Impact of IFRS Adoption on Taxation

In India, the taxman does not impose any separate book keeping system on Corporates for tax purpose. Therefore, the financial statements and books of accounts of the companies form the basis for taxation – both Direct and Indirect. In such a scenario, any change in the accounting system is bound to impact the tax levy and collection. Hence, it warrants a study of the possible impact on the levy and collection due to the advent of IFRS. In India, the companies which will get ready for the Phase-1 implementation of IFRS are the listed ones and those with net worth more than ₹1,000 crore. The path breaking changes brought about in the new Ind AS especially on Revenue Recognition aspects, affect almost all the sectors and, therefore, the immediate impact on tax revenues and GDP in the threshold phase can be expected to be higher. This article attempts to have a closer look at the radical changes that are brought about in the IFRS converged Indian GAAP version i.e. Ind AS (yet to be notified) and the resultant tax implications.

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Impact on Corporate Taxes

Basically, the foundation is that the tax department will accept the method of accounting consistently followed by assessee (Section 145 of the IT Act). Income Tax implications can be felt cumulatively through several changes, affecting the corporate profits of which the significant ones are enumerated below.

Corporate Revenue:

- Revenue is the principal driver of profit. Ind-AS 18 requires all revenues to be measured at normal credit terms (where deferred credit is given). This means that the impact of the abnormal credit needs to be carved out of the transaction value and accounted separately as finance income. This finance income is recognised in Books, based on an effective interest rate method. Thus a chunk of tax collections which was possible in the same year under current IGAAP, will get deferred in the form of a deferred finance income.
- As per Appendix-B to Ind AS-18, Customer loyalty

programmes do have a bearing on the accounting for Revenues. Earlier, the total amount of Revenue which included the value of award credits was recorded as such, but now, the consideration is required to be allocated to the principal components of the sale and award credits/points and the portion pertaining to award credits is required to be deferred and recognised over the period when the points are redeemed by the Customer. This is another instance of deferral in tax revenues to the Government.

- Service Sector being the contributor of more than 60% to our GDP is bound to be impacted as well. Earlier, AS-9 on Revenue recognition under the erstwhile GAAP, gave an option to account for the revenues from Continuous service contracts based on Completed service method or Percentage of Completion method. But under Ind AS-18, only percentage of completion method is to be followed. Thus, tax collections will be impacted accordingly.

Claim of Depreciation:

- Appendix-C to Ind AS-17 on Leases requires determining whether an arrangement which does not appear in form to be a lease, is in substance a lease arrangement subject to fulfilment of certain criteria. Some of the examples include outsourcing arrangements, arrangements in telecom industry etc. The result of this application is, that the arrangement may either become a finance lease or operating lease as governed by Ind AS-17. If it turns out to be a finance lease, then the lessee will be able to account the asset and claim depreciation, which hitherto may not have been the case. Tax implication may thus arise, if there is difference in the status of either party. For e.g. If Lessor is a 100% EOU with lower tax liability due to additional deductions under Chapter VIA and the lessee is not, then if the arrangement is concluded as a Finance lease, the tax collection to the Government might be impacted as in the numerical example below.

	UNDER IGAAP		UNDER IND AS-18	
PARTICULARS	**Lessor (100% EOU)**	**Lessee**	**Lessor (100% EOU)**	**Lessee**
	(₹)	(₹)	(₹)	(₹)
Value of transferred asset	100000			
Amount capitalised	100000	0	0	100000
Depreciation @15%	15000	0	0	15000
Reduction in taxable profit	(15000)	0	0	(15000)
Tax Rate	0%	30%	0%	30%
Reduction in Corporate tax	0	0	0	(4500)

- Appendix-C to Ind AS-18 on Revenue states that where assets are transferred from Customers for use in production on their behalf, the transferred assets will have to be accounted in the books of the transferee, unlike earlier where these assets were still held in the Customer's Balance sheets. Thus accordingly, the claim of depreciation will also get shifted as in the scenario mentioned before leading to tax implications.
- Accounting for Property, Plant and Equipment will be getting governed by Ind AS-16. This standard requires that PPE should be capitalised at Cash price equivalent of the consideration for the purchase of the asset at the inception. There is a need for clarification whether this amount will be accepted for tax purpose and depreciation or will create permanent differences in our deferred tax computations.
- Similarly, Ind AS-16 also requires, that asset retirement obligations are to be estimated and capitalised at the time of purchase itself (For e.g. dismantling costs of plant on termination of an agreement with Local authority) which is a material departure. Also, major inspection/overhaul costs are required to be capitalised which was not the earlier case. Taxman needs to clarify whether this component is eligible to be included in the definition of 'actual cost' for the purpose of claim of depreciation under the Income tax Act 1961.

In *CIT vs. CESC Ltd*, the Supreme Court held that though a company may keep its accounts in foreign currency, depreciation will have to be calculated

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in Indian Currency at the time of acquisition of the asset using the exchange rate at that point. With the introduction of the concept called 'Functional currency' under Ind AS-21, companies may not be recording the transaction necessarily at their domicile currency subject to fulfilment of the specified criteria. How will this judgment impact? Separate set of computation of depreciation will be required outside the books for tax purpose in INR, while for accounting, depreciation may be recorded at functional currency itself unlike earlier.

Effective Interest Rate Method:

Effective interest rate is any benchmark rate that is used to allocate the total interest component over a relevant period. This need not necessarily be the same as the stated rate of interest on the instrument.

- As explained in one of the preceding paragraphs, there are instances where an item of PPE obtained on credit terms is required to be recorded at Cash Price equivalent, while the credit element gets recorded as finance expense using the effective interest method over the credit period. All along, for interest deduction under tax, a law has been based on legal form i.e. no recognition for implicit or notional interests. Here is a case where the parties have not agreed to pay an explicit interest. Whether the finance (interest) expense so calculated will be acceptable for the taxman is something that requires a clarification. If this is not allowable, then the finance income arising to the corresponding seller by application of Ind AS-18 should also not be included in Taxable income. In other cases such as interest income or expense relating to a Held to Maturity Investment which is required to be calculated using an effective interest rate, the issue is only with respect to allocation of the total interest component which is specified in the agreement.
- Let us consider a Company which lends ₹10,000/- to its employee at 0% interest rate, for say three years. This will be classified as 'Loans and Receivables' as per Ind AS-39, requiring amortised cost basis of accounting using effective interest rate method. Thus, though the instrument is rated as zero interest, the company has to account for a notional interest income which reflects the effective interest rate. Let us assume the market interest rate for similar product to be 5%. The maturity amount of ₹10,000/- (same as principal amount) has to be discounted at the market rate of 5%, which will result in a present value of ₹8,638/. The difference of ₹1,362/- (10,000-8,638) is incremented to the carrying amount of the asset over these three years as per the PV table such that at maturity date, the carrying amount of the asset will be ₹10,000/. There will be a credit to interest income for ₹1,362/- (though actual interest receivable from employee is zero). The unfortunate thing about this is that a part of corpus might have to be offered for income under the tax law. i.e. the interest income of ₹1,362/- will get taxed, if the assessee follows accrual method of accounting despite forming a part of the corpus ₹10000/-. This might be against the principles of taxation that capital receipts or payments cannot enter the computation of taxable income.

The definition of Arms length price (ALP) as per Chapter X of the Income tax Act seems to be in contrast to the Fair value defined by Ind AS. Arms Length Price, by virtue of the definition, requires adjustment to the price arrived by benchmarking with a comparable uncontrolled transaction under uncontrolled conditions. The adjustment is necessitated to eliminate significant differences between the subject transaction and the benchmarked one which affect the price in the open market.

- Following the above, there could be potential double taxation in the following manner. The employee in the above example will also have to offer the interest free portion of the Loan for tax as perquisites under the head 'Salaries'. To recollect the relevant portion of Rule 3(7) (I) under Income tax rules,

  "The value of the benefit to the assessee resulting from the provision of interest-free or concessional loan for any purpose, made available to the employee or any member of his household during the relevant previous year by the employer or any person on his behalf, shall be determined as the sum equal to the interest computed at the rate charged per annum by the State Bank of India, constituted under the State Bank of India Act, 1955 (23 of 1955), as on the 1st day of the relevant previous year in respect of loans for the same purpose advanced by it on the maximum outstanding monthly balance as reduced by the interest, if any, actually paid by him or any such member of his household……".

  Thus, if we assume the SBI interest rate as mentioned in the above rule to be 10%, then in

our cited example, the employee will calculate the notional interest as ₹1000/- (i.e. 10000*10%) and add it to his taxable salary as perquisites.

PARTICULARS	UNDER IGAAP		UNDER IND AS-39	
	Employer (₹)	Employee (₹)	Employer (₹)	Employee (₹)
Value of interest free loan	10000			
Initial recognition of Financial asset/Financial liability in Books (Eff. Rate 5%)	10000	10000	8638	8638
Imputed Interest recognised as income/expense over the loan period using effective interest rate method	-	-	1362	1362
Amount taxable as Interest Income - Employer (A)	-	-	1362	
Interest rate as on 1st day of Previous Year	10%			
Amount taxable - Employee (Rule 3(7) of IT Rules on perks valuation) as Perquisites under Section17 of the IT Act (B)	-	1000	-	1000
Total amount taxed by IT department (A+B)	1,000		2362	

Though the amounts taxed vary at each end, this could be clearly a case of double taxation if necessary remedies are not provided.

Provision for Constructive Obligations:

- In general, only legal obligations and certain specific provisions mentioned in the Income Tax Act 1961, are allowed as deduction under the head Profits and Gains of Business or Profession. Ind AS-37 governing provisions introduce a new category of obligations in line with the corresponding IAS-37 called 'Constructive Obligation'. These are defined as an obligation that derives from an entity's actions where (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the entity has ***created a valid expectation*** on the part of those other parties that it will discharge those responsibilities. An apt example given is the corporate restructuring provision. Subjectivity has been created in the above definition by requiring us to gauge the validity of a third party expectation. Also, taxman follows only the guidance provided by Supreme Court (e.g. in Calcutta Co. Ltd case) that as long as provisions are made against the current year revenues, based on matching principle they should be allowed. But restructuring provisions are entirely futuristic. Therefore, it remains to be seen whether the tax department will allow the same. Certainly, amendments or related SC pronouncements in future are welcome in the Income-tax Act, 1961 or the DTC, to afford more clarity in these areas.
- Also, there can be an issue from the perspective of Minimum Alternate Tax (MAT) Liability. The computation of MAT requires that, any provision for unascertained liability to be added back to arrive at the Book Profit, which is the basis for calculating MAT. It remains to be seen as to how the provision for Constructive obligations (especially those like restructuring provisions) will be viewed by the Income Tax department.

Since IFRS is set to become the order of the day, it is imperative to mention that the SAP ECC-6 Version ERP comes with a Multiple General Ledger facility which allows maintaining different versions of a GL a/c following different accounting principles. For each GL the set of accounting principles are required as input and each transaction will get recorded in both the designated leading ledger as well as the other ledgers.

Discovery of Prior Period Errors:

As per Ind AS-8, Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that (a) was available when financial statements for those periods were approved for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. The rather stringent remedy advocated in this standard is to either (a) restate the comparative period figures in the financial statement, if the error pertains only to that previous period which is

presented or (b) if the error relates to a year even before the earliest prior period presented in the financials, then restate the opening balance of assets, liabilities or equity and reserves.

Section 147 of the current Income-tax Act, 1961 deals with powers of the assessing officer to reopen an earlier completed assessment, if he has reason to believe that an income has escaped assessment. The power to reopen is valid up to four years from the end of the relevant assessment year, unless the assessee himself has failed to furnish the return of income under Section 139 or to respond to a notice issued under Section 142 or Section 148 of the Act. Will every discovery of prior period error and restatement of previous year figures prove to be costlier or harmful to the assessee, if the taxman starts to cash in on the opportunities of reassessment?

Fair Value for Ind AS vs. Arm's length price for Income Tax Act:

The definition of Arm's length price (ALP) as per Chapter X of the Income tax Act seems to be in contrast to the Fair value defined by Ind AS. Arm's Length Price, by virtue of the definition, requires adjustment to the price arrived at, by benchmarking with a comparable uncontrolled transaction under uncontrolled conditions. The adjustment is necessitated to eliminate significant differences between the subject transaction and the benchmarked one, which affect the price in the open market. In contrast to this, the Fair value as defined in Ind AS is *the amount at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction*. The contrast between these two definitions can be portrayed in the form of a short example below. Assume a transaction between two related parties X and Y for purchase of Steering wheel at ₹10,000.

Quoted Price of Steering wheel in the open market	₹9,000
Fair value for recognition under Ind AS	₹9,000
Add: Adjustment for difference in the nature of assets employed, credit terms etc. when compared to the benchmarked uncontrolled transaction	₹600
Arm's length price for IT Act	₹9,600

From the above example, we can form a conclusion that what goes missing in the fair value for accounting under Ind AS, is the adjustment for specific factors associated with the subject transaction which causes difference in the price normally charged in the open market. (It is also noteworthy that the exposure draft on Ind AS-113, which spells out the guidance on fair value measurement, categorises the inputs as Level 1, Level 2 and Level 3 depending on how observable they are in the market. Out of these, Level 1 comprises of actual quoted prices for the asset/ liability in the market. Paragraph 77 of the standard states that a Quoted price in an active market provides the most reliable evidence of fair value and ***shall be used without adjustment to measure fair value***. Any such adjustment to quoted price will drag down the quality of the input to Level 2 or Level 3. A drop in the level only means more effort to establish the correctness of accounting. Therefore, the natural preference is the unadjusted Quoted price. Tax measure seems to be a more scientific one. This also creates scope to the tax department to dispute the Fair value adopted by the assessee.

Utility of SAP- ECC 6 Version:

Since IFRS is set to become the order of the day, it is imperative to mention that the SAP ECC-6 Version ERP comes with a Multiple General Ledger facility, which allows maintaining different versions of a GL a/c following different accounting principles. For each GL, the set of accounting principles are required as input and each transaction will get recorded in both the designated leading ledger as well as the other ledgers. For e.g. Assume that the leading ledger is the one based on Existing GAAP and the other ledger is based on Ind AS. An asset purchase transaction would get accounted in Indian GAAP ledger as per AS-10 on fixed asset accounting as well as in the Ind AS ledger applying the principles of Ind AS-16 on Property, Plant and Equipment (i.e. Cash price equivalent, finance expense etc) Ultimately, the difference in accounting policies governing these two ledger versions can be used to prepare a reconciliation between the purchase figures reported therein. Likewise, one can also designate the additional ledger for tax purpose by setting them to the tune of Indian tax law. It may be noted, that Ind AS-101 on first time adoption of Ind AS gives an option to prepare the comparatives under Ind AS on a memorandum basis and provides reconciliation with the previous GAAP

figures. In such cases, these systems could be extremely useful.

Impact on Indirect Taxes

• ***Service Tax:***

With the introduction of the new Point of Taxation Rules 2011, the liability of service tax is on the date of raising invoice if the invoice is raised within the stipulated time of 30 days from completion of service, or else on the date of completion of service. Of course, if payment is received before the completion of service, the liability falls on the date of receipt of money. Thus, when Ind AS-18 will rigidly require the recognition of the service revenue on the date of completion of service with reference to the stage of completion and subject to certain conditions, the service tax rule might shift the service tax liability to the date of raising invoice.

It may be noted that as per Ind AS-37, provision is required only for a liability and in this particular case, service tax payment may not be a liability on Balance sheet date, since as per the definition in the standard, it is not a present obligation of the company on that date. Companies will be able to defend themselves that as per the rules, the liability occurs only on invoice date which falls only in the next financial year. With this being the case, it is possible that for a significant amount of taxable service during the fag end of the fiscal, the service tax liability may not reflect in the Balance sheets and it might be difficult for the auditor to cross verify the correctness of tax percentage through alternate test procedure. Also, taxable turnover reflected in the ST-3 Service tax return (corresponding to the service tax liability and payment) may not be the same as reflected in the Books of accounts for the financial year due to the variation in timing. It might take additional effort for reconciliation unlike earlier, when both were more often the same.

• ***Excise Duty:***

The liability for excise duty is only when the goods are cleared out of the factory gate and not related to the actual sale date and hence, it does not connect to the Ind AS in any way. However, it may be noted that Ind AS-18 does align to the excise valuation rules in the following manner. In cases like transfer of moulds, jigs or fixtures by customer to manufacturer for use by him in production on buyer's behalf, excise rules require adding a certain amount towards 'amortisation' cost for arriving at excisable value. Similarly, Ind AS-18 requires recognising such transferred assets in the books of the transferee, which means he can claim depreciation and recover it in his pricing to the transferring customer. There is possibility for the Assessable value in the excise return to at least come close to matching with the Sales value recorded in the Books. Of course, the amortisation for excise purpose is fixed more scientifically by a Chartered Engineer, whereas the depreciation under Companies law is an average rate and therefore may not be the same. However, earlier, the turnover amount reported in monthly Cenvat Return was different from the books due to the amortisation cost which was not to be recorded in Books of accounts under the Indian GAAP.

Valuation for Customs purpose is entirely determined on a different plane and irrespective of Books of accounts and, therefore, there is no noteworthy impact.

Conclusion

Statistics reveal that as of December 2011, there are about 5112 companies listed in BSE and more than 1640 listed in NSE, making it more than 6750 companies in total (source: Wikipedia). Taking this as a base for simplicity and assuming that the adoption of Ind AS affects the corporate profits by as low as say only 0.5%, the impact on corporate tax collection to the Government can be visualised as below,

	Rupess (₹) in Crore		
PARTICULARS	**NSE**	**BSE**	**TOTAL**
Market capitalisation	49250000	50000000	99250000
Assumed Return on Capital employed (worst case)	1%	1%	1%
Net Profit before Tax under Existing GAAP regime	492500	500000	992500
Assumed Impact of Ind AS (at the most minimal level)	0.50%	0.50%	0.50%
Approx. change in Net profit due to Ind AS regime	2463	2500	4963
Impact on Corporate Tax @ 30%	739	750	1489

Of course, the assumptions of net profit and % of impact due to Ind AS are purely hypothetical. But given the fact that the effect on elements such as Revenue recognition and Depreciation on account of factors explained herein will be omnipresent, the assumptions do seem reasonable to suggest at least the possible lower range of impact. ■