A critical analysis of the taxation of income arising to contractors in relation to the execution of engineering, procurement, construction and installation ('EPCI') contracts in the oil and gas sector

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"I can do all things through Christ who strengthens me"

- Philippians 4:13

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ABSTRACT

Globally, the past two years have been successful years in oil and gas exploration with discoveries almost doubling those made in 2017.[1] Notwithstanding Africa's endowment in vast natural resources, including substantial oil and gas reserves, one of the most dramatic finds in Africa has been Mozambique's natural gas developments. Mozambique is set to become one of the largest and most dominant natural gas finds in the world. These developments have attracted the attention from countries around the world, the UAE, in particular, taking the lead.

Engineering, procurement, construction and installation ("EPCI") contracts, are a common form of contract in the oil and gas sector, which is used to undertake large scale oil and gas projects. The nature of these contracts consists of significant local (in-country work) and foreign (out-of-country work) elements. Due to the complex nature of EPCI contracts, one of the major areas of dispute in the taxation environment are the uncertainties around the taxation of profits arising to contractors under these contracts.

The taxpayer and the Revenue Authorities have different views as to where the income arising from EPCI contracts is to be taxed. The taxpayer takes the stand that only such income from the project as is relatable to activities in the host state, should be taxed in the host state. The Revenue Authorities contend that EPCI contracts are to be considered as one and indivisible, and hence the entire income from the contract is liable to be taxed in the host state. Based on an examination of recent judgments passed by the Authority of Advanced Rulings ("AAR") and various Tax Courts, currently, there seems to be no certainty regarding the taxation of income arising to contractors under an EPCI contract and this has in turn resulted in a number of contractors having to pay excessive taxes.

This dissertation seeks to analyse the tax treatment of income arising to contractors, from supplies and services under an EPCI contract in the context of the oil and gas sector entered into between Mozambique and the United Arab Emirates ("UAE"), in Mozambique.

The purpose of this analysis is to determine how these profits should be taxed, in light of the Mozambique-UAE Treaty[2] and Mozambican domestic legislation. In other words, the question that this dissertation seeks to answer is, whether profits arising from an EPCI contract in the oil and gas sector, should be taxed as a whole in Mozambique, or per the various components of the EPCI contract.

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[1] Fuel for thought, Africa oil and gas review, 2019, *Current developments and a look into the future*, www.pwc.co.za/oil-gas review [November 2019].

[2] Convention between the Republic of Mozambique and the Government of the United Arab Emirates for the Avoidance of Double Taxation with respect to Taxes on Income and Capital (2003).

The key finding arising from the research presented in this dissertation is that although an EPCI contract is entered into in Mozambique (consisting of both offshore and onshore elements), this would not make the entire income from that contract to be taxable in Mozambique. Importantly, only such part of the income as is attributable to the operations carried out in Mozambique can be taxed in Mozambique.

Following the analysis, as described above, this dissertation finally endeavors to provide recommendations on how contractors should approach and structure EPCI arrangements in order to create the best possible situation for themselves within the limits of what the law allows, and to reduce potential tax litigation. This can serve to inform other developing countries who have oil and gas operations.

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CHAPTER 1: INTRODUCTION

1.1 Background and objectives

Engineering, procurement, construction and installation ("EPCI") contracts are a common form of contracts used to undertake large-scale and complex oil and gas projects as it involves the performance of multifarious functions, such as engineering, procurement, construction and installation which might be performed offshore or in the home state of the EPCI contractor.[3]

The nature of these contracts consists of both supply of services and equipment, and with some portions rendered offshore and others onshore, each attracting different taxes. In this respect, cconsiderable tax planning is applied into designing structures where parties can achieve significant tax savings, without altering their risk profile. However, there are risks and challenges which stems from operational structures of EPCI arrangements. A common operational structure for EPCI contracts is that a foreign contractor would sub-contract the domestic segments to entities in the host country in a bid to ring-fence overseas revenues from local taxation. The overseas-domestic revenues matrix is skewed in favour of offshore income, the implication being that a small fraction of the contract sum is available for local taxation, in the host state.[4]

Over time, the tax benefits of this arrangement have motivated the continuation of this practice.[5] It is for this reason that the nature of the arrangements and taxation of EPCI contracts receive a hostile reception from the Revenue Authorities and courts.

The taxation of EPCI contracts has been an ongoing contentious issue.[6] There are several issues regarding the tax treatment of income from EPCI contracts that have been litigated in the past and recent periods. In particular, the issue with respect to the taxation of offshore supplies of equipment and onshore services rendered under an EPCI contract has been a matter debated before the courts for a long time and various authorities and courts have passed differing judgments on the same or similar issues and subject matters.

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[3] PwC: *"EPC Contracts in the oil and gas sector"* January 2016, p.1.
See also PwC: *"Africa Energy and Utilities"* Tax Guide, 2018.
Available online from: https://www.pwc.com.au/legal/assets/investing-in-infrastructure/iif-5-epc-contracts-oil-gas-feb.

[4] Amaefule, K., *"Taxation of EPC Contracts: Analysis of Nigerian Case law and emerging trends"*, in the International Tax Journal, Wolters Kluwer publication, May-June 2018, p.47.

[5] *Ibid*, p.47.

[6] Indian ITAT: Assignment of contract is international transaction subject to transfer pricing regulations August 2013, p.1, [cited 23 November 2019].
Available online from: https://www.internationaltaxreview.com/article/b1fyg8fnz19kmq/indian-itat-assignment-of-contract-is-international-transaction.

This issue over time has remained largely the same with different judgments being passed either in favour of the taxpayer or the Assessing Officers. Under each of such contracts, the supplies of the equipment take place outside of the host state and the income therefore is said to be derived outside of the host state. Here, no part of the income either arises in the host state or can be deemed to arise in the host state. In addition to the offshore supplies, such contracts contain the installation and commissioning of the project in the host state. These services are executed in the host state through subsidiaries or branches of the foreign contractor. Thus, it effectively creates an installation permanent establishment ("PE") in the host state, which is taxable in the host state.

The problem however, in the assessment of EPCI contracts arose, when the Revenue Authorities contended that such contracts are to be considered as one and indivisible since it is a composite contract for the commissioning of a project. The Revenue Authorities and Assessing Officers contend that the entire value of the contract lies in the host state and hence, the entire income from the contract is liable to tax in the host state. The non-resident EPCI contractors take the stand that only such income from the project as is relatable to activities carried out in the host state can be taxed in the host state. Due to the above anomaly in opinion, there has been numerous litigations at various stages of appeal with the Revenue Authorities and before the courts. There has been no consistency in terms of the rulings or judgments in this regard as there are a number of judgments either in favour of the taxpayer or the Revenue Authorities.

The aim of this dissertation is to analyse, in light of the existing Income and Capital Tax Treaty between Mozambique and the UAE[7] ("Mozambique-UAE treaty" or "the treaty"), the tax treatment of income arising to contractors, from supplies and services under an EPCI contract in the context of oil and gas exploration and production in Mozambique, for the execution of EPCI projects involving work to be carried out in Mozambique as well as outside Mozambique.

Having regard to the operational mechanics of EPCI contracts, this dissertation will also examine judicial precedents in respect of the taxation of income from offshore supplies and services under EPCI contracts. In this respect, this dissertation delineates the various approaches taken and uncertainties surrounding the subject matter of the taxation of income from offshore supplies and services under an EPCI contract.

Lastly, recommendations will be put forward on how contractors should approach and structure EPCI arrangements in order to create the best possible situation for themselves within the limits of what the law allows, and to reduce potential tax litigation.

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[7] Convention between the Republic of Mozambique and the Government of the United Arab Emirates for the Avoidance of Double Taxation with respect to Taxes on Income and Capital (2003).

1.2 Research question and scope

The main research question is how should the income from the supplies and services arising to contractors in terms of an EPCI contract entered into between the UAE and the host state, Mozambique, be taxed in light of the existing UAE-Mozambique treaty and Mozambican domestic tax law i.e. should these profits be taxed as a whole in Mozambique, or per the various components of the EPCI contract?

Considering the complexity of the EPCI contract, there are several aspects of the applicable tax regime in relation to the execution of the EPCI contract by the contractors that are not straightforward. Under the umbrella of the main research question, this dissertation will consider the taxation of the following aspects:

a) Taxation of the contractors

1. Contractors' tax residency and the Mozambique-UAE treaty application.
2. Business activities of the UAE contractors.
   - Profits attributable to the UAE head offices.

b) Taxation of the branches of the contractors (i.e. subcontractors)

1. Business activities of the Mozambican branches.
   - Profits attributable to the Mozambican branches and computation of their taxable income.
2. Services supplied by Mozambican resident subcontractors to the Mozambican branches.
3. Services supplied by non-Mozambican resident subcontractors without a PE in Mozambique.
4. Services supplied by non-resident subcontractors with a PE in Mozambique to the Mozambican branches.

c) Other issues

1. Services supplied by non-Mozambican resident subcontractors to the contractors.
2. Profit remittance from the branches to the contractors.

The focus of this analysis is limited to various facets of EPCI contracts and the income tax implications thereon, and therefore, will not consider the implications of indirect taxes on EPCI contracts.

1.3 Research method

In this dissertation, a doctrinal investigative method together with a hypothetical case study approach will be used to address and conclude on the research question. This has been carried out through an analysis of selected aspects of the Mozambique-UAE treaty together with Mozambican domestic tax law, namely the Mozambican Corporate Income Tax Code ("IRPC Code").[8]

The hypothetical case study will be used to illustrate the contractual structure of the project-financed oil and gas project using an EPCI contract.

In applying the doctrinal investigative method, primary sources such as the current domestic tax law of Mozambique and selected secondary sources such as foreign case law and reviews of international literature and publications, dealing with the taxability of income attributable to the supplies and services component under an EPCI contract, will be analysed and interpreted.

1.4 Structure of the dissertation

The structure of this dissertation is as follows, Chapter 2 of this dissertation provides an overview of the oil and gas sector in Mozambique and significant developments in oil and gas exploration and extraction activities that has occurred in Mozambique. Chapter 2 further sets out the current status of the income and capital tax treaty between Mozambique and the UAE.

Prior to examining the taxation of income arising from an EPCI contract consisting of a hypothetical case study, Chapter 3 explores the basic features EPCI contracts in the oil and gas sector.

Chapter 4 discusses the concept of the PE concept in the context of the offshore oil and gas activities as well as the specific provisions that are relevant in the determination of the taxable profits attributable to PEs, under an EPCI contract in the oil and gas sector.

Chapter 5 is to traverse through foreign judicial precedent and decisions taken by Revenue Authorities, to determine how courts and the Revenue Authorities have interpreted the rules relating to the taxation of income arising to contractors in relation to EPCI contracts.

Chapter 6 consists of a hypothetical case study, technical analysis of the case study and findings in regard to the taxation of income arising from the execution of an EPCI contract. This chapter also sets out the conclusions drawn from the analysis as well as recommendations to the identified problems.

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[8] Mozambican Corporate Income Tax Code ("IRPC") approved by Law 34/2007 of 31 December.

CHAPTER 2: OVERVIEW OF MOZAMBIQUE'S OIL AND GAS SECTOR AND TAX LANDSCAPE

2.1 Introduction

The purpose of this chapter is to provide a brief background of the oil and gas sector in Mozambique and significant new developments that have occurred. In addition, this chapter also considers the current status and tax landscape of the income and capital tax treaty between Mozambique and the UAE. In this respect, this section of the chapter is not to provide an analysis of the treaty between Mozambique and the UAE, but rather consideration of the current status of the treaty and how certain concepts or provisions may possibly change in the future under renegotiation of the treaty. The chapters that follow will consist of a critical analysis of the application of the current provisions to the EPCI contract in terms of the treaty.

2.2 A brief overview of Mozambique's oil and gas sector

Mozambique is located in the Southern African region, comprising of 11 provinces with Maputo as its capital. Mozambique has experienced its own construction boom in response to significant oil and natural gas finds in the Rovuma Basin. The substantial natural gas deposits discovered in the Rovuma Basin has transformed the country into a significant liquified natural gas ("LNG") exporter. The Rovuma Basin is the largest oceanic basin in Southern and East Africa and has secured three major LNG projects that will transform Mozambique further as a gas economy and global player.[9]

According to the Energy Information Administration ("EIA") Oil and Gas Journal, in 2018 Mozambique held 100 trillion cubic feet ("Tcf") of proved natural gas reserves and is the third largest holder of proved natural gas reserves in Africa.[10] Natural gas discoveries in the recent launching of natural gas projects have positioned Mozambique as a development hub. It therefore comes as no surprise that the Arabian Gulf investors from the UAE have turned their attention to Mozambique.[11]

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[9] PwC: "*Africa Energy and Utilities Tax Guide*" 2018, p.209. [cited 23 November 2019], Available online from: https://www.pwc.com/ng/en/publications/africa-energy-and-utilities-tax-guide-2018.html.
[10] Mozambique - International – Analysis U.S. Energy Information Administration, May 2018, p.1, Available online from: https://www.eia.gov/beta/international/analysis.php?iso=Moz,[cited 23 November 2019].
[11] Ratcliffe, V., *"Gas and oil boom fuels Mozambique's big ambitions"* in The National, June 2013, p.1, [cited 23 November 2019], Available online from: https://www.thenational.ae/business/gas-and-oil-boom-fuels-mozambique-s-big-ambitions-1.300172.

International companies are building their presence in Mozambique and vying for participation in the development and extraction of Mozambique's recently discovered resources. As mentioned above, it is for this reason that the UAE have turned their attention to this Southern African country.[12]

In 2013, the UAE was Mozambique's largest investor, according to the Mozambican Centre for Investment. In recent years, the UAE has been strengthening its presence in Mozambique becoming the largest investor of diverse products in Maputo in 2018.[13] In 2018 alone, trade between these two countries stood at US$500 million.[14]

The start of production of LNG and allied projects in Mozambique is slated for 2023. With Mozambique entering the list of the world's largest holder of natural gas and hydrocarbon production, there is a growing interest in being part of the business. To date, the UAE has communicated its intention to develop logistics appropriate to the development of Mozambique's oil and gas and hydrocarbon sector. In terms of future commercial transactions in the oil and gas sector, the volume of trade between Mozambique and the UAE is reported to be around US$700 million. The positive outlook for the global LNG market and long-term growth in natural gas demand is positioning Mozambique to realise sustainable long-term economic growth.

2.3 The current status of the income and capital tax treaty between Mozambique and the UAE

The income and capital tax treaty between Mozambique and the UAE was concluded in 2003. To date there has been no amendments to this treaty, or any further protocols entered into besides an initial protocol added at the time of signing the treaty.

According to the website of the International Bureau of Fiscal Documentation ("IBFD"), following a meeting between officials from Mozambique and the UAE held in Maputo on 5 May 2016, negotiations for a revision of the treaty have started and are ongoing. No details on the negotiations are available.

Various developments took place (and are still in process) in the world of international tax in the last decade, most of which are aimed at levelling the playing field and countering tax abuse. The G20 countries have mandated the Organisation for Economic Cooperation and Development ("OECD") to lead

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[12] Ratcliffe, V., *"Gas and oil boom fuels Mozambique's big ambitions"* in The National, June 2013, p.1, [cited 23 November 2019], Available online from: https://www.thenational.ae/business/gas-and-oil-boom-fuels-mozambique-s-big-ambitions-1.300172.

[13] *Ibid*, p.1.

[14] Frey, A., *"United Arab Emirates strengthens its presence in Mozambique"*, 11 October 2019, p.2, Available online from: http://www.clubofmozambique.com [cited 17 October 2019].

the development of various new standards to address base erosion and profit shifting ("BEPS"). In conjunction with this certain regional bodies, such as the African Tax Administration Forum ("ATAF") in Africa, are also intensifying their cooperation and rules.

Most prominent of these actions are those in respect of BEPS, and specifically relevant for purposes of this treaty, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Profit Erosion and Profit Shifting ("MLI"). In short, BEPS deals with fifteen action plans on coherence substance, transparency and administration in respect of international taxation. The MLI is the major instrument to implement tax treaty related BEPS measures. Essentially, it is the bulk renegotiation mechanism. As a great simplification the MLI can be described as an instrument that will amend existing treaties without the need to renegotiate the individual treaties on a bilateral basis. Some of the changes prescribed by the MLI are far-reaching. An important aim of the MLI is to bring an end to treaty shopping.

By signing the MLI a country fully commits and becomes bound by certain mandatory changes envisaged by the MLI, termed "minimum standards". There are optional further measures that are not minimum standards (e.g. in respect of permanent establishments), in respect of which there is flexibility and choices. There are a second tier of countries which have not yet (or are not planning to do so at this stage) signed the MLI but who are part of the so-called "Inclusive Framework". The "Inclusive Framework" is an intergovernmental collaboration to implement BEPS measures, in reality it is a pressure group with the OECD acting as the main body to peer review compliance in BEPS implementation. Inclusive Framework members who have not signed the MLI have agreed to a peer review of their tax systems and to adopt BEPS minimum standards via other measures (e.g. bilateral renegotiation of treaties).

One of the implications of signing the MLI is that members must adopt certain minimum standards. A key minimum standard addresses treaty abuse. The measures are twofold: A substantial new general anti-avoidance rule disqualifies taxpayers from claiming treaty relief if it is reasonable to conclude, in light of the relevant facts and circumstances, that "obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted in directly or indirectly in that benefit". In other words, setting up an entity in the UAE to transact with Mozambique may result in denial of treaty relief should "one of the principal purposes" be the obtaining of the tax treaty benefits. This is also referred to as the Principal Purpose Test ("PPT").

The second aspect of the MLI's mandatory treaty abuse measures include the addition of the following preamble language:

> "Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)".

The preamble language underlines what the objective of the PPT rule is, namely, to bring an end to tax treaty-shopping arrangements, especially when it may result in non-taxation (i.e. income escaping taxation in both contracting States to a treaty). The PPT may be a difficult rule to pass – the test is not whether tax was the main consideration or only consideration – rather, the question is whether tax was one of the principal considerations when deciding to set up an intermediary entity in a specific country. In an American case, namely, *Starr International Company Inc v United States of America*[15], the court found rather harshly against the taxpayer in terms of a similar rule. If one takes a cynical view one could argue that it will be difficult to ever pass this test, if the shareholders of an intermediary entity are predominantly resident in a third country. What arguably counted against the taxpayer in this case is that there was a history of moving its holding company around the world. It is not clear how a court will decide in a situation where there is no such history. The PPT requires that all facts and circumstances must be considered, thus at least opening the possibility to look at wider considerations that may have influenced the choice of jurisdiction.

The UAE signed the MLI on 27 June 2018 and is also a member of the Inclusive Framework. Mozambique on the other hand has not signed the MLI and is not affected by the fact that the UAE has signed the MLI and is a member of the Inclusive Framework. As mentioned above, bilateral renegotiation of the treaty was initiated in 2016. The UAE will also find itself under pressure to include the BEPS minimum standards in a renegotiated treaty with Mozambique because its compliance therewith will be peer reviewed as a member of the Inclusive Framework.

The objectives of BEPS and the MLI can only be achieved if most or all of the countries of the world are somehow included as part of the process. There are indications of pressure being exerted on countries which were initially not that interested to participate, and which have now joined the process – it seems that the UAE also falls into this category.[16] It appears that a number of countries are in the process of renegotiating their treaties. In addition, Mozambique is part of the United Nations ("UN") and ATAF. It

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[15] *Starr International Company Inv v United States of America*, Case No 14-cv-01593 (CRC), 14 August 2017.

[16] December 2017, flagging 17 countries which they considered to be "non-cooperating against a wider tax evasion agenda". The aim is to potentially subject these countries to "defensive actions" by EU Member States, which could include denial of channelling certain European Union ("EU") funded developments through these countries. The UAE was added to the original Black List. In response hereto the UAE committed to undertake certain tax reforms, which led to its removal from the EU Black List and being placed on the so-called "Grey List" on 23 January 2018. In line with this commitment, the UAE has now joined the Inclusive Framework on BEPS.

will therefore be difficult for Mozambique to be unaffected by all the changes that are taking place around it.

It is realistic to speculate that the treaty may change. As mentioned above, it has already been under-renegotiation since 2016. It is likely that the renegotiations were not sparked because of BEPS and the MLI (because it started before these two actions gained maximum momentum). It is not unlikely however that some of the BEPS and MLI provisions may find their way into the treaty.

2.2.1 Special provisions relating to the extraction of natural resources

2.2.1.1 *"Income from hydrocarbons" Article*

It is possible that there could be changes e.g. rules in respect of the "permanent establishment" principle, or specific rules on the taxation of the oil and gas industry, such as, for example, the inclusion of a special "Income from Hydrocarbons" article in the treaty. Apart from a handful of treaties, the UAE has included this article in nearly all its treaties which has come into effect over the past decade and will likely take a strong position during the renegotiation to include this provision.

2.2.1.2 *"Offshore activities" Article*

Due to the special nature of the activities involved in the extraction of natural resources, specific provisions have been formulated which have been adopted in tax treaties around the world and may be considered by Mozambique and the UAE to be included in the treaty renegotiations.

One of the most common provisions is the specific "Offshore activities"[17] article which aims to allocate the taxing rights between countries with regard to income arising from the activities in connection with the extraction of natural resources. This article generally states the following:

- "An enterprise shall be deemed to be carrying on business through a PE to the extent that any activities in connection with the exploration and extraction of natural resources carried on offshore in the territory of one of the countries are carried on in such country for a specific period of time.

[17] Convention between the Nordic Countries for the Avoidance of Double Taxation with respect to taxes on Income and Capital (1996).

- Activities carried on by two associated enterprises shall be deemed to be carried out by one enterprise insofar such activities are performed in the same country and are substantially the same.
- Profits derived from the transportation of supplies or personnel or from the operation of tugboats and similar vessels in relation to the exploration of natural resources shall only be taxable by one of the contracting states".

No recent tax treaty concluded by Mozambique or the UAE include such an article.

CHAPTER 3: THE FEATURES, STRUCTURE OF AND INCOME STREAMS UNDER AN EPCI CONTRACT

3.1 Introduction

EPCI is an omnibus expression that includes within its ambit, a contract for engineering, procurement, construction and installation. It is a contract involving a combination of these four tasks.[18] The EPCI contracts executed by a consortium are a common form of contract used to undertake construction works on large-scale and complex oil and gas projects.[19] EPCI contracts involves the performance of multifarious functions and their execution spreads across time and different components are completed in different financial years.[20]

Before delving into the crux of the research question, it is important to understand the definition, features and scope of EPCI contracts. This chapter will discuss the meaning of the respective elements of an EPCI contract and will further consider the primary features of an EPCI contract executed by a consortium.

[18] Khincha, H.P, *"Structuring of EPC Contracts – Tax and Other issues"*, 19th International Tax and Finance Conference, 2015, p.2.
[19] PwC: *"EPC Contracts in the oil and gas sector"* January 2016, p.1.
Available online from: https://www.pwc.com.au/legal/assets/investing-in-infrastructure/iif-5-epc-contracts-oil-gas-feb.
[20] Verma, D., *"India - Taxation of Income from a Composite Contract for a Turnkey Project"*, 12 March 2019, Issue: Asia-Pacific Tax Bulletin, 2019 (Volume 25), No. 2, p.2, Journals IBFD, [cited 24 October 2019].

3.2 The meaning of engineering, procurement, construction and installation

A "composite contract" includes under its purview an EPCI contract. The meaning of a composite contract is not defined in the Income Tax Act and the same can be deduced from judicial precedent and other references. It is beneficial to first understand the meaning of the word "composite" as defined in the Oxford dictionary. The dictionary defines the word as, "adjective, made up of several parts or elements".

Further, the Apex Court in the case of *Hindustan Shipyards v State of AP*[21], held that the following kind of contract is a "composite contract".

> *"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"*

It is necessary to consider the meaning of the various elements and the scope of the components in the execution of an EPCI contract.

Under an EPCI contract, the contractor designs the installation, procures the necessary materials, and builds or constructs the project either directly or by outsourcing the work. The meaning of these terms (i.e. engineering, procurement, construction and installation) have been defined and detailed in various literatures. The scope of these four terminologies is further explained below:

1. ***Engineering*** – Engineering involves design and engineering for the project. The engineering would include engineering, project engineering and detailed engineering for the project as well as the plant, equipment and components thereof.[22]

2. ***Procurement*** – Procurement involves identifying, negotiating and arranging supplies of equipment duly ensuring the compatibility of different pieces of equipment with each other. In case of non-standard equipment, this could also involve design, fabrication and supply of equipment. The EPCI contractor is also required to ensure that the different pieces of the equipment are delivered within the agreed time frame.[23]

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[21] *Hindustan Shipyards v State of AP* [2000] 6 SCC 579 (SC).
[22] "*Taxation of EPC Contracts"*, May 9, 2016, p.1. Available online from: https://taxofindia.wordpress.com/2016/05/09/taxation-of-epc-contracts/.
[23] *Ibid*, p2.

3. ***Construction*** – Construction involves civil works, receiving and handling equipment on-site, on-site erection, project management, project monitoring, supervision, commissioning and testing of the project.[24]

4. ***Installation*** – Installation involves installing and assembling activities for the project equipment and materials at the site in accordance with approved construction drawings, procedures and specifications.[25]

3.3 Features of EPCIs contracts executed by a consortium in the oil and gas sector

An EPCI contract is executed between the project owner and the contractor. The entire liability and responsibility for the execution of the contract is that of the contractor. An EPCI contract may be split between the offshore components and onshore components. The basic structure involves splitting the EPCI into an onshore and offshore supply and installation contract.[26] Under an EPCI contract, the project company does not look to a single contractor to satisfy all the contractual obligations, for example, design, construction and performance. In this regard, there are at least two offshore entities with those obligations.[27]

In addition, some of the functions like designing, fabrication and planning, may be performed offshore or in the home country of the EPCI contractor. Similarly, the procurement of machinery and equipment and its transfer to the project owner is more often than not, done offshore (and often on high seas). Most of the stages of the contract after the supply of material and equipment, like the erection, commissioning, testing and installation are done in the host country.[28] However, usually a substantial part of the work in an EPCI contract, prior to the erection, commissioning and installation is performed outside the host country.

In terms of an EPCI contract, a contractor may appoint sub-contractors for specific portions of the work. The sub-contractor may form part of a group of the EPCI contract, or they may be independent contractors. In essence, the foreign contingent of the consortium also includes foreign entities (i.e. sub-

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[24] *Ibid*, p2.
[25] "The project definition". Available online from: https://www.theprojectdefinition.com/p-construction/.
[26] PwC: *"EPC Contracts in the oil and gas sector"* January 2016, p.9.
Available online from: https://www.pwc.com.au/legal/assets/investing-in-infrastructure/iif-5-epc-contracts-oil-gas-feb.
[27] *Ibid*, p.10.
[28] Verma, D., *"India - Taxation of Income from a Composite Contract for a Turnkey Project"*, 12 March 2019, Issue: Asia-Pacific Tax Bulletin, 2019 (Volume 25), No. 2, p.2, Journals IBFD, [cited 24 October 2019].

contractors).[29] The EPCI contract incorporates a consortium agreement between the consortium members which specifies the individual scope for each consortium member under the EPCI contract.

In terms of its structure, an EPCI contract is awarded by the project company or operator, operating in the host state, to a consortium of local and foreign contractors, for the engineering, procurement, construction and installation, pre-commissioning, commissioning and other ancillary services in relation to offshore works, necessary for exploiting the offshore oil and gas resource.

3.3.1 Income streams under an EPCI contract

As discussed above, certain stages of the contract are done in the host state (i.e. "in-country work"), however a substantial part of the work is also performed outside the host state (i.e. "out-of-country work"). An EPCI contract would therefore result in several distinctly identifiable streams of income to the contractors. This involves the following components:

- Offshore supplies of plant and equipment;
- Offshore services;
- Onshore supplies of plant and equipment; and
- Onshore services.

To date there has been much uncertainty regarding the tax treatment of income arising to non-residents from offshore supplies and services under an EPCI contract, and it remains a matter of copious litigation. Various authorities and courts have passed judgments on the same or a similar subject matter, however the litigation continues with controversies and uncertainties far from settled.

Chapter 6 that follows, consists of a critical examination of foreign judicial precedent surrounding the taxation of income arising from the offshore component to a non-resident under an EPCI contract.

[29] Amaefule, K., *"Taxation of EPC Contracts: Analysis of Nigerian Case law and emerging trends"*, in the International Tax Journal, Wolters Kluwer publication, May-June 2018, p.51.

CHAPTER 4: A BRIEF OVERVIEW OF THE RELEVANT INTERNATIONAL TAX PRINCIPLES UNDER EPCI CONTRACTS IN THE OIL AND GAS SECTOR

4.1 Introduction

Oil and gas or extractive industries are typically engaged in finding, developing and selling natural resources such as crude oil and natural gas, and these industries are vital sectors in many developing and emerging economies. Due to the fact that entities in the offshore oil and gas industry are often resident in one state and perform business in the sea or on the continental shelf of another state, it is important to determine how the income earned by non-residents is or should be treated in the source state. As mentioned above, EPCI contracts are a common form of contract to undertake large-scale and complex oil and gas projects. In this regard, one of the major areas of dispute prevalent in the taxation environment, is the issue of attribution of profits to PEs in the context of EPCI contracts.

This chapter, firstly, examines the PE concept in the context of offshore oil and gas activities, and how this principle should be applied in terms of the treaty between Mozambique and the UAE (which is based on the 2001 UN Model Tax Convention ("UN Model").[30] This chapter further considers the specific provisions that are relevant in the determination of the taxable profits attributable to PEs, under an EPCI contract. This chapter takes into account the perspectives and relevant articles embodied in the 2001 and 2017 UN Model, as well as references to its Commentary and the 2017 OECD Model Tax Convention ("OECD Model") and its Commentary.[31]

4.2 The PE concept under an EPCI contract in the oil and gas sector

The PE concept is one of the central elements of international taxation, particularly the law of tax treaties, and is primarily used for the purpose of the allocation of taxing rights when an enterprise of one State derives business profits from another State. The PE concept is used in tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one

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[30] United Nations Model Double Taxation Convention between Developed and Developing Countries (2001). The 2019 Model Tax Convention were not considered as the treaty under discussion has not been amended since 2003. It is however possible that the 2019 Model Tax Convention could potentially have relevance for a renegotiated Mozambique-UAE treaty.

[31] OECD, *Model Tax Convention on Income and on Capital (2017).*
OECD, Commentaries, *Model Tax Convention on Income and on Capital (2017).*

State are taxable in the other State only if the enterprise maintains a PE in the latter State and only to the extent that the profits are attributable to the PE.[32]

The extractive sector, and oil and gas activities in particular, comprise of different phases, features and activities, that need to be examined to determine the existence of a PE, based on the facts and circumstances involved. In general, States enter into negotiations with oil and gas companies ("contractors") regarding the economic aspects of the contract that specifies the extractive operations to be performed. These contracts generally grant legal rights for exploration and production in a given delimited area, which is normally managed by several oil and gas companies under a Joint Operating Agreement ("JOA" or "consortium") with normally one company appointed as the operator.[33]

An important aspect of the oil and gas sector is that a great number of subcontractors are hired by the operator, due to the need for and use of specialised and diverse types of work required on site where exploration and production activities take place. Under an EPCI contract the non-resident contractor is required to render a number of services in the host state. These services will be performed either by the contractor, or through the use of subcontractors instructed by the contractor, bearing in mind that the nature of these contracts consist of some portions of services rendered onshore and others offshore.[34] In light of this, what needs to be determined is whether the presence of the non-resident contractor in rendering services in the host state under an EPCI contract will result in the non-resident contractor creating a PE in the host state.

4.2.1 The PE concept under the Mozambique – UAE treaty

The PE definition under the Mozambique-UAE treaty, is based on the definition under the 2001 version of the UN Model. As mentioned above, the PE concept generally serves as a threshold that must be satisfied by a non-resident enterprise before a country will be able to tax such non-resident enterprise on business profits derived from sources in that country. To meet this threshold, the non-resident enterprise in the UAE will need to have established a significant presence in Mozambique.

Under Article 5 of the Mozambique-UAE treaty, the UAE entity, will meet this threshold to the extent that:

[32] United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, (2017), p.69.
[33] *Ibid*, p.71.
[34] *Ibid*, p.71.

- It has established a fixed place of business such as a branch, office, factory, workshop or have an or gas well or any other fixed place of business used to extract natural resources within Mozambique;
- It is involved in construction or installation project, including supervisory activities connected therewith, in Mozambique for a period exceeding 12 months;
- It renders services through the use of employees in Mozambique for a period aggregating 9 months or more;
- It conducts business through dependent agents which regularly negotiate and conclude contracts on behalf of the non-resident state in Mozambique.

Accordingly, if it is established that the activities performed by the UAE entity in respect of the EPCI contract creates a PE in Mozambique, Mozambique will have the right to tax the UAE entity's income, notwithstanding the fact that the PE may have no separate legal existence. In the event that the UAE entity has created a PE in Mozambique, Mozambique may only tax any profits to the extent that they are attributable to such PE. In what follows, this chapter considers the different types of offshore activities that may constitute PEs.

4.2.1.1 "*Construction and installation*"

The PE concept encompasses, *"construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than 12 months"*. The period of time under the construction PE provision may be agreed by the contracting States. The Commentary of Article 5(3) of the 2017 OECD Model[35] reproduced in the 2017 UN Model, extends the scope of the definition of construction to "the laying of pipe-lines and excavating and dredging". Likewise, drilling activities are also treated as construction work.[36]

It is not significant for oil and gas companies whether the construction work clause applies, as extractive and exploration activities of oil and gas companies by definition, have a local presence in the state of operation by means of an incorporated entity or registered branch of the foreign entity, that constitutes a PE within the source state.

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[35] OECD, *Model Tax Convention on Income and on Capital* (2017).
[36] UN Model Tax Convention Commentary (2017) on Article 5, paragraph 15.
See also, United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, (2017), p.97.

However, as noted above, numerous subcontractors perform various activities in the contractual area and the identification of the construction works has been a concern for numerous countries, in order to protect their tax base. Such identification can be justified if different works form a "commercial and geographical coherent whole".[37] The "commercial and geographical coherence test", provides that, in principle, any geographical area that commercially constitutes a unit may be considered a fixed place of business for PE purposes.[38]

From the perspective of an oil and gas company, legal title by means of an oil and gas contract in the form of a concession is granted over a contractual area (geographic element) which is normally governed by several partners under a JOA, one of them being designated the operator. Therefore, from a factual point of view, each contractual area (geographical element) is independently managed through a consortium (commercial element). Both the commercial and geographical aspects of this "coherent whole" test need to be met, under the 2017 UN Model Commentary [39], "where there is no commercial coherence, the fact that the activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business".[40]

4.2.1.2 *"Drilling activities"*

As with contractors under an EPCI contract in the oil and gas sector, the operator of a drilling rig is often a local entity or a branch of a foreign entity, whereas the owner of the drilling rig could be a separate, related or unrelated entity.[41] Contractors under an EPCI contract in the oil and gas sector, may therefore well engage a drilling service provider to undertake drilling on the seabed to confirm the presence of oil and gas, test the production environment and construct production or development wells. Drilling activities are typically undertaken both in the exploration and extraction phases. Platforms may be fixed to the ocean floor or may float. Fixed platforms are fixed to the same geographical area for long periods

[37] *"Guidance Note on Permanent Establishment Issues for the Extractive Industries",* by the Committee of Experts on International Cooperation in Tax Matters Thirteenth Session, New York, 5-8 December (2016), paragraph 13.9, p.26.
[38] *"Guidance Note on Permanent Establishment Issues for the Extractive Industries",* by the Committee of Experts on International Cooperation in Tax Matters Thirteenth Session, New York, 5-8 December (2016), paragraph 19.1, p.35.
[39] UN Model Tax Convention Commentary (2017) on Article 5.
See also, United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, (2017), p.98.
[40] *Ibid*, p.98.
[41] M.S Gelineck, "*Permanent establishments and the offshore oil and gas industry – Part 1*", Bulletin for International Taxation, 2016 (Volume 70), No.4, Published online [18 March 2016], Tax Research Platform – IBFD, p.9.

of time and, therefore, will satisfy the "fixed" test.[42] In these circumstances, such drilling rigs can meet the geographical and commercial criteria and be considered to be fixed.[43] Whether mobile drilling rigs are considered to comply with the "fixed" test should be considered on a case-by-case basis, as drilling rigs can remain in the same place for long periods of time or a couple of months.[44]

A drilling rig is where the entity providing the drilling services performs its business activity under the instruction of its customer i.e. the oil and gas company. Consequently, drilling rigs constitute a place of business of a non-resident entity, operating the rig. This view is supported by Skaar, who states that: *"Practice makes it clear that drilling rigs, ships are places of business with respect to the definition of a PE".*[45] As a drilling rig is used for the actual construction of the hole in the seabed, and for the extraction of natural resources via pipes and subsea installation, such activity would most logically fall within the scope of Article 5(3) of the Mozambique -UAE treaty.

4.2.1.3 *"Service and supply ships"*

Service and supply ships cover a wide range of maritime support services provided to oil and gas drilling companies. These vessels are regarded as mobile assets not fixed to the seabed. Vessels are used for transporting supplies to the rig from port facilities. Vessels are also used for towing and anchor handling, construction support, multi-purpose support, their common character being their mobility.[46]

The issue in question is to what extent personnel and supply transportation vessels fall under the PE concept, taking into consideration that they are not geographically fixed to a place. Notwithstanding the general understanding that a moving ship would typically not constitute a fixed place, the OECD proposed in a 2012 discussion draft, the addition of a new paragraph 5.5. to the Commentary on Article 5, which considers ships to be a PE:

> *"Similarly, a ship or a boat that navigates within territorial waters of inland waterways is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of a ship*

[42] *Ibid*, p.8
[43] *Ibid*, p.9
[44] United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, (2017), p.99.
[45] A. Skaar, "*Permanent Establishments, Erosion of a Tax Treaty Principle"*, Series on International Taxation p.13 (Kluwer L. and Tax. Publishers) (1991), p.120.
[46] M.S Gelineck, "*Permanent establishments and the offshore oil and gas industry – Part 1*", Bulletin for International Taxation, 2016 (Volume 70), No.4, Published online [18 March 2016], Tax Research Platform – IBFD, p.12.

or boat is restricted to a particular area that has commercial and geographical coherence). Business activities carried on abroad such as a ship or boat, must be treated the same way".[47]

If a vessel operates in areas that are considered to be geographically and commercially coherent, the fixed test may be satisfied. In considering this question, several factual issues, such as whether the services are done under the same contract, for identical or different clients, and invoiced under the same or different work orders or invoices, should be taken into account.[48]

4.3 Attribution of profits to PEs under the Mozambique-UAE treaty

Once a PE is deemed to exist in Mozambique, attention should be given to what profits should be attributable to the PE.

Article 7 of the Mozambique-UAE treaty provides as follows:

> *"The business profits of a foreign enterprise are taxable in a State only if the enterprise has a PE to which the profits are attributable in that State".*

According to the Commentary to Article 7 of the 2001 UN Model,[49] this article allocates taxing rights with respect to the business of an enterprise of a Contracting State if these profits are not subject to different rules under other articles of the Convention / treaty. It incorporates the basic principle that unless an enterprise of a Contracting State has a PE situated in the other State, the business profits of that enterprise may not be taxed by that other State unless the profits fall into special categories of income for which other articles of the Convention / treaty specifically give taxing rights to that other State. The attribution of profits to a PE concerns the computation of how much of an entity's profits may be taxed in the source state where the PE exists.

As is apparent from the above, the construction activities will likely create a PE in the source state. On this basis, the profits of the legal entity are required to be allocated to the PE. The starting point for determining the profits attributable to the PE, is to consider the financial results of the PE. The overarching rules in Article 7 of the UN Model and ATAF Model relates to calculating the profits attributable to a PE, by specifying:

- No notional head office expenses may be claimed; and

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[47] United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries, (2017), p.104.
[48] *Ibid*, p.104.
[49] UN Model Tax Convention Commentary (2001) on Article 7.

- Profits that can be attributed to the PE are limited, as the attributed profits cannot exceed the profits that the whole enterprise earned from the relevant business activity.

4.4 Conclusion

In conclusion, the first step is to determine if there is a PE. If there is a PE, then the profits that are attributable to that PE should be determined by using the financial accounts of the PE. The analysis of the PE definition shows that different types of offshore activities can constitute a PE. Due to the complex nature of EPCI contracts in the oil and gas sector, it would be beneficial to consider comments and guidance in the Commentary on Article 5 of the UN and OECD Model Tax Convention, as to how different activities relating to the exploration and exploitation of natural resources should be dealt with in analysing whether a PE exists. The foregoing would ensure a more consistent allocation of taxing rights with regard to offshore oil and gas activities, as well as providing certainty for non-resident entities in the offshore extractive industries.

The provisions of Articles 5 and 7 are relevant for different actors in the extractive industries sector. These provisions will be important for the operators, who may operate in the host country without having established an incorporated entity, since the existence of a PE will determine whether the host country may levy tax on profits made by the operator. These provisions will be also be relevant for the various non-resident service providers and suppliers in the extractive industries sector operating in the host country.

CHAPTER 5: AN ANALYSIS OF FOREIGN JUDICIAL PRECEDENT DEALING WITH THE TAXATION OF INCOME ARISING UNDER AN EPCI CONTRACT

5.1 Introduction

The issue regarding the treatment of income arising from an EPCI contract and whether it is to be taxed wholly in the host state, or separately per the various components of the contract, has become the bone of contention between the revenue authority and the contractors. Judicial precedents have often been considered to also be a source of law. The role of the courts is elevated in the absence of statutory guidance on a particular matter. The obvious recourse in such an event is to consider the decisions of the judiciaries. This chapter examines the discerned views that have been taken by various authorities and courts of law when deciding on the above issue.

5.2 An analysis of landmark decisions on the taxation of income arising from the execution of an EPCI contract

Ishikawajima-Harima Heavy Industries Limited v DIT

The issue whether income arising from a composite contract is to be taxed as a whole, or separately per the various components of the contract, came for consideration before the Supreme Court of India in the case of *Ishikawajima-Harima Heavy Industries Limited v DIT* [50] In the present case, Ishikawajima-Harima Heavy Industries Limited, an entity incorporated in and tax resident of Japan, formed a consortium with five other Japanese entities and entered into a composite contract with Petronet LNG Limited, an entity incorporated in India, to set up a liquefied natural gas receiving and storage facility in India. Ishikawajima-Harima Heavy Industries Limited was to develop, design, engineer and procure equipment and material for the project and therefore a composite contract was executed for:

1) Offshore supply of material, equipment and provision of services; and
2) Onshore supply of material and equipment, the provision of onshore services and certain construction services.

As per the terms of the contract, separate and distinct obligations and prices were set for the offshore supplies and services and for the component of onshore supplies and services. Further the contract was entered into in India and Ishikawajima-Harima Heavy Industries Limited admittedly had a PE in India as defined in the India-Japan treaty for onshore supplies, onshore services and construction and erection activities.

Ishikawajima-Harima Heavy Industries Limited initially filed an application to the Authority for Advance Rulings (“AAR”), seeking a ruling on the taxability of “offshore supply” and “offshore service” of the contract.

Ishikawajima-Harima Heavy Industries Limited contended that as per the terms of the contract, separate and distinct obligations and prices were set for the offshore supplies and services and for the component of onshore supplies and services. Further, the contract was entered into in India and Ishikawajima-Harima Heavy Industries Limited admittedly had a PE in India as defined in the India-Japan treaty for the onshore supply, services and construction and erection activities. However, it was further argued that the title to the equipment was transferred outside India and the PE in India had no role to play in the execution of the offshore contract.

[50] *Ishikawajima-Harima Heavy Industries Limited v DIT*, [2007] 288 ITR 408 (SC), Tax Treaty Case Law, IBFD.

The Revenue Authorities on the other hand objected to the contention of Ishikawajima-Harima Heavy Industries Limited, stating that the contract was a "composite" one with each component directly relating to the performance of the integrated contract. The Revenue Authorities further argued that both the offshore and onshore component were inextricably linked to each other and a breach of one would lead to a breach of the entire contract.

The AAR ruled that both offshore supplies and services would be taxable as a whole in India. The AAR had ruled that:

1) The offshore supplies were taxable as supplies through the business connection, and as part of a composite contract involving various operations; and
2) The offshore services were taxable as fees for technical services.

The Supreme Court overruled the ruling delivered by the AAR and held that the contract being designed as a composite contract and entered into in India and the fact that a part of it was executed in India, does not necessarily mean that the entire contract must be considered as an integrated contract for tax purposes and that the entire income from the contract would be taxable in India. The fact that separate and distinct obligations were set out with respect to the supply and service components of the contract indicate that liability is different with respect to various components under the contract.

The Court held that only such part of the income, as is attributable to the operations carried out in India can be taxed in India. Held further, where different parts of the "composite contract" is performed in different places, the principle of apportionment should be applied. This principle helps determine where the territorial jurisdiction of a particular state lies, to determine its capacity to tax an event. Thus, the situs of signing a contract is of no material consequence if all activities connected with offshore supplies were outside India. In such case, income cannot be deemed to accrue or arise in India. For a non-resident to be taxed on income for services, such services need to be rendered within India. Accordingly, the Court ruled that no operation relating to the offshore supplies and services, was carried out in India by *Ishikawajima-Harima Heavy Industries Limited v DIT* and thus no income could be deemed to have accrued or arisen in India whether directly or indirectly or through any business connection in India.

Commissioner of Income Tax v Hyundai Heavy Industries Limited

Shortly after the above judgment, the Supreme Court passed a similar judgment in the case of *Commissioner of Income Tax v Hyundai Heavy Industries Limited.* [51] In this case, Hyundai, an entity incorporated in South Korea, entered into an agreement with the Oil and Natural Gas commission of India for commissioning of petroleum extraction facilities in Mumbai. The contract consisted of two parts, one being for fabrication and procurement of the material and the other for installation and commissioning in India.

The issue in this case involved deciding on the question of quantum of profits and tax of the South Korean entity i.e. Hyundai. The Assessing Officer held that the contract, being a composite contract of the income from designing, fabrication and procurement of the material, had a nexus with the installation and commissioning in India. Hence, the income from the entire project was taxable in India. On appeal, the Supreme Court ruled in favour of Hyundai in terms of classifying the first part of the contract for fabrication as being executed outside India and therefore no profits being attributable to its PE in India. The Supreme Court decision in the case of Hyundai thus reaffirms the ratio laid down in *Ishikawajima-Harima Heavy Industries Limited v DIT* in as far as the taxability of offshore supplies are concerned.

Vodafone International Holdings BV Netherlands v Union of India and Another

The uncertainty regarding the taxability of offshore supplies and offshore services was therefore more or less resolved by the above decisions. However, subsequent to the *Ishikawajima-Harima Heavy Industries Limited v DIT* judgment, the decision of the Supreme Court in the case of *Vodafone International Holdings BV Netherlands v Union of India and Another* [52] ("the Vodafone case") revived the controversy. Although this case involved a matter relating to taxation of profits from transfer of shares, which was unrelated to the taxation of profits from a composite contract. This case was decided by a three-judge bench and involved the substantial question of law regarding the taxability of transfer of shares in an Indian entity between two non-residents outside India.

The Court upheld what is termed as the "look at" approach, in preference to the "look through" approach. In other words, the Court held that a transaction is to be seen in its entirety and a dissecting approach need not be adopted. The Court stated that "*It is important for the tax administration, as well as the Courts to 'look at' at the legal nature of the transaction, in its entirety and holistically".* Held further that, the

[51] *Commissioner of Income Tax v Hyundai Heavy Industries Limited* [2007] 291 ITR 482 (SC).
[52] *Vodafone International Holdings BV Netherlands v Union of India and Another,* [2012,345 ITR1(SC)], Tax Treaty Case Law IBFD.

gospel of substance of a transaction, rather than mere form, controls the tax incidence. While doing so, once has to look at the entire transaction holistically and not adopt a dissecting approach. The judgment was finally passed in favour of Vodafone International Holdings BV Netherlands. The Vodafone case unsettled the position relating to the taxation of offshore supplies and services from composite contracts laid down by the Supreme Court in *Ishikawajima-Harima Heavy Industries Limited v DIT*. Following the Vodafone case, in the case of *Linde A.G., Roxar Maximum Reservoir Performance WLL, Alstom Transport SA*[53], the AAR opined that after the Supreme Court's decision in the Vodafone case, it was not appropriate or open to follow the "dissecting approach" in a composite project that was adopted in *Ishikawajima-Harima Heavy Industries Limited v DIT* . The AAR held that it being a composite contract for supply as well as installation and commissioning, the payment received for the contract as a whole was to be taxed in India.

5.3 Conclusion

The aforesaid judgments have given birth to an anomaly in legislation regarding the taxability of offshore supplies of equipment and services components under a composite / EPCI contract. Over the past decade, litigations have increased in contemplating the same question of law: "Whether the profits attributable to offshore supplies and services in a composite / EPCI contract are taxable in the host state?". In subsequent cases, such as *Van Oord Acz BV*[54], and *M/s Hyundai Rotem Co*[55], following the related observation made by the Supreme Court decision in the Vodafone case, the AAR ruled that companies coming together to execute a composite project will be taxed as a whole in the host state. These cases have brought a certain level of ambiguity to a decided issue that was put to rest by the Supreme Court judgment in the case of *Ishikawajima-Harima Heavy Industries Limited v DIT*.

The judgment in *Ishikawajima-Harima Heavy Industries Limited v DIT*, however appears to be the more appropriate judgment to the extent that offshore supplies should not be taxable in whole in the host state. Due to the fact that different and several parts of a composite contract are performed at different places, the principle of apportionment is a better approach to determine which fiscal jurisdiction can tax the particular part of the transaction. A non-dissecting or a mere "look at" approach could lead to inappropriate taxing rights with the implication being that the entire contract sum / income will be available for local taxation, in the host state.

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[53] Linde A.G., AAR No. 962 of 2010 [2012]; IN: AAR, 7 May 2012, *Roxar Maximum Reservoir Performance WLL v. DIT*, AAR No. 977 of 2010 [2012], Tax Treaty Case Law IBFD; IN: Alstom Transport SA, AAR No. 958 of 2010 [2012].
[54] *Van Oord Acz BV*, AAR,248 ITR 399 [2001].
[55] *M/s Hyundai Rotem Co*., Korea, AAR. Nos 798-799 of 2008,323 ITR 277, [2008].

Due to the complex nature of these contracts, the structure to bring out the nature of various components included in the EPCI project should be clear. In this regard, it is crucial that the contract is structured and drafted in a manner that lays down and demarcates the scope, situs, timeframe, place of remuneration for each offshore and onshore component involved in the EPCI contract.

CHAPTER 6: A TECHNICAL ANALYSIS OF THE TAXATION OF INCOME ARISING TO CONTRACTORS IN RELATION TO THE EXECUTION OF AN EPCI CONTRACT ENTERED INTO BETWEEN MOZAMBIQUE AND THE UAE IN MOZAMBIQUE

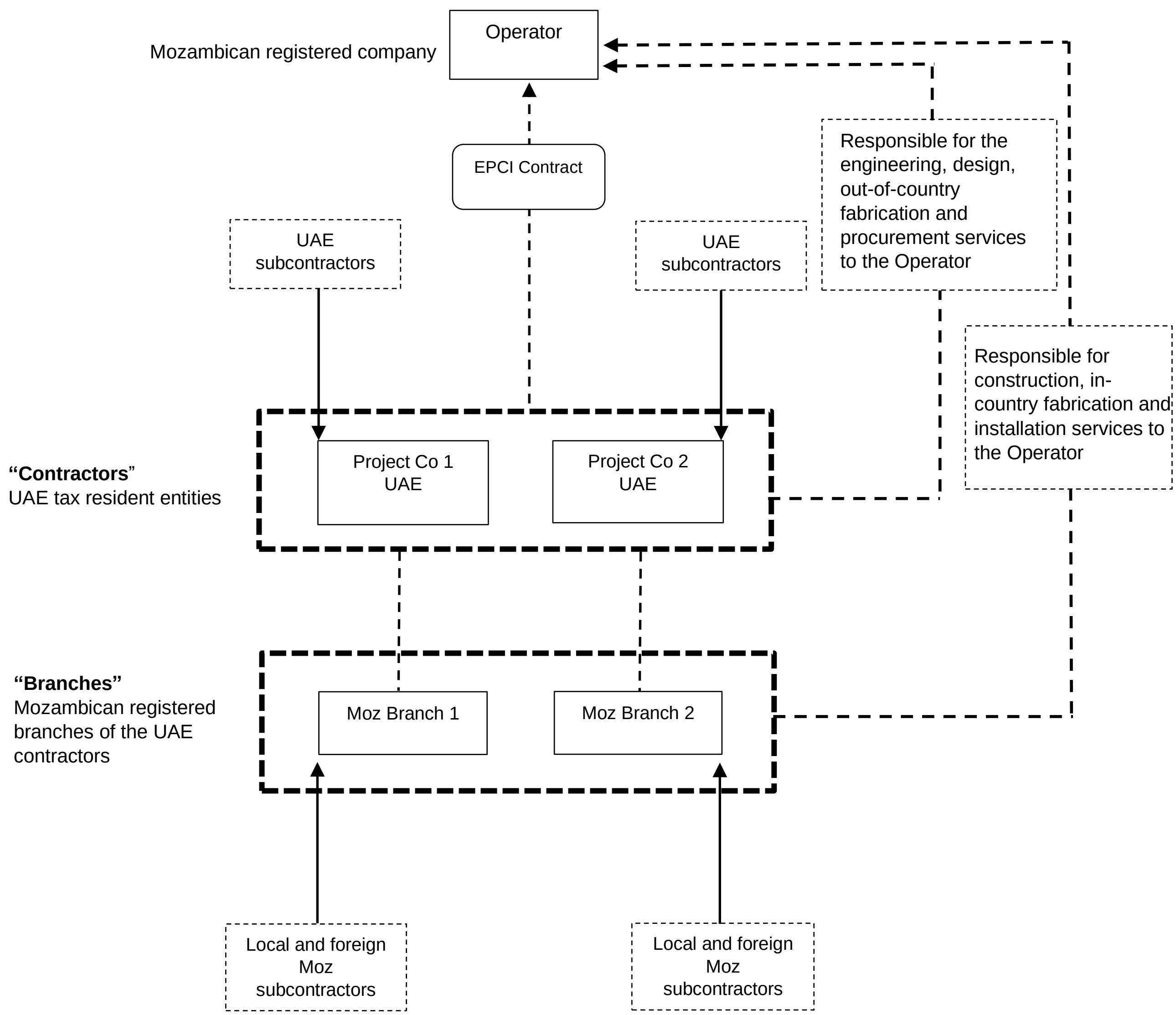
6.1 Introduction

The purpose of this dissertation is to determine whether the profits attributable to supplies and services arising to contractors in terms of an EPCI contract entered into between a non-resident contractor in the UAE and the host state, Mozambique, is taxable as a whole in the host state, or separately, in light of the existing UAE-Mozambique treaty and Mozambican domestic tax law.

To achieve the purpose of this dissertation, this chapter consists of a hypothetical case study approach to illustrate the income tax treatment and consequences in relation to the execution of an EPCI contract entered into between a concessionaire ("the Mozambican operator" or "the Operator") and a joint venture ("JV") consortium from the UAE. The hypothetical case study considers the overall income tax consequences arising from the EPCI contract to the contractors.

The detailed structures of EPCI contracts will vary from project to project. However, most projects will have the basic structure illustrated below. The diagram below illustrates the contractual structure of the oil and gas project using an EPCI contract.

6.2 Hypothetical contractual structure



6.3 Background relating to the hypothetical contractual structure

An EPCI contract is entered into by a Mozambican registered company ("the Operator") and a joint venture ("JV") consortium between Project company 1 and Project company 2 ("the Contractors") from the UAE, to develop a deep-water oil and gas discovery offshore, involving the connection of subsea wells to an onshore LNG plant ("the Project").

Due to the size and the nature of the different works associated with the EPCI contract, not all the work can be provided by a single entity / group. The EPCI contract is entered into with various companies with highly specialised and demonstrated expertise and experience in the oil and gas industry.

The scope of the EPCI contract comprises of highly specialised project management, design, engineering, procurement and fabrication services, with the view to construct the subsea production system consisting of but not limited to production pipeline systems, the production manifolds, and other subsea and onshore items, which will be installed in the project area. The EPCI contract requires work to be undertaken outside Mozambique, by the UAE entities ("out-of-country work") (as no resources and technical expertise are available in Mozambique), as well as work to be undertaken in Mozambique, by the registered Mozambican branches of the UAE entities ("in-country work").

6.3.1 *Out-of-country work*

The work to be carried out outside Mozambique will be delivered to the Operator by the UAE contractors. The EPCI contract will be executed taking advantage of the UAE contractors' experience with the Operator. The contractors will ensure the proper execution of the detailed engineering, procurement, installation under the EPCI for the benefit of the Project in Mozambique.

In relation to projects of this size, the UAE contractors will have to engage with various corporate entities, including related and non-related parties, which will render and provide contracted work in relation to the portion of the work that is to be be carried out outside Mozambique to the UAE Contractors. For example, the UAE contractors will subcontract entities in different areas around the globe which have the technical expertise and facilities to fabricate the pipes.

6.3.2 *In-country work*

Although certain work can only be carried out outside Mozambique, global management, design, and engineering, procurement, transit of marine spreads and fabrication, with integrated delivery managed from the UAE, there will be a significant portion of the work which will be carried out by the contractors in Mozambique.

The in-country-work will be carried out and delivered by the UAE Contractors' registered branches in Mozambique ("the Branches"). The in-country work will also involve project activities subcontracted to Mozambican resident subcontractors and non-resident subcontractors. In this respect, the work will consist of local project management, engineering work at site, installation, on-site fabrication, procurement at site, and mobilization of vessels.

6.4 Technical analysis of the taxation of income arising to contractions in the execution of an EPCI contract

6.5 *Taxation of contractors*

6.5.1 Contractors’ tax residency and Mozambique-UAE treaty application

In determining the tax rules applicable to either the contractors and their branches, one should apply the relevant rules set forth in the treaty entered into between the Republic of Mozambique and the UAE, together with the Mozambican domestic tax provisions on International Conventions established in Article 8 of the General Tax Law.

Mozambique-UAE treaty

The general principle of Article 1 of the treaty is that tax treaties should apply only in respect of the persons (i.e. natural persons and legal persons, such as companies) that are residents of one or both Contracting States. Article 4 subsequently provides a definition of who is a resident of a Contracting State for treaty purposes and, in doing so, the Article refers back to the domestic law of the Contracting States.

Article 1: Personal Scope

This Convention shall apply to persons who are **residents** of one or both of the Contracting States. [56]

Article 4: Resident

(2) For the purpose of paragraph (1) of this Article, the term resident in UAE includes:

(b) any governmental institution created in accordance with the law, such as central bank, funds, **corporations**, authorities, foundations, agencies or any other similar authorities **established in the UAE.**[57]

[56] Article 1 Mozambique-UAE treaty.

[57] Article 4(2)(b) Mozambique-UAE treaty.

Article 7: Business Profits

(1) The profits of an enterprise of a Contracting State (UAE) shall be taxable only in that State (UAE) unless the enterprise carries on business in the other Contracting State (Mozambique) through a permanent establishment situated therein (Mozambique). If the enterprise carries on business as aforesaid, the profits of the enterprise may also be taxed in the other Contracting State (Mozambique), but only so much of them as are attributable to that permanent establishment.[58]

(7) Where profits include items of income that are dealt with separately in other Articles of this Convention, the provisions of those Articles shall not be affected by the provisions of this Article.[59]

General Tax Law

Article 8: International Conventions

(1) The international tax provisions apply in the domestic regime provided approved and ratified under the Constitution of the Republic of Mozambique and the law, after official publication and while internationally binding on the Mozambican State.[60]

As described before, the EPCI Contract is an agreement between the Contractors and the Operator, which was entered into by the latter in its own name and pursuant to which the Contractors agree to provide services to the Operator in relation to the engineering, procurement, construction and installation of the subsea and onshore infrastructures needed for the Operator to gather and transport hydrocarbons from the wells offshore Mozambique to the liquefaction facility onshore Mozambique.

The Contractors are entities duly registered and tax resident in the UAE, where they operate with demonstrated economic presence and economic substance. Hence, the Contractors are not mere conduit companies incorporated for the sole purposes of a specific project in order to take abusive advantage of the treaty. Consequently, the Mozambique-UAE treaty is fully applicable to the income obtained in Mozambique by the Contractors, as tax resident entities in the UAE.

It is important to note that the fact that the Contractors are tax resident in the UAE, thus benefiting from the Mozambique-UAE treaty should not be construed as an abusive tax planning strategy (so-called treaty shopping).

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[58] Article 7(1) Mozambique-UAE treaty.
[59] Article 7(7) Mozambique-UAE treaty.
[60] Article 8 of the General Tax Law - Law 2/2006 of 22 March 2006. (General principles and rules of the Mozambican tax system).

6.6 Business activities of the UAE Contractors

6.6.1 Profit attributable to Contractors

As per Article 7(1) of the Mozambique-UAE treaty, only the profits attributable to the PE of a non-resident entity may be taxed in the country of presence of the PE.

<u>Mozambique – UAE treaty</u>

Article 7: Business Profits

(1) The profits of an enterprise of a Contracting State (UAE) shall be taxable only in that state (UAE) unless the enterprise carries on business in the other Contracting State (Mozambique) through a permanent establishment situated therein (Mozambique). If the enterprise carries on business as aforesaid, the profits of the enterprise may also be taxed in the other Contracting State (Mozambique), **but only so much of them as are attributable to that permanent establishment.**[61]

(2) Subject to the provisions of paragraph (3) of this Article, where an enterprise of a Contracting State carries on its business in the other Contracting State through a permanent establishment situated therein, then there shall be attributed to such permanent establishment, profits that might have been earned if it had been a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly and independently with the enterprise of which it is a permanent establishment.[62]

This means that, as a rule, the profits of the Contractors (except to the extent that they may be treated differently under the treaty e.g. capital gains, interest, royalties, dividends) shall not be subjected to tax in Mozambique, through withholding or other method as they are not attributable to a local permanent establishment. In the situation at hand, this means that Mozambique shall not be entitled to tax the fees charged by the contractors to the concessionaires but only the taxable profit attributable to the contractors' branches.

When referring to the part of the profits of an enterprise that are attributable to a PE, the second sentence of paragraph 1 of Article 7 emphasised above refers directly to paragraph 2, which provides the directive

[61] Article 7(1) Mozambique-UAE treaty.
[62] Article 7(2) Mozambique-UAE treaty.

for determining which profits should be attributed to a PE (and the profits that contrarily, should be attributed to its head office). As highlighted by the OECD 2010 Report on the attribution of profits to PE's [63] and which is commonly accepted across the world:

> *"(...) the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the "fixed place" that constitutes the PE and the functions performed at that "fixed place".*[64]

As a result, Mozambique does not have taxing powers in relation to the activities, responsibilities and functions performed by the contractors at their head offices level in the UAE, where correspondent fees are invoiced by the contractors to the Operators. In the current situation, the delivery of the out-of-country work does not involve the use of assets or staff of the branches. Further, the risk related to the delivery of the out-of-country work and any assets and personnel needed for such work is borne exclusively by the contractors in the UAE on the basis that he contractors will have their own premises, offices, assets, employees in the UAE, which will execute the out-of-country work. Therefore, the profits from the performance of the out-of-country services are wholly attributable to the contractors in the UAE, the UAE has therefore exclusive taxation rights in relation to the same in accordance with the first part of Article 7(1) of the treaty.

Consequently, Mozambique shall not have the powers to tax the fees paid by the concessionaires to the contractors with respect to such out-of-country services, subject to completion of the relevant treaty formalities from a Mozambican law perspective.

6.7 *Taxation of the branches*

6.7.1 Business activities of the Mozambican branches

6.7.1.2 Profits attributable to the Mozambican branches and computation of their taxable income

As described above, and as is typical in relation to contracts of this scale, the execution of the EPCI contract will involve work to be carried out outside of Mozambique and work to be carried out inside Mozambique.

[63] 2010 OECD Report on the Attribution of Profits to Permanent Establishments (22 July 2010).
[64] *Ibid,* p.26, paragraph 60.

For the purpose of the execution of the EPCI contract in relation to the work that is to be carried out in Mozambique, the contractors are to perform such work through the Mozambican registered branches. As mentioned above, the contractors are companies incorporated under the laws of the UAE and considered tax residents therein, resulting in the Mozambique-UAE treaty applying to the contractors as per Articles 1 and 4(2)(b).

The contractors will also be subject to corporate tax in Mozambique as they will carry out a business therein through a PE. The Mozambican entitlement to tax arises as a result of the second part of Article 7(1) of the Mozambique-UAE treaty, which gives the right to Mozambique to tax the business profits of the contractors' PEs in Mozambique. The Mozambican entitlement to tax is restricted to the profits attributable to the Mozambican PEs, as clearly established in the second part of Article 7(1) of the Mozambique-UAE treaty. As per the UN Commentary to the UN Model, paragraph 1 of Article 7 incorporates the following view:

> *"… the profits to be attributed to a PE are those which that PE would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market".*[65]

As mentioned, the execution of the EPCI contract will involve work to be carried out in Mozambique, specifically through the contractors' Mozambican branches. As per the Mozambique-UAE treaty, Mozambique will be entitled to tax the profits attributable to such PEs. According to paragraph 3 of Article 7 of the treaty:

> *"In determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including executive and general administrative expenses whether incurred in the Contracting State in which the PE is situated or elsewhere. This provision shall apply independently of the restrictions established by the domestic law".*

Under the Mozambican domestic provisions within the IRPC Code non-resident entities deriving income from Mozambican resident PEs are generally taxable on the same terms as Mozambican resident entities, with two main differences. First, the taxation of the PE is restricted to Mozambican source income, i.e. income from the activities performed by the non-resident entity in Mozambique, as per Article 4(1)(c) of the IRPC Code.[66] In this regard, considering that the Mozambique-UAE treaty overrides the domestic provisions in anything that is contrary to what is established therein, and although the contractors will not

[65] UN Model Tax Convention Commentary (2001) on Article 7, paragraph 15.
[66] Article 4(1)(c) of the Corporate Income Tax Code - Law 34/2007.

carry out business activities in Mozambique of the same or similar kind as those that will be undertaken by the branches, Article 4(2) of the IRPC Code[67] should not apply. Only the profits attributable to the Mozambican PEs as per Article 7(1) of the Mozambique-UAE treaty should be taxed in Mozambique.

The second difference in relation to Mozambican resident entities taxation, is that in calculating the taxable profits of the branches, it is possible to deduct the general administration costs incurred by the non-resident head office, as per Article 44(3) of the IRPC code.[68] In this respect, the taxable profit of the branches should be the revenue from the provision of the in-country services by the branches to the Operator invoiced by these to the Operator and paid by the Operator to the Mozambican branches, after deduction of the costs directly incurred by the branches in Mozambique in relation to the in-country work and a portion of the general administration costs borne by the contractor's head offices. The taxable income so obtained by the branches, shall be subject to IRPC at a rate of 32%. Only such taxable profit of the branches can be subject to Mozambican IRPC.

As the branches are obtaining income from supplies and services performed or used in Mozambique, as per Article 67(1)(g) of the IRPC Code,[69] and these are subject to the IRPC in relation to such work, the Operator is not required to withhold any tax in relation to payments to the branches, as provided for in Article 68(1)(d) of the IRPC Code.[70]

6.7.2 Services supplied by Mozambican-resident subcontractors to the Mozambican branches

As mentioned, as part of the EPCI contract, in-country work, the branches shall engage with Mozambican-resident subcontractors for the acquisition of goods and performance of local services. To the extent that the services subcontracted are provided by Mozambican-resident entities, the branches will have to comply with certain tax obligations established in the IRPC Code.

Among others, the branches may have to comply with withholding tax obligations in relation to the Mozambican income obtained as a result, by the Mozambican-resident subcontractors, as per Article 67 of the IRPC Code, and remit the tax so withheld to the tax authorities, as per the regime established within Article 45 of the IRPC Regulations. However, typically, such withholding obligation shall not

[67] Article 4(2) of the Corporate Income Tax Code - Law 34/2007.
[68] Article 44(3) of the Corporate Income Tax Code - Law 34/2007.
[69] Article 67(1)(g) of the Corporate Income Tax Code - Law 34/2007.
[70] Article 68(1)(d) of the Corporate Income Tax Code - Law 34/2007.

apply in most cases to the extent that the branches shall be hiring local services not subject to withholding as per Articles 68(1)(d) and 67(1)(g) of the IRPC Code.

In conclusion, services subcontracted by the branches to Mozambican-resident subcontractors for the supply of local services should generally be excluded from withholding tax.

6.7.3 Services supplies by non-resident subcontractors without a PE in Mozambique to the Mozambican branches

As part of the EPCI contract in-country work, the branches shall engage with non-resident entities for the acquisition of materials and equipment at a Mozambican port.

As the branches will simply be acquiring the goods and no direct taxation is due on the acquisition of goods, the payments from such acquisitions should not be subject to Mozambican tax. To the extent that the presence in Mozambican waters of the entities delivering the goods sold is of limited duration and does not exceed six months per year, these will not have a PE in Mozambique. Instead, they will qualify as non-resident subcontractors without a PE in Mozambique, and not subject to Mozambican taxation as they are not undertaking any activity in Mozambique but delivering the goods to the branches at a Mozambican port. As a result, no withholding tax obligation shall therefore arise in relation to the payments of goods by the branches.

6.7.4 Services supplied by non-resident subcontractors with a PE in Mozambique to the Mozambican branches

The branches will be subcontracting construction vessels from non-resident subcontractors. To the extent that these vessels are not provided by entities which are tax resident in a country with whom Mozambique does not have a tax treaty, then it will need to be determined by Mozambican domestic legislation on whether such services may result in the non-resident entities having a PE in Mozambique. In this regard, in terms of Article 3(2)(b) of the IRPC Code, entities providing construction work shall have a PE in Mozambique where the duration of the work or activity exceeds six months.[71]

To the extent that the Mozambican branches will be subcontracting non-resident subcontractors with a local presence and providing local services, the latter shall not be subject to withholding tax as per Articles 68(d) and 67(1)(g) of the IRPC Code.

[71] Article 3(2)(b) of the Corporate Income Tax Code - Law 34/2007.

In conclusion, services contracted by the branches to non-resident subcontractors for the supply of construction services which result in a Mozambican PE, shall generally be excluded from withholding tax.

Differently stated, if these entities' presence in Mozambique is shorter than six months and therefore not resulting in a Mozambican PE, these shall be subject to withholding tax, in terms of the Mozambican domestic legislation or under the applicable treaty.

6.8 *Other issues resulting from the EPCI contract*

6.8.1 Services supplied by non-Mozambican resident subcontractors to the contractors in the UAE

As mentioned above, in the course of providing the out-of-country services, the contractors shall resort to suppliers across the world. As per the applicable accounting principles and rules, such costs are not allocated to the branches, remaining instead at the head offices level as these are incurred in relation to the out-of-country revenue.

The taxing powers in relation to the income so obtained by the suppliers across the world shall belong exclusively to the UAE, as the source country of the income, and to the state of residence of the suppliers, as the residence country of the suppliers. Mozambique has no connection to such service supply which would justify the granting of taxing powers thereto. This stems from the provision of Article 5 of the IRPC Code, pursuant to which non-resident entities shall only be subject to IRPC i.e. Corporate Income Tax, to the extent that they obtain income in Mozambique, notably income where the debtor is a resident, has a head office or a place of effective management in Mozambique or which payment can be attributed to a PE therein.

In terms of the applicable accounting rules, the costs incurred for the out-of-country work are allocated to the head offices in the UAE, where these are offset against the corresponding out-of-country revenue to determine the contractor's profits. As a result, the income from the supply of goods by non-resident Mozambican suppliers to the contractors' UAE head offices shall not be subject to taxation in Mozambique.

6.8.2 Profit remittance from the branches to the UAE head offices

Under Mozambican law, there is no "branch remittance tax". For Mozambican legal purposes the head office of an entity and its PE are the same legal entity, hence no tax being due over the profits of the PE, after tax, remitted to the head office.

The head office and the PE are the same as a whole, consequently the profits of the PE are automatically perceived as the head office's profits. Hence, Article 5(3) of the IRPC code establishing that non-resident entities shall only be subject to tax in Mozambique in relation to the income obtained therein,[72] with such income being *"the income attributable to a PE located thereon"* as per Article 5(4) of the IRPC Code.[73]

It thus results unequivocally that under such concept the taxation of the PE occurs as a part of the taxation of the foreign legal entity, i.e. the non-resident contractors, and that their PEs are not considered, under Mozambican law, as separate legal entities.

It follows that any remittance of the branches accumulates post-tax profits / reserves to their head offices is not subject to IRPC (or any other tax) as they do not portray an actual accrual of the head offices by merely the allocation of profits / reserves which have already been subject to tax. As such, the remittance does not fall within the objective scope of the IRPC Code, as set forth under Articles 4 and 5 of the IRPC Code. The contractors shall therefore not be subject to any form of taxation by reason of the remittance of the branches' accumulated post-tax reserves, with no further tax being due in Mozambique as a result.

6.9 Summary of the case study findings

Based on the case study analysis, the taxing rights regarding the operations in relation to the EPCI contract, are as follows:

a) The contractors are qualifying persons and tax residents in the UAE for the purposes of the Mozambique-UAE treaty, carrying out their business activity in Mozambique;

b) The Mozambican entitlement to tax is restricted to the contractors' profits attributable to the Mozambican branches in-country work, as established in Article 7(1) of the Mozambique-UAE treaty;

[72] Article 5(3) of the Corporate Income Tax Code - Law 34/2007.
[73] Article 5(4) of the Corporate Income Tax Code - Law 34/2007.

c) The fees received by the contractors for the out-of-country work qualify as business profits. Hence, under Article 7(1) of the Mozambique-UAE treaty, no Mozambican tax is due on these fees paid to the contractors in relation to the out-of-country work;

(d) The Mozambican branches are subject to Corporate Income Tax in Mozambique on the profits attributable to them, i.e. the profits resulting from the in-country-work;

(e) With regard to the branches that are obtaining income from supplies of services performed and used in Mozambique, as per Article 67(1)(g) of the IRPC Code, these are subject to IRPC in relation to such work;

(f) The fees paid by the branches to Mozambican resident entities or to non-resident entities with a PE in Mozambique, for services in relation to the in-country-work, shall be excluded from withholding tax as per Articles 68(d) and 67(1)(g) of the IRPC Code;

(g) The fees paid for the acquisition of goods by the branches and delivered to the branches at a port in Mozambique by non-resident entities are not subject to Mozambique direct taxation as no IRPC is due on acquisition of goods;

(h) The non-resident entities providing fully equipped light construction vessels to the branches shall only have a PE in Mozambique where the duration of the work or activity by the non-resident entities' vessels exceeds six months as per Article 3(2)(b) of the IRPC Code;

(i) To the extent that the entities' presence in Mozambique is shorter than six months, these shall be subject to withholding tax in terms of the Mozambican domestic legislation or under the applicable treaty.

(j) The income from the supply of services and or goods by non-Mozambican resident suppliers to the UAE contractors shall not be subject to taxation in Mozambique on the basis that the income so received as consideration for those services falls outside the objective and territorial scope of the IRPC; and

(k) The contractors shall not be subject to any form of branch remittance tax by reason of the remittance of the branches' post-tax profits/ reserves as these are not in scope of the IRPC or any other tax.

6.10 Conclusion and recommendations

The determination of taxation of income arising in the execution of an EPCI contract is not a straightforward exercise. Judgments regarding the taxation of income arising to contractors in the execution of an EPCI contract is fraught with various issues. The defence of the taxpayer and contentions by the Revenue Authorities seemingly remain a matter of controversy and the above decisions of the Authorities have supplemented the issue with ambiguity.

The analysis performed in this case study, however, illustrates that only such part of the income, as is attributable to the operations carried out in Mozambique, can be taxed in Mozambique. The application of Article 7 of the treaty is of vital importance to composite contracts, as it limits the tax on business profits to that arising from the operations of the PE.

To the extent that separate and distinct obligations are set out with respect to the supplies and services components of the contract, indicate that tax liabilities are different with respect to the various components of the contract. In this case, as certain parts of the transaction were carried on outside Mozambican soil, the transaction should not be taxed as a whole in Mozambique, as these services rendered outside of Mozambique, can thus not be attributable to a PE and therefore not taxable in Mozambique. The principle of apportionment, wherein the territorial jurisdiction of a particular state determines its capacity to tax an event, must be followed as it is essential to determine the taxability of various operations which have some operations in one territory and some in others.

As actions are often a reflection of the intent of contractual parties, the terms of the contract, and the conduct of the parties play a vital role in determining the taxability of the income arising from the supplies and services in the execution of an EPCI contract. In *Ishikawajima-Harima Heavy Industries Limited v DIT*, the Supreme Court held that the intention of the parties must thus be judged from the different types of services, prices and currencies in which the prices are to be paid. As contracts record the intended course of action of the parties, it provides clinching evidence to conclude on the nature of the transactions. In this regard, the terms of the contract and the intention of the parties are thus critical in deciphering the real essence of a transaction. It is thus essential that EPCI contracts are worded carefully, to bring out the standalone nature of various components included in the composite contract. This is aptly illustrated by a recent AAR ruling in *MERO Asia Pacific Pte Ltd* [74]. In this case, even though there was a distinct offshore supply component, the wordings of the contract did not adequately bring out the bifurcation between offshore supply and installation. The terms of the contract showed that the Singaporean company continued to bear various risks and insurance charges related to the offshore

[74] *MERO Asia Pacific Pte Ltd.*, AAR No. 981 of 2010 [2016].

supplies till the completion of installation. Further, the payment was made in India in Indian currency and a part of the payment that was made in Singaporean currency did not clearly relate to the offshore supply of plant and material. The AAR ruled that the entire income from the composite contract is taxable in India.

It is therefore extremely crucial that the contract is structured in a manner that clearly lays down and demarcates the scope, situs, timeframe, currency and place of payment of remuneration for each offshore and onshore component involved in the turnkey project. If possible, it is preferable to enter into separate contracts for the major offshore activities. Where there is composite contract disclosing various features of EPCI, the following statement by the Supreme Court in *Faqir Chand Gulati v. Uppal Agencies (P) Ltd* [75], is thus important to keep in mind, *"the essence and terms of the contract is supreme"*.

[75] *Faqir Chand Gulati v. Uppal Agencies (P) Ltd.,* 10 SCC 345, [2008].

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