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Flash News

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CBDT issues draft ICDS on real estate transactions

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 other than an individual or a Hindu undivided family who is not required to get his/her accounts of the PY audited in accordance with the provisions of Section 44AB of the Income-tax Act, 1961 (the Act). Such assessees need to follow the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head 'Profits and Gains of Business or Profession' or 'Income from other sources'. The ICDS are applicable to the specified assessees from Assessment Year (AY) 2017-18.

The Finance Minister constituted a Committee (the Committee) comprising of experts from accounting, departmental officers and representatives from the Institute of Chartered Accountants of India (ICAI) to recommend the areas in respect of which further ICDS may be notified under the Act.

The Committee vide a press release dated 11 May 2017 has issued the draft ICDS on real estate transactions (draft ICDS). The draft ICDS is based on the Guidance Note issued on Real Estate Transactions (ICAI GN) issued by ICAI in 2012. For the purposes of providing uniformity and certainty and harmonising the same with provisions of the IT Act, the Committee suggested certain changes in draft ICDS in comparison to the ICAI GN.

The draft ICDS is open for comments from stakeholders till 26 May 2017.

The draft ICDS is summarised as follows:

1. Applicability

- **Forms of real estate transactions**: Similar to ICAI GN, the ICDS should be applied for determination of income from all forms of transactions in real estate, including land, building and rights in relation thereto. This will include the following:
  - Sale of plots of land (including long term sale type leases) without any developments
  - Sale of plots of land (including long term sale type leases) with development in the form of common facilities
  - Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land
  - Acquisition, utilisation and transfer of development rights
  - Redevelopment of existing buildings and structures
  - Joint development agreements for any of the above activities.

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2. Definition of a project

The draft ICDS emphasises that a project would be the smallest group of units, plots or saleable spaces, as the case may be, which are linked with a common set of basic facilities. While the ICAI GN requires the set of facilities to be connected by a common set of amenities to constitute a single project.

3. Illustrative list of items falling in the definition of project cost

The draft ICDS does not include an illustrative list of items (as given in the ICAI GN) that can be included, allocated or excluded in the definition of project cost.

4. Recognition

- **Projects where the economic substance is similar to a construction contract**: Apply Percentage of Completion Method (POCM) as per ICDS III, Construction Contracts to recognise project revenue and project costs. Revenue under POCM should be recognised when:
  - ➢ The expenditure incurred on construction and development costs is 25 per cent or more of the construction and development costs
  - ➢ 25 per cent or more of the saleable project area is secured by contracts or agreements with buyers and
  - ➢ 10 per cent or more of the total revenue as per the agreements of sale or any other legally enforceable documents are realised in respect of each of the contracts and it is reasonably certain that the parties to such contracts will comply with the payment terms as defined in the contracts.

Guidance note

It provides the same guidance as mentioned in the draft ICDS.

- **Projects where the economic substance is not similar to a construction contract**: Apply ICDS IV, Revenue Recognition. Provisions of para 3,4 and 5 of ICDS IV would apply provided:
  - ➢ The seller has transferred to the buyer all significant risks and rewards of ownership and the seller retains no effective control of the real estate to a degree usually associated with ownership or the seller has effectively handed over possession of the real estate unit to the buyer forming part of the transaction
  - ➢ No significant uncertainty exists regarding the amount of consideration that will be derived from the real estate sales
  - ➢ There is a reasonable certainty that the revenue will be ultimately collected from buyers.

Guidance note

It provides the same guidance as mentioned in the draft ICDS.

- **Indicators of economic substance of project being similar to a construction contract are as follows:**
  - ➢ The duration of such projects is beyond 12 months and the project commencement date and project completion date fall into different previous years.
  - ➢ Project involves activities similar to construction contracts such as land development, structural engineering, architectural design, construction or activities of similar nature.
  - ➢ While individual units of the project are contracted to be delivered to different buyers these are interdependent upon or interrelated to completion of a number of common activities with or without provision of common facilities.
  - ➢ The construction or development activities form a significant proportion of the project activity.

Guidance note

It provides the same guidance as mentioned in the draft ICDS.

5. Transferable Development Rights (TDRs)

- **In case of rights acquired by way of direct purchase or development and construction of built-up area:** Recognise cost of acquisition as the cost of purchases or amount spent on development or construction of built up area, respectively.
- **In case of rights acquired by way of giving up of rights over existing structures or open land:** Development rights should be recorded at fair value of the acquired development rights.

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- Cost of acquisition should be added to the project costs in case the development rights are utilised in a real estate project.
- **In case of sale/transfer of development rights:** Revenue should be recognised if both the conditions mentioned below are met:
  - Title of the right is transferred to the buyer and
  - It is reasonable to expect that the revenue will be ultimately collected.

Guidance note

In case of acquisition of TDRs, the ICAI GN provides that where development rights are acquired by way of giving up of rights over existing structures or open land, the development rights shall be recorded at the fair market value or net book value.

6. Transactions with multiple elements

- Similar to ICAI GN: In case of a contract for delivery of goods or services in addition to the construction or development of real estate between a person and a buyer:
  - Contract consideration should be split into separately identifiable components including one for the construction and delivery of real estate units
  - Consideration received or receivable should be allocated to each component on the basis of the fair value of each component.
  - Recognition of revenue of each of the components should be as per the provisions of the relevant ICDS.

7. Disclosures

- Disclosure requirements of the draft ICDS are as follows:
  - Disclose amount of project revenue recognised as revenue in the period
  - Disclose the methods used to determine the project revenue recognised in the period
  - Disclose the method used to determine the stage of completion of the project.
  - In case of projects in progress as at the end of the previous year, disclose:
    - The aggregate amount of costs incurred and profits recognised (less recognised losses) to date
    - The amount of advances received
    - The amount of work in progress and the value of inventories and
    - Excess of revenue recognised over actual bills raised (unbilled revenue).

Guidance note

It provides the same guidance as mentioned in the draft ICDS.

8. Transitional provisions

- Project revenue and project costs associated with the real estate project, which commenced on or after 1 April 201X[1] should be recognised in accordance with the provisions of this standard.
- Project revenue and project costs associated with the real estate project, which commenced on or before the 31 March 201X[2] but not completed by the said date, should be recognised based on the method regularly followed by the person prior to the previous year beginning on the 1 April 201X.

Our analysis

In order to put rest to the controversy on whether ICDS III and ICDS IV are applicable to real estate transactions, the CBDT has now released draft ICDS on real estate transactions. The draft ICDS has made certain changes when compared with the ICAI GN on real estate transactions in areas such as:

- **Definition of project**: Use of the term 'basic facilities' in place of 'common facilities' as defined in the ICAI GN. The intention behind this change is that this is expected to provide clarity and consistency but is likely to result in recognition of revenues earlier.
- **Application of POCM for real estate projects**: The ICAI GN permits all methods for determining POCM e.g., cost incurred, survey of work done, technical estimation, etc. The ICAI GN, however, puts a cap on recognition of revenue based on POCM with reference to project cost incurred. The draft ICDS does not provide for capping the recognition of revenue based on POCM determined with reference to the project cost incurred.

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[1] For transitional provisions this date has not been prescribed in draft ICDS

[2] For transitional provisions this date has not been prescribed in draft ICDS

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- **Measurement of revenue for TDRs**: The ICDS proposes recognition of TDRs acquired by way of giving up of rights over existing structures or open land, then TDRs would be recorded at the fair value of the TDRs so acquired. While the ICAI GN required them to be recorded at fair market value or net book value.
- **Alignment with Ind AS GN on real estate transactions**: Like all other ICDS, the draft ICDS is based on ICAI GN issued in 2012, it has certain differences from Ind AS. Key differences are the measurement of revenue – under Ind AS revenue is recognised at fair value of the consideration received or receivable. Additionally, when TDRs are acquired by way of giving up of rights over existing structures or open land then the cost of such TDRs would be measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.
- **Transition provisions**: As there was no clear guidance available, the assessees may have used various methods for recognising project revenue and project cost. Therefore, projects that would have commenced before the applicability of this ICDS (as explained in the transition provisions above) would continue to recognise project revenue and project cost as per the method followed by the assessee for the transition period. Thus, for some time, the assessees are likely to follow two separate methods of accounting in case they were following some other method of accounting for their existing projects.

This ICDS covers within its ambit JDA transactions. While this ICDS shall be certainly applicable to the Developer under JDA transaction, whether it would also be applicable to the Land Owner under JDA transaction shall depend on the construct and terms of JDA, roles and responsibilities of the parties, etc.

This ICDS requires application of POCM to real estate transactions where the economic substance is similar to construction contracts, which is to be determined based on various parameters viz. duration of project is beyond 12 months and project commencement and completion date fall into different previous years, project involves significant construction activities such as land development, structural engineering, etc. If economic substance is not similar to construction contracts, provisions of ICDS IV would apply. Thus, it would be vital to determine whether respective transactions shall be covered under ICDS IV or this ICDS. For instance, pure land sale versus sale of developed land consisting of land fencing, landscaping, provision of access to roads, etc.

This ICDS provides grandfathering to the projects commenced before 1 April 201X[3], wherein project revenue and cost could be recognized as per the method regularly followed prior to 1 April 201X[4] i.e as per percentage of completion method or as per project completion method. However it is pertinent to note that the word 'commence' has not been defined in this ICDS. In order to avoid litigation, it would be relevant to clarify when does project gets commenced, whether upon filing of application before authorities for the approvals or receipt of Letter of Intent (LOI) or Intimation of Disapproval (IOD) or purchase of land or signing of JDA, etc.

There is no specific Accounting Standard in Indian GAAP for accounting of real estate transactions and the accounting for such transactions is largely driven by the ICAI GN. It is welcome step by the MoF to prescribe an ICDS on this topic to bring the clarity and certainty around computation of income for the real estate project. It will bring clarity and certainty in application of provisions of ICDS and computation of taxable income to this sector. We encourage stakeholders to provide their comments to the Committee by 26 May 2017.

It is also important to note that while there are some minor changes, the ICDS is largely aligned with the accounting principles prescribed in the ICAI GN which will result in smooth transition. While there are few areas where it differs from Ind AS GN on real estate transactions.

[3] For transitional provisions this date has not been prescribed in draft ICDS
[4] For transitional provisions this date has not been prescribed in draft ICDS

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