IN THE INCOME TAX APPELLATE TRIBUNAL
PUNE BENCH "B", PUNE

Before Shri Shailendra Kumar Yadav, Judicial Member
and Shri R.K. Panda, Accountant Member

ITA NO. 1481/PN/2010
(Assessment Year 2006-07)

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Prop.Mrs. Uma Surendra Shinde
3957, Guruprasad Mudra Mandir,
Near City Police, Ahmednagar. .. Appellant
PAN No. AAABW 0039R

Vs.

DCIT, Ahmednagar Circle,
Ahmednagar. .. Respondent

Appellant by	:	Sri S.N. Puranik
Respondent by	:	Smt. S. Praveena
Date of Hearing	:	28-02-2013
Date of Pronouncement	:	19-03-2013

ORDER

PER R.K. PANDA, AM :

This appeal filed by the assessee is directed against the order dated 22-10-2010 of the CIT(A)-I, Pune relating to Assessment Year 2006-07.

2. Facts of the case, in brief, are that the assessee is engaged in the business of development and sale of school educational softwares for Standard 1 to 12 in Marathi as well as in English Medium. During the course of assessment proceedings the Assessing Officer noted that the assessee has made a provision of ₹43,50,000 as labour charges payable. On being questioned by the Assessing Officer it was submitted that the provision was made for expenses which are required to be made by the assessee for upgradation of softwares to different clients. It was submitted that the assessee is obliged to carry out the upgradation as a condition of

sale. It was accordingly explained that the journal entries were passed in different names "as amount payable for job work charges". The Assessing Officer noted that no TDS was deducted from the above provision. He therefore held that the expenditure cannot be allowed as deduction u/s.40(a)(ia).

3. Before the CIT(A) the assessee strongly challenged the order of the Assessing Officer and submitted that no disallowance u/s.40(a)(ia) is called for. Various decisions were also cited before him.

3.1 However, the learned CIT(A) was not satisfied with the explanation given by the assessee and upheld the action of the Assessing Officer by holding as under :

> *"5.3 I have carefully considered the facts of the case appearing from the available records and the applicable law, and find that this is a case in which the appellant is engaged in the business of development and sale of educational softwares. The softwares which are sold to different clients contained condition on the part of the supplier to provide modification/development as per their requirement for two years. In view of the above, the appellant has claimed that the expenditure which are relating to the sale of softwares recognised as revenue in this year, have to be considered in this year. In other words, the expenditure which are likely to arise in the period of two years starting from the date of sale on account of development/ modifications has to be considered in this year and therefore, the appellant has made a provision for the same and debited it in the Manufacturing account. On examination of facts it is found that the expenditure is on estimate and has actually not crystalised or accrued. At the most it can be considered that the commitment to incur such expenditure has arisen. It cannot be said that such a commitment will lead to expenditure, as the same is contingent upon the requirement of modification by clients which may or may not arise. The reliance placed by the appellant on the case of Calcutta Co. Ltd. is found to be not correct. The above issue was relating to A.Y. 1948-49 when the present Act was not in operation. Even in this judgement the Hon'ble Court has allowed the expenditure as it was found that the expenditure has accrued relating to income which was also brought to tax on accrual basis. In this case, even though the income has accrued and arisen, the expenditure which are likely to occur because of a clause in the sale document cannot be considered to have accrued. The expenditure is purely on contingent and estimate basis. The direct expenditure which has been incurred by the appellant has already been allowed and there is no dispute on that. In addition to the above, the appellant has claimed on the issue of disallowance made by .the Assessing Officer u/s 40a(ia) that though the above expenditure is on estimate basis and it is not known to whom it will be paid, but the same has to be provided. In view of the same, the appellant claims that the obligation to deduct TDS has not arisen and therefore, disallowance u/s 40a(ia) cannot be made. The arguments of the appellant made in respect of allowability of the expenditure and the application of provisions relating to 40a(ia) are contradictory to each other. On the issue of allowability it*

is being claimed that the expenditure has crystalised, whereas on the issue of applicability of 40a(ia), it is being claimed that the expense is on estimation to be incurred in future, and in such eventuality the vender will be appointed for providing these services and therefore, appellant claims to be not even knowing the persons to whom the expenditure is to be made. If such is the case then the expenditure is only contingent in nature and cannot be considered to have accrued. In my opinion, the disallowance made by the Assessing Officer is correct. If the expenditure is contingent, then it is not allowable and if the expenditure has accrued then 40(a)(ia) will be applicable and the expenditure will get disallowed. The appeal therefore, is dismissed on this addition."

4. Aggrieved with such order of the CIT(A) the assessee is in appeal before us with the following grounds :

1) The learned Commissioner of Income Tax (Appeals) erred in upholding disallowance u/s. 40(a)(ia) of the Income Tax Act, 1961 on the ground that the provision of the said section were applicable to the expenditure had accrued.

2) The learned CIT(A) failed to appreciate that an amount of Rs.43,50,000/-was provided for labour charges payable and the said provision was found admissible as deduction by the learned Assessing Officer.

3) The learned CIT(A) further failed to appreciate that the provision of Rs. 43,50,000/- found admissible u/s.37 of the Income Tax Act, 1961 was not liable for deduction of tax at same as the payee/ payees thereof was/ were not identifiable.

4) The learned CIT(A) further failed to appreciate that CBDT has accepted the legal position vide its letter no.275 /126/96 IT(B) dated July 5, 1996 that the provision of sec. 193 were not applicable in cases where provision was made but payee was not identifiable. The provision was made but payee was not identifiable. The position stated in the said letter equally applies to the assessee's case.

5) The appellant crave, leave, to add, alter, raise or modify; any ground at the time of hearing.

5. The learned counsel for the assessee strongly challenged the order of the CIT(A). He submitted that the assessee has been assigned the contract by the Government of Maharastra for developing software based on school education curriculum for Standard 1 to 12 in Marathi as well as in English Medium. The assessee has to develop software, get it approved and circulate CDs to various schools in Maharastra. Referring to Paper Book Pages 211 to 214 he submitted that such tender was allotted in April 2005 and according to the terms and conditions of the Tender the CDs/softwares shall be under two year warranty along with upgradation and/or

modifications in contents as directed by Maharastra Prathamik Sikshan Parishad. For the impugned assessment year the turnover of the assessee on account of sale on supply to Government Schools was ₹2.84 crores. He submitted that in terms of tender conditions for two years warranty and for upgradation/modification the assessee made a provision of ₹43,50,000 since whole sale proceeds are accounted for during this year. He submitted that the provision so debited to profit and loss account is as per mercantile system of accounting and in consonance with the decision of Hon'ble Supreme Court in the case of Calcutta Co. Ltd. Vs. CIT reported in 37 ITR. He submitted that since the payees are un-identifiable and since payee-wise amount payable was not there, therefore, the liability to TDS was not ascertainable.

5.1 He submitted that during assessment proceedings assessee had produced the list of job work operators to whom payments were made in subsequent years. As regards the allegation the learned CIT(A) that the expenditure is contingent upon requirement of modification which may or may not arise and that if the expenditure is contingent then it is not allowable and if expenditure is accrued then 40(a)(ia) will be applicable he submitted that since the Assessing Officer has accepted accrual of expenditure and has verified the actual payment for job work in subsequent years out of provision, therefore, there is no reason to doubt.

5.2 Referring to the decision of Hon'ble Supreme Court in the case of Rotork Controls India Pvt. Ltd. reported in 314 ITR 62 he submitted that provision for warranty is an allowable expenditure. So far as the allegation of the revenue that there is default in TDS he submitted that in absence of identification of amount payable to particular persons it was not possible to make TDS out of such provision. He further submitted that the assessee being an individual was not liable to TDS before 01-06-07 since section 194C was amended w.e.f.01-06-07. He submitted that the assessee was not liable to tax audit in the immediately preceding assessment year 2005-06. Further, if at all liable, the liability arises when the contract/payment exceeds ₹50,000 per contract payment.

5.3 He submitted that since the assessee himself was a Government contractor for development of software and supply of educational CDs etc. and since job workers were not his sub contractors as they have no privity of contract with Maharastra Prathamik Shikshan Parishad, therefore, the provisions of section 194C are not applicable to him. For this proposition he relied on the decision of Pune Bench of the Tribunal in the case of Vijay Ramchandra Shirsth Vs. ACIT in ITA No.1241/PN/2009 and ITA No.185/PN/2010 order dated 29-09-2011 for A.Y. 2005-06 and 2006-07. He submitted that under somewhat similar circumstances the Tribunal had held that provisions of Chapter XVIIB of the Act, particularly provisions of section 194C are not applicable for the payments made to various parties by the assessee and accordingly disallowance made u/s.40(a)(ia) by the Assessing Officer and confirmed by the CIT(A) was directed to be deleted. He accordingly submitted that the order of the CIT(A) be set aside and the Assessing Officer be directed to delete the disallowance made u/s.40(a)(ia).

6. The learned Departmental Representative on the other hand heavily relied on the order of the Assessing Officer and the CIT(A). He submitted that the assessee has made provisions without knowing the names of the parties etc. to whom such amount is likely to be paid. Therefore, the same amounts to contingent liability and therefore the same is not an allowable

expenditure. If the contention of the assessee that the liability has accrued is accepted then the assessee is liable to deduct tax u/s.194C of the Act and in absence of the same provisions of section 40(a)(ia) are attracted. Referring to the decision of Hon'ble Supreme Court in the case of Indian Molasses Co. Pvt. Ltd. Vs. CIT reported in 37 ITR 66 he submitted that a contingent liability is not an allowable expenditure.

7. We have considered the rival arguments made by both the sides, perused the orders of the Assessing Officer and the CIT(A) and the Paper Book filed on behalf of the assessee. We have also considered the various decisions cited before us. There is no dispute to the fact that the assessee in the instant case is engaged in the business of development and sale of education software to various schools in Maharastra. There is also no dispute to the fact that as per the tender conditions the CDs/softwares shall be under two year warranty along with upgradation and/or modifications in contents as directed by Maharastra Prathamik Shikshan Parishad, a fact submitted by the assessee before the revenue authorities and not controverted by the revenue. According to the assessee since the whole sale proceeds are accounted during the impugned assessment year and since the same is subject to liability for two year warranty, therefore, the provisions made for such liability is an allowable expenditure. It is also the submission of the learned counsel for the assessee that since the names of the parties are not known, therefore, the assessee has not made any TDS as per the provisions of section 194C r.w.s. 40(a)(ia). It is the case of the revenue that if the names of the parties to whom such amount is payable is not known, then it is a contingent liability and therefore the same is not an allowable expenditure. In case the same is an accrued liability then in view

of violation of provisions of section 194C disallowance of the same has to be made u/s.40(a)(ia).

8. In the instant case, as has already been mentioned earlier, the assessee has accounted for the entire sale proceeds during the impugned assessment year with a condition for two year warranty for upgradation and/or modifications of contents of the CDs/softwares as directed by the Maharastra Prathamik Shikshan Parishad. Accordingly, the assessee has made provision of ₹43,50,000 and in subsequent years the assessee has made payment for the same amounting to ₹9,60,703 in A.Y. 2007-08 and ₹7,71,795 in A.Y. 2008-09.

8.1 The Hon'ble Supreme Court in the case of Calcutta Co. Ltd. (Supra) has held as under :

> *"Apart, however, from the question whether section 10(2)(xv) of the Income tax Act would apply, to the facts of the present case, the case is, in our opinion, well within the purview of section 10(1) of the Income tax Act. The appellant here is being assessed in respect of the profits and gains of its business and the profits and gains of the business cannot be determined unless and until the expenses or the obligations which have been incurred are set off against the receipts. The expression " profits and gains " has to be understood in its commercial sense and there can be no computation of such profits and gains until the expenditure which is necessary for the purpose of earning the receipts is deducted therefrom whether the expenditure is actually incurred or the liability in respect thereof has accrued even though it may have to be discharged at some future date. As was observed by Lord Herschell in Russel v. Town and County Bank Ltd.:*
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> *" The duty is to be charged upon ' a sum not less than the full amount of the balance of the profits or gains of the trade, manufacture, adventure, or concern;' and it appears to me that that language implies that for the purpose of arriving at the balance of profits all that expenditure which is necessary for the purpose of earning the receipts must be deducted, otherwise you do not arrive at the balance of profits, indeed, you do not ascertain, and cannot ascertain, whether there is such a thing as profit or not. The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. That seems to me to be the meaning of the word ' profits ' in relation to any trade or business. Unless and until you have ascertained that there is such a balance, nothing exists to which the name ' profits ' can properly be applied."*
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> *A similar opinion was expressed in Gresham Life Assurance Society v. Styles:*
> *" When we speak of the profits and gains of a trader we mean that which he had made by his trading. Whether there be such a thing as profit or gain can only be ascertained by setting against the receipts the expenditure or obligations to which they have given rise. "*

These are no doubt observations from the English cases dealing with English statutes of income tax, but the general principles which can be deduced therefrom are, nevertheless, applicable here and it was stated by Lord Macmillan in Pondicherry Railway Co. Ltd. v. Commissioner of Income tax :

" English authorities can only be utilised with caution in the consideration of Indian income tax cases owing to the differences in the relevant legislation, but the principle laid down by Lord Chancellor Halsbury in Gresham Life Assurance Society v. Styles, is of general application unaffected by the specialties of the English tax system. 'The thing to be taxed', said his Lordship, ' is the amount of profits or gains'. The word ‘profits', I think, is to be understood in its natural and proper sense in a sense which no commercial man would misunderstand."

It may be useful to observe at this stage that prior to the amendment of the Indian Income tax Act, 1939, bad and doubtful debts were not treated as deductible allowance for the purpose of computation of profits or gains of a business. The Privy Council in Income tax Commissioner v. Chitnavis observed :

" Although the Act nowhere in terms authorises the deduction of bad debts of a business, such a deduction is necessarily allowable. What are chargeable to income tax in respect of a business are the profits and gains of a year; and in assessing the amount of the profits and gains of a year account must necessarily be taken of all losses incurred, otherwise you would not arrive at the true profits and gains."

The High Court in disallowing the claim of the appellant in the present case only considered the provisions of section 10(2)(xv) of the Act and came to the conclusion that on a strict interpretation of those provisions the sum of Rs.24,809 was not an allowable deduction. Its attention was drawn by the learned counsel for the appellant to the provisions of section 10(I) of the Act also but it negatived this argument observing that under the Indian Act, the profits must be determined by the method of making the statutory deductions from the receipts and any deduction from the business receipts, if it was to be allowed, must be brought under one or the other of the deductions mentioned in section 10(2) and that there was no scope for any preliminary deduction under general principles. It was, however, held by this court in Badridas Daga v. Commissioner of Income tax :

" It is to be noted that while section 10(I) imposes a charge on the profits or gains of a trade, it does not provide how those profits are to be computed. Section 10(2) enumerates various items which are admissible as deductions, but it is well settled that they are not exhaustive of all allowances which could be made in ascertaining profits taxable under section 10(I). "

Venkatarama Aiyar, J., who delivered the judgment of the court then proceeded to discuss the cases of Commissioner of Income tax v. Chitnavis, Gresham Life Assurance Society v. Styles and Pondicherry Railway Co. v. Income tax Commissioner, and observed :

" The result is that when a claim is made for a deduction for which there is no specific provision in section 10(2), whether it is admissible or not will depend on whether, having regard to accepted commercial practice and trading principles, it can be said to arise out of the carrying on of the business and to be incidental to it. If that is established, then the deduction must be allowed, provided of course there is no prohibition against it, express or implied, in the Act.

Turning now to the facts of the present case, we find that the sum of Rs.24,809 represented the estimated expenditure which had to be incurred by the appellant in discharging a liability which it had already undertaken under the terms of the deeds of sale of the lands in question and was an accrued liability which according to the mercantile system of accounting the appellant was entitled to *debit in its books of account for the accounting year as against the receipts of Rs.43,692-II-9 which represented the sale proceeds of the said lands. Even under section 10(2) of the Income tax Act, it might possibly be urged that the word " expended " was capable of being interpreted as " expendable " or " to be expended " at least in a case where a liability to incur the said expenses had been actually incurred by the assessee who adopted the mercantile system of accounting and the debit of Rs.24,809 was thus a proper debit in the present case. We need not how ever base our decision on any such consideration. We are definitely of opinion that the sum of Rs.24,809 represented the estimated amount which would have to be expended by the appellant in the course of carrying on its business and was incidental to the same and having regard to the accepted commercial practice and trading principles was a deduction which, if there was no specific provision for it under section 10(2) of the Act, was certainly allowable deduction, in arriving at the profits and gains of the business of the appellant under section 10(I) of the Act, there being no prohibition against it, express or implied, in the Act.*

It is to be noted that the appellant had led evidence before the Income tax authorities in regard to this estimated expenditure of Rs.24,809 and no exception was taken to the same in regard to the quantum, though the permissibility of such a deduction was questioned by them relying upon the provisions of section 10(2) of the Act.

It, therefore, follows that the conclusion reached by the High Court in regard to the disallowance of Rs.24,809 was wrong and it should have answered the referred question in the affirmative.

9. The Hon'ble Supreme Court in the case of Rotork India Pvt. Ltd. Vs. CIT reported in 314 ITR 63 has held as under :

"Held, reversing the decision of the High Court, that the value actuators, manufactured by the assessee, were sophisticated goods and statistical data indicated that every year some of these were found effective; that value actuator being a sophisticated item no customer was prepared to buy a value actuator without a warranty. Therefore, the warranty became an integral part of the sale price; in other words, the warranty stood attached to the sale price of the product. In this case the warranty provisions had to be recognised because the assessee had a present obligation as a result of past events resulting in an outflow of resources and a reliable estimate could be made of the amount of the obligation. Therefore, the assessee had incurred a liability during the assessment year which was entitled to deduction under section 37 of the Income-tax Act, 1961.

The present value of a contingent liability, like the warranty expense, if properly ascertained and discounted on accrual basis can be an item of deduction under section 37. The principle of estimation of the contingent liability is not the normal rule. It would depend on the nature of the business, the nature of sales, the nature of the product manufactured and sold and the scientific method of accounting adopted by the assessee. It would also depend upon the historical trend and upon the number of articles produced.

A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognised 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 recognised.

> *The principle is that if the historical trend indicates that a large number of sophisticated goods were bring manufactured in the past and the facts show that defects existed in some of the items manufactured and sold, then provision made for warranty in respect of such sophisticated goods would be entitled to deduction from the gross receipts under section 37.*

10. From the details furnished by the assessee we find that although the assessee has submitted the list of job work operators to whom payments were made in two subsequent financial years for modification, however, the Assessing Officer has missed to note such payments made in subsequent years. Further, the submission of the assessee that most of the job operators were paid less than ₹50,000/- for which no TDS is required has also not been considered. We, therefore, restore the issue to the file of the Assessing Officer with a direction to verify the payments made in subsequent years to various job workers. Since the assessee has made a provision for such warranty on estimate basis which is higher than the actual payments in the two subsequent years, therefore, the Assessing Officer shall decide the reasonable amount of estimated liability which has subsequently been paid by the assessee and decide the issue afresh and in accordance with law keeping in mind the decisions of Hon'ble Supreme Court cited above. Needless to say the Assessing Officer shall give due opportunity of being heard to the assessee. We hold and direct accordingly. The grounds raised by the assessee are accordingly allowed for statistical purposes.

11. In the result, the appeal filed by the assessee is allowed for statistical purposes.

Pronounced in the Open court on this, the 19th day of March 2013.

Sd/-	Sd/-
(SHAILENDRA KUMAR YADAV)	**(R.K. PANDA)**
JUDICIAL MEMBER	**ACCOUNTANT MEMBER**

Pune, dated the 19th March 2013
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Copy of the order is forwarded to :

1. The assessee
2. The Department
3. The CIT(A)-I, Pune
4. CIT-I, Pune
5. D.R. “B” Bench, Pune
6. Guard File

By order

// True Copy //

Senior Private Secretary,
Income Tax Appellate Tribunal, Pune