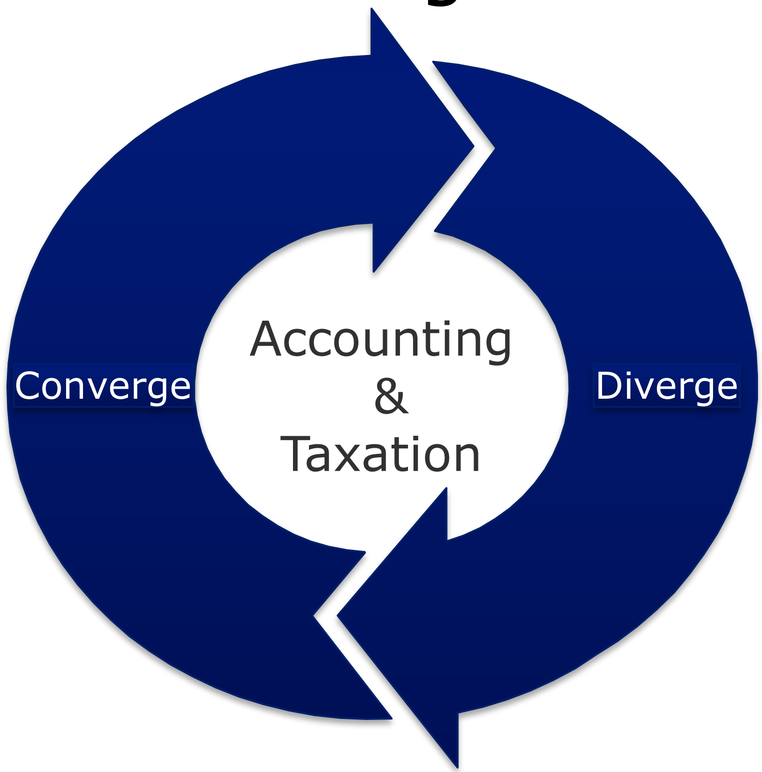
Accounting and Taxation - Convergence or Divergence?



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Conventional accounting & Accounting Standards:

Traditional accounting – Salient features:

- A historical description of financial activities
- An effective measurement & reporting system
- Involves estimates
  - bad debts, inventory obsolescence, warranty obligation, useful lives of depreciable assets, etc.

Accounting Standards – Salient features:

- Established rules for recognition, measurement & disclosures
- Ensure that enterprises are comparable & their financial statements are true and fair
- Attempt to reduce subjectivity & lay down rules to arrive at the best possible estimates

Maintenance of books of account under the company law:

Companies Act, 2013 – Key provisions:

- Section 128:
  - ✓ Books of account to be prepared & kept on accrual basis
- Section 129:
  - ✓ Financial statements to comply with the Accounting Standards prescribed u/s 133
  - ✓ In case of non-compliance, disclosure of the deviation, the reasons for the same & the financial effect of such deviation
- Section 133:
  - ✓ Central Government to prescribe Accounting Standards as recommended by the ICAI in consultation with the NFRA

Companies Act, 1956:

- Similar requirements were provided u/s 211

ICAI AS:

- Crystallised accounting principles for the preparation of true and fair financial statements
- Provide valuable guidance on the accounting treatment of an item
- Objects:
  - ✓ To evolve methods by which accounting income is determined & made transparent
  - ✓ To leave less room for subjective selection of methods
  - ✓ To provide attention to the quality of estimates used
- J.K. Industries Ltd [2008] 297 ITR 176 (SC):
  "The main object sought to be achieved by Accounting Standards which is now made mandatory is to see that accounting income is adopted as taxable income and not merely as the basis from which taxable income is to be computed. Thus, if the rules by which inventories are to be valued are laid down in the Accounting Standards and are followed in the determination of accounting income, then tax laws do not need to lay down the rules and the tax authorities do not need to examine the computation of the value of inventories and its effect on computation of income. Similarly, if there is an accounting standard on depreciation which requires estimation of the useful life and prescribes the appropriate method for apportionment of cost of fixed assets over their useful life, it is unnecessary for tax laws to apply an artificial rule to decide the extent of allowance for depreciation. Finally, the adoption of Accounting Standards and of accounting income as taxable income would avoid distortion of accounting income which is the real income"
- Are relied upon by taxpayers as well as the Revenue to justify their respective stands

Accounting and accounting principles – The evolution:

- Globalization has led to a revolutionary change in the role of accounting
- Now considered as a service activity
- Includes several branches, e.g., Financial Accounting, Management Accounting, Governmental Accounting, etc.
- Fair valuation principles are gaining increasing importance

Ind AS – The convergence to IFRS:

- IFRS:
  - ✓ Developed by the International Accounting Standards Board
  - ✓ A common financial accounting language
  - ✓ Increases comparability of entities
  - ✓ Enables uniform reporting systems across group entities having worldwide presence
  - ✓ Committed to be adopted by the G20 nations including India
- Ind AS:
  - ✓ Notified by the MCA in an effort to converge to IFRS
  - ✓ Based on the concepts of:
    - Substance over form
    - Fair valuation
    - Time value of money

Roadmap to Ind AS:

For companies other than banks, insurance companies, NBFC	
2015-16 Voluntary Phase	▪ Early adoption
2016-17 Mandatory Phase I	▪ Companies with net worth of Rs.500 crore or more
2017-18 Mandatory Phase II	▪ All listed companies not covered in Phase I ▪ All unlisted companies with net worth of Rs.250 crore or more

For banks, insurance companies, NBFC	
2018-19 Phase I	▪ Scheduled commercial banks ▪ Term lending refinancing institutions ▪ Insurer/ insurance companies ▪ NBFC with net worth of Rs. 500 crore or more
2019-20 Phase II	▪ All listed NBFC (or in the process of listing) & not covered in Phase I ▪ All unlisted NBFC with net worth of Rs.250 crore or more, but less than Rs. 500 crore

- Also applies to holding, subsidiaries, joint ventures & associate companies of the above companies
- Applies to both standalone & consolidated financial statements
- Financial statements to be presented with an opening balance sheet & comparative period

Method of accounting and income-tax: (1/2)

- Kedarnath Jute Mfg. Co. Ltd. [1971] 82 ITR 363 (SC):
  Whether the assessee is entitled to a particular deduction or not will depend on the provision of law & not on the view which the assessee might take of its right, nor can the existence or absence of entries in the books of account be decisive or conclusive

- B.S.C. Footwear Ltd. [1972] 83 ITR 269 (HL):
  Income-tax law does not march step by step in the divergent footprints of the accountancy profession

- Chowringhee Sales Bureau (P.) Ltd. [1973] 87 ITR 542 (SC):
  It is the true nature and quality of the receipt and not the head under which it is entered in the account books that would prove decisive

- Challapalli Sugars Ltd [1975] 98 ITR 167 (SC):
  Where an expression or term has not been defined under the income-tax law, it should be construed in the sense which no commercial man would misunderstand; for this purpose it would be necessary to ascertain the connotation of the expression in accordance with the normal rules of accountancy prevailing in commerce and industry

- State Bank of Travancore [1986] 158 ITR 102 (SC):
  Where an income has accrued and in a given circumstance the amount had been taken to a suspense account for accounting purpose, that would not affect its taxability as such

Method of accounting and income-tax: (2/2)

- Sutlej Cotton Mills Ltd.[1979] 116 ITR 1 (SC), Tuticorin Alkali Chemicals & Fertilizers Ltd. [1997] 227 ITR 172 (SC):
  The question whether a receipt of money is taxable or not or whether certain deductions from that receipt are permissible in law or not has to be decided according to the principles of law and not in accordance with accountancy practice; Accounting practice cannot override the provisions of the Act

- Madras Industrial Investment Corpn. Ltd [1997] 225 ITR 802 (SC):
  Discount on issue of debentures was to be spread over the period of the debentures as there was continuing benefit to the business over the entire period

- U.P. State Industrial Development Corpn. [1997] 225 ITR 703 (SC):
  The ordinary principles of commercial accounting should be applied so long as they do not conflict with any express provision of the relevant statutes

- Woodward Governor India (P.) Ltd. [2009] 312 ITR 254 (SC):
  To find out if an expenditure is deductible, the following factors have to be considered:
  - ✓ Whether the mercantile system of accounting has been followed
  - ✓ Whether the same system is followed from the very beginning and if there was a change in the system, whether the change was bona fide
  - ✓ Whether the same treatment has been given to losses as well as gains accrued
  - ✓ Whether the assessee has been consistent and definite in making entries in the account books in respect of losses and gains
  - ✓ Whether the method is as per nationally accepted Accounting Standards
  - ✓ Whether the system adopted by the assessee is fair and reasonable or is adopted only with a view to reduce the incidence of taxation

Points for Discussion - I

Points for Discussion - I: (1/3)

- Can the tax department ignore a bonafide accounting practice if it is at variance with the tax law?

  ✓ The principles of accounting can be applied so long as they do not conflict with any express provision of the Act. Other than that the principles of Supreme Court in Tuticorin Alkali as cited earlier will apply and tax law will prevail even if it is a bonafide accounting practice.

- An ecommerce company has incurred a huge spend on advertising and discounts on items sold through the website. The ecommerce company has claimed huge losses as a result of the expenditure incurred. The AO has however disallowed the expenditure on the basis that the same has lead to creation of an intangible and therefore cannot be allowed as a deduction. The CIT(A) has confirmed the action of the AO. Are the AO and CIT(A) correct in their actions?

  ✓ Globally, the e-commerce business has thrived on marketing through deep discounts

  ✓ The discounts are claimed as a revenue expense, leading the companies to post losses and therefore not being liable to tax

  ✓ The tax department's view is that the expenditure is capital in nature as these discounts are a part of the brand-building exercise and the business derives benefits over a longer time period

  ✓ Similar view was expressed in the assessments made on e-commerce giants, Flipkart & Amazon. The CIT(A) confirmed the AO's action in the case of Flipkart. Recently, the Bengaluru ITAT passed an order dated 6 February 2018 [90 taxmann.com 153] rejecting Flipkart's petition for stay of demand of Rs. 110 crores

Points for Discussion - I: (2/3)

- E-commerce discounts controversy: Contd..

  ✓ Important principles for determining whether an expenditure is capital or revenue – Empire Jute Co. Ltd. [1980] 124 ITR 1 (SC):

  – What is material to consider is the nature of the advantage in a commercial sense and it is only where the advantage is in the capital field that the expenditure would be disallowable on an application of the enduring benefit test

  – If the advantage consists merely in facilitating the assessee's trading operations or enabling the conduct of the business to be carried on more efficiently or profitably while leaving the fixed capital untouched, the expenditure would be on revenue account, even though the advantage may endure for an indefinite future

  – The test of enduring benefit is therefore, not a certain or conclusive test and it cannot be applied blindly and mechanically without regard to the particular facts & circumstances of a given case,

  – Further as held by the Supreme Court in many cases,(the most recent Taparia Tools Limited(372 ITR 605) there is no concept of deferred expenditure and the amount has to be allowed as a deduction.

Points for Discussion - I: (3/3)

- Can a taxpayer opt for the treatment of an item as per the tax law or optionally the accounting treatment provided the accounting treatment is an accepted principle that can be applied?

  ✓ The position emerging from the various SC rulings (interalia Taparia Tools(372 ITR 605)) is that:

  - The question whether a receipt of money is taxable or whether certain deductions from that receipt are permissible, has to be decided according to the principles of law
  - Accounting practice cannot override the provisions of the Act
  - The ordinary principles of commercial accounting may be applied as long as they do not conflict with the tax law
  - Also, it is for the taxpayer to opt for the treatment of an item as per the tax law or the accounting treatment, provided the accounting treatment is an accepted principle that can be applied

Section 145 of the ITA:

- Section 145 - Provisions:

  - ✓ Business profit or Income from other sources shall be computed as per the cash or the mercantile accounting method regularly followed by the assessee

  - ✓ The Central Government may notify ICDS to be followed by any class of assessees or in respect of any class of income

  - ✓ Assessment in the manner of a best judgment assessment may be made, if:
    - The AO is not satisfied about the correctness or completeness of the assessee's accounts; or
    - Where the assessee fails to regularly follow the chosen accounting method; or
    - The assessee does not compute income in accordance with the ICDS

- Standard Triumph Motor Co. Ltd. [1979] 119 ITR 573 (Mad HC):

  Section 145 is only a machinery provision; It cannot override charging provision

Points for Discussion - II

Points for Discussion - II: (1/5)

- Consider a case where an assessee following the mercantile system of accounting, advanced a loan during an earlier year, which is partly outstanding as on date. The borrower expressed inability to pay interest for the current year; partial repayments were however made of the principal amount. The assessee passed a Board resolution for waiver of current year's interest on the ground of commercial expediency to recover the outstanding principal. Accordingly, the assessee did not credit any interest in its books of account for the current year. The ITO however holds that interest income stands accrued in view of the mercantile method applied by the assessee. Is the ITO justified?

  - ✓ section 145 is a machinery provision & cannot override the other provisions of the Act

  - ✓ Where specific provisions are made for inclusion of particular income or for allowance of particular expenditure on cash or accrual basis, then the income shall be so computed irrespective of the method of accounting (eg: section 8, section 43B)

  - ✓ What can be taxed is only real income; If income does not result at all, there cannot be a tax, even though in book-keeping, an entry is made about a 'hypothetical income', which does not materialize:
    - Shoorji Vallabhdas & Co. [1962] 46 ITR 144 (SC)
    - Excel Industries Ltd. [2013] 358 ITR 295 (SC)
    - Vasisth Chay Vyapar Ltd [TS-619-SC-2017 dt Jan 2018]

  - ✓ The fact that interest was offered to tax in earlier years & the Board resolution for waiver of the current interest based on commercial consideration, indicated that no interest income accrued for the current year; merely because the assessee followed the mercantile method of accounting and continued to receive principal repayment, interest income could not be said to have accrued - Shivlaxmi Exports Ltd. [2017] 81 taxmann.com 262 (Cal HC)

Points for Discussion - II: (2/5)

- In another case, deduction of performance bonus payment pertaining to an earlier year was denied to an assessee since books were maintained on the basis of mercantile system of accounting. This was despite the fact that the assessee could quantify the bonus only in the subsequent year and, thus, its liability crystalized during such year. Is the bonus payment deductible in such subsequent year?

  ✓ Quantification of the bonus liability depended upon figures that could be gathered only after closure of accounts and hence the entire exercise could be completed only in the subsequent year. Thus as the liability crystallized and was discharged during such subsequent year, the bonus payment pertaining to an earlier year was deductible in the subsequent year, notwithstanding the mercantile method of accounting followed by the assessee - Spencer's Retail Ltd. [2017] 77 taxmann.com 324 (Kol ITAT) following the ratio of the Supreme Court in Swadeshi Flour Mills Limited.

Points for Discussion - II: (3/5)

- Can different methods of accounting be adopted for different income sources, say mercantile system for Business income and cash system for Income from other sources?

  - ✓ It is legitimate to expect that the assessee would exercise his option u/s 145 for his own benefit. If the assessee thought that it would be more advantageous to follow the cash system in respect of its income assessable under other sources and to follow the mercantile system in respect of its income assessable under business, it is entitled to do so- J.K. Bankers [1974] 94 ITR 107 (All HC), Smt. Vimla D. Sonwane [1995] 212 ITR 489 (Bom HC)

  - ✓ Prior to amendment by the Finance Act, 1991, section 145(1) permitted 'hybrid method' of accounting

  - ✓ Features of 'hybrid method' - Citibank N.A. [1994] 208 ITR 930 (Bom HC):
    - Has elements of both cash and mercantile system;
    - It is possible to employ one method of accounting for one class of customers or transactions and a different method for another class

  - ✓ Thus, while it may be possible to apply different methods for different sources of income, it would not be possible to employ different methods of accounting for different class of customers or transactions in view of the derecognition of the hybrid method of accounting by the Finance Act, 1991

Points for Discussion - II: (4/5)

- Can different methods of accounting be applied for different businesses, e.g. if an assessee is a practising interior decorator as well as engaged in the business of civil contractor, can he choose to follow cash basis of accounting for his professional income and mercantile basis for the business income?

  - ✓ U/s 145, income chargeable under the head 'Profits and gains of business or profession' shall be computed in accordance with one of the two methods of accounting
  - ✓ Section 28(i) states that the profits and gains of any business or profession carried on during the previous year shall be chargeable under the head 'Profits and gains of business or profession'
  - ✓ By implication, therefore, the profits and gains of any business or profession carried on during the previous year shall be computed in accordance with one of the two methods of accounting regularly followed by the assessee
  - ✓ Now, if an assessee carries on more than one business, the profits and gains of each business has to be computed separately and the aggregate thereof is taxable under the head 'Profits and gains of business or profession'
  - ✓ It follows, therefore, that the condition of regularly following any one particular method of accounting would apply to each of such business separately
  - ✓ Accordingly, it can be contended that an assessee may choose to adopt mercantile method for one business and cash method for the other

Points for Discussion - II: (5/5)

- Does the term 'regularly employed by the assessee' imply a permanent method of accounting which cannot be changed?

  ✓ Regularly followed should mean 'during the period under consideration'. The term cannot be interpreted to mean that once a system of accounting is adopted, it can never be changed. 'Regular' cannot in the context mean permanent - Punjab State Industrial Development Corpn. Ltd. [2002] 255 ITR 351 (P& H HC)

  ✓ It is a settled law [interalia Eastern Bengal Jute Trading Co. Ltd. [1978] 112 ITR 575 (Cal HC), Ganga Charity Trust Fund [1986] 162 ITR 612 (Guj HC)] that it is open to an assessee to make a change in the method of accounting if:

  (i) the change does not involve any mala fide motive;
  (ii) the assessee regularly follows the changed method of accounting; and
  (iii) the change is not resorted to too frequently.

  However, the change should not result in hybrid method being followed

- Can the assessee be compelled to choose a particular method?

  ✓ Option regarding adoption of system of accounting is with the assessee & not with the income-tax department. The tax department cannot compel an assessee to adopt the mercantile system of accounting, if the assessee chooses to adopt the cash system - Juggilal Kamlapat Bankers [1975] 101 ITR 40 (All HC), Smt. Vimla D. Sonwane [1995] 212 ITR 489 (Bom HC)

ICDS notified u/s 145(2) of the ITA:

- 10 ICDS notified by the CBDT on 31 March 2015

- Rescinded vide notification dated 29 September 2016 and new ICDS issued

- Form 3CD amended to provide for reporting of ICDS related adjustments & disclosures

- Salient features:
  - ✓ ICDS apply to all assessees following the mercantile system of accounting, except for individuals, HUF not covered under the tax audit provisions

  - ✓ ICDS apply only to computation of:
    - Profits and gains of business or profession
    - Income from other sources

  - ✓ Do not apply to maintenance of books of account

  - ✓ In case of conflict, the provisions of the Act/ Rules shall prevail over ICDS

  - ✓ ICDS shall prevail over judicial precedents

Constitutional validity of the ICDS:

- While deciding on the constitutional validity of the notified ICDS, the Delhi HC [The Chamber of Tax Consultants [2017](87 taxmann.com 92)(Del HC)] held as under:

  - ✓ ICDS cannot override a binding judicial precedent, unless there is an amendment to the Act by way of a validation law

  - ✓ In case the notified ICDS sought to alter the system of accounting or tax treatment to a particular transaction, it would require the legislature to step in to amend the Act to incorporate such change

  - ✓ In order to preserve its constitutionality, section 145(2) is read down to restrict the power of the Central Government to notify ICDS that sought to override binding judicial proceedings or provisions of the Act

  - ✓ Accordingly, portions of specific ICDS which are found contrary to the provisions of the Act and/ or judicial precedents, are ultra vires the Act and hence struck down

Proposals in the Finance Bill, 2018:

- Several amendments proposed to provide retrospective statutory backing to the notified ICDS

- Memorandum explaining the provisions of the Finance Bill clarifies that:

  - ✓ The amendments are with a view to bring certainty in the wake of recent judicial pronouncements raising doubts on the legitimacy of the notified ICDS

  - ✓ A large number of taxpayers have already complied with the ICDS for computing income for AY 2017-18. Hence, in order to regularise the compliance by a large number of taxpayers and to prevent any further inconvenience to them, it is proposed to bring the amendments retrospectively w.e.f 1 April 2017, being the date on which the ICDS were made effective

Proposed amendments: (1/6)

ICDS	Delhi HC's ruling	Amendment proposed
I – Accounting Policies	▪ Provides that MTM or other expected loss, shall not be recognized unless such recognition is in accordance with other ICDS ▪ The concept of prudence is embedded in section 37(1) of the Act, which allows deduction in respect of expenses "laid out" or "expended" for the purpose of business ▪ Hence, to the extent the concept of prudence has been done away with, the provisions of ICDS are contrary to the provisions of the Act and the principles laid down in binding judicial precedents and are therefore, unsustainable in law	▪ New section 36(1)(xviii) to allow deduction of MTM or other expected loss computed as per ICDS

Proposed amendments: (2/6)

ICDS	Delhi HC's ruling	Amendment proposed
II – Valuation of Inventories	▪ Provides that in case of dissolution of a partnership firm, inventory shall be valued at NRV. Hence no distinction is made whether the business is continued or discontinued after dissolution ▪ This will lead to taxing of notional income and is contrary to the decision in Sakthi Trading Co. [2001] 250 ITR 871 (SC) ▪ ICDS II is held to be ultra vires the Act & struck down	▪ Section 145A amended to provide interalia that inventory shall be valued at lower of actual cost or NRV computed in the manner provided in ICDS

Proposed amendments: (3/6)

ICDS	Delhi HC's ruling	Amendment proposed
III – Construction Contracts	**Retention money** ▪ Provides for taxation as part of the contract revenue ▪ Judicial precedents have held that retention money does not accrue until & unless the defect liability period is over & it is certified that no liability is attached further ▪ The treatment is thus to be determined as per terms of the contract on case-to-case basis, by applying the settled principles of income accrual ▪ Taxing the amount, the receipt of which is uncertain/ conditional, is contrary to the settled position **Set off of incidental income** ▪ Does not allow reduction of incidental income from borrowing cost ▪ The ICDS is contrary to the decision in Bokaro Steel Limited [1999] 236 ITR 315 (SC) holding that if the amount received is inextricably linked with the setting up of plant, the same will be reduced from the cost of asset To the extent above, ICDS III is ultra vires & struck down	▪ New section 43CB to provide interalia that:- – Contract revenue shall include retention money; – Contract cost shall not be reduced by incidental interest, dividend and capital gains

Proposed amendments: (4/6)

ICDS	Delhi HC's ruling	Amendment proposed
IV – Revenue Recognition	Export incentive ▪ Recognizes income in the year of making claim, if there is "reasonable certainty" of its ultimate collection ▪ Contrary to the decision in Excel Industries [2013] 358 ITR 295 (SC) wherein it was held that the right to receive accrues in the year in which the claim is accepted by the government ▪ Hence ultra vires the Act & struck down	▪ New section 145B to provide interalia that the claim for export incentives shall be deemed to be the income of the previous year in which reasonable certainty of its realisation is achieved
	Revenue recognition method ▪ The proportionate completion method and the contract completion method have been recognized as valid methods of accounting under the mercantile system of accounting in Bilahari Investment Pvt. Ltd. [2008] 299 ITR 1 (SC) ▪ Therefore, to the extent the ICDS permits only one of the methods i.e. proportionate completion method, it is held to be ultra vires & struck down	▪ New section 43CB to provide that profits arising from a construction contract or a contract for providing services shall be determined on the basis of percentage of completion method except for certain service contracts

Proposed amendments: (5/6)

ICDS	Delhi HC's ruling	Amendment proposed
VI - Effects of changes in foreign exchange rates	▪ Disallows MTM loss/ gain in case of foreign currency derivatives held for trading or speculation purposes ▪ Disallowance of MTM loss/ gain is contrary to the ratio laid down in Sutlej Cotton Mills Ltd [1979] 116 ITR 1 (SC) ▪ Hence ultra vires the Act & struck down	▪ New section 43AA to provide that subject to the provisions of section 43A, any foreign exchange gain or loss in respect of specified foreign currency transactions shall be treated as income or loss, and such gain or loss shall be computed as per ICDS
VII – Government grants	▪ Provides that recognition of government grants cannot be deferred beyond actual receipt ▪ Income may thus have to be recognized on receipt basis, though it may not have accrued. This is contrary to the accrual system of accounting and is held to be ultra vires & struck down	▪ New section 145B to provide that income referred to in section 2(24)(xviii) i.e. grant, subsidy, etc. from the Government, shall be deemed to be the income of the previous year in which it is received, if not charged to income tax for any earlier previous year

Proposed amendments: (6/6)

ICDS	Delhi HC's ruling	Amendment proposed
VIII – Securities (Part A)	▪ Entities to which RBI regulations are not applicable, are required to value securities category wise and not on individual basis. Such treatment is contrary to the accounting prescribed by AS, requiring maintenance of separate books of account for tax purposes ▪ The change cannot be effectuated without corresponding amendment to the Act. To that extent, it is held as ultra vires	▪ Section 145A amended to provide interalia that:- – Inventory of unlisted, or listed but not quoted securities, shall be valued at actual cost initially recognized as per ICDS; – Inventory of listed securities shall be valued at lower of actual cost or NRV in the manner provided in ICDS and for this purpose, comparison of actual cost and NRV shall be done category-wise

Points for Discussion - III

Points for Discussion - III: (1/5)

- Would the revised provisions of ICDS apply to both the cash and mercantile system of accounting followed by a taxpayer?

  - ✓ Section 145(2) states that the Central Government may 'notify' from time to time, ICDS to be followed by any class of assessees or in respect of any class of income
  - ✓ Notification No. 87/2016 dated 29 September, 2016 notifying the revised ICDS provides that the ICDS shall apply to assessees (other than individuals/ HUF liable for tax audit) following the 'mercantile system of accounting' for the purposes of computing business income or income from other sources
  - ✓ There is no amendment to section 145 by the Finance Bill, 2018
  - ✓ Hence ICDS shall not apply to an assessee following the cash system of accounting

Points for Discussion - III: (2/5)

- Is there any possibility to argue that export incentives need to be realized before they are actually taxed in light of the term "claim" being used?

  ✓ In Excel Industries [2013] 358 ITR 295 (SC), the SC held that until imports are actually made, benefits under advance license or DEPB represent only hypothetical income which cannot be brought to tax u/s 28(iv)
  - Applying tests namely, whether the income accrued to the assessee is real or hypothetical; whether there is a corresponding liability of the other party to pass on the benefits to the assessee even without any imports having been made; and the probability or improbability of realisation of the benefits by the assessee considered from a realistic & practical point of view (the assessee may not have made imports), it is quite clear that in fact no real income but only hypothetical income had accrued to the assessee and section 28(iv) was hence inapplicable

  ✓ The proposed new section 145B provides that any claim for export incentives shall be deemed to be the income of the previous year in which 'reasonable certainty of its realisation' is achieved

  ✓ What would constitute 'reasonable certainty of realisation' has not been specified. Reliance could be placed on the observation in the Excel Industries decision that the probability or improbability of realisation of the benefits by the assessee should be considered from a realistic and practical point of view i.e. the assessee may not have made imports. It may hence be possible to argue that 'reasonable certainty of realisation' is achieved only if imports are made and hence the principle laid down in the Excel Industries ruling still holds good

  ✓ Whether deduction would be allowed u/s 36(1)(vii) if the export incentives taxed on claim basis, are not actually realized due to absence of subsequent imports

Points for Discussion - III: (3/5)

- What will be the tax treatment of MTM gains/ losses in light of the amendments proposed in the Finance Bill, 2018?

  ✓ Proposed section 36(1)(xviii) provides for deduction of MTM & expected losses as computed in accordance with the ICDS

  ✓ Proposed section 40A(13) restricts deduction of MTM & expected losses, except as allowable u/s 36(1)(xviii)

  ✓ ICDS II on Valuation of Inventories, ICDS VIII on Securities and proposed section 145A provide that the inventories and securities held as inventory (listed and quoted) should be valued at lower of cost or net realizable value. For inventory being securities not listed, or listed but not quoted, valuation should be at actual cost. Any MTM loss arising on account of above would be allowed as deduction

  ✓ Proposed section 43AA r.w. ICDS VI provides for deductibility/ taxability of loss/gain arising from foreign exchange fluctuations

  ✓ Proposed section 43CB r.w. ICDS III on Construction contracts provides for recognition of profits arising from a construction contract or contract for services based on percentage completion method. In case, there are any expected losses on such contracts, same would be considered under section 43CB

  ✓ Except for the above, no MTM or expected losses would be allowed as deduction be it on revenue or capital account, in view of restriction in proposed section 40A(13)

  ✓ No specific provision for taxability of MTM gains - FAQ 8 of Circular 10/2017 dated 23 March 2017 clarifies that the same principle as applicable to MTM & expected losses, shall apply mutatis mutandis

Points for Discussion - III: (4/5)

- In light of the amendments proposed in the Finance Bill, 2018, what will be the tax treatment of gains/ losses arising due to exchange fluctuations related to acquisition of indigenous assets?

  ✓ Proposed section 43AA(1) provides that subject to the provisions of section 43A, any gain or loss arising on account of any change in foreign exchange rates shall be treated as income or loss, & such gain or loss shall be computed as per the ICDS

  ✓ Section 43AA(2) states that for the purposes of sub-section (1), gain or loss arising on account of the effects of change in foreign exchange rates shall be in respect of all foreign currency transactions, including those relating to—
  (i) monetary items and non-monetary items;
  (ii) translation of financial statements of foreign operations;
  (iii) forward exchange contracts;
  (iv) foreign currency translation reserves

  ✓ Section 43A applies only when the assets are acquired from outside India. When this is not the case, section 43AA (supra) r.w. ICDS VI would apply

  ✓ Section 43AA does not distinguish between capital item and revenue item; Hence, the provisions of section 43AA would be applicable on capital items as well

Points for Discussion - III: (5/5)

- In light of the amendments proposed in the Finance Bill, 2018, what will be the tax treatment of gains/ losses arising due to exchange fluctuations related to acquisition of indigenous assets? (Contd..)

  - ✓ Tata Iron and Steel Co. Ltd. [1998](231 ITR 285)(SC):
    Cost of an asset & cost of raising money for purchase of asset are two different & independent transactions. Thus, events subsequent to acquisition of assets cannot change the price paid for it. Hence, fluctuations in foreign exchange rate while repaying instalments of foreign loan raised to acquire asset cannot alter actual cost of assets. Thus, the variation in the loan amount has no bearing on the cost of the asset as the loan is a distinct & independent transaction in comparison with acquisition of assets out of said loan. Actual cost of the corresponding fixed asset acquired earlier by utilizing the aforesaid loan will not undergo any change owing to such fluctuation

  - ✓ Deduction allowable u/s 37(1) of the loss on foreign currency loans availed for acquisition of indigenous assets to which the provisions of section 43A did not apply – Hyundai Motor India Ltd [2017](187 TTJ 97)(Chen ITAT), TVS Motor Co Ltd [2017](77 taxmann.com 105)(Chen ITAT), Cooper Corporation (P) Ltd [2016](159 ITD 165)(Pune Trib)

  - ✓ However, in the following cases, the forex gains relating to indigenous assets financed through foreign currency loans, were held as capital receipts:
    - GHCL Limited (ITA Nos.830, 2508/Ahd/2008 order dt 30.09.2015)(Ahd Trib)
    - Essel Mining & Industries Ltd (ITA Nos.352, 589/Kol/2011 order dt 20.05.2016)(Kol Trib)

Divergence:

Permanent Differences	Timing Differences
▪ Differences between the taxable income and the accounting income which originate in one period and do not reverse subsequently ▪ E.g: If for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference ▪ Do not result in Deferred tax asset or Deferred tax liability	▪ Differences between the taxable income and the accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods ▪ These arise because the period in which some items of revenue and expenses are included in taxable income do not coincide with the period in which such items of revenue and expenses are included or considered in arriving at accounting income ▪ E.g: Machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the P&L as depreciation over its useful life ▪ Result in Deferred tax asset or Deferred tax liability

Some areas of divergence: (1/4)

- Valuation of Inventories:

  ✓ Section 145A provides for the inclusive method of valuation where under the inventory value would include the amount of MODVAT/ CENVAT credit

  ✓ Both AS – 2 and Ind AS - 2 prescribe the exclusive method of valuation where under inventory value would include only those taxes, duties which are not subsequently recoverable from the taxing authorities

- Depreciation:

  ✓ Book depreciation based on the estimated useful life of an asset; Tax depreciation based on the 'block of assets' concept

  ✓ Difference in composition of 'actual cost' on which depreciation is applied e.g. section 43A requires the exchange difference relating to acquisition of a foreign asset to be adjusted in the cost of the asset, at the time of payment

  ✓ Difference in the methods [Written Down Value, Straight Line Method, etc] & rates

  ✓ If an asset is retired from active use, tax depreciation is allowable on the WDV of the block of such asset. Book depreciation is however not allowed and such asset will have to be stated as a current asset, at lower of its net book value and NRV; Any expected loss would have to be recognized immediately in the P&L

  ✓ On sale of an asset, the sale proceeds have to be reduced from the opening WDV of the block; Hence, no tax depreciation is admissible in the year of sale. However, in books, depreciation will be charged till the date of sale

Some areas of divergence: (2/4)

Leases:

- Finance Lease:
  - ✓ A lease that transfers substantially all the risks and rewards incidental to the ownership of an asset
  - ✓ Under the AS, depreciation is allowed in the hands of the lessee
  - ✓ Circular No. 2/2001 dated 9 February 2001:
    - The owner of the asset is entitled to depreciation if the asset is used in the business
    - The ownership of the asset is determined by the terms of contract between the lessor and the lessee
    - AS 19 will have no implication on the allowance of depreciation under the Act
  - ✓ IndusInd Bank Ltd [2012] 135 ITD 165 (Mum ITAT SB):

    Lessee (and not the lessor) may be considered as the real owner of the leased asset and will be eligible to claim depreciation, if the following criteria are fulfilled:
    - Lease is non-cancellable and there is a fixed obligation on the lessee for payment of lease money
    - Such a lease is always for a fixed period which is decided by taking into consideration the economic life of the asset;
    - The asset is intended to be sold to the lessee after the lease period
    - The risks and rewards incidental to the ownership vest with the lessee
    - The lessee is responsible for repairs, insurance, taxes, etc.

Some areas of divergence: (3/4)

Leases: (Contd..)

- Finance Lease: (Contd..)
  - ✓ I.C.D.S Ltd [2013] 350 ITR 527 (SC):

    Lessor) will be eligible to claim depreciation, if the following criteria are fulfilled:
    - Lessor should be the exclusive owner of the asset at all points of time
    - If the lessee committed a default, the lessor should be empowered to re-possess the asset (and not merely recover money from the customer)
    - At the conclusion of the lease period, the lessee should be obliged to return the vehicle to the lessor
    - The lessor should have the right of inspection of the asset at all time
  - ✓ In terms of the AS, lease rentals arising to the lessor are apportioned between finance income and reduction of lease receivable, whereas the full rental is treated as income for tax purposes
  - ✓ In the lessee's books, lease rentals are apportioned between finance charges and reduction of liability. Only the finance charges are debited to the P&L whereas the full lease rental is claimed deductible for tax purposes
- Operating Lease:
  - ✓ As per AS-19, lease income should be recognized in the P&L on a straight line basis over the lease term amongst other factors. However, for income-tax purpose, such lease income is recognized on cash or mercantile basis, depending on the method of accounting regularly followed by the assessee

Some areas of divergence: (4/4)

- Intangible Assets:

  - ✓ Depreciation @ 25% allowed under the Act

  - ✓ for accounting purpose, an intangible asset is required to be amortized over its expected useful life. The amortization may be based on straight line method, diminishing balance method or unit of production method

- Miscellaneous:

  - ✓ Expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the P&L but allowed for tax purpose on payment basis

  - ✓ Payments to non-residents accrued in the P&L, but disallowed u/s 40(a)(i) and allowed for tax purposes in subsequent years when relevant tax is deducted and/or paid

  - ✓ Income recognized in the books of account over a number of years, but offered to tax in entirety in the year of receipt

  - ✓ Unabsorbed depreciation and brought forward losses available for set off against future taxable income

Book profit u/s 115JB: Rewriting of P&L by the AO

- Apollo Tyres Ltd. [2002] 255 ITR 273 (SC),:
  - ✓ The Assessing Officer does not have the jurisdiction to go behind the net profits shown in the profit and loss account except to the extent provided in the Explanation

- Rain Commodities Ltd.[2010] 40 SOT 265 (Hyd. ITAT SB):

  In the following two cases, the ITO can rewrite the P&L i.e. recalculate the net profit and then follow the adjustments of MAT as usual:

  - ✓ If it is discovered that P&L is not drawn up in accordance with Schedule VI to the Companies Act. However, the ITO cannot disturb the Net Profit as shown by the assessee where there are no such allegations, fraud or misrepresentation but only a difference of opinion on presentation of a particular amount

  - ✓ If accounting policies, accounting standards are not adopted for preparing such accounts or method, rate of depreciation have been incorrectly adopted for preparation of P&L laid before the AGM

- Sumer Builders (P) Ltd [2012] 50 SOT 198 (Mum ITAT):
  - ✓ ITO has powers to go behind the accounts of a company to see whether the same have been prepared in accordance with the requirements of Parts II and III of Schedule VI of Companies Act

- J.K. Lakshmi Cement Ltd. (ITA No. 1275/Kol/2010) (Kol ITAT):
  - ✓ The adjustment of book loss which was made pursuant to the HC order, was to be ignored by the ITO while determining the amount of brought forward loss available for set off against book profit. The adjustment was not in accordance with Schedule VI & the assessee would have a right to recast the account especially given that the auditors had qualified the accounts as not being in accordance with Schedule VI

Book profit u/s 115JB: Can non-taxable sums be taxed?

- Sums not constituting taxable income, could not be taxed as book profit under section 115JB of the Act:
  - ✓ Sutlej Cotton Mills Ltd. [1993] 45 ITD 22 (Cal ITAT)(SB) - Capital gains which were not chargeable to tax in terms of section 54E
  - ✓ Shivalik Venture (P) Ltd [2015] 70 SOT 92 (Mum ITAT) - Profit arising on transfer of capital asset to subsidiary company.
  - ✓ McNally Bharat Engineering Co. Ltd. [TS-80-ITAT-2017(Kol ITAT)] - Retention money

- Contrary rulings [interalia Metal & Chromium Plater (P.) Ltd. [2016] 76 taxmann.com 229 (Mad HC), Duke Offshore Ltd. [2011] 9 taxmann.com 214 (Mum ITAT), Technicarts (P.) Ltd. [2011] 46 SOT 294 (Mum ITAT), B & B Infotech Ltd. [2015] 63 taxmann.com 122 (Bang ITAT)] holding that section 115JB being a separate code in itself, is not concerned with the 'income' aspect of the book profit

- JSW Steel Limited [2017] 82 taxmann.com 210 (Mum ITAT):
  - ✓ Capital surplus arising on waiver of loan, is neither taxable, nor can be included in the computation of book profit for MAT purpose

Points for Discussion - IV

Points for Discussion - IV: (1/2)

- Will section 145 apply to computation of book profit under section 115JB of the Act?

  ✓ Section 115JB is a separate code overriding all other provisions of the Act. Further, section 115JB(5) makes applicable other provisions of the Act and saves all the provisions which are made in the section itself. Section 115JB(2) defines as well as provides for the mode and manner in which book profit should be computed

  ✓ For computing the book profit u/s 115JB, the P&L is required to be prepared in accordance with the provisions of the company law read with the ICAI AS/ Ind AS

  ✓ Thus, section 115JB(2) provides for the method of accounting as well as the Policies & Standards which are required to be followed. Additionally, the first & the second provisos clearly provide that the company should follow the same Policies, Standards and Depreciation as have been adopted for the preparation of the statutory P&L

  ✓ The above provisions indicate that section 115JB will prevail over the provisions of sections 145 and 145A for computing book profit u/s 115JB

  ✓ To summarize:

    – For computing income under the regular provisions of the Act, the company will have to apply section 145 of the Act r.w. the ICDS notified thereunder; and

    – For computing book profit u/s 115JB, the company will have to apply the provisions of the Companies Act read with the ICAI AS/ Ind AS

Points for Discussion - IV: (2/2)

- Does the AO have the power to recast the books of account in any given situation?

  - ✓ The position based on judicial precedents is that except for the adjustments provided u/s 115JB, the AO does not have the power to recast the book profits as arrived at in the financial statements, provided that:

    - The accounts are prepared in accordance with the provisions of the company law and are certified as being in accordance therewith, by the statutory auditors;
    - The auditor's report is adopted by the members in the AGM;
    - The same is filed with the registrar of companies

  - ✓ The ITO is however empowered to rework the net profit as per the financial statements if:

    - The accounts are not drawn up in accordance with the provisions of the company law with an intention to defraud or misrepresent;
    - If accounting policies, accounting standards applied for the preparation of the financial statements are not consistent with those adopted for preparing the accounts laid before the AGM

- Can capital receipts which do not constitute taxable income per se, be taxed u/s 115JB?

  - ✓ Though there is a contrary view that section 115JB is an independent overriding code, based on judicial precedents as cited earlier, it is arguable that sums, e.g. capital receipts, which do not constitute taxable income per se, cannot be taxed u/s 115JB of the Act

MAT and Ind AS:

- Lohia Committee report suggesting the framework for computation of MAT for Ind AS compliant companies in the year of adoption and thereafter

- Amendments to section 115JB by the Finance Act, 2017:
  - ✓ Adjustments which need to be considered every year while calculating book profit and treatment of certain items recognized in the Statement of P&L including Other Comprehensive Income - Section 115JB(2A);
  - ✓ Specific adjustments to be considered having regard to treatment on convergence date in the year of convergence to Ind AS - Section 115JB (2C); and
  - ✓ Adjustment in case of resulting companies in case of a demerger - Sec 115JB(2B)

- Circular No. 24/2017 dated 25 July 2017, addressing certain FAQ on significant issues arising from the implementation of MAT for Ind AS compliant companies

Thank You