Accounting Standards, ICDS and the Income Tax Act, 1961- Case of Real Estate Developers

Recently, Hon'ble ITAT, Panaji in ACIT vs. Alcon Developers – 54 taxmann.com 54 [2015], held that recognition of the revenue from the sale of plots by the assessee only when the registration of the sale deed has been done by the assessee in favour of the buyer is not a recognised method of recognising the revenue. The method adopted by the assessee cannot be regarded to comply with the ingredients as laid down under Section 145 of the Income-tax Act, 1961. The two fundamental principles of tax jurisprudence are, first, each year is an independent and self-contained unit of assessment and, second, it is the correct income for the year that is to be brought to tax for that year [CIT vs. British Paints India Ltd. [1991] 188 ITR 44/54 Taxmann 499 (SC)]. Keeping this in mind, various fallouts of the above decision in the context of accounting standards vis-à-vis the Income Tax Act and the newly notified Income Computation and Disclosure Standards (ICDS) regime with effect from the assessment year 2016-17 as applicable to the real estate business are discussed in the article. Read on…

CA. Vinay V. Kawdia

(The author is a member of the Institute who may be reached at vkawdia@gmail.com.)

A) Background:

A.1) Income-tax Act, 1961 – Section 145:

Section 145 of the Income-tax Act, 1961 as amended by the Finance Act, 1995 with effect from 01.04.1997, makes it mandatory on part of the assessee to follow either cash or mercantile system of accounting regularly.

Pre-amendment, taxpayers were allowed to compute their income in accordance with any method, provided they regularly employed the method and their income could be properly deduced from it. Section 145 was thereafter amended. And so, from the assessment year 1997-98, income chargeable under the head *'profits and gains from business or profession' or 'income from other sources'* can be computed by following either the cash or mercantile system of accounting– a mixture or 'hybrid' method of accounting is not permitted for the reasons as explained by the CBDT in Circular No. 717 dated 14.08.95.

Thus after the above amendment, the method of accounting to be followed under Section 145 is *qua* assessee and not *qua* source of income.

A.2) What Accounting Standards say?

In the context of the subject matter, accounting standard (AS) 7 [Construction Contracts] and accounting standard (AS) 9 [Revenue Recognition] issued by the ICAI acquire significance.

[The Income-tax Act does not prescribe any method of accounting for construction contracts under Section 145. Even accounting standards prescribed under Section 145 does not include any standard on construction contracts. However, as held by the courts from time to time, views of the ICAI as the premier regulatory body for the profession of the accountancy had to be accorded respect.]

AS-7: Construction Contracts:

AS-7 deals with accounting for treatment of revenue and costs associated with construction contracts in the financial statements of contractors. The revised AS-7 recognises *only the percentage completion method* and is to be applicable only to the construction contractors' financial accounting.

This method of accounting requires that, when the outcome of a construction contract can be estimated reliably, contract revenue and contract cost associated with the construction contract should be recognised as revenue and expenses by reference to the stage of completion of the contract activity at the reporting date.

The Guidance Note draws upon the principles enunciated in AS-7, Construction Contracts, wherever percentage completion method is appropriate (as most of the Real estate transactions and activities have the same economic substance as construction contracts), whereas, in respect of transactions of real estate which are in substance similar to delivery of goods, principles enunciated in accounting standard (AS) 9, Revenue Recognition, are applied.

AS-9: Revenue Recognition:

Firstly, this standard does not deal with the revenue arising from construction contracts, to which AS-7 apply. AS-9 recognises both, i.e., percentage completion method and project completion method.

As far as real estate transactions are concerned, recognition of revenue will depend on whether all the significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control and no significant uncertainty exists regarding the amount of the consideration from the sale of the property.

A.3) Guidance Note on Accounting for Real Estate Transactions:

In the typical facts and circumstances of the case, ICAI's Guidance Note on Accounting for Real Estate Transactions (Revised 2012) is worth readers' attention. *[Though, applicable to all projects where revenue is being recognised for the first time on or after 01/04/2012, earlier adoption of this Guidance Note is encouraged.]*

This Guidance Note covers all forms of transactions in real estate. An illustrative list of transactions which are covered by this Guidance Note is as under:

(a) Sale of plots of land (including long term sale type leases) without any development.
(b) Sale of plots of land (including long term sale type leases) with development in the form of common facilities like laying of roads, drainage lines and water pipelines, electrical lines, sewage tanks, water storage tanks, sports facilities, gymnasium, club house, landscaping, *etc.*
(c) Development and sale of residential and commercial units, row houses, independent houses, with or without an undivided share in land.
(d) Acquisition, utilisation and transfer of development rights, redevelopment of existing buildings and structures.
(e) Joint development agreements for any of the above activities.

The Guidance Note draws upon the principles enunciated in AS-7, *Construction Contracts*, wherever percentage completion method is appropriate (as most of the real estate transactions and activities have the same economic substance as construction contracts), whereas, in respect of transactions of real estate which are in substance similar to delivery of goods, principles enunciated in accounting standard (AS) 9, *Revenue Recognition*, are applied.

B) Alcon Developer's Case (Supra):

Highlights (on relevant issue):

a) As claimed by the assessee, it was following the mercantile system of accounting as well as the project completion method. The assessee was engaged in the business of real estate development.

b) The development of the plots has been carried out fully by the assessee as on 31.3.2009 and against this, the assessee has received consideration to the extent of 70% to 90%. But, still the assessee had not shown the sale proceeds in the profit and loss account.

c) Assessee has recognised the revenue only when the registration of the sale deed has been done by it in favour of the buyer.

Observations of the Hon'ble ITAT:

a) Under AS-7, this is not a recognised method of recognising the revenue. This method is neither project completion method nor percentage of completion method.

b) Registration of the sale deed represents only the transfer of the title in favour of the buyer from the assessee. It has nothing to do with the method of accounting followed by the assessee.

c) Under the percentage of completion method, revenue is recognised in the profit and loss account in the accounting period, to the extent the work is completed. In case the revenue has to be recognised on the basis of receipt of the payment from the plot-holders, that will also not be regarded to be percentage of completion method.

d) Recognising the revenue when the sale deed has been registered by the assessee in favour of the buyer cannot be regarded to be either cash or mercantile system of accounting.

e) The method adopted by the assessee, therefore, cannot be regarded to comply with the ingredients as laid down under Section 145 of the Income-tax Act, 1961.

Hon'ble ITAT Bangalore in *Prestige Estate Projects Ltd. vs. DCIT, 129 ITD 342* confirmed the principle of revenue recognition laid by the Guidance Note on *Recognition of Revenue* by Real Estate Developers issued by ICAI and decided accordingly.

C) Analysis:

C.1) Though not referred, the Hon'ble ITAT rightly confirmed the system of revenue recognition as prescribed by the ICAI Guidance Note on *Accounting for Real Estate Transactions (supra).* In the context of recognition of revenue in real estate transactions, the Guidance Note clarifies as follows:

Revenue is to be recognised when all of the following conditions are satisfied: (Completed contract method)

(a) The seller has transferred all significant risks and rewards of ownership and retains no effective control of the real estate (including ownership),

(b) The seller has handed over the possession of the real estate unit to the buyer,

(c) The amount of sale consideration can be reasonably measured,

(d) It is not unreasonable to expect ultimate collection of revenue from buyer,

(e) Where the transfer of legal title is a condition before the buyer taking over significant risks and rewards of ownership, revenue should be recognised when the legal title is transferred.

Thus, even under the project completion method, registration of sale deed or actual flow of consideration for sale transaction has nothing to do with the recognition of revenue/method of accounting, as long as the other conditions as mentioned above are satisfied.

Hon'ble ITAT Bangalore in *Prestige Estate Projects Ltd. vs. DCIT, 129 ITD 342* confirmed the principles of revenue recognition laid by the Guidance Note on *Recognition of Revenue* by Real Estate Developers issued by ICAI and decided accordingly.

However, in *Alcon Developer's case (supra)*, it is not clear whether there was any agreement between the assessee and the intending buyers of plots. When, as per agreement, if any, the possession of plots was not given to the buyers before registration of the document, or in other words, the developer has not transferred all significant risks and rewards of

ownership so as to get an enforceable right to receive the balance of sale consideration, the question of applying Section 53A of the Transfer of Property Act would not arise so as to recognise the revenue before actual registration.

C.2) There is a plethora of judgments favouring the applicability of ICAI accounting standards (ASs) for tax purposes in cases of builders and contractors. To note a few:

CIT vs. Bilahari Investments (P) Ltd. (2008) 299 ITR 1 (SC)

Recognition/identification of income under the Income-tax Act 1961 is attainable by several methods of accounting. Project completion method [PCM] is one such method.

CIT vs. Advance Construction Co. (P) Ltd. (2005) 275 ITR 30 (Guj.)

Assessee-contractor having offered profits for tax on the basis of percentage completion method which is a standard accounting practice and has been consistently followed by the assessee in subsequent years, the same could not be rejected and impugned amount which has been deducted in working out the profit is not chargeable to tax in the year under consideration, same having been offered for taxation in later years.

Lunar Electricals vs. ACIT [2012] 22 taxmann.com 230 (Delhi) (A.Y. 1997-98)

Completed contract method [CCM] can be adopted under Section 145 when an assessee follows mercantile system of accounting.

Bhoomi Construction vs. ACIT (2015) 44 CCH 0129 (MumTrib)

If the assessee has been following one of the recognised methods as prescribed by AS-9, then Revenue cannot impose a different method upon the assessee, unless there is a finding of fact that such a method is not reflecting the true profits of the assessee.

As per ICDS, revenue from service transactions shall only be recognised by following the "percentage completion method". Apart from this, as far as real estate transactions are concerned, the ICDS -4 on revenue recognition is in line with AS-9 on revenue recognition.

ACIT vs. Hill County Properties Ltd. [2015] 57 taxmann.com 400 (Hyd. - Trib.)

Section 145 of the Income-tax Act, 1961, read with AS-9 of the ICAI - Method of accounting - uncertainty in ultimate collectability of revenue justifies change of method of accounting by property developer from percentage of completion to recognition of income based on registration of agreements for sale or completion of possession and consequential reversal of revenue on cancellations/legal cases. This change in method of recognition of income, as adopted by assessee was in terms of relevant accounting standard laying down prudential norms of revenue recognition, and the same was legally correct.

Applicability of Method of Accounting for Disclosure in the Course of Search

Assessee was regularly following the project completion method. Undisclosed income in the form of 'on money' should be taxed in the respective assessment years as per method of accounting followed by the assessee. *[Dhanvarsha Builders & Developers (P) Ltd. vs. DCIT (2006) 102 ITD 375 (Pune) (A.Y. 1996-97)]*

Applicability of Completed Contract Method [CCM] for Construction that Commenced Before 01.04.03

AS-7 (Revised) applies only to contractors and in respect of construction commencing on or after 01.04.03. Thus, AS 7 (old) applies to construction that commenced before AS-7 (Revised) became applicable. In such a case, a real estate developer can follow either the CCM or PCM for recognition of revenue from agreement for sale entered into with buyers – *Awadhesh Builders vs. ITO (2010) 37 SOT 122 (Mum.)*

C.3) The law on the subject matter is exhaustively explained by the ITAT Mumbai (Special Bench) in *DCIT vs. Sudhir V. Shetty [2014] 50 taxmann.com 372* as follows:

- *The law provides either party the right to seek performance of the contract and, thus, has to be regarded as an enforceable legal right. Of course, this has to be coupled with the uncertainty, i.e., as to the price or the ultimate realisation of income, if any, that may exist in as much as no income can be said to have accrued where uncertainty to any significant extent obtains, qua any contract, with regard thereto - which is again a matter of*

fact, to be assessed on the conspectus of the facts and circumstances of the case, i.e., on the basis of the best available information. Finally is the question of the stage of completion of a project. This assumes relevance in determining the extent to which income can be said to have accrued, i.e., its quantification.

- *The income arising to the assessee during a particular period has to be brought to tax for that period, and that period alone; each year being an independent unit of assessment. It is trite law that profit is to be understood in the commercial sense and, subject to the provisions of the Act, computed accordingly. The issue is not as to which of the two methods, i.e., the percentage completion or the project completion, is the correct method in-as-much as each could be valid in a particular set of facts. What is relevant is which of the two methods results in the correct reporting of the operating profit and the state of affairs of a business entity in the facts and circumstances of the case. AS-7, mandated for contractors, endorses the former method in-as-much as the risks and, thus, return, is with reference to the work undertaken, which is rightly captured in the proportionate method.*
- *The case of builders, undertaking construction on own account, is more appropriately covered by AS-9. The question, therefore, reduces to as to which of the two methods is, on facts of the case, in consonance with AS-9. The said standard stipulates the basic conditions that should obtain if the income can be said to have accrued. The first is the transfer of all significant risks and rewards of ownership. Income arises on exchange. Risk and reward are incidents of ownership, income, thus, can be said to have accrued when there has been i.e., given the binding legal contract, transfer of these incidents, wholly or substantially so.*

  It is only then that the consideration received in exchange, i.e., the compensation for the release/ transfer of ownership can be said to have been so in one's own right, and the income embedded therein, accrued to the recipient. In fact, it matters little even if the consideration stands not actually received in-as-much as a debt has inured in favour of the transferor. Then, again, income cannot be said to have arisen if uncertainty to any significant extent exists as to the ultimate realisation of income, so that the existence of a legal debt or a civil liability is itself not sufficient to hold of accrual of income. The Standard is thus set in terms broader than the legal concept of accrual, though is principally in agreement with. ICAI has also issued a Guidance Note on recognition of income for real estate developers.

D) Income Computation and Disclosure Standards Applicable From 01.04.2015:

D.1) Pre ICDS Scenario: Section 145(2) of the Income-tax Act, 1961 provides that the Central Government may notify accounting standards ('AS') for any class of assessees or any class of income. However, till date only two AS relating to *'Disclosure of Accounting Policies'* and *'Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies'* were notified.

To resolve this tussle between accounting standards and the Income-tax Act, in December 2010, CBDT constituted a committee to harmonise the AS issued by the ICAI with the provisions of the Act for the purposes of notification under the Act and to suggest amendments to the Act.

After considering the key recommendations of the committee, CBDT notified ten *Income Computation & Disclosure Standards [ICDS] vide* notification dated 31.03.2015. It has been clarified that the ICDS notified under the Act would be applicable only for computation of income chargeable under the head "profit and gains of business or profession" or "income from other sources" and not for the purpose of maintenance of books of account. Further, in case of conflict between the provisions of the Act and these ICDS, the provisions of the Act shall prevail to that extent.

D.2) What ICDS says: In the context of this article, ICDS-3 relating to construction contracts and ICDS-4 relating to revenue recognition are important.

As per current form of ICDS it has, in principle, approved the method of accounting prescribed by

AS-7 and AS-9 and the concerned Guidance Note even for the purpose of calculation of taxes with little modifications as follows (only significant differences are compiled):

Issue	Accounting Standard	ICDS (w.e.f. 01.04.15)
Accrual of income in respect of retention* money	AS – 7 is silent on the issue of retention money.	Contract revenue in respect of retention* money shall be recognised on the basis of percentage of completion method [POCM].
Reversal of revenue	AS-7 provides for reversal of revenue on account of uncertainty arising on realisability of contract revenue which was already recognised as income.	Where contract revenue already recognised as income is subsequently written off in the books of accounts as uncollectible, the same shall be recognised as an expense and not as an adjustment of the amount of contract revenue.
Recognition of losses (including expected losses)	When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately (irrespective of the percentage of completion of contract).	Contract costs exclude costs that relate to future activity on the contract i.e. the losses incurred shall be allowed only in proportion to the stage of completion.
Early stage of contract	Revenue should not be recognised during early stages of contract. ["Early stage" not defined in AS-7]	During the early stages of a contract, where the outcome of the contract cannot be estimated reliably, contract revenue is recognised only to the extent of costs incurred. The early stage of a contract shall not extend beyond 25 % of the stage of completion.
Recognition of incentive payments	Only when (i) contract is sufficiently advanced that it is probable that specified performance standards shall be met or exceeded; and (ii) amount of incentive payment can be measured reliably.	If the incentive payments are capable of being reliably measured, same are to be recognised as per POCM.
Recognition of claims	Only when (i) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and (ii) The amount that will be accepted by the customer can be measured reliably.	If the claims are capable of being reliably measured, same are to be recognised as per POCM.

** "Retentions" are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. [Para 2(1) of ICDS -3]*

Further, AS-9 recognises both, the *"proportionate completion method"* and *"completed service contract method"* for recognition of revenue from service transactions. As per ICDS, revenue from service transactions shall only be recognised by following the "percentage completion method". Apart from this, as far as Real estate transactions are concerned, the ICDS -4 on revenue recognition is in line with AS-9 on revenue recognition.

D.3) Impact of ICDS on settled judicial principles:

Till date, due to non recognition of ICAI Accounting Standards formally by the Income-Tax Act or CBDT, courts were applying the principles enumerated in AS for tax purposes, having regard to the facts and circumstances of each case, using their own discretion. However, due to advent of mandatory ICDS notified by CBDT, many of the settled judicial precedents (delivered on the basis of ICAI-AS) may not hold good with effect from A.Y. 2016-17. To note a few:

- Retention money could not be said to be accrued to assessee for tax purposes till completion of work/contract. [*CIT vs. P & C Constructions-318 ITR 113 (Mad.), DIT vs. Ballast Nedam Int. [2013] 215 Taxman 254 (Guj.), Amarshiv Construction vs. DCIT [2014] 223 Taxman 171 (Guj.), etc.]*
- AS-7 allows assessee to make provision for foreseeable losses and therefore, said losses provided by assessee in its books had to be allowed. *[ACIT vs. Cementation India Ltd. [2013] 146 ITD 59 (Mum.)]*
- Provision for future losses—where completed contract method of accounting is followed in relation to the projects undertaken by the assessee which is consistent with the accounting standards and these accounting standards lay down the norms indicating the particular point of time when the provision for all known liabilities and losses has to be made, such a provision appears to be justified. [*CIT vs. Triveni Engineering (2011) 336 ITR 374 (Delhi HC)], etc.*

Conclusion:

It is important to note that the income for purposes of taxation cannot be different from what is computed in accordance with the general principles of commercial accounting. Where substantial risks and reward in respect of a property sold are passed on to the buyer at pre-completion stage, revenue will have to be recognised immediately by adopting Percentage of completion method [POCM] even for tax purposes. Thus, when for example, the guidance note requires recognition of revenue by applying POCM, the same method should also be applied for the purpose of computation of taxable income. This has, in principle, also been confirmed by the new ICDS regime applicable with effect from assessment year 2016-17. However, henceforth, before relying on settled judicial principles on the subject matter, the principles set out in applicable ICDS must be applied first.■