

Tax Wire



**Delhi High Court ruling on
Constitutional Validity of
Income Computation and
Disclosure Standards (ICDS)**

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Evolution

'Accountancy is a matter of taste. One tax payer may be conservative and others may not.' - So was told by Lord Greene in *Henriksen (Inspector of Taxes) vs Grafton Hotel Ltd*

Whether accounting principles for recognition of income should be considered for the purpose of taxation has been a matter of constant debate between tax authorities and tax payers in India.

Chronology of events

- The memorandum to Finance Bill stated that with the intention of framing Standards under the Income Tax Act, 1961 ("Act") to compute income 'precisely and objectively', the Finance Act, 1995 substituted subsection (2) to section 145 of the Act with effect from April 1, 1997 where in it empowered the Central Government to notify Accounting Standards to be followed by any class of assessee or in respect of any class of income.
- In 1996, two standards were notified which were largely similar to the corresponding Accounting Standards issued by ICAI.
- The CBDT by a press release dated 26th October, 2012 issued 14 Tax ASs drafted by the Accounting Standards Committee comprising of Indian Revenue Service (IRS) officers from the Income Tax Department and professionals like CAs, which recommended that the said standards be notified under the Act only for the purposes of computation of taxable income.
- In July 2014, an amendment was made to Section 145 of the Act by the Finance Act, 2014, which introduced the

concept of Income Computation and Disclosure Standards (ICDS).

- On 31st March, 2015 the CBDT notified ten ICDS which were required to be followed by all the Assesseees following mercantile system of accounting, for the purposes of computation of income chargeable under the head "Profits and Gains of Business or Profession" and "Income from Other Sources" for the AY 2016-17 and the subsequent years.
- By a Press Release dated 6th July 2016, CBDT deferred the applicability of ICDS to 1st April 2016.
- Following the above, the CBDT issued two further notifications in the Official Gazette on 29th September 2016: (i) Notification No. 86/2016 rescinding Notification dated 31st March 2015 (ii) Notification No. 87/2016 dated 2nd September 2016 notifying the ten ICDS applicable from financial year 2016-17 onwards.
- This was followed by a host of clarifications that were sought by tax payers on this matter. Towards this, The Direct tax board issued clarifications in the form of 25 Frequently Asked Questions (FAQs) purporting by way of answers thereto, to provide clarity for better implementation of the ICDS.

Before Delhi Court

The Chamber of Tax Consultants filed a petition against Union of India before Hon'ble High Court seeking a declaration of the constitutional invalidity of all circulars relating to introduction of ICDS and the substituted and amended Section 145 of the Act on the ground of their being violative of certain Articles of the Constitution of India. The Delhi High Court

in its ruling¹ has struck down certain ICDS and parts of certain ICDS as constitutionally invalid.

Summary of the Order

A brief summary of the order for each ICDS has been provided hereunder:

➤ **Amendment to Section 145 and its Validity**

The High Court held that 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.

➤ **ICDS I - Significant Accounting Policies**

Court held that this standard does away the concept of “prudence” which is present in AS1 notified under Section 145 (2) of the Act. It stipulates that prudence is not to be followed unless specified, and this is contrary to the decisions given by the courts. Non-acceptance of the concept of prudence in the said ICDS is per se contrary to the provisions of the Act and is therefore, unsustainable in law.

➤ **ICDS II - Valuation of Inventories**

Delhi High Court taking cognizance of Supreme Court ruling in **Shakti Trading Co. V. CIT (2001) 250 ITR 871 (SC)** that upon dissolution of a firm, where the business of the 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. In the case of dissolution of a partnership firm, if the business is discontinued then stock-in-trade has to be valued at market price only. ICDS-II fails to take into account these two different scenarios and insists

that the stock-in-trade of the firm in both scenarios would have to be valued at market price irrespective of whether the business is discontinued. This would amount to taxing notional income.

Further, it was also observed by Delhi High Court that section 145A of the Act allows valuation of inventory based on based on method of accounting regularly followed by the taxpayer, while ICDS takes away that right from the tax payer.

For the above reasons, the High Court held ICDS -II to be ultra vires the Act and struck down as such.

➤ **ICDS III - Construction Contracts**

On matters relating to taxing retention money even before it accrues and the matter that ICDS seeks to not allow reduction of incidental income from borrowing costs, both of which are against various settled Supreme Court and High Court decisions, the Delhi High Court struck down the ICDS III.

➤ **ICDS IV - Revenue Recognition**

High Court considered the ratio of accrual laid down by Apex court in **CIT v. Excel Industries Ltd (2015) 358 ITR 295 (SC)** and held that para 5 is not inconsistent with the law laid down by Apex court.

The Supreme Court has recognized the proportionate completion method as well as the contract completion method as given in AS-9 issued by the ICAI, as valid method of accounting under mercantile system of accounting. However, para 6 of ICDS-IV permits only one of the methods, i.e., proportionate completion method and therefore, it is contrary to those decisions and hence ultra vires.

Para 8 dealing with interest accrual was held not to be in violation of any ruling and hence not valid.

Thereby, ICDS IV has been struck down in part.

¹ **The Chamber Of Tax Consultants & Anr vs Union of India & Ors** W.P.(C) 5595/2017 & CM APL 23467/2017 dated 8th November,2017

➤ **ICDS VI - Effects of Changes in Foreign Exchange Rates**

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 **Sutlej Cotton Mills Limited v. CIT (1979) 116 ITR 1 (SC)**, insofar as it relates to marked to market loss arising out of forward exchange contracts held for trading or speculation purposes.

In Circular No. 10 of 2017 an answer to Question No. 16 the CBDT has clarified that Foreign Currency Translation Reserve Account balance as on 1st April 2016 has to be recognized as income/loss of the previous year relevant to the AY 2017-18. The losses/gains arising by valuation of monetary assets and liabilities of the foreign operations as at the end of the year cannot be treated as real income. The court held that it is only in the nature of notional or hypothetical income which cannot be even otherwise subject to tax.

➤ **ICDS VII - Government Grants**

It provides that income has to be recognized on receipt basis which may not have accrued. Many a times, conditions would be attached to the receipt of government grant, non-fulfillment of which may lead to return of such amount. In such instance, it cannot be said that there is any accrual of income although the money has been received in advance. This is contrary to and in conflict with the accrual system of accounting. To that extent it was held to be ultra vires the Act and struck down as such.

➤ **ICDS VIII - Valuation of Securities**

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 whom, ICDS prescribes Part B is applicable and court has held that it is consistent with RBI guidelines.

For other entities Part A of ICDS VIII is applicable, which is different from accounting norms prescribed by the AS. In effect, such entities will be required to maintain separate records for income tax purposes for every year. To this extent Part A of ICDS VIII was held to be ultra vires the Act and was struck down as such, a change has to be brought out with an amendment in the Act.

While closing the ruling, the High Court also held that 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, which clearly reiterated the importance of judicial authority in interpretation of law.

Advith Comments

Firstly it is commendable that The Chamber of Tax Consultants took up the effort of filing this petition before the High Court. Secondly, it is equally commendable that Hon'ble Delhi High Court made all the efforts to understand the impact of introduction of ICDS and came out with such a detailed ruling on this matter. This reinforces the trust on the tax judicial system which is more than required at a time when tax officers are given revenue targets and are resorting to high pitched assessments only to meet revenue targets.

On the matter relating to ICDS, the ruling says it all and seems to strike the right chord as regards the powers of CBDT and Parliament. It will be interesting to see the next steps that the Government will take. Will this lead to amendment in the law or will ICDS knock the doors of Supreme Court, the time will tell.

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