* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **{ITA No.1154 OF 2009}**

% *Judgment reserved on: January 6, 2011*
*Judgment delivered on: January 24, 2011*

**THE COMMISSIONER OF INCOME TAX . . . APPELLANT**

Through : Mr. N.P. Sahni, Sr. Standing Counsel with Mr. Ruchesh Sinha, Advocate .

VERSUS

**WHIRPOOL OF INDIA LTD. ….RESPONDENT**

Through: Mr. Ajay Vohra, Advocate with Ms. Kavita Jha, & Mr. S. Shukla, Advocates.

**CORAM :-**

**HON'BLE MR. JUSTICE A.K. SIKRI**
**HON'BLE MR. JUSTICE M.L. MEHTA**

1. Whether Reporters of Local newspapers may be allowed to see the Judgment?
2. To be referred to the Reporter or not?
3. Whether the Judgment should be reported in the Digest?

**A.K. SIKRI, J.**

1. Before pointing out the questions of law which were framed while admitting this appeal and to answer those questions, we deem it appropriate to take note of the facts under which these questions have arisen for consideration.

2. In the assessment year 1996-97 relevant to financial year 1995-96, the respondent/assessee had filed its return of income on 30th November, 1996 declaring a loss of ₹ 48.71 crores. This income was assessed under Section 143 (3) of the Income-Tax Act (hereinafter referred to as the 'Act') making various additions. The Assessing Officer assessed the loss at ₹ 45.25 crores instead of ₹

48.71 crores as declared by the assessee. We are concerned here with only two such additions which are as under:-

(i) The assessee had made provision for warranty in the sum of ₹ 3,09,42,798/- which was disallowed.

(ii) The claim of royalty paid to the tune of ₹ 70.66 Lacs which was disallowed by the Assessing Officer (AO) under Section 40 (a) (i) of the Act.

3. The assessee herein preferred appeal against the assessment order challenging all the additions including the aforesaid two additions made by the AO whereby certain other additions were deleted but both the aforesaid additions were confirmed. However, in respect of deduction for royalty payments, the CIT (Appeal) allowed this deduction and deleted the addition made by the AO. Both the assessee as well as the Revenue approached the Tribunal against this order of CIT (A). In so far as the assessee is concerned, in its appeal, both the aforesaid additions were challenged. The Tribunal has sustained the challenge thereby deleting these additions. This is how the Revenue is in appeal before us.

4. It is in this factual background that the present appeal was admitted on the following two substantial questions of law:-

> "(a) Whether the ITAT was correct in law in deleting the addition of ₹ 3,09,42,798/- made by the Assessing Officer on account of disallowance of provision for warranty claims?
>
> (b) Whether the ITAT was correct in law in deleting the addition of ₹ 70,66,000/- made by the Assessing Officer on account of disallowance of royalty?"

**RE: PROVISION FOR WARRANTY CLAIMS**

5. It is not in dispute that the assessee is manufacturing and selling refrigerators and deep freezers and the same being consumer durable products, assessee offers optional service contract (OSC) for a period of seven years on the machines sold. The warranty for the first year of sale is for the whole machine whereas from the $2^{nd}$ to $7^{th}$ year it relates only to the compressor. The amounts received by the assessee on account of OSC are included in its income in the year of sale. The assessee has been consistently making provision for warranty on the basis of actuarial valuation in respect of machines sold during the year. On the said provision the assessee has been allowed deduction year after year. The actual expenditure incurred for warranty claims are deducted against the provision made. In this manner, right from the financial year, 1989-90 till 1994-95, the Warranty Provisions were made which were shown in the books of accounts and income calculated after the deduction of the said provision. The Income Tax Department had accepted this Warranty Provisions made by the assessee. We may also point out that whenever complaints are received from the consumers to whom the goods are sold which are to be serviced, the expenditure incurred thereupon is adjusted against the aforesaid provision made.

6. In the year in question, however, the assessee found that in certain years, the provision for warranty amount had depleted sharply and in two years it had been reduced to 'Nil'. The position during the year ending $31^{st}$ March, 1996 i.e. previous year relevant to the assessment year was as under:-

| Financial Year | Balance Available | Remaining Years of Warranty |
|---|---|---|
| 1989-90 | 21,99,424 | 1 |
| 1990-91 | 0 | 2 |
| 1991-92 | 0 | 3 |
| 1992-93 | 38,40,204 | 4 |
| 1993-94 | 71,71,092 | 5 |
| 1994-95 | 2,38,72,473 | 6 |
| | **3,70,83,193** | |

7. The assessee thus felt shortages in warranty liability account. It entrusted the matter to a qualified independent actuary to study all the invasions and undertake actuarial valuation of warranty provisions. It is claimed by the assessee that on the basis of the report undertaken by the independent agency applying the scientific method considering number of products sold under warranty provisions of ₹ 3.09 crores was made in the year in question. As per the assessee, the variations/shortfall in the warranty provision on account of different years has arisen due to various reasons like increase between the time of provision and the time of actual repair of the machines, the failure rate of machines, available power factor at the disposal of the customers, handling of products by the customers etc., all of which were beyond the control of the assessee but routine in the nature of appellant’s business. Another justification given for making this provision was that the compressor division has been sold by the assessee during the previous year was relevant to the assessment year 1998-99 resulting in the repair work

of compressor under warranty being carried out from outside parties and, therefore, expenses on this account were expected to rise. The main reason for disallowing this additional warranty provision by the AO was that it was a contingent liability, ad hoc in nature and having no connection with the sale affected in the year in question. The CIT (A) had accepted this reasoning of the AO observing that the claims made for unexpired period of warranty could be considered as and when actual claims arise and it would not be proper to make the second estimate of warranty liability. The ITAT, however, found fault in this approach of the authorities below and has taken the view that the assessee was justified and legally entitled to make such a provision. In the words of the Tribunal:-

> "In our opinion the approach of revenue is not in consonance with law. At the year end, the assessee is required to make provision for all known liabilities, though to be discharged at the subsequent year. The liability has to be scientifically arrived at. The assessee has obtained a report of an Actuary for making the provision. Thus the provision is on scientific basis. As on the end of the year the liability estimated were ₹ 6.80 crores against which the earlier provision made was only ₹ 3.78 crores. This required the assessee to make additional provision. Though the sales is not make during the year, the assessee can be called upon to meet its warranty obligation. If on earlier occasion the provision was made but if later on the provision so made is found short of the liability provided for, the assessee is entitled to review such provision from time to time and make provision for the additional liability or write back the liability if provision is no more required. The expenditure cannot always be related to the year of sale. It is settled law that even though there is some difficulty in estimation, it would not convert the accrued liability into an additional one or a contingent liability. Reference can be made to the decision of Hon'ble Supreme Court in the case of Calcutta Co. Ltd. 37 ITR 1 and that of Bharat Earth Movers Ltd. 245 ITR 428. The Hon'ble Karnataka High Court in the case of Motor Industries Co. Ltd. (supra) held that where the assessee is required to make provision for additional gratuity liability

> pertaining to the past services, the same is held to be an allowable deduction. Thus the ration laid down can help the case of the assessee in the sense that even if the sales were affected in the past, the additional liability on the re-appreciation of the material on hand will acquire the assessee to make provision for additional liability if the situation so demand and can be claimed as deduction. The decision of Hon'ble Delhi High Court in the case of CIT Vs. Vinitec Corporation Pvt. Ltd. (supra) relied upon by the learned DR laid down that provision for future liability under warranty which is under the Warranty Clause of sale document is a current liability though actual quantification is deferred to the future date and though to be discharged at a future date. However, this will not help the case of the revenue. In the present case, it is seen that the provision is made for additional liability on the basis of actuarial valuer appointed for the purpose. Thus the same cannot be disallowed by holding that either the liability pertained to the past years or that the liability will be discharged in the subsequent years. The liability has accrued during the year as the assessee carried on an exercise to evaluate its present liability as on the last day of the financial year and came to the conclusion that the provision was short to the extent claimed. We accordingly delete the disallowance of ₹ 3,09,42,798/-."

8. Whereas, Mr. Sahni, learned counsel for the Revenue challenged the line of action taken by the Tribunal and supported the view of the AO as well as CIT (A). Endeavour of Mr. Vohra, learned counsel appearing for the assessee, on the other hand, was to demonstrate that reverse was true. Both had relied upon certain judgments and it would be apposite to take note of these judgments and then take a decision as to who is correct.

9. The first judgment relied upon by Mr. Sahni was that of Supreme Court in the case of ***Indian Molasses Co. (P) Ltd***. Vs. ***CIT*** 37 ITR 66. In that case, one John Bruce Richard Harvey was the managing director of the assessee company in 1948. He had served

the company for 13 years, and was due to retire at the age of 55 years on September 20, 1955. There was, an agreement by which the company was under an obligation to provide a pension to Harvey after his retirement. On September 16, 1948, the company executed a trust deed in favour of three trustees to whom the company paid a sum of Pound 8,208-19-0 (₹ 1,09,643) and further undertook to pay annually ₹ 4,364 (Pound 326.14 ) for six consecutive years, and the trustees agreed to execute a declaration of trust. The trustees undertook to hold the said sums to spend the same in taking out a deferred annuity policy with the Norwich Union Life Insurance Society in the name of the trustees but on the life of Harvey under which Pound 720 per annum were payable to Harvey for life from the date of his superannuation. It was also provided in the deed that notwithstanding the main clause the trustees would, if so desired by the assessee company, take out instead a deferred longest life policy, with the said insurance company in their names, but in favour of Harvey and Mrs. Harvey for an annuity of Pound 558-1-0 per annum payable during their joint lives from the date of Harvey's superannuation and during the lifetime of the survivor, provided further that if Harvey died before attaining the age of 55 years, the annuity payable to Mrs. Harvey would be Pound 611-12-0 during her life. It was further provided that if Harvey dies before attaining the age of 55 years, the trustees would stand possessed to the capital value of the deferred annuity policy, upon trust to purchase therewith an annuity for Mrs. Harvey with the above insurance company or with any other insurance company of repute. In furtherance thereof, the trustees took out a policy on January 12, 1949 and paid early premia for few years before Harvey died. The premium paid was claimed as

deduction from the profits. The Supreme Court held that such payment could not be treated as expenditure. Not only payment was contingent but even the liability itself was contingent as it would have accrued only in the eventuality Mr. Harvey, attained the age of 55 years, had he died attaining the age of 55 years, the trustees were to receive the capital value of the deferred annuity policy. It is thus to be borne in mind that on the facts of that case the Court had found that there was no ascertained liability which was contingent on happening of certain event and even the payment made was merely contingent. Following discussion in the judgment would bring forward this aspect:-

> "These cases may help to determine the nature of the contract with the insurance company but cannot help in the solving of the question whether the payments to the insurance company were expenditure. That insurance of human lives involves a contingency relating to the duration of human life is a very different proposition from the question whether the payment in the present case to the trustees was towards a contingent liability depending on an contingency.
>
> In our opinion, the payment was not merely contingent but the liability itself was also contingent. 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. In the present case, nothing more was done in the account years. The money was placed in the hands of trustees and/or the insurance company to purchase annuities of different kinds, if required, but to be returned if the annuities were not bought and the setting apart of the money was not a paying out or away of these sums irretrievably".

10. Another case referred by Mr. Sahni was again a judgment of Supreme Court in ***Shree Sajjan Mills Ltd.*** *Vs.* ***Commissioner of***

***Income Tax, M.P. & Another,*** *156 ITR 585.* One of the questions referred to the High Court in the said case was as follows:-

> "Whether on the facts and in the circumstances of the case, the Tribunal was right in law in allowing deduction of Rs.15,71,855 under Section 37 of the I.T. Act, 1961 out of the sum of Rs.28,59,431 for which provision was made towards liability for gratuity?"

11. An important fact which appeared in that case was the company's practice was to account for gratuity on cash basis as and when paid. The company had made a provision in the books of accounts for payment of gratuity to its employees which was disallowed as contingent holding as under:

> "The right to receive the payment accrued to the employees on their retirement or termination of their services and the liability to pay gratuity became the accrued liability of the assessee, when the employees retired or their services were terminated. Until then the right to receive gratuity is a contingent right and the liability to pay gratuity continues to be contingent liability qua the employers. An employer might pay gratuity when the employee retires or his service is terminated and claim the payment made as an expenditure incurred for the purpose of business under Section 37. He might, if he followed the mercantile system, provide for the payment of gratuity which became payable during the previous year and claim it as an expenditure on accrued basis under Section 37 of the said Act. Since the amount of gratuity payable in any given year would be a variable amount depending upon the number of employees who would be entitled to receive the payment during the year, the amount being a large one in one year and a small one in another year, the employer often finds it desirable and/or convenient to set apart for future use, a sum every year to meet the contingent liability as a provision for gratuity or a fund for gratuity. He might create an approved gratuity fund for the exclusive benefit of his employees under an irrevocable trust and make contributions to such fund every year. Contingent liabilities do not constitute expenditure and cannot be the subject matter of deduction even under the mercantile system of accounting. Expenditure which was deductive 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. (See in this connection, the observations of this court in Indian Molasses Co. (P) Ltd. Vs. CIT [1959] 37 ITR 66). A distinction is often 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."

12. One has, however, to keep in mind that the assessee had claimed deduction under Section 37 of the Act and the plea of the Revenue was that it is not permissible as deduction for gratuity could not be granted because there was non-compliance of the statutory provision of section 40-A (7) of the Act. The entire discussion, therefore, revolved around the interplay of Section 40A (7) and Section 37 of the Act on the other hand. It is clear from the following discussion contained in the following judgment. Thus, the provision for gratuity was not allowed in view of the mandate provided in sub Section (7) of Section 40A of the Act.

13. ***CIT*** Vs. ***Indian Metal and Metallurgical Corporation,*** 51 ITR 240 was the decision rendered by Madras High Court cited by the learned counsel for the Revenue. In that case, provision for gratuity was made which could be paid by the assessee/employer to his employees in the event such employees are retrenched and it becomes payable under Section 25 of the Industrial Disputes Act. In this backdrop, the question was as to whether the provision made was in respect of "ascertained liability". The Court took the view that provision was made merely on the apprehension that at some future date, due to the vicissitudes of business, recourse may have to had by way of retrenchment of some members of the staff who might be

felt to be surplus, having regard to the then business exigencies. The Court thus held that evaluation of the employer's liability was in respect of an unforeseen and perhaps imaginary state of business. Compelling retrenchment of the surplus staff must depend upon several hypothetical contingencies and denied the deduction of the aforesaid provision.

14. We may take note of a decision of this Court in ***CIT*** Vs. ***Vinitec Corporation (P) Ltd.*** 278 ITR 337 which is referred by the Tribunal also. In that case the assessee had claimed deduction under Section 37 of the Act, *inter alia,* on the provision made by it in the year against future claims by customers under the warranty clause which was part of the sale. The AO disallowed the claim on the ground that it was a contingent liability. The Tribunal, however, accepted the assessee's claim holding that the liability was definite and certain quantification was done on estimate basis after taking into consideration the data for past years of the percentage of warranty expenses. The High Court affirmed the decision of the Tribunal holding that the warranty clause was a part of the sale document and imposed a liability upon the assessee to discharge its obligation under that clause for the period of warranty. It was a liability, which was capable of being construed in definite terms, which had arisen in the accounting year, although its actual quantification and discharge might be deferred to a future date. Once the assessee is maintaining his accounts on the mercantile system, a liability 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. In

forming the aforesaid view, the Court applied the test laid down in ***Bharat Earth Movers,*** Vs. ***CIT***, 245 ITR 428 and analyzed the said judgment and another judgment of Privy Council in the following terms:-

> "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 assessed 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. v. CIT [1959]37 ITR1 (SC) wherein this Court has held that the liability on the assessed 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 above said 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 favor of the assessed 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."

The 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 assessed 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 assessed 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”.

15. Entire law on this aspect is revisited by the Supreme Court in the case of ***Rotork Controls India P. Ltd.*** Vs. ***Commissioner of Income-Tax,*** 314 ITR 62. That was also a case where a standard warranty was provided by the assessee at the time of sale of the goods and provision for warranty was made. However, question again was whether it was contingent liability or praesenti and thus could be treated as expenditure for the purpose of deduction under Section 37 of the Act in the year in which the said provision was made. In lucid manner the court dealt with the issue. First it discussed the meaning of 'provision', 'liability', 'present obligation, 'product warranties' and we extract the said discussion for our benefit herein below:-

> "What is a provision? This is the question which needs to be answered. A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized when: (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.
>
> Liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
>
> A past event that leads to a present obligation is called as an obligating event. The obligating event is an event that creates an obligation which results in an outflow of resources. It is only those obligations arising from past events existing independently of the future conduct of the business of the enterprise that is recognized as provision. For a liability to qualify for recognition there must be not only present obligation but also the probability of an outflow of resources to settle that obligation. Where there are a number of obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement, is determined by considering the said obligations as a whole. In this connection, it may be noted that in the case of a

> manufacture and sale of one single item the provision for warranty could constitute a contingent liability not entitled to deduction under Section 37 of the said Act. However, when there is manufacture and sale of an army of items running into thousands of units of sophisticated goods, the past event of defects being detected in some of such items leads to a present obligation which results in an enterprise having no alternative to settling that obligation."

16. The Court also discussed the manner in which provision for product warranties can be made and various options which are available, highlighting the options which are more suitable in the cases of 'product warranties'. This discussion is as follows:-

> "In this case we are concerned with Product Warranties. To give an example of Product Warranties, a company dealing in computers gives warranty for a period of 36 months from the date of supply. The said company considers following options : (a) account for warranty expense in the year in which it is incurred; (b) it makes a provision for warranty only when the customer makes a claim; and (c) it provides for warranty at 2% of turnover of the company based on past experience (historical trend). The first option is unsustainable since it would tantamount to accounting for warranty expenses on cash basis, which is prohibited both under the Companies Act as well as by the Accounting Standards which require accrual concept to be followed. In the present case, the Department is insisting on the first option which, as stated above, is erroneous as it rules out the accrual concept. The second option is also inappropriate since it does not reflect the expected warranty costs in respect of revenue already recognized (accrued). In other words, it is not based on matching concept. Under the matching concept, if revenue is recognized the cost incurred to earn that revenue including warranty costs has to be fully provided for. When Valve Actuators are sold and the warranty costs are an integral part of that sale price then the appellant has to provide for such warranty costs in its account for the relevant year, otherwise the matching concept fails. In such a case the second option is also inappropriate. Under the circumstances, the third option is most appropriate because it fulfills accrual concept as well as the matching concept."

17. The Court then proceeded to determine as to what would be the most appropriate method for making a provision for 'product warranty', based on historical trend and held that:-

(a) It should be based on historical trend and for determining a proper historical trend, the company should have proper accounting system for capturing of sales, warranty provisions made and the actual expenses incurred subsequently.

(b) A detailed assessment of the warranty provisioning policy is required particularly if the experience suggests that warranty provisions are generally reversed if they remained unutilized based on past experience.

(c) The warranty provision for the product should be based on estimate at year end of future warranty expense. This becomes clear from the following discussion in the said judgment:-

> "For determining an appropriate historical trend, it is important that the company has a proper accounting system for capturing relationship between the nature of the sales, the warranty provisions made and the actual expenses incurred against it subsequently. Thus, the decision on the warranty provision should be based on past experience of the company. A detailed assessment of the warranty provisioning policy is required particularly if the experience suggests that warranty provisions are generally reversed if they remained unutilized at the end of the period prescribed in the warranty. Therefore, the company should scrutinize the historical trend of warranty provisions made and the actual expenses incurred against it. On this basis a sensible estimate should be made. The warranty provision for the products should be based on the estimate at year end of future warranty expenses. Such estimates need reassessment every year."

18. Apart from other things, the Court highlighted that provision for warranty on turnover of the company based on past experience fulfills accrual concept as well the matching concept. The Court not only laid stress on the past experience based on historical trend of warranty provisions, it was also emphasized that this provided estimates under the assessment every year.

19. We may also point out at this stage itself that the Supreme Court distinguished the judgments in ***Sajjan Mills*** (supra) as well as ***Indian Molasses Co.*** *(supra).* We would also like to refer to the judgment of the Supreme Court in ***CIT*** Vs.***Woodward Governor India P. Ltd.*** *312 ITR 254* wherein it was held that the accounting method followed by the assessee continuously for a given period of time has to be presumed to be correct till the AO comes to the conclusion for the reasons to be given that the estimate does not reflect to be true and correct profits .

20. The legal principle delineated in the aforesaid judgment would clearly demonstrate that whenever there is a warranty clause in the bulk product sold by the company/assessee to its customers, warranty provision can be made and it would not be treated as contingent liability. There is no quarrel to this proposition and in fact in this very case the assessee has been making the provisions for warranty every year which was accepted by the AO. The question that really calls for an answer is as to whether such a provision which has already been made in the previous years can be revised later on in a particular year as sought to be done by the assessee in the present case. Going by the reasons which justifies making of such a

provision and treating them as expenditure under Section 37 of the Act, more particularly when it fulfills the accrual concept as well the matching concept, we see no reason as to why the assessee could be precluded from revising this provision after taking into consideration that warranty period of the goods sold under warranty was existing provision already provided in a particular is falling short of the expected claims that may be received. It is, however, to be kept in mind that such a provision is based on scientific study and actuarial basis that is precisely done by the assessee in the instant case and, therefore, we see no reason to differ with the view taken by the Tribunal in the impugned order. We, therefore, answer this question no. '(a)' in the affirmative.

**RE: ROYALTY PAYMENT**

21. The assessee had paid royalty to the tune of ₹ 70.66 lacs which was disallowed by the AO under Section 40 (a) (i) of the Act. The CIT (A) had allowed the deduction and deleted the addition for which order of the CIT (A) is confirmed by the Tribunal.

22. The facts of the case are not in dispute. The assessee had entered into foreign technical collaboration agreement with M/s Whirpool Corporation, USA on 24th February, 1995 which was duly approved by the Government of India. Under this agreement, the assessee was to pay to its foreign collaborator royalty @ 5% on the domestic sales and 8% on export proceeds subject to taxes for a period of ten years. The royalty accrued from the date of agreement i.e. from 24th February, 1995. Royalty, however, was paid for sales made from 1st March, 1995 onwards and entire royalty of ₹ 70.66 lacs made during the period from 1st March, 1995 to 31st March, 1995 was accounted for the captioned assessment year which was claimed in

this assessment year on the ground that tax had been deduced on the said royalty and deposited only on 10th May, 1996 in this assessment year and this deposit was made within the time prescribed in Rule 30 of the Income Tax Rules, 1962.

23. The only objection of the Department is that the royalty pertains to the previous year i.e. assessment year 1995-96 in which it was paid and, therefore, should have been claimed by the assessee in the assessment year 1995-96 and not in this assessment year namely 1996-97. The submission of the assessee, on the contrary, was that having regard to the provision of Section 40 (a) (i) of the Act, the payment towards royalty could be claimed only in this year as tax at source which was deduced on the said payment was deposited in this assessment year.

24. What emerges from the aforesaid fact is that royalty of ₹ 70.66 lacs accrued in the last assessment year which was for the period from 1st March, 1995 to 31st March, 1995. According to the assessee, however, it could not have been allowed in that year as tax at source was not deposited in that year which was deposited only on 10th May, 1996 and, therefore, could be claimed only in this year in view of proviso to Section 40 (a) (i) of the Act. It is not in dispute as per Section 40 (a) (i) payment of royalty which is payable outside India is not deductable if tax has not been paid or deduced under Chapter XVII-B of the Act. Proviso to this clause reads as under:-

> "provided that where in respect of any sum, tax had been paid or deducted under Chapter XVII-B in any subsequent year, such sum shall be allowed as a deduction in computing the income of the previous year in which such tax has been paid or deducted."

As per this provision if the tax has been paid or deducted in the subsequent year the deduction is to be allowed in the year in which tax has been paid or deducted. In the present case, the tax was deducted in the previous year when the payment was made but paid in this year. This Court in ***CIT*** Vs. ***Nestle India Ltd.*** 275 ITR 1 analysed and explained the aforesaid provision in the following manner:-

> "It is a settled canon of interpretation of law that wherever a provision uses plain and simple language free of ambiguity such provision should be given its plain meaning without addition or subtraction of any expression into the language of the provisions. The scope of Section 40 spells out what amounts are not deductible from the income charged to tax under the profits and gains of business or profession. Thus, the Section indicates what ought not to be excluded despite anything provided under Section 3 to 38 of the Act where in the case of an assessed any interest Royalty which is payable outside or in India to the non-residents and at which tax is deductible at source under Chapter XVII-B of the Act and if such tax is not deducted or after deduction has not being paid during the previous year or in the subsequent year before the expiry of the time prescribed under sub-Section (1) of Section 200 shall not be deducted. The Section has three ingredients (a) Royalty which is payable outside India or in India to a non-resident; (b) the tax is deductible at source under Chapter XVII-B and has not being deducted; or (c) after deduction has not being paid during the period specified. In the Section it is a composite performance and a satisfaction of these ingredients which would deduct the amount indicated in the Section beyond the mischief of Section 40(a)(i). If language of these ingredients are not satisfied, the obvious result thereof would be that the specified amount shall not be liable to be deducted".

25. The question is as to whether deduction is to be claimed in the year in which tax is deducted at source or in the year in which it is deposited, though within the time allowed. In that case, the assessee had claimed the expenses in the year in which tax at source was

deducted stating that even if it was deposited in the next financial year, this deposit was within the limitation specified under Chapter XVII-B of the Act. The Tribunal had allowed the deduction and this Court accepted the view taken by the Tribunal as one of the permissible views. Interestingly, the Department in that case had argued that the deduction should be allowed in the year when it was actually deposited which was repelled in the following terms:-

> "Upon interpretation of these provisions, the Tribunal has taken a view which is permissible and is not perverse merely because another view if possible would not give rise to a substantial question of law. Once two interpretations are possible, one which deals in favor of the assessed would be given precedence over the other view. The argument raised on behalf of the Respondent department that the deduction should be allowed in the year of actual deposit of tax per se does not appear to be having any merit. Once time of deposit is specified in the statute itself, it will be unfair to dissect the language to give a meaning which would frustrate the very relief that is sought to be granted to an assessed by the provisions. The Legislature has made it mandatory by using the expression and at one place and by or at the other. They cannot be interchanged and both the ingredients must co-exist simultaneously during the period permissible in law. If the argument of the Respondent is accepted probably in some of the cases, the benefit could never accrue to the assessed as the deduction at source and its payment to the authorities may not ever occur in the same financial year that does not even appear to be the legislative intent inasmuch as Section provides in the situation where deduction is made in one year and is deposited/paid in another year. In our view, the most significant aspect of this provision is its payment within the time specified in law. We have already noticed that the authorities had found it as a matter of fact that the payments of the tax deducted at source were made within the prescribed time".

26. Same approach was adopted by this Court in ***CIT*** Vs. ***Oracle Software India P. Ltd.,*** 293 ITR 353. That was also a case where the assessee paid royalty in the assessment year 1994-95 and tax

deducted thereof was deposited in the year 1995-96 i.e. within the time provided by the statute. The Court held that the assessee would be entitled to claim deduction in the assessment year 1994-95.

27. Following these judgments, we are of the view that the assessee should have claimed the deduction in the assessment year in question i.e. 1995-96. It is more so, when proviso itself stipulates that the same shall be allowed as deduction in the year in which it is either paid or deducted under Chapter XVII-B of the Act. Here it was deducted in the assessment year 1995-96 when payment of royalty was made. Explanation to Section 195 of the Act states "whichever is earlier". The deduction is also in point of time and payment was made within the stipulated period *albeit* in the next assessment year i.e. 1996-97.

28. On this reckoning also, the assessee could have claimed deduction against payment of royalty in the assessment year 1995-96. We, thus, answer the question no. '(b)' in the negative i.e. against the assessee and in favour of the Revenue. However, the assessee would be entitled to claim the deduction of this payment in the assessment year 1995-96. However, we make it clear that appeal is disposed of in the aforesaid terms.

**(A.K. SIKRI)**
**JUDGE**

**(M.L. MEHTA)**
**JUDGE**

**JANUARY 24,2011**
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