

Delhi High Court decides on constitutional validity of amended section 145(2) and notified Income Computation and Disclosure Standards

November 15, 2017

In brief

In a recent decision, the Delhi High Court (HC)¹ has held that the powers conferred in section 145(2) of the Income-tax Act, 1961 (the Act), have to be read down to restrict the power of the Central Government (CG) to notify Income Computation and Disclosure Standards (ICDS) that sought to override binding judicial precedents or provisions of the Act. The HC considered the amendment to section 145(2) as ultra vires to the Act and Article 141 read with Article 144 and 265 of the Constitution of India. The HC observed that the power to enact a validation law was an essential legislative power that could be exercised, in the context of the Act, only by the parliament and not by the executive.

In detail

Background

- Section 145 of the Act was amended by the Finance Act (FA) (No. 2) 2014, empowering the CG to notify ICDS. Accordingly, the Central Board of Direct Taxes (CBDT) notified² 10 ICDS.
- It was provided that the provisions of the Act and the Income-tax Rules, 1962 (the Rules) would prevail over the ICDS provisions.
- The CBDT issued a circular³ which resulted in ICDS provisions prevailing over judicial precedents which

may be to the contrary.

- A petition was filed before the Delhi HC challenging the constitutional validity of the notified ICDS.

Issues before HC

- Whether the amendments to section 145 was an instance of delegation by the Parliament of essential legislative powers to the CG?
- Was the ICDS an instance of excessive delegation of legislative powers? Whether the impugned ICDS was contrary to the settled law as explained in various judicial precedents, and was

therefore, liable to be struck down?

- Whether the impugned amendments to section 145 of the Act and the consequential ICDS and Circular violates Articles 14, 19 (1) (g), 141, 144 and 265 of the Constitution?

HC's decision

Delegation of essential legislative functions

- Where there was a binding judicial precedent, by virtue of Articles 141 and 144 of the Constitution, it is not open to the executive to

¹ W.P.(C) 5595/ 2017 & CM APL 23467/ 2017

² Notification No. 87/ 2016 dated 29 September, 2016

³ Circular No. 10/ 2017 dated 23 March, 2017

override it unless there is an amendment to the Act by way of a validation law.

- In case the notified ICDS sought to alter the system of accounting or tax treatment to a particular transaction, it would require the legislature to step in to amend the Act to incorporate such change.
- The amended section 145(2) of

the Act has to be read down to restrict power to notify ICDS that sought to override binding judicial precedents or provisions of the Act. The power to enact validation law was to be exercised only by the Parliament and not by the executive. If the amended section 145(2) of the Act were not so read down, it would have been ultra vires the Act

and Article 141 read with Articles 144 and 265 of the Constitution.

Excessive delegation of legislative powers

The HC considered it necessary to look at each of the ICDS that was contrary or sought to overcome binding judicial precedents and held as follows:

ICDS No.	Name of ICDS	ICDS provision	HC order
I	Accounting policies	<ul style="list-style-type: none"> • The concept of prudence, which was present in the earlier AS – 1, has been completely done away with. ICDS - 1 stipulates that prudence is not to be followed unless specified under the provisions of any other ICDS. 	<ul style="list-style-type: none"> • Concept of prudence is embedded in section 37(1) of the Act, which allows deduction in respect of expenses “laid out” or “expended” for the purpose of business. • To this extent, the provisions of ICDS, are contrary to the provisions of the Act and the principles laid down in binding judicial precedents,⁴ and are therefore, unsustainable in law.
II	Valuation of inventories	<ul style="list-style-type: none"> • Valuation of inventory in case of dissolution of a partnership firm has to be on net realisable value. • No distinction whether the business is continued or discontinued after dissolution. 	<ul style="list-style-type: none"> • The provisions will lead to taxing notional income and are contrary to the decision of the Supreme Court (SC) in Shakti Trading Co.⁵ • Fails to acknowledge the valuation of inventory at market value upon settlement of accounts of the outgoing partner is distinct from valuation of the inventory of the business, which is continuing. • ICDS II is held to be ultra vires the Act and struck down as such.
III	Construction contracts	<p>Retention money</p> <ul style="list-style-type: none"> • Retention money to be part of revenue, assessable to tax on proportionate computation method. Also clarified in Question No. 11 of the circular.³ <p>Set off of incidental income</p> <ul style="list-style-type: none"> • The ICDS does not allow reduction of incidental income from borrowing cost. 	<p>Retention money</p> <ul style="list-style-type: none"> • The treatment of retention money to be determined as per terms of the contract on case-to-case basis, by applying the settled principles of accrual of income. • It is upheld in various judicial precedents⁶ that retention money does not accrue until and unless the defect liability period is over and it is certified that no liability is attached further.

⁴ 49 DTR 253 (Del), 275 ITR 30 (Guj)

⁵ 250 ITR 871 (SC)

⁶ 179 ITR 8 (Calcutta), 318 ITR 113 (Madras), 367 ITR 659 (Gujarat), 355 ITR 300 (Gujarat), 247 ITR 114 (Delhi)

ICDS No.	Name of ICDS	ICDS provision	HC order
			<ul style="list-style-type: none"> • Taxing the amount, the receipt of which is uncertain/ conditional, is contrary to the settled position. <p>Set off of incidental income</p> <ul style="list-style-type: none"> • The ICDS provisions are contrary to the decision of the SC in Bokaro Steel Limited,⁷ wherein it was held that if the amount received is inextricably linked with the setting up of plant, the same will be reduced from the cost of asset. <p>To the extent explained above, ICDS III is ultra vires and struck down as such.</p>
IV	Revenue recognition	<ul style="list-style-type: none"> • Export incentive Recognise income from export incentive in the year of making claim, if there is “reasonable certainty” of its ultimate collection. • Revenue recognition method The ICDS prescribes only one method, i.e., the percentage completion method for computing revenue from service contracts. • Interest income Interest income to be offered to tax on time basis and corresponding deduction can be claimed under section 36(1)(vii) of the Act. The provision is in line with the amendment by the Finance Act, 2015 under section 36 of the Act. 	<p>Export incentive</p> <ul style="list-style-type: none"> • Contrary to the decision of the SC in Excel Industries,⁸ wherein it was held that the right to receive accrues in the year in which the claim is accepted by the government. • Therefore, held to be ultra vires the Act and struck down as such. <p>Revenue recognition method</p> <ul style="list-style-type: none"> • The proportionate completion method and the contract completion method have been recognised as valid methods of accounting under the mercantile system of accounting by the SC in the case of Bilhari Investment Pvt. Ltd.⁹ • Therefore, to the extent the ICDS permits only one of the methods, it is held to be ultra vires the Act and struck down as such. <p>Interest income</p> <ul style="list-style-type: none"> • This is to create a mechanism of tracking unrecognised interest amounts for future taxability and is in line with the amended provisions of the Act. Para 8 has been held to be valid.
VI	Effects of changes in foreign exchange rates	<ul style="list-style-type: none"> • Marked to market loss/ gain in case of foreign currency derivatives, held for trading or speculation purposes, not to be allowed. 	<ul style="list-style-type: none"> • Disallowance of marked to market gain/ loss is contrary to ratio laid down by the SC in Sutlej Cotton Mills Limited.¹⁰ • Therefore, it is held to be ultra vires the Act and struck down as such.

⁷ 236 ITR 315 (SC)

⁸ 358 ITR 295 (SC)

⁹ 299 ITR 1 (SC)

¹⁰ 116 ITR 1 (SC)

ICDS No.	Name of ICDS	ICDS provision	HC order
VII	Government grants	<ul style="list-style-type: none"> Recognition of government grants cannot be deferred beyond actual receipt. 	<ul style="list-style-type: none"> Income may have to be recognised on receipt basis, which may not have accrued. This position is contrary to the accrual system of accounting and is held to be ultra vires and struck down as such.
VIII	Securities	<ul style="list-style-type: none"> Entities on which Reserve Bank of India regulations are not applicable, are required to value securities category wise and not on individual basis. 	<ul style="list-style-type: none"> Such treatment is contrary to the accounting prescribed by Accounting Standard leading to requirement to maintain separate books of account for tax purposes. The change cannot be effectuated without corresponding amendment to the Act. To that extent, it is held as ultra vires.

Constitutional validity of amended section 145(2) of the Act and the consequential ICDS and circular

- The CBDT is meant to clarify the law by exercising the powers under section 119 of the Act and not to change it. Some of the ICDS mandate the applicability of accounting principles contrary to the provisions of the Act, for the purpose of computation of income.

In order to preserve its constitutionality, section 145 (2) of the Act as amended is required to and is hereby read down to

restrict the power of the CG to notify ICDS that sought to override binding judicial proceedings or provisions of the Act.

The takeaways

- The Delhi HC has reaffirmed that the ICDS provisions cannot overrule the provisions of the Act, the Rules and the judicial precedents interpreting the provisions of the Act. The interpretations laid down by various judicial precedents would prevail and will not be affected by ICDS.
- Given the above, the taxpayers will have to decide the

positions to be taken in the tax returns which are yet to be filed and whether a revision of return is necessitated for the returns already filed. Amongst other things, the possibility of effects of this decision being subsequently modified, any applicable interest liability, the limitation period to revise tax returns etc. may need to be considered.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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