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Income Computation and Disclosure Standard VIII relating to Securities

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Kanwal Gupta

Director, Deloitte Haskins & Sells LLP

Rakhi Agrawal

Manager ,Deloitte Haskins & Sells LLP

The Central Board of Direct Taxes has notified the Income Computation and Disclosure Standards ('ICDS') vide notification no. 32/2015, F. No. 134/48/2010-TPL, dated March 31, 2015. As per the notification, ICDS notified under the Income Tax Act, 1961 ('Act')[1] is applicable only for computation of income chargeable under the head 'profit and gains of business or profession' or 'income from other sources' and not for the purpose of maintenance of books of accounts. It also provides that in the case of conflict between the provisions of the Act and these ICDSs, the provisions of the Act shall prevail to that extent.

ICDS VIII deals with securities held as stock-in-trade which is different from Accounting Standard ('AS') 13 issued by the Institute of Chartered Accountants of India which deals with accounting for current investments, long term investments and investment property but excludes shares, debentures or other securities held as stock-in- trade. However, AS-13 indicates that though it does not apply to stock-in-trade, the manner in which they are accounted for is quite similar to current investments. Accordingly, the provisions of AS 13 to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in the standard. This article outlines some of the provisions and issues relating to ICDS VIII.

ICDS VIII defines securities as having same meaning assigned to it in clause (h) of Section 2 of the Securities Contract (Regulation) Act, 1956 ('SCRA') (42 of 1956), other than Derivatives referred to in sub-clause (1a) of that clause. Section 2(h) of the SCRA defines securities to include shares, scrips, stocks, bonds, debentures, debenture stock, units of mutual fund scheme, Government securities, rights or interest in securities, etc. Thus, one may find that instruments considered as rights or interest in the securities, e.g right of first refusal ('ROFR') or rights to conversion etc; are being classified as securities, with challenges being posed whether the same should be considered for determining the profits independently of the underlying security(though under the accounting principles the rights may be mentioned as a note for information purposes) or on the valuation mechanics to be adopted therein.

ICDS VIII does not specify when securities can be considered as stock-in-trade. Litigation around the same continues and one still have to rely on plethora of judgements and CBDT circular no. 4/2007 dated 15 June 2007 read with Instruction no. 1827 dated 31 August 1989 to determine whether securities are held as investments or stock-in-trade. It would have been better if it would have been clarified as to how and when the securities could be considered to be held as stock-in-trade.

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It has been provided that ICDS VIII would not be applicable in respect of securities held by a person engaged in the business of insurance and by mutual funds, venture capital funds, banks and public financial institutions formed under a Central or a State Act or so declared under the Companies Act, 1956 or the Companies Act, 2013. Thus, ICDS VIII will be applicable to every person, other than those specifically excluded, who will required to compute income chargeable under the head profits and gains of business or profession or income from other sources It may be mentioned that where a person (e.g. NBFCs) holding the securities as stock-in-trade, may be doing so in the same manner as to what the excluded entities would be doing and hence the taxable profits could be determined on different parameters for entities with the same/ similar objectives of holding securities as stock-in-trade.

With regard to determining valuations, fair value has been defined in ICDS VIII as the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. The definition of fair value in AS 13 is similar with the addition that under appropriate circumstances, market value or net realisable value ('NRV') provides an evidence of fair value.

It has been provided that, the cost of security shall comprise of the purchase price, including acquisition charges such as brokerage, fees, tax, duty or cess. In respect of the cost of acquisition of securities by way of exchange of an asset or issue of securities, AS 13 provides that if an investment is acquired by issue of shares or other securities, the acquisition cost is the fair value of the securities issued or if an investment is acquired in exchange for another asset, the acquisition cost of the investment shall be the fair value of the asset given up. However, fair value of the investment acquired shall be considered if it is more clearly evident. On the other hand, ICDS VIII provides that where a security is acquired in exchange for other securities, the fair value of the security so acquired shall be its actual costor where a security is acquired in exchange for another asset, the fair value of the security so acquired shall be its actual cost. Thus, under accounting standards the value is determined on the basis the value of the asset going out, whereas under ICDS VIII, it would be based on the value of the asset which is being acquired, thereby leading to variations in the computation of profits for the entity.

In view of the above method of valuation, in case of say a convertible security, it is unclear whether the value of the security received pursuant to the conversion could be considered as a security received in exchange (as an exchange could contemplate an existence of the security pursuant to the conversion, which may not be case) and hence its valuation would be based on fair value of security so acquired or would the same be considered as the purchase price of the security being converted.

ICDS VIII also provides that at the end of the previous year, securities held as stock-in-trade shall be valued at actual cost initially recognised or NRV at the end of that previous year, whichever is lower. On the other hand, AS 13 provides that the carrying cost of current investments shall be lower of cost and fair value. However, ICDSVIII does not indicate as to how the NRV is to be computed and one could be tempted to adopt any of the options available.

Further such valuation under ICDS VIII would not be applicable in respect of securities not listed on a stock exchange or listed but not quoted on a recognised stock exchange with regularity. It has not been provided as to when could a security be considered as quoted with regularity and hence evidence would be needed to support the contention that the security is to be considered as quoted with regularity.

It has been further provided in ICDS VIII that where the actual cost initially recognised cannot be ascertained with reference to the specific identification, the cost of such security shall be determined on of first-in-first-out ('FIFO') method. This probably contemplates a situation where the securities are held in demat form and section 45(2A) read with circular no. 768 dated 24 June 1998 indicates that the transfer therefrom would be considered to be on FIFO basis.

To conclude, though ICDS VIII may be considered to provide some clarity to the valuation of securities held as stock-in-trade, one may still need to fall back on existing judicial prudence to support contention which may not squarely fall within the standard specified.

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[1]Under section 145(2) of the Act

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