Commissioner Of Income Tax vs M/S.Rotork Controls India Ltd on 5 February, 2007

Author: Chitra Venkataraman

Bench: P.D.Dinakaran, Chitra Venkataraman

IN THE HIGH COURT OF JUDICATURE AT MADRAS

DATED :: 05-02-2007

CORAM

THE HONOURABLE MR.JUSTICE P.D.DINAKARAN
AND
THE HONOURABLE MRS.JUSTICE CHITRA VENKATARAMAN

TAX CASE (APPEAL) Nos.163 of 2003,
1 of 2004, 94 of 2004, 95 of 2004,
229 of 2004, 565 of 2004 and 2203 of 2006

Commissioner of Income Tax,
Chennai. ... Appellant in all the Appeals

-vs-

M/s.Rotork Controls India Ltd.
(formerly Beacon Rotork Controls Ltd.)
Chennai ... Respondent in T.C.Nos.163/2003,1/2004,
94/2004, 95 of 2004 & 565 of 2004

M/s.Beema Manufacturers Pvt. Ltd.,
Chennai ... Respondent in T.C.No.229/2004

M/s.Thompson Consumer Electronics,
44, 1st Main Road,

Gandhi Nagar,
Adyar, Chennai-20 ... Respondent in T.C.No.2203/2006

T.C.(A)No.163 of 2003 is against the order of the Income-tax Appellate Tribunal, Madras 'A' Bench, dated 28.2.2003 in ITA No.468/(Mds)/95.

T.C.(A)No.1 of 2004 is against the order of the Income-tax Appellate Tribunal, Madras 'A' Bench, dated 7.7.2003 in ITA No.874/Mds/1996.

T.C.(A)No.94 of 2004 and 95 of 2004 are against the common order of the Income-tax Appellate Tribunal, Madras 'C' Bench, dated 28.4.2003 respectively in ITA Nos.276 and 1244/Mds/95.

T.C.(A)No.229 of 2004 is against the order of the Income-tax Appellate Tribunal, Madras 'D' Bench, dated 30.9.2003 in ITA No.1285/Mds/2001.

T.C.(A) No.565 of 2004 is against the order of the Income-tax Appellate Tribunal, Madras 'B' Bench, dated 10.02.2004, in ITA No.1091/Mds/97.

T.C.(A)No.2203 of 2006 is against the order of the Income-tax Appellate Tribunal, Madras 'B' Bench, dated 31.10.2005 in ITA No.1317/Mds/2001.

For appellant
in all the T.Cs. : Mr.T.Ravikumar

For respondents : Mr.R.Vijayaraghavan for
in all the T.Cs. : N/s.Subbaraya Aiyar & Padmanabhan

COMMON JUDGMENT

(Judgment of the Court was delivered by CHITRA VENKATARAMAN,J.) All these appeals are clubbed together, for passing a common order, considering the identity of the issues raised therein.

2. The common question that arises for consideration is, whether the Tribunal was right in holding that the warranty provision is an allowable deduction ? and, whether the Tribunal was right in holding that a provision made in respect of future claims that may not rise at all is a deductible expenditure in the current year ?

3. In T.C.No.94 of 2005, apart from the warranty charges, there is yet another question relating to the disallowance under Section 40 A (2) (b) (iv) of the Income Tax Act, regarding payment of corporate service charges paid to a closely connected company.

4. The facts in all these appeals centre on the question of warranty charges. Taking T.C.No.163 of 2003 for consideration of facts, it may be seen that the assessee made a provision as regards warranty charges payable under the terms of sale. It is stated that such a provision is made in the accounts to mete out the future requirements arising on account of the warranty clause in the sale agreement. It is admitted by the assessee that the warranty provision made as against the liability had not crystalised against the assessee. Consequently, holding the provisions as unascertained liability, the assessing authority rejected the plea of the assessee. The Assessing Officer followed the orders passed earlier, in respect of similar claims. Aggrieved of the same, the assessee preferred an appeal before the first appellate authority, who followed the earlier orders of the Tribunal and allowed the claim. Aggrieved of this, the Assessing Officer further went on appeal, following the orders passed earlier under similar circumstances. Hence, these appeals.

5. It is a matter of fact that in all these cases, the claims are not made on the basis of any particular data available for earlier years.

6. Learned counsel appearing for the revenue referred to the decision of the Supreme Court in Shree Sajjan Mills Ltd. v. Commissioner of Income-Tax, (1985) 156 ITR 585, and makes a particular reference to the distinction between 'provision' and 'reserve', dealt with by the Apex Court and to the extract from the decision reported in Vazir Sultan Tobacco Co.Ltd. v. CIT [1981] 132 ITR 559 (SC), which may be usefully extracted hereunder :

> "The distinction between a provision and a reserve is in commercial accountancy fairly well known. Provisions made against anticipated losses and contingencies are charges against profits and, therefore, to be taken into account against gross receipts in the P.& L.account and the balance sheet. On the other hand, reserves are appropriations of profits, the assets by which they are represented being retained to form part of the capital employed in the business. Provisions are usually shown in the balance sheet by way of deductions from the assets in respect of which they are made whereas general reserves and reserve funds are shown as part of the proprietor's interest."

7. Based on the said decision, the learned Standing Counsel submits that when there was no obligation cast as on the date of sale except for an agreement and in the absence any comparison to make a provision for an uncrystallised or uncertain liability, the assessee was not entitled to the benefit, as granted by the Tribunal. He also placed reliance on the decisions in Indian Smelting and Refining Co.Ltd. v. Commissioner of Income-Tax, [2001] 248 ITR 4 and Commissioner of Income-Tax v. Dynavision Ltd., [2004] 265 ITR 289 and makes a reference to page 297, to impress on the fact that the contingency liability, by its very nature, cannot have a provision for purposes of deduction. He also made a specific reference to the decision in Bharat Earth Movers v. CIT, [2000] 245 ITR 428, and submitted that the same is distinguishable on facts and in the absence of certainty

of a liability and certainty of an event to incur that liability, a provision cannot go for deduction. The learned counsel further submitted that the assessees in these cases have not submitted any proof as regards previous pattern of expenditure, to maintain a provision. In this connection, he placed reliance on Commissioner of Inland Revenue v. Mitsubishi Motors New Zealand Ltd., [1996] 222 ITR 671 at 701; Commissioner of Income-Tax v. Vinitec Corporation Pvt. Ltd., [2005] 278 ITR 337 (Delhi) and Commissioner of Income-Tax v. Indian Transformers Ltd., [2004) 270 ITR 259.

8. Per contra, Mr.Vijayaraghavan, learned counsel for the assessees, submits that a committed liability is an accrued liability and, hence, even though the exact quantification is postponed to a future date, yet a provision in terms of the agreement undertaken has to be considered for deduction. In short, he submits that the determination of exactness of the liability on a future date does not make a liability as on the date of agreement a contingency liability. In this connection, he placed reliance on Section 37 (1) and drew support from [2001] 248 ITR 4 and [2000] 245 ITR 428. In the above circumstances, the learned counsel for the assessees prays that the order of the Tribunal be upheld.

9. We agree with the submission made by the learned counsel for the revenue, that considering the nature of the liability, which is yet to crystalise but loaded with uncertainty of the event to cause a liability, there is no justification to accept the plea of the assessees to uphold the order of the Tribunal.

10. The reliance placed on the decision of the Supreme Court in (1985) 156 ITR 585 needs to be noted herein. It relates to a provision for future use for payment of gratuity to the employees on retirement or on termination of their services. The Apex Court held that the liability to pay gratuity becomes an accrued liability of an assessee, when the employees retire or when their services are terminated and, until then, the right to receive gratuity is a contingent right and the liability to pay gratuity continues to be a contingent liability qua the employer. Taking note of the nature of liability, the Supreme Court also made a reference to the decision in Metal Box Co.of India Ltd. v. Their Workmen, [1969] 73 ITR 53, and held that it was permissible for an assessee, if he so chooses, to provide in his profit and loss account for the estimated liability under a gratuity scheme, by ascertaining the present value on accrued basis and claiming it as an ascertained liability, to be deducted in the computation of profits profits and gains of the previous year. Referring to the provisions of Section 40 A (7) in that case, the Supreme Court held that the requirements for gratuity to be deductible under the Act must be fulfilled under Section 40 A (7). It may be noted that though it relates to a gratuity payment, the fact remains, that, to qualify for a deduction, there must be a liability and it is a certainty. Although the quantification, as such might be postponed to a future date, as long as the event is of certainty, the claim for deduction, as such, cannot be denied. However, where the liability itself is not held out with certainty, which may happen or may not happen, such liabilities, contingent in character, cannot be the subject matter of deduction, even under the mercantile system of accounting. The eligibility or otherwise for deduction hence depends on the certainty of the event, namely, the liability to occur even under the terms of sale agreement. Hence, with such uncertainty, the writ large on the occurring of an event, there is no justification to extend the benefit of deduction on the provision on a contingent liability. The decision reported in [2001] 248 ITR 4 relied on by the assessee is distinguishable to the effect that the provision made

for liability on the basis of show cause notice, which the assessee did not admit as a liability, was not deductible; that was only a contingent liability and, hence, could not constitute as an expenditure for the purpose of income tax. [2004] 265 ITR 289 is the decision of this Court, on the question of the character of a liability as the contingent liability. Referring to the decision in [1985] 156 ITR 585 (SC), this Court held that "the basic requirement is that the amount sought to be excluded should be an expenditure and the 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 an expenditure."

11. The Revenue as well as the assessees placed reliance on [2000] 245 ITR 428. This relates to a claim on leave encashment. The assessee, in that case, created a fund making provision for meeting its liability, arising on account of accumulated earned/vacation leave. A certain sum was set apart in a separate account as provision for encashment of accrued leave. Assessee made a claim for deduction. The High Court reversed the view of the Tribunal that provision for accrued leave salary was a contingent liability that was not a permissible deduction. Reversing the said view, the Apex Court held that the provision made by the assessee therein for meeting its liability was under

> the leave encashment scheme proportionate with the entitlement earned by the employees of the company, subject to a ceiling on accumulation as applicable on relevant date.
>
> Consequently, the Apex Court held that the liability was not a contingent liability.

12. A perusal of the decision of the Supreme Court shows that what should be certain is the incurring of the liability. Even though the actual quantification may not be possible, it should also be capable of being estimated with reasonable certainty. 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 makes no difference to the point of time when the liability shall have to be discharged.

13. The Supreme Court decision referred to above lays down the law on the question of deductibility of a provision on contingent liability and that the deduction to be allowable thereon must be that liability existing with certainty to be called an accrued liability. Hence, where there was no difficulty in ascertaining the existence of a liability, mere existence of difficulty in actual quantification does not convert the accrued liability to that of a conditional one, to look upon to the happening of an event. The settled principles, hence, emphasis on the existence of element of certainty rather than on the quantification of the liability.

14. A perusal of the facts in these cases makes it clear that what has been projected in these cases is that under the terms of the agreement of sale, there is a warranty provision. The accounts of the assessee made a provision for warranty at a percentage on the turnover.

15. Learned counsel for the assessee could not deny the fact that considering the uncertainty of a liability, deduction could still be a possibility under the law declared by the supreme Court.

16. In none of these cases, the assessee could lay its hand on the actual incurring of a liability under the warranty clause on the basis of fixing a percentage on the turnover. In the absence of any details, accepting the claim of percentage on the turnover could not be sustained.

17. As to the reliance placed on the decision in [1996] 222 ITR 697, as rightly submitted by the learned Standing Counsel for the Revenue, the said decision was prompted by the statistical data available that in respect of 63% of the vehicles sold by the tax payer, they were returned to the dealers for some kind of work to be done under the warranty clause. The Privy Council held that the tax payer could reasonably make an accurate forecast, based on the previous experience, as to what would be the total cost of remedial work for all the vehicles sold in a given year. Taking note of the commercial practice, the Privy Council granted the relief in the assessee's appeal.

18. With no such details in the appeals at any stage of the proceedings, we do not find any justification to grant 1.5 per cent on the total turnover, as provision for the warranty clauses.

19. Learned counsel for the assessee placed reliance on [2005] 278 ITR 337 (Delhi), a decision of the Delhi High Court, and [2004] 270 ITR 259, a decision of the Kerala High Court.

20. A perusal of the above two decisions shows that the claims in those cases were based on the data of the previous years, which enabled the assessee to estimate its liability under the warranty clause.

21. In the decision reported in [2005] 278 ITR 337 (Delhi), the Delhi High Court noted that the assessee had given figures for five years of warranty liability provided vis-a-vis the expenditure incurred, so also, in the decision reported in [2004] 270 ITR 259.

22. We do not think that the decisions of the Delhi High Court and the Kerala High Court lend support to the cause of action. In the absence of any such details, an adhoc provision on a percentage of the turnover disentitles the assessee to the relief.

23. Learned counsel for the assessees reiterated the fact that under the terms of sale, warranty clause is a committed liability and, as such, the claim is not reasonable as to the particular percentage in the total turnover.

24. We do not agree with the above said submission of the learned counsel that they could be granted some ad hoc percentage. Considering the fact that the liability, as such, being a contingent one and not a certainty, we fail to understand the reasoning of the Tribunal in accepting the case of the assessee on the strength of decisions, which certainly are based on definite data. Under the circumstances, the decision of the Tribunal deserves to be reversed.

25. As regards the question relating to the charges paid under additional service charges arising in the case of T.C.Nos.94 and 95 of 2004, we find that the Tribunal granted the relief , without adverting to the facts which required the additional expenditure. It is stated that under the terms of the agreement, with increased sales, amount was paid as a corporate service charge to the holding company. The assessing authority allowed the claim in earlier years based on this. However, in

respect of the assessment year 1991-92, the assessee claimed that payment at 2% required a revision commensurate with the increase in turnover. The Assessing Officer, however, rejected the claim, as excessive and unreasonable, having regard to the nature of services rendered by the holding company. The assessee explained the increase in the payment of commission, on account of the increase in the turnover. Hence, a sum of Rs.25.00 lakhs extra was paid to the holding company. The first appellate authority, confirming the order of the assessing authority, held that the disallowance of Rs.15.00 lakhs was reasonable and hence allowance of Rs.10.00 lakhs was upheld. The Commissioner also held that the assessee had not produced any data regarding the services rendered extra, justifying the huge payment.

26. On appeal, the Tribunal held that the assessee had produced the necessary calculation sheet; that the assessee had spent less amount towards the charges, consequent to the fact that where it had no branches, it took the services of the holding company to get its business. The Tribunal held that there was nothing to show that the calculation given by the assessee was found to be false. Consequently, it was not open to the revenue to reject the contention in an ad hoc manner.

27. The learned Standing Counsel referred to the decisions in Commissioner of Income-Tax v. Shatrunjay Diamonds, [2003] 261 ITR 258 and V.S.T.Motors Ltd. v. Commissioner of Income-Tax, [2003] 260 ITR 440, wherein it was held that in the absence of necessary details to support the claim, disallowance was justified and, hence, prayed for restoring the order of the Assessing Officer.

28. Per contra, learned counsel for the assessees, however, submitted that there is no denial of the fact that the holding company had rendered additional services. He submitted that the authorities must look at the commercial exigencies, which require the payment to the fixed extent. Learned counsel also submitted that considering the various aspects of the claim, the Tribunal had rightly concluded the issue in favour of the assessee.

29. A perusal of the order of the Tribunal shows that the Tribunal has mainly accepted the plea of the assessee that the expenditure was warranted by commercial exigencies and the assessee would have spent more if it were to maintain branches, instead of taking services of a holding company.

30. We feel, in the absence of any details in the order as to the services rendered, in order to result in a better business, the matter be remitted to the assessing authority for fresh consideration on issue of granting relief to enable the assessee to furnish the details as to the additional services rendered, to justify the payment over and above 2% services charges on the sales effected. Consequently, the first question in T.C.Nos.94 and 95 of 2004, namely, whether the Income Tax Appellate Tribunal was right in holding that the disallowances made under Section 40 A (2) (b) (iv) of the Income Tax Act in respect of corporate service charges paid to a closely connected company were not justified, stands remanded to the assessing authority to re-do the assessment in this regard.

31. As regards T.C.No.2203 of 2006, learned counsel appearing for the assessee submitted that the calculation of the liability was made on scientific basis with reference to the past experience. Consequently, the decision of the Privy Council as well as the decision of the Apex Court will have a

bearing on the issue.

32. A perusal of the assessment order shows that the assessee company paid on an average Rs.150/- per set to T.D.Electronics. The liability to pay arose as and when sales were effected. The assessing authority noted that in the case of five year warranty, the entire expenditure spent was dependent on the liability occurring. Since the obligation was purely contingent and not actual, their claim was not sustainable. The Tribunal followed the earlier year's order in the assessee's case as well as that of the Privy Council in [1996] 222 ITR 697.

33. It may be noted that the assessee was providing warrantee for the repair for a period of one year, when they were paying Rs.150/- per set to another company, by name, T.D.Electronics Service Company. That apart, there was another five year warranty and the expenditure on this account was estimated at Rs.68.00 lakhs and this expenditure was to be incurred only when there arose a liability, to be borne. The facts herein are no different from that of the earlier cases.

34. Under the circumstances, we do not find any justification to accept the plea of the assessee that the proviso merited a deduction. In the light of the view that we have taken, which is supported by the decision of the Supreme Court, the appeals preferred by the Revenue, on the question of warranty charges as a contingent liability, are allowed, holding that the same as not deductible. No costs. dixit To The Commissioner of Income Tax, Chennai.