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Delhi High Court rules on constitution of an Association of Persons (AOP) and the taxability of offshore supplies and services in a turnkey contract

In brief

The Delhi High Court, in a recent decision in the case of Linde AG, Linde Engineering Division[1] (the taxpayer or the Company) held that a consortium formed by the Applicant with another non-resident, for bidding for and execution of a turnkey contract, did not constitute an Association of Persons (AOP) under the Income-tax Act, 1961 (the Act).

Further, the decision dealt with the following related aspects in a typical consortium arrangement:

- The impact of withdrawal of Instruction No. 1829 issued by the Central Board of Direct Taxes (CBDT) (dealing with taxation of power projects)
- Precedential value of AAR rulings
- Taxation of AOPs (with non-resident members) under the Double Tax Avoidance Agreement (tax treaty)
- The application of the 'look at' principle *versus* the dissecting approach
- Taxability of offshore supply and services (inextricably linked to the supply)

[1]Linde AG, Linde Engineering Division *v.* DCIT [TS-226-HC-2014(DEL)]

Facts

- ONGC Petro Additions Ltd. (OPAL) floated a tender notice for carrying out all activities and services required for the design, engineering, procurement, construction, installation, commissioning and handing over of the plant on a lump sum turnkey basis for the Dual Feed Cracker and Associated Units of the Dahej Petrochemical Complex.

- Linde, along with Samsung Engineering Company Ltd. (Samsung), through a Memorandum of Understanding (MoU), decided to bid for this contract and work as a consortium. Subsequent to the MoU, Linde and Samsung entered into an Internal Consortium Agreement (ICA) which also clearly specified that the scope of work of Linde and Samsung were separate and independent.

- The tender submitted by the consortium of Linde and Samsung (the consortium) was accepted and the contract was awarded to it. Pursuant to that, the consortium entered into a formal agreement with OPAL for the aforementioned scope of work.

- The taxpayer filed an application under section 197 of the Act claiming that no portion of the amount to be paid in respect of the supply of equipment, material and spares and in respect of basic and detailed engineering services was liable to withholding tax in India as the supply and work was carried out offshore and payments were received offshore and hence not subject to tax in India.

- The Tax Officer (TO) rejected the application and the taxpayer thereafter filed an application before the Authority for Advance Rulings (AAR).

- The AAR noted that the contract was awarded by OPAL to the consortium as a whole, as a lump sum, indivisible turnkey contract, and not to independent members of the consortium individually. Furthermore, the liability of the taxpayer and Samsung was joint and several. Thus, it held that the consortium of the taxpayer with Samsung constituted an AOP.

  The AAR also ruled that as the contract was indivisible and the consortium constituted an AOP, the income received/ receivable by the taxpayer for the offshore supply of equipment, materials and spares and for offshore supply of drawings and designs relating thereto were taxable in India.

- The taxpayer filed a writ petition before the Delhi High Court against the AAR's ruling.

Issues before the High Court

1. Whether the consortium of Linde and Samsung constituted an AOP under the Act?

2. Whether the income received/receivable by Linde for the supply of equipment, material and spares outside India, and for rendering services outside India, was taxable in India?

Issue 1 – Consortium of Linde and Samsung – whether an AOP

Taxpayer's submissions

- The bid was submitted jointly to meet the bid criteria and consortium was formed only for the limited purpose of securing the contract.

- While the liability of the taxpayer and Samsung was joint and several, the respective scope of work of each member was clearly demarcated, and each party was to perform its specified portion of the contract separately and independently.

- There was no sharing of risks, expenses, costs, assets or resources, and both the parties were responsible for their respective profits and liabilities.

- The consideration payable to the taxpayer and Samsung for their respective items of work was separately specified and paid directly to each member of the consortium.

- In view of the above facts, and relying upon the Supreme Court's decision in the case of Indira Balkrishna[2] and AAR rulings in the cases of Hyundai Rotem Co.[3], Hyosung Corporation[4], and, In Re: Van Oord Acz. BV[5], the taxpayer contended that no joint management, joint action or common purpose in the performance of the contract could be inferred and hence, the consortium could not be assessed as an AOP.

  Furthermore, relying upon the Supreme Court's judgment in the case of Columbia Sportswear Co.[6], the taxpayer contended that the AAR was bound to follow its earlier rulings[3,4,5] and the principles of law as laid down therein.

- Instruction No. 1829 dated 21 September 1989 issued by the CBDT, in respect of taxability of income of non-residents arising from the execution of power projects on turnkey basis, indicated the correct understanding of the law and should be considered. While the aforesaid Instruction had been withdrawn by the CBDT *vide* subsequent Instruction[7], as the taxpayer had entered into a contract with OPAL prior to such withdrawal, this Instruction was applicable.

- Furthermore, it was submitted that treating the consortium as an AOP would lead to denial of benefits under the tax treaty and would tantamount to 'treaty override'.

Revenue's submissions

- The contract was entered into by OPAL with the consortium of the taxpayer and Samsung as one entity, which was described as a 'contractor' under the contract.

- Submission of the proposal was done jointly and the contract was also awarded to the consortium with the members agreeing to be jointly and severally liable, including for liquidated damages.

- The contract provided for a lump sum consideration payable for execution of the entire contract and hence was indivisible. Certificate of completion and acceptance of work performed was to be given to the consortium and not to individual members.

- Reliance was placed on the ruling in the case of Geoconsult ZT GmbH[8] in support of the above contentions. It was also contended that the case of Hyundai Rotem Co.[3] was not applicable in the facts of the present case.

- Instruction no. 1829 issued by the CBDT was not applicable to the present case, since this was limited to power projects. In any case, this had been withdrawn.

High Court decision

Essential features of an AOP

The High Court referred to various judicial precedents [B.N. Elias[9], Laxmidas Devidas[10], Indira Balkrishna[2], N.V. Shanmugham[11] , G. Murugesan[12]], on the interpretation of the term 'AOP' and laid down the following essential features for an association to be considered an AOP, namely:

(1) Two or more persons must constitute it.

(2) The constituent members must have come together for a common purpose.

[2] CIT *v.* Indira Balkrishna [1960] 39 ITR 546 (SC)
[3] Hyundai Rotem Co., Korea / Mitsubishi Co., Japan, *In re.* [2010] 323 ITR 277 (AAR)
[4] Hyosung Corporation *v.* DIT [2009] 314 ITR 343 (AAR)
[5] Van Oord Acz. BV, *In re.* [2001] 248 ITR 399 (AAR)
[6] Columbia Sportawear Company *v.* DIT [2012] 11 SCC 224
[7] Instruction No. 5 / 2009 dated 20 July 2009
[8] Geoconsult ZT GmbH, *In re* [2008] 304 ITR 283 (AAR)
[9] B.N. Elias, In re. [1935] 3 ITR 408 (Cal)
[10] CIT *v.* Laxmidas Devidas [1937] 5 ITR 584 (Bombay)
[11] N.V. Shanmugham & Co. *v.* CIT [1970] 2 SCC 139
[12] G. Murugesan & Bros. *v.* CIT [1973] 4 SCC 211

(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. The association amongst members must be real and substantial, which is sufficient to treat the association as a separate homogenous taxable entity.

Consortium of taxpayer and Samsung does not constitute an AOP

The High Court, based on the following, held that there was insufficient degree of joint action between Linde and Samsung, either in execution or management of the project to constitute an AOP.

- The consortium arrangement was for the limited purpose of presenting a common face and complying with the conditions laid down by OPAL, with no intention to form an association.

- The work to be performed by both members was separate, definite and divisible. None of the members had any role to play with respect to the scope of work allocated to the other member.

- The payments to be made for separate items of work were specified in the contract and the consideration was to be paid directly to the concerned member in accordance with separate invoices raised by them.

- Mere joint and several liability towards a third party was not sufficient to constitute an AOP. Under the ICA, each member was responsible for deficiency in its scope of work.

- Neither party exercised control over the quality of the equipment/plant supplied by the other, or exercised any control with respect to the quality of the work executed. There was no pooling of resources to form a common management, despite the appointment of Project Directors for overall co-ordination.

On the other related aspects, the High Court held as under:

- **Instruction No. 1829 issued by the CBDT**, although withdrawn, did indicate the correct understanding of law in respect of the taxability of an AOP under the Act. However, the applicability of the Instruction needed to be viewed in relation to the relevant assessment years during which this was in force.

- The AAR was bound by **"principles of law"** as laid down in earlier rulings rendered on similar facts.

- The taxation of an AOP, being a separate taxable entity, was not prohibited by the provisions of the DTAA.

Issue 2 - Taxability of income received for offshore supply and services

High Court decision

Accrual of income in a turnkey contract

- The contract was an indivisible one. However, for the purpose of tax, the contract did specify the amounts that were payable with respect to the various activities carried out by the aforesaid parties. Income could accrue or arise at various stages and on account of varied activities.

- The subject matter of taxation was not the contract between the parties, but the income that the taxpayer derived from the contract. Thus, the *situs* of the object of the contract would not be as relevant as determination of the *situs* where the income of the taxpayer had accrued or arisen.

- In cases where a contract entailed only a part of the operations to be carried out in India, the taxpayer would not be liable for that part of income that arose from operations conducted outside India. In such a case, the income from the

venture would have to be appropriately apportioned, as held by the Supreme Court in the case of Ishikawajima[13].

- In the present case, there was no controversy which involved lifting of the corporate veil or looking at any scheme to find whether a transaction was a sham or had any substance. The controversy only revolved around the *situs* of the income accruing or arising from the contract, and hence the application by the AAR of the Supreme Court decision in the case of Vodafone[14] was out of context.

Taxability of offshore supplies

- The equipment and materials were manufactured and procured outside India, and the title to these was also transferred outside India. Accordingly, the income attributable to the supply thereof could not be brought to tax under the Act, relying on the decision in the case of Ishikawajima[13].

Taxability of offshore services

- Submissions of the taxpayer with regard to offshore services being inextricably linked with the manufacture and fabrication of the equipment to be supplied overseas had not been evaluated by the AAR.

- Relying on the AAR ruling in the case of Rotem Company[15], the High Court held that if the services relating to the design and engineering were inextricably linked to, and formed an integral part of, the manufacture and fabrication of the offshore supply, then such services rendered by the taxpayer would not be taxable as fees for technical services (FTS) under the Act. Otherwise, the income from offshore services would be taxable as FTS under the Act.

- In the event the offshore services were held to be FTS under the Act, then this would be assessable as FTS under Article 12 of the DTAA, subject to determination of the PE. In case it was found that the taxpayer had a PE in India at the time the services were rendered, then income attributable to the PE would be taxable as business profits.

- On the factual aspects related to the above, the High Court remanded the matter back to the AAR, to be decided based on the above principles.

PwC observations

- The HC decision is a welcome judgment on AOP taxation, and a significant one from an EPC contract perspective. The conclusion reached on constitution of an AOP is a critical one and reiterates the need for a close re-look at bid documents, consortium agreements and the contract.

- Furthermore, the re-affirmation of the dissecting approach by the High Court in the context of taxability of offshore supply and services is reassuring for the EPC sector.

[13] Ishikawajima-Harima Heavy Industries *v.* DIT [2007] 288 ITR 408 (SC)
[14] Vodafone International Holdings BV *v.* UOI [2012] 6 SCC 613
[15] Rotem Co. *v.* DIT [2005] 279 ITR 165 (AAR)

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