

**DIRECT TAX ISSUES ON BUILDERS &
DEVELOPERS**
(INCLUDING ISSUES RELATED TO ACCOUNTING)

5th January, 2013

CA Satish.V. Shanbhag

Meaning of Builder, Developer & Contractor

BUILDER	DEVELOPER	CONTRACTOR
<ul style="list-style-type: none">-Builds for himself & also for others on contract.- Project known by name of the party they build for.	<ul style="list-style-type: none">-Develops a residential/commercial complex in his name on his own or through another person.- Sells the units under his banner.	<ul style="list-style-type: none">-General term for any person carrying on business under a contract.- Has a fixed price & receives payments to the extent of work completed.

REAL ESTATE DEVELOPER

□ At what stage the income be recognized in the hands of Developer?

stages

- *Pre-launch*
- *Booking of units*
- *Buyer's Agreement / Allotment Letter*
- *Handing over possession*
- *Sale Deed*

Issues Arising Out Of Accounting Standards

How the profits be computed?

1. Relevance of Accounting Standards

- *Challapalli Sugar Ltd v/s CIT 98 ITR 167 (SC)*

- *Tuticorin Alkali Chemicals & Fertilizers Ltd v/s CIT (1997)227 ITR 172 (SC)*

2. AS – 7 : Construction contracts earlier recognized 2 methods of Accounting

- *Completed Contract Method*

- *Percentage Completion Method*

Revised AS – 7 (w.e.f. 01.04.2003) is not applicable to Builders and Developers.

Department's stand on Builders/Developers

- Income accrues or arises to builder / developers out of advance payments received. (Section 5)
- Completed Contract Method (CCM) is not finding place in any AS 7 now. This method is Deliberately excluded from AS – 7 by ICAI.
- Income should be recognized on percentage completion basis. Principles of Revenue Recognition as per AS-9 are applicable.
- Profit of a construction business of a builder be determined on year to year basis. [*PM Mohammed Meerkhan v/s CIT(1969) 73 ITR 735 (SC)*]

Assessee's Arguments In Favor Of Completed Contract Method

- What if project ultimately incurs loss?
- Advance payment received by builders is mere Earnest Money/ Advances. (*CIT v/s Motilal Patel 1988 173 ITR 173 ITR 666 (Guj)*)
- Sale in case of a Builder is complete only on transferring the legal titles & possession given to the buyer.
- Income accrues or arises u/s 5 of Income Tax Act only after completion of sales transaction. (*E.D.Sassoon & Co. vs CIT(1954) 26 ITR 27 (SC)*)
- No need to change consistently followed method.

Radha swamy satsang sabha vs ITO 25 ITR 472 Alh

ICAI Guidance Note On Accounting of Real Estate Transaction (Revised 2012)

Applicability

- Applies to 'Real Estate Developers/ Property Developers' or 'Builders'.
- - Projects in real estate which have **commenced** after 1.4.2012.
- - Projects s which have **already commenced** but revenue being recognized for the first time on or after 01.04.2012.
- - Option to apply for **running projects** provided GN is applied from commencement of project

ICAI Guidance Note On Accounting of Real Estate Transaction (Revised 2012)

Principals of Guidance Note:

- Guidance Note is based on Principles of AS – 7 and AS – 9 which are in substance similar to delivery of goods.

Basis of Revenue Recognition:

Transferring significant risks and rewards of ownership to the buyer

- Legally enforceable **Agreement for sale**. (allotment letter??)
- . Revenue be recognized Even though **legal title** of the property is not transferred and **possession** is not given.
- Once seller transfers significant risks and rewards of ownership to buyer, seller thereafter acts like a contractor. Accordingly revenue recognition will have to be as in **Percentage Completion Method**. (AS – 7)

ICAI Guidance Note On Accounting of Real Estate Transaction (Revised 2012)

Events need to be completed for application of Percentage Completion Method:

❑ Critical Approvals obtained-

-Environmental clearance, plan approvals, titles to land/
Development rights, change of user.

❑ Stage of Completion

- At least 25% of total **construction and development cost** incurred. (other than land cost and borrowing cost)
- At least 25% of **Saleable area** is secured by contracts or agreements.
- At least 10% of **Revenue** as per agreement of sale realized.

Total saleable area	20,000 Sq. ft.
Estimated Project Costs (This comprises land cost of Rs. 300 lakhs and construction costs of Rs. 300 Lakhs)	Rs. 600 Lakhs
Total construction Cost incurred till end of reporting period (This includes <u>land cost</u> of Rs 300 Lakhs and <u>construction cost</u> of Rs 60 Lakhs)	Rs. 360 Lakhs
Total Area Sold till the date of reporting period	5,000 Sq. ft.
Total Sale Consideration as per Agreements of Sale executed	Rs. 200 Lakhs
Amount realised till the end of the reporting period	Rs.50 Lakhs
Percentage of completion of work	60% of total <u>project cost</u> including land cost or 20% of <u>total construction cost</u>
REVINUE RECOGNITION : cannot be made since at least 25% of total construction/dev cost not incurred, though other three criterias are complied with.	

ICAI Guidance Note ... Illustration Conti..

If the work completed till end of reporting period is (This includes land cost of Rs 300 Lakhs and construction cost of Rs 90 Lakhs)	Rs. 390 Lakhs
Percentage of completion of work would be	65% of total project cost including land cost or 30% of construction cost
The enterprise would be able to recognize revenues at the end of the accounting period. The revenue recognition and profits would be as under:	
Revenue recognized (65 % of Rs 200 Lakhs as per Agreement of Sale)	Rs. 130 Lakhs
Proportionate cost (5000 sq.ft./20,000 sq.ft.) X 390	Rs. 97.50 Lakhs
Income from the project	Rs. 32.50 Lakhs
Work in progress to be carried forward (390	Rs. 292.50 Lakhs

ICAI Guidance Note .. Profit & Loss A/c

Profit and Loss Account

To Land	300.00	By Sales	130.00
To Cost of constn/dev	<u>90.00</u>	By WIP	292.50
total	390.00		
To Gross profit	32.50		
Total	422.50	Total	422.50

Other Issues On Accounting

- Valuation of Inventories:

As per AS – 2 inventories should be valued at lower of cost and net realizable value (para 5)

- Cost of Inventories (WIP):

Cost of inventories should comprise of all cost of purchases, cost of conversion and other costs incurred to bring the inventories to their present location and condition (para 6)

Note: Valuation of WIP is important particularly on view of provision of MAT u/s 115B.

Other Issues On Accounting

Accounting of borrowing costs: (AS – 16 -Para 6)

-Borrowing costs that are directly attributable to acquisition, production and construction of a qualifying asset should be capitalized.

-**Other borrowing costs** should be recognized as *EXPENSES* in the period in which they are incurred.

Turnover for Tax Audit

- In case of a Builder T/e limit of Rs. 1 Cr is very insignificant.
- Project completion method - Whether advance payment received from prospective buyers by builder is “Gross receipt“ for the purpose of section 44AB.
- *DCIT vs Gopalkrishna Builders (91 ITD 124) ITAT Lucknow*
 - Gross receipts mentioned u/s 44AB includes money taken by the builder and shown as advance in balance sheet.
 - Gross receipts be considered for section 44AB: Advance receipts received will be considered as ‘**Gross Receipts**’ if such amounts have **profit making quality** in them.
 - If accounts are not subjected to Tax audit very objective of section 44AB will be defeated.

Turnover for Tax Audit

- Contrary Judgment by ITAT Mumbai:

M/s Siroya developers vs DCIT [ITA no 600/MUM/2010/12.01.2011]

- *ACIT vs B K Jha & Associate (Pune Branch) 69 ITD 14*

- Turnover, sales Gross Receipts are commercial terms.
- *Gross Receipts* : refer to Gross inflow of funds arising in the ordinary course of sale of goods / services to the BUYER.
- *WIP* : There is no buyer.

Two parties required for 'sale'.

There is *no profit element*.

- 'Turnover' : essentially requires *transfer of title to the*
Goods to the buyers

STATUTORY DISALLOWANCES

- **SECTION 40 A(3)**

- Stamp Duty/ Registration charges paid in cash.

Rule 6DD(b)-

In respect of payments to be made to Government, under the rules framed by it, such payments are required to be made by legal tender.

- Contravention of 40A(3) in prev.yr included in opening WIP.
- No remedy for contravention.

STATUTORY DISALLOWANCES

Explanation to Section 37-

- Payment of speed money / protection money.

Therefore for the purpose which is of offense or which is prohibited by law not allowed.

Pranav Construction Co. v/s ACIT (1998) ITAT (MUM) 61 TTJ 145.

- Section 40(a)-

Payments to Non Residents for-

-Purchase of Land

-Professional fees for Plans, Drawings, Consultancy

STATUTORY DISALLOWANCES

❑ Section 40a(ia)-

- Relief being granted to assessee after the judgement of spl bench of ITAT vishakapattanam in case of **MERILYN SHIPPING & TRANSPORT Vs ACIT.**
- Operation of this Judgment is however stayed by High Court of Andhra Pradesh on 18.10.2012.

❑ Section 43(b)-

- Payment of interest to bank.
- Employee contribution to PF/ ESIC etc. Permanently disallowable if violated.
- Work Contract Tax and Service Tax.

ISSUES ARISING DURING SURVEYS AND SEARCHES

❑ **Information on Hawala** from Sales Tax Department.

❑ **Few suggestions to Assessee:**

- Restrict declaration to current year and avoid making declaration for previous years.
- Declaration should be of quantum of income not w.r.t modus operandi.
- If declaration is in regards to expenditure recorded in the books, non availability of evidence should be admitted and not the absence thereof.
- Retraction of declaration if any be made as expeditiously as possible recording cogent reasons for the same.



DEDUCTION U/S 801B (10)

ISSUES:

- Whether amendments to restrictions on commercial Area (come to affect from AY 2005-06 & then again amended from AY 2010-11) is retrospectively applicable?

AMENDMENT- Ay 2005-06	AMENDMENT- 2010-11
5 % of aggregate built up area or 2000 sq ft whichever is LESS.	3 % of aggregate built up area or 5000 sq ft whichever is HIGHER.

Manan Corporations vs. ACIT (GUJ) 30/09/2012 - No retrospective effect.

- Whether amenities provided in large Housing projects (school, hospitals, club house) is 'commercial' for 801B (10)(d) ?
- Where parts of project is complete and completion certificate is not obtained within prescribed time, whether proportionate deduction available.

Income From Letting Out

Section 22: Conditions-

- Property consisting of any Building or land appurtenant thereto
- Assessee is owner of such property
- Such property is not used for his own business.

ISSUES:

1. Rent Received from letting out of unsold shops/flats by a Builder/Developer.

2. Whether builder is liable to pay taxes on **notional rent** in respect of flats, shops held as stock in trade.

(CIT vs. Ansal Housing Finance And Leasing Co. Ltd. Delhi High Court).

3. Business asset let out for temporary period, what would be the head of Taxability? (**dominant factor**)

Direct Tax relating to Builders & Developers

ISSUES RELATING TO PROPERTY OWNERS

Transfer of tenancy rights-

Steps involved in an tenancy transaction:

1. An Agreement between Tenant and the Developer.
2. Tenant vacates tenanted property and **surrenders possession** to developer.
3. Developer provides temporary accommodation.
4. On completion of re-development, tenant is **allocated a unit in redevelopment property.**

Transfer of Tenancy Rights

- Issue 1-

What is the date of transfer of tenancy rights?

- Date of surrender of possession or
- Date of Allotment of Re-developed property

Caution- (Dept's arguments)

Section 2(47)(v)/(vi) *Chaturbuj Dwarkadas Kapadia 260 ITR 49*
Bombay high court held that mere enabling enjoyment of property constitutes 'transfer'. Therefore 'Transfer of Tenancy Rights' happens on handing over possession to developer.

Argument-

Section 2(47)(v)(vi) applies to immovable property and not to Tenancy Rights.

Transfer of tenancy rights-

● Issue 2-

Where Assessee gets a residential unit in lie of surrender of Tenancy right, whether he can take reinvestment benefit?

*(Tenancy Right is a capital asset (55(2)). Benefit of Reinvestment u/s 54F is available subject to conditions . **Bava Shivcharan Singh(149 ITR 29 Del)***

Even 54EC can be claimed if you have received consideration for transfer of tenancy rights.)

Issue 3-

Assessee is given a **shop** against surrender of tenancy rights in an old tenanted **residential** building.

(Benefit of sec 54F available only in respect of investment in Residential house and not in shop)

Land converted into plots and sold

- **Facts-**

Large plot of land is converted into several small plots in an organized manner and sold to various buyers after obtaining permission for subdivision from local authority.

- **Departments view-**

- This is an **adventure in the nature of trade**. Entire gain (sales realization minus cost of land plus expenses) is business income. *Raja J Rajeshwar Rao v/s CIT (1961) 42 ITR 171.(SC)*
- It's a case of **conversion of land into stock-in-trade**
u/s 45(2).

Land converted into plots and sold

Assessee's Stand-

- Subdivision of land and its subsequent sale cannot always be presumed to be in nature of business. —

Subdivision of the plots to secure better price

(Janki Ram Bahadur Ram V/s CIT 131 Taxman 823 (All)(2003))

Huge area of land cannot be sold as on units. (259 ITR 671 (p&H))

- Other issues to argue:

Intention on of party in purchasing property -Length of holding -
Assessee's conduct -Subsequent dealings of the assesses.

- -Assessee may agree to application of section 45(2).

SALE OF BUNGLOW TO BUILDER

➤ Consequences of owner demolishing the bungalow and selling land

- Benefit of 54 is lost
- Benefit of 54 F can be claimed

Net consideration be invested.

Not to have more than one house other than the new asset.

Other Restrictions on Transfer.

➤ If the developer gives constructed units in lieu of bungalow .

Market value thereof is the consideration

TAXATION : **DEVELOPMENT AGREEMENTS**

POINT OF ACtual OF INCOME TO LAND OWNER.

- Date of Execution of Development Agreement?
- Date of Handing over the possession of land to the developer?
- Date of Handing over the possession of land to the developer together with a GPA property authorizing him to transfer his share of property?

Development Agreements: Point of accrual of income.

- **Date of Execution of of Development Agreement?**

Mere execution of Development Agreement would not satisfy the provisions of sec 2(47) (v) together with provisions of sec 53A of TOPA.

2(47)(v): any transaction involving the possession of an immovable property to be taken or retained in part performance of a contract referred to in section 53A of Transfer of Property Act, 1882.

Caution: Judgement Bombay HC in case of Chaturbhuji Dwarkadas Kapadia Vs CIT 260ITR 491 2003. (powers given to deal with the property, 2(47)(v)invoked)

Development Agreements(DA):

Point of accrual of income.

Date of Handing over the possession of land to the developer?

- ❑ Strictly speaking, this would satisfy requirements of sec 2(47)(v), unless DA specifically contains a clause that:
“possession will remain with the owner till obligations undertaken by the Developer under DA are completed and that he would be permitted to enter the land only as a LICENCEE for the limited purpose of carrying on construction.”
- ❑ Conditions of sec 53A of Transfer of Property Act.
 - i) Transferee has taken *possession*
 - ii) Transferee is *willing to perform* his part of the contract
- ❑ *Mere licence to enter upon the land is different from possession since it does not confer any right of enjoyment of property (Ramnord Research Lab305ITR 299 Bom2008*

Development Agreements(DA): Point of accrual of income.

Date of Handing over the possession of land to the developer together with a GPA property authorizing him to transfer his share of property?

Contradictory Situation:

- A GPA is given to Developer to sell his share of built up area.
- The Agreement also carries a clause that till Land Owner gets his share of built up area, there is no transfer.

Transfer takes place on the date of handing over the possession of land.

Development Agreements(DA)

Jasbir Singh Sarkaria (2007) 294 ITR 196

- *“Capital Gains arise to the land owner when irrevocable GPA is given in favor of Developer”*
- Land owners are put in great difficulty by this decision as they will have to pay the capital gains even before any construction takes place.

➤ Applicability of Sec 50 C

“ subject matter of Development Agreement being undivided share in the land, 50C is applicable “

Ashok Leyland Finance (230 ITR 398) Madras HC.

Joint Development Agreement & Deduction U/s 54.

CIT v K.G. Rukminamma (2010) 48 DTR 377 (K ar).

- Assessee entered in joint development agreement with developer.
- Assessee share –48 % Built up area –represented by four flats
- Developer share –52 % Built up area.
- Full value of Consideration -Consideration for selling 52% of site was four residential flats representing 48%.
- Applicability of S. 54 -Four residential flats acquired by assessee could not be construed as four residential houses but only as **‘a residential house’** for the purpose of section 54 in respect of entire value of four flats.

Recap

- Project completion/Percentage completion Methods
- ICAI guidelines(Revised 2012)
- Valuation of inventories/WIP/115JB
- Turnover for Tax Audit
- Statutory Disallowances 40A(3)/40(a)/40(a)(ia)/43B
- Issues relating to surveys
- Deductions U/s 80(IB) (10)
- Income from Letting out
- Transfer of Tenancy Rights
- Land converted into plots and sold
- Sale of Bungalow to Builder
- Development Agreements and Joint Development Agreements

Any Questions ??

THANK YOU !