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Article

Inventory valuation caught in the cob-web of ICDS, IndAS and settled Jurisprudence!

By **S.Sriram**

Valuation of inventory is not supposed to give rise to any income and therefore the same should be at lower of cost or market value, as held Apex Court in a landmark decision[1]. However, with changing accounting and tax regulations, the old age principles need to be revisited.

Section 5(1) of the Income-tax Act, 1961 ('the IT Act') provides that the total income of a person would include all sums that *inter alia* accrue or arise to him. Section 14 of the IT Act provides that the income so accruing shall be classified under different heads of income, including 'profits and gains of business or profession' of a person and 'income from other sources'. Section 145(1) of the IT Act provides that the income chargeable under the above referred heads of income shall be computed in accordance with either cash or mercantile system of accounting which is regularly employed by the assessee. Section 145(2) of the IT Act further provides that the Central Government may notify Income Computation and Disclosure Standards ('ICDS') to be followed in computing the income taxable under the above referred heads of income.

The Central Government vide a notification[2] has notified 10 ICDS , effective financial year 2016-17, to be followed by all assessees other than individual and HUF who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB of the said Act) following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profits and gains of business or profession" or "Income from other sources". One such standard, ICDS-II, relates to method to be adopted for determining the value of stock in trade of any business ('inventories'). This write up discusses a few issues that arise in relation to ICDS II on valuation of inventory.

Even before specific Standards for Accounting were formally prescribed by any governing body, it was a well-established principle of commercial accounting that, the value of the stock in hand at the beginning and at the end of the accounting year should be recorded at 'cost' or 'market value', whichever is lower. This is an exception to the general rule that a precautionary reserve for anticipated loss is not allowable and no unrealised loss can be set-off against the profits of the accounting period. This accounting principle has historically been accepted in determining taxable profits as well[3], although there is nothing about this in the taxing statutes[4].

(i) Validity of ICDS II vis-à-vis Ind-AS 2 read with Section 145A of the IT Act

1. Section 145A of the IT Act was introduced by the Finance (No.2) Act, 1998 and came into force from A.Y. 1999-2000. This section *inter alia* provides that, not withstanding anything contained in Section 145 of the IT Act (under which ICDS has been prescribed), purchase, sales and inventory shall be valued in accordance with the

[1] *Chainrup Sampatram* v. *CIT* [1953] 24 ITR 481 (SC)
[2] Notification No 87/2016 dated 29th September, 2016

[3] *Kikabhai Premchand* v. *CIT* [1953] 24 ITR 506 (SC)
[4] Whimster & Co. v. IRC [1925] 12 TC 813

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method of accounting regularly employed by tax payer. The Ministry of Corporate Affairs, in exercise of powers conferred under Section 133 and 459 of the Companies Act, 2013, notified the Companies (Indian Accounting Standard), Rules, 2015 which *inter alia* required companies to mandatorily maintain their books of accounts as per the 'Ind-AS' prescribed therein. In other words, Ind-AS requires companies to maintain their books of accounts, *inter alia*, in relation to valuation of stock in trade, as per Ind-AS 2 notified by the Central Government.

2. A combined reading of Section 145A of the IT Act read with the Companies (Indian Accounting Standard), Rules, 2015 clearly shows that any rule made under Section 145 of the IT Act, including ICDS, cannot have a overriding effect on the method of accounting adopted by the tax payer, i.e. Ind-AS. In other words, the scheme of ICDS, in so far as it is contrary not only to the IT Act, but also to Ind-AS on valuation of inventory, would be in contradiction to Section 145A of the IT Act, and hence invalid.
3. A few such deviations prescribed in ICDS II which are contrary to Ind-AS 2 include the following,
   a. Ind-AS 2 (in para 11) requires the cost of purchase of inventory to include only those taxes that are subsequently not recoverable by the entity from the taxing authorities (taxes for which credit is not available). On the other hand, ICDS II (in para 5) requires cost of purchases to include all duties and taxes, irrespective of availability of credit for such taxes paid. However as this requirement of ICDS II is in conformity with section 145A, the same does not pose any challenge from income tax perspective.
   b. Ind AS 2 read with Ind AS 23 on borrowing cost provides that interest cost incurred on assets that take a 'substantial period' of time to bring them into existence shall alone be added to the cost of the inventory. On the other hand, ICDS II (para 11) provides that any interest cost incurred towards an asset taking more than 12 months time to bring into existence shall be added to the cost of the asset and shall not be allowable as revenue expenditure.
   c. While Ind AS 2 (para 25) provides an option to a company to follow either First-in-First-Out method or weighted average method for determining value of inventory, ICDS II (para 16) restricts the method to the one that would reflect the fairest possible approximation to the cost incurred on the inventory. What is 'fair' approximation is a subjective and would lead to unwarranted litigation.

(ii) Valuation of closing stock of service industry

The phrase 'closing stock' has traditionally been associated only with tangible goods in a manufacturing or trading business. However, even with the significant contribution of service industry to the Indian economy[5], adaptation of the concept of 'inventory' to service sector has not achieved much traction. Though there exists a presumption (even amongst the judiciary) that a tax payer engaged in rendering services could not recognise 'inventory' in its books of accounts[6], in practice, many IT and ITES businesses (as in other similar businesses) where contract terms provides for billing on a

[5] World Bank estimates service sector to contribute 53.8% of Gross Value Addition to India's GDP (https://data.worldbank.org/indicator/NV.SRV.TETC.ZS), accessed on 19th September, 2017

[6] *ACIT* v. *Curam Software International (P.) Ltd* [[2017] 82 taxmann.com 465 (Bangalore - Trib.)]

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milestone basis, i.e. billing based on achieving a pre-designated milestone, costs incurred under such contracts are regarded as 'closing stock' and carried over to next year as such.

Neither Ind-AS 2 nor ICDS II specifically address the question of valuation of such service providers. The definition of 'inventories' does not indicate as to whether the unbilled services of a service provides would be regarded as an 'asset' held for sale in the ordinary course of business. However, the standards deal with certain isolated aspects of valuation of stock held by service providers. While ICDS-II in para 6 explains as to what would constitute the 'cost of services', there is nothing to indicate as to how 'Net Realisable Value' of such stock has to be recognised. To the contrary, while Ind-AS (in para 31) indicates how 'Net Realisable Value' for a service contract has to be recognised, it is silent about the determination of the cost of such services. Interestingly, Ind-AS II which contemplates to adopt the international accounting practices, has intentionally omitted para 19 of International Accounting Standard 2 which deals with valuation of inventory by a service provider. The position for tax purposes can be largely resolved by referring to ICDS III & IV which collectively prescribe Percentage of Completion Method (PoCM) for recognising revenue by Service Providers. In essence, except at initial states of the contract (not beyond 25% of the stage of completion) where the outcome of the contract cannot be reliably estimated the service providers need to recognise revenue based on percentage of work completed as per methodology prescribed. This in effect means that not only an inventory is (indirectly) recognised, the same will usually be above cost (assuming the contract to be profitable)

(iii) Non-taxable, notional and hypothetical items being treated as income

As noted in the beginning, the Supreme Court in *Chainrup Sampatram*[7] held that no taxable gains arises from the valuation of stock in trade at the end of the year and hence, stock in trade has to be valued in the books of accounts at cost or market value, whichever is lower. The Supreme Court in *ALA Firm*[8] held that the principle laid down in *Chainrup Sampatram (supra)* will hold good only for assessees who are carrying on their business as a going concern, but not to assessees who have dis-continued their business and are in the process of liquidation. For the latter case, the Supreme Court held that the stock in trade has to be valued at the market value for determining the taxable profits of the liquidating firm.

This preposition was latter explained by the Supreme court in *Sakthi Trading*[9], wherein it was held that the principle laid down in *ALA Firm* (supra) would not apply to businesses that are succeeded by another person. The Supreme Court held that "on no principle can one justify the valuation of the closing stock at a market value higher than cost as that will result in the taxation of notional profits the assessee has not realised". However ICDS II (para 24) mandates that in case of a dissolution of a firm or association of persons the inventory on the date of dissolution has to be valued at net realisable value, whether the business is discontinued or not.

When the Supreme Court has categorically held that no taxable income arises on succession of business due to revaluation of stock, it is no doubt true that the Legislature is free to amend the definition of 'income' to include such notional profits as taxable income. The Legislature may

[7] *Chainrup Sampatram* v. *CIT* [1953] 24 ITR 481 (SC)
[8] *ALA Firm* v. *CIT* [1991] 189 ITR 285 (SC)
[9] *Sakthi Trading* v. *CIT* [2001] 250 ITR 871 (SC)

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also be competent to delegate the power to notify the items that would be regarded as 'income' for the purpose of the IT Act to the Central Government, and if, upon exercise of such power the Central Government notifies revaluation of stock to be regarded as 'income', no challenge could possibly arise on the exercise of power by the Central Government.

However, under the power vested to notify Accounting Standards for the purpose of computing tax liability of an assessee engaged in carrying on business or profession, the Central Government has, by notifying ICDS II (para 24) requires the assessee to account as income, any increase in the market value of closing stock, if the business of the assessee is succeeded by another assessee. In some sense the rule in ICDS II goes beyond the avowed scope of 'computing' the income and extends to 'treating' something as income when there exists none.

It is true that the Legislature can expand the scope of meaning of income by including within its definition, which naturally cannot be treated as 'income'. However, such exercise can only be done by the Parliament[10], or at best, by the delegated authority, if such power is delegated by the Parliament[11]. However, where the delegation of power by the Parliament to the Central Government is restricted to framing of ICDS, in the opinion of the author, expansion of the scope of income in the garb of framing rules for the purpose of computation of 'income' would be read down by the Courts. A challenge to ICDS as a whole as well as on specific standards is pending before the Hon'ble Delhi High Court[12].

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Ratio Decidendi

An EPC contractor supplying goods and services cannot be compared with service providers alone

The taxpayer was a Swiss tax resident having a Permanent Establishment (PE) in India. It was awarded a contract by an Indian customer on Engineering Procurement and Commissioning (EPC) basis. The project included offshore supplies, offshore services, onshore supplies and onshore services. With a view to carry out its obligations under the said EPC contract it entered into transactions of purchasing goods and services from its Associated Enterprise (AE). It accounted for its income under two segments namely Supplies and Services and benchmarked the two separately for the purpose of demonstrating compliance with Indian Transfer Pricing regulations. Revenue authorities objected to this treatment and contended that there is only one segment viz. execution of EPC contracts and both supply of goods as well as rendition of services are integrally connected to each other and should not be benchmarked separately. The ITAT upheld the contention of Revenue Authorities observing that the fact that prices of different components are separately agreed upon does not detract from the fact that the same are closely linked transactions and have to be benchmarked on a collective basis. It also held that the characterization of the assessee as a provider of engineering services was incorrect

[10] *Navnitlal C. Javeri* v.*K.K.Sen*, AAC [1965] 56 ITR 198 (SC).
[11] *Tata Tea Ltd.* v. *State of W.B.* [1988] 173 ITR 18
[12] *The Chamber of Tax Consultants* v. *UOI* W.P.(C) 5595/2017

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and appropriate comparables have to be chosen since an EPC contractor providing turnkey solutions cannot be compared to a service provider.[*RTA Alsea AG* v. *CIT*, TS-675-ITAT-2017 Del-Trib]

AO should pass a draft order in the case of an eligible assessee even in case of assessment pursuant to remand

While disposing off the appeal in the case of a taxpayer eligible for procedure under section 144C of the Income tax Act, 1961 ('the Act') before it the Income Tax Appellate Tribunal (ITAT) remanded the matter back to the file of Assessing Officer (AO). AO after re-examining the matter in the light of remand directions passed a final order directly and raised tax demand accordingly. On challenge in a writ petition the Hon'ble High Court held that AO should have passed only a draft assessment order and accordingly the Court set aside the final order so passed by the AO. [*JCB India Ltd.* v. *DCIT*, 85 Taxmann.com 155 (Del HC)]

Income from letting of building with amenities taxable as income from other sources

The assessee entered into an agreement to lease out the ground, first and second floors of a certain business premises that it owned. The floors were leased out with a fully furnished setup, air conditioning and diesel generator set. The assessee offered income generated from the said letting to tax under the head 'Income from house property'. However, the department was of the view that income was in the nature of composite rent taxable under Section 56(2)(iii) of the IT Act as income under the head 'Income from Other sources'. As a consequence of which deduction claimed by the assessee under Section 24(a) of the Act was disallowed. Before the Delhi High Court, the assessee argued that there was no separate consideration for amenities and that the predominant purpose of the transaction was to lease out the building. The Revenue, on the other hand, argued that, the fact that the lease was a composite one was evident from the lease deed entered into by the parties and therefore the entire income must be taxed under the head income from other sources. The Delhi High after hearing both the parties, placing reliance on the principles laid down by the Apex Court in *Sultan Bros P Ltd* v. *CIT* [1964] 51 ITR 353, examined whether there was any separability between the two aspects of lease – building and amenities. The Delhi High Court referred to the clauses of lease deed and inferred that there was a specific obligation on the assessee to provide the amenities and in turn a specific obligation on the lessee to handover the office along with all the amenities in good condition after the end of the lease period. Hence, the Court opined that there cannot be any doubt that this was a case of composite letting and it was therefore held that the rental income was taxable under Section56(2)(iii) and it was also noted that corresponding claim of depreciation can be made. [*Jaymetal Indsutries P Ltd v. CIT*, [2017] 84 taxmann.com 11 (Del)]

Subsidy representing exemption from sales tax taxable as revenue receipt

The assessee is engaged in the manufacture of cold rolled/galvanized steel strips, sheets etc. It had two units - cold rolling unit/ galvanized unit which was located at Sahibabad District in Uttar Pradesh. Under two notifications issued under the Uttar Pradesh General Sales Tax Act, exemption from payment of sales tax was given upto a period of 6 years in respect of any goods manufactured in an industrial unit which is a new unit located in a specified backward area. The assessee's units were eligible for the exemption

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and thus by virtue of the exemption, whatever was collected as amounts of sales tax was not required to be remitted to the Government. The said amounts were accounted for as a capital subsidy by the assessee. The Assessing officer, applied Section 43B of the Act and treated the aforesaid amounts as income of the assessee. The CIT (A) held that the subsidy, representing tax collected which were exempted from being paid to the Government, would not be in the nature of trade receipts. The CIT(A), relying on the preamble to the two notifications, opined that these are given for setting up industries in the backward areas. It was also stated that though the subsidy/grant allowed appears to be in the nature of exemption in sales tax, in reality the sales tax amount is only a measurement of subsidy to be allowed by the State. Upon Appeal by the revenue to the Delhi High Court, the revenue relied on the ratio laid down in *Sahney Steel and Press Works Ltd* [1997] 228 ITR 253. Analyzing the provisions of the exemption scheme, it was put forth by the revenue that there were no restrictions on use of amounts so retained by the assessee while in the original scheme there were specific provisions for capital subsidy. The Court thus held that considering the fact that there was no end use specified for the subsidy amounts, essentially, the purpose was for greater profitability as an incentive to investing and the amount was taxable as revenue receipt. [*CIT* v. *Bhushan Steels and Strips Limited*, [2017] 83 taxmann.com 204 (Del)]

Write off of a sum without specific waiver of liability cannot be treated as a bad debt

The assessee advanced a sum of money to a broker for purchase of shares. The shares were, however, not purchased by the said broker and he could not repay the sum advanced to the assessee as well. Later, an agreement was entered into with the broker who agreed to pay a part of the sum and give shares for the balance. The assessee had written off the amount for which share was agreed to be given, as a bad debt in the books of accounts. The AO was of the view that the amount could not be treated as a bad debt since there is no specific waiver of liability and no debt was, in the first instance recognized as such. The AO further stated that broker had undertaken to pay part amount and give shares for the balance and if it was considered a loss, it must be held to be speculative in nature. The AO, further noting the fact that no income was, in the first instance offered to tax so as to allow the bad debts claim, denied the deduction to the assessee as bad debts. Observing that every advance was not a debt, the High Court held that a sum written off without specific waiver of liability cannot be treated as a bad debt. [*CIT* v. *Estotrac Finance and Investments Ltd* [2017] 84 taxmann.com 67 (Del)]

Directors should be issued notice before proceeding for recovery of dues of the company

The department sought to recover unpaid dues of a private company from the assessee who was a director in the said company. The company had filed its return of income and was processed under Section 143(3). However, the Commissioner set aside the assessment as time-barred. Notice for re-opening was issued and re-assessment order was passed determining the income of the company at a higher rate. Simultaneously, penalty proceedings were initiated and penalty under Section 271(1)(c) was imposed. On the premise that the company had not discharged such tax and penalty liabilities, department sought to recover tax and penalties from the director and order under Section 179(1)

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was passed. The Court opined that though the language of the section is in the negative covenant casting primary duty on the director to establish such facts, a director of a company would discharge his responsibility of establishing necessary facts only when he is put to notice that the authority proposes to pass order under section 179(1) of the Act. Thus the High Court set-aside the order issued under Section 179 (1) since the earlier notices were issued on the company and not on the directors of the company and there was no record of neglect, misfeasance or breach of duty on part of the director, which is a requirement as per Section 179. [*Susan Chacko Perumal* v. *ACIT*, [2017] 84 taxmann.com 68 (Gujarat)]

News Nuggets

Furnishing estimation of income and tax liability in certain cases – CBDT issues draft notification

CBDT has issued a draft notification on 19-9-2017 in respect of companies and person other than companies to insert a new Rule 39A which would mandate such assesses to whom Section 44AB applies, to furnish an estimate of income, tax liability and intimation of payment of taxes. In terms of the proposed rule, those assessees who are to get their accounts audited as per Section 44AB would have to furnish the information as on 30th September of the previous year on or before 15th November of the previous year. If the income estimated as on 30th September is less than that of the income of the corresponding period of the immediately previous year by Rs. 5 lakh or 10% which ever is higher, the assessee will have to furnish details of the estimated income and tax liability as on 31st December, before 31st January of the previous year.

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