IN THE INCOME TAX APPELLATE TRIBUNAL
"D" Bench, Mumbai

Before Shri D.K. Agarwal, Judicial Member
and Shri B. Ramakotaiah, Accountant Member

ITA No. 8035/Mum/2010
(Assessment Year: 2006-07)

M/s. Dredging International N.V. PWC-House - Plot 18/A Guru Nanak Road, (Station Road) Bandra (W), Mumbai 400050 PAN - AABCD 1445 N	Vs.	Asst. Director of Income Tax (International Taxation) 1(2) 1st Floor, Scindia House, N.M. Rd. Ballard Pier, Mumbai 400038
Appellant		**Respondent**

Appellant by: S/Shri Kanchan Kaushal/Niranjan Govindekar/Dhanesh Bafna & Aliasagar Rampurawala

Respondent by: Dr. S. Senthil Kumar

Date of Hearing: 24.08.2011
Date of Pronouncement: 16.09.2011

O R D E R

Per B. Ramakotaiah, A.M.

This appeal by the assessee is directed against the order of the Assistant Director of Income Tax (International Taxation – 1(2)) passed under section 143(3) r.w.s 144C(13) of the I.T. Act. Assessee in the grounds is questioning the order of the DRP-1, Mumbai in issuing various directions and the action of the A.O. implementing them. There is no dispute with reference to the fact that assessee is a foreign company and is covered by the definition of 'eligible assessee' under sub- section 15(b) of Sec.144C.

2. The grounds raised by the assessee are as under: -

"1. On the facts and in the circumstances of the case and in law, the Hon'ble Dispute Resolution Panel ('DRP') erred in directing the learned Assistant Director of Income-tax (International Taxation) – 1(2) ('ADIT') has erred in enhancing the assessment, pursuant

to such directions of Hon'ble DRP, to impute profit for the year of Rs.1,05,03,587 on estimated basis which was not a variation proposed in the draft order passed by the learned ADIT under section 144C(1) of the Income-tax Act, 1961 ('the Act').

It is, therefore, prayed that the direction issued by the Hon'ble DRP under section 144C of the Act and consequent enhancement by the learned ADIT on the variation not proposed in the draft assessment order should be treated as invalid, bad in law and to that extent the enhancement so made be ordered to be deleted.

Without prejudice to Ground No. 1 above,

2. *On the facts and in the circumstances of the case and in law, the learned ADIT has erred in estimating 20% of the total contract price as revenue of the year on an arbitrary basis and has also erred in applying an adhoc rate of 8% as profit margin thereon, thereby charging to tax net profit of Rs.1,05,03,587 for the Assessment Year 2006-07.*

   It is prayed that the aforesaid estimation of profits at Rs.1,05,03,587 be deleted.

   Without prejudice to Ground 1 and 2 above,

3. *On the facts and in the circumstances of the case and in law, the Learned ADIT erred in estimating revenues (i.e. value of work in progress) at Rs.13,12,94,847 being 20 percent of contract value without appreciating the fact that appellant itself had credited to the Profit and Loss Account revenue (i.e. work in progress) at Rs.19,83,63,908 and further erred in estimating a profit at the rate of 8% without granting deduction for actual project costs as debited to the Profit and Loss Account by the Appellant.*

   It is prayed that the learned ADIT be directed to compute profit/loss after granting deduction for actual project costs from the value of project revenues.

   Without prejudice to Ground No. 1 and 2 above and strictly in the alternative,

4. *On the facts and in the circumstances of the case and in law, the learned ADIT erred in not computing the work-in-progress as directed by the Hon'ble DRP.*

   It is prayed that the learned ADIT be directed to compute revised work-in-progress as directed by the Hon'ble DRP.

5. *On the facts and in the circumstances of the case and in law, the learned ADIT erred in disallowing claim of the appellant in respect of provision for foreseeable losses amounting to Rs.32,86,17,293.*

It is prayed that the claim of provision for future loss of Rs.32,86,17,293/- be allowed while computing income of the Appellant.

6. *On the facts and in the circumstances of the case and in law, the learned ADIT erred in not quantifying additional depreciation of Rs.5,14,015 on fixed assets, arising on account of directions issued by Hon'ble DRP to capitalize the amount of the foreign exchange fluctuation to the cost of the asset.*

It is prayed that learned ADIT be directed to quantify and allow additional depreciation of Rs.5,14,015 to the appellant."

3. We have heard the learned counsel and the learned D.R. in detail and their arguments are being considered in the course of this order at the relevant places.

4. Briefly stated, the A.O. [DDIT, International Taxation – 1(2)] has proposed a draft assessment order dated 24.12.2009 as provided under section 144C(1) of the Act. Assessee, being a foreign company incorporated in Belgium, is covered by the provisions and is primarily engaged in dredging and land reclamation activities. During A.Y. 2006-07 it was awarded a contract by Reliance Industries Ltd. (RIL) for undertaking dredging and site filling related worked near Gadimoga village in Andhra Pradesh. A.Y. 2006-07 is the first year of assessee's operation in India. For the purpose of execution of the project the company set up a project office in India and since the duration of the project undertaken has exceeded six months, there was a permanent establishment in terms of Article 7 of Indo-Belgium Tax Treaty. During the relevant year assessee filed its return of income declaring a total loss of ₹31,22,11,230/-. In the draft order the DDIT has proposed the following adjustments: -

a) Depreciation on temporary structure	₹43.29 lakhs
b) Provision for future losses	₹32.86 crores
c) Disallowance of expenses	₹22.10 lakhs
d) Unexplained cash credit	₹12.21 crores
e) Foreign Exchange loss	₹52,48 lakhs

5. Assessee made objections to the proposed variations and the Dispute Resolution Panel (DRP) – I vide directions dated 16.09.2010 accepted the

objection-1 relating to depreciation on temporary structure, objection No. 3 – disallowance of expenses and objection No. 4 – unexplained cash credit. With reference to objection No. 2 the DRP did not allow the claim of future losses but directed the A.O. to consider 20% of the contract as completed during the period and estimate a reasonable percentage at 8% thereby taxing net profit at ₹1,05,03,587/-. With reference to objection No. 5 the DRP directed to examine whether the losses claimed are capital loss or revenue loss. Its direction was that capital loss shall be included in the cost of the assets and revenue loss shall be capitalised to the work-in-progress. The A.O. passed order in compliance to the directions issued and assessee is contesting the issues arising out of such directions against the assessee.

6. Ground No. 1 to 4 pertains to the issue of direction given for bringing to tax an amount of ₹1,05,03,587/- at 8% of the percentage completion of 20% contract price, which was determined by the DRP at ₹13,12,94,847/-. These grounds are inter-related to the issue of directions and the powers of the DRP to propose variation in the draft assessment order *suo moto,* which was not proposed by the A.O.

7. The arguments are that the assessee has already shown the revenue receipt, i.e. work-in-progress at ₹19,83,63,908/- which was more than the contract receipts determined by the DRP at ₹13,12,94,847/- and so the question of estimating revenue on the amount as directed by the DRP does not arise as contested in ground No. 3. Further, since assessee claimed the future loss of ₹32,86,17,293/- and this future loss was proposed to be disallowed by the A.O. in the draft assessment order, the DRP cannot direct the A.O. to estimate the profit on 20% of the contract at 8%, which is at variance with the proposed draft order. It was also the contention that the DRP does not have any powers to give such directions, which are at variance with the proposed draft order and various arguments have been raised in this regard.

8. The learned counsel referred to the provisions of the I.T. Act with reference to the powers of the DRP, then compared them with reference to the earlier positions of section 144B to submit that the directions of the DRP

are at variance with the original proposed draft order and, therefore, the direction is invalid. The learned counsel further relied on the recent decision of the Hon'ble Karnataka High Court in the case of GE India Technology Centre Pvt. Ltd. in Writ Appeal No. 1010 of 2011 dated 5th July 2011.

9. The learned D.R., however, supported the order of the DRP to submit that the A.O. proposed restriction of the loss and the DRP directed part of the claim to be treated as profit and to be considered for work-in-progress. It was his submission that the directions are not at variance.

10. After considering the arguments of the learned counsel and the learned D.R. we are of the opinion that the DRP's direction in taxing 20% of the gross contract receipt at 8% is at variance with the proposed draft order by the A.O. disallowing the future loss claimed. The disallowance of future loss claimed is contested by the assessee in ground No. 5, which we intend to deal later separately. For the purpose of these grounds, the issue of estimation of profit at 8% was not before the A.O. when he proposed the draft order. As seen from the draft order the A.O. has made a reference to section 92CA(1) of the I.T. Act to the Additional Commissioner of Income Tax, Transfer Pricing-1(2) who did not propose any adjustment to the value of international transaction. After this the A.O. has proposed disallowance of depreciation on temporary structure, disallowance of future loss, disallowance of expenses on adhoc basis and addition of unexplained cash credit and foreign exchange losses in the computation. As against losses claimed at ₹31,22,11,230/- the proposed additions or disallowances resulted in total income of ₹15,03,78,290/-. Therefore estimation of 8% of income on contract receipt is at variance with the originally proposed draft order. Not only that, as seen from the final order passed by the A.O. in consonance with the directions of the DRP vide order dated 25.10.2010, the A.O. himself has recorded the following: -

> ***Further, the DRP has directed to determine profit of the assessee at a specified percentage of part contract value on estimated basis*** *and observed as under: -*
>
> *"Since the DRP has applied the net rate of profit on the proportionate receipts pertaining to the accounting year, no further allowance*

either on account of objection No. 1 i.e. depreciation on account of temporary structure and on account of losses on fluctuation of foreign exchange shall actually be allowed to the assessee for the set off from the net profit and these two amounts along with the net profit to be assessed at Rs.1,05,03,587/- shall be included in the work-in-progress for considering the same for computation of final profits when the project is complete. Hence, the A.O. is directed to assess the income at Rs.1,05,03,587/- and work out the closing work-in-progress."

In view of the above direction of the DRP, 20% of the contract is considered to have been completed in the financial year 2005-06 and profit at 8% of the completed contract revenue is considered as reasonable profit of the period. Accordingly, amount of ₹1,05,03,587/- [65,64,74,235 X 20%) X 8%] is considered as net profit of the financial year 2005-06."

11. Even the A.O. is admitting that the DRP has directed to determine the profit at specific percentage on estimation basis and in view of the direction 20% of the contract is considered to have been completed and profit at 8% was estimated. This direction of the DRP is not only against the principles of law but also against the facts. Assessee has accounted for ₹19.83 crores in the P & L Account and shown in the work-in-progress, whereas the DRP without any basis determined the receipts at ₹13.13 crores. Moreover estimation of profit on percentage completion method was not an issue before the A.O., so in our view the DRP has erred in directing the A.O. to estimate the profit and determining profit at ₹1,03,03,587/-.

12. Coming to the provisions of law, section 144C is as under: -

"144C. *(1) The Assessing Officer shall, notwithstanding anything to the contrary contained in this Act, in the first instance, forward a draft of the proposed order of assessment (hereafter in this section referred to as the draft order) to the eligible assessee if he proposes to make, on or after the 1st day of October, 2009, any variation in the income or loss returned which is prejudicial to the interest of such assessee.*

(2) On receipt of the draft order, the eligible assessee shall, within thirty days of the receipt by him of the draft order,—

(a) file his acceptance of the variations to the Assessing Officer; or

(b) file his objections, if any, to such variation with,—

(i) the Dispute Resolution Panel; and

(ii) the Assessing Officer.

(3) The Assessing Officer shall complete the assessment on the basis of the draft order, if—

(a) the assessee intimates to the Assessing Officer the acceptance of the variation; or

(b) no objections are received within the period specified in sub-section (2).

(4) The Assessing Officer shall, notwithstanding anything contained in section 153, pass the assessment order under sub-section (3) within one month from the end of the month in which,—

(a) the acceptance is received; or

(b) the period of filing of objections under sub-section (2) expires.

(5) The Dispute Resolution Panel shall, in a case where any objection is received under sub-section (2), issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.

(6) The Dispute Resolution Panel shall issue the directions referred to in sub-section (5), after considering the following, namely:—

(a) draft order;

(b) objections filed by the assessee;

(c) evidence furnished by the assessee;

(d) report, if any, of the Assessing Officer, Valuation Officer or Transfer Pricing Officer or any other authority;

(e) records relating to the draft order;

(f) evidence collected by, or caused to be collected by, it; and

(g) result of any enquiry made by, or caused to be made by, it.

(7) The Dispute Resolution Panel may, before issuing any directions referred to in sub-section (5),—

(a) make such further enquiry, as it thinks fit; or

(b) cause any further enquiry to be made by any income-tax authority and report the result of the same to it.

(8) The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order so, however, that it shall not set aside any proposed variation or issue any direction under sub-section (5) for further enquiry and passing of the assessment order.

(9) If the members of the Dispute Resolution Panel differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members.

(10) Every direction issued by the Dispute Resolution Panel shall be binding on the Assessing Officer.

(11) No direction under sub-section (5) shall be issued unless an opportunity of being heard is given to the assessee and the Assessing Officer on such directions which are prejudicial to the interest of the assessee or the interest of the revenue, respectively.

(12) No direction under sub-section (5) shall be issued after nine months from the end of the month in which the draft order is forwarded to the eligible assessee.

(13) Upon receipt of the directions issued under sub-section (5), the Assessing Officer shall, in conformity with the directions, complete, notwithstanding anything to the contrary contained in section 153, the assessment without providing any further opportunity of being heard to the assessee, within one month from the end of the month in which such direction is received.

(14) The Board may make rules for the purposes of the efficient functioning of the Dispute Resolution Panel and expeditious disposal of the objections filed under sub-section (2) by the eligible assessee.

(15) For the purposes of this section,—

(a) "Dispute Resolution Panel" means a collegium comprising of three Commissioners of Income-tax constituted by the Board for this purpose;

(b) "eligible assessee" means,—

(i) any person in whose case the variation referred to in sub-section (1) arises as a consequence of the order of the Transfer Pricing Officer passed under sub-section (3) of section 92CA; and

(ii) any foreign company."

13. Section 144C of the Income-tax Act, 1961 was introduced by Finance (No. 2) Act, 2009 to provide for an alternate dispute resolution mechanism to facilitate expeditious resolution of disputes on a fast track basis in the cases of foreign companies and transfer pricing disputes. On receipt of the draft order, the taxpayer, under section 144C(2), has a right to file his objections to the variations proposed in the draft order with the DRP. Sub-sections (5) and (8) which deal with disposal of the objections by the DRP are reproduced below: -

"(5) The Dispute Resolution Panel shall, in a case where any objection is received under sub-section (2), issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment.

.....

(8) The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order so, however, that it shall not set aside any proposed variation or issue any direction under sub-section (5) for further enquiry and passing of the assessment order."

A plain reading of sub-section (5) suggest that DRP can issue directions only in respect of the objections raised by the taxpayer and the objections are to

be in terms of variation proposed in the draft order. Section 144C(8) specifically provides that powers of the DRP are restricted to confirm, reduce or enhance the variation as proposed in the draft assessment order. Hence, DRP directions are to be with reference to the objections to the variations proposed in the draft order.

14. Provision under section 144B (which has been deleted w.e.f. April 1, 1989) on similar lines was prevalent in the Income-tax law. A comparison of provisions of section 144C and section 144B(since deleted) is given below: -

Section 144B- Reference to Inspecting Assistant Commissioner in certain cases		**Parallel Provisions of Section 144C – Reference to dispute resolution panel**	
1	Notwithstanding anything contained in this Act, where, in an assessment to be made under sub-section (3) of section 143, the Income-tax Officer proposes to make any variation in the income or loss returned which is prejudicial to the assessee and the amount of such variation exceeds the amount fixed by the Board under sub-section (6), the Income-tax Officer shall, in the first instance, forward a draft of the proposed order of assessment (hereinafter in this section referred to as the draft order) to the assessee	1	The Assessing Officer shall, notwithstanding anything to the contrary contained in this Act, in the first instance, forward a draft of the proposed order of assessment (hereinafter in this section referred to as the draft order) to the eligible assessee if he proposes to make, on or after the 1st day of October, 2009, any variation in the income or loss returned which is prejudicial to the interest of such assessee
2	On receipt of the draft order, the assessee may forward his objections, if any, to such variation to the Income-tax Officer, within seven days of the receipt by him of the draft order or within such further period not exceeding fifteen days as the Income-tax Officer may allow on an application made to him in this behalf	2	On receipt of the draft order, the eligible assessee shall, within thirty days of the receipt by him of the draft order: - (a) file his acceptance of the variations to the Assessing Officer; or (b) file his objections, if any, to such variation with, (i) the Dispute Resolution Panel; and (ii) the Assessing Officer.
3	If no objections are received within the period or the extended period aforesaid, or the assessee intimates to the Income-tax Officer the acceptance of the variation, the Income-tax Officer shall complete	3	The Assessing Officer shall complete the assessment on the basis of the draft order, if – (a) the assessee intimates to the Assessing Officer the acceptance

	the assessment on the basis of the draft order.		of the variation; or (b) no objections are received within the period specified in sub-section (2).
4	If any objections are received, the Income-tax Officer shall forward the draft order together with the objections to the Inspecting Assistant Commissioner and the Inspecting Assistant Commissioner shall, after considering the draft order and the objections and after going through (wherever necessary) the records relating to the draft order, issue, in respect of the matter covered by the objections, such directions as he thinks fit for the guidance of the Income-tax Officer to enable him to complete the assessment.	5 6 7 8	The Dispute Resolution Panel shall, in a case where any objection is received under sub-section (2), issue such directions, as it thinks fit, for the guidance of the Assessing Officer to enable him to complete the assessment. The Dispute Resolution Panel shall issue the directions referred to in sub-section (5), after considering the following, namely: - (a) draft order; (b) objections filed by the assessee; (c) evidence furnished by the assessee; (d) report, if any, of the Assessing Officer, Valuation Officer or Transfer Pricing Officer or any other authority; (e) records relating to the draft order; (f) evidence collected by, or caused to be collected by, it; and (g) result of any enquiry made by, or caused to be made by, it. The Dispute Resolution Panel may, before issuing any directions referred to in sub-section (5), - (a) make such further enquiry, as it thinks fit; or (b) cause any further enquiry to be made by any income-tax authority and report the result of the same to it. The Dispute Resolution Panel may confirm, reduce or enhance the variations proposed in the draft order so, however, that it shall not set aside any proposed variation or issue any direction under sub-section (5) for further enquiry and passing of the assessment order.

	Provided that no directions which are prejudicial to the assessee shall be issued under this sub-section before an opportunity is given to the as to be heard.	11	No direction under sub-section (5) shall be issued unless an opportunity of being heard is given to the assessee and the Assessing Officer on such directions which are prejudicial to the interest of the as or the interest of the Revenue, respectively.
5	Every direction issued by the Inspecting Assistant Commissioner under sub-section (4) shall be binding on the Income-tax Officer	10 13	Every direction issued by the Dispute Resolution Panel shall be binding on the Assessing Officer. Upon receipt of the directions issued under sub-section (5), the Assessing Officer shall, in conformity with the directions, complete, notwith-standing anything to the contrary contained in section 153, the assessment without providing any further opportunity of being heard to the assessee, within one month from the end of the month in which such direction is received.
6	For the purposes of sub-section (1), the Board may, having regard to the proper and efficient management of the work of assessment, by order, fix, from time to time, such amount as it deems fit: Provided that different amounts may be fixed for different areas: Provided further that the amount fixed under this sub-section shall, in no case, be less than twenty-five thousand rupees.	4 9 12 14	The Assessing Officer shall, notwith-standing anything contained in section 153, pass the assessment order under sub-section (3) within one month from the end of the month in which, - (a) the acceptance is received; or (b) the period of filing of objections under sub-section (2) expires. If the members of the Dispute Resolution Panel differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members. No direction under sub-section (5) shall be issued after nine months from the end of the month in which the draft order is forwarded to the eligible assessee. The Board may make rules for the purposes of the efficient functioning of the Dispute Resolution Panel and expeditious disposal of the objections filed under sub-section (2) by the eligible assessee.
7	Nothing in this section shall apply to the case where an Inspecting		

	Assistant Commissioner exercises the powers or performs the functions of an Income-tax Officer in pursuance of an order made under section 125 or section 125A.		
		15	For the purpose of this section, - (a) "Dispute Resolution Panel" means a collegium comprising of three Commissioners of Income-tax constituted by the Board for this purpose; (b) "eligible assessee" means, - (i) any person in whose case the variation referred to in sub-section (1) arises as a consequence of the order of the Transfer Pricing Officer passed under sub-section (3) of section 92CA; and (ii) any foreign company.

Section 144B provided for a reference to be made to the Inspecting Assistant Commissioner ('IAC') by the A.O. along with the draft order and the objections of the taxpayer (where variations exceeded a particular limit). Section 144B(4) which discussed the power of the Inspecting Assistant Commissioner(later designated as deputy commissioner, now as joint commissioner) on the reference of a case is reproduced below:

> *"(4) If any objections are received, the Assessing Officer shall forward the draft order together with the objections to the Deputy Commissioner and the Deputy Commissioner shall, after considering the draft order and the objections and after going through (wherever necessary) the record relating to the draft order, issue, in respect of the matters covered by the objections, such directions as he thinks fit for the guidance of the Assessing Officer to enable him to complete the assessment"*

The judicial precedence laid by decided cases by the Courts in connection with interpretation of jurisdiction and powers of IAC under section 144B should apply with equal force to the interpretation of section 144C owing to similarity between the two provisions. In the context of section 144B, various judicial precedents have held that the review mechanism which section 144B provides for is limited only to the additions proposed by the

A.O. and objected by the assessee. Further, enhancement of the assessment as a result of the directions issued by the Inspecting Assistant Commissioner under section 144B(4) on the items not covered by the draft order would be invalid to the extent "it was not covered by the draft". It was observed by judicial precedents that the Inspecting Assistant Commissioner has no jurisdiction to give any instructions which is beyond the purview of the draft order and the objections filed by the taxpayer. The following judicial precedents, amongst various others, support the above proposition:

a) In the case of Asiatic Oxygen Ltd. vs. CIT 190 ITR 328, the Inspecting Assistant Commissioner disallowed a particular expenditure which was allowed by the A.O. (accordingly, no objection by the taxpayer on such amount) and thereby resulting in enhancement of income to the extent of disallowance. While holding that action of the Inspecting Assistant Commissioner was not lawful, the Calcutta high Court observed as follows: -

"In such a case, the Inspecting Assistant Commissioner does not have the power to direct the Income-tax Officer to make the disallowance and thereby enhance the assessment or reduce the loss suffered by the assessee.

...

We are of the view that, in the instant case, the direction was not lawful.

...

Any act done beyond the scope of powers defined by the statues will be ultra vires. This term has a broad application and includes acts prohibited by the statue or which are in excess of the powers granted. Exercise of power in a manner not allowed by law is ultra vires and not lawful as well.

...

Accordingly, the direction of the Inspecting Assistant Commissioner under section 144B of the Act to disallow the said expenditure is not sustainable."

b) In the case of Bengal & Assam Investors Ltd. vs. CIT 142 ITR 156, the assessee filed a return disclosing income of ₹4,70,830/-. The ITO forwarded a draft order under section 144B(1) proposing assessment on a total income of ₹5,75,656/-. On receipt of directions, the assessment was completed on an income of ₹6,61,561/-, because while the ITO proposed to allow a deduction of ₹3,51,105/- under section 80M the same was reduced to ₹2,65,300/- under the directions of the IAC, though this matter was not the subject matter of reference to him.

While holding that action of the Inspecting Assistant Commissioner was not lawful, the Calcutta High Court observed as follows: -

"Having regard to the provisions of section 144B(4) it appears that the correct view would be that the enhancement of the assessment as a result of the direction issued by the IAC under section 144B(4) on the items not covered by the draft assessment order would be invalid to the extent "it was not covered by the draft". In the facts the circumstances of the case, the fact that it was deleted on appeal by the CIT is quite irrelevant."

In view of the above judicial precedents on the powers of supervisory authority, since the similar provisions were incorporated in the new section 144C with reference to draft orders, the principles are equally applicable.

15. This issue whether the DRP has power to issue directions at variance to the proposed draft order was also decided in the case of another foreign company M/S GE India Technology Centre Pvt. Ltd. by way of Writ Appeal before the Hon'ble Karnataka High Court. In Writ Appeal No. 1010 of 2011 dated 5th July 2011, the Hon'ble High Court has elaborately discussed the issue and came to the conclusion that the DRP cannot go beyond the proposed draft order. The facts in the above referred case are that the assessee declared income of ₹2,12,18,961/- and this case was selected for scrutiny. Under section 92CA of the Act the matter was referred to TPO for determining the arms length price and the Addl. TPO proposed adjustment of arms length price to an extent of ₹1,04,96,20,245/-. Therefore the proposed draft order was made why the excess claim of ₹44,49,280/- should not be disallowed and the arms length price as determined by the TPO should not be accepted. Since the assessee objected to the proposed variations the DRP came to the conclusion that adjustment of ₹29,68,71,593/- was required to be made under section 92CA r.w.s. 92C to the arms length price determined. However, DRP found that having regard to the material on the record and the documents submitted to the DRP for consideration assessee was not eligible to any exemption under section 10A and, therefore, notice was issued and the DRP passed final order holding that assessee was not entitled to exemption under section 10A. Being aggrieved on the directions issued, assessee thereon field writ petition and the Hon'ble Single Judge negated the contentions raised. However, the

matter was taken up by the Division Bench, examined the issue and held as under: -

*"It is clear on a reading of the above said sub-Sections of 144C that the provisions of section 144C(5) (*wrongly reported as (4*)) cannot be read de hors the power of the DRP under sub-Section (8) and while considering the power of DRP it is clear that while considering Section 144C(1) regarding the draft proposal order or draft order is only applicable to eligible assessee as defined under sub-Section (15) that is in respect of the variations referred to above sub-Section arising as a consequence of the order of the Transfer Pricing Officer under sub-Section (3) of Section 92CA and even under Section 144C(8). The DRP may confirm, reduce or enhance the variations proposed in the draft order and wherefore the word eligible assessee in Clause (1) and (15) and the proposed draft order referred to under Clause 144c(1) and (8) will have to be given full meaning. It cannot lead to the conclusion that the Dispute Resolution Panel can affirm, reduce or enhance the variations proposed in the draft order and cannot go beyond the proposed draft order, failing which if it is held by accepting the contention of the revenue we will be expanding the provisions of the powers of DRP to a regular appeal to the Commissioner of Income-Tax against an order of assessment which is sought to be given up in view of the provisions of section 92C and Section 144C. The directions issued by the DRP under section 144C is binding on the assessing officer and against the said order of the assessing officer a direct appeal to the Income-Tax Appellate Tribunal. Wherefore we have to look into the proposed draft order in the present case to find out as to whether the directions issued by the DRP as per direction No.(iv) culled out above is valid and binding or not. It is clear from the proposed draft order that the appellant had claimed exemption of Rs.32,58,26,375/-. The proposed draft order annexed to the proposed draft referable to excess claimed under section 10A in a sum of Rs.44,49,280/- is arrived in the draft proposal order as follows: -*

ANNEXURE

DEDUCTION U/S 10A

PARTICULARS	*Rs.*
Total turnover of the undertaking (A)	*305,31,27,853*
Export turnover of the undertaking	*305,31,27,853*
Less: Communication Expenses	*3,25,98,610*
Travel Expenses in foreign currency	*90,92,976*
Adjusted Export turnover (B)	*304,14,36,267*
Profit of the Undertaking (C)	*32,58,26,375*
Exemption u/Section 10A (D – B/A x C	*32,13,77,095*

Less: Actually claimed (E)	*32,58,26,375*
Excess claimed (F-E-D)	*44,49,280*

Therefore it is clear from the proposed draft order that as per the proposed draft the Arms Length Price fixed by the TPO was accepted and the claim made by the appellant was reduced by Rs.44,49,280/- but in the proposed draft order there may be deduction of Rs.32,13,77,095/-. However, as per the direction issued by the DRP it is clear that the DRP has issued a direction to the assessing officer by holding that the appellant assessee is not entitled to any reduction under section 10A it would be binding on the Assessing Officer in view of the provisions of section 144C(13) and wherefore having regard to the facts and circumstances of this case that in a proposed draft order there was no proposal to hold that the assessee is not entitled to any benefit under section 10A of the Act and what was proposed was only rejection of the excess claim of Rs.44,49,280/- the direction issued by the DRP in wholly without jurisdiction and suffers from inherent lack of jurisdiction and amenable to judicial review under Article 226 of the Constitution of India."

16. Applying the above principles, it is clear that in the proposed draft order vide objection No. 2, the variation proposed was only with reference to disallowance of future losses claimed whereas the DRP *suo moto* considered 20% of the total contract as completed during the year (which is in fact was not correct as assessee has offered more turnover in its books of account) and proposed bringing to tax the net profit at 8% of the above determined turnover. This direction of the DRP is wholly without jurisdiction and suffers from inherent lack of jurisdiction as it is not in conformity with the powers under section 144C(5) r.w.s. 144C(8). Therefore assessee's ground No. 1 is to be upheld as the DRP has varied from the proposed draft order and took up a new issue and issued directions which are at variance with the proposed draft order. In view of this, ground No. 1 raised by assessee is upheld. Consequently ground No. 2, 3 & 4 which are raised as alternate grounds without prejudice, are also deemed to have been allowed.

17. The next issue to be considered in ground No. 5 is with reference to the claim of provision for foreseeable loss amounting to ₹32,86,17,293/-. Assessee made a debit to the P & L Account of the above amount and the A.O. proposed disallowance of the above loss vide para 5 of the draft order

on the reason that the expenses were contingent upon occurrence or non-occurrence of certain events and assessee itself has classified it as a provision for future losses. The contingent liability did not constitute expenditure as the same cannot be subject matter of deduction and the expenditure which is deductible for this purpose is only those liabilities which are not contingent. By holding this, assessee disallowed the provisions for future losses and in doing so relied upon the case law regarding liability under Income Tax Act determined in the following cases: -

i) CIT vs. Nainital Bank Ltd. 62 ITR 638 (SC)

ii) Madras Industrial Investment Corporation Ltd. vs. CIT 225 ITR 802(SC)

iii) M.P. Financial Corporation vs. CIT 26 Taxman 92 (MP)

iv) Mysore Kirlosker Ltd. vs. CIT 166 ITR 836 (Kar)

18. It was assessee's contention before the DRP (vide Appendix 3 of the objection raised before the DRP) that paragraph 35 of AS-7 mandates that when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately and paragraph 36 of AS-7 further provides that the amount of such loss is to be provided irrespective of whether or not the work has commenced and the stage of completion of contract activity.

19. With reference to the facts of estimation of total cost of the contract and working of the loss it was submitted in para 2.5 of the objection as under: -

> *"2.5 The assessee estimated the total cost of the contract at the time of finalization of balance sheet for year ended March 31, 2006 and realized that the total contract cost (as estimated) would exceed the contract revenue by Rs.32,86,17,293. The primary reason due to which the cost increased are as under: -*
>
> - *When the dredger arrived at the site it was realised that the draught of the dredger was 5.1 and not 4.09 which would have easily moved in the channel. However, even then an attempt was made to pull the dredger inside after offloading most of bunker, lot of heavy items etc but in vein. Finally, an access channel was dredged for 2 weeks to make way for the dredger. The channel was 70m wide and was dredged upto – 6m.*

- *Lot of slit was observed passing through water boxes in spite of low fine contents shown by sieve analysis. Accordingly, bund was made between Area 2 and 3 to trap most of the slit insider Area 1 and 2 and thus to avoid major problem at the end of the job. However, in spite of such effort further 55,000m3 slit deposited in two ponds (storm water ponds for RIL) which had to be taken out.*
- *The shallow condition also prevailed while the dredger had to exit from the site after completion of the job. The previously dredged access channel was filled up to such extent that the dredger could not come out. This was majority due to the abnormal flood discharge during August 06. The dredger, had to therefore, dredged an exit channel for one month to come to a location where a ladder can be put on the frame to gain some reduction in draught. After so much effort and cost finally the dredger came out of the channel during spring tide.*
- *As mentioned earlier, the dredging work was being carried out in river Godavari. During the monsoon of 2006, there were heavy rains in Andhra Pradesh due to which flood water discharge volume in Godavari River on 6th and 7th August were 2.6 and 2.8 million cusecs respectively (9 to 10 times of normal flood discharge). As a result of this flow of extra ordinary flood water discharge very high current was generated in Godavari River (up to 15 knots). Due to this, some of the equipment mounted on Assurancetourix could not hold ground through the anchor and got drifted into sea. While a frame was retrieved, the floating line was lost and booster was found near Kolkatta after 1 month (i.e. approximately 800 nautical miles away from their actual location).*

20. It was the contention that assessee made provision of future losses amounting to ₹32,86,17,293/- as assessee expects to incur loss on the said project. It was further submitted that assessee has suffered loss on completion of work and the loss was also returned in the return filed for the subsequent year which was also verifiable by the A.O. However, the DRP in its order rejected the contentions as under: -

> *"**objection No 2**:- This objection relates to disallowance of future loss of Rs. 32,86,17,293. It is claimed by the assessee that it is following percentage project completion method for the dredging contract and it has recognised the expenditure incurred till 31st march as the reasonable revenue to be realised and it has envisaged huge loss at the end of the contract and has followed Accounting Standard AS 7 for claiming proportionate loss. The DRP asked the assessee*

to explain the correct system of accounting followed by the assessee and the assessee was also asked to explain why reasonable percentage of profit should not be treated as income on the proportionate receipts for actual work completed till the last date of the accounting period. The assessee did not file the proper reply and again claimed that income has been returned as per accounting standard AS-7. The DRP does not agree with the views of the assessee and DRP is of the view that assessee has completed about 20% of the contract during the accounting period and the assessee should have recognized 20% on the total amount received which works out to Rs.13,12,94,847/-. The reasonable percentage of profit is taken at 8% and on this basis the net profit should be Rs.1,05,03,587/-. This profit should have been included by the assessee in the closing stock of work-in-progress for computation of final profit of the completed project in the next Financial year. Thus, the claim of the assessee for claiming loss on the project on estimate basis of future period is premature and same cannot be allowed."

21. Assessee is objecting to the above directions of the DRP and it was submitted that assessee has given detailed explanation with reference to working of loss and various case law relied on by it. The learned counsel drew our attention to the detailed objection made by the DRP to contest the observation of the DRP that "assessee did not file proper reply". The learned counsel further drew our attention to Accounting Standard AS-7, the orders of the Coordinate Bench in the case of Jacob Engineering Pvt. Ltd. vs. ACIT 2009 TIOL 533, the decision of in the case of Mazagon Dock Ltd. vs. JCIT 29 SOT 356 (Mum) and also the decision of the Thermax Babcock & Wilcox Ltd. 79 ITD 63 (Pune). He also relied on the decision of the Hon'ble Supreme Court in the case of UP Industrial Development Corporation 225 ITR 703 for the proposition that ordinary principle of commercial accounting should be applied so long as they are not in conflict with any express provisions of the relevant statute.

22. The learned D.R., however, objected to the fact of application of AS-7 to assessee's case contesting that assessee is not involved in construction contract and so the principles do not apply and also referred to various provisions of accounting standard, which was placed on record in the paper book.

23. The learned counsel objected to the draft Accounting Standard relied on by the learned D.R. to submit that it was applicable from 1st April 2011 and placed AS-7 as applicable to assessee in the relevant year on record and referred to various guidelines therein to submit that assessee is covered by the guidelines of AS-7. The term building site or construction or installation project, as per the commentary to Article 5 of OECD also included laying of pipe lines and excavating and dredging in its definition. It was further submitted that A.O. has never objected to the fact of assessee being in 'construction contract' and objection to application of AS-7 was not either before the A.O. or before the DRP so as to raise the objection in the course of appellate proceedings.

24. We have considered the issue and examined the various arguments and papers placed on record. The assessee justified its claim of future losses not only before the A.O. but also before the DRP by giving detailed factual position as well as legal arguments. We are surprised to note that instead of countering all these arguments and submissions the DRP rejected the entire explanation with a single sentence that assessee did not file proper reply. However, the DRP failed to explain what is 'proper reply' and how it expects the 'proper reply'. Since no reasons were given in rejecting assessee's explanation, we are unable to understand what the DRP meant by stating that assessee did not file proper reply. As far as the factual position is concerned assessee has given detailed explanation for estimating the future losses which in fact it had suffered and the final loss was already determined by the A.O. in the next assessment year, the order of which does not contain any disallowance. There is evidence on record that assessee has suffered loss and loss claimed in that year on completion of the project stood allowed. No adjustments have been made to the loss claimed in later year. In view of this we are of the opinion that as far as quantification of loss is concerned assessee has made a justifiable claim in arriving at the future loss for this year.

25. Now with reference to the guidelines of AS-7, paragraph 35 and 36 are very clear in its guidelines: -

"35. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

36. The amount of such a loss is determined irrespective of:

(a) whether or not work has commenced on the contract;

(b) the stage of completion of contract activity; or

(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 8."

26. The assessee following the above guidelines provided for the estimated loss in books of account. This issue about the claim of future loss on the basis of AS-7 was also examined by various Coordinate Benches of ITAT and claim of future losses on the basis of AS-7 was considered as allowable deduction while computing profit of the year.

27. In the case of Jacobs Engineering Private Ltd. vs. ACIT 2009 TIOL 533 the Mumbai Tribunal has held that the provision for foreseeable losses under AS-7 is an allowable expenditure. In the facts of this case, the assessee who also prepared financial statements as per the provisions of AS -7 had claimed provision for foreseeable losses for A.Y. 2002-03 and A.Y. 2003-04 of ₹18,73,568/- and ₹5,83,038/- respectively. After analyzing the legal and factual position on the subject, the Tribunal allowed the claim of the appellant holding that such a provision is an allowable expense. The relevant extract of the decision is extracted below: -

"Having regard to the above legal and factual discussions, and following the decision of the ITAT in the case of Mazagaon Dock Ltd. (supra) and Metal Box Co. of India Ltd. (supra) and decision of the Hon'ble Delhi High Court in the case of CIT vs. Woodward Governor India Pvt. Ltd. (2007) 294 ITR 451 (Del), ***the contention of the assessee regarding allowability of foreseeable loss is accepted in principle."***

The decision of Mumbai Tribunal in the case of Mazagaon Dock Ltd. vs. JCIT 29 SOT 356 was also in favour of allowing future losses. In this case, assessee, as per method of accounting in case of contracts where loss was anticipated reckoned the entire loss, based on estimated realizable values and estimated cost of contracts in the first year itself. The A.O. disallowed

assessee's claim observing that this being only a provision made on estimated basis, cannot be allowed. The Tribunal held as below: -

> *"He seems to have swayed more by revenue loss than by the correct principle to be applied. The matching principle of accounting is not of much significance in the present context because if the loss has been property estimated in the year in which the contract has been entered into then it has to be allowed in that very year and cannot be spread over the period of contract. The matching principle is of relevance where income and expenditure, both are to be considered together. However, in the present case, the effect of valuation of WIP will automatically affect the profits of subsequent years accordingly. We, accordingly, do not find any reason for not accepting in principle assessee's claim as being allowable."*

Assessee also placed reliance on the decision of Thermax Babcock & Wilcox Ltd. 79 ITD 63 (Pune) wherein the ITAT had upheld the percentage completion method of Accounting followed by assessee as prescribed by AS-7. The Tribunal held that where assessee is following constantly the same method adopted in the first year of operation, also in subsequent years and where the method is one of the accepted accounting principles and practices sanctified by usage and is also in line with recommended standard AS-7 prescribed by ICAI, then the said method did not violate the provisions of charging section and addition on account of provisioning is not justified.

28. Assessing Officer relied in the following case laws which are not relevant for the issue under consideration and is completely out of context: -

i. In CIT vs. Nainital Bank Ltd. 62 ITR 638 (SC), one of the patrons of the assessee had pledged certain jewellery with the bank against which loan was taken by them. Certain dacoits stole the jewellery of the patron on July 11, 1951. In regard to the loss of the jewellery, the bank settled the claim of the patron and the difference was paid by the bank to the patron. In view of these facts, the issue was raised before the Hon'ble Supreme Court whether the amount paid by the bank to the patron was allowable business expenditure. The Apex Court held that the amounts paid by the bank were expenditure laid out for the purpose of business and hence the same was an allowable expense.

ii. In Madras Industrial Investment Corporation Ltd. vs. CIT 225 ITR 802 (SC), the Hon'ble Supreme Court was concerned with allowability of discount on debentures. The Apex Court held that proportionate discount on debentures was allowable as expenditure on pro-rata basis over different accounting period.

iii. In M.P. Financial Corporation vs. CIT 165 ITR 765 (MP), the court was concerned with the same issue raised before the Apex Court in the case of madras Industrial Investment Corporation Ltd., i.e. allowability of discount on debentures. The Court held that while the entire amount of discount was not allowable deduction, the discount had to be spared out proportionately over the number of years for which the bonds were issued and the proportionate amount of discount would be allowed expenditure.

iv. In Mysore Kirlosker Ltd. vs. CIT 166 ITR 836 (Kar), the issue which was raised before the Court was whether donation given by the assessee can be claimed under section 37(1). In this case, assessee company had promoted a trust which had constructed school to provide education for the children of the employees and ex-employees of the assessee company. During the year, assessee company donated ₹62,000/- to meet the expenditure of the school. Assessee claimed deduction of this expense under section 37(1) of the Act. The Court observed that sections 37(1) and 80G are not mutually exclusive. In other words, the Court observed donation if laid out wholly and exclusively for the purpose of business should be allowed under section 37(1) of the Act. Accordingly, the Court in the present case allowed deduction of ₹62,000/- to assessee.

29. Keeping the principle laid down on this issue in various coordinate bench decisions, we are of the opinion that assessee's claim for provision for loss, which was made in accordance with the guidelines of AS-7 and duly debited in the audited accounts of the company is an allowable expenditure. Therefore, DRP was not correct in rejecting the same without assigning any reason. The AO is directed to allow the claim of future loss in this year. Since assessee's claim was rejected by the AO in the order and adjusted in the next assessment year, A.O. is free to pass necessary modification order, if necessary in A.Y. 2007-08 withdrawing the claim to that extent being allowed in this year. Ground No. 5 is accordingly allowed.

30. Ground No. 6 is with reference to quantifying additional depreciation on fixed assets arising on account of directions issued by the DRP to capitalize the amount of foreign exchange fluctuation to the cost of the assets.

31. It was the contention that eventhough the DRP directed to capitalise the amount of foreign exchange loss to certain extent and assessee has furnished details, the corresponding depreciation was not allowed on the cost of the assets to the extent of capitalization in the order finally passed.

The A.O. is directed to examine this and allow depreciation as per law on the amount capitalized to assets and rework out depreciation accordingly. With this direction, the ground is considered allowed.

32. In the result, assessee's appeal is allowed.

Order pronounced in the open court on 16th September 2011.

Sd/-	Sd/-
(D.K. Agarwal)	**(B. Ramakotaiah)**
Judicial Member	**Accountant Member**

Mumbai, Dated: 16th September 2011

Copy to:

1. *The Appellant*
2. *The Respondent*
3. *DIT, Mumbai, Mumbai*
4. *The DR, "D" Bench, ITAT, Mumbai*

By Order

//True Copy//

Assistant Registrar
ITAT, Mumbai Benches, Mumbai

n.p.