IFRS Notes

Framework proposed by the MAT-Ind AS Committee

10 May 2016

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Introduction

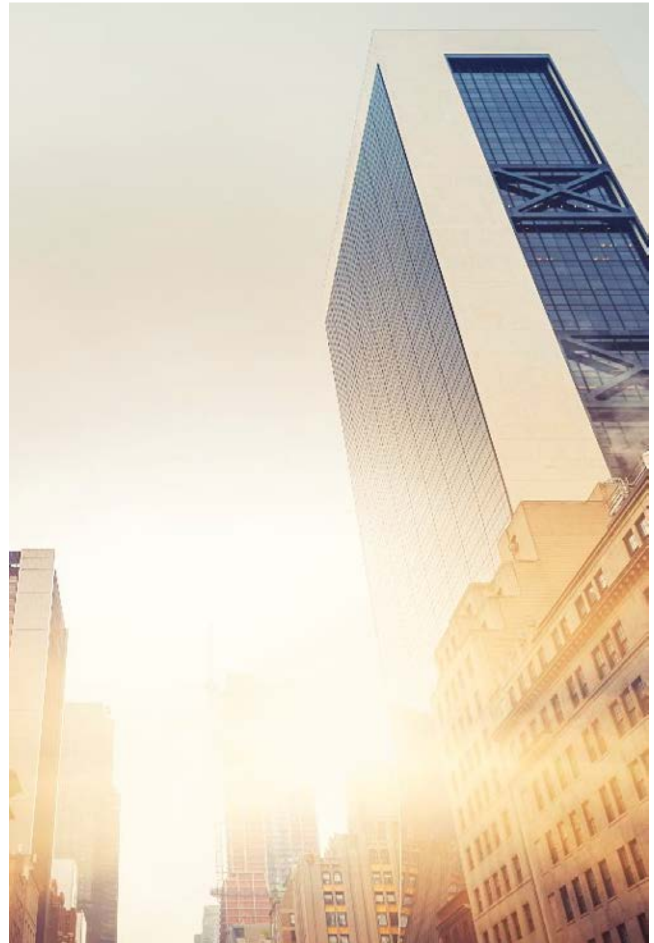
On 18 March 2016, the Minimum Alternate Tax (MAT)-Indian Accounting Standards (Ind AS) Committee (the Committee) formed by the Central Board of Direct Taxes (CBDT) issued a report (the report) proposing a framework for computation of book profit for the purposes of levy of MAT under Section 115JB of the Income-tax Act, 1961 (the IT Act) for Ind AS compliant companies in the year of adoption and thereafter.

Background

The MCA, through its notification dated 16 February 2015, issued a road map for implementation of Ind AS by companies other than banking companies, insurance companies and Non-Banking Financial Companies (NBFCs) in two phases i.e. for accounting periods commencing on 1 April 2016 and 1 April 2017 based on certain prescribed thresholds. Subsequently, on 18 January 2016 and 30 March 2016, the MCA notified Ind AS road map for banks, insurers and NBFCs.

While adopting the Ind AS, one of the biggest challenges faced by the corporate sector is how this change in financial reporting would impact taxable income. In response, on 31 March 2015, the Ministry of Finance (MOF) issued 10 Income Computation and Disclosure Standards (ICDS), operationalising a new framework for computation of taxable income by all assessees (in relation to their income under the heads 'Profits and Gains of Business or Profession' and 'Income from Other Sources'). While the ICDS are expected to fill some gaps that exist in the current taxation set up by bringing in consistency and clarity in computation of taxable income and providing stability in tax treatments of various items, there is still some uncertainty on the levy of MAT for companies that would compute their book profits under Ind AS.

Therefore, on 8 June 2015, the CBDT formed the MAT-Ind AS Committee to suggest a framework for computation of book profit for the purpose of levy of MAT under Section 115JB of the IT Act for Ind AS compliant companies in the year of adoption and thereafter.



"The recommendations of the MAT-Ind AS Committee give the corporate sector much needed visibility on the CBDT's current thinking on the approach for computing MAT for companies reporting under Ind AS, and the resultant implications. While Indian companies are moving to the Ind AS framework with a view to improve the transparency and quality of financial reporting, they are likely to incur additional tax outflows on account of MAT on several items of unrealised fair value changes routed through the statement of profit and loss and also on adjustments made to reserves on the transition date. These tax outflows could be quite significant in some situations such as demerger, etc. Considering the significance of the issues involved, the industry should actively work with CBDT and MCA to arrive at an equitable approach ''

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Overview of the Committee's Report

Clarifications sought by the Committee from the Ministry of Corporate Affairs (MCA)

The Committee observed that the adjustments currently provided under section 115JB of the IT Act are of a nature that seek to compute the realised profit before tax that would be available for appropriation/distribution, based on the provisions of the companies law. This indicates that there is an implicit relation between the distributable profits available for payment of dividend and the tax base for levying MAT.

The Companies Act, 2013 permits the declaration of dividend out of the profits of the current year or the earlier year. In addition, if these profits are inadequate, dividend can also be declared out of free reserves. While free reserves are accumulated profits of the earlier years transferred to reserves, and exclude unrealised gains, notional gains or revaluation of assets, or any change in the carrying amount of an asset or liability recognised in equity, (including surplus in the statement of profit and loss on measurement of the asset or liability at fair value), the net profit and net Other Comprehensive Income (OCI) under Ind AS may include significant notional/unrealised gains or losses. This indicates that there is no restriction on distribution of profit from notional/unrealised gains included in the net profit or net OCI of the current or earlier year, resulting in a differential treatment of such unrealised gains or losses as compared to those in accumulated reserves.

The computation of distributable profit under the Companies Act, 2013 is also different to the computation of profit for determining managerial remuneration (which excludes changes in the carrying amount of an asset or a liability in equity, including surplus in the statement of profit and loss on its measurement at fair value).

In view of these differing requirements, the Committee, on 27 July 2015, sought clarity/guidance from the MCA on the following issues, before it could recommend a framework for computation of book profits for the purpose of levy of MAT:

- The underlying principles for the differential treatment for unrealised gains and losses included in the net profit and net OCI for the current and earlier year, and those included in accumulated reserves.
- Proposed guidance for calculating distributable surplus or computing the profit base for managerial remuneration under the Companies Act, 2013 (by excluding the notional/unrealised gains) to ensure uniformity in application by Ind AS compliant companies.
- The treatment of notional/unrealised losses for the computation of free reserves, as the current definition provides for exclusion of notional/unrealised gains but is silent on the treatment of such notional/unrealised losses.
- Any change in law being considered by MCA for avoiding the complex computations involved in determining profits (for distribution or managerial remuneration) after excluding unrealised/notional gains or losses.

Clarifications issued by the MCA

The MCA through an office memorandum dated 11 January 2016 provided clarity on the above issues after consultation with the Institute of Chartered Accountants of India (ICAI). This memorandum listed certain items (components of OCI as per Schedule III of the Companies Act, 2013), which are notional/unrealised gains and are to be excluded for the purpose of arriving at distributable profits for payment of dividend as well as for calculation of profit for managerial remuneration. It further suggested that the Committee may consider extending this principle for determining book profits for levy of MAT. The components of OCI listed by the MCA are as per Table 1 below.

Table 1: Notional/unrealised gains to be excluded from computation of book profits

Sr. No	Name of component	Ind AS
1.	Changes in revaluation surplus.	Ind AS 16, Ind AS 38
2.	Remeasurements of defined benefit plans.	Ind AS 19
3.	Gains and losses arising from translating the financial statements of a foreign operation.	Ind AS 21

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Table 1: Notional/unrealised gains to be excluded from computation of book profits (cont.)

Sr. No	Name of component	Ind AS
4.	Gains and losses from investments in equity instruments designated at fair value.	Ind AS 109
5.	Gains and losses on financial assets measured at fair value.	Ind AS 109
6.	The effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income.	Paragraph 5.7.5 of Ind AS 109
7.	For particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk.	Ind AS 109
8.	Changes in the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value.	Chapter 6 of Ind AS 109
9.	Changes in the value of the forward elements of forward contracts when separating the forward element and spot element of a forward contract and designating as the hedging instrument only the changes in the spot element, and changes in the value of the foreign currency basis spread of a financial instrument when excluding it from the designation of that financial instrument when excluding it from the designation of that financial instrument as the hedging instrument.	Chapter 6 of Ind AS 109

Recommendations of the Committee

The Committee has made the following recommendations:

- Since current year profits are available for distribution as dividends and considering the implicit relation between distributable profits under the Companies Act, 2013 and the tax base for levy of MAT, ***no further adjustments*** should be made to the net profits (excluding net OCI) of Ind AS compliant companies, other than those already specified in Section 115JB of the IT Act.
- The current year's net profits (excluding net OCI) under Ind AS may include a significant amount of notional/unrealised gains or losses, for example, gains or losses on fair valuation of derivative instruments or those on fair valuation of investments that are classified and measured at 'fair value through profit or loss'. The Committee stated that the requirements for additional adjustments under Section 115JB may be considered at a later stage if the MCA prescribes any further adjustments to current year's profits for computing distributable profits.
- Under Ind AS, the net OCI includes certain items that will permanently be recorded in reserves and hence, never reclassified to the statement of profit and loss account/included in the computation of book profits. These items should be included in book profits for MAT purposes at an appropriate point of time. The Committee provided an illustrative list of such items along with the recommended treatment for MAT (see Table 2 below):

Table 2: Illustrative list of items included in OCI and recommended MAT treatment

Sr. No	Items	Recommended treatment
1.	Changes in revaluation surplus (Ind AS 16 and 38).	To be included in book profits at the time of realisation/disposal/retirement.
2.	Remeasurements of defined benefit plans (Ind AS 19).	To be included in book profits every year as the remeasurements gains and losses arise.
3.	Gains and losses from investments in equity instruments designated at fair value through OCI (Ind AS 109).	To be included in book profits at the time of realisation.

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Adjustments on first-time adoption of Ind AS

Ind AS compliant companies are required to record adjustments relating to first-time adoption of Ind AS directly in retained earnings/reserves at the date of transition to Ind AS. Several of these adjustments may subsequently never be reclassified to the statement of profit and loss/included in the computation of book profits. In this regard, the Committee has recommended that the adjustments are categorised as follows:

- Category I: Those adjustments recorded in reserves and which would subsequently be reclassified to the statement of profit and loss, should be included in book profits in the year in which these are reclassified to the statement of profit and loss. These include, for example, adjustments relating to recognition of a cash flow hedging reserve based on the fair value changes in derivatives that are designated as hedging instruments in a cash flow hedge relationship. This amount would subsequently be reclassified to the statement of profit and loss when the hedged item affects profit and loss.
- Category II: Those adjustments recorded in net OCI and which would never be subsequently reclassified to the statement of profit and loss should be included in book profits as per Table 2 above. These include changes in revaluation surplus, remeasurements of defined benefit plans, and gains and losses from investments in equity instruments at fair value through OCI.
- Category III: All other adjustments recorded in retained earnings and which would otherwise never subsequently be reclassified to the statement of profit and loss, should be included in book profits in the year of first time adoption of Ind AS. These could include adjustments relating to availing the deemed cost exemption or revaluation of property, plant and equipment and fair value adjustments relating to transition date measurement of investments in equity instruments that are classified as 'fair value through profit or loss', straight-lining adjustment of operating lease rentals, share-based payment expense, etc.

Section 115JB already provides for certain adjustments for computation of book profit. The above adjustments would therefore be subject to the existing provisions of Section 115JB (e.g. the amount set aside as provision for diminution in the value of any asset is required to be added to book profits and accordingly would not be included in any of the adjustments mentioned above).

Our comments

Unrealised gains and losses in current year profits

The CBDT and MCA seem to be of the view that computation of MAT should be linked to distributable profits. However, similar to the approach adopted for determination of free reserves, it may be appropriate to adjust for unrealised gains, notional gains or revaluation of assets for both distribution of profits and consequently, computation of MAT. The MAT recommendations seem to indicate that MCA and the CBDT hold a view that unrealised gains and losses under Ind AS are primarily accounted in OCI. However, several unrealised gains and losses are charged to the statement of profit and loss including fair value adjustments. In case such an approach is adopted the Committee may consider a similar adjustment for unrealised losses, notional losses, etc. in the statement of profit and loss as well.

While the extensive use of fair values under Ind AS is from a perspective of improving quality and transparency in financial reporting, a number of these non-cash items may now be included in book profits for levy of MAT. Therefore, companies may be required to evaluate the differences identified between Indian GAAP and Ind AS and consider potential outflows from a perspective of MAT.

Impact on application of Ind AS 101, First-time Adoption of Indian Accounting Standards while selecting accounting policies and first-time adoption exemptions

The Ind AS 101 adjustments are envisaged to provide companies with ease in transition to Ind AS, especially when restating information relating to historical periods. In view of this report, companies would have to consider MAT implication while selecting accounting policies and first-time adoption exemptions. To tax companies on these notional gains in the year of transition may not be reasonable. An alternate approach could be to negate the impact of the adjustments considered on date of transition on subsequent periods. For example, the fair value gain on an investment in equity share classified as fair value through profit or loss recognised on date of transition is ignored and consequently, on disposal, the profit on sale of investment recognised under Ind AS may be adjusted by the gain recognised on date of transition.

It may be particularly important to provide clarity on the requirements for MAT especially for listed companies whose first Ind AS public reporting deadline is a few days away. Given the

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significance of some of the adjustments on the date of transition, the prospect of paying MAT may result in a lot of companies relooking at their choices on first-time adoption.

Reclassifications vs reversals of adjustments recorded in reserves on first-time adoption of Ind AS

The Committee has recommended that adjustments recorded in reserves upon first-time adoption of Ind AS which would subsequently be reclassified into the statement of profit and loss should be included in the book profits of the year in which these are reclassified to the statement of profit and loss. However, it is unclear whether the term 'reclassified' includes adjustments that may get reversed in subsequent years through the statement of profit and loss. The Committee may consider providing additional clarity on this issue.

If the term 'reclassified' does not cover adjustments which subsequently reverse into the statement of profit and loss, several adjustments on first-time adoption of Ind AS may be subject to MAT in the first year of adoption (i.e. 2016-17 for companies that transition in this year).

For example, if a reporting entity designates an investment in equity shares as fair value through profit or loss and recognises fair value gains on the date of transition, the sum credited to retained earnings may be subject to MAT, since this amount will not be subsequently 'reclassified' into the statement of profit and loss.

This may also raise a question on how the consequential impact arising from first-time adoption adjustments relating to 2015-16 may be treated.

For example, if the investment referred to in the previous example was measured at cost under Indian GAAP and is sold by the reporting entity in the financial year 2015-16 at a profit, MAT would apply to the entire profit in the financial year 2016-17, including to the portion of the fair value adjustment that pertains to the accounting period ending 31 March 2015.

Impact for entities that are not covered by MAT provisions in the year of first-time adoption of Ind AS

If an entity is not eligible for levy of MAT in the first year of adoption of Ind AS, it is unclear whether the adjustments recorded in reserves by such an entity on first-time adoption will be included in book profits in a subsequent year when the entity is eligible for levy of MAT. The Committee may consider clarifying whether adjustments relating to first time adoption of Ind AS are included in book profits for computing MAT only if the entity falls under the MAT provisions in the first year of adoption of Ind AS.

The recommendations by the Committee on the basis for determining book profits by Ind AS compliant companies for levy of MAT is a welcome step as it provides greater clarity to companies that have transitioned to Ind AS. However, it is important that responses to clarifications sought by companies are provided at the earliest in order for them to evaluate or re-evaluate their choices on first-time adoption in view of these implications.

Next steps

Approach towards computation of MAT

While the ICDS issued in context of computation of taxable income by all assessees ensured horizontal equity, the approach for computation of MAT outlined in the Committee Report may not result in either horizontal equity or tax neutrality. Given that a company may not be required to pay MAT in all years, the approach of subjecting transition adjustments on date of transition may result in an outflow (including outflows on account of time value of money) of tax without any subsequent benefit (except for MAT credit set off with tax on 'Profits and gains on business or profession' and 'Income from Other Sources').

The companies should also consider the impact of this report on their expected advance tax payment in the current financial year.

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Voices on Reporting

Framework proposed by the MAT-Ind AS committee – new development

In our call on 6 May 2016, we provided an overview of the report of the MAT-Ind AS Committee proposing a framework for computation of book profit for the purposes of levy of MAT under Section 115JB of the Income-tax Act, 1961 (the IT Act) for Ind AS compliant companies in the year of adoption and thereafter. And also the recommendations suggested by the CBDT.

The CBDT has invited the stakeholders and general public to bring out issues/points which in their opinion would require further clarification/guidance by 10 May 2016.

Our Voices on Reporting conference call took place on Friday, 6 May 2016 between 04:00 – 05:00 PM.

Missed an issue of our Accounting and Auditing Update, First Notes or IFRS Notes

Issue no. 8/2016 – Financial Services

This month the Accounting and Auditing Update focusses on the financial services sector and highlights key matters relating to accounting, financial reporting and regulatory areas relevant to this sector. The Indian financial services sector comprises commercial banks, Non-Banking Finance Companies (NBFCs), insurance companies, mutual fund, Asset Management Companies (AMCs) and broking companies.

The government has put forward the road map for implementation of Ind AS by banks, insurance companies and NBFCs. In this publication, we have summarised the impact of Ind AS on the financial services sector.

This publication also features an interaction with Mr. Keki Mistry, Vice Chairman and CEO of Housing Development Finance Corporation Limited and explores some key accounting, reporting and other topical matters relevant to the industry.

Further, this publication also provides a keen perspective on key regulatory updates issued by the RBI, the impact of the Income Computation and Disclosure Standards (ICDS) and the proposed Goods and Services Tax (GST) on the financial services sector. We also strive to undertake an analysis of the Expert Advisory Opinion on Special Reserves issued by the Institute of Chartered Accountants of India.

The proposed Companies (Amendment) Bill, 2016

31 March 2016

Based on the recommendations of the CLC report, on 16 March 2016, the government proposed the Companies (Amendment) Bill 2016, (the Bill) on issues arising on account of implementation of the Companies Act, 2013 (2013 Act) in the Lok Sabha to amend the 2013 Act. The Bill considered the suggestions made by the CLC as well as the comments received from the stakeholders and ministries/departments.

The recommendations cover significant areas of the 2013 Act, including definitions, raising of capital, accounts and audit, Corporate Social Responsibility (CSR), managerial remuneration, companies incorporated outside India and offences/penalties.

This issue of First Notes summarises key recommendations of the Bill.

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