

## **Income Computation and Disclosure Standards – An Overview**

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**By –**

**CA Vivek Newatia – [vnewatia@sjaykishan.com](mailto:vnewatia@sjaykishan.com)**

Mr. Newatia is a practicing Chartered Accountant, holds an honours degree in commerce from St. Xaviers College, Kolkata and has also completed Diploma in Economics from London School of Economics. He is a qualified CISA and a holder of Diploma in Information Systems Audit from ICAI. His fields of specialization are Auditing, Risk Advisory, FEMA, structuring and International Taxation.

**CA Puja Borar – [pujaborar@sjaykishan.com](mailto:pujaborar@sjaykishan.com)**

Ms. Borar is a qualified Chartered Accountant and Company Secretary. She holds an honours degree in commerce from St. Xaviers College, Kolkata. She has handled assignments relating to Taxation (Direct and Cross Border taxation), structuring, Transfer Pricing, FEMA and Valuations for various clients.

### **Introduction**

As per the provisions of Section 145, Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.

The Central Government has been empowered by the provisions of sub-section 2 of Section 145 to notify the Income Computation and Disclosure Standards for any class of assessee or for any class of income. Accordingly, the CG has vide Notification No. SO 892(E), dated 31-3-2015 notified ten Income Computation and Disclosure Standards for assessee's following mercantile system of accounting. The preamble to each of these ICDS lay down that these are applicable for computation of income under the head "business or profession" and "other sources" and not for the purposes of maintenance of books of account.

The assessee's regular method of accounting determines the mode of computing the taxable income but it does not determine or even affect the range of taxable income or the ambit of taxation. Accordingly, while the authority of accounting profession continues to be recognized for preparation of accounts and computing commercial profits, the taxable profits shall be determined in accordance with newly notified Income Computation and Disclosure Standards. The computation of taxable income will now, therefore, start with the profits as per the profit and loss account, but such profits will have to be first adjusted so as to give effect to the ICDS provisions and thereafter further adjusted to give effect to the specific provisions of the Act so as to arrive at the profits chargeable to tax under the head "business or profession" and "other sources".

### **Understanding delegated legislation**

Pursuant to the provisions of sub-section (2) of Section 145, powers have been delegated to the Central Government to notify Income Computation and Disclosure Standards. However, no policies or principles

have been laid down by the Legislature to provide guidance to the Central Government to frame such standards. As discussed above, Section 145(1) provides that the assessee should follow one of the said two methods of accounting only and that he should follow it regularly. But this principle deals only with the maintenance of accounts. The ICDS on the other hand deals with computation of income. Further sub-section (2) and (3) also do not provide for any such principle to offer assistance to the Central Government in formulation of the Standards. The concept of delegated legislation as is elucidated by Supreme Court in case of Vasanlal Maganbhai Sanjanwala [1960] 1 SCR 341 provided that when the Legislature enacts laws to meet the challenge of the complex socioeconomic problems, they often find it convenient and necessary to delegate subsidiary or ancillary powers to delegates of their choice for carrying out the policy laid down by the Acts as part of the administrative law. The Legislature has to lay down the policy and principle to afford guidance for carrying out the said policy before it delegates its subsidiary powers in that behalf. The Supreme Court in the case of Avinder Singh vs State of Punjab AIR 1979 SC 321 also stated that the Legislature is the master of legislative policy and if the delegate is free to deal with policy, it may be usurpation of legislative power itself. The Supreme Court laid down the following tests for valid delegation of legislative power:

- i. the Legislature cannot efface itself?
- ii. it cannot delegate the plenary or the essential legislative function?
- iii. even if there be delegation, Parliamentary control over delegated legislation should be a living continuity as a constitutional necessity.

In the absence of any guiding policies and principles, essential legislative powers have been delegated to the Central Government to formulate the ICDS. However, it is essential to note that such powers cannot have the effect of bringing income which is otherwise not chargeable to tax, into the ambit of taxation.

From a combined reading of Section 145 with Section 4 and 5 of the Income tax Act, it is to be inferred that the provisions of Section 145 cannot override Section 5 of the Act. Income received in India or accruing and arising in India is chargeable to tax. Income which is otherwise not chargeable to tax u/s 5 of the Act, cannot be brought to tax merely because there has been a book entry recognizing such hypothetical income. Even when the assessee is following the mercantile system of accounting, it is only real income which is chargeable to tax. The computational provisions cannot enlarge or restrict the contents of taxable income. The view finds support from the judicial precedence in the case of CIT vs. Shoorji Vallabhdas & Co.[1962] 46 ITR 144 wherein it was held that “*Where income has in fact been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, tax may be payable. Where, however, the income cannot be said to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might in certain circumstances have been made in the books of accounts*”.

### **Conflict between ICDS and the provisions of the Act**

Further, the preamble to every ICDS clearly states that in case of conflict between the provisions of the Act and the ICDS, the provisions of the Act shall prevail. Indeed, it is a settled law that a notification cannot travel beyond the statutory provisions. The Supreme Court in CIT v. Sirpur Paper Mills [(1999) 237 ITR 41 (SC)] held that where section provides for a deduction of a certain expenditure and confers powers on the CBDT to notify conditions subject to which the deduction can be availed, the notification cannot have

the effect of curtailing the deduction in the guise of prescribing conditions. The Apex Court held that “in fact, this is not a condition but an impermissible attempt to rewrite the section”. Earlier, the Supreme Court had held in the case of CIT v. Taj Mahal Hotels [(1971) 82 ITR 44 (SC)] that even the rules notified by the CBDT were meant only for the purpose of carrying out the provisions of the Act and they could not take away what was conferred by the Act or whittle down its effect. These principles would continue to apply in respect of the notification as regards ICDS.

### **Key Issues**

The key issues pertaining to some of the ICDS have been discussed as hereunder: -

- ICDS is required to be followed by assessee’s following the mercantile system of accounting for computation of their income. However, the standards do not specify whether assessee’s who are otherwise not required to maintain their books of accounts, have to mandatorily do so and ensure compliance with the Income Computation and Disclosure Standards.
- There is also a lack of clarity as to whether the assesseees who have opted for presumptive scheme of taxation u/s 44AD are also required to comply with ICDS. A view may be taken that ICDS is applicable for computation of income and not gross turnover as is required to be computed for determining the presumptive income.
- ICDS is required to be followed for computation of income under the head Profits and Gains from Business and Profession and also Income from Other Sources. Compliance with all the computation and disclosure requirements of ICDS by individuals who have only Income from Other Sources is tedious. However, the Standards do not provide any relief in respect thereof.
- The preamble clearly provides that ICDS is not for the purposes of maintenance of accounts. However, ICDS 1 on Accounting Policies suggests otherwise. Without prejudice to this, the concept of Prudence and Materiality which are important considerations in preparation of financial statements have been done away with in the ICDS.
- ICDS 2 on Inventories provides that in the event of dissolution of a partnership firm or AOP or BOI, the inventory as on the date of dissolution shall be valued at the Net Realizable Value, whether or not the business has been discontinued. This is contrary to the decision of the Supreme Court in the case Shakti Trading Company (250 ITR 871), wherein it was held that where there is no cessation of business, closing stock cannot be directed to be valued at the market rate. Where the standards are in contradiction with the well settled principles which have been laid down by the Supreme Court within the realms of the law enacted by the Legislature, such standards should essentially be reviewed.
- The provisions of Section 145A of the Income Tax Act begins with a non obstante clause and override the provisions of Section 145. It provides that the valuation of the inventory for the purposes of determining the income chargeable under the head “Profits and Gains from Business or Profession” shall be in accordance with the method of accounting regularly employed by the assessee. In the absence of any amendment to the provisions of Section 145A and considering the

fact that it specifically overrides the provisions of Section 145 it is essential to evaluate whether the ICDS on Inventories as is notified by the Central Government will be totally redundant.

- ICDS IV requires that interest income should be recognized on time basis. If the principal itself is doubtful of recovery, no income can be recognized on commercial accounting principles and also based on real income theory. ICDS apparently ignores these principles.

Conclusion: -

The Income Computation and Disclosure Standards intend to bring about certainty in the computation of income. However, certain provisions of ICDS may need further clarification/ guidance for proper implementation. Even the CBDT had requested the stake holders and general public to bring out issues/points which in their opinion would require further clarification/guidance for proper implementation of the provisions of the ICDS.