Income Tax Appellate Tribunal - Hyderabad
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Swaranandhra Ijmii Intergrated ... vs Assessee on 31 December, 2012
IN THE INCOME TAX APPELLATE TRIBUNAL

HYDERABAD BENCH 'A', HYDERABAD

BEFORE SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER and SHRI SAKTIJIT DEY, JUDICIAL MEMBER

ITA No. 2072/Hyd/2011

Assessment year 2007-08

M/s. Swarnandhra IJMII Vs. The Deputy CIT Integrated Township Circle-3(3) Development Company Pvt. Ltd. Hyderabad Hyderabad

PAN: AAHCS3641P

Assessee Respondent

Assessee by: Dr. M.V.R. Prasad

Respondent by: Sri K. Harilal Naik/M. Ravinder Sai

Date of hearing: 17.10.2012/20.12.2012

Date of pronouncement: 31.12.2012

ORDER

PER CHANDRA POOJARI, AM:

This appeal by the assessee is directed against the order of the Dispute Resolution Panel (DRP), Hyderabad dated 23.9.2011 for assessment year 2007-08.

2. The assessee company M/s. Swarnandhra IJMII Integrated Township Development Company Pvt. Ltd. was established to carry out the development of integrated township in the land admeasuring 34.71 acres situated at Sy. No. 1009/1, Kukatpally village, Rangareddy dist., by virtue of the development and shareholders agreements dated 4.11.2003 entered between Andhra Pradesh Housing Board and IJMII. Thus, the Assessee is engaged in the business of development of integrated township and sale of flats. The return of income was filed on 30-10-2007 declaring a total income of Rs. 15,95,32,740 and subsequently filed a revised return of income on 22.08.2010 declaring the total taxable income at NIL after set off of carried forward losses. The case was subjected to scrutiny by the Assessing Officer, In course of assessment proceeding, the assessee-company produced its books of account and various other details as required by the Transfer Pricing 2 ITA No. 2072/Hyd/2011

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Officer and Assessing Officer from time to time. The Transfer pricing officer has passed the order u/s. 92CA(iii) of the Income tax Act, 1961 on 30th April, 2010 determining the adjustments to Arms Length price at Rs. 38,34,39,496. Subsequently, the assessment was finally completed on 30.12.2010 determining the total income at Rs. 101,45,42,242. The order was served on 04.01.2011.

3. Brief facts relating to the disallowance are as follows: As per clause 4.1.6 of the shareholders agreement, the company has paid land compensation to the land owners i.e,, Andhra Pradesh Housing Board (APHB) an amount of Rs. 2,200 per sq. yard for the land transferred by APHB to the company. The land compensation of Rs. 2,200 per sq. yard Is termed as guaranteed compensation in the said agreement. Further, the land compensation is considered at Rs. 1,400 as a land cost and Rs. 800 as anticipated profits from the business of township development to the tune of Rs. 13,43,97,120. The assessing officer has disallowed an amount of Rs. 13,43,96,800 being part of the land compensation as distribution of profits to APHB.

3.1 As per clause 14.1.6 of section 4 of the Shareholders agreement, the company has paid incentive to IJMII an amount of Rs. 18,59,85,000. The development of township is the effort of IJMII. Considering the participation of IJMII and its involvement as construction contractor, an incentive was proposed to IJMII in the shareholders agreement. Accordingly, as per the terms and conditions of the contractual agreement between the shareholders the company has paid the incentive to the IJMII.

3.2 The assessing officer interpreted the shareholders agreement by treating the company is not a party to the agreement. The assessing officer has disallowed an amount of Rs. 18,59,85,000 incentive paid to IJMII for its role as construction contractor and not otherwise.

3.3 During the financial year, the assessee company has paid interest u/s 234B and 234C an amount of Rs. 55,77,852/-. While filing the return of 3 ITA No. 2072/Hyd/2011

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income, the assessee has disallowed the interest paid u/s 234B and 234C under the head Interest on delayed statutory payments. However, without considering the assessee voluntary disallowance, the assessing officer has disallowed the said amount of Rs. 55,77,852 again.

3.4 The Assessee sold the flats to the purchasers. As per the terms of agreement, the assessee has to complete the construction within 12 months from the date of agreement or any other specified period. However, considering the inordinate delay in completing the construction, the Assessee has paid delay in handing over charges of Rs. 7,74,36,597 to the purchasers. The said payment of Rs. 7,74,36,597 was treated by the assessing officer as interest and disallowed the said amount u/s. 40(a)(ia) of the I.T. Act, 1961 under the guise of non-deduction of TDS. The assessing officer has disallowed an amount of Rs. 7,74,36,597 delay in handing over charges paid to the purchasers.

3.5 As per Clause 4.16 of Section 4 of the shareholders agreement, the Assessee has paid the land compensation to the land owners. As per the terms and conditions of the shareholders agreement, the Assessee Company constructed 500 LlG houses and handed over to the land owner as per the agreed price. Since, the 500 LIG houses were sold to the land owner, the land pertaining to the said houses need not be transferred to the Assessee and again re transfer the same to the land owner. The assessing officer has disallowed the land cost attributable to the 500 LIG houses an amount of Rs. 1,92,19,200.

3.6 As per clause 4.1.6 of Section 4 of the development and shareholders agreement, the assessee has handed over 500 LIG houses consisting of 450 sq. ft. each at a total consideration of Rs. 9 Crores. The said transaction is done by the Assessee absolutely as per the contractual agreement. The assessing officer has disallowed the cost of construction in excess of Rs .9 Crores at an amount of Rs. 18,06,75,000.

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3.7 The Assessee company awarded development of township work to IJMII. On such development work, some of the work bills submitted by the IJMII were paid belatedly. On such belated payments, the assessee has paid interest to the IJMII as per the minutes of the meeting drawn between the parties. The assessing officer disallowed an amount of Rs. 2,21,95,301.

3.8 The assessing officer had added a sum of Rs 38,34,39,486 based on the order of the TPO as per details given below:

i) The TPO has also treated a sum of Rs 34,86,00,000 paid by the assessee company to IJMII as deemed international transaction. It was explained to the TPO that there should be at least one non resident company for a transaction to be treated as a deemed international transaction. However the same was not considered and a sum of Rs 34,86,00,000 was treated as a deemed international transaction between two resident companies. The payment made to IJMII was reported in Form 3 CD u/s 40(A)(2)(b).

ii) The assessee made a payment of Rs 2,32,72,451 as technical services fees to its AE. Despite giving the technical services agreement and other details as to benefits received from the AE and the payments made at Arms Length Price was treated as NIL and the AO has made an addition of Rs 2,32,72,451/- based on the TPO order.

iii) The assessee has also made a payment of Rs 1,15,67,035 as reimbursement of bank guarantee charges to its AE .The AE was sanctioned a loan on an overall basis from Standard Chartered Bank Malaysia both fund and non fund based. The share of the assessee of Rs 1,15,67,035 was reimbursed to its AE. The TPO treated the arms length price of Reimbursement towards bank guarantee charges at Rs nil. The Assessing Officer made an addition of Rs 1,15,67,035/- to the total income of the assessee based on the TPO order.

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Thus the details of additions are as under:

S. No. Item Amount (Rs.) i) Disallowance of cost of land transferred to APHB 13,43,96,800 ii) Disallowance of incentive paid 18,59,85,000 iii) Disallowance of interest payment 55,77,852 iv) Disallowance of delay in handing over charges 7,74,36,597 v) Disallowance of land cost relating to land sold by 1,92,19,200 APHB on 500 LIG houses

vi) Disallowance of cost of construction of the houses 18,06,75,00 handed over to APHB

vii) Disallowance of interest paid to IJM (India) Ltd. 2,21,95,301 viii) Addition u/s. 92CA(4) 38,34,39,486

Thus, the total income of the assessee was determined at Rs. 101,45,42,242. However, the DRP granted relief towards interest payment at Rs. 55,77,852 and the total income determined at Rs. 100,89,64,390 after DRP order.

3.9 The assessee went in appeal before the Dispute Resolution Panel (DRP). Regarding disallowance of land transferred by APHB at Rs. 13,43,97,120, the DRP observed that it is made out of profit, taxes are to be paid u/s. 155-O of the Act and confirmed the disallowance. Regarding disallowance of incentive paid at Rs. 18,59,85,000, it was observed that it is unreasonable and confirmed the disallowance. Regarding disallowance of interest at Rs. 55,77,852 the DRP observed that the assessee had already disallowed the same in its computation of income and the Assessing Officer made further addition which resulted in double addition. Accordingly, the DRP directed the Assessing Officer to delete the same. Regarding the disallowance of delay in handing over charges at Rs. 7,74,36,597, since no proof is adduced, the disallowance is confirmed. Regarding disallowance o cost of land relating to land sold by the APHB on 500 LIG houses at Rs. 1,92,19,200 and with regard to disallowance of cost of construction of houses handed over to APHB at Rs. 18,06,75,000, it was observed by the DRP that it is a diversion of profit and confirmed the disallowance. With regard to disallowance of interest paid to IJMII at Rs. 2,21,95,301 it is observed that preferential treatment has been given to the contractor cum shareholder and no interest is charged. Accordingly, it was disallowed. 6 ITA No. 2072/Hyd/2011

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Against these findings of the DRP the assessee is in appeal before us with the following grounds of appeal:

1.1 The order passed by the learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad under section 143(3) read with section 144C(13) to the extent it is prejudicial to the assessee is bad in law and liable to be quashed.

2.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making addition of Rs. 13,43,96,800 in respect of cost of land transferred by APHB to the assessee.

2.2 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in treating a portion of the payment made to APHB as payment towards profits.

2.3 On facts and in the circumstances of the case and law application, the addition made by the assessing officer amounting to Rs. 13,43,96,800 is incorrect, contrary to facts, underlying documents and therefore to be deleted in entirety.

3.1 The learned Deputy Commissioner of Income-tax, Circle 3(3), Hyderabad has erred in disallowing incentive paid to contractor amounting to Rs. 18,59,85,0001- on the ground that the said payment is not reasonable as per section 40A of the Act.

3.2 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making disallowance under section 40A without demonstrating the excess over the "market value".

3.3 The conclusions of the learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad in disallowing the impugned payment is incorrect, contrary to facts and law and is to be disregarded.

3.4 On facts and in the circumstances of the case and law applicable, the addition made by the assessing officer amounting to Rs. 18,59,85,000 is to be deleted in entirety.

4.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in disallowing payment in the nature of "handing over charges" amounting to Rs. 7 ITA No. 2072/Hyd/2011

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7,74,36,597. On facts and in the circumstances of the case and law applicable, no addition is to be made in respect of the above payment. The addition made is to be deleted in entirety.

5. I The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making addition of Rs. 1,92,19,200 in respect of cost of land attributable to houses handed over to APHB. On facts and in the

circumstances of the case and law applicable, the addition made by the assessing officer in respect of the above payment is to be deleted in entirety.

6.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making addition of Rs. 18,06,75,000 in respect of cost of construction of houses handed over to APHB. On facts and in the

circumstances of the case and law applicable, the addition made by the assessing officer in respect of the above payment is to be deleted in entirety.

7.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in disallowing interest paid to M/s. IJMII India Ltd amounting to Rs. 2,21,95,301 in computing the business income. On facts and in the circumstances of the case and law applicable, the disallowance of interest paid is bad in law. The addition made on this count is to be deleted in entirety.

8.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making addition in respect of transfer pricing adjustment made by the TPO

amounting to Rs. 38,34,39,486/- On facts and in the circumstances of the case and law applicable, the addition on account of transfer pricing adjustment is to be deleted in entirety.

8.2 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in making a reference to Transfer Pricing Officer for determining arm's length price without demonstrating as to why it was necessary and expedient to do so.

8.3 The learned Transfer pricing officer has erred in making adjustments under Chapter X in respect of transactions which were not 'international transactions' as defined in section 92B of the Act.

8.4 The learned Transfer pricing officer has erred in not 8 ITA No. 2072/Hyd/2011

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appreciating that the provisions of Chapter X do not apply in respect of transactions with 'resident' entities.

8.5 The learned Assessing Officer, learned Transfer Pricing Officer and Honourable Dispute Resolution Panel have erred in

(a) passing the order without demonstrating that assessee had motive of tax evasion.

(b) Ignoring the fact that the members of Dispute Resolution Panel also being jurisdictional

Commissioner/Directors of Income Tax of the

assessee, the constitution of the Dispute Resolution Panel is bad in law.

(c) not appreciating that the charging or computation provision relating to income under the head "Profits & Gains of Business or Profession" do not refer to or include the amounts computed under Chapter X and therefore addition made under Chapter X is bad in law.

8.6 The Hon'ble DRP has erred in confirming the additions made by the TPO despite not agreeing to the conclusions of the learned TPO on many issues.

8.7 The Hon'ble DRP has erred in confirming the additions (i) only with a view to keep the matter alive and (ii) for the reason that the department does not have recourse to any remedy against the directions in favour of the assessee.

8.8 The learned assessing officer, TPO and the DRP has erred in making additions in respect of individual international transactions despite making adjustment at enterprise level profit margin using TNMM.

8.9 The findings and the conclusions of the learned Transfer pricing officer, DRP and the assessing officer are incorrect, bad in law and liable to be quashed.

8.10 On facts and in the circumstances of the case and law applicable, the addition on account -of transfer pricing adjustment amounting to Rs. 38,34,39,486/- is to be deleted in entirety.

9.1 The learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad has erred in levying interest under section 234B and 2340 of the Act. On facts and in the circumstances of the case and law applicable, interest is 9 ITA No. 2072/Hyd/2011

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not leviable under section 234B and 234D. The

assessee denies its liability to pay interest under section 234B and 234D.

10.1 In view of the above and other grounds to be adduced at the time of hearing, the assessee prays that the order passed by the learned Deputy Commissioner of Income tax, Circle 3(3), Hyderabad to the extent prejudicial to the assessee be quashed

Or in the alternative, the above grounds are summarised as below:

(i) addition of Rs. 13,43,96,8001- be deleted; (ii) addition of Rs. 18,59,85,000/- be deleted; (iii) addition of Rs. 7,74,36,5971Â· be deleted; (iv) addition of Rs. 1,92,19,200/- be deleted; (v) addition of Rs. 18,06,75,0001- be deleted; (vi) addition of Rs. 2,21,95,301/- be deleted; (vii) addition on account of transfer pricing adjustment amounting to Rs. 38,34,39,486/- be

deleted;

(viii) interest levied under section 234B and 2340 be deleted.

3.10 The assessee also filed additional ground as follows:

1. Assuming without admitting that the various additions made to income returned are correct, the learned Assessing Officer has erred in not setting off brought forward business loss totally amounting to Rs. 2,36,46,319 in computing the taxable income for the year under consideration.

2. Assuming without admitting that the various additions made to income returned are correct, the learned Assessing Officer has erred in not setting off unabsorbed depreciation totally amounting to Rs. 28,05,937 in computing the taxable income for the year under

consideration.

3.11 The assessee filed a petition for admitting the additional ground. We are admitting the additional ground after satisfying that the reasons advanced by the assessee counsel are bona-fide and the assessee is having reasonable cause for not raising the above grounds on earlier occasion. 10 ITA No. 2072/Hyd/2011

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4. With regard to addition in respect of cost of land transferred to Andhra Pradesh Housing Board (APHB) at Rs. 13,43,96,800 (Ground Nos. 2.1 to 2.3), the AR submitted as follows:

4.1 There was an acute shortage of quality residential accommodation in the state of Andhra Pradesh. In order to alleviate this problem, the Govt. of Andhra Pradesh through its arm - Andhra Pradesh Housing Board constituted under the Andhra Pradesh Housing Board Act, 1956 (Board for short hereafter) decided to undertake housing projects in a large scale. The Board had limited financial resources, technical expertise and wherewithal to undertake the housing projects on such a large scale. The Govt. of AP therefore decided that the Board should undertake the housing projects with participation from the private sector.

4.2 The Board invited expression of interest from private sector companies with established track record in handling giant housing projects. In the competitive bidding process, M/s IJM (India) Infrastructure Limited (IJMII for short hereafter) emerged as the competent and eligible private sector participant to develop the proposed integrated township project in Kukatpally, Hyderabad, in joint participation with the Board.

4.3 A Memorandum of Understanding (MoU) was entered into between the Board and IJMII on 15.5.2002 in the presence of the then Hon'ble Chief Minister of Andhra Pradesh. The MoU was entered into with a view to develop an integrated township project over an area of about 34.71 acres of land in Kukatpally, Hyderabad. The MoU inter alia provided for many aspects of development of the township project as well as relationship between the Board, IJMII and all other concerned matters governing the management and affairs of the Company. The Board and IJMII decided to promote a Joint Sector Company to undertake the integrated township project.

4.4 It was agreed in the MoU that the Joint sector Company i.e., the assessee shall be responsible for the construction and implementation of the housing projects as contemplated by the Board and it shall be bound by the 11 ITA No. 2072/Hyd/2011

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policy framework of the Govt. of Andhra Pradesh. The assessee was to be bound by the guidelines of the Govt. of AP and the Board from time to time and shall undertake the housing projects on terms accepted and finalised by the Govt. of AP and the Board.

4.5 The assessee i.e., M/s Swarnandhra IJMII Integrated Township Development (P) Limited was incorporated on 25.3.2003 as a SPV to undertake the development of an integrated township project. The Board and IJMII are the shareholders of the assessee in the ratio of 49:51. The first meeting of the Board of directors of the assessee was held on 26.3.2003. The Board of directors discussed, passed resolutions and the recorded the minutes on the following aspects in the said meeting. (i) Chairman to conduct the proceedings of the meeting;

(ii) Appointment of first directors, additional director and chairman of the Company, and managing director;

(iii) Circumstances leading to the formation of the Company and matters concerning the share capital and shareholding pattern;

(iv) Approval of Foreign Investment Promotion Board (FIPB) for development of integrated township project;

(v) Appointment of IJMII as the main contractor and project manager for the development of integrated township project, entering into sales and marketing agreement with IJMII;

(vi) Entering into technical collaboration agreement with M/s IJM Properties Sdn. Bhd, Malaysia

(vii) Appointment of M/s CESMA International, Singapore as the Architects of the project;

(viii) Power of attorney from the Board in favour of the assessee;

(ix) Commencement of site clearing and earth works;

(x) Registered office of the Company, financial year, appointment of first auditors, common seal, printing and signing of share certificates and share transfer endorsements and opening of bank account.

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4.6 'Development & Shareholders Agreement' dated 4.11.2003 was entered into between the shareholders of the assessee Company viz., Board and IJMII. The said agreement was entered into to set forth or agree upon the respective rights and obligations for the proposed development of townships and housing project and to provide for the governance, management and operation of the assessee Company. A power of attorney was given by the Board to the assessee on the same day i.e., 4.11.2003 for the purpose of undertaking the developmental work on the land provided by the Board.

4.7 The Board made available the land owned by it to the assessee for the purpose of development of integrated township. In consideration of the land provided by the Board for the purpose of development of integrated township, it was entitled to an overall compensation at the rate of Rs. 2,200/- per square yard. The said amount comprised of Rs. 1,400/- as the land cost and Rs. 800/- as the anticipated profits of the Board from the business of the integrated township development. The sum of Rs. 2,200/- per square yard was understood and referred to as 'guaranteed compensation' payable to the Board by the assessee. It was agreed that the assessee shall pay the guaranteed profits at the rate of Rs. 800/- per square yard whether or not the assessee realises profits from the development of integrated township. The relevant terms of the Development & Shareholders Agreement in this connection are as under.

"4.1.6 For the land mentioned un sub-clause 4.1.3 above, APHB shall be entitled to an overall compensation at the rate of Rs. 2,200/- (Rupees Two Thousand two hundred only) pgr square yard, which comprises of Rs. 1,400/- (Rupees One Thousand four hundred Only) as the land cost and Rs. 800/- (Rupees Eight hundred only) as anticipated profits being the share of APHB from the business of the integrated township development. The said compensation amount shall be realisable by APHB as detailed below:

(a) Share Capital: 49,000,000/-

(b) 500 Low-income-group apartment units with the size of 450 Sft. Each @ Rs. 400/- per sft. : 90,000,000/-

(c) Payments made through bank: Rs. 223,619,447/- 13 ITA No. 2072/Hyd/2011

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The aforesaid guaranteed compensation of Rs. 2,200/- per square yard is inclusive of the land cost and APHB's share of anticipated profits in the development of integrated township. The Joint sector company shall pay the guaranteed profits at the rate of Rs. 800/- per square yard amounting to Rs. 13,43,97,120/- (Rupees Thirteen Crores Forty Three Lakhs Ninety Seven Thousand One Hundred Twenty Only), to APHB whether or not the Joint Sector Company realises profits from the integrated township. If the Joint Sector Company makes profits amounting to more than 15% of the Total Development Cost, APHB and IJMII shall be entitled to share such additional profits in the ratio of 49:51. For avoidance of doubts it is made clear that IJMII shall alone be entitled to receive all the profits generated by the Joint Sector Company up to 15% of the total development cost"

4.8 The Board of directors in their meeting on 2.2.2004 discussed and recorded minutes regarding the shareholders and development agreement dated 4.11.2003 and other matters.

4.9 The Assessing Officer and the DRP have disallowed the payment of Rs. 800/- per square yard totally amounting to Rs. 13,43,96,800/- for the reason that the said payments are in the nature of distribution of profits.

4.10 With regard to the question as to whether a payment is an expenditure allowable in computing the profits of the business or whether it is a distribution of profit depends on the real nature of disbursement and on a true construction of the contract between the parties. The nomenclature given by the parties cannot be considered as conclusive in determining the true consequences of an agreement entered into. [Travancore Minerals Co. Ltd v CIT [1955] 28 ITR 505 (Travancore & Cochin High Court)] A distribution of profit can happen only when profits are ascertained after providing for all outlays incurred in earning such profit and then the same is divided. [Union Cold Storage Co. Ltd. v. Adamson (1931) 16 T.e. 293]

4.11 He relied on the judgement in the case of Lord Maugham in Indian Radio & Cable Communications Co., Ltd. v. CIT [1937] 5 ITR 270 held: "It is not universally true to say that a payment the making of which is conditional on profits being earned cannot properly be 14 ITA No. 2072/Hyd/2011

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described as an expenditure incurred for the purpose of earning such profits. The typical exception is that of a payment to a director or a manager of a commission on the profits of a company. It may, however, be worth pointing out that an apparent difficulty here is really caused by using the word "profits" in more than one sense. If a company having made an apparent net profit of E. 10,000 has then to pay E. 1,000 to directors or managers as the contractual recompense for their service during the year, it is plain that the real net profit is only Â£9,000. "

4.12 The learned AR submitted that in the case of Travancore Minerals Co. Ltd v CIT [1955] 28 ITR 505 (Travancore & Cochin High Court), where royalty was payable to the lessor at a percentage of net profit of the lessee, it was held that the reference to the percentage of net profits is merely meant as a mode of calculation to arrive at the amount payable in order that the interests of both the parties may be subserved. It was held that the net profits of the company should be calculated by applying the principles of business. Accordingly the payment of royalty held allowable in computing taxable profits.

4.13 He relied on the judgement in the case of CIT v Parikh (C) & Co (India) Ltd [1966) 29 ITR 661 (SC), where the managing agents' commission was payable as a percentage of net profits, it was held that commission so paid was eligible for deduction in computing the profits chargeable to tax. The fact that the commission payable had to be computed as a percentage of net profits was held not relevant in determining whether the same is eligible for deduction. [Nizam Sugar Factory v C Ag. IT [1964) 52 ITR 939 (AP))

4.14 According to the AR, the Income-tax is a tax on the real income, i.e., the profits arrived at on commercial principles subject to the provisions of the Income-tax Act. The real profit can be ascertained only by making the permissible deductions. There is a clear-cut distinction between deductions made for ascertaining the profits and distributions made out of profits. In a given case whether the outgoings fall in one or the other is a question of fact to be found on the relevant circumstances, having regard to business principles. This was the view of the Supreme Court in Poona Electric Supply 15 ITA No. 2072/Hyd/2011

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Co. Ltd v CIT [1965) 57 ITR 521. In the above decision, the assessee Company was liable to adjust its rates for sale of electricity periodically so that its profits did not exceed the amount of 'reasonable return'. In case if it was found that the assessee company had earned profits higher than the reasonable return, it was liable to refund a part of its profits to consumers. On a question as to whether the amount refunded to consumers are eligible for deduction in computing the taxable profits, the Supreme Court held: "(i) that the amounts credited by the assessee during the accounting years to the "Consumers' Benefit Reserve Account", being a part of the excess amount paid to it and reserved to be returned to the consumers, did not form part of the assessee's real profits; and to arrive at the taxable income of the assessee from the business under section 10(1) of the Indian Income-tax Act, 1922, the amounts had to be deducted.

(ii) That, as the assessee had adopted the mercantile system of accounting, the amounts so reserved for future payments were deductible in computing the income, profits and gains from the assessee's business for the relevant years, since the liability had accrued in those years.

(iii) Under section 10(1) of the Indian Income-tax Act, 1922, profits and gains of a business carried on by any assessee are not profits regulated by a statute, but profits in a business computed on commercial principles. They are business profits and not statutory profits. They are real profits and not notional profits. The real profits of a businessman under section 10(1) cannot obviously include the amounts returned by him by way of rebate under statutory compulsion. It is as if he received only the original amount minus the amount to be returned. In substance there cannot be any difference between a businessman collecting from his constituents a sum of Rs. Y In addition to Rs. X by mistake and returning Rs. Y to them and another businessman collecting Rs. X alone. The amount returned is not a part of the profits at all."

4.15 It was submitted that in the case of CIT v Travancore Sugars and Chemicals Ltd [1973] 88 ITR 1 (SC), the promoters of the respondent Company viz., the Govt. of Travancore and Sir William Wright on behalf of Parry & Co. Ltd., entered into an agreement wherein the business of three concerns were agreed to be sold by the Government of Travancore to the respondent Company which was to be floated for that purpose. Under the said agreement, in addition to the consideration for the transfer of business, 16 ITA No. 2072/Hyd/2011

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the Govt. of Travancore was entitled to a certain sum calculated at a percentage of net profits of the respondent Company. On a question as to whether the sums paid to Govt. of Travancore under the agreement constitutes diversion of income by overriding title or whether the same is allowable as deduction in computing the income, the Kerala High Court ruled in favour of the respondent Company on both the questions. The Supreme Court affirmed the above decision and held as under:

"On a construction of the terms of the contract in this case and the obligations arising therefrom we cannot say that the conclusions of the Kerala High Court are unsustainable. The assessee had no choice at the time of inception, as a condition of its coming into existence to agree to the several terms stipulated by the Government for transferring the profit-earning assets. No doubt, as the learned advocate for the revenue said, the company paid the Government in full for the value of the assets and the company had, therefore, no

obligation to the Government on that account. This may be true to some extent but then there are the other obligations which are interlinked with the transfer of assets notwithstanding the fact that the company paid a price fixed for the transfer of the assets which may not in all cases, as in this case it is not, be the true value of the assets which are the subject-matter of the transaction. The Government has established businesses and they were willing to part with them at a certain price plus certain stipulations to which we have referred which form the conditions of transfer. It may be mentioned that under the contract the company had to engage only the Travancore labour and staff that it had to take apprentices recommended by the Government and train them and that there was no limitation as to the period the company had to pay 20% or as the later agreement revised it to 10% of the net profits, notionally computed for that purpose after deduction of certain items mentioned in clause 7. All this appears to us to be a stipulation for payment of an amount for a concession granted to it and is therefore deductible at its inception. Viewing it from any point of view, whether as a revenue expenditure or as an overriding charge of the profit-making apparatus, or as laid out and expended wholly and exclusively for purposes of trade, the answer must be in the affirmative and against the revenue. The appeal is accordingly dismissed with costs"

4.16 He relied on the judgement in the case of CBDT v Oberoi Hotels (India) Pvt. Ltd [1998] 2311TR 148 (SC) it was held: 17 ITA No. 2072/Hyd/2011

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"We do not think that this is a correct statement as the royalty, commission or fees can be in terms of percentage of profits earned by the foreign enterprise on account of services rendered by the Indian company. It is the substance of the case which matters and not the name."

4.17 He relied on the judgement in the case of CIT v Mehsana District Co- operative Milk Producers Union Ltd [2006] 282 ITR 24 (Guj), the respondent paid additional price to member societies supplying milk on last day of the previous year pursuant to resolution of its board of directors. The assessing officer and the first appellate authority disallowed the said payment for the reason that the same amounted to distribution of profit and a case of profit adjustment with the object of evading tax. The Tribunal in its third member decision held that the payment was an additional purchase price and if it is regarded as adjustment of profit at a pre-determined level, the nature of the payment would not change and cannot be termed as distribution of profits. The High Court on appeal held that the amount in question had gone out of the coffers of the assessee and had been received by the member societies. He placed reliance on the judgement of the Supreme Court in CIT v. Ashokbhai Chimanbhai [1965] (56 ITR 42) where it was held that profits of a business do not accrue day to day or month to month and the same accrue at the year end on comparison of Assets at two stated points, the Gujarat High Court held that payment to member societies were not made after drawing the accounts and after determining the profits and hence, the question of distribution of profits does not arise. It was also held that the said payments were eligible for deduction in the process of computing the real profits and gains under section 28 and alternatively as a deduction under section 37. The allegation of tax evasion was jettisoned taking note of the fact that (i) the assessee-society was working under superintendence of various Government organizations; (ii) there were nominee-directors of the State Government and financial institutions on the board of directors; (iii) the Department has not been able to discharge the onus which was on it; (iv) there was complete lack of evidence pointing to any "personal gain" qua the assessee which is a co-operative society.

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4.18 He placed reliance on the judgement of Bombay High Court in the case of Manjara Shetkari Sahakari Sakhar Karkhana Ltd [2008] (301 ITR 191) (Bom) wherein held that where a payment was made to cane growers as per the rate fixed by the State Government which was binding on the assessee and which was based on the price recommended by the assessee after the finalisation of accounts. The said payments cannot be regarded as appropriation or distribution of profits.

4.19 He summarised the principles underlying the above as under:

(a) The question as to whether a payment constitutes expenditure allowable in computing the taxable income or whether the same is a distribution of profit depends on the real nature of disbursement and on a true construction of the contract between the parties.

(b) The nomenclature given by the parties cannot be considered as conclusive in determining the true consequences of an agreement entered into.

(c) A payment which computed as a percentage of profits is deductible, if the circumstances warrant, in computing the profits and gains computed on the basis of commercial principles.

(d) Such payments are allowable in computing the real 'profits and gains' chargeable under section 28(i). Alternatively, the said payments are allowable under section 37 of the Act.

(e) Payment to be made compulsorily by virtue of statue or agreement, irrespective of existence of profits, cannot be regarded as 'distribution of profits'. The said payments are deductible in computing the profits taxable under the Act.

(f) A payment agreed to be made compulsorily at the inception from income which may accrue or arise subsequently, whether by virtue of statue or contract, results in diversion of income by overriding title. The income to the extent of payments agreed to be made compulsorily at the inception is not taxable by virtue of overriding title.

4.20 He submitted that in the present case, the assessee was incorporated by the Govt. of Andhra Pradesh through its arm - The Andhra Pradesh Housing Board (Board). The assessee was incorporated as a SPV with a view to 19 ITA No. 2072/Hyd/2011

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alleviate the acute shortage of housing in the state of Andhra Pradesh. As per the term of the MoU dated 15.5.2002 the assessee was responsible for the construction and implementation of the housing projects as contemplated by the Board and it was bound by the policy framework of the Govt. of Andhra Pradesh. The assessee was bound by the guidelines of the Govt. of AP and the Board from time to time. The assessee undertook the development of housing projects on terms accepted and finalised by the Govt. of AP and the Board.

4.21 He submitted that the Board provided the land required for development and the joint venture partnerÂ· M/s IJMII undertook to assist the assessee in development of housing projects, Vide agreement dated 4.11.2003, it was agreed that the Board and the joint venture partner should be compensated for their role in the housing project. This agreement was between the shareholders of the assessee. The terms of the agreement relating to payments proposed to be made to Board and IJMII was ratified by the Board and recorded in the minutes of Board of directors meeting held on 2,2.2004. The terms of the agreement dated 4.1.2003 was suitably incorporated in the Articles of Association of the assessee. In accordance with the terms of agreement dated 4.11.2003, the Board was to be paid Rs. 2,200/- per square yard for the land. This was to be discharged as Rs. 1,400/- towards the land cost and Rs. 800/- under the caption 'share of profit'. From assessee's perspective, the entire sum paid amounting to Rs. 2,200/- per square yard constituted cost of land. Under the agreement dated 4.11.2003, the payments to Board were to be made whether or not the assessee realised profits from the development of integrated township. The payments to Board were not conditional upon the profits realised by the assessee. The payments made to Board were not measured or computed with reference to profits realised by the assessee. The agreement also stated that the Board shall not be entitled to any share of profits generated by the assessee up to 15% of total development cost. The payments to Board were made before drawing the annual accounts and consequently before determination of profits chargeable to tax. Decisions explaining the difference 20 ITA No. 2072/Hyd/2011

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between a payment constituting distribution of profit and a payment allowable in computing the profits have been discussed above. Even in a case where payment was made as a percentage of a profit, the courts have held that the said payment, in substance, is allowable in computing the real profits and gains chargeable to tax under section 28.

4.22 According to the AR, the facts of the present case do not envisage payment to Board being dependent or conditional upon profits. The amount payable to Board is also not computed as a percentage of profit. The payments to Board therefore cannot be regarded as distribution of profits. The payment made to Board thus constituted expenditure allowable in computing the profits of the business under section 28. Alternatively and without prejudice, the said payments partake the character of expenditure wholly and exclusively incurred for the purpose of business and consequently allowable under section 37.

4.23 He relied on the judgement of Bombay High Court in the case of CIT v Crawford Bayley and Co. [1977]106 ITR 0884 (Bom), the aspect of diversion of income by overriding title was explained as under: "In respect of this matter the material question to be considered is, is there diversion of income by an overriding title or whether there is an application of income after it accrued to the assessee-firm. The true test in determining this question is laid down in Sitaldas Tirathdas"s case [1961} 41 ITR 367 (SC). The true test for the application of the rule of diversion of income by an overriding charge, is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the assessee. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one"s own income, which has been received and is since applied."

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4.24 The High Court in the above judgement further held that the fact that the recipients are not parties to the contract is not relevant. The relevant observations of the High Court are as under.

"Ordinarily, it is true that a person who is not a party to the contract cannot enforce it, but there are several well recognised exceptions to this rule. One of the well recognised exceptions is a cestui que trust. In a cestui que trust even though a person may not be a party to a contract he can enforce his right under contract by adopting appropriate legal proceedings. Such is the case so far as the rights of a widow of a deceased partner under these partnership deeds are concerned. Such payments have to be made by reason of an overriding title and there is no question of income being applied by the assessee-firm after it accrued to it."

4.25 According to the AR, in the present case, as explained earlier, the payments to Board were required to be made mandatorily whether or not the assessee made profits. Further, a part of such payments were realised by the Board directly by selling some of the residential units. The payments to Board therefore diverted by overriding title and hence cannot be regarded as income of the assessee. Accordingly, he prayed to delete the addition of Rs. 13,43,96,800.

5. Regarding disallowance of cost of land transferred to APHB to the assessee the learned DR submitted that a reading of clause No. 4.16 of the agreement of Development and Shareholders Agreement shows that APHB was assured of profit @ Rs. 800 per square yard. There is no necessity to mention separately this rate of Rs.800 per square yard and refer to it as 'anticipated profits'. The assessee has not registered this agreement. The land is never registered and transferred to the taxpayer by the APHB. Such evidence is not produced. When specifically questioned as to why registration is not done, the AR only replied that there is no necessity to register the agreement.

5.1 According to the DR, agreements can be mutually concluded which can be of self-serving nature. Such agreements can also be concluded to avoid tax. From subsequent paras of agreement wherein incentive is also 22 ITA No. 2072/Hyd/2011

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paid to the other shareholder, the matters would get further clarified. First the exact words used in the agreement are to be considered. These words clearly show that the 'anticipated profits' are being passed on. The details of rate per square yard as per Sub Registrar is not produced. Kukatpally Housing Board Colony is nearby and it is one. of the biggest townships in Asia, Hence, it is also for consideration as to why the company failed to register this developmental agreement to get it recognized or give it the authenticity. Moreover, the land was given in terms of acres because it was not yet developed. Hence, the rate per acre would be applicable and not rate per square yard.

5.2 The DR submitted that even in para (d) clause 4.1.6 of shareholders agreement, it is stated that Rs.13,43,97,120 i.e., land cost @ 800 per square yard, guaranteed profits shall .be progressively realized by the APHB from the taxpayer "from time to time as sales collections are received by the assessee taxpayer on account of sale of flats". This clearly shows that only the profit accumulated is paid and the profit on land was

arrived at. It should not be ignored that this agreement is subsequent to incorporation (i.e., after 8 months) and section 40A(2)(a) and (2)(b) provisions also apply. Besides this, the taxpayer knew fully well that if such payment is made from out of profits, taxes are to be paid u/s. 115-O and hence, this method is adopted. Hence, the contentions of the taxpayer on this issue should be rejected.

Findings relating to ground Nos. 2.1 to 2.3

6. We have heard both the parties and perused the material on record with regard to disallowance of Rs. 13,43,96,800 towards cost of land transferred to APHB. This was disallowed on the reason that this payment is made out of profits of the assessee and it is appropriation of profits paid to the APHB. The assessee was formed by an agreement dated 4.11.2003 entered between APHB and IJMII. The foundation of formation of the assessee is this agreement. Clause 4.1.6 of the said agreement stipulates as follows:

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4.1.6 For the Land mentioned in sub-clause 4.1.3 above, APHB shall be entitled to an overall compensation at the rate of Rs. 2, 200 (Rupees Two thousand two hundred only) per square yard, which comprises of Rs. l,400 (Rupees One Thousand four Hundred Only) as the Land cost and Rs. 800/- (Rupees Eight Hundred Only) as anticipated profits being the share of APH8 from the business of the Integrated Township development. The said compensation amount shall be realizable by APHB as detailed below:-

(a) Rs. 4,90,00,000 (Rupees Four Crores Ninety Lakhs only) shall be appropriated and converted by the Joint Sector company towards APHB's Percentage Equity interest @49%, as per Clause 2.3.1;

(b) Rs. 9,00,00,000 (Rupees Nine Crores Only) shall be directly realized by APHB by allotting/selling five hundred (500) low- Income-group apartment units of the size of 450 square feet each (inclusive of apportioned common areas), at Rs.400/- per sq. feet. Provided however, APHB shall cause the allottees of the said 500 apartment units, to pay directly to the Joint Sector Company, all other costs, charges and expenses including but not limited to stamp duty, registration, water, electricity sewerage deposit, maintenance charges and deposit, parking area etc.

(c) 15% of the balance Land cost amounting to Rs. 1,44,29,244 shall become due and payable by the Joint Sector Company to the APHB on the 90th day from the date of APHB making available to the Joint Sector Company, the vacant unencumbered Land mentioned in sub-clause 4.1.3; and

(d) the balance of the Land cost amounting to Rs. 5,17,65,716 and the guaranteed profits of Rs. 800 per sq. yd amounting to RS. 13,43,97,120 (Rupees Thirteen Crores Forty three lakhs Ninety seven thousand one hundred and twenty Only) totalling to Rs. 21,61,62,836 shall be progressively realized by the APHB from the Joint Sector company from time to time, from the sales collections received by the Joint Sector Company from the sale of apartment units (other than those referred to in sub-clause 4.1.4(b) above), during the proposed development period of the integrated Township, at a redemption rate of 15% or a mutually agreed fixed amount until full settlement.

(e) Notwithstanding anything contained in clause 2.3.2, but subject to the Applicable Laws and if the parties decide not to undertake new projects under the Joint Sector Company. 24 ITA No. 2072/Hyd/2011

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In consideration for provision of land for the Company's project and as a compensation to APHB, IJMII will have the right to acquire or APHB would have the right to enforce acquisition of the entire share capital held by APHB within 90 days from the completion of the project for a consideration of Rs. 4,90,00,000 (Rupees Four Crores Ninety lakhs only) which shall be reduced for any dividend paid by the company to APHB in Its capacity as shareholder or otherwise, APHB will be liable for any taxes, duties and cess applicable to the aforesaid transfer of shares.

The aforesaid guaranteed compensation of Rs. 2,200/- per square yard is inclusive of the land cost and APHB's share of anticipated profits in the development of integrated Township. The Joint Sector Company shall pay the guaranteed profits at the rate of Rs. 800/- per square yard amounting to Rs. 13,43,97,120 (Rupees Thirteen Crores Forty three lakhs Ninety seven thousand one hundred and twenty Only) to APHB whether or not the Joint Sector company realizes profits from the Integrated Township.

6.1 As per clause 4.1.6 of the shareholders agreement, the assessee has paid land compensation to the land owners i.e,, Andhra Pradesh Housing Board (APHB) an amount of Rs. 2,200 per sq. yard for the land transferred by APHB to the company. The land compensation of Rs. 2,200 per sq. yard Is termed as guaranteed compensation in the said agreement. Further, the land compensation is considered at Rs. 1,400 as a land cost and Rs. 800 as anticipated profits from the business of township development. However, as far as the company point of view, the total land compensation as guaranteed to the land owner is Rs. 2,200/- per sq. yard. The said compensation has to be paid by the company whether it realizes any profits or not. Considering the terms and conditions of the contractual agreement between the shareholders, the company has paid the compensation to the land owners. Without considering the merits of the contractual agreement, the assessing officer has disallowed an amount of Rs. 13,43,96,800 being part of the land compensation as distribution of profits to APHB. The assessing officer has not mentioned the section and provision under which the distribution of profits is treated as income.

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6.2 This is a contractual payment and the assessee is having no control over this and if the assessee failed to abide by the agreement entered by the APHB and IJMII it would lead to total break-down of the contract. The true test for allowability of this expenditure is where an amount is sought to be deducted, it never to be reached the assessee as its income. An amount paid, if it is an application of income it cannot be allowed. The nature of obligation under which the assessee is liable to be incurred is very decisive. There is a difference between an amount which a person is obliged to apply out of its income and an amount which by the nature of the obligation as part of the contractual obligation the assessee to be incurred. Whereby there is obligation by a contract an amount incurred even before or after the income reached the assessee, it is to be allowed; but where the income is required to be applied after such income reaches the assessee the same cannot be allowed if it is clear appropriation of profit. In other words, the payment is merely an obligation to pay a portion of assessee's own income, which has been received and is since applied, it cannot be allowed as a deduction. In the present case, M/s. APHB is entitled to receive a portion from the assessee's income which is as per

pre-determined terms in the contract and the assessee cannot oblige to violate the same and, therefore, the payment made by the assessee is an expenditure which was necessary for the purpose of business of the assessee to earn its income. Further, a fair and comprehensive reading of the stipulation in the agreement shows that the assessee, though not a party to the agreement (supra), it was abided by the stipulation in the agreement. That agreement itself has given birth to the assessee. When the agreement itself is a reason for the birth of the assessee, the assessee, at any cost, is bound by the stipulation or condition therein. The legal obligation created by that agreement, by which the assessee is created, and the assessee is bound by that, as it is an enforceable document against the assessee. Further, when the assessee set apart a portion of its receipts under contractual obligation and over which the assessee loses all control and domain and it is to be paid to the parent party as diverted at source by overriding title and it cannot form part of real income of the assessee. In the present case, there is a clear diversion of a portion of 26 ITA No. 2072/Hyd/2011

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amount received by the assessee which was earmarked at source and it does not at any time form part of assessee's own income so as to utilise the same at will of the assessee. The question of ownership of the fund in this context is not relevant. It is also not relevant whether the assessee kept this fund itself for time being. As the accounting year comes to an end, the assessee has to part with the same to the parent body. The Department has taken a plea before us that the provisions of the agreement are not binding on the assessee as the assessee is not the party to the agreement entered between the APHB and IJMII. As we have observed earlier, these two companies are parent companies who formed the assessee through that agreement. Then, undoubtedly, the provisions of the agreement are not to be violated by the assessee. The assessee cannot say that only the beneficial clauses in that agreement would be followed and the other part cannot be acted upon. The agreement as a whole is to be acted upon by the assessee in order to give full effect to the agreement. The obligation of the assessee under the agreement is nothing but an actionable claim in favour of the APHB. It is true that the burden of a contract cannot be assigned without the consent of the other party of the contract. But so far as this contract is concerned, a contract as a whole is to be acted upon for the functional operation of the assessee. The terms of the agreement are very clear that unless obligations cast upon the assessee are carried on by the assessee, the assessee cannot function and operate. The assessee is bound by the terms therein and being so it is not possible to accept on behalf of Revenue that this is a case where income has accrued to the assessee and later on it was applied by it by passing the share of profit in favour of the APHB. As per agreement entered by APHB and IJMII, the right to receive this payment was vested with the APHB and the assessee has to comply with the agreement in true letter and spirit. In view of the above discussion, we are of the opinion that the payment made by the assessee to the APHB in terms of the agreement dated 4.11.2003 is to be allowed as wholly and exclusively incurred for the purpose of business. This ground of the assessee is allowed.

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7. With regard to disallowance of incentive (Ground Nos. 3.1 to 3.4) paid to IJMII amounting to Rs. 18,59,85,000, the AR submitted as follows:

7.1 As per clause 14.1.6 of the Development & Shareholders Agreement dated 4.11.2003, the assessee paid incentive to IJMII amounting to Rs. 18,59,85,000 As per the MoU and the development agreement, IJMII assisted the assessee in development of township. IJMII was the main construction contractor in developing the township. The incentive to IJMII was the consideration paid in relation to contract work undertaken by IJMII. The said expenditure was quantified under the agreement as a percentage (15%) of the cost of development incurred for developing the integrated township. It is inconceivable that a substantial contract would be undertaken devoting time, attention and labour only on a 'cost recovery' basis. Commercial realities visualise and acknowledge a mark up to such costs. In the instant case, the parties agreed that 15% mark up could be added to the costs incurred The mark up was for the contractor. For the assessee it was a cost of the project. Being a cost of the project, it was deductible. It was an expenditure incurred wholly and exclusively for the purpose of business carried on by the assessee. It was agreed by the parties that the payment of incentive will be subject to availability of profits. For the year ending 31.3.2007, the cost of development incurred was Rs. 367,69,09,874/ and 15% of the same amounted to Rs. 55,15,36,481/- However, expenditure in the nature of incentive was recognised only to the extent of Rs. 18,59,85,000 and an amount of Rs. 33,76,53,731/- was not recognised due to absence of sufficient profits. The purpose and genuineness of the expenditure has not been doubted by the learned income tax authorities.

7.2 The learned assessing officer has disallowed the incentives paid to IJMII amounting to Rs. 18,59,85,000/- for the following reasons.

(a) The payment of incentive is not reasonable and attracts the provisions of section 40A of the Income tax Act.

(b) Assessee is not liable for payment of incentive as it is not a party to the shareholders agreements.

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(c) Payment of incentive above the contract price amounts to distribution of profits.

(d) As per the details available the claim of incentive is not related to this year, as the project is not yet completed.

(e) IJMII has not executed the work in time to term the payment as incentive for timely completion.

7.3 The AR submitted that the Honourable DRP has confirmed the impugned findings of the learned assessing officer and has confirmed the addition amounting to Rs. 18,59,85,000/-

7.4 The AR submitted that the incentive paid to IJMII has been disallowed for the reason that the said payments are not reasonable and attracts the provisions of section 40A of the Income tax Act. Section 40A(2)(a) provides as under:-

"Where the assessee incurs any expenditure in respect of which payment has been or is to be made to any person referred to in clause (b) of this sub-section, and the Assessing Officer is of opinion that such expenditure is excessive or unreasonable having regard to the fair market value of the goods, services or facilities for which the payment is made or the legitimate needs of the business or profession of the assessee or the benefit derived by or accruing to him therefrom, so much of the expenditure as is so considered by him

to be excessive or unreasonable shall not be allowed as a deduction. "

7.5 The AR drew our attention to the scope of section 40A(2) has been set out in CBDT Circular No. 6P (LXXVI-66) of 1968, dated 6-7-1968.

7.6 He submitted that section 40A(2)(a) is placed after section 37, Disallowance under section 40A(2)(a) is made if the expenditure otherwise allowable is excessive or unreasonable, A disallowance made under section 40A(2)(a) pre-supposes that the expenditure disallowed has satisfied the tests of section 37 and is otherwise allowable as deduction, In the present case, the incentive paid to IJMII has been disallowed under section 40A(2)(a), In other words, the assessing officer has accepted the fact that the incentive paid to IJMII is an expenditure wholly and exclusively incurred for the purpose 29 ITA No. 2072/Hyd/2011

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of the business, Thus, the contention of the assessing officer that the incentive paid to IJMII amounts to 'distribution of profit' is incorrect, bad in law and liable to be quashed, Without prejudice, submissions in respect of disallowance under section 40A(2)(a) is as under,

7.7 According to the AR, section 40A(2)(a) cannot have any application, unless it is first held that the expenditure was excessive and unreasonable, He placed reliance on the judgement of Supreme Court in the case of Upper India Publishing House (P,) Ltd. v, CIT [1979] 117 ITR 569. He submitted that reasonableness is to be decided on the basis of fair market value of the goods, services or facilities. The reasonableness of any expenditure is to be seen from the viewpoint of the businessman and not from the view point of the revenue authorities. He placed reliance on the judgement of Gujarat High Court in the case of Voltamp Transformers (P.) Ltd. v. CIT [1981] 129 ITR 1051 and on the judgement of Delhi High Court in the case of Mittal Metal vs ITO (2008) 021 SOT 0186.

7.8 He submitted that the provision of section 40A(2) is intended to prevent evasion of tax. [CBDT Circular No. 6P (LXXVI-66) of 1968] Though the object of the section is to prevent evasion of tax, the provision must be worked not from the standpoint of the Tax Collector but from that of a businessman. The Income-tax Officer must take an overall picture of the financial position of the business. He should put himself in the position of the prudent businessman or the director of the company and deal with a sympathetic and objective approach. He placed reliance on the judgement of Supreme Court in the case of ClT v. Gangadhar Banerjee and Co. (P.) Ltd. [1965] 57 ITR 176 (SC); CIT v. Edward Keventer (P) Ltd [1972] 86 ITR 370 [approved by the Hon'ble Supreme Court in CIT v. Edward Keventer (P.) Ltd. [1978] 115 ITR 149].

7.9 According to the AR, the disallowance under section 40A(2)(a) can be made only if the expenditure otherwise allowable is excessive or unreasonable. A disallowance made under section 40A(2)(a) pre-supposes that the expenditure disallowed has satisfied the tests of section 37 and is 30 ITA No. 2072/Hyd/2011

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otherwise allowable as deduction. In the present case, the incentive paid to IJMII has been disallowed under section 40A(2)(a). In other words, the assessing officer has accepted the fact that the incentive paid to IJMII is

an expenditure wholly and exclusively incurred for the purpose of the business. However, for invoking the provisions of section 40A(2)(a}, the onus lies upon the Assessing Officer that the payment is excessive or unreasonable having regard to the fair market value of goods or legitimate needs of the business. Under the general law, transactions even with the relatives and associate concerns cannot be discarded. In other words, unless it is shown that the transaction in question is a sham one or unless the value shown is not the value in the books of account or unless it is not a bona fide transaction, it is not open to the taxing authorities to disregard the figures of the transactions shown in the books of account. The onus is on the department to prove that the transaction was sham or not bona fide or the value shown in the books was not the value really paid. The Assessing Officer must establish that the payment is excessive or unreasonable. ITO cannot proceed merely on the basis of surmises and conjectures. Revenue has to place on record evidence as regards excessiveness or unreasonableness. He placed reliance on the judgement of Gujarat High Court in the case of Marghabhai Kishabhai Patel and Co. v. CIT [1977] 108 ITR 54 (Guj); S. K. Engineering v. JCIT [2006] 286 ITR (AT) 210 ITAT Bangalore; Mittal Metal vs ITO (2008) 021 SOT 0186 (DELHI)]. He submitted that there cannot be any microscopic consideration and a broader view has to be taken, taking into consideration the business intention and business consideration under section 40A(2)(a). So long as there is no intention to evade tax, section 40A(2)(a) cannot be invoked. He placed reliance on the judgement of Karnataka High Court in the case of DCIT vs. Microtex Separators Ltd (2007) 293 ITR 0451 and CIT v. Indo Saudi Services (Travel) P. Ltd. [2009] 310 ITR 306 (Bom)]

7.10 The AR submitted that the disallowance of incentive paid has been made for the reason that the assessee is not liable for payment of incentive as it is not a party to the shareholders agreements. Having made disallowance u/s 40A(2)(a) thereby accepting that the impugned expenditure 31 ITA No. 2072/Hyd/2011

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qualifies for deduction under section 37, the assessing officer cannot turn around and conclude that the assessee was not liable for payment of incentives. The assessing officer cannot blow hot and cold at the same time. Disallowance cannot be made for two opposite and contrary reasons. The disallowance is to be deleted for this reason alone.

7.11 According to AR, even otherwise, the conclusion of the assessing officer that the since assessee was not a party to the shareholders agreements, it was not liable to pay incentive is incorrect. The assessee was incorporated solely for the purpose of development of township with APHB and IJMII as its shareholders. It was imperative for the assessee to agree to the terms of MoU and shareholders agreement. The assessee had no choice at the time of inception, as a condition of its coming into existence to agree to the several terms stipulated by the AP Government through APHB and the other shareholder viz., IJMII. He placed reliance on the judgement of Supreme Court in the case of CIT v Travancore Sugars and Chemicals Ltd [1973] 88 ITR 1 (SC). Thus, the fact that the assessee was not a party to the shareholders agreement is not relevant. Even otherwise, shareholders can bind the Company in various manner. For example, in an Annual general meeting, it is the shareholders who appoint auditors, adopt final accounts, approve distribution of dividends etc. A special resolution is passed by the shareholders to bind the Company. A Company does not have hands and legs to conduct its business. It has to operate through Board of directors and the shareholders. The general management and administration of the Company has to be exercised by the Board of directors. However, the Board of directors does not have powers to take decisions in respect of certain matters such borrowing in excess of certain limits, amalgamation, sale of business, appointment of auditors etc. The shareholders have to approve such actions which then bind the Company. In the present case also, the payment of incentive was approved by the shareholders in the development and shareholders agreement dated 4.11.2003. Subsequently the Board of directors in their meeting held on 2.2.2004 discussed the matters concerned with the agreement

dated 4.11.2004 and recorded the minutes. The 32 ITA No. 2072/Hyd/2011

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payment of incentive was promoted out of business needs and commercial expediency. The revenue cannot itself put in the arm chair of businessman and decide what type of expenditure is necessary for the conduct of business. He placed reliance on the judgement of Supreme Court in the case of CIT v S A Builders (288 ITR 1). The aspect of 'necessity' of an expenditure is irrelevant for the purpose of allowability of an expenditure for tax purposes. He placed reliance on the judgement of Supreme Court in the case of He placed reliance on the judgement of Supreme Court in the case of Sassoon J. David and Co. (P.) Ltd. v. CIT [1979]118 ITR 261. Thus, there is no merit in the contention of the assessing officer in disallowing the incentives paid.

7.12 He submitted that the assessing officer has disallowed the incentive paid to IJMII for the reason that the said payments amounts to distribution of profits. The incentive paid to IJMII constituted an expenditure incurred for the purpose of business and the same is allowable in computing the real profits and gains chargeable under section 28. Alternatively, the said payments are allowable under section 37. The fact that payment of incentive was measured or quantified as a percentage of development cost subject to availability of profits is not a relevant criteria at all. He placed reliance on the judgement of Supreme Court in the case of CIT vs. Ponni Sugars and Chemicals Ltd [2008] 306 ITR 392 (SC), wherein held that where subsidy was allowed by the Govt. for the purpose of repayment of loans and the same was allowed through a rebate on excise duty, it was held that the form or the mechanism by which the subsidy was allowed is irrelevant in determining whether the subsidy allowed is capital receipt or revenue receipt. It was also held that the source of subsidy or the point of time at which it is paid is not irrelevant. In the present case, the incentive paid to IJMII was a consideration for undertaking the construction contract for development of the township. Thus, the said payments are allowable under section 28 or under section 37 in computing the profits of the business. Alternatively and without prejudice, the said payments constituted diversion of income by overriding title for the assessee. 33 ITA No. 2072/Hyd/2011

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7.13 According to him, the assessing officer has disallowed the incentive paid to IJMII for the reason that (i) the claim of incentive is not related to this year, as the project is not yet completed; and (ii) IJMII has not executed the work in time to term the payment as incentive for timely completion. The above reasons are irrelevant in determining the allowability of the impugned expenditure. The assessee was contractually bound to pay incentive to IJMII. As explained earlier, for the year ending 31.3.2007, the cost of development incurred amounted to Rs. 367,69,09,874/- and 15% of the same amounted to Rs. 55,15,36,481/- However, expenditure in the nature of incentive was recognised only to the extent of Rs. 18,59,85,OOO/- and an amount of Rs. 33,76,53,731/- was not recognised due to sufficient profits.

7.14 He submitted that the assessee follows mercantile system of accounting. In computing the profits of business chargeable under the Act, the expenditure actually incurred and the liability accrued in respect of such expenditure (but required to be discharged at some future date) should be deducted. He placed reliance on the judgement of Supreme Court in the case of Calcutta Company Limited v. CIT [1959] 37 ITR I, wherein held as follows: ,

"The assessee here is being assessed in respect of the profits and gains of its business and the profits and gains of the business cannot be determined unless and until the expenses or the obligations which have been incurred are set off against the receipts. The expression 'profits and gains' has to be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom -- whether the expenditure is actually incurred or the liability in respect thereof has accrued even though it may have to be discharged at some future date."

7.15 Under the mercantile or accrual system of accounting, income and expenditure are recorded at the time of their accrual or incurrence. For instance, income accrued during the previous year is recorded whether it is received during the previous year or during a year preceding or following the previous year. Similarly, expenditure is recorded if it becomes due during the previous year, irrespective of the fact whether it is paid during the previous 34 ITA No. 2072/Hyd/2011

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year or not. The profit calculated under the mercantile system is profit actually earned during the previous year, though not necessarily realized in cash.

7.16 He drew our attention to Accounting Standard-I, relating to disclosure of accounting policies, issued by the Central Government under section 145(2), requires the assessees to make provisions towards all known liabilities and losses, even though the amount cannot be determined with certainty. This is the principle of prudence.

7.17 He referred to the word "provision" as defined in paragraph 7(1)(a) of Part III of Schedule VI to the Companies Act to mean "any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. "

7.18 He contended that if a business liability has definitely arisen in the accounting year, the deduction should be allowed although the liability may have to be quantified and discharged at a future date. What should be certain is the incurring of the liability. It should also be capable of being estimated with reasonable certainty though the actual quantification may not be possible. If these requirements are satisfied the liability is not a contingent one. The liability is in praesenti though it will be discharged at a future date. It does not make any difference if the future date on which the liability shall have to be discharged is not certain. He placed reliance on the judgement of Supreme Court in the case of Bharat Earth Movers v CIT [2000] 245 IT 428 (SC)].

7.19 He contended that in the present case, the assessee was contractually liable to pay incentive to IJMII. The said payment was measured as a percentage of development costs incurred for development of integrated township. During the year, the incentive payable was quantified based on the quantum of development costs incurred till 31.3.2007. Accordingly, the liability to pay incentive crystallised during the year. The fact that the 35 ITA No. 2072/Hyd/2011

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incentive payable is to be finalised after completion of construction based on the total cost of development does not postpone the incurrence of liability. Hence, incentive paid to IJMII is allowable irrespective of the fact that the construction of the township had not been completed at the end of the year. Similarly, the fact that the execution of work was not in time is irrelevant for the purpose of allowability of expenditure. Since, substantial completion of the project is done and only some minor works are pending which are very time consuming such as interiors, design changes by the owners etc., On facts and in the circumstances of the case and law applicable, incentive paid to IJMII amounting to Rs. 18,59,85,000/- is fully allowable in computing the business income. The disallowance of the said expenditure is to be deleted in entirety.

8. Regarding disallowance of incentive paid at Rs. 18,59,85,000, the learned DR submitted that as per the shareholders agreement, if the taxpayer makes profit, M/s. IJMII is entitled to receive an incentive of not exceeding 15% of the total development cost and the balance, if any, more than 15% of the total development cost will be shared by APHB and IJMII in the ratio of their shareholding. During the previous year Rs.18,59,85,OOO/- has been provided towards incentive to IJMII. A reference was made in para No. 5.8 of agreement in this regard. Herein it is stated that IJMII shall alone be entitled to receive all the profits generated by the taxpayer up to 15% of the total cost. The quantification of incentive is premature according to the AO. Payment of incentive to the contractor is something peculiar. It also envisages that profit of over 15% would certainly be generated. However, the profit is normally 8 to 12% in real estate and after tax it works out to 5.6% to 8.4% only. The AO also narrated in page 6 of his order the facts as obtained from the record of M/s. IJMII that the profit disclosed is only 0.09%. If incentive is considered, it comes to 4.8% which is still on the lower side.

8.1 The DR further submitted that the taxpayer is not a party to the agreements between the shareholders. He also relied on the doctrine of Privity of Contract. Accordingly, for the following reasons the sum of 36 ITA No. 2072/Hyd/2011

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Rs.18,59,85,OOO incentive paid to one of the shareholders i.e., IJMII: i) The payment of incentive is not reasonable and attracts the provisions of section 40A of the Income Tax Act, ii) SITCO is not liable for payment of incentive as it is not a party to the shareholders agreements.

iii) Payment of incentive above the contract price amounts to distribution of profits.

iv) As per the details available the claim of incentive is not related to this year; as the project is not yet completed. v) JMII has not executed the work in time to term the payment as incentive for timely completion.

8.2 The DR submitted that it is the assessee's contention that the AO misinterpreted the shareholders agreement. The subsequent happenings, administration, governance and all management of the taxpayer company is solely defined in the shareholders agreement. It is argued that the incentive is paid for the services rendered and it is not a case of distribution of profits. The contractor can be paid incentive. Application of section 40A is not attracted in the impugned case. A reading of the shareholders agreement, para 4.1.6 and the entire section 3 and especially para 4 is crucial to this case. One of the shareholders i.e., APHB is given Rs. 800/- per square yard as 'anticipated profit'. The other shareholder IJMII being also the contractor is also guaranteed 15% of total developmental cost (both these amounts are almost the same). With or without profit being disclosed, these sums are debited and claimed as expenditure in the case of the taxpayer. The total project cost/construction is estimated is Rs.367 crores up to 31.03.2007. It is the housing board project, where the flats are sold to the public and money raised. The cost of the land to the Housing Board is not for sure, but

it cannot be assumed that it was high.

8.3 The DR submitted that a reading of the letter dated 16.12.2009 filed before the ACIT, Circle-3(3} shows that the incentive was paid out of the profits available It is mentioned that sum of Rs.18,59,85,OOO/- is the profits 37 ITA No. 2072/Hyd/2011

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available and paid to IJMII. From the facts above, it can clearly be seen that section 2(22)(a) applies to the facts of the case. It reads:

Dividend includes - "any distribution by a company of accumulated profits, whether capitalized or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company".

8.4 The DR submitted that on this ground there is necessity to hold that it is only dividend that is paid to the shareholder and hence the deduction is not admissible. On the other side, it should also be noted that even before the work is executed in time and without examining the quality, an incentive is sought to be paid in crores. In fact, this is a case wherein there was .substantial delay in handing over the flats and nearly Rs. 7 crores of liquidated damages / compensation was paid for the delay in execution and handing over the flats. The commercial complex was not completed in time. It is not clear how such incentive was paid and what is the necessity for such payment while the project was in progress. It is also a fact that IJMII is 51% shareholder of this company (taxpayer). It is also to be seen that incentive as well as 'anticipated profits' are taken away and profit is not disclosed for income tax purposes such. that no dividend tax nor any tax need be paid. Further, different contracts are concluded with IJMII towards technical services execution of work and separate payments are made. Mobilisation advance is also paid to IJMII.

The profit margin of the taxpayer is given in the table below:

Item FYE 2006 FYE 2007 FYE 2008 FYE2009 Operating revenue 151,55,48,204 190,20,17,413 10,31,74,585 9,33,80,730 Operating ;expenses 153,87,37,152 186,35,01,499 11,18,96,786 14,66,95,733 Operating profit (-) 1, 13,57,822 3,85,15,194 (-)87,22,201 (-)5,33,15,003 OP/Sales {-)0.75% 2.02% (-) 8.45% {-)57.09% OP/Cost 0.74% 2.06% (-)7.80% (-)36.34%

The profit disclosed is very negligible which can be seen from the above Table. The taxpayer claimed huge refund of Rs.5.90 crores for Asst. Year 2007-08.

The income disclosed by APHB, one of the shareholders, is given below: 38 ITA No. 2072/Hyd/2011

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Sl. Net profit/loss as

A.Y. Income returned

No. per P&L alc

1 2005-06 Rs.43,62,70,753 (-)Rs.65,05,784

2 2006-07 (-)121,67,49,541 (-)8,70,76,260

3 2007-08 (-)110,96,10,573 Nil

8.5 The profit/income disclosed by the taxpayer as well as one of the shareholders is depicted above. Among other justified reasons another issue to be noticed is that low incomes are only disclosed by taxpayer as well as one of the shareholders i.e., APHB. No doubt, the reason can be traced to the self-serving nature of the agreement concluded after 8 months of incorporation. Based on all the above reasons, such as the applicability of Sections 2 (22), 40A(2) and unreasonableness of payment, there is no justification to allow the deduction on account of incentive paid. Hence. this ground of objection should be rejected

3.4:

Findings with regard to Ground Nos. 3.1 to 3.4:

9. We have heard both the parties and perused the material on record. The second ground is with regard to disallowance of incentive paid to IJMII at Rs. 18,59,85,000. This payment has been disallowed by the Assessing Officer on the reason that the payment is not reasonable and it would attract provisions of section 40A(2) of the Act. As discussed in earlier para, this payment was made in terms of the agreement dated 4.11.2003. It cannot be considered as distribution of profit. The expenditure was incurred on account of commercial expediency and the assessee has no option to overlook the agreement entered by parent bodies. To invoke the provisions of section 40A(2), the Assessing Officer is required to bring on record comparable market value for the services rendered by the parties and the burden of proof under this section is on the Assessing Officer. If the assessee incurred expenditure to the legitimate needs of the business of the assessee and the Assessing Officer finds that it is an excessive payment, then the duty of the Assessing Officer is to bring on record the comparable cases and disallow that portion of the expenditure only. The Assessing Officer cannot disallow the entire expenditure by observing that section 40A(2) is applicable. However, it is not the case of the Department that the expenditure was either 39 ITA No. 2072/Hyd/2011

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not incurred or if incurred then were incurred for other than business purposes or for acquiring any personal benefit of the assessee. For the details of the evidence produced by the assessee, the expenditure were incurred for the purpose of carrying on the business of the assessee in terms of contractual obligations which in turn result in earning profit in the business of the assessee. In our opinion, in the present case, the incentive was paid to IJMII as a consideration for undertaking the construction contract for development of integrated township. The assessing officer has not doubted the genuineness and purpose of the expenditure. The fact that the expenditure has been disallowed u/s 40A(2)(a) itself demonstrates that the requirements of section 37 has been satisfied. The scope and requirements of section 40A(2)(a) has been explained above. In order to disallow an expenditure under section 40A(2)(a), the assessing officer has to demonstrate with evidence that the impugned expenditure is excessive or unreasonable having regard to the (i) fair market value of the goods, services or facilities for which the payment is made or (ii) the legitimate needs of the business of the assessee; or (iii) the benefit derived by or accruing to him therefrom. The burden of proof under section 40A(2)(a) is on the assessing officer.

9.1 In our opinion, the assessing officer has to compare the payment made with the fair market value of the goods, services or facilities. In the present case, the fair market value of the payment made to IJMII has not been brought on record by the assessing officer. The excessiveness or unreasonableness of the impugned payments has not been demonstrated having regard to the FMV of such impugned payments. The disallowance under section 40A(2)(a) is, therefore, is not justified.

9.2 Further, the disallowance cannot be made unless it is proved that the payments are excessive or unreasonable having regard to the legitimate needs of the business of the assessee or the benefit derived by or accruing to him therefrom. In the present case, IJMII was the main contractor for development of the integrated township. The assessee is a Joint venture 40 ITA No. 2072/Hyd/2011

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company between APHB and IJMII, wherein APHB contributed the land and IJMII contributed its technical expertise, skills and experience which were indispensible far the actual development of the township. As explained earlier, the joint venture partner was invited since APHB did not have the technical wherewithal to develop the township in a large scale. It therefore invited tenders. IJMII was selected from out of various bidders confirming that its pricing was the best. Without the involvement of IJMII, the development of township was not possible. The payment therefore satisfied that legitimate needs and the benefit criteria. The fact that the assessee also paid project management fees and other similar fees to. IJMII are irrelevant in so far it pertains to disallowance u/s 40A(2)(a). These payments were made as a consideration for services separately availed from IJMII. The assessing officer has not brought any evidence on record in order to substantiate that the impugned payments were unreasonable or excessive having regard to the legitimate needs and the benefit there from. Further, as explained earlier, no. disallowance u/s 40A(2)(a) can be made unless the requirement of 'evasion of tax' is prayed. The assessing officer has failed to prove that the payment of incentive to IJMII has lead to evasion of tax. The assessee was eligible to set off brought forward losses and unabsorbed depreciation and hence there was no incentive to evade taxes. The assessee and IJMII both were domestic companies with uniform tax rate for the year under consideration. IJMII was not eligible for any tax holiday like ss. lOA, lOB, 10AA so that the incentive earned was tax exempt. IJMII has also paid tax on the incentive received from the assessee. The taxable income of IJMII was more than that of the assessee for the year under consideration. Thus, there was no evasion of tax. The assessing officer has failed to view the transaction underlying the payment of incentive on a holistic approach from commercial or business perspective. The disallowance made in violation of the requirements of s. 40A(2)(a), Board Circular No. 6P (LXXVI-66) of 1968, dated 6-7-1968 and the principles laid down by the Courts is, therefore, not justified. Therefore, on the basis of the documents placed on record, we are of the opinion that expenditure incurred was for commercial expediency and, therefore, are to be allowed as business expenditure. Commercial expediency must be decided in 41 ITA No. 2072/Hyd/2011

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the context of assessee's business operations and not from the point of view of the Assessing Officer. In our opinion, in the present case, the assessee was contractually liable to pay incentive to IJMII. The said payment was measured as a percentage of development costs incurred for development of integrated township. During the year, the incentive payable was quantified based on the quantum of development costs incurred till

31.3.2007. Accordingly, the liability to pay incentive crystallised during the year. The fact that the incentive payable is to be finalised after completion of construction based on the total cost of development does not postpone the incurrence of liability. Hence, incentive paid to IJMII is allowable irrespective of the fact that the construction of the township had not been completed at the end of the year. Similarly, the fact that the execution of work was not in time is irrelevant for the purpose of allowability of expenditure. Since, substantial completion of the project is done and only some minor works are pending which are very time consuming such as interiors, design changes by the owners etc., On facts and in the circumstances of the case and law applicable, incentive paid to IJMII amounting to Rs. 18,59,85,000/- is fully allowable in computing the business income. Accordingly, the disallowance of the said expenditure is deleted. We, therefore, allow the ground taken by the assessee.

10. The next issue (Ground No. 4.1) is with regard to disallowance of 'handing over charges' at Rs. 7,74,36,597.

10.1 Brief facts of relating to this issue are that as per the terms of the agreement entered into with the buyers, the assessee has to complete the construction and handover the possession of the vacant flats to buyers within the agreed date. If there was any delay in completion of construction or handing over the possession of flats, the assessee agreed to pay liquidated damages at the rate of Rs. 5/- per sq. ft of built up area of the apartment. During the year, there was a delay in completion of construction by the assessee. A sum of Rs. 7,74,36,597/- was therefore paid by the assessee to various buyers as handing over charges.

10.2 The assessing officer has disallowed the above payment under section 42 ITA No. 2072/Hyd/2011

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40(a}(ia) for the reason that the impugned payments constitute 'interest' under section 2(28A) and the assessee has failed to deduct tax at source in respect of the said payments under section 194A of the Act. The Hon'ble DRP has confirmed the disallowance made by the assessing officer.

11. The AR submitted that section 4(2) provides the basis for deduction of tax at source. Section 190 provides that tax on income shall be payable by deduction of tax at source in accordance with the provisions of Chapter XVII, notwithstanding that the regular assessment in respect of any income is made in a later assessment year. Section 194A mandate deduction of tax at source in respect of interest other than interest on securities. He drew our attention to the term 'interest' is defined in section 2(28A).

11.1 The AR submitted that as per section 2(28A), interest means interest payable in any manner in respect of any moneys borrowed or debt incurred. It is clear from the definition in section 2(28A) of the Income-tax Act, 1961, that before any amount paid is construed as interest, it has to be established that the same is payable in respect of any money borrowed or debt incurred. He placed reliance on the judgement of Delhi High Court in the case of ClT v Cargill Global Trading P. Ltd [2011] 335 ITR 94 (Del)]. In the present case, the payment of handing over charges to various buyers was made for the delay in completion of construction of flats. The said payments were not made in connection with any money borrowed or debt incurred by the assessee. He placed reliance on the following orders/judgements: Delhi Development Authority v ITO [1995] 53 ITD 19 and the judgement of Himachal Pradesh High Court in the case of CIT v HP Housing Board [2012] 340 ITR 388 has held that payment of interest to buyers for the delay in completion of construction and handover of flats cannot be considered as 'interest' under section 2(28A) and consequently such payments are not liable for TDS u/s 194A.

11.2 The AR submitted that in view of the above, the contention of the assessing officer that the payment of handing over charges partakes the character of 'interest' under section 2(28A) is incorrect, bad in law and liable 43 ITA No. 2072/Hyd/2011

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to be quashed. The decisions relied on by the assessing officer are also distinguishable for the same reasons. The disallowance made under section 40(a)(ia) should therefore be deleted.

11.3 The AR submitted that even otherwise, the handing over charges were actually paid during the year, and there was no sum payable as on 31.3.2007 The Vishakhapatnam ITAT SB in Merilyn Shipping and Transports v Ad. CIT [20121 16 ITR (Trib) 1 has held that disallowance under section 40(a)(ia) can be made only in respect of amounts remaining payable as on the last day of the previous year and the payments actually made during the previous year cannot be disallowed under section 40(a)(ia). The disallowance under section 40(a)(ia) should be deleted even for this reason.

12. The learned DR submitted that the case is to be examined with respect to EPC contract on which the assessee relied upon. As per clause 38 of the agreement the assessee was to handover the flats after completion of construction within 12 months from the date of agreement with the purchasers. However, there was inordinate delay in completing the construction and the assessee has to pay compensation to the purchasers. The AO held that the impugned sum is to be treated as interest as per definition u/s 2(28A) and to the extent there was failure to do TDS and the same is held to be disallowable u/s 40a(ia). However, the case is to be examined with respect to the EPC Contract on which the assessee is relying upon. As per clause 38 which deals with delay in completion, the contractor shall pay to the employer for every day's delay certain compensation. These sums are to be as liquidated damages for delay and not as a penalty. As per Appendix:-B liquidated damages clause.38.1 the tax payer is liable to collect the damages from the contractor-cum-shareholder, i.e. IJMII. The AO has already pointed out that IJMII has not executed the work in time to term the payment as incentive for timely completion. There is no evidence placed on record to state that contractor handed over possession in time and hence, the liability to pay liquidated damages squarely vested in the tax payer. Since no proper proof is adduced, the stand of the assessee. To be rejected. 44 ITA No. 2072/Hyd/2011

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Findings in respect of ground Nos. 4.1:

13. We have heard both the parties and perused the material on record. In our opinion, payment of handing over charges cannot be equated with interest defined in section 2(28A) of the Act. U/s. 2(28A) "interest" reads as under:

"Interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debit incurred or in respect of any credit facility which has not been utilised."

13.1 It is clear from the above that before any amount paid is construed as interest, it has to be established that the same is payable in respect of any money borrowed or debt incurred. In the present case, on the aforesaid facts appearing on record, in our opinion, the handing over charges paid were not in respect of any debt incurred or money borrowed. Instead, the assessee had merely paid compensation for delay in completion and handing over possession of flats. We place reliance on the following judgements in support of our conclusions:

(a) Delhi Development Authority v ITO [1995] 53 ITD 19 (Del)

It cannot be said that the instalments paid by the allottee to the DDA were "money borrowed" by the latter or that it was "debt incurred" by the latter as both these terms stipulate a liability on the part of the DDA which on the facts of the case it was not except to the extent that it as obliged to construct the dwelling units with the funds provided by the allottees and deliver them within a stipulated period. Then again the amounts of instalments do not represent a "deposit" in the hands of the DDA having been taken to the income account {as stated by Shri G. C. Sharma and not rebutted by the learned Departmental Representative} and not denoting an interest earning event. The transaction further does not qualify for categorization under the other terms appearing in section 2{28A} viz., "service fee" or "other charge" and not does it fall for consideration under the terms "claim or other similar right to obligation". According to us the definition of interest in section 2(28A} is not wide enough to encompass all types of transactions much less the one under consideration. The provisions of section 194A would be attracted only if the case falls under section 45 ITA No. 2072/Hyd/2011

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2(28A} irrespective of the fact that a particular receipt may represent income in the hands of the recipient.

(b) CIT v HP Housing Board [2012] 340 ITR 388 (HP)

"That, in case the houses were ready within the stipulated period the assessee would not be liable to pay interest. When construction of a house was delayed there could be escalation in the cost of construction. The allottee does not get the right to use the house and was deprived of the rental income from such house. He was also deprived of the right of living in his own house. In these circumstances, the amount which was paid by the assessee was not payment of interest but was payment of damages to compensate the allottee for the delay in the construction of his house/flat and the harassment caused to him. Though compensation had been calculated in terms of interest this was because the parties by mutual agreement agreed to find out a suitable and convenient system of calculating the damages which would be uniform for all the allottees. The allottees had not given the money to the assessee by way of deposit nor had the assessee borrowed the amount from the allottees. The amount was paid under a self- financing scheme for construction of the flats and the interest was paid on account of damages suffered by the claimant for delay in completion of the flats."

13.2 In view of the above discussion, we are of the opinion that handing over charges cannot be equated with the word "interest" so as to invoke the provisions of section 40(a)(ia) of the Act and no addition is possible on this count. Accordingly, this ground of the assessee is allowed.

14. The next ground is with regard to addition of Rs. 1,92,19,200/- (ground No. 5.1) in respect of cost of land attributable to flats handed over to APHB.

14.1 Facts relating to this issue are that as per the development and shareholders agreement dated 4.11.2003, the assessee paid compensation to Board at the rate of Rs. 2,200/- per sq. yard of the land contributed by the

Board. A part of the above consideration was directly realised by the Board by allotting / selling 500 low income group apartment units of the size of 450 46 ITA No. 2072/Hyd/2011

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sq.ft each at Rs. 400/- per sq. ft. The assessing officer has made an addition of Rs. 1,92,19,200/- [1400 x 13,728] computed at Rs. 1400/- per sq. yard in respect of 13,728 sq. yards representing the portion of land attributable to 500 apartments as referred above for the reason that the above portion of land was not transferred to the assessee.

14.2 He submitted that as per the development and shareholders agreement dated 4.11.2003, the Board made available the entire land (including 13,728 sq. yards as referred above) to assessee for the purpose of development of integrated township. A power of attorney was also given on the same day to the assessee to carry out the developmental work in respect of the land contributed by the Board. Thus, there is no merit in the contention of the assessing officer that land to the extent of 13,728 sq. yards has not been offered for development by the Board. The assessee paid compensation at the rate of Rs. 2200/- per square yard for the entire land including the above portion of 13,728 sq. yards. Merely because a portion of the above compensation was realised by the Board directly by selling 500 flats, it cannot be concluded that there was no contribution of land by the Board. The direct selling of flats by the Board was possible only after completion of construction of these flats by the assessee and the said construction could not have been made by the assessee without the contribution of land by the Board. Further, (i) sale of 500 flats by the assessee and payment of same as compensation to Board or (ii) direct realisation by the Board by sale of flats, lead to the same result. The two way traffic of first selling the houses by the assessee and then paying the same amount to Board as compensation was avoided. The compensation of Rs. 2,200/- per sq. yard paid to the Board was partly realised in the form of direct sale of 500 flats. He placed reliance on the judgement of Supreme Court in the case of J.B. Boda and Co. Pvt. Ltd. v. CIT [1997) 223 ITR 271 and also on the order of Tribunal, Special Bench, Chennai in the case of Zylog Systems Limited v ITO [2011) 7 ITR (Trib) 348 wherein held that in taxation matter "A two-way traffic is unnecessary. To insist on a formal remittance first and thereafter to receive the commission 47 ITA No. 2072/Hyd/2011

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from the foreign reinsurer, will be an empty formality and a meaningless ritual, on the facts of this case"

15. The AR submitted that on facts and in the circumstances of the case and law applicable, addition of Rs. 1,92,19,200/- is to be deleted in entirety.

16. Regarding addition of Rs. 18.06.75.000/- (ground N. 6.1) towards of construction of houses handed over to APHB, the AR submitted as follows:

16.1 As per the terms of the development and construction agreement dated 4.11.2003, the assessee paid compensation to Board at the rate of Rs. 2,200/- per sq. yard of the land contributed by the Board. A part of the above consideration was directly realised by the Board by allotting / selling 500 low income group apartment units of the size of 450 sq. ft each at Rs. 400/- per sq.ft. The assessing officer has made an addition

of Rs. 18,06,75,000/- [Rs. 803 x 2,25,000 sq. ft] computed at Rs. 803/- per sq. ft in respect of 2,25,000 sq. ft of built up area of 500 LlG apartments [500 LlG houses x 450 sq. ft]. The assessing officer computed the average cost of construction per sq. ft at Rs. 1,203/- per sq. ft. [Total cost of Rs. 337,77,71,071/- divided by total saleable area of 28,06,972 sq. ft] After considering that the assessee provided 500 LlG houses at Rs. 400/- sq. ft, the assessing officer held that the assessee has transferred these 500 LlG houses at a discount of Rs. 803/- per sq. ft [Rs. 1203 - Rs. 400] It is stated by the assessing officer that this transaction attracts section 40A(2)(a) of the Act. It is concluded that the assessee has no obligation to transfer the properties at a discounted price. Accordingly, a sum of Rs. 18,06,75,000/- has been added to income of the assessee. The Hon'ble DRP has confirmed the addition made by the assessing officer.

16.2 The AR submitted that the computation of average cost of construction per sq. ft at Rs. 1,203/- per sq. ft. is incorrect. Vide submissions dated 29.10.10 the assessee submitted before the assessing officer that the cost of construction of 500 LlG houses is only Rs. 635/- per sq. ft. Further, the assessee has also recovered Rs. 35,000/- for each apartment separately in 48 ITA No. 2072/Hyd/2011 M/s. Swarnandhra IJMII Integrated

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respect of water charges and electricity charges. Thus, the actual discount at which these houses are transferred is only Rs. 107/- per sq. ft as computed below:

Sale price for houses Rs. 450/- per sq. ft Add: Amount recovered separately

(Rs. 35,000/450 sq.ft.) Rs. 78/- per sq. ft Rs. 528/- per sq. ft

Less: Cost of construction of houses Rs. 635/- per sq. ft Discount Rs. 107/- per sq. ft

16.3 The transfer of 500 LlG houses at a discount was mandatory for the assessee in terms of the development and shareholders agreement dated 4.11.2003. The APHB was obliged to provide residential accommodation to low income group people by virtue of the governmental instructions and policy framework. The transfer of 500 houses at a price of Rs. 450/- per sq.ft was therefore made as a condition pre-requisite for entering into developers and shareholders agreement dated 4.11.2003. The assessee had no choice but to accept to the terms of the said agreement. The transfer of 500 houses at a price of Rs. 450/- per sq. ft was therefore out of commercial or business expediency.

16.4 The learned assessing officer has concluded that s. 40A(2){a) is applicable in the present case. The expression used in section 40A(2) is "incurs any expenditure in respect of which payment has been or is to be made to any person" [Emphasis supplied]. The emphasized words clearly show that there has to be an expenditure incurred and actual payment should have been or is to be made in respect of such expenditure before the provision can be said to be applicable. He placed reliance on the judgement of Delhi High Court in the case of United Exports v. CIT (2009) 185 Taxman 374 (DELHI) and ClT v Subbaraya Chetty (A.K.) and Sons [1980] 123 ITR 592 (Mad)

16.5 According to the AR, the term 'expenditure' is equal to 'expense' and 'expense' is money laid out by calculation and intention. The idea of 'spending' in the sense of 'paying out or away' money is the primary meaning of the term 'expenditure' ' Expenditure' is thus what is 'paid out or away' and is 49 ITA No. 2072/Hyd/2011

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something which is gone irretrievably. He placed reliance on the judgement of Supreme Court in the case of Indian Molasses Company (P) Ltd. v. CIT [1959] 37 ITR 66 (SC).

16.6 In the present case, there was no expenditure incurred or payment by the assessee to APHB. On the other hand, the assessee received Rs. 35,000/- per unit towards electricity and water charges. There was a transfer of houses at a "discounted price". However, the same did not result in incurrence of an expenditure. Discount given is not an expenditure. It is a loss. He drew our attention to CBDT Instruction No. 1175, dated May 16, 1978 provides that a chit discount is a loss in the hands of the subscriber. He also placed reliance on the order of Tribunal, Special Bench, Chennai in the case of ACIT v K S Shetty and Co. [2003] 263 ITR (AT) 71, wherein it was held that chit discount is a loss. He also placed reliance in the order of the Tribunal, Bangalore Bench, in the case of DCIT v Shree Lakshmi Tractors 2010-TIOL-572-ITAT-BANG wherein it was held that discount allowed cannot be disallowed under section 40A(3) as there was no cash payment. He placed reliance on the judgement of Delhi High Court in the case of United Motors v CIT 2009-TIOL-477-HC-DEL-IT and the Madras High Court in CIT v Subbaraya Chetty and Sons [1980] 123 ITR 592 wherein held that discount allowed is not an expenditure and hence the same cannot be disallowed u/s 40A(2)(a). The transaction of transfer of 500 LIG houses to APHB resulted in a loss to the assessee Loss is different from expenditure. He also placed reliance on the judgement of Supreme Court in the case of Dr. T. A. Quereshi v. CIT [2006] 287 ITR 547 (SC)]. Loss is something which comes ab extra. There is no spending or cash outflow in case of loss. S. 40A(2)(a) therefore has no application in the present case as it applies only to an expenditure and not sale proceeds less received.

16.7 The assessing officer has added a sum of Rs. 18,06,75,000/- for the reason that the assessee should not have transferred the houses for a lesser sum. The addition made represents a sum which the assessee never received or earned. In other words, the assessing officer has imputed income in 50 ITA No. 2072/Hyd/2011

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making additions. The revenue cannot question the rates at which an assessee provides services, sells goods or leases property. The following reasons are in support of the above position of law.

a) Income tax Act is a fiscal statute. It has to be interpreted strictly. One cannot tax an assessee based on intendment. In the absence of clear words, income on which tax is computed cannot be deemed. The Income Tax Act does not contain any general provision for imputing income in excess of what is actually earned or received by the assessee. The income received and computed as per the provisions of the Act has to be accepted by the revenue as the taxable income.

b) The income from development of integrated township, being business income, would be taxable under the provision of Chapter IV-D, comprising of sections 28 to 44DB. There are no specific provisions in chapter IV-D, which enable the revenue authorities to impute higher income to the assessee on the ground that transactions are entered into by the assessee at rates below the market value.

c) On the other hand there is a specific provision in this chapter, viz., section 40A(2)(a) which empowers the assessing officer to adopt fair market value in place of expenditure reflected by the assessee, if it is found that the assessee has made excessive or unreasonable payments as expenditure to specified related parties.

d) It is only in specific cases that the Act provides for the adoption of fair market value or similar value for the purpose determining the income. One can refer to sections 23, 50C, 80-IA(8), 80-IA(10) and section 92 in this regard. The provisions of section 80-IA(8) and 80-IA(10) have been incorporated by reference in various other sections including in sections 1OA, 80IB etc. These provisions are not attracted in the present case.

e) The courts have time and again taken the view that contractual values cannot be substituted with fair market values or other values in 51 ITA No. 2072/Hyd/2011

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genuine commercial transactions. He referred to the decision in the case of Sri Ramalinga Choodambikai Mills Ltd. v. CIT, [1955] 28 ITR 952 (Mad); CIT v. A. Raman & Co., [1968] 67 ITR 11 (Se); CIT v. Calcutta Discount Co. Ltd, [1973] 911TR 8 (SC); Das and Company v. CIT, [1962] 45 ITR 369 (Pat.), CIT v. Keshavlal Chandulal [1966] 59 ITR 120 (Guj), etc, in support of this proposition.

f) Assessees are entitled to arrange their affairs in a manner most beneficial to them. Just because some transactions, which are legal and enforceable, incidentally lead to reduction of taxes, they cannot be treated as sham transactions. As long as the transactions are genuine, the revenue authorities cannot interfere with the income or loss resulting from such transactions. The following observations of the hon'ble Supreme Court in the case of Union of India v. Azadi Bachao Andolan, [2003} 263 ITR 707 (Se) are pertinent in this context:

"We are unable to agree with the submission that an act which is otherwise valid in law can be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents."

g) The Supreme Court in S.A Builders Ltd. v. CIT (A), [2007] 288 ITR 1 (SCj, has defined the expression "commercial expediency" in the context of business expenditure in the following manner: "The expression 'commercial expediency' is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business. The expenditure may not have been incurred under any legal obligation yet it is allowable as a business expenditure if it was incurred on grounds of commercial expediency."

Extending the above principle in the context of income, one can hold that the decision to charge less or more is left to the discretion of the businessman. If business compulsions or commercial expediency is the basis for fixing of prices of services and consideration in other contracts, the same has to be respected even by revenue authorities. The revenue authorities cannot substitute its views to that of a business man. No businessman can be compelled to maximize his 52 ITA No. 2072/Hyd/2011

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profits. [S.A Builders Ltd. v. CIT (A) [2007] 288 ITR 1 (SC)]

16.8 He submitted that courts have held in various cases that the department cannot impute a notional income to an assessee, even if the consideration charged by an assessee for a transaction appears low to an assessing

officer. He referred to decision of the Supreme Court in CIT v. M Sivrammurthy and Raghu [1993} 204 ITR (St.) 5 (SC), Highways Construction Co. (P) Ltd. v. CIT, [1993} 199 ITR 702 (Gau), B and A Plantations & Industries Ltd. v. CIT, [2000} 242 ITR 22 (Gau.); Keshrichand Jaisukhlal v. CIT, [2001} 248 ITR 47 (Gau.) and in Development Investors Ltd. v. CIT, [1997} 223 ITR 432 (Gau), Cauvery Spinning and Wvg. Mills Ltd v DCIT [2012} 340 ITR 550 (Mad), CIT v Moni Kumar Subba [2011} 333 ITR 38 (Del), CIT v Asian Hotels Ltd [2010} 323 ITR 490 (Del), CIT v Govind Agencies P Ltd (2007) 295 ITR 290 (All), CIT v J Chelladurai 204 Taxman 258 (Mad) in support of the above position of law. In view of the above, the impugned addition of Rs. 18,06,75,000/- is to be deleted in entirety.

17. The ld. DR submitted with regard to disallowance of land cost relating to houses handed over to APHB on 500 LIG houses at Rs. 1,92,19,200 and with regard to disallowance of cost of construction of the houses handed over to APHB at Rs. 18,06,75,000 totalling at Rs. 19,98,94,200/- that this is the total cost incurred by the taxpayer on account of the project and the same can be allowed as deduction only when there is proper justification. This loss/expenditure/cost incurred should be for the purposes of its business. In case, there is certain portion unrealized because of stipulations of agreement, the same is to be examined. First of all, the assessee is to prove that it recovered only Rs. 400/- per sq. ft. towards sale or transfer of these 500 LIG houses. The onus is on the tax payer to prove that APHB also sold this property at Rs. 4OO per sq. ft. only. It cannot be ignored that APHB is one of the shareholders and hence, the profit cannot be diverted to the shareholder. The shareholder cannot be allowed to sell the flats at a higher price and appropriate the profits. Secondly, had the taxpayer sold the flats at a higher price and paid Rs.9 crores as per the agreement, the situation would be different as no loss would have arisen to the taxpayer. It is also to be 53 ITA No. 2072/Hyd/2011

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noted that had the taxpayer-sold it directly at Rs. 4OO/- and credited the sales account, the loss or the expenditure may have to be allowed. But, herein the expenditure is incurred for a specified person as per Sec.40A(2}(a)/(b) as per mutual consent and agreement concluded between the shareholders which is not binding on the taxpayer as it was not a party to the same. It is also to be seen that such agreement came into existence after 8 months of incorporation of the company. Agreement concluded for mutual convenience cannot be the basis for allowing such expenditure.

17.1 The DR submitted that real consideration received on account of 500 flats would be the correct consideration for the purpose of Income-tax. If one has not consider the real consideration received, it would be a case where profit is diverted to the shareholder by incurring loss in the hands of the company/tax payer and hence, disallowance is called for. The income is to be taxed on the correct hands He relied on the judgement in the case of Ramprasad vs. ITO (82 Taxmann 199) (All.) submitted that provisions of law such as 40A(2) etc. cannot be ignored and mutually convenient agreements concluded cannot gain precedence or importance over principles of law.

17.2 The DR submitted that the taxpayer cannot take the stand that it will not reveal or that it has no necessity to state at what rate APHB shareholders sold the flats. Nothing prevented the tax payer to sell directly and credit such consideration to its P&L account. The necessity to conclude this agreement after incorporation of the company and to sell the flats only through shareholder is not substantiated. The expenditure is in fact incurred for the business purpose of shareholder and not for taxpayer's business. The necessity to incur such loss is also not established. Then again, Sec. 40A(2)(a) arises in this case as APHB is a shareholder holding 49% of shares in the company. The excess expenditure is incurred for the specified person. Further, it also amounts to diversion of profit since the shareholder, APHB, can sell at a far higher than Rs.400/- and make

profit whereas the taxpayer incurs loss which is the quantum of addition made by the AO as disallowance. Moreover, already the incomes disclosed by taxpayer and APHB are pointed 54 ITA No. 2072/Hyd/2011

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out. The tax avoidance device is once again brought to light besides the legal issues. Hence. the contention of the assessee is to be rejected on both the above disallowances.

collectively

Findings with regard to Ground Nos. 5 and 6 collectively is given herein below:

below:

18. We have heard both the parties and perused the material on record. Ground No. 5 is with regard to addition of Rs. 1,92,19,200 made on account of land cost relating to land attributable to flats handed over to APHB. We have heard both the parties and perused the material on record. We find no merit in the argument of the learned counsel for the assessee. The land was not registered in favour of the assessee by APHB. The APHB is always the owner of the impugned land. There is no question of retransferring of the said land to APHB when the land itself is not registered in favour of the assessee and the cost of the land attributable to the flats handed over to APHB cannot be claimed as deduction in the hands of the assessee. This ground is rejected.

18.1 Ground No. 6 is with regard to disallowance of Rs. 18,06,75,000 towards cost of construction of houses handed over to APHB. On this issue also the Assessing Officer invoked the provisions of section 40A(2) of the Act. According to the Assessing Officer, the assessee has transferred the houses at lesser price. As held in the earlier paras with regard to disallowance incentive, the Assessing Officer is required to bring on record comparable cases having regard to the fair market value of the service rendered. The burden is on the Assessing Officer to bring on record the proof with regard to market value of the services rendered. If the assessee sold the houses at discounted price, that discount allowed cannot be considered as disallowance u/s. 40A(2) of the Act. The provisions of section 40A(2) pertain to disallowance of an expenditure which is made by the assessee, that it means an amount actually spent by the assessee and claimed in the Profit and Loss A/c. The expression used in this provision is "incurs any 55 ITA No. 2072/Hyd/2011

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expenditure in respect of which payment has been made or is to be made in person". This clearly shows that actually payment must be made and there has to be expenditure incurred before the provision can be said to be applicable. A trade discount, and admittedly it is not disputed that subject matter of the claim is a discounted price of offer and not an expenditure, clearly, therefore, does not arise the question of invoking the provisions of section 40A(2). Being so, the disallowance is not possible. This ground of the assessee is allowed.

19. Regarding disallowance of interest paid to IJMII (Ground No. 7.1), the AR submitted that interest paid to IJMII for delay in payment of contract bills has been disallowed for the reason that the construction agreement

dated 9.2.2004 does not provide for payment of interest. It is also concluded that the payment of interest is hit by the provisions of section 40A(2)(a) of the Act. The learned assessing officer has erred in not appreciating that the payment of interest was agreed to between the parties and the same was prompted out of business or commercial expediency. There was no evasion of tax since interest paid to IJMII was offered to tax by IJMII and the taxable income of IJMII was higher than the taxable income of the assessee. The interest was paid at prevalent bank rates. Even though the construction agreement did not provide for payment of interest, the same was later on agreed between the parties orally and later confirmed in writing. Even otherwise, contractual obligation is not necessary for incurring the expenditure. Expenditure incurred voluntarily out of business or commercial expediency is allowable under section 37. He placed reliance on the judgement in the case of CIT v. Associated Electrical Agencies 266 ITR 63 (Mad)] Tax was also deducted at paid in respect of the interest paid to IJMII. The said expenditure being wholly and exclusively incurred for the purpose of business and hence the same is allowable under section 37 of the Act. According to the AR disallowance of interest paid amounting to Rs. 2,21,95,301/- should be deleted in entirety.

20. With regard to disallowance of interest (Ground No. 7.1) paid to IJMII, the learned DR submitted that a perusal of the specific clauses of the 56 ITA No. 2072/Hyd/2011

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agreement show that such a clause is not incorporated therein. In fact, the taxpayer ought to have charged liquidated damages on delay in construction. It is also seen that on the mobilization advance given to the contractor-cum- shareholder, no interest is charged. The preferential treatment given to the contractor-cum-shareholder is not justified. Moreover, payments such as project management, incentive, etc., are also made to the contractor. There are four contracts concluded such as Construction Agreement, Project Management Agreement, Sales and Marketing Agreement & Technical Service Agreement and substantial amounts paid to shareholder M/s. IJMII. Hence, this ground of objection is also should be rejected.

20.1 The DR placed reliance is placed on the decision of the Tribunal Bench 'D' Mumbai (Special Bench) in ITA. No. 5792/Mum/2009 in the case of M/s Dalal Boracha Stock Broking Pvt. Ltd (2011)-TIOL-375-ITAT-Mum-SB. wherein it is held that when commission is paid to the director of the assessee company who hold all the shares of the company, disallowance is warranted on the ground that the commission was paid in lieu of the dividend to avoid tax on dividend. Application of Sec.40A(2) was also considered in the impugned decision. Disallowances made by the AO with regard to incentive fall within the purview of the findings given in this decision.

7.1:

Findings with regard to Ground No. 7.1:

21. We have heard both the parties and perused the material on record. This ground is with regard disallowance of interest paid to M/s. IJMII at Rs. 2,21,95,301. This payment was disallowed on the reason that as per the agreement dated 9.2.2004 the assessee is not required to pay interest to IJMII and also according to the Assessing Officer provisions of section 40A(2) are applicable to this payment. This expenditure has been actually incurred by the assessee for the purpose of its business. The payment of interest is not demonstrated by the Assessing Officer that it is paid in excess of the prevailing market rate and the assessee having incurred the expenditure wholly and exclusively for the purpose of business, the same is allowable in terms of section 37 of the Act. Accordingly, this ground of the assessee is allowed.

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22. Now we will take up the issue relating to transfer pricing.

23. The AR submitted with regard to adjustment under section 92CA and addition to income amounting to Rs. 38.34.39.486/- (Ground Nos. 8.1 to 8.9) as follows:

23.1 The assessee is a company created as a result of a joint venture between the Andhra Pradesh Housing Board (APHB) and IJM (India) Infrastructure Limited (hereinafter referred to as "IJMII). IJMII, an Indian Company is a subsidiary of IJM Corporation, Berhad (hereinafter along with its affiliates referred to as IJM Group or AE). IJMII and APHB hold shares of 51% and 49% respectively in the assessee.

23.2 During the year under consideration, the assessee had entered into international transactions with its Associated Enterprise (IJM Group). One of the international transaction consisted of provision of technical services by the AE to the assessee. The assessee paid a fee of Rs. 2,32,72,451/- for services rendered by its AE. The assessee reimbursed bank guarantee charges of Rs. 1,15,67,035/- and other expenses of Rs. 62,125 to its AE.

23.3 With respect to fess for technical services, the assessee adopted Transactional Net Margin Method (hereinafter referred as "TNMM" for short) to justify the price charged in the international transactions. After carrying out a methodical search process on Prowess and Capitaline database, the assessee selected 18 companies as comparables. Adopting operating profits to sales as the Profit Level Indicator (PLI), the arithmetic mean of comparables was computed at 8%. The budgeted PLI of the assessee was computed at 20%. Since the assessee's budgeted operating margin on sales was more than the arithmetic mean of comparables, the assessee concluded that its international transactions are at arm's length.

23.4 As the reimbursements reimbursement of bank guarantee charges and other expenses were made at cost, the assessee concluded that the same are at arm's length.

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23.5 In the order passed under section 92CA, the learned TPO rejected some of the comparables selected by the assessee and thereafter rejected the TP analysis.

23.6 During the year, apart from the transactions with the AE, the assessee entered in to transactions with IJMII. The TPO has held the following transactions entered into by the assessee with IJMII, as deemed international transactions u/s 92B(2) of the Act:

SI No. Nature of Transaction Amount (Rs.) 1 Project Execution Services 85,94,10,399 2 Project Management services 36,22,079 3 Reimbursement of Expenses 29,15,107 4 Incentives 18,59,85,000 Total 105,19,32,585

23.7 The TPO has held that the above transactions with IJMII are deemed international transactions u/s 92B(2). The TPO selected 25 companies as comparable and determined the average margins at 20.35%. The transfer pricing adjustment has been determined at Rs. 34,86,00,000/-

23.8 The TPO also proposed to perform a separate transfer pricing analysis in relation to fees for technical services paid by the assessee to its associated enterprises. The TPO adopted the Comparable Uncontrolled Price Method (hereinafter referred as "CUP method" for short) as the most appropriate method in place of TNMM selected by the assessee. The TPO determined the arm's length price of technical services fees paid by the assessee to its associated enterprises at NIL on the ground that the assessee has not received any benefit from it. Accordingly the TPO proposed transfer pricing adjustment of Rs. 2,32,72,452/-

23.9 The TPO determined the arm's length price of bank guarantee charges reimbursed by the assessee to its AE at NIL on the ground that the assessee has not furnished any documents/evidence to justify the payment of bank guarantee fee. Accordingly the TPO proposed transfer pricing adjustment of Rs. 1,15,67,035/-

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23.10 Based on all the above, the TPO proposed a transfer pricing adjustment of Rs. 38,34,39,486/- detailed as under:

TP Adjustment

SI No. Particulars

(INR)

1 Deemed international transactions 34,86,00,000 2 Fees paid towards technical services 2,32,72,451 3 Reimbursement of bank guarantee charges 1,15,67,035 Total 38,34,39,486

24. About the deemed international transactions, the learned AR submitted as follows;

24.1 The assessee is involved in the development of "Raintree Park" - an integrated township. IJMII is the EPC contractor for the project. For executing the Project, the assessee entered into transactions with IJMII, a company incorporated under the provisions of the Companies Act, 1956. IJMII rendered services like project management and project execution services to assist the assessee in the development of Raintree Park.

24.2 As already submitted the assessee is a joint venture company of APHB and IJMII. IJMII holds 51% of the share capital of the assessee. IJMII is a subsidiary of IJM Group. During the year, the assessee entered in to transactions with IJMII. The TPO has held that though the transactions are entered into by the assessee with IJMII, the terms of such transactions are determined in substance between the assessee and its associated enterprise (IJM Group). The TPO was of the view that though the associated enterprise (IJM Group) is not a party to the transaction, yet it has determined its essential terms. The TPO has held that as the terms of transaction, are fixed or dictated by the associated enterprise (IJM Group), the transactions cannot be said to have been entered into between the assessee and IJMII. The TPO thus held that in substance, the transaction is a deemed international transaction u/s 92B(2) of the Act.

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24.3 After considering the transactions with IJMII as deemed international transactions u/s 92B, the TPO has determined the transfer pricing adjustment at Rs.34,86,OO,OOO/-.

24.4 The AR submitted that the TPO has erred in concluding that the transactions between the-assessee and its holding company IJMII, are international transaction, under section 92B(2).

24.5 The scope of section 92B(2) is explained in CBDT circular No. 14 of 2001, dated 22.11.2001 with an illustration as under:

"55.8 Sub-section (2) of section 928 extends the scope of the definition of international transaction by providing that a transaction entered into with an unrelated person shall be deemed to be a transaction with an associated enterprise, if there exists a prior agreement in relation to the transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined by the associated enterprise. An illustration of such a transaction could be where the assessee, being an enterprise resident in India, exports goods to an unrelated person abroad, and there is a separate arrangement or agreement between the unrelated person and an associated enterprise which influences the price at which the goods are exported. In such a case the transaction with the unrelated enterprise will also be subject to transfer pricing regulations."

24.6 He submitted that it is clear from a reading of the CBDT circular that the transaction between an enterprise and an unrelated person should have been influenced by the associated enterprise of the first party having an arrangement or agreement with the unrelated party. The associated enterprise and the unrelated person can be said to have exercised influence over the transaction in question, if the terms of such transaction would have been different but for such influence. Therefore, where the associated enterprise and the unrelated person have not been able to influence the transaction between an enterprise and the unrelated person, section 92B(2) does not have any application.

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24.7 According to the AR, the nature, manner or extent of influence to be exercised to attract section 92B(2) is defined. It can take two forms. Firstly, it can be in the form of a prior agreement in relation to the transaction in question (between the associated enterprise and the unrelated person). Secondly, the terms of the transaction have to be in substance determined by the associate enterprise and the unrelated party.

24.8 He submitted that prior agreement means one which is independent of and prior in time in comparison to the transaction in question. The term "agreement" generally connotes a consensus ad idem, i.e., a meeting of minds to achieve a particular result. In the context of section 92B(2), the result sought to be achieved by the prior agreement must be avoidance of taxes or shifting of incomes. Otherwise, Chapter X becomes inapplicable. Such prior agreement would consequently be in the nature of an arrangement or an

understanding or an action in concert between the unrelated party and the associate enterprise, not meant to be in public domain and in most cases unwritten. Unless tainted with an object of avoiding taxes or shifting of incomes, an agreement in relation the transaction cannot be regarded as a prior agreement.

24.9 Further, the prior agreement has to be in relation to such transaction. The object of avoiding taxes under the prior agreement should be sought to be achieved by influencing the transaction between one party to such prior agreement and the associated enterprise of the other.

24.10 Even where there is no prior agreement, it is sufficient, if the unrelated person and the associated enterprise have in substance determined the terms of the transaction. The words "substance" means that which is essential and that which is used in opposition to 'form'. The word 'determined', which is derived from the word 'determine', means to fix the character by prescribing imperatively or laying down decisively or authoritatively.

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24.11 The second type of influence will arise if the associate enterprise and the unrelated party are able to jointly and imperatively prescribe or fix the essence of the character of the transaction in question. In other words, the Indian entity will not have an opportunity of determining the substance of the transaction as per its volition. The Indian entity will have to yield itself to the influence of its associate enterprise and the unrelated party.

24.12 In the present case, IJMII has acted as EPC contractor of the assessee. The contract was granted by the assessee to IJMII. The TPO has not demonstrated as to how the IJM Group has in substance determined the essential terms of contract.

24.13 According to the AR, the preconditions to attract section 92B(2) have not been satisfied in the instant case. It cannot therefore be deemed that the transaction between the assessee and IJMII is one between associated enterprises. Therefore, the basic condition for the existence of an international transaction is not satisfied.

24.14 As already detailed, a condition that is required to be satisfied for a transaction to constitute an international transaction is that at least one among the associated enterprise should be a non-resident. Both the assessee and IJMII are residents for the purpose of Indian taxation, as they are Indian companies. Any transaction between them will not constitute an international transaction. Thus the second condition for attracting section 928(1) is not satisfied.

24.15 Circular No. 14 of 2001 explaining the scope of section 928(2) considers an illustration. The illustration deals with an Indian company exporting goods to an unrelated person abroad. A separate arrangement between the unrelated person and the AE influences the prices at which the assessee in India exports goods. In such circumstances the Circular contends that the transaction between the assessee in India and the unrelated entity abroad would be governed by transfer pricing provisions. The "unrelated entity" in the illustration is stated to be abroad obviously for the reason that it 63 ITA No. 2072/Hyd/2011

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has to be a non-resident. Only then, the basic premise of the transaction being subject to transfer pricing provisions would suffice. In the assessee's case, IJMII is not situated abroad. Going by the rationale of the Circular, the transactions between the assessee and IJMII cannot be deemed to be an international transaction.

24.16 The above can also be understood through the diagrammatic illustration below:

Facts matrix in the illustration provided in the CBDT Circular

Associated Intermediary Enterprises

Overseas

India

Would be an international

Indian Entry transaction, if section 92B(2) satisfied, the unrelated

intermediary being abroad.

Facts matrix in the present case

Associated

Enterprises Overseas

India Indian Entry Intermediary

Would not be an international transaction even

if section 92B(2) satisfied, as unrelated

intermediary (if IJMII can be so called) is not

abroad. the unrelated intermediary being

24.17 To summarize, whether an international transaction emerges under various permutations and combinations of transactions between residents and non residents is tabulated herein below:

S. Party 1 to a Party 2 to a International No. Transaction Transaction Transaction? 1 Resident Non-Resident Yes 2 Non- Resident Resident Yes 3 Non-Resident Non- Resident Yes 4 Resident Resident No 64 ITA No. 2072/Hyd/2011

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24.18 The transactions between the assessee and IJMII fall under item 4 above. Consequently, the transaction between the assessee and IJMII does not constitute an international transaction. The transfer pricing provisions of Chapter X are therefore not attracted.

24.19 According to the AR, the DRP has agreed with the above contention. The DRP has held that the conclusion of the TPO of applying the transfer pricing provisions to the impugned transaction is not correct. However, the DRP declined to interfere by observing as follows:

"The TPO has concluded that the profits are shifted out of the country by the foreign entities (lM Corp and /JM Properties) by creating /JMII as a conduit. Inasmuch as the foreign holding companies have invested in India, they are entitled to the returns on their investments subject to the laws of the land. In this case, when the returns are paid abroad, they become subject to the provisions of TP and examined for their reasonableness. Hence, we are of the opinion that this conclusion of the TPO is not correct.

Still it is a novel issue involving correct interpretation of the legal provisions. It is the stand of the TPO that subsection (2) of s. 928 expands the scope of definition of International Transaction. The position to be adopted is amenable to different interpretations. For any decision taken at this level, the Department does not have recourse to any remedy. Hence, to keep the issue alive, we don't interfere with the determination of the TPO".

24.20 The AR submitted that the learned TPO has erroneously exercised jurisdiction and examined the transactions between the assessee and IJMII under transfer pricing regulations. The transactions between the assessee and IJMII are domestic transactions and not international transactions.

24.21 He submitted that in the case of DIT (International Taxation) vs Morgan Stanley (292 ITR 416), the Honourable Supreme Court observed that "The object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India". The explanatory circular No.14 to the Finance Act 2001 has stated that the basic intention of the transfer pricing 65 ITA No. 2072/Hyd/2011

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regulations is to prevent shifting profits out of India by manipulating prices charged or paid in international transactions, thereby eroding the country's tax base. The relevant extracts of the said circular are as below:

"The new provision is intended to ensure that profits taxable in India are not understated (or losses are not overstated) by declaring lower receipts or higher outgoings than those which would have been declared by persons entering into similar transactions with unrelated parties in the same or similar circumstances. The basic intention underlying the new transfer pricing regulations is to prevent shifting out of profits by manipulating prices charged or paid in international transactions, hereby eroding the country's tax base. The new section 92 is, therefore, not intended to be applied in cases where the adoption of the arm's length price determined under the regulations would result in a decrease in the overall tax incidence in India in respect of the parties involved in the international transaction".

24.22 The AR submitted that in the present case the transactions are between two resident companies. There is no possibility of shifting of profits outside India or erosion of country's tax base. Therefore its transactions with IJMII are outside the purview of the transfer pricing regulations.

24.23 The AR reiterates that transfer pricing provisions are not applicable to transactions between two domestic related parties. The transfer pricing regulations have been specifically been made applicable to transactions between two domestic related parties by virtue of the amendment through Finance Act, 2012. In case, the existing provisions were applicable to domestic transactions then there was no need to bring about the for the above amendment.

24.24 Based on all the above the AR submitted that the TPO has erred in regarding the transactions between the assessee and its holding company IJMII, as international transaction and applying transfer pricing regulations. The addition being bad in law is liable to be rejected. 66 ITA No. 2072/Hyd/2011

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24.25 Without prejudice to the above, the AR submitted that the learned TPO has erred in rejecting certain comparables selected by it and instead selecting inappropriate comparables.

24.26 The search process adopted by the learned TPO for selecting comparable companies is as follows (page 16 and 17 of the TP order):

- Companies whose data is not available for the FY 2006-07 were excluded.

- Companies having different financial year ending (i.e., not March, 2007) or data of the companies does not fall within twelve months period i.e 01.04.2006 to 31.03.2007 were rejected

- Companies having sales less than Rs 1. Crore were rejected

- Companies having no segmental results were excluded

- Companies which are functionally different were excluded

- Companies having related party transactions more than 25% were excluded

24.27 After applying the above filters, the learned TPO selected 25 companies as comparables. The arithmetic mean of the margins of the comparables was determined at 20.35% on cost.

24.28 The AR submitted that the following comparables selected by the TPO deserves be rejected:

Filter under

Sl. Name of the which company

Reasons for rejection

No. company should be

rejected

1. Radhe Functionally The assessee submits that this company is Developers different engaged in the development activity (on Ltd. behalf of others) based on contract for each of the projects as against the

assessee which is engaged in development

as well as sale of residential and

commercial units. Thus this company

deserves to be rejected as a comparable.

2. IndeGraniti- No segmental As per the Prowess database, during the Inds. Ltd. results year under consideration the total sales of available. this company is Rs. 3.56 crores. Out of this revenue from sale of flats was Rs.

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1.27 crores. Segmental details of

construction and sale of flats is not

available and thus this company should be

rejected as comparable.

3. Marg Related party As per annual report of the company for FY Constructions transactions 2006-07, total revenue during the year is Ltd. more than 25% Rs. 1418.45 Million. Out of this, revenue from the related parties amounts to Rs.

1,348 Million. The revenue from related

parties amounts to 95% of total revenues

of the company and, therefore, this

company should be rejected as

comparable.

24.29 The AR further submitted that there is error in margin computation of K Raheja Pvt Ltd. The learned TPO has computed the margin of this company at 47.76%. As per segmental information available under Notes to Accounts of the company, this company operates in three segments namely i) Real Estate; ii) Hotels; and iii) others. Based on the segmental results of Real Estate segment, the margin of this company is 29.30%. The margin computation is as below:-

Particulars Amount (Rs.)

Total Revenue 5,405,405,135

Operating Profits 1,584,016,817

Operating Profits/ Sales 29.30%

The AR submitted that margin of 29.30% should be considered for computation of arm's length price.

24.30 Based on all the above, the AR has tabulated below, a list of comparables and their operating margin, out of the TPO's comparables.

SI No Name of the comparable OP/Sales(%) 1 Patel Projects Ltd 1.41 2 Jogani Constructions 8.22 3 Maruti Infra 5.66 4 Rajeshwari Foundations 12.96 5 Rainbow Foundations (Seg) 10.34 6 Rajeshwari Infra 7.92 7 East Buildtech Ltd 16.90 8 Raghava Estates 12.13 9 Manjeera Constructions Ltd 25.42 10 ISRaheja Pvt Ltd 29.30 68 ITA No. 2072/Hyd/2011

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11 TirupatiSarjan 4.62 12 Luxmi Township 8.55 13 SAB Industries (Seg) 16.10 14 CHD Developers (Seg) 27.20 15 Alpine Housing 20.27 16 Prince Found 30.75 17 Aristo Realty Developers 38.53 18 Vijay ShanthiBuilers Ltd 14.44 19 Ansal Housing 33.67 20 Parshvnath Land 20.18 21 Parshvanath Landmark Developers Ltd. 24.00 22 HDIL 33.91 Arithmetic Mean 18.29

24.31 To benchmark the international transactions, the assessee had performed the transfer pricing study. In the transfer pricing study, the assessee had adopted 18 companies as comparables. The learned TPO has rejected certain comparables selected by the assessee. The AR submitted that such a rejection is bad in law for the reasons stated below:-

Sl. Name of the Reason for

Arguments of the assessee

No. company rejection by TPO

1. Ansal No segmental As per data available no Capitaline database, Buildwell Ltd. results. this company has only one segment i.e., Real Estate and construction business.

2 Ansal No segmental As per data available in Capitaline database this Properties and results company has only one segment i.e., Real Estate Infrastructure Development Ltd.

3 Ashiana No segmental In the facts of the case, Foreign exchange Housing & results and revenue filter is not applicable. Even TPO has Finance foreign exchange not applied forex revenue filter in his TP (India) Ltd revenue is zero analysis. As per data available in Prowess database, 97% of the revenue of the company

is from construction and sale of residential

buildings.

4 Conart No segmental In the facts of the case, Foreign exchange Engineers Ltd results and revenue filter is not applicable. Even TPO has foreign exchange not applied forex revenue filter in his TP revenue is zero

analysis. As per data available in Prowess database 100% of the revenue of the company

is from construction and sale of residential

buildings.

5 Kamwala Foreign exchange In the facts of the case, Foreign exchange Housing revenue is zero revenue filter is not applicable. Even TPO has Constructions not applied forex revenue filter in his TP Ltd analysis.

6 Martin Burn Foreign exchange In the facts of the case, Foreign exchange Ltd revenue is zero revenue filter is not applicable. Even TPO has not applied forex revenue filter in his TP

analysis.

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7 Tribhuvan Foreign exchange In the facts of the case, Foreign exchange Housing Ltd revenue is zero revenue filter is not applicable. Even TPO has not applied forex revenue filter in his TP

analysis.

8 Vipul Ltd Related part As per data available in Capitaline database transactions related party transactions are less than 25% of sales.

9 Sobha Foreign exchange In the facts of the case, Foreign exchange Developers revenue is zero revenue filter is not applicable. Even TPO has Ltd and no segmental not applied forex revenue filter in his TP results. analysis. Further as per page 65 of the annual report of the company it has only one segment.

It is mainly engaged in the business of

development and construction of properties.

24.32 The AR submitted that above 9 companies should be retained as comparables while computing arm's length price.

24.33 Based on all the above, the AR has tabulated below, a list of comparables and their operating margin, out of the TPO's comparables and after including the assessee's comparable as above.

SL No Name of the comparable OP/Sales (%) 1 Ansal Buildwell Ltd 7.00 2 Ansal Properties and Infrastructure Ltd 15.00 3 Ashiana Housing and Finance (India) Ltd 3.00 4 Conart Engineers Ltd 6.00 5 Kamwala Housing Construction Ltd 8.00 6 Martin Burn Ltd 8.00 7 Tribhuvan Housing Ltd 2.00 8 Vipul Ltd 8.00 9 Sobha Developers Ltd 14.00 10 Patel Projects Ltd 1.41 11 Jogani Constructions 8.22 12 Maruti Infra 5.66 13 Rajeshwari Foundations 12.96 14 Rainbow Foundations (Seg) 10.34 15 Rajeshwari Infra 7.92 16 East Buildtech Ltd 16.90 17 Raghava Estates 12.13 18 Manjeera Constructions Ltd 25.42 19 K. Raheja Pvt Ltd 29.30 20 TirupatiSarjan 4.62 21 Luxmi Township 8.55 22 SAB Industries (Seg) 16.10 23 CHD Developers (Seg) 27.20 24 Alpine Housing 20.27 25 Prince Found 30.75 26 Aristo Realty Developers 38.53 70 ITA No.

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27 Vijay Shanthi Builers Ltd 14.44 28 Ansal Housing 33.67 29 Parshvnath Land 20.18 30 Parshvanath Landmark Developers Ltd 24.00 31 HDIL 33.91 Arithmetic Mean 15.27

24.34 The learned TPO has determined the TP adjustment at Rs. 34,86,00,000. While determining the TP adjustment, the learned TPO has considered an operating cost at Rs. 1,86,35,01,499/-. The operating revenue has been considered at Rs. 1,90,20,00,000/-.

24.35 In the order passed u/s 92CA, the TPO has determined the arm's length price of the following transactions as NIL.

SL No. Nature of Payment disallowed Amt (Rs.) 1 Fee for Technical Services 2,32,72,451 Reimbursement of Bank Guarantee

2 Charges 1,15,67,035 Total 3,48,39,486

24.36 Further, during the course of proceedings under section 143(3) of the Act, the learned Assessing Officer has disallowed following payments:-

Sl.

Nature of Payment disallowed Amt. (Rs.) No.

1 Disallowance on account of re-computation of cost of 13,43,96,800 land transferred

2 Disallowance of incentive paid 18,59,85,000 3 Disallowance of interest payment 55,77,852 4 Disallowance of delay in handling over chargbes 7,74,36,597 5 Disallowance of land cost attributable to land sold by 1,92,19,200 APHB on 500 LIG Houses

6 Disallowance of cost of construction 18,06,75,000 7 Disallowance of interest to IJM 2,21,95,301 Total 62,54,85,750

24.37 Without prejudice to the AR contention that the determination of ALP at Nil by the TPO and disallowance of above payments by the AO are bad in law and without basis, the AR submitted that if the above payments are disallowed, then these amounts should be reduced from 71 ITA No. 2072/Hyd/2011

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the Operating Cost of the assessee while making TP Adjustment u/s 92C of the Act.

24.38 In this regard, the AR relied on the decision of Tribunal, Delhi Bench in the case of Hawarth (India) Pvt Ltd v DCIT - (2011) 11 Taxmann.com 76(Delhi). In this case, the assessee had suo moto disallowed commission payment of Rs. 1,32,09,105/- made to local dealers for assistance in procuring order for the products of assessee's associated enterprises from the Indian customers. The disallowance was also confirmed by the AO. However, while computing the operating cost of the assessee the learned TPO also considered commission payment of Rs. 1,32,09,105/-. The AR contended that as the commission payment has been disallowed the same should be excluded from the Operating Cost to avoid double taxation. On appeal the Tribunal upheld the claim of the assessee. The relevant observations of the Tribunal are as under:-

"66. It can be seen from the above table that the major component of receipt of international transaction of the assessee is commission income as it constitute Rs. 15,39,33,769 of the total operating income of Rs. 17,73,98,197. Therefore, it cannot be said that commission expenses which have been suo moto disallowed by the assessee were not claimed as operating expenses while computing the arm length price. If they are subsequently disallowed suo moto by the assessee in the revised return, they are required to be excluded from the operating cost and the calculation of the assessee should have been accepted that its profit margin should have been taken according to the income computed in the revise return for which the assessee has also paid the due taxes. In this manner, finding force in the contentions of Id. AR, we are of the opinion that ground No. 2 of the assessee is to be allowed and accordingly allowed. Ground No. 3 is the alternative argument and as the main argument of the assessee is accepted we need not required to go in the alternative claim made by the assessee."

24.39 Based on the above, the AR submitted that the above amounts should be excluded from the operating cost of the assessee. The revised operating cost of the assessee would be as follows :-

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Particulars Amount in INR

Operating Cost as considered by the TPO 186,35,01,499 Less: Payments disallowed by the TPO 3,48,39,486 Less: Payments disallowed by the AO 62,54,85,750 Revised Operating Cost 120,31,76,263

24.40 The revised Operating Margins of the assessee after considering the above Operating Cost would be as under:

Particulars Amount in INR

Operating Revenues 1,90,20,00,000 Operating Expenses 1,20,31,76,263 Net Profit 69,88,23,737 Operating profit/Operating cost 36.74%

24.41 Based on the above, the AR submitted that its operating margin of 36.74% is more than the arithmetic mean of comparable companies under both the above Tables. Therefore no adjustment is required to be made to the reported values of the assessee's transactions with its associated enterprises.

24.42 Without prejudice to the above submissions, the AR submitted that TP adjustment, if any should be restricted to AE transactions only. During the year under consideration, the assessee had transactions with both AE as well as non-AE. The total cost debited to profit and loss account was Rs. 1,906,260,711/-. Out of

this cost related to transactions with AE is Rs. 1,075,205,036/- (Rs. 1,051,932,585+23,272,451) which constitutes 56.40% of total cost. Accordingly, these transactions alone are the subject matter of transfer pricing assessment under Chapter X of the Income Tax Act. The TPO cannot make an adjustment to the price or margin of the transactions with non-associated enterprises. The learned TPO in the Order passed has not restricted the transfer pricing adjustment only to transactions with Associated Enterprises.

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24.43 The AR submitted that the TP adjustment, if any should be restricted to AE transactions alone. The transactions with non-AE are not international transactions. It is only with reference to the transactions with related parties (AE) it could be alleged that the prices are "manipulated" to result in a fight of profit from India. It is sonly such "fight" of profits that needs correction.

24.44 The AR contended that the TP adjustment should be restricted to only transactions with the AE is supported by various judicial precedents. He submitted that The Mumbai Tribunal in the case of DCIT v Sterlite ITA No. 2279/MUM/06 has observed as follows:

"We also agree with the arguments of learned counsel for the assessee that adjustments, if any, arising due to computation of ALP should be restricted only to the international transactions and not to the entire turnover of the assessee company. No addition can be made to Local transactions under Chapter X of the Act."

24.45 He submitted that a similar conclusion was arrived at by the Mumbai Tribunal in case of IL Jin Electronics (L) Pvt Ltd V ACIT 2010-TIOL-151-ITAT- MUM. In this case, the assessee was engaged in the manufacture of printed circuit boards. Out of the total purchase, 45.51% was from associated enterprises. On these facts, the Tribunal held that adjustment can be made only to the extent of 45.51% of the turnover. The relevant observation of the Tribunal in para 15 of the judgment is as follows:

"After considering the facts of the case, we do not find any difficulty in accepting this contention of the assessee that at best only 45.51% of the operating profit can be attributed to imported raw material acquired from assessee's associate concerns."

24.46 He also submitted that a similar conclusion has been reached by the Mumbai Tribunal in the case of ACIT v T Two International Private Limited 2010-TOIL-166-ITAT-MUM. In this case, assessee had controlled sales of Rs. 25.02 crores and uncontrolled sales of Rs. 64.49 crores. The TPO made adjustment for all the transactions. The CIT(A) upheld the assessee's 74 ITA No. 2072/Hyd/2011

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contention that adjustment should only be with respect to AE transactions. On this matter, ITAT observed as follows:

"We have considered the rival submissions carefully. We partially agree with the submissions of the Id. Counsel for the assessee that original TPO's order if definitely erroneous because he has applied the net profit margin of 7.25% on the gross sales and followed a complicated procedure to arrive at the amount of adjustment. In simple terms if the sales to Associated Enterprises is taken at Rs. 25 crores and straightway 7.25% margin is applied then approximately total margin would be Rs. 1.81 crores, whereas adjustment has been made at Rs. 2,57,26,138/-"

24.47 He also submitted that the Delhi Tribunal in the case of Global Vantedge Private Limited (2010-TOIL-24-ITAT-DEL) upheld the following observations made in the CIT(A) order:

"In view of the above discussions, I hold that while applying the TNMM to determine ALP, the revenue earned by the assessee from servicing the independent clients, without any involvement of RCS should not be benchmarked. The proportionate (18.14%) attributable to such revenue should be ignored while computing ALP of the international transactions."

24.48 Further he placed reliance on the following decisions of the Tribunal:

1. DCIT v Startex Networks (India) Pvt Ltd 2010-TIL-13-ITAT-DEL-TP;

2. ACIT v Wockhardt Ltd (6 Taxman.com 78 (Mum - ITAT));

3. Ad. CIT v Tejdiam (2010-TIL-27-ITAT-MUM-TP);

4. Abhishek Auto Industries Limited (2010-TIL-54-ITAT-DEL-TP); and

5. Ankit Diamonds 43 SOT 523 (Mum)

6. M/s Genisys Integrated Systems (India) Pvt. Ltd v DCIT ITA No. 1231/Bang/2010

24.49 Based on all the above, the AR submitted that the TP adjustment, if at all should be restricted to transactions with the AE only.

25. Regarding the issue on Fees for Technical services, the learned AR submitted as follows:

25.1 During the year under consideration, the AE rendered technical services to the assessee. These services were rendered based on Technical 75 ITA No. 2072/Hyd/2011

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Services Agreement between the assessee and its AE. The assessee's AE rendered Project Management Services and Design and Technical Services to the assessee. The assessee paid technical services fee of Rs. 2,32,72,451/- for services rendered by its AE.

25.2 The assessee adopted TNMM to justify the price charged in the international transactions. After carrying out a methodical search process on Prowess and Capitaline database, the assessee selected 18 companies as comparables. Adopting operating profits to sales as the Profit Level Indicator (PLI), the arithmetic mean of comparables was computed at 8%. The Budgeted PLI of the assessee was computed at 20%. Since the assessee's operating margin on sales was more that the arithmetic mean of comparables, the assessee

concluded that its international transactions are at arm's length.

25.3 The TPO proposed to perform a separate transfer pricing analysis in relation to fees for technical services paid by the assessee to its associated enterprises. The TPO adopted the CUP method as most appropriate method instead of TNMM. The learned TPO held that these transactions constitute a separate class of transactions and the Act does not preclude the TPO from applying an appropriate method for each class of transactions like technical services fee and apart from applying TNMM at the enterprise level. The TPO has determined arm's length price of technical services fees paid by the assessee to its associated enterprises at NIL. Accordingly the TPO, has made transfer pricing adjustment of Rs. 2,32,72,452/-.

25.4 The learned TPO has made following arguments in determining the arm's length price of the technical services as NIL:

- The assessee has not produced any evidence in support of technical services for which payment is made;

- The assessee has not been able to show that it derived any economic benefit from the technical services rendered by its AE. 76 ITA No. 2072/Hyd/2011

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25.5 The AR submitted that under the transfer pricing methodology, either a price or margin is tested. Price is tested in case of CUP Method. Margin is tested in case of other methods. Once the margin is tested and held to be at arm's length, it pre-supposes that the various components of income and expenditure that have been considered in the process of arriving at the Net Profit are also at arms length. A satisfaction of margins being at arm's length cannot be re-evaluated / re-examined. Price or margins are alternative. They are not to be cumulatively satisfied. The law does not envisage a successive application of the price or margin theory with the objective of finally settling down at a revenue favouring result. On the contrary, if on either parameter, an assessee favouring result emerges, it would preclude the TPO from proposing an adjustment to the results as disclosed by the assessee.

25.6 In the process of adopting the TNMM, the assessee adopted the Net Profit as the starting point. In arriving at this net profit, the assessee had factored the fees for technical services paid to AE. Once the net profit margin is demonstrated to be at arms length, it pre-supposes that the various components of income and expenditure that have been considered in the process of arriving at the Net Profit are also at arms length. The operating margins as computed by the assessee were demonstrated to be at arm's length and therefore fees for technical services paid by the assessee cannot be separately tested.

25.7 The AR submitted that the above is also supported by the decision of the Tribunal, Delhi Bench in the case of McCann Erikson India Pvt Ltd vs. ACIT - ITA No.5871/Del/2011.

25.8 In this case the assessee company was engaged in the business of advertising and allied services. During the year, the assessee had several international transactions including payment of management fees (Rs.36,293,148) and coordination cost (3,958,838) to its AE. The assessee applied the Transactional Net Margin Method ('TNMM') to confirm the arm's length pricing of all its international transactions. However the TPO held that the assessee has not demonstrated that it has derived any economic benefit 77 ITA No. 2072/Hyd/2011

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from payment of management fees and coordination cost. Accordingly ALP of these payments were computed as 'NIL' by adopting CUP method. The assessee filed objections before DRP who allowed partial relief to the assessee. On appeal to the Tribunal, the issue was decided in the favour of the assessee. The relevant observations of the Tribunal extracted below:-

"9. We have heard both sides and have also gone through the orders of the AO, TPO and DRP. We have also perused the relevant evidences filed before the authorities below. The DRP has allowed part relief to the assessee. The assessee had placed evidences in respect of the management service charges and client coordination fee on record. The chart at pages 18 to 26 of this order which is part of assessee's argument establishes the nature of service provided by AE and received by assessee. Benefits derived by the assessee are also narrated to this chart. In our considered view, the Revenue had not brought out anything for negating any content of this chart of services and benefits derived thereof. The assessee company has disclosed net margin for 26% as against 8% average of the comparable other companies at entity level. The assessee is engaged in one class of business that is advertising and its allied services. In the business of the assessee, there are no segments or different activities which can be said independent of each other. In our considered view, the entity level benchmarking on TNMM method shall be most appropriate for all international transactions with AE. ....."

25.9 He submitted that even the DRP has agreed that once enterprise level margin is determined using TNMM method, making additional adjustments for individual international transactions would lead to double adjustment to the income of the assessee and hence not justified. The relevant observations of the DRP on page 31 of the order is are as follows:

"Beside the test of benefits received, the issue is raising the question whether additional adjustments for individual international transactions can be carried out once the enterprise level profit adjustment is made using TNMM method. While the TPO believes it can be done, we are of the opinion that it would lead to double adjustments to the income of the assessee and hence, not justified. The position to be adopted is amenable to different interpretations. For any decision taken at this level, the Department does not have recourse to any remedy. Hence, to keep the issue alive, we do not interfere with the determination of the TPO"; 78 ITA No. 2072/Hyd/2011

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25.10 The addition proposed by the TPO and given effect by the AO on this count is therefore to be deleted.

25.11 The learned TPO had alleged that the assessee has not produced any evidence to show any economic benefit received by it. Further, the learned TPO has stated that there is no evidence to show that the assessee has actually received any technical services during the year. Therefore he has determined the arm's length price of technical services fee paid by the assessee at NIL.

25.12 The AR submitted that the TPO's contention that it has not received any technical services is without basis. The assessee submits that it has entered in to Technical Services Agreement with its AE for receipt of technical services which will assist the assessee in development of Rain Tree Park. As per the Agreement the AE has to provide the following technical services to the assessee:

a) Engineering and construction technology services in respect of drawings, designs, maps, sketches, and for all civil/construction related methods practices and matters.

b) To render all the required technical and engineering assistance and advice in the execution of the project according to the standards specifications and technology in accordance with existing building by laws and any other standards.

c) To advice on quality control aspects with a view to assisting the company to execute the project in accordance with specifications, standards and quality, as stipulated under the main contract Agreement.

d) To advice on matters concerning procurement of superior quality construction materials, aggregates and construction plant, machinery and equipment to be used in or engaged for the project.

e) To render technical assistance and advices in connection with operation and maintenance of construction plant, machinery and equipment used in the execution of project as well as on systems and procedures for safe, efficient and optimum use thereof.

f) To advice on strategies, plans and schedules for proper execution of 79 ITA No. 2072/Hyd/2011

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project in accordance with the time schedules as specified by the company.

g) To advice on appropriate safely measures to be implemented while executing the project.

h) To advice on the cost and budgetary control aspect of execution of the project.

i) To generally act as technical consults and advisors to the project, from time to time, including rendering of technical advices, opinions interpretation of technical and engineering data, planning and review of work schedules, programmes and formulating strategies.

25.13 The AR submitted that it has received the above technical services during the year and has derived adequate benefit from it. This is demonstrated by the following:

â ¢ The assessee is engaged in development and construction of integrated township. The design for the township was prepared by the Architects from Singapore. Without their support, the assessee could not have completed the project.

â ¢ The Government of Andhra Pradesh actively participates in functioning of the assessee. In view of active participation of Government of Andhra Pradesh it cannot be said that the assessee would have paid the fees to AE without receiving services.

â ¢ Documents designed and drafted by the AE is an evidence to the fact that the AE has provided services to the assessee. Reference is made to page no.43 to 112 of paper book volume 'A' wherein sample documents designed and drafted by the AE is attached.

25.14 Based on the above, the AR submitted that it has received the services and has derived adequate benefit from it.

25.15 The AR submitted that the TPO cannot ignore the Agreement entered by it and cannot question its commercial decision. The AR invited our attention to the decision of Tribunal, Mumbai Bench in the case of Dresser- Rand India Pvt. Ltd v ACIT ITA No.8753/Mum/2010, wherein the Tribunal was concerned with payment of Rs. 10.055 crores to the associated enterprise towards cost contribution agreement. The assessee had received various services like legal services, treasury services, technical support services etc. 80 ITA No. 2072/Hyd/2011

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The TPO computed the ALP for these services at NIL on the ground that no real services were received by the assessee and it had not received any benefit under the cost contribution arrangement. On appeal, the Tribunal deleted the above addition made by TPO. The relevant observations of the Tribunal in this connection are as follows:

"8. We find that the basic reason of the Transfer Pricing Officer's determination of ALP of the services received under cost contribution arrangement as 'NIL' is his perception that the assessee did not need these services at all, as the assessee had sufficient experts of his own who were competent enough to do this work. For example, the Transfer Pricing Officer had pointed out that the assessee has qualified accounting staff which could have handles the audit work and in any case the assessee had paid audit fees to external firm. Similarly, the Transfer Pricing Officer was of the view that the assessee had management experts on its rolls, and, therefore, global business oversight services were not needed. It is difficult to understand, much less approve, this line of reasoning. It is only elementary that how an assessee conducts his business is entirely his prerogative and it is not for the revenue authorities to decide what is necessary for an assessee and what is not. An assessee may have any number of qualified accountants and management experts on his rolls, and yet he may decide to engage services of outside experts for auditing and management consultancy; it is not for the revenue officers to question assessee's wisdom in doing so. The Transfer Pricing Officer was not only going much beyond his powers in questioning commercial wisdom of assessee's decision to take benefit of expertise of Dresser Rand US, but also beyond the powers of the Assessing Officer. We do not approve this approach of the revenue authorities. We have further noticed that the Transfer Pricing Officer has made several observations to the effect that, as evident from the analysis of financial performance, the assessee did not benefit, in terms of financial results, from these services. This analysis is also completely irrelevant, because whether a particular expense on services received actually benefits an assessee in monetary terms or not even a consideration for its being allowed as a deduction in computation of income, and, by no stretch of logic, it can have any role in determining arm's length price of that service. When evaluating the arm's length price of a service, it is wholly irrelevant as to whether the assessee benefits from it or not; the real question which is to be determined in such cases is whether the price of this service is what an independent enterprise would have paid for 81 ITA No. 2072/Hyd/2011

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the same. Similarly, whether the AE gave the same services to the assessee in the preceding years without any consideration or not is also irrelevant. The AE may have given the same service on gratuitous basis in the earlier period, but that does not mean that arm's length price of these services is 'nil'. The authorities below have been swayed by the considerations which are not at all relevant in the context of determining the arm's

length price of the costs incurred by the assessee in cost contribution arrangement."

25.16 The Tribunal, after going through the documents filed by the assessee, concluded that the assessee has received the services and deleted the addition. In the assessee's case also, it has demonstrated that it has received services and therefore the addition made by the TPO is to be deleted.

25.17 The AR also invited our attention to Tribunal Decision in the case of DVIT v Ekla Appliances ITA No. 3895, 421 & 4333/DEL/2010. In this case, the learned TPO assessed the arm's length price of royalty payment NIL on the ground that assessee has not benefited from the technical know-how received from AE. On appeal, the CIT(A) held that royalty payment was incurred from genuine business purpose and deleted the addition on the following grounds:

â ¢ The royalty payment was approved by the Government of India.

â ¢ The losses incurred by the assessee were due to various internal and external factors.

â ¢ The turnover increased and losses came down after acquisition of the technology.

â ¢ The TPO had completely disregarded business and commercial strategy/realities behind the transaction and acted in a completely mechanical manner without regard to the economic circumstances surrounding the transaction and business decision taken by the assessee.

25.18 On appeal by Income Tax Department, the Tribunal upheld the findings of CIT(A).

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25.19 The Tribunal decision has been confirmed by the Honourable High Court of Delhi in ITA No. 1068/2011 & ITA No. 1070/2011. The Honourable High Court after discussing the applicable rules, OECD guidelines and decisions of various courts made the following observations:

"21. The position emerging from the above decisions is that it is not necessary for the assessee to show that any legitimate expenditure incurred by him was also incurred out of necessity. It is also not necessary for the assessee to show that any expenditure incurred by him for the purpose of business carried on by him was actually resulted in profit or income either in the same year or in any of the subsequent years. The only condition is that the expenditure should have been incurred "wholly and exclusively" for the purpose of business and nothing more. It is this principle that inter alia finds expression in the OECD guidelines, in the paragraphs which we have quoted above.

22. Even Rule 10B(1)(a) does not authorize disallowance of any expenditure on the ground that it was necessary or prudent for the assessee to have incurred the same or that in the view of the Revenue the expenditure was unremunerative or that in view of the continued losses suffered by the assessee in his business, he could have feared better had he not incurred such expenditure. These are irrelevant considerations for the purpose of Rule 10B. Whether or not to enter into the transaction is for the assessee to decide. The quantum of expenditure can no doubt be examined by the TPO as per law but in judging the allowability thereof as business expenditure, he has no authority to disallow the entire expenditure or a part thereof on the ground that the assessee has suffered continuous losses. The financial health of assessee can never be a

criterion to judge allowability of an expense; there is certainly no authority for that. What the TPO has done in the present case is to hold that the assessee ought not to have entered into the agreement to pay royalty/ brand fee, because it has been suffering losses continuously. So long as the expenditure or payment has been demonstrated to have been incurred or laid out for the purposes of business, it is no concern for the TPO to disallow the same on any extraneous reasoning. As provided in the OECD guidelines, he is expected to examine the international transaction as he actually finds the same and then make suitable adjustment but a wholesale disallowance of the expenditure, particularly on the grounds which have been given by the TPO is not contemplated or authorised.

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23. Apart from the legal position stated above, even on merits the disallowance of the entire brand fee/ royalty payment was not warranted. The assessee has furnished copious material and valid reasons as to why it was suffering losses continuously and these have been referred to by us earlier. Full justification supported by facts and figures has been given to demonstrate that the increase in the employees cost, finance charges, administrative expenses, depreciation cost and capacity increase have contributed to the continuous losses. The comparative position is over a period of 5 years from 1998 to 2003 with relevant figures have been given before the CIT (Appeals) and they are referred to in a tabular form in his order in paragraph 5.5.1. In fact there are four tabular statements furnished by the assessee before the CIT (Appeals) in support of the reasons for the continuous losses. There is no material brought by the revenue either before the CIT (Appeals) or before the Tribunal or even before us to show that these are incorrect figures or that even on merits the reasons for the losses are not genuine.

24. We are, therefore, unable to hold that the Tribunal committed any error in confirming the order of the CIT (appeals) for both the years deleting the disallowance of the brand fee/ royalty payment while determining the ALP. Accordingly, the substantial questions of law are answered in the affirmative and in favour of the assessee and against the Revenue. The appeals are accordingly dismissed with no order as to costs."

25.20 The AR submitted that the above decision supports its contention that TPO cannot question the commercial decisions made by the assessee. The main issue to be considered is whether the assessee received the services towards payments. As already detailed, the assessee has received technical services as per agreement with its AE and has derived adequate benefit from such services.

25.21 He submitted that even otherwise, the fees for technical services paid by the assessee is sought to be disallowed on the basis of the CUP method. Why and how the CUP method was chosen as the most appropriate method has not been demonstrated. Even otherwise, the conclusion has been arrived at by the TPO without considering any comparable. The law of transfer pricing is based on the rest of comparability. Under the CUP method, comparable uncontrolled transactions are identified. The results of the international
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transaction are bench marked against such comparable uncontrolled transaction and appropriate conclusions drawn. If no comparables are identified, it cannot be concluded that the transaction is not at arms length. In the absence of any comparable transactions, the entire exercise of the TPO is, not in accordance with the law and hence liable to be ignored.

25.22 The AR invited our attention to Rule 10B(1)(a) which provides for computation of arm's length price under the CUP Method. The methodology is extracted as below:

(a)comparable uncontrolled price method, by which,-

i. the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction, or a number of such transactions, is identified:

ii. such price is adjusted to account for differences, if any, between the international transaction and the comparable uncontrolled transactions or between the enterprises entering into such transactions, which could materially affect the price in the open market;

iii. the adjusted price arrived at under sub-clause (ii) is taken to be an arm's length price in respect of the property transferred or services provided in the international transaction;

25.23 As highlighted above, the first step in applying CUP Method is identifying the comparable uncontrolled transaction. The TPO has not identified any comparables. Therefore the assessee submits that the whole methodology proposed by the TPO is not in accordance with law and is therefore liable to be rejected.

25.24 As per the provisions of section 92F "arm's length price" means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. Therefore to determine arm's length price there should be uncontrolled transaction. Rule 10A(a) defines "uncontrolled transaction" means a transaction between enterprises other than associated enterprises, whether resident or non-resident. Therefore to determine arm's length price what is 85 ITA No. 2072/Hyd/2011

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important is that there should be uncontrolled transactions. The learned TPO has not identified any such transaction. Without a comparable, the process adopted by the TPO in proposing an adjustment is bad in law and is therefore to be quashed.

26. Regarding reimbursement of bank guarantee charges, the learned AR submitted as follows:

26.1 During the year under consideration, the assessee's AE provided bank guarantee for an amount of Rs. 108 crores in favour of APHB for purchase of Phase-II land. The AE paid bank guarantee charges to the Bank, which was reimbursed by the assessee. The assessee made payment of Rs. 1,15,67,035/- towards reimbursement of bank guarantee charges to its AE. As the reimbursements were made at cost without any markup, the assessee concluded that the same is at arm's length.

26.2 The learned TPO has determined the arm's length price of reimbursement of bank guarantee charges at Nil on the ground that the assessee has not furnished any documents/agreements, the AE has furnished to the bank to justify the payment of bank guarantee charges. Accordingly, the TPO has determined the ALP as NIL and made an adjustment of Rs. 1,15,67,035/-

26.3 With respect to above, the AR submitted that the debit notes raised by the AE with respect to the charges paid to the bank by them and the 'bank guarantee charges' invoice issued by the AE's bankers justify the payment of bank guarantee charges. Reference may be made to page No. 113 to 144 of paper book volume 'A' wherein the above documents are attached. Accordingly, the assessee submits that the payment of bank guarantee charges are at cost and are to be treated as at arm's length.

26.4 In the global business environment, often group companies incur expenses on behalf of other companies in the group. These amounts are recovered by the expending entities from the entity on behalf of whom such expenses have been incurred.

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26.5 He submitted that in the instant case, the assessee has reimbursed the ban guarantee charges to the AE, which the AE had paid to Bank. The reimbursement is at cost. The assessee submits that since the reimbursement is at cost, the reimbursement of bank guarantee charges are to be regarded as at arm's length price.

26.6 He submitted that this view is also supported y Para 7.36 of the OECD Guidelines. The relevant extracts are as follows:

'When an associated enterprise is acting only as an agent or intermediary in the provision of services, it is important in applying the cost-plus method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such case, it may not be appropriate to determine arm's length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself, or alternatively, depending on the type of comparable data being used, the mark-up on the cost of services should be lower than would be appropriate for the performance of the service themselves. For example, an associated enterprise may incur the costs of rented advertising space on behalf of group members, costs that the group members would have incurred directly had they been independent. In such a case, it may well be appropriate to pass these costs to the group recipients without a mark-up, and to apply a mark-up only to the costs incurred y the intermediary in performing its agency function'.

26.7 Based on the above, the AR submitted that payment of bank guarantee charges is to be treated as at arm's length and addition by the TPO is to be deleted. Without prejudice to the above, he submitted that when a TP adjustment is to be made, it should be given a benefit of 5% range as provided under proviso to section 92C(2) before making adjustments for the transfer price.

27. The DR relied on the order of the Assessing Officer and TPO.

8.10):

Findings on Transfer Pricing issue (Ground Nos. 8.1 to 8.10):

28. We have heard both the parties and perused the material on record. The learned counsel for the assessee made a lengthy argument on the 87 ITA No. 2072/Hyd/2011

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transfer pricing. After considering the entire facts and circumstances of the case and the findings of the DRP, we are of the opinion that the transaction taken place is with domestic enterprises and at least one among the AEs are not non-resident. Both the assessee and IJMII are the residents for the purpose of Indian Taxation as they are Indian companies. Any transaction between them will not constitute an international transaction. The primary condition for attracting transfer pricing provisions is that there should be a transaction between two or more associated enterprises. Section 92A defines the term "associated enterprise". Section 92A(1) provides the broad parameters on satisfaction of which two or more enterprises constitute associated enterprises. These parameters are participation in the management or control or capital of the other enterprise. Sub-section (2) of section 92A enlists specific situations which make two or more enterprises associates of each other for the purposes of sub-section (1).

28.1 The term "international transaction" is defined in section 92B(1) as follows:

"92B. (1) For the purposes of this section and sections 92, 92C, 920 and 92E,

"international transaction" means a transaction between two or more associated enterprises, either or both of whom are non- residents, in the nature of purchase, sale or lease of tangible or intangible property, or provision of services, or lending or borrowing money, or any other transaction having a bearing on the profits, income, losses or assets of such enterprises, and shall include a mutual agreement or arrangement between two or more associated enterprises for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to anyone or more of such enterprises."

A transaction between associated enterprises satisfying the prescribed criteria becomes an international transaction.

28.2 One of the essential limbs/constituents of an international transaction is "associated enterprise". Section 92B(2) outlines the circumstances under which a transaction between two persons would be deemed to be between 88 ITA No. 2072/Hyd/2011

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associated enterprises. Such deeming fiction is in addition to the one created under section 92A(2). The deeming fiction under section 92A(2) are limited to the parameters of management, control or capital. Section 92B(2) travels beyond these parameters.

28.3 Transaction between an enterprise and a person which is not an associated enterprise under section 92A, may be deemed to be transaction between associated enterprises for the purposes of section 92B{l) if the conditions contained in section 92B(2) are attracted. Section 92B(2) provides:

"(2) A transaction entered into by an enterprise with a person other than an associated enterprise shall, for the purposes of sub-section (1), be deemed to be a transaction entered into between two associated enterprises, if there exists a prior agreement in relation to the relevant transaction between such other person and the associated enterprise, or the terms of the relevant transaction are determined in substance between such other

person and the associated enterprise."

28.4 Section 92B(2) embodies a legal fiction. It deems a transaction to have been entered into between two associated enterprises. Though section 92B(2) is a part of section 92B with the heading "Definition of international transaction", it is to be read as an extension of section 92A(2) and not as an extension of section 92B(1). This is for the following reasons:

(a) Both section 92A(2) and 92B(2) deal with situations under which two or more persons constitute associated enterprises.

(b) Section 92B(1) does not define the term "associated enterprise". It defines the term "international transaction". This definition provides that there can be an international transaction only between two or more associated enterprises and not otherwise. Therefore recourse to section 92A and section 92B(2} is required before referring to section 92B(1}.

(c) Section 92B(2} only deems certain transaction to be 'transaction between associated enterprises' and not as 'international transaction between two enterprises'. 89 ITA No. 2072/Hyd/2011

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28.5 There is a difference between associated enterprises defined under section 92A and transaction deemed to be between associated enterprises under section 92B(2}. Under section 92A, two or more enterprises once determined to be associated enterprises remain so for the entire financial year. Their relationship will not change for different transactions between them. They will remain associated enterprises even if they do not have any transaction during the previous year. On the other hand, a transaction between an enterprise and another person can be deemed to be transaction between associated under section 92B(2} only in respect of transactions specified therein and not otherwise. This fiction is transaction specific and does not apply to all transactions between the enterprise and person, on the basis that one transaction attracts section 92B(2}.

28.6 Section 92B(2} was enacted to hit at those cases where two associated enterprises intend to have an international transaction but want to avoid transfer pricing provisions by interposing a third party as an intermediary. In such cases, the third party intermediary will generally not be the ultimate consumer of the services or goods. The intermediary would facilitate the transfer of services or goods from one enterprise to its associate enterprise with no value addition or insignificant value addition. The intermediary is used to break a transaction into two different parts, which parts when viewed in isolation would not satisfy the requirements of section 92A. The legal form of the transaction in such circumstances is ignored. The substance of the transaction is given effect to, not by disregarding the existence of the intermediary but by deeming the transaction with the intermediary itself to be one with an associated enterprise.

28.7 The legal fiction created in respect of the specified transaction can be used only for the purpose of examining whether such transaction constitutes an 'international transaction' under section 92B(1). In case section 92B(1) is not attracted, the fiction under section 92B(2) ceases to operate. In our opinion, the impugned transaction between the assessee and IJMII does not fall under section 92B(2). This is for the following reasons. 90 ITA No. 2072/Hyd/2011

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(a) Both the assessee and IJMII are residents of India for tax purposes. They pay their taxes in India. To fall under 92B(1), the international transaction has to be between associated enterprises, at least one of whom is a non-resident. As both the parties are residents, the transaction between the assessee and IJMII do not constitute an international transaction. Thus the basic premise for invoking the deeming fiction under section 92B(2) does not arise.

(b) The transaction in question did not involve transfer of goods or services from the assessee to IJM Group or to any other non-resident enterprise, either directly or indirectly, or by using IJMII as an intermediary. The transaction in question involved direct rendering of services by IJMII to the assessee.

(c) The APHB came into existence under the A.P. Housing Board Act, 1956. It performs governmental functions. Its policies are directly controlled by the Andhra Pradesh Government. In view of the active participation of the Government of AP in the functioning of the assessee, it cannot be said that IJM Group would influence the assessee either in entering into contract with IJMII or in determining the terms and conditions thereto.

a. The transactions between the assessee and IJMII fall under item 4 above. Consequently, the transaction between the assessee and IJMII does not constitute an international transaction. The transfer pricing provisions of Chapter X are therefore not attracted.

b. That transfer pricing provisions are not applicable to transactions between two domestic related parties. The transfer pricing regulations have been specifically been made applicable to transactions between two domestic related parties by virtue of the amendment through Finance Act, 2012. In case, the existing provisions were applicable to domestic transactions then there was no need to bring about the for the above amendment.

28.8 The primary condition for attracting transfer pricing provisions is that there should be a transaction between two or more AEs in terms of section 92A(1) and 92A(2) of the Act. In our opinion, the transactions between the assessee and IJMII do not fall under section 92B(2) of the Act. Being so, as contended by the learned AR in his lengthy arguments, in our opinion, the DRP simply wants to keep the matter alive, though they agreed with the assessee's counsel, and confirmed the order of the TPO (AO). In our opinion, 91 ITA No. 2072/Hyd/2011

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the argument of the Department is devoid of merit. Accordingly, we agree with the contention of the assessee's counsel on legal issue. Since we have decided on legal issue on applicability of transfer pricing on the assessee, we refrain from going into the other grounds raised by the assessee on the issue of transfer pricing. The addition made towards transfer pricing transactions is deleted in its entirety.

29. With regard to ground No. 9.1 relating to levy of interest u/s. 234B and 234D of the Act, we are inclined to direct the Assessing Officer to recompute the same while passing giving effect order to this order, as this is mandatory and consequential in nature.

30. Now coming to the additional grounds raised by the assessee with regard setting off of brought forward business loss and unabsorbed depreciation, we are inclined to remit the same to the file of the Assessing Officer, as this ground is raised for the first time before us and the lower authorities have no occasion to

examine the same. The Assessing Officer is required to see whether these losses have been quantified by the assessee in its returns of income and also if the returns have been filed in time in respect of relevant assessment years, then the same is to be allowed in terms of section 72 of the Act. The Assessing Officer is directed to examine the issue after giving opportunity to the assessee.

31. In the result, appeal of the assessee is partly allowed for statistical purposes.

Order pronounced in the open court on 31st December, 2012.

Sd/- Sd/-

(SAKTIJIT DEY) (CHANDRA POOJARI) JUDICIAL MEMBER ACCOUNTANT MEMBER

Hyderabad, dated the 31st December, 2012

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Copy forwarded to:

1. M/s. Swarnandhra IJMII Integrated Township Development Company Pvt. Ltd., 1-90A, Plot Nos. 20 & 21, RBI Colony, Madhapur, Hyderabad-500 081.

2. The Deputy CIT, Circle-3(3), Hyderabad.

3. The Dispute Resolution Panel (DRP), Hyderabad.

4. The Addl. CIT (Transfer Pricing), Hyderabad.

5. The DR - A Bench, ITAT, Hyderabad.

Tprao