

## Tax Alert | Delivering clarity

20 April 2020

### Advertisement expenditure, provision for warranty and foreign exchange fluctuation loss

The Bangalore Bench of the Tribunal has held that advertisement expenditure is revenue in nature. Further, it held provision for warranty made on scientific basis is an allowable expenditure. It also held that, foreign exchange fluctuation towards trading activities is an allowable expenditure.

#### Facts of the case:

##### Issue 1 – Advertisement expenditure

- Acer India Private Limited (the taxpayer)<sup>1</sup> is in the business of manufacturing computers, servers and distribution of laptops, monitors, projectors and peripherals products software, under license from its associated enterprise. The taxpayer had incurred expenses on media advertisement amounting to INR 49.6 million and claimed a tax deduction for the same.
- The Dispute Resolution Panel (DRP) directed that media advertisement expenses are capital expenditure which resulted in enduring benefit in form of brand creation and therefore, cannot be said to be wholly and exclusively for business carried out. The Assessing Officer (AO), based on directions from DRP, disallowed advertisement expenses under Section 37(1) of the Income-tax Act, 1961 (Act).
- Aggrieved by the addition, the taxpayer filed an appeal with the Bangalore Bench of the Income-tax Appellate Tribunal (ITAT).

##### Issue 2 – Provision for warranty

- The taxpayer had claimed and the AO / Transfer Pricing Officer (TPO) had allowed provision for warranty amounting to ~INR 309 million.
- Aggrieved by allowance by the AO / TPO, the Revenue filed an appeal with the ITAT, on the basis that the taxpayer has not conclusively proved that expenditures pertain to actual utilization of warranty pertaining to sale invoices (which are under warranty period).

##### Issue 3 – Foreign exchange fluctuation loss

- The taxpayer had claimed and the AO had allowed foreign exchange fluctuation loss.
- Aggrieved by the allowance by the AO, the Revenue filed an appeal with the ITAT, on the basis that the transactions are speculative in nature and contingent in character; and such losses can be allowed if actual sales had taken place and transaction is complete.

#### Decision of the ITAT:

##### Issue 1 – Advertisement expenditure

- The ITAT has held that expenditure incurred towards advertisement to promote sales can in no way be treated as capital expenditure. It affirmed the principle laid down by various High Courts which have held advertisement expenses to be revenue in nature, because

---

<sup>1</sup> IT(TP)A 458/Bang/2016 and IT(TP)A 473/Bang/2016

advertisements do not have long-lasting effect and once advertisements stop, the effect thereof under general public and customer, diminishes and vanishes.

- The ITAT affirmed the judicial precedents<sup>2</sup> relied upon by the taxpayer in support of its claim and held that deduction for advertisement expenditure for promoting sales is allowable under Section 37(1) of the Act.

### **Issue 2 – Provision for warranty**

- The ITAT relied on the judicial precedents<sup>3</sup> of the ITAT in taxpayer's own case, wherein it was held that the provision for warranty stood crystallized as soon as the sale was made and therefore, it cannot be considered as a contingent provision. Further, it was observed in those judicial precedents<sup>3</sup> that the taxpayer had created provision based on the estimation of warranty liability, which is based on failure rates of the past, year data / experience and industry trends and not on adhoc basis. It was also held in those judicial precedents<sup>3</sup> that the decision of the Supreme Court in case of Rotork Controls Pvt. Ltd.<sup>4</sup> was squarely applicable. The Supreme Court had held that provision made on the basis of past experience is a scientific method and is the most appropriate method.
- Relying on the judicial precedents<sup>3</sup> of the ITAT in taxpayer's own case, the ITAT held that provision for warranty based on failure rates of the past, year data / experience and industry trends (and not on adhoc basis) is an allowable expenditure.

### **Issue 3 – Foreign exchange fluctuation loss**

- The ITAT observed that the taxpayer had been consistently recognizing gains / losses arising out of forward exchange contract and has been offering income, if any, to tax arising from such contracts. Further, the forward exchange contracts had been entered into by the taxpayer in order to protect its interest against fluctuation in foreign currency in respect of consideration for export proceeds which are revenue in nature.
- The ITAT, relying on the judicial precedent of the Supreme Court in the case of Woodward Governor<sup>5</sup>, held that the taxpayer had incurred foreign exchange loss for year under consideration, towards trading activities, and therefore, it is directly attributable to business of the taxpayer, which is an allowable expenditure.

## **Observations:**

### **Issue 1 – Advertisement expenditure**

- The tax authorities have been challenging tax deduction for advertisement expenditure on the ground of enduring benefit. The ruling will support taxpayers' claim for deduction of advertisement expenditure as revenue in nature.

### **Issue 2 – Provision for warranty**

- Deduction for provision for warranty has been a subject matter of litigation. The ruling reiterates that the same is an allowable expenditure if computed on a scientific basis. Taxpayers should maintain documentation to support the claim of provision for warranty.

---

<sup>2</sup> CIT vs Indo Nisan Foods Ltd. (2013) 35 Taxmann.com 637 (Bom HC), CIT vs Asian Paints (India) Ltd. (2016) 75 Taxmann.com 152 (Bom HC), CIT vs Spice Distribution Ltd. (2015) 54 Taxmann.com 325 (Del HC)

<sup>3</sup> ITA Nos. 1179 & 1180/Bang/2012 and ITA No. 784/Bang/2010

<sup>4</sup> M/s. Rotork Controls India (P) Ltd. vs CIT (314 ITR 62) (SC)

<sup>5</sup> CIT vs Woodward Governor India (P) Ltd. (2009) 312 ITR 254 (SC)

### **Issue 3 – Foreign exchange fluctuation loss**

- The ruling affirms the principles laid down by the Supreme Court allowing foreign exchange loss incurred towards trading activities.



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a more detailed description of DTTL and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmatsu India LLP (DTTI LLP) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This material contains information sourced from third party sites (external sites).

DTTI LLP is not responsible for any loss whatsoever caused due to reliance placed on information sourced from such external sites. None of DTTI LLP, Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this material, rendering professional advice or services. This information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this material.

©2020 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited