IN THE INCOME TAX APPELLATE TRIBUNAL

(DELHI BENCH 'E' : NEW DELHI)

BEFORE SHRI KULDIP SINGH, JUDICIAL MEMBER

AND

SHRI DR. M.L.MEENA, ACCOUNTANT MEMBER

ITA No.207/Del./2016, A.Y. 2010-11

A.C.I.T Circle -6 92), New Delhi (APPELLANT)	Vs.	M/s. Continental India Ltd. (Formerly known as Modi Tyres Company Pvt. Ltd. NH-58, Roorkee Road, Modipuram Meerut PAN : AAFCM5366B (RESPONDENT)

ASSESSEE BY : Sh. Rihit Jain, Adv., Sh. Deepesh Jain, C.A
REVENUE BY : Smt. Rinku Singh, Sr. DR

Date of Hearing : 05.02.2019
Date of Order : 19.03.2019

O R D E R

PER KULDIP SINGH, JUDICIAL MEMBER :

The appellant Assistant Commissioner of Income Tax, New Delhi (hereinafter referred to as 'the revenue') by filing the aforesaid appeal, sought to set aside the impugned order dated 15/10/2015 passed by Ld. Commissioner of Income Tax(Appeals)-14, New Delhi qua the Assessment Year 2010-11 on the grounds inter alia that :

"The Assessing Officer, Asstt. Commissioner of Income Tax Circle 6(2), New Delhi is directed to file appeal in the above mentioned case before the ITAT, New Delhi on the following grounds of appeal.

1. On the facts and in the circumstances of the case and in law, the Ld. CIT(A) has erred in deleting the addition of Rs. 2,13,40,735/- on account of Disallowance of Provision for Warranty ignoring the facts that the provision made is on estimate basis and the reliability and correctness of the basis cannot be ascertained.

2. On the facts and in the circumstances of the case and in law, the Ld. CIT(A) has erred in facts and in law in deleting the addition of Rs. 2,97,93,143/- on account of Disallowance of Technical Know-How / Royalty ignoring the fact that section 32(1)(ii) provides for depreciation @ 25% in case of intangible assets where the Technical know-how is specifically included under this category.

3. The appellant craves leave for reserving the right to amend, modify, alter, add or forego any ground(s) of appeal at any time before or during the hearing of this appeal."

2. Briefly stated that facts necessary for adjudication of the controversy at hand are : Assessing Officer noticed that the assessee has made the provision for warranty of Rs. 2,13,40,735/- by debiting the same to P & L Account. Declining the contention raised by the assessee, AO proceeded to disallow the amount of Rs. 2,13,40,735/- created and charged to P & L Account by the assessee on the ground that the provision is made merely on estimated basis, and as such reliability and correctness of basis cannot be ascertained.

3. Assessing Officer also noticed that the assessee has debited an amount of Rs. 2,97,93,143/- to its P & L Account on account of technical know-how. Declining the contention raised by the assessee that expenses on technical know-how is in the nature of revenue expenditure disallowed the same u/s 37 of the Act, However, classified the technical know-how as an intangible assets and granted depreciation at 25% and thereby made addition of Rs. 2,23,44,857/-.

4. Assessee carried the matter before the Ld. CIT(A) by way of filing the appeal who has deleted the addition by partly allowing the appeal. Feeling aggrieved the revenue has come up before the Tribunal by way of filing the present appeal.

5. We have heard the ld. DR for the revenue and gone through the order passed by the lower revenue authority.

Ground no. 1 :

6. Undisputedly assessee has made provision qua warranty charges payable under the terms of sales and such provision has been made in order to meet future requirement arising on account of warranty clause in the sale agreement. It is also not in dispute that the year under assessment is the first year of operation in which sale is made and provision for warranty is created and charged to P & L account. It is also not in dispute that there is no historical data on record to work out warranty expenses.

7. It is contended by the Ld. AR for assessee that in such situation provision has to be made on the basis of fair and scientific approach and relied upon decision rendered by Hon'ble Supreme Court of India in case cited as **Rotark Controls India Ltd. Vs. CIT 314 ITR 62 (SC)**. It is further contended that Ld. AR for assessee that provision was made before auditing the financials of the assessee. It is further contended that in such like situation estimate has to be made on the basis of past event of sales which is worked out at 0.55% of the total turn over.

8. However on the other hand Ld. Sr. DR for the revenue relied upon assessment order.

9. Hon'ble Supreme Court of India in case of **Rotark Controls India Ltd. Vs. CIT 314 ITR 62 (SC) (supra)** decided the issue, "as to how a provision for warranty as a result of past event is to be measured". Operative part of the judgment is as under :-

> ***"10. 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.***
>
> ***11. 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.***

12. 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. In the present case, the appellant has been manufacturing and selling Valve Actuators. They are in the business from assessment years 1983- 84 onwards. Valve Actuators are sophisticated goods. Over the years appellant has been manufacturing Valve Actuators in large numbers. The statistical data indicates that every year some of these manufactured Actuators are found to be defective. The statistical data over the years also indicates that being sophisticated item no customer is prepared to buy Valve Actuator without a warranty. Therefore, warranty became integral part of the sale price of the Valve Actuator(s). In other words, warranty stood attached to the sale price of the product. These aspects are important. As stated above, obligations arising from past events have to be recognized as provisions. These past events are known as obligating events. In the present case, therefore, warranty provision needs to be recognized because the appellant is an enterprise having a present obligation as a result of past events resulting in an outflow of resources. Lastly, a reliable estimate can be made of the amount of the obligation. In short, all three conditions for recognition of a provision are satisfied in this case.

13. 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. 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 warrantyexpenses. Such estimates need reassessment every year. As one reaches close to the end of the warranty period, the probability that the warranty expenses will be incurred is considerably reduced and that should be reflected in the estimation amount. Whether this should be done through a pro rata reversal or otherwise would require assessment of historical trend. If warranty provisions are based on experience and historical trend(s) and if the working is robust then the question of reversal in the subsequent two years, in the above example, may not arise in a significant way. In our view, on the facts and circumstances of this case, provision for warranty is rightly made by the appellant-enterprise because it has incurred a present obligation as a result of past events. There is also an outflow of resources. A reliable estimate of the obligation was also possible. Therefore, the appellant has incurred a liability, on the facts and circumstances of this case, during the relevant assessment year which was entitled to deduction under Section 37 of the 1961 Act. Therefore, all the three conditions for recognizing a liability for the purposes of provisioning stands satisfied in this case. It is important to note that there are four important aspects of provisioning. They are - provisioning which relates to present obligation, it arises out of obligating events, it involves outflow of resources and lastly it involves reliable estimation of obligation. Keeping in mind all the four aspects, we are of the view that the High Court should not to have interfered with the decision of the Tribunal in this case."

10. Ratio of **Rotark Controls India Ltd. Vs. CIT 314 ITR 62 (SC) (supra)** is provision for liability which can be measured only by using a substantial degree of estimation. The Ld. AR for the assessee contended that the company has made a provision for warranty on scientific basis by making complete trail of sales made to M/s. Avtar Tyres and this

provision was made before auditing the financial of the assessee and drew our attention towards letter dated December 26, 2012 available at page 67 of the paper book written to the AO.

11. Along with letter, assessee has given complete detail of the sale made during the year under assessment. Assessee has also brought on record before Ld. CIT(A) copy of relevant extract of complaints registered qua the sales made to Avatar Tyres as "Annexure 5". Assessee also brought on record relevant extract of claim inspection register / claimed defect identification qua the complaint filed by the purchasers of the tyre as "Annexure 6" and also brought on record letter issued for replacement reward in respect of aforesaid complaint as "annexure 7", copy of relevant ledger extract qua aforesaid warranty reward and copy of new invoice issued post warranty award reducing the warranty claim for product price as "annexure 9".

12. Ld. CIT(A) on the basis of account ledger, complaint register, sale invoice qua sales made to Avatar Tyres, relevant extract of claim inspection register / claim defect identification, copy of letter issued for replacing reward copy of new invoice issued post aforesaid warranty award etc. reached the conclusion that the provision for warranty expenses made by the assessee in the books of accounts qua the year under assessment was created out of actual warranty expenses on

scientific basis in view of ratio of **Rotark Controls India Ltd. Vs. CIT 314 ITR 62 (SC) (supra).**

13. So when the year under assessment is first year of operation of the assessee who is manufacturer and trader of tyres of heavy vehicles sold along with warranty and was under obligation of replacement of the tyre sold during the warranty period on free of cost, if any component is found to be suffering from manufacturing defect, the basis for creating provision for warranty is scientific one.

14. So when the provision of warranty expenses has been made on the basis of actual warranty expenses met out during the period 01.04.2010 to 25.09.2010 qua the product sold during the year under assessment the entire estimate is based on the scientific basis. Moreover the provision for warranty made by the assessee has been duly audited at the time of auditing the financials of company. So in these circumstances we are of the considered view that Ld. CIT(A) has rightly deleted the addition made by AO on account of disallowance of provision for warranty. Consequently ground no. 1 is determined against the assessee.

Ground no. 2

15. Ld. CIT(A) deleted the addition of Rs. 2,97,93,143/- on account of disallowance of technical know-how / royalty made by the AO u/s 32(1)(ii), which is now under challenge before the Tribunal.

16. Undisputedly the assessee company has entered into technical assistance agreement (TAA) dated 14.08.2008 with continental AG, Germany for provision of non-exclusive and non-transferable license for use of technology for manufacturing of tyres in India. It is also not in dispute that payment for use of such license as per the contract was fixed at Euros 4,00,000 per annum, subject to maximum production of 4,00,000 units. The assessee company shall make further payment of Euro 1.5 per unit for production beyond, 400,000/- units. It is also not in dispute that during the year under assessment the assessee's production was less than 4,00,000 unit, thus, made the payment of 4,00,000 Euros only.

17. The Ld. AR for the assessee contended that when the assessee was authorized to utilize "know how" received in a limited and restricted manner for its business purpose only having no right to transfer the same or to make copies thereof or to use the date and drawings for any purpose other than the manufacture of tyres in own business and on termination of the agreement, the assessee was required to discontinue use of the technology, hence, acquired no proprietary right in the know-how received from continental AG and relied upon decision rendered by Delhi High Court in **CIT vs. Sharda Motor Industries Ltd. 319 ITR 109 (Del. HC), CIT vs. Hero Honda Motors Ltd. 372 ITR 481 (Del.HC).**

18. The Ld. DR supported the assessment order by relying upon decision rendered by Hon'ble Supreme Court **Honda Siel Car India**

Ltd., And decision rendered by co-ordinate bench of Tribunal in case cited as **Semoco Electrical Pvt. Ltd.**

19. Hon'ble Delhi High Court in case of **Sharda Motors Industries Ltd. (Supra)** decided the identical issue of transfer of technical know-how and allowed the payment of the same as revenue expenditure by relying upon decision rendered by Hon'ble Delhi High Court in case cited as **CIT vs. J.K.Synthetics Ltd. [2009] 309 ITR 371 (Delhi)** by returning following findings :-

> ***"5. In CIT v. J. K. Synthetics Ltd. : [2009] 309 ITR 371 (Delhi), after elaborately discussing the entire case law on the subject, the court culled out the broad principles to determine as to whether expenditure in a particular case would be capital or revenue expenditure. One of the principles enumerated therein reads as under (pages 412-413):***
>
> ***(v) expenditure incurred for grant of licence which accords 'access' to technical knowledge, as against 'absolute' transfer of technical knowledge and information would ordinarily be treated as revenue expenditure. In order to sift, in a manner of speaking, the grain from the chaff, one would have to closely look at the attendant circumstances, such as:***
>
> ***(a) the tenure of the licence,***
>
> ***(b) the right, if any, in the licensee to create further rights in favour of third parties,***
>
> ***(c) the prohibition, if any, in parting with a confidential information received under the licence to third parties without the consent of the licensor,***
>
> ***(d) whether the licence transfers the 'fruits of research' of the licensor, 'once for all',***

(e) whether on expiry of the licence the licensee is required to return back the plans and designs obtained under the licence to the licensor even though the licensee may continue to manufacture the product, in respect of which 'access' to knowledge was obtained during the subsistence of the licence.

(f) whether any secret or process of manufacture was sold by the licensor to the licensee. Expenditure on obtaining access to such secret process would ordinarily be construed as capital in nature ;

6. In the present case, on facts, it was, inter alia, found as follows:

(a) in that case the grant of technical aid was for setting up of the factory combined with the right to sell products while in our case our company is already producing exhaust systems and the technology agreement was not for setting up of the factory.

(b) in the cited case the foreign company who gave the technology agreed not to manufacture similar products in India while there is no such regulation in our agreement.

(c) in the cited case the technical knowledge obtained was held to give an advantage of enduring nature to the assessee-company and as it had the right to continue to manufacture the product even after termination of the agreement. While in our case the design patent applies to the foreign company and we are only licensed to produce the goods for Hyundai Car and we cannot continue to produce the goods if the agreement is terminated. This itself is a major difference between the case cited by your honour and the facts of our case.

On the facts and after applying the aforesaid principle, it becomes crystal clear that the expenditure is of revenue nature."

20. In a similar set of facts and circumstances, Hon'ble Delhi High Court in case cited as **Hero Honda Motors Ltd (supra)**. held the

payment made by the assessee for using technology licensed by Hero Honda Motors as revenue expenditure by returning following findings :-

> ***"Section 37(1) of the Income –tax Act, 1961-Business expenditure-Allowability of (Royalty)-Assessment years 2000-01 to 2002-03- Assessee was joint venture between Hero Group and Honda, Japan, for manufacture and sale of motorcycle using technology licenced by Honda – Assessee and Honda thereupon entered into an agreement called 'licence and technical assistance agreement' in terms of which assessee paid royalty to Honda- Assessee claimed deduction of said payment under section 37(1) – Assessing Officer rejected assessee's claim holding that it was in nature of capital expenditure- Tribunal, however, allowed assesssee's claim – Whether since payment in question was for acquiring rights to use technical know how and ownership of intellectual property rights in know how remained with Honda Japan, Tribunal was justified in holding that said payment was to be allowed as revenue expenditure – Held, yes [Paras 16 and 21] [In favour of assessee]"***

21. Following the ratio of the judgment **CIT vs. Sharda Motor Industries Ltd., CIT vs. Hero Honda Motors Ltd. (supra),** we are of the considered view that assessee company satisfied the test that transfer of technical know how / royalty by the continental AG to the assessee company was "non-exclusive and non-transferable" licence for the use of technology for manufacturing of tyres in India, which was only a production licence and for limited purpose for use for manufacturing of tyres. Even the termination clause 11.8 is very categoric that immediately upon termination of the agreement the assessee shall delivered to the continental AG statement of product sold or disposed of to the effective

date of termination which have not already been accounted for and shall pay to the continental amount of royalties due in respect thereof, assessee shall immediately return to continental all documents, original data and technology related to technology and information for manufacturing and design of products placed at its disposal by the continental AG under this agreement.

22. We are of the considered view that the expenditure incurred by the assessee in accordance with TEA agreement pertaining to the technical "know-how" is quantified on the basis of sale / production effected by using such technical know-how is of revenue nature and as such allowable as business deduction. Ld. CIT(A) has also relied upon Circular no. 21 of 1969 issued by CBDT / clarified that when a licence is obtained for user of technical knowledge from a foreign participant for a limited period together with or without the right to use the patents and trademarks of the foreign party, the payment would not bring into existence an asset of enduring advantage to the Indian party. So in view of the matter decision relied upon by Ld. DR viz. **Honda Siel Car India Ltd. v. ACIT, Semoco Electrical Pvt. Ltd.** are not applicable to the facts and circumstances of the case. Consequently, we find no illegality or perversity in the findings returned by Ld. CIT(A). Hence, ground no. 2 is determined against the revenue.

23. In view of what has been discussed above, present appeal filed by the revenue is hereby dismissed.

Order pronounced in open court on this 19th March, 2019.

Sd/-	**Sd/-**
(Dr. M.L.MEENA)	**(KULDIP SINGH)**
ACCOUNTANT MEMBER	**JUDICIAL MEMBER**

Dated: 19 /03/ 2019
BR

Copy forwarded to:
1. Appellant
2. Respondent
3. CIT
4. CIT(A)-XXVI, New Delhi.
5. CIT(ITAT), New Delhi.

AR, ITAT
NEW DELHI

Date of dictation	21.02.2019
Date on which the typed draft is placed before the dictating Member	22.02.2019
Date on which the typed draft is placed before the Other Member	
Date on which the approved draft comes to the Sr. PS/PS	
Date on which the fair order is placed before the Dictating Member for pronouncement	19.03.2019
Date on which the fair order comes back to the Sr. PS/PS	19.03.2019
Date on which the final order is uploaded on the website of ITAT	19.03.2019
Date on which the file goes to the Bench Clerk	
Date on which the file goes to the Head Clerk	
The date on which the file goes to the Assistant	

Registrar for signature on the order	
Date of dispatch of the Order	