

Taxing an Association of Persons—A Practical Approach



Infrastructure developments being the talk of the day and tenders have been floated by various government authorities requesting the bidder to be consortium or joint venture; it is inevitable for the construction sector to form an AOP for the purpose of executing the contracts. Presently, the assessment of AOP is purely a direct tax subject. Now, it has become a talk of the day with the introduction of Joint liability concept in service tax vide notification dated 30/ 2012. Under this notification where services are received from an AOP, then service recipient has to discharge part of the service tax liability. This article elaborates the formation, operation and assessment of AOP under both direct and indirect tax provisions. Further it discusses in detail the assessment under income tax act and forthcoming litigations with the introduction of the new concept of joint liability vide notification 30/ 2012 date 20.06.2012. Read on...

AOP Formation

An AOP is not defined in the Indian laws. General Clauses Act, 1897 has not defined an AOP directly but, while defining person, it also includes association. Section 2(31) of the Income-tax Act, 1961 also has not defined AOP, but given similar treatment to AOP the way General Clauses Act has given. An AOP is formed by relation between parties. It may be a consortium or joint venture registered or unregistered.

Since association of persons is not defined, the meaning has to be understood from the meaning assigned to the term by the Supreme Court which observed in the case of *CIT vs. Indira Balkrishna* (39 ITR 546) that an association of persons, must be one in which two or more persons join in a common purpose or common action and the association must be one the object of which is to produce income, profits or gains.

Andhra Pradesh High Court, in the case of *Deccan Wine and General Stores vs. CIT* (106 ITR 111), laid down the principles governing an AOP by stating that it is clear that an association of persons does not



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mean any and every combination of persons; it is only when they associate themselves in income-producing activity that they become an association of persons. They must combine to engage in such an activity; the engagement must be pursuant to the combined will of the persons constituting the association; there must be a meeting of the minds, so to speak. In nutshell, there must be a common design to produce income. If there is no common design, there is no association.

The meaning, as culminates from different decisions of the Supreme Court and the High court, of an AOP is that an association of persons exists when following conditions are satisfied:

- (i) Two or more persons join;
- (ii) Voluntarily for;
- (iii) A common purpose or common action with object to produce profit or gains and
- (iv) Combine for in joint enterprise; and
- (v) Creates some kind of scheme for common management.

It is evident that an AOP is not created but formed. It may be either registered or unregistered, as the case may be.

Relevance of AOPs

Infrastructure development is an area of concern for the Government of India till date. The Government has introduced public-private partnership (PPP) concept in the infrastructure development. Both the Government and the private parties join together in building an infrastructure facility. Highway contracts, toll roads, water resource development contracts, etc., are some of the live examples in this case. The Government forms a special purpose vehicle (SPV) and takes the infrastructure development under its control. The SPV will award the contract to the eligible contractors. In today's scenario, these contracts are awarded to a consortium only, so that risk and investment will be spread. Further, if the tender calls for international commercial bidding (ICB), there must one partner in the consortium who has the relevant expertise being a nonresident. This method of ICB is followed in developing infrastructure for exploration of oil contracts.

It is evident that, in the current day's scenario, it is inevitable to form an AOP to win a bid and execute the contract especially when they are awarded by the Government /Government companies.

Modus Operandi of AOP

An AOP, duly formed and executed by the documents of

deed, shall be legally binding on the parties, whether it is registered or not. Such a duly formed AOP normally follows two methods of executing the project.

Method 1 – Registered AOP:

AOP shall be registered as such for all purposes and it will have separate registration number under various compliances. Profit or loss on the contract is ascertained each year and members will divide the same in an agreed ratio. In this method, parties to the AOP normally subcontract the work from an AOP and bill their respective share to the AOP. An AOP will raise a consolidated bill on the customer. Customer will pay to the account of AOP and the AOP will pay the subcontract charges to the members initially. Remaining profit will be shared in the agreed ratio.

Method 2 - Unregistered AOP:

An AOP will be formed through a deed/memorandum. Members among them appoint one leader for coordination with the customers. They either raise bill on the customer and forward to the leader, or, raise the bill on the leader for their share of work. Leader will raise a consolidated bill on the customer on behalf of all the members. The Collection mechanism is also made through respective bank accounts of the member. Otherwise, the leader will collect the amount and pay the respective share to the members concerned. In this method of operation, there is no need for separate registration under various statutes governing the business. Rather, the members of consortium will discharge their compliance part. There will be no separate profit/loss account in the AOP as such, and an AOP is just a facilitator in the contract.

In present scenario, almost all contracts floated by the Government require an AOP formation from the bidding stage itself. Hence, the contractors can opt for any method suitable for the execution. Further, *Method 2* adheres to the proportionate consolidated method of AS 27.

Taxation of AOP

Direct Taxes:

Taxation of AOP happens in two phases: one at the AOP level and the other at members' level. At the first level, taxation of income depends on whether the share of income is determinate or not. Section 167 B reads:

- 1) *Where the individual shares of the members of an association of persons or body of individuals (other than a company or a co-operative society or a society registered under the Societies*

Registration Act, 1860 (21 of 1860) or under any law corresponding to that Act in force in any part of India) in the whole or any part of the income of such association or body are indeterminate or unknown, tax shall be charged on the total income of the association or body at the maximum marginal rate:

Provided that, where the total income of any member of such association or body is chargeable to tax at a rate which is higher than the maximum marginal rate, tax shall be charged on the total income of the association or body at such higher rate.

(2) Where, in the case of an association of persons or body of individuals as aforesaid [not being a case falling under sub-section (1)],—

(i) the total income of any member thereof for the previous year (excluding his share from such association or body) exceeds the maximum amount which is not chargeable to tax in the case of that member under the Finance Act of the relevant year, tax shall be charged on the total income of the association or body at the maximum marginal rate;

(ii) any member or members thereof is or are chargeable to tax at a rate or rates which is or are higher than the maximum marginal rate, tax shall be charged on that portion or portions of the total income of the association or body which is or are relatable to the share or shares of such member or members at such higher rate or rates, as the case may be, and the balance of the total income of the association or body shall be taxed at the maximum marginal rate.

Explanation.—For the purposes of this section, the individual shares of the members of an association of persons or body of individuals in the whole or any part of the income of such association or body shall be deemed to be indeterminate or unknown if such shares (in relation to the whole or any part of such income) are indeterminate or unknown on the date of formation of such association or body or at any time thereafter.]

At the second level, Section 86 of Income-tax Act reads:

Where the assessee is a member of an association of persons or body of individuals (other than a company or a co-operative society or a society registered under the Societies Registration Act, 1860 (21 of 1860), or under any law corresponding to that Act in force in any part of India), income-

tax shall not be payable by the assessee in respect of his share in the income of the association or body computed in the manner provided in section 67A:

Provided that,—

(a) where the association or body is chargeable to tax on its total income at the maximum marginal rate or any higher rate under any of the provisions of this Act, the share of a member computed as aforesaid shall not be included in his total income;

(b) in any other case, the share of a member computed as aforesaid shall form part of his total income:

Provided further that where no income-tax is chargeable on the total income of the association or body, the share of a member computed as aforesaid shall be chargeable to tax as part of his total income and nothing contained in this section shall apply to the case.]

When the shares are determinant and income of the AOP is assessed with respective members' share at their applicable rate, then the income of the member will be taxed on their respective share with the credit of taxes paid by the AOP. The above provisions of Section 86 read with Section 167 B can be explained in the following table:

Nature of AOP	AOP - assessed	Member assessed
Share Determinant - Income Assessment	Income of AOP is assessed at Maximum Marginal Rate	Exempt in the hands of the members
Share Determinant - Income Assessment	Nil rates/ other than MMR – when individuals are members	Chargeable in the hands of the assessee, with credit of taxes if any
Share undeterminant - Income Assessment	Income is assessed at Maximum Marginal Rate. Any member is assessed at higher than Maximum Marginal Rate, Income is assessed at such a higher rate	Share of Income is exempt in the hands of the member

Service Tax:

So far, no separate provisions have been enacted for

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the applicability/assessment under service tax for the AOP till June 2012. With effect from 1st July, 2012, a new concept of joint liability has been introduced by the Notification No. 30/ 2012 dated 20.06.2012. By virtue of this notification, both service provider and the service receiver have to jointly discharge the service tax liability. In relation to works contract, 50% of service tax is payable by the service provider and 50% by the service receiver. Relevant extract of the notification is:

“the Central Government hereby notifies the following taxable services and the extent of service tax payable thereon by the person liable to pay service tax for the purposes of the said sub-section, namely:-

I. The taxable services,-

(A) (i) provided or agreed to be provided by an insurance agent to any person carrying on the insurance business;

(2) services specified in sub-clauses (i), (ii) and (iii) of clause (a) of section 66D of the Finance Act, 1994, to any business entity located in the taxable territory;

(v) provided or agreed to be provided by way of renting of a motor vehicle designed to carry passengers to any person who is not in the similar line of business or supply of manpower for any purpose or **service portion in execution of works contract** by any individual, Hindu Undivided Family or **partnership firm, whether registered or**

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not, including association of persons, located in the taxable territory to a business entity registered as body corporate, located in the taxable territory;

(II) The extent of service tax payable thereon by the person who provides the service and the person who receives the service for the taxable services specified in (I) shall be as specified in the following Table, namely:-

Sl.No.	Description of a service	Percentage of service tax payable by the person providing service	Percentage of service tax payable by the person receiving the service
9.	in respect of services provided or agreed to be provided in service portion in execution of works contract	50%	50%

Explanation-II. – In works contract services, where both service provider and service recipient is the persons liable to pay tax, the service recipient has the option of choosing the valuation method as per choice, independent of valuation method adopted by the provider of service.

2. This notification shall come into force on the 1st day of July, 2012.

This method of collection of tax is to ensure that there is no revenue leakage for the Government, since 50% revenue is collected from business entity registered as body corporate in a taxable territory. Body corporate is defined with reference to Section 2(7) of the Companies Act, 1956.

Practical Issues in Assessment

An AOP formed for a business purposes though falling within the ambit of *CIT vs. Indira Balkrishna (39 ITR 546)* case will be assessed as an AOP or otherwise. Authority of advance rulings has delivered two different judgments in this regard. Without altering the essence of the above judgment, the AAR in the case of *Geoconsult ZT GMBH (2008-TII-11-ARA-INTL)* and *Hyundai Rotem Co. (2010-TII-22-ARA-INTL)* has delivered the judgments based on facts of the cases.

Comparison between Advance rulings

Sl.No.	Geo consult ZT GMBH	Hyundai Rotem Co.
Facts	Applicant is a resident of Austria who has formed joint venture with two Indian companies M/s. Rites Ltd. India and M/s. Secon Pvt. Ltd. India to provide project consultancy services for phase I & Phase II, for the development of seven tunnels in Shimla as well as other areas of H.P	DMRC issued tender inviting bids for design, manufacture, supply, testing, commissioning, training and transfer of technology of 156 EMUs. Mitsubishi, Japan, Hyundai Rotem Company, Korea, Mitsubishi Electric Corporation, Japan and BEHL Limited, India entered into a consortium Agreement and won the bid.
Question	Whether applicant can be said to have permanent establishment in India within the meaning of Double Taxation Avoidance Agreement Between India and Austria?	Whether the consortium of MC, Rotem, MELCO and BEML for the purpose of bidding and executing the contract RS3 of DMRC could be assessed as independent Companies under scheme 2(31) (ii) of IT Act 1961 or AOP u/s 2(31) (v) of the Act.
Decision	<p>The essential of an association of an association of person are the following:</p> <ol style="list-style-type: none"> 1) Two or more persons. 2) Voluntary Combination 3) A common purpose or common action with the object to produce profit or gain. 4) Combination in Joint enterprise 5) Some kind of scheme for common management. <p>A close look into various clauses of contract agreement as well as service agreement reveals that all the essential ingredients of being an AOP stand satisfied in this case.</p> <ol style="list-style-type: none"> 1) There was a MOU entered into by three entities according to which JV has to be formed to undertake the contract. It was followed by contract between HPRIDC and J.V. 2) The JV partners have associated themselves with a common design to provide consultancy service to the client for development of tunnel in Shimla and other areas of Himachal Pradesh and common act/objective of the J.V Partners is to earn income in the wake of consultancy. 3) In the event of insolvency of a member, the other member irrevocably appointed to act for that member in the matter of performance of the agreement “being jointly and severally responsible on this behalf”. Further each member shall have unrestricted access to any work carried by the member in connection with the project. The JV partners are jointly and severally liable to the client for the obligation. 4) Manner of payment as mentioned in schedule 4 of agreement, Secon and Rites are responsible for invoicing the lead partner i.e Geo for their services. The lead partner shall prepare a consolidated invoice and submit to the client. Though each member receives the payment directly, the bills are processed by the lead partner who sends a consolidated invoice after checking the particular. The payment must be deemed in law to have been made to and received by the joint venture as a unit, though the members have authorized the client to issue cheques to the individual accounts based on invoices. Total payments are to be made to J.V. and not to individual partner. <p>In view of the above, the applicant is a member of AOP consisting of the applicant and two other entities. Therefore it is unnecessary to deal with other questions.</p>	<p>Whether or not a combination of persons or entities for undertaking the business venture would give rise to AOP depends on the facts and circumstances relating to a given contract or transaction. There is no hard and fast rule or clear cut definition. Various relevant factors have to be weighed to reach the conclusion.</p> <p>As per clause of agreement, the following facts are noticed.</p> <ol style="list-style-type: none"> 1) There is specific declaration in SCA that nothing in the agreement is intended shall be construed as creating a partnership, joint venture or other legal entity among the parties. There is no such specific declaration in case of Geo consultant 2) The scope of work of each member of MRMB Consortium is specifically defined and it is mutually exclusive to each other. There cannot be interchangeability or overlapping of the work to any substantial extent. The nature of work performed by each member is qualitatively different and each member has distinct skills. The access to the work carried on by others or providing assistance to another does not arise. The question of substitution of the other JV member in place of an insolvent member does not arise in this case. 3) The parties have specifically provided in the agreement that each party will bear its loss and retain its profits separately. MC, being the consortium leader, would collect payments on behalf of BEML and distribute to other consortium members in their respective participation ratios. <p>In light of above discussion, it is ruled that the MRMB Consortium cannot be treated as Association of persons for the purpose of assessment under the Income Tax Act 1961 and applicants can be only subjected to taxation on the basis that they are separately taxable entities.</p>

Basis	Geo Consult	Hyundai Rotem
Intention to create JV	Present	Absent
Scope of work of each member	Skill set of each member same and scope of work is overlapping	Scope of work is materially different
Unrestricted Access to work carried out by other members	Yes	No
Insolvency of any member	Portion of work to be reassigned among other members	No reassignment as each member has different sets of skills

Points for Consideration

Proper structuring of the contract is necessary. Certain safeguards should be inserted in the contract to mitigate the exposure of an AOP. Some of these safeguards are:

- 1) Clearly defined and documented separate scope of work for each of the contracting entities;
- 2) Separate consideration for each individual scope of work;
- 3) Agreement should clearly spell out that the arrangement is not intended to create any partnership or JV;
- 4) Agreement to clarify that no sharing of profit/losses between the service companies is envisaged;
- 5) Each entity should have primary responsibility for its own scope of work.

In direct tax, it is evident that though an AoP is formed, an assessment depends on the contractual obligation between the parties. But the new amendment in the service tax vide the aforementioned Notification No. 30/2012 is not clear on the following issues:

1. AOP is not defined but body corporate is assigned the meaning under the Companies Act 1956.

This method of collection of tax is to ensure that there is no revenue leakage for the Government, since 50% revenue is collected from business entity registered as body corporate in a taxable territory. Body corporate is defined with reference to Section 2(7) of the Companies Act, 1956.

The basic idea behind the introduction of this joint liability concept is to tap the revenue leakage, so that responsibility will be cast on the bodies corporate to the extent of the specified percentage, and the revenue will be secured. This revenue leakage is more when the service provider is un-incorporated.

2. Whether formation of AOP between two corporations in line with the Hyundai Rotem model will be considered as an AOP?

The basic idea behind the introduction of this joint liability concept is to tap the revenue leakage, so that responsibility will be cast on the bodies corporate to the extent of the specified percentage, and the revenue will be secured. This revenue leakage is more when the service provider is un-incorporated. It is a welcome amendment to create a responsibility on the receiver.

On the other hand, in case of body corporate forming consortiums that are governed by laws and principles of accounting, assessing from the revenue point is easier and more secured. Further, accepting the position of an AOP for the purpose of indirect tax will hamper the position of considering individual assessment (not as an AOP) direct tax.

Conclusion

In the construction industry wherein formation of the AOPs are necessitated, basically the Government/Government companies contracts are in the nature of infrastructure development. No Government company will take a stand that an AOP formed for winning the bid cannot be considered as an AOP, though it has been clearly spelt out from the contract. They naturally look for discharging 50% as service recipient. This will lead to :

- Accepting the formation of an AOP for Service tax purposes and discharging only 50 % of service tax liability; and
- Defending the same for income tax purposes otherwise.

With new amendment, the service tax has opened the gateway of new litigations. Unless the CBEC comes out with a clarification on the definition of an AOP, the assessee has to face new litigations both in direct as well as indirect taxes. It is better to make representations in this regard to have a smooth direct and indirect tax assessments. ■