Central Board of Direct Taxes releases draft Income Computation and Disclosure Standard on Real Estate transactions

Executive summary

This Tax Alert explains draft Income Computation and Disclosure Standard (ICDS) on Real Estate Transactions (draft ICDS) released by Central Board of Direct Taxes (CBDT) [1] for soliciting stakeholders’ comments.

ICDS are applicable from tax year 2016-17 to taxpayers following the mercantile system of accounting and for the computation of income chargeable under the “Business” [2] or “Other Sources” [3] heads. They do not apply to taxpayers who are individuals or Hindu Undivided Families (HUF), who are not liable for tax audit under the provisions of the Indian Tax Laws (ITL).

Currently, CBDT has notified 10 ICDS covering diverse items like Accounting Policies, Inventories, Revenue Recognition, Tangible Fixed Assets etc. [4] The ICDS are formulated by an Expert Committee (Committee) constituted by CBDT on the basis of Accounting Standards (AS) framed by The Institute of Chartered Accountants of India (ICAI) and notified under Companies Act 2013 for compliance by companies. Considering that there is no mandatory accounting standard on real estate revenue recognition, the Committee recommended a separate ICDS for such transactions based on the Guidance Notes (GN) issued by ICAI on the subject.

[1] Apex administrative authority for direct taxes in India
[2] Profits and gains from business and profession
[3] Income from other sources
[4] Refer EY Alert dated 3 October 2016, “Government of India amends Income Computation and Disclosure Standards and also defers them by one year to tax year 2016-17”
This Alert discusses the broad principles of tax treatment provided in draft ICDS for real estate transactions and significant deviations from ICAI GN on the subject. Draft ICDS shall apply to real estate projects “commenced” on or after the effective date of applicability, thus, grandfathers projects which have “commenced” prior to such date – but the term “commenced” is not defined in ICDS.

Stakeholders can provide their comments on draft ICDS by 26 May 2017 to Director TPL-III by e-mail at dirtpl3@nic.in.

**Background**

► Section 145 of the ITL provides that the taxable income of a taxpayer falling under the “Business” or “Other Sources” heads shall be computed in accordance with either cash or mercantile system of accounting, whichever is regularly employed by the taxpayer.

► Based on the recommendations of the Committee and public consultation, the Central Government (CG) had earlier notified the first version of ICDS (old ICDS), effective from tax year 2015-16. However, stakeholders raised several concerns on the implementation of the old ICDS, which resulted in hardships to taxpayers and created uncertainty on the tax treatment of several incomes and expenses, including transitional impact of ICDS.

► Having regard to concerns raised by stakeholders, the CG notified revised ICDS to be effective from tax year 2016-17 onwards and also issued Circular No. 10/2017 dated 23 March 2017 providing clarifications on 25 issues, in the form of FAQs, for the smooth implementation of ICDS. FAQs clarified that since specific ICDS on Real Estate Transactions has not been notified, relevant provisions of the ITL and ICDS shall apply to these transactions as may be applicable.

► The revised ICDS continue to apply to all the taxpayers following the mercantile system of accounting and for computation of income under the head “Business” or “Other Sources”. However, they do not apply to taxpayers who are individuals or HUFs, who are not liable for tax audit under the ITL.

► ICAI has issued two GNs on Accounting for Real Estate Transactions viz. (a) GN issued in 2012 applicable to all enterprises in general (ICAI GN) (b) GN issued in 2016 applicable to companies to whom Ind-AS is applicable (Ind-AS GN). Considering that there is no mandatory AS on the subject, the Committee had recommended the issue of separate ICDS for such transactions.

► Vide Press Release dated 11 May 2017, CBDT has now released draft ICDS on Real Estate Transactions for soliciting stakeholders comments. A statement attached to draft ICDS clarifies that it is based on ICAI GN with certain carve outs/ deviations. Stakeholders may provide their comments/suggestions on draft ICDS by 26 May 2017 to Director TPL-III by e-mail at dirtpl3@nic.in.

**Significant features of draft ICDS on Real Estate Transactions**

**Scope**

► Draft ICDS shall be applicable for determination of income from all forms of real estate transactions which include the following:

  ► Sale of plots of land (including long-term sale type leases) with/without any development


[6] Refer EY Tax Alert dated 3 October 2016, “Government of India amends Income Computation and Disclosure Standards and also defers them by one year to tax year 2016-17”.


[8] Indian Accounting Standards are converged form of International Financial Reporting Standards (IFRS) applicable to particular class of companies.
► Development and sale of residential and commercial units, independent houses etc.
► Acquisition, utilization and transfer of development rights
► Redevelopment of existing buildings
► Joint development agreements

► For application of ICDS, “project“ is defined as the smallest group of units or plots or saleable spaces which are linked with a common set of “basic facilities”\(^9\), if any, in such a manner that unless the facilities are made available and functional, such units/plots/spaces cannot be put to their intended effective use. A larger venture “shall“\(^{10}\) be split into smaller projects when these basic conditions are fulfilled.

Core principles for revenue recognition from real estate transactions

► As in case of ICAI GN, draft ICDS requires the taxpayers to make an assessment based on “economic substance“ whether real estate project is akin to construction contract or akin to sale of goods and then apply the accounting principles as relevant to construction contract (ICDS III) or sale of goods (ICDS IV).

 Recognition as per ICDS III - construction contracts

► Project revenue and project costs shall be recognized as per percentage of completion method (POCM) as per ICDS III on Construction Contracts on \textit{mutatis mutandis} basis if the economic substance of projects is similar to construction contracts. Indicators of this feature are as follows:

   i. At least 25% of construction and development costs is incurred;
   ii. At least 25% of the saleable project area is secured by contracts or agreements with buyers;
   iii. Out of the total revenue as per sale agreement, at least 10% is realized in respect of each of the contracts and it is reasonably certain that the parties to such contract will comply with the contractually agreed payment terms.

 Recognition as per ICDS IV - sale of goods

► If the economic substance of a project is not similar to construction contract, revenue shall be recognized as per the provisions of ICDS IV on Revenue Recognition dealing with recognition of revenue on sale of goods.

► Revenue shall be recognized in such cases when (a) seller has transferred significant risks and rewards of ownership to the buyer or seller has effectively handed over the possession of unit to the buyer, (b) there is no significant uncertainty on amount of consideration to be derived from the sale and (c) there is reasonable certainty of ultimate collection of revenue.

\(^9\) As against “common amenities“ used in ICAI GN
\(^{10}\) As against “can” used in ICAI GN
Treatment of Transferable Development Rights (TDRs)

► TDRs are generally acquired by (a) direct purchase or (b) development and construction of built-up area or (c) giving up of rights over existing structures or open land.

► In the first two cases, cost of acquisition of TDR would be the cost of purchase or the amount spent on development or construction of built up area, respectively. But in the third case, TDR shall be recorded at fair value of such TDR.[11]

Transitional provision

► Draft ICDS mandates “grandfathering” of real estate projects which have “commenced” prior to the effective date of applicability of ICDS which shall be recognized as per the method regularly followed by the taxpayer prior to such date. Draft ICDS shall apply to projects which have “commenced” on or after effective applicable date.[12]

Significant carve outs/deviations from ICAI GN

As per statement attached to draft ICDS, following are the significant carve outs/deviations from ICAI GN:

► Definition of “project” is modified by substituting the term “common amenities” under ICAI GN with “basic facilities” with the intent that the project is linked with the smallest possible group of units and not with peripheral common amenities like club-house, entertainment, sports, gymnasiums, health club, restaurants, etc.

► Unlike ICAI GN, obtaining of critical approvals which are necessary for commencement of project is not a relevant criteria under draft ICDS for recognizing revenue on POCM. This is in view of newly enacted “The Real Estate (Regulation and Development) Act, 2016” (RERDA) in terms of which a real estate developer cannot accept advance beyond 10% of sale value unless the project is registered under RERDA and such registration cannot happen unless critical approvals (including legal title to land) are obtained.

► For determining revenue as per POCM under draft ICDS, the stage of completion can be determined either by proportion of costs method, survey method or physical completion method which are prescribed under ICDS III. Unlike ICAI GN, there is no further cap to restrict revenue recognition by reference to stage of completion determined as per proportion of costs method.

E.g., for a taxpayer following survey method, if the stage of completion as per survey method is 40% whereas the stage of completion as per project cost method is 30%, the revenue to be recognized as per ICAI GN is 30% (restricted to project costs method) whereas the revenue to be recognized as per ICDS is 40% (as per survey method followed by taxpayer). This could lead to accelerated recognition of income under ICDS and consequential mismatch with book profit relevant for Minimum Alternate Tax (MAT) computation for companies.

► In case of acquisition of TDRs by giving up the rights over existing structures or open land, ICAI GN requires recognition at fair value of TDR or net book value of asset given up, whichever is lower. But draft ICDS requires such recognition at fair value of TDR acquired to bring certainty and consistency with other ICDS. It may be noted that ICDS V on Tangible Fixed Assets and ICDS VIII on Securities (held as stock-in-trade) also provide for recognition of such “barter” transactions at fair value of asset acquired.

► Unlike ICAI GN, draft ICDS merely sets out main principles without providing any illustrations which is consistent with the framework of other ICDS.

[11] As against option given by ICAI GN to record TDRs at fair value or net book value of asset given up, whichever is less, Ind-AS GN requires application of principles of exchange of assets as per Ind-AS 38 on Intangible Assets.

[12] However, the term “commenced” is not defined or explained in draft ICDS.
Comments

The publishing of the draft ICDS for public consultation before final notification is a welcome move in line with the international best practice of consultative approach.

Notification of ICDS on real estate transactions will have significant impact on real estate developers. This is because there is no mandatory AS on the subject which governs the accounting treatment. GNs issued by the ICAI are recommendatory in nature.

Further, the deviations in the draft ICDS compared to ICAI GN are also likely to raise significant concerns, controversies and uncertainties. To illustrate, questions may arise about the scope of identification of “project” and mandate to split projects into smaller projects for the purpose of revenue recognition on such smallest possible group of units as against higher threshold for similar purpose under ICAI GN. The draft ICDS may result in commercially single project united by “common amenities” to be split into different smaller projects based on unison by “basic facilities”. Also, tax treatment of TDRs acquired by giving up rights over existing structures or open land may lead to accelerated taxation since permissible alternative of recording the same at net book value as available in ICAI GN is not provided.

Similar result of accelerated revenue recognition may follow if the stage of completion is determined by a method other than the project cost method. This is because, unlike ICAI GN, capping the amount of project revenue by reference to stage of completion determined as per project costs method is not allowed under draft ICDS.

Draft ICDS when notified will mandate computation of taxable income as per the principles provided therein which may result in mismatch between accounting income and taxable income. This may also have consequential impact on MAT liability for companies (including Ind-AS companies).

It is necessary that stakeholders carefully assess the potential impact of draft ICDS and express their concerns to CBDT by 26 May 2017.
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