



**Expenditure incurred prior to RBI's approval for execution of a project in India is allowable. Expenditure carried forward as opening work in progress as per Accounting Standard – 7, cannot be disallowed treating it as 'prior-period expenditure'**

Recently, the Mumbai Income-tax Appellate Tribunal (the Tribunal) in the case of Stork Engineers & Contractors BV<sup>1</sup> has held that the expenditure incurred for execution of a project before the Reserve Bank of India's (RBI) approval to set up a project office in India was allowable as it was incurred during the year and for the purpose of business.

Further, the Tribunal also held that the expenditure claimed by the taxpayer as opening work in progress was allowable since it was as per Accounting Standard (AS) – 7 issued by the Institute of Chartered Accountants of India (ICAI) and it would be wrong to disallow opening work in progress in the second year by branding it as 'prior period expenditure' because unless the entire expenditure is considered at the end of the project, the correct amount of profit cannot be finally determined.

**Whether expenditure incurred for setting up the project office in India by the taxpayer after the contract was awarded but before obtaining the approval of RBI was allowable?**

**Facts of the case**

- The taxpayer company was incorporated in Netherland. It was engaged in the business of providing broad range of services to its clients offering engineering, design, consulting procurement, construction and construction management activities, etc.

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<sup>1</sup> DDIT v. Stork Engineers & Contractors BV India Project Office [2009- TIOL-417-ITAT-Mum)

- The taxpayer company was awarded a contract by the Indian Oil Corporation Limited for engineering procurement and construction (EPC) on turnkey basis in India.
- The taxpayer charged INR 17.63 million to the profit and loss account, incurred by the Head Office before the approval of RBI but after receiving the contract. The Assessing Officer (AO) held that the expenditure was a prior period item and was not allowable while computing taxable income.
- However, the Commissioner of Income tax (Appeals) [CIT(A)] allowed the expenditure after observing that the actual work in the form of basic engineering etc. commenced during the previous year.

### **Tribunal's ruling**

- The Tribunal observed that the expenditure was incurred for the purposes of execution of the project but before setting up of the project office in India.
- The Tribunal also observed that as long as the expenditure was incurred for the project there could not be any question of not allowing the expenditure.
- The Tribunal also relied on the judgment of Madras High court in the case of Franco Tosi Ingegneria<sup>2</sup> where it was held that the taxpayer was also entitled to the deduction of expenditure incurred by it after the commencement of its operation i.e. from the date of securing the letter of intent from the Indian concern for carrying out the relevant work, notwithstanding that the permission from RBI for establishing project office was received subsequently.
- Accordingly, the Tribunal held that the expenditure incurred before the RBI approval was allowable as it was incurred during the year for the purpose of business

### **Whether the expenditure carry forward as opening work-in-progress as per the Accounting Standard 7, can be disallowed on the grounds of prior period expenditure or non-filing of return of income?**

#### **Facts of the case**

- The taxpayer incurred some expenditure while bidding for the contract. The taxpayer did not file a return for the year in which such expenditure was incurred as there was no taxable income. Such expenditure was carried forward by the taxpayer as opening WIP as per the percentage completion method prescribed under Accounting Standard (AS) – 7 issued by the ICAI. The AO disallowed such expenditure after considering it as a prior period item.

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<sup>2</sup> CIT v. Franco Tosi Ingegneria [2000] 241 ITR 268 (Mad.)

- The CIT(A) observed that the taxpayer followed a percentage completion method as prescribed in AS 7 and effects given of such expenditure was in line with the AS. Accordingly, the CIT(A) allowed such expenditure.

### **Tribunal's Ruling**

- The Tribunal observed that under the method followed by the taxpayer the costs incurred in the project were accumulated on year to year basis till the project was completed. In other words, the cost incurred in the first year was carried forward to second year as work in progress and so on till the project gets completed.
- Therefore, the Tribunal held that it would be wrong to disallow the first year's brought forward expenditure in the second year by branding it as 'prior period expenditure' because unless the entire expenditure was considered at the end of the project, the correct amount of profit cannot be finally determined. Further in the percentage completion method, the income on the basis of the estimate of the completion of the project was also shown on cumulative basis.
- The Tribunal also observed that if the figure of the opening working in progress was not reckoned, as done by the AO, then the resultant figure of the profit will be fully distorted since the receipts were considered on the basis of the percentage completion of the project including that part which was completed in the earlier year. Further, if revenue as well as expenditure were considered for the current year alone, then there will be difficulty in computing the ultimate profit on the completion of project as a whole. Thus, it was manifest that the opening work in progress has to be taken into consideration in computing the income from the project.
- The Tribunal also noted that as per section 139(1) of the Income-tax Act, 1961 (the Act) the requirement to file a return of income arises only when the income exceeds the maximum amount which was not chargeable to tax. Thus, if there was no income then law does not cast a duty to file a return of income. Further, to claim a set off of carry forward of losses it was required to file a return of income within the time limits of section 139(1) but in the present case since only carry forward of losses was involved there was no requirement to file a return of income by the taxpayer.
- As per AS – 7, the taxpayer was required to offer income only if the work completed was 20 to 25 percent but since the work completed by the taxpayer was far below the prescribed limit i.e. only four percent, it was not required to offer an income as per AS – 7.
- Accordingly, the Tribunal held that the expenditure claimed by the taxpayer as opening work in progress was allowable and non submission of return of income cannot become a base to disallow the expenditure as the requirements of the Act and AS was fulfilled.

## **Our Comment**

- This is an important ruling where it has been laid down that every expenditure incurred in the prior years cannot be disallowed on the ground of treating it as 'prior period expenditure'. The taxpayer has followed AS-7 to recognise revenue from construction contracts therefore, the expenditure carried forward as opening work in progress cannot be disallowed on the grounds of 'prior period expenditure' or for non-filing of return of income. It is important to note that the Tribunal has also observed that to claim a set off of carry forward of losses it was required to file a return of income within the time limits of section 139(1) but in the present case since only carry forward of losses was involved there was no requirement to file a return of income by the taxpayer.

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