Income Computation and Disclosure Standards – An Update and Analysis

The evolution of Income Computation and Disclosure Standards (ICDS) is one of the biggest reforms relating to the income-tax in recent past. Taxpayers have been burdened with a separate set of standards which are required to be complied with while computing profits and gains from business or profession and income from other sources. By incorporating necessary changes in a Tax Audit Report, an onerous task has been entrusted upon the members to certify compliance with the provisions of ICDS and to quantify the impact of deviation as well as make the required disclosures. Many issues have emerged under the provisions of ICDS more particularly due to its conflict with several judicial pronouncements. The author in this article highlights some of these practical issues faced while applying these Standards. Read on…

Introduction

Reducing litigation in taxation is the topmost priority of the Government and introduction of ICDS (Income Computation and Disclosure Standards) is one step forward in this direction. Though the objective with which ICDS have been introduced is laudable, many challenges have been experienced while implementing them.

Many provisions of ICDS attempt to nullify the principles laid down by the Courts on the concerned issues. The issue which is under debate at present is whether the provisions of ICDS shall override the judicial precedents. It has been clarified in the Circular issued by CBDT[1] that certain judicial pronouncements were pronounced in the absence of authoritative guidance on the issues under the Act. The ICDS have been notified after due deliberation and after examining judicial views for bringing certainty on the issues covered by it. Since certainty is now provided under ICDS, its provision shall prevail.

However, the view expressed by CBDT is not free from doubt. In the preamble of ICDS, it is stated that in case of conflict between the provisions of the Act and ICDS, the provisions of the Act shall prevail. In many cases, the Courts have interpreted

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[1] Circular No. 10/2017 dated 23-3-2017 – Clarifications on ICDS (referred as Circular in this article).

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some specific provisions of the Act. For instance, in the case of E. D. Sassoon & Co. Ltd. (26 ITR 27), the Supreme Court has interpreted the provisions of Section 5 with respect to the accrual of income. In such cases, the provisions of the Act as interpreted by the Courts should prevail over the conflicting provisions of ICDS. But, in cases where the Courts have relied upon generally accepted accounting principles in the absence of express provisions of the Act, ICDS should override them.

Valuation of Inventories including All Taxes and Duties

As per ICDS-II, the duties and taxes are required to be included in costs of purchase though they are subsequently recoverable from the taxing authorities. To this extent, it differs from AS 2 as well as Ind AS 2. Section 145A also contains similar provision but it is not restricted only to valuation of inventories and extends to valuation of purchases and sales also. Generally, the overall impact of the adjustments made to comply with the provisions of Section 145A on the taxable income is nil as explained in the Guidance Note on Tax Audit issued by ICAI. Therefore, it has been clarified in Technical Guide that the assessee who is following exclusive method would be required to prepare the memorandum account to demonstrate that *vis-à-vis* inclusive method, it is tax neutral. This will be sufficient compliance with Section 145A as well as ICDS-II.

However, the format in which a tax auditor is required to report in Form No. 3CD poses a difficulty. Since ICDS-II deals with only valuation of opening and closing inventory, it will result into either increase or decrease in profit. The neutrality as discussed above is due to overall impact of adjustments to all; inventories as well as purchases and sales. Reporting of any such increase or decrease in profit may lead to automatic adjustment to the total income of the assessee, though it is not warranted when viewed along with the provisions of Section 145A. Thus, in order to avoid unintended consequences, reporting of increase or decrease in profit only due to exclusive method being followed by the assessee may be avoided with appropriate remark in Form No. 3CA/3CB.

Accrual of Interest on Time Basis

The provision of ICDS IV requiring recognition of interest on time basis has been the most debated issue so far. Fortunately, the Finance Act, 2017 has extended much awaited relief to non-scheduled co-operative banks by including them under the provisions of Section 43D which overrides ICDS. However, NBFCs have been still kept out of it which may lead to unwanted litigation about taxability of interest on their non-performing assets. The clarification issued by CBDT adds fuel to the fire as it states that it would be mandatory to accrue interest even when its collection is uncertain. It tries to justify such accrual on the basis that its non-recovery can be claimed as bad debts which would be deductible as per Section 36(1)(viii).

The requirement of ICDS to accrue interest on time basis has further aggravated the complexity in case of debt securities where interest is receivable on due dates at fixed intervals. In case of interest bearing securities, their prices are negotiated after taking into account unpaid interest thereon which is referred as broken period interest. The issue of broken period interest had first arisen in the case of *Vijaya Bank Ltd. (187 ITR 541)*. In this case, the apportionment of acquisition cost of securities towards interest which had accrued on them till the date of purchase was denied. It was held that the acquisition price paid was in the nature of a capital outlay, and no part of it can be set off as expenditure against income accruing on those securities.

In a later decision of *American Express International Banking Corporation (258 ITR 601 Bom),* it was held that Vijaya Bank's decision is not applicable when interest on securities is assessable as business income under Section 28[2]. Now, ICDS-VIII (Part A) dealing with securities held as stock-in-trade specifically provides for adjustment of broken period interest. It provides that receipt of interest post acquisition should be allocated between pre-acquisition and post-acquisition periods. The pre-acquisition portion of interest should be deducted from the actual cost of securities.

[2] Rajasthan High Court has disagreed with this view in the case of Bank of Rajasthan Ltd. (316 ITR 391).

The requirement of accrual of interest and adjustment of broken period interest in respect of debt securities post-ICDS can be summarised as:

Status of Securities	Accrual of interest on time basis	Treatment of pre-acquisition period's interest received	Treatment of interest already accrued but not received when securities are sold
Stock-in-trade	Required as per ICDS-IV	To be reduced from the cost of acquisition as per ICDS-VIII (Part A)	Sales proceed to be reduced to that extent while computing business income.
Capital asset	Required as per ICDS-IV	ICDS-VIII (Part A) is not applicable. It is taxable as income as per SC's decision	Circular clarifies that it shall be taken into account while computing capital gains. However, Section 48 does not provide for any adjustment to full value of consideration.

Ordinarily, when securities are held as stock-in-trade, it will not make any difference whether the income is classified as interest or as profits on sale as both are taxable as business income. However, in case of tax-free securities, interest can be claimed as exempt but not the profits. In case of securities held as capital asset, characteristic of income gets changed if interest is accrued on time basis and sale consideration is reduced to the extent of accrued interest as per ICDS read with Circular.

In a Technical Guide on ICDS[3], it has been clarified that the assessee would be still required to apply the principles of accrual as well as reasonable certainty in respect of interest and royalty and need not accrue interest always on time basis. These principles have been laid down in the case of *Credit Suisse First Boston (Cyprus) Ltd. 351 ITR 323 (Bom)* and *Vasisth Chay Vyapar Ltd. 330 ITR 440 (Del)* respectively.

Therefore, difficulties as expressed above would get resolved only if a view is taken that interest on debt securities accrues only on the concerned due dates and it need not be recognised as income where reasonable certainty of its recovery is lacking.

Interest on Refund of Tax

The assessee is eligible for interest on the amount refunded to him under certain circumstances as provided in Section 244A. In cases where a mercantile system of accounting is followed, such interest is taxable in the year in which it has accrued to the assessee as provided in Section 5. The Courts have taken contrary views with respect to the year in which such interest can be said to have accrued, more particularly, when it has been granted as a result of favourable appellate orders.

In the case of *K. Devayani Amma (328 ITR 10),* the Kerala High Court held that interest accrues only when the assessee is found to be eligible for refund of excess tax on revision of assessment based on orders in appeal. In the case of *M. Jaffer Saheb (361 ITR 25), the* Andhra Pradesh High Court disagreed with this view and held that interest under Section 244A is not taxable in the year of grant of refund but has to be spread over the respective AYs to which it relates. While holding so, it has relied upon the decision of Supreme Court in the case of *Ramabai (181 ITR 401)* in which similar view was taken with respect to the interest payable on enhanced compensation under the Land Acquisition Act.

ICDS-IV provides that interest on refund of any tax, duty or cess shall be deemed to be the income of the previous year in which such interest is received. Thus, it shifts the basis of chargeability from accrual to receipt but without any sanctity under the Act. It is in direct conflict with the provisions of Section 5 as interpreted by the AP High Court. Therefore, it would be difficult to invoke this provision of ICDS unless necessary changes have been made in the Act similar to Section 145A(b).

Scope of 'Borrowing Costs'

The definition of 'borrowing costs' includes, apart from interest, 'other costs incurred by a person in connection with the borrowing of funds'. The parent provisions under the Act dealing with capitalisation of borrowing costs, i.e. Section 36(1)(iii) and Explanation 8 to Section 43(1) refer only to 'interest'. The term 'interest' is defined exhaustively under Section 2(28A). Thus, an issue may arise about capitalisation of such other costs which strictly do not fall within the definition of 'interest'. For instance, CBDT itself has clarified vide Letter F. NO. 164/18/77-IT (AI), dated 13-7-1978 that brokerage payable to a middleman for arranging finance is not includible within the meaning of 'interest'.

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[3] Issued by ICAI.

The borrowing cost which is required to be capitalised is not eligible for deduction as per Proviso to Section 36(1)(iii). If it is not eligible for deduction, then the disallowance provisions would not apply to it at all. It is only the balance amount of borrowing cost remaining after capitalisation to which disallowance provision may apply.

Supreme Court has held that expenditure incurred for obtaining loan like stamp duty, registration fees, legal fees etc. cannot be considered as capital expenditure and deductible under Section 37(1). It was further held that it is irrelevant to consider the object with which the loan was obtained. The provisions similar to Proviso to Section 36(1)(iii) have not been incorporated in Section 37(1) so far.

It is possible to take a view that those 'other costs' which cannot be regarded as 'interest' are eligible for deduction under Section 37(1) as interpreted by the Supreme Court. The provisions of ICDS-IX requiring capitalisation of such 'other costs' are conflicting with these provisions of Section 37(1) and, hence, not applicable.

Borrowing Costs to be Capitalised Should Exclude Amount Disallowable

One of the clarifications issued in the Circular is that borrowing costs to be considered for capitalisation under ICDS-IX shall exclude those borrowing costs which are disallowed under specific provisions of the Act like 14A, 43B, 40(a)(1), 40(a)(ia), 40A(2)(b), etc. The reason is that the specific provisions of the Act override the provisions of ICDS.

The question of disallowance under the aforesaid provisions would arise only if borrowing cost is otherwise eligible for deduction under Section 36(1)(iii). For instance, Section 43B provides that *"Notwithstanding anything contained in any other provision of this Act, a deduction otherwise allowable under this Act in respect of ……."* The borrowing cost which is required to be capitalised is not eligible for deduction as per Proviso to Section 36(1)(iii). If it is not eligible for deduction, then the disallowance provisions would not apply to it at all. It is only the balance amount of borrowing cost remaining after capitalisation to which disallowance provision may apply. Insertion of second proviso to clause (1) of Section 43 by the Finance Act, 2017 supports this view.

Thus, it should be first capitalisation of entire borrowing costs which is required to be considered and then disallowance, if any, is applicable only on the remaining amount of borrowing costs. Otherwise, the borrowing cost which is disallowable and not capitalised might escape capitalisation forever, as it may be claimed as a deduction in subsequent year (after period of capitalisation has ceased) upon fulfillment of conditions as provided in the relevant sections.

Monetary Item relating to Asset Acquired within India

ICDS-VI requires conversion of foreign currency monetary items into reporting currency at the year-end and resultant exchange difference to be recognised as income or as expense of the concerned year. It does not make any differentiation between capital items or revenue items. However, it is subject to the provision of Section 43A which is applicable when an asset has been acquired from out of India. Section 43A does not cover a situation where assets are acquired from within India by availing a foreign currency loan or borrowing. Thus, exchange difference arising on account of conversion of foreign currency loan obtained for acquisition of indigenous asset into reporting currency is deductible or taxable as per ICDS.

This treatment under ICDS is contrary to the view expressed by the Supreme Court in the case of *Sutlej Cotton Mills Ltd.* (116 ITR 1). It has been held that the income on account of exchange differences in respect of capital account transactions is income not liable to tax, being a capital receipt. Similarly, if it is an expense, then it is not deductible, being a capital loss.

Interestingly, in case where there is a loss upon such conversion of monetary item related to asset, the assessees would be benefitted as ICDS permits its deduction. One of the possible views is that ICDS cannot override the decisions of the Courts taking a particular position based on interpretation of specific provisions of the Act. Since the Supreme Court has considered it as a capital loss and not deductible under Section 28, deduction of that loss cannot be claimed only because ICDS allows it.

Conclusion

CBDT is in the process of coming out with more standards. The draft of standard on real estate transactions was already released for public comments. Apart from issuing more standards, CBDT needs to resolve the issues which have emerged under ICDS in order to achieve its desired objectives. ■