

# ICDS



## SOME CRITICAL ASPECTS

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# INCOME COMPUTATION AND DISCLOSURE STANDARDS

(ICDS)



STANDARDS	DESCRIPTION <i>(relating to)</i>
ICDS - I	Accounting Policies
ICDS – II	Valuation of Inventories
ICDS – III	Construction Contracts
ICDS – IV	Revenue Recognition
ICDS – V	Tangible Fixed Assets
ICDS – VI	Effects of change in foreign exchange rates
ICDS – VII	Government Grants
ICDS – VIII	Securities
ICDS – IX	Borrowing Costs
ICDS – X	Provisions, Contingent Liabilities and Contingent Assets

# NEED FOR ICDS



1. Income tax read with the Rule itself is a standard
2. Charge and computation are integral part of levy : 128 ITR 294 SC
3. Both need to be provided by law [art 265] read with the rule
4. We have accordingly specific charging section and computation provisions for each head of income.
5. Wherever, valuation is necessary, rules have been framed.

# NEED FOR ICDS



1. These rules are tabled before both houses of Parliament
2. Merely by giving statutory sanction to ICDS, the above concept cannot be upset
3. Such sanction effectively amounts abdication of statutory powers.

# INTRODUCTION



1. Section 145(2) provides for issue of ICDS
2. In CTC's case, it is held that ICDS cannot override Act as well as judicial precedents
3. ICDS recognizes the first limitation whereas CBDT in circ 10/2017 does not recognize second limitation
4. The current amendments appear to accept CTC's verdict
5. Wherever inconsistencies [with law and judiciary] have been explicitly dealt with by current amendments, ICDS would prevail through amendment
6. In rest of the cases, the provisions of law and judicial precedents prevail over ICDS

# INTRODUCTION



1. Circulars cannot be used to introduce new tax provision in statute :  
Bharat V Patel 404 ITR 37 SC
2. A computation provision may fail to operate if the relevant income stays outside section 5 as held in Sedco Forex International [2017] 399 ITR 1 (SC).

# APPLICABILITY



1. Applies to all assesseees who follow mercantile system of accounting
2. Applies to even individual and HUF with turnover exceeding tax audit thresholds
3. One who follows cash for some incomes and mercantile for some other incomes, ICDS would apply only to the latter – ICAI GN para 7.6 and 7.7
4. Hybrid system of accounting : VTC Leasing & Finance Ltd [2010] 323 ITR 514 (Rajasthan),
5. ICDS v. Presumptive income under sec 44AD etc.
  - ICAI GN para 9
  - Circ 10 of 2017 [F&Q 3]

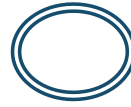


# CTC vs. UOI

[2017] 87 taxmann.com 92 (Delhi HC)



# GENERAL OBSERVATIONS



42. The above **legal proposition is well** settled and has been followed in a number of subsequent decisions. Therefore it is only a competent legislature that can make a validation law to override judicial precedents and that too by actually removing the defect pointed out by such precedent. Such a power is not available to the executive. **In other words, where there is a binding judicial precedent, by virtue of Articles 141 and 144 of the Constitution, it is not open to the executive to override it unless there is an amendment to the Act by way of a validation law.**

# GENERAL OBSERVATIONS



43. To that extent, Section 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, in the context of the Act, only by the Parliament and not by the executive. If Section 145 (2) of the Act 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.

Question (ii): Excessive delegation of legislative powers

44. The next, but related, aspect is the excessive delegation of legislative powers. The Court finds merit in the contention of the Petitioners that ICDS notified under Section 145 (2) of the Act has the effect of modifying the basis for computation of taxable income as recognised by the Act and as interpreted by the Supreme Court.

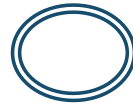
# CTC v. FA 2018

General Observations	CTC	FA 2018
Power u/s. 145 (2) cannot permit changing the basic principles of accounting that have been recognised in the various provisions of the Act.	38	
Changing the method of accounting for computation of taxable income, would partake of an essential legislative function.	38	
The notified ICDS seeks to alter the system of accounting, or taxing treatment to a particular transaction, then it will require the legislature to step in to amend the Act to incorporate such change. This may be unique to a fiscal statute like the Act.	39	

# CTC v. FA 2018

General Observations	CTC	FA 2018
In the guise of a delegated power, the Central Government cannot do what is otherwise legally impermissible.	39	

# ICDS ~ I ~ ACCOUNTING POLICIES



57. There is merit in the contention of the Petitioners that **ICDS-I does away with the concept of 'prudence' which is present in AS-1 notified under Section 145 (2) of the Act.** A negative provision has in fact been made in the ICDS by stating that prudence is not to be followed unless it is specified. In its counter-affidavit, in para 6.1 (v) **it is accepted by the CBDT** that the concept of prudence has been done away with and has been replaced by specific aspects of prudence at the relevant places in the ICDS on a case to case basis.

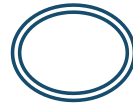
# ICDS IV ~ REVENUE RECOGNITION [PARAS 58, 77 TO 87]

Reasonable certainty	CTC	FA 2018
Provides for the concept of realizing revenue in respect of recognition of income	58	
In respect of interest income, royalty income and income from rendering of services other than the one specified above, there is no such concept of 'reasonable certainty of realising the revenue'.	58	
In response to the specific query in this regard, the CBDT has in Circular No. 10 of 2017, in answer to Question 13 stated that interest accrues on time basis and royalty accrues on the basis of contractual term and subsequent non-recovery can be claimed as deduction under Section 36(1)(vii).	58	
Therefore, it is not correct for the CBDT to contend that the concept of reasonable certainty of realizing the revenue has been retained in ICDS-IV	58	

# ICDS I ~ PRUDENCE [PARAS 53 TO 63]

	CTC	FA 2018
The further averment is that the concept of prudence has been retained in ICDS-X by allowing provision for further liability.	59	
This is contrary to what has been clarified in Circular No. 10 of 2017. ICDS-X allows recognition of provisions in respect of present liability arising out of a past event.	59	
It specifically prohibits recognition of costs or liability that needs to be incurred to operate in the future.	59	

# GENERAL OBSERVATIONS



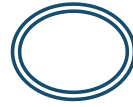
101. In order to preserve its constitutionality, Section 145 (2) of the Act as amended is required to and is hereby read down to restrict power of the Central Government to notify ICDS that do not seek to override binding judicial proceedings or provisions of the Act.



# CTC v. FA 2018

General Observations	CTC	FA 2018
<p>Section 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, in the context of the Act, only by the Parliament and not by the executive. If Section 145 (2) of the Act 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.</p>	102 (i)	
<p>The ICDS is not meant to overrule the provisions of the Act, the Rules thereunder and the judicial precedents applicable thereto as they stand.</p>	102 (ii)	

# POINTS



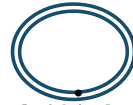
- In Para 101 & 102(i), High Court has struck down Section 145(2) read with ICDS itself.
- Unless ICDS is revisited, Section 145(2) is unworkable.

# FA AMENDMENTS AND CTC



- Amendments/new sections brought in by CTC seek to lend legitimacy to some aspects of ICDS
- However, even post amendments, there is excessive reliance on ICDS
- Nothing much has been done except creating a layer between sec 145(2) and ICDS by way of some sections
- The sin of excessive delegation and abdication of legislative functions remains

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- Finance Act 2018 brought in various provisions to give legitimacy to only some aspects of ICDS
- There are still some aspects which are not given legal sanction but which run contrary to law and judicial views
- These aspects are therefore unenforceable

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 1 [4(i)] : treatment and presentation shall be governed by substance and not merely by form
- GAAR in chapter X-A provides a statutory framework for substance over form
- Decisions relying form
  - ❑ Vodafone 341 ITR 1 SC
  - ❑ Mangalore Ganesh Beedi Works v. CIT 378 ITR 640 SC para 33
  - ❑ Gillanders Arbuthnot and Co. [1973] 87 ITR 407 (SC)
  - ❑ *Bhopal Sugar Industries Ltd. (1977) 40 STC 42 (SC)*
  - ❑ Gosalia Shipping P. Ltd. [1978] 113 ITR 307 SC
- In the absence of statutory recognition, the aforesaid mandate fails

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 1 (4)(ii), 36(1)(xviii) and 40A(13): Expected loss and MTM are to be allowed to the extent dealt with by ICDS
  - Expected loss v. Expenditure/anticipated expenditure
  - Provision for a liability [i.e. provision for expenses] is dealt with by ICDS 10 – No statutory sanction to ICDS 10 and hence not valid to the extent of inconsistency with law and judiciary
1. ICDS 10(9)/(10) bars recognition of contingent liability/asset
  2. Contra : BEML 245 ITR 428 SC at page 431 follows Metal Box 73 ITR 53 SC at page 64 provides that even a contingent liability/right may be considered provided its discounted present value is available.

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 1 (4)(ii), 36(1)(xviii) and 40A(13): Expected gain and MTM gain are also covered by the above bar : FAQ 8 in circular 10/2017
- Corollary : Expected gain and MTM gain to the extent covered by ICDS could be taxed
  1. Eg : Profits embedded in WIP in case of construction/service contract under proportionate completion method – ICDS 3/4
  2. Section 43CB statutorily recognizes taxing profits embedded
  3. This would offend section 5 [Sedco Forex 399 ITR 1 SC]
  4. ICDS 10(11) provides for recognition of contingent asset and related income when it becomes certain that inflow of economic benefit will arise – This mandate is not statutorily recognized and may also offend section 5 [even if by subsequently recognized by statute]

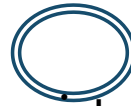
# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 2 [24] provides that in case of dissolution of a partnership firm or association of person or body of individuals, notwithstanding whether business is discontinued or not, the inventory on the date of dissolution shall be valued at the net realisable value
- It is contrary to section 145A(i) which mandates lower of actual cost or net realizable value
- It is also contrary to distinction existing between ALA Firm [1991] 189 ITR 285 (SC) & Shakthi Trading [2001] 250 ITR 871 (SC)



# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



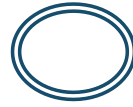
- ICDS 2 [5] : The costs of purchase shall consist of purchase price including duties and taxes, freight inwards and other expenditure directly attributable to the acquisition
  - Section 145A(i) : Valuation of inventory is made at lower of AC or NRV computed in accordance with ICDS
  - Section 145A(ii) : Valuation of purchase and sale of goods/services/inventory shall be adjusted to include the amount of any tax, duty, cess or fee to bring the goods/services to present location and condition
  - Inconsistency between ICDS 2(5) and section 145A(ii)
1. Inclusion twice over
  2. If ICDS is followed, duty would be included in AC before comparing with NRV
  3. If section 145A(ii) is followed, duty would be included in the value arrived by adopting lower of AC or NRV
  4. See Example

# 145A(ii)



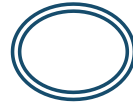
1. Sec 145A(ii) deals with valuation of purchase and sale of goods or services and of inventory
2. There is no reference to ICDS in sec 145A(ii)
3. In so far as inventory referred in clause (ii) is concerned, it acts an addendum to sec 145A(i) – further adjusted v. adjusted
4. In so far ‘services’ including construction referred in clause (ii) is concerned, it acts an addendum to sec 43CB

# 145A(II)



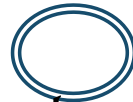
1. In so far purchase and sale of goods referred in clause (ii) is concerned, there is no specific reference to any section legislatively sanctifying the ICDS
2. In such case, the general mandate of ICDS -4 issued under sec 145(2) would apply only to the extent of no provision or judicial pronouncement providing to the contrary

# ICDS ~ 2



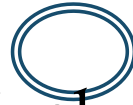
1. Para 2(1)(a) defines inventories as ‘assets’ and makes a reference only to production and not to manufacture
2. Para 2(2) – general mandate for valuation of inventories at lower of cost or NRV

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 3 and 4 : mandate percentage completion method in respect of construction contract and service contract
- This mandate to the extent it seeks to tax any income ahead of its legal accrual offends section 5
- Percentage completion method can either coincide with accrual or may defer the tax by following cash system
- If such method has the effect of taxing the income ahead of its legal accrual, the same falls foul particularly when forced upon the assessee [Sedco Forex 399 ITR 1 SC]

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 3 and 4 – though legislatively sanctified by Section 43CB still fall foul of section 5, if it is sought to tax income ahead of its accrual
- Eg : Embedded profits in WIP

## SECTION 43CB(1) ~ NEWLY INSERTED

- The profits and gains arising from a construction contract or a contract for providing services
- shall be determined on the basis of percentage of completion method
- in accordance with the ICDS notified under section 145 (2)

# SECTION 43CB(1) – NEWLY INSERTED



- Provided that profits and gains arising from a contract for providing services,—
  - (i) with duration of not more than *90 days* shall be determined on the basis of *project completion method*;
  - (ii) involving *indeterminate number of acts over a specific period* of time shall be determined on the basis of *straight line method*.



# SECTION 43CB(2)



## Sub-Section (2):

- For the purposes of percentage of completion method, project completion method or straight line method referred to in sub-section (1)—
  - (i) the contract revenue **shall include retention money**;
  - (ii) the contract costs shall not be reduced by any incidental income in the nature of interest, dividends or capital gains.”.

# ICDS 3(10)(A) – RETENTIONS

	CTC	FA 2018
The retention money does not accrue to an Assessee until and unless the defect liability period is over and the Engineer-in-Charge certifies that no liability is attached to the Assessee.	71	<ul style="list-style-type: none"><li>• Sec 43CB (2) (i) ~ contract revenue shall include retention money</li><li>• Offends section 5 [Sedco 399 ITR 1 SC]</li></ul>

Circ 10/2017 FAQ 11 : Clarifying that retention would be included on the basis of reasonable certainty of ultimate collection is of no avail, if retention has not accrued in terms of contract terms

# SECTION 43CB(2) (I)



- Sec 43CB(2) (i) provides that contract revenue will include retention money
  1. ICDS 3 para 2(1)(d) defines retention money
  2. ICDS 3 para 10(a) provides for inclusion of the same
  3. However, ICDS 3 para 9 read with Circ 10 of 2017 [FAQ 11] provides for recognition when there is reasonable certainty of its ultimate collection. This aspect is not built into sec 43CB(2) (i).
  4. Retention money v. section 5 and precedent caselaws
  5. Sec 43CB v. Reasonable certainty v. Sec 5 - Sedco 399 ITR 1 (SC)
- Under Para 74, HC states that Para 10 of ICDS does not specify at what stage retention money would be treated as ‘contract revenue’
- Even the amended provision does not provide for the same.

## SECTION 43CB(2) (I)

- Sec 43CB(2)(ii) provides that contract costs shall not be reduced by incidental income in the nature of interest, dividends and capital gains
  1. It is very rare for a contractor to have such incidental income
  2. It is usually the contractee who would have such income : Bokaro Steel 236 ITR 315 SC
  3. Therefore, Bokaro principle is untouched
  4. Contractor earning interest on temporary deposit of mobilization advance
    - When not forming part of WIP – revenue neutral
    - When forming part of WIP – impacts profit but revenue neutral over the years

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- Sec 43CB(1) mandates percentage completion method for construction and service contract
  1. Construction contract – ICDS 3 para 16
  2. Service contract – ICDS 4 para 6
- Proviso to sec 43CB(1) creates an exception to service contracts
- Contract with duration of not more than 90 days – project completion method [ICDS 4 para 7 provides for recognition on completion or **substantial completion**]
- ICDS 4 to the extent of suggesting ‘substantial completion’ is contrary to proviso to sec 43CB
- ICDS 4 uses ‘may be’ whereas proviso to sec 43CB(1) uses ‘shall be’

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4 [8(1),(2), (3) & (9)]

(1) Subject to sub paragraph (2), interest shall accrue on the time basis determined by the amount outstanding and the rate applicable.

(2) 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

(3) Discount or premium on debt securities held is treated as though it were accruing over the period to maturity

9. Royalties shall accrue in accordance with the terms of the relevant agreement and shall be recognised on that basis unless, having regard to the substance of the transaction, it is more appropriate to recognise revenue on some other systematic and rational basis

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4 [8(1),(2), (3) & (9)] do not recognize ‘reasonable certainty of its ultimate collection’
- Circ 10 of 2017 FAQ 13 confirms this
- **Excel Industries Ltd. [2013] 358 ITR 295 SC has recognised real income concept with reference to export incentive**
- Legal accrual under section 5 – tempered by Reasonable certainty [accounting concept approved by judicial doctrines]
- The above paragraphs therefore offend section 5 as tempered above

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- Further, the above paragraphs creates discrimination between sale of goods/services v. interest
- ICDS 4 – No statutory amendment to sanctify the infirmities pointed in CTC on prudence in para Para 57 and 102(iv)
- Therefore, ICDS 4 is not effective to the extent quashed by CTC



# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4(8)(1) – interest shall accrue on the time basis determined by the amount outstanding and the rate applicable
- CTC does not quash ICDS 4(8)(1) : see para 84 to 87 and 102 (x) on the grounds
  1. No challenge to second proviso to section 36(1)(vii)
  2. ICDS 4(8)(1) read with aforesaid proviso helps tracking accrual and its write off
  3. Background : HUDCO 396 ITR 667 Delhi
- ICDS 4(8)(1) to the extent it seeks to tax income ahead of its accrual falls foul of section 5
- ICDS 4(8)(1) which mandates the offer to tax of interest merely on its legal accrual which is doubtful of recovery falls foul of ‘prudence’ – Para 57 and 102(iv)

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4(8)(1) deals only with recognition of interest income and second proviso deals with any income
- Second proviso does not validate income recognition norm of ICDS but only provides for an eventuality where such norm is applied.
- In other words, it deals with a situation of income recognition norm which is otherwise valid.
- The correctness of such norm has to be tested independently
- By the logic of second proviso, all situations of ICDS recognizing income ahead of its accrual cannot be validated [eg: embedded profits in WIP]

# ICDS 4(8)(1)



- No statutory amendment to sanctify ICDS 4(8)(1) probably on the basis that the same was upheld in CTC
- HUDCO 396 ITR 667 Delhi
  1. Dealt with revenue derecognition by HUDCO on the basis of NHB directives
  2. Dismisses the claim of HUDCO on the basis that NHB directives cannot be read into section 43D read with Rule 6EB
  3. Distinguishes Vasisth Chay Vyapar 330 ITR 440 Del on the basis that the same related to income recognition and not with write off.
  4. While holding so, ignores that sec 43D dealt with revenue recognition and not provisioning
  5. Civil appeal in case of Vasisth Chay Vyapar was dismissed [civil appeal No.5802 of 2012 dismissed *TS-619-SC-2017*]

# ICDS 4(8)(1)



7. Southern Technologies 320 ITR 577 SC clearly distinguishes provisioning and income recognition

8. *CIT Vs Bijapur District Central Co Bank* [2018-TIOL-449-SC-IT](#) **SLP**

9. *Ludhiana Central Co-op bank* 410 ITR 72 P&H : see para 8

- Para 22 : while anticipated loss is considered, anticipated gain is not considered.
- Para 25 to 27 : applies Southern Technologies as applicable only to provisioning of bad debts and not for income accrual. Understands Southern Technologies as holding that RBI norms are mandatory for income recognition.
- Para 30 and 31: distinguishes section 43D

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4(8)[3] which treats discount or premium as accruing over the period to maturity seeks to regard discount or premium on revenue account.
- This is contrary to section 45 read with sections 2(14)/48/55
- This is contrary to **Madhya Pradesh Financial Corpn 132 ITR 884 (MP), JCT LTD 2012-TIOL-728-HC-KOL**
- Zero coupon bonds – 2(47)(iva), 2(48), First Proviso to 2(42A), 36(1)(iiia), Rules 8B & 8C
- DDB [Circ 2 of 2002]
- ICDS 4(8)(3) is not statutorily recognised

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4[5] provides that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for escalation of price and export incentives, revenue recognition in respect of such claim shall be postponed to the extent of uncertainty involved
- Section 145B(2) provides that any claim for escalation of price and export incentives, shall be deemed to be income in the previous year in which reasonable certainty of the realisation is achieved
- Accrual v. reasonable certainty
- Both ICDS 4(5) as well as sec 145B(2) offend section 5 in all cases of reasonable certainty not backed up by legal accrual

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 4[8](2) 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
- This is contrary to section 5 which provides for inclusion of income upon its accrual
- Choice to offer the same on cash basis is available only to the assessee upon his following cash system of accounting under sec 145(1)

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 8 [8] provides that *where unpaid interest has accrued before the acquisition of an interest-bearing security and is included in the price paid for the security, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion of the interest is deducted from the actual cost*
- The above is contrary to Vijaya Bank v. Addl. CIT [1991] 187 ITR 541 (SC)
- This has two components – income component and actual cost component for valuation of inventory



# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- To the extent it relates to income component, it is contrary to above decision
- To the extent it relates to valuation of inventory, it is covered by section 145A(iii) / (iv)
- It creates a mismatch between buyer holding securities as inventory and seller holding same as capital asset
- See example

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



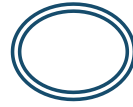
- ICDS 6 [5(i) & (ii)] reads as follows;
  - (i) In respect of monetary items, exchange differences arising on the settlement thereof or on conversion thereof at last day of the previous year shall be recognised as income or as expense in that previous year.
  - (ii) In respect of non-monetary items, exchange differences arising on conversion thereof at the last day of the previous year shall not be recognised as income or as expense in that previous year.
- Section 43AA provides that gain or loss arising on account of any change in forex rate shall be treated as income or loss, as the case may be, and such gain or loss shall be computed in accordance with ICDS
- The limited mandate for ICDS is only to compute gain or loss and not to decide whether such gain or loss should be recognized or not.

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- Similarly, ICDS 6 bars MTM in case of forward contracts for trading, speculative, firm commitment and highly probable forecast. Sec 43AA has not conferred such power on CBDT
- ICDS 6 being contrary to settled legal principle is open to attack
- Tuticorn Alkaly 227 ITR 172 SC : A standard cannot determine the allowability or otherwise of an expenditure/loss

# SECTION 43AA(1) ~ NEWLY INSERTED



- 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, as the case may be, and
- Such gain or loss shall be computed in accordance with the ICDS notified under section 145 (2)

## SECTION 43AA(2) ~ NEWLY INSERTED

- 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

# ANALYSIS



Section 43AA(2)	ICDS 6
monetary items and non-monetary items;	treatment of transactions in foreign currencies [para 1(a)]
translation of financial statements of foreign operations;	translating the financial statements of foreign operations [para 1(b)]
forward exchange contracts;	treatment of foreign currency transactions in the nature of forward exchange contracts [para 1(c)]
foreign currency translation reserves	Not dealt with

# 43AA

1. Overreach of computation provision over charge : A computation provision may fail to operate if the relevant income stays outside section 5 as held in Sedco Forex International [2017] 399 ITR 1 (SC).
2. Section 43AA uses 'gain or loss arising on account of change in forex rate' – meaning of 'arise' with reference to section 5 and Balbir Singh Maini 398 ITR 531 SC
3. Section 43AA provides for forex gain or loss to be treated as income or loss and further provides that such gain or loss is to be computed as per ICDS
4. ICDS VI deals with not only computation but also treatment as income or loss

# 43AA



1. For example, para 4 deals with computation of gain or loss whereas para 3 deals with initial recognition and para 5 deals with recognition of exchange differences.
2. As sec 43AA does not refer to ICDS in so far as recognition is concerned, it is possible to take a view that recognition may be made as per applicable Accounting Standards and Swadeshi Cotton Mills 116 ITR 1 SC and Woodward Governor 312 ITR 254 SC
3. Sec 43AA does not deal with premium and discount which are dealt with ICDS. Therefore, the amortization mandated by ICDS may not have statutory recognition.



# 43AA



1. Sec 43AA(2) provides that gain or loss arising on account of effects of change in forex rates shall be in respect of all foreign currency transactions including;
  - Monetary and non monetary items – ICDS VI para 5
  - Translations of financial statements of foreign operations – ICDS VI para 7
  - Forward exchange contracts – ICDS VI para 8
  - Foreign currency translation reserves – not dealt with by ICDS
2. Sec 43AA quashes circ 3 of 2010 on MTM
3. Sec 43AA quashes rule 10TA(j)/(k) dealing with safe harbor rule which provides that forex gain is not operating income

# ICDS 6



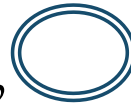
1. Para 2(k) defines monetary items as money held and assets to be received or liabilities to be paid in fixed or determinable sums of money.
2. Loans taken for locally bought assets/working capital etc., would be monetary items
3. Para 4(a) provides for restatement of monetary items by applying the closing rate
4. Para 5(i) provides that exchange difference arising on settlement or on conversion as on last day is recognized as income or expense
5. Loans taken for imported assets though monetary would be governed by sec 43A [para 6 which makes ICDS 6 subject to sec 43A and Rule 115]

# ICDS 6



1. Para 2(1)(l) defines non monetary items as other than monetary items.
2. Para 5(ii) provides that exchange difference arising on conversion as on last day is not to be recognized as income or expense
3. Only exception is when inventory expressed in forex is stated at NRV
4. Para 5(ii) is disabling and deals with conversion gain/loss. It does not deal with gain/loss on settlement

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 11 [2(1)(a) defines ‘borrowing costs’

“**Borrowing costs**” are interest and other costs incurred by a person in connection with the borrowing of funds and include:

(i) commitment charges on borrowings;

***(ii) amortised amount of discounts or premiums relating to borrowings;***

(iii) amortised amount of ancillary costs incurred in connection with the arrangement of borrowings;

***(iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements.***

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- *Amortised amount of discounts or premiums relating to borrowings;*
- **The above would be contrary to the concept that there is either capital expenditure or revenue expenditure and ‘deferred revenue expenditure’ is alien to tax law but could be adopted at the choice of the assessee;**
- ❖ **Taparia Tools Ltd Vs JCIT 2015-TIOL-25-SC** : liability to pay the interest upfront can also be claimed upfront and cannot be forced for spreading over a period of five years
- ❖ **Manipal Health Systems 65 ITR SN 50 Delhi** : once revenue, entire amount has to be allowed
- ❖ **Banyan Networks P. Ltd. v. ACIT 233 Taxman 245 Madras** : Madras Investment Corporation does apply only to discount.
- ❖ **CIT Vs M/s Vodafone Essar South Ltd 2014-TIOL-2045-HC-DEL** : Deferral is the choice for the assessee and not for revenue
- ❖ *Madras Industrial Investment Corporation Vs. Commissioner of Income Tax, 225 ITR 802 (SC)*

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ***finance charges in respect of assets acquired under finance leases or under other similar arrangements;***
- The above would be contrary to the concept that under IT Act, there is no distinction between finance lease and operating lease;
- ❖ CBDT circular dated February 9, 2001 : treatment of Finance lease under AS-19 will have no implications on the income-tax provisions and in all the leasing transactions the owner would only be entitled to depreciation
- ❖ lease charges paid for use of asset without acquiring any ownership rights would be allowable as revenue expenditure u/s 37 **[TS-567-ITAT-2015(DEL)]**
- ❖ *Asea Brown Boveri Ltd vs. IFCI (2004) 12 SCC 570 v. ICDS 350 ITR 527 SC*

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- **ICDS 9 [2(1)(2), 3 and 4] provides for capitalisation of interest in case of certain inventories**

(b) **“Qualifying asset”** means:

(i) land, building, machinery, plant or furniture, being tangible assets;

(ii) know-how, patents, copyrights, trade marks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;

(iii) inventories that require a period of twelve months or more to bring them to a saleable condition.

3. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation shall be determined in accordance with this Income Computation and Disclosure Standard. Other borrowing costs shall be recognised in accordance with the provisions of the Act.

4. For the purposes of this Income Computation and Disclosure Standard, “capitalisation” in the context of inventory referred to in item (iii) of clause (b) of sub-paragraph (1) of paragraph 2 means addition of borrowing cost to the cost of inventory.

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- **Section 145A (i) provides that valuation of inventory shall be made at lower of actual cost or net realisable value computed in accordance with ICDS**
- **ICDS 2(11) provides that interest and other borrowing costs shall not be included in the costs of inventories, unless they meet the criteria for recognition of interest as a component of the cost as specified in the ICDS on borrowing costs**
- **ICDS 9 [2(1),(2), 3 and 4] is vulnerable to attack although ICDS 2(11) is sanctified by 145A(i)**
  1. **Section 36(1)(iii) specifically allows interest cost**
  2. **Section 43B (e) allows any sum payable by the assessee as interest on loan from a scheduled bank or co-op bank and section 43B overrides entire IT Act [Modipon Ltd, 400 ITR 1 SC]**
  3. **By inventorising borrowing cost, ICDS 2 and 11 are negating the mandate of Section 36(1)(iii) and section 43B**



# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- **ICDS 9 [2(1)(a)] defines borrowing cost as**

“**Borrowing costs**” are interest and other costs incurred by a person in connection with the borrowing of funds and include:

- (i) commitment charges on borrowings;
  - (ii) amortised amount of discounts or premiums relating to borrowings;
  - (iii) amortised amount of ancillary costs incurred in connection with the arrangement of borrowings;
  - (iv) finance charges in respect of assets acquired under finance leases or under other similar arrangements.
- Interest is defined in section 2(28A) as interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- **ICDS 9 [2(1)(a)] defining borrowing cost beyond section 2(28A) may be ultra virus the Act**
- ICDS 9 [6] deals with capitalization of borrowing costs pertaining to general borrowings.
- The proviso to section 36(1)(iii) states that *“amount of the interest paid, in respect of capital borrowed for acquisition of an asset (whether capitalised in the books of account or not); for any period beginning from the date on which the capital was borrowed **for acquisition of the asset** till the date on which such asset was first put to use, shall not be allowed as deduction”*.
- The proviso to section 36(1)(iii) deals with case of specific borrowing and not general borrowing.
- Therefore, paragraph 6 being contrary to section 36(1)(iii) is to be ignored.

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 5[5] provides that the actual cost of an acquired tangible fixed asset shall comprise its purchase price, import duties and other taxes, **excluding those subsequently recoverable**, and any directly attributable expenditure on making the asset ready for its intended use. Any trade discounts and rebates shall be deducted in arriving at the actual cost
- Explanation 9 to section 43(1) provides for exclusion of only cenvat credit and not to GST/VAT credit
- Section 16(3) of CGST Act bars input credit of GST if depreciation is claimed on asset value including GST
- Therefore, ICDS 5(5) to the extent going beyond Explanation 9 is ultra virus the Act.

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 5[8] provides that expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, shall be capitalised
- Circular 10/2017 [FAQ 15] states that expense incurred after test run and experimental production but before commencement of commercial production is required to be capitalised
- Expenditure on test runs and experimental production cannot form part of actual cost as per section 43(1) read with Explanations
- Only interest prior to date of putting the asset to use is covered by Section 36(1)(iii) Proviso

# ICDS MANDATE CONTRARY TO LAW AND JUDICIARY



- ICDS 5[11] provides that when a tangible fixed asset is acquired in exchange for shares or other securities, the fair value of the tangible fixed asset so acquired shall be its actual cost
- Consider a case where a machinery is acquired in consideration for issue of 1L shares of Rs.10 each at par
- The cost should be Rs.10L
- If the fair value is more or less than Rs.10L, as per ICDS only fair value should be taken.
- This may be contrary to section 43(1)

SECTION 36 (1) (xviii) & 40A (13) ~  
NEWLY INSERTED

**Marked to Market Loss**  
**Or**  
**Other expected loss**

# CTC vs. UOI (supra)



61. The Petitioners rightly point out that cases not governed by any specific ICDS are to be governed by ICDS-I. **CBDT has in ICDS I notified that expected losses and marked-to-market losses are not to be recognized/allowed.** It is rightly pointed out by the Petitioners that 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.** The concept of prudence is inherent in this.

## CTC vs. UOI (supra)

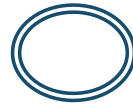


89. .... Consequently, the loans have to be valued at the closing rate thereby giving rise to foreign exchange gain/loss irrespective of the fact that such loan has been taken for capital purposes. ICDS VI is therefore contrary to the decision in Sulej Cotton Mills Ltd. (supra).

90. 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 Supreme Court in Sulej Cotton Mills Ltd. (supra), insofar as it relates to marked to market loss arising out of forward exchange contracts held for trading or speculation purposes.



# SUMMARY OF FINDINGS



102. The findings in this judgment may be summarised thus:

(xi) ICDS-VI which states that marked to market loss/gain in case of foreign currency derivatives held for trading or speculation purposes are not to be allowed, is not in consonance with the ratio laid down by the Supreme Court in Sulej Cotton Mills Ltd. (supra), *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 as such.*

# ICDS I ~ PRUDENCE [PARAS 53 TO 63]

	CTC	FA 2018
ICDS I has done away with concept of 'Prudence' which is present in AS-1 as stood notified u/s 145 (2).	57	Indirectly dealt in sec 36(1)(xviii) r.w.s 40A(13)
In counter-affidavit, in para 6.1 (v) it is accepted by the CBDT that the concept of prudence has been done away with and has been replaced by specific aspects of prudence at the relevant places in the ICDS on a case to case basis.	57	..do..

## CTC

## FA 2018

CBDT has in ICDS I notified that expected losses and marked-to-market losses are not to be recognized/ allowed.

61

a. MTM and expected loss as per sec 36(1)(xviii)/40A(13)

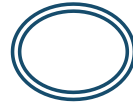
It is rightly pointed out by the Petitioners that the concept of prudence is embedded in Section 37 (1) of the Act which allows deduction in respect of expenses "laid out" or "expended" for the purpose of business. The concept of prudence is inherent in this.

b. Foreign currency transactions are dealt with by 43AA read with ICDS VI

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.

102  
(iv)

# SECTION 36(1)(xviii) ~ DEDUCTION ~ MTM LOSSES



- marked to market loss or other expected loss
- as computed in accordance with the ICDS notified under section 145(2)

# SECTION 40A (13) ~ NO DEDUCTION ~ MTM LOSSES



- No deduction or allowance shall be allowed
- in respect of any marked to market loss or other expected loss,
- except as allowable under 36 (1) (xviii)

# 36(1)(xviii), 40A(13) AND ICDS 1(4)



- ICDS 1(4) reads as follows :

Accounting policies adopted by a person shall be such so as to represent a true and fair view of the state of affairs and income of the business, profession or vocation. For this purpose,

- (i) the treatment and presentation of transactions and events shall be governed by their substance and not merely by the legal form; and
- (ii) 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 Income Computation and Disclosure Standard.

- Section 36(1)(xviii) allows MTM/EL as computed as per ICDS
- Section 36(1)(xviii) delegates only the computation of MTM/EL whereas ICDS 1(4) goes a step ahead to state that MTM/EL shall not be recognized.

# 36(1)(xviii), 40A(13) AND ICDS 1(4)



- Either Section 36(1)(xviii) is prone to attack on excessive delegation
- Or ICDS 1(4) exceeds brief of section 36(1)(xviii)

# 36(1)(xviii), 40A(13)



1. MTM loss and expected loss to be allowed under sec 36(1)(xviii) only as per ICDS
2. Being losses, these could have been otherwise claimed under sec 28
3. Section 37(1) bar does not apply to losses
4. Therefore, sec 40A(13) is enacted to bar allowance of MTM and expected loss except as allowed by sec 36(1)(xviii)
5. There is a risk of sec 40A(13) denying deduction under sec 36(1)(viiia)



# 36(1)(xviii), 40A(13)



1. Expected loss is not the same as provision for expenditure incurred or laid out
2. MTM gain or loss on forex is dealt with by sec 43AA. There is an overlap to that extent between sec 36(1)(xviii) and sec 43AA
3. MTM loss or gain is dealt with by ICDS as follows;
  - On inventories : ICDS 2
  - On forex : ICDS 6
  - On securities : ICDS 8
4. CTC however says MTM and expected loss are part of concept of prudence embedded in 'laid out' used in sec 37(1). This finding appears incorrect if 'laid out' is understood as per Calcutta Co. 37 ITR 1 SC.

# 36(1)(xviii), 40A(13)



1. ICDS 1[4(ii)] deals with MTM and Expected loss
2. Expected loss v. laid out
3. ICDS 10[6] provides that no provision shall be recognized for costs that need to be incurred to operate in future
4. ICDS 10[4(1)(a)] : provision is a liability which can be measured only by substantial degree of estimation
5. ICDS 10[4(1)(b)] : liability means present obligation from past events...
6. ICDS 10[7] : obligation from past events existing independent of future conduct of business alone is recognized as provision

# 36(1)(xviii), 40A(13)



- ICDS 10 v. Calcutta Discount 37 ITR 1 SC
  1. Liability v. obligation v. laid out
  2. Rotork Control 314 ITR 62 SC
  3. Warranty provision v. provision for estimated cost to be incurred
  4. Section 37(1) uses both expended and laid out

# ICDS 3 [PARA 11]



- Contract revenue recognized but written off as uncollectible to be treated as expense and not adjusted in contract revenue
- Expense v. loss
  1. Quereshi 287 ITR 547 SC
  2. Woodward Governor 312 ITR 254 SC
- Does contractor have choice of expense write off in para 11 OR sec 36(1)(vii)
- Subsequent recovery : section 41(1) and section 41(4)

# ICDS 3 [APPLICABILITY]



- Para 1 makes this ICDS applicable to construction contract of **a contractor**
- Para 2(1)(a) defines “**Construction contract**” as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes :
  - (i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;
  - (ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.
- Does an architect or a legal advisor come under ICDS 3
- Significance of use of word ‘**contractor**’ in para 1
- If not covered in ICDS 3, he is covered by ICDS 4. Para 6 of ICDS 4 incorporates ICDS 3

# ICDS 3 [APPLICABILITY]



- Whether a real estate developer is covered by ICDS 3?
- No as per FAQ 12 of circular 10 of 2017

# ICDS 4



- Para 2(1)(a) defines revenue as the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of a person from the sale of goods, from the rendering of services, or from the use by others of the person's resources yielding interest, royalties or dividends. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
- Does it recognize barter?

# ICDS 4



- Decisions holding barter is not sale

Motors and General Stores (Pvt.) Ltd. (1967) 66 ITR 692 (SC)

**SAIL v. ACCT** [1996] 41 KLJ 322 Kar

**Indian Steel & Wire Products Ltd. v. State of Madras** [1968] 21 STC 138 [SC]' AIR 1968 SC 478

**Sumer Corporation 102 VST 251 Bby: where the consideration is in the form of developmental right which has a marketable value, it is a case of benefit capable of being computed in terms of money and hence a sale.**

**Vaswani Estates Developers 89 KLJ 1 KAT : Paras 19,20,28,25 and 15 : JDA for non monetary consideration is a barter not exigible to tax.**

- Decisions holding barter is sale

Orient Trading Co Ltd v. CIT 224 ITR 371(SC)

Bombay Burmah Trading 161 ITR 386 SC

Dhampur Sugar Limited v. Commissioner of Trade Tax, Uttar Pradesh (2006) 61 KLJ 130 (SC)



# ICDS 4 : SALE OF GOODS



- Para 2(1)(a) – Agency : Revenue is only commission and not gross inflow
- Para 3(4) – Reasonable certainty is a factor to be considered
- Para 3(5) – Provides for postponement of recognition to the extent of uncertainty

SECTION 145B  
NEWLY INSERTED

**Taxability of certain income**

W.R.E.F. 01.04.2017  
(M – 18 & 19 ; N – C45)

# ICDS IV ~ REVENUE RECOGNITION [PARAS 58, 77 TO 87]

Export Incentive ~ Reasonable certainty	CTC	FA 2018
Para 5 of ICDS-IV requires an Assessee to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection.	80	Sec. 145B (2) ~ shall be deemed to be income of the PY in which reasonable certainty of its realization is achieved
In Excel Industries (SC), it is only in the year in which the claim is accepted by the Government that a right to receive the payment accrues in favour of the Assessee.	80	
Para 5 of ICDS-IV is not inconsistent with the law explained by the SC	80	

# ICDS VII ~ GOVERNMENT GRANTS [PARAS 92 & 93]

	CTC	FA 2018
ICDS-VII requires that amount has to be taxed in the year of receipt.	93	Section 145B
This again is contrary to and in conflict with the accrual system of accounting.		(3) r.w.s 2 (24) (xviii)

## SECTION 145B (1)



- Notwithstanding anything to the contrary contained in section 145,
- the interest received by an assessee on any compensation or on enhanced compensation, as the case may be,
- shall be deemed to be the income of the previous year in which it is received

## SECTION 145B (2)



- Any claim for escalation of price in a contract or
- export incentives
- shall be deemed to be
- the income of the previous year in which
- reasonable certainty of its realisation is achieved.

## SECTION 145B (3)



- The income referred to in Section 2(24) (xviii)
- shall be deemed
- to be the income of the previous year in which it is received,
- if not charged to income-tax in any earlier previous year.

# 145B(1)



1. Taxation of interest received by an assessee on compensation or on enhanced compensation dealt with by erstwhile section 145A(b) is now moved to section 145B(1) with the same language
2. However, section 57(iv) which gives 50% deduction refers to 56(2)(viii) which in turn continues to refer to erstwhile sec 145A(b).



# 145B(2)



1. Section 145B(2) inserted by Finance Act, 2018 provides that any claim for escalation of price in a contract or export incentives shall be deemed to be the income of the previous year in which reasonable certainty of its realization is achieved.
2. The mercantile system of accounting recognized in Section 145(1) considers 'reasonable certainty of realisation' as a pre-requisite factor.
3. Understood thus, there is no difference between the mandate of section 145B(2) and mercantile system of accounting adopted under section 145(1).
4. A question may arise as to whether section 145B(2) dispenses with cash system of accounting.
5. The answer may be no for the reason that section 145B(2) does not use the phrase 'notwithstanding anything to the contrary contained in section 145' unlike section 145B(1).

# 145B(3)



1. Section 145B(3) provides that income referred to in section 2(24)(xviii) shall be deemed to be the income of the previous year in which it is received, if not charged to income-tax in any earlier previous year.
2. Section 2(24)(xviii) deems as income any assistance in the form of subsidy, grant, cash incentive, duty drawback, waiver, concession or reimbursement by whatever name called with some exceptions.
3. One may notice some overlap between sub-sections 145B(2) and (3) in respect of export incentives.
4. A possible reconciliation is to consider the export incentives specifically named in section 2(24)(xviii) as falling under section 145B(3) and the rest of the export incentives as falling under section 145B(2).

# 145B(3)



1. Section 145B(3) deems incomes referred to in section 2(24)(xviii) to be income of the previous year of receipt, if the same was not charged to tax in any earlier previous year.
2. Section 145B(3) neither interferes with the method of accounting nor mandates cash basis of accounting.
3. If an assessee follows accrual system of accounting and recognizes the said income in any previous year, section 145B(3) is not applicable to him.
4. In case such assessee, despite following accrual system of accounting, omits to account and offer such income to tax in the year of accrual, section 145B(3) provides for taxing the same in the year of receipt.
5. By so providing, section 145B(3) obviates disturbing the assessment of earlier previous year. If an assessee follows cash system of accounting, section 145B(3) coincides with the cash system of accounting.

# Thank you



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