



Global Business Tax Alert

Sharp Insights

¹Delhi High Court rules on powers of the central government to notify ICDS² to ensure they do not override binding judicial precedents or provisions of the Act. High Court rules specifically on few standards and on particular paragraphs of other standards

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¹ The Chamber of Tax Consultants & ANR vs. Union of India & ORS [WP.(C) 5595/2017 & CM APL 23467/2017]

² Income Computation and Disclosure Standards notified u/s. 145(2) of the Income-tax Act, 1961 vide Notification No. 87/2016 dated 29 September 2016.

Background

The Chamber of Tax Consultants ["Petitioner"] filed a Writ Petition before the Delhi High Court challenging the constitutional validity of the ICDS notified by the central government for the purpose of computing the income of the taxpayer(s) following mercantile system of accounting, taxable under the head "Profits and gains of business or profession" or "income from other sources".

Key arguments

Broad arguments put forth by the Petitioner before the High Court were:

- The effect of ICDS is to modify the basis of taxation;
- In the guise of delegating powers to the central government to issue accounting standards/ICDS, what has been effectively done is delegation of essential legislative power to amend the provisions of the Income-tax Act, 1961 ["the Act"] especially those affecting chargeability and computation of taxable income.
- A power to impose tax by way of introduction of the ICDS cannot be inferred from mere generality of powers conferred on the central government by the enabling Act. It must be specifically conferred by the enabling Act and must thereafter be exercised within the strict limits of authority conferred by such Act.
- The impugned notification notifying ICDS is contrary to the settled law since its implementation would nullify judgments of the Supreme Court and the High Courts. Reference in this regard was made to various judgments which would now stand virtually inapplicable on account of ICDS.
- Consequently, with ICDS being made mandatory it was no longer open to a taxpayer to compute taxable income in terms of the Act as explained by the judgments of the Supreme Court and High Courts. This method of overriding the binding decision of Courts, by the executive, was contrary to the law explained in **Shri Prithvi Cotton Mills Limited v/s. Broach Borough Municipality (1969) 2 SCC 283**.
- The notified ICDS and the impugned notification lacked one of the important elements of the rule of law i.e. legal certainty.
- The vagueness or subjectivity in the ten ICDS would result in unequal and discriminatory taxation and would increase the burden on the taxpayer(s) for maintaining one set of books of accounts for accounting purposes and another for tax purposes, would create confusion, interpretation issues, multiplicity of records and additional compliance burden which would outweigh the gains of ICDS and constitute an unreasonable restriction on the freedom to conduct business.

Broad arguments put forth by the Respondent were:

- At every stage of issuance of the ten ICDS there was a detailed consultation with the stakeholders.
- The amendment to Section 145 of the Act was aimed at codifying the law and give complete guidance to the taxpayer to ensure that if they follow the guiding principles, then the AO has no option but to accept it and there should be no reason to object an attempt to codify standards for computation of income for greater clarity and to act as a check on the powers of the AO.

- Reliance placed on the decision of the Supreme Court in the case of **Commissioner of Income Tax v/s. Poddar Cement P. Limited (1997) 226 ITR 625**, where the Court had applied the doctrine of “updating construction”, which required acknowledgment of emergent trends in business, technology and law and the corresponding revision of the Accounting Standards issued by the ICAI.
- It was denied that the computation provided under ICDS does not overrule the judicial precedents since the changes brought about are only aimed at bringing uniformity and clarity in the computation of income.

Issues before the High Court

- Whether the amendments to Section 145 are instances of delegation of essential legislative powers by the Parliament, to the central government?
- Is the ICDS an instance of excessive delegation of legislative powers? Whether the impugned ICDS are contrary to the settled law as explained in various judicial precedents and are, therefore, liable to be struck down?
- Whether the impugned amendments to Section 145 of the Act and the consequential ICDS and circular violate Articles 14, 19 (1) (g), 141, 144 and 265 of the Constitutionⁱⁱ?

Observations and Ruling of the High Court

Re: Whether the amendments to Section 145 are an instance of delegation by the Parliament of essential legislative powers to the central government?

- The High Court observed that the amendments to Section 145 permit the central government, as a delegate of the legislature, to notify standards for income computation but not to bring about changes to settled principles as laid down in judicial precedents which seek to interpret and explain statutory provisions contained in the Act.
- It opined that if such power is permitted to be exercised by the central government, then clearly it would be an instance of unfettered power in the hands of the executive which is unguided and uncanalised.
- The power under Section 145 (2) of the Act cannot permit changing the basic principles of accounting that have been recognized in various provisions of the Act unless of course corresponding amendments are carried out to the Act itself.
- It also held that where there is a binding judicial precedent, by virtue of Articles 141 and 144 of the Constitution, it is not open to the executive to override it unless there is an amendment to the Act by way of a validation law.
- To that extent, Section 145 (2), as amended, has to be read down to restrict powers 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.

Re: Are the ICDS an instance of excessive delegation of legislative powers? Whether the impugned ICDS are contrary to the settled law as explained in various judicial precedents and are, therefore, liable to be struck down?

The High Court found merit in the contention of the Petitioner(s) that ICDS notified under the provision of the Act have the effect of modifying the basis for computation of taxable income as recognised by the Act and as interpreted by the Supreme Court.

Accordingly, it found it necessary to look at each of the ICDS which are contrary to or seek to overcome binding judicial precedents. The finding of the High Court on each of the ICDS which were challenged before it, are as under:

- **ICDS I** (relating to Accounting Policies) which does away with the concept of "prudence", is contrary to the Act and binding judicial precedents and is therefore unsustainable in law.
- **ICDS II** (pertaining to valuation of inventories) eliminates the distinction between a continuing partnership business after dissolution from one which is discontinued upon dissolution and fails to acknowledge that the valuation of inventory at market value upon settlement of accounts of the outgoing partner is distinct from valuation of the inventory in the books of the business which is continuing. Accordingly, ICDS II is held to be *ultra vires* the Act and struck down.
- **ICDS III** (relating to construction contracts):
 - The treatment of retention money under paragraph 10 (a) in ICDS-III will have to be determined on a case-to-case basis by applying settled principles of accrual of income.
 - This is because by deploying ICDS-III in a manner that seeks to bring to tax the retention money, the receipt of which is uncertain/conditional, at the earliest possible stage, would be contrary to the settled position in law.
 - Para 12 of ICDS III read with para 5 of ICDS IX, dealing with borrowing costs, makes it clear that no incidental income can be reduced from borrowing cost which is contrary to the decision of the Supreme Court in **CIT v/s. Bokaro Steel Limited [1999] 236 ITR 315** and is therefore struck down.
 - Supreme Court in the said decision has held that if a taxpayer receives any amounts which are inextricably linked with the process of setting up of its plant and machinery, such receipts would go to reduce the cost of its assets. Plainly therefore, to the extent that ICDS III is interpreted and applied in a manner contrary to the law settled by the various decisions of the Supreme Court and the High Courts, it cannot be sustained.
- **ICDS-IV** (relating to revenue recognition)
 - para 5 requires a taxpayer to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection which is contrary to the decision of the Supreme Court in **CIT v/s. Excel Industries (2015) 358 ITR 295**, and is, therefore, *ultra vires* the Act and is struck down.
 - Proportionate completion method as well as the contract completion method have been recognized as valid methods of accounting under the mercantile system of accounting by the Supreme Court in **CIT v/s. Bilhari Investment Pvt. Ltd. (2008) 299 ITR 1** and by the Delhi Court in **CIT v/s. Manish Buildwell Pvt. Ltd (2011) 245 CTR 397** and **Paras Buildtech India Pvt. Ltd. v/s. CIT (2016) 382 ITR 630**.

- Therefore, to the extent para 6 of ICDS-IV permits only one of the methods, i.e., proportionate completion method, it is contrary to the above decisions, and is held to be *ultra vires* the Act and struck down.
- Para 8 (1) of ICDS IV (providing that interest shall be accrued on time basis determined by the amount outstanding and the rate applicable) has not been shown to be contrary to any judicial precedent. Also, there is no challenge to Section 36(1) (vii) of the Act. Accordingly, para 8 (1) of ICDS-IV is held to be not *ultra vires* the Act and its validity is upheld.
- **ICDS-VI** (relating to effects of changes in foreign exchange rates) which states that marked-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 **Sutlej Cotton Mills Limited v/s. CIT (1979) 116 ITR 1**, insofar as it relates to marked-to-market loss arising out of forward exchange contracts held for trading or speculation purposes. It is therefore held to be *ultra vires* the Act and struck down.
- **ICDS VII** (relating to government grants), provides that recognition of government grants cannot be postponed beyond the date of accrual receipt, is in conflict with the accrual system of accounting and to that extent, held to be *ultra vires* the Act and struck down.

This is because many a times, conditions are attached to the receipt of government grant, the non-fulfilment of which may lead to return of such amount. In such instances, it cannot be said that there is any accrual of income although the money has been received in advance.

- **ICDS VIII** (relating to securities) provides that those entities not governed by the RBIⁱⁱⁱ (namely entities other than Scheduled Banks and Public Financial Institutions) to whom Part A of ICDS VIII is applicable, the accounting prescribed by the AS has to be followed which is different from the ICDS.

In effect, such entities will be required to maintain separate records for income tax purposes for every year since the closing value of the securities would be valued separately for income tax purposes and for accounting purposes and to this extent Part A of ICDS VIII is held to be *ultra vires* the Act and is struck down.

Re: Whether the impugned amendments to Section 145 of the Act and the consequential ICDS and Circular violate Articles 14, 19 (1) (g), 141, 144 and 265 of the Constitution?

The High Court ruled that in order to preserve the constitutionality of the said section, Section 145 (2) of the Act as amended is required to and is hereby read down to restrict power of the central government to notify ICDS that do not seek to override binding judicial proceedings or provisions of the Act.

Conclusion

The High Court has struck down some ICDS' and also few paragraphs from other ICDS' as being ultra vires the provisions of the Act and/or in being contrary to the settled law as laid down by various decisions of the Supreme Court.

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ⁱ Section 145 of the Act (as amended with effect 01 April 2015) provides that income chargeable under the head 'profits and gains of business or profession' or 'income from other sources' shall be computed in accordance with the cash or mercantile system of accounting regularly employed by the tax payer and shall be subject to the ICDS notified.

ⁱⁱ Article 14 of the Constitution of India - Equality before law;
Article 19 (1) (g) of the Constitution of India – Right of citizens to practise any profession;
Article 141 of the Constitution of India – Law declared by Supreme Court to be binding on all courts;
Article 144 of the Constitution of India – Civil and judicial authorities to act in aid of the Supreme Court; and
Article 265 of the Constitution of India - Taxes not to be imposed save by authority of law.

ⁱⁱⁱ Reserve Bank of India