

**IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCHES "A" : HYDERABAD
(THROUGH VIDEO CONFERENCE)**

**BEFORE SHRI S.S.GODARA, JUDICIAL MEMBER
AND
SHRI LAXMI PRASAD SAHU, ACCOUNTANT MEMBER**

I.T.A. No. 271/HYD/2018

Assessment Year: 2014-15

Ogene Systems India
Limited,
HYDERABAD
[PAN: AAACO7056R]

(Appellant)

Income Tax Officer,
Vs Ward-16(4),
HYDERABAD

(Respondent)

For Assessee : Shri P.Murali Mohana Rao, AR

For Revenue : Shri Sunil Kumar Pandey, DR

Date of Hearing : 24-03-2021

Date of Pronouncement : 06-05-2021

ORDER

PER S.S.GODARA, J.M. :

This assessee's appeal for AY.2014-15 arises from the CIT(A)-4, Hyderabad's order dated 21-12-2017 passed in case No.0395 / 16-17 / ITO,Wd.16(4) / CIT(A)-4, Hyd / 17-18, in proceedings u/s.143(3) of the Income Tax Act, 1961 [in short, 'the Act'].

Heard both the parties. Case file perused.

2. Coming to the sole substantive issue raised in assessee's pleadings that both the lower authorities have erred in law and on facts in disallowing its security deposit encashment claim of

Rs.1,10,61,051/- treated as penal in nature, we notice that the CIT(A)'s detailed discussion reads as under:

"5. Ground nos. 5 to 7 and additional ground nos. 10 to 11 are with regard to addition of Rs.1,10,61,051/- towards disallowance of security deposit. During the scrutiny proceedings, the Assessing Officer submitted as under:

The assessee has debited an amount of Rs.1,10,61,051/- towards Security deposit non performance. When asked about the same, the AR of the assessee filed submissions. The submissions of the AR is carefully considered and it was found that the assessee paid bank guarantee for executing turnkey project with High Explosive Factory, Pune. But, the assessee failed to execute the project. The encashment of bank guarantee is in the nature of penalty levied for the default in executing the project. Further, the assessee has not realized any amount out of this project. As the expenditure claimed by the assessee is penal in nature and as there was no income out of this project, the expenditure of Rs.1,10,61,051/- claimed by the appellant was disallowed and added to the income.

5.1 In this regard, the appellant contended as under:

The Assessee company is engaged in the business of manufacturing and trading of bulk drugs, chemicals & & intermediates, electronic chemicals, drug development services including chemistry, analytical services and trading of bulk drugs intermediates. During the year under consideration, the assessee company has taken up a Trunkey project from "High Explosives Factory", Khadki, Pune. For the purpose of executing the project, the assessee has entered into bank guarantee of Rs.1,10,61,051/- which was made by the State Bank of Hyderabad. But due to the uncontrollable circumstances, the Appellate was unable to execute the contract and hence the contract was revoked.

Due to the non execution of the project, the contractee, High Explosives Factory", as per terms of the contract encashed the bank guarantee. Later, the Bank recovered the amount from the assessee. As the assessee incurred a loss on account of revocation of contract, the loss of Rs.1,10,61,051/- was debited by the assessee as loss to P & L account. The Assessing Officer has disallowed the amount of loss of Rs.1,10,61,051/- on the ground that it is penal in nature.

(a) Loss incurred by the assessee is in the nature of the business:-

In this regard, we would like submit that the assessee accepted the contract as a part of its normal course of business. But due to the uncontrollable circumstances, the assessee was unable to execute the project and subsequently the project was revoked as the contractor (assessee) failed to execute the Trunkey project for Design, Supply

Erection & Commissioning of special chemical plant as per terms and conditions of contract. Due to the non execution of the project, the general manager of High Explosives Factory has requested the State Bank of Hyderabad, who to gave guaranteed the contract to remit back the guarantee amount of Rs.1,10,61,051/- in the favour of High Explosives Factory Public Fund Account i.e Contractee. Later, the bank recovered guarantee amount from the assessee. The assessee has debited the same into P&L of the relevant FY i.e., 2013-14 under the sub head "Administrative and Selling Expenditure" under the head "Other Expenditure "(Note 25 of Audited Financial Statements). Thus, the assessee incurred the loss in the normal course of the business. The forfeiture of the bank guarantee is compensatory in nature.

(b) Loss incurred by the assessee is in nature of compensatory and not in the penal nature and same should be allowed u/s.37 of the Act:

In this regard, we would like to submit that merely because of the amount paid on the cancellation of contract, the same cannot be considered as penal in nature. Merely because agreement referred to, in question as a penal in nature, any such payment would not partake character of penalty. It is further submitted that the amount of bank guarantee paid by the assessee to the bank is compensatory in nature and not penal in nature and the expenditure incurred which is in nature of compensatory is allowable u/s. 37(1) of the Act. In this regard, we would like to review the section 37 of the Act,

Section 37(1): Conditions laid down under this section for allowance of

- a) It should not be in the nature of expenditure described in section 30 to 36.*
- b) It should not be in the nature of capital or personal expenditure.*
- c) It must be expended wholly and exclusively for the purpose of the business.*

Explanation to Section 37(1) :

Expenditure incurred for any purpose which is an offence or prohibited by law shall not be allowed.

Brief Facts related to the above discussion:

There are instances where the assessee incurs and pays certain amount for not fulfilling certain terms of any agreement. In these cases, some of the assessee's book the expenditure under 'Penalty' or 'Penal Charges' in the Profit and loss Account. Now, they claim it to be an allowable deduction under section 37(1) of the Act. However, if the case is selected for regular assessment u/s 143(3) and the A.O.

notices this particular heading in the P/L account then it is more likely than not that the same would be disallowed on the ground that is in the nature of penalty [i.e., Explanation to Sec 37(1)] which is incorrect.

In instant case, liability was not statutory but only contractual. It was compensation for deprivation of use of money and was part and parcel of liability and, therefore, it represented expenditure laid out wholly and exclusively for purposes of business which was allowable as deduction under section 37(1) of the Act.

(c) In support of the above, the reliance is placed on the following judgements:

- In the Income Tax Appellate Tribunal, Mumbai bench lib", Hyderabad before Shri B. Ramakotiah, Accountant member and Shri Saktijit dey, judicial member ITA no. 1605/hyd/10, Assessment Year: 2006-07,*

Considering the orders of the co-ordinate bench on the issue and the fact that AO allowed principal amount as deduction u/s. 37(1), we see no reason to disallow the interest as penal in nature. This interest arises not as penalty but as compensatory amount. Therefore, we hold that interest is allowable. Ground No.5 is allowed.

- HIGH COURT OF BOMBAY in the case of Commissioner of Income-tax-9. v.Regalia Apparels (P.) Ltd., [2013] 32 taxmann.com 237 (Bombay) wherein it was held that :-*

Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of [Forfeiture of bank guarantee] - Assessment year 2004-05 - Assessee was a manufacturer of garments - Apparel Export Promotion Council (APEC) granted to it entitlements for export of garments and knitwares - In consideration thereof, assessee furnished bank guarantee in support of its commitment to abide by terms and conditions in respect of export entitlements - However, loss occurred in course of business and assessee took a business decision not to honour its commitment of fulfilling export entitlement - Consequently, APEC encashed said bank guarantee - Assessee claimed said forfeiture business expenditure - However, Assessing Officer concluded that forfeiture was in nature of penalty and disallowed same - Whether since assessee had not contravened any provision of law, forfeiture of bank guarantee was compensatory in nature and, thus, allowable as deduction under section 37(1) - Held, yes [Pam 4] [In favour of assessee.

- HIGH COURT OF GUJARAT in the case of Commissioner of Income-tax -1. V .Neo Structo Construction Ltd. wherein it was held that :-*

"Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of [Compensation] - Assessment year 2006-07 - Assessee, a contractor, entered into a contract with a contractee 'O' -

At time of entering into contract, it had given bank guarantee, which was furnished as performance guarantee - Subsequently assessee having noticed that it would not be possible for it to perform contract took decision not to proceed further with contract and informed contractee accordingly - Due to non-performance of contract, contractee encashed bank guarantee and recovered amount - Assessee claimed deduction of said amount as business expenditure - Whether assessee would be entitled to deduction of said amount as business expenditure under section 37(1), as same was compensatory in nature - Held, yes [Para 10] [In favour of assessee]"

• [2013] 35 taxmann.com 64 (Gujarat), HIGH COURT OF GUJARAT, Commissioner of Income-tax-II v. Gujarat State Financial Corporation, wherein it has been held that :-

"Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowability of [Penalty] - Assessee received loans and advances from State Government - It paid certain amount to State Government towards interest as delayed payment of installments of loan - Revenue authorities held that such payment of interest was penal in nature and, thus, it could not be allowed as deduction - Tribunal, however, allowed assessee's claim in respect of payment of said interest. Whether, merely because agreement referred to interest in question as a penal interest, any such payment would not partake character of penalty - Held, yes - Whether even otherwise, since it was not case of revenue that amount paid by assessee was for payment of penalty rather it was simplicitor liability of interest on delayed payment of instalments, Tribunal was justified in allowing said payment as business expenditure - Held, yes [Para 4J] [In favor of assessee]"

• [2000] 113 TAXMAN 316 (J. & K.), HIGH COURT OF JAMMU & KASHMIR, Commissioner of Income-tax v, New Alpine Forests, where in it has been held that,

"Section 37(1) of the Income-tax Act, 1961 - Business expenditure - Allowable as _ Assessment year 1972-73 - Assessee, a forest contractor, took on lease certain forests from Government for which it was required to pay penalty to Forest Department - Assessee's claim deduction of interest on delayed payment of royalty was disallowed by Assessing Officer on grounds that it was in nature of penalty and that no provision was made for it in accounts -Whether law is well-settled that if any expenditure incurred by assessee is compensators in nature, deduction has to be allowed under section 37(1) -Held, yes - Whether since in instant case liability to pay interest was not statutory but only contractual in terms of lease deed, it was compensation for deprivation of use of money and was part and parcel of liability to pay royalty and, therefore, it represented

expenditure laid out wholly and exclusively for purposes of business which was allowable as deduction under section 37(1) - Held, yes"

• *HIGH COURT OF ALLAHABAD in the case of Dharam Chand Dwarka Das ... vs Commissioner, wherein it was held that :-*

1969 Current Law Journal 290: It was held that a penalty under s. 18(2) of the Punjab Excise Act was not in the nature of punishment and the option to pay the penalty was in the nature of enabling provision which could have some relation with the approximate quantum of loss which the licensee might suffer in case of an order cancelling the licence for the remaining period. Further, this Bench had an occasion to consider this matter in the case of Shadi Singh Kashmira Singh vs. ITO (1983) 15 TLR 485 (Chg-Trib.) and it was held therein that the payment made in respect of default under s. 36B of the Punjab Excise Act, 1914 was incidental to trade and was allowable as such.

• *HIGH COURT OF PUNJAB-HARYANA in the case of Commissioner Of Income Tax vs Hoshiari Lal Kewal Krishan on 18 October, 2006 Bench: A K Goel, R Bindal wherein it was held that :-*

The fine was incurred by the assessee for making belated payments of the said excise duty. Though termed as fine, the payment was not in the nature of punishment but was by way of compensation. The payment was in effect intended to compensate the loss on account of delay in making the payment and was not by way of penalty for breach of law. The amount paid can be considered to be 21 ITA 272/JP/2017 DCIT Vs. M/s Agribiotech Industries Ltd. legitimate business expense of the assessee, though technically, it may be called penalty.

- *Prakash Cotton Mills Private Limited -vs.- CIT (1993) 201 ITR 684 (SC)*
- *ITO -vs.- VRM Share Broking (P) Ltd. (2009) 27 SOT 469 (Mum)*
- *Master Capital [2008] 23 SOT 60*

5.2 I have carefully considered the assessment order, facts of the case, submissions and case laws relied upon by the appellant. Since the appellant has not done any business and no income or loss earned. As per the agreement, since the appellant failed to do the same and not fulfilled the conditions, hence bank guarantee revoked by the other party. Hence, the same is not allowable expenditure and therefore, confirmed".

3. We have given our thoughtful consideration to the rival pleadings against and in support of the impugned disallowance. The Revenue's only case is that both the lower

authorities have rightly disallowed the impugned encashment of bank guarantee being penal in nature on account of non-performance of contract at assessee's behest.

3.1. Learned authorised representative's case on the other hand is that the impugned encashment of bank guarantee is outcome of failure to perform its contractual obligation only without involving any offence or penal component u/s.37(1) of the Act.

3.2. Faced with this issue, we find that a catena of case law (2013) 37 taxmann.com 57 (Gujarat), CIT Vs. Neo Structo Construction Ltd., (2013) [32 taxmann.com 237] (Bombay), CIT Vs. Regalia Apparels P. Ltd., Jamna Auto Industries Vs. CIT (2008) [299 ITR 92] (Punjab & Haryana) and Green Delhi BQS Ltd., Vs. ACIT (2018) [170 ITD 738] (Delhi-Trib) holds that such an encashment of bank guarantee is incurred in the normal course of business than involving any penalty element at all. We adopt the very reasoning herein as well and direct the Assessing Officer to delete the impugned disallowance/addition in issue.

4. This assessee's appeal is allowed in above terms.

Order pronounced in the open court on 6th May, 2021

Sd/-
(LAXMI PRASAD SAHU)
ACCOUNTANT MEMBER

Hyderabad, Dated: 06-05-2021

TNMM

Sd/-
(S.S.GODARA)
JUDICIAL MEMBER

Copy to :

1.Ogene Systems India Limited, C/o. P. Murali & Co., Chartered Accountants, 6-3-655/2/3, 1stFloor, Somajiguda, Hyderabad.

2.The Income Tax Officer, Ward-16(4), Hyderabad.

3.CIT(Appeals)-4, Hyderabad.

4.Pr.CIT-4, Hyderabad.

5.D.R. ITAT, Hyderabad.

6.Guard File.