Credit arising on pre-mature repayment of accumulated sales tax liability otherwise deferrable for a 10 year period

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1 A public limited listed company, incorporated in 1966, is engaged in the manufacturing of a variety of organic chemicals and resins at three production sites, one of which is set up in designated backward districts of the State of Maharashtra. The said unit originally belonged to another registered company which, post its commercial operation stage, happened to merge with the company after due adherence to various statutory compliances.

2 The querist has stated that the Government of Maharashtra, with the main aim of encouraging industrialisation in the State as well as to achieve dispersal of industries across the State, has several incentives bestowing schemes on offer. The schemes are fundamentally targeted at encouraging greater flow of capital investments into the deficiencies prone industrially backward regions of the State. The schemes (a) provide for defraying cost of deficiencies to some extent and/or (b) enable and facilitate generation of the seed capital and recurring working capital needs of the unit through various options like, deferral of payment of certain liabilities as has been allowed in the case of this company. The operating and implementation part of most of the schemes stipulate issuance of various permissions to the unit (like, entitlement and eligibility certificates) and also call for entering into an agreement by the unit with the State Government, prior to the actual availment of the incentives. These documents specify the maximum value of incentives that a unit can avail, based on the fixed capital investment made in it.

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 22nd volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

3 According to the querist, under the Package Scheme of Incentives (PSI), 1993, the aforestated unit (of the erstwhile company) was permitted, since beginning of the month of May 1999, to

- collect sales tax (as normally expected to be collected in regular course of any business but net of taxes paid for various purchases), and
- defer depositing the same with the Government.

The tax thus payable, but not deposited in the Government treasury under the scheme is stipulated to be paid in 5 equal annual instalments after a period of 10 years.

4 The Government of Maharashtra announced w.e.f. May 01, 2002, acceptance of pre-payment of the stated, but alternatively deferrable sales tax liability after discounting at a predetermined rate by means of inserting an enabling proviso in section 38 of the Bombay Sales Tax Act, 1959, to that effect.

5 The querist has stated that during March 2003, the company pre-paid the abovesaid sales tax liability (accumulated for the period of January 2001 to October 2001) amounting to Rs. 314.33 lakh at a discounted value of Rs. 99.13 lakh to the Government, and, consequently accrued differential credit of Rs. 215.20 lakh in its books of account.

6 The querist has stated that the company has credited the resultant surplus of Rs. 215.20 lakh directly to the Capital Reserve (i.e., without routing it through the Profit and Loss Account) in view of an understanding that the said sales tax liability whilst being unpaid, by its inherent

nature and objective, meant and represented no more than a long term loan, the possible extinguishment of which could only give rise to profits that are essentially and only capital in nature. Further, the company feels guided by various interpretations enunciated by the judiciary while interpreting the term 'income' as "something that comes in or is expected to come in with some sort of regularity or from a definite source". The term 'gain' has a different meaning and connotation than the term 'income'. According to the querist, a revision effected in the definition of the term 'Extraordinary items' in AS 5 amply proves the point. The words 'gains or losses' occurring therein were replaced with the words 'income or expenses' that have more specific and a different meaning. In past, it has been held that "a receipt that depends upon will of the payer can not be regarded as an income" (*Vijaykuverba* vs. *CIT* 49 ITR 594) and consequently could only partake colour of a capital receipt. However, an alternative view (that may not be totally faulty) that the aforesaid differential credit/surplus should only be credited to the profit and loss account is also prevalent.

7 According to the querist, there could also exist yet another alternative accounting treatment, i.e., treating the credit, at the time of its occurrence, as a Capital Reserve to be finally apportioned to the Revenue Reserves on a piecemeal basis over the future life of the capital assets existing in the entitled unit or alternatively over the future period of the liability.

8 The querist has also provided a copy each of the following for reference of the Committee:

(a) Certificate of Entitlement issued by the Sales Tax Department in the erstwhile company's case.
(b Eligibility Certificate issued by the implementing agency in the erstwhile company's case.
(c) Stipulated agreement entered into with the Government of Maharashtra by the erstwhile company.
(d) Receipts issued by the Sales Tax Department showing the amount received and the liability discharged.
(e) Extract of the enabling provisions (section 38 – fourth proviso) incorporated in the Bombay Sales Tax Act, 1959.

B. Query

9 The querist has sought the opinion of the Expert Advisory Committee on the issue as to the accounting treatment to be given to and the disclosures required on account of the credit arising in the company's books with regard to partial extinguishment of sales tax liability under the newly enacted arrangement.

C. Points considered by the Committee

10 The Committee is of the view that the manner of treatment of an item of income in the books of account of an entity should be decided on the basis of the relevant accounting principles and practices rather than on the basis of the relevant tax provisions which might have been enacted to fulfil different objectives.

11 The Committee notes that the company has discharged its existing accumulated sales tax liability amounting to Rs. 314.33 lakh by paying Rs. 99.13 lakh to the Government. In other words, the company has extinguished sales tax liability recognised by it to the extent of Rs. 215.20 lakh by paying Rs. 99.13 lakh by virtue of the scheme of the Government allowing prepayment of the deferred sales tax liability at a discounted rate. In this respect, the Committee notes paragraph 91 of the 'Framework for the Preparation and Presentation of Financial Statements', issued by the Institute of Chartered Accountants of India, as reproduced below:

> "91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable)."

From the above, the Committee is of the view that since a decrease in the liability has taken place due to pre-payment of the sales tax liability, the resultant income should be recognised in the profit and account.

12 With regard to the disclosure, a question may arise as to whether the credit should be disclosed as an extraordinary item. In this connection, the Committee notes the following definition of 'Extraordinary items' as stated in Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in

Accounting Policies', issued by the Institute of Chartered Accountants of India:

> ***"Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly."***

13 The Committee also notes paragraph 9 of AS 5 as reproduced below:

> "9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item."

14 The Committee is of the view that since sales tax liability arises in the ordinary course of business, the extinguishment thereof, even though it may occur infrequently, should be considered as an item arising in the course of the ordinary activities of the company. In this context, the Committee further notes paragraph 12 of AS 5 as reproduced below:

> ***"12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately."***

15 On the basis of the above, the Committee is of the view that if the company considers that the size and incidence of the item is such that its disclosure is relevant to explain the performance of the company for the period, the nature and the amount of the item should be disclosed separately.

D. Opinion

16 Based on above, the Committee is of the opinion that the credit arising on premature repayment of accumulated sales tax liability should be credited to the profit and loss account for the period with disclosure as recommended in paragraph 15 above. ■

Announcement

The Corporate and Allied Laws Committee of the Institute of Chartered Accountants of India proposes to bring out the Publications/Books on the following subjects/topics related to ***Corporate and Allied Laws.***

- Foreign Contribution (Regulation) Act, 1976
- Consumer Protection Act, 1986
- Emblems and Names (Prevention of Improper Use) Act, 1950
- Industries (Development and Regulation) Act, 1951
- Contract Act, 1872
- Sale of Goods Act, 1930
- Indian Partnership Act, 1932
- Stamp Act, 1899
- Societies Registration Act, 1860
- Trust Act, 1882
- Charitable Endowment Act, 1890
- Telecom Regulatory Authority of India Act, 1997
- Transfer of Property Act, 1882

The Corporate and Allied Laws Committee invites the members of the Institute/Experts to assist in preparing the basic drafts of the Publications/Books on above topics. They may also intimate the names of the Resource Persons who are experts in the above areas/fields and can associate themselves with the Institute in preparing the basic drafts of the above Publications/Books.

The interested Members/Experts/Resource Persons are requested to send their Resume highlighting their past record in the field of their expertise to the Secretary, Corporate and Allied Laws Committee of the Institute at the following address:

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