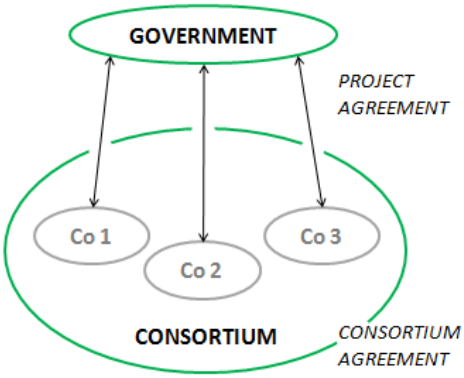
Consortium contracts with Government – Legal status

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.

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

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 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.

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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)

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 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

[8] Hyundai Rotem Co., Korea / Mitsubishi Co., Japan, In re [2010] 190 Taxman 314 (AAR – New Delhi)

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 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.

[The author is a Principal Associate, Direct Tax Practice, Lakshmikumaran & Sridharan, Mumbai]

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9 CGT v Valsala Amma (R) (1971) 82 ITR 828 (SC) affirming (1969) 72 ITR 579 (Ker)

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)."