

IT: Where assessee, engaged in providing marketing, technical support installation and Commissioning services to telecommunication sector, made a provision for warranty services by way of repair and replacement for a pre-defined period, said provision was eligible for deduction under section 37(1)

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IN THE ITAT DELHI BENCH 'C'

Huawei Telecommunication (India) Company (P.) Ltd.

v.

Assistant Commissioner of Income-tax, Circle- 1 (1), Gurgaon*

AMIT SHUKLA, JUDICIAL MEMBER
AND PRASHANT MAHARISHI, ACCOUNTANT MEMBER
IT APPEAL NO. 1494 (DELHI) OF 2014
[ASSESSMENT YEAR 2008-09]
MAY 7, 2018

Section [37\(1\)](#) of the Income-tax Act, 1961 - Business expenditure - Allowability of (Warranty provision) - Assessment year 2008-09 - Assessee was a company engaged in providing marketing, technical support installation and commissioning services to telecommunication sector - As part of contract with customers, assessee was required to provide warranty services by way of repair and replacement for a predefined period - During relevant year assessee company provided certain amount for warranty expenses and debited same to profit and loss account - Assessing Officer rejected assessee's claim on ground that provision made by assessee was a contingent liability - Whether when revenue earned during year was credited to profit and loss account of year and corresponding warranty provision expenditure required to be made over a period of warranty claim was definitely to be charged to profit and loss account to arrive at correct figure of profit, in such a case liability of warranty cost could not be regarded as contingent at all - Held, yes - Whether, therefore, impugned order passed by Assessing Officer was to be set aside - Held, yes [Para 9] [In favour of assessee]

FACTS

- The assessee was a company engaged in providing marketing technical support installation and commissioning services to the telecommunication sector. During relevant year the assessee company provided certain amount for warranty expenses and debited the same to the profit and loss account.
- The assessee explained that the warranty expenses had been determined on the basis of the costs liable to be incurred in relation to warranty obligation contracted with respective customers.
- The Assessing Officer held that the provision of warranty expenses was not an allowable deduction in view of the note given by the auditors in the audit report. He further held that provision made by the assessee was a contingent. Therefore, he disallowance assessee's claim of warranty expenditure.

- The Commissioner (Appeals) confirmed said disallowance.
- On second appeal:

HELD

- The assessee company is engaged in the business of trading of telecom equipment and provision for installation and commissioning services related to the same. In the trading and installation services of the telecom equipment, the assessee provides warranty to the buyers. As part of the contract with the customers, assessee was required to provide warranty services by way of repair and replacement for a predefined period. The obligation of the appellant to provide the services is inbuilt in the contract for the sale and services only. Therefore, apparently assessee is supposed to incur certain expenditure over the period of warranty claim contract. The assessee made a provision based on the inputs from technical team for each customer contract having regard to the nature of the products supplied and installation services provided.
- According to the assessee, it takes into account the labour cost, material cost and other technical services cost expected to be incurred to meet the warranty obligation with respect to these customers. Undoubtedly, the revenue earned during the year was credited to the profit and loss account of the year and the corresponding warranty provision expenditure required to be made over a period of the warranty claim was definitely to be charged to the profit and loss account to arrive at the correct figure of the profit, in such a case liability of warranty cost could not be regarded as contingent at all. But it is necessary that such provision of warranty expenditure is made on some scientific basis so that the estimate of provision made by the assessee can be said to be a reliable estimate of such liability. Estimates of the warranty provision depends upon a different industry in which assessee operates. There may be different manner of making a provision because of warranty services in different industry. There cannot be straightjacket formulae for warranty provision in each industry alike. Therefore, the reliable estimate made by the assessee is required to be looked from the perspective of the industry in which the assessee operates.
- In the present case, the assessee has obtained the estimate of the warranty claim liability based on the percentage of actual work completed until 31-3-2008 as submitted by the technical team of the assessee. The assessee has also estimated the labour cost during the warranty period and other expenditure for execution of warranty claims of the customers. From the total liability as on 31-3-2008, the assessee has looked that the provision outstanding at the beginning of the year and the balance provision has been made during the current year by debiting to the profit and loss account. The lower authorities has considered the claim of the assessee and held that it is not based on any scientific methodology. However, the assessee has stated that it has received input from its technical team which is most competent to see what kind of expenditure is required to be made for the purposes of fulfilling the warranty obligation embedded in contract with the customers. Therefore, whether the provision of the assessee of warranty expenditure is reliable estimate or not the lower authorities should have looked into the basis of the estimate made by the assessee.
- It is further required to be seen that what kind of expenditure have been incurred by the assessee in subsequent years that will give the best picture with the original

provision made by the assessee's reliable estimate or not. Further as the sale prices has been booked into the profit and loss account the corresponding expenditure on account of warranty expenses are also a liability in present and therefore it cannot be said that it is a contingent liability wherein the contract with the customers the clauses of warranty are existing. Therefore, it is an allowable expenditure. In fact, there cannot be any doubt that the assessee is eligible for deduction of warranty expenditure.

- The only dispute is whether the claim made by the assessee is a reliable estimate or not but in any case, it cannot be nil. Qualification in the audit report with respect to quantification is only because of non-availability of the reliable trend for the past years. The assessee has also disclosed in the notes on accounts the details of the warranty expenses. Furthermore, the assessee has also stated that expenditure incurred during the year is not separately identifiable. The lower authorities have not examined these details. The provisions of the warranty expenditure was required to be estimated based on the past experience of the assessee demonstrated on the basis of past warranty liability on similar type of contracts and further it could be proved by incurring the warranty expenditure in subsequent period to the sales. This exercise has not been done either by the assessee or by the revenue.
- In view of this, the whole issue is remanded back to the file of the Assessing Officer with a direction to the assessee to prove before the Assessing Officer how the warranty provisions have been made by the assessee along with the technical inputs received from the technical team of the assessee. The Assessing Officer may examine the above claim and then decide the issue afresh on merits after giving assessee a reasonable opportunity of hearing. [Para 9]

CASES REFERRED TO

Rotork Controls India (P.) Ltd. v. CIT [[2009\] 180 Taxman 422/314 ITR 62 \(SC\)](#) (para 5).

Ravi Sharma, Adv. *for the Appellant.* **Amit Jain**, Sr. DR *for the Respondent.*

ORDER

Prashant Maharishi, Accountant Member - This is an appeal filed by the assessee against the order of the Id CIT (A), Faridabad dated 27.12.2013 for the Assessment Year. 2008-09.

2. The assessee has raised the following grounds of appeal:—

"1. That the Ld. CIT (Appeals), has erred on facts and in law, in confirming the action of the Learned Assessing Officer in disallowing the provision for warranty expenses amounting to Rs. 37,87,010/-without appreciating the fact that the same is an ascertained liability and has been calculated based on technical estimates.

1.1. That the Ld. CIT (Appeals), has erred on facts and in law, in not appreciating the decision of Hon'ble Apex court in the case of *Rotork Control India Private Limited v. CIT* ([314 ITR 62](#)) and the Delhi High Court in the case of *CIT v. Vintec Corporation Pvt. Ltd.* ([278 ITR 337](#))

2. That the Ld. CIT (Appeals), has erred on facts and in law in levy of interest under section 234C of the Act.

3. That the Ld. Assessing Officer has erred in initiating the penalty proceedings under section 271(1)(c) of the Act.

4. That the Ld. CIT (Appeals), has erred on facts and in law in not allowing the full credit of taxes deducted at source and taxes paid by the appellant by dismissing the grounds raised by the appellant."

3. Briefly, the facts culled out from the assessment order are that assessee is a company engaged in providing marketing technical support installation and commissioning services to the telecommunication sector. It filed its return of income on 30/9/2008 Rs. 116079430/- which was further revised on 31/3/2010 at Rs. 107256784/-.

4. The only issue involved in the appeal is the allowability of warranty expenditure provision made by the assessee.

5. During the year the assessee company provided for warranty expenses of Rs 3787010/- and debited the same to the profit and loss account. The assessee was asked to explain why the provision for the warranty expenses is allowable to the assessee. The assessee explained that the warranty expenses have been determined on the basis of the costs liable to be incurred in relation to warranty obligation contracted with respective customers. Assessee further relied on the decision of the Hon'ble Supreme Court in case of *Rotork Controls India (P.) Ltd. v. CIT* [\[2009\] 180 Taxman 422/314 ITR 62](#) and submitted that the case of the assessee is of an identical nature and therefore the same expenditure is allowable according to the decision of the Hon'ble Supreme Court. The Ld. AO considered the arguments of the assessee and submitted that warranty expenses provided by the assessee is not on scientific basis in compliance of the accrual basis of accounting and hence is not allowable as deduction whereas the assessee has also not submitted the said expenses calculated on any scientific basis but have been determined on the basis of the costs liable to be incurred in relation to warranty obligation contracted with respective customers. He further held that the provision of warranty expenses is not an allowable deduction in view of the note given by the auditors in the audit report in clause (f) of the report. He further held that provision made by the assessee is a contingent and is not a liability in present. Therefore, he disallowed the expenditure of Rs. 37,87,010/- on account of warranty expenditure. Consequently the assessment order under section 143 (3) of income tax act was passed on 30/12/2011 determining the total income of the assessee at Rs. 11,10,43,794/-.

6. The assessee aggrieved with the order of the Ld. AO preferred an appeal before the Ld. CIT (A). The Ld. CIT A held that the note by given by the auditor in clause (f) of the audit report puts a big question mark on the accuracy or appropriateness of the provision for warranty in the books of accounts of the appellant. He further held that the warranty provision has not been made by making estimation with reasonable accuracy as held by the various judicial pronouncements. He therefore upheld the above disallowance. Therefore, assessee is in appeal before us.

7. The Ld. authorized representative submitted that assessee has made detailed calculation of the warranty provision with reasonable accuracy. He submitted a chart wherein it has been explained that the according to the percentage of actual work completed the assessee estimates estimated local labour cost for the warranty and other overhead on estimated total warranty costs are determined from the above figures, the earlier year balance provision is reduced and the balance liability is made during the year. He further submitted a chart wherein he submitted that it in assessment year 2007- 08 the provision of warranty expenditure as a percentage of turnover was only 0.07% whereas in this year it is 0.21%. Therefore, he submitted that the provision of the warranty made by the assessee is based on reliable estimate based on experience. He therefore submitted that warranty expenditure provision made by the assessee satisfies the conditions laid down by the Hon'ble Supreme Court in the decision of *Rotork Controls (India) (P.) Ltd.* He therefore submitted that the Ld. lower authorities have failed to appreciate that there is no arithmetical formula, which can apply to each and every industry identically in the case of provision of warranties. He further submitted that assessee is engaged in the business of trading of

telecom equipment and provision of installation and commissioning services. The warranty is related to the same. The warranty expenditure coupled in the agreement is based on the various projects undertaken by the assessee for installation etc in telecom sector. He therefore submitted that assessee is not the manufacture of any product therefore the warranty provisions cannot be made on the basis of the number of product sold. He explained the subtle difference between the warranty provision in case of manufacturer and in case of a service provider who is providing the identical services like assessee.

8. The Ld. apartment representative vehemently contested the arguments of the Ld. authorized representative and relied upon the orders of the lower authorities. He submitted that lower authority have given detailed reasons and stated that coupled with remarks of the auditor in the audit report as well as the failure on part of the assessee to show the provision of the warranty services on scientific basis the disallowance has been correctly made.

9. We have carefully considered the rival contention and perused the orders of the lower authorities. The assessee company is engaged in the business of trading of telecom equipment and provision for installation and commissioning services related to the same. In the trading and installation services of the telecom equipment. The assessee provides warranty to the buyers. As part of the contract with the customers, it is required to provide warranty services by way of repair and replacement for a predefined period. The obligation of the appellant to provide the services is inbuilt in the contract for the sale and services only. Therefore, apparently assessee is supposed to incur certain expenditure over the period of warranty claim contract. The assessee made a provision based on the inputs from technical team for each customer contract having regard to the nature of the products supplied and installation services provided. According to the assessee, it takes into account the labour cost, material cost and other technical services cost expected to be incurred to meet the warranty obligation with respect to these customers. Undoubtedly, the revenue earned during the year is credited to the profit and loss account of the year and the corresponding warranty provision expenditure required to be made over a period of the warranty claim is definitely to be charged to the profit and loss account to arrive at the correct figure of the profit for the year. The liability of warranty cost therefore cannot be said to contingent at all. But it is necessary that such provision of warranty expenditure is made on some scientific basis so that the estimate of provision made by the assessee can be said to be a reliable estimate of such liability. Estimates of the warranty provision depends upon a different industry in which assessee operates. There may be different manner of making a provision because of warranty services in different industry. There cannot be straightjacket formulae for warranty provision in each industry alike. Therefore, the reliable estimate made by the assessee is required to be looked from the perspective of the industry in which the assessee operates. In the present case, the assessee has obtained the estimate of the warranty claim liability based on the percentage of actual work completed until 31st of March 2008 as submitted by the technical team of the assessee. The assessee has also estimated the labour cost during the warranty period and other expenditure for execution of warranty claims of the customers. From the total ability as on 31st of March 2008, the assessee has looked that the provision outstanding at the beginning of the year and the balance provision has been made during the current year by debiting to the profit and loss account. The Ld. Lower authorities has considered the claim of the assessee and held that it is not based on any scientific methodology. However, the assessee has stated that it is received input from its technical team which is most competent to see what kind of expenditure is required to be made for the purposes of fulfilling the warranty obligation embedded in contract with the customers. Therefore, whether the provision of the assessee of warranty expenditure is reliable estimate or not the lower authorities should have looked into the basis of the estimate made by the assessee. It is further required to be seen that what kind of expenditure have been incurred by the assessee in subsequent years that will give the best picture with the original provision made by the assessee's reliable estimate or not. Further as the sale prices has been booked into the profit and loss account the corresponding expenditure on account of warranty expenses are also a liability in present and therefore it cannot be said that it is a

contingent liability wherein the contract with the customers the clauses of warranty are existing. Therefore, it is an allowable expenditure. In fact, there cannot be any doubt that the assessee is eligible for deduction of warranty expenditure. The only dispute is whether the claim made by the assessee is a reliable estimate or not but in any case, it cannot be nil. Qualification in the audit report with respect to quantification is only because of non-availability of the reliable trend for the past years. The assessee has also disclosed in the notes on accounts the details of the warranty expenses. Furthermore, the assessee has also stated that expenditure incurred during the year is not separately identifiable. The lower authorities have not examined these details. The provisions of the warranty expenditure is required to be estimated based on the past experience of the assessee demonstrated on the basis of past warranty liability on similar type of contracts and further it can be proved by incurring the warranty expenditure in subsequent period to the sales. This exercise has not been done either by the assessee or by the revenue. In view of this, we set aside the whole issue back to the file of the Ld. assessing officer with a direction to the assessee to prove before the Ld. AO how the warranty provisions have been made by the assessee along with the technical inputs received from the technical team of the assessee. The Ld. AO may examine the above claim and then decide the issue afresh on merits after giving assessee a reasonable opportunity of hearing. In the result ground No. 1 of the appeal of the assessee is allowed with above direction.

10. The ground No. 2 and 3 of the appeal of the assessee is with respect to the levy interest under section 234C of the income tax act which is consequential in nature and further initiation of the penalty proceedings under section 271 (1) © of the act. As the chargeability of interest under section 234C of the income tax act is consequential in nature and further the initiation of the penalty proceedings is also premature. Hence, both the grounds No. 2 and 3 of the appeal of the assessee are dismissed.

11. The ground No. 4 of the appeal of the assessee is against not allowing the full credit of taxes deducted at source and taxes paid by the appellant dismissing the grounds raised by the appellant. As the amount of tax deduction at source and taxes paid by the assessee is required to be given credit from the tax liability determined by the Ld. AO if they are supported by the necessary evidences, hence we set aside this ground of appeal to the file of the Ld. assessing officer with a direction to examine the claim made by the assessee of credit for tax deduction at source and advance tax paid. In the result ground No. 4 of the appeal of the assessee is allowed with above direction.

12. In the result appeal of the assessee is partly allowed for statistical purposes.

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*In favour of assessee.