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Determination of Business Income for Real Estate Developers – CBDT proposes ICDS

Background:

– Accounting Standard, AS-7- 'Construction Contracts' issued by ICAI in December, 1983 and subsequently revised in 2002, w.e.f. 1.4.2003 which is mandatory, provides for accounting treatment of revenues and costs associated with 'construction contracts', with reference to the stage of completion of a contract, i.e., as per Percentage of Completion Method (**'POCM'**).

– In view of definition of 'construction contract' contained in aforesaid AS-7, the said AS does not strictly apply to real estate developers/ builders, who do not act as construction contractors, but develop the projects on their own account for further sale to the customers[1].

– Having regard to the uncertainty relating to accounting of revenues and expenses by the real estate developers, ICAI issued 'Guidance Note on Accounting for Real Estate Transactions' in 2006, which was subsequently revised in the year 2012.

– The Guidance Note primarily provides that where economic substance/ features of project are similar to that of construction contract, the real estate developer ought to recognize income and expenses as per POCM provided in AS-7. It further provides that for other projects, revenue must be recognized as per principles laid down in AS-9 relating to 'Revenue Recognition'.

– However, considering that the Guidance Note is not binding in nature, it is not mandatory for a real estate developer to follow POCM and may accordingly follow project completion method.

– For the purposes of computation of business income under the provision of Income tax Act, 1961, the real estate developer had the option to follow POCM or any other reasonable method like project completion/ completed contract method, if followed consistently[2].

– It is in the aforesaid background and to provide certainty for tax purposes, the CBDT had, in terms of section 145(2) of the Act, *inter-alia,* notified (on 29.09.2016) ICDS-III relating to construction contracts, which was broadly in line with AS-7.

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1 Awadhesh Builders v. ITO: 37 SOT 122 (Mum), ITO v. Bhadrasen Construction (P) Ltd: 2010-TIOL-421-ITAT (Mum.)

2 CIT vs. Bilahari Investments (Supreme Court):299 ITR 1(SC), Manish Buildwell Ltd.: 245 CTR 397 (Del), Prestige Estate Projects (P) Ltd. vs. Dy. CIT: 129 TTJ 680 (Bang.)

- Vide Circular No.10/2017, the CBDT clarified that no specific ICDS was notified for, inter-alia, recognition of income/ expense by real estate developers (refer Question 12 of the Circular).CBDT has now come out with a draft ICDS for detemination of income from various real estate transactions.

Analysis:

- The draft ICDS adopts principles for recognition of income and expenses in case of real estate developers prescribed in the aforesaid Guidance Note issued by ICAI.
- The draft provides that project (defined), whose economic substance is similar to a construction contract, revenue and cost relatable thereto must be recognized by way of POCM. Following indicators have been prescribed to determine if economic substance of the project is similar to a construction contract:
  - project duration of more than 12 months, commencement & completion lie in different years;
  - involves activities similar to construction contracts- development, engineering, design etc.;
  - individual units to be delivered to different buyers are interdependent upon completion of number of common activities;
  - construction and development activity form a significant proportion of the project activity.
- For revenue recognition as per POCM, following conditions must be cumulatively satisfied:
  - expenditure incurred on construction & development cost is 25% or more of construction & development costs;
  - 25% or more of saleable are or is secured by contracts or agreements with buyers; and
  - 10% or more of the total revenue as per agreements with buyers are realized and reasonable certainty as to receipt of balance payment as per payment terms exists.
- For applying POCM, provisions of ICDS-III on construction contract shall apply.
- For other projects, i.e., projects not meeting indicators prescribed for construction contracts, revenue should be recognized in accordance with ICDS IV relating to Revenue Recognition in case of sale of goods. In such cases, revenue must be recognized only if, (a) significant risk and reward is transferred to buyer, and seller retain no effective control; (b) amount of consideration is reasonably certain, and (c) certainty to realize consideration from buyer exits.
- **<u>Other Highlights:</u>**
  - **Transferable Development Rights (TDRs):** The cost of development rights acquired by (I) direct purchase or (ii) by development and construction of built-up area, shall be equal to the actual cost incurred by the

assessee. Cost for development right acquired by way of giving up rights over existing structures or open land shall be deemed to be the fair value of development right so acquired.

- **Indirect Costs:** The draft provides that any cost, including the borrowing cost, which would not be directly attributable to a project shall be excluded while computing the project cost.

- **Transactions with multiple elements:** In case of transaction with multiple elements such as delivery of goods or services along-with construction/development, consideration shall be split into separate identifiable components on the basis of the fair value of each component, to be recognized as per relevant ICDS-IV (Revenue Recognition).

VA Comments:

– In view of mandatory applicability of ICDS, option would not be available to real estate developer to follow project completion method for projects which fulfill parameters specified in the above draft ICDS. For such contracts, POCM method prescribed under the draft ICDS read with ICDS-III for construction contract is to be applied for computing business income irrespective accounting policy followed in the books of accounts.

– Judicial precedents, discussed supra, permitting use of any other method cease to be of effect going forward.

– The draft ICDS is applicable for determination of 'business income' and/or 'income from other sources' from, inter-alia, Joint Development Agreements (JDAs). Therefore, income from such agreements also will be computed as per POCM, whereas income taxable under the head 'capital gains' in the hands of land owners (individuals/ HUFs) entering into a specified registered JDA with developer(s) would be governed by newly inserted sub-section (5A) to section 45 of the Act which provides for taxation in the year in which certificate of completion is issued and not in the year of transfer i.e., when JDA is entered.

– The notable variances in draft ICDS vis-a-vis Guidance Note are tabulated hereunder:

S. No.	Particulars	As per Guidance Note	As per draft ICDS
1.	Conditions for application of POCM	Mandatory to obtain all 'critical approvals' as per para 5.3 (a).	No such condition in view of Real Estate (Regulation & Development) Act, 2016
2.	Cap on recognition of Revenue under POCM.	Stage of completion to be determined as per various methods viz. 'project cost' method, survey, technical estimation, etc. Revenue recognized as per any method cannot exceed revenue as per 'project cost' method.	No such cap as regards the revenue to be recognized. Any method may be used to determine the revenue.

3.	Value of TDRs acquired by way of giving up rights	Lower of: (i) fair value of right given up or acquired (whichever is more clearly evident); (ii) net book value of the portion of the asset given up.	Fair market value of development rights acquired
4.	Definition of 'project'	Smallest set of units which are linked with common set of amenities E.g. common set of amenities may include gymnasium, club house, restaurant, etc.	Smallest set of units which are linked with common set of basic facilities. Basis facilities would, in our view, include facilities such as lift, water tanks etc. which are part and parcel of independent dwelling units. This ensures restricting definition to smallest group of units

– Comments in respect of the draft have been invited by the CBDT till 26.5.2017.

For any details and clarifications, please feel free to write to:

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