

Tax Hotline

March 16, 2016

INDIAN TAX AUTHORITIES CLARIFY TAXATION OF EPC/TURNKEY AGREEMENTS

The Indian Central Board of Direct Taxes (“**CBDT**”) recently issued a Circular No.7 of 2016¹ (“**Circular**”) to provide clarity and guidance to taxpayers on the circumstances in which members of a consortium formed to implement an Engineering, Procurement and Construction (“**EPC**”) and/or a turnkey contract may not be characterized as an Association of Persons (“**AOP**”) under the Indian Income Tax Act, 1961 (“**ITA**”).

The Circular comes in the wake of several conflicting decisions² rendered by Indian judicial authorities on the question of whether a consortium formed to implement large infrastructure projects should be characterized as an AOP under the ITA, and accordingly be made subject to the accompanying Indian tax consequences. This issue is of particular relevance where a consortium involves non-residents as the existence of an AOP can expose a large portion (and sometimes all) of a consortium’s income to taxation in India, including that relating to the activities which may not be undertaken in India.

BACKGROUND: WHAT IS AN AOP?

An AOP is a separate taxable entity under the ITA and is deemed to come into existence when two or more persons join together in common purpose or common action with the object of producing income.³ Income earned by an AOP is usually taxable in the hands of the AOP at the maximum marginal rate.

An AOP is deemed to be a resident of India where its control or management is not situated wholly outside India. In other words, the threshold for an AOP to be considered as an Indian resident can be easily met if even a fraction of the control can be said to be exercised from India.

The Supreme Court of India (“**Supreme Court**”) has in a number of judicial pronouncements⁴ distilled the requirements for the existence of an AOP. These are that:

1. it must be constituted by two or more persons;
2. the constituent members must have come together for a common purpose;
3. the association must move by common action and there must be some scheme of common management;
4. the cooperation and association amongst the constituent members must not be perfunctory and/or merely in form, but real and substantial i.e., sufficient to treat the association as a separate homogenous taxable entity.

However, the above is a not bright-line test and there is room for varying interpretations depending on the facts of a particular case. Expectedly, the Indian courts have held differing opinions on when an AOP may be deemed to come into existence. Most recently, the Delhi High Court (“**Delhi HC**”) has ruled⁵ against the existence of an AOP in the context of a consortium formed between two non-resident companies for the design and construction of a petrochemical plant in India. Opining on the requirement for common management, the Delhi HC held that mere co-operation of one person with another in serving one’s business objective would not be sufficient to constitute an AOP merely because the business interests are common.

Prior to the decision of the Delhi HC however, the Authority for Advance Rulings, (“**AAR**”), in the context of a joint venture (“**JV**”) among a non-resident company and two resident companies, had delivered a positive ruling⁶ on the existence of an AOP, relying on clauses present in the joint venture agreement (“**JVA**”) between the parties. Factors such as the existence of joint and several liability, an intention to collaborate, and management on a joint-basis by all three members influenced the decision of the AAR.

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Other factors that the courts have considered in concluding for or against the existence of an AOP have included (i) whether profits, losses and expenses are borne by the parties the parties individual or collectively (ii) whether the parties to the consortium have joint and several liability for execution of the entire project, (iii) whether the scope of work of each member to the consortium has is specified and distinct and whether one member is capable of performing the work of another member (iv) whether there is express language disavowing an intention to create an AOP etc.

CIRCULAR NO.7 OF 2016

In this background, the Circular states that a consortium arrangement for executing EPC/turnkey contracts which has the following attributes may not be treated as an AOP if:

- Each member is independently responsible for executing its part of the work through its own resources and also bears the risk of its scope of work i.e., there is a clear demarcation in the work and costs between the consortium members, and each member incurs expenditure only in its specified area of work;
- Each member earns profit or incurs losses, based on performance of the contract falling strictly within its scope of work. However, consortium members may share contract price at a gross level only to facilitate convenience in billing;
- The men and materials used for any area of work are under the risk and control of the respective consortium members;
- The control and management of the consortium is not unified and common management is only for inter-se coordination between the consortium members for administrative convenience.

The Circular also clarifies that the above criteria are not exhaustive, and that there may be other additional factors which may justify that a consortium is not an AOP, which would have to be examined on a case by case basis.

The Circular is not applicable in cases where the parties to a consortium arrangement are associated enterprises.⁷

ANALYSIS

The Kelkar Committee Report⁸ on "Revisiting and Revitalizing Public Private Partnership Model in Infrastructure" has recommended the development of airports, ports and railways through the Public Private Partnership Model. The recent Indian Budget is also pushing for rapidly increasing the pace of infrastructure development in the country. As such, clarity in tax consequences for those involved becomes important.

The Circular marks a step in that direction and is an attempt to bring about consistency and predictability in the application of Indian tax rules, with a view to achieving the aforementioned objectives. That said, the Circular does not necessarily provide the level of certainty that was brought by Instruction No.1829 of the CBDT⁹, which dealt with the taxability of non-residents engaged in the execution of power projects on a turnkey basis. While the Circular appears to provide a descriptive list, it only states that a consortium with those attributes "may" not be regarded as an AOP. To the extent that the intention was for those factors to be sufficient to avoid creation of an AOP, the drafting choice of 'may' can raise questions as to whether this gives the tax authorities a window to inquire further. The hope, of course, is that the tax authorities uphold the spirit of the Circular and do not open cases which prima facie fulfill the criteria prescribed in the Circular.

Further, the Circular states that "...each member must be independently responsible for executing its part of work through its own resources and also bears the risk of its scope of work i.e., there is a clear demarcation in the work and costs between the consortium members and each member incurs expenditure only in its specified area of work". As such, cases where the members have joint and several liability or give performance guarantees for completion of the entire project work will have to be evaluated in depth as to whether they are able to benefit from the Circular or what arrangements/agreements should be put in place to reflect the demarcation required by the Circular. It should be noted that the courts have held in the past¹⁰ that simply because the parties take on joint and several liability, this will of its own not give rise to the existence of an AOP.

The rationale behind the exclusion of associated enterprises from the ambit of the Circular is also unclear, since the definition of 'associated enterprise' in the ITA is quite wide. It is conceivable that members of a consortium may qualify as associated enterprises under the ITA, and considering that the intention of the Circular was to clarify the circumstances in which an AOP may be said to come into existence, this exclusion may serve to dilute that objective.

On a more positive note, the Circular further states that consortium members may share contract price at a gross level to facilitate convenience in billing and permits common management for the sake of administrative convenience and inter-se coordination between parties. These are important clarifications since turnkey projects often require one member to take total and complete responsibility for the other consortium members and accordingly to furnish performance guarantees for timely completion. Thus the Circular allows some level of commonality, without comprising on the economic

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distinctiveness of the members.

In conclusion, the Circular serves as a reminder of the importance, in order to avoid the inadvertent creation of an AOP, of carefully drafted agreements which clearly set out the roles and responsibilities of each member of a consortium, ensuring that the economic liability for each member's scope of work distinctly rests with that member only.

– Joachim Saldanha & Mansi Seth

You can direct your queries or comments to the authors

¹ Circular No.07 of 2016

² *In re, Van Oord ACZ B.V.*, AAR No. 469 of 1999; *In re, Geoconsult ZT GmbH*, AAR No. 745 of 2007; *Hyosung Corporation v. DIT*, AAR Nos. 773 of 2008; *In re, Hyundai Rotem Co.*, AAR Nos. 789 & 799 of 2009 ; *In re, CTCI Overseas Corporation Ltd.*, AAR No. 854 of 2009; *In re, Alstom Transport SA*, AAR No. 958 of 2010; *In Re, ABC*, AAR No. P of 2010; *Linde AG v. DIT*, W.P. (C) No. 3914 of 2012; *CIT v. Oriental Structural Engineers Pvt. Ltd.*, ITA Nos. 444 & 445 of 2014

³ *CIT v. Balkrishna*, 39 ITR 546; *Mohammed Noorullah v. CIT*, 42 ITR 115;

⁴ *Ibid*

⁵ *Linde AG v. DIT*, W.P. (C) No. 3914 of 2012;

⁶ *In re, Geoconsult ZT GmbH*, AAR No. 745 of 2007

⁷ Section 92A(1) of the ITA defines an associated enterprise, in relation to another enterprise, as "an enterprise-

(a) Which participates, directly or indirectly, or through one or more intermediaries, in the management or control of capital of the other enterprise; or

(b) In respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

⁸ Available at: <http://finmin.nic.in/reports/ReportRevisitingRevitalisingPPPModel.pdf>

⁹ Instruction No.1829 was issued in 1989, and subsequently revoked in 2009.

¹⁰ *Linde AG v. DIT*, W.P. (C) No. 3914 of 2012;

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