Tax return filing considerations for NBFCs – 1st Year of Ind-AS adoption

Last fiscal year (viz. FY 2018-2019) assumes significance for non-banking finance company (NBFC) from an accounting and tax perspective as it was first year of new Indian Accounting Standards (Ind-AS) adoption. The Ind-AS transition is expected to have significant impact on profitability, asset provisioning, taxation and various other aspects. The NBFCs now gear up to file its maiden income tax return under new Ind-AS regime. The article summarises some important tax aspects which can be considered by NBFC as part of tax return filing activities under new Ind-AS regime. Read on to know more…

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The month of April and May was a busy season of year-end results for India Inc. and non-banking financial companies (NBFC) world was in limelight during last fiscal (i.e.; FY 2018-19). However, the year was equally very important for NBFC world from an accounting stand-point as it was the first year of adoption of new Indian Accounting Standard (Ind-AS). Ind AS comprises of accounting standards, that are largely converged with International Financial Reporting Standards (IFRS) which have been notified by the by the Ministry of Corporate Affairs (MCA) based on recommendations of the ICAI under section 133 of the Companies Act, 2013. It is given that any transition brings about new challenges and Ind-AS was a significant transition for NBFC sector having a direct impact on profitability, asset quality, taxation and various other aspects. Let me first congratulate the Senior Management, CFOs, overall finance and other support function of NBFCs for smooth adoption of challenging Ind-AS regime. Efforts of MCA and the Institute of Chartered Accountants of India (ICAI) also to be lauded for constant guidance on the evolving and complex subject.

Tax considerations are very critical aspect of Ind-AS transition and filing of tax return of 1st Ind-AS financial statement needs special attention. The tax filings are due in September/November depending upon applicability of transfer pricing regulations. The article covers certain aspects which should be carefully analysed and considered by the corporates as part of tax return filing preparation:

1. **Golden rule of "documentation"**: Tax system in India pre-dominantly relies on "substance over form" concept and proper documentation holds the key for establishing essence of a

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transaction. The golden rule equally applies for Ind-AS transition. Ind-AS transition will result in Generally Accepted Accounting Principles (GAAP) differences between Ind-AS and erstwhile Indian GAAP (IGAAP) regime and one should maintain adequate supporting of various GAAP differences on the adoption date ie 1st April, 2018. The supporting may comprise existing accounting treatment under IGAAP, accounting treatment under Ind-AS with reference to relevant literature on specific accounting standard, working papers of GAAP differences, reconciliation etc. In a way, the Ind-AS transition also entails maintaining separate books of accounts for tax purpose which in a way is expected to pose challenges considering voluminous data and reconciliations. The efficient approach will be to gather documents and supporting data on "as and when basis" rather at the time of filing tax returns. This will lay a strong foundation to determine tax position in tax returns. Simplicity helps and it is therefore suggested that simple illustration with hypothetical numbers are maintained for impact of transition and ease of understanding. This will also help in explaining complex subject with ease.

2. **Double-dip deduction or doubly taxed income:** It is a fundamental and basic principles of taxation that an expense cannot be claimed twice as deduction nor an income be taxed twice across financial years. Such principle should equally apply to Ind-AS transitions unless a contrary principle is specified by income tax provisions. Ind-AS transition may result in certain items viz. amortisation of fees expenses over period of year which were expensed upfront in IGAAP regime. Corporates need to review each of such adjustment and provide appropriate tax treatment in return of income. It is also suggested that necessary working papers are maintained to establish that such items are offered to tax or claimed as expense in tax return of prior years (i.e.; pre Ind-AS regime).

3. **Income tax laws is the boss**: The computation of income is prepared in accordance with the provisions of the Income Tax Act, 1961 read with various notifications and circular issued from time to time. It goes without saying that the income tax provisions will prevail over Ind-AS as far as filing of tax return is concerned. The tax accounting standard viz. Income Computation and Disclosure Standard (ICDS) notified by the CBDT should be carefully reviewed by the corporates for evaluating implications on Ind-AS financial statements. While the principle of "*res-judicata*" strictly may not apply to income tax, it is observed that a consistent tax positions on a particular item over a period of years strengthen a tax claim. Accordingly, tax position considered for tax return in erstwhile IGAAP regime should broadly be similar in Ind-AS regime. However, the tax position also depends upon facts and circumstances of individual case, prevailing tax laws, tax litigations and its resolutions, etc. and may vary from case to case.

4. **Common Ind-AS adjustments for NBFC:**

Based on perusal of year-end (YE) results for YE March 2019 for listed NBFC, it would be good to deliberate some common Ind-AS adjustments for NBFC, erstwhile IGAAP treatment and the emerging tax position.

- ***Loans and advances – Expected credit loss (ECL) vis-à-vis provisioning as per prudential RBI norms***

Ind-AS 109 requires NBFC to compute ECL on financial asset (viz. loans, investments) at the time of origination and at every reporting date. It works on a forward-looking framework as compared to current rule-based provisioning norms prescribed by the RBI. The impairment criterion under ECL norms depends on the classification of the Loans into Stage 1, Stage 2 or Stage 3 and such norms are likely to result in increased loan loss provisions. Under IGAAP regime, provisions were not allowed as a deduction from a tax perspective and as a consequent, reversal of provisions, if any in future years was excluded from profits. Bad debts write-off was claimed as a deduction under section 36(1)(vii) of the Income-tax Act, 1961 ('the Act'). Pursuant to Finance

Act, 2016, NBFC are also eligible to claim a deduction in respect of provision for bad and doubtful debts not exceeding 5% of total income under section 36(1)(viia) of the Act. The tax implications under erstwhile IGAAP regime in respect of NPA provisions are expected to be followed under Ind-AS regime for ECL provisions. Stage 3 loans can be considered equivalent to Non-performing advances depending on facts and circumstances and hence, it can be possibly inferred that NBFC shall be eligible for special deduction under section 36(1)(viia) of the Act in respect of Stage 3 ECL provisions.

- ***Investment valuation – fair valuation approach vis-à-vis Negative MTM approach***

  Under the erstwhile IGAAP principle read with prudential RBI norms, investments are broadly valued at Cost less permanent diminution for long-term investment and lower of cost or market value for short-term investments. In effect, IGAAP prescribes recognition of only negative MTM on investment and appreciation (i.e.; positive MTMs), if any, is to be ignored for accounting purposes. In case of investments classified as subsequently measured at fair value through profit or loss, no such restriction is placed by Ind-AS 109 for valuation of investments and therefore, both positive and negative MTMs needs to be recognised in the statement of profit and loss.

  From an income-tax perspective, any gains/ loss resulting from sale of investment held by NBFC will get characterised as business loss or capital loss depending upon the facts whether such investments are held as business asset or as capital asset. It is a contentious issue and is solely dependent upon the facts of each case. CBDT old instructions (Instruction no. 1827 dated August 31, 1989) read with Circular 4/2007 dated June 15, 2007 in respect of certain tests to distinguish between shares held as stock-in-trade and shares held as investment can be useful reference.

  Para 4 of ICDS 1 (Accounting policies) provides that mark to market loss or an expected loss shall not be recognised unless the loss is in accordance with the provisions of any other ICDS. As per ICDS 8 (Securities), MTM loss on investments held by NBFC are not allowed for tax deduction as ICDS 8 (Securities) Part B permits deduction of MTMs recognised as per extant RBI guidelines only for banks and public financial institutions.

  On positive MTMs, response to Q8 of CBDT Circular No 10/2017 dated 23rd March 2017 provides that same principle as contained in ICDS-1 relating to MTM losses or an expected loss shall apply *mutatis mutandis* to MTMS gains or an expected profit.

> The SC held that the taxpayer was entitled to full deduction of upfront interest in the year of payment and deduction should not be spread over the term of debentures in the absence of concept of deferred revenue expenditure.

- ***Amortisation of fees expenses and income on financial instruments viz. loans classified as subsequently measured at Amortised Cost or Fair Value through Other Comprehensive Income***

  Ind-AS requires that fee expenses and income in respect of financial liability (viz. borrowings) *loans classified as subsequently measured at Amortised Cost* or financial asset (loans) *classified as subsequently measured at Amortised Cost or Fair Value through Other Comprehensive Income to be* recognised based on the effective interest rate method over relevant period of such asset or liability. A classic example in case of NBFC is issue expenses for non-convertible debentures (NCD). As per the Companies Act, 2013, issue expenses incurred on issue of shares/debentures were charged-off against securities premium on an upfront basis. Such expenses were also claimed on an upfront basis in the tax returns under IGAAP. Claim of issue expenses on upfront basis is a contentious issue and the Supreme Court (SC) ruling in case of *Taparia Tools Limited (TS-134-SC-2015)* is helpful. The SC held that the taxpayer was entitled to full deduction of upfront interest in the year of payment and deduction should not be spread over the term of debentures in the absence of concept of deferred revenue expenditure.

  As the Ind-AS regime provides recognition of such expenses over the period of loan, taxpayer needs to decide the tax position on such issue expenses. It is suggested

that consistent position of claiming issue expenses on an upfront basis under IGAAP regime may continue under Ind-AS regime as there is no change in fact pattern of the particular loan product and its business use. Such position would depend on facts and circumstances of each case. Corporates are also advised to appropriately disclose such tax position in notes to return of income.

- ***Interest income accrual on Stage 3 Loans; taxability of real income***

  Ind-AS 109 provides that interest income on Stage 3 Loans shall be recognised on Amortised Cost balance i.e. Gross amount of loans less existing ECL provisions. Under prudential RBI guidelines, interest income on non-performing advances, are not recognised as *income*. The issue of taxability of real income especially for NBFC world in the context of Interest on Non-performing advances (NPA) is a vexed issue and time and again tested in litigation across courts. The Bombay High Court (HC) in recent case of *Bajaj Finance Limited (ITA 237 of 2017 with ITA 485 of 2017)* have held that interest income on non-performing advances should be taxed on receipt basis even though special provisions of Section 43D does not apply to NBFC. The Bombay HC also relies upon the Delhi HC ruling in the case of *CIT vs. Vasisth Chay Vyapar Limited* which held that interest income on NPA cannot be taxed on accrual basis. The Delhi HC decision was also approved by the Supreme Court in the judgement reported in (2018) 253 Taxman 401(SC).

  This issue is debatable and possibility of litigation cannot be ruled out. A suitable amendment in Section 43D that interest income recognised on Stage 3 Loans by NBFC shall be taxable on receipt basis will provide much needed clarity for NBFC industry as a whole.

5. **Review of Tax audit (Form 3CD) and ITR 6 clauses with respect to Ind-AS**: A timely preparation always helps and it is advisable that all the clauses of tax audit report and return of income with respect to Ind-AS are reviewed and data indent be initiated for such items. An early kick-off discussion with auditor on such requirement will also help and smoothen the audit process. However, the presentation of such items in tax audit and return of income and its impact in tax computation is a careful consideration which should be kept in mind. Experience suggests that practical issues arise only once such format are filled/updated, and hence, timely preparation will help to tackle with such practical issues. Such preparation will also provide a timely visibility on assessment of income tax liability and its pay-out, if any.

6. **Minimum alternative tax**: Central Board of Tax (CBDT) have issued necessary guidance and FAQ (Amendment in Section 115JB vide Finance Act, 2017 and CBDT Circular 24/2017 dated July 25, 2017) in respect of computation of MAT for 1st year of Ind-AS adoption. It is extremely important that corporates should start feed in relevant Section of Form 29B with respect to transition amount (viz. Serial 21 to 33). This will facilitate corporates to review whether MAT liability will trigger due to such transition adjustment. It is also suggested that the rationale for each Ind-AS adjustment and its treatment in MAT computation be documented in accordance with CBDT guidance. This will support the position adopted by corporates during tax assessment process.

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7. **Tax disclosures**: Transparency is a best policy and hence, notes to return of income are furnished by corporates along with return of income. Such notes include various tax consideration/positions in the tax return as appropriate. The corporates may consider to disclose tax positions of Ind-AS adjustments in notes to return of income. This will facilitate such claim as bona-fide and help to defend such claim during assessment proceedings.

To summarise, Ind-AS is an evolving subject and tax consideration are equally evolving especially in absence of precedence. I hope the article will help NBFC sector in tax filing of 1st Ind-AS financial statement. ■