



Jaipur Tribunal's decision on revenue recognition in case of real estate developer

Background

Recently, the Jaipur Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Vastukar Township Pvt. Ltd.¹ (the taxpayer) dealt with the issue with respect to revenue recognition in the case of real estate developer. With respect to revenue recognition on registered sales deeds where entire amount of consideration received, the Tribunal held that the taxpayer should not recognise the entire revenue collected as it is obliged to perform the specified development activities even after the sale deeds have been duly executed in favour of buyers. The revenues in such cases should therefore be recognised on proportionate basis by applying percentage completion method.

With respect to advances received from the customers where sales deed were not registered, the Tribunal held that the advance received shall be recognised as income applying the percentage completion method since the conditions² provided under the ICAI Guidance Note have been fulfilled. The taxpayer is not appropriate in postponing the revenue till the registration of sales deed. However, the revenue recognition can be postponed to the extent of uncertainty involved in terms of realisation of subsequent installments.

¹ Vastukar Township Pvt. Pvt. Ltd. v. DCIT (ITA No. 105/JP/2017) – Taxsutra.com

² ICAI Guidance Note on Accounting for Real Estate Transactions - as per Guidance Note following three conditions to be fulfilled before revenue is to be recognised:

- (i) The seller has transferred to the buyer all significant risk and rewards of ownership and the seller retain no effective control of the real estate to a degree usually associated with the ownership.
- (ii) No significant uncertainty exists regarding the amount of consideration that will be derived from real estate sales.
- (iii) It is not unreasonable to expect ultimate collection.

Facts of the case

- The taxpayer is engaged in development of township project in collaboration with Shakuntalam Colonizers Pvt. Ltd. and Vastukar Colonizers Pvt. Ltd. With some customers, the taxpayer entered into 'plot buyer's agreement' with for the sale of plot where registered sale deed is not executed. In terms of buyers' agreement, the buyer agrees to purchase a plot of specified size, and location. The agreed price covers development of internal services such as roads, electricity, water and drainage system within the peripheral limits of township. The nature of transaction under consideration is therefore sale of plots of land with development of internal common facilities within the township.
- With respect to certain customers' the sale deed is executed.
- The taxpayer has been following 'percentage completion method' but recognises only part of the sales as 'revenue' (with respect to customers whose sale deed was registered) and no income is offered for tax in respect of the amount of 'advance received from customers' (where sale deed was not registered). The taxpayer contended that as per the consistent accounting policy, sales for the year are recognised at INR21.13 million as against the sale proceeds of INR45.01 million and no sales is recognised against the advance/booking amount of INR44.42 million received from customers.
- With respect to revenue recognition from registered sale deed, the Assessing Officer (AO) held that the entire ownership has been transferred to the buyer. Hence, the entire receipts from such sales are to be recognised as revenue.

- With respect to advance received against 'plot buyer agreement', the AO held that income has accrued to the taxpayer in lieu of the sale of plots to the customer. The customer is bound by the payment schedule and the taxpayer is entitled to receive the payments as per the agreement. The AO applied the percentage completion method and computed income on advance received.

Tribunal's decision

Transactions with respect to sale deed and recognition of revenue

- In the present case, in respect of transactions where sale deeds for plots of land have been duly executed and registered with the relevant authorities, there is no dispute that the taxpayer has transferred to the buyer all significant risk and rewards of ownership and the taxpayer retains no effective control of the real estate to a degree usually associated with ownership. No significant uncertainty exists regarding the amount of the consideration and its collection as the same has been fully recovered prior to signing of the sale deed.
- The Tribunal observed that economic substance of the transaction is also relevant to be considered. In the present case the economic substance of transaction under consideration is therefore sale of plots of land along with development of internal common facilities within the township. The buyer of plot of land is not paying merely for piece of land cut into specified size at a given location but also for development of various common facilities.
- There is no separate identifiable consideration for development activities which is available on record and therefore, one can only speculate and debate about whether these activities are substantial or not, the fact remains that unless such facilities are made available and functional, these plots of land cannot be put to intended use.
- The development activities are therefore closely linked to the sale of plot of land and the economic substance of the transaction is therefore sale and purchase of developed plots of lands. The taxpayer is therefore obliged to perform the specified development activities even after the sale deeds have been duly executed in favour of buyers.
- Accordingly, the Tribunal held that the revenues in such cases should be recognised on proportionate basis as the acts are performed, i.e. by applying percentage completion method in the manner explained in Accounting Standard (AS) 7 - Construction Contracts³.

Taxability of advance and booking amounts received from customers

- On cumulative reading of all the clauses in the agreement, it is clear that the price risk which is one of the significant risks in relation to real estate has been fully transferred by the taxpayer to the buyer. Further, regarding any external regulatory risk by way of any direction or action of the state government or any local authority, the entire cost and risk has again been passed on by the taxpayer to the buyer and at the same time, the taxpayer has safeguarded its own interest and risk.
- The buyer clearly has a right to sell or transfer his interest in the property after taking prior written approval as well as payment of specified administrative charges. The approval of the taxpayer cannot be read to mean in any way restricting the taxpayer's right to deal with the plot of land rather such an approval is more of a regulatory mechanism put in place by the taxpayer which the buyer should adhere to. There is no restriction which has been provided in the agreement which specifically restrict such right of the buyer in terms of handling or transferring his interest in the property to a third person till the entire sale consideration has been paid.
- The amount of the consideration for the sale of plot has been clearly specified in the plot buyer's agreement, the Tribunal did not find any uncertainty regarding the amount of the consideration that will be derived from the said sale of plot of land.
- Further it is not unreasonable to expect ultimate collection, the buyer has agreed to deposit the booking advance of 20 per cent and also agreed to deposit the postdated cheques for the balance installments as per the payment plan specified in the agreement. However, it is for the taxpayer to assess the ultimate collection with reasonable certainty in each of the individual cases vis-a-vis the acts and commitments as well as taking into account any default if so committed by the respective buyers and where the seller comes to a view that the ultimate collection is lacking in certain cases, revenue recognition can be postponed to the extent of uncertainty involved.

³ AS – 7 - It provides that contract revenue are required to be matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.

- The Guidance Note issued by Institute of Chartered Accountants of India (ICAI) provides that where the aggregate payments or continuing payments by the buyer provide insufficient evidence of the buyer's commitment to make complete payment, revenue to the extent of actual realisation of the consideration should be recognised provided other conditions for recognition of revenue are satisfied.
- Therefore, in the instant case in absence of a specific finding by the AO to the contrary and the fact that taxpayer has not realised the full sale consideration at the time of signing of the buyers agreement, a reasonable presumption can be drawn that the ultimate collection of the full amount of the sale consideration with reasonable certainty is lacking.
- Accordingly, the amount which has actually been realised/received during the year in respect of the advance received from customers should be recognised in the financial statement as revenues accruing for the period, to the extent of percentage of work completed, following the percentage completion method.
- However, the revenue recognition is to be postponed to the extent of uncertainty involved in terms of realisation of subsequent installments.

Accounting policy followed by the taxpayer

- The litmus test of accrual of income under the mercantile system of accounting is the passing of risks and rewards of ownership to the buyers. Under percentage completion method of recognition of revenues, the income is computed by deducting the cost incurred in reaching the stage of completion from the proportionate sale attributable to the work completed.
- Therefore, where under the plot buyer's agreement, where significant risk and rewards have been transferred to the buyers, the consideration so received to the extent of stage of completion of the project has accrued and will be subject to tax. By not offering the consideration in form of advance so received from the customers, the taxpayer cannot be said to be following percentage completion method, rather it would be following project completion method.
- The Delhi High Court in case of Paras Buildtech⁴ held that where the advances have been received during the year and not offered to tax following the project completion method, and where the same is consistently followed by the taxpayer, it should not be disturbed. The Delhi High Court relied on the decision of Gujarat High Court in case of

Shivalik Buildwell⁵ to support its case. However, in the present case, where the taxpayer has admittedly chosen to follow the percentage completion method, it cannot be allowed to breach the very same method by not offering the advances so received during the year to tax and following a project completion method. The above said decisions therefore did not support the case of the taxpayer. Further, the decision of the Gujarat High Court in case of Ashaland Corporation⁶ is distinguishable on facts of the present case.

- It has been observed that in respect of revenues from executed sale deeds, the revenues have been recognised to the extent of work completed and the said principle will apply in respect of advances so received from the buyers. The taxpayer has therefore to maintain the consistency in its method of accounting where it is following percentage completion of method and within the said method, it cannot be allowed to make variation on the basis of plot buyer's agreement and executed sale deeds so long as the basic parameters for recognition of revenues, have been fulfilled.
- Accordingly, in respect of total advances actually received from the customers amounting to INR44.43 million arising out and in respect of which plot buyers agreement has been executed, revenues to the extent of percentage of work completed (45.73 per cent) which comes to INR20.31 million, following the percentage completion method has been rightly brought to tax by the AO.
- With respect to executed sale deeds revenue amounting to INR21.13 million shall be recognised for the year under consideration.

Our comments

The real estate sales take place in a variety of ways and may be subject to different terms and conditions as specified in the agreement for sale. Accordingly, the point of time at which all significant risks and rewards of ownership can be considered as transferred, is required to be determined on the basis of the terms and conditions of the agreement for sale. In the case of real estate sales, the events, such as, transfer of legal title to the buyer or giving possession of real estate to the buyer under an agreement for sale, usually, provide an evidence to the effect that all significant risks and rewards of ownership have been transferred to the buyer.

⁴ Paras Buildtech India Private Limited & Anr. v. CIT [2016] 382 ITR 630 (Del)

⁵ CIT v. Shivalik Buildwell [2013] 40 Taxmann.com 219 (Guj)

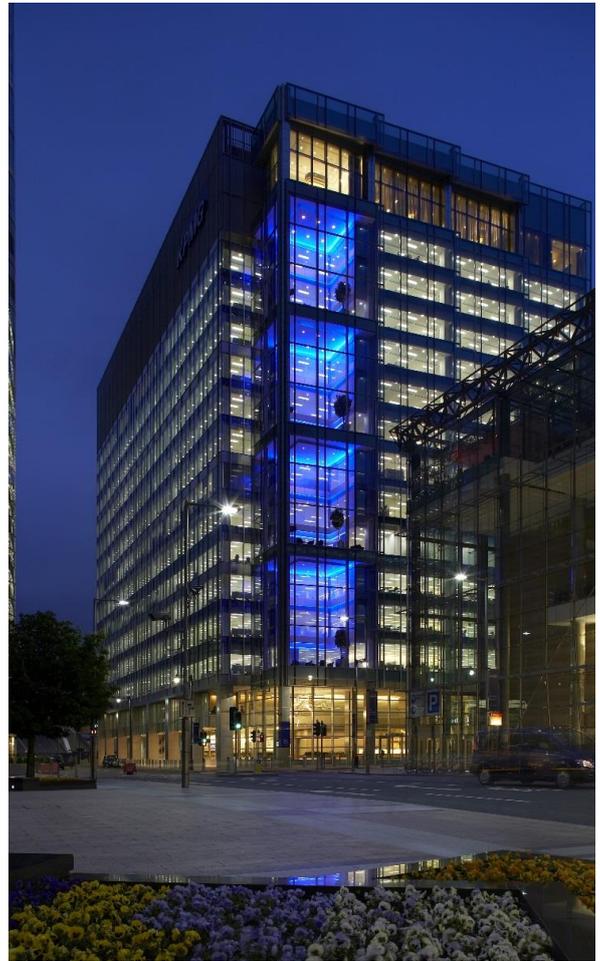
⁶ CIT v. Ashaland Corporation [1982] 133 ITR 55 (Guj)

The Delhi Tribunal in the case of Malibu Estates (P.) Ltd⁷ observed that under the agreements with customers, unless a conveyance deed was executed and registered, seller (i.e., taxpayer) would continue to be owner of plot. In such situation, it cannot be said that merely on receipt of advance, the contract has fully been satisfied by the buyer qua the seller.

Similarly, the Jaipur Tribunal in the case of Unique Builders & Developers⁸ held that merely by making advance booking of a flat, it cannot be assumed that any income has arisen to the taxpayer. The advance received remain a liability till the sale transaction is completed by delivering possession and sale deed is executed. Accordingly, there is no element of accrual of income in these circumstances. Since the taxpayer does not transfer the title or ownership to proposed buyer at the time of booking by receiving advance and both parties are at liberty to cancel the booking, any income neither accrues nor arises.

However, the Jaipur Tribunal, based on facts and circumstances of the present case, held that advances received from the customers in respect of which plot buyers agreement has been executed, revenues to the extent of percentage of work completed shall be recognised as income. Revenue recognition can be postponed in case of subsequent installments only to the extent there is no reasonable certainty of ultimate collection.

The Tribunal observed that even where the entire sale consideration is received and the taxpayer has been following percentage completion method, the revenue is recognised on the proportionate basis attributable to work completed.



⁷ DCIT v. Malibu Estates (P.) Ltd [2012] 52 SOT 54 (Del)

⁸ Unique Builders & Developers v. DCIT (ITA No. 464, 465 & 466/JP/2012, dated 30 April 2015)

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