Amendments to Revalidate ICDS

The Income Computation and Disclosure Standards ("ICDS") notified under Section 145(2) of the Income-tax Act, 1961 ("the Act") have had a chequered history. Starting off in a draft form as Tax Accounting Standards, their nomenclature was modified to ICDS, they were first notified in March 2015 applicable from Assessment Year 2016-17, their applicability was then postponed till August 2016 on representations being made, when these were cancelled and new amended ICDS were finally notified, which were implemented in assessment year 2017-18. In the present article the author has discussed in detail the amendments brought about to revalidate ICDS and much more. Read on to know more....

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The ICDS have been the subject matter of a challenge to their constitutional validity before the Delhi High Court, in the case of *Chamber of Tax Consultants vs. Union of India* [2017] 299 CTR (Del) 137. In this case, the Delhi High Court struck down some of the ICDS as invalid, while reading down some of the provisions of the ICDS.

The conclusions of the Delhi High Court in this decision are summarised below:

- S.145(2), as amended, has to be read down to restrict power of the Central Government to notify ICDS that do not seek to override binding judicial precedents or provisions of the Act. The power to enact a validation law is an essential legislative power that can be exercised only by Parliament and not by the executive. If Section 145 (2) as amended is not so read down, it would be ultra vires the Act and Article 141 read with Article 144 and 265 of the Constitution.
- It is clear that ICDS is not meant to overrule the provisions of the Act, the Rules thereunder and the judicial precedents applicable to the provisions of the Act as they stand.
- ICDS-I, which does away with the concept of 'prudence', is contrary to the Act and binding judicial precedents, and is therefore unsustainable in law.
- ICDS-II, pertaining to valuation of inventories, eliminates the distinction between a continuing partnership business after dissolution from one which is discontinued upon dissolution, is contrary to the decision of the Supreme Court in *Shakti Trading Co.* (2001) 250 ITR 871. ICDS-II is held to be ultra vires the Act and struck down.
- The treatment to retention money in ICDS-III will have to be determined on a case to case basis by applying settled principles of accrual of income. Deployment of ICDS-III in a manner that seeks to bring to tax the retention money, the receipt of which is uncertain or conditional, at the earliest possible stage, irrespective of the facts, would be contrary to the settled position in law, as explained in various decisions, and to that extent, para 10(a) of ICDS-III would be ultra vires.
- Para 12 of ICDS-III read with para 5 of ICDS-IX, dealing with borrowing costs, makes it clear that no incidental income can be reduced from borrowing cost. This is contrary to the decision of the SC in *CIT vs. Bokaro Steel Limited* [1999] 236 ITR 315 and is therefore struck down.
- Para 5 of ICDS-IV requires an Assessee to recognise income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection. This is contrary to the decision of the Supreme Court in *CIT vs. Excel Industries Ltd.* (2013) 358 ITR 295 (SC), and is, therefore, ultra vires the Act and struck down.
- As far as para 6 of ICDS-IV is concerned, the proportionate completion method as well as the contract completion method have been recognised as valid methods of accounting under the mercantile system of accounting by the Supreme Court in *Bilahari Investment Pvt. Ltd.* [2008] 299 ITR 1 (SC) and this Court in *CIT vs. Manish Buildwell Pvt. Ltd.* (2011) 245 CTR 397 and *Paras Buildtech India Pvt. Ltd. vs. CIT* (2016) 382 ITR 630. To the extent that ICDS-IV permits only one of the methods, i.e., proportionate completion method, it is contrary to the above decisions, held to be ultra vires the Act and struck down.
- ICDS-VI states that marked to market loss/gain in case of foreign currency derivatives held for trading or speculation purposes are not to be allowed. This is not in consonance with the ratio laid down by the SC in *Sutlej Cotton Mills Ltd vs. CIT* (1979) 116 ITR 1, insofar as it relates to marked to market loss arising out of forward exchange contracts held for trading or speculation purposes. It is, therefore, held to be ultra vires the Act and struck down.
- In Circular No. 10 of 2017 in answer to Question No. 16, CBDT has clarified that Foreign Currency Translation Reserve Account balance as on 1st April 2016 has to be recognised as income/loss of the previous year relevant to the AY 2017-18. The losses/gains arising by valuation of monetary assets and liabilities of the foreign operations as at the end of the year cannot be treated as real income. It is only in the nature of notional or hypothetical income which cannot be even otherwise subject to tax.
- ICDS-VII which provides that recognition of government grants cannot be postponed beyond the date of accrual receipt, is in conflict with the accrual system of accounting. To that extent it is held to be ultra vires the Act and struck down.

ICDS-II, pertaining to valuation of inventories, eliminates the distinction between a continuing partnership business after dissolution from one which is discontinued upon dissolution, is contrary to the decision of the Supreme Court in Shakti Trading Co. (2001) 250 ITR 871. ICDS-II is held to be ultra vires the Act and struck down.

Under paragraph 4 of ICDS I, marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other ICDS.

- ICDS-VIII pertains to valuation of securities. For those entities not governed by the RBI to whom Part A of ICDS-VIII is applicable, the accounting prescribed by the AS has to be followed which is different from the ICDS. In effect, such entities will be required to maintain separate records for income tax purposes for every year since the closing value of the securities would be valued separately for income tax purposes and for accounting purposes. To this extent, Part A of ICDS VIII is held to be ultra vires the Act and is struck down.
- To the extent the specific ICDS as noted hereinbefore have been struck down as ultra vires the Act, the impugned Notification Nos. 87 and 88 dated 29th September 2016 and Circular No. 10 of 2017 issued by the CBDT are also held to be ultra vires the Act and struck down.

By this decision, therefore, most of the significant amendments proposed to the tax computation provisions through ICDS were rendered ineffective, and the legal position prevailing prior to introduction of ICDS was effectively restored.

The options before the Government were either to challenge the decision of the Delhi High Court before the Supreme Court, to scrap ICDS or to enact changes to the Act to incorporate the changes which it desired to carry out through ICDS. The Government chose the third option, preferring not to agitate the matter further before the Supreme Court.

The Finance Bill, 2017 proposes to amend various provisions of the Act with retrospective effect from assessment year 2017-18, so as to revalidate the provisions of ICDS and make them effective once again. The Explanatory Memorandum explains the rationale behind the amendments in part G- Rationalisation Measures as *"in order to bring certainty in the wake of recent judicial pronouncements on the issue of applicability of ICDS"*. It further clarifies that:

> *"Recent judicial pronouncements have raised doubts on the legitimacy of the notified ICDS. However, a large number of taxpayers have already complied with the provisions of ICDS for computing income for assessment year 2017-18. In order to regularise the compliance with the notified ICDS by a large number of taxpayers so as to prevent any further inconvenience to them, it is proposed to bring the amendments retrospectively with effect from 1 April 2017, i.e., the date on which the ICDS was made effective and will, accordingly, apply in relation to assessment year 2017-18 and subsequent assessment years."*

These changes, which are being made retrospectively with effect from assessment year 2017-18, are as under:

1. Mark-to-market/expected loss

Under paragraph 4 of ICDS I, marked to market loss or an expected loss shall not be recognised unless the recognition of such loss is in accordance with the provisions of any other ICDS. Since the Delhi High Court upheld the applicability of the concept of prudence, such a loss would have been allowable on the ground of prudence. Therefore, a new clause (xviii) is being inserted in Section 36(1), to provide that marked to market loss or other expected loss as computed in accordance with ICDS notified under Section 145(2), shall be allowed in computing the profits and gains of business or profession. Simultaneously, a new sub-Section (13) is being added in Section 40A, to provide that no deduction or allowance is to be allowed in respect of any marked to market loss or other expected loss, except as allowable under Section 36(1)(xviii).

This would effectively align the provisions of the Act with the requirements of ICDS I so far as profits and gains of business are concerned. ICDS also apply for computation of income under the head "Income from Other Sources". However, these amendments would not apply to computation of income under that head.

Unfortunately, both these amendments do not expressly provide that they would apply only in cases of assessees to whom ICDS are applicable. There are many assessees to whom ICDS do not apply, such as individuals/HUFs not liable to tax audit under Section 44AB, assessees following the cash method of accounting, insurance companies, etc. In the absence of an express provision stipulating that these amendments apply only to assessees to whom ICDS apply, it may be construed that these amendments

apply to all assessees having profits and gains of business or profession, irrespective of whether the provisions of ICDS apply to them or not, which clearly is not the intention.

2. Taxation of Foreign Exchange Gains or Losses

A new Section 43AA is being inserted to provide that any gain or loss arising on account of the effect of changes in foreign exchange rates in respect of all foreign currency transactions shall be treated as income or loss, as the case may be. Further, such income or loss is to be computed in accordance with ICDS notified under Section 145(2). Foreign currency transactions for this purpose would include those relating to monetary and non-monetary items, translation of financial statements of foreign operations, forward exchange contracts, and foreign currency translation reserves. This provision is subject to the provisions of Section 43A, which requires adjustment of certain foreign exchange gains or losses towards the cost of the capital asset or capital expenditure.

Therefore, first one needs to verify whether the foreign exchange difference falls within the purview of Section 43A. If so, the treatment of such foreign exchange difference would be in accordance with Section 43A. If the foreign exchange difference does not fall within the provisions of Section 43A, then it will be covered by Section 43AA, and its treatment would then be in accordance with ICDS VI - Effects of Changes in Foreign Exchange Rates.

Further, one would need to examine as to whether any provision of the ICDS is in conflict with the Income Tax Rules, in particular Rule 115, as the ICDS provides that the provisions of Rule 115 would override the provisions of the ICDS.

Incidentally, while the section refers to transactions of Foreign Currency Translation Reserve (FCTR), the ICDS does not refer to such reserve at all. Therefore, in the absence of any reference to such a reserve in the ICDS, what is the tax treatment to be given? It would appear that the adjustments to the FCTR of the relevant year would be regarded as income or loss of the relevant year in accordance with Section 43AA.

It may be noted that the provisions of Section 43A apply only to a situation where the assessee has acquired an asset from a country outside India, and does not apply to a situation where an assessee has acquired an asset in India funded by a foreign currency loan. There were doubts earlier as to whether the foreign exchange difference in respect of such loan was in the nature of income or was allowable, as the case may be, or whether such gain or loss was a capital gain or loss, not taxable or not allowable as a deduction. Section 43AA read with ICDS VI now makes it fairly clear that such gain or loss would be either treated as income or allowed as a deduction, as the case may be. Therefore, the entire concept of capital versus revenue in relation to foreign exchange differences would undergo a significant change, post this amendment.

Since ICDS VI requires recognition of foreign currency differences in respect of derivatives held for trading or speculation purposes on settlement basis, the ratio of the Supreme Court decisions in the case of *Sutlej Cotton Mills* (supra) and *Woodward Governor* 312 ITR 254 to the effect that such differences were to be recognised on a mark to market basis, would no longer be applicable after the amendment.

This amendment too does not draw any distinction between assessees to whom ICDS is applicable, and assessees to whom ICDS is not applicable, and seems applicable to all assessees.

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3. Profits and Gains from a Construction Contract/ Contract for Provision of Services

ICDS III- Construction Contracts requires recognition of profits and losses on a construction contract on a percentage of completion basis. ICDS IV- Revenue Recognition requires income from service contracts also to be recognised on a similar percentage of completion basis, unless the contract is for a duration of not more than 90 days, in which case, the revenue from such contracts may be recognised on a completed contract basis.

In order to align the provisions of these ICDS with the provisions of the Act, a new Section

43CB is being inserted. This section provides that profits and gains arising from a construction contract or a contract for providing services is to be determined on the basis of percentage of completion method in accordance with ICDS notified under Section 145(2). It further provides 2 exceptions to this - in case of contracts for providing services with duration of not more than 90 days, the profits and gains is to be determined on the basis of project completion method, and in case of contract for providing services involving indeterminate number of acts over a specific period of time, the profits and gains is to be determined on the basis of a straight-line method.

It may be noted that there is one significant difference between the provisions of ICDS and those of Section 43CB. ICDS provides that the revenue from contracts for a duration of not more than 90 days may be recognised on a project completion basis, which means that an assessee has an option to recognise such revenue either on project completion basis or on percentage of completion basis. However, Section 43CB clearly does not provide any such option, and mandatorily requires the computation of profits and gains from such contracts to be taken on project completion basis. This seems to be a drafting error. In case this drafting error is not rectified, the provisions of Section 43CB will prevail.

The section further provides that for all the 3 methods– percentage of completion method, project completion method and straight-line method– contract revenue would include retention money. Therefore, retention money would also be required to be included in the computation of profits for determining profits under any of these 3 methods. The various High Court decisions wherein it had been held that such retention money is taxable only in the year in which the conditions for release of retention money are met, would therefore no longer apply after the amendment.

Further, for computation of such profits, contract costs are not to be reduced by any incidental income in the nature of interest, dividends, and capital gains. Such incidental income would therefore be taxable as income, post amendment. Here too, the section does not draw any distinction between assessees to whom the provisions of ICDS apply, and those to whom such provisions do not apply. Can it therefore be said that in the case of an assessee following cash method of accounting, revenue from service contracts are to be recognised by the percentage of completion method? This is clearly an absurd proposition, as under the cash method, revenue is not recognised either on proportionate completion, nor on completion of the contract, but only on receipt of the revenues subsequent to completion of the work. Similarly, contract revenue in the form of retention money would be recognised only on receipt of the retention money under the cash method, and therefore this section should not apply at all to assessees following cash method of accounting. In order to avoid litigation, it would be best if the CBDT were to clarify the situation.

ICDS provides that the revenue from contracts for a duration of not more than 90 days may be recognised on a project completion basis, which means that an assessee has an option to recognise such revenue either on project completion basis or on percentage of completion basis. However, Section 43CB clearly does not provide any such option, and mandatorily requires the computation of profits and gains from such contracts to be taken on project completion basis.

4. Valuation of inventory

In order to align the provisions of the Act with the provisions of ICDS II- Inventories, Section 145A, is being completely replaced by a new provision. Under the new Section 145A:

(i) valuation of inventory is to be made at lower of cost or net realisable value computed in accordance with ICDS notified under Section 145(2);

(ii) valuation of purchase and sale of goods or services and of inventory is to be adjusted to include the amount of any tax, duty, cess or fee (by whatever name called) actually paid or incurred by the assessee to bring the goods or services to the place of its location and condition as on the date of valuation;

(iii) inventory of securities not listed on a recognised stock exchange, or listed, but not quoted with regularity from time to

time on a recognised stock exchange, is to be valued at actual cost initially recognised in accordance with notified ICDS;

(iv) inventory of other securities is to be valued at lower of actual cost or net realisable value in accordance with notified ICDS, such comparison between actual cost and net eligible value being made category -wise.

Therefore, the concept of valuation of inventory primarily in accordance with the method of accounting regularly employed by the assessee, and subject to the adjustments contained in existing Section 145A, would no longer apply after this amendment becomes effective. Further, the inclusive method would now also have to be followed for services, unlike in existing Section 145A, where it had to be followed only for goods.

5. Year of Taxability of Certain Specific Incomes

A new Section 145B is being inserted, to provide for the year of taxation of certain specific incomes, as under:

(i) interest received on any compensation or enhanced compensation is deemed to be income of the year in which it is received (this provision is currently part of existing Section 145A);

(ii) price escalation claim in a contract and export incentives are deemed to be income of the year in which reasonable certainty of realisation is achieved- this aligns the provisions of the Act with the provisions of ICDS III and ICDS IV respectively;

(iii) a government subsidy, grant, cash incentive, duty drawback, waiver or concession is deemed to be income of the year of receipt, if it has not been taxed earlier. This aligns the provisions of the Act with those of ICDS VII - Government Grants.

These provisions also do not specify that they apply only to assessees to whom ICDS is applicable, and therefore there is a risk that even assessees to whom ICDS does not apply, may be regarded as covered by these provisions.

Conclusion

The purpose of the Government in overcoming the ratio of the Delhi High Court decision, ensuring that the provisions of ICDS would be valid and would apply, will be achieved by these amendments to some extent. One aspect of the Delhi High Court decision

which has not been addressed is that relating to valuation of closing stock on dissolution of a firm or AoP/BoI, where the business is continued. However, these amendments do not cover all provisions of the ICDS, which are contrary to various High Court judgments. There is likely to be further litigation on various other provisions of the ICDS, which would further need amendments to the Act from time to time. Besides, any changes to the ICDS may also require corresponding changes to the Act. This will further complicate the Act.

Further, by amending the provisions of the Act in the manner in which it has been done, one has to look at both the Act, as well as the ICDS, in determination of income. The Act refers to ICDS, and at times, ICDS requires one to relook at the Act. Would it not have been far better to scrap the ICDS, and merely incorporate the desired provisions in the Act on a stand-alone basis?

There will be many issues which will arise on account of a combined reading of the contents of these provisions, and the relevant ICDS. This will give rise to substantial litigation, unless these are resolved expeditiously by issue of clarifications by the CBDT.

An issue does arise where the amended sections now refer to the computation under ICDS (such as in Section 43AA). Can major amendments to the computation provisions be made in the future through changes in ICDS without legislative changes? Does this amount to an excessive delegation of power as held by the Delhi High Court, and is therefore invalid?

The language of these amendments seems to indicate that these provisions apply to all assessees, and not just to those assessees to whom ICDS is applicable. This clearly is not the intention, and therefore it is essential that either these provisions be amended before being enacted to clarify that they do not apply to assessees to whom ICDS are not applicable, or alternatively, the CBDT should issue a clarification to this effect. ■