

The Duration Test: Geographical and Commercial Coherence of Contracts Essential to Constitute Permanent Establishment



POINT(S) OF LAW

Where an offshore enterprise is carrying out different engineering and construction contracts in India, whether the duration of these contracts could be aggregated so as to calculate the threshold time limit as prescribed in Article 5(2)(i) of the Indo-Mauritius tax treaty to determine whether or not the same constitutes a permanent establishment in India.

BRIEF FACTS

The offshore enterprise, a tax resident of Mauritius, is engaged in general engineering and construction business. The Offshore enterprise executed three (3) contracts in India and claimed that the income arising out of these contracts would be business profits. Since, it does not have a PE in India, the business profits from these contracts cannot be subject to tax in India.

The offshore enterprise claimed that under each of the three (3) contracts, the duration of the work was below the threshold limit of nine months as applicable for assumption of a PE in India under Article 5(2)(i) of the Indo Mauritius DTAA ("DTAA"). The offshore enterprise further contended that each of the contracts is a separate contract and thus, has to be treated independently from each other and the time spent on these cannot be aggregated to determine the application of duration test. On the other hand, the AO was of the view that all the contracts are to be considered together for calculating the threshold limit of nine months and determining the existence of PE under the DTAA.

CIT(A) rejected the contentions put forth by the AO and held that the duration of the said projects could not be aggregated for the purposes of ascertaining as to whether or not the PE of the assessee can be said to have existed in India.

Against the said order of the CIT(A), the AO preferred an appeal to ITAT, Mumbai

If an offshore enterprise carries out engineering and construction projects in India, the time spent on each project cannot be combined or clubbed together to determine whether the foreign enterprise would constitute a permanent establishment in India, unless the relevant tax treaty provides for aggregation of time spent on different projects or the activities of different projects of the foreign enterprise are so inextricably interconnected or interdependent that the contracts cannot be isolated from each other

DECISION

The ITAT ruled that in light of the provisions of Article 5(2)(i) of the DTAA, the activities of the offshore enterprise in this case cannot be combined together for calculation of the threshold limit as prescribed therein. It also held that Article 5(2)(i) of the DTAA does not provide for the aggregation of number of days spent on various sites, projects and activities. The ITAT also held that since aggregation of time spent by a foreign entity in engineering and construction contracts is specifically not provided in the Article 5(2)(i) of the Indian-

Mauritius Tax Treaty, therefore, it is not open to the Authority to infer the application of such aggregation principle.

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REASONING

As per Article 5(2)(i) of the DTAA, the site, project or supervisory activity should continue for a period of more than nine (9) months so as to constitute a permanent establishment in India. In certain tax treaties, such as India-Australia Tax Treaty and India-Thailand Tax Treaty, the relevant Article specifically provides

for aggregation of time spent on various projects.

The ITAT ruled that the aggregation of time spent on various activities should be done only in cases where the activities are so inextricably interconnected or interdependent that these are essentially required to be viewed as a coherent whole. The ITAT also stated that India has entered into various tax treaties with other countries wherein the principle of aggregation of duration of time has been specifically included, in case the activities of foreign entities engaged in construction and engineering contracts are proved to be commercially and geographically coherent with each other.

There are treaties entered into by India with other jurisdictions, wherein the principle of aggregation of duration of time has been specifically excluded for considering whether or not, a foreign entity engaged in construction and engineering contracts would constitute a PE in India.. The ITAT held that the true test is not geographical proximity and commercial nexus, but interconnection and independence of the contracts performed by such foreign entity in India. The ITAT was of the view that the duration test should be applied in cases where the tax treaty specifically includes/provides for aggregation of time spent in contracts related to engineering and construction contracts of foreign enterprise to determine whether such foreign enterprise would constitute a permanent establishment in India. In the absence of such provision, the activities performed under various engineering and construction contracts of a foreign enterprise should be so inextricably interconnected or interdependent so that no such contract can be isolated from each other for such foreign enterprise to constitute a permanent establishment in India