

**IN THE INCOME TAX APPELLATE TRIBUNAL
“B” BENCH : BANGALORE**

**BEFORE SHRI GEORGE GEORGE K., JUDICIAL MEMBER AND
Ms. PADMAVATHY S, ACCOUNTANT MEMBER**

ITA No.1963/Bang/2018
Assessment year : 2014-15

The Deputy Commissioner of Income Tax, Circle 5(1)(2), Bengaluru.	Vs.	Pace Digitek Infra Pvt. Ltd. [formerly Pace Power Systems Pvt. Ltd.], Plot No.12, Industrial Estate, No.V-12, Industrial Estate, Kumbalgodu, Bengaluru – 560074. PAN: AAACP 2697K
APPELLANT		RESPONDENT

Appellant by	:	Shri Manjunath Karkihalli, CIT(DR)(ITAT), Bengaluru.
Respondent by	:	Shri Naginchand Khincha, H., CA

Date of hearing	:	30.05.2022
Date of Pronouncement	:	08.06.2022

ORDER

Per Padmavathy S., Accountant Member

This appeal by the revenue is against the order of the CIT(Appeals)-5, Bengaluru dated 31.3.2018 for the assessment year 2014-15 on the following grounds:-

- “a) The order of the learned CIT(A) is opposed to law and facts of the case.
- (b) Whether on the facts and circumstances of the cases and in law, CIT(A) was right in deleting the addition made by disallowance of provision for loss on onerous contract of Rs 7,35,30,657/- despite the fact that this is a contingent liability

and not an ascertained liability as the same had not been created on the basis of Scientific Analysis and thus is not allowable U/s 37 of the Income Tax Act,1961 ?

- (c) Whether on the facts and circumstances of the cases and in law, CIT(A) was right in deleting the addition made by disallowance of provision for services rendered but not due of Rs 11,34,01668/- as the same is a contingent liability and not an ascertained liability since both the payee and the quantum of payment are not known and thus is not allowable U/s 37 of the Income tax Act,1961 ?
- (d) Whether on the facts and circumstances of the cases and in law, CIT(A) was right in holding that since no exempt income has been received by the assessee during the year no disallowance/addition can be made u/s 14A rw Rule 8D of Income tax Rules, ignoring the Board's circular No. 5/2014 ?
- (e) For these and other grounds that may be urged upon at the time of hearing, it is prayed that the order of CIT(A) in so far as it relates to the above grounds, may be reversed and that of the Assessing Officer may be restored.
- (f) The appellant craves leave to alter, amend or delete any of the grounds mentioned above and / or add any new grounds on or before the hearing.”

2. The assessee is engaged in the manufacture and supply of power management products for telecom operators, power telecom infrastructure producers and distributors both in India and overseas. The assessee is also responsible for installation and commissioning of products sold by them and third parties like battery and power supplies. It also undertakes warranty and after sales service for the products supplied by them. After sales services, annual maintenance contracts of products are also part of the assessee's business. It also carries out operations and maintenance (O&M) of telecom towers consisting of diesel generator, power management unit, AC, batteries, etc.

3. The assessee filed the return of income for the AY 2014-15 on 29.11.2014 declaring an income of Rs.25,99,73,830. The case was selected for scrutiny and assessment was completed u/s. 143(3) of the Income-tax Act, 1961 [the Act] where the AO has made the following disallowances:-

- (i) Disallowance of warranty expenses u/s. 40(a)(ia) – Rs.1,09,39,173.
- (ii) Disallowance of provision for loss on onerous contract – Rs.7,35,30,657.
- (iii) Disallowance of provision for services rendered but not due – Rs.11,34,01,688.
- (iv) Disallowance u/s. 14A r.w. Rule 8D – Rs.12,36,884.

4. The CIT(Appeals) deleted all the above additions, against which the revenue is in appeal before the Tribunal. The revenue is contending only the issues (ii), (iii) & (iv) listed above.

Disallowance of provision for loss on onerous contract – Rs.7,35,30,657

5. During the year under consideration, the assessee had creation provision of Rs.7,35,30,657 under the head 'provision for estimated losses on onerous contracts'. The AO noted that assessee had created short term provisions under the head 'Provision for estimated losses on onerous contracts' (Provision for underperformance charges) and the same was not added back in the computation.

6. The assessee submitted that as per the agreement, the assessee was under an obligation to render services at the specified level and within specified time. In case of any lapse or shortfall in the services rendered,

the customer deducts the amount as under performance charges (loss on onerous contracts). During the year, these charges are created at Rs. 7,35,30,657. The actual debit notes are received from the customers at a later date and booked in the subsequent period by debiting the provision account. However, the AO disallowed these expenses on the ground that the expenditure is not incurred during the previous year and that the loss is not consistent in proportion to the revenue earned by the assessee compared to the earlier years.

7. On appeal before the CIT(Appeals), the assessee reiterated the submissions made before the AO and submitted the complete list of debit notes and other relevant details. The CIT(Appeals) after considering the submissions deleted the disallowance observing as under:-

“A provision is recognized in accounts when there is an obligation as a result of past events and it is probably that an outflow of resources will be required to settle the obligation and for which a reliable estimate can be made. The pronouncement of Institute of Chartered Accountants of India in the matter of provisions under para 14 of as 29 provisions, contingent liabilities tingent assets is given as under for better understanding:-

14. A provision should be 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 embodying economic benefits 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 should be recognized.

In the appellant's case all of the above requirements are fulfilled:

- (a) The underperformance charges provisioned by the appellant is a present obligation of the appellant. There have arisen from past event being appellant's sale contract with customers.
- (b) Under the arrangement with customers there is definite obligation on the appellant towards charges for under performance.
- (c) Based on track records of underperformance and past business experience with the client the appellant is in a position to make a reliable estimate of the amount of obligation.

Further from the analysis as made above and considering the guidelines issued by the Institute of chartered Accountants of India and as per the generally accepted accounting principles, it is clear that the expenditure in referred to provisions relates to the year under appeal. Merely because the debit notes are raised in the subsequent year it cannot be said that the provisions do not relate to the current year. The underperformance charges are very much incurred during the year under appeal and only quantified in subsequent year. Thus the assessing officer's observation that no expense has been incurred in the previous year is contrary to the facts of the appellant's case. It is also not justified in concluding that the provision was made when there was highest revenue and that the provision commenced at the time when company had lowest revenue and table comprising of gross revenue figures and details of provisions of 3 years suggesting that provision for underperformance charges is arbitrary and not based on scientific basis. As has been submitted earlier the appellant is engaged in the business of sale of equipment and also rendering of operations and maintenance services the provision of underperformance debited by the appellant relates to revenue earned in respect of operations and maintenance services. The Assessing Officer has not appreciated this fact and has wrongly considered the appellant's gross turnover from all activities for year on year comparison with provision for underperformance charges for the FY 2011-12 relevant to AY 12-13. The appellant did not have any revenue

from operations and maintenance services and rightly did not have any provision for underperformance charges. The underperformance charges debited to the profit and loss account for the AY 2011-12 relates to the Key performance indicator deductions on product service operations. The appellant's revenue from operations and maintenance services for years ended 31.03.2013 and 31.03.2014 stood at Rs.27,63,53,805/- and Rs.67,26,79,992/- respectively. In any case the amount of underperformance charges is not linked to the revenue of the appellant but is dependent on the quality of services rendered by the appellant. Further the Assessing Officer is not justified in concluding that the amount for provision as estimated by the appellant is on arbitrary basis and not based on a scientific analysis. The provision is based on appellant's Actual records of underperformance. Charges payable under the agreement and actual charges debited by the clients in earlier years it is incorrect to say that the provision is arbitrary. In fact the low variance of only Rs.19,929/- between the amount of provisioned by the appellant (Rs.7,35,30,657/-) and the amount finally settled with clients (Rs.7,35,10,728/-) itself goes on to prove validity of appellant's estimations.”

8. The CIT(Appeals) relied on the Supreme Court decision in the case of *Rotork Controls India Pvt. Ltd. v. CIT (314 ITR 62)* wherein it was held that in case of warranties the sale price itself includes the price of warranty and therefore any expenditure incurred or any provision made for warranty is deductible. The loss on sale of onerous contract as claimed by the appellant is akin to warranty. He also relied on other judicial pronouncements and deleted the disallowance.

9. Aggrieved, the revenue is in appeal before the Tribunal. The Id. DR profoundly supported the disallowance made by the AO stating that the loss is not incurred during the previous year and the manner in which the loss is worked out by the assessee subsequently based on the debit not notes is not a proper analysis on scientific basis.

10. The Id. AR submitted that the period to which the losses are incurred is mentioned in the debit notes raised by the customers and accordingly the proportionate loss is claimed as a deduction in the year under consideration.

11. We have considered the rival submissions and perused the material on record. As per the contracts entered into by the assessee with the customers, there is a performance obligation whereby the assessee is under an obligation to maintain certified specified service level within specified time. For any shortfall, the customers could raise debit notes with charges in respect of deficiency in services. The assessee therefore during the year makes a provision towards the charges based on the past performance. These are negotiated with the customers and actual debit note is raised by the customers during the course of next year. In the year under consideration, the assessee made provision as follows:-

Opening balance of provision	5,68,02,667
Less : Debit Notes accounted in FY 13-14 against opening balances	(5,68,02,667)
Provision for current year	7,66,50,626
Less: Debit Notes received in the same year	(31,19,969)
Closing balance of provision as per balance sheet	7,35,30,657

12. During the proceedings before the CIT(Appeals), the assessee submitted the list of debit notes received subsequently which matches with the provision made with a minor difference which is as follows:-

SI No	Customer Name	Debit Note Number	Debit Note Value	DN Value for FY 2013-14
1	VIOM Networks Limited	VIOM/DN/OPEX/14-15/004	88,285,212	52,971,127
2	VIOM Networks Limited	VIOM/DN/OPEX/14-15/003	18,877,079	18,877,079
3	Indus Towers Limited	GUJA/Vendors/14-15/DN014	3,912	3,912
4	Indus Towers Limited	GUJA/Vendors/14-15/DN026	11,076	11,076

5	Indus Towers Limited	GUJA/Vendors/14-15/DN0IS	3,746	3,746
6	Indus Towers Limited	RPWB/O&M/SME/000292/13-14	39,040	39,040
7	Indus Towers Limited	RPWB/O&M/SME/000020/13-14	29,280	29,280
8	TowerVision India Limited	13902232/28.02.14	68,751	68,751
9	TowerVision India limited	13901310/05.11.13	60,340	60,340
10	TowerVision India Limited	13900341/11.06.13	174,180	174,180
11	TowerVision India Limited	13900524/30.06.13	503,675	503,675
12	TowerVision India limited	13901079/16.09.13	84,967	48,967
13	TowerVision India Limited	13901536/15.11.13	76,099	76,099
14	TowerVision India Limited	13900825/07.08.13	148,132	148,132
15	TowerVision India limited	13900786/31.07.13	63,000	63,000
16	TowerVision India Limited	13900824/07.08.13	46,759	46,759
17	TowerVision India Limited	13900318/31.05.13	194,085	194,085
18	TowerVision India Limited	13900171/29.06.13	69,850	69,850
19	TowerVision India Limited	1390206/11.02.14	121,630	121,630
				73,510,728

13. We also notice that the customers while raising the debit note mention the period and the assessee has claimed only the loss proportionate to the financial year concerned. The sample debit notes is given below for reference:-

VICOR NETWORKS LIMITED
 Corp. Office: Vikor Towers, 150, 3rd Industrial Complex, Sec-18, Gurgaon 122002
 D-2 408/Sec Park, Saltor, New Delhi-110007


DEBIT NOTE


VSNV/DN/0825/14-15/004 23-Feb-15

To,
 The Accounts Manager,
 Pace Power Systems Pvt. Ltd.
 Plot No. V-12, Industrial Estate, Kumbalangi,
 Bangalore-560074

File No. AACCT1282E
 Service Tax No-AACCT1282EST002

Particulars	Amount (Rs.)
Debit recovery on account of Deficit in Bill	
For the period July '13 To Sep '14 Deduction from the bills of Pace Power on account of deficit in services received by Vikor networks Ltd. This deduction is in under section 1 of CGST Act (Section No. 12) of Comprehensive operation and Maintenance from 31-Jan-2015 as per A. defined and set report following deductions are made.	58,285,212
Debit	
Checks	33,14,036/-
Bank and Recdhand	33,14,036/-
Independent	2,03,11,998/-
ADPO	1,39,55,629/-
Total Debit Value	78,675,699/-
Service Tax	
E Case	10,794,223
E. H. E. case	211,287
	105,942
TOTAL	99,679,764
Total Service Tax One Crore Nine Lakhs Twelve Thousand Two Hundred Two Only. Total Debit Note Value Nine Crores Three Lakh Ninety Seven Thousand Two Hundred Fifty Four Only.	

For Vikor Networks Limited


VICOR NETWORKS LIMITED																
Corp. Office: Vion Towers, 14A, Marol Industrial Complex, Sec-18, Gurgaon 122002 D-2 southern Park, Saket, New Delhi-110007																
DEBIT NOTE																
VION/CM/DPCL/14-15/003	23-Feb-13															
To, The Account Manager, Pace Power Systems Pvt. Ltd., Plot No. V-12, Industrial Estate, Kumbhalgode, Bangalore-560074	Fin No- AACCT122E Service Tax No-AACCT122EST902															
Particulars	Amount (Rs.)															
<p>Debit note on account of Power & Fuel</p> <p>For the period April 13 To June 13 deduction from the bills of Pace Power on account of deficit in services received by Vion networks ltd. This deduction is as under section-1 of LOI(Extension No.12) of Comprehensive operation and Maintenance date 31-Jan-2015 as SLA defined are not meet following deductions are made.</p> <table border="1"> <thead> <tr> <th>Circle</th> <th>Amount</th> <th>Period</th> </tr> </thead> <tbody> <tr> <td>Uttar And Jharkhand</td> <td>78,37,778/-</td> <td>April 2013 to June 2013</td> </tr> <tr> <td>Machhlypura-Jab</td> <td>69,30,637/-</td> <td>April 2013 to June 2013</td> </tr> <tr> <td>DPCL</td> <td>40,52,614/-</td> <td>April 2013 to June 2013</td> </tr> <tr> <td>Total Debit Value</td> <td>1,88,77,079/-</td> <td></td> </tr> </tbody> </table>	Circle	Amount	Period	Uttar And Jharkhand	78,37,778/-	April 2013 to June 2013	Machhlypura-Jab	69,30,637/-	April 2013 to June 2013	DPCL	40,52,614/-	April 2013 to June 2013	Total Debit Value	1,88,77,079/-		18,877,079
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<p>Service Tax</p> <p>Excise</p> <p>S. H. S. cess</p>	<p>2,365,249</p> <p>43,363</p> <p>21,652</p>															
TOTAL	21,216,294															
<p>Total Service Tax: Twenty three Lakhs Thirty Three Thousand Two Hundred Four Only.</p> <p>Total Debit Note Value: Two Crores Twelve Lakhs Ten Thousand Two Hundred Eight Six Only.</p>																
																

14. Accounting Standard [AS-29] talks about the recognition of contracts which are onerous. The CIT(Appeals) in his order has dealt with the same in detail. Accordingly, the assessee is required to create a provision towards the onerous contract. With regard to the manner in which the assessee has computed the amount of provision, we find that the assessee has considered the period mentioned in the debit note/invoices as the basis for proportionately creating the provision. This, in our considered view, is correctly done with proper analysis of documents and the relevant period. We therefore see no reason to interfere with the order

of the CIT(Appeals) who has considered all the aspects of the issue on merits. Therefore, the ground raised by the revenue is dismissed.

Disallowance of provision for services rendered not due

15. During the year, the assessee created provision for services rendered by third party vendors for Rs.11,34,01,668. Before the AO it was submitted that the assessee is outsourcing portion of service contracts to third party vendors, whose work is certified by the assessee and subsequently the vendors raise actual invoices. The assessee therefore creates provision towards the services rendered on an estimate basis for the year end. These provisions would get reversed on the first day of the next financial year when the actual bills are accounted for after TDS. The assessee had already billed its customers including the outsourced services for which revenue is recognized. Hence, as a matching principle, the corresponding expenses payable towards services rendered by the vendors is also accounted for.

16. The AO rejected the submissions of the assessee and proceeded to disallow the entire expenses stating that the expenses are unascertained and does not pertain to the assessment year under consideration since not billed by the vendors. The AO disallowed the entire expenses since, according to him, the conditions prescribed u/s. 37 were not satisfied.

17. On appeal, the CIT(Appeals) allowed it in favour of the assessee stating as follows:-

“7. I have carefully considered the submissions made by the appellant and also gone through the findings of the appellant (sic). The entire provision for expenses has been disallowed on the grounds that the provision is not an liability and that the expenditure is not incurred during the year.

The use of the words 'laid out or expended' along with the word 'expenditure' in Sec.37 of the Act, indicates that expenditure may either be an actual outgo of money irretrievably or a putting aside of money towards an existing liability. In *Calcutta Company Limited v. CIT* [1959] 37 ITR 1, the Hon'ble Supreme Court has held that in computing the profits and gains of a business, both the expenditure actually incurred and the liability accrued in respect of such expenditure (but required to be discharged at some future date) is allowed be deducted Expenditure for the purposes of section 37. therefore, includes amounts which the assessee has actually expended or which the assessee has provided for or laid out in respect of an accrued liability. Expenditure will be allowed as a deduction in the year of payment or outgo of money in case the assessee follows the cash method of accounting. On the other hand, expenditure will be allowed in the year in which the liability arises and not in the year of actual payment if the assessee follows mercantile method of accounting. The income under the head profits and gains of ness or profession is to be computed in accordance with the method of accounting regularly employed by an assessee. However, u/s. 209 of the Companies Act,1956 as amended ended with effect from June 15, 1986, companies are bound to maintain their accounts on the accrual or mercantile basis only. Under the mercantile or accrual system of accounting income and expenditure are recorded at the time of their accrual or incurrence. 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 resource 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. From a conjoint reading of the definitions of three terms provision, Liability and present obligation and rules of recognition of a provision cited above, it ensues a the following conditions should be satisfied before an obligation can constitute a provision entitled for deduction:

- 1) There should be an obligation.

- 2) Such obligation should arise due to past events.
- 3) The discharge of the obligation should be expected to result in outflow of resources, which embody economic benefits.
- 4) The obligation should be a present obligation.
- 5) The obligation should be capable of measurement by using a reliable estimation.
- 6) The obligation should not result in a contingent liability.

In the present case, provision for expenses pertains to services and materials received during the year and the appellant is under an obligation to make payment for services and material received in the course of business. Therefore the contentions of the appellant are hereby accepted and the grounds are allowed.”

18. The revenue is in appeal before the Tribunal, aggrieved by the order of the CIT(Appeals).

19. The Id. DR supported the order of the AO. Alternatively, the Id. DR submitted that the expenses ought to be disallowed u/s. 40(a)(ia) as the assessee has not deducted tax at source.

20. The Id. AR submitted that the bill wise details of expenses have been furnished before the lower authorities. After due verification of the same, the CIT(Appeals) has allowed the assessee's claim for deduction u/s. 37 of the Act, which has to be upheld.

21. We have considered the rival submissions and perused the material on record. We notice that the assessee has submitted the complete break-up of the expenses with party name, bill no. etc. [pages 76 to 94 of PB] before the CIT(Appeals), who has verified the same from perspective of its

allowability u/s. 37 of the Act and deleted the disallowance. We uphold the order of the CIT(Appeals) on this count.

22. Thus, this ground of the revenue is partly allowed.

Disallowance u/s. 14A of the Act

23. The AO invoked the provisions of section 14A r.w. Rule 8D to disallow a sum of Rs.12,36,884 as expenses attributable to earning of exempt income. For this purpose, he considered the average investment based on opening and closing balance of investments and applied 0.5% on the same. The AO also took the expenses proportionate of the investments to the average of total assets and disallowed the expenses in the computation u/s. 14A.

24. The assessee submitted before the CIT(Appeals) that during the year the assessee has not earned any exempt income so as to invoke the provisions of section 14A of the Act. The assessee relied on the following decisions:-

- ACIT Vs. M. Baskaran, 50 taxmann.com 138(Mad)
- Alliance Infrastructure Projects Pvt. Ltd. Vs. DCIT
- CIT Vs. Holcin India Pvt. Ltd. (New Delhi)
- CIT Vs. Shivam Motors Pvt. Ltd.(All. Trib)
- CIT Vs: Winsome Textile Industries Ltd.319 ITR 204(P&H)
- ICICI Venture Funds Management Co. Ltd. Vs. DCIT
- Cheminvest Ltd. Vs. CIT, 61 Taxmann.com 118(Delhi)
- Redington (India) Ltd. Vs. ACIT, 392 ITR 633 (Madras)

25. The CIT(Appeals) deleted the disallowance relying on the decision of the Chennai Bench of the Tribunal in the case of *ACIT v. M. Baskaran (supra)*.

26. Before us, the Id. DR submitted that the expenditure incurred towards earning of exempt income should be disallowed irrespective of whether exempt income is actually earned or not. In this regard, the Id. AR submitted that the decision of the Special Bench of Delhi ITAT is set aside by the Delhi High Court and accordingly the law is settled that section 14A will not apply where there is no exempt income.

27. We have carefully considered the rival submissions. The Hon'ble Delhi High Court in the case of *Cheminvest Ltd.*, 61 taxmann.com 118 (Delhi) has held as under:-

“23. In the context of the facts enumerated hereinbefore the Court answers the question framed by holding that the expression 'does not form part of the total income' in Section 14A of the envisages that there should be an actual receipt of income, which is not includible in the total income, during the relevant previous year for the purpose of disallowing any expenditure incurred in relation to the said income. In other words, Section 14A will not apply if no exempt income is received or receivable during the relevant previous year.”

28. Respectfully following the judgment of the Hon'ble Delhi High Court in *Cheminvest Ltd. (supra)*, we hold that since the assessee in the present case did not have any exempt income during the year under consideration, no disallowance is warranted u/s. 14A of the Act. With regard to the contention of the Id. DR that the Explanation inserted in section 14A of the Act by the Finance Act, 2022 is retrospective and applicable to assessee's case, we hold that the Explanation is inserted w.e.f. 1.4.2022 and therefore prospective and not applicable to the assessee's case for the year under consideration. This ground raised by the revenue is dismissed.

29. In the result, the appeal of the revenue is partly allowed.

Pronounced in the open court on this 08th day of June, 2022..

Sd/-
(GEORGE GEORGE K.)
JUDICIAL MEMBER

Sd/-
(PADMAVATHY S.)
ACCOUNTANT MEMBER

Bangalore,
Dated, the 08th June 2022.

/Desai S Murthy /

Copy to:

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

By order

Assistant Registrar
ITAT, Bangalore.