



Contract receipts cannot be treated as income of a joint venture company since it was a case of diversion of income by overriding title

Background

Recently, the Jammu & Kashmir High Court in the case of Soma TRG Joint Venture¹ (the taxpayer) held that contract receipts cannot be treated as income of the joint venture company and it was the case of diversion of income by overriding title. The taxpayer was formed only for the purposes of submission of tender, and it was agreed between two companies of the project that in case the joint venture is awarded the work by the employer, a more detailed joint venture based on the agreement shall be signed. The definition of income provided under Section 2(24) of the Income-tax Act, 1961 (the Act) is inclusive and wide, yet the fact remains that the income diverted at the source before it accrues to the taxpayer cannot be regarded as income.

The High Court held that the disallowance under Section 40(a)(ia) of the Act is inapplicable in the hands of the taxpayer since no amount is payable by the taxpayer at the close of the year. Since the relevant taxes have been paid by the joint ventures, the taxpayer could not be held to be an assessee in default so as to disallow the amount attributed by the joint venture under Section 40(a)(ia) of the Act. The High Court held that the amendment² made in the Act is retrospective and is clarificatory in nature.

¹ Soma TRG Joint Venture v. CIT (ITA No.34/2013, dated 15 September 2017) – Taxsutra.com

² Amendment to Section 40(a)(ia) of the Act - The second proviso in Section 40(a)(ia) was inserted by the Finance Act, 2012 with effect from 1 April 2003 provides that where a taxpayer fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any sum but is not deemed to be an assessee in default under the first proviso to Section 201(1), then, it shall be deemed that the taxpayer has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the said proviso.

Facts of the case

- The two separate and independent limited companies³ incorporated under the provisions of Companies Act entered into two separate joint venture agreements for the formation of the taxpayer. The taxpayer was formed with the objective of submission of two tenders for construction of two tunnels of Northern Railway on the two rail link project.
- The need for formation of the taxpayer arises due to the fact that TRG Industries (P) Ltd was not meeting the qualifying criteria laid down in the notice inviting tender floated by Northern Railways. It was only Soma Enterprises Ltd. which had the necessary experience under the notice inviting tender.
- Soma Enterprises Ltd. had enabled TRG Industries (P) Ltd. to obtain the contract, therefore it received 3 per cent of the contract value, and TRG Industries (P) Ltd received 97 per cent of the contract value from the aggregate receipts received under the tender.
- Neither work was intended to be done by the taxpayer, nor the same was done by the taxpayer. The entire expenditure was not incurred by the taxpayer but was only by TRG Industries (P) Ltd. The aggregate receipts were allocated to the joint venture partners under the joint venture agreement and no income accrued to the taxpayer as there was a diversion of income at source. The taxpayer did not incur any expenditure on the said project and was merely a conduit to obtain the contract from the northern railways.

³ i.e., TRG Industries (P) Ltd and Soma Enterprises Ltd

- In terms of the agreement, the taxpayer received a sum of INR 11.95 million in Assessment Year (AY) 2004-05. The aforesaid sum was received in the ratio of 97:3 as per the separate agreement entered between the two joint venture for the construction of two projects.
- The taxpayer being an Association of Persons (AOP) furnished a return of income and declared nil income. Subsequently, the Assessing Officer (AO) disallowed the amount paid by the taxpayer to the joint venturers for non-compliance of the provisions of Section 40(a)(ia) of the Act. The AO held that the taxpayer had sub-contracted the execution of the work in the ratio of 97:3 and thus provisions of Section 40(a)(ia) of the Act are attracted for not deducting tax at source.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO. However, the Tribunal held that income had accrued to the taxpayer and it was not a case of diversion of income by overriding title because all payments were received and duly credited in the books of the taxpayer. It was held that the taxpayer was liable for deduction of tax at source in respect of payments made to TRG Industries (P) Ltd and Soma Enterprises Ltd under Section 194C and 194J of the Act, respectively. It was also held that the payments made by the taxpayer to TRG Industries (P) Ltd and Soma Enterprises Ltd were not eligible for deduction in view of Section 40(a)(ia) of the Act for not deducting tax at source.

High Court's decision

Diversion of income overriding title

- On a perusal of the relevant clauses of the agreement, it indicates that the taxpayer was formed only for the purposes of submission of tender, and it was agreed between the two companies that in case the joint venture is awarded the work by the employer, a more detailed joint venture based on the agreement shall be signed.
- Neither the existence nor the genuineness of the agreements has been disputed or even doubted by the tax department. There is no finding by the AO that the members of the joint venture had authority to interfere with or comment on the work executed by the other member or that both the members have jointly executed the work.
- Neither amount would have been received by the taxpayer from the northern railways for which no work performed by it nor it could be said that the taxpayer has performed any activity, but still the income has accrued. The definition of income as provided under Section 2(24) of the Act is inclusive and wide, yet the

fact remains that the income diverted at the source before it accrues to the taxpayer cannot be regarded as income. The High Court relied on various decisions⁴.

- The taxpayer had not incurred any expenditure, and the work admittedly was executed by Soma Enterprises Ltd. In the case of Sitaldas Tirathdas⁵, it has been held that true test of diversion of income by overriding title is whether the amount sought to be deducted, in truth, never reached the taxpayer as his income. To apply the doctrine of diversion of income by overriding title, the first and foremost condition to be satisfied is the nature of taxpayer's obligation. Whether by the obligation, the income is diverted before it reaches the taxpayer, or whether the income is required to be applied to discharge an obligation after such income reaches the taxpayer.
- In the present case, there is a diversion of income at the source itself. Therefore, the receipt of the amount of INR 120.10 million could not be treated as income of the taxpayer, and it was the case of diversion of income by overriding title.

Disallowance under Section 40(a)(ia) of the Act

- The second proviso in Section 40(a)(ia) was inserted by the Finance Act, 2012 with effect from 1 April 2003 provides that where an taxpayer fails to deduct the whole or any part of the tax in accordance with the provisions of Chapter XVII-B on any sum but is not deemed to be an assessee in default under the first proviso to Section 201(1), then, it shall be deemed that the taxpayer has deducted and paid the tax on such sum on the date of furnishing of return of income by the resident payee referred to in the said proviso.
- The Supreme Court in the case of R.B. Jodha Mal Kuthiala⁶ has held that one should apply the rule of reasonable interpretation. A proviso which is inserted to remedy unintended consequences and to make the provision workable. It proviso which supplies an obvious omission in the section and is required to be read into the section to give the section a reasonable interpretation. It requires to be treated as retrospective in operation so that a reasonable interpretation can be given to the section as a whole. Subsequently, the Delhi High Court followed the aforesaid decision in the case of Rajinder Kumar⁷ and held that the amendment

⁴ CIT v. Sitaldas Tirathdas [1961] 41 ITR 367 (SC), Provat Kumar Mitter v. CIT [1961] 41 ITR 624 (SC), Motilal Chhadami Lal Jain v. CIT [1958] 190 ITR 1 (SC), CIT v. Sahara Investment India Ltd [2004] 266 ITR 641 (SC), CIT v. Chamanlal Mangal Das & Co. [1960] 39 ITR 8 (SC), Dalmia Cement Ltd. v. CIT [1999] 237 ITR 617 (SC), CIT v. Sunil J. Kinariwala, [2003] 259 ITR 10 (SC)

⁵ CIT v. Sitaldas Tirathdas [1961] 41 ITR 367 (SC)

⁶ R.B. Jodha Mal Kuthiala v. CIT [1971] 82 ITR 570 (SC)

⁷ CIT v. Rajinder Kumar, [2014] 362 ITR 241 (Del)

in the proviso to Section 40(a)(ia) of the Act is retrospective in nature.

- Thus, with insertion of the proviso by the Finance Act, 2012 to Section 40(a)(ia) of the Act as otherwise also since the taxes have been paid by the joint ventures, the taxpayer could be held to be an assessee in default so as to disallow the amount attributed by the joint venture under Section 40(a)(ia) of the Act. The aforesaid amendment is retrospective and is clarificatory in nature.
- However, Section 40(a)(ia) of the Act is inapplicable to the present case since no amount was payable by the taxpayer at the close of the year and if two views are possible, the one which favours the taxpayer has to be adopted. The High Court referred the decision of Red Brick Realtors⁸. Accordingly, the decision is held in favour of the taxpayer.

Our comments

The consortium formed to bid for a turnkey contract and its taxability in the hands of its members/joint venture has been a matter of debate before the Courts.

In this decision, the High Court held that contract receipts cannot be treated as income of the joint venture company and it was the case of diversion of income by overriding title. The taxpayer was formed only for the purposes of submission of tender, and it was agreed between the two companies/parties of the project that in case the joint venture is awarded the work by the employer, a more detailed joint venture based on the agreement shall be signed. The definition of income provided under Section 2(24) of the Act is inclusive and wide, yet the fact remains that the income diverted at the source before it accrues to the taxpayer cannot be regarded as an income.

The present decision provides guidance on the circumstances in which a consortium may claim that the amount received by it is diverted in favour of its members. Further, the High Court also observed that the amendment in Section 40(a)(ia) of the Act is retrospective in nature. The High Court allowed relief on the ground that the disallowance under Section 40(a)(ia) of the Act can be applied only to the amount remaining unpaid as at year end.

It is important to note that recently the Supreme Court in the case of Palam Gas Service⁹ held that Section 40(a)(ia) of the Act covers not only those cases where the amount is 'payable' but also when it is 'paid' and tax has not been deducted on the same.



⁸ ACIT v. Red Brick Realtors [2015] 70 SOT 592 (Chen)

⁹ Palam Gas Service v. CIT [2017] 394 ITR 300 (SC)

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