Taxation of Real Estate and Construction Business

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Historical Perspective

- Real Estate Business has its origin ever since man set his foot on earth with all his conscience and intelligence. Ownership is the key to possessing an asset, real estate is no exception.

Historical Perspective

- Difficulties in determination of income due to factors such as market value, guideline value and real value passed on to the seller has made whole business look murky.
- Let's spend some time in understanding the accounting and taxation issues concerning real estate under Indian conditions

Accounting treatment and policies

- The I C A I has prescribed various guidance and standards for income recognition, expenditure accounting, inventory valuation etc.
- Standards 2,7 and 9 are discussed here as it has great relevance for the subject.

Accounting Standard (AS) 7 (revised)

- Accounting Standard (AS) 7 on Construction Contracts (revised 2002) has come into effect 1-4-2003.
- It is the gospel for those realtors constructing and selling properties.

AS 7 contd…

- **Fixed price** or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses (or)
- **Cost plus contract** in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

AS 7 contd…

- **Contract revenue:** It should comprise the initial amount of revenue agreed in the contract and variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and are capable of being reliably measured

AS 7 contd….

- **Contract Costs:** It should comprise costs that relate directly to the specific contract costs that are attributable to contract activity in general and can be allocated to the contract; and such other costs as are specifically chargeable to the customer under the terms of the contract.

Recognition of Contract Revenue and Expenses

- **Fixed price contract:**

  When the contract revenue and cost can be estimated reliably and the **stage of contract completion** at the reporting date can be measured reliably.

Recognition of Contract Revenue and Expenses

- **Cost plus contract**: Where the outcome of a construction contract can be estimated reliably and the probable economic benefits associated with the contract will flow to the enterprise

Recognition of Contract Revenue

- **Percentage of completion method: R**evenue is matched with the contract costs incurred in reaching the stage of completion and the profit is attributed to the **proportion of work completed**. This method provides useful information on the extent of contract activity and performance during a period.

Recognition of Contract Revenue

- When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

Disclosures

- An enterprise should disclose
- (a) the amount of contract revenue recognized in the period;
- (b) the methods used to determine the contract revenue;
- (c) the methods used to determine the stage of completion of contracts in progress;
- (d) the aggregate amount of costs incurred and recognized profits (less recognized losses),
- (e) the amount of advances received and the amount of retentions.

A S 9 Revenue Recognition

- Standard (as is the case of other accounting standards) assumes that the three fundamental accounting assumptions i.e., going concern, consistency and accrual have been followed in the preparation and presentation of financial statements.

AS 2 Valuation of Inventories

- Work in progress arising under construction contracts,…… shall be measured at net realizable value in accordance with well established practices in those industries.

Taxation Aspects of Real Estate & Construction

- Section 145 of the Income Tax Act do not include any standard on construction contracts.

- Hence, its possible that non-corporate entities may decide to adopt the completed contract method as its method of accounting. **(*Madhuvan House Building Co-operative Society Vs. Asst. Commissioner of IT (202) 76 TTJ (Bang)*** *propounds the view that in contracts running to several years the completed contract method is preferable)*

Taxation issues contd…

- Section 44AD of the IT Act prescribes taxing of civil construction @ 8% of the gross turnover, subject to the satisfaction of other conditions.
- The Section can be resorted to for contracts involving construction of Buildings, bridges, dams or other structure or any other structure or of any canal or road, electrical fitting, plumbing, land filling, land scaping work etc. (Circular 684 dt.10th June 1994).

Taxation issues contd…

Applicability	Civil Construction Contractors whose turnover does not exceed Rs.40 Lakhs
Minimum amount of presumptive income	8% or more of gross turnover or gross receipts
Allowability of depreciation in case of subsequent previous year	WDV of the assets shall be computed as if depreciation is deemed to have been allowed in earlier years.
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Taxation issues contd…

Consideration of turnover for Compulsory audit u/s 44AB	Shall not be considered if the assessee opts for section 44AD / AE / AF
Option for lesser amount of Income	Books of accounts to be maintained u/s 44AA and Audit u/s 44AB has to be fulfilled.
Computation of presumptive income in case the assessee is a firm.	Compute presumptive income as above Less interest, salary and remuneration to partners. The balance is chargeable to tax.

Taxation issues contd…

Benefit of Chapter VIA and Chapter VIII	Deduction u/s 80C to 80U [and Prior to Ay 2006-07 rebate u/s 88, 88B, 88C] shall be available to the assessee.
The material supplied by the contractee at fixed cost to the civil construction contractor shall not be included in the gross receipts of turnover u/s 44 AD.	Briji Bhusan Lal Parduman Kumar 115 ITR 524 (SC)

Assessment of residential property

- The investment in a house, should be out of taxed income or explainable source of funds like bank loans, advances, etc. The sources of investment have to be explained and that part which cannot be satisfactorily explained, is treated as income and taxed.
- In many a case, the actual area constructed is in variance to the sanctioned plan. The tax department is concerned with the actual area constructed and not the sanctioned area.
- Normally housing loans are taken for the investment. Care needed to take loans by Account Payee Cheque.
- The borrower, is prohibited either to accept or repay in cash. This prohibition also applies to deposits (exceeding Rs 20,000) like rental and mortgage deposits.

Assessment of residential property

- Loans taken should be confirmed by the lenders in writing. Else, the amounts borrowed are considered as the income of the investor and taxed. It is advisable to borrow from reputed and sound sources. In case of relatives and friends, make sure that they are of sound financial background and assessed to income tax.
- The tax department needs to be satisfied about the extent of investment, especially, in case of construction. The cost of construction can be referred to Departmental Engineers.
- Valuation is an estimate based on some accepted base assumption. It cannot be actual. Thus, it normally varies from actual expenses. Variance up to 15% is normally an acceptable range. Beyond this, the difference is treated as income of the investor.
- Maintain proper and correct records and documents of the cost, like material bills/ vouchers, labour vouchers, contractors agreement, bills & receipts, etc.;
- To the extent possible, issue cheque for all payments. Wherever cash is paid maintain a trail with corroborating drawings from bank. When records are maintained, normally, the cost or investment is accepted.

Tax Holiday under Section 80IB(10) of the I T Act.

- A significant measure by the government for boosting the housing industry, particularly for the low income group people is the provision of S. 80-IB(10) .
- The provision since its inception has undergone amendments, the latest being through the Finance Act, 2004.
- As it is provides 100% tax exemption by way of deduction in respect of the profit of an undertaking developing and building housing projects, subject to the condition that the project should be on the area of the plot of land which has a minimum area of one acre.

Tax Holiday under Section 80IB(10) of the I T Act.

- The maximum built-up area of the residential unit is 1,000 sq.ft., where such residential unit is situated within the cities of Delhi or Mumbai or within 25 kms; from the municipal limits thereof and 1500 sq.ft.; at any other place.
- Provision for shops and other commercial establishments should be limited to 5% of the aggregate built-up area of the project or 2,000 sq.ft., whichever is less.

Housing Project-Some issues

- Application of the provision reveals that those recognizing the profit on project completion basis will have the benefit in the year of substantial completion.
- That recognizing profit year to year on the basis of bookings or any other basis will not give significant benefit.

Housing Project-Some issues

- Three factors governing the applicability of the provision are

(i) Approval of the project from concerned local authority

(ii) Commencement of construction and

(iii) Completion of project.

Housing Project-Some issues

- Finance Act, 2004 has imposed condition that the work of development and construction is completed within 4 years from the end of the financial year in which the approval was obtained or before 1-4-2008, whichever is later.
- The date of completion will be the date when a completion certificate is granted by the local authority.
- This significantly restricts the freedom to choose the taxable year for profit from such projects and may even conflict with the Accounting Standard which permits profit recognition from year to year.

Some issues affecting the 100% exemptions

- The area of the plot under development should be of minimum one acre. Development of existing project in remaining area with approval after 1.10.1998 may not be eligible.
- It is arguable case as the total plot area under development is more than one acre but developed in different times. (Clarification issued by CBDT vide ltr. dt. 4/5/01 to M C C I).
- If a developer purchases or acquires adjacent 4-5 plots, aggregating more than one acre, deduction may be available in respect of the same.

Some issues affecting the 100% exemptions

- Housing project need not mean “it should” be the “exclusive project”. It may so happen that the Assessee may have on the same plot of eligible and ineligible projects, however, deduction would be restricted to the profits of eligible projects if the conditions prescribed are satisfied, though the department has differed on this view.

- Built up area means inner measurements of residential units at the floor level, including projections and balconies as increased by thickness of the walls but does not include common areas shared with other residential units.

- The area of the shops and commercial establishments should not be more than 5% or 2,000 sq.ft whichever is lower. Question arises as to whether amenity is provided to the large housing projects like school, colleges, hospitals, club houses etc., are to be included or not.

Some issues affecting the 100% exemptions

- Method to be followed:
- Since the deduction is available on complying with the conditions prescribed in the section, does it mean only Completion Method is to be followed?
- It is felt that percentage Completion Method could also be followed but if the conditions are not satisfied later on, deduction granted earlier may be withdrawn?

Sec.80-IB(10) Vs. sec.115JB

- Even though profit from the development of the project is exempt from tax, while calculating the book profit for MAT as per 115JB, the same will not be reduced from the book profit.

Decided Case Laws – so far..

- Proportionate Deduction: ACIT v. Bengal Ambuja Housing Development Ltd. ITA No. 1735/Kol./2005 (Cross appeal ITA No. 1595/Kol./2005)

- Proportionate Deduction between residential and commercial areas - Arun Excello Foundations (P) Lts Vs. Asst. Commissioner of Income Tax (ITA Nos. 2090 and 2091/Mad/2006)

Decided Case Laws – so far..

- Assessee need not be the owner of the land - Radhe Developers v. ITO ITA No. 2482/Ahd./2006

- Distance of 25 kms from the municipal limit to be by road and not be “ as the crow flies” - Laukik Developers v. DCIT ITA Nos. 532/Mum./2006
- If the Local authority has approved as housing project, the commercial area clause need not be insisted - Brahma Associates vs. JCIT

Decided Case Laws – so far..

- Incurring some expense on a project prior to approval need not dis-entitle deduction - ITO, 14(3)(3) v. Shri Vimalchand M. Dhoka ITA No. 5520/Mum./2005
- Filing revised return removing the deduction does not entail penalty - Telebuild Construction (P.) Ltd. *v.* Assistant Commissioner of Income-tax (9)(3) IT Appeal NO. 1164 (Mum.) of 2006
- No definition for "Housing Project" in Sec 80-IB(10), then fall back on 80-HHBA - Vandana Properties v. ACIT, ITA NO. 1253(MUM) of 2007

Thank you

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- Wish you all professionally satisfying year ahead.