
Northern India Regional Council

HAM: Implications under Income Tax Act

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ALA LEGAL

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COVERAGE

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Section 43CB

43CB. (1) The profits and gains arising from a **construction contract** or a contract for providing services shall be **determined** on the basis of **percentage of completion method** in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145...

ALA Comments

- Section 43CB provides for computing profits and gains arising from **construction contracts**.
- Construction contract not defined in the Income Tax Act; but defined in ICDS
- Profits and gains to be determined on the basis of percentage of completion method (“**POCM**”).
- **POCM** shall be applied in accordance with **Income computation and disclosure standards** (“**ICDS**”) notified under Section 145(2) of the Income Tax Act.
- Section 43CB(2) provides that Contract revenue shall include **retention money**.
- Further, contract cost shall not be reduced by any incidental income in the nature of interest, dividend or capital gain.

Section 145

145. Method of accounting

- (1) *Income chargeable under the head "Profits and gains of business or profession" or "Income from other sources" shall, subject to the provisions of sub-section (2), be computed in accordance with either cash or mercantile system of accounting regularly employed by the assessee.*
- (2) *The Central Government may notify in the Official Gazette from time to time income computation and disclosure standards to be followed by any class of assesseees or in respect of any class of income.....*

ALA Comments

- As per Section 145(2), Central Government may notify income computation and disclosure standards (“**ICDS**”) to be followed by any class of assessee or in respect of any class of income.
- CG has vide Notification No. 87/2016 dated 29.09.2016 has issued 10 ICDS to be applied for the purposes of computation of income chargeable to income-tax under the head **PGBP** or **income from other sources**.
- CBDT has issued Circular No. 10 of 2017 which contains FAQs with respect to application of ICDS

Section 145

ALA Comments

- The Delhi High Court in the case of the Chamber of Tax Consultants & Anr. V. UOI W.P. (C) 5595/2017 had the occasion to decide the constitutional validity of Section 145
- In the said matter the Hon'ble High Court held that:
 - Section 145(2) has to be read to restrict power of CG to notify ICDS that do not seek to override binding judicial precedents or provisions of Act.
 - If Section 145(2) of the Act is not so read down it would be ultra vires the Act and Article 141 read with Article 144 and 265 of the Constitution.

ICDS III: Construction Contracts

Scope

- This ICDS should be applied in *determination of income* for a *construction contract* of a contractor.

Construction contracts

- (a) “Construction contract” is a contract specifically negotiated for the construction of an asset or a combination of assets and includes :
- (ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

ALA Comments

- Construction contract has been defined to mean the contract specifically negotiated for the construction of an asset. Construction contract also includes the contract for *restoration of Asset*.

ICDS III: Construction Contracts

ALA Comments

- HAM projects generally includes following scope:
 - Construction of roads;
 - Operation and maintenance of project: including major maintenance
- Activity of construction of road is clearly covered within the ambit of construction contract.
- Further, O&M also would be covered within the ambit of construction contract as within O&M, Concessionaire is also required to undertake major maintenance of the Road. In terms of *Clause 17.11* of the MCA the Concessionaire is also required to restore the asset.

Combining and segmenting construction contract

Combining and Segmenting Construction Contracts

5. *The requirements of this Income Computation and Disclosure Standard shall be applied separately to each construction contract except as provided for in paragraphs 6, 7 and 8 herein. For reflecting the **substance** of a contract or a group of contracts, where it is necessary, the Income Computation and Disclosure Standard should be applied to the **separately identifiable components** of a single contract or to a group of contracts together.*

ALA Comments

- Subject to para 6, 7 and 8, ICDS III shall be applied separately in respect of each construction contract.
- However, for reflecting substance of contract, ICDS should be applied to the separately identifiable components of a single contract.
- Since, in case of HAM contract, there is one single contract for both construction and O&M and the prices are quoted separately only for the purposes of determining the timing of cash flows. Thus, in our view ICDS III should be applied on whole of the contract considering it as one.

Combining and segmenting construction contract

ALA Comments

- Also, the contract is awarded on the basis of the NPV of the total price quoted. Thus, based on all these reasons, in case of HAM, ICDS-III is to be applied to the whole contract *treating it as a single construction contract.*

Alternative view

- However, alternatively for reflecting the substance of contract, where the facts of any particular case requires, then ICDS III be applied on the *separately identifiable components* of HAM Contract, being construction and O&M.

Contract Cost

Definition

12. Contract costs shall comprise of :

- (a) costs that relate **directly** to the specific contract;
- (b) costs that are **attributable** to contract activity in general and can be **allocated** to the contract;
- (c) such other costs as are **specifically chargeable** to the customer under the terms of the contract; and
- (d) **allocated borrowing costs** in accordance with the Income Computation and Disclosure Standard on Borrowing Costs.

These costs shall be reduced by any incidental income, not being in the nature of interest, dividends or capital gains, that is not included in contract revenue.

Contract cost

ALA Comments

- For the purpose of HAM contract, the contract cost includes:

Material Cost

Labour Cost

Architect cost

Sub-contractor charges

Hire charges for plant and machinery

Technical Engineer and design fee

Soil investigation fee

Environment study and impact assessment fee

GST on inputs/ input services that is becoming cost to concessionaire

O&M cost

General insurance charges

Company overhead

Cost of shifting utilities (now these are not refundable)

Allocated Borrowing cost computed in terms of ICDS IX

Contract cost

ALA Comments

- **Treatment of inflation**: all the costs should be accounted for the factor of inflation for computing the total contract cost.

Example

- If on the bid date it is estimated that the cost for annual O&M would be Rs. 25 Cr. ,but, since, the O&M is to be incurred after completion of construction and it is to be incurred over a period of 15 years. Thus, for computing the total contract cost the O&M cost would be computed after factoring into the effect of inflation.

Contract Revenue

Definition

10 Contract revenue shall comprise of:

- (a) the initial amount of revenue agreed in the contract, including retentions; and*
- (b) variations in contract work, claims and incentive payments:*
 - (i) to the extent that it is probable that they will result in revenue; and*
 - (ii) they are capable of being reliably measured.*

ALA comments

- For the purpose of HAM projects, contract revenue would include the **Bid project Cost** i.e the amount that the Concessionaire has bid for construction work (**Rs. 800 Cr.**) and the **O&M payments** i.e. the amount that the concessionaire has bid for O&M (**Rs. 300 Cr.**)
- In HAM projects both the above components are subject to inflation. Thus, both these components would be adjusted to the factor of inflation.

Recognition of Contract Revenue

Para 9

9 Contract revenue shall be recognised when there is reasonable certainty of its ultimate collection.

ALA comments

- Contract revenue shall be recognised when there is reasonable certainty. Reasonable certainty means that there is no doubt regarding collection of contract revenue.
- HAM projects entered into with NHAI – **reasonable certainty?**

Recognizing contract revenue and contract cost

Recognition of contract revenue and expense

16. *Contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the **stage of completion** of the contract activity at the reporting date.*

17....

18. *The stage of completion of a contract shall be determined with reference to:*

(a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers are not determinative of the stage of completion of a contract.

ALA Comments

- Contract revenue and contract cost should be recognised to the extent of stage of completion achieved at the reporting date.

Recognizing contract revenue and contract cost

ALA Comments

- For computing stage of completion any of the following method can be used:
 - surveys of work performed (*on the basis of report of independent engineer*), or
 - On the basis of percentage of cost incurred.
 - completion of a physical proportion of the contract work.
- Recognition of the Contract Cost and Contract revenue is explained with the help of an example.

Example

- The total contract cost is 200 Cr. And the revenue is 300 Cr.; and in the year 2018-19 50 Cr. Cost is incurred. Further, as per survey of the independent engineer in 2018-19, 23% of work is completed

Recognition as per proportionate cost method

- Contract cost to be recognised is 50 Cr.
- Percentage completion is $50/200 * 100 = 25\%$
- Revenue to be recognised for the year 2018-19 is $25% * 300 = 75\text{Cr.}$

Recognizing contract revenue and contract cost

Recognition as per survey method

- As per independent engineer 23% of construction contract is complete. Thus, 23% of cost (Rs 46 Cr.) and revenue (Rs. 69 Cr.), will be recognised and profit would be computation accordingly.
- While applying % cost method future cost will not be included for computing the stage of completion based.

Example:

- In the year 2019-20 the contractor has made advance payment of Rs. 2 Cr. to sub-contractor. In such a case for computing the stage of completion the said advance payment of Rs. 2 Cr. would not be included in the contract cost incurred during the year 2019-20 and same would be included in the contract cost only in the year 2020-21 when the said advance is adjusted towards the work done by the sub-contractor.

Borrowing Cost treatment

Contract cost (ICDS III)

Contract costs shall comprise of :

(a) costs that relate directly to the specific contract;

.....

(d) allocated borrowing costs in accordance with the Income Computation and Disclosure Standard on Borrowing Costs.

ALA comments

- Borrowing cost allocated to contract is required to be included in contract cost. Borrowing cost that needs to be included would be computed in terms of ICDS IX.
- As per ICDS IX the borrowing cost incurred till the date of completion of construction would become the part of contract cost.
- Thus, the interest and other borrowing cost incurred till the construction of road is complete shall become part of the contract cost

Change in estimates

Para 21 of ICDS III

21 The percentage of completion method is applied on a cumulative basis in each previous year to the current estimates of contract revenue and contract costs. Where there is change in estimates, the changed estimates shall be used in determination of the amount of revenue and expenses in the period in which the change is made and in subsequent periods.

ALA Comments

- Where there is change in estimates, such change would be recognised in the year when such change is made or in subsequent year.
- The Technical Guide on ICDS issued by ICAI also supports this view. It provides that escalation in cost or revenue should be reported in the year of escalation and in the subsequent year [refer para 9.1 of Technical Guide].

Change in estimates - example

Example

- In the year 2018-19 the total cost was Rs. 1000 and the total revenue Rs. 1200 and the total cost incurred in the said year was Rs. 200. Further in year 2019-20 the cost inflated to Rs. 1100 and the revenue was also inflated to Rs. 1400. Also, the cost incurred in the year 2019-20 was Rs. 500

In year 2018-19

- a. Percentage completion = $200 / 1000 = 20\%$
- b. Contract Cost recognized = Rs. 200
- c. Contract revenue recognized = $20\% * 1200 = \text{Rs. } 240$

In year 2019-20

- a. Percentage completion = $(500+200) / 1100 = 63.63\%$
- b. Contract Cost recognized = Rs. 500 (actual expense incurred)
- c. Contract revenue recognized = $(63.63\% * 1400) - \text{revenue already recognized} = \text{Rs. } 890 - 240 = \text{Rs. } 650$

Disclosures: ICDS III

23. *A person shall disclose:*

- (a) the amount of contract revenue recognised as revenue in the period; and*
- (b) the methods used to determine the stage of completion of contracts in progress.*

24. *A person shall disclose the following for contracts in progress at the reporting date, namely:—*

- (a) amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;*
- (b) the amount of advances received; and*
- (c) the amount of retentions.*

ALA comments

- Thus, based on above, Concessionaire needs to report following on the reporting date:
 - Amount of contract revenue recognized as revenue.
 - Concessionaire should report the method that they are using to determine the stage of completion

Disclosures: ICDS III

ALA comments

- Amount of cost incurred;
- Amount of advances received; and
- Amount of retention

ICDS IV: Revenue recognition for interest income

Scope

- *Provides for the bases for recognition of revenue arising in the course of the ordinary activities of a person inter alia from the use by others of the person's resources yielding interest, royalty and dividends.*

Recognition of revenue

8. *(1) Subject to sub paragraph (2), interest shall accrue on the time basis determined by the amount outstanding and the rate applicable.*

ALA Comment

- Concessionaire shall recognize the interest received from NHAI in terms of ICDS IV.
- Such interest shall be recognized on accrual basis determined by the amount outstanding and the rate applicable.

Borrowing cost: post construction

- Treatment of interest payable by Concessionaire on the loan taken by them (accrued after construction of road is complete) is not provided in ICDS IV
- The same shall be treated in accordance with the Income tax Act – Section 36(1)(iii)
- ICDS IX – related to borrowing cost also clarifies that borrowing cost, other than that needs to be capitalized, shall be recognized in accordance with the provision of the Act [refer para 3].

Rate of tax

Normal rates with deduction

- As per the Finance Act 2020 the rate of tax applicable for the assessment year 2020-21 on domestic company is :

S. No.	Type of Company	Rate of income tax
(i)	Where the total turnover or the gross receipt in the previous year 2017-2018 does not exceed Rs. 400 crore rupees;	25% of the total income
(ii)	other than that referred to in item (i)	30% of the total income

Rate of tax

Normal rates with deduction

- In addition to the rate of tax as mentioned above, a surcharge is also paid which is calculated at the rate and manner as mentioned below:
 - i. in the case of every domestic company,—
 - a) having a total income exceeding Rs. 1 crore rupees but not exceeding Rs. 10 crore rupees, at the rate of 7% of such income-tax; and
 - b) having a total income exceeding Rs. 10 crore rupees, at the rate of 12% per cent. of such income-tax;
- Health and Education Cess: The amount of income-tax and the applicable surcharge, shall be further increased by health and education cess calculated at the rate of four percent of such income-tax and surcharge.

Optional rate of tax

Optional reduced rate of tax: section 115BAA

- An option to a domestic company to pay income tax on its total income at the rate of 22%.
- This is subject to conditions provided in the said section.
- Such rate of tax is applicable in respect of total income of domestic person for any previous year relevant to the Assessment year beginning on or after the **1st day of April 2020**.
- Rate of tax under Section 115BAA
 - a. **Income tax @ 22%**
 - b. **Surcharge @ 10%** of the said income tax
 - c. **Health and Education Cess @ 4%** of such income-tax and surcharge.

THANK YOU

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