Tax alert: Deferment of upfront storage fees over the period of contract without deferring the related expenditure violates matching principle

Issued on: 08 July 2019

Summary

The Chennai bench of the Income Tax Appellate Tribunal (ITAT) in a recent decision[1] has held that the apportionment of revenue over the period of the contract while claiming the entire expenditure incurred in earning such revenue in the first year violates the matching principle concept of accounting. The matching principle postulates that the expenditure corresponding to an income recognised should also be accounted for in the same year.

Facts of the case

- The taxpayer is a private limited company engaged in the business of preservation and storage of blood stem cells, viz. cells from the umbilical cord, embryonic stem cells and audit stem cells.
- During the year, the taxpayer received an upfront sum of money for the storage of stem cells (storage fees) for a period of 21 years. It recognised the income relating to the current year only and deferred the remaining amount to the balance period of service.
- The tax officer brought the entire storage fees to tax in the current year.

Revenue's contentions

- The entire expenditure relating to the storage fees has been claimed in the current year, and deferment of income to future years would violate the basic matching principles of accounting.
- The tax officer observed from the terms of the agreement that the entire fees paid is not refundable in any case except in case of termination of the contract by the taxpayer or by operation of law.

Taxpayer's arguments

- The expenditure claimed is only the current year expenditure but income received relates to future years. Further, the taxpayer argued that since the expenditure towards power, personnel

[1] Lifecell International Pvt. Ltd. v ACIT [ITA No. 247 & 248/CHNY/2018]

and consumables, etc., will be incurred in future periods, accordingly the income has been deferred to comply with the matching principle.

- It cannot be said that income has accrued unless the services are rendered and the services are to be rendered over a period of 21 years. The storage fee received is an advance for future years and hence should be apportioned over the entire period of service, ie 21 years.
- The taxpayer referred to an earlier ruling[2] of the Special Bench of Chennai ITAT in respect of time share membership fees, wherein it was held that the entire upfront fee receivable at the time of enrolment of a member cannot be charged to tax in the initial year on account of contractual obligation to provide services in the future, over the term of the contract. It has to be spread over the ensuing years.
- The taxpayer also relied on the decisions of the Chennai Tribunal in its own cases, for earlier years, where this issue was decided in favour of the taxpayer.

ITAT's ruling

- The ITAT observed that whether or not a particular receipt had accrued to the taxpayer is to be decided as per the terms of the agreement the taxpayer has with its clients.
- Relying on an earlier ruling[3] of the Supreme Court, the ITAT explained that the income accrues to a taxpayer only when he/she creates a debt in his/her favour, ie when he/she acquired the right to receive the income.
- The ITAT, on perusal of the terms of agreement, noted that that the agreement is valid for a period of 21 years. Storage fees is payable prior to the birth of the child and is refundable only in case the agreement is terminated prior to collection of the umbilical cord or, at any time prior to retrieval of the specimen, is terminated by the taxpayer or by operation of law. This indicates that there is no uncertainty as regards the right to receive the payment by the taxpayer. It can be safely concluded that debt has been created in favour of the taxpayer.
- The contingencies under which income has to be refunded have not much

[2] ACIT v Mahindra Holidays & Resorts (India) Ltd, (2010) 3 ITR 600

[3] E.D. Sassoon & Company Ltd and Others v CIT, 26 ITR 27

relevance since the refund has to be given in a short span of period after entering into an agreement with the client.

- Undoubtedly, the taxpayer is under an obligation to store the stem cells over a period of 21 years. Therefore, income can be apportioned over 21 years.
- Further, the ITAT analysed the judicial precedents[4] where the courts have explained the accounting principle of matching concept which requires matching of expenditure against corresponding revenue and held as per the facts of the case that the taxpayer has not followed the principle by apportioning only the income over a period of 21 years and not the apportioning expenditure over such period.
- This has resulted in the distortion of profit or loss for the period and thus the accounting policy of recognition of income adopted by the taxpayer does not give a true picture of the profit and loss for the period. Therefore, the claim of the taxpayer that the income can be apportioned over a period of the contract cannot be accepted.
- Therefore, it was concluded that the claim of the taxpayer of apportioning the income over the period of contract without apportionment of expenses violates the principle of matching concept and hence, could not be accepted.
- In respect of the taxpayer's earlier-year rulings, the ITAT commented that in earlier years, neither was the issue of deferment of expenditure discussed nor the profit and loss account analysed. Thus, the decisions of the coordinate benches cannot be binding.

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[4] J.K. Industries Ltd and Another v Union of India and Others, 297 ITR 176; CIT v Taparia Tools Ltd., 327 ITR 605

Our comments

The ITAT has relied on earlier judicial precedence and stated that the accounting policies of a company cannot override the provisions of the Income-tax Act, 1961.

While the taxpayer in the present case has favourable decisions of the Chennai ITAT on the same issue, the issue of deferment of corresponding expenditure was not discussed by the ITAT in those cases.

As per the accounting principles applicable to companies in India, which follow either Accounting Standards (IGAAP) or Indian Accounting Standards (Ind AS), revenue from aforementioned transactions is recognised over time, ie as the services are rendered to the customers by the entity.

In case of Ind AS, it needs to be assessed whether the expenditure incurred by the entity is capable of being deferred as costs to fulfil the contract and where the prescribed criteria for deferral are not met, such expenditure may need to be recognised as expense as and when incurred. Consequently, deferring the corresponding expenditure is not always allowed under the accounting principles, since the accounting principles follow the concept of prudence.

This ruling may need to be considered by businesses which have a similar fact pattern.

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