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Article

ICDS – Will it make an Impact?

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Formulation of Income Computation and Disclosure Standards ('ICDS')

The Central Government is empowered[1] to notify 'accounting standards' under Section 145 of the Act[2] which need to be necessarily followed while computing income under the head 'profits and gains of business or profession' or 'other sources'. In the year 1996[3], two[4] 'accounting standards' were notified with the intention of ensuring that the income is computed precisely and objectively.

For formulating 'accounting standards' to be notified under the Act, a committee was also constituted later in July 2002, which recommended that the 'accounting standards' issued by ICAI[5] should be adopted with relevant modifications in the Act, wherever necessary. The committee was of the view that it would be impractical for a taxpayer to maintain two sets of books of accounts, i.e., one in accordance with the standards issued by ICAI while the other in accordance with the standards notified in the Act. The recommendations of the committee could not be implemented, since it would have required extensive amendments to the Act which could have rather resulted in complexities besides litigation.

Significant developments took place thereafter firstly, by way of MCA notifying certain 'accounting standards' in the Companies Act, then subsequently, introduction of Indian accounting standards ('Ind-AS') for facilitating convergence of Indian accounting standards with IFRS by MCA and lastly and more importantly, in absence of relevant accounting standards in the Act itself, uncertainty moved around some issues which led to continued litigation.

Wary of these difficulties, CBDT constituted another Committee in December 2010 to harmonise the accounting standards issued by the ICAI with the provisions of the Act and also for suggesting amendments to the Act required for transitioning to Indian accounting standards. The committee examined all the 31 accounting standards in force at that point of time and released 14 Tax accounting standards ('TAS') for public comments (the rest 17 were pertaining to disclosure requirements and therefore irrelevant from tax aspect) in October 2012. After examining the suggestions of stake holders the CBDT released the revised drafts of 12 Income Computation and Disclosure Standards ('ICDS') and invited suggestions of various stakeholders and the general public.

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1 *Vide* Finance Act, 1995

2 Income Tax Act, 1961 (hereinafter referred to as 'Act')

3 Notification No. SO 69(E) dated 25-1-1996

4 Relating to *'Disclosure of Accounting Policies'* and *'Disclosure of Prior period and extraordinary items and changes in accounting policies'*

5 Institute of Chartered Accountants of India

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The names of all standards are changed from 'TAS' to 'ICDS', pursuant to amendment[6], to clarify that the 'ICDS' apply only to computation of taxable income and tax payers are not required to maintain separate books of account to comply with 'ICDS'. Transitional provisions have also been inserted in all 'ICDS', which broadly requires recognition of the concerned contract/transaction, asset, income, expense, loss or provision existing as on or entered into on or after 1st of April, 2015.

Controversy

Primarily, the intention of introducing the 'ICDS' is to maintain uniformity and to remove uncertainty besides reducing litigation as it attempts to purge alternative accounting/tax treatments and it is certainly a welcome move! However, to what extent it aims to settle some unsettled disputes and unsettle some settled disputes is yet to be seen.

In this Article, the author has examined one of such issues which have been a subject matter of controversy of late, that 'whether in respect of a Finance lease transaction, the depreciation will be allowable in the hands of the 'lessor' or in the hands of the 'lessee'?

The distinction between a 'Finance lease' and an 'Operating lease' is set out in Accounting Standard ('AS-19') on Leases[7] (as also in new set of 'ICDS'). It further provides that in a Finance lease transaction, typically, all the risks and rewards incidental to ownership vests with the 'lessee' and it is the 'lessee' who is a *actual and real owner* and the 'lessor' is rather a *nominal or symbolic owner* and therefore the depreciation in such cases is available in the hands of the 'lessee'. Tribunal (SB) decision in the case of ***IndusInd Bank Ltd.***[8] also held that depreciation is allowable in the hands of lessee in case of a finance lease.

The relevance of Accounting Standards was highlighted by the Supreme Court in ***CIT v. Woodward Governor***[9] wherein it was held that the Accounting Standards which are continuously adopted by an assessee, can be superseded or modified by legislative intervention. However, but for such intervention, the method of accounting undertaken by the assessee continuously is supreme.

Therefore in absence of any contrary treatment prescribed in the Act, in a Finance lease transaction, the treatment prescribed in 'AS-19' could thus have been followed and the depreciation would be available in the hands of the 'lessee'. However, the controversy was ignited when the decision of the Supreme Court in ***I.C.D.S Ltd. v. CIT***[10] was pronounced, wherein it was held the 'lessor' is entitled to claim the depreciation since in a finance lease transaction it is the 'lessor' who is the legal owner of the asset and the use by the 'lessor' in its leasing business would satisfy the test of use as well and physical

[6] By Finance Act (No. 2) 2014

[7] Issued by Institute of Chartered Accountants of India

[8] ITA No. 6566/Mum/2002 & ITA No. 606/Mum/2003

[9] [2009] 312 ITR 254 (SC) (2 JB)

[10] [2013] 29 taxmann.com 129 (SC)

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use of the asset is not necessary.

Let us examine various provisions of the Act, to understand whether the law laid down by the decision in *I.C.D.S Ltd.* (supra) and its interplay with the ICDS (issued by CBDT)?

Legal position

As per the mandate of section 32 of the Act, depreciation is available to the assessee who *'owns'* the asset and *'uses'* the same for the purposes of its business. Therefore, the twin requirement of 'ownership' as well as 'use' is required to be met.

'Ownership' - does not necessarily co-exist with legal title. The Supreme Court in the case of ***CIT v. Podar Cement***[11] settled the controversy on the significance of 'legal title' in the context of Section 22 of the Act and held that 'owner is the person who is entitled to receive income from property in his own right and not necessarily the person having legal title over that property'.

Further, the Supreme Court in ***Jodhamal Kuthiala v. CIT***[12] also laid down certain propositions, (a) a property cannot be owned by two persons, each one having independent and exclusive right over it; (b) the concept has also to be looked into from practical point of view having regard to reasonability and justice; (c) the meaning given to the word 'owner' must not be such as to make the provision capable of being made an instrument of oppression; (d) the word 'owner' has different meanings in different contexts; (e) under certain circumstances a lessee may be considered as the owner of the property leased to him.

It was thus held in the above case that 'an assessee whose house property is vested in the hands of a custodian, cannot be assessed as owner since the word 'owner' must mean, a person who can exercise the rights of the owner and is entitled to the income from the property'.

The Supreme court, again, in the case of ***Mysore Minerals v. CIT***[13] applying the above decisions, observed in the context of Section 32 of the Act, that the term 'owned' must be assigned a wider meaning and anyone in possession of property in his own title exercising dominion over the property as would enable others being excluded there from and having the right to use and occupy the property or to enjoy its usufruct in his own right would be the owner of the building though a formal deed to title may not have been executed and registered.

It therefore emerges from the above decisions that, (a) legal title over the asset is not decisive to determine the owner of the said asset; (b) depreciation under Section 32 of the Act is a periodic allowance of the capital cost incurred and hence should be available to the person incurring that cost in real sense having regard to reasonableness and justice; (c) the lessee could also be treated as the owner of the asset provided the lessee exercises such rights over the asset which gives him the dominion over the asset and

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[11] 226 ITR 625 (SC)

[12] 82 ITR 570 (SC)

[13] 239 ITR 775 (SC)

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enable him to enjoy the benefits there from.

'Use' - the assets should be used by the lessee for the purposes of business which is being carried on and thus this test could be satisfied in a relatively easier way.

CBDT Circular[14] states that the accounting treatment will have no bearing on the allowance of depreciation on assets under the Act and ownership of the asset needs to be determined having regard to the substance of the terms between the 'lessor' and the 'lessee'. Therefore, it does leave scope for a case where based on terms, the 'lessee' would be treated to be owner for the purpose of depreciation.

Conclusion

In a finance lease transaction, *where* the terms of the lease are such that the substantive rights incidental to ownership vests with the 'lessee' while the 'lessor' continues to be the symbolic or nominal owner, the depreciation could be claimed by the 'lessee'. Therefore, where the substantive rights vests with the 'lessee' and a sliced down legal tile with the 'lessor', it is the 'lessee' who should be considered to be the owner of the asset for the purpose of Section 32 of the Act.

The Supreme Court's decision in ***I.C.D.S*** (supra) may be considered supreme for the set of facts. Yet the ICDS issued by CBDT and Tribunal (SB) decision in the case of ***IndusInd Bank Ltd.***[15] can still be validly applied in certain cases.

Undoubtedly, the new set of ICDS seeks to put an end to the protracted litigation and bring uniformity amidst the varied treatments prescribed in ICAI -AS and the MCA notified Ind-AS, yet to some extent it settles some unsettled disputes and unsettles some settled disputes.

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Circular

'Other sum chargeable' - Clarification on basis for disallowance for non-deduction of TDS

CBDT *vide* Circular No. 3 of 2015 *dated* 12-2-2015, has clarified that for the purpose of disallowance under Section 40(a)(i) of the Act, in respect of *'other sum chargeable'* as mentioned in Section 195 of the Act, it is only the appropriate portion of the sum, with income component therein, which is chargeable to tax under the Act, that shall form the basis of such disallowance. The CBDT has also clarified that, where the determination of *'other sum chargeable'* has been made under sub-section (2), (3) or (7) of Section 195 of the Act, then the sum so determined, will form the basis for disallowance. This clarification of CBDT paves way for arguing that, reimbursements that are not taxable in India, cannot be subject matter of dis-allowance for non-deduction of tax.

[14] 2/2001 dated 9-2-2001

[15] ITA No. 6566/Mum/2002 & ITA No. 606/Mum/2003

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Ratio decidendi

TP analysis cannot be rejected merely because they are based on unaudited results

The taxpayer had provided certain IT and ITeS services to its associated enterprise. Transfer pricing analysis was done separately in respect of all the services on the basis of segmental results by adopting TNMM as the most appropriate method. The TPO, however, rejected the Transfer pricing analysis on the ground that the same was based on unaudited segmental results and allocation of expenses involved a lot of assumptions and presumptions, and arrived at the Arm's length price by applying TNMM at the entity level margins. On these facts, the Tribunal held that Transfer pricing analysis cannot be rejected merely on the ground that they were unaudited and more so when there is no specific reasoning by the TPO to show that the allocation keys adopted by the taxpayer were wrong or unreasonable. [*Syniverse Mobile Solutions Pvt. Ltd.* v. *DDIT* (ITAT Hyderabad), ITA 1416/Hyd/2014, dated 11-02-2015]

Credit period allowed to non associated enterprises must be used for comparability

The taxpayer provided certain IT and ITeS services to its associated enterprises. In respect of certain instances of excess credit period allowed by the taxpayer to its associated enterprises on its receivables, the TPO made adjustments on the ground that under similar circumstance with third parties, interest would have been charged for the delay. For making the adjustment, credit period of one month was taken as reasonable period without any basis. On these facts, the Tribunal observed that since credit period was offered by the taxpayer in its transaction with unrelated non-associated enterprises as well, such period should be considered as internal comparables in determining any adjustment. [*Syniverse Mobile Solutions Pvt. Ltd.* v. *DDIT* (ITAT Hyderabad), ITA 1416/Hyd/2014, dated 11-02-2015]

Corporate guarantee - not an international transaction

The taxpayer had provided 'Corporate guarantee' to its associated enterprise. The transaction was not treated as an international transaction by the taxpayer. However, the TPO regarded extension of guarantee as an international transaction and determined arm's length price for it. The taxpayer contended that the guarantee provided does not come within the purview of 'international transaction' since it does not have an impact on income, profit, losses or assets of the enterprise. On these facts, the Tribunal relying on *Bharti Airtel* and *Redington's* case held that a corporate guarantee issued for the benefit of associated which does not involve any cost or have any bearing on profits, income, losses or assets of the enterprise would not fall within the purview of 'international transaction' as defined in Section 92B of the Act. [*Videocon Industries Ltd.* v. *ADIT* (ITAT Mumbai), ITA 6145/Mum/2012, dated 06-02-2015]

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Rendering of re-insurance services does not result in Permanent Establishment

The taxpayer, a Swiss incorporated company provided re-insurance services to cedant insurers in India. The premium received, being 'business income' was treated by the taxpayer as not taxable in the absence of Permanent Establishment in India. The Revenue alleged that the subsidiary of the taxpayer in India was to be treated as its Service PE and Dependant Agent PE. The Tribunal held that mere existence of subsidiary would not ipso-facto result in a PE in India. It further held that reinsurance services are specifically excluded from being construed as Dependant Agent PE under Article 5(4) of the Tax Treaty between India and Switzerland and hence the taxpayer could not be regarded as having a PE in India in the facts of the taxpayer. [*Swiss Re-insurance Company Limited* v. *DDIT* (ITAT Mumbai)in ITA No 1667/Mum/2014 dated 13-02-2015]

Wide connotation to the expression 'manufacture or produce' for claiming deduction u/s 10B

The taxpayer carried on the business of manufacturing and export of engineering goods and claimed deduction under section 10B of the Act. The deduction was denied by the AO on the ground that activities of testing, painting and prepackaging for export did not amount to 'manufacture', and that setting up of a plant outside India would not entitle claim of deduction under Section 10B. It was held that the word 'production' has a larger magnitude and is expansive and liberal than the term 'manufacture' and that the activity of testing and prepackaging would be covered by the term 'manufacture or production'. It was noted that this wide connotation is explicit in Explanation 4 whereby cutting and polishing of precious and semi precious stones is treated as manufacture or production. On reading of Explanation 3, the Court also held that software developed outside India and even services rendered for development of software outside India are to be treated as export for the purpose of granting exemption under Section 10B. [*CIT* v. *AAR ESS Exim Pvt. Ltd* (Del HC) in ITA No 551 & 553/2013 dated 05-02-2015]

Distinction between 'sale' and 'right to use' capacity in telecommunication contracts

The taxpayer, a Bermudan company was incorporated to build high capacity undersea cable system between United Kingdom and Japan. A MoU was entered into by the taxpayer with various telecommunication companies across the globe (including VSNL in India) for planning and implementing the cable system. VSNL made lump-sum payment to the assessee for purchase of 'capacity' in the submarine cable system. In addition, certain payments were made as standby maintenance charges by VSNL for repair and maintenance as and when required by the surveillance ships deployed by the taxpayer. The Revenue treated the payment as Royalty by holding that the sale of 'capacity' by the taxpayer to VSNL merely grants a 'right to use' the capacity. Observing that the terms of agreement are decisive to determine the commercial character and

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nature of transactions, the Tribunal held that transfer of capacity granted an unfettered right to VSNL as regards usage, resale or assignment of interest in the capacity to the exclusion of assessee and treated it to be 'sale' of capacity. As regards stand-by repairs and maintenance charges, it has been held that 'rendering' of services is *sine qua non* for determining taxability as Fee for technical services. Since no services were actually rendered, the Tribunal concluded that the payments did not qualify to be Fee for technical services. [*Flag Telecom Group Ltd* v. *DCIT* in ITA No 6254/Mum/2003, vide order dated 06-02-2015]

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