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Delhi High Court¹ upholds constitutional validity of ICDS but strikes down provisions inconsistent with Act/ Judicial precedents

Background:

As per section 145 of the Income Tax Act, 1961 ('the Act'), income of an assessee chargeable to tax under the head "Profits and gains of business and profession" is determined as per the method of accounting consistently followed by an assessee. Sub-section (2) of the aforesaid section was amended by the Finance (No.2) Act, 2014 w.e.f. April 1, 2015 to provide that the Central Government may notify the Income Computation and Disclosure Standards (hereinafter referred as 'ICDS') to be followed by any class of assessee for accounting of any specified class of income.

In view of the above mandate, the Central Government ('CG') had vide Notification No. 87/2016 dated September 29, 2016 notified 10 ICDS for the purpose of computing income chargeable to tax under the head "Profit and gains of business or profession" or "Income from other sources" for all assesseees following mercantile system of accounting, which are applicable from assessment year 2017-18 and onwards. The Central Board of Direct Taxes (CBDT) vide Circular No. 10 of 2017 dated March 23, 2017 also issued clarifications on various issues concerning the interpretation of ICDS.

The Chamber of Tax Consultants had filed a writ petition before the Delhi High Court challenging the constitutional validity of the aforesaid amendment to section 145 of the Act and the subsequent notification of ICDS.

Decision of the Delhi High Court:

The Delhi High Court has upheld the constitutional validity of the amendment to section 145 of the Act and notification of ICDS for computing taxable income; however, the key provisions of ICDS which were inconsistent with the provisions of the Act and the settled judicial position have been struck down.

The key highlights of the decision of the Delhi High Court are as under:

- Legislature is only competent to amend law to override judicial precedents. Such a power is not available to the Executive by virtue of Articles 141 and 144 of the Constitution. It was not, therefore, open to the Executive/CG to override a binding judicial precedent through notification of ICDS, without a corresponding amendment to the Act.

1 Chamber of Tax Consultants v. Union of India: W.P. (C) NO. 5595 OF 2017

- Section 145(2) of the Act has, therefore, been read down as not empowering the Central Government to notify ICDS that seek to override binding judicial precedents or provisions of the Act.
- In view of the above, the Court has struck down/read down the following provisions of different ICDS to the extent the same override the provisions of the Act and settled judicial precedents:

Relevant provision of ICDS struck down	Reasoning of the Court for striking down
<p>ICDS I: Accounting Policies</p> <p>Concept of prudence was not to be followed unless specifically allowed to be followed under other ICDS</p>	<p>Rejection of concept of prudence which was specifically recognized by the Courts in case of <i>CIT v. Triveni Engineering & Industries Ltd (2011) 49 DTR 253 (Del)</i> and <i>CIT v. Advance Construction Co. Pvt. Ltd. (2005) 275 ITR 30 (Guj)</i>, has been struck down.</p>
<p>ICDS II: Valuation of Inventories</p> <p>Valuation of stock-in-trade at market value in case of dissolution of a firm.</p>	<p>This provision was contrary to the decision of the Supreme Court in <i>Shakti Trading Co. v. CIT (2001) 250 ITR 871 (SC)</i> wherein it was held that in the case of dissolution of a partnership firm, where the business of firm is not discontinued and is taken over by other partners, the stock-in-trade of the firm can be valued at cost or market value, whichever is lower. Accordingly, the Court has read down the provision of ICDS II to the aforesaid extent in relation to dissolution of a firm, without discontinuation of business, by way of being taken over by other partners.</p>
<p>ICDS III: Construction Contract</p> <p>* Contract revenue shall, inter alia, comprise of the initial amount of revenue agreed in the contract, including retentions and the same has to be assessed to tax based on “proportionate computation” method.</p>	<ul style="list-style-type: none"> • The treatment of retention money will have to be determined on a case-to-case basis by applying settled principles of accrual of income. The present ICDS seeks to bring to tax the retention money, the receipt whereof is uncertain/conditional, at the earliest possible stage, and runs contrary to the principle of accrual of income and settled position in law² and to that extent para 10 (a) of ICDS III is ultra vires.

2 The Courts have held that 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. (Refer, *CIT v. Simplex Concrete Piles India (P) Ltd (1988) 179 ITR 8*, *CIT v. P & C Constructions (P) Ltd (2009) 318 ITR 113*, *Amarshiv Construction (P) Ltd v. DCIT (2014) 367 ITR 659* etc.)

<ul style="list-style-type: none"> • Para 12 of ICDS III read with para 5 of ICDS IX dealing with borrowing costs, provides that no incidental income can be reduced from borrowing cost. 	<ul style="list-style-type: none"> • This is contrary to the decision of the Supreme Court in the case of <i>CIT v. Bokaro Steel Limited: (1999) 236 ITR 315</i> wherein it was held that if an assessee receives any amounts which are inextricably linked with the process of setting up of its plant and machinery, such receipts would go to reduce the cost of such assets.
<p>ICDS IV: Revenue Recognition</p> <ul style="list-style-type: none"> • 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. • Para 6 of ICDS-IV only provides for the concept of realizing revenue in respect of recognition of income from sale of goods and recognition of income from rendering of services under the percentage completion method. 	<ul style="list-style-type: none"> • This is contrary to the decision of the Supreme Court in the case of <i>CIT vs. Excel Industries Ltd.: (2013) 358 ITR 295</i>, wherein it was held that income from export incentive can be said to have accrued and accordingly, recognized as income only in the year in which the claim is accepted by the Government inasmuch as it is at that stage that a right to receive the payment accrues in favour of the assessee, and corresponding obligation to pay fastens to the Government. Accordingly, para 5 of ICDS-IV to the extent inconsistent with the law explained by the Supreme Court has been stuck down. • The proportionate completion method as well as the contract completion method have been recognized as valid methods of accounting under the mercantile system of accounting by the Supreme Court in the case of <i>CIT v. Bilhari Investment Pvt. Ltd. [2008] 168 Taxman 95 (SC)</i>. Accordingly, to the extent that para 6 of ICDS-IV permits only one of the methods, i.e., proportionate completion method, the same being contrary to the above decisions, has been held to be ultra vires.
<p>ICDS VI: Effects of change in foreign exchange rates</p> <p>It states that mark to market loss in case of foreign currency derivatives held for trading or speculation purposes is not to be allowed as deduction.</p>	<p>This is contrary to the law laid down by the Supreme Court in the case of <i>Sutlej Cotton Mills Limited v. CIT: [1979] 116 ITR 1 (SC)</i> wherein the Court held that profit or loss arising to an assessee on account of appreciation or depreciation in the value of an asset, on conversion into</p>

	<p>another currency, would, ordinarily, be trading profit or loss if the asset is held by the assessee on revenue account or as part of circulating capital embarked in the business. If on the other hand, the asset is held as a capital asset or as fixed capital, such profit or loss would be of capital nature. The Court, accordingly, struck down the provision to the aforesaid extent.</p>
<p>ICDS VII: Government Grants</p> <p>It provides that recognition of governmental grants as income cannot be postponed beyond the date of receipt.</p>	<p>In so far as the ICDS states that income has to be recognized on receipt basis even if the same may not have accrued, the same is in conflict with the accrual system of accounting. To this extent, the aforesaid ICDS has been held to be ultra-vires.</p>
<p>ICDS VIII: Securities</p> <p>There are two parts of ICDS VIII; Part A deals with entities other than scheduled banks and public financial institutions and Part B deals with scheduled banks and public financial institutions.</p> <p>Under Part B, ICDS VIII has prescribed that recognition of securities should be in accordance with the RBI guidelines.</p>	<p>The method prescribed by the Reserve Bank of India (RBI) for valuation of securities is applicable only to banks, financial institutions, and other financial bodies regulated by the RBI. For other entities, the Accounting Standard ('AS') prescribes the valuation of inventories on individual basis.</p> <p>For entities not governed by the RBI, the accounting prescribed under AS have to be followed, which are different from the ICDS. In effect, such entities will be required to maintain separate records of income for tax purposes for every year since the closing value of the securities would be valued separately for income tax purposes and for accounting purposes. This change is therefore not possible to be effectuated without a corresponding amendment to the Act. To that extent, Part A of ICDS VIII has been held to be ultra vires the Act.</p>

VA Comments:

- The aforesaid decision of the Delhi High Court has per se upheld the constitutional validity of ICDS, but has read down/struck down the relevant part(s) of ICDS which run contrary to the provisions of the Act or binding judicial precedents.
- The aforesaid decision has come after the expiry of the due date of filing income tax return for various assessees (except assessees required to furnish Transfer Pricing report, which is due on November 30, 2017), who would have already complied with the provisions of the notified ICDS for computing their tax liability for the relevant assessment year. Such assessees may have to evaluate filing revised return of income for revising claims taken on the basis of ICDS, which have been read down/struck down by the Delhi High Court.
- For assessees covered by transfer pricing provisions, where return of income is yet to be filed before November 30, 2017, such assessees would need to analyse the impact of the aforesaid decision on the computation of income as per the extant provisions of ICDS.

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