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Taxability of EPC Contracts as an AOP – A vexed issue & the consequences thereto

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Introduction

1. Engineering Procurement & Construction contract (EPC) requires a high level of technical skill set and provides for a voluminous scope of work &, accordingly is practically difficult for an individual entity to carry out the whole scope of work. In turn, two or more entities having different skill sets form a consortium amongst themselves so as to undertake all activities relating to the supply, engineering and construction as per the contract. Generally, EPC contract is awarded to such consortium by way of bidding process. Often these contracts are awarded on lump sum turnkey (LSTK) basis, despite providing for a separate scope of work, separate & well defined consideration and joint & several liabilities for each of the members. Such consortiums consist of a foreign entity acting as a technical partner and an Indian entity acting as a construction partner. The arrangements may vary, depending upon the facts and the requirements of each case. Once the foreign entity is involved, application of Double Taxation Avoidance Agreement (DTAA) also gets triggered.

Main Issue

2. Off late income-tax authorities have disregarded the divisibility of such EPC contracts and have held such consortiums to be forming Association of Persons (AOP) for income-tax purposes. Whether such consortium can be ascribed as an Association of Persons (AOP) for Income-tax purpose? Well there is no straight forward answer to this simple question, as it depends upon the facts of the individual case. There are far reaching consequences of such consortium being taxed as an AOP. Let us understand the realm of taxability of EPC contracts as an AOP & consequences attached to it.

Taxability of EPC contracts as an AOP

3. As per section 2(*31*), the term 'person' includes, among others, '**an association of persons** or body of individuals, whether incorporated or not'. However, attributes of an Association of Persons (AOP) are nowhere specifically defined under the Income-tax Act.

3.1 *Relevant Case Laws* :–

3.1-1 Supreme Court in the case of *CIT* v. *Indira Balkrishna* [1960] 39 ITR 546 has

observed as under:

> 'The word "associate" means "to join in common purpose, or to join in an action". Therefore, "**association of persons**", as used in section 3 of the Income-tax Act, means an association 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, profit or gains.'

3.1-2 Supreme Court in the case of *G. Murugesan & Bros.* v. *CIT* [1973] 88 ITR 432 has observed as under:

> "For forming an 'association of persons', the members of the association must join together for the purpose of producing an income. An 'association of persons' can be formed only when two or more individuals voluntarily combine together for a certain purpose. Hence, volition on the part of the members of the association is an essential ingredient."

3.1-3 Gauhati High Court in the case of *Smt. Jaswant Kaur Sehgal* v. *CIT* [2004] 271 ITR 475/[2005] 144 Taxman 243 held as under:

> "An association of persons, therefore, essentially pre-supposes a union of the members thereof for a common purpose. There has to be a community of interest. For the purpose of the Act such a combination must be one, the object of which is to secure income, profit or gain. Not only, therefore, the persons concerned join in a common purpose or action they are required to put in joint and concerted efforts to generate income, profit or gain in the enterprise undertaken. Jointness in effort and endeavour is one of the essential traits, which distinguish an association of persons from an individual."

3.1-4 *Summary of judicial decisions not ascribing consortiums as AOPs*:–

3.1.4-1 Authority for Advance Rulings ("AAR") in the case of *Van Oord Acz BV, In re* [2001] 248 ITR 399/115 Taxman 317 (AAR - New Delhi)has observed as under:

> "In order to constitute an association of persons there will have to be a common purpose or common action and the object of the association must be to produce income jointly. It is not enough that the persons receive the income jointly. In the instant case, each of the two parties had agreed to bear its own loss or retain its own profit separately. Both had agreed to execute the job together for better co-operation in their relationship with the Chennai Port Trust. The association with the Indian company was not with the object of earning income but for co-ordination in executing the contract. The applicant and the Indian company could not be treated as an association of persons for the purpose of levy of income-tax".

3.1.4-2 AAR in case of *Hyundai Rotem Co., Korea/Mitsubishi Co., Japan, In re* [2010] 190 Taxman 314 (AAR - New Delhi) observed as under :

"The scope of each member of MRMB consortium was specifically defined and was mutually exclusive to each other. There could be no interchangeability or overlapping of the work to any substantial extent and the nature of work performed by each member was qualitatively different and each member had distinct skills. Also, the access to the work carried on by others or providing assistance to others did not arise in the current situation. It can, thus, be deduced that in order to be termed as an AOP, there should be some degree of overlapping among the tasks performed by the members as well as the scope of each of the member. In the absence of such elements MRMB consortium could not be treated as an AOP and the applicants were subjected to taxation as separate taxable entities."

3.1.4-3 AAR in the case of *Hyosung Corpn.* v. *DIT (International Taxation)* [2009] 181 Taxman 270 (AAR - New Delhi) held as under :

"Mere collaborative effort and the overall responsibility assumed by the applicant for successful performance of the project are not sufficient to constitute AOP in the eyes of the law."

3.1-5 *Summary of recent contrary rulings ascribing consortium as an AOP:*

3.1.5-1 AAR in case of *Linde AG, In re* [2012] 207 Taxman 299/19 taxmann.com 238 (AAR - New Delhi) held that non-resident companies forming consortium to execute an Indian turnkey project would be treated as an AOP, in spite of internal division of responsibilities, separate payments made to one of members for design, etc. The relevant observation of the AAR was as under:

"The fact that the two consortium members entered into an MOU first and then into an agreement between them separating their area of operations cannot alter the picture. Nor can the fact, that payments were agreed to be made to them separately for the work they had divided between them, affect the status they acquired when they came together to bid for the work and their bid was accepted in terms of the tender for the whole work. Accordingly, this is a case of the applicant and Samsung forming an AOP in respect of the work undertaken by the consortium.

Having tendered for the entire work of the project and accepted the tender, OPAL (project owner) itself could not have under normal circumstances, split up the contract. That has also not happened here. The internal division of responsibility by the consortium members and the recognition thereof by OPAL or the making of separate payments by OPAL to the two members cannot dislodge the legal position of formation of an AOP by the applicant and Samsung. Therefore, an AOP has been formed in this case."

3.1.5-2 AAR in the case of *ABC, In re* [2012] 207 Taxman 315/20 taxmann.com 152 (AAR - New Delhi) has observed as under:

"The coming together to make a bid was obviously in furtherance of their respective independent businesses. It was with a common object. It was a case of two

adventures coming together for promotion of a joint enterprise. The fact that two consortium members entered into an MOU first and then enter into an agreement between them separating their area of operations can't alter the picture. Thus, in the circumstances of the case the AOP was formed in this case. It further relying on SC decision in the case of *Vodafone International Holdings BV* v. *Union of India* (341 ITR 1) held that applying the 'look at' test and interpreting the terms of the contract as a whole, the contract in this case was one and indivisible and it was not open to the applicant, a member of the consortium, to attempt to split up each component of the contract for the purpose of taxation."

3.1.5-3 AAR in the case of *Alstom Transport SA, In re* [2012] 208 Taxman 223/22 taxmann.com 304 (AAR - New Delhi) observed as under:

"The contract for the installation and commissioning of a project like the present one cannot be split into separate parts as consisting of independent supply or sale of goods and for the installation at work site, leading to commissioning and so on. Their arranging the *inter se* relationship while performing their joint & common obligation cannot alter the status they acquire as consortium members in performing a joint obligation undertaken by the consortium. The income from contract was, thus, accordingly, held as taxable for the whole contract as association of persons".

3.1.5-4 AAR in the case of *Geoconsult ZT GmbH, In re* [2008] 304 ITR 283/172 Taxman 396 (AAR - New Delhi) has observed as under:

"Thus, it is seen that the client namely, HPRIDC has entered into the contract with a 'Consortium' of three companies, and it looks to that joint enterprise for the due execution of work and the contract price is stipulated to be made to the JV as a unit. The contract between HPRIDC and JV gives sufficient indication of a combination of three entities into one with the common purpose of executing the work entrusted to the JV. That each member is made jointly and severally liable for performance of work is another important stipulation which points to the existence of AOP".

4. Consequences of EPC contracts being taxed as an AOP:

4.1 *Under the Income-tax Act:*

(*a*) AOP is treated as separate entity, independent of its members for tax purposes. As per section 6(2) of the Act, AOP is regarded as resident in India if the control and management of its affairs are partly situated in India. If AOP is regarded as resident in India ***Tax treaty benefits may not be available*** to any income earned by such an AOP.

(*b*) **Set off of losses** against income of members will **not** be **available to members.**

(*c*) In terms of section 40(*ba*) of the Act, **certain payments, viz., interest, salary, bonus, commission** by AOP to its members are **not allowable as deductions.**

(*d*) Certain portion of AOP's income may get **taxed at maximum marginal rate, i.e., at 42.02%.**

(*e*) **Difficulty for foreign company in getting tax credits** in its home country on taxes levied on income of AOP in India.

4.2 *Under FEMA*:—

(*a*) Prior approval of the RBI for making investment in the capital of the AOP by a foreign company,

(*b*) No clarity on repatriability of such investment,

(*c*) Conversion of AOP into a company requires RBI's approval.

Conclusion

5. It is, thus, notable that sword of taxability of EPC contracts as an AOP revolves around the facts of the case. A broad list of deterrents to tax it as otherwise could be the following:

- Joining of two or more parties for a common purpose;
- Jointness in efforts and endeavour put in by two or more parties;
- Common management and common action between the parties;
- Joint liability of JV partners for execution of the project;
- Sharing of profits or losses jointly by the parties.

Thus, it is advisable for the consortium members, especially the foreign entities to revisit their structural arrangements, keeping in mind the recent aggressive attitude of the tax authorities in India.

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DT : Secs. 2 and 40(*ba*).