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Newsflash: Certain clauses of ICDS found contrary to the binding judicial precedents and thus, held unconstitutional - Delhi High Court

THE POWER OF BEING UNDERSTOOD

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Case name

Delhi High Court in the case of the Chamber of Tax Consultants & ANR vs. Union of India [W.P.(C) 5595/2017] dated 8 November 2017.

1.0 Brief Facts

- Section 145(1) of the Income-tax Act, 1961('the Act') provides that the income chargeable under the head "Profits and gains of business or profession" or "Income From Other Sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee. Section 145(2) provides that the Central Government may notify Income Computation and Disclosure Standards (ICDS) for any class of assessees or for any class of income.

- Accordingly, Central Government notified 10 ICDS vide Notification No.87/2016 dated 29 September 2016. The revision of the Tax Audit Report vide Notification No. 88/2016 dated 29 September 2016 was made for ensuring the compliance with the provisions of ICDS and for capturing the disclosures mandated by the ICDS. Subsequently, the CBDT issued clarification in the form of 25 FAQs through Circular No. 10 of 2017 dated 23 March 2017. These ICDS are applicable from Assessment Year 2017-18 (Financial Year 2016-17)

- The significance of the changes brought in by the ICDS can be appreciated from the fact that the Assessing Officer (AO) empowered by section 145(3), can, for the purposes of computation of the taxable income, reject the books of accounts maintained by the Assessee if he is not satisfied about their correctness or completeness. In such an event, the AO can resort to a 'best judgment assessment' under Section 144 of the Act.

- In this context, the Petitioners[1] filed writ petition in public interest challenging the constitutional validity of the amended Section 145 mandating compliance with ICDS. The petitioner also sought for quashing the notification No.87 and 88 of 2016 dated 29 September, 2016 and Circular No.10/2017dated 23 March, 2017.

2.0 Decision of the Honourable Delhi High Court

- The High Court ruled that Section 145 (2) of the Act, 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. If Section 145 (2) of the Act as amended is not so read down it would be ultra vires the Act and Article 141 read with Article 144 and 265 of the Constitution.

- The High Court struck down certain clauses of various ICDS stating that they were unconstitutional. Each such clauses of the ICDS along with the reasoning given by the High Court are tabulated as under:

[1] The Chamber of Tax Consultants and Mr. C.S. Mathur

ICDS	Extent to which they were held unconstitutional	Reasons given by the High Court
ICDS I Accounting Policies	To the extent it does away with the concept of 'prudence' is contrary to the Act and binding judicial precedents and is therefore unsustainable in law.	Doing away with the concept of 'prudence' is contrary to the Act and binding judicial precedents and is therefore unsustainable in law.
ICDS II Valuation of Inventory	Entire ICDS-II	For sidestepping the decision of the Supreme Court in the case of **Shakti Trading Co.**[2] wherein it was held that on dissolution of a firm where the business is not discontinued, stock in trade has to be valued at cost or market value, whichever is lower. Further, entire ICDS II is contrary to the provisions of section 145A.
ICDS III Construction con-tracts	To the extent it relates to treatment of retention money and deductibility of incidental income against borrowing cost **[Paragraph 10 (a) and 12 (d) of the ICDS]**	Treatment of retention money and is contrary to the **settled position of the law**[3]. Similarly restricting the deductibility of incidental income against borrowing cost is contrary to the decision of the Supreme Court in **CIT vs. Bokaro Steel Limited**[4].
ICDS IV Revenue Recognition	To the extent it relates to recognition of export incentive income in the year of the claim and restriction to follow completed contract method in respect of Service Transaction **[Para 5 and 6 of the ICDS]**	The requirement to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection is contrary to the decision of the **Supreme Court in Excel Industries**[5]. wherein it was held that it is only in the year in which the claim is accepted by the Government that a right to receive the payment accrues in favour of the Assessee. Besides the proportionate completion method, the contract completion method has been recognized as valid method of accounting under the mercantile system of accounting by **various decisions of Supreme Court**[6]. Therefore, to the extent that para 6 of ICDS-IV permits only one of the methods, i.e., proportionate completion method, it is contrary to the above decisions, held to be ultra vires the Act and struck down as such.

[2] (2001) 250 ITR 871 (SC)
[3] CIT v. Simplex Concrete Piles India (P) Ltd (1988) 179 ITR 8, CIT v. P & C Constructions (P) Ltd (2009) 318 ITR 113, Amarshiv Construction (P) Ltd v. DCIT (2014) 367 ITR 659, DIT v. Ballast Nedam International (2013) 355 ITR 300 which followed the decision in Anup Engineering Limited v. CIT (2000) 247 ITR 114
[4] [1999] 102 Taxman 94 (SC).
[5] (2015) 358 ITR 295 (SC)
[6] CIT v. Bilhari Investment Pvt. Ltd. (supra) and this Court in CIT v. Manish Buildwell Pvt. Ltd and Paras Buildtech India Pvt. Ltd. v. CIT (supra)

ICDS	Extent to which they were held unconstitutional	Reasons given by the High Court
ICDS VI **Effects of changes in foreign exchange rates**	To the extent it states that market 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 the case of **Sutlej Cotton Mills Limited vs. CIT**[7]**.**
ICDS VII **Government Grants**	To the extent it provides that recognition of government grants cannot be postponed beyond the date of actual receipt.	This is in conflict with the accrual system of accounting.
ICDS VIII **Valuation of securities**	To the extent it requires that closing value of securities held as stock on the basis of bucket approach rather than on individual basis **[Part A of the ICDS VIII]**	Valuation based on bucket approach is different from the approach prescribed by the AS. Such change through ICDS cannot be allowed unless there is an amendment to the Income-tax Act in this regard. Further, it would cause entities to maintain separate records for income tax purpose for every year since the closing value of the securities would be valued separately for income-tax purposes and for accounting purposes.

Our Comments

This verdict of the High Court has reinforced the well-settled principle that a tax cannot be levied by way of an executive action but only by parliamentary action.

By striking down some of the key clauses of the ICDS, the Delhi High Court has essentially taken the teeth out of it and thereby brought cheer to the taxpayers who are already grappling with regulatory changes of the GST, Ind-AS, Companies Act, 2013.

However, it is important to note that the High Court's verdict is not the last word on matter and is expected to be challenged before the Supreme Court.

In the interim period, since the constitutional validity of specific clauses of various ICDS are under challenge, the CBDT may clarify as to what position be taken by taxpayers who are due to file return of income by the end of this month i.e. 30th November 2017.

Further, it is believed that CBDT is in the process of notifying new ICDS on Real Estate Transactions. Considering the above decision of the High Court, it would be imperative for the Central Government to finalize the clauses of proposed ICDS in sync with binding judicial precedents.

In its verdict, the High Court has remarked at some places that ICDS cannot prescribe any method/approach without there being a corresponding amendment to the Act. With Union budget 2018 just a couple of months away, it would be interesting to see whether some of these clauses get introduced as amendments to the Income-tax Act by the parliament.

[7] [1979] 116 ITR 1 (SC)

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This newsflash is general in nature. In this newsflash, we have summarized the decision of Delhi High Court in the case of the Chamber of Tax Consultants & ANR vs. Union of India [W.P.(C) 5595/2017] dated 8 November 2017. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said notification and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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