

IN THE INCOME TAX APPELLATE TRIBUNAL
"C" BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND SHRI PRADIP KUMAR KEDIA, ACCOUNTANT MEMBER

IT(TP)A Nos. 2444/Bang/2019
Assessment year: 2015-16

M/s Lenovo India Pvt. Ltd. Ferns Icon, Level 2 Doddenakundi Village, Marathalli Outer Ring Road, Marathalli Post, KR Puram Hobli, Bangalore – 560 037. PAN: AABCI 02300E	Vs.	The Income Tax Officer, Ward - 4(1)(1) Bangalore.
APPELLANT		RESPONDENT

Appellant by	:	Shri Padamchand Khincha, CA
Respondent by	:	Shri Pradeep Kumar, CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	03.03.2020
Date of Pronouncement	:	06.03.2020

ORDER

Per N V Vasudevan, Vice President

This is an appeal by the Assessee against the final order of assessment dated 30.10.2019 of Income Tax Officer, Ward-4(1)(1), Bangalore, passed u/s.143(3) read with Sec.144C of the Income Tax Act, 1961 (the Act) relating to assessment year 2015-16.

2. The grounds of appeal raised by the Assessee in this appeal reads as follows:-

“I. General Ground:

1. The Final Assessment Order dated 30 October 2019 (received on 4 November 2019), passed by the learned Income Tax Officer, Ward 4(1)(1), Bangalore ("AO") under section 143(3)

read with section 144C(13) of the Income-tax Act, 1961 ("the Act"), the Directions issued by the Honourable Dispute Resolution Panel ("DRP") under section 144C(5) and the order passed by the learned Transfer Pricing Officer ("TPO") under section 92CA of the Act are not in accordance with the law and made in violation of the principles of equity and natural justice and are contrary to the facts and circumstances of the present case.

II. TP adjustment of INR 7,96,04,375 in relation to manufacturing segment:

2. The Honourable DRP and the learned AO / TPO have erred in law and on facts in making transfer pricing ("TP") adjustment of INR 7,96,04,375 to the returned income of the Appellant and in holding that the international transactions undertaken by the Appellant with its associated enterprises ("AEs") in the manufacturing segment were not at arm's length.

Rejection of Internal Comparable Uncontrolled Price Method adopted as the most appropriate method by the Assessee:

3. The Honourable DRP and the learned AO / TPO have erred in law by rejecting the application of Internal Comparable Uncontrolled Price ("Internal CUP") method selected as the most appropriate method ("MAM") by the Appellant for benchmarking the international transaction of import of raw materials in relation to manufacturing segment, without giving any cogent and valid reasons for such rejection.

4. The Honourable DRP and the learned AO / TPO have erred in rejecting the Internal CUP method as MAM when the same has been upheld in Appellant's own case in preceding years as below:

- a. Upheld by the jurisdictional bench of Honourable ITAT for AY 2006-07 (1st and 2nd round), AY 2009-10 and AY 2010-11;

- b. Upheld by the Honourable DRP for AY 2006-07 (2nd round) and AY 2010-11; and

c. Accepted by the learned TPO for AY 2007-08 and AY 2008-09.

5. The Honourable DRP and the learned AO / TPO have erred in not following the settled principle based on the rulings of the Honourable Supreme Court ("SC") that where a fundamental fact permeates through more than one year and is accepted by the Revenue authorities, it should not be arbitrarily rejected.

6. The Honourable DRP and the learned AO / TPO have erred in rejecting Internal CUP as MAM by providing following reasons which are incorrect and contrary to facts of the present case:

a. This method is applied by using industry average rates; and

b. There is no publicly available information on prices charged in independent transactions of similar or identical nature, so External CUP cannot be applied.

Notwithstanding and without prejudice to the above grounds that the Internal CUP is the MAM,

7. The Honourable DRP and the learned AO / TPO have erred in law and on facts by adopting the Transactional Net Margin Method ("TNMM") as the MAM for benchmarking the international transaction of import of raw materials in relation to manufacturing segment.

8. The Honourable DRP and the learned AO / TPO have erred in law in adopting the following filters for conducting TP analysis:

a. Rejection of comparable companies having different financial year ending (other than 31 March 2015);

9. The learned AO / TPO has erred in law and on facts in not rejecting the following companies which are not comparable to the Assessee due to reasons including functional dissimilarity, presence of significant R&D etc.:-

a. Apollo Micro Systems Limited

b. Zen Technologies Limited

10. The learned AO / TPO has erred in law and on facts in not accepting the following companies which are comparable to the Assessee and thereby not considering the detailed submissions of the Assessee:

a. VXL Instruments Limited

b. CCS Infotech Limited

11. The Honourable DRP and the learned AO / TPO have erred in law by not granting appropriate favourable economic adjustments (including the working capital adjustment) while calculating the arm's length margin for final set of comparable companies under the TNMM for the manufacturing segment.

III. TP adjustment of INR 1,18,60,27,058 on account of alleged excess AMP expenditure pertaining to trading segment:

12. The Honourable DRP and the learned AO / TPO have erred in law and on facts, in making TP adjustment of INR 1,18,60,27,058 to the returned income of the Appellant by assuming the existence of an alleged international transaction of brand promotion services to AE and alleging the same to be not at arm's length in terms of the provisions of sections 92C(1) and 92C(2) of the Act read with Rule 10D of the Income tax Rules, 1962 ("the Rules").

AMP expenditure not an international transaction,

13. The Honourable DRP and the learned AO / TPO have erred in law and on facts by alleging that the unilateral Advertising, Marketing and Promotion ("AMP") expenditure, being payments made to third parties, is an "international transaction" as per the provisions of section 92B of the Act, without appreciating that they had not incurred any expenditure on the directions of the AE.

14. The learned TPO erred in suo-moto benchmarking the alleged international transaction related to the AMP expenses

without there being any order or reference from the AO in relation thereto.

15. The Honourable DRP and the learned AO / TPO have erred in unilaterally re-characterizing the AMP expenses being payments made by the Appellant to independent third parties as an 'international transaction' under chapter X of the Act, and particularly when the jurisdiction of the TPO is only to compute arm's length margin of the international transaction.

16. The Honourable DRP and the learned AO / TPO have erred in law and on facts by not appreciating that no such TP adjustment can be made in respect of AMP expenses (being legitimate, bona fide and deductible business expenditure) incurred by the Appellant towards payments to independent parties, the benefit of which accrues to the Appellant alone.

17. In this regard, the Honourable DRP and the learned AO / TPO have failed to consider that the alleged AMP expenses were incurred exclusively in relation to the Appellant's business, which is also evident from the fact that the expenditure has been accepted by the AO under section 37 of the Act.

18. The Honourable DRP and the learned AO / TPO have erred in law and on facts in concluding that the "conduct of the Appellant clearly shows the presence of an arrangement for promotion of marketing intangibles".

19. The Honourable DRP and the learned AO / TPO have erred in law and on facts by not appreciating that the Appellant is a distributor of products imported from its AEs and these transactions are carried out on a principal-to-principal basis, and is solely responsible for improving its business market in India and increasing the sales of its products in India. The Appellant had incurred expenditure on AMP to cater to local market needs. AMP expenditure has been incurred in relation to local product advertisements and towards domestic independent third parties, thus the domestic unilateral expenditure incurred by the Appellant for the purpose of its business cannot as a deemed international transaction under section 92B(2) of the Act.

20. The Honourable DRP and the learned AO / TPO have failed to appreciate that the Appellant has been uninterruptedly using the said brand for the last several years and till date, thus, all benefits endured to the Appellant, for which the Appellant has not even been paying any royalty to its AE. Consequently, for all purposes the Appellant is the sole beneficiary of all the benefits of AMP expenditure incurred during financial year ending 31 March 2015.

21. The Honourable DRP and the learned AO / TPO have erred in law and on facts, by holding that the Appellant by incurring excessive AMP expenditure has resulted in creation of marketing intangible in favor of the AE, for which it should be compensated by the AE.

22. The Honourable DRP and the learned AO / TPO have erred in law and on facts by disregarding judicial pronouncements in undertaking TP adjustments in relation to AMP.

Notwithstanding and without prejudice to the above grounds that the AMP expenditure incurred by the Appellant does not constitute an international transaction under Chapter X of the Act, the Appellant craves to raise following grounds of objections on merits.

23. The Honourable DRP and the learned AO / TPO have erred in disregarding the Appellant's submission that the Appellant would operate at arm's length under following scenarios using RPM and TNMM for trading segment and hence no adjustment is warranted in this regard:

a. Scenario 1 - Adjusted gross margin approach: The adjusted gross profit margin of the Appellant after considering AMP expenditure is compared with the adjusted gross profit margin of the comparable companies.

b. Scenario 2 - Adjusted marked-up gross margin approach: The adjusted gross profit margin of the Appellant after considering AMP expenditure along with mark-up is compared with the adjusted gross profit margin of the comparable companies.

c. Scenario 3 - Net profit margin approach: The net profit margin of the Appellant is compared with the net profit margin of the comparable companies.

d. Scenario 4 - Adjusted marked-up net margin approach: The net profit margin of the Appellant after considering AMP expenditure along with mark-up is compared with the net profit margin of the comparable companies.

24. The Honourable DRP and learned AO / TPO have erred in law in not considering the detailed submissions of the Appellant that even after performing an AMP expense intensity adjustment to the comparable companies, the adjusted net margin earned from the trading activity by the Appellant is at arm's length. The AMP expense intensity adjustment was affirmed by the Honourable ITAT in cases of Luxottica India Eyewear Pvt Ltd Vs. ACTT' and BMW India Private Limited Vs. DCIT2 wherein the AMP intensity adjustment is performed on the profit levels of comparable companies so as to bring them to the level of the Appellant after factoring in the differences in the intensities of AMP expenditure of the comparable companies vis-a-vis the AMP expenditure incurred by Appellant.

25. The Honourable DRP and the learned AO / TPO have erred in applying the Bright Line Test as a methodology to quantify the brand promotion service alleged to have been rendered by the Appellant to its AE.

26. Further, the Honourable DRP and the learned AO / TPO have erred in selecting companies that are not comparable to the intensity of AMP functions of the Appellant for computing the AMP/Sales ratio and thereby considered companies that have very low AMP/Sales ratio.

27. The Honourable DRP and the learned AO / TPO have erred in law and on facts in concluding that the distribution and AMP are two distinctive functions and requires to be remunerated separately.

28. The Honourable DRP and the learned AO / TPO have erred in law and on facts by characterizing the incurrence of

AMP expense as a provision of brand promotion services by the Appellant to its AE requiring a mark-up.

29. The Honourable DRP and the learned AO / TPO have erred in law and on facts in not appreciating that the Appellant has not provided any value added / brand building services to its AE by incurring AMP expenses, and therefore, no mark-up could have been charged / levied on such expenses, even if the same was to be characterized as an 'international transaction'.

30. The Honourable DRP and the learned AO / TPO have erred in not appreciating that in view of the Appellant being contractually assured of a margin after cost recovery, the entire AMP expenditure has in fact been recovered from the AE and hence adjustment could only be restricted to markup, that too if the operating margin of the company was not at arm's length.

That the Honourable DRP and the learned AO / TPO have erred in not appreciating that the cost is recovered is evident from its contract, and the extract from the inter-company distribution agreements is reproduced below for your Honours ready reference:

"The parties intend to set the prices for sale of Products by Supplier to Distributor at levels that will results in Distributor earning annual operating income, determined under local generally accepted accounting principles, with respect to the Products (after taking into account all expenses and reimbursements attributable to the Products)"

Benchmarking analysis undertaken in determining the mark-up to be charged on the alleged brand promotion services,

31. The Honourable DRP and the learned AO / TPO have erred in carrying out a search for comparable companies in order to determine the mark-up that the Appellant should have recovered from the AE in relation to the alleged AMP expenses considered to be in the nature of brand promotion service.

32. The Honourable DRP and the learned AO / TPO have erred in determining the mark-up for the alleged international transaction of brand promotion services by selecting following

companies which are not comparable to the Appellant due to reasons including functional dissimilarity, failing quantitative filters, etc.

- a. Irunway India Private Limited
- b. Just Dial Limited

33. Further, the learned AO / TPO has erred in law and on facts in not accepting the following companies which are comparable and thereby not considering the detailed submissions of the Assessee:

- a. MCI Management India Private Limited
- b. Supernova Advertising Limited
- c. Concept Communication Limited
- d. Quadrant Communications Limited

34. The Honourable DRP and the learned AO / TPO have erred in not granting appropriate favorable economic adjustments (including the working capital adjustment) when computing the arm's length nature of alleged international transaction.

IV. Transfer pricing adjustment of INR 8,69,03,763 in relation to the Sales Facilitation Services segment and INR 6,30,82,889 in relation to Administrative and Business Support Services segment

35. The Honourable DRP and the learned AO / TPO have erred in law and on facts in making TP adjustment of INR 14,99,86,652 to the returned income of the Assessee and in holding that the international transactions undertaken by the Assessee with its AEs in the Sales Facilitation Service segment and Administrative and Business Support Services segment were not at arm's length.

36. The Honourable DRP and the learned AO / TPO have erred in law and on facts in undertaking a composite benchmarking for both the segments and thereby failing to

appreciate that the services rendered by the Appellant to its AEs in each of these segments are separate and distinct and accordingly needs to be benchmarked separately.

37. The Honourable DRP and the learned AO / TPO have erred in law in rejecting the TP documentation of the Appellant as "not reliable or correct", under section 92C(3) of the Act, merely because the learned TPO did not agree with the positions and filters adopted by the Assessee in its TP documentation, and adopted certain additional filters / modified filters in selecting the comparable companies by using non contemporaneous data of the said companies.

38. The Honourable DRP and the learned AO / TPO have erred in law in adopting the below filter for conducting TP analysis:

- a. Rejection of comparable companies having different financial year ending (other than 31 March 2015)

39. The Honourable DRP and the learned AO / TPO have erred in not rejecting the following companies despite the same not being comparable to that of the Assessee due to various factors such as functional dissimilarity, product / intangible led revenues, failing learned TPO's own filters, use of unreliable segment financials etc.

- a. Irclass Systems and Solutions Limited
- b. Ugam Solutions Private Limited
- c. Axience Consulting Private Limited
- d. Axis Integrated Systems Limited
- e. India Trade Promotion Orgn.

40. Further, the Honourable DRP and the learned AO / TPO have erred in law and on facts in not accepting the following companies which are comparable and thereby not considering the detailed submissions of the Appellant:

- a. MCI Management (India) Limited

- b. Crayon Advertising Limited
- c. Supernova Advertising Limited

41. The Honourable DRP and the learned AO / TPO have erred in law by not granting appropriate favourable economic adjustments (including the working capital adjustment) while calculating the arm's length margin for final set of comparable companies for these segments.

V. Other TP related grounds

42. The Honourable DRP and the learned AO / TPO have erred by not carrying out the determination of arm's length price as required under section 92C of the Act read with Rule 10D of the Rules.

43. The Honourable DRP and the learned AO / TPO have failed to appreciate the Appellant's commercial judgment about the application of arm's length principle which is tied to the business realities.

44. The Honourable DRP and the learned AO / TPO have erred in law and on facts, in making several observations and findings, which are based on incorrect interpretation of law and contrary to facts of the case.

VI. Disallowance of Provision for warranty

45. The Honourable DRP and the learned AO have erred in law in arbitrarily disallowing the provision for warranty amounting to INR 73,93,02,026 claimed as a deduction by the Appellant.

46. The Honourable DRP and the learned AO have erred in law by not following the order of the Honourable ITAT in the Appellant's own case for the AY 2006-07, AY 2007-08, AY 2010-11 and AY 2011-12, wherein it was held that the provision for warranty has been created on a scientific basis and that the same should be allowed as a deduction.

47. The Honourable DRP and the learned AO have not appreciated the fact that the Appellant maintains its books on a mercantile basis of accounting and that the said warranty

provision has been created on a scientific manner followed consistently over the years, having due regard to the nature of activity, its global warranty accrual processes and the industry requirement in which the Appellant operates.

48. The Honourable DRP and the learned AO have erred on facts in failing to consider that the Appellant has provided for warranty on a scientific and consistent manner every year applying the principles laid out by the Honourable Supreme Court ("SC") in the case of Rotork Controls India Privat and therefore such expenditure is an allowable deduction under section 37 of the Act.

49. The Honourable DRP and the learned AO have erred in appreciating that the Appellant provides warranty for a period from one year to four years on its products and accordingly, the entire provision could not be utilized in one year and has to be spread over multiple years.

VII. Addition of provision for warranty to the book profits

50. The learned AO has erred in adding back the warranty provision created during the relevant AY amounting to INR 73,93,02,026 to the book profit of the Appellant.

51. The Honourable DRP and the learned AO have erred in law and on facts in holding that the warranty provision of INR 73,93,02,026 is an unascertained liability and therefore, not appreciating that the warranty provision is created on a scientific basis after considering technical estimates which is consistently followed by the Appellant year on year.

52. The Honourable DRP and the learned AO have erred in law by not following the order of the Honourable ITAT in the Appellant's own case for the AY 2006-07, AY 2007-08, AY 2010-11 and AY 2011-12, wherein it was held that the provision for warranty has been created by the Appellant on a scientific basis and that the same should not be treated as an unascertained liability and therefore, provision for warranty should not be

added back while re-computing book profits under section 115JB of the Act.

VIII. Other grounds

53. The learned AO has erred in law and on facts by not granting appropriate credit of the Tax Deduction at Source ("TDS"), as claimed by the Appellant in the return of income.

54. The learned AO has erred in law and on facts in computing interest under section 234B of the Act and section 234C of the Act.

55. The learned AO has erred in law and on facts in initiating penalty proceedings under section 271(1)(c) of the Act without concluding on whether the Appellant has concealed any particulars of income or has furnished inaccurate particulars of income or has not acted in good faith and has not exercised due diligence.

The Appellant craves leave to add, alter, vary, omit, substitute or amend the above grounds, at any time before or at the time of hearing of the appeal. Each of the above objections is independent and without prejudice to the other grounds preferred by the Appellant.”

3. Ground I raised by the Assessee is general and requires no specific adjudication.

4. Ground No.II raised by the revenue is in relation to determination of Arm's Length Price in respect of an international transaction of import of parts and components from its Associated Enterprise (AE). The Assessee is a company incorporated in India. It is engaged in the business of trading, manufacture and sale of desktops, laptops, servers and smartphones. It has a manufacturing facility in Pondicherry, India.

5. During the FY 2014-15, the assessee imported certain parts and components from its Associated enterprises ("AEs") for purpose of

manufacturing of Personal Computers (PCs). The transaction of import of parts and components was an international transaction and therefore income from such international transaction has to be determined have regard to Arm's Length Price (ALP) as laid down in Sec.92 of the Income Tax Act, 1961 (Act). The Assessee also imported parts and components from third parties. The methodology adopted by the Assessee for benchmarking the price paid to the AE for import and components was as follows:

Nature of international transaction	MAM	Value as per books of accounts	ALP as determined by Assessee	Remarks
Import of parts and components for manufacture of PCs	CUP	1,484,262,448	1,462,645,707	Suo-moto adjustment of INR 21,616,741 is made in the Return of Income for prices not at ALPS

It can be seen from the aforesaid chart that the Assessee chose Comparable Uncontrolled Price (CUP) as the Most Appropriate Method (MAM) for determining ALP i.e., it compared the price it paid for import of parts and components from unrelated persons (CUP) with the price paid for import of parts and components to the AE. In its Transfer Pricing Analysis (TP Analysis), the Assessee considered itself as assuming most of the risks including market risk, inventory risk, credit and collection risk, forex risk, warranty and idle capacity risk. Based on the functions and risks performed, the Assessee characterized itself as a "full-fledged manufacturer" for its manufacturing activity. The basis of benchmarking the aforesaid transaction was provided below.

During the FY 2014-15, the Assessee imported 416 different varieties of products from its AEs which can be identified on the basis of a distinctive code. Out of 416 products, 299 products were purchased from its AEs exclusively while the rest 177 were purchased from AEs as well as from unrelated third party vendors.

Products imported from AEs only (299 products)

With respect to the imports from AEs only, the prices paid by AEs to its third party vendors were considered as CUP. In this regard:

Out of the 299 products, 95 products were sold by the AEs on a cost to cost basis. Accordingly, the same has been considered to be at ALP.

On the balance 204 products, the AEs have sold the products to Lenovo India at a price at cost plus 0.10 percent margin. However, the same was considered to within the range of + /-3 percent as permitted under the second proviso to Sec.92CA(2) of the Act. Hence, the same was considered to be at ALP.

Products imported from AEs as well as third party vendors (117 products)

With respect to the imports from AEs as well as third parties, the prices paid by the Assessee to third party vendors were considered as CUP:

Out of 117 products imported from AEs and third parties, 52 products imported by the Assessee were at a price lower than the price at which Assessee purchased from unrelated parties. Accordingly, the prices paid for these imports have been considered to be at ALP.

With respect to remaining 65 products that did not fall within the arm's length price, it was the case of the Assessee that the difference from the ALP is not material and the Assessee did not undertake any further analysis for such differences. However, suo-moto adjustment of INR 21,616,741 was made in the Return of Income.

6. The Transfer Pricing Officer (TPO) to whom the question of determination of ALP was referred to by the Assessing Officer (AO) u/s.92CA of the Act, did not accept the aforesaid TP analysis for the reasons given in his show cause notice(SCN) to the AO dated 26.9.2018. In the said SCN, the TPO firstly, expressed his opinion that for applying

CUP method, reliable data is required for comparing controlled transaction with an uncontrolled transaction and such reliable data was not available. The reply of the Assessee in this regard was that each of the component/parts were identified with a unique identification number and the details were captured in the TP Analysis. The second objection of the TPO was that the Assessee used weighted average of price of components/parts imported throughout the year and therefore it cannot be said that the method adopted by the Assessee was CUP as weighted average price is not the actual price in the controlled and uncontrolled transaction. The Assessee's reply in this regard was that the components/parts were imported throughout the year and were large in number. It was practically impossible to compare each and every import transaction. It was the plea of the Assessee that the price would depend on quantity imported and used in the manufacture of computers and hence weighted average would be the most appropriate price that should be chosen for comparison. In support of its contention that weighted average price is more appropriate the Assessee relied on decision of ITAT Mumbai Bench in the case of *Gharda Chemicals Ltd. 2009 TIOL 790 (Mumbai-ITAT)* and *Audco India Ltd. 47 SOT 420*. The third reason given by the TPO was that industry average billing will not be reflected in CUP method. The TPO placed reliance on decision of Special Bench ITAT Bangalore in the case of *Aztec Software & Technology Vs. ACIT*. The Assessee's reply to this objection was that the said case related to a Software Industry which was different from import of components/parts and that the method used in that case of external CUP and not internal CUP as in Assessee's case. The last objection of the TPO was that there was no publicly available information on prices charged in independent transactions of similar or identical nature, so external CUP cannot be applied. The reply of the Assessee on this objection was that when internal CUP is used there is no

need to look at publicly available information and doing so will be against the basic feature of CUP method of determination of ALP.

7. The Assessee also submitted that for the prior AYs (i.e. AY 2006-07 to 2015-16), the Assessee had adopted CUP as MAM to benchmark its international transaction of Import of parts and components for manufacture of PCs pertaining to its manufacturing segment. The Assessee submitted that the functions performed for undertaking its manufacturing activity for all the years i.e. AY 2006-07 to AY 2015-16 have remained the same and accordingly, CUP was considered as the MAM for the subject AY as well. It was also submitted that the Hon'ble ITAT of Bangalore in Assessee's own case has upheld the application of CUP Method adopted by the Assessee for benchmarking the subject transaction in AY 2006-07 to AY 2009-10 and AY 2010-11. Copies of ITAT Orders with clear findings for these years was also filed before the TPO.

8. The TPO however applied the Transaction Net Margin Method (TNMM) as the MAM and determined ALP which resulted in an addition of Rs.67,09,25,862 to the total income of the Assessee in the draft assessment of the AO. The Assessee filed objection to the proposed addition before the Dispute Resolution Panel (DRP) but the DRP upheld the order of the TPO. The DRP upheld the order of the TPO by observing that in CUP method strict comparability is required and such comparability is not possible in the case of the Assessee. The DRP also upheld application of TNMM as MAM and methodology adopted to determine ALP under the TNMM by the TPO.

9. Aggrieved by the order of the DRP, the Assessee has raised Grd.No.II before the Tribunal. We shall first take up Gr.No. II sub grounds 2 to 6 which grounds relate to the contention of the Assessee that CUP should have been accepted as the MAM. We have heard the rival submissions. As far as the issue of MAM in the case of the Assessee in

the transaction of import of components is concerned, we have already extracted the reasons assigned by the TPO for rejecting CUP as MAM and the reasons given by the Assessee as to why the reasons assigned by the TPO are unsustainable.

10. In AY 2006-07, the Tribunal has in its order dated 30.5.2016 in IT (TP) A.No.582/Bang/2015 upheld the DRP's direction that CUP is the MAM to be applied in the case of the Assessee. In AY 2007-08, the DRP upheld CUP as the MAM and the department did not file any appeal against that order of DRP before the Tribunal. In AY 2008-09 the TPO vide his order dated 31.10.2011 accept Assessee's adoption of CUP as MAM and also accepted that price paid in the international transaction to the AE is at Arm's Length. In AY 2009-10 in ITA(TP)A.No.74/Bang/2014 order dated 6.7.2018 the Tribunal upheld order of the DRP accepting CUP as MAM. In AY 2010-11 the Tribunal in IT(TP)A No.580/Bang/2015 order dated 31.3.2017 upheld the order of the DRP upholding CUP as MAM. There are no changes in the facts and circumstances in the present AY and hence the decision of the Tribunal rendered in the past will apply to the present AY 2015-16 also.

11. We are therefore the view that CUP should be adopted as the MAM. We direct the TPO to apply CUP as the MAM and determine ALP after due opportunity of being afforded to the Assessee. Ground II sub-grounds 2 to 6 are allowed. In view of the above conclusions the other sub-grounds 7 to 11 raised in Ground No.II does not require any adjudication.

12. Ground No. III (12) to (34) relates to the treatment of alleged excess AMP expenditure pertaining to trading segment as an international transaction and determining the ALP and making the consequent addition to the total income of the assessee. As far as the aforesaid grounds are concerned, we will take up the issue raised in ground III (13) to (22) that the AMP expenditure incurred cannot be considered as an international

transaction at all. The facts which are necessary to be considered with reference to the aforesaid ground are as follows.

13. As we have already seen the assessee company is engaged in the business of manufacturing and distribution of desktop, laptop, servers and smartphones. During the relevant previous year, the assessee incurred expenditure in connection with campaigning, depicting features of new products, providing information to the public about details of product, its specification etc. According to assessee, the aforesaid advertisement and business promotion activities undertaken by the assessee are specific to the products sold in India. It was the contention of assessee that in the trading segment of desktop, laptops etc., it decides on advertisement, training etc. According to the Assessee the expenditure so incurred was to improve its sale and it cannot be said that by incurring such expenses, the assessee promoted the brand of its foreign AE. It was the case of revenue that assessee did not confine itself to distribution of trading goods, but has performed additional functions in the form of advertisement and marketing promotion to promote the brand of foreign AE and therefore the assessee needs to be adequately compensated for such additional function. The TPO adopted Resale Price Method (RPM) as the most appropriate method. The TPO chose 9 comparable companies and arrived at the AMP to sales of those companies and compared the same with that of the assessee. By such comparison, the TPO came to the conclusion that assessee was incurring much higher AMP expenditure than the industry average and incurring of excessive AMP expenses constitutes an international transaction of promotion of AE's brand. The TPO concluded that assessee performed additional functions which promoted the marketing intangibles of the AE and that the assessee should have been reimbursed by the AE the additional expenses along with mark-up. In other words, the TPO adopted

the Brightline Test in making the aforesaid addition. The DRP upheld the order of the TPO.

14. The Id. counsel for the assessee submitted before us that incurring of AMP expenses does not constitute an international transaction and in this regard filed before us a copy of the decision of the Hon'ble Delhi High Court in the case of *Sony Ericsson Mobile Communications India P. Ltd. v. CIT, 374 ITR 118 (Del)*. Our attention was drawn to para 101 of the aforesaid decision in which the Hon'ble Delhi High Court held that once the TPO accepts and adopts TNM Method and then chooses to treat a particular expenditure like AMP as a separate international transaction without bifurcation and segregation, it would lead to an unusual and incongruous results as AMP is the cost or expense and is not diverse. It is factored in the net profit of the interlinked transaction. This would be also in consonance with Rule 10B(1)(e), which mandates only arriving at the net profit margin by comparing the profits and loss account of the tested party with the comparable. The TNM Method proceeds on the assumption that functions, assets and risk being broadly similar and once suitable adjustments have been made, all things get taken into account and stand reconciled when computing the net profit margin. Once the comparables pass the functional analysis test and adjustments have been made, then the profit margin as declared when matches with the comparables would result in affirmation of the transfer price as the arm's length price. Then to make a comparison of a horizontal item without segregation would be impermissible.

15. The Id. counsel for the assessee pointed out that in the present case, the TPO accepted the international transaction of trading of AE's product as at arm's length and in this regard drew our attention to para 6 of the TPO's letter dated 26.9.2018, a copy of which is at pages 934 to 972 of assessee's PB. The relevant para 6 is at page 946 in which the TPO

accepted that the PLI of 9 comparables chosen by the assessee was 4.23% and that taxpayer's PLI was 13.08%. In the TP order, the TPO did not make any adjustment in the trading segment and therefore it is presumed that he has accepted the transaction of trading with the AE as at arm's length. The Id. counsel for the assessee submitted that following the decision of the Hon'ble Delhi High Court in the case of *Sony Ericsson Mobile Communications India P. Ltd. (supra)*, incurring of AMP expenses cannot be regarded as an international transaction at all.

16. The Bench queried that in the case decided by the Hon'ble Delhi High Court, TNM Method was adopted whereas in the case of assessee in the trading segment RPM has been adopted and that would make a difference. The Id. counsel for the assessee firstly pointed out that the AMP addition on account of determination of AMP expenses has been made only in the trading segment and in this regard drew our attention to an order dated 14.11.2018 passed by the TPO u/s. 154 of the Act wherein the fact that AMP expenditure is in relation to trading segment only has been accepted by the TPO. His next submission was that the assessee has also demonstrated in its TP study with regard to the trading segment that the net margins earned by it were at arm's length. In this regard, the Id. counsel for the assessee brought to our notice that even before the TPO, the assessee had given the net margins by way of alternative submission and those details are at pages 1392 and the computation is at page 1540. Our attention was drawn to the fact that Scenario-3 was projected by the assessee in which the net margin of the comparable companies was arrived at 2.62% and the assessee's net profit margin was 1.45% which was within the +/- range permitted under proviso to section 92CA(2) of the Act.

17. We have considered his submission and are of the view that it would be just and appropriate to set aside the issue of determination of net

margin of the assessee and in the trading segment, as claimed by the assessee in Scenario-3 before the TPO. If the margins are accepted as at arm's length and then applying the principles laid down by the Hon'ble Delhi High Court in the case of *Sony Ericsson Mobile Communications India P. Ltd. (supra)*, incurring of AMP expenses cannot be treated as international transaction and consequently determination of ALP would not arise for consideration at all. We therefore set aside the order of the AO and remand the issue to the TPO for consideration of ALP of the trading segment applying the net profit margin method and if by such method the price received in the international transaction is considered as at arm's length, then no separate addition needs to be made. In view of the above conclusion, we are of the view that sub-grounds (23) to (34) in ground III does not require adjudication at this stage.

18. Ground No.IV is in relation to determination of ALP in respect of price received by the assessee from its AE for providing sales facilitation services and for providing administrative and business support services. As far as those grounds are concerned, the first aspect which was brought to our notice is that the TPO aggregated the sales facilitation services segment and administrative & business support services segment and determined the ALP. The objection of the assessee to the aforesaid approach of TPO in aggregating the aforesaid transaction was highlighted by the assessee before the DRP, specifically in objection No.7.2. In this regard, the assessee also pointed out that it had carried out separate TP analysis in respect of sales facilitation services at page 169 of the PB and that with regard to sales support services is at page 174 of PB. It was the plea of assessee that the FAR analysis of both these segments were different and cannot be aggregated as one transaction. The DRP, however, did not deal with the aforesaid objection at all.

19. We have considered the rival submissions. As per the Indian Income-Tax Act, ideally, the transfer pricing is to be made on a transaction by transaction basis. However, Rule 10A(d) provides that the term 'transaction' includes a number of closely linked transactions. Thus, in cases where separate transactions are so closely linked or are closely inter-related or continuous and where application of the arm's length principle on a transaction by transaction basis becomes cumbersome for all involved and would not lead to an accurate result, recourse is often had to evaluate transactions following an 'aggregation' principle. Due to increasing presence of composite contracts and 'package deals' in an MNE group, the aggregation of transactions become necessary as a composite contract may contain a number of elements including royalties, leases, sale and licenses all packaged into one deal. One would usually want to consider the deal in its totality to understand how various elements relate to each other, but the components of the composite package deal may or may not, depending on the facts and circumstances of each case, need to be evaluated separately to arrive at the appropriate transfer price. Aggregation issue may also arise when looking at uncontrolled comparables. This is because third party information is not often available at the transaction level. In such circumstances, entity level information is the only recourse available. Therefore, whether ALP-principle is to be applied on a transaction by transaction basis or on an aggregation basis depends on the facts of each case and is not universally or generally applied in all composite contracts involving multiple transactions.

20. Since this specific objection of assessee has not been met by the TPO/DRP, we deem it fit and proper to set aside the order of AO in this regard and remand the matter to the TPO for fresh consideration of the question, whether international transactions can be aggregated in the given facts and circumstances. If aggregation is not possible, then the ALP of the

sales facilitation services segment and administrative & business support services segment should be determined separately. The assessee will be afforded opportunity of being heard in this matter. In view of the above, the other grounds related to manner of determination of ALP by aggregating the above two transactions does not require consideration at this stage.

21. Ground No.V and sub-grounds (42) to (44) of ground IV are general in nature and call for no specific adjudication.

22. Ground No.VI comprising of Sub-grounds 45 to 49 deal with the grievance of the Assessee against the orders of the revenue authorities disallowing provision for warranty amounting to Rs.73,93,02,026/-. The Assessee sells products and as per the terms of sale, the Assessee provides warranty for performance, replacement etc. Based on the past experience i.e., historical data, liability on account of probable warranty claims is provided in the books of accounts of the Assessee. During the relevant previous year, the assessee debited an expenditure of Rs.259,83,13,924/- under the head 'Warranty Expenses. The Provision for Warranty Account of the Assessee as on 31.3.2015 stood as follows:

Provision for warranty	Amount (in I)
Opening balance	154,82,86,076
Provision made during the year	259,83,13,924
Utilisation	147,92 55,949
Closing balance	266,73,44,051

23. As can be seen from the aforesaid table, the actual liability incurred on account of warranty liability during the year was Rs.147,92,55,949/-. The warranty period is one to four years and the warranties are against manufactured and other defects as per the terms of contracts(s) with the customer. The warranty is disclosed as a contingent liability in the balance Sheet as required by Accounting Standard-29 (AS-29) issued by the

Institute of Chartered Accountants of India (ICAI). The assessee vide letter dated 20/11/2018 submitted that the warranty provision has been created as per Accounting Standard 29 and is based on the scientific formula as explained below:-

Machine months X Repair rate X Cost per claim

Where:

Machine months is the factor of the unexpired warranty period in months and the number of PCs which are under warranty at the end of the year;

Repair rate is the percentage of claims out of the total sales made on the historical data for the region; and

Cost per claim is the average expected repair cost per PC on historical data for the region.

The Provision for warranty liability created in the books and the actual liability on account of warranty liability incurred in each of the Financial years from 2005-06 is as follows:

Financial year	Opening balance	Addition during the year	Utilized/Reversed during the year	Closing balance
2005-06	-	34,94,49,249	7,66,52,762	27,27,96,487
2006-07	27,27,96,487	55,18,39,359	40,27,12,947	42,19,22,899
2007-08	42,19,22,899	61,21,80,442	51,91,74,867	51,49,28,474
2008-09	51,49,28,474	108,79,40,662	103,94,28,778	56,34,40,358
2009-10	56,34,40,358	97,20,25,066	68,32,51,088	85,22,14,336
2010-11	85,22,14,336	147,74,52,660	101,70,66,189	131,26,00,807
2011-12	131,26,00,807	103,75,04,656	100,25,76,056	134,75,29,407
2012-13	134,75,29,407	148,76,96,121	135,36,26,321	148,15,99,208
2013-14	148,15,99,208	197,19,70,205	190,52,83,337	154,82,86,076
2014-15	154,82,86,076	259,83,13,924	147,92,55,949	266,73,44,051

24. Generally contingent liability is not allowed as deduction while computing income even under the mercantile system of accounting. If expenditure is to be deductible for the income tax purposes, it should be 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. However in respect of provision for warranty, the Hon'ble Supreme Court in the case of Rotork Controls India Pvt Ltd vs. CIT (2009) 314 ITR 62 held that provision for warranty liability cannot always be regarded as contingent liability and laid down the following principles in coming to the conclusion whether the liability can be said to be contingent or actual liability:-

- (1) 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;
- (2) A 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;
- (3) 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;**
- (4) **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 u/s 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.

25. The AO examined the claim of the Assessee for deduction on account of provision for warranty expenses in the light of the principles laid down by the Hon'ble Supreme Court. According to him, it was required to verify the reasonability and the reliability of the assessee's estimation of provision for warranty based on historical trend. The AO analyzed the historical trend of provision for warranty created, utilized and the percentage of the utilization / reversal to the provision created over the years which is tabulated below:

Financial year	Opening balance	Addition during the year	Utilized /Reversed during the year	Closing balance
			%age Utilisation / Reversal over Creation	
2005-06		34,94,49,249	7,66,52,762 22 %	27,27,96,487
2006-07	27,27,96,487	55,18,39,359	40,27,12,947 48 %	42,19,22,899
2007-08	42,19,22,899	61,21,80,442	51,91,74,867 50 %	51,49,28,474
2008-09	51,49,28,474	108,79,40,662	103,94,28,778 64 %	56,34,40,358
2009-10	56,34,40,358	97,20,25,066	68,32,51,088 45 %	85,22,14,336
2010-11	85,22,14,336	147,74,52,660	101,70,66,189 69 %	131,26,00,807
2011-12	131,26,00,807	103,75,04,656	100,25,76,056 42%	134,75,29,407
2012-13	134,75,29,407	148,76,96,121	135,36,26,321 48%	148,15,99,208
2013-14	148,15,99,208	197,19,70,205	190,52,83,337 55%	154,82,86,076
2014-15	154,82,86,076	259,83,13,924	147,92,55,949 35%	266,73,44,051

26. According to the AO, the above analysis would show that the assessee has used around 35% of the total provision for warranty during the current financial year and that there was a great mismatch between the actual expenditure and the provision created, which shows that the estimate made is unreliable. He also analyzed the reasonability of the creation of provision by comparing the provisions with the actual expenditure as ratio of utilization to the provision created. According to him provision being an estimation, should always be at a higher side so that the actual expenditure would not lend the business man at a fix or corner. Therefore, a prudent businessman would always keep something against the rainy-day but such saving should not be so big and high that allegation of unjust enrichment could be leveled against such businessman. In other words, extremes should be avoided. Therefore, a ratio of 70 % or round figure 70:100 between the actual expenditure and the provision. Reversely, the ratio 140:100. In other words, the total provision including the opening balance should be around 140% of the actual expenditure. He thereafter tabulated the ratio between the actual expenditure and the provision and found that the ratio in the case of the Assessee was around 279:100 which according to him was highly disproportionate. He observed that the average ratio is also worked out for the earlier years and it has always been around 238:100 or more. He therefore concluded that the warranty provision created by the Assessee was unscientific and therefore unascertainable. The AO also co-related year-wise sales turnover with that of warranty provision created and utilized and came to the conclusion that sales/turnover increased from Rs.1044.24 crores in FY.2005-06 to Rs.1805.40 crores in FY.2007-08. Subsequently, there was drop in turnover to Rs.1286.92 crores in FY.2008-09 with a marginal increase to Rs.1329.58 crores in FY.2009-10. However, in terms of provision for warranty liability there was drastic increase in Warranty provision created from Rs.61.21 crores in FY.2007-08 to as high as Rs.108.79 crores in

FY.2008-09, though there was fall in turnover from Rs.1805.40 crores in FY.2007-08 to Rs.1286.92 crores in FY.2008-09. Thus, provision created has increased from 3.34% of turnover to 8.40% of turnover in FY.2008-09. The AO also found a reverse situation where there was provision created had fallen from Rs.108.79 crores in FY.2008-09 to Rs.97.20 crores in FY.2009-10, inspite of increase in turnover from Rs.1286.92 crores in FY.2008-09 to Rs.1329.58 crores in FY.2009-10. Here, provision created has fallen from 8.40% to 7.31% in FY.2009-10. According to the AO, even if it is presumed that the reason for increase in provision created was due to increase in service cost including labor, travelling expenses, etc., the same does not justify the fall in provision created in the very next year though there is increase in turnover.

27. According to the AO, the Warranty provision utilized over the years has always been less than the provision created. Never ever the provision utilized has crossed the water mark of provision created. Consequently, the closing balance of the provision created has increased over the years, which has reached as high as Rs.259.83 crores in FY 2014-15 when compared to Rs.27.27 crores in FY.2005-06. This according to the AO shows that such a huge amount of Rs.259.83 crores has been claimed as expense over the years without actually incurring the same and the claim of the provision for warranty though increasing year after year has not been charged to tax. The AO therefore concluded that the assessee does not have a reasonable, scientific and reliable basis for the calculation of the provision for warranty. Accordingly, provision for warranty of Rs.259,83,13,924/- created by the assessee was treated as contingent and unascertainable in nature and hence not allowed as a revenue expense u/s.37 of the I.T. Act. However, the AO was of the view that actual expenditure incurred of Rs.147,92,55,949 should be allowed. **Hence, an amount of Rs.111,90,57,975/- being difference of provisional warranty**

created and actual expenditure incurred (Rs. 259,83,13,924 - 147,92,55,949) was disallowed and added to the income.

28. Before DRP apart from pointing out that in the earlier AYs the Tribunal has allowed similar claim of the Assessee, the Assessee pointed out the following factual details regarding the AO having considered incorrect amount of provision for warranty created during the year amounting to INR 259,83,13,924. However, the amount debited to the statement of profit and loss towards warranty expenses for the FY 2014-15 is only INR 221,85,57,975, as appearing in Note 25 of the audited financial statements (relevant page of the financial statement attached as Annexure -21). The Assessee also submitted that the provision for warranty created during the year of INR 259,83,13,924, as appearing in the balance sheet of Lenovo India as on March 31, 2015, includes an amount of INR 37,97,55,949, which pertains to provision for warranty on acquisition of business from IBM India Private Limited as a going concern, as mentioned in Note 26 and Note 45 of the audited financial statements (relevant page of the financial statement attached as Annexure 22). The Assessee thus pointed out that an amount of INR 37,97,55,949 has not been debited to the statement of profit and loss for the year ended March 31, 2015 and that the same has been included in the closing provision for warranty as appearing in the balance sheet as on March 31, 2015, as a result of acquisition. Since, the Assessee has not debited such amount to the statement of profit and loss, the same has not been deducted in computing the taxable income. It was thus submitted that the learned AO has erred in facts by disallowing an amount of INR 259,83,13,924 instead of INR 221,85,57,975 towards provision for warranty created during the year. Therefore, at best the learned AO could have disallowed INR 73,93,02,026 on account of provision for warranty i.e., after allowing the actual expenditure incurred during the year. The above argument was without

prejudice to the Assessee's argument that the entire provision for warranty liability should be allowed as deduction.

29. The DRP upheld the order of the AO in principle but held that the disallowance should be a sum of Rs.110,90,13,924/- which is the difference between the provision created during the relevant previous year of Rs.259,83,13,924 and the warranty liability that was actually discharged viz., a sum of Rs.147,93,00,000/-.

30. Aggrieved by the order of the DRP which was incorporated in the final order of assessment, the Assessee is in appeal before the Tribunal.

31. We have heard the rival submissions. The learned counsel for the Assessee submitted before us that the approach of the AO and the DRP is flawed because they have compared the provision made in AY 2015-16 with the actual liability incurred on account of performance of warranty claims of the same AY 2015-16. The proper approach should be to compare the current year provision with the actual of the succeeding year because the discharge of the warranty obligation will have only in the subsequent years and not in the year in which the products are sold. Our attention was drawn to the decision of the Hon'ble ITAT in AY 2006-07 in IT(TP) A.No.582/Bang/2015 dated 30.5.2016 wherein the Tribunal pointed out and explained how a similar approach of the revenue authorities are not correct. The following were the relevant observations of the Tribunal:-

“16. We have perused the materials and heard the rival contentions. Question before us is whether assessee had made the provisioning for warranty in a scientific manner. It is not disputed that in the impugned assessment year it had started doing the business of sale of laptops and desktops. Obviously assessee had no historical data with it. It is also not disputed that assessee had taken over this business from IBM, who had substantial experience in such business. Hence if the assessee relied on the methodology followed by IBM for working out the warranty provision we cannot say that it was incorrect. There is no case for the Revenue that any provisioning made by IBM in respect of such business

in any earlier years were disallowed for a reason that it was unscientific. It is true that assessee had adopted two factors namely, repair action rate and cost per claim from IBM data available at Asia Pacific Level. It might also be true that assessee had not produced records relating to IBM to show that these rates were correctly worked out by IBM. Nevertheless a look at the warranty provisioning table of the assessee for the succeeding assessment years reveals the following :

Provision for warranty account

FY 2005-06			
Particulars	Debit (Rs)	Particulars	Credit (Rs)
Opening balance	-	Warranty utilisation	76,652,762
Warranty provision during the year	349,449,249	Closing balance of provision required based on machine months under warranty	272,796,487
Total	349,449,249	Total	349,449,249

FY 2006-07			
Particulars	Debit (Rs)	Particulars	Credit (Rs)
Opening balance	272,796,487	Warranty utilisation	402,712,947
Warranty provision during the year	551,839,359	Closing balance of provision required based on machine months under warranty	421,922,899
Total	824,635,846	Total	824,635,846

FY 2007-08			
Particulars	Debit (Rs)	Particulars	Credit (Rs)
Opening balance	421,922,899	Warranty utilisation	519,174,867
Warranty provision during the year	612,180,442	Closing balance of provision required based on machine months under warranty	514,928,474
Total	1,034,103,341	Total	1,034,103,341

FY 2008-09			
Particulars	Debit (Rs)	Particulars	Credit (Rs)
Opening balance	514,928,474	Warranty utilisation	1,039,428,777
Warranty provision during the year	1,087,940,662	Closing balance of provision required based on machine months under warranty	563,440,359
Total	1,602,869,136	Total	1,602,869,136

FY 2009-10			
Particulars	Debit (Rs)	Particulars	Credit (Rs)
Opening balance	563,440,359	Warranty utilisation	683,251,088
Warranty provision during the year	972,025,066	Closing balance of provision required based on machine months under warranty	852,214,337
Total	1,535,465,425	Total	1,535,465,425

Financial year	Opening Balance	Addition during the year	Utilised / reversed during the year	Closing balance	Ratio of CY provision with next year utilisation
2005-06	-	349,449,249	76,652,762	272,796,487	86.77
2006-07	272,796,487	551,839,359	402,712,947	421,922,899	106.29
2007-08	421,922,899	612,180,442	519,174,867	514,928,474	58.90
2008-09	514,928,474	1,087,940,662	1,039,428,778	563,440,358	159.23
2009-10	563,440,358	972,025,066	683,251,088	852,214,336	95.57
2010-11	852,214,336	1,477,452,660	1,017,066,189	1,312,600,807	

There is much strength in the argument of the Ld. AR that provision done for a year should be compared with the actual spending in the succeeding year. This is for the simple reason that expenditure incurred against warranty given on sales made in any given year would be reflected in the succeeding year, when the provisioning is done on the basis of machine months. Assessee had done the provisioning based on machine months. If by application of the formula of multiplying machine months with repair action rate and cost per claim, an excessive warranty provisioning had resulted, then definitely in the succeeding year the expenditure incurred on warranty would be much less. The table above would show that expenditure on warranty was higher in almost all succeeding years except financial year 2009-09. In such circumstances we cannot say that assessee had followed a method which was not scientific. We are of the opinion that the three conditions set out by the Hon'ble Apex Court in the case of Rotork Controls India (Pvt) Ltd have been satisfied by the assessee, viz., establishing that there is a present obligation on account of a past event, working out the probable estimate of the outflow of the resources required and substantiating the reliability of such estimate. Especially so since the assessee was mandatorily required to follow AS-I and principles of prudence stipulated in such AS-I required provisioning for all known liabilities even if it could not be determined with certainty, but was made based on available data. We therefore delete the addition made by the AO disallowing the provision for warranty. Ground 7 of the assessee stands allowed.”

32. The learned DR relied on the order of the AO/DRP.

33. We have carefully considered the rival submissions. The basis for creating provision adopted by the Assessee is Machine months \times repair rate \times cost per claim Where:

Machine Months = Factor of the unexpired warrant period in months and the number of PCs which are under warranty at the end of the year

Repair Rate = Percentage of claims out of the total sales made on the historical data for the region.

Cost per claim = Average expected repair cost per PC on historical data for the region.

34. The hypothetical computation by the revenue authorities of percentage of actual claim for the year and provision made for the very same year, cannot be sustained because the basis of providing warranty is Machine months \times repair rate \times cost per claim. The tribunal has already pointed out the flaw in the approach of the revenue authorities in its order for AY 2006-07 that the basis should be the actual expenditure incurred on discharge of warranty claims in future which is much more than the provision made in an earlier year. The warranty obligation is not just for one year and it spreads over a period of more than 1 year and therefore the comparison as done by the revenue authorities is unsustainable. The method followed by the Assessee for creating provision for warranty has been held to be scientific and based on historical data of sales and repair ratio in every region in which the products are sold. The method has been accepted by the Tribunal in its order for several AYs. The method followed has not been shown to be not scientific by the revenue authorities. In such circumstances, we are of the view that the method followed by the Assessee should be accepted as proper and the deduction allowed as per the provision created by the Assessee. We hold and direct accordingly.

35. As far Gr.No.VII raised by the Assessee is concerned, the same relates to addition made to the book profits u/s.115JB of the Act on account of provision for warranty liability treating the same to be a liability of a contingent nature and hence liable to be added to the profit as per profit and loss account prepared in accordance with companies act to arrive at the book profit of the Assessee for the purpose of levy of tax on book profit under Sec.115JB of the Act. We have already held that the provision for warrant expenses is not contingent and has to be allowed as deduction while computing income under the head "Income from Business & Profession". As a consequence of such finding, the addition made to the book profits is to be deleted because the liability cannot be said to be contingent. We hold and direct accordingly.

36. Ground No.VIII is purely consequential and the AO is directed to give consequential relief.

37. In the result, appeal by the Assessee is partly allowed

Pronounced in the open court on this 6th day of March, 2020.

Sd/-

(PRADIP KUMAR KEDIA)
ACCOUNTANT MEMBER

Sd/-

(N V VASUDEVAN)
VICE PRESIDENT

Bangalore,
Dated, the 6th March, 2020.

/Desai S Murthy /

Copy to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar
ITAT, Bangalore