

11 November 2011

# EY Tax Alert

EY recommendations on Discussion Paper on Tax Accounting Standards



## Executive summary

This Tax Alert summarizes Ernst & Young's (EY) recommendations on the Discussion Paper on Tax Accounting Standards (Tax AS) issued by the Central Government (CG) on 17 October 2011. The Discussion Paper contains recommendations of the Accounting Standards Committee (Committee) constituted by the CG and drafts of the proposed Tax AS on (i) Construction Contracts (ii) Government Grants. The CG invited comments/suggestions on the Committee's recommendations and draft Tax AS by 11 November 2011<sup>[1]</sup>.

We are pleased to inform you that we have presented EY's views on the Discussion Paper and the proposed Tax AS to the CG on 10 November 2011.

The task of formulating accounting standards is a formidable and monumental one. The present set of 28 accounting standards issued by The Institute of Chartered Accountants of India (ICAI AS) and notified by the CG under Section 211(3C) of the Companies Act, 1956, is a result of evolution over four decades. We are appreciative of the professed object of the Committee to recommend Tax AS with the intent of achieving horizontal equity and uniformity and to provide for certainty and clarity. We do recognize the challenge of adopting a white board approach and evolving tax-specific set of standards.

<sup>[1]</sup> Please refer EY Tax Alert dated 20 October 2011 on 'Central Government issues Discussion Paper on Tax Accounting Standards'.

The challenge before the Committee would also be to take into account the comprehensive mandate which would require the Committee to prepare for the transition to a regime of Indian Accounting Standards (IND AS) converged to International Financial Reporting Standards (IFRS).

Given the above and consistent with the object of certainty and clarity, we believe that an alternative approach should be adopted rather than attempting to reinvent the wheel by notifying an independent set of standards.

## Background

The CG, vide an Order<sup>[2]</sup> dated 20 December 2010, had constituted the Committee, comprising officials of the Tax Authority and professionals, with the following terms of reference:

- i. To study the harmonization of ICAI AS with the Indian Tax Laws (ITL) and to suggest accounting standards for tax compliance under the ITL, with relevant modifications.
- ii. To suggest a method for determination of tax base (book profit) for the purpose of Minimum Alternate Tax (MAT) in case of companies migrating to IFRS-converged IND AS in the initial year of adoption and thereafter.
- iii. To suggest appropriate amendments to the ITL in view of transition to IND AS regime.

<sup>[1]</sup> Order No. 134/48/2010-SO(TPL)

## Interim Report of the Committee

The Committee submitted its interim report in August 2011 in which it presented its recommendations only on the first term of reference viz., harmonization of ICAI AS with the ITL and suggestion of accounting standards for tax compliance. It is yet to present its recommendations on the other two terms of reference.

Its main recommendations on the first term of reference are as follows:

1. ICAI AS cannot be notified without modification for the purpose of tax compliance since they are not in harmony with the ITL. Hence, separate Tax AS should be notified which should provide specific rules enabling computation of income with certainty and clarity. To ensure horizontal equity and uniformity, Tax AS should eliminate alternatives for differing accounting treatment, as far as possible.
2. It would be burdensome for the taxpayer to maintain two separate books of account for corporate law and tax compliance purposes, in accordance with the respective accounting standards. Accordingly, Tax AS should be made applicable only for computation of taxable income and the taxpayer should not be required to maintain books of account on the basis of Tax AS.
3. Two different sets of accounting standards may cause confusion for the taxpayers and other stakeholders. Accordingly, Tax AS should be termed as 'Tax Accounting Standards' to distinguish them from

ICAI AS or accounting standards relevant for compliance with the Indian Corporate Laws (ICL).

4. Since Tax AS are based on the mercantile system of accounting, they should be applicable only to those taxpayers following mercantile system of accounting and not to those following cash system of accounting.

5. Since Tax AS are intended to be in harmony with the ITL, they should, specifically, provide that, in case of conflict between the ITL provisions and Tax AS, the ITL provisions shall prevail.

6. Currently, the starting point for computation of taxable income under the heads 'Profit and gains of business or profession' or 'Income from other sources' is the income as per financial statements. Since Tax AS may not correspond with accounting standards used for preparation of financial statements, reconciliation between income as per financial statements and income computed as per Tax AS should be presented.

## Draft Tax AS on Construction Contracts and Government Grants

Drafts of Tax AS on Construction Contracts and Government Grants, as recommended by the new Committee, were annexed to the Discussion Paper. Drafts of other Tax AS will be issued in due course. These are in addition to Tax AS I relating to disclosure of accounting policies and Tax AS II relating to disclosure of Prior Period and Extraordinary Items and

changes in accounting policies already notified by CG in 1996.

## EY recommendations

### General recommendations

- ▶ It may be advisable to continue to be guided, for tax purposes, by ICAI AS, in particular, when the same is notified by the CG under the ICL. It may be incorrect to suggest or apprehend that such accounting standards would not reflect the income base of a taxpayer correctly. It would be incorrect to assume that any of such standards has a tilt of tax avoidance in favor of a taxpayer.
- ▶ Assuming the above is not acceptable for any reason or logic, still, it may be reviewed whether there is a need for necessarily prescribing a standard on each and every subject matter which has been dealt with by ICAI. We do strongly believe that, instead of creating a parallel maze of multiple standards formulated in a different language and a different style, leading to issues of independent understanding and raising chances of independent litigation on interpretation of the new standards, the purpose may be achieved by adopting one of the undermentioned alternatives:
  - ▶ In a case where ICAI AS do not offer more than one alternative to the accounting treatment, the CG may kindly refrain from notifying a separate standard; it may merely adopt ICAI AS as its own standard. The CG has successfully adopted this approach and notified 28 ICAI AS under the ICL, with a very nominal carve out.

- ▶ In a case where the CG perceives a need for deviating from ICAI AS, either because ICAI AS offer alternatives which are not acceptable to the Committee or because of some other logical reason, the Committee may, as far as is possible, restrict itself to the consideration of the deviations and may restrain itself from dealing with any subject matter except the defined deviations. The deviations/carve outs may be listed along with adequate reasoning and basis for the same so that the intent of the Committee/CG is made clear and the reader is able to appreciate how the proposed carve out achieves the professed object of certainty and clarity.
- ▶ The Committee has rightly recognized that the statutory provision will continue to have overriding impact and that Tax AS will always be subservient to the provisions of the statute. In keeping with this spirit, it is suggested that:
  - ▶ At par with a statutory provision, Tax AS should also be read as subservient to any judicial pronouncement which may have interpreted the statutory provision to which the formulated Tax AS is recommended to be subservient.
  - ▶ In a case where Tax AS is in conflict with any statute, including, say, the ITL or The Banking Regulation Act or The Insurance Act or the ICL or the like, the tax impact should not be visited as the taxpayer is constrained by other applicable statutory provisions.
- ▶ In any view of the matter, the recommended Tax AS should be made applicable on a prospective basis and should be made applicable to all those incidents of accounting which accrue or shape up after the date of notification of the new Tax AS.

- ▶ It may be clarified that Tax AS will not apply to computation of 'book profit' under the MAT provisions of the ITL.

### **Recommendations on Tax AS on Construction Contracts**

- ▶ Since comparable ICAI AS permit only one method viz., percentage of completion method, there is no need to notify separate Tax AS on construction contracts.
- ▶ Alternatively, ICAI AS on Construction Contracts which is notified under the ICL, may be notified under the ITL, with specific carve outs/deviations desired for tax purposes.
- ▶ Tax AS may be made applicable only to new contracts undertaken on or after the date of its applicability.
- ▶ To remove ambiguity and to maintain consistency with settled judicial precedents and consideration of prudence, provision made for foreseeable loss which is reasonably certain to occur should be expressly permitted at any stage of the contract.
- ▶ To avoid any ambiguity, it should be specifically clarified, on the lines of ICAI AS, that damages payable to customer for delayed execution of contract and downward variation in contract will be treated as decrease in contract revenue.
- ▶ Specific guidance on reliable estimation of outcome of contract may be inserted in Tax AS to avoid any ambiguity.

### **Recommendations on Tax AS on Government Grants**

- ▶ It should be clarified that the requirement of not postponing recognition of Government grants beyond the date of actual receipt applies only for grants for which attached conditions are fulfilled. Otherwise, such requirement will have a flavor of cash basis of accounting, which is contrary to the Committee's recommendations and the framework of Tax AS and Tax AS I notified under the ITL, which mandate mercantile method of accounting).
- ▶ As actual cost/tax written down value (WDV), forming basis of computation of business income, is governed by specific provisions of the ITL, the alternatives permissible under the comparable ICAI AS for Government grants relating to fixed asset are really academic and do not impact computation of tax liability. It may, therefore, be advisable to maintain status quo and not suggest any carve out to ICAI AS.
- ▶ In view of the settled position under the ITL that Government grants related to fixed assets (whether depreciable or not) represent capital receipts, mandate of Tax AS to treat grants related to non-depreciable fixed assets as income is likely to give rise to dispute and litigation. It may, therefore, be advisable to maintain status quo and not suggest any carve out to ICAI AS.
- ▶ It should be clarified that the treatment specified for recognizing compensation for past expenses or losses as income is restricted to Government grants of revenue nature and not to capital grants,

merely because such grant is quantified on the basis of past expenses or loss.

- ▶ In view of the settled position under the ITL that grants of capital nature are not liable to tax, the omnibus provision of Tax AS requiring all other Government grants to be treated as income may be modified to make it applicable only to grants of revenue nature.
- ▶ To avoid litigation, as also to accord with ICAI AS and settled judicial precedents, it should be specifically provided that grants in the nature of promoters' contributions should be credited to capital reserve.
- ▶ In respect of the disclosure requirement for Government grants not recognized as income or reduction from actual cost/WDV, it should be clarified that the requirement of separate disclosure is in respect of Government grants which, though recognized in books, is recognized either as a liability or a capital reserve instead of being credited as income in Profit & Loss account or as asset cost reduction.

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