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Article
Consortium contracts with Government – Legal status 2

Notifications and Circulars 5

Ratio Decidendi 6

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Article

Consortium contracts with Government – Legal status

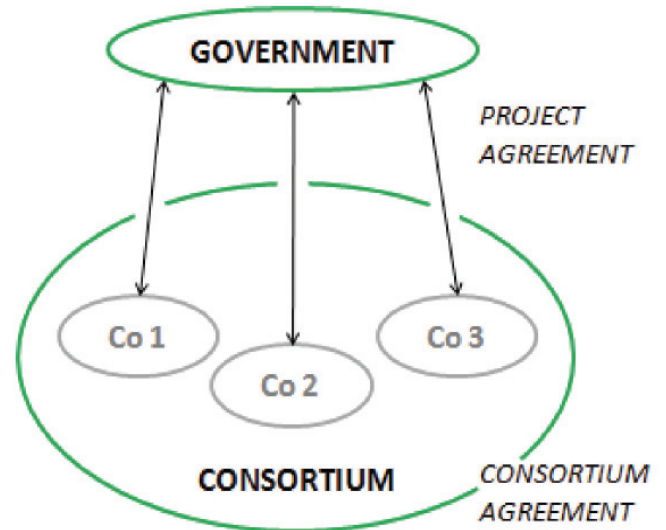
By **Amar Gehlot**

I. Introduction

It is basic economics - when it comes to consumption, government has the largest appetite. Government purchases include goods and services obtained from domestic and international suppliers and deployed in myriad projects ranging from defence and railways to infrastructure and oil. Of late, these public projects have grown in size and the project requirements often exceed the capacity (and more importantly, the risk tolerance) of an individual company. The consortium model has now gained popularity, whereby companies usually collaborate and jointly bid for government projects.

The arrangement that results, as everyone negotiates, is worthy of an analysis into its true nature. Largely, such an arrangement would comprise of two agreements – first, among the companies jointly bidding for the project ('consortium agreement' or 'CA'), and second, between the consortium and the government ('project agreement' or 'PA'). Does such an arrangement amount to this consortium being called an 'association of persons' ('AOP')? – is a question we'll try to answer in this write-up.

It is noteworthy that in such projects, the government sticks to contracts it has formulated and refined over time. Such contracts may also be inspired by similar contracts in practice across various nations. For example, the Ministry of Petroleum & Natural Gas engages itself into



oil production through contracts based on the Model Production Sharing Contract ('PSC')[1]. Similarly, the Railways has its own model contracts for various projects it undertakes. We shall be using various provisions of the model oil PSC as illustrations.

II. The concept of an Association of Persons

To answer our moot question, we need to first understand what is meant by an AOP as per various judicial pronouncements, and consequently apply the tests laid therein to the current situation.

The Income Tax Act, 1961 ('the IT Act') does not define what constitutes an AOP, which under section 2(31) of the IT Act is an entity or unit of assessment. Further, in general law also, the term AOP is not defined. Thus, the words 'association of persons' should be construed

[1] The Indian model PSC is accessible at: http://petroleum.nic.in/docs/rti/MPSC%20NELP-VIII.pdf

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in their plain ordinary meaning[2].

The *locus classicus* on the issue of AOP in income-tax law is *Indira Balkrishna*[3]. Addressing the question as to what constitutes an AOP, the Apex Court pronounced as under:

"… an association of persons must be one in which two or more persons join in a common purpose or common action, and as the words occur in a section which imposes a tax on income, the association must be one the object of which is to produce income, profits or gains…"

Further, the Supreme Court, in the case of *G. Murugesan & Bros*[4] observed that an association of persons is formed only when two or more individuals voluntarily combine together for a certain purpose. Thus, volition on the part of the members of the association is an essential ingredient.

Identifying another important parameter in an association of persons, the Gauhati High Court, in the case of *Smt. Jaswant Kaur Sehgal*[5] and the Bombay High Court in the case of *Shiv Sagar Estates (AOP)*[6], have recognized that jointness in effort and endeavour is an essential trait of an AOP. This can be contrasted with a situation wherein persons have come together for a common purpose but not all the participants in such an arrangement contribute efforts.

In the context of an EPC contract, the Delhi High Court held recently in the case of *Linde AG*[7] that there was an insufficient degree of joint action between the members of the consortium, either in execution or management of the project to constitute an AOP. Thus, besides laying down that a joint enterprise or action is necessary to constitute an AOP, the High Court has opined that common management is also a necessary characteristic that should be present.

On the basis of the above discussion, the following can be enumerated as the necessary ingredients of an AOP: two or more persons getting together, voluntarily, for a common purpose or common action, and putting in joint efforts and some scheme of common management.

III. Analysis of the consortium model

In the consortium setup under discussion, it is factually undisputed that the participant companies come together voluntarily, for a common purpose, and with an object to produce profit or gain. Clearly, the first three ingredients are available in the arrangement and need no further deliberation. Jointness of effort and common management shall be investigated in the subsequent paragraphs.

To assess whether there is *jointness in efforts*, it is necessary to analyse firstly the scope and nature of work to be undertaken, and secondly, the division of such work amongst

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2 Re: Elias 3 ITR 408, 415; Saldhana v CIT 6 ITC 114, 118 (FB); Mohammad Abdul v CIT 16 ITR 412, 426
3 CIT v. Indira Balkrishna (1960) 39 ITR 546 (SC)
4 G. Murugesan & Bros v. CIT [1973] 88 ITR 432 (SC)
5 Smt. Jaswant Kaur Sehgal v. CIT [2004] 271 ITR 475 (Gauhati High Court)
6 CIT v Shiv Sagar Estates (AOP) [1993] 201 ITR 953
7 Linde AG, Linde Engineering Division and Anr v. DDIT (2014) 361 ITR 1 (Delhi)

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the participant companies.

The scope of work in public projects is quite large and detailed. The nature is essentially technical and one that requires domain expertise. Clearly, it would be undesirable to have multiple companies executing the same portion of the project. As a result, the second aspect, i.e. the division of work amongst the companies, is quite clearly laid out in the PA and CA read together.

In infrastructure projects or EPC contracts, the work to be performed by each party are clearly defined and segregated. To illustrate – in the case of *Hyundai Rotem*[8], a consortium of four companies jointly executed a Delhi Metro Rail project. While one participant carried out the administrative work, the other three were responsible for mechanical, electrical, and localization works respectively. In such case, the Authority for Advance Rulings ('AAR') held that it does not constitute an AOP since the nature of work executed by each member was different. It can therefore be said that consortiums lack jointness of efforts. Every participant carries out its own responsibilities.

Whether there is a *common management* or not, has to be probed in substance and not merely in form. In form, nearly every PA would stipulate a management body to be taking the high-level decisions. Article 6 of the model oil PSC provides for the constitution of a Management Committee, which is supposed to meet every six months. However, the functions performed by the Committee do not have any semblance of day-to-day management of the operations.

However, in substance, the purpose of these committees is to ensure that the interests of any of the participants or the government are not vitiated. Such committees do not, as a mandate, supervise the day-to-day project operations. Respecting this view, the consortiums in the cases of *Linde AG* and *Hyundai Rotem* were held as not constituting an AOP, even though those consortiums had management committees in place. In another case, the SC held that the mere fact that there was a common management of a colliery was not a justification for the assessment of the owners as an association of persons[9]. The element of common management also is absent from consortiums.

Besides these, there are other relevant factors as well. The 'intention test' could be helpful. In the *Hyundai Rotem* case, it was held that there was a specific declaration in the Consortium Agreement that nothing in the agreement should be construed as creating a partnership, joint venture or any other legal entity among the parties. Thus, the AAR held that there shall be no AOP since there was no intention of the members to create a joint venture to carry on common business.

The manner in which the income or consideration for the project arises to the participants is also a determiner. If, as per the PA, income arises separately to each party, as

8 Hyundai Rotem Co., Korea / Mitsubishi Co., Japan, In re [2010] 190 Taxman 314 (AAR – New Delhi)
9 CGT v Valsala Amma (R) (1971) 82 ITR 828 (SC) affirming (1969) 72 ITR 579 (Ker)

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per its share in the project, the arrangement moves farther away from being an AOP. In case of the model oil PSC discussed above, the income from the petroleum operations arises to the companies in the form of petroleum produced from the oil block, and it arises to each party separately[10].

IV. Conclusion

Business expediency requires companies to come together and jointly carry out projects. Such arrangement results in various implications in tax laws. Income-tax liabilities might significantly increase if the consortium is treated as an AOP in assessment, and the non-resident participants would have to rework their profit expectancy. Similarly, service-tax liability would be substantially enhanced if moneys flow from the participant companies to the consortium, and it is treated as a transfer to an AOP. However, the lack of jointness of efforts and common management, which are characteristic to any AOP, provides a cushion against these tax implications. In order to establish that there is no commonality of management, business efforts, actions and sharing of profits the text of the pre-bid documents, bid-documents, agreements and actual conduct becomes crucial. Due care in planning, drafting the documents and hygiene in conduct can go a long way in keeping tax risks at a bay.

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Notifications and Circulars

Rules for furnishing statement of reportable accounts as per Section 285BA notified

India signed the Inter-governmental agreement with the USA on July 9, 2015, for improving tax compliance and implementing the Foreign Account Tax Compliance Act (FATCA). India has also signed a multilateral agreement on June 3, 2015, to automatically exchange information based on Article 6 of the Convention on Mutual Administrative Assistance in Tax Matters under the Common Reporting Standard(CRS). In order to operationalize both these agreements, the CBDT, by way of Notification No.62/2015 [142/21/2015-TPL]/2155(E), dated 7-8-2015, has inserted Rules 114F, 114G, 114H and Form 61B to the Income-tax rules. Rule 114F lays down definitions of reporting financial institution, reportable account, and financial account, besides others. Rule 114G details out the information to be maintained and reported in the statement of reportable account, besides

[10] Article 18.5 of the model PSC states that:
"Each Company comprising the Contractor shall, throughout the term of this Contract, have the right to separately take in kind and dispose of all its share of Cost Petroleum and Profit Petroleum and shall have the obligation to lift the said petroleum on a current basis and in such quantities so as not to cause a restriction of production or inconvenience to the other Company(ies)."

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other procedural aspects. Rule 114H contains the due diligence requirement.

Guidance Note on implementation of FATCA and CRS

The CBDT has released a Guidance Note, *vide* Letter No. 500/137/2011-FTTR-III, dated 31-8-2015, on the implementation of reporting requirements under Rules 114F to 114H of Income Tax Rules 1962. The guidance note covers explanation on how to determine whether a person is a Reporting Financial Institution or not, and how should they determine which financial accounts to review. The note further elaborates on the due diligence process which the RFIs need to carry out to identify the reportable accounts – both for pre-existing as well as new accounts. The note also explains the manner in which information is to be maintained and reported, and the procedure for furnishing the report, besides the monitoring and compliance requirements.

Ratio decidendi

'Is liable to taxation' means the right of Government to tax: In the context of Indo-Mauritius DTAC, the P&H High Court recently held that for a person to claim the benefit if Indo-Mauritius treaty, being a resident of Mauritius, it is not necessary that he should be suffering tax in Mauritius. He can be treated as Mauritius resident if he is 'liable to taxation therein' as the expression is not synonymous with 'actually taxed therein'. The fact that the Government entitled to tax the person has chosen not to tax the person or to exempt his income, does not alter the position. The court also held that a Certificate of Residence issued by Mauritius is sufficient evidence for residence for the purpose of invoking Convention. It noted that though the Finance Bill 2013 proposed to alter the condition for residence, by proposing to insert sub-section (5) in Section 90 of the Income Tax Act, 1961, however the sub-section was not finally enacted. [*Serco BPO (P) Ltd* v. *Authority for Advanced Rulings, New Delhi,* [2015] 60 Taxmann.com 433 (P&H)]

Applicability of Profit Split Method in Dual Shore Model: The taxpayer was engaged in software development business wherein its AE in US was responsible for marketing, client identification and customer relationship management functions. Pricing decisions were taken jointly by taxpayer and its Associated Enterprise (AE). Taxpayer was responsible for software development and delivery to end customer. Functions, Assets and Risk analysis was undertaken in the light of information gathered by interviewing key management personnel of Indian taxpayer and US AE and loss was split between the two based on key value drivers as it was not possible to find comparables. ITAT accepted this approach and rejected the allegation of revenue that this model is adopted by assessee to allocate global losses to India operations. [*Infogain India P. Ltd* v. *DCIT,* [2015] ITA - 6134/Del/2012 (Delhi-Trib)]

No AE relationship merely because of substantial purchases from same entity : The taxpayer made substantial purchases from an Ireland entity. Revenue relied on Section

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92A(2)(i) whereby if goods are purchased from an entity and price and other conditions are determined by such other entity then the two will be deemed to be AEs. Taxpayer's agreement with supplier stated that no variation of the agreement shall be effective unless signed by each party and also that either party may terminate the agreement with pre-agreed notice period. Based on these clauses ITAT held that both parties are independent and do not constitute AEs and no material proving the contrary was produced by revenue. [*DCIT* v. *W.B. Engineers International P. Ltd.*, [2015] ITA - 523/PN/2014 (Pune-Trib)]

BPO and KPO are not comparable sectors for ALP determination: The assessee company, a wholly owned subsidiary of a USA company, was engaged in the business of providing voice-based customer care services to its AE's clients. Its operating profit margin was computed at 14.83%. The inclusion of two KPO companies as comparables by the Revenue, which increased the profit margin of comparable companies to 28.96%, was questioned before the Delhi High Court. The court, holding in favour of the assessee company, concluded that while both BPO as well as KPO service providers might be using IT-based delivery systems, their characteristics of services, the functional aspects, business environment, risks and the quality of human resource employed would be materially different. Comparing both the sectors would be unreliable and possibly flawed. [*Rampgreen Solutions (P) Ltd* v. *CIT*, [2015] 60 Taxmann.com 355 (Delhi)]

Revision valid if no TDS enquiries carried out by AO: The ITAT Chandigarh recently held that revision under Section 263 was justified, where the Assessing Officer, while completing assessment, did not make any enquiry relating to non-deduction of tax at source from payments of discounts or commissions to vendors against pre-paid recharge vouchers,. The assessment order passed by the AO was erroneous and prejudicial to the interests of Revenue. The Tribunal further held that revisionary power was of wide amplitude and in the instant case the power was rightly invoked. [*Vodafone South Ltd* v. *CIT(TDS)*, [2015] 61 Taxmann.com 108 (Chandigarh-Trib)]

Scope of Section 195(2) does not extend to purchase contracts: In a case where the assessee-company entered into an agreement for purchase of certain items with a Dubai based company, the High Court of Madhya Pradesh held that provisions of Section 195(2) for deduction of tax at source, would not be applicable. The court held that since the agreement was a simple purchase contract and not a composite contract, addition made under Section 195(2), 201(1) and 201(1A) was incorrect. The court followed the Apex Court's decision in GE India Technology[11] and held that no question of law arises in the instant case. [*CIT* v. *Prism Cement Unit*, [2015] 61 taxmann.com 273 (MP)]

[11] GE India Technology Cen. (P.) Ltd. v CIT [2010] 193 Taxman 234 (SC)

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Payment for broadcasting IPL matches not FTS: The BCCI engaged the assessee company for capturing and delivering live audio and visual coverage of IPL cricket matches. Answering the question as to whether sum received by the assessee company for live coverage of IPL matches would be taxable as Fees for Technical Services under India-UK DTAA, the ITAT Mumbai answered in favour of the assessee. It held that the production of program content was different from the provision of technology itself. In the instant case the assessee was delivering the final product in the form of program content produced by it by using its technical expertise. It did not deliver or make available any technology/knowhow to the BCCI. The Tribunal further held that in the instant case the essential condition of 'make available' clause was not satisfied and hence the amount could not be considered as FTS in terms of Art. 13(4)(c) of the India-UK DTAA. [*IMG Media Ltd* v. *DDIT (International Taxation)*, [2015] 60 Taxmann.com 432 (Mumbai-Trib)]

Second proviso to Section 40(a)(ia) whether retrospective in nature? The second proviso to Section 40(a)(ia) inserted by Finance Act , 2012 states that if an assessee fails to deduct any tax at source no disallowance of the relevant expense shall be made if resident recipient has disclosed the amount in its return of income and paid tax thereon. On the applicability of this proviso for a period prior to its introduction the High Court of Delhi held that an assessee could not be penalized under Section 40(a)(ia) when there is no loss of revenue and concluded that the proviso being declaratory and curative in nature has retrospective effect from 1st April, 2005, being the date from which Section 40(a)(ia) was inserted by the Finance (No. 2) Act, 2004, even though the Finance Act, 2012 had not specifically stated that proviso is retrospective in nature. [*CIT* v. *Ansal Land Mark Township (P.) Ltd,* [2015] 61 Taxmann.com 45 (Delhi)]

Per contra, the Karnataka High Court held that the said provision is not retrospective. It observed that a statutory provision, unless otherwise expressly stated to be retrospective or by intendment shown to be retrospective, is always prospective in operation. Finance Act 2012 shows that the second proviso to Section 40 (a)(ia) has been introduced with effect from 01.04.2013. [*Thomas George Muthoot* v. *CIT,* [2015] ITA 278 of 2014(Ker)]

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