(40)

IN THE HIGH COURT OF DELHI

ITA No. 107/2005

Judgment reserved on : April 13, 2005
Date of Pronouncement : May 05, 2005

Commissioner of Income Tax ....Appellant
through: Mr.Sanjeev Sabharwal with Mr.Vishnu Sharma, Advocates.

Versus

M/s. Vinitec Corporation Pvt. Ltd. ....Respondent
through :Mr. Rajeev Saxena, Advocate.

CORAM :

HON'BLE MR. JUSTICE SWATANTER KUMAR
HON'BLE MR. JUSTICE MADAN B. LOKUR

1. Whether reporters of local paper may be allowed to see the judgment? Yes.
2. To be referred to the reporter or not? Yes.
3. Whether the judgment should be referred in the Digest? Yes.

SWATANTER KUMAR, J.

Commissioner of Income-tax-VI, Central Revenue Building, New Delhi has challenged the correctness of the order of

Income-tax Appellate Tribunal dated 6th August, 2004 on the ground that the present appeal under section 260-A of the Income-tax Act raises a question of law as the Appellate Tribunal has answered the following question in favour of the assessee.

> "2.1 Whether provision for future warranty expenses is contingent liability or is allowable under section 37 of the Act?"

It is contended that the above question ought to have been answered in favour of the Revenue and the view taken by the Appellate Tribunal suffers from a patent error of law. The decision is contrary to the judgments of the Court as well as not in-conformity with the statutory provisions. Thus the above substantial question of law according to the Revenue, falls for consideration of the Court in the present appeal.

The assessee had filed his return of income for the assessment year 2000-01 declaring an income of Rs.31,62,190/- on 30th November, 2000. It was processed under section 143 and subsequently the same was taken for scrutiny and assessment under section 143(2) for which a notice was issued to the assessee on 26.11.2001. The representative of the assessee appear before

the Assessing Officer and vide order dated 31st March, 2003 additions were made and the depreciation claimed by the Company to the extent of Rs.4,41,879/- was disallowed and consequent liability alongwith interest under sections 234(a), 234(b) and 234(c) was raised against the assessee. Aggrieved from this order of the Assessing Officer, appeal was preferred by the assessee before the Commissioner Income-tax (Appeals), who partly allowed the appeal of the assessee vide order dated 4.12.2003 and held as under :-

> "Contingent liabilities do not constitute 'expenditure' - Contingent liabilities do not constitute expenditure and cannot be the subject matter of deduction even under the mercantile system of accounting. Expenditure which is deductible for income-tax purposes is towards a liability actually existing at the time but setting apart money which might become expenditure on the happening on an event is not expenditure.
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> In the case of Mysore Lamp Works Ltd. V. CIT (1990) 52 Taxman 260/185 ITR 96 (Kar) it is held that
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> "Expenditure must be towards actually existing liability-Expenditure which is deductible for income-tax purposes is one which is towards a liability actually existing at the time, but the putting aside of money which may become expenditure on the happening of an event is not expenditure."
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> In the case of CIT v Gemini

Cashew Sales Corpn. (1967) 65 ITR 643 (SC) it is held that

> "where obligation itself is purely contingent, question of estimating its present value will not arise- Broadly stated, the present value on commercial valuation of money to become due in future, under a definite obligation, will be a permissible outgoing or deduction in computing the taxable profits of a trader even if in certain conditions the obligation may cease to exist because of forfeiture of the right. Where, however, the obligation of the trader is purely contingent, no question of estimating its present value may arise, for, to be a permissible outgoing or allowance, there must in the year of account be a present obligation capable of commercial valuation."

Still being dissatisfied with the partial relief granted, the assessee preferred an appeal before the Income-tax Appellate Tribunal. The appeal of the assessee was again partly allowed and the assessee was granted further relief. The Tribunal upheld the order of the Commissioner Income-tax (Appeals) in so far as it had remanded the matter to the Assessing Officer in relation to allowing of the commission and verification thereof. The Tribunal while granting relief to the assessee by accepting its contention that provision for future warranty expenses was liable under section 37 and was not an contingent liability, held as under :-

"This explanation has also been given before the

AO and it was contended that the change was made for the above reasons. The AO or the CIT (A) has not challenged the bonafide of the reasons for the change nor have they questioned the rationale behind the change. The changed system has been regularly followed by the assessee in all subsequent years up to the year ended 31.3.04. Since the change has been made for bona fide reasons, and has also been followed regularly, the departmental authorities were not justified in refusing to accept it. As regards their objection that the liability in respect of the warranty is contingent in nature, we are unable to accept the same. The sale as well the warranty are inextricable bound with each other and, therefore, if the sale proceeds are taken note of in a year, the liability in respect of the warranty is also to be taken note of in the same year. The liability is not contingent. It is a definite and certain liability. Only the quantification of the liability is based on estimate, which in turn is based on the past experience and data. From the data furnished at page 21 of the paper book, we find that in the AYs 1997-98, 98-99 and 1999-00, the percentage of warranty expenses in relation to the sale was 3.53%, 5.07% and 2.10%, respectively. On this basis, and adopting a conservative position, the assessee estimated the liability in respect of the warranty on sales made during the year under appeal at 2% of the sales. The sales for the year amounted to Rs.11,62,96,506/- and 2% thereof comes to Rs.23,25,010/-. The quantification of the liability, in our opinion, has been made on an acceptable basis, namely the past experience and data and, therefore, cannot be questioned as arbitrary. Therefore, we accept the assessee's contention that the liability is not contingent and that the quantification thereof is also reasonable. We accordingly direct the AO to allow the

deduction of the provisions."

Learned counsel appearing for the Revenue while relying upon the judgment of the Bombay High Court in the case of Sheraton Apparels Vs. Assistant Commissioner of Income-tax (2002) 256 ITR 20 and of the Supreme Court in Shree Sajjan Mills Ltd. Vs. Commissioner of Income-tax, M.P. & Anr. [1985] 156 ITR 585 argued that taking into consideration the correct definition of books of accounts, the provision made by the assessee is an expenditure which would be incurred on happening of an event and as such the same cannot be treated as a business expenditure within the ambit and scope of the provisions of section 37 of the Act. In the present case, the Commissioner of Income Tax (Appeals) though partly allowed the appeal of the assessee on other counts, however, rejected the contention of the assessee in relation to the deduction on provision made on account of the warranty clause as not 'expenditure' and therefore, disallowing the deduction claimed. In this regard reference was made to the judgment of the Kerala High Court in the case of Mysore Lamp Works Ltd. vs. Commissioner of Income Tax 1990 (52) Taxman 260 (= 185 Income Tax Reports 96). The view expressed was that the expenditure has

to be actually existing liability expenditure which is deductible for income tax purposes, but merely putting aside the money which may become expenditure on happening of an event is not an expenditure. On the other hand, it is contended on behalf of the assessee while placing reliance upon the Bharat Earth Movers Vs. Commissioner of Income-tax, (2000) 245 ITR 428 and Commissioner of Inland Revenue Vs. Mitsubishi Motors New Zealand Ltd. (1996) 222 ITR 697 that the warranty for each item sold was contingent on a defect appearing and notified to the dealer once it was in consonance of the terms and conditions of sale. Theoretically, the contingencies could be disregarded if the tax payer, who was in arrear of sale under an accrued legal obligation make payment of those warranties even though it may not be required to do so until following year. It was definitely committed in the year of sale to that expenditure. Thus the assessee was entitled to the deduction from its total income for the provisions made in regard to contingent liability arising therefrom.

As far as the change in the accountancy system of the assessee is concerned, it has been accepted even by the Assessing Officer and the Commissioner of Income Tax (Appeals). It is

nobody's case that this change was motivated or lacked bonafides. On the contrary, the authorities have recorded a definite finding that such a change was required and was bona fide. Thus, it would be difficult to say that if the assessee, as a consequence of such change in accountancy system has made a provision for expenditure in furtherance to the warranty clause contained in the document of sale itself, can be treated as invalid or improper. This in the facts and circumstances of the case would have to be construed as an existing liability for which the provision has to be made by the assessee more so keeping in view figures relatable to the business of the assessee in the past.

It is not in dispute before us that when the assessee sells his goods the warranty clause is part of the sale transaction and therefore is a committed liability by the assessee at the very initial stage of sale. But for prescription of such a warranty clause, the customer may not even buy the product of the assessee. In order to substantiate his claim for the assessment year 2000-2001, the assessee had given figures of last five years of warranty liability provided and *vis-a-vis* to the expenditure incurred.

These figures clearly exhibited that the assessee had

incurred expenditure resulting from warranty clause to the extent of more than 2% of its total sales in the previous years. There was direct nexus between the claim of the assessee and its obligation arising from the warranty clause.

The judgment relied upon by the Revenue in the case of Sheraton Apparels (supra) has no application to the controversy in the present case. In that case, the Court was primarily concerned with the disclosure of income recorded in the `books of accounts' and what is meant by `books of accounts' and its resultant effect on enunciation of penalty under section 271(1)(c) of the Act. Even the judgment of the Supreme Court in the case of Shree Sajjan Mills Ltd. is of no help to the appellant. In that case, the Court while dealing with the question of payment of gratuity made to the employee on his retirement or termination of his services held that such deduction could be allowed strictly in compliance with the conditions stated in section 40A(7) of the Act as it contains the non obstante clause in relation to other provisions of the Act. The right to receive gratuity would arise in favour of the employee only on his retirement as it was a contingent provision. Even in this case, Their Lordships held that till insertion of provision of section

40A(7), the provisions made in the profit and loss account for the estimated present value of the contingent liability properly ascertained and discounted on an accrued basis as falling on the assessee in the year of account could be deducted either under section 28 or section 37 of the Act. In the present case, we are not concerned with the claim of deduction which is relatable to the provisions of section 40A(7) of the Act or a situation akin thereto.

In our opinion, the judgment of the Supreme Court in Bharat Earth Movers (supra) has a direct bearing on the issue in controversy before us. Dealing with the preposition whether the assessee would be allowed to deduction in the accounting year, although the liability may have to be quantified and discharged at a future date, the liability is to be treated in the present time and would or would not be a contingent liability, the Court held as under :-

> "So is the view taken in Calcutta Co.Ltd. Vs. CIT [1959] 37 ITR 1 (SC) wherein this Court has held that the liability on the assessee having been imported, the liability would be an accrued liability and would not convert into a conditional one merely because the liability was to be discharged at a future date. There may be some difficulty in the estimation thereof but that would not convert the accrued liability into a conditional one; it was always open to the tax

authorities concerned to arrive at a proper estimate of the liability having regard to all the circumstances of the case.

Applying the abovesaid settled principles to the facts of the case at hand we are satisfied that the provision made by the appellant-company for meeting the liability incurred by it under the leave encashment scheme proportionate with the entitlement earned by employees of the company, inclusive of the officers and the staff, subject to the ceiling on accumulation as applicable on the relevant date, is entitled to deduction out of the gross receipts for the accounting year during which the provision is made for the liability. The liability is not a contingent liability. The High Court was not right in taking the view to the contrary.

The appeal is allowed. The judgment under appeal is set aside. The question referred by the Tribunal to the High Court is answered in the affirmative, i.e. in favour of the assessee and against the Revenue."

It will be useful for us to make a reference to the judgment of the Privy Council in the case of Commissioner of Inland Revenue (supra) where the Privy Council dealing with a taxpayer who was selling new motor vehicles to the dealers to indemnify them against warranty claims which, in turn, resulted in providing of warranty clause for 12 months from the date of delivery to the

purchaser by the dealer, held as under :-

> Held, dismissing the appeal, that, although the taxpayer's liability under the warranty for each vehicle sold was contingent on a defect appearing and being notified to the dealer within the warranty period so that no liability was incurred by the taxpayer until those conditions were satisfied, regard could be had to its estimation of warranty claims based on statistical information, which showed that as a matter of existing fact not future contingency 63 per cent. of all vehicles sold by the taxpayer contained defects likely to be manifested within the warranty period and require work under warranty; that since theoretical contingencies could be disregarded, the taxpayer was in the year of sale under an accrued legal obligation to make payments under those warranties and even though it might not be required to do so until the following year, it was definitively committed in the year of sale to that expenditure; and that, accordingly, in computing the profits or gains derived by the taxpayer from its business in the year in which the vehicles were sold, the taxpayer was entitled under section 104 to deduct from its total income the provision which it had made for the costs of its anticipated liabilities under outstanding warranties in respect of vehicles sold in that year."

Ratio decidendi of the above cases is squarely applicable to the facts of the present case. It is not disputed that the warranty clause is part of the sale document and imposes a liability upon the assessee to discharge its obligations under that clause for the period of warranty. It is a liability which is capable of being construed in definite terms which has arisen in the accounting

year. May be its actual quantification and discharge is deferred to a future date. Once an assessee is maintaining his accounts on the mercantile system, a liability is accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy.

There is nothing on record before us which even can remotely suggest that change in accountancy system was motivated or was improper. There is also nothing on record to suggest that the provisions made in the accounting year and deduction claimed as business expenditure are unduly exhaustive and are intended to evade taxation.

For the reasons aforestated and in view of the above referred judgments of the Supreme Court and other Courts, we are of the considered view that no question of law much less a substantial question of law arises for determination in the present appeal. The appeal of the Revenue, thus, is dismissed while leaving the parties to bear their own costs.

SWATANTER KUMAR
(JUDGE)

MADAN B. LOKUR
(JUDGE)

May 05, 2005
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Certified that the corrected copy of the judgment has been transmitted in the main Server.