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Maintenance costs not to be included while determining profits out of construction activities as per percentage of completion method

The Delhi Bench of the Indian Income-tax Appellate Tribunal (ITAT) rendered its decision that operation and maintenance phase could not be a part of construction activities and is to be separately considered while determining profits out of construction activities as per percentage of completion method

Facts of the case:

- Veolia India (P.) Ltd. (the taxpayer)¹ is engaged in activities relating to water distribution, supply, maintenance, treatment / management and / or sewage treatment / sanitation / related civil construction activities. It earns revenue from construction as well as operation and maintenance (O&M) of water infrastructural facilities.
- During the Financial Year (FY) 2009-10, corresponding to Assessment Year (AY) 2010-11, the taxpayer entered into a construction contract of the Project Demo Zone (PDZ) [with Nagpur Municipal Corporation (NMC)] pertaining to rehabilitation and implementation of water supply in the pilot area of Dharampeth. The total contract cost was INR 302.56 million and comprised of the following:

Particulars	Duration	Cost (INR Million)
Phase I – Study phase	9 months	24.36
Phase II – Rehabilitation phase	18 months	24.90
Phase III – Operation and maintenance (O&M phase)	60 months	41.50
Rehabilitation cost	-	211.80
Total cost		302.56

- The taxpayer while computing the taxable income as per the percentage of completion method (POCM) under accounting standard (AS) 7 (accounting standard relating to construction contract), did not include the costs and expenses pertaining to the O&M phase.
- During the course of audit, the Assessing Officer (AO) held that the entire contract value was to be considered while calculating POCM since, the contract under consideration was a composite

¹ Veolia India (P.) Ltd. v. DCIT [2020] 116 taxmann.com 893 (Delhi - Trib.)

contract consisting of three different parts and the third part (i.e. O&M part) could not be considered separately.

- On appeal, the Commissioner of Income-tax Appeals [CIT(A)] upheld the order of the AO.
- Aggrieved by the CIT(A)'s order, the taxpayer filed an appeal before the Delhi Bench of Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

- The ITAT noted the following facts in the case under consideration:
 - Based on the letter from Executive Engineer of the NMC (dated 31 January 2012), Phase I (i.e. study phase of 9 months) and Phase II (i.e. rehabilitation phase of 18 months) were completed. The Phase III O&M work of 60 months was ongoing and involved volumetric building of the consumers, collection of payments, monitoring of new connections, disconnections and illegal connections. Further, this maintenance work was for a period of 5 years and was post the execution of work.
 - As per AS-7 i.e. Accounting Standard relating to construction contract:
 - A construction contract meant any contract which was entered into specifically for construction of an asset or a combination of assets that are closely inter-linked or inter-dependent with respect to their technology / design / function or the nature of their ultimate purpose or use.
 - Where a contract included more than one asset, the construction of each asset was to be treated as a separate construction contract; if separate proposals were given for each asset, each asset was separately negotiated and the costs and revenues of each asset was identifiable separately. For example, a contract for construction of three different buildings on the same plot with different specifications; each building was separately negotiated with the contractor.
 - The taxpayer had raised separate invoices for O&M phase on a regular basis and were duly offered to tax by the taxpayer in the respective year in which it was received.
- In view of the above observations, the ITAT held that the amount pertaining to O&M phase was to be separately considered while determining the profits out of the construction activities on the following basis:
 - The three different phases of the contract were separate in execution;
 - The O&M phase involved the supply of water, giving connections and monitoring the connections, which was a post construction activity. Accordingly, the O&M phase could not be a part of the construction activity and the O&M costs could not be included in determining the revenue as per POCM;
 - Maintenance activities could not be clubbed with the construction activity;

- Application of AS-7 (Accounting Standard relating to construction contract) and AS-9 (Accounting Standard relating to revenue recognition) to separately identifiable components of a single contract was allowable while determining the percentage completion of the project;
- The O&M phase commenced after the construction activity of rehabilitation phase.

Comments:

- This ruling has relied on the provisions of AS-7 while determining the revenue as per POCM. Considering that the income computation and disclosure standards (ICDS) would now be relevant while computing the taxable income and that ICDS 3 applies to construction contracts, taxpayers may want to evaluate impact of this ruling on their facts.



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