
(2003) 09 KL CK 0007

In the High Court Of Kerala

Case No : Income-tax Appeal No's. 142 of 1999, 44 of 2000 and 154 of 2001

Commissioner of Income Tax

APPELLANT

Vs

Indian Transformers Ltd.

RESPONDENT

Date of Decision : 04-09-2003

Acts Referred:

Income Tax Act, 1961 — Section 37

Citation : (2004) 192 CTR 216 : (2004) 270 ITR 259

Hon'ble Judges : J.M. James, J;G. Sivarajan, J

Bench : Division Bench

Advocate : P.K.R. Menon, in ITA No. 142 of 1999 and P.K.R. Menon and George K. George, in ITA Nos. 44 of 2000 and 154 of 2001, for the Appellant; S. Ananthakrishnan and N.K. Subramanian, in ITA Nos. 142 of 1999 and 44 of 2000 and A. Kumar in ITA No. 154 of 2001, for the Respondent

Final Decision : Dismissed

Judgement

G. Sivarajan, J.—The Commissioner of Income Tax (Appeals) has filed these three appeals against the separate orders of the Income Tax Appellate Tribunal, Cochin Bench (for short "the Tribunal"), in the case of the same respondent-assessee for different assessment years 1991-92, 1992-93 and 1993-94, respectively. Since the question involved in all the three cases is one and the same, these appeals are disposed of by this common judgment.

2. The matter arises under the Income Tax Act, 1961 (for short "the Act"), in respect of a claim made by the respondent-assessee u/s 37 of the Act. The respondent-assessee is a company engaged in the business of manufacture and sale of electrical transformers. In the assessment for the years 1991-92, 1992-93 and 1993-94, the assessee claimed deduction of Rs. 3,50,000/-, Rs. 4,01,000/- and Rs. 4,78,000/-, respectively, representing provision for after sales services based on the warranty issued at the time of sale of the transformers. The Assessing Officer disallowed the claim and added back the provision mainly on the ground that the provision is made in respect of a

contingent liability and not in respect of a definite and ascertained liability. However, the said claim was allowed by the first appellate authority in appeal. The same was confirmed by the Tribunal in the appeal filed by the Revenue. Being aggrieved by the order of the Tribunal on this issue, the Department has come up in appeal. This court, while admitting the appeals, ordered notice on the following questions of law :

"(1) Whether, on the facts and in the circumstances of the case also in the light of the decisions reported in A.P.S. Cold Storage and Ice Factory Vs. Commissioner of Income Tax, and Commissioner of Income Tax Vs. Pretty Cycle Industries, the assessee is entitled to claim deduction of the provisions made towards repairs of transformers ?

(2) Whether, on the facts and in the circumstances of the case, (i) in the absence of an ascertained liability, (ii) the provision being only on an estimate without any basis, the Tribunal is right in law and fact in allowing the deductions of the provision towards repairs of transformers ?

(3) Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in affirming the finding of the Commissioner of Income Tax (Appeals) that the provision was towards an ascertained liability only ?"

3. Shri George K. George, the learned Central Government standing counsel for taxes appearing for the appellant, submitted that the provision made by the respondent-assessee for after sales services based on the warranty issued to the customers at the time of sale of transformers is only a contingent liability. Standing counsel further submitted that the liability will accrue or arise only on a claim being made by the purchasers of transformers during the accounting period relevant to the assessment years concerned and that in the instant case at the most the claims are preferred by the purchasers only in respect of two amounts which are mentioned by the first appellate authority in its order. Standing counsel further submitted that both the appellate authorities had seriously erred in holding that the respondent-assessee had made a provision for after sales services based on definite and ascertained liability. Standing counsel in support of his contentions has also relied on the decisions of the Supreme Court in Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal, and in Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal and Another, .

4. Shri Sarangan, learned senior counsel appearing along with Shri S. Ananthakrishnan for the respondent, submitted that the assessee had made the provision for after sales services based on the warranty issued to the customers in the accounting period during which the sales of transformers were effected to the customers from its experience and on a reasonable basis which is a permissible deduction. Senior counsel took us to the order of the Commissioner of Income Tax (Appeals) where the said authority has noted the submission of the authorised representative of the appellant that the claims made towards

repairs and after sales service charges during the warranty period were being allowed year after year and that the first appellate authority has clearly noted that in the case of MES, Goa, the appellant had made a provision for Rs. 42,000/- towards replacement of HF/LV coils and leak repeated failure of the transformers and had obtained excise permission for warranty and that in the case of BHEL a provision for Rs. 90,000/- has been made based on the claim made by them during the previous year. Senior counsel further pointed out that the BHEL had sent a letter dated October 20, 1990, to the appellant wherein it was mentioned that they had purchased ten numbers of OFW 2.75 MVA transformers from one of the GEC subsidiaries of M/s. ITL, Cochin, that all of them failed within a year of operation which resulted in serious dislocation at Rourkela which was brought to the notice of the chairman, GEC also. Senior counsel further submitted that the authorised representative of the assessee had furnished the details of the actual expenditure incurred for the current years which were very much higher than the provision made which had been debited in the account for the subsequent year. The senior counsel also submitted that the authorised representative had explained that the sum of Rs. 12,23,381/- brought back to the accounts did not relate to any provision for warranty claim. Senior counsel submitted that both the appellate authorities have clearly entered a finding of fact after verifying the facts as noted in paragraph 9 of the Tribunal's order that the provision made is in respect of a definite and ascertained liability. Senior counsel further submitted that before the appellate authority, the assessee had relied on the decision of the Supreme Court in Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal, . Senior counsel also relied on the decision of the Privy Council in Commissioner of Inland Revenue v. Mitsubishi Motors New Zealand Ltd. [1995] 3 WLR 671; [1996] 222 ITR 697 and the decision of the Supreme Court in Bharat Earth Movers Vs. Commissioner of Income Tax, Karnataka, which had applied the principles laid down in Calcutta Company Ltd. Vs. The Commissioner of Income Tax, West Bengal, in support of his contentions.

5. We have considered the rival submissions and also perused the orders of the three authorities.

6. The question to be considered is whether the claim for deduction of the provision made by the assessee in the accounts representing after sales services is a contingent liability as contended by the Revenue or is a permissible deduction u/s 37(1) as contended by the assessee. In this context it is relevant to note the third question on which the notice issued is whether the Tribunal is right in law in affirming the finding of the Commissioner of Income Tax (Appeals) that the provision was towards an ascertained liability only ? Thus if the findings entered by the two appellate authorities that the provision for after sales services made by the assessee was towards an ascertained liability is upheld then questions Nos. 1 and 2 will stand answered. In the above circumstances, we will refer to the findings of the three authorities on this question. The Assessing Officer in the assessment order (annexure A) has dealt with the issue thus :

"The assessee had debited the profit and loss account with Rs. 3,50,000/- representing provision for after sales service. The assessee was asked to file the correspondences to come to the conclusion that the repairs or defects were intimated to the assessee on or before March 31, 1991, and also working sheets as to how the provision for after sales service was worked out for each item of defect. The assessee filed a list in which only the name of the machinery and the amount of provision is mentioned. The assessee has not filed the intimation received from the purchase parties of transformers intimating the defect. In case the defect is intimated to the assessee only after March 31, 1991, this will be allowed only in the next year. Some of the correspondences filed by the assessee shows that it relates to subsequent years. Further, the exact working as to how each amount was arrived was also not filed. As seen from Schedule 11 of the balance-sheet, the assessee has written back Rs. 12,23,382/- as provision no longer required. Thus, the amount of provision made is not accurate and the company is making huge provision every year and after a few years it is written back to postpone the tax liability. Because of this, the provision made by the assessee amounting to Rs. 3,50,000/- is added back."

7. The first appellate authority in its appellate order (annexure B) has considered the matter as follows :

"I have considered the facts and circumstances of the case. It is seen that the provision of Rs. 3,50,000/- has been made towards repairs as well as provision for expenses for assembling of cable boxes, radiators, etc., supplied by the company. For example, in the case of MES, Goa, warranty claim, the appellant has made a provision for Rs. 42,000/- towards replacement of HF/LV coils and leak repeated failure of the transformer. It has also obtained excise permission for repairs on warranty. Thus, this is an ascertained liability towards repairs and has to be allowed. Similarly, in the case of BHEL, a provision for Rs. 90,000/- has been made. The appellant has filed a letter from BHEL dated October 20, 1990 (within the financial year), whereby it has mentioned that they had purchased ten numbers of OFW 2.73 MVA transformers from one of the GEC subsidiaries M/s. ITL, Cochin. This had failed within an year of operation and it resulted in serious dislocation of production at Rourkela. This was brought to the notice of the GEC chairman to give serious attention to the quality issue and since these had failed provision was made for the replacement of the defective parts. Once again, in my opinion, this is a definite liability which has accrued and, therefore, is allowable. Considering the facts, I am of the view that if the appellant has provided for the expenses accrued in the discharge of a definite liability, the expenditure is allowable. Under the circumstances, the Assessing Officer is directed to allow the provision for after sales services debited in the appellant's books of account. Relief to the appellant will be Rs. 3,50,000/-."

8. The Tribunal, after adverting to the findings of the Assessing Officer as well as the first appellate authority and the argument of the authorised representative of the Revenue, noted that the authorised representative of the assessee had filed

before the Tribunal a statement showing the provision created for various years from the assessment years 1991-92 to 1995-96 and against the actual expenditure on repairs in respect of machines sold by the assessee and pointed out that as against the provision of an amount of Rs. 3,50,000/- created for the previous year relevant to the assessment year 1991-92, the actual expenditure incurred was Rs. 7,98,958/- debited to the accounts in the subsequent year. The Tribunal also observed that the authorised representative had clarified that a sum of Rs. 12,23,381/- brought back to the accounts as provision no longer required did not represent expenses for repairs under warranty. It is also observed that the details furnished showed that the said amount represented pro forma credits, sales tax provision for various years and various expenses like legal charges, advertisement charges, etc. The Tribunal thereafter considered the matter thus :

"Considering the submissions on both sides and on verifying the facts, we are of the view that the Commissioner of Income Tax (Appeals) was justified in holding that the assessee was entitled to deduct the sum of Rs. 3,50,000/- representing the provision for repairs. It is not disputed that the provision was created for repairs/replacement of the transformers and other equipment supplied by the assessee. From the order of the Commissioner of Income Tax (Appeals), we find that in the case of MES, Goa, the assessee had made a provision for Rs. 42,000/- towards replacement of HF/LV coils for setting right the repeated failure of the transformer. The provision was created after ascertaining the extent of the repairs required on the transformer supplied to them. In respect of the transformer supplied to BHEL, a provision for Rs. 90,000/- was created after noticing that the machinery had failed within a year of operation, resulting in serious dislocation of production. The concern had brought to the notice of the company the defects in the transformers. The Commissioner of Income Tax (Appeals) thus found that in respect of various items the provisions were created on the basis of definite information regarding defects and on estimating the expenditure involved in repairs and replacements. The objection raised by the Revenue against the deduction that the assessee had been creating excess provision does not appear to be correct. From the details furnished by the learned representative of the assessee it could be seen that the actual expenditure incurred was more than the provision created. The sum of Rs. 12,23,381/- brought back to the accounts as provision no longer required was not out of the provision for repairs, replacements, etc., but in respect of certain other items. In the case of *Jay Bee Industries v. Deputy CIT 66 ITD 530*, the Amritsar Bench of the Appellate Tribunal held that the assessee is entitled to claim deduction of the provision created towards the liability for repair/replacement of assets of transformers in the warranty period. Our view that the assessee is entitled to deduct the provision towards repairs finds support in the above decision of the Tribunal. We accordingly uphold the finding of the Commissioner of Income Tax (Appeals) and decide this ground against the Revenue."

9. It is evident from the findings of the two appellate authorities which we have

extracted above that they came to the conclusion that the provision created was towards a definite liability accrued at the time of supply of the machinery and so the assessee is entitled to the claim for deduction. As already noted, the first appellate authority has clearly noted that during the accounting period relevant to the assessment year 1991-92 itself defects in the transformers supplied were brought to the notice of the assessee and that the second transaction referred to in the appellate order is in respect of ten transformers supplied to BHEL and that all the ten transformers failed within a year of operation which resulted in serious dislocation of production at Rourkela. It is also relevant to note that the BHEL itself had brought this fact to the notice of the chairman of the GEC and requested him to give serious attention to the quality. The Tribunal considered the further fact that the actual expenses incurred for the assessment year 1991-92 was Rs. 7,98,958/- as against the provision made for Rs. 3,50,000/-. The Tribunal had also noted that the amount of Rs. 12,23,381/- written back as the provision did not relate to the warranty claim. Thus it is clear that the Tribunal has found as a fact that the claim of deduction for the amount of Rs. 3,50,000/- made towards after sales services is an ascertained liability. We do not find any illegality in the said finding of the Tribunal. As already noted if the finding of the two appellate authorities that the provision made is for an ascertained liability is upheld questions Nos. 1 and 2 stand answered to the effect that the assessee is entitled to the claim for deduction made before the Assessing Officer on this account.

10. Now we will deal with the decisions relied on by standing counsel for the Revenue. In *Indian Molasses Co. (Private) Ltd. Vs. Commissioner of Income Tax, West Bengal*, , the Supreme Court considered the question regarding the principles to be applied for allowing business expenditure and observed thus (page 75) ;

"The Income Tax law does not allow as expenses all the deductions a prudent trader would make in computing his profits. The money may be expended on grounds of commercial expediency but not of necessity. The test of necessity is whether the intention was to earn trading receipts or to avoid future recurring payments of a revenue character. Expenditure in this sense is equal to disbursement which, to use a homely phrase, means something which comes out of the trader's pocket. Thus, in finding out what profits there be, the normal accountancy practice may be to allow as expense any sum in respect of liabilities which have accrued over the accounting period and to deduct such sums from profits. But the Income Tax laws do not take every such allowance as legitimate for purposes of tax. A distinction is made between an actual liability in praesenti and a liability de future which, for the time being, is only contingent. The former is deductible but not the latter . . ."

11. Again the Supreme Court in *Shree Sajjan Mills Ltd. Vs. Commissioner of Income Tax, M.P., Bhopal* and *Another*, in the context of allowance of provision for gratuity, reiterated the above principles and observed thus (headnote) :

"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 of an event is not expenditure."

12. It is also observed that the position till the provisions of Section 40A(7) were inserted in the Act in 1973 was that, the provision 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 deductible either u/s 28 or Section 37 of the Act.

13. These decisions would show that if the provision made is towards a contingent liability and not for a liability in praesenti, such provision is not deductible u/s 37. In other words if the provision made is towards an actual liability in praesenti it is deductible. The decision of the Privy Council in *Mitsubishi Motors New Zealand Ltd.*'s case [1996] 222 ITR 697, relied on by senior counsel for the assessee is relevant. In that case the taxpayer sold new motor vehicles to dealers undertaking to indemnify them against warranty claims. On selling a vehicle to a purchaser the dealer gave the purchaser a warranty in respect of defects in materials or workmanship appearing within 12 months after delivery, subject to the purchaser returning the vehicle to the dealer with notification of the defect. Based on statistical information the taxpayer estimated that 63 per cent. of all vehicles sold would contain defects requiring repair under warranty. In calculating its assessable income for the year ending December 31, 1988, the taxpayer claimed as a deduction the amount of a reserve for its anticipated liabilities under unexpired warranties in respect of vehicles sold in that year. In assessing the taxpayer to Income Tax for the year ending March 31, 1989, based on the taxpayer's return of income furnished on December 31, 1988, the Commissioner disallowed that deduction. On a case being stated in the High Court of New Zealand the judge held that the warranty provision was deductible expenditure within Section 104. However, the Court of Appeal of New Zealand held that it was not deductible u/s 104. On the Commissioner's appeal to the Judicial Committee of the Privy Council it was observed thus (headnote) :

"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 definitely 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 u/s 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."

14. Section 104 of the New Zealand Income Tax Act, 1976, uses the expression, "all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income." The said expression was interpreted to mean that the taxpayer must have either paid or become "definitively committed" to the expenditure. Regarding the warranty liabilities the Privy Council observed as follows (page 701) ;

"The evidence of accounting practice adduced before Doogue J. left no doubt about the proper treatment of the outstanding warranty liabilities. They were part of the cost of the vehicle sales and therefore, so far as capable of reasonable estimation, should be matched against the corresponding revenue. The evidence satisfied the judge that a reasonable estimate could be placed upon the anticipated liabilities. All vehicles which leave the taxpayer's assembly plant at Porirua have been tested and examined for defects. So far as the taxpayer is aware, there is nothing wrong with them. Nevertheless, experience shows that in many cases, a defect will be discovered during the warranty period. Often it is no more than a blemish in the paintwork. Sometimes it is more serious. Sixty three per cent. of the vehicles sold by the taxpayer in the year 1988 were returned to the dealers for some kind of work to be done under the warranty. Although it cannot of course be predicted whether any particular vehicle will turn out to be defective or how serious the defect will be, the taxpayer can make a reasonably accurate forecast, based on previous experience, of what will be the total cost of remedial work for all the vehicles sold in a given year. Normal commercial practice, therefore, requires that this amount should be brought into account as a deduction from income in estimating the profits or gains of the business in the year in which the vehicles were sold."

15. It was observed that the question whether, the expenditure has been "incurred" involves characterising the nature of the legal relationship between the taxpayer and the person to whom the obligation is owed, that one view is that it requires one to decide as a matter of construction whether the obligation is contingent or vested but defeasible and that this is a nice distinction which can easily become a matter of language rather than substance and on which judicial views may differ. After referring to the warranty, the Privy Council further considered the matter and observed thus (page 707) :

"The relevance of this principle is that estimation on the basis of statistical

experience can be used to conclude that 63 per cent. or thereabouts of the vehicles sold by the taxpayer in fact had defects which would manifest themselves within the warranty period of 12 months or 20,000 km. The finding of Doogue J. on the evidence was that 63 per cent. or thereabouts of all vehicles sold by (the taxpayer) contain defects". Since this information could only be derived from the taxpayer's experience of warranty claims, their Lordships understand the finding to mean that this was the level of defects notified to dealers in accordance with the terms of the warranty. It also seems a fair inference that the defects were present at the time of sale. Mr. Andrew Park, who appeared for the Commissioner, said that the terms of the warranty did not require that the defect should have existed at the time of sale. It could have come into existence within the warranty period. As a matter of construction this is true. It is however hard to imagine the circumstances in which a defect in the "material or workmanship" of the vehicle would appear within 12 months of sale unless it was present, even if hidden, at the time the vehicle left the assembly plant. At any rate Mr. Park could not think of an example. In deciding whether the tax payer had incurred a liability at the time when the vehicle was sold, it is therefore legitimate to have regard to the evidence establishing that 63 per cent., would in fact have had defects.

This, however, is not in itself enough to show that a liability was incurred. As has been said, their Lordships agree with the Court of Appeal that the language in which the warranty was expressed made liability dependent upon the manifestation and notification of the defect within the 12 months period. But the Australian authorities show that the question of whether the taxpayer is "definitively committed" to an expenditure or whether it is merely "impending, threatened or expected" (to adopt the language used in the leading case of *Federal Commissioner of Taxation v. James Flood Pty. Ltd.* [1953] 88 CLR 492 does not depend simply upon whether future events which may determine liability are expressed in the language of contingency or defeasance. Their Lordships think it would be strange if a concept so eminently practical as the computation of profits for Income Tax depended upon theoretical distinctions more appropriate to the rule against perpetuities. The question is rather whether, in the light of all the surrounding circumstances, a legal obligation to make a payment in the future can be said to have accrued. For this purpose, merely theoretical contingencies can be disregarded. In *Coles Myer finance Ltd. v. Federal Commissioner of Taxation* 176 CLR 640, Deane J. gave some examples of linguistic contingencies which were soon unlikely as not to affect the certainty of the obligation. And in *Commercial Union Assurance Co. of Australia Ltd. v. Federal Commissioner of Taxation* 14 ALR 651, Newton J. felt able to disregard a condition in an insurance policy requiring notice of the occurrence of an insured event to be given within a stipulated time on the ground that, according to the evidence, the condition was hardly ever insisted upon.

If one asks whether in respect of each of the vehicles sold by the taxpayer, the warranty conditions make its liability contingent in substance as well as in form,

the answer must be yes. A substantial number--37 per cent.-- will have no defects at all. But, for the reasons given above their Lordships think it legitimate to narrow the focus to those vehicles which left the assembly plant with defects of a kind likely to manifest themselves within the warranty period of 12 months or 20,000 km. That 63 per cent. of vehicles had such defects was a matter of existing fact not future contingency. Since these defects were by definition likely to show themselves within the warranty period, their Lordships consider that the contingency that the owners might be content not to require remedial work would be real only in the case of the most trivial defects. It would not make any material difference to the accuracy of the estimated amount of expenditure to which the taxpayer could be said, as a matter of law, to be definitively committed."

16. The Supreme Court in *Bharat Earth Movers Vs. Commissioner of Income Tax, Karnataka*, considered the general principles regarding allowance of business expenditure and the difference between accrued and contingent liabilities. It was held that, (page 431) "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".

17. The decision of the Privy Council is almost on the point. Even though the warranty provides for that the purchaser returning the vehicle to the dealer with notification of the defect within 12 months after delivery, the taxpayer had made provision on an estimated basis even before any such event on the basis of the statistical information that 63 per cent. of all vehicles sold would contain defects requiring repair under warranty. The provision made based on this experience was held to be deductible. In the present case also, as we have already noted, the two instances of defects came to the notice of the assessee of which one was with respect to ten numbers of transformers sold to BHEL and as per the complaint all the transformers failed within one year of such purchase. This gave a clear picture that a major portion of the transformers sold were defective and therefore a reasonable provision has to be made. We have noted that for the assessment year, the assessee had made a provision of Rs. 3,50,000/- but the actual expenses incurred for that year was Rs. 7,98,958/-. These circumstances clearly show that the provision is made on a reasonable basis. By applying the principles laid down by the Supreme Court in *Bharat Earth Movers Vs. Commissioner of Income Tax, Karnataka*, , it has to be held that the Tribunal has rightly held that the provision made for the three years is based on an ascertained liability and that it cannot be treated as a contingent liability. Thus, our answer to the question referred is in the affirmative, that is, in favour of the

assessee and against the Revenue.

18. In the above circumstances we do not find any merit in these appeals filed by the Department. They are accordingly dismissed.