then be escaping the PE concept, and a new deemed PE concept may apply, with key rules as may be decided by the Govt. Pillar one

and Pillar two of BEPS action which addresses the digital PE arising will also help alleviate the difficulties and the deemed provisions will apply to prevent loss of revenue to the respective states. The taxpayer will be using various structures to minimize his tax liabilities which can be legitimately held to be valid, but the Govt dispensation will be mostly to enact legislation, to plug in the loop-hole and that will effectively reduce opportunities to do tax planning, and hence force more aggressive forms of tax planning, using SPVs, trusts, and others, that can border on the margins of tax avoidance. The judiciary will have to continuously evolve the new paradigms with good business sense as an investor or entrepreneur structure and manage his business, and the right balance on these parameters will bring in trust in the tax policies and measures, failing which litigation will be the prime recourse to resolution, shaking the investor and business confidence, which best be avoided.

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