OVERVIEW OF INCOME COMPUTATION & DISCLOSURE STANDARDS (ICDS)

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OVERVIEW OF ICDS

ICDS – Journey so far!

- ICDS notified by the Central Government as a delegated legislation u/s 145(2) w.e.f. AY 2017-18
  - Applicable to all taxpayers following mercantile method of accounting
  - Does not apply to individuals and HUFs not liable to tax audit
  - For computation of income under the head 'Profits & Gains of Business & Profession' and 'Income from other sources'
- Tax Audit Report (Form 3CD) and return of income were amended to include ICDS related disclosures
- Revised ICDS were notified in September 2016 and FAQs also released by the CBDT in March 2017 to address the implementation issues faced by taxpayers
- The Delhi HC in case of The Chamber of Tax Consultants (255 Taxman 77) struck down several contentious provisions of the ICDS, thus rendering ICDS substantially ineffective

ICDS – General Principles

- ICDS largely borrowed from ICAI AS with carve-outs
  - Do not address all AS/ Ind-AS items
- Contains main principles only; no explanations or illustrations provided
- ICDS has both ‘computation’ and ‘disclosure’ requirements
  - Disclosure required in Form 3CD; not applicable if taxpayer is not liable for tax audit (FAQ 25 of Circular)
- MAT continues as per book treatment (AS or Ind-AS) (FAQ 6 of Circular)
  - Likely MAT mismatch due to timing differences between book profit and tax profit

ICDS – Principles of construction

- Provisions of the Income-tax Act, 1961 (Act) to prevail in case of conflict with ICDS
  - Past trend suggests that amendments are brought in the Act to give legislative backing/ tooth to ICDS provisions
- Undefined words/ expression take their meaning from ITA

Hierarchy of ICDS

- Specific statutory provisions (Act)
- Income tax rules
- Real income theory
- Tax jurisprudence on above
- ***ICDS***
- Commercial principles of accounting

Legislative intent of ICDS amendments with retrospective effect from AY 2017-18

- In order to provide legitimacy to ICDS and to bring certainty in the wake of recent judicial pronouncements on the issue of applicability of ICDS, Finance Act 2018 introduced certain provisions in the Act to legitimate ICDS
- Retrospective amendment is sought to regularize compliance by large number of taxpayers and to prevent any further inconvenience to them. The relevant extracts from Memorandum are reproduced as under:

> ***"Recent judicial pronouncements have raised doubts on the legitimacy of the notified ICDS.*** *However, a large number of taxpayers have already complied with the provisions of ICDS for computing income for assessment year 2017-18. In order to regularise the compliance with the notified ICDS by a large number taxpayers so as to prevent any further inconvenience to them, it is proposed to bring the amendments retrospectively with effect from 1st April, 2017 i,e the date on which the ICDS was made effective and will, accordingly, apply in relation to assessment year 2017-18 and subsequent assessment years"*

ACCOUNTING POLICIES (ICDS I)

Fundamental Accounting Assumptions and Materiality

- Going concern, consistency and accrual are fundamental accounting assumptions – disclosure required if any of the assumptions not followed
  - Accrual of income takes place when there emerges a debt in favour of taxpayer which is enforceable in law [E.D. Sassoon & Co. Ltd. (26 ITR 27) (SC)]
- Concept of 'materiality' which was relevant in selecting and applying accounting policy omitted

Prudence and s. 36(1)(xviii), s. 40A(13)

- ICDS I prohibits recognition of marked to market (MTM) or expected loss, unless permitted by any other ICDS
- S. 36(1)(xviii) provides that MTM/ expected loss shall be deductible in accordance with ICDS
- S. 40A(13) further provides that no deduction for MTM/ expected loss shall be allowed except as allowable u/s 36(1)(xviii) i.e. as computed in accordance with ICDS
- Instances of losses permitted under other ICDS:
  - Foreseeable loss in construction contracts on POCM basis (ICDS III)
  - Provisions for liabilities on ‘reasonable certainty’ basis (ICDS X)
- Does not prohibit “actually incurred loss” recognised on best estimate basis (eg. loss by fire, theft) or actuarially valued liabilities (eg. pension obligation)
- Once MTM loss is disallowed, loss to be claimed on actual settlement u/s 37(1)
- At par with denial of MTM loss, MTM gain taxable only at the time of realization (FAQ 8)

Accounting Policy

- Accounting policy to represent true and fair view of state of affairs and income of the business, profession or vocation
- All significant accounting policies adopted by taxpayer need to be disclosed
- Accounting policy can be changed for any 'reasonable cause'
  - 'Reasonable cause' is not defined in ICDS; an existing concept, to be governed by judicial precedents (FAQ 9 of Circular)
    - 'Reasonable cause' means a reason which appeals to a person of average intelligence and ordinary prudence; probable cause (Refer, illustratively, Woodward Governor India (P) Ltd (Del) (253 ITR 745), Azadi Bachao Andolan (Del) (252 ITR 471))
- Upon change in accounting policy, disclosure required in the year of change and also in the year in which it has material effect for the first time

VALUATION OF INVENTORY, INCLUDING SECURITIES (ICDS II & VIII)

Valuation of inventory, including securities

Pre-amendment position

- S.145A (i.e. method of accounting regularly employed) overrides anything to the contrary under ICDS
  - Eg. ICDS VIII providing category-wise valuation of securities overridden by book valuation
- Supported by Del HC ruling which struck down category-wise valuation of securities
  - Such change not possible without corresponding amendment in the Act

FA 2018 amendment

- Amended s. 145A mandates valuation of inventory (including securities held as inventory) in accordance with ICDS provisions
  - Method of accounting regularly adopted by taxpayer no more relevant
- Since ‘inventory’ not defined, guidance may be drawn from ICDS
  - As per the ICAI Technical Guide, ‘inventory’ as per ICDS II does not include ‘services’

Valuation of inventory, including securities

- Post amendment, overview of s. 145A

Sr.	Category	Inventory valuation
1	• Valuation of purchase and sale of goods • Valuation of purchase and sale of services • Valuation of inventory	• Adjusted to include the amount of any tax, duty, cess or fee
2	Valuation of items of inventory (other than (3) and (4) below)	• Lower of actual cost or NRV computed in accordance with ICDS
3	Inventory being unlisted securities or listed securities but not quoted with regularity from time to time	• Actual cost initially recognised in accordance with ICDS
4	Inventories being securities other than those stated in pt (3) above (i.e. principally listed securities)	• Lower of actual cost or NRV computed in accordance with ICDS • Comparison to be done category-wise i.e. bucket approach (categories as per ICDS VIII include shares, debt securities, convertible securities and others)
5	Inventory being securities held by a scheduled bank or public financial institution	• In accordance with ICDS after taking into account extant RBI Guidelines in this regard

Category wise valuation of listed securities

Illustrative impact

Security	Category	Cost	NRV	Lower of cost or NRV	ICDS value
A	Share	100	75	75	
B	Share	120	150	120	
	Total	**220**	**225**	**195**	**220**
C	Debt security	150	160	150	
D	Debt security	105	90	90	
	Total	**255**	**250**	**240**	**250**
Security total		**475**	**475**	**435**	**470**

Scrip wise valuation

Category wise valuation

Impact analysis:

- Category wise valuation virtually results in accelerated taxation
- May also create mismatch with MAT

CONSTRUCTION CONTRACTS & REVENUE RECOGNITION (ICDS III & IV)

ICDS III - Broad Overview

- ICDS III determines income of a **contractor** arising from **construction contract**
- Mandates recognition of revenue under Percentage of Completion Method (POCM)
  - Mandatory to recognize profit/loss on POCM basis beyond 25% stage of completion
- Components of revenue recognition (revenue, expenses and profit) on POCM basis
  - Retention money specifically included as part of contract revenue
- Recognition of expected/ anticipated losses not allowed
  - Foreseeable loss allowed only to the extent of proportion of work completed by year end
- Neither ICDS III nor ICDS IV may aptly apply to real estate developers
- Grandfathering of contracts commenced prior to 1 April 2016

ICDS – Revenue recognition criteria

Revenue recognition criteria as per ICDS

- Construction contract (including services directly related to construction like architect)
  - POCM
- Sale of goods
  - Transfer of property or significant risks & rewards of ownership to buyer
- Rendering of services
  - Ordinarily, POCM
  - If contract duration ≤ 90 days, permits completed contract method
  - If services by indeterminate number of acts, permits straight line method
- Interest
  - Receipt basis for interest on tax refund
  - Time basis for other
- Royalty (as defined by ITA)
  - As per contractual terms, unless some other systematic / rational basis as per substance of transaction
- Dividend
  - As per ITA

Revenue recognition – Interest

- Interest income to be recognized on time basis
- As per FAQ 13 of Circular, test of reasonable certainty of ultimate collection does not apply to interest and royalty income
  - Specific provisions of the Act (e.g. s. 43D) override ICDS
- As per settled legal position, interest income not taxable (unless contractually due) in absence of real income
  - Onus on taxpayer to prove that there is no reasonable certainty of realization
- Alternatively, taxpayers can offer income and claim bad debt deduction under second proviso to s.36(1)(vii)
- Interest on refund of any tax, duty or cess to be taxable on receipt basis
  - Adjustment of interest on statutory refund against other disputed demand constitutes constructive receipt and hence, taxable as per ICDS

Applicability of ICDS to taxpayers governed by presumptive tax provisions

- As per FAQ 3 &14 of Circular, ICDS applies even to taxpayers opting for presumptive tax provisions for determining “receipt” or “turnover” and also for computation of income on gross basis u/s 115A

Presumptive sections like s.44B/ BBA/ BBB specify presumptive tax base as amount paid/ payable or received/ deemed to be received

- These presumptive tax provisions are self-contained and complete code in itself
- Thus, taxation cannot be as per ICDS

Presumptive sections like s.44AD/ ADA do not define gross receipt/ turnover

- Taxpayers governed by s.44AD/ ADA not liable to tax audit
- Thus, individual and HUF continue to remain outside the ICDS net

Incomes taxed on gross basis u/s.115A

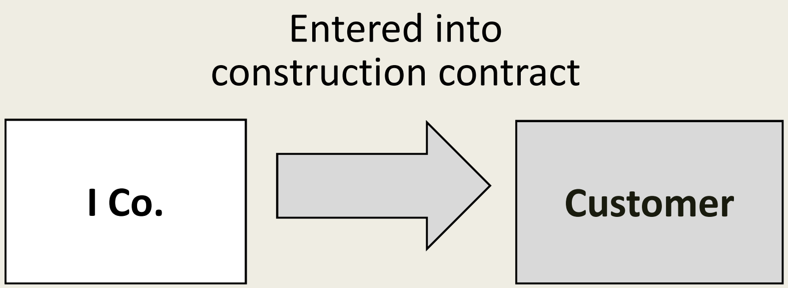
- S.115A merely prescribes rate of tax and quantifies tax lability after income is computed
- Thus, income covered by S.115A necessarily gets subjected to ICDS

- However, if taxpayers opt out of presumptive provision and offer lower income, they are governed by normal tax provisions and also liable for tax audit. ICDS will apply in that case

Taxation of profits from construction and service contracts [S. 43CB]

- Methodology under ICDS III/ IV now codified u/s 43CB, no major change
- Profits from service contracts (duration > 90 days, not involving indeterminate acts) and construction contracts to be computed as per POCM “in accordance with” ICDS
- Service contracts with duration < 90 days to recognize as per completed contract method
- Service contracts with indeterminate number of acts to recognize on straight line basis
- Contract revenue shall specifically include retention money as per s. 43CB
  - Whether s. 43CB is a charging provision?

Case study – Retention money



Customer pays consideration	
During construction period	90 %
Retention money payable after 2 years	10 %
Total	**100%**
Stage of completion of contract of year 1	40%

Facts

- I Co executes a construction contract for customer for consideration of Rs. 100 Cr
- As per the contractual terms, 90% of payment is released while construction is in progress
- Balance 10% will be released after 2 years (Yr 3) post completion of contract subject to satisfactory performance without defects
- Retention money recognised as revenue in books of accounts of year 1

Issue

- What is the amount of contract revenue to be booked in Year 1, Rs. 40 crs or 36 crs?

TAXATION OF FOREIGN EXCHANGE FLUCTUATION (ICDS VI)

Taxation of foreign exchange fluctuation [s. 43AA]

- Subject to s.43A, any forex gain/ loss arising on all the following foreign currency transactions "shall be treated as income or loss" and computed in accordance with ICDS:
  - Monetary and non-monetary items
  - Translation of financial statements of foreign operations
  - Forward exchange contracts
  - Foreign currency translation reserve
- Is it in-built charging and computation provision?
- Question of chargeability relevant for forex gains/ losses on capital account
  - Forex gains/loss on loans related to **domestic assets** – allowable on MTM basis

Taxation of foreign exchange fluctuation [s. 43AA]

- Forex fluctuation treatment in case of monetary and non-monetary items may be summarized as under:

Particulars	Examples	Tax Treatment: Profit/ loss	ICDS VI
Monetary items	Cash, bank balance, creditors, debtors, loans etc.	Forex fluctuation on borrowing for **imported capital asset** – Capitalisation on payment basis u/s 43A	No tax impact other than s. 43A
		Forex fluctuation on borrowing for **domestic capital asset** – On MTM basis u/s 43AA	Allowable as per para 5(i)
Non-monetary items	Fixed assets, inventories etc.	No restatement	No tax impact

Particulars	Example	Tax treatment
Monetary items	Forex fluctuation on bank deposits held in foreign currency (assessed under IFOS)	S. 43AA may be restricted to business head?

TAXATION OF GOVERNMENT GRANTS (ICDS VII)

Taxation of Government Grant [ICDS VII]

- Recognition of government grant depends on 'reasonable assurance' of satisfaction of conditions attached to grant and receipt of grant (Para 4(1) of ICDS VII)
  - Recognition cannot be postponed beyond actual date of receipt (Para 4(2))
- Treatment of Government Grant is as under:

Nature of Grant	Treatment
Grants related to specific depreciable fixed assets	Reduce from cost of asset (Para 5)
Grants related to non-depreciable assets	Deferred income over period matching with cost of meeting the obligations or upfront basis (Para 6)
Grants not directly related to assets acquired	Reduce from actual cost/ WDV of block of assets on pro-rata basis (Para 7)
Grant related to compensation for expense or loss	Recognise as income in the year it is receivable (Para 8)
Grant in the form of non-monetary asset given at concessional rate (or NIL cost)	Account asset at reduced cost (Para 10)
Any other government grant (eg: Government grant in nature of promoter contribution)	Deferred income over period matching with cost of meeting the obligations (Para 9)

Taxation of Government Grant [s. 145B]

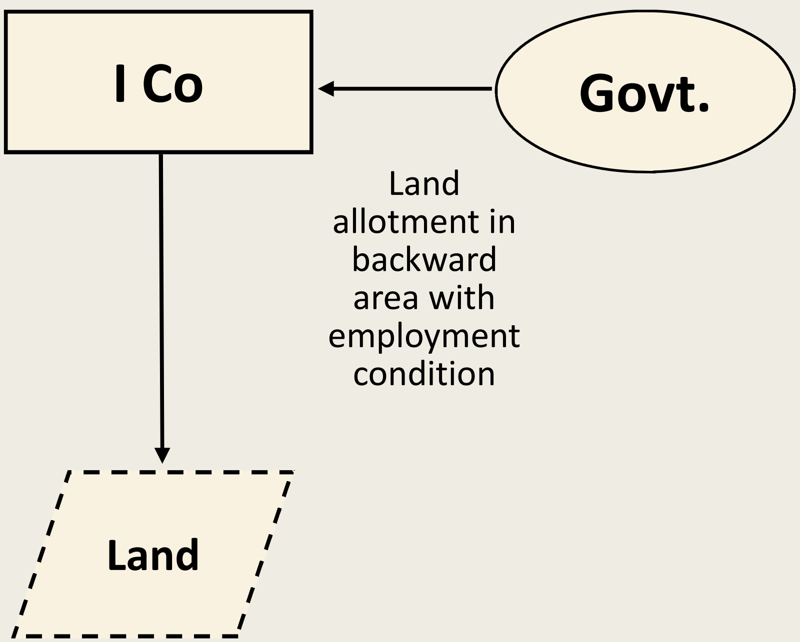
Pre-amendment position

Nature of income/ expense	Book treatment	Tax position prior to ICDS	Treatment as per ICDS VII	Delhi HC ruling
Government grants received pending compliance of attached conditions	Recognition of government grants on reasonable certainty of fulfilment of attached conditions	Taxable only upon fulfilment of attached conditions as per SC ruling in Excel Industries	Recognition of government grants cannot be postponed beyond date of actual receipt	ICDS VII is ultra vires the Act on this aspect and hence struck down

FA 2018 amendment

- As per s. 145B(3), government grant shall be deemed to be taxable on receipt basis, if not charged to tax in any of the earlier years
  - Reference to “in accordance with ICDS” missing in s. 145B(3)

Taxation of Government Grant [s. 145B]



Year of Receipt	Year 1 (FY 2019-20)
Year of Accrual	Years 1 to 5 (FY 2019-20 to FY 2023-24)

Facts

- ICo receives land worth Rs. 10 Cr. in Year 1 in backward area pursuant to Govt.'s packaged scheme of incentives
- Obligation to set up industrial unit & provide certain employment over a period of 5 years. If it does so, ICo doesn't have to pay anything to Govt. towards land cost
- If ICo defaults, liable to pay pro-rata cost of land to Govt.

Issues

- **Issue 1:** Whether taxation can be triggered in Year 1 on receipt basis due to s.145B(3) despite absence of perfected entitlement?
- **Issue 2:** Assuming taxation is triggered in Year 1 on receipt basis, whether grant can be recognised on spread over basis as per Paras 5 to 9 of ICDS VII?

BORROWING COSTS (ICDS IX)

ICDS IX on Borrowing Costs

- ICDS provides for capitalisation of borrowing costs in respect of qualifying assets viz. tangible/ intangible assets and inventories
  - Inventories are qualifying assets only if they require 12 months or more to bring them to saleable condition
  - Interest to be capitalised till date of first put to use/ inventory is ready for sale
- Proviso to s. 36(1)(iii) r.w. ICDS IX may not apply to stock-in-trade as it cannot be put to use – thus, not warranting any capitalization of borrowing cost
- In case of specific borrowing, capitalization to commence from date of borrowing upto date when asset is put to use
  - As against ICAI AS-16, condition of incurrence of cost upto readiness to use
- In case of general purpose borrowing:
  - Capitalisation triggers only if qualifying asset necessarily requires 12 months or more for its acquisition, construction or production
  - Capitalisation as per normative pro-rata formula, to be done on asset-by-asset basis

Capitalization of general borrowing cost

- ICDS requires capitalisation of general borrowing cost based on complex formula
- Interest to be capitalised as per ICDS IX = $\mathbf{A} \times \dfrac{\mathbf{B}}{\mathbf{C}}$

A = Total borrowings cost (less) specific borrowing cost

B = Average of various qualifying assets (other than those directly funded from specific borrowings)

C = Average of total assets[1] as per Balance Sheet (excluding assets directly funded from specific borrowings)

[1]*Includes all assets appearing in Balance Sheet including non-qualifying assets and current assets*

Capitalisation and disallowance provisions

- As per CBDT Circular, *interest which is otherwise allowable under the Act after application of disallowance provisions like s.43B, 40(a)(ia), 14A etc. shall qualify for capitalisation under ICDS IX (FAQ 20)*

- Proviso to s. 36(1)(iii) states that interest shall not be allowed as deduction
  - If interest is not allowed as deduction u/s 36(1)(iii), can it qualify for application of disallowance provisions?

- Capitalisation as per ICDS takes precedence over disallowance provisions like s. 43B, 14A

- **Illustration:**

Particulars	Amount
Interest incurred for FY 2019-20	100
Amount to be capitalised as per proviso to s.36(1)(iii)	100
Amount to be disallowed as per s.43B	40
Amount of borrowing cost to be considered for capitalization purposes under ICDS IX	?

Thank you

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