

Inter-Relationship Between Accounting and Taxation

Some Key Points

Accounting is the foundation on which the provisions of tax laws are applied. The books of account maintained by the assessee forms the basis for taxing an event or transaction. However, in the recent times some of the provisions in the tax laws are enacted for the sake of ease in implementation and hence have dispensed with the requirement of relying on books of account and resorted to collection of taxes by way of deeming / presumptive provisions.

Similarly, to regulate the taxpayers, some deeming provisions are inserted in the tax law to allow certain deductions on actual payment basis or tax certain incomes on actual receipt basis. Section 43B is a provision allowing deduction on actual payment basis and section 56(2)(viii) relating to interest on compensation / enhanced compensation provides for taxing a receipt on actual receipt basis.

Sections 43B, 115JB and 145A are some of the legal provisions which override or even negate the time tested accounting practices. Similarly, presumptive provisions such as sections 44AD, 44AE, 44B, 44BB, 44BBA are meant for estimation of deemed income for tax purposes and thus shifting the basis of determining the income away from the books of account.

Enhancing the turnover limit for getting the accounts audited under section 44AB and prescribing presumptive income scheme for all assesseees (except LLP and corporates) under section 44AD in respect of business income signifies simplification and acceptance of approximate income determination by the tax administration in the recent times.

Question 1

Explain whether there is conflict between accounting standards and provisions of the Income-tax Act, 1961 in respect of the following:

- (i) *Effect of fluctuation in foreign currency rates where a capital asset is imported by a company.*
- (ii) *Permanent fall in value of long-term investments held by a company.*

Answer

- (i) As per AS 11 on "The effects of changes in foreign exchange rates", exchange

differences relating to a liability incurred (i.e. loan taken to be repaid in installments) for acquiring fixed assets, which are carried in terms of historical cost, cannot be adjusted in the carrying amount of the said fixed assets. The effect of fluctuation in foreign currency has to be charged to profit and loss account at the end of each year.

However, the provisions of section 43A of the Income-tax Act, 1961 requires such exchange differences to be adjusted against the actual cost of the imported asset in the year in which the actual payment is made irrespective of the method of accounting followed by the assessee.

Therefore, there is a difference regarding the treatment of the effect of fluctuation in foreign currency rates (where a loan is taken for purchase of capital asset imported by a company) as per the accounting standards and as per the provisions of the Income-tax Act, 1961.

Note – It may be noted that in the case of companies, the exchange difference relating to acquisition of a depreciable capital asset can be adjusted against the cost of the asset at the end of each year, at the option of the enterprise. Such option is irrevocable and has to be applied to all such foreign currency monetary items.

- (ii) As per AS 13 on “Accounting for Investments”, long-term investments should be carried at cost and provision should be made to recognize a permanent decline in the value of long-term investments. Such reduction should be determined and made for each investment individually.

However, under the Income-tax Act, 1961, there is no provision to recognize any decline in the value of investments, whether permanent or temporary. Only if the investments are disposed of, the profit/loss on account of the same is recognized.

Therefore, there is a difference in the treatment of the permanent decline in the value of the long term investments held by a company under the accounting standards and the provisions of the Income-tax Act, 1961.

Question 2

ABC Co. Ltd engaged in manufacture of boilers received a subsidy of ₹ 20 Lacs from the Government for having commenced an industry in a backward area. The assessee claims that the subsidy so received is not liable to tax and accordingly credited the subsidy directly to capital reserve account. Is the contention of assessee, valid in law?

Answer

The Supreme Court in its judgment in the case of *Sahney Steel And Press Works Ltd v. CIT* (1997) 228 ITR 253 (SC) has held that the payment from public funds to assist the assessee in carrying on trade or business must be treated as revenue receipt. The subsidy granted to the assessee such as sales tax refund, power concession or refund of bills paid and exemption from payment of water charges are to be treated as revenue receipts chargeable to

tax. It was held that the character of the subsidy in the hands of the recipient will have to be determined having regard to the purpose for which the subsidy is given.

The subsidy in this case, was received as a matter of encouragement to commence an industry in a backward area. Whether it is received before or after commencement of production is of no consequence. Therefore, the subsidy so received as a matter of incentive is not liable to tax. However, if the subsidy was by way of refund of sales tax or power consumption etc then it is liable to tax.

Question 3

Critically analyse the validity or otherwise of the following proposition "income computed on the basis of method of accounting is not a binding factor for taxation of income in certain circumstances".

Answer

As per the provisions of section 145, assessee can follow either cash or mercantile system of accounting in respect of income from business or profession. However, even in cases where mercantile system is followed, certain deductions are allowed only on actual payment basis. Such provisions are briefly outlined as under:

Section 35AD – Capital expenditure incurred by the assessee would be allowed as deduction.

Section 35DDA - Amortization of expenditure incurred under voluntary retirement scheme on payment actually made to the employee in 5 instalments.

Section 40A(7) – Provision for gratuity allowable on payment basis only.

Section 43B – This is one of the most important provisions in this regard and the items covered by this section are deductible only on payment basis. They are -

1. Tax, duty, cess or fee.
2. Contribution to any provident fund, superannuation fund, gratuity fund or welfare fund.
3. Payment of bonus or commission.
4. Interest payable to certain financial institutions.
5. Interest payable to scheduled banks.
6. Any sum payable by the assessee as an employer as leave encashment to the employees.

Section 56(2)(viii) provides for taxation of interest received on compensation or enhanced compensation on receipt basis with deduction at 50% prescribed in section 57(iv).

Thus, the proposition given above is correct.

Question 4

State the tax provisions which provide for determination of income ignoring the books of account and method of accounting of the assessee.

Answer

Section 44AD provides for presumptive determination of income for computing profits and gains of any business (other than those covered by section 44AE) meant for resident assessee by deeming income at 8% of the turnover. However, to opt this presumptive provision the turnover of the assessee from business should not exceed ₹ 100 Lacs. This presumptive provision however is not applicable in respect of –

- (1) a person carrying on profession as referred to in section 44AA(1);
- (2) a person earning income in the nature of commission or brokerage; or
- (3) a person carrying on any agency business.

Section 44AE is meant for persons carrying on the business of plying, hiring or leasing goods carriages. The revised presumptive income rates are ₹ 5,000 per month or part of a month in respect of each heavy goods vehicle and ₹ 4,500 per month or part of month for each other goods vehicle.

Section 44B prescribes presumptive income determination in the case of non-residents engaged in shipping business at 7.5% of the aggregate amounts (i) received for carriage of passengers, livestock, mail or goods shipped at any port in India; and (ii) any amount received or deemed to be received in India on account of the aforesaid items shipped at any port outside India.

Section 44BB applicable for non-residents engaged in the business of providing services or facilities in connection with supplying plant and machinery on hire which are used in the prospecting for or extracting or production of mineral oils by deeming income at 10% of amounts received towards provision of services and facilities.

Section 44BBA is a presumptive income scheme meant for computing deemed business income from operation of aircrafts in the case of non-residents and the presumptive income rate is prescribed at 5% of the amounts received or deemed to be received from any place in India or outside India towards carriage of passengers, livestock, mail or goods to India.

Section 44BBB for foreign companies engaged in the business of civil construction or erection of plant and machinery or testing or commissioning thereof in connection with turnkey power projects approved by the Central Government. The presumptive income chargeable on deemed basis is at 10% of the amounts so received by the foreign company.

Question 5

Explain how the accounting principle is applied on dissolution of firm for tax purposes.

Answer

The going concern concept of accounting provides for valuation of inventory at cost or market price, whichever is less. However, on dissolution of firm, there is settlement of account *inter se* amongst the partners. The accounting practice prescribes valuation of inventory on market

value basis. The provisions of tax law do not provide for such market price valuation though section 45(4) prescribes for adopting market value in respect of capital assets.

The Apex Court in *ALA Firm v. CIT (1991) 189 ITR 285 (SC)* has held that when the firm is dissolved and business is discontinued, the closing stock is to be valued at market price and not at cost and the surplus, if any, shall be taxed as business income.

It is possible to argue that the tax law also provides for such valuation by means of section 45(4) by interpreting that on dissolution and discontinuance of business, the stock in trade loses the exception prescribed in section 2(14) and becomes a capital asset, thus falling within the domain of section 45(4).

It may be of interest to note that when there is dissolution of firm by operation of law but there is no discontinuance of business, the stock valuation will not be at market price as held in *Sakthi Trading Co. v. CIT (2001) 250 ITR 871 (SC)*.

Even dissolution of firm due to demise of one partner and continuation of business by the other partner as proprietor was held as not within the ambit of section 45(4) as held in *CIT v. Moped & Machines (2006) 281 ITR 52 (MP)* on the reasoning that there was no transfer as contemplated under section 2(47).

Question 6

BCFS Limited is a Non-Banking Financial Company (NBFC). The company has not credited interest of ₹ 30 lakhs due on certain loan accounts which had become non-performing assets in its profit & loss account. As per NBFC Prudential Norms (RBI) Directions, 1998, which is binding on the company, interest or discount or any other charges on non-performing assets shall be recognised as income only when it is actually realised. Can the Assessing Officer make addition of such interest on the ground that the assessee, being a company, follows mercantile system of accounting?

Answer

The issue under consideration is whether in the case of an assessee following mercantile system of accounting, the interest from the NPA has in fact accrued to the assessee and whether such interest can be regarded as income accrued under section 5 of the Income-tax Act, 1961.

As per section 145, the income shall be computed in accordance with the method of accounting regularly followed by the assessee. In the case of a NBFC, it is bound by the RBI directives. The classification as NPA is as per prudential norms of the RBI.

In the case of NPAs, the recovery of the principal amount of loan itself is doubtful. Therefore, where the interest was not received on NPAs and possibility of recovery was almost nil, it could not be treated to have accrued in favour of the assessee. Accordingly, the assessee, on the basis of prudence, is justified in not accounting for interest in the books of account on the ground that there is no real accrual of interest from a NPA under section 5.

In the case of *DIT v. Brahmaputra Capital Financial Services Ltd.* (2011) 335 ITR 182, the High Court took a similar view.

Hence, the Assessing Officer cannot make an addition on the premise that the company follows mercantile system of accounting.

Self-examination Questions

1. Explain whether accounting principles are recognized by judicial forums while settling tax disputes, with the aid of case laws.
2. Explain the areas of similarity in treatment of expenses/income/assets/liabilities under Accounting Standards and Income-tax law.
3. Mention the areas where there is a difference in treatment of expenses/income/assets/liabilities under the Accounting Standards and Income-tax law.
4. Distinguish between "Permanent difference" and "Timing difference", with the help of examples.
5. When does a deferred tax asset and deferred tax liability arise? Explain giving examples.
6. What are the criteria for recognizing a deferred tax asset?
7. What are the accounting entries to be passed for recognition and reversal of a deferred tax asset and deferred tax liability?
8. Explain the method of accounting of tax, duty etc. under section 145A of the Income-tax Act, 1961 and AS 2 on Valuation of Inventories.