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NEWSLETTER

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DAMANIA & VARAIYA

Chartered Accountants

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INCOME TAX & INTERNATIONAL TAX

Circular No. 38 dated 22nd November 2016

Sub: Keyman Insurance Premium of partner in a firm.

CBDT vide their circular No. 762 dated 18.02.1998 had clarified that premium paid on Keyman Insurance Policy is allowable as business expenditure. However, in case of such expenditure incurred by a partner in a partnership firm, the general approach of the assessing officer was to treat the expenditure as not incurred for the purpose of the business and therefore disallow the same.

In view of favourable decisions by various High Courts on allowability of such expenditure, CBDT has confirmed that in case of a firm, premium paid by the firm on the Keyman Insurance Policy of a partner, to safeguard the firm against a disruption of business**, is an admissible expenditure** under section 37 of The Income Tax Act.

Consequently, if any appeal is filed by the Department on this settled issue, the same may be withdrawn.

Circular No. 40 dated 9th December 2016

Sub: No reopening for the reason of higher turnover.

Recent initiatives of the Government to curb the black economy in the country have encouraged businessmen to shift towards digital mode of payment while making financial transactions. The advantage of adopting digital mode of payment , no financial transactions would remain undisclosed and consequently an enhanced turnover of business might get reflected in the books of accounts. Under the circumstances, an apprehension has been raised that increased turnover in the current year may lead to reopening of earlier years' cases involving lower turnover u/s 147 of the Income-tax Act by the Assessing Officer causing undue harassment to tax payers.

CBDT has clarified that reopening of cases u/s 147 of the Act is feasible only when the Assessing Officer "has reason to believe that any income chargeable to tax has escaped assessment for any assessment year" and **not merely on the basis of any reason to suspect**. Mere increase in turnover, because of use of digital means of payment in a particular year cannot be a sole reason to believe that income has escaped assessment in earlier years. Hence, Assessing Officers are advised not to reopen past assessments in cases merely on the ground that the current year's turnover has increased.

Re: Ravjibhai Nagjibhai Thesia

Sub: Capital Gain – Section 50C

The assessee sold his land for	Rs. 16.00 Lakhs
The Stamp duty valuation of that land	Rs. 233.70 Lakhs
Valuation of the land done by the Valuation Officer u/s. 5C(2)	Rs. 24.15 Lakhs

The AO passed the assessment order based on the stamp duty valuation treating the difference amount as undisclosed income.

The Gujarat High Court held as:

- Once a reference was made to the Valuation Officer u/s. 50C of the Act for valuation of the capital asset, the Assessing Officer was obliged to complete the assessment in conformity with the valuation arrived at by the Valuation Officer.

- Under Section 50C(2), it was such lower valuation which was required to be taken into consideration for the purpose of the assessment.

Re: ABB FZ-LLC, UAE

Sub: Where there is no article on Fees for Technical Services (FTS) in the Treaty

The Company was incorporated in and resident of UAE. The Company provided certain services and received fee for the same. Though the receipt was accepted to be of the nature of FTS, the tax Payer contented that since there is no article on FTS in the India-UAE treaty the income should be classified as "Business Income" and in absence of any PE in India, the income will not be chargeable to tax in India. The AO however was of the view that if a Treaty does not have any clause for taxation of any item of income, such income should be taxed in accordance with the Income Tax Act.

The Banglore Tribunal held that:

- Absence of any provision in the Treaty is not an omission but an agreement between the two contracting States not to seperately classify such income as FTS.
- If royalty or FTS is derived from regular business activities of the taxpayer, it is to be regarded as business income. However, if these items of income are seperately classified, the taxation would apply according to that classification.
- Income in this case is derived by the taxpayer from providing services, which is a regular business activity and therefore such income from such services is to be classified as business income under the Treaty.
- In absence of any specific article on FTS in the India-UAE Treaty, the fee received by the taxpayer would be taxable as business income. Since the Taxpayer does not have a PE in India, the business income is not chargeable to tax in India.

Compiled by: Malay Damania, Partner

CORPORATE LAW, ACCOUNTING STANDARD & Ind AS

Impairment of Financial Assets – IND AS 109 – [Expected Credit Loss Model- ECL]

During the financial crisis, it was observed that there was a weakness in the existing accounting standards on recognition of credit losses on loans (and other financial instruments) as the existing incurred loss model delayed the recognition of credit losses till the occurrence of a trigger event. Accordingly the International Accounting Standards board introduced the expected credit loss model which forms a critical part of IND-AS 109 on financial instruments and is expected to have a significant impact on the financial results of reporting entities.

IND-AS 109 requires entities to recognise loss allowances on loans (and other financial assets) at an amount equal to **the lifetime expected credit loss** or **the 12 month expected credit loss** based on the increase in the credit risk of the borrower. The standard prescribes a dual measurement approach that reflects the general pattern of deterioration or improvement in the credit quality of financial instruments.

An entity is required to recognise a credit loss allowance of 12-month expected losses on the initial recognition of a financial asset, except when the simplified approach is applied. Subsequently, 12-month expected losses are replaced by lifetime expected losses if the credit risk increases significantly since initial recognition (the lifetime expected credit losses criterion). The credit losses allowance or provision will revert to 12-month expected losses if the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met.

Lifetime expected credit losses are required to be estimated based on the present value of all expected cash shortfalls over the remaining life of the financial instrument. Lifetime expected credit losses are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight.

12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. It is not the expected cash shortfalls over the next twelve months as it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months. Also it is also not the credit losses on assets estimated to actually default in the next 12 months.

Credit loss (ie cash shortfall) arises even if the entity expects to be paid in full but later than when contractually due because expected credit losses consider the amount and timing of payments. Credit losses are required to be computed based on the present value of all cash shortfalls. Expected credit losses are an estimate of credit losses over the life of the financial instrument. Accordingly, an entity should consider the following for measuring expected credit losses;

a) the probability-weighted outcome: expected credit losses should represent neither a best or worst-case scenario. Rather, the estimate should reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs;

b) the time value of money: expected credit losses should be discounted to the reporting date; and

c) reasonable and supportable information that is available without undue cost or effort.

An entity is required to use reasonable and supportable information that is available at the reporting date without undue cost or effort, and that includes information about past events, current conditions and forecasts of future conditions.

IND-AS 109 requires lifetime expected credit losses to be recognised when there are significant increases in credit risk since initial recognition. Expected credit losses are updated at each reporting date for new information and changes in expectations even if there has not been a significant increase in credit risk.

IND-AS 109 does not mandate the use of an explicit probability of default to make this assessment. An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly. An entity should consider reasonable and supportable information that is available without undue cost or effort when determining whether the recognition of lifetime expected credit losses is required.

Assessment of significant increases in credit risk may be done on a collective basis, for example on a group or sub-group of financial instruments. This is to ensure that lifetime expected credit losses are recognised when there is a significant increase in credit risk even if evidence of that increase is not yet available on an individual level.

In addition, under IND-AS 109 the same impairment model is applied to all financial instruments that are subject to impairment accounting. This includes financial assets classified as amortised cost and fair value through other comprehensive income, lease receivables, trade receivables, and commitments to lend money and financial guarantee contracts.

The impairment has to be computed in the following three stages;

Stage 1

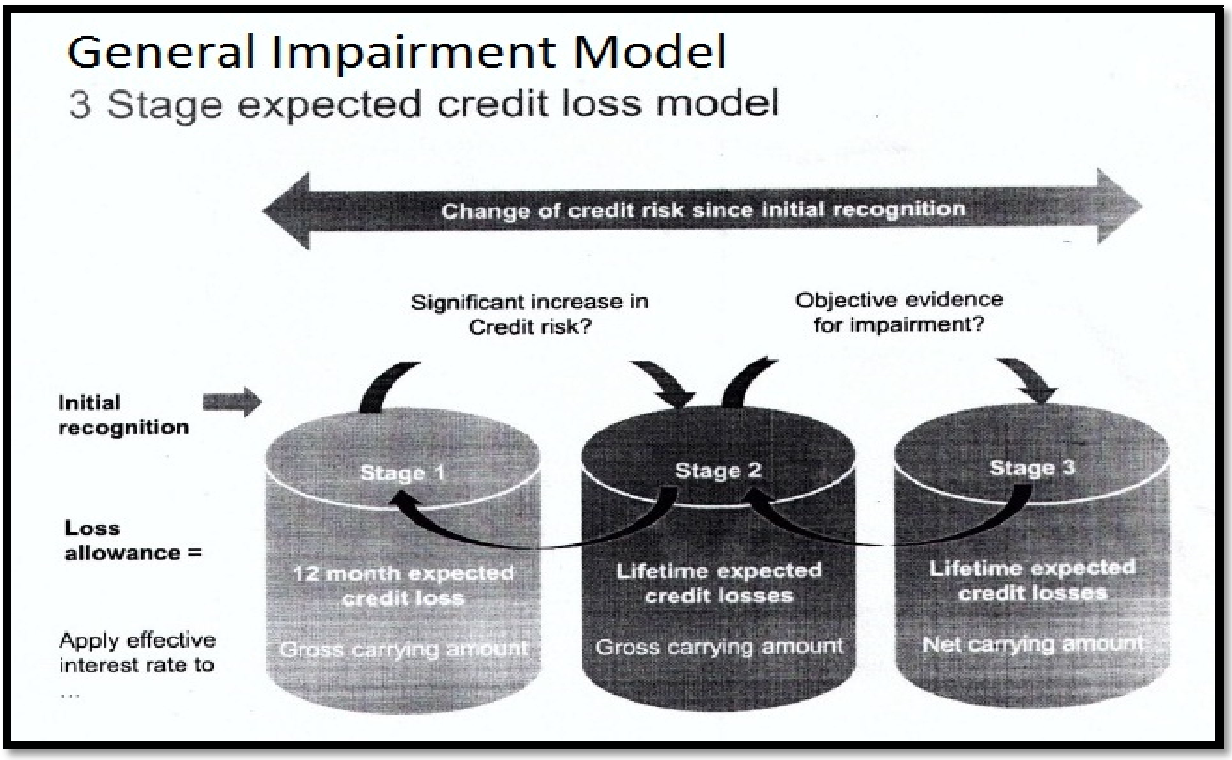
As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (ie without adjustment for expected credit losses).

Stage 2

If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised. Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instrument. The calculation of interest revenue on financial assets remains the same as for Stage 1.

Stage 3

If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount adjusted for the loss allowance). Financial assets in this stage will generally be individually assessed. Lifetime expected credit losses are still recognised on these financial assets



Expected loss allowance
12- month vs. lifetime

12-month expected losses

- All assets begin in this bucket, unless credit impaired on initial recognition or accounting policy (trade and lease receivables)
- Effect of the entire credit loss on a financial instrument weighted by the probability that this loss will occur in next 12 months.

Lifetime expected losses

- Assets migrate to this bucket if the credit risk has increased significantly since initial recognition (unless 'low credit risk')

Examples

- Portfolio of Rs.10 crores in loans
- Expected 2% probability to default in next 12 months
- Entire loss that would arise on default is 10%

12 month expected credit loss = Rs.200,000 (2% x 10% x 10 crores)

- Portfolio of Rs.10 crores in loans
- Expected 12% probability to default over lifetime
- Entire loss that would arise on default is 10%

Lifetime expected credit loss = Rs.1,200,000 (12% x 10% x 10 crores)

CORPORATE LAW, ACCOUNTING STANDARD & Ind AS*(cont.)*

The main objective of the new impairment requirements is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments. The model requires an entity to recognise expected credit losses at all times and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

This model is forward-looking and it eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger event to have occurred before credit losses are recognised. Consequently, more timely information is required to be provided about expected credit losses. The requirements in IND AS 109 broaden the information that an entity is required to consider when determining its expectations of credit losses.

Specifically, IND-AS 109 requires an entity to base its measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information.

Compiled by: Bharat Jain, Partner