CASE NO.:
Appeal (civil) 9 of 2007

PETITIONER:
Ishikawajma-Harima Heavy Industries Ltd

RESPONDENT:
Director of Income Tax, Mumbai

DATE OF JUDGMENT: 04/01/2007

BENCH:
S.B. Sinha & Dalveer Bhandari

JUDGMENT:
J U D G M E N T
[Arising out of SLP (Civil) No.5318 of 2005]
S.B. SINHA, J :

Leave granted.

Appellant herein is a company incorporated in Japan. It is a resident of the said country. It pays its taxes in Japan. It is engaged, inter alia, in the business of construction of storage tanks as also engineering etc. It formed a consortium along with Ballast Nedam International BV, Itochu Corporation, Mitsui & Co. Ltd., Toyo Engineering Corporation and Toyo Engineering (India) Ltd. With the said consortium members, it entered into an agreement with Petronet LNG Limited (hereinafter referred to as "the Petronet") on 19.01.2001 for setting up a Liquefied Natural Gas (LNG) receiving storage and degasification facility at Dahej in the State of Gujarat. A supplementary agreement was entered into by the parties on 19.03.2001. The contract envisaged a turnkey project. Role and responsibility of each member of the consortium was specified separately. Each of the member of the consortium was also to receive separate payments. Appellant was to develop, design, engineer and procure equipment, materials and supplies, to erect and construct storage tanks of 5 MMTPA capacity, with potential expansion to 10 MMTPA capacity at the specified temperatures i.e. -200 degree Celsius. The arrangement also was to include marine facilities (jetty and island break water) for transmission and supply of the LNG to purchasers; to test and commission the facilities relating to receipt and unloading, storage and re-gasification of LNG and to send out of re-gasified LNG by means of a turnkey fixed lump-sum price time certain engineering procurement, construction and commission contract. The project was to be completed in 41 months. The contract indisputably involved : (i) offshore supply, (ii) offshore services, (iii) onshore supply, (iv) onshore services and (v) construction and erection. The price was payable for offshore supply and offshore services in US dollars, whereas that of onshore supply as also onshore services and construction and erection partly in US dollars and partly in Indian rupees.
Liability to pay income tax in India by the appellant herein being doubtful, an application was filed by the same before the Authority for Advance Rulings (Income Tax) (hereinafter referred to as 'the Authority') in terms of Section 241(Q)(1) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'). The following questions were proposed by the appellant for determination:

"1. On the facts and circumstances of the case, whether the amounts, received/receivable by the applicant from Petronet LNG for offshore supply of equipments, materials, etc. are liable to tax in India under the provisions of the Act and India-Japan tax treaty?

2. If the answer to (1) is in the affirmative in view of

Explanation (a) to section (1)(i) of the Act and/or Article (1) read together with the protocol of the India-Japan tax treaty, to what extent are the amounts reasonably attributable to the operations carried out in India and accordingly taxable in India?

3. On the facts and circumstances of the case, whether the amounts received/receivable by the applicant from Petronet LNG for offshore services are chargeable to tax in India under the Act and/or the India-Japan tax treaty?

4. If the answer to (3) above is in the affirmative, to what extent would be amounts received/receivable for such services be chargeable to tax in India under the Act and/or the India-Japan tax treaty?

5. If the answer to (3) above in the affirmative, would be applicant be entitled to claim deduction for expenses incurred in computing the income from offshore services under the Act and/or the India-Japan treaty?

Before the Authority no issue was raised as regards the liability of the appellant to pay income tax on onshore supply and onshore services and on its activities relating to construction and erection. The dispute centered round its exigibility to pay tax in respect of 'offshore supply' and 'offshore services'.

It is also not in dispute that the Government of India and the Government of Japan entered into a by-lateral treaty in regard to the tax liabilities.

Contention of the appellant before the Authority was that the contract being a divisible one, it did not have any liability to pay any tax in regard to offshore services and offshore supply. Revenue, on the other hand, contended that the contract being a composite and integrated one, they were so liable.

The Authority referred to a large number of decisions governing the field and opined that having regard to the provisions contained in Section 5 read with Section 9 of the Act, following propositions of law would emerge :

"(1) In a case of sale of goods simpliciter by a non-resident to a resident in India, if the consideration for sale is received abroad and the property in the goods also passes to the purchaser outside India, no income accrues or arises or deemed to accrue or arise to the seller in India.

(2) In a case of transaction of sale of goods by the non-resident to an Indian resident which is a part of a composite contract involving various operations within and outside India, income from such sale shall be deemed to accrue or arise in India if it accrues or arises through or from any business connection in India.

(3) In the case of a business of which all operations are not carried out in India, the deemed accrual or arising of income shall be only such part of the income as is reasonably attributable to the operations carried out in India.

(4) Whether there is business connection in India or/and whether all operations of the business are not carried out in India are questions of fact which have to be determined on the facts of each case."

Applying the said principles to the facts of the present case, the Authority opined that the appellant was liable to pay direct tax even under the Treaty having regard to Articles 5 and 7 thereof as also Clause 6 of the Protocol. It was held :

"The substance of the protocol quoted above, represents the consensus reached between the parties to the treaty in regard to the meaning of the phrase "directly or indirectly attributable to that permanent establishment" employed in paragraph 1 of article 7. Further, profits shall also be regarded as attributable to the permanent establishment to the extent indicated in the said protocol even when the contract or order relating to the sale or provision of goods or services in question is made or placed directly with the overseas head office of the enterprise rather than with the permanent establishment.

It would be clear that having regard to provisions of article 7(1) of the Treaty read with para 6 of the protocol supply of equipment of machinery (sale of which was completed abroad, having placed the order directly overseas office of the enterprise) the same should be within the meaning of the phrase directly or indirectly attributable to that permanent establishment."

As regards taxability of the amounts 'received' and 'receivable' by the appellant from Petronet for offshore services, it was held :

"In so far as the Treaty is concerned, both section 115A(1)(b)(B) and para 2 of Article 12 of the Treaty clearly indicates that the whole technical fee without any deduction is chargeable to tax, however, the tax so charged shall not exceed 20% of the gross amount of the royalty or fee for technical services."

Question Nos. 4 and 5 were held to be the consequential ones. It was opined :

"In the light of the above discussions we rule on :

(i) Question No.1 that on the facts and in the circumstances of the case, the amounts received/receivable by the applicant from Petronet LNG in respect of offshore supply of equipment and materials is liable to be taxed in India under the provisions of the Act and the India-Japan Treaty.

(ii) Question No.2 that in view of the Explanation (a) to section 9(1)(i) of the Act and/or Article 7(1) read with the Protocol of the India-Japan Treaty the amounts that would be taxable in India is so much of the profit as is reasonably attributable to the operations carried out in India, we decline to answer the other part of the question in regard to quantification of the amount taxable in India as the parties produced no evidence and did not address

in this regard.

(iii) Question No. 3 that the amount received/receivable by the applicant from Petronet LNG for offshore services is liable to be taxed in India both under the provisions of the Act as well as under Indo-Japan Treaty.

(iv) Question No.4 that the entire amount received for offshore services is chargeable to tax under the Act and under the Treaty but at the rate not more than 20% of the gross amount.

(v) Question No. 5 that the applicant would not be able to claim any deduction in computing the income from offshore service under the Act, and/or under the Indo-Japan Treaty."

Before us, the following findings of the Authority are not disputed :

"(i) the Petitioner has a business connection in India;

(ii) if consideration accrues only for supply of goods and the sale is completed outside India no profits can accrue in India;

(iii) however, if a contract envisages a composite consideration for the various obligations to be performed and if certain operations are to be performed by or through the business connection, then, profits would be deemed to accrue in India;

(iv) property in the goods, which were the subject matter of the offshore supply, passed outside India; and

(v) the petitioner has a permanent establishment in India within the meaning of the said term in paragraph 3 of Article 5 of the Double Taxation Avoidance Agreement entered into between the Governments of India and Japan (hereinafter referred to as "the DTAA")."

Mr. Harish N. Salve, the learned Senior Counsel appearing on behalf of Appellant, urged :

(i) The Authority misconstrued and misinterpreted the contract in arriving at its aforementioned findings, as from a bare perusal thereof, it would appear that the payments were made in US dollars in respect of 'offshore supply' and 'offshore services' and furthermore title to the goods passed on to Petronate outside the territories of India and services had also been rendered outside India;
(ii) The fact that the contract signed in India was of consequences as converse could not have made the appellant not liable to pay the tax;
(iii) The Authority committed a manifest error in arriving at its findings insofar as it failed to properly construe Explanation-2 appended to Section 9(1)(vii) of the Act as it was nobody's case that the consideration related to a construction, assembly, mining or like project so as to fall outside the scope thereof;
(iv) Although fee received by Appellant is effectively connected to the contract but it is not attributable to the permanent establishment and, therefore, Article 12(5) of the Double Taxation Avoidance Agreement (DTAA) is not attracted;
(v) Appellant being a non-resident in terms of Section 5(2) of the Act,

it would be chargeable to tax in India only in the event income accrues or arises in India or is deemed to accrue or arise in India or income is received or is deemed to be received in India and not otherwise;
(vi) As no part of the income for the 'offshore supply' or 'offshore services' is received in India, the Authority misdirected itself in passing the impugned judgment;
(vii) A legal fiction raised under the Act cannot be pushed too far. Also, as all operations in connection with the offshore supply are carried out outside India, the question of any portion of the consideration to be regarded as deemed to accrue or arise in India would not arise;
(viii) The requirement of the appellant to perform certain services in India, such as unloading, port clearance, transportation of the equipments supplied would not render the appellant eligible to tax as the consideration thereof is embedded in the consideration for the offshore supply;
(ix) Although the appellant was required to carry out certain activities in India, the consideration for offshore services had separately been provided for.
(x) Assuming that the income from the offshore supply is chargeable to tax in India on the premise that Section 9(1)(i) applies, it was required to be examined by the Authority as to whether it would also be chargeable in accordance with the provisions of the Double Taxation Avoidance Agreement (DTAA) in terms whereof no charge to tax in India was leviable in respect of the consideration for offshore supply.

Mr. Mohan Parasaran, the learned Additional Solicitor General appearing on behalf of the respondent, on the other hand, submitted :

(i) The question as to whether terms of the contract constitute a composite contract or not is essentially a question of fact and the findings of the Authority being final, therefore, should not ordinarily be interfered with;
(ii) The Authority having found in favour of the Revenue two primary tests to determine as to whether the contract in question was a composite one for execution of a turnkey project viz :
(a) whether the 'offshore' and 'onshore' elements of the contract are so inextricably linked that the breach of the 'offshore' element would result in the breach of the whole contract;
(b) whether the dominant object of the contract is the execution of a turnkey project and the question whether the title to the goods supplied passes offshore or within India is secondary to the execution of the contract,
the impugned judgment should not be interfered with;

(iii) Each component of the contract was directly relatable to the performance of the integrated contract as violation and/or breach on the part of the parties thereto would affect the entire contract;
(iv) The contract itself providing for milestone dates, the breach of any of the terms thereof would result in the breach of the entire contract and not just the particular obligation;
(v) The turnkey project contemplated a permanent establishment and in that view of the matter Explanation appended to Section 9(1)(i) of the Act is directly applicable.
(vi) The appellant has business connection in India and in that view of the matter the causal connection between the offshore supply and offshore services being interlinked with the entire project, the opinion of the Authority cannot be faulted;

(vii) By reason of DTAA, the parties thereto can always allocate the jurisdiction to tax the entire income attributable to such permanent establishment to the country in which it is established;

(viii) Supply of goods whether offshore or onshore as well as rendition of service whether offshore or onshore are attributable to the turnkey project and, thus, it would be wrong to contend that in terms of Article 7 of DTAA, no tax could be levied upon the appellant.

Contract : The Material Part :

Petronat LNG Limited, on the one hand, and five members of the consortium, on the other, are parties to the contract. The contract contained broad items. It has its own interpretation clauses. Clause 2.1 provides for scope of the work in the following terms :

"2.1 The Work

Except as otherwise expressly provided in this Contract, Contractor shall provide, furnish and perform, or cause to be provided, furnished and performed, on a turnkey basis all necessary design, engineering, procurement, supplies, installation, erection, construction, testing, commissioning, operation and turning over services, activities and work (including all rectification and remedial services, activities and work relating to defects and deficiencies) for the Equipment and Materials and the Facilities in accordance with the Scope of Work (Exhibit A) and the other terms, provisions and requirements of this Contract, including the Contract Schedule, and shall provide all necessary and sufficient Contractor's Equipment and experienced personnel having the requisite expertise for such purposes.

After Mechanical Completion of the Facilities, Contractor shall carry out Commissioning, start-up and testing of the Facilities and, if requested by Owner, shall provide advisory assistance in connection with the operation and maintenance of the Facilities and shall provide all necessary and sufficient experienced personnel having the requisite expertise for the prompt performance of any rectification and remedial work required until Final Acceptance of the Facilities, in accordance with this Contract.

The Parties acknowledge and agree that this Contract is a lump-sum firm fixed price time certain turnkey contract and Contractor's obligation to provide, furnish and perform its services, activities and work under this Contract includes Contractor providing Owner with the operating and completed Facilities, complete in every detail within the time and for the purposes specified in this Contract and to do and furnish Owner everything necessary in connection herewith.

The foregoing obligations, work, services, activities and responsibilities of Contractor are more fully set forth in this Contract, including the Scope of Work (Exhibit A). The Technical Documents and the obligations under Clause 2.2. are herein collectively referred to as the "Work".

Except as otherwise expressly provided in this Contract, Contractor agrees and acknowledges that Contractor shall perform all of its obligations and responsibilities under this Contract at its own risk, cost and expense."

Clause 2.2. provides for additional responsibilities of the appellant, which reads as under :.

"2.2 Additional Responsibilities

Except as otherwise expressly provided in this Contract, Contractor shall be responsible for providing, or causing the provision of, design, engineering, procurement,

erection, construction and commissioning and testing services, activities and work, and personnel and labour, and all Equipment and Materials (and components thereof) and Contractor's Equipment, and any other items not specifically described in the Scope of Work (Exhibit-A) and/or the Technical Documents if (a) it reasonably may be inferred in accordance with Good Industry Practice that the providing, or causing the provision, of such additional items was contemplated as part of the Work (including the Technical Documents) or (b) the providing, or causing the provision, of such additional items is necessary in order for Contractor to satisfy the Completion and Performance Guarantees and the warranties set forth, in this Contract and to make the Facilities operable and capable of performing as specified in the Technical Documents or as otherwise necessary in order to comply with the requirements of this Contract. Without limitation to the foregoing, wherever this Contract describes any portion of the Work in general terms, but not complete in detail, Contractor agrees that the Work shall include any incidental work, activities and services which may be reasonably inferred as required or necessary to complete and render operable the Facilities in accordance with the terms and conditions of the Contract, and owner shall have no obligation or responsibility whatsoever (except as specifically set forth in this Contract) with respect to the completion of the Facilities.

Contractor shall ensure that the Facilities shall be fit and suitable for its intended purpose (including attaining the Completion and Performance Guarantees) as evidenced by, or reasonably to be inferred from, this Contract, and shall fully comply with the Contract.

Work undertaken, Equipment and Materials (including components thereof), Contractor's Equipment, labour and personnel, and additional items provided pursuant to this Clause 2.2 shall not give rise to any adjustment in this Contract Price, the Contract Schedule or any other terms of this Contract, and shall be included in and comprise the Work for all purposes of this Contract.

Clause 7.1 provides for shipment in the following terms :

"7.1 Notice of Shipment

Contractor shall comply with and follow the procedures for shipment set forth in Section E of Exhibit H (General Project Requirements and Procedures). In particular, at least prior to arrival of each shipment in India, Owner and Owner's insurance company providing insurance will receive from the Contractor, the notice of shipment, such notice shall set forth the following information concerning such shipment : (a) a reference to the date, parties and subject matter of this Contract; (b) a description of, or that part of, the Equipment and Materials contained in such shipment; (c) the date of embarkation and departure, (d) the port of origin, (e) the means of shipment (air or sea); (f) the estimated date of arrival in India; (g) the port of entry in India; (h) the value of the shipment; (i) the approximate weight and volume (gross and net); (j) the name, flag and owner of the vessel if shipment by sea or the designation of aircraft

if ship is by air; and (k) the number and value of bill of lading or airfreight bill. Contractor shall ensure that a provision similar to this Clause 7.1 is included in all agreements with Suppliers.

Contractor shall be responsible for packing, loading, transporting, receiving, unloading, storing and protecting all Equipment and Materials and/or Contractor's Equipment and other things required for the Works."

Price is specified under Clause 13.1 in the following terms :

"13.1 Contract Price

The total price to be paid by or on behalf of Owner to Contractor in full consideration for the performance by Contractor of its obligations and responsibilities under this Contract, including the Work, shall be a fixed and firm lump sum price of US$ 151,044.192 (One hundred fifty one million forty four thousand one hundred ninety two US Dollars) (the "US Dollar Portion) and Rs.7,602,796,324 (Seven billion six hundred two million seven hundred ninety six thousand three hundred twenty four Indian Rupees) (the "Indian Rupee Portion"), which shall be subject to adjustment only as provided under Clause 13.4 (the US Dollar Portion and the Indian Rupee Portion, as the same may be so adjusted, together, the "Contract Price")."

The contract envisages that the appellant may do the job itself or get the same done by sub-contracting. It may only do a part of the job itself.

The contract splits in dollar and rupee components separately. Clause 14.8 provides for general terms of payment, effect of payment and methodology of payment. Pursuant to or in furtherance whereof separate payment in US dollars and Indian rupees is to be made depending upon the nature of supply viz. offshore supply and offshore services and onshore supply and onshore services.

Clause 22.1 deals with passing of title to the goods supplied in the following terms :

22.1 Title to Equipment and Materials and Contractor's Equipment

Contractor agrees that title to all Equipment and Materials shall pass to Owner from the Supplier or Subcontractor pursuant to Section E of Exhibit H (General Project Requirements and Procedures). Contractor shall, however, retain care, custody, and control of such Equipment and Materials and exercise due care thereof until (a) Provisional Acceptance of the Work or (b) termination of this Contract, whichever shall first occur. Such transfer of title shall in no way affect Owner's rights under any other provision of this Contract."

The interpretation of different components of contract has been dealt within Annexure-A appended thereto. So far as 'offshore services work items' are concerned, the same has been defined to mean the items of work set forth as item numbers D-2.2.1, 2.2.2 and 2.2.3 of the Contract Price Schedule; details whereof have been mentioned in the said Annexure, which, inter alia, provides :

Notes

General

1. xxx xxx xxx

2. Offshore supply (Exhibit D-2.1) is the price of Equipment & Material (including cost of engineering, if any, involved in the manufacture of such Equipment & Material) supplied from outside India on CFR basis, and the property therein shall pass on to the Owner on high seas for permanent incorporation in the Works, in accordance with the provisions of the Contract.

3. Offshore Services (Exhibit D-2.2) is the price of design and engineering including detail engineering in relation to supplies, services and construction & erection and cost of any other services to be rendered from outside India.

4. Onshore Supply (Exhibit D-2.3 is the price of Equipment & Material supplied from within India for direct delivery at Site and permanent incorporation in the Works.

5. Onshore services (Exhibit D-2.4) is the price of design engineering, detail engineering, customs clearance, inland transportation, procurement services, supervision services, project management, testing and commissioning and any such service in relation to the Works rendered in India."

The break down of contract price is as under :

Exhibit No./Sl. No.	Description of Scope	In Indian Rupees	In US Dollars	Name and address of Contracting entity
D-2.1	Offshore Supply (Total of 2.1.1., 2.1.2 and 2.1.3	Nil	81,711,877	IHI, BNI & TEIL
D-2.2	Offshore Services (Total of 2.2.2 to 2.2.3)			

Nil
19,756,225
IHI, BNI &
TEIL
D-2.3
Onshore Supply
(Total of 2.3.1 to
2.3.3)
1,869,978,658
Nil
IHI, BNI &
TEIL
D-2.4
Onshore Services
(Total of 2.4.1 to
2.4.3)
1,774,353,282
12,780,467
IHI, BNI &
TEIL
D-2.5
Construction and
Erection
(Total of 2.5.1. to
2.5.3)
3,958,464,384
36,795,623
IHI, BNI &
TEIL
D-2.0
Total (D-2.1 to D-
2.5) (See Note 9
7,602,796,324
151,044,192

Treaty : Double Taxation Avoidance Agreement (DTAA) :
Article 5 of the Double Taxation Avoidance Agreement (DTAA) between India and Japan, inter alia, provides as under :

"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially :

(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
(g) a warehouse in relation to a person providing storage facilities for others;
(h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;
(i) a store or other sales outlet; and
(j) an installation or structure used for the exploration of natural resources, but only if so used for a period of more than six months.

\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005\005"

Clause 1 of Article 7 of the said agreement reads as under :

"1. The profits of an enterprise of a Contacting State shall be taxable only in that Contracting 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 that other Contracting State but only so much of them as is directly or indirectly attributable to that permanent establishment."

Clauses 1, 2 and 5 of Article 12 which are relevant for the purpose of this case, read as under :

"1. Royalties and fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.

2. However, such royalties and fees for technical services may also be taxed in the Contracting State in which they arise and according to the laws of that Contracting State, but if the recipient is the beneficial owner of the royalties or fees for technical services, the tax so charged shall not exceed 20 per cent of the gross amount of the royalties or fee for technical services.

5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise, through a permanent establishment situated therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, and the right, property or contract in respect of which the royalties or fees for technical services are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of article 7 or article 14, as the case may be, shall apply."

The Treaty contains the Japanese notes, clause 6 whereof reads as under :

"6. With reference to paragraph 1 of article 7 of the Convention, it is understood that by using the term "directly or indirectly attributable to the permanent establishment", profits arising from transactions in which the permanent establishment has been involved shall be regarded as attributable to the permanent establishment to the extent appropriate to the part played by the permanent establishment in those transactions. It is also understood that profits shall be regarded as attributable to the permanent establishment to the above-mentioned extent, even when the contract or order relating to the sale or provision of goods or services in question is made or placed directly with the overseas head office of the enterprise rather than with the permanent establishment."

Statutory provisions :

Sections 5(2), Section 9(1)(i), Section 9(1)(vii) of the Act, which are relevant for our purpose, read as under :

"5(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which \026

(a) is received or is deemed to be received in India in such year by or on behalf of such person; or

(b) accrues or arises or is deemed to accrue or arise to him in India during such year."

"9(1). The following incomes shall be deemed to accrue or arise in India :

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India or through the transfer of a capital asset situate in India.

\005 \005 \005 \005

(vii) income by way of fees for technical services payable by \026

(a) the Government; or

(b) a person who is a resident, except where the fees are payable in respect of services utilized in a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India; or

(c) a person who is a non-resident, where the fees are payable in respect of services utilized in a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India :

Provided that nothing contained in this clause shall apply in relation to any income by way of fees for technical services payable in pursuance of an agreement made before the 1st day of April, 1976, and approved by the Central Government."

Analysis :

For the purpose of taxation, the authority had proceeded on the basis that the element of tax consisted of : (i) onshore supply and onshore services; and (ii) construction of offshore supply and offshore services. It is not denied or disputed, as indicated hereinbefore, that in respect of the first element of onshore supply and onshore service, and construction tax would be payable in India.

Two basic issues which, thus, arise for our consideration are : (a) the taxation of the price of goods supplied, by way of offshore supply price of which is specified in Ex. D, Clause 2.1; and (b) the taxation of consideration paid for rendition of services described in the contract as offshore services

at Ex. D.

The contract is a complex arrangement. Petronat and Appellant are not the only parties thereto, there are other members of the consortium who are required to carry out different parts of the contract. The consortium included an Indian company. The fact that it has been fashioned as a turnkey contract by itself may not be of much significance. The project is a turnkey project. The contract may also be a turnkey contract, but the same by itself would not mean that even for the purpose of taxability the entire contract must be considered to be an integrated one so as to make the appellant to pay tax in India. The taxable events in execution of a contract may arise at several stages in several years. The liability of the parties may also arise at several stages. Obligations under the contract are distinct ones. Supply obligation is distinct and separate from service obligation. Price for each of the component of the contract is separate. Similarly offshore supply and offshore services have separately been dealt with. Prices in each of the segment are also different.

The very fact that in the contract, the supply segment and service segment have been specified in different parts of the contract is a pointer to show that the liability of the appellant thereunder would also be different.

The contract indisputably was executed in India. By entering into a contact in India, although parts thereof will have to be carried out outside India would not make the entire income derived by the contractor to be taxable in India. We would, however, deal with this aspect of the matter a little later.

Scope of work is contained in clause 2.1 of Ex. A appended to the contract which includes supply of equipment, materials and facilities. The said exhibit spells out different systems to be set in place. It imposes an obligation on the contractor to supply equipments required therefor. It was to arrange for the engineering services in relation thereto. It was also required to render various other services within India. Ex. D, however, provides for the prices to be paid in respect of offshore supplies and offshore services, onshore supply and onshore services, construction and erection. Payment schedule has also been separately specified in respect of each of the components separately.

It is not in dispute that title in the equipments supplied was to stand transferred upon delivery thereof outside India on high-sea basis as provided for in Article 22.1. Similarly, Article 13.1. provides for a lump sum contract price, whereas Article 13.3.2. specifically refers to the cost of offshore supplies. The provisions with regard to offshore supplies and offshore services were to be read with the provisions contained in Ex. D which formed the basis of customs duty. Clause 13.4 refers to Ex. D as the basis for price escalation.

The question of imposition of tax on income arising from a business connection may, thus, have to be considered keeping in view the aforementioned factual backdrop.

Section 9(1)(i) of the Act states that income accruing or arising whether directly or indirectly, through or from any business connection in India shall be deemed to accrue or arise in India. Appellant is a non-resident assessee.

Section 9 raises a legal fiction; but having regard to the contextual interpretation and furthermore in view of the fact that we are dealing with a taxation statute the legal fiction must be construed having regard to the object it seeks to achieve. The legal fiction created under Section 9 of the Act must also be read having regard to the other provisions thereof. [See Maruti Udyog Ltd. v. Ram Lal and Others, (2005) 2 SCC 638]

For our benefit we may notice the provisions of Section 42 of the

Income Tax Act, 1922. It provided that only such part of income as was attributable to the operations carried out in India would be taxable in India.

Territorial nexus doctrine, thus, plays an important part in assessment of tax. Tax is levied on one transaction where the operations which may give rise to income may take place partly in one territory and partly in another. The question which would fall for our consideration is as to whether the income that arises out of the said transaction would be required to be proportioned to each of the territories or not.

Income arising out of operation in more than one jurisdiction would have territorial nexus with each of the jurisdiction on actual basis. If that be so, it may not be correct to contend that the entire income 'accrues or arises' in each of the jurisdiction. The Authority has proceeded on the basis that supplies in question had taken place offshore. It, however, has rendered, its opinion on the premise that offshore supplies or offshore services were intimately connected with the turnkey project.

The learned Additional Solicitor General in support of his contention that the contract is a composite one, has relied upon the following decisions : N. Khadervali Sahib (Dead) by L.Rs. and Another v. N. Gudu Sahib (Dead) and Others [(2003) 3 SCC 229]; Hindustan Shipyard Ltd. v. State of A.P. [(2000) 6 SCC 579]; State of Rajasthan v. M/s Man Industrial Corporation Ltd. [(1969) 1 SCC 567], K.S. Subbiah Pillai v. Commissioner of Income Tax [(1999) 3 SCC 170]; M/s Patnaik and Co. Ltd. v. Commissioner of Income Tax, Orissa [(1986) 4 SCC 16]; BSES Ltd. (Now Reliance Energy Ltd.) v. Fenner India Ltd. and Another [(2006) 2 SCC 728]. The said decisions, in our considered view, are not applicable herein.

In Khadervali Sahib (supra), the question which arose for consideration was whether an award amounted to creation of or transfer of any fresh rights in respect of movable or immovable properties so as to require registration under Section 17 of the Registration Act, when the same related to the properties of a partnership firm. Therein by reason of an award, the residue upon settlement of accounts on dissolution of the partnership firm was allocated to the partners. It was held that the award did not require any registration.

In Hindustan Shipyard (supra), the question which arose for consideration was whether a contract constituted a sale or works contract. Laying down the tests therefor, having regard to the terms and conditions contained therein, it was opined that a contract of sale of goods was separate from a contract for works and labour. In regard to the categories of contract, it was stated :

"(i) the contract may be for work to be done for remuneration and for supply of materials used in the execution of the work for a price;

(ii) it may be a contract for work in which the use of the materials is accessory or incidental to the execution of the work; and

(iii) it may be a contract for supply of goods where some work is required to be done as incidental to the sale."

Whereas the first contract was held to be a composite contract, the second was held to be a contract for work and labour not involving the sale of goods; and the third was held to be a contract of sale where the goods were sold as chattels and the work done was merely incidental thereto.

The view taken in State of Madras v. Gannon Dunkerley & Co. (Madras) Ltd. [1959 SCR 379] is sought to be applied. The contract in such a case must stipulate that the equipment would be supplied on CRF basis. It

spells out the price for supply of goods, in which event, for the purpose of sales tax, the contract would involve sale of goods. The principle of Gannon Dunkerly (supra), does not appear to be of much relevance in the instant case.

Decisions of this court under the Sales Tax Laws referred to by the learned counsel, moreover, may have to be considered on a different footing.

In this case, we are faced with a different situation. It is only for the purpose of taxability that the terms of the contract are required to be construed. A turnkey contract may involve supply of materials used in the execution of the contract for price as also for use of the materials by works and labour; but the same may not have any relation with the taxability part of it.

It is interesting to note that Instruction No.1829 issued by the Central Board of Direct Taxes on 21.09.1989 provides for certain guidelines having regard to the possibility of undertaking of Hydro Electric Power Project by a consortium of a foreign company, stating :

"The concept of turnkey execution of the project involves total and complete responsibilities of the persons undertaking the contracts for commissioning the project and they are accordingly required to furnish performance guarantees for timely completion."

It was further stated :

"Apart from the separate contracts for the jobs mentioned in Para 4 above, there would be an overall co-ordination agreement between the public sector company on the one hand and the foreign contracting parties referred to in Paragraph 4 on the other hand to ensure guaranteed performance of all the contracts in a coordinated manner, and within an agreed time frame and for undertaking to meet necessary liabilities and responsibilities including payments of liquidated damages for delays etc. One of the companies would, for this purpose, act as leader to ensure supervision and coordination of inter-related tasks."

In M/s Man. Industrial Corporation Ltd. (supra), this Court held :

"16. Our attention was invited to a judgment of the Court of Appeal in Love v. Norman Wright (Builders) Ltd. [1944] 1 K.B. 484 In that case the respondents contracted with the Secretary of State for War to do the work and supply the material mentioned in the Schedules to the contract, including the supply of black-out curtains, curtain rails and battens and their erection at a number of police stations. It was held by the Court of Appeal that the respondents were liable to pay purchase-tax. Reliance was placed upon the observations made by Godiard, L.J. at p. 482:

"If one orders another to make and fix curtains at his house the contract is one of sale though work and labour are involved in the making and fixing, nor does it matter that ultimately the property was to pass to the War Office under the head contract. As between the plaintiff and the defendants the former passed the property in the goods to the defendants who passed it on to the War Office."

We do not think that these observations furnish a universal test that whenever there is a contract to "fix" certain articles made by a manufacturer the contract must

be deemed one for sale and not of service. The test in each case is whether the object of the party sought to be taxed is that the chattel as chattel passes to the other party and the services rendered in connection with the installation are under a separate contract or are incidental to the execution of the contract of sale."

In M/s Patnaik and Co. (supra), whereupon reliance has been placed by the learned Additional Solicitor General, the question which arose for consideration was as to whether the investment in the loan by the assessee out of the advance payment made by the Government departments was a capital asset and the loan was a capital loan or not. We are not herein concerned with such a situation. The said decision, therefore, cannot be said to have any application at all.

In BSES Ltd. (supra), this Court was concerned with the construction of bank guarantees. The question which arose for consideration therein was as to whether in the fact situation of the case, customer faced irretrievable injuries so as to obtain an order of injunction. In view of the terms and conditions of the contract, it was opined, although for the sake of convenience, the same had been split up into four sub-contracts, it constituted a composite contract executable on a turnkey basis. The question which arose for consideration, thus, was whether in terms of the contract having been reduced into writing by the "wrap around agreement", Appellant therein had a right to negotiate any or all the guarantees for any breach of any of the four contracts. The said decision again has no application in the facts of the present case.

Tax under the Act has to be assessed under different heads. Income under one head may be subject to exemption; under same head, deductions may be claimed; yet under another, no tax may be payable at all. Whether a part of the income of the assessee would be taxable or not depends upon the fact of each case. Even there is nothing to prevent the income accruing or arising at the sources.

In Union of India and Another v. Azadi Bachao Andolan and Another (2004) 10 SCC 1], this Court was dealing with a double taxation treaty. It was held :

"6. The Agreement provides for allocation of taxing jurisdiction to different contracting parties in respect of different heads of income. Detailed rules are stipulated with regard to taxing of dividends under Article 10, interest under Article 11, royalties under Article 12, capital gains under Article 13, income derived from independent personal services in Article 14, income from dependent personal services in Article 15, directors' fees in Article 16, income of artists and athletes in Article 17, governmental functions in Article 18, income of students and apprentices in Article 20, income of professors, teachers and research scholars in Article 21 and other income in Article 22.

In Commissioner of Income Tax, Bombay v. Ahmedbhai Umarbhai & Co., Bombay [(1950) SCR 335], this Court, having regard to the provisions contained in Section 42 of the Income Tax Act, 1922, held that profits accrued to the assessee of a part of the business in an Indian State having accrued out of such business carried on in such State are exempted under the third proviso to Section 5 of the Excess Profit Tax Act.

Opining that the source of income can never be the place where the income accrues or arises, Kania, CJ, stated :

"\005In my opinion there is nothing to prevent income accruing or arising at the place of the source. The question where the income accrued has to be determined

on the facts of each case. The income may accrue or arise at the place of the source or may accrue or arise elsewhere, but it does not follow that the income cannot accrue or arise at the place where the source exists. Therefore it is necessary to ascertain whether that part of the business which is capable of being treated as one separate unit in the Hyderabad State has given rise to the income or profit sought by the assessee to be exempted from taxation in the present case\005"

Patanjali Sastri, J. approved the application of the principle underlying the decision in Commissioner of Taxation v. Kirk [(1900 AC 588], namely, the principle of apportioning profits as between different processes employed in producing those profits and the different places where they were employed.

Mahajan, J. held :

"\005For instance, where a person carries on manufacture, sale, export and import, it is not possible to say that the place where the profits accrue to him is the place of sale. The profits received relate firstly to his business as a manufacturer, secondly to his trading operations, and thirdly to his business of import and export. Profit or loss has to be apportioned between these businesses in a businesslike manner and according to well-established principles of accountancy. In such cases it will be doing no violence to the meaning of the words "accrue" or "arise" if the profits attributable to the manufacturing business are said to arise or accrue at the place where the manufacture is being done and the profits which arise by reason of the sale are said to arise at the place where the sales are made and the profits in respect of the import and export business are said to arise at the place where the business is conducted. This apportionment of profits between a number of businesses which are carried on by the same person at different places determines also the place of the accrual of profits. To hold that though a businessman has invested millions in establishing a business of manufacture, whether in the nature of a textile mill or in the nature of steel works, yet no profits are attributable to this business or can accrue or arise to the business of manufacture because the produce of his mills is sold at a different place and that it is only the act of sale by which profits accrue and they arise only at that place is to confuse the idea of receipt of income and realization of profits with the idea of the accrual of profits. The act of sale is the mode of realizing the profits. If the goods are sold to a third person at the mill premises no one could have said that these profits arose merely by reason of the sale. Profits would only be ascribed to the business of manufacture and would arise at the mill premises. Merely because the mill owner has started another business organization in the nature of a sales depot or a shop, that cannot wholly deprive the business of manufacture of its profits, though there may have to be apportionment in such a case between the business of manufacture and business of shop keeping. In a number of cases such apportionment is made and is also suggested by the provisions of Section 42 of the Indian Income Tax Act, reference to which has also been made in Proviso (2) of Section 5 of the Excess Profits Tax Act."

In Anglo-French Textile Co. Ltd. v. Commissioner of Income Tax, Madras (1954) SCR 523], the question which arose for consideration, inter alia, was :

" (2) Can the income received in India be said to arise in India within the meaning of Section 4-A(c)(b) of the Act? If not, should only those profits determined under Section 42(3) as attributable to the operations carried out in India be taken into account for applying the test laid down in Section 4-A(c)(b), and remanded the case to the High Court with the direction that it should give its opinion on these two questions."

In regard to the first question, it was opined that Section 42(3) had nothing to do with the determination of the income arising in the taxable territories as distinguished from the income arising without taxable territories as understood in Section 4A(c)(b) of the Act, it was held

"The phraseology of Section 42(3) of the Act also repels the contention insofar as the profits and gains of the business which are referred to therein and which are capable of apportionment as therein mentioned are deemed to accrue or arise in the taxable territories thus using the words "accrue" and "arise" as synonymous with each other.

The above passage is also sufficient in our opinion to establish that the apportionment of income, profits or gains between those arising from business operations carried on in taxable territories and those arising from business operations carried on without the taxable territories is based not on the applicability of Section 42(3) of the Act but on general principles of apportionment of income, profits or gains\005"

While the first question was answered in negative, question no.2 was answered in the following terms :

"Question 2\027The income received in British India cannot be said to wholly arise in India within the meaning of Section 4-A(c)(b) of the Act and that there should be allocation of the income between the various business operations of the assessee company demarcating the income arising in the taxable territories in the particular year from the income arising without the taxable territories in that year for the purposes of Section 4-A(c)(b) of the Act."

In Carborandum Co. v. Commissioner of Income-Tax, Madras [(1977) 108 ITR 335 : (1977) 2 SCC 862], this Court referring to its earlier decision in Commissioner of Income Tax, Punjab v. R..D. Aggarwal and Co.& Another [(1965) 56 ITR 20], opined :

"15. On a plain reading of sub-sections (1) and (3) of Section 42 it would appear that income accruing or arising from any business connection in the taxable territories \027 even though the income may accrue or arise outside the taxable territories \027 will be deemed to be income accruing or arising in such territory provided operations in connection with such business, either all or a part, are carried out in the taxable territories. If all such operations are carried out in the taxable territories, sub-

section (1) would apply and the entire income accruing or arising outside the taxable territories but as a result of the operations in connection with the business giving rise to the income would be deemed to accrue or arise in the taxable territories. If, however, all the operations are not carried out in the taxable territories the profits and gains of the business deemed to accrue or arise in the taxable territories shall be only such profits and gains as are reasonably attributable to that part of the operations carried out in the taxable territories. Thus comes in the question of apportionment under sub-section (3) of Section 42."

In CIT v. Mitsui Engineering and Ship Building Co. Ltd. [259 ITR 248], on which reliance was placed; the contention was that the finding that the contract for designing, engineering, manufacturing, shop testing and packing up to f.o.b port of embarkation could not be split up since the entire contract was to be read together and was for one complete transaction. It was in the said fact situation held that it was not possible to apportion the consideration for design on one part and the other activities on the other part. The price paid to the assessee was the total contract price which covered all the stages involved in the supply of machinery.

This case is clearly distinguishable from the facts of the present case, since the payment for the offshore and onshore supply of goods and services was in itself clearly demarcated and cannot be held to be a complete contract that has to be read as a whole and not in parts.

The principle of apportionment is also recognized by Clause (a) of Explanation I. Thus, if submission of the learned Additional Solicitor General is accepted that the contract is a composite one, then offshore supply would be of equipment designed and manufactured in one territory (Japan), and then sold in another tax territory, leading to division of profits arising in two tax territories, which is not envisaged under our taxation law.

It gives rise to the question as to what would be the meaning of the phrase 'business connection in India'. Mere existence of business connection may not result in income of the non-resident assessee from transaction with such a business connection accruing or arising in India.

In Mazagaon Dock Ltd. v. CIT and Excess Profits Tax [34 ITR 368], whereupon again reliance placed is distinguishable. In that case a non-resident carried on business with a resident, and the issue adjudicated upon by the Court was that whether there was a clear and close connection between them that produced profits or not, and whether any such income generated by the non-resident company sending its ships for repairs to the resident company is taxable, if it amounted to business. The Court answered both questions affirmatively.

The principle laid down therein has no application to the current fact situation because there was an extremely close connection between the appellant company and non residents in that the two non-resident (British) companies beneficially owned the entire share capital of the appellant company. In the present situation there is no such connection, which can be said to give rise to a business connection between the permanent establishment in India and the transaction that is sought to be taxed.

Yet again in Anglo French Textile Co. Ltd. v. CIT Madras [23 ITR 101], in the fact situation obtaining therein, it was held that when there was a continuity of business relationship between the person in India who helps make the profits and the person outside who receives or realizes this profit, a business connection exists.

In that case, the Assessee company incorporated in the UK, owned a

textile company in French Pondichery and had appointed another limited company in Madras to act as its constituted agents. The same was held to be a business connection within British India. Such a close connection cannot be envisaged in the present case since it does not involve any such principle-agent relationship between the PE and the non residents.

Barendra Prasad Ray v. ITO [129 ITR 295] whereupon reliance has been placed, is not apposite. Therein, the Court held that the professional relationship of a solicitor, who was a non-resident, with an Indian firm will be a business connection. There was a connection between the Indian firm and the British solicitor which was real and intimate and not just a casual one and the fees earned by the solicitor was only through this connection, and could not have done so without associating himself with the firm. Thus, the income earned by the solicitor was subject to tax in India, and payable by the firm as agents of the solicitor.

The principle of this case, is again not applicable in the present scenario since the nature of the relationship between the permanent establishment, the foreign firms and the Indian firms are evidently contractual and not professional. And the transaction of sale and supply of goods offshore have not taken place with the involvement of the permanent establishment, therefore excluding this transaction from the scope of taxation in India.

In Commissioner of Income-Tax, A.P. v. Toshoku Ltd. [(1980) 125 ITR 525 : (1980) Supp. SCC 614], this Court interpreted Section 9(1)(i) and the Explanation thereto on the factual matrix obtaining therein that the statutory agent exported his goods to Japan and France where they were sold through the assessee and the entire sales price was received in India by the said agent who made credit entries in his accounts books regarding the commission amounts payable to the assessees and remitted the commission amounts to them subsequently. Having regard to the fact that the Japanese company was a non-resident company, distinguishing the case Raghava Reddi & Another v. Commissioner of Income Tax, A.P. [(1962) 44 ITR 720] , it was held :

"\005It is not possible to hold that the non-resident assessees in this case either received or can be deemed to have received the sums in question when their accounts with the statutory agent were credited, since a credit balance without more only represents a debt and a mere book entry in the debtor’s own books does not constitute payment which will secure discharge from the debt. They cannot, therefore, be charged to tax on the basis of receipt of income actual or constructive in the taxable territories during the relevant accounting period."

A Division Bench of the Karnataka High Court presided over by Venkataramiah, J., in VDO Tachometer Werke, West Germany etc. v. Commissioner of Income-Tax, Karnataka-I etc. [(1979) 117 ITR 804] following Carborandum Co. (supra), held that notwithstanding the amendment of Section 9 of the Act by the addition of Clauses (vi) and (vii), the cases continued to be governed by the provisions of Section 9 of the Act.

In Commissioner of Income-Tax v. Atlas Steel Co. Ltd. [(1987) 164 ITR 401], a Division Bench of the Calcutta High Court following Carborandum (supra) and other decisions held :
"35. The expression "business connection" in the context of the Income-tax Act has come to acquire a special meaning as laid down by the Supreme Court in R. D. Aggarwal & Co.’s case. A business connection contemplated under Section 42 of the Indian Income-tax Act, 1922 (corresponding to Section 9 of the Income-tax Act, 1961, involved "a relation between a business

carried on by a non-resident and some activity in the taxable territories which are attributable directly or indirectly to the earnings, profits or gains of such business". It was laid down by the Supreme Court that there must be trading activity both outside and within the taxable territory. In the facts of this case, for the supply of inventions, patents, application for patents, secret knowledge and know-how, no trading activity had been or was required to be carried on by the assessee within the taxable territory. Further, on a consideration of the agreement, it cannot be said that the trading activity which was intended to be carried on by the assessee as production adviser of Hindustan Steel Ltd., in future was relatable to or connected with the past supply of the said know-how and other items.

[See also Income-Tax Officer and Others v. Shriram Bearings Ltd. \026 (1987) 164 ITR 419]

A similar view was taken, when the matter came before this Court in Income-Tax Officer and Others v. Shriram Bearings Ltd. [(1997) 224 ITR 724 : (1997) 10 SCC 332], wherein B.P. Jeevan Reddy, J. speaking for the Division Bench, opined :

"We are not prepared to agree that the High Court has not correctly understood the purport of the agreement between the respondent and M/s Nippon Seike Kabushiki Kaisha (NSK). The agreement is in two parts. It is true that the two parts are interdependent but yet the consideration for the sale of trade secrets and consideration of technical assistance is separately provided for and mentioned under separate sections. So far as the consideration for the technical assistance is concerned, its taxability is not in doubt. The only controversy is with respect to the taxability of 1,65,000 US Dollars which is stipulated as the consideration for sale of trade secrets. The agreement specifically says that the said sale is effected in Japan. We are unable to see on what basis it can be said that any part of the said amount has been earned in India."

In construing a contract, the terms and conditions thereof are to be read as a whole. A contract must be construed keeping in view the intention of the parties. No doubt, the applicability of the tax laws would depend upon the nature of the contract, but the same should not be construed keeping in view the taxing provisions.

In Commissioner of Income-Tax, Tamil Nadu-V v. Fried Krupp Industries [(1981) 128 ITR 27], a Division Bench of the Madras High Court opined :

"\005Nowadays we have what are called turnkey projects, and in such projects until the machinery is actually run and proves its performance, the responsibility of the foreigner would continue. But in the present case the contract cannot be equated to a turnkey contract. The operations in India for the erection of the machinery are only the responsibility of the Indian company. It is only any defect in the machinery or any negligence in the performance of the foreign engineer, that may give rise to a claim for damages. But that is not the same as the foreign company performing any operation in pursuance of this contract in India. Whatever we have said above would apply also to deputation of foreign personnel for procuring Indian spare parts. It was obviously considered

necessary to get foreign personnel from abroad for this purpose only because the type of spare parts required for the foreign machinery could be better picked up by these personnel, who have experience in running the machinery. It is merely an assistance provided to the Indian company, the foreign personnel being treated as the employees of the Indian company. Having gone through the terms of the agreement in full, we are satisfied that there are no operations in India attributable to the foreign company which can give rise to any profits being earned in India. The agreement itself says that the terms of the payments were in Germany. Thus, there is absolutely no operation in India which would give rise to tax liability in India as far as the foreign company is concerned\005"

The term 'permanent establishment' has not been defined in the Income Tax Act.

Since the appellant carries on business in India through a Permanent Establishment, they clearly fall out of the applicability of Article 12(5) of the DTAA and into the ambit of Article 7. The Protocol to the DTAA, in paragraph 6, discusses the involvement of the permanent establishment in transactions, in order to determine the extent of income that can be taxed. It is stated that the term 'directly or indirectly attributable' indicates the income that shall be regarded on the basis of the extent appropriate to the part played by the permanent establishment in those transactions. The permanent establishment here has had no role to play in the transaction that is sought to be taxed, since the transaction took place abroad.

Clause 1 of Article 7, thus, provides that if an income arises in Japan (Contracting State), it shall be taxable in that country unless the enterprise carries on business in the other Contracting State (India) through a permanent establishment situated therein. What is to be taxed is profit of the enterprise in India, but only so much of them as is directly or indirectly attributable to that permanent establishment. All income arising out of the turnkey project would not, therefore, be assessable in India, only because the assessee has a permanent establishment.

It is relevant to note that the tax treaty between India and Japan is essentially based on OECD model, providing :

"a) the income of a resident, including of the kind that would fall under would be table under Section 9, would be taxed in the State of residence, save and except the income attributable to a Permanent Establishment, and

b) even in the case of a permanent establishment, income from business would be taxable in the State of residence."

In Klaus Vogel on Double Taxation Conventions, it is stated :

"g) No force of attraction principle : The second sentence of Art. 7 (1) allows the State of the permanent establishment to tax business profits, 'but only so much of them as is attributable to that permanent establishment'. The MC has thus decided against adopting the so-called 'force of attraction of the permanent establishment', i.e. against the principle that, where there is a permanent establishment, the State of the

permanent establishment should be allowed to tax all income derived by the enterprise from sources in that State irrespective of whether or not such income is economically connected with the permanent establishment. In line with the domestic law then prevailing in the USA, such a 'force of attraction' was, for instance, incorporated in Germany's 1954 DTC with USA (second sentence of Art. III (I). In contrast, the second sentence of Art. 7(1) MC allows the State of the permanent establishment to tax only those profits which are economically attributable to the permanent establishment, i.e. those which result from the permanent establishment's activities, which arise economically from the business carried on by the permanent establishment (cf. also para 5 MC Comm. Art. 7, supra m. no. 10). As regards the profits made by the enterprise in the State of the permanent establishment, a distinction must always be made between those profits which result from the permanent establishment's activities and those made, without any interposition of the permanent establishment, by the head office or any other part of the enterprise (also for mere assembly permanent establishment :BFH 37 RIW 258 (1991). It is only when there is a connection with the permanent establishment that the State of the permanent establishment is entitled to impose tax. Conversely, losses incurred in connection with direct transactions may not be set off against a permanent establishment's profits. Since a DTC may not increase tax liability, the USA, it is true, imposes tax at the lower amount that would ensue if the permanent establishment's business and direct transactions were combined and treated as if no DTC existed (of course, the taxpayer may, in such event, not only set off the result of individual direct transactions, which amounted to a loss against the permanent establishment's positive operating result :I.R.S. Rev. Rul. 84-17, 1984-I Cum. Bull. 308). According to that ruling, the taxpayer is in such cases entitled to elect taxation which discounts the DTC. (see surpa Art. I, at m. no.44)."

We generally agree with the said statement law.

The distinction between the existence of a business connection and the income accruing or arising out of such business connection is clear and explicit. In the present case, the permanent establishment's non-involvement in this transaction excludes it from being a part of the cause of the income itself, and thus there is no business connection.

Article 5.3 provides that a person is regarded as having a permanent establishment if he carries on construction and installation activities in a Contracting State only if the said activities are carried out for more than six months. Paragraph 6 of the Protocol to India Japan Tax Treaty also provides that only income arising from activities wherein the permanent establishment has been involved can be said to be attributable to the permanent establishment. It gives rise to two questions, firstly offshore services are rendered outside India; the permanent establishment would have no role to play in respect thereto in the earning of the said income. Secondly, entire services having been rendered outside India, the income arising therefrom cannot be attributable to the permanent establishment so as to bring within the charge of tax.

For attracting the taxing statute there has to be some activities through permanent establishment. If income arises without any activity of the permanent establishment, even under the DTAA the taxation liability in

respect of oversea services would not arise in India. Section 9 spells out the extent to which the income of non-resident would be liable to tax in India. Section 9 has a direct territorial nexus. Relief under a Double Taxation Treaty having regard to the provisions contained in Section 90(2) of the Income Tax Act would arise only in the event a taxable income of the assessee arises in one Contracting State on the basis of accrual of income in another Contracting State on the basis of residence. Thus, if Appellant had income that accrued in India and is liable to tax because in its State all residents it was entitled to relief from such double taxation payable in terms of Double Taxation Treaty. However, so far as accrual of income in India is concerned, taxability must be read in terms of Section 4(2) read with Section 9, whereupon the question of seeking assessment of such income in India on the basis of Double Taxation Treaty would arise.

In cases such as this, where different severable parts of the composite contract is performed in different places, the principle of apportionment can be applied, to determine which fiscal jurisdiction can tax that particular part of the transaction. This principle helps determine, where the territorial jurisdiction of a particular state lies, to determine its capacity to tax an event. Applying it to composite transactions which have some operations in one territory and some in others, is essential to determine the taxability of various operations.

It is, therefore, in our opinion, the concepts profits of business connection and permanent establishment should not be mixed up. Whereas business connection is relevant for the purpose of application of Section 9; the concept of permanent establishment is relevant for assessing the income of a non-resident under the DTAA. There, however, may be a case where there can be over-lapping of income; but we are not concerned with such a situation. The entire transaction having been completed on the high seas, the profits on sale did not arise in India, as has been contended by the appellant. Thus, having been excluded from the scope of taxation under the Act, the application of the double taxation treaty would not arise. Double Tax Treaty, however, was taken recourse to by Appellant only by way of an alternate submission on income from services and not in relation to the tax of offshore supply of goods.

We would in the aforementioned context consider the question of division of taxable income of offshore services. Parties were ad idem that there existed a distinction between onshore supply and offshore supply. The intention of the parties, thus, must be judged from different types of services, different types of prices, as also different currencies in which the prices are to be paid.

Section 9(1)(vii)(c) of the Act states that "a person who is a non-resident, where the fees are payable in respect of services utilized in a business or profession, carried on by such person in India, or for the purposes of making or earning any income from any source in India". Reading the provision in its plain sense, it can be seen that it requires two conditions have to be met \026 the services which are the source of the income that is sought to be taxed, has to be rendered in India, as well as utilized in India, to be taxable in India. In the present case, both these conditions have not been satisfied simultaneously, therefore excluding this income from the ambit of taxation in India. Thus, for a non-resident to be taxed on income for services, such a service needs to be rendered within India, and has to be a part of a business or profession carried on by such person in India. The Petitioners in the present case have provided services to persons resident in India, and though the same have been used here, it has not been rendered in India.

Section 9(1)(vii) of the Act whereupon reliance has been placed by the learned Additional Solicitor General, must be read with Section 5 thereof, which takes within its purview the territorial nexus on the basis whereof tax is required to be levied, namely, : (a) resident; and (b) receipt or accrual of income.

Global income of a resident although is subjected to tax, global income of a non-resident may not be. The answer to the question would depend upon the nature of the contract and the provisions of DTAA.

What is relevant is receipt or accrual of income, as would be evident from a plain reading of Section 5(2) of the Act.. The legal fiction created although in a given case may be held to be of wide import, but it is trite that the terms of a contract are required to be construed having regard to the international covenants and conventions. In a case of this nature, interpretation with reference to the nexus to tax territories will also assume significance. Territorial nexus for the purpose of determining the tax liability is an internationally accepted principle. An endeavour should, thus, be made to construe the taxability of a non-resident in respect of income derived by it. Having regard to the internationally accepted principle and DTAA, it may not be possible to give an extended meaning to the words 'income deemed to accrue or arise in India' as expressed in Section 9 of the Act. Section 9 incorporated various heads of income on which tax is sought to be levied by the Republic of India. Whatever is payable by a resident to a non-resident by way of fees for technical services, thus, would not always come within the purview of Section 9(1)(vii) of the Act. It must have sufficient territorial nexus with India so as to furnish a basis for imposition of tax. Whereas a resident would come within the purview of Section 9(1)(vii) of the Act, a non resident would not, as services of a non-resident to a resident utilize in India may not have much relevance in determining whether the income of the non-resident accrues or arises in India. It must have a direct live link between the services rendered in India, when such a link is established, the same may again be subjected to any relief under DTAA. A distinction may also be made between rendition of services and utilization thereof.

Section 9(1)(vii)(c) clearly states "\005where the fees are payable in respect of services utilized in a business or profession carried on by such person in India\005" It is evident that Section 9(1)(vii), read in its plain, same envisages the fulfillment of two conditions : services, which are source of income sought to be taxed in India must be (i) utilized in India and (ii) rendered in India. In the present case, both these conditions have not been satisfied simultaneously.

The provisions of Section 9(1)(vii) of the Act are plain and capable of being given a meaning. There, therefore, may not be any reason not to give full effect thereto. However, even in relation to such income, the provisions of Article 7 of the DTAA would be applicable, as services rendered outside India would have nothing to do with permanent establishment in India. Thus, if any services have been rendered by the head office of Appellant outside India, only because they were connected with permanent establishment. Even in relation thereto, principle of apportionment shall apply.

The Authority, in our opinion, has committed an error in this behalf, as if services rendered by the head office are considered to be the services rendered by the permanent establishment, the distinction between Indian and foreign operations and the apportionment of the income of the operations shall stand obliterated.

It would be contrary to the intent and purport of the Double Taxation Convention which is a part of the scheme under the Income Tax Act.

We, therefore, hold as under :

Re : Offshore Supply :

(1) That only such part of the income, as is attributable to the operations carried out in India can be taxed in India.

(2) Since all parts of the transaction in question, i.e. the transfer of property in goods as well as the payment, were carried on outside the Indian soil, the transaction could not have been taxed in India.
(3) The principle of apportionment, wherein the territorial jurisdiction of a particular state determines its capacity to tax an event, has to be followed.
(4) The fact that the contract was signed in India is of no material consequence, since all activities in connection with the offshore supply were outside India, and therefore cannot be deemed to accrue or arise in the country.
(5) There exists a distinction between a business connection and a permanent establishment. As the permanent establishment cannot be said to be involved in the transaction, the aforementioned provision will have no application. The permanent establishment cannot be equated to a business connection, since the former is for the purpose of assessment of income of a non-resident under a Double Taxation Avoidance Agreement, and the latter is for the application of Section 9 of the Income Tax Act.
(6) Clause (a) of Explanation 1 to S. 9(1)(i) states that only such part of the income as is attributable to the operations carried out in India, are taxable in India.
(7) The existence of a permanent establishment would not constitute sufficient 'business connection', and the permanent establishment would be the taxable entity. The fiscal jurisdiction of a country would not extend to the taxing entire income attributable to the permanent establishment.
(8) There exists a difference between the existence of a business connection and the income accruing or arising out of such business connection.
(9) Paragraph 6 of the Protocol to the DTAA is not applicable, because, for the profits to be 'attributable directly or indirectly', the permanent establishment must be involved in the activity giving rise to the profits.

Re: Offshore Services :
(1) Sufficient territorial nexus between the rendition of services and territorial limits of India is necessary to make the income taxable.
(2) The entire contract would not be attributable to the operations in India viz. the place of execution of the contract, assuming the offshore elements form an integral part of the contract.
(3) Section.9(1)(vii) of the Act read with Memo cannot be given a wide meaning so as to hold that the amendment was only to include the income of non-resident taxpayers received by them outside India from Indian concerns for services rendered outside India.
(4) The test of residence, as applied in international law also, is that of the taxpayer and not that of the recipient of such services.
(5) For Section 9(1)(vii) to be applicable, it is necessary that the services not only be utilized within India, but also be rendered in India or have such a "live link" with India that the entire income from fees as envisaged in Article 12 of DTAA becomes taxable in India.
(6) The terms 'effectively connected' and 'attributable to' are to be construed differently even if the offshore services and the permanent establishment were connected.
(7) Section 9(1)(vii)(c) of the Act in this case would have no application as there is nothing to show that the income derived by a non-resident company irrespective of where rendered, was utilized in India.
(8) Article 7 of the DTAA is applicable in this case, and it limits the tax on business profits to that arising from the operations of the permanent establishment. In this case, the entire services have been rendered outside India, and have nothing to do with the permanent establishment, and can thus not be attributable to the permanent establishment and therefore not taxable in India.
(9) Applying the principle of apportionment to composite transactions which have some operations in one territory and some in others, is

essential to determine the taxability of various operations.

(10) The location of the source of income within India would not render sufficient nexus to tax the income from that source.

(11) If the test applied by the Authority for Advanced Rulings is to be adopted here too, then it would eliminate the difference between the connection between Indian and foreign operations, and the apportionment of income accordingly.

(12) The services are inextricably linked to the supply of goods, and it must be considered in the same manner.

For the reasons aforementioned, the appeal is allowed in part and to the extent mentioned hereinbefore. No costs.