VERDICTUM.IN

$~58, 11 & 12

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

% **Judgment delivered on: 30 May 2024**

\+ ITA 304/2024
PRINCIPAL COMMISSIONER OF INCOME TAX 1
..... Appellant

Through: Mr.Prashant Meharchandani, Sr.SC with Mr.Akshat Singh, Jr.SC, Ms.Ritika Vohra and Mr.Utkarsh Kandpal, Advs.

versus

M/S CARE HEALTH INSURANCE LIMITED (EARLIER KNOWN AS M/S RELIGARE HEALTH INSURANCE CO. LTD.)
..... Respondent

Through: Mr.Ajay Vohra Sr.Adv. with Mr.Kishore Kunal, Ms.Ankita Prakash and Mr.Anuj Kumar, Advs.

11

\+ ITA 290/2024
PRINCIPAL COMMISSIONER OF INCOME TAX 1
..... Appellant

Through: Mr.Prashant Meharchandani, Sr.SC with Mr.Akshat Singh, Jr.SC, Ms.Ritika Vohra and Mr.Utkarsh Kandpal, Advs.

versus

M/S CARE HEALTH INSURANCE LIMITED (EARLIER KNOWN AS M/S RELIGARE HEALTH INSURANCE CO. LTD.)
..... Respondent

Through: Mr.Ajay Vohra Sr.Adv with Mr.Kishore Kunal, Ms.Ankita

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Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

Prakash and Mr.Anuj Kumar, Advs.

12

\+ ITA 291/2024
PRINCIPAL COMMISSIONER OF INCOME TAX 1

..... Appellant

Through: Mr.Prashant Meharchandani, Sr.SC with Mr.Akshat Singh, Jr.SC, Ms.Ritika Vohra and Mr.Utkarsh Kandpal, Advs.

versus

M/S CARE HEALTH INSURANCE LIMITED (EARLIER KNOWN AS M/S RELIGARE HEALTH INSURANCE CO. LTD.) ..... Respondent

Through: Mr.Ajay Vohra Sr.Adv with Mr.Kishore Kunal, Ms.Ankita Prakash and Mr.Anuj Kumar, Advs.

CORAM:
HON'BLE MR. JUSTICE YASHWANT VARMA
HON'BLE MR. JUSTICE PURUSHAINDRA KUMAR KAURAV

J U D G M E N T

YASHWANT VARMA, J.

CM APPLs. 32189/2024 & 32190/2024 (delay) in ITA 304/2024;
CM APPLs. 29258/2024 & 29259/2024 (delay) in ITA 290/2024,;
CM APPLs. 29282/2024 & 29283/2024 (delay) in ITA 291/2024,

1. Bearing in mind the disclosures made, the delay in filing and refiling the appeals is condoned.

2. The applications shall stand disposed of.

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

ITA 304/2024, ITA 290/2024 & ITA 291/2024

1. The Principal Commissioner of Income Tax calls in question the order of the **Income Tax Appellate Tribunal**[1] dated 10 May 2023 and poses the following questions for our consideration:-

> "A) Whether on the facts and circumstances of the case and in law, the Hon'ble ITAT has erred in deleting the disallowance of provision for unsettled claims outstanding as on March 31st ignoring that the amount is shown as a provision in books of account of the assessee and can be allowed in the year when it is materialised and not in the year under consideration.
>
> B) Whether on the facts and circumstances of the case and law, the Hon'ble ITAT erred in deleting the disallowance on account of the provision for unlogged claim ignoring that this provision was purely on ad-hoc basis and the assessee was already allowed special provision in terms of rule 6E of the IT Act.
>
> C) The appellant craves leave to add, alter or amend any substantial question of law raised above at the time of the hearing."

2. Upon hearing, Mr. Meharchandani, learned counsel for the appellant and Mr. Vohra, learned senior counsel who appeared for the respondents, we find that the principal questions which arise pertain to the provisions made for "unsettled outstanding claims" and the **Incurred But Not Reported**[2] claims. For the years in question, the **Assessing Officer**[3] had held that both the provision for unsettled claims as well as IBNR would amount to contingent liabilities and thus could not be validly claimed under Section 37 of the **Income Tax Act, 1961**[4].

3. Insofar as outstanding or unsettled claims are concerned, the

[1] Tribunal
[2] IBNR
[3] AO
[4] Act

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

Tribunal took note of the contention of the respondent-assessee that the provision for unsettled claims cannot be viewed as being ad hoc or an estimate since they record all outstanding claims to the extent lodged by policy holders. It is on the basis of the claims so lodged that the respondent appears to have made appropriate provisions in its books of account. It was asserted before the Tribunal that while the quantification or adjudication of the claim may happen subsequently, the same would only have an impact in the subsequent period and that such post facto circumstances which were not envisaged would not warrant the same being viewed as a contingent liability. The assessee also appears to have contended that once the claim comes to be lodged by the policy holder, it is only an exercise of verification and quantification which remains. The aforesaid issue in the estimation of the respondent stood settled in light of the judgment rendered by the Kerala High Court in **Commissioner of Income Tax vs. Kerala Transport Company**[5].

4. It was on a due consideration of the aforesaid that the Tribunal proceeded to uphold the view as taken by the **Commissioner of Income Tax (Appeals)**[6]. We, in this respect, deem it apposite to extract paragraphs 11 and 12 of the judgment rendered by the Tribunal hereunder:-

> "11. Upon careful consideration, we find that as regards provision for unsettled claims, the AO has made the disallowance by holding that these are adhoc provisions made on account of contingent liabilities and not ascertained liabilities and, therefore, not allowable under section 37 of the Income-tax Act, 1961 (for short 'the Act').

[5] 1998 SCC OnLine Ker 591
[6] CIT(A)

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

Ld. CIT (A)'s order in this regard read as under :-

> "4.2 I have carefully considered the facts of the case, submissions of the appellant and the impugned order of the AO. The fundamental submission of the appellant is that since the provision for unsettled claims has been made on basis of actual communication received from the policy holders, it can by no stretch of imagination be considered to be ad-hoc in nature as alleged by the Ld. AO. The appellant has submitted that incurrence of liability and its quantification are two separate aspects and merely because some claims are rejected subsequently being fraudulent/ erroneous in nature, the same cannot be considered to be an ad-hoc provision against contingent liability resulting in disallowance of the said liability,
>
> The principle enunciated in the case of Kerela Transport Company vs Assistant Commissioner of Income Tax [1994]50 TTJ 435 supra squarely applies to the facts on hand, In the light of above, I do not find any merit in the addition made by the AO in this case. Accordingly, ground no 3 is allowed in favour of the appellant."

> 12. Upon due consideration, we find that AO has erred in holding provision for unsettled claims as contingent liability. In the light of assessee's submissions noted above and case laws submitted, we find that ld. CIT (A) has passed correct order which does not need any interference from us. The liability in this regard is duly ascertained. Hence, this ground raised by the Revenue is dismissed."

5. In our considered opinion, the Tribunal was clearly justified in taking into consideration the indubitable fact of the distinction that must be borne in mind between the incurrence of a liability and its ultimate quantification. Before us it was not disputed by the appellant that the provision was made by the respondent-assessee on the basis of customer wise details of claims lodged. Merely because those claims ultimately came to be adjudicated subsequently would have no bearing on a provision being validly made.

6. Insofar as the question of IBNR is concerned, the Tribunal has

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

essentially followed the view taken by its Kolkata Bench in **Deputy Commissioner of Income Tax vs. National Insurance Co. Ltd.**[7]. Dealing with this aspect, the Tribunal has held:-

> "13. The AO made disallowance for provision for IBNR claims as contingent liability. Ld. CIT (A) deleted the addition by relying upon the decision of Kolkata ITAT Bench in the case of DCIT vs. National Insurance Co. Ltd.. The concluding part of the order of Id. CIT (A) read as under :-
>
> > "5.2 I have carefully considered the facts of the case, submissions of the appellant and the impugned order of the AO. The fundamental submissions of the appellant is that the provision for claims incurred but not reported is in accordance with the IRDA Regulations and the appellant being an insurance company is bound by such regulation.
> >
> > Further, the recent ruling of the Kolkata ITAT Bench in the case of Deputy Commissioner of Income tax vs National Insurance Co. Ltd.
> > (2016) 72 taxmann.com 116 (supra) is squarely applicable to the facts of the case as reproduced hereunder:
> >
> > > "3.6 We have heard the rival submissions and gone through facts and circumstances of the case. We find that the Ld CIT(A) had given a categorical finding that the provision made for liabilities incurred but not reported (IBNR) made by the assessee as per the regulations framed by Insurance Regulatory Development Authority (IRDA) based on a scientific calculation with a proper rationale could only be termed as ascertained liability. Hence, the same need not be added back by treating the same was unascertained liability whi1e computing the book profits u/s115JB of the Act. The revenue was not able to controvert the findings given by the Ld CITA before us. Hence, we find no infirmity in the order of the Ld. CITA in this regard and accordingly dismiss the Ground No. l raised by the revenue."
>
> Thus, as said provision has been created by it to meet ascertained liabilities, the Company is entitled to claim a deduction of the same

[7] IT APPEAL NOS. 674, 982 & 983 (KOL.) OF 2012

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

> while computing its income under the head 'profits & gains from business and profession'. Therefore, respectfully following the decision of the Hon'ble ITAT in the case of National Insurance above, I do not find any merit in the addition made by the AO in this case. Hence, this ground of appeal is allowed."
>
> 14. We have heard both the parties and perused the records. In the light of the assessee's submissions herein above, we find that ld. CIT (A) has taken correct decision, which does not need any interference on our part. The case law from Kolkata Bench of ITAT duly holds that these are ascertained liabilities. Hence, we uphold the order of ld. CIT (A). ”

7. The computation of profits of general insurance business is undisputedly regulated by the provisions made in the First Schedule of the Act and which requires an entity engaged in the business of insurance to compute its profits and gains from business as per its profit and loss account prepared in accordance with the Insurance Act, 1938, the rules framed under the said enactment or the Insurance Regulatory and Development Authority Act, 1999 and the rules and regulations framed by the IRDA. We find that the provisioning for IBNR is based upon the **Insurance Regulatory and Development Authority of India (Assets, Liabilities and Solvency Margin of General Insurance Business) Regulations, 2016**[8].

8. The determination of amount of liabilities of a general insurer is regulated by Regulation 5 and which requires a general insurer to prepare a statement of liabilities in accordance with Schedule II of those Regulations. The subject of claims reserve is regulated by Clause 3 of Schedule II of the Regulation which reads as follows:-

> “ 3. CLAIMS RESERVE
> (1) The Claims Reserve shall be determined as the aggregate amount

[8] Regulations

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

of Outstanding Claims Reserve and Incurred but Not Reported Claims Reserve (IBNR) as described below for the following lines of business:

xxxx xxxx xxxx

(2) Outstanding Claims Reserve

The outstanding claims reserve shall be determined in the following manner:

(a) Where the amount of outstanding claims of the insurers is known, the amount is to be provided in full;

(b) Where the amount of outstanding claims can be reasonably estimated according to the insurer, insurer shall follow the 'case by case method' after taking into account the explicit allowance for changes in the settlement pattern or average claim amounts, expenses and inflation;

(c) For lines of business, where the Appointed Actuary is of the view that the statistical method is most appropriate for the estimation of Outstanding claims, the Appointed Actuary may use the appropriate statistical method of claims reserving instead of following case by case method. In such cases, the claims outstanding reserve shall be certified by Appointed Actuary. Where the Appointed Actuary identifies material changes in the claims handling practices, their impact on the outstanding claims reserve pattern shall be taken into account and reported.

(3) Incurred But Not Reported (IBNR) Claims Reserve

(a) The incurred but not reported (IBNR) claims reserve shall be determined using actuarial principles and methods detailed in clause 4 below

(b) The IBNR shall be estimated using appropriate actuarial principles and shall be certified by the Appointed Actuary.

(c) The Appointed Actuary shall estimate IBNR on both net of reinsurance and gross of reinsurance basis.

(d) The Appointed Actuary shall estimate the provision for IBNR for each year of occurrence and the figures shall be aggregated to arrive at the total amount to be provided.

(e) If estimate of IBNR provision for any year of occurrence is negative, the Appointed Actuary shall reexamine the underlying assumptions. Even after re-examination, if the mathematics produces negative value, the Appointed Actuary shall ignore the IBNR provision for that year of occurrence.

(f) The estimation process shall not discount the estimated future development of paid claims to the current date."

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

9. While dealing with IBNR claims reserve, Clause 3(3) of Schedule II provides that IBNR would be estimated by usage of appropriate actuarial principles. IBNR itself is to be estimated on the basis of a study undertaken by an appointed actuary. Clause 4 then prescribes the various actuarial methods that may be used for the estimation of IBNR reserves. The said Clause reads as follows:-

> "**4. ACTUARIAL METHODS**
> (1) The following Standard Actuarial Methods may be used for the estimation of IBNR reserves:
> (a) Basic Chain Ladder Method (both on incurred and paid claims)
> (b) Bornhuetter Ferguson Method (both on incurred and paid claims)
> (c) Frequency – Severity Method
> (2) The Appointed Actuary shall use more than one method to arrive at an estimate that s/he believes is adequate to meet the future liabilities.
> (3) Appointed Actuary may use methods other than standard actuarial methods of IBNR estimation.
> (4) In his/her annual report submission to the Regulator, Appointed Actuary should provide an explanation of the rationale underlying the selection of a particular method over the other available methods along with the advantages and disadvantages of doing so.
> (5) Where the results of different methods or assumptions differ significantly, an Appointed Actuary must comment on the likely reasons for the differences and explain the basis for the choice of results. "

10. As is evident from the aforesaid, IBNR reserves are created by general insurers based on an actuarial exercise which is undertaken in accordance with one of the stipulated methods noticed in Clause 4. It is thus an empirical estimation for claims on the basis of an identified predictive methodology which in the opinion of the general insurer have already been incurred but may not have been reported at the time when a provision is made. We were informed by Mr. Vohra that the aforesaid procedure has been historically followed in the general

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

insurance business. It was in the aforesaid backdrop that Mr. Vohra had sought to draw a parallel between IBNR and warranties that may be issued by entities and the various judgments rendered with respect to the latter.

11. Having heard learned counsels for respective sides at some length, we find merit in the stand as struck by the respondents for reasons which are set out hereunder. One of the seminal decisions rendered by the Supreme Court in the context of warranties and whether provisions made in respect thereof would amount to contingent liabilities is the one rendered in **Rotork Controls India Private Limited. vs. Commissioner of Income Tax, Chennai**[9]. In the aforesaid matter, the Supreme Court was concerned with whether a standard warranty which had been provided by the assessee in respect of claims likely to arise could be construed to be a contingent liability and thus not allowable as a deduction under Section 37.

12. While expounding upon the concept of a provision being made in the books of account, the Supreme Court pertinently observed as follows:-

> "**22.** 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 recognised when: (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognised.
>
> **23.** Liability is defined as a present obligation arising from past events, the settlement of which is expected to result in an outflow

[9] (2009) 13 SCC 283

Signature Not Verified
Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

from the enterprise of resources embodying economic benefits. 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 recognised 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.

24. 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.

25. In the present case, the appellant has been manufacturing and selling valve actuators. They are in the business from Assessment Year 1983-1984 onwards. Valve actuators are sophisticated goods. Over the years the 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 recognised as provisions. These past events are known as obligating events.

26. In the present case, therefore, warranty provision needs to be recognised 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. As is evident from the principles enunciated above, the

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

Supreme Court explained the concept of provisioning for liabilities as being based upon a present obligation which may come to be owed by an enterprise as a result of a past event and the probability of an outflow of resources that may be required to settle that obligation. One of the crucial aspects which was highlighted in this regard was of the enterprise being entitled to make a reliable estimate and whether such an estimation could be made of the amount that may be ultimately owed on account of the obligation. Apart from obligations flowing from past events, the Supreme Court also recognized the concept of historical trends and those justifying the making of an appropriate provision. Historical trend was acknowledged to be a study of defects detected over a period of time and the data collated in respect thereof. The concept of historical trends was explained as under:-

> "**35.** In the present case, the High Court has principally gone by the judgment of the Supreme Court in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] . That was the case of gratuity. For Assessment Year 1974-1975 the assessee Company sought to deduct a sum of Rs 18,37,727 towards the amount of gratuity payable to its employees and worked out actuarially. No provision was made for Rs 18,37,727. The claim for deduction was made on the ground that the liability stood ascertained by actuarial valuation and, therefore, was deductible under Section 37 of the 1961 Act. The Income Tax Officer allowed the deduction only in respect of the amounts actually paid by the assessee and the rest was disallowed on the ground of non-compliance with the provisions of Section 40-A(7) of the 1961 Act. This view of ITO was affirmed by CIT(A).
>
> **36.** The Tribunal in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] held that for the earlier assessment year relating to 1973-1974, actuarially ascertained liability for gratuity arising under the Payment of Gratuity Act, 1972 was an allowable deduction. However, for the assessment year in question, the Tribunal held that the increased liability claimed by the assessee for deduction was allowable on general principles of accounting. This view was taken by the Tribunal on the basis that the actuarially determined liability was

Signature Not Verified
Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

not provided for in the assessee's books of account.

37. In appeal by the Department, the High Court held that the assessee therein was not entitled to deduction without complying with the provisions of Section 40-A(7) of the 1961 Act. This view of the High Court was affirmed by this Court in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] . It was held that Section 40-A(7) which stood inserted by the Finance Act, 1975 w.e.f. 1-4-1973 has been given an overriding effect over Section 28 as well as Section 37 of the 1961 Act. Consequently, the deduction allowable on general principles was ruled out as Section 40-A(1) made it clear that Section 40-A had effect notwithstanding anything contained in Sections 30 to 39 of the 1961 Act. In other words, as regards deduction in respect of gratuity, the assessee was required to comply with the provisions of Section 40-A(7) after the Finance Act, 1975.

38. It is interesting to note that prior to 1-4-1973 actual payment or provision for payment was eligible for deduction either under Section 28 or under Section 37 of the 1961 Act. This has been reiterated in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] . The position got altered only after 1-4-1973. Before that date, provision made in the profit and loss account for the estimated present value of the contingent liability properly ascertained and discounted on an accrued basis could be deducted either under Section 28 or Section 37 of the 1961 Act. This has been explained in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] at p. 599.

39. Section 40-A(7) deals only with the case of gratuity. Even in the case of gratuity but for insertion of Section 40-A(7), provision made in the profit and loss account on the basis of present value of the contingent liability properly ascertained and discounted on an accrued basis was entitled to deduction either under Section 28 or under Section 37 of the said Act. This aspect, therefore, indicates that the present value of the contingent liability like the warranty expense, if properly ascertained and discounted on accrued basis, could be an item of deduction under Section 37 of the said Act. This aspect is not noticed in the impugned judgment.

40. We may add a caveat. As stated above, the principle of estimation of the contingent liability is not the normal rule. As stated above, it would depend on the nature of business, the nature of sales, the nature of the product manufactured and sold and the scientific method of accounting being adopted by the assessee. It will also depend upon the historical trend. It would also depend upon the number of articles produced. As stated above, if it is a case of single item being produced then the principle of estimation of contingent liability on pro rata basis may not

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

apply.

41. However, in the present case, it is not so. In the present case, we have the situation of large number of items being produced. They are sophisticated goods. They are supported by the historical trend, namely, defects being detected in some of the items. The data also indicates that the warranty cost(s) is embedded in the sale price. The data also indicates that the warranty is attached to the sale price. In the circumstances, we hold that the principle laid down by this Court in Metal Box Co. of India [AIR 1969 SC 612 : (1969) 73 ITR 53] will apply.

42. In Metal Box Co. of India case [AIR 1969 SC 612 : (1969) 73 ITR 53] this Court held that contingent liabilities discounted and valued as out of necessity could be taken into account as trading expenses if these were capable of being valued. It was further held that an estimated liability even under a gratuity scheme even if it was a contingent liability if properly ascertainable and if its present value stood fairly discounted, was deductible from the gross profits while preparing the profit and loss account. In view of this decision it became permissible for an assessee to provide, in his profit and loss account, for the estimated liability under a gratuity scheme by ascertaining its present value on accrued basis and claiming it as an ascertained liability to be deducted in the computation of profit and gains of the previous year either under Section 28 or under Section 37 of the 1961 Act. However, the above principle would not apply after insertion of Section 40-A(7) w.e.f. 1-4-1973. It may be stated that the principles of commercial accounting, mentioned above, formed the basis of the judgment of this Court in Metal Box Co. of India [AIR 1969 SC 612 : (1969) 73 ITR 53] and those principles are affirmed by the judgment of the Supreme Court in Shree Sajjan Mills [(1985) 4 SCC 590 : 1986 SCC (Tax) 82 : (1985) 156 ITR 585] up to 1-4-1973. ”

14. What follows from the above is the right of an enterprise to make provisions for a liability which could be measured by and as the Supreme Court described a *“substantial degree of estimation”*. It was thus held that as long as a liability is properly ascertainable on the basis of empirical data or a known methodology, the same cannot possibly be held to be a contingent liability.

15. The Supreme Court ultimately in *Rotork Controls* held as

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Digitally Signed
By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

follows:-

> "**47.** At this stage, we once again reiterate that a liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources and in respect of which a reliable estimate is possible of the amount of obligation. As stated above, Indian Molasses Co. [AIR 1959 SC 1049 : (1959) 37 ITR 66] is different from the present case. As stated above, in the present case we are concerned with an army of items of sophisticated (specialised) goods manufactured and sold by the assessee whereas Indian Molasses Co. [AIR 1959 SC 1049 : (1959) 37 ITR 66] was restricted to an individual retiree. On the other hand, Metal Box Co. of India [AIR 1969 SC 612 : (1969) 73 ITR 53] pertained to an army of employees who were due to retire in future.
>
> **48.** In Metal Box Co. of India case [AIR 1969 SC 612 : (1969) 73 ITR 53] the company had estimated its liability under two gratuity schemes and the amount of liability was deducted from the gross receipts in the profit and loss account. The company had worked out its estimated liability on actuarial valuation. It had made provision for such liability spread over to a number of years. In such a case it was held by this Court that the provision made by the assessee Company for meeting the liability incurred by it under the gratuity scheme would be entitled to deduction out of the gross receipts for the accounting year during which the provision is made for the liability.
>
> **49.** The same principle is laid down in the judgment of this Court in Bharat Earth Movers [(2000) 6 SCC 645 : (2000) 245 ITR 428] . In that case the assessee Company had formulated leave encashment scheme. It was held, following the judgment in Metal Box Co. of India [AIR 1969 SC 612 : (1969) 73 ITR 53] , that the provision made by the assessee for meeting the liability incurred under leave encashment scheme proportionate with the entitlement earned by the employees, was entitled to deduction out of gross receipts for the accounting year during which the provision is made for that liability.
>
> **50.** The principle which emerges from these decisions is that if the historical trend indicates that large number of sophisticated goods were being manufactured in the past and in the past if the facts established show that defects existed in some of the items manufactured and sold then the provision made for warranty in respect of the army of such sophisticated goods would be entitled to deduction from the gross receipts under Section 37 of the 1961 Act. It would all depend on the data systematically maintained by the

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By:KAMLESH KUMAR
Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

assessee.

> **51.** It may be noted that in all the impugned judgments before us the assessee(s) has succeeded except in Civil Appeals Nos. 3506-10 of 2009 — arising out of SLPs (C) Nos. 14178-82 of 2007 — Rotork Controls India (P)Ltd. v. CIT, in which the Madras High Court has overruled the decision of the Tribunal allowing deduction under Section 37 of the 1961 Act. However, the High Court has failed to notice the "reversal" which constituted part of the data systematically maintained by the assessee over last decade. "

16. A lucid explanation of the concept of contingent liabilities is then found in **The Commissioner of Income Tax vs. Whirpool of India Ltd.**[10] In the facts of that case, this Court found that the assessee there had been consistently making provisions on the basis of actuarial valuation in respect of machines sold and warranty claims lodged. Both the AO as well as the CIT(A) in that case had taken the view that claims pertaining to unexpired periods of warranty could be considered only when actual claims may arise and that the assessee would not be justified in estimating a warranty liability.

17. While dealing with this aspect, the Court observed:-

> "**14.** We may take note of a decision of this Court in ***CIT Vs. Vinitec Corporation (P) Ltd***. 278 ITR 337 which is referred by the Tribunal also. In that case the assessee had claimed deduction under Section 37 of the Act, inter alia, on the provision made by it in the year against future claims by customers under the warranty clause which was part of the sale. The AO disallowed the claim on the ground that it was a contingent liability. The Tribunal, however, accepted the assessee‟s claim holding that the liability was definite and certain quantification was done on estimate basis after taking into consideration the data for past years of the percentage of warranty expenses. The High Court affirmed the decision of the Tribunal holding that the warranty clause was a part of the sale document and imposed a liability upon the assessee to discharge its obligation under that clause for the period of warranty. It was a liability, which

[10] Neutral Citation: 2011 DHC:394-DB

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Signing Date:03.06.2024
14:45:04

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was capable of being construed in definite terms, which had arisen in the accounting year, although its actual quantification and discharge might be deferred to a future date. Once the assessee is maintaining his accounts on the mercantile system, a liability accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy. In forming the aforesaid view, the Court applied the test laid down in ***Bharat Earth Movers, Vs. CIT***, 245 ITR 428 and analyzed the said judgment and another judgment of Privy Council in the following terms:-

> "In our opinion, the judgment of the Supreme Court in Bharat Earth Movers (supra) has a direct bearing on the issue in controversy before us. Dealing with the preposition whether the assessed would be allowed to deduction in the accounting year, although the liability may have to be quantified and discharged at a future date, the liability is to be treated in the present time and would or would not be a contingent liability, the Court held as under :-
>
> "So is the view taken in Calcutta Co.Ltd. v. CIT [1959]37 ITR1 (SC) wherein this Court has held that the liability on the assessed having been imported, the liability would be an accrued liability and would not convert into a conditional one merely because the liability was to be discharged at a future date. There may be some difficulty in the estimation thereof but that would not convert the accrued liability into a conditional one; it was always open to the tax authorities concerned to arrive at a proper estimate of the liability having regard to all the circumstances of the case.
>
> Applying the above said settled principles to the facts of the case at hand we are satisfied that the provision made by the appellant-company for meeting the liability incurred by it under the leave encashment scheme proportionate with the entitlement earned by employees of the company, inclusive of the officers and the staff, subject to the ceiling on accumulation as applicable on the relevant date, is entitled to deduction out of the gross receipts for the accounting year during which the provision is made for the liability. The liability is not a contingent liability. The High Court was not right in taking the view to the contrary.

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14:45:04

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The appeal is allowed. The judgment under appeal is set aside. The question referred by the Tribunal to the High Court is answered in the affirmative, i.e. in favor of the assessed and against the Revenue."

It will be useful for us to make a reference to the judgment of the Privy Council in the case of Commissioner of Inland Revenue (supra) where the Privy Council dealing with a taxpayer who was selling new motor vehicles to the dealers to indemnify them against warranty claims which, in turn, resulted in providing of warranty clause for 12 months from the date of delivery to the purchaser by the dealer, held as under :-
"Held, dismissing the appeal, that, although the taxpayer's liability under the warranty for each vehicle sold was contingent on a defect appearing and being notified to the dealer within the warranty period so that no liability was incurred by the taxpayer until those conditions were satisfied, regard could be had to its estimation of warranty claims based on statistical information, which showed that as a matter of existing fact not future contingency 63 per cent. of all vehicles sold by the taxpayer contained defects likely to be manifested within the warranty period and require work under warranty; that since theoretical contingencies could be disregarded, the taxpayer was in the year of sale under an accrued legal obligation to make payments under those warranties and even though it might not be required to do so until the following year, it was definitively committed in the year of sale to that expenditure; and that, accordingly, in computing the profits or gains derived by the taxpayer from its business in the year in which the vehicles were sold, the taxpayer was entitled under section 104 to deduct from its total income the provision which it had made for the costs of its anticipated liabilities under outstanding warranties in respect of vehicles sold in that year."

The ratio decidendi of the above cases is squarely applicable to the facts of the present case. It is not disputed that the warranty clause is part of the sale document and imposes a liability upon the assessed to discharge its obligations under that clause for the period of warranty. It is a liability which is capable of being construed in definite terms which has arisen in the accounting year.

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Signing Date:03.06.2024
14:45:04

VERDICTUM.IN

> May be its actual quantification and discharge is deferred to a future date. Once an assessed is maintaining his accounts on the mercantile system, a liability is accrued, though to be discharged at a future date, would be a proper deduction while working out the profits and gains of his business, regard being had to the accepted principles of commercial practice and accountancy"

18. After noticing the judgment in *Rotork Controls*, the Court held:-

> "17. The Court then proceeded to determine as to what would be the most appropriate method for making a provision for 'product warranty', based on historical trend and held that:-
> (a) It should be based on historical trend and for determining a proper historical trend, the company should have proper accounting system for capturing of sales, warranty provisions made and the actual expenses incurred subsequently.
> (b) 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 based on past experience.
> (c) The warranty provision for the product should be based on estimate at year end of future warranty expense. This becomes clear from the following discussion in the said judgment:-
>
> > "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 warranty expenses. Such estimates need reassessment every year."
>
> **18.** Apart from other things, the Court highlighted that provision for warranty on turnover of the company based on past experience fulfills accrual concept as well the matching concept. The Court not

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14:45:04

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> only laid stress on the past experience based on historical trend of warranty provisions, it was also emphasized that this provided estimates under the assessment every year.
>
> **19.** We may also point out at this stage itself that the Supreme Court distinguished the judgments in Sajjan Mills (supra) as well as Indian Molasses Co. (supra). We would also like to refer to the judgment of the Supreme Court in CIT Vs.Woodward Governor India P. Ltd. 312 ITR 254 wherein it was held that the accounting method followed by the assessee continuously for a given period of time has to be presumed to be correct till the AO comes to the conclusion for the reasons to be given that the estimate does not reflect to be true and correct profits ."

19. Upon due consideration of the principles enunciated in the aforenoted decisions, we come to the firm conclusion that it would be wholly incorrect to understand IBNR provisioning to be a contingent liability. We, in this regard, bear in consideration the precepts of reasonable estimation, the capability of a liability being quantified based upon historical trends and the known actuarial methods for estimation which are liable to be adopted in accordance with the IRDA Regulations. We consequently find no error in the view ultimately taken by the Tribunal.

20. The appeals consequently fail and shall stand dismissed.

YASHWANT VARMA, J.

PURUSHAINDRA KUMAR KAURAV, J.

MAY 30, 2024/RW

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