



Delhi High Court strikes down several ICDS provisions

Background:

Section 145 of the Income-tax Act, 1961 ('the Act') gives the power to the Central Government to notify Income Computation and Disclosure Standards ('ICDS') to be followed by specified class of taxpayers or in respect of specified class of income. After several rounds of public consultation, the Central Government, in September 2016, notified ten ICDS¹ (effective from financial year 2016-17) for compliance by taxpayers following mercantile system of accounting for the purposes of computation of income chargeable to income tax under the head "Profits and gains of business or profession" or "Income from other sources". The Central Board of Direct Taxes ('CBDT') had also issued a Circular² clarifying various aspects of ICDS.

While the object of ICDS was to standardize accounting alternatives so that taxable income could be computed precisely and objectively, concerns were expressed that deviations/carve outs in ICDS went beyond their stated objective and led to accelerated recognition of income or deferment of expenditure/loss for tax purposes in certain cases. The potential for varied interpretations of ICDS leading to uncertainty and increased litigation was also highlighted.

A writ petition was filed in the Delhi High Court by the Chamber of Tax Consultants challenging the validity of certain ICDS provisions. In an important and far-reaching decision, the Court struck down several ICDS provisions as being *ultra vires* the Act.

A summary of the decision is given below:

Summary:

The High Court held that although section 145 empowered the Central Government (as a delegate of the legislature) to notify standards for income computation, the Central Government could not, in the exercise of such powers, override judicial precedents or statutory

¹ Notification no 87 dated 29 September 2016 [S.O.3079(E)]

² Circular no 10 dated 23rd March 2017



provisions as the power to do so vests only with Parliament. The High Court went on to hold that section 145 had to be read down to restrict the power of the Central Government to notify only such ICDS that do not seek to override the binding judicial precedents or the income-tax provisions.

A summary of the relevant provisions of ICDS that were challenged, and the conclusions of the High Court thereon is set out below:

ICDS	Legal principle laid down by the Courts	Treatment as per ICDS	High Court Ruling
I – Accounting Policies	<p>The concept of ‘<i>prudence</i>’ was upheld in various decisions³ which, inter-alia, held that:</p> <ul style="list-style-type: none"> Expected/ foreseeable losses should be allowed as a deduction Revenues to be recognised only when there is reasonable certainty of realising the same 	The ICDS purported to do away with the concept of <i>prudence</i> , which was made applicable only on a case to case basis.	<p>The High Court upheld the Petitioner’s contention that non-acceptance of concept of <i>prudence</i> in ICDS I is <i>per se</i> contrary to the provisions of the Act and cannot be countenanced.</p> <p>Accordingly, ICDS I was held to be unsustainable in law</p>
II – Valuation of Inventories	The Supreme Court in the case of <i>Shakti Trading Co vs CIT</i> [2001] (250 ITR 871) had held that if the business was not discontinued, stock in trade could be valued at cost or market value, whichever is lower.	Under the ICDS II, stock in trade is required to be valued at market price irrespective of whether the business is discontinued or not.	<p>The High Court held that inventory should be valued as per the method of accounting regularly employed by the assessee as laid down in section 145A of the Act. While doing so, the High Court also held that section 145A (which begins with non-obstante clause) will override the ICDS provisions.</p> <p>Accordingly, ICDS II was held to be ultra vires the Act</p>
III – Construction Contracts (<i>Retention money issue</i>)	Various Courts ⁴ have held that the “retention money” does not accrue to an assessee and hence should not be liable to tax until and unless the defect liability period is over.	The ICDS stated that the retention money would be a part of the contract and the same would be assessed to tax based on ‘proportionate computation’ method.	The High Court held that retention money is liable to tax only when the same has “accrued” to the assessee. The Court held that the treatment to retention money will have to be determined on a case to case

³ *CIT vs Triveni Engineering & Industries Ltd* [2011] (336 ITR 374) (Del); *CIT vs Advance Construction Co Pvt. Ltd* [2005] (275 ITR 30) (Guj)

⁴ *CIT v. Simplex Concrete Piles India (P) Ltd* [1988] (179 ITR 8) (Cal); *CIT vs P&C Constructions* [2009] (318 ITR 113) (Mad); *Amarshiv Construction Pvt Ltd vs DCIT* [2014] (367 ITR 659) (Guj)



ICDS	Legal principle laid down by the Courts	Treatment as per ICDS	High Court Ruling
			basis by applying the settled principles of accrual of income. Interpreting ICDS III in a manner that seeks to tax retention money (the receipt of which is uncertain and conditional) at the earliest possible stage is contrary to the settled position in law. Para 10(a) of ICDS III was held <i>ultra vires</i> the Act.
III – Construction Contracts (<i>Incidental income issue</i>)	The Supreme Court in the case of <i>Bokaro Steel Limited</i> [1999] (236 ITR 315), held that if an assessee received any amount which was inextricably linked with the process of setting up its plant and machinery, such receipts would reduce the cost of its assets.	As per ICDS III read with ICDS IX, no incidental income could be reduced from borrowing cost.	The High Court held that the law laid down by the Supreme Court in <i>Bokaro Steel</i> should be followed and to that extent the ICDS III is contrary to the law and cannot be upheld.
IV – Revenue Recognition (<i>Proportionate completion method vs Contract completion method</i>)	As laid down in AS-9 and several judgements ⁵ of the Courts, an assessee has an option to follow either proportionate completion method or contract completion method for the purposes of revenue recognition.	The ICDS permits only proportionate completion method to recognize revenue.	The High Court held that allowing the assessee to follow only proportionate completion method is contrary to the various judicial precedents and hence impermissible.
IV – Revenue Recognition (<i>Accrual of interest income</i>)	Interest on non-performing assets is taxable only when the same is recoverable and not when the same has accrued.	Interest on non-performing assets is taxable on accrual or time basis even though such interest is not recoverable.	The High Court held that since section 36(1)(vii) of the Act is amended to permit a deduction of such interest if the same is written off as irrecoverable in the books, the treatment envisaged by ICDS cannot be said to be <i>ultra vires</i> the Act.
IV – Revenue Recognition (<i>Taxability of</i>	These are taxable only in the year in which claims are accepted by the Government,	Under Para 5 of ICDS IV, this is to be recognized as revenue	The High Court held that Para 5 of ICDS IV was contrary to the Supreme Court's decision in the

⁵ *CIT vs Bilhari Investment Pvt Ltd* [2008] (299 ITR 1) (SC); *CIT vs Manish Buildwell Pvt Ltd* [2011] (245 CTR 397) (Del); *Paras Buildtech India Pvt Ltd vs CIT* [2016] (382 ITR 630) (Del)



ICDS	Legal principle laid down by the Courts	Treatment as per ICDS	High Court Ruling
<i>Export Incentives</i>)	and the right to receive the payment accrues in favour of the assessee ⁶ .	once there is a reasonable certainty of its ultimate collection	<i>Excel Industries case</i> , and hence ultra vires the Act.
VI – Effects of Changes in Foreign Exchange Rates	The Supreme Court in the case of <i>Sutlej Cotton Mills Limited</i> [1979] (116 ITR 1) held that exchange gain/loss in relation to a loan utilized for acquiring a capital asset would be capital in nature. Hence, the loans would have to be valued at the closing rate, giving rise to foreign exchange gain/loss irrespective of the fact that such loan has been taken for capital purposes.	ICDS states that marked to market loss/gain in case of foreign exchange currency derivatives held for trading or speculation purposes will not be allowed as a deduction.	The Court held that the treatment of the ICDS was not in consonance with the ratio of the Supreme Court as far as MTM gains/ losses on forward exchange contracts are concerned. The Court further held that valuing the monetary assets and liabilities as on 1 April 2016 and transferring the gain/loss to Foreign Currency Translation Reserve cannot be regarded as real income and hence cannot be subjected to tax.
VII – Government Grants	Government Grants should be recognised as income provided they have ‘accrued’ to the assessee and are unconditional in nature or where the stipulated conditions are fulfilled.	The ICDS provides that the recognition of the Government Grant cannot be postponed beyond the date of actual receipt irrespective of whether they have been accrued or not.	The Court agreed with the view of the petitioners regarding the attachment of certain conditions to the receipt of the grant, the non-fulfilment of which can lead to cancellation/ returning of the grant. Given the same, the High Court held that the treatment as per ICDS is contrary and in conflict with the accrual system of accounting.
VIII – Securities (Part A)	Securities are typically valued at cost of net realisable value, whichever is lower on itemised valuation basis.	Contrary to the Accounting Standards, ICDS mandates following a “bucket approach” wherein the total bucket cost of securities (say, shares) is compared with total bucket realisable value; the lower of which is the closing stock value.	The High Court held that such a change in valuation of securities is not possible without an amendment in the Act and hence to this extent Part A of ICDS VIII is <i>ultra vires</i> the Act.

⁶ *CIT v. Excel Industries Limited* [2015] 358 ITR 295 (SC)



Given the above, to the extent the specific ICDS as noted above have been struck down as *ultra vires* the Act, the impugned notification No 87 of 2016 and Circular No. 10 of 2017 were also held to be *ultra vires* the Act and struck down as such.

Comments:

This judgment is a far reaching one, and will have a significant impact on the reporting of taxable incomes for AY 2017-18 and subsequent years. Specifically, taxpayers will need to carefully consider the impact of this decision on the returns for AY 2017-18 (including those due on 30 November 2017). One may also expect that this judgment will be taken in further appeal to the Supreme Court by the Tax authorities, and interim relief may also possibly be sought. These will need to be closely considered by taxpayers while adopting return positions.



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