

Query No. 32

Subject: Provision for disputed tax cases.¹

A. Facts of the Case

1. A private limited company (hereinafter referred to as ‘the company’) is registered under the Companies Act, 1956. The company is engaged in the manufacturing of heavy equipments and providing services to group companies outside India.

2. The querist has stated that the financial statements of the company are prepared in accordance with Indian Accounting Standards (Ind ASs) notified vide Companies (Indian Accounting Standards) Rules, 2015 under section 133 of the Companies Act, 2013 (the Act) and other relevant provisions of the Act.

3. In line with the requirements of Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’ the company has adopted the following accounting policy with respect to accounting for provisions, contingent liabilities and contingent assets specifically related to corporate income taxes:

“Provisions are recognised when the company has a present legal or constructive obligation as a result of past events, for which it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount can be made. Provisions are reviewed regularly and are adjusted where necessary to reflect the current best estimates of the obligation. When the company expects a provision to be reimbursed, the reimbursement is recognised as a separate asset, only when such reimbursement is virtually certain.

Contingent Liabilities: Contingent liabilities are disclosed when there is a possible obligation arising from past events, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the company or a present obligation that arises from past events where it is either not probable that an outflow of resources will be required to settle, or a reliable estimate of the amount cannot be made.”

4. During the course of assessment proceedings under the Income-tax Act, 1961, certain disallowances/additions are made to the taxable income as reported in the corporate income tax returns by the Assessing Officer/Transfer Pricing Officer and demands are raised. In respect of the disallowances/additions which are contested before the higher authorities (‘the disputed tax positions’), the tax demands paid/adjusted, if any/as appropriate are shown as advances and included under ‘Advance Income Tax’ (current tax asset) in the balance sheet.

5. As per the querist, for various reasons, some positions assumed by the company at the time of finalising the financials/filing the returns are not disputed by the tax authorities (CBDT). However, subsequently, these positions may be disputed by CBDT for other corporations and won against various appellate forums, based on which the positions assumed by the company may be rendered *certain or uncertain*. In such cases, CBDT may even open closed assessments for scrutiny as long as the relevant assessment years are not time-barred for further evaluation. (Emphasis supplied by the querist.)

6. The company evaluates all open / disputed tax positions based on actual prior income tax audit history for similar matters, relevant external judicial precedents for the matters

¹ Opinion finalised by the Committee on 8.1.2019.

disputed and legal opinions as appropriate, to ascertain the probability and likelihood of sustaining the company's tax return filing position upon appeal. Based on such assessment, no reserve is created if a favourable outcome is *certain*. (Emphasis supplied by the querist.)

B. Query

7. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee for the above explained tax positions as to:

- (a) Whether the accounting policy adopted by the company of not making tax provision in respect of disputed tax positions which have favorable judicial precedence/attorney opinion as discussed in paragraphs 5 and 6 above, is acceptable as per the generally accepted accounting practices of the Indian Accounting Standards and the prudence concept.
- (b) For uncertain positions in such disputed tax cases, through the company's evaluation as discussed in paragraphs 5 and 6 above,
 - (i) where the company has a 'more likely than not' assessment of a favourable outcome, whether a contingent liability disclosure alone is appropriate?
 - (ii) where the company does not have a 'more likely than not' assessment of a favourable outcome, should the accounting treatment be creation of reserve (including reserve for interest)?
- (c) When no provision/ contingent liability is recognized, should there be any disclosure to this effect in the notes to the financial statements, assuming the outcome is certain?

C. Points considered by the Committee

8. The Committee notes that the basic issue raised in the query relates to accounting for disputed tax positions, viz., the disallowances/additions which are contested by the company before the higher authorities. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for tax positions taken by the company which have not yet been disputed by the Income-tax authorities for the tax returns filed by the company, accounting for tax demands paid/adjusted in respect of disputed tax positions, etc. Further, the Committee wishes to point out that its opinion is expressed purely from accounting perspective and not from any legal perspective. At the outset, the Committee wishes to mention that the opinion expressed hereinafter is based on the Ind ASs applicable for the financial year 2018-19. However, the Committee wishes to point out that future amendment to Ind AS 12 'Income Taxes', viz., Appendix C relating to 'Uncertainty over Income Tax Treatments' which is applicable from future date, may have a bearing on the extant issue.

9. With regard to accounting for disputed tax positions, the Committee notes that Ind AS 12 provides guidance on current tax and deferred tax, however does not provide detailed guidance on provisions relating to income tax disputes and uncertainties. In this regard, the Committee notes that Ind AS 37, 'Provisions, Contingent Liabilities and Contingent Assets' provides detailed guidance on provision relating to similar kind of disputes and uncertainties. Accordingly, although provisions relating to income taxes have not been addressed in Ind AS 37, the Committee has considered, hereinafter, the requirements of Ind AS 37 in the context of such provisions. The Committee further notes the following requirements of Ind AS 12,

‘Income Taxes’ and Ind AS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’, notified under the Companies (Indian Accounting Standards) Rules, 2015:

Ind AS 12:

88 An entity discloses any tax-related contingent liabilities and contingent assets in accordance with Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise, for example, from unresolved disputes with the taxation authorities. Similarly, where changes in tax rates or tax laws are enacted or announced after the reporting period, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see Ind AS 10, *Events after the Reporting Period*).

Ind AS 37:

“A *provision* is a liability of uncertain timing or amount.

A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

An *obligating event* is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A *legal obligation* is an obligation that derives from:

- (a) a contract (through its explicit or implicit terms);**
- (b) legislation; or**
- (c) other operation of law.**

A *constructive obligation* is an obligation that derives from an entity’s actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and**
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.**

A *contingent liability* is:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or**
- (b) a present obligation that arises from past events but is not recognised because:**
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or**
 - (ii) the amount of the obligation cannot be measured with sufficient reliability.”**

“14 A *provision* shall be recognised when:

- (a) **an entity has a present obligation (legal or constructive) as a result of a past event;**
- (b) **it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and**
- (c) **a reliable estimate can be made of the amount of the obligation.**

If these conditions are not met, no provision shall be recognised.

15 In rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

16 In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:

- (a) where it is more likely than not that a present obligation exists at the end of the reporting period, the entity recognises a provision (if the recognition criteria are met); and
- (b) where it is more likely that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).”

“23 For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard, an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, ie the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).”

“27 An entity shall not recognise a contingent liability.

28 A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is remote.”

“86 Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable:

- (a) **an estimate of its financial effect, measured under paragraphs 36–52;**

- (b) **an indication of the uncertainties relating to the amount or timing of any outflow; and**
- (c) **the possibility of any reimbursement.”**

“91 Where any of the information required by paragraphs 86 and 89 is not disclosed because it is no practicable to do so, that fact shall be stated.”

10. The Committee notes from the above that an element of judgement is required to determine whether the demand raised in respect of additions /disallowances in cases pending before various Income-tax authorities should be provided for in the accounts or treated as contingent liability and disclosed by way of a note to the accounts depending upon the assessment of likelihood of the outcome of the uncertainty. It is for the management of the enterprise to decide and for the auditor to assess, considering the circumstances of each case, whether the demand raised warrants recognition of provision or disclosure of contingent liability. The Committee is of the view that while making such judgement, all the facts and circumstances of the case and all the evidences available on the reporting date, including for example, legal opinion of an expert on the possibility and extent of outcome (success or failure) of the company’s cases in the court of law, experience of the company or other enterprises in similar cases, decisions of appropriate authorities, etc. should be considered. Further, the Committee is also of the view that events after the reporting period but, before the date of finalization of accounts, should also be taken into consideration. The Committee wishes to clarify that the fact that no demand has been raised by the authorities does not necessarily indicate that demand cannot be raised in future. Accordingly, on the basis of above evaluation, if it is determined that it is more likely than not that a present obligation exists at the end of the reporting period, the company should recognise a provision (if the recognition criteria are met) and where it is more likely that no present obligation exists at the end of the reporting period, the entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

11. Further, the Committee is of view that accounting for the interest liability that may arise on demands should be dealt with considering the same principles as for the original income tax liability, as discussed in paragraph 10 above.

D. Opinion

12. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

- (a) and (b) Considering the requirements of Ind AS 12 and Ind AS 37, as discussed in paragraphs 9 and 10 above, in respect of disputed tax positions where the demands have been raised in respect of additions/disallowances, an element of judgement is required to determine whether the same should be provided for in the accounts or treated as contingent liability and disclosed by way of a note to the accounts depending upon the assessment of likelihood of the outcome of the uncertainty. While making such judgement, all the facts and circumstances of the case and all the evidences available on the reporting date, including for example, legal opinion of an expert on the possibility and extent of outcome (success or failure) of the company’s cases in the court of law, experience of the company or other enterprises in similar cases, decisions of appropriate authorities, etc. and events after the reporting period but, before the date of finalization of accounts should be considered. On the basis of above evaluation, if it is determined that it is more likely than not that a present

obligation exists at the end of the reporting period, the company should recognise a provision (if the recognition criteria are met) and where it is more likely that no present obligation exists at the end of the reporting period, the entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote. Accounting for interest liability (if any) should be dealt with considering the same principles as for the original income tax liability, as discussed in paragraph 11 above.

- (c) Since no provision/ contingent liability is recognised/ disclosed considering the requirements of Ind AS 37, no disclosure is required in the notes to financial statements.
