Accounting Standards Interpretation (ASI)4[1] (Revised)

Losses under the head Capital Gains

Accounting Standard (AS) 22, Accounting for Taxes on Income

[This revised Accounting Standards Interpretation replaces ASI 4 issued in December 2002.]

ISSUE

1. The issue is how AS 22 should be applied in respect of 'loss' arising under the head 'Capital gains' of the Income-tax Act, 1961 (hereinafter referred to as the 'Act'), which can be carried forward and set-off in future years, only against the income arising under that head as per the requirements of the Act.

CONSENSUS

2. Where an enterprise's statement of profit and loss includes an item of 'loss' which can be set-off in future for taxation purposes, only against the income arising under the head 'Capital gains' as per the requirements of the Act, that item is a timing difference to the extent it is not set-off in the current year and is allowed to be set-off against the income arising under the head 'Capital gains' in subsequent years subject to the provisions of the Act. In respect of such 'loss', deferred tax asset should be recognised and carried forward subject to the consideration of prudence. Accordingly, in respect of such 'loss', deferred tax asset should be recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions
of the Act. Whether the test of virtual certainty is fulfilled or not would

[1] Published in 'The Chartered Accountant', December 2005, pp. 929-931. The authority of this ASI is the same as that of the Accounting Standard to which it relates. The contents of this ASI are intended for the limited purpose of the Accounting Standard to which it relates. ASI is intended to apply only to material items.

depend on the facts and circumstances of each case. The examples of situations in which the test of virtual certainty, supported by convincing evidence, for the purposes of the recognition of deferred tax asset in respect of loss arising under the head 'Capital gains' is normally fulfilled, are sale of an asset giving rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act) after the balance sheet date but before the financial statements are approved, and binding sale agreement which will give rise to capital gain (eligible to set-off the capital loss as per the provisions of the Act).

3. In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, the deferred tax asset should be recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future years as per the provisions of the Act.

Transitional Provision

4. Where an enterprise first applies this revised ASI, the deferred tax asset recognised previously considering the reasonable level of certainty, as per the pre-revised ASI 4, and no longer meets the recognition criteria laid down in the revised ASI, should be written-off with a corresponding charge to the revenue reserves.

BASIS FOR CONCLUSIONS

5. Section 71 (3) of the Act provides that "Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss and the assessee has income assessable under any other head of income, the assessee shall not be entitled to have such loss set off against income under the other head".

6. Section 74 (1) of the Act provides that "Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss to the assessee, the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and—

(a) in so far as such loss relates to a short-term capital asset, it shall

be set off against income, if any, under the head "Capital gains" assessable for that assessment year in respect of any other capital asset;

(b) in so far as such loss relates to a long-term capital asset, it shall be set off against income, if any, under the head "Capital gains" assessable for that assessment year in respect of any other capital asset not being a short-term capital asset;

(c) if the loss cannot be wholly so set-off, the amount of loss not so set off shall be carried forward to the following assessment year and so on."

Section 74 (2) of the Act provides that "No loss shall be carried forward under this section for more than eight assessment years immediately succeeding the assessment year for which the loss was first computed".

7. AS 22 defines 'timing differences' as "the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods".

8. Where an enterprise's statement of profit and loss includes an item of loss, which is considered a 'loss' under the head 'Capital gains' as per the provisions of the Act, the loss is a timing difference, to the extent the same is not set-off in the current year, because this loss can be allowed to be set-off against income arising under the head 'Capital gains' in future, subject to the provisions of the Act, and to that extent the amount of income under that head will not be taxable in the future year even though the said income would be included in the determination of the accounting income of that year.

9. AS 22 provides that "***Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets as set out in paragraphs 15-18***". Paragraph 15 of AS 22 provides that "***Except in the situations stated in paragraph 17, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised***."

Paragraphs 17 and 18 of AS 22 provide as follows:

> ***"17. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.***
>
> 18. The existence of unabsorbed depreciation or carry forward of losses under tax laws is strong evidence that future taxable income may not be available. Therefore, when an enterprise has a history of recent losses, the enterprise recognises deferred tax assets only to the extent that it has timing differences the reversal of which will result in sufficient income or there is other convincing evidence that sufficient taxable income will be available against which such deferred tax assets can be realised. In such circumstances, the nature of the evidence supporting its recognition is disclosed."

The income under the head 'Capital gains' does not arise in the course of the operating activities of an enterprise. Thus, for the purpose of recognition of a deferred tax asset, the degree of certainty of such an income arising in future should be higher. Accordingly, in case of 'loss' under the head 'Capital gains', deferred tax asset should be recognised and carried forward only to the extent that there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act.

In this regard, virtual certainty of the availability of sufficient future taxable income against which deferred tax assets can be realised, will be construed to mean virtual certainty of the availability of taxable income under the head "Capital gains" in future in accordance with the provisions of the Act.

10. In cases where there is a difference between the amounts of 'loss' recognised for accounting purposes and tax purposes because of cost indexation under the Act in respect of long-term capital assets, deferred tax asset is recognised and carried forward (subject to the consideration of prudence) on the amount which can be carried forward and set-off in future

years as per the provisions of the Act since that is the amount which will be available for set-off in future years as per the provisions of the Act.

11. As per the requirements of the pre-revised ASI 4, deferred tax asset in respect of a loss arising under the head 'Capital Gains', in certain situations, was recognised on the consideration of the reasonable certainty. The revised ASI 4, however, requires that in all cases, deferred tax asset in respect of such loss is recognised only to the extent there is a virtual certainty, supported by convincing evidence, that sufficient future taxable income will be available under the head 'Capital gains' against which the loss can be set-off as per the provisions of the Act. As a result, a deferred tax asset, recognised as per the pre-revised ASI 4, may not meet the recognition criteria laid down in the revised ASI and consequently, would be required to be written-off. A deferred tax asset, which is required to be written-off in this manner, is charged to the revenue reserves.