A TAXING ISSUE

JAIRAJ PURANDARE sheds more light on the recently notified Income Computation and Disclosure Standard III.

The business world in India is on the brink of a paradigm shift in the manner of recognising and disclosing income for the purposes of taxation as per the Income-Tax Act, 1961 ('the IT Act') as a result of notification of Income Computation and Disclosure Standards ('ICDS') by the Central Board of Direct Taxes ('CBDT'). The ICDS have been notified on March 31, 2015, and have come into effect from April 1, 2015 (i.e. Financial Year 2015-16 onwards).

So far, 10 standards have been notified, which lay down the framework for recognising and disclosing taxable income under the heads 'profits and gains of business or profession' and 'income from other sources'. The ICDS are applicable to all taxpayers following the mercantile system of accounting, without any monetary threshold. Therefore, ICDS will be applicable to corporate as well as non-corporate entities such as partnerships, limited liability partnerships, association of persons, and even individuals.

The 10 standards cover various aspects of computation of income such as recognition of revenue, valuation of inventories, fixed assets and changes in foreign exchange rates, among others. ICDS III relating to 'Construction Contracts' would in particular have an impact on the construction industry. This standard is to be applied in computing the income of a contractor from a construction contract. For the purpose of this standard, a construction contract is defined as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of design, technology, function or ultimate use and includes a contract for rendering services that are directly related to the construction of the asset.

The key provisions of ICDS III are discussed below:

Separate construction contracts

The provisions of this standard are to be applied to each construction contract separately except where a group of contracts is negotiated as a single package or the contracts are closely related or are performed concurrently or in a continuous sequence.

In case of construction of an additional asset, such a construction should be considered as a separate contract if the asset differs significantly from the assets covered in the original contract or if the price of the asset is negotiated separately.

Contract revenues

Revenue from contracts is to be recognised and offered to tax when there is reasonable certainty of its ultimate collection and the revenue can be measured reliably. Contract revenue should include initial amount of revenue agreed as per the contract, retention money, variations in contract work, claims and incentive money.

Where contract revenue is recognised as income of a particular year and subsequently such amount cannot be recovered, the said amount is to be recognised as an expense in the

subsequent year in which the fact of non-recovery is crystallised, as against reducing this amount from the contract revenue.

Contract costs

Contract costs should include costs that are directly related to the specific contract or costs that can be directly attributable and allocable to the contract activity, including borrowing costs and costs incurred in securing a contract if they can be separately identified and there is a probability of securing the contract. If the costs cannot be specifically attributable to any contract, such costs are to be excluded from the construction contract. Costs relating to future activities are required to be recognised as assets, and classified as work in progress.

Recognition of revenues and costs

This standard mandates the use of 'percentage of completion method' for recognition of contract revenue and costs. As per this method, contract revenue and costs are considered as income and expenditure with reference to stage of completion of the contract. The stage of completion is determined based on the proportion of costs incurred to the estimated total contract costs or completion of a physical proportion of the contract work or based on surveys of work. In determining the stage of completion, contract costs relating to future activities or payments made to subcontractors in advance are to be excluded.

Further, during the early phases of a contract (defined as up to 25 per cent of the whole contract), revenue is to be recognised only to the extent of costs incurred. However, once the contract is completed to the extent of 25 per cent of the whole contract, contract revenue is to be recognised in accordance with the percentage of completion method.

Provision for anticipated losses is not allowed as per ICDS. Losses are to be recognised as expenditure in the year of actual occurrence having regard to the stage of completion of contract.

Transition

For construction contracts that

have not been completed as on March 31, 2015, revenues and costs are to be recognised as per this new standard.

Disclosure requirements

Contract revenue recognised during the relevant year and methods used to determine stage of completion of contract are required to be disclosed. For contracts in progress, details such as the breakup of costs incurred, recognised profits, advances received and amount of retention money are to be disclosed.

Key departures from AS 7 'Accounting for construction contracts'

Inclusion of retention money in contract revenue is a significant deviation from common practice to date. Based on various judicial precedents, retention money was recognised for the computation of income only when the right to receive retention money accrued to the taxpayer. However, as per ICDS III, retention money is to be recognised based on the percentage of completion. While this would merely result in a temporary timing difference, this provision appears to be inconsistent with the mercantile system of accounting where income accrues only when the taxpayer gets the right to receive such income.

Provision for anticipated losses is permitted to be recognised under AS 7 whereas as per ICDS, losses cannot be recognised unless they are actually incurred. Further, actual losses can also be recognised only on the basis of percentage of completion.

Open issues

ICDS III is silent on issues such as decrease in the contract price on account of disputes, imposition of damages, etc, which are a common occurrence in long-term contracts. Absence of provisions for such issues may lead to conflicting treatment and thereby result in litigation, causing hardship to taxpayers.

Impact of ICDS

As a result of the introduction of ICDS, the profits of taxpayers as per the books of account will now have to be adjusted to give effect to the principles laid down in the ICDS. Thereafter, such adjusted profits will be further subject to adjustments as per the IT Act. In practice, it may amount to requiring taxpayers to maintain a separate set of books of account, in line with the ICDS, resulting in an additional compliance burden.

Delegated legislation

The CBDT has been granted powers to notify rules or issue clarifications on provisions contained in the IT Act, under a delegated legislation. While delegating powers to the CBDT, the Legislature is required to lay down the policy of the law and the principles to carry out the policy, and the CBDT has the powers to prescribe rules for the execution of the policy.

However, as per Section 145(2) of the IT Act, the power to notify the standards itself has been delegated to the CBDT, as against power to issue mere clarifications. While in recent years, courts have been more liberal and the trend has been towards delegating greater powers to the executive wing, the fundamental issue still remains as to whether the power to notify the entire framework for computation of income under ICDS is within the ambit of delegated legislation or whether it overrides delegated powers. | CW |

About the author:

Jairaj (Jai) Purandare, Chairman, JMP Advisors, based in Mumbai, has over three decades of experience and significant expertise in advising multinational and Indian clients across fields on investment proposals to regulatory authorities including the FIPB and the RBI. He has been named among the leading tax advisors in India by Euromoney in its report, World's Leading Tax Advisors.

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