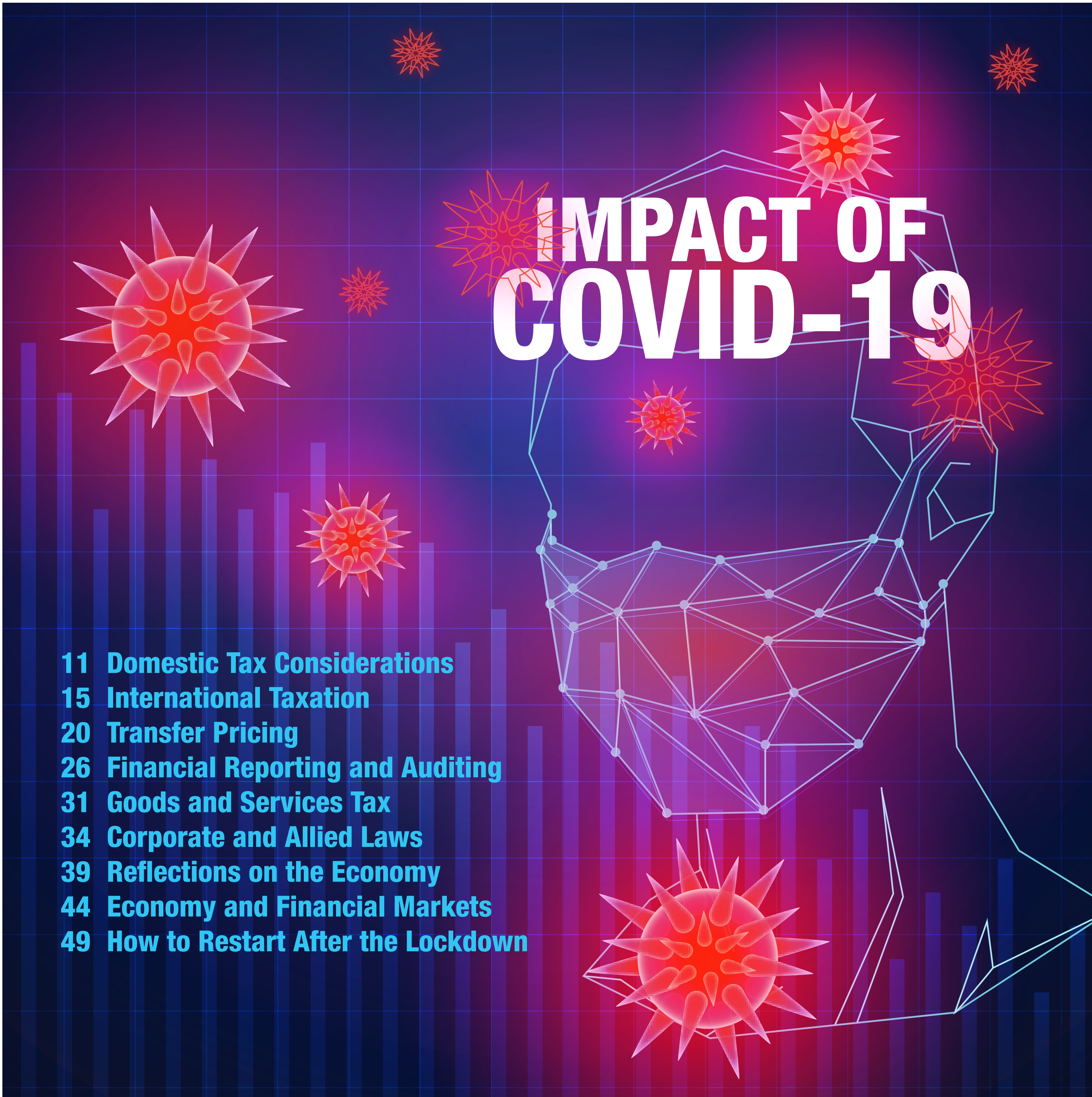
MAY 2020
VOL. 52-A PART 2
PAGES 148
PRICE: ₹100

# BCAJ

THE BOMBAY CHARTERED ACCOUNTANT JOURNAL

CURIOSITY TO CREATIVITY

BCAJ VOL. 52-A PART 2 | MAY 2020



## IMPACT OF COVID-19

# DOMESTIC TAX CONSIDERATIONS DUE TO COVID-19

BHAUMIK GODA | SAUMYA SHETH
Chartered Accountants

## BACKGROUND

The intensifying Covid-19 pandemic and the looming uncertainty on future business outlook have put the emergency brakes on India Inc. Sudden lockdown, supply side disruption, adverse foreign exchange rate, travel restriction as also uncertainty on vaccine to cure the misery have added to the uncertainty, pushing Captains of India Inc. into rescue mode. Clearly, while the immediate focus is to save the ship from sinking, tax considerations also require due consideration in time to come. This article focuses on some of the direct tax issues which are likely to be faced by Indian taxpayers.

## DEDUCTION OF EXPENSES INCURRED ON COVID 19

As the pandemic increased its spread into the country, India Inc. rose to the occasion and started supporting various noble causes of the society in terms of supplying food, medical supplies, setting up of quarantine centres, etc. Most of the corporates joined hands in the national interest and contributed to PM CARES and CM Covid-19 Funds to support frontline workers and assist in the medical war. MCA, with a noble intention, amended Schedule VII of the Companies Act, 2013 ('Cos Act') to include Covid-19 expenditure as eligible CSR expenditure in compliance with CSR law.

Explanation 2 to section 37(1) of the Income-tax Act, 1961 ('the Act') provides that any expenditure incurred by an assessee on the activities relating to corporate social responsibility referred to in section 135 of the Companies Act, 2013 (18 of 2013) shall not be deemed to be an expenditure incurred by the assessee for the purpose of the business or profession.

The amendment to Schedule VII of the Companies Act read with the Explanation 2 to section 37(1) of the Act raises the following issues:

a) Whether the expenditure on Covid-19 is tax deductible for an assessee not required to comply with CSR regulations of the Companies Act, 2013?
b) Can an assessee claim business expenditure for Covid -19 related expenditure which he does not claim to be CSR for the purpose of compliance with section 135 of Cos Act?

It is possible to take a view that Explanation 2 to section 37(1) of the Act is applicable only to those assessees who are covered by section 135 of the Companies Act. Thus, if an assessee is not covered by the said regulation, the limitation of Explanation 2 to section 37 is not applicable. Courts have held that factors like meeting social obligation, impact on goodwill on contribution to society, etc. meet the test of commercial expediency and deduction has been granted[1]. Thus, onus will be on the assessee to prove nexus of the expenditure with the business and the positive impact on business to perfect the claim of deduction. Branding of company on distribution of food and essential requirements, images of employees wearing company branded shirts and supporting larger cause, media reports, posting on social websites will all support the claim for deduction.

The issue arises in the second category i.e. an assessee who is otherwise covered by section 135 of Companies Act who does not claim Covid-19 related expenditure for compliance with CSR laws. The difficulty arises as Explanation 2 to section 37(1) disallows expenditure 'referred to in section 135'. Referred to would mean 'mentioned' in section 135 of the Companies Act. Explanation 2 to section 37(1) fictionally deems such expenditure as not being for business purpose. Whilst argument in favour of deduction seems a better view of the matter, it is recommended that assessee should take fact-specific legal advise before claiming deduction.

## IMPACT ON LEASE RENTAL

Lockdown and social distancing are likely to have significant impact on lease rentals. The impact may be deep for let-out properties in shopping malls and hotels. Further, the sudden lockdown may have resulted in economic disruption of business of the lessee, impairing its ability to pay rent. Following situations are likely to arise:

a) Lessee does not pay rent for lockdown period by invoking *force majeure*, which is accepted by the lessor;
b) Lessee invokes *force majeure* which is not accepted by the lessor;

1 ***CIT vs. Madras Refineries Ltd., (2004) 266 ITR 170 (Mad); Orissa Forest Development Corporation Ltd. vs. JCIT, (2002) 80 ITD 300 (Cuttack); Surat Electricity Co. Ltd. vs. ACIT, (2010) 5 ITR(Trib) 280 (Ahd)***

c) Lessor and lessee defer rent for a mutually agreed period;
d) Lessee is unable to pay rent and vacates the premises;
e) Lessor is subsequently unable to find a lessee for the property either on account of lockdown or lower rental yield;

In case of situation a), act of *force majeure* goes to the root of the contract making the contract unworkable. On account of the said event, a view could be taken that the property ceases to be a let-out property. Accordingly, it may be possible for the lessor to seek benefit of vacancy allowance u/s 23(1)(c). The said provision states that in case actual rent received or receivable is less than deemed Annual Let out Value (ALV) on account of vacancy then, actual rent received or receivable will be deemed to be ALV. In this case, vacancy arises contractually. In other words, even though goods or assets of lessee may continue to be lying in said property but still it has to be treated as not let out, absolving the lessee from the liability to pay rent. Vacancy in the context in which it is used in section 23(1)(c) will need to be interpreted as the antithesis of let out.

Situation b) is tricky as there is a rent dispute during the lockdown period. Section 23(1)(b) provides that when actual rent received or receivable is higher than ALV, then said amount will be treated as ALV. 'Receivable' postulates concept of accrual. As per one option, lessor may treat same amount as unrealised rent and offer the same in the year of receipt u/s 25A. However, if it is required to keep rent as receivable in books of accounts to succeed under the Contract Act, then in such an event, tax liability will arise.

Situation c) involves mere deferment of payment of rent and accordingly lessor will be required to pay tax on rent component as it fulfils the test of receivable u/s 23(1)(b).

Situation d) is a case comparable to unrealised rent. Explanation to section 23 read with Rule 4 provides for exclusion of such rent if the conditions prescribed in Rule 4 are complied with.

Issue in case of situation e) arises as section 23(3) permits only two houses to be treated as self-occupied. Situation narrated in e) needs to be distinguished from a situation wherein assessee in past years has offered income from more than two houses under the head Income from house property. Conclusion does not change for such assessee. Situation e) deals with a situation wherein assessee desires to actually let out his house but could not find a tenant. In such situations, the Tribunal[2] has held that even if the house remains vacant for the entire year despite the best attempts of the assessee, then benefit of vacancy allowance u/s 23(1)(c) should be granted to the assessee and accordingly ALV for such property would be Nil. Against this proposition, there is also an adverse decision in the case of ***Susham Singla [2016] 76 taxmann.com 349 (Punjab & Haryana)***[3]. Perhaps a distinguishing feature could be that in cases where vacancy allowance was granted by the Tribunal, the assessee was able to demonstrate efforts made to let out property.

## IMPACT ON BUSINESS INCOME

<u>Revenue recognition</u>

Revenue recognition for computing income under the head 'profits and gains of business or profession' is governed by the principles of accrual enshrined in section 4 as also ICDS IV dealing with revenue recognition. ICDS IV permits revenue recognition in respect of sale of goods only if the following criteria are met:

- Whether significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control
- Evaluate reasonable certainty of its ultimate collection

These criteria are relevant for revenue recognition for F.Y. 2019-20. On account of lockdown and logistics issues, it is possible that goods dispatched could not reach the customer. Contractually, even though the transaction may have been concluded, the seller was obliged to deliver goods to the buyer. In such a case, because of lockdown, goods may be in transit or in the seller's warehouse. In such a situation, significant risk and reward of ownership continues to be with the seller. Accordingly, the seller may not be required to offer the said amount to tax. Further, economic stress may change the credit profile of the customer, raising a question on the realisability of sale proceeds of the goods sold even pre-Covid-19 outbreak. In such a case, even though the test of accrual would be met, since there is uncertainty in ultimate collection, the assessee may not recognise such revenue. This criterion is also important as the customer may invoke *force majeure* clause or material adverse clause and turn back from its commitment.

2 ***Sachin R. Tendulkar vs. DCIT [2018] 96 taxmann.com 253 (Mumbai - Trib.); Empire Capital (P.) Ltd vs. DCIT [2018] 96 taxmann.com 253 (Mumbai - Trib.); Ms. Priyananki Singh Sood vs. ACIT [2019] 101 taxmann.com 45 (Delhi - Trib.)***

3 SLP dismissed by Supreme Court **[2017] 81 taxmann.com 167 (SC)**

Section 43CB of the Act read with ICDS IV requires the service industry to apply Percentage of Completion Method (POCM). If duration of service is less than 90 days, the assessee can apply Project Completion Method (PCM) and offer revenue to tax on completion of the project. Disruption caused due to pandemic and work from home is likely to impact numerous service contracts. Assessee will have to determine stage of completion of contract on 31st March 2020 for each open contract at year end to determine its chargeable income. It is equally possible that a contract which was estimated to be completed in less than 90 days may take more time and accordingly move from PCM to POCM basis of recognition. Thus, it is possible that an income which was estimated to be offered to tax in F.Y. 2020-21 may partially be required to be taxed in F.Y. 2019-20, changing the assumptions at the time of computing advance tax. An issue which judiciary is likely to face is whether the 90 days period should be read as a rigid test or exceptional events like Covid-19 can be excluded for computing the 90 days' periods.

Provision for onerous contract

Ind AS 37 requires recognition of provision for onerous contract. An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

Section 36(1)(xviii) of the Act provides that mark to market (M2M) loss or other expected loss shall be computed in accordance with ICDS. Section 40A(13) of the Act provides that no deduction or allowance shall be allowed in respect of any M2M loss or expected loss except as allowable u/s 36(1)(xviii). ICDS 1 provides that expected loss shall not be recognised unless the same is in accordance with other ICDS. ICDS X provides that no provision shall be recognised for costs that need to be incurred to operate in the future. On co-joint reading of aforesaid law, no deduction shall be allowed for onerous contract under normal provisions. However, for MAT purposes, such provision will be deductible as it cannot be said that such provision is for unascertained liability. This treatment will require an assessee to accurately track expenses incurred on such contract in future years and claim it as deduction in year of incurrence.

Liquidated damages

Disruption in the supply chain may result in claims or counter claims as it is possible that the assessee would not be in a position to meet its contractual obligations. The contract may provide for payment of liquidated damages. Courts have held that such payment is tax deductible[4].

Remeasurement of provision

Lockdown and social distancing have resulted in India Inc. rethinking on extension of warranty and service period in respect of goods sold prior to Covid-19. This is likely to result in change in warranty provision. Provision for warranty is tax deductible if otherwise the requirements of ICDS X are met. Practically for companies following Ind AS, warranty provisions are discounted to fair value. However, ICDS X expressly prohibits deduction based on discounting to net present value basis. This mismatch will require an assessee to accurately reconcile claims made in the past ignoring NPV basis, revise the provision and ignore NPV discounting for claiming deduction. This is much easier said than done.

Further, companies following Ind AS are required to make provision for debtors based on Expected Credit Loss (ECL) method. This method requires consideration of not only the historic data but also of the future credit risk profile of debtor. In turbulent times like these, making an estimate of the future profile of a customer is likely to be challenging since the business outlook is uncertain. Further, the impact of lockdown on each customer, its ability to raise finances and stay afloat involves significant assumptions and customer-specific data. Normative mathematical models cannot be relied upon. It is possible that ECL provision may increase for F.Y. 2019-20. Such provision may not be tax deductible under normal computation provisions [Explanation 1 to section 36(1)(vii)]. As regards MAT, the issue is debatable. Gujarat High Court's Full Bench in case of ***CIT vs. Vodafone Essar Gujarat Ltd***[5] has held that if the provision is accounted as reduction from debtor / asset side and not reflected separately in liabilities side then, in such case said provision is not hit by any limitation of Explanation 1 to section 115JB and is tax deductible.

Inventory valuation

ICDS 2 permits valuation of inventory at cost or Net Realisable Value (NRV) whichever is lower. It is possible that on account of prolonged shutdown, disruption in

4 ***PCIT vs. Green Delhi BQS Ltd [2019] 417 ITR 162 (Delhi); CIT vs. Rambal (P.) Ltd [2018] 96 taxmann.com 170 (Madras); PCIT vs. Mazda Ltd [2017] 250 Taxman 510 (Gujarat) ; Haji Aziz and Abdul Shakoor Bros [1961] 41 ITR 350 (SC)***

5 ***[2017] 397 ITR 55 (Gujarat)***

supply chain, overhaul of non-essential commodities, some of the inventory which may be lying in warehouse or stuck in transport may no longer be marketable e.g perishable goods, inventory with short shelf life (food products) may be required to be disposed of. In such case, it should be possible to recognise NRV at Nil. Care should be taken to obtain corroborative evidence in terms of internal technical reports, subsequent measures to dispose of, etc. to substantiate Nil realisable value.

Fixed Asset

The spread of Covid-19 has had a differing impact on various nations. It is possible that some of the fixed assets acquired could not be installed on account of cross border travel prohibitions not only in India but across the globe. In such a case, such assets which were earlier contemplated to start active use in F.Y. 2019-20 will miss the deadline. In absence of satisfaction of the user test, no depreciation can be claimed in F.Y. 2019-20. Further in terms of ICDS V – tangible fixed assets, cost attributable to such fixed asset may also be required to be capitalised. Further, if such asset is purchased out of borrowed funds, interest expenditure will be required to be capitalised. Unlike Ind AS 23, ICDS IX does not suspend capitalisation when active development is suspended. This mismatch will require the assessee to accurately determine interest cost which is expensed for books purpose and capitalise it as part of borrowing for tax purposes. It is equally possible that unexpected delay may impact advance tax projections made for F.Y. 2019-20.

## SHARES AND SECURITIES

The Act provides special anti-abuse provisions in respect of dealing in shares and securities. Sections 50CB and 56(2)(x) regulate transactions where actual consideration is less than fair market value. Rule 11UA provides a computation yardstick to compute fair market value. The economic downturn may force some promoters to sell their shares at less than Rule 11UA value to genuine investors either to repay debts borrowed on pledge of shares or to raise capital for future survival. Provisions of sections 50CB and 56(2)(x), if invoked, may result in additional tax burden. Fortunately, Mumbai Tribunal in ***ACIT vs. Subhodh Menon*** relying on the Supreme Court decision in the case of ***K P Varghese*** read down the provision to apply only in abusive situations.

Further, the pandemic may require promoters to pump in capital into the company. Section 56(2)(viib) regulates share infusion by a resident shareholder. The provision proposes to tax infusion of share capital above the fair market value as computed by a merchant banker. DCF is a commonly accepted methodology to value business. DCF requires reasonable assumption of future cash flows, risk premium, perpetuity factor etc. Considering that the present situation is exceptional, it may involve significant assumptions by the valuer as also the company. Further, there will be an element of uncertainty, especially when the business outlook is not clear. It is possible that the actual business achievements may be at material variance with genuine assumptions.

In contrast, the existing situation may have an impact on capital infused in the past, say 2-3 years, which were justified considering the valuation report availed from the Merchant Banker at the said time. Tax authorities may now rely upon actual figures and question the valuation variables used by the Merchant Banker. Tax authorities may attempt to recompute fair value considering actual figures. In such a situation, the onus will be on the assessee to demonstrate impact of Covid-19 on valuation assumptions made in the past. Evidence such as loss of major customer, shutdown in major geographies, increased cost of borrowing, capacity underutilisation will support the case of the assessee to justify valuation done before Covid-19 breakout.

## CONCLUSION

One hopes normalcy returns soon. Aforesaid are some of the issues which, in view of the authors, are only the tip of the iceberg. If the pandemic deepens its curve, it is likely to result in significant business disruption. Every impact on business has definite tax consequences and tax professionals have a special role to play. ■

6 ***[2019] 103 taxmann.com 15 (Mumbai)***

7 ***[1981] 131 ITR 597 (SC)***

*I cried because I had no shoes until I met a man who had no feet*

**— Helen Keller**