INCOME COMPUTATION & DISCLOSURE STANDARDS

ICDS VI TO X

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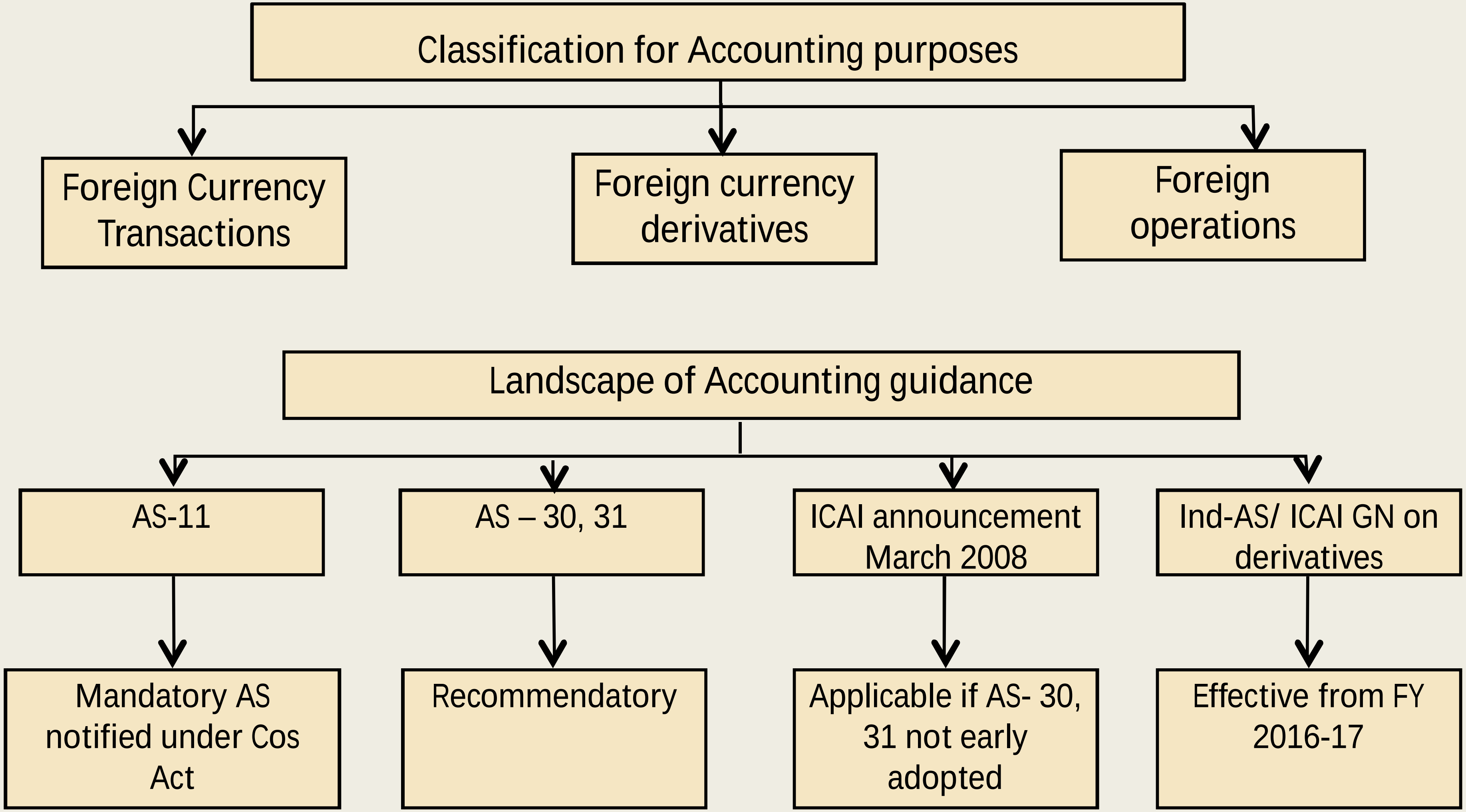
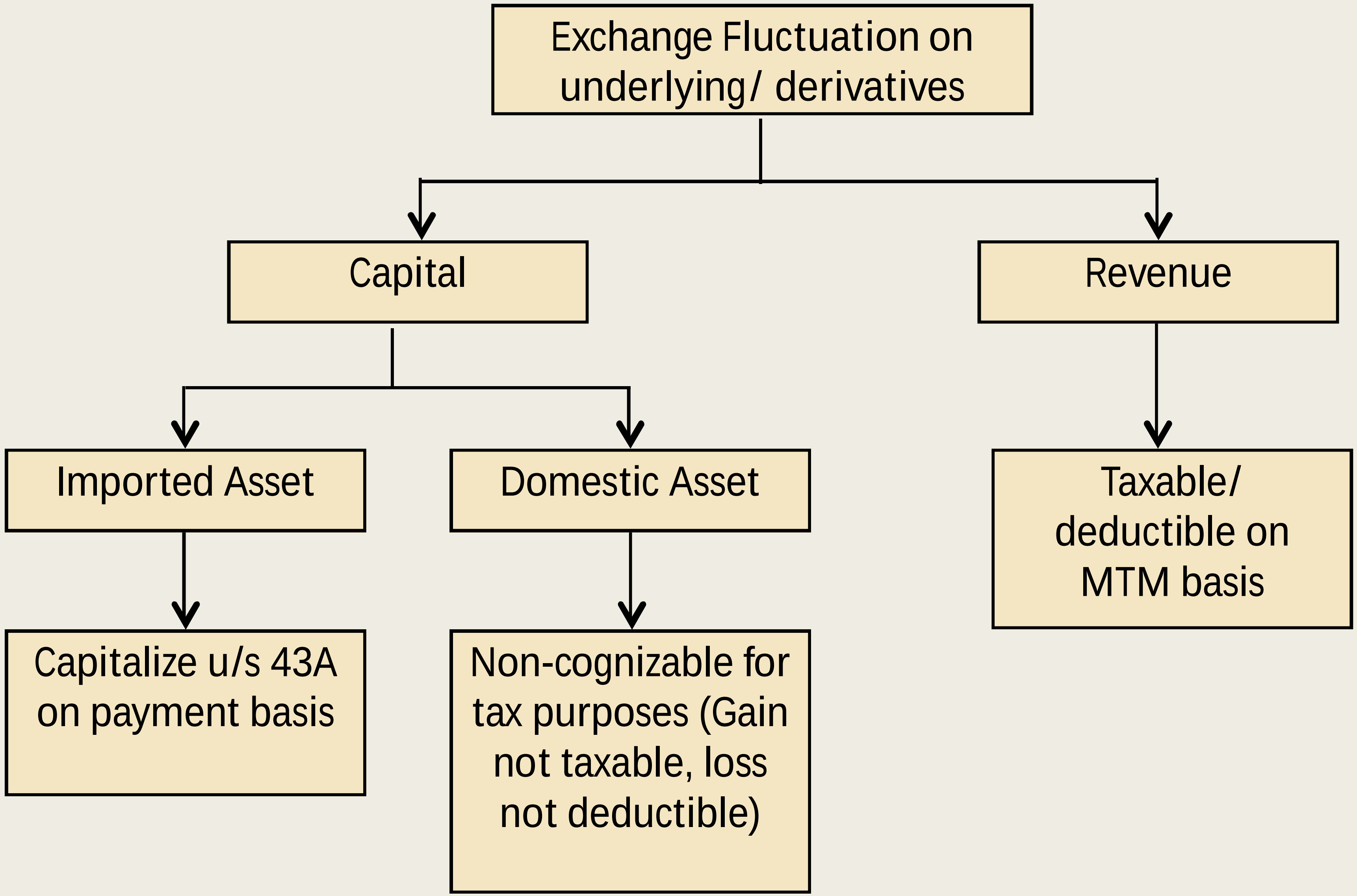
25 June 2016

ICDS VI
FOREIGN EXCHANGE FLUCTUATION

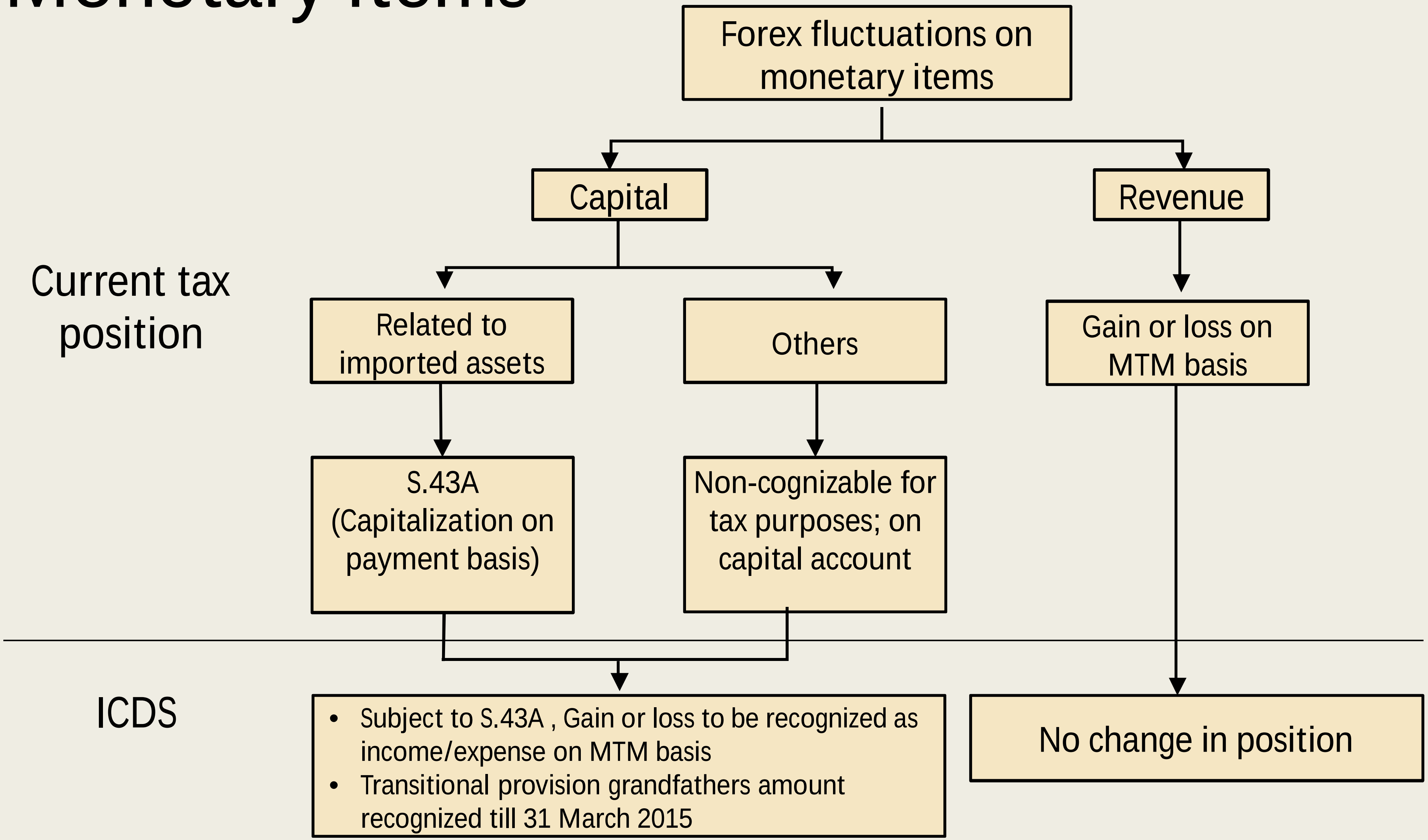
Accounting guidance for forex transactions



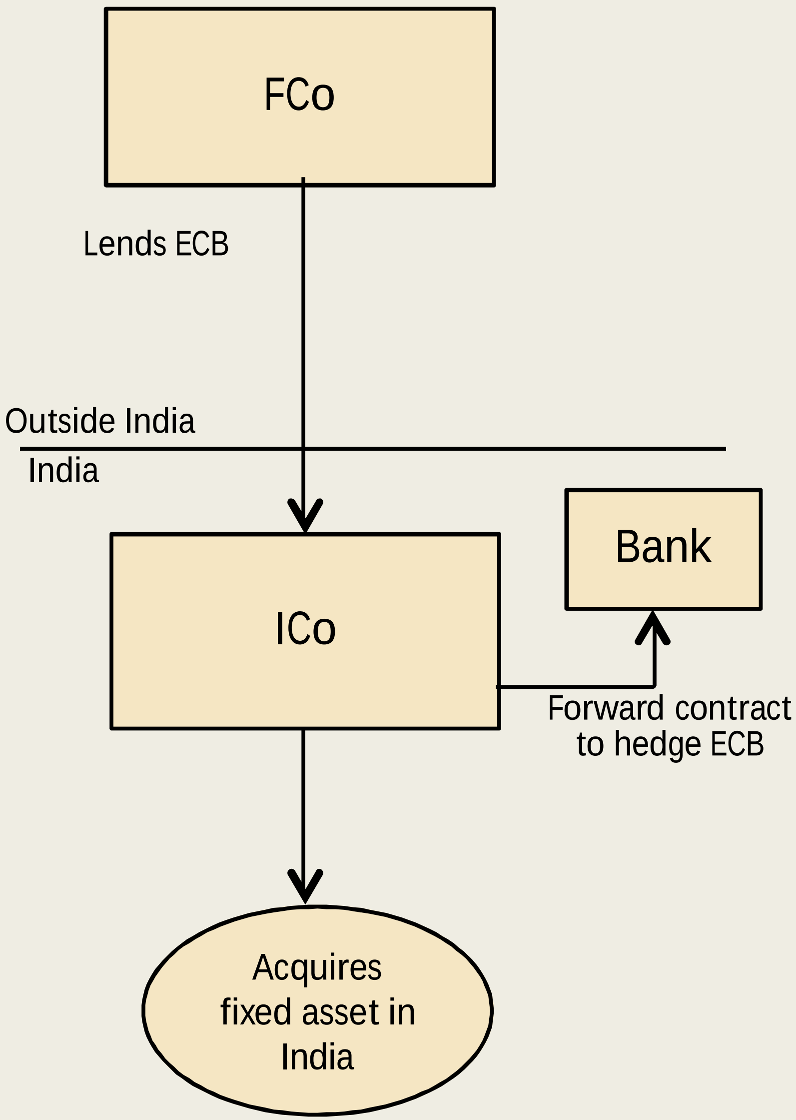
Summary of tax position prior to ICDS



Foreign exchange fluctuations – Monetary items



Case study – Capital monetary items



Facts

- ICo borrows foreign currency loan (ECB) from FCo repayable after 3 years
- ICo utilizes ECB proceeds to acquire domestic assets in India
- ICo incurs MTM loss of Rs. 1 Cr. at end of year 1
- In year 2, ICo enters into forward contract with a bank to hedge the ECB loan. At end of year 2, there is MTM gain on forward contract of Rs. 2 Cr which is offset by MTM loss on ECB of same amount

Case study – Capital monetary items

Book Treatment as per ICAI AS

- AS-11 does not distinguish between capital and revenue nature of exchange fluctuation
- MTM loss of Rs.1 Cr in Year 1 is debited to P&L
- It may be capitalised to fixed asset if ICo has opted for one time irrevocable option under para 46A of MCA notified AS-11
- In Year 2, MTM loss of Rs.2 Cr on loan is offset against MTM gain of Rs.2 Cr on forward contract. Net impact in P&L is nil

PRE ICDS

Tax Treatment pre ICDS

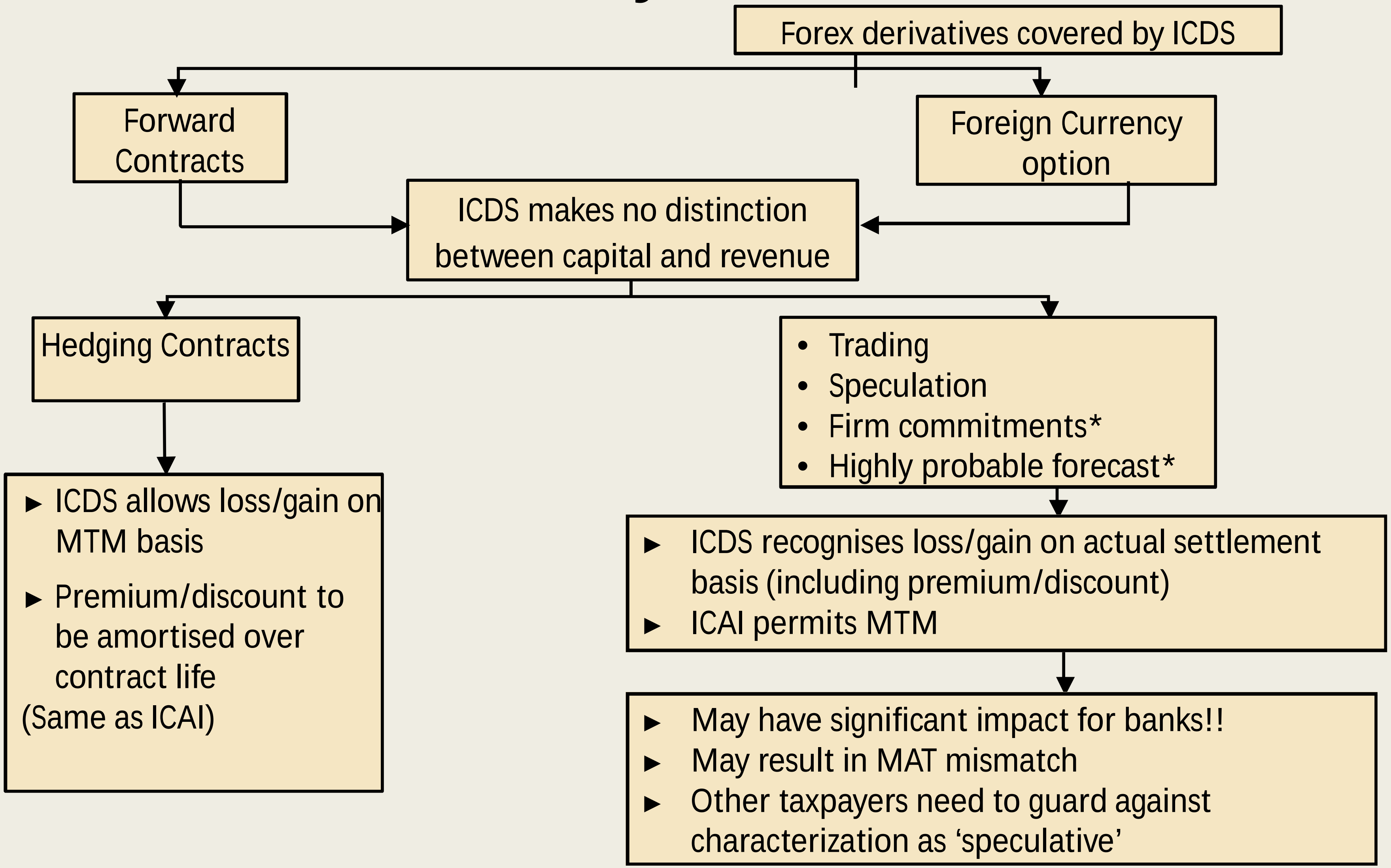
- Distinction between capital and revenue nature of exchange fluctuation is well settled
- Exchange fluctuation of capital nature not cognizable for tax purposes (gain not taxable, loss not deductible)
- S.43A permits capitalization for imported assets only
- Loss of Rs. 1 Cr of Year 1 is a dead loss

POST ICDS

Tax Treatment post ICDS

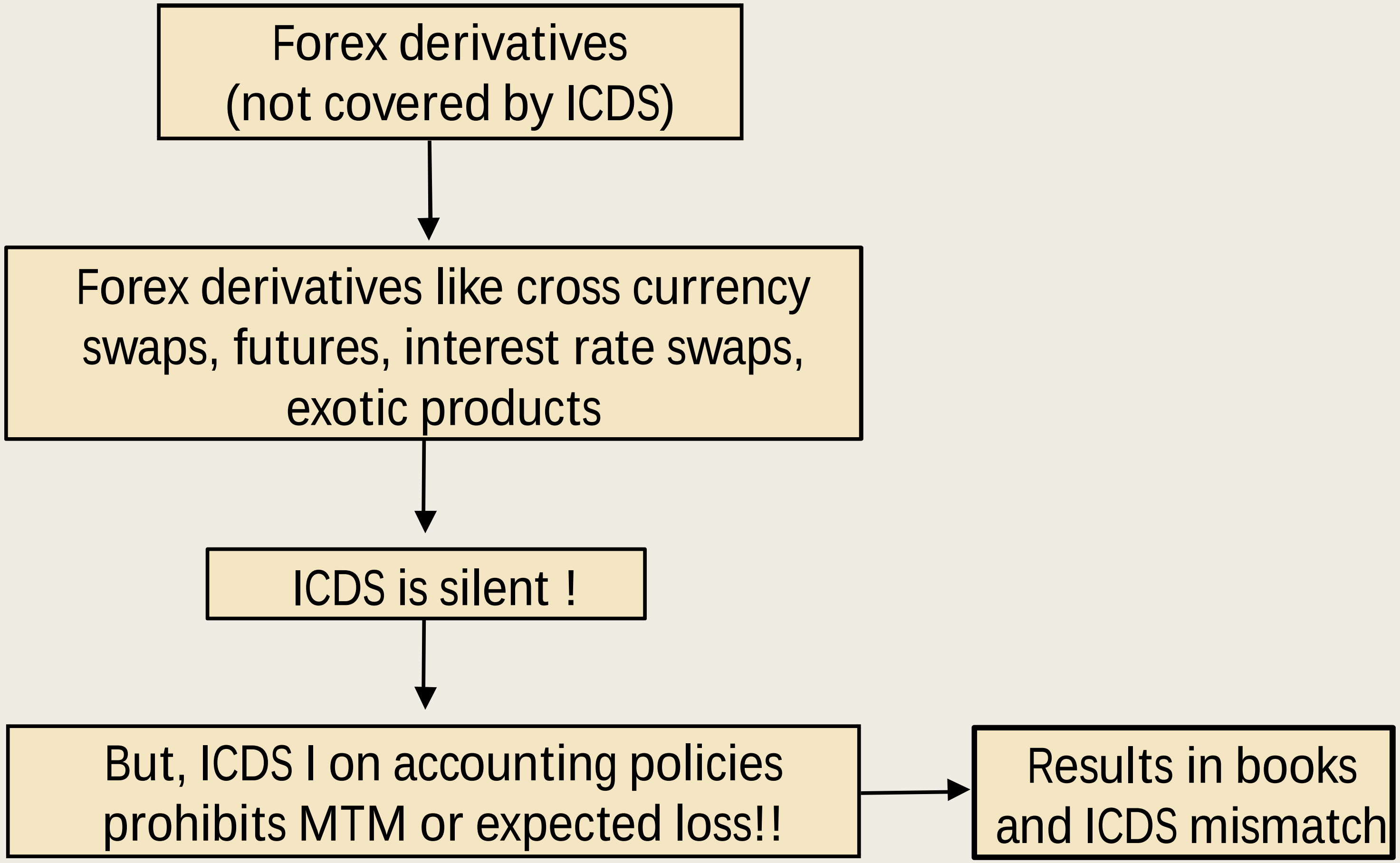
- Contrary to settled judicial position, ICDS requires recognition of MTM gain/loss as income/expense (subject to s.43A)
- Can ICo claim deduction for MTM loss of Rs.1 Cr in year 1 by asserting that ICDS changes the position? Can AO deny it ?
- ICo's deduction claim for loss of Rs. 1 Cr is likely to be at cross roads with taxpayers who have gain, and who would seek to claim that judicially settled position continues to prevail since ITA overrides ICDS?

Foreign exchange fluctuations – Derivatives covered by ICDS



[1] ICAI AS- 11 excludes these contracts. ICDS explains firm commitment to not include assets/liabilities which exist by end of the previous year

Foreign exchange fluctuations – Derivatives not covered by ICDS



Integral vs non-integral foreign operations

Foreign Operations

Integral operations
(e.g. Warehouse, liaison office)

- ICDS VI applies same principles as own assets and liabilities subject to s.43A and Rule 115
- But no distinction between capital vs. revenue

(Largely aligns with ICAI AS-11)

Non-integral operations
(e.g. Branch functioning on independent basis)

- ICDS requires translation on MTM to be recognized as income/expense subject to s.43A and Rule 115 (whereas ICAI AS-11 requires accumulation in reserve)
- No distinction between capital and revenue items
- MTM to be recognized even on tangible fixed asset?
- Transitional provision grandfathers amount 'recognized' till 31 Mar 2015.
  - Can Tax Authority seek upfront recognition in FY 2015-16 of amount lying in reserve on 31 Mar 2015?

Is opening balance of FCTR as on 1 April 2015 taxable?

ICDS VII
GOVERNMENT GRANTS

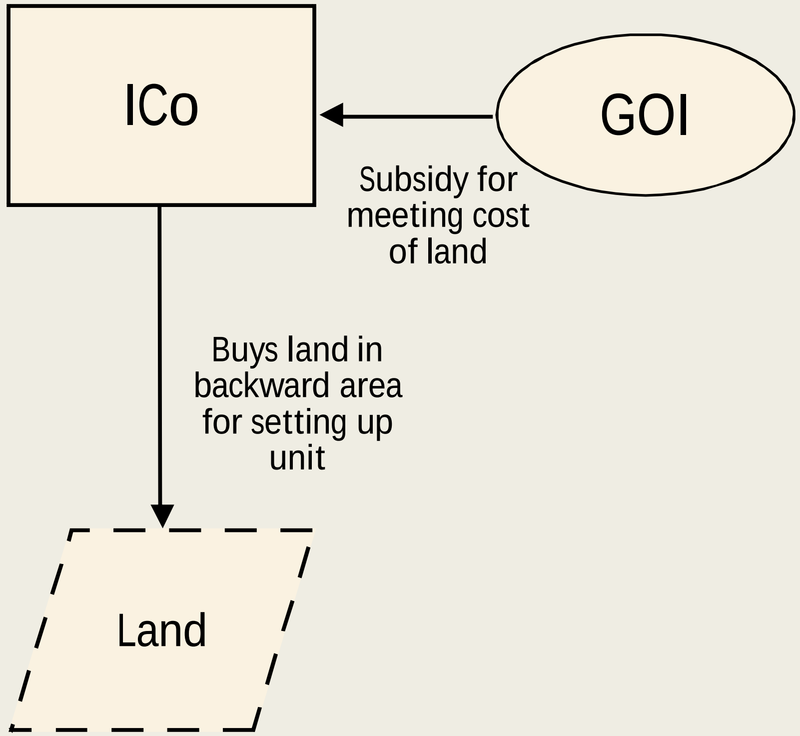
ICDS VII on Government grants

- Recognition of grant cannot be postponed beyond the date of actual receipt
  - Impact of non-grandfathering of past receipts
- Consistent with s.43(1), grant relatable to depreciable fixed asset is to be reduced from cost
- Grant relatable to non-depreciable fixed asset to be considered as income on upfront basis (or, over a period matching related cost)
  - Amendment to 'income' definition addresses possible conflict on taxation of capital receipt
- Any Government grant not dealt with specifically to be accounted as income
  - Government grant in the nature of promoter contribution may fall under this category
  - Amendment to 'income' definition preempts capital receipt argument

ICDS VII on Government grants

- ICDS VII is limited to government grants and has no impact on parental subvention
- Accelerated recognition on receipt basis and/or income recognition of grant credited to capital reserve may create MAT mismatch
- ICDS also requires disclosure of all unrecognized grants
  - Perhaps, the intent is to require disclosure of grants which are not recognised due to absence of reasonable assurance of compliance of future conditions and/or receipt of grants

Case study - Government Grant related to non-depreciable asset



Facts

- ICo buys land at cost of Rs.10 Cr. in Year 1 in backward area pursuant to package scheme of incentives offered by Government
- ICo has obligation to set up industrial unit & provide certain level of employment
- ICo receives subsidy of Rs.2 Cr. from Government for meeting cost of land in Year 3 after setting up of unit

Case study - Government Grant related to non-depreciable asset

Book Treatment as per ICAI AS-12

- ICo can recognize subsidy of Rs. 3 Cr in capital reserve in the balance sheet

PRE ICDS

Tax Treatment pre ICDS

- Arguably, subsidy in given facts is non-chargeable capital receipt
- Land cost may not be reduced by Rs. 2 Cr if primary object of subsidy can be substantiated to be for promoting industrialization and employment in backward area

POST ICDS

Tax Treatment post ICDS

- ICDS requires subsidy related to non-depreciable asset to be recognized as income (over a period matching with incurrence of related costs)
  - Income definition amended to cover all subsidies and hence not possible for ICo to argue that being capital subsidy, ICDS cannot apply to such grant
  - Can ICo argue that ICDS, read literally, does not cover the subsidy under reference since there are no related revenue costs?

ICDS VIII
SECURITIES

ICDS VIII - Securities

- Deals with securities held as stock-in-trade
  - Currently, ICAI AS-13 principles on “current investments” apply to securities held as stock-in-trade for tax purposes
- “Securities” defined to have meaning assigned in s.2(h) of SCRA except derivatives referred to in S.2(h)(1a)
- ICDS does not apply to securities held by:
  - Insurance Companies; Mutual Funds; Venture Capital Funds; Banks; Public Financial Institutions
- Coverage of ICDS VIII will illustratively affect:
  - Stock-Brokers; NBFCs; Others engaged in securities trading

Bucket Approach

- In contrast with ICAI AS-13, ICDS VIII mandates "bucket" approach for valuation of securities at lower of cost or NRV
- Securities to be classified into following buckets/ categories:
  - Shares; Debt Securities; Convertible Securities; Any Other Securities
- Fair value of security acquired in exchange for other securities or assets to be regarded as actual cost of the security acquired
  - Fair value of securities or assets given up is not relevant
- Opening Value shall be:
  - Cost of securities available, if any, on commencement of business if business commenced during the previous year
  - Closing value of immediately preceding previous year in any other case

Bucket approach for lower of cost or NRV

Illustrative impact

Sr.	Cost	Movement of share price	Year end NRV	Year end conventional valuation
1.	100	(-80)	20	20
2.	100	(-80)	20	20
3.	100	(-80)	20	20
4.	100	(-80)	20	20
Subtotal (A)	400	320	80	80
5. (B)	100	+300	400	100
Total (A+B)	500	(-20)	480	180

Stock value on Bucket valuation

Itemised valuation

Impact analysis:

- Bucket approach virtually results in accelerated taxation with reference to the security (at item (5) above) which appreciates in value
- May also create mismatch with MAT

ICDS IX
BORROWING COST

ICDS IX on Borrowing Cost

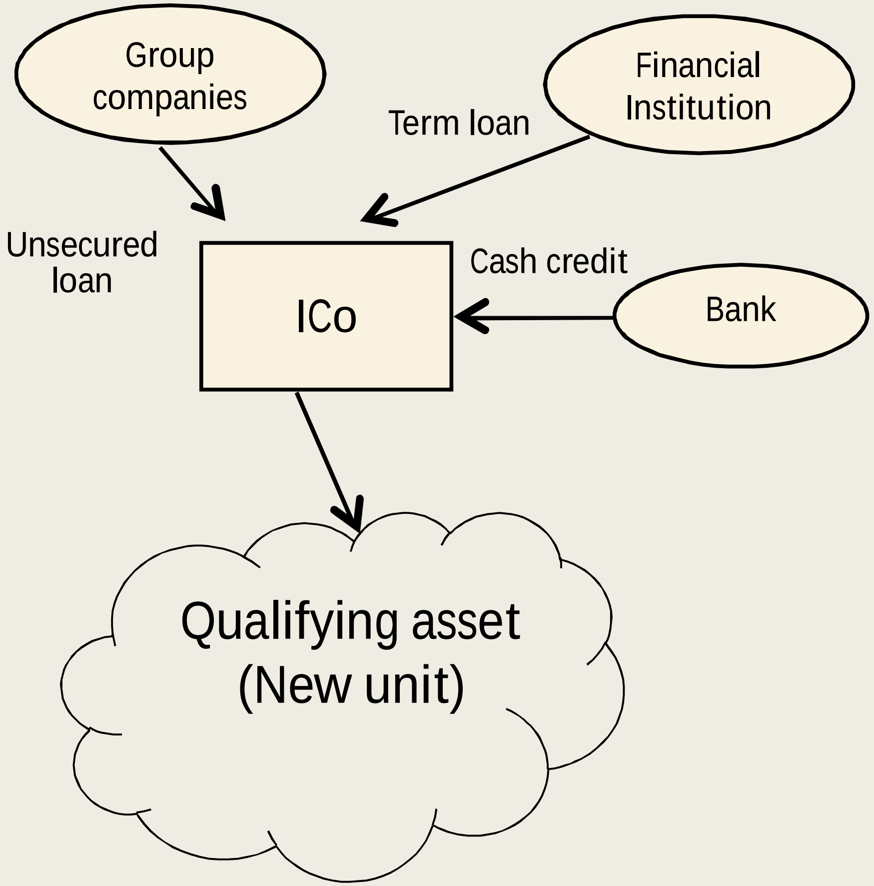
- ICDS IX provides for capitalisation of borrowing costs in respect of qualifying assets viz. tangible/intangible assets and inventories
  - Inventories are qualifying assets only if they require 12 months or more to bring them to saleable condition
  - Interest to be capitalized till date of first put to use/ inventory is ready for sale
- Other borrowing costs to be dealt as per ITA
  - Proviso to s.36(1)(iii) amended to omit phrase ‘for extension of existing business or profession’ as a condition for disallowance of interest for acquisition of asset
- SC in case of Taparia Tools Ltd.[1] upheld deduction for upfront interest by holding that ITA does not recognize concept of deferred revenue expenditure
- Allowance of deduction in year of project completion for real estate developer following project completion method may not conflict with s.36(1)(iii)

[1] *TS-134-SC-2015*

ICDS IX on Borrowing Cost

- In case of specific borrowing, capitalization to commence from date of borrowing upto date when asset is put to use
  - Unlike ICAI AS-16 condition of incurrence of cost upto readiness to use
- In case of general purpose borrowing:
  - Capitalisation to commence from date of utilization
  - Capitalisation as per, ambiguously worded, normative pro-rata formula
- ICDS IX silent on reduction of income from temporary deployment of unutilized funds from specific loans!
  - ICAI AS requires the same to be reduced from borrowing cost
- Unlike ICAI AS-16, requirement to suspend capitalization during interruption of active development of asset/inventory is removed in ICDS

Case study – Methodology of Capitalization



Facts

- ICo is engaged in manufacturing business
- ICo sets up new unit for manufacturing
- ICo unit admittedly represents extension of business
- The investment in new unit is financed from
  - Specific term loans from financial institutions for plant and machinery
  - Cash credit facility for working capital;
  - Unsecured loans from group companies
- The new unit is treated as qualifying asset under AS-16 and borrowing cost is capitalized in books as per capitalization norms provided under AS-16

Case study – Methodology of Capitalization

Particular	ICAI AS-16		ICDS	
	Specific Borrowing	General Borrowing	Specific Borrowing	General Borrowing
Commencement date of capitalization	Fulfillment of all three conditions viz. incurrence of capex, incurrence of borrowing costs and construction activity is in progress		From date of borrowing once borrowing is for fixed asset	Date of utilization of borrowed funds
Method of Capitalization	Borrowing costs directly attributable to qualifying asset from date of fund deployment to date of asset being ready for use	Weighted average cost of borrowing applied to capex from date of capex to date of asset being ready for use	Borrowing costs from date of borrowing till date of asset first put to use (Proviso to S.36(1)(iii))	▶ Pro-rata borrowing cost allocation as per normative formula (Refer illustration in subsequent slides) ▶ Capitalisation triggered w.r.t. 50% cost irrespective of whether the asset remains under construction for 1 or 364 days
Suspension of capitalisation if unexpected interruption in project?	Yes		No	

Case study – Mismatch in capitalization of specific borrowing cost

Financial year	2015-16
Date of borrowing	1 April 2015
Date of Capex	1 Jan 2016
Amount of Capex	400
Amount borrowed	1000
Interest rate p.a.	12%
Borrowing cost incurred	120
Date of asset put to use	1 July 2016 (i.e. beyond F.Y. 2015-16)

Particulars	AS-16	ICDS
Base amount for capitalization	400	400
Interest rate p.a.	12%	12%
Period of capitalization	3 months (Jan 16-Mar 16)	12 months (Apr 15-Mar 16)
Interest to be capitalized	12	48

Case study – Mismatch in capitalization of general borrowing cost

- AS-16 requires capitalization by applying weighted average cost of borrowing to capex for the period during which asset is under development
- ICDS requires capitalisation based on complex formula
- Interest to be capitalised as per ICDS = $A \times \dfrac{B}{C}$

A= [Total borrowings cost (less) specific borrowing cost](-say,1000 @10% on borrowing of 10,000)

B= Average of various qualifying assets (other than those directly funded from specific borrowings) (see table on next slide)

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*

Case study – Mismatch in capitalization of general borrowing cost

Balance Sheet Items	01.04.2015	31.03.2016	Capitalization base	Basis
I. Fixed Assets				
• Assets under construction	2,000	2,000	2,000	Average of opening & closing
• Assets from opening CWIP put to use during the year[1]	6,000	6,000	6,000	Average of opening & date put to use
• Assets acquired but not installed[1]	-	4,000	2,000	@50% of cost
• Assets acquired & put to use	-	20,000	10,000	
Sub-total of all qualifying assets	8,000	32,000	20,000 (B)	
II. Other assets as per Balance Sheet (including current assets)	12,000	18,000		
III. Total assets as per Balance Sheet	20,000	50,000	35,000 (C)	Average of opening and closing

Interest capitalization assuming rate of interest is 10% p.a.	AS-16	ICDS
Base amount for capitalization	2000	As per table in previous slide
Interest to be capitalized	200 (@10% for 1 year)	$1000(A) \times \frac{20,000(B)}{35,000(C)}$ i.e. 572

[1] *Installation period <12m*

ICDS X
PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Provisions

- Provision for liability can be made if, as per yardstick of 'reasonable certainty', there is present obligation likely to involve outflow of economic resources
  - ICAI AS-29 requires provisions to be made as per yardstick of probability i.e. more likely than not
  - Reasonable certainty criteria is used in other ICAI AS/ICDS also (eg. AS-9/ ICDS IV on revenue recognition or AS-22 on recognition of DTA)
  - Committee's justification – To provide certainty and align with principles for recognition of revenue
- ICDS silent on present obligation which arises out of business custom/practice or such equitable consideration, even in absence of contractual obligation
- Provision for restructuring costs will continue to be governed by specific provisions of ITA
- ICDS silent on 'onerous executory contracts'

Whether provisions made in books based on 'probability' criteria will be allowable for tax purposes?

Contingent Assets

- Contingent asset to be recognized as income if inflow of economic benefit or reimbursement is *'reasonably certain'*
  - Substantial deviation compared to the threshold of 'virtual certainty' as per ICAI AS-29
  - Committee's justification – To remove differential treatment between recognition of income and expense
  - Conflicts directly with concept of accrual of income as per ITA?
  - Ambiguity on whether transitional provision requires recognition of all past accumulated contingent assets in F.Y. 2015-16!!
- Yardstick of *'reasonable certainty'* needs to be uniform in case of provision for liability as also asset, but, is prone to subjective considerations by different assessees in identically placed situation
- In either case, opinion of experts and events after balance sheet date may be relied upon by Tax Authority

Contingent Asset Recognition: Transitional Impact

- Evaluate impact of requirement of recognition based on ‘reasonable certainty’
- Transitional provisions require recognition of assets and related income as on 1 April 2015 in accordance with ICDS
- Consider following chronicle related to insurance claim under loss of profit policy:

Event	Year
Incurrence of loss	2005
Claim accepted by lower court	2008
Claim accepted by High Court	2013
Year of transition to ICDS	2016
Claim accepted by SC	2020

- Will taxpayer need to recognize claim receivable and related amount as income of FY 2015-16?

CONCLUDING THOUGHTS

Some high impact areas of ICDS

- Conflict with settled judicial principles on capital receipts being called 'income' (e.g. Forex fluctuation)
- 'Real income' theory whether overridden? (e.g. Retention money, Contingent assets, Bucket approach)
- Potential retrospective catch up taxation due to transitional provisions (Service revenue recognition on POCM, contingent assets, non-integral foreign operations)
- Mismatch with MAT due to timing difference between books and tax
- Deferment of foreseeable loss on onerous contracts
- Change in borrowing cost capitalization norms for tax purposes
- Forex derivative loss on actual settlement basis (other than forwards and options for hedging purposes)

Way forward for Taxpayers

Impact Assessment

- Understand differences between ICDS and ICAI AS/ Ind-AS in greater detail
- Evaluate how ICDS impacts your current tax computation
- Identify high/low impact items
- Evaluate, in particular, impact of transitional provisions

System reconfiguration

- MIS/accounting system will need modifications to capture new data points relevant to ICDS (e.g. Full life cycle of foreign currency transactions and derivatives, contingent assets, etc.)
- Reconciliation between financial books and tax books will need to be more robust
- Disclosure requirements of ICDS will require special attention for reporting compliance in return and tax audit report

Tax strategy

- Evaluate tax position to be adopted on conflicts between ICDS and judicially settled principles (e.g. capital receipts, real income theory etc.)
- Strategize for possible litigation in tax assessments and keep factual data ready for alternative computations

Compliance process

- Processes for generating tax computation, populating return form, audit report details as per ICDS
- Review by tax auditors, tax consultants before filing of return
- Prepare for scrutiny assessment with back up data

Questions

Thank you

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