Marked to Market loss from Income-tax perspective

Introduction

1. The Income Computation Disclosure Standards (ICDSs) notified by the CBDT earlier were welcomed by the professional fraternity but were rescinded and reintroduced in September 2016. They became applicable from the assessment year 2017-18 onwards. The Delhi High Court in Chamber of Tax Consultants v. Union of India [2017] 87 taxmann.com 92/[2018] 252 Taxman 77 made a threadbare analysis of the mechanics of the introduction and application of ICDS and highlighted the inconsistency between the legal provisions vis-a-vis ICDSs. The CBDT Circular No.10/2017 dated 23-3-2017 was also subjected to dissection. Many of the ICDSs which were incongruous with the legal provisions were held ultra vires by the Delhi High Court.

The tax administration took the Finance Act, 2018 as the gateway for getting the stamp of approval from the legislature and specific legal provisions such as sections 43AA and 43CB were introduced besides substitution of section 145A with retrospective effect from 1-4-2017.

The decision of the Delhi High Court, holding that the ICDSs did not stand the test of judicial scrutiny prompted the taxpayers/tax counsels to toy with the idea of revising the returns filed by withdrawing the adjustments made in consonance with the ICDSs for the purpose of computing total income for the assessment year 2017-18. The Finance Act, 2018, by giving approval for ICDSs retrospectively, has also pre-empted such move and validated those returns filed for the assessment year 2017-18.

Accounting concept

2. Students of accounting would recall that one of the cardinal principles of ascertaining the income or profit is to apply the concept of “conservatism”. This concept provides the push to the concept of prudence which is one of the fundamental accounting assumptions to be followed by an enterprise. Only when such assumption is not followed, the ICDS-1 dealing with accounting policy seeks a disclosure of departure.
In *Tuticorin Alkali Chemicals & Fertilizers Ltd. v. CIT* [1997] 227 ITR 172/93 Taxman 502 (SC) the assessee-company earned interest on deposits which was set-off against business income. Later, on it filed a revised return showing business loss and adjusted the interest income against pre-production expenses (such as interest and finance charges) and was ultimately capitalized. The Revenue rejected the claim of the assessee and held that interest income is chargeable to tax. On the principle of accounting treatment of the capitalization of pre-commencement or pre-production expenses, the Apex Court, while making reference to the accounting principles and taxation of income, observed that “it is true that this court has very often referred to accounting practice for ascertainment of profit made by a company or value of the asset 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”.

Thus, the taxation of income is with reference to income-tax law and would not give weightage to the accounting principles or practices.

**Meaning of ‘Marked to Market loss’**

3. ICDS-1 says that “marked to market loss” or expected loss shall not be recognized, unless such, recognition is in accordance with the provisions of any other ICDS.

Marked-to-market loss means that the asset value is adjusted to reflect its market price by recognizing the decrease in value. The decrease in value representing loss for the purpose of computing total income of the assessee cannot be made unless the ICDSs permit such recognition.

Let us list out various ICDSs as to when they permit or reject the recognition/adjustment of marked to market loss.

### 3.1 ICDS 2 - Valuation of Inventories

- In ICDS-2 the valuation of inventory is at cost or net realizable value – whichever is less. Thus, when the market price plummets and the net realizable value is less than cost, the marked to market loss is permissible.
- Para 19 of ICDS-2 says “inventories shall be written down to net realizable value on an item-by-item basis”. This could be explained with the help of the following example:

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Cost</th>
<th>Net realizable value</th>
<th>Inventory valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>30</td>
<td>37</td>
<td>30</td>
</tr>
<tr>
<td>B</td>
<td>40</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>C</td>
<td>50</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Total</td>
<td>120</td>
<td>107</td>
<td>100</td>
</tr>
</tbody>
</table>

- The inventory value to be adopted would be ₹ 100 when the net realizable value is computed on an item-by-item basis.
- In the case of dissolution of firm or AOP or BOI the valuation of inventory is at net realizable value as per ICDS-2. If the net realizable value is less than their actual cost, the marked to market loss is recognized for income-tax purposes. On the contrary, if the net realizable value is more than the actual cost, the profit (though not realized and fictional) it is chargeable to tax.

### 3.2 ICDS 3 - Construction contracts

- In the case of construction contracts, the retention amounts represent the amounts withheld by the contractee (party) until the satisfaction of conditions specified in the contract is obtained or the defects therein are rectified. The ICDS-3 in para 10 says that the contract revenue shall comprise of retentions also.
- However, para 9 says that contract revenue shall be recognized when there is reasonable certainty of its ultimate collection. Where there is no certainty, such revenue need not be recognized.