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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **W.P.(C) 5595/2017 & CM APL 23467/2017**

Reserved on: October 16, 2017
Date of decision: November 08, 2017

THE CHAMBER OF TAX CONSULTANTS & ANR ..... Petitioners
Through: Mr. S. Ganesh, Senior Advocate with Mr. Prakash Kumar, Mr. Vipul Joshi, Mr. R.P. Garg, Mr. Ajay Singh, Mr. Dharan Gandhi and Ms. Rashmi Singh, Advocates.

versus

UNION OF INDIA & ORS ..... Respondents
Through: Mr. Brajesh Kumar, Advocate for R-1.
Mr. Sanjay Jain, Additional Solicitor General with Mr. Ruchir Bhatia, Mr. Puneet Rai, Ms. Adrija Thakur, Advocates for R-2.

CORAM:
JUSTICE S.MURALIDHAR
JUSTICE PRATHIBA M. SINGH

J U D G M E N T

% **08.11.2017**

Dr. S. Muralidhar, J.:

Introduction

1. This writ petition by the Chamber of Tax Consultants, (Petitioner No. 1) and Mr. C.S. Mathur, (Petitioner No. 2) seeks a declaration of the constitutional invalidity of:

(i) the notification No. 87/2016 dated 29th September 2016 issued by the Central Board of Direct Taxes (CBDT), Department of Revenue, Ministry of

Finance, Government of India whereby in exercise of the powers conferred by Section 145 (2) of the Income Tax Act, 1961 (‘Act’), the Central Government notified ten 'income computation and disclosure standards' (‘ICDS’), as specified in the Annexure to the said notification to be followed by all Assessees following the mercantile system of accounting, for the purposes of computation of income chargeable to income tax under the head “Profits and gains of business or profession” or “income from other sources”. [The expression 'Assessee' excluded an individual or a Hindu Undivided Family who is not required to get his accounts of the previous year audited in accordance with the provisions of Section 44 AB of the Act]

(ii) Circular No. 10 of 2017 dated 23rd March 2017 issued by the CBDT (TPL Division) issuing clarifications to the said ICDS.

(iii) The substituted and amended Section 145 of the Act [by the Finance Acts (FA) of 1995 and 2014].

2. The declaration is sought on the ground of their being violative of Articles 14, 19 (1) (g), 141, 144 and 265 of the Constitution of India. Another specific prayer is for the quashing of the Notification dated 29th September 2016 and Circular No. 10 of 2017 dated 23rd March 2017.

The Petitioners

3. Petitioner No. 1 is stated to be a society established and registered under the Societies Registration Act, 1860 as well as Bombay Public Trusts Act, 1950. It is stated to have more than 3600 members which include Advocates, Chartered Accountants, Tax Practitioners, Company Secretaries

and corporates. Petitioner No. 1 has its registered office in Mumbai and a Chapter in New Delhi. It is stated to be a voluntary non-profit organization formed *inter alia*

> "(i) to spread education in matters relating to tax laws and other laws and accountancy; and allied subjects of professionals' interest
>
> (iii) to carry on activities for the extension of knowledge in the fields of tax laws and other laws, accountancy and allied subjects of professionals' interest
>
> (iv) (e) to make representations to any government or non - government authority, committees, commissions and study teams, or at conferences or similar gatherings
>
> (iv) (l) to seek representation and appear before the other tax law enforcement authorities, tribunals and courts in matters of public interest and in cases of importance to professionals and Assessees in general, including taking up and pursuing public interest litigations."

4. Petitioner No. 2, Mr. C.S. Mathur, is stated to be a qualified Chartered Accountant (CA) practising in the area of Direct Tax Laws for the last 40 years. He is stated to be the Past Chairman of the Delhi Chapter of Petitioner No. 1.

5. The CBDT has been impleaded as Respondent No. 2 and the Union of India through the Department of Revenue, Ministry of Finance is Respondent No. 1.

6. Notice was issued in this petition on 7th July 2017 whereby Respondent Nos. 3 and 4 were deleted from the array of parties leaving Respondent No.1, Union of India and Respondent No. 2, CBDT. The Court made it clear

in the order passed on that date that the pendency of the present petition would not preclude the Union of India and CBDT from holding consultations with Petitioner No. 1 and other professional bodies and consider the representations already stated to have been made by them on the issue.

7. Initially, the deadline for filing of income tax returns for the Assessment Year ('AY') 2017-18 was to expire on 30th September 2017. This was extended up to 31st October 2017.

8. Pursuant to the notice issued in the writ petition, a counter-affidavit has been filed on behalf of Respondent No. 2 and a rejoinder thereto has been filed by the Petitioners.

Changes to Section 145

9. The central issue in the present petition concerns the validity of the ICDS notified by the Central Government for the purpose of computing the income of Assessees following the mercantile system of accounting, taxable under the head "Profits and gains of business or profession" or "income from other sources". The major premise on which the impugned ICDS is based is that the income computed for the purposes of income tax under the above two heads need not be (as is often not) the income as reflected in the books of accounts maintained by such Assessee. Although the computation of such taxable income would normally be based on the books of accounts of the Assessee, and dependant on the method of accounting followed by the Assessee subject to the adjustments for allowances and deductions under the Act, an Assessing Officer (AO) can, for the purposes of computation of the

taxable income, and in exercise of the powers under Section 145 (3) of the Act, 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 order, therefore to appreciate the significance of the changes sought to be introduced by the ICDS by the impugned notifications, it is necessary to first examine the changes to Section 145 of the Act.

10. Section 145 of the Act was substituted by the Finance Act, 1995 (FA) with effect from 1st April 1997. In terms of the said amendments, an Assessee had to follow either the mercantile or cash system of accounting. The Central Government was empowered to notify in the Official Gazette, from time to time, the accounting standards (AS) to be followed by any class of Assessees or in respect of any class of income. The amended Section 145 of the Act fell in Chapter XIV which deals with the 'Procedure for Assessment' and read as under:

> "145. Method of accounting
>
> (1) 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.
>
> (2) The Central Government may notify in the Official Gazette from time to time accounting standards to be followed by any class of Assessees or in respect of any class of income.
>
> (3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the Assessee, or where the method of accounting provided in sub-section (I) or accounting standards as

notified under sub-section (2)) have not been regularly followed by the Assessee, the Assessing Officer may make an assessment in the manner provided in section 144."

The steps towards notifying the ICDS

11. By a notification dated 25th January 1996 the Central Government notified two AS on the basis of which the accounts of the Assessees were to be maintained, i.e. (i) AS-1, 'Disclosure of Accounting Policies and accounting standards (ii) AS-II, Disclosure of Prior Period items and Extraordinary items and Changes in Accounting Policies' (AS-5). The Petitioners point out that the aforementioned ASs were adopted from the AS issued by the Institute of Chartered Accountants of India (ICAI), a statutory body established under an act of Parliament to regulate the profession of CAs.

12. The CBDT, in December 2010, constituted the Accounting Standards Committee ('AS Committee') comprising of Indian Revenue Services (IRS) officers from the Income Tax Department and professionals like CAs, with the following objects:

(i) to study the harmonization of ASs issued by the ICAI with the direct tax laws in India, and suggest ASs which need to be adopted under Section 145 (2) of the Act along with the relevant modifications;

(ii) to suggest a method for determination of the tax base (book profit) for the purpose of Minimum Alternate Tax (MAT) in the case of companies migrating to International Financial Reporting Standards ('IFRS') (to be known as Ind-AS) in the initial year of adoption and thereafter; and

(iii) to suggest appropriate amendments to the Act in view of transition to Ind-AS regime.

13. The aforementioned Committee examined 31 ASs issued by the ICAI. The Committee drafted 14 Tax ASs and recommended that the said standards be notified under the Act only for the purposes of computation of taxable income. The Committee was of the view that "a taxpayer would not be required to maintain books of account on the basis of the AS notified under the Act". By a Press Release dated 26th October 2012, the CBDT issued the Final report of the Committee and sought for comments from general public and stakeholders by 26th November 2012.

14. Petitioner No. 1 made a detailed representation to the CBDT pointing out how the proposed Tax ASs were directly in conflict with the well-established legal position under the Act about the concept of accrual, income, prudence, materiality, etc. Petitioner No. 1 also highlighted the fallacies concerning each of the Tax ASs.

15. After almost two years, i.e., in July 2014, an amendment was made to Section 145 of the Act by the Finance (No. 2) Act, 2014. The amended Section 145 reads as under:

> "Section 145: Method of accounting
>
> (1) 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.

(2) The Central Government may notify in the Official Gazette from time to time income computation and disclosure standards to be followed by any class of Assessees or in respect of any class of income.

(3) Where the Assessing Officer is not satisfied about the correctness or completeness of the accounts of the Assessee, or where the method of accounting provided in sub-section (I) has not been regularly followed by the Assessee, or income has not been computed in accordance with the standards notified under sub-section (2), the Assessing Officer may make an assessment in the manner provided in section 144. "

16. By a separate Press Release dated 9th January 2015, the CBDT circulated a draft of 12 ICDS for comments from stakeholders and general public by 8th February 2015. Thereafter, on 31st March 2015 the CBDT notified the ten ICDS which were required to be followed by all the Assessees following mercantile system of accounting, for the purposes of computation of income chargeable under the head 'Profits and Gains of business or profession' and 'income from other sources' for the AY 2016-17 and the subsequent years, i.e., applicable with effect from 1st April 2015. The preamble to each of the ten ICDS clearly mentioned that the ICDS is not for the purposes of maintenance of books of accounts. The text of the standard Preamble reads as under:

"The Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gain of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.

In the case of conflict between the provisions of the Act and this

Income Computation and Disclosure Standard, the provisions of the Act shall prevail to that extent."

17. According to the Petitioners, a conjoint reading of the ten ICDS suggested that for their implementation, parallel sets of books of accounts/ records were required to be maintained.

18. The CBDT appeared to have issued a comprehensive guidance/clarification by a Press Release dated 26th November 2015 stating that the stakeholders and general public may bring out, by 15th December 2015, the issues/points which in their opinion would require further clarification/guidance. In response thereto, Petitioner No. 1 made a detailed representation dated 15th December 2015 comprising of three parts. Part A dealt with general points which should supersede all ICDS, Part B dealt with those provisions of ICDS which need to be deleted or substantially modified so as not to cause any conflict between the provisions of the ICDS and the provisions of the IT Act as interpreted by the Supreme Court. Part C dealt with other provisions that would cause hardship to taxpayers and needed clarification, guidance or dispensation.

19. By a Press Release dated 6th July 2016, CBDT deferred the applicability of ICDS to 1st April 2016. This, according to the Petitioners, was to incorporate the recommendations of the Income Tax Simplification Committee (ITSC) in the notified ICDS for clarification in respect of the representations received from the stakeholders and general public. The second reason was to make revisions in the Tax Audit Report for ensuring compliance with the provisions of the ICDS and for capturing the

disclosures mandated by the ICDS.

Impugned notifications and circular

20. Following the above, the CBDT issued two further notifications in the Official Gazette on 29th September 2016:

> (i) Notification No. 86/2016 [S.O. 3078 (E)] dated 29th September 2016 rescinding Notification No. 32/2015 [S.O. 892(E)] dated 31st March 2015
>
> (ii) Notification No. 87/2016 [S.O. 3079(E)], dated 2nd September, 2016 notifying the ten ICDS applicable from assessment year 2017-18 onwards.

21. By a separate notification No. 88 of 2016 dated 29th September 2016, the CBDT in exercise of the powers conferred by Section 44AB read with Section 295 thereof, further substituted the existing sub-clause (d) to Clause 13 in the Form No. 3CD, in Part B of the Tax Audit Report, with sub-clauses (d) and (e), so as to reflect the adjustments required to be made to the profit or loss, as the case may be, for complying with the provisions of the ICDS notified under Section 145 (2) of the Act.

22. This led to Petitioner No. 1 joining with the Bombay Chartered Accountants' Society (BCAS) to make a further 'Representation on Direct Taxes' to the ITSC chaired by Justice Easwar, a former Judge of this Court. Thereafter by Circular No. 10 of 2017 dated 23rd March 2017, the CBDT issued clarifications in the form of 25 Frequently Asked Questions (FAQs) purporting by way of answers thereto to provide clarity for better implementation of the ICDS. The aforementioned Notification Nos. 87 and 88 of 2016 dated 29th September 2016 and the circular dated 10th March

2017 have been challenged in this petition.

Submissions on behalf of the Petitioners

23. Mr. S. Ganesh, learned Senior counsel appearing for the Petitioners, submits as under:

(i) The effect of the ICDS was to modify the basis of taxation. For taxation purposes, profits are now required to be computed as per commercial accounting principles but to the extent now modified by the provisions of the ICDS.

(ii) In the guise of delegating powers to the Central Government to issue accounting standards/ICDS, what has been effectively done is to delegate the essential legislative power to amend the provisions of the Act, especially those affecting the chargeability and computation of taxable income. The Central Government cannot be conferred with such unfettered powers by the Parliament in the guise of delegated legislation to notify ICDS modifying the basis of taxation which otherwise, if at all, can be done only by the Parliament by making amendments to the provisions of the Act.

(iii) A delegate cannot override the Act either by exceeding its authority or by making provisions inconsistent with the Act. The ICDS are not based on any policy or principle discernible from the Act and in particular Section 145 thereof. In the circumstances, such delegation to the Central Government and further sub-delegation by the Central Government to the CBDT would amount to abdication of legislative powers and excessive delegation by the Parliament. Reliance was placed on the decision in

Avinder Singh v. State of Punjab AIR 199 SC 321.

(iv) A power to impose a tax by way of introduction of the ICDS cannot be inferred from the mere generality of the powers conferred on the Central Government by the enabling Act. It must be specifically conferred by the enabling Act. It must thereafter be exercised within the strict limits of the authority conferred by such Act. Further, it is well settled that no tax, fee, or compulsory charge can be imposed by any bye-law, rule or regulation or notification unless the statute under which the subordinate legislation is made, specifically authorizes such imposition.

(v) The impugned notification notifying ICDS is contrary to the settled law since its implementation would nullify the judgments of the Supreme Court and the High Courts. Reference was made to the various judgments which would now stand virtually inapplicable on account of the ICDS. It was clarified by the CBDT itself that in the case of conflict between the provisions of the ICDS and the Act, the provisions of the Act shall prevail. Consequently, with the ICDS being made mandatory it was no longer open to an Assessee 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. Broach Borough Municipality (1969) 2 SCC 283***.

(vi) Whereas the AS issued by the ICAI were applicable to all corporate and non-corporate entities following the mercantile system of accounting, ICDS was applicable only to taxpayers following mercantile system of accounting (i.e. to all assessees except individuals and HUFs whose accounts are not required to be audited under Section 44B of the Act). There was no reasonable basis on which such differentiation or classification can be made for the applicability of the ICDS since the Assessee following cash system of accounting would escape from the implications and compliance requirement of the ICDS. This was violative of Article 14 of the Constitution.

(vii) One of the important elements of the 'rule of law' was legal certainty which the ICDS and the impugned notification lacked. The vagueness or subjectivity in the ten ICDS would result in unequal and discriminatory taxation. 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. Thus, the impugned notifications were violative of Article 19 (1) (g) of the Constitution.

Submissions on behalf of the Respondents

24. Mr. Sanjay Jain, learned Additional Solicitor General of India, appearing for Respondent No. 2, replied to the above submissions and also submitted a written note of arguments. Mr. Jain placed the background to the changes brought about by Section 145 of the Act. The CBDT constituted an expert committee and submitted its first report in August 2001. The committee invited comments on the report from the stakeholders. In August 2012, the Committee submitted its recommendations to the effect that standards

proposed to be notified under the Act should apply only to the computation of taxable income but there should not be any compulsion to maintain books in terms of the notified AS. Eventually, the final report was submitted in October 2013 and in 2014 the amended Section 145 was brought about.

25. According to Mr. Jain, at every stage of issuance of 10 ICDS by notification dated 30th March 2015 there was a detailed consultation with the stakeholders. The commencement date was shifted from 1st April 2015 to 1st April 2016. Mr. Jain does not dispute that ICDS is applicable only to the Assessees following the mercantile system. Mr. Jain pointed out that the amendment to Section 145 was aimed to codify the law and give complete guidance to the Assessee to ensure that if they follow the guiding principles, then the AO has no option but to accept it. There should be no reason why an attempt to codify standards for computation of income for greater clarity and to act as a check on the powers of the AO should be objected to.

26. Mr. Jain referred to the decision of the Supreme Court in ***Subhash Photographics v. Union of India 1993 Suppl (3) SCC 323*** and submitted that a distinction had to be drawn between taxing statutes and other statutes. He also referred to ***R.K. Garg v. Union of India (1982) 1 SCR 947,*** where it was observed that "every legislation particularly in economic matters is essentially empiric and it is based on experimentation or what one may call trial and error method and therefore, it cannot provide for all possible situations or anticipate all possible abuses." Reliance was placed on the decision in ***Union of India v. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)*** where it was held that it is not for the Court to examine the merits or

demerits of such a policy and how the provisions of the statute can best be implemented. Reliance was also placed on the decision in ***Sashi Prasad Barohaa v. Agricultural Income Tax Officer (1977) 107 ITR 784 (SC)*** which held that "it is not unconstitutional for the legislature to leave it to the executive to determine details relating to the working of taxation laws, such as the selection of persons on whom the tax is to be laid, the rates at which it is to be charged in respect of different clauses of goods and the like."

27. One central plank of the submission of Mr. Jain was the decision in ***J.K. Industries v. Union of India (2008) 297 ITR 176 (SC)*** where a similar challenge to the notification of AS 22 was negatived by the Supreme Court. Mr. Jain also relied on the decision in ***Commissioner of Income Tax v. Poddar Cement P. Limited (1997) 226 ITR 625 (SC)*** where the Court applied the doctrine of 'updating construction', which required acknowledgment of the emergent trends in business, technology and law and the corresponding revision of the AS issued by the ICAI. Reliance was placed on the decisions in ***Spences Hotel P. Limited v. State of West Bengal (1991) 2 SCC 154*** and ***Union of India v. Dhanwanti Devi (1996) 6 SCC 44.*** It is denied that the computation provided under ICDS amounted to overruling the judicial precedents. It is claimed that the changes brought about are only aimed at bringing uniformity and clarity in the computation of income.

28. Reliance was placed on the decision in ***Saraswati Sugar Mills v. Commissioner of Central Excise 2011 (270) ELT 465*** and ***National Agricultural Cooperative Marketing Federation of India Limited v. Union***

of India (2003) 260 ITR 548 to urge that where the law has itself been changed, the question of legislature overruling the judiciary did not arise. Mr. Jain pointed out that the ICAI which is the apex body regulating accountancy had accepted the ICDS.

Questions that arise

29. From the above submissions, the following questions arise for consideration:

> (i) Whether the amendments to Section 145 are an instance of delegation by the Parliament of essential legislative powers to the Central Government?
>
> (ii) 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?
>
> (iii) 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?

Question (i): Delegation of essential legislative functions

30. The substitution of Section 145 with an amended version by the FA 1995, with effect from 1st April 1997, was intended to restrict the options available to an Assessee following a system of accounting other than mercantile or cash. The legislature felt the need to provide accounting

standards for income computation. The Central Government could thus by notification in the Official Gazette notify from time to time ASs to be "followed by any class of Assessees or in respect of any class of income." On 25th January 1996 the ASs of ICAI were notified by the Central Government.

31. On 7th December 2006, Ministry of Corporate Affairs ('MCA') notified as many as 28 ASs of the ICAI under Section 211 of the Companies Act, 1956, and mandated that the same to be followed by the companies. In May 2010, it was decided to converge the Indian AS with IFRS (IND-AS).

32. The position as far as corporates are concerned is that there are two methods of accounting to be followed: one under GSR 739 (E) notified by the MCA on 7th December 2006 in terms of Section 211 of the Companies Act, 1956. The other is for computation of taxable income which is as a result of the convergence of the Indian AS with the IFRS. Admittedly, both have different methods of recognition of the revenue, assets and liabilities.

33. In order to address this gap, the CBDT constituted an expert committee, which submitted its first report in August 2011. In August 2012, the Committee submitted its recommendations to the effect that standards proposed to be notified in terms of Section 145 (2) of the Act should apply only to computation of taxable income without any compulsion to maintain books as per those notified AS. The Committee recommended use of 14 of the 31 ASs issued by ICAI and the AS be identified as ICDS for the purposes of providing a comprehensive framework for computing taxable income. After the final report of the Committee was submitted in October

2013, an amendment to Section 145 of the Act was brought about in 2014. Ten ICDS were notified by Notification No. SO 892 (E) dated 31st March 2015 and was made applicable from the Financial Year 2015-16 (AY 2016-17). It is stated that prior thereto, detailed consultations were held with the stakeholders. Based on the representations received, the Central Government decided to defer the commencement date of the ICDS from 1st April 2015 to 1st April 2016, i.e., relevant FY 2017-18. Eventually, the impugned notification dated 29th September 2016 was issued making the ICDS applicable effective 1st April 2017.

34. The Circular No. 10 of 2017 issued by the CBDT on 23rd March 2017 is titled "Clarifications on Income Computation and Disclosure Standards (ICDS) notified under Section 145 (2) of the Income-tax Act, 1961." The Circular acknowledges that it had been brought to the notice of the CBDT that some of the ICDS may require "amendment/ clarification for proper implementation." The matter was then referred to the Committee which, after duly consulting the stakeholders recommended a two-fold approach for the implementation of ICDS. One was to amend the ICDS itself. The other was to issue clarifications by way of FAQs. Thus Circular No. 10/2017 was in the form of FAQs.

35. It is unclear whether Circular No. 10 of 2017 has been issued under Section 119 of the Act. However, Question No. 2 in the said Circular and an answer thereto is significant and reads thus:

> "*Question 2: Certain ICDS provisions are inconsistent with the judicial precedents. Whether these judicial precedents would prevail over ICDS?*

The ICDS have been notified after due deliberations and after examining judicial views for bringing certainty on the issues covered by it. **Certain judicial pronouncements were pronounced in the absence of authoritative guidance on these issues under the Act for computing income under the head 'Profits and gains of business or profession' or income from other sources**. Since certainty is now provided by notifying ICDS under Section 145 (2), the provisions of ICDS shall be applicable to the transactional issues dealt therein in relation to assessment year 2017-18 and subsequent assessment years." (emphasis supplied)

36. From the above clarification, it is unmistakable that the ICDS is intended to prevail over judicial precedents which may be to the contrary. The question that arises is whether this is permissible in exercise of delegated legislative power?

37. The amendments to Section 145 noticed hereinbefore 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. 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.

38. Article 265 of the Constitution of India states that no tax shall be levied or collected except under the authority of law. The power under Section 145 (2) of the Act cannot permit changing the basic principles of accounting that have been recognized in the various provisions of the Act unless of course corresponding amendments are carried out to the Act itself. Such

amendments would be consistent with an acknowledgment that as far as the Act is concerned, changing the method of accounting for computation of taxable income, would partake of an essential legislative function.

39. To elaborate, if the power to notify standards has to be exercised consistent with the recognised ASs that do not contradict any principle recognised in the Act or as explained in judicial precedents, it would be a permissible exercise of the delegated power of notifying ASs. However, where the notified AS or as in this case the ICDS, seeks to alter the system of accounting, or according accounting or taxing treatment to a particular transaction, then it will require the legislature to step in to amend the Act to incorporate such change. This may be unique to a fiscal statute like the Act. However, in the guise of a delegated power, the Central Government cannot do what is otherwise legally impermissible.

40. The system of checks and balances in the Constitution of India envisages judicial review of legislative action. Equally, it recognises the power of the legislature to enact 'validating laws' to overcome the defects (or plug the loopholes as it were) pointed out by judicial precedents.

41.1 In ***Shri Prithvi Cotton Mills Limited v. Broach Borough Municipality*** (*supra*) the facts were that Section 73 of the Bombay Municipal Boroughs Act 1925 (BMBA)allowed the Municipality to levy a ‘rate’ on buildings or lands or both situate within the municipal borough. The rules under the Act applied the rates on the basis of the percentage on the capital value of lands and buildings.

41.2 Earlier in ***Patel Gordhandas Hargovindas v. Municipal Commissioner, Ahmedabad (1964) 2 SCR 608,*** the Supreme Court had interpreted the word 'rate' to mean a tax for local purposes imposed by local authorities. The basis of such tax was the annual letting value of the lands or building ascertained by taking into account the actual rent fetched by the land or building where it is let or where it was not let, by taking into account the hypothetical tenancy and where neither method was available by applying 'suitable percentage'. Rule 350A which laid the rate on land at a percentage of the valuation based upon capital was, therefore, declared *ultra vires* the Act itself.

41.3 By Section 3 of the Gujarat Imposition of Taxes by Municipalities (Validation) Act, 1963 ('Validation Act'), the rates so imposed were validated notwithstanding the above judgment of the Supreme Court in ***Patel Gordhandas Hargovindas*** (*supra*). Section 3 of the Validation Act stated that they were not to be called in question merely on the ground that the assessment of the tax for rate on the basis of the capital value of the building or land, or on the basis of a percentage of such capital value.

41.4 Negativing the challenge to the Validation Act, the Supreme Court in ***Shri Prithvi Cotton Mills Limited v. Broach Borough Municipality*** (*supra*) acknowledged that "legislature does possess the power to levy a tax on lands and buildings based on capital value thereof and in validating the levy on that basis, the implication of the use of the word 'rate' could be effectively removed and the tax on lands and buildings imposed instead. The tax, therefore, can no longer be questioned on the ground that Section 73 spoke of a rate and the imposition was not a rate as properly understood but a tax on capital value.”

41.5 In the process of coming to the above conclusion, the Supreme Court went on the legal position governing validation laws whereby the Parliament seeks to rectify the defects pointed by the judiciary. In para 4, it was held as under:

> “4. Before we examine Section 3 to find out whether it is effective in its purpose or not we may say a few words about validating statutes in general. When a legislature sets out to validate a tax declared by a court to be illegally collected under an ineffective or an invalid law, the cause for ineffectiveness or invalidity must be removed before validation can be said to take place effectively. The most important condition, of course, is that the legislature must possess the power to impose the tax, for, if it does not, the action must ever remain ineffective and illegal. Granted legislative competence, **it is not sufficient to declare merely that the decision of the Court shall not bind for that is tantamount to reversing the decision in exercise of judicial power which the legislature does not possess or exercise. A court's decision must always bind unless the conditions on which it is based are so fundamentally altered that the decision could not have been given in the altered circumstances**. Ordinarily, a court holds a tax to be invalidly imposed because the power to tax is wanting or the statute or the rules or both are invalid or do not sufficiently create the jurisdiction. Validation of a tax so declared illegal may be done only if the grounds of illegality or invalidity are capable of being removed and are in fact removed and the tax thus made legal. Sometimes this is done by providing for jurisdiction where jurisdiction had not been properly invested before. Sometimes this is done by re-enacting retrospectively a valid and legal taxing provision and then by fiction making the tax already collected to stand under the re-enacted law. Sometimes the legislature gives its own meaning and interpretation of the law under which the tax was collected and by legislative fiat, makes the new meaning binding upon courts. The legislature may follow any one method or all of them and

while it does so it may neutralise the effect of the earlier decision of the court which becomes ineffective after the change of the law. Whichever method is adopted it must be within the competence of the legislature and legal and adequate to attain the object of validation. If the legislature has the power over the subject-matter and competence to make a valid law, it can at any time make such a valid law and make it retrospectively so as to bind even past transactions. **The validity of a Validating law, therefore, depends upon whether the legislature possesses the competence which it claims over the subject-matter and whether in making the validation it removes the defect which the courts had found in the existing law and makes adequate provisions in the Validating law for a valid imposition of the tax**." (emphasis supplied)

42. The above legal proposition is well settled and has been followed in a number of subsequent decisions. Therefore it is only a competent legislature that can make a validation law to override judicial precedents and that too by actually removing the defect pointed out by such precedent. Such a power is not available to the executive. In other words, 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.

43. To that extent, Section 145 (2), 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.

Question (ii): Excessive delegation of legislative powers

44. The next, but related, aspect is the excessive delegation of legislative powers. The Court finds merit in the contention of the Petitioners that ICDS notified under Section 145 (2) of the Act has the effect of modifying the basis for computation of taxable income as recognised by the Act and as interpreted by the Supreme Court.

45. For taxation purposes, profits are required to be computed as per the ICDS notified by the Central Government in exercise of the power delegated to it under Section 145 (2) of the Act as amended. For this purpose it is necessary to look at each of the ICDS which are contrary to or seek to overcome binding judicial precedents.

46. There are ten ICDS that have been notified. However, the Petitioners have focussed their challenge on some of them as will be discussed hereafter. The ICDS that have been challenged are discussed hereafter in seriatim.

47. ICDS I talks of accounting policies. It is settled law that accounting standards cannot override the basis on which the taxable income is computed.

47.1 In ***Tuticorin Alkali Chemicals and Fertilizers Limited v. Commissioner of Income Tax (1997) 227 ITR 172*** after noticing that Section 14 of the Act lays down, for the purpose of computation of taxable income, six heads of income viz., (a) Salaries, (b) Interest on securities, (c) Income from house property (d) profits and gains of business or profession, (e) capital gains (f) income from other sources, the Supreme Court explained:

> "The computation of income under each of the above six heads will have to be made independently and separately. There are specific rules of deduction and allowances under each head. **No deduction or adjustment on account of any expenditure can be made except as provided by the Act**." (emphasis supplied)

47.2 The Supreme Court in the above decision then proceeded to examine the issue of permitting the Assessee to set off its income against interest payable on capital. In this context it observed as under:

> "It has been argued that the source from which the company has earned interest is borrowed capital. The company has to pay interest to its creditors on the same borrowed capital. Having regard to the identity of the fund on which interest is earned and interest is payable, the company should be allowed to set off its income against interest payment payable by it on the same fund. We are of the view that no adjustment can be allowed except in accordance with the provisions of the Income-tax Act. However, desirable it may be from the point of view of equity, this adjustment cannot be made unless the law specifically permits such adjustment."

47.3 The Court quoted with approval the following observations of Lord Morris of Borth-y-Gest in ***BSC Footwear Ltd. v. Ridgway Inspector of Taxes) (1972)83 ITR 269***:

> "Whether merits there may be in the company's accountancy methods

> for the purposes of its internal affairs I am not persuaded that Cross J. And the Court of Appeal were wrong in finding them unacceptable for tax purposes."

47.4 The Court also noted that in ***Challapalli Sugars Limited v. Commissioner of Income Tax (1975) 98 ITR 167,*** the Supreme Court had acknowledged that the ICAI was a recognized authority on accounting principles and executive instructions had to be viewed from that perspective. The Supreme Court in ***Tuticorin Alkali Chemicals and Fertilizers Limited v. Commissioner of Income Tax*** (*supra*) proceeded to observe thus:

> "It is true that this Court has very often referred to accounting practice for ascertainment of profit made by the company or value of the assets of a company. But when the question is whether a receipt of money is taxable or not or whether certain deductions from that receipt are permissible in law or not, the question has to be decided according to the principles of law and not in accordance with accountancy practice. Accounting practice cannot override Section 56 or any other provision of the Act. As was pointed out by Lord Russel in the case of ***B.S.C. Footwear Ltd (1970) 77 ITR 856, (CA),*** the income-tax law does not march step by step in the footprints of the accounting profession."

47.5 On the facts of the case before it, the Supreme Court concluded as under:

> "Whether a particular receipt is of the nature of income and falls within the charge of Section 4 of the income-tax Act is a question of law which has to be decided by the Court on the basis of the provisions of the Act and the interpretation of the term "income" given in large number of decisions of the High Courts, the Privy Council and also this court. It is well settled that income attracts tax as soon as it accrues. The application or destination of the income has nothing to do with its accrual or taxability. It is also well-settled that interest income is always of a revenue nature unless it is received by way of damages or compensation."

48. It is, therefore, the settled legal position that the AS has hardly any role to play in the principles governing determination of income, which has been well settled by the provisions of the Act as well as by judicial precedents. As pointed out by the Petitioners, the ASs have existed more than 35 years. However, the basic taxation principles remain the same and would remain binding even in the application of the ICDS.

49. In order to demonstrate that any change in accounting policies has to be brought about by a corresponding amendment to the Act, reference was illustratively made to Section 115 JB of the Act. That provision stipulates the adjustments be made to weed out the difference arising from the adoption of IFRS. This was to ensure that adoption of IND AS has no impact on taxation principles. This is of course, just one instance. There could be several other provisions impacting the computation of taxable income which require a corresponding accounting treatment for tax purposes.

50. Mr. Jain referred to the Speech of the President of the ICAI to infer that the ICDS had been approved by the ICAI. The said speech is dated 31st July 2016, i.e., even before the said notification dated 29th September 2016 was issued. In any event that speech does not indicate that the ICAI has accepted the ICDS. It only refers to the request made by the ICAI for deferring its applicability. On the contrary, the Petitioners have handed over a chart to show that in respect of many of the ICDS, a different view has been expressed by the ICAI in its Technical Guide.

ICDS subject to the Act

51. The Preamble of ICDS itself clarifies as under:

> ***Preamble***
> *"This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" and not for the purpose of maintenance of books of accounts.*
>
> *In the case of conflict between the provisions of the Income-tax **Act,** 1961 ('the **Act')** and this Income Computation and Disclosure Standard, the provisions of the **Act** shall prevail to that extent."*

52. Thus, it is clear that the ICDS is not meant to overrule the provisions of the Act, the Rules thereunder and the judicial precedents applicable to the provisions of the Act as they stand. As noted hereinbefore, the challenge in the present case is to a few clauses of the various ICDSs notified on 29th September, 2016 by the Central Board of Direct Taxes ('CBDT'), Department of Revenue, Ministry of Finance.

ICDS I

53. This standard deals with significant accounting policies. The Petitioners contend that the concept of '*prudence*' has been completely done away with by the Respondents, which was present in the earlier AS – I. It is submitted that the ICDS now stipulates that prudence is not to be followed unless specified, and that this is contrary to the decisions in ***CIT v. Triveni Engineering & Industries Ltd (2011) 49 DTR 253 (Del)*** and ***CIT v. Advance Construction Co. Pvt. Ltd. (2005) 275 ITR 30 (Guj)***.

54. The stand of the Respondents is that the concept of prudence has not been done away with but has been followed on a case to case basis and cannot be dealt with generally. The justification provided is that income and losses generally have to be meted a similar treatment and preferential treatment for losses has to be given only in specific situations. Some illustrative examples have been set out to demonstrate that the concept of `prudence' continues to apply -

- "Inventory valuation where the concept of cost or market price whichever is lower is adopted. This has been kept intact in the ICDS-2.

- In recognizing the expected losses in case of the contract is considered, the same is also kept in ICDS 3 with the only modification that the said loss will be allowed in proportion of completion of the contract, rather than allowing the same for the unfinished portion of the contract. This was primarily for bringing horizontal equity of treating the contract profit and contract loss on the same principle.

- Retaining the concept of reasonable certainty of realizing the revenue in ICDS IV on revenue recognition.

- The losses on account of forward cover transactions in the nature of hedging (except to the extent the same pertain to highly probable or firm commitment contracts) is continued in ICDS VI.

- Valuation of inventory under ICDS VIII retain the concept of cost or market price whichever is lower. The change is made primarily for taking RBI approved "bucket principle of valuation".

- Recognizing the provisions for the future liabilities in ICDS 10."

55.1 Since considerable reliance has been placed by Mr. Jain on the decision in ***J.K. Industries Ltd. v. Union of India*** (*supra*), it requires to be examined in depth. There the Supreme Court was tasked with determining the validity of AS-22' framed by the Central Government in consultation with the National Advisory Committee on Accounting Standards ('NAC') under Section 211 (3C) of the Companies Act, 1956. While dealing with the objective of AS-22, the SC explained:

> "In its origin, an accounting standard is the policy document. In matters of recognition of various items of income, expenditure, assets and liabilities, the aim is to achieve standards/norms which would help to reflect a "**true and fair**" view of the accounts of a company....
>
> ....
>
> Accounting Standard are established rules relating to the recognition, measurement and disclosures thereby ensuring that all enterprises that follow them are comparable and that their financial statements are "true and fair"..........." (emphasis supplied)

55.2 Thereafter, the Supreme Court, in ***J. K. Industries*** (*supra*) while examining the scheme of the Companies Act, 1956 in relation to AS-22, and the rule making power of the Central Government under Section 642, held as follows:

> "The Companies Act has been enacted to consolidate and amend the law relating to companies and certain other associations. Under section 211(3A) Accounting Standards framed by the National Advisory Committee on Accounting Standards constituted under S. 210A are now made mandatory. Every company has to comply with the said standards.....Similarly, under Section 211(1) the company accounts have to reflect a "true and fair" view of the state of affairs. Therefore, the object behind insistence on compliance with the AS

and "true and fair" accrual is the presentation of accounts in a manner which would reflect the true income/profit. **One has, therefore to look at the entire scheme of the Act. In our view, the provisions of the Companies Act together with the rules framed by the Central Government constitute a complete scheme. Without the rules, the Companies Act cannot be implemented**...

....

........In our view, the impugned rule/notification is valid. It has nexus with the matter entrusted to the Central Government to be covered by the appropriate rules. Therefore, in our view, **the impugned rule is valid as it has a nexus with the statutory functions entrusted to the Central Government which is the rule-making authority under the Act**........" (emphasis supplied)

55.3 Finally, in deciding whether AS-22 were contrary to Sections 209 and 211 of the Companies Act, 1956, read with Parts I and II of Schedule VI thereto, the Supreme Court in ***J.K. Industries*** (*supra*) held that the impugned rules did not seek to modify the essential features of the Companies Act. The relevant portion of the judgment reads as under:

"In our view, paragraph 9 of AS-22 merely represents a gap-filling exercise, therefore, there is no merit in the contention advanced on behalf of the appellants that AS-22 is inconsistent with the provisions of the Companies Act including Schedule VI. It proceeds on the principle that every transaction has a tax effect. The words "true and fair" view in Section 211(1) connotes the widest law making powers and, in that context, we hold that **the impugned rule adopting AS-22 is intra vires as the said rule is incidental and/or supplementary to the specific powers given to the Central Government to make rules,**

> **particularly when such power is given to fill-in details**. The word "supplementary" means something added to what is there in the Act, to fill-in details for which the Act itself does not provide......In the present case, in our view, the impugned rule constitutes a legitimate aid to construction of the provisions of the Companies......" (emphasis supplied)

56. There is more than one reason why the above decision in ***J.K. Industries*** (*supra*) will not apply in the instant case. Unlike AS-22, the ICDS-I does not attempt to merely fill the gaps in the Act or the Rules when it comes to the question of recognising the principle of prudence. As far as the Act is concerned several aspects of the computation of taxable income are governed by specific provisions of the Act and the Rules and, where an issue of interpretation arises, by decisions of the Court. Therefore, unlike the Companies Act 1956, there is no aspect of computation of taxable income that is not governed either by the Act or the Rules or some binding judicial pronouncement. For e.g., even the prudence principle is acknowledged in at least two decisions referred to: ***CIT v. Triveni Engineering & Industries Ltd*** (*supra*) and ***CIT v. Advance Construction Co. Pvt. Ltd.*** (*supra*). Importantly, there was no parallel provision in the Companies Act that was in conflict with the said AS. The AS did not seek to override a binding judicial precedent. Therefore to draw an analogy with the upholding of the validity of AS 22 in the context of Section 211 (C) of the Companies Act may not be apposite in considering the validity of the ICDS that seek to alter the principles of computation of taxable income that is governed by the Act or Rules or judicial precedent without first effecting corresponding changes

to the Act and Rules.

57. There is merit in the contention of the Petitioners that ICDS I does away with the concept of 'prudence' which is present in AS1 notified under Section 145 (2) of the Act. A negative provision has in fact been made in the ICDS by stating that prudence is not to be followed unless it is specified. In its counter-affidavit, in para 6.1 (v) it is accepted by the CBDT that the concept of prudence has been done away with and has been replaced by specific aspects of prudence at the relevant places in the ICDS on a case to case basis.

58. ICDS IV only provides for the concept of realizing revenue in respect of recognition of income from sale of goods and recognition of income from rendering of services under the percentage completion method. In respect of interest income, royalty income and income from rendering of services other than the one specified above, there is no such concept of 'reasonable certainty of realising the revenue'. In response to the specific query in this regard, the CBDT has in Circular No. 10 of 2017, in answer to Question 13 stated that interest accrues on time basis and royalty accrues on the basis of contractual term and subsequent non-recovery can be claimed as deduction under Section 36 (1) (vii). Therefore, it is not correct for the CBDT to contend that the concept of reasonable certainty of realizing the revenue has been retained in ICDS IV.

59. The further averment is that the concept of prudence has been retained in ICDS X by allowing provision for further liability. This is contrary to what has been clarified in Circular No. 10 of 2017. ICDS X allows recognition of

provisions in respect of present liability arising out of a past event. It specifically prohibits recognition of costs or liability that needs to be incurred to operate in the future.

60. The contention of the CBDT that in ICDS III expected losses arising out of construction contracts have been allowed as per percentage completion method, is contrary to the AS-7 issued by ICAI where expected losses in the case of construction contracts are allowed immediately in the year in which they are incurred, irrespective of the method of accounting followed by the Assessee. ICDS III allows expected losses only on proportionate basis as per the percentage completion method. Therefore, it is not in accordance with the concept of prudence. Expected losses have been allowed as deduction in ***CIT v. Triveni Engg. & Industries Limited*** and ***CIT v. Advance Construction Co. Pvt. Ltd*** (*supra*).

61. The Petitioners rightly point out that cases not governed by any specific ICDS are to be governed by ICDS-I. CBDT has in ICDS I notified that expected losses and marked-to-market losses are not to be recognized/allowed. It is rightly pointed out by the Petitioners that the 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. The concept of prudence is inherent in this.

62. ICAI too has in para 6.9 of its Technical Guide clarified as under:

> "6.9 Chapter IV-D of the Income Tax Act houses Section 37 which deals with expenditure which is general in nature and not covered within sections 30 to 36. Section 37 covers expenditure laid out or expended wholly and exclusively for the purposes of the business.

> The phrase "laid down" connotes setting aside or storage for future. The expression "laid out" in Section 37 thus encompasses not only actual outflow of expenses but amounts parked in the present for future settlement. Accordingly, the concept of Prudence is inherent in the business income deductions."

63. Accordingly, the Petitioners are right in their contention that non-acceptance of the concept of prudence in ICDS I is *per se* contrary to the provisions of the Act and therefore, cannot be countenanced.

ICDS II

64. ICDS-II pertains to valuation of inventories. In ***Shakti Trading Co. V. CIT (2001) 250 ITR 871 (SC)*** the Supreme Court held that on the dissolution of a firm, where the business of firm is not discontinued and is taken over by other partners, the stock-in-trade of the firm can be valued at cost or market value, whichever is lower. In arriving at the above conclusion, the Supreme Court distinguished the earlier decision in ***A.L.A. Firm (1989) 189 ITR 285 (SC)*** on the ground that in the case of dissolution of a partnership firm, if the business is discontinued then stock-in-trade has to be valued at market price only. However, if, on dissolution of a firm, the business is not discontinued, stock-in-trade has to be valued at cost or market value whichever is lower.

65. ICDS-II fails to take into account the two different scenarios aforementioned. It is, therefore, apparent that ICDS-II sidesteps the decision in ***Shakti Trading Co.*** (*supra*). The ICDS-II insists that the stock-in-trade of the firm in both scenarios would have to be valued at market price irrespective of whether the business discontinues. This would amount to

taxing notional income. The counter affidavit of the CBDT states in para vi (a) that the Supreme Court in ***Shakti Trading Co.*** (*supra*) was "swayed" by the fact that the business was continuing and that there was no settlement of accounts. This is in fact contrary to the facts in ***Shakti Trading Co.*** (*supra*). The said decision has been re-affirmed in ***CIT v. Kwality Steel Suppliers Complex (2017) 395 ITR 1 (SC).***

66. It is contended on behalf of the Respondents that Section 45 (4) of the Partnership Act has itself pointed out the concept of valuation of capital assets at market value at the time of dissolution of the firm. This is however contrary to what has been explained by the Supreme Court in ***Shakti Trading Co.*** (*supra*). 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.

67. Section 145A of the Act begins with a *non-obstante* clause and is independent of Section 145 (2) under which the ICDS has been notified. Section 145A of the Act provides that inventory of goods shall be valued in accordance with the method of accounting regularly employed by the Assessee. Therefore, where the Assessee regularly follows a certain method for valuation of goods then that will govern irrespective of the ICDS notified under Section 145 (2) of the Act.

68. The upshot of the above discussion is that ICDS II is also an attempt to overreach the binding judicial precedents by the device of notifications issued by the central government. It is an exercise of excessive delegation of legislative power which is impermissible in law.

ICDS III

69. Turning now to ICDS-III which relates to construction contracts, para 10 thereof states that retention money would be a part of the contract and the same has to be assessed to tax based on 'proportionate computation' method. This is reiterated in answer to Question No. 11 in Circular No. 10 of 2017.

70. The above justification is contrary to the law explained in the following decisions:

(i) ***CIT v. Simplex Concrete Piles India (P) Ltd (1988) 179 ITR 8***

(ii) ***CIT v. P & C Constructions (P) Ltd (2009) 318 ITR 113***

(iii) ***Amarshiv Construction (P) Ltd v. DCIT (2014) 367 ITR 659*** and

(iv) ***DIT v. Ballast Nedam International (2013) 355 ITR 300*** which followed the decision in ***Anup Engineering Limited v. CIT (2000) 247 ITR 114***.

71. All the above decisions hold that the retention money does not accrue to an Assessee until and unless the defect liability period is over and the Engineer-in-Charge certifies that no liability is attached to the Assessee.

72. The ICST Committee noted what was sought to be done by the Tax AS proposed as ICDS as under:

> "AS-7 is silent about treatment of accrual of income in respect of the retention money. There are some judicial pronouncements holding that the retention money is not deemed to have accrued for tax purposes. To overcome this unintended meaning, the TAS (CC) specifically provides that the retention money shall accrue to the person for computing revenue based on the percentage of completion

method."

73. The stand of the Respondent seems to be that since retention money is treated as part of the revenue, it should also be considered as part of the income. The Respondent argues that it intends to bring uniformity between the accounting treatment and the tax treatment of retention money. The Respondent relies upon ***Rotork Controls Pvt. Ltd. v. CIT (2009) 314 ITR 62*** which states that a provision for present obligations in respect of past events is allowed.

74. Paragraph 10 does not specify as to at what stage retention money would be treated as `*contract revenue*'. Obviously the amount has to accrue as income. That is fundamental to the law of income tax. An analysis of the case law and the stand of the Petitioner and the Respondent clearly reveals that the treatment to be given to retention money depends upon the facts of each case and the conditions attached to such amounts. It would also depend upon the contractual terms between the contractor and the person awarding the contract. The treatment to 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. 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, the Respondents would be acting contrary to the settled position in law as explained in the above decisions.

75. The Petitioners also challenges paragraph 12(d) of ICDS-III read with paragraph 5 of ICDS-IX, which reads as under:

"ICDS-III, paragraph 12(d)
12. Contract costs shall comprise of:
(a)......(c)
(d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs

ICDS-IX, paragraph 5
5. Subject to paragraph 8, the extent to which funds are borrowed specifically for the purposes of acquisition, construction or production of a qualifying asset, the amount of borrowing costs to be capitalised on that asset shall be the actual borrowing costs incurred during the period on the funds so borrowed."

76. 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. This is contrary to the decision of the Supreme Court in ***CIT v. Bokaro Steel Limited (1999) 236 ITR 315*** wherein it was held that if an Assessee 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

77. ICDS-IV pertains to revenue recognition. It deals with the basis for recognition of revenue arising in the course of the ordinary activities of a person from:

(i) the sale of goods;

(ii) the rendering of services;

(iii) the use by others of the person's resources yielding interest, royalties or dividends.

78. The challenge by the Petitioners is to the paragraphs 5, 6 & 8(1) of the ICDS-IV. The said clauses are reproduced herein below:

> *"5. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim for escalation of price and export incentives, revenue recognition in respect of such claims shall be postponed to the extent of uncertainty involved.*
>
> *6. Subject to Para 7, revenue from service transactions shall be recognised by the percentage completion method. Under this method, revenue from service transactions is matched with the service transaction costs incurred in reaching the stage of completion, resulting in the determination of revenue, expenses and profit which can be attributed to the proportion of work completed. Income Computation and Disclosure Standard on construction contract also requires the recognition of revenue on this basis. The requirements of that Standard shall mutatis mutandis apply to the recognition of revenue and the associated expenses for a service transaction. However, when services are provided by an indeterminate number of acts over a specific period of time, revenue may be recognised on a straight line basis over the specific period.*
>
> *8. (1) Subject to sub paragraph (2), interest shall accrue on the time basis determined by the amount outstanding and the rate applicable"*

79.The stand of the Department/Revenue is that the ICDS IV is consistent with the principles framed by the Supreme Court in ***CIT v. Excel Industries Limited (2015) 358 ITR 295 (SC)*** insofar as it relates to recognition of income from export incentives.

80. Para 5 of ICDS-IV requires an Assessee to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection. In ***Excel Industries*** (*supra*), the Supreme Court 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 and the corresponding obligation to pay arises in the hands of the Government. Only in such year the income from export incentive can be said to have accrued and can be recognized as income. Therefore, para 5 of ICDS-IV is not inconsistent with the law explained by the Supreme Court.

81. The stand of the Respondents is that if the right to receive a sum by the Assessee does not accrue till such time the claims are accepted by the Government, it would amount to giving a complete go by the rule of law and would tantamount to alleging that the Government would not abide by its law, is not convincing at all. As far as the accrual of income is concerned, Sections 4 and 5 of the Act governs. The law as explained by the Supreme Court in ***Excel Industries*** (*supra*) is that until and unless the right to receive accrues in favour of the Assessee no income can be said to have accrued.

82. AS-9 permits the completed contract method in specified circumstances. Para 7.1 of the AS-9 issued by the ICAI permits a person to follow proportionate completion method or completed service contract method

without any qualification. Paras (i) and (ii) of AS-9 describes the functioning of the prescribed methods. Whether there is only a single act in performance of service contract or more than one act, a person can follow either of two methods. The AS issued by ICAI are not binding on all categories of the Assessee, firms etc. Therefore, Assessees are free to follow any method of accounting.

83. The proportionate completion method as well as the contract completion method have been recognized as valid method of accounting under mercantile system of accounting by the Supreme Court in ***CIT v. Bilhari Investment Pvt. Ltd. (2008) 299 ITR 1 (SC).*** This Court too has done likewise in ***CIT v. Manish Buildwell Pvt. Ltd. (2011) 245 CTR 397 (Del)*** and ***Paras Buildtech India Pvt. Ltd. V. CIT (2016) 382 ITR 630 (Del).*** However, para 6 of ICDS-IV permits only one of the methods, i.e., proportionate completion method and therefore, it is contrary to the above decisions.

84. In ICDS-IV accrual of interest is dealt with as under:-

> "8. (1) Subject to sub paragraph (2), interest shall accrue on the time basis determined by the amount outstanding and the rate applicable.
> (2) Interest on refund of any tax, duty or cess shall be deemed to be the income of the previous year in which such interest is received."

85. This clause is applicable in myriad situations including for Banks, lenders, financial institutions, loan agreements etc., NBFCs are just one facet of business where this clause is applicable. This is challenged on the

ground that non-performing assets of NBFCs would also become taxable on accrual basis even though such interest is not recoverable. The Respondent has clarified in Circular No. 10 of 2017 that such income has to be applied on accrual basis and deduction, if any, can be claimed only under Section 36 (1)(vii) of the Act. The Respondent further submits that this provision is in line with the recent amendments brought about by Finance Act, 2015 wherein a proviso was added to the following effect:

> "Section 36(1)- The deductions provided for in the following clauses shall be allowed in respect of matters dealt with therein, in computing the income referred to in section 28 –
> (i).............(vi).........
>
> (vii) subject to the provisions of sub-section (2), the amount of any bad debt or part thereof which is written off as irrecoverable in the accounts of the assessee for the previous year:
>
> Provided that........................
> Provided further that where the amount of such debt or part thereof has been taken into account in computing the income of the assessee of the previous year in which the amount of such debt or part thereof becomes irrecoverable or of an earlier previous year on the basis of income computation and disclosure standards notified under sub-section (2) of Section 145 without recording the same in the accounts, then, such debt or part thereof shall be allowed in the previous year in which such debt or part thereof becomes irrecoverable and it shall be deemed that such debt or part thereof has been written off as irrecoverable in the accounts for the purpose of this clause."

86. In its counter-affidavit the Respondent has clearly explained this aspect in the following manner:

> "The Petitioners completely ignore the fact that this very provision of the ICDS have been given approval by the highest legislative body, i.e., the parliament by making an amendment to Section 36(1) (vii) of the Act with effect from 1.4.2016 by FA 2015. The Petitioners for furthering their point have erroneously mentioned that the Second Proviso to section 36(1) (vii) casts an additional burden on the Assessee prove that the debt is established to have become due. In fact, a provision which is for the benefit of the Assesses is being projected to be a provision which is against the interests of the Assessee.
>
> The ICDS does not in any way wish to alter the well laid down principles of real income by the Hon'ble Supreme Court, but is actually ensuring that there is a trace available of the income which is foregone on this concept. Therefore, if there is an interest income which is not likely to be realised is written off by the assessee in the same very year immediately on its recognition (and even without passing through its books), then it would be first recognised as revenue and then allowed as a deduction under S. 36(1) (vii) of the Act, including in the case of NBFCs. However, in this process, the tax department would have information about the income which is so written off and keep a track of the said sum then realised. Therefore, there is no enlargement of scope of income or any deviation from the principles laid down by the Hon'ble Supreme Court."

87. Since there is no challenge to Section 36(1) (vii), para 8 (1) ICDS-IV

cannot be held to be *ultra vires* the Act. This is to create a mechanism of tracking unrecognized interest amounts for future taxability, if so accrued. In fact the practice of moving debts which the bank or NBFC considers irrecoverable to a suspense account is a practice which makes the organisations lose track of the same. The justification by the Respondent clearly demonstrates that this is a matter of a larger policy and has the backing of Parliament with the enactment of 36 (1) (vii). The reasoning given by the Respondent stands to logic. It has not been demonstrated by the Petitioner that para 8 (1) of ICDS IV is contrary to any judgment of the Supreme Court, or any other Court.

ICDS VI

88. ICDS-VI concerns the effects of changes in foreign exchange rates. The stand of the Department/Revenue is that a branch of an entity for tax purposes is not a separate assessable entity. Consequently, a separate treatment for the branch, as distinct from that applicable to the entity as a whole is stated to be "wholly incorrect."

89. In ***Godhra Electric Supply Company Limited v. CIT (1997) 225 ITR 746 (SC),*** the Supreme Court held that hypothetical income cannot be taxed. This was in the context of the same treatment for monetary assets and liabilities of the Indian entity as well as the foreign operations which leads to adjustment of notional income/loss to the total income. In ***Sutlej Cotton Mills Limited v. CIT (1979) 116 ITR 1 (SC)*** it was explained that exchange gain/loss in relation to a loan utilized for acquiring a capital item would be capital in nature. Consequently, the loans have to be valued at the closing

rate thereby giving rise to foreign exchange gain/loss irrespective of the fact that such loan has been taken for capital purposes. ICDS VI is therefore contrary to the decision in ***Sutlej Cotton Mills Limited v. CIT*** (*supra*).

90. ICDS-VI 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. CIT*** (*supra*), insofar as it relates to marked to market loss arising out of forward exchange contracts held for trading or speculation purposes.

91. In Circular No. 10 of 2017 an answer to Question No. 16 the CBDT has clarified that Foreign Currency Translation Reserve Account balance as on 1st April 2016 has to be recognized as income/loss of the previous year relevant to the AY 2017-18. The losses/gains arising by valuation of monetary assets and liabilities of the foreign operations as at the end of the year cannot be treated as real income. It is only in the nature of notional or hypothetical income which cannot be even otherwise subject to tax.

ICDS VII

92. ICDS VII pertains to government grants which have to be recognized as income. It provides that recognition of government grants cannot be postponed beyond the date of accrual receipt. In other words, income has to be recognized on receipt basis which may not have accrued.

93. It is explained by the Petitioners that many a times, conditions are attached to the receipt of government grant, non-fulfilment of which may

lead to return of such amount. In such instance, it cannot be said that there is any accrual of income although the money has been received in advance. ICDS VII however requires that amount has to be taxed in the year of receipt. This again is contrary to and in conflict with the accrual system of accounting.

ICDS VIII

94. ICDS VIII pertains to valuation of securities. The method prescribed by the Reserve Bank of India (RBI) for valuation of securities is applicable only to banks, financial institutions, and other financial bodies regulated by the RBI. For other entities, the AS prescribes the valuation of inventories on individual basis.

95. There are two parts of ICDS VIII; Part A dealt with entities other than scheduled banks and public financial institutions and Part B deals with scheduled banks and public financial institutions. Under Part B, ICDS VIII has prescribed that recognition of securities should be in accordance with the RBI guidelines. To that extent, it is consistent with the RBI norms. However, for those entities not governed by the RBI to whom Part A of ICDS VIII is applicable, the accounting prescribed by the AS has to be followed. This 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.

96. It is pointed out that under similar circumstances, ICDS II which deals

with valuation of inventories does not prescribe such a 'bucket approach'. Thus the Respondents themselves have adopted separate approaches at different places for the purpose of valuation of securities. This change is therefore not possible to be effectuated without a corresponding amendment to the Act. To that extent Part A of ICDS VIII is *ultra vires* the Act.

Issue (iii): Constitutional validity of the ICDS, Circular

97. In exercise of its power to issue notifications under Section 119 of the Act, the CBDT is meant to clarify the law, not change it. At the highest it can additionally notify the change in rates of depreciation etc. Some of the impugned ICDS, to the extent discussed hereinbefore, however do not merely clarify the existing law. Some of them mandate the applicability of accounting principles, contrary to what is recognised by the Act, for the purpose of computation of income.

98. As already concluded, if the ICDS is permitted, in exercise of the delegated power of the central government under Section 145 (2) of the Act, to override a governing principle recognised by the Act or the Rules or judicial precedents, it would be *ultra vires* the Act. It would then render the ICDS as an instance of excessive delegation of essential legislative functions. The books of account prepared on the basis of a valid accounting method can be rejected by an AO for not complying with the ICDS. This virtually permits an AO to disregard binding judicial precedents.

99. The cases cited at the bar on behalf the Respondents deal with the permissible limits of legislative power. In ***Harishankar Bagla v. State AIR***

1954 SC 465 the Supreme Court upheld the validity of a particular provision of the Essential Supplies Act since the said Act was an emergency measure and was intended to provide for the continuance, during a limited period, of powers to control the production, supply and distribution of, and trade and commerce in, certain commodities. The said guiding principles were discernable from the relevant tax statutes itself.

100. However, in the present case there are no guiding principles in Section 145 (2) of the Act for the scope and ambit of the delegated power of the central government. As explained by the Madras High Court in ***CIT v. Standard Triumph Motor Co. Limited (1979) 119 ITR 573 (Mad)*** Section 145 (1) is only an enabling provision to effectuate the statute. When the rules framed under an Act have to conform to the Act [See ***Bimal Chandra v. State (1971) 81 ITR 105 (SC), Director of Inspection v. Pooranmall (1974) 96 ITR 390 (SC), CIT v. Taj Mahal Hotel (1971) 82 ITR 44 (SC)]*** a mere notification under Section 119 of the Act cannot go beyond the provision of the Act so as to bring to tax any income not so envisaged by the Act. That a tax cannot be levied by way of an executive action is a settled position (See ***State of Kerala v. Joseph AIR 1958 SC 296***). Tax cannot also be levied by way of administrative instructions as observed by the Supreme Court in ***Harivanshlal Mehra v. State of Maharasthra AIR 1971 SC 1130***.

101. In order to preserve its constitutionality, 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.

Summary of findings

102. The findings in this judgment may be summarised thus:

(i) Section 145 (2), 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.

(ii) The ICDS is not meant to overrule the provisions of the Act, the Rules thereunder and the judicial precedents applicable thereto as they stand.

(iii) The decision in ***J.K. Industries Ltd. v. Union of India*** (*supra*) is distinguishable in its application to the case on hand.

(iv) ICDS I which does away with the concept of 'prudence' is contrary to the Act and binding judicial precedents and is therefore unsustainable in law.

(v) ICDS II pertaining to valuation of inventories and eliminates the distinction between a continuing partnership business after dissolution from one which is discontinued upon dissolution is contrary to the decision of the Supreme Court in ***Shakti Trading Co.*** (*supra*). It 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. ICDS II is held to be *ultra vires* the Act and struck down as such.

(vi) The treatment to 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. 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, irrespective of the facts, the Respondents would be acting contrary to the settled position in law as explained in the decisions referred to in para 68 and to that extent para 10 (a) of ICDS III would be rendered *ultra vires*.

(vii) 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. This is contrary to the decision of the Supreme Court in ***CIT v. Bokaro Steel Limited*** (*supra*) and is therefore struck down.

(viii) Para 5 of ICDS-IV requires an Assessee to recognize income from export incentive in the year of making of the claim if there is 'reasonable certainty' of its ultimate collection. This is contrary to the decision of the Supreme Court in ***Excel Industries*** (*supra*), and is, therefore, *ultra vires* the Act and struck down as such.

(ix) As far as para 6 of ICDS IV is concerned, the proportionate completion method as well as the contract completion method have been recognized as valid method of accounting under the mercantile system of accounting by the Supreme Court in ***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*). 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.

(x) Para 8 (1) of ICDS IV is not been shown to be contrary to any judicial precedent. There is also 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. Its validity is upheld.

(xi) ICDS-VI 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, is not in consonance with the ratio laid down by the Supreme Court in ***Sutlej Cotton Mills Limited v. CIT*** (*supra*), 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 as such.

(xii) ICDS VII which provides that recognition of government grants cannot be postponed beyond the date of accrual receipt, is in conflict with the accrual system of accounting. To that extent it is held to be *ultra vires* the Act and struck down as such.

(xiii) ICDS VIII pertains to valuation of securities. For those entities not governed by the RBI 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. To this extent Part A of ICDS VIII is held to be *ultra vires* the Act and is struck down as such.

Conclusion

103. To the extent the specific ICDS as noted hereinbefore have been struck down as *ultra vires* the Act, the impugned notification Nos. 87 and 88 dated 29th September 2016 and Circular No. 10 of 2017 issued by the CBDT are also held to be *ultra vires* the Act and struck down as such.

104. The writ petition and the application are disposed of in the above terms with no orders as to costs.

S. MURALIDHAR, J.

PRATHIBA M. SINGH, J.

NOVEMBER 08, 2017
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