I.R. 118/VI

MINISTRY OF FINANCE
DEPARTMENT OF INLAND REVENUE
NICOSIA

Circular No.: 1987/21
Income Tax: 1987/20

23rd July, 1987.

To All Assessing Staff,

Real Estate Developers & Contractors:-
Timing of profit recognition for tax purposes
Computation of taxable profit
Computation of Expenditure for Capital Allowances

---- I enclose detailed instructions on the above subject with effect as from:-

(i) 1.1.1988 for contracts starting thereafter

(ii) 1.1.1989 for accounts submitted thereafter in respect of previous years

Accounts in respect of existing contracts submitted by 31.12.1988 can be on the basis of previous practice provided that if the percentage of completion method was used, it will not be changed to the substantially completed method.

Make sure that all additional information set out in Appendices A1-A4 is submitted with the accounts in time.

Acting Director
of the Department of Inland Revenue.

Copy to: All Authorised Accountants (E.A.E. 1987/2)

I.R. 151/II

AG/AP

I.R.151
REAL ESTATE DEVELOPERS AND CONTRACTORS
"TIMING OF PROFIT RECOGNITION FOR TAX PURPOSES"
"COMPUTATION OF TAXABLE PROFIT"
"COMPUTATION OF EXPENDITURE FOR CAPITAL AL'CES"

Three cases of projects distinguished:-
1. Land Development (separation and sale of sites).
2. Fixed Price Contracts (Construction of flats/offices/shops undertaken on account of third parties).
3. Development Projects (construction and sale of flats/shoos/offices).

The method of accounting for the above projects for tax purposes is the following:

1. LAND DEVELOPMENT

Revenue is recognised as soon as sales of sites begin provided application for the securing of separation permit has been submitted and the separation (parcellation) of sites is in progress. Profit in respect of sites sold is recognised as far as, cash is received. If the separation is done in phases, each phase should be treated separately. The cost of the project comprising of land cost and separation expenses is allocated to the sites on the basis of selling prices.

$$\text{Total cost per site} = (\text{Land Cost} + \text{Separation Exp.}) \times \frac{\text{Est. Sel. Price of Site}}{\text{Total Estimated Sales.}}$$

Profit is recognised as far as cash is received.

$$\text{Recognised Profit} = \text{profit of site} \times \frac{\text{Cash receipts in respect of site}}{\text{Actual Selling price of site}}$$

Cash receipts are to be kept cumulatively and profit recognised in previous years is to be deducted from profit to be recognised in current year.

When separation of the sites is completed, any unsold sites will be allocated a final cost figure as per the cost per site formula and on sale the profit will be calculated by merely deducting from the actual selling price that cost.

Definitions:

(i) Land Cost includes the purchase price of the land, L.R.O. transfer fees, legal fees and commissions if any. If the land was acquired by inheritance or for reasons other than trading in the case of a developer (therefore not included in trading stock so far) then land cost is the market value at the time that intention to trade with the land is first shown.

(ii) Estimated Selling Prices are the prices known at the time of the submission of the first accounts that include the project i.e. they are the actual prices of the sites sold by the time of the submission of the accounts and the estimated prices of the sites not sold on the basis of the prices of the sites sold.

(iii) Separation expenses include all the expenses incurred due to the separation such as water reservoirs, pipelining, excavation of ditches, electricity supply, roads etc. Separation expenses are initially included in the calculations as per developer's estimates and on completion of separation the actual expenses are apportioned to the sites.

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(iv) Final cost of sites: On completion of separation all actual expenses are apportioned to the sites on the basis of known and estimated selling prices. This cost figure is not subject to revision, it is fixed and whenever the site is sold and at whatever price, to find the profit one simply deducts from the price, this cost.

For additional information to be provided in respect of each project separately with the submission of accounts of land developers see Appendix A(1). It is emphasised that both the accounts and the information must be kept separately for each project. For example see Appendix B (1).

2. <u>Fixed Price Contracts (Construction of flats/offices /shops undertaken on account of third party).</u>

<u>Timing of profit recognition:</u>
Taxpayer can choose between the following two methods but his option is exercised once for all contracts.

a) The substantially completed method:-
profit is recognised in the year that work certified reaches 90% of the total contract price (including agreed extras). All profit is assessed to tax in that year irrespective of actual cash receipts to that date.
The provisional tax provisions for the imposition of 10% additional tax due to low computation will apply to that year's profits only

(b) The percentage of completion method:-
The profit is recognised right from the start of the project but in any case as soon as work executed exceeds 50% of the contract price plus agreed extras. Chargeable profit is calculated on the basis of cash received and provisional tax provisions apply as soon as 50% of the contract is completed.

<u>Profit Computation</u>
<u>method (a)</u>
i) <u>Project in progress</u>

Work Certified to date > 90% Total Contract Price		X
Contract Price	X	
Less: Actuall expenditure to date Estimated expenditure to completion	X	X
		X
Estimated Contract Profit		

Profit to Present Stage= Contract Profit x $\frac{\text{Work Certified}}{\text{Contract Price}}$

Profit for year X = Profit up to year X - profit up to year (X-1)

Definitions:

(i) Total contract revenue is the contract price agreed and any extras agreed later and supported by documentary evidence.

(ii) Work executed to the reporting date is the work performed as per the certificates of independent body of architects or civil engineers (excluding of course materials on site). In case no certificate was issued by the architects/engineers due to a dispute, the claim submitted by the contractor to be accepted.

(iii) Expenditure is the cost attributable to the contract as per auditor's detailed analysis. These costs relate either directly to a specific contract e.g. materials, or to the contract activity in general and can be allocated to specific contracts, e.g. design construction overheads. Note that costs that relate to the contract activity but cannot be related to specific contracts e.g. general administration and selling costs, finance costs, are excluded from the accumulated contract costs and are written off in the P & L a/c in the year they incur. Any subcontract expenses not yet finalised between contractor and sub-contractor can be deducted provided these are supported by documentary evidence and a full analysis of the expenditure is submitted.

(iv) Cash receipts as per auditor's account for the project

(v) Where a project is undertaken in phases, each phase is considered separately for profit recognition puproses and 50% completed contract is to mean 50% completed phase and the costs are kept separately for each phase.

(vi) Claims in dispute, supported by documentary evidence are to be included in the profits of the year of their settlement.

Additional information to be submitted as per Appendix A(2) and Example provided in Appendix B(2).

3. Development projects (construction and sale of flats/shops/offices)

Timing of profit recognition

Taxpayer can choose once and for all projects between the substantially completed method and the percentage of completion method as described under fixed price contracts.

Profit Computation

Estimated sales		X
Less:	Land Cost	(X)
	Estimated Construction Cost	(X)
Estimated project profit		X

$$\text{Estimated profit margin} = \frac{\text{Profit}}{\text{Est. Sales}} \times 100 = P\%$$

On sale of flat/shop/office:-

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Estimated profit= Selling Price x P%.
If method (a) is adopted test:-
Construction Cost to date > 90% Budgeted Construction Cost
or Work Certified > 90% Contract Price if,developer is not the contractor himself and assess on Estimated Profit as calculated above.

If method (b) is adopted test:-
Construction Cost to date > 50% Budgeted Construction Cost
or Work Certified > 50% Contract price and assess on Estimated Profit on cash received basis.

$$\text{Taxable Profit} = \text{Estimated Profit} \times \frac{\text{Cash Receipts}}{\text{Selling Price.}}$$

The above profit computations assume that land was purchased. If land was acquired in exchange for the erection of flats/shops /offices,estimated sales do not include flats/shops/offices to be transferred to landowner, nor does land cost be included in the calculations.

On completion of the project

Actual sales and construction cost are known and the above calculations are carried out again with actual figures to arrive at final profit. Actual figures are compared with estimated figures for provisional tax purposes.
The method followed (a) or (b),determines the years for which additional tax can be imposed due to low computations.
Note, that any unsold shops/flats/offices enter the calculations at estimated selling prices as at the time of completion of the project.
Also note that any flats/offices/shops that are transferred to the land owner in exchange for the land, are not taken into consideration either as sales or as cost, construction cost being reduced by cost of land to take such shops/flats/offices into account.

Unsold shops/offices/flats on completion of the project are attributed their cost for future profit calculations when their sale is effected.
Cost of unsold shop/flat/office= Est.Sel.Price (1 - P%).
On sale,Profit = Actual Sel.Price - Cost

Definitions

(i) Total Estimated Cost of construction is either the agreed price between contractor and developer, if the developer is not the contractor himself plus any extras documented, or the total cost as estimated by the developer if he is undertaking the construction himself. The total cost is estimated at the time of the submission of the accounts on the basis of the expenditure incurred for the proportion of the work already carried out. Should any part of the project be transferred to the owner of land in exchange for the land, its cost should be excluded from the project's construction cost. Such cost is equal to the cost of the land to the developer.

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(ii) Where a project is undertaken in phases, for profit recognition purposes, each phase is to be considered separately, Swimming pools, tennis courts, parking spaces, costs for the whole project must be allocated to the phases on the basis of the area of each phase.

(iii) Claims in dispute, supported by documentary evidence are to be included in the profits of the year of their settlement.

For additional information to be submitted with the accounts see Appendix A(3) and for an Example see Appendix B(3).

CAPITAL ALLOWANCES

For the buyer

On completion of the project each shop/flat/office will be allocated with its construction cost on the basis of its area and weight factor as per the architects or civil engineers of the project. For capital allowance purposes an element of the profit, corresponding to the construction, should be added to that construction cost. The profit element can be calculated as follows:

Actual Sales and Estimated Sales on completion	X
Less: Land valued at outset of project	(X)
Actual construction expenditure	(X)
Project Profit	X

$$\text{Profit to Cost} = \frac{\text{Profit} \times 100}{\text{Land Value + Construction Cost}}$$

Expenditure for Cap.Al'ces = (1 + % Profit) Construction Cost.

For land owner

As per value of land less any cash received or plus any cash paid to the developer. This total to be allocated to the shops/flats/offices on the basis of their area and the relevant weight factors.

For developer

Only on construction cost, no element of profit to be added.
For Additional Information and Example see Appendices A(4) and B(4) respectively.

The provisions of this Circular have effect as follows:
i) Contracts starting after 1.1.88
ii) Accounts in respect of any year submitted after 31.12.88

Accounts in respect of existing contracts submitted by 31.12.88 can be on the basis of the previous practice (either the percentage of completion method or the substantially completed method). However, no change of the basis of profit recognition to the substantially completed method will be allowed for contracts that accounts have already been submitted on the percentage of completion method.

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Appendix A(1)
Information

Land Development Projects

a) Land /site

i) Registration no: sheet plan no:
location: area:

ii) Date of acquisition

iii)Purchase price

iv) Name & address of previous owner if he has any connection,direct or indirect with present owner.

v) If for cost calculations the value of land considered was other than the purchase price include a copy of the estimate and the data on which it was based.

vi) Copy of the Land Purchase Agreement.

b) Details of sites
Attach Site Plan & Separation Plan (as per separation permit) . Also attach Published Price List of Sites.

c) Separation costs
i)Estimated separation expenses (at the time of the submission of the accounts,therefore if actual expenses are known by then include the actual).
ii)Yearly statement of Separation Costs as per Books of Account.

	From Previous Year	Current Year	Cumulative
1.Materials			
2.Labour			
*3.Professional fees			
*4.Subcontracts			
5.Other Expenses			

* Details of Names,identity card numbers, addresses,amounts paid, to be given.

iii)Revised Separation Expenses (if necessary).

d) Land Cost & Separation Expenses for each site

Site	Estimated Selling	Land Cost	Separation Expenses Est. Revised Actual	Total Cost

(e)Details of Sales

Site	Actual Selling Price	Cumulative Cash Receipt Net of Interest	Yearly Interest Paid

f) <u>Details of Buyers</u>
i) Name, identity card no, address.
ii) Site No. & Price

g) Computation of profit at the end of each year for each project separately.

Information (a)-(c)(i)	Submitted only in the first year of the accounts
c(ii)-(c)(iii)	Submitted whenever necessary until separation finalised.
(d)	Submitted in the first year and whenever separation costs are revised and on completion of the separation for Actual separation expenses.
(e) - (g)	Submitted every year until all revenue for sites sold is received.
(f)	Submitted in year of sale.

Appendix A(2)

Information

Fixed Price Contracts

a) (i) Client:

Name, identity card no/registration no. if company, full address.

(ii) Land site:

Registration No.: Sheet Plan No.:
Location: Area:

b) Description of Structure

Basement/ Floor	Parking Space/ Storeromm/shop with or without mezzarine/Office/ Flat	**Area**	**Weight** Factor	**Specific Extras**

(c) Contract Price

i) Initial Contract Price: Copy of the contract to be attached.
ii) Revised Price supported by documents for extras

(d) Cost of construction as per Books of Account

	From previous years	Current year	Cumulative
1. Materials			
2. Labour			
*3. Professional Fees			
*4. Sub-contracts			
5. Other expenses			

***** Details of names, identity card no., full address & amounts paid to be given.

(e) Estimated Cost to Compistion of Contract

1. Materials
2. Labour
3. Professional Fees
4. Sub-contracts
5. Other expenses

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(f) Work Certified

Attach Architects' or Civil Engineers' Certificate showing work performed during the year and authorised payments.

(g) Computation of profit for each project separately

Information	(a)- c(i)	submitted in the first year.
	c(ii)	whenever extras are agreed
	(d)- (f)	every year until completion of project
	(g)	every year until final payment.

Appendix A(3)
Information.

Development projects

a) Land /site

i) Registration No: Sheet/Plan No:
Location: Area:

ii) Date of Acquisition.
iii) Method of Acquisition
iv) Purchase price:
v) Name, identity card no., address of previous owner and the connection direct or indirect, if any, with present owner.
vi) If for cost calculations the value of land considered was other than the purchase price, include copy of the estimate and the data on which the Market Value was based.
vii) Copy of the agreement for the purchase of land, if applicable.

b) Cost of project
Estimated Cost of Construction as per Budget at the start of the project or in the case of contractor being other than the developer, the agreed contract price, copy of the agreement to be attached.

c) Progress of Project
i) As per work certified if contractor is other than developer.
ii) As per actual cost to the date as per the Books of Account if contractor and developer are one and the same.

	From Previous Year	Current Year	Cumulative
1. Materials			
2. Labour			
*3. Professional Fees			
*4. Subcontractors			
5. Other expenses			

* Names, identity card no, addresses & amounts paid to be included.

(d) Description of Structure & Cost of Construction per shop/flat/office.

asement / Floor	Parking spaces & storerooms/shops with or without mez/ flats/offices	Area	Weight factor as per Civil Eng.	Actual Cost of Construction

Note: In cases that payment to land owners comprises of flats/shops/offices, the cost of construction to be allocated to these flats/offices/shops must be the cost of land and only the remaining cost of construction should be alloated to the other shops/flats/offices. The same basis of construction cost allocation to be used for land owners' flats/offices/shops & developers' flats/offices/shops. Indicate which shops/flats/offices are to be transferred to land owner.

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e) Estimated Sales & Land Cost per shop/flat/office.

Shop/Office/Flat/	Estimated Selling Price	Land Cost

Do not include shops/flats/offices to be transferred to the land owner in lieu of payment for the land.

(f) Details of sales

Shop/Flat/Office	Actual Selling Price	Cummulative Cash Receipts Net of Interest.	Yearly Interest Paid

(g) Details of buyers

i) Name, identity card no, address.

ii) Shop/flat/office no.sold & price

iii) Relationship of buyer to developer if any

(h) Computation of profit by project

(i) Computation of Expenditure for Capital Al'ces

See Appendix A(4).

Information (a) -(b) submitted only in the first year.
(c) every year until completion of project
(d) &(e) On completion of project.
(f) &(h) every year until all revenue is received.
(g) whenever sale is effected.
(h) on completion of project.

Appendix A(4)
Information

Capital Allowances

On completion of a project the developer should provide the following information:

Total sales (including estimates for unsold ones)	x
Less: Actual Construction Cost	(x)
Market value of land at outset of project	(x)
Profit	P

Profit/Total Cost.................................... % Profit

Shop/Flat/ Office (For sale)	Area	Weight Factor	Construction Cost	(1+ % Profit) Constr. Cost

Shops/Flats/Offices to land owner	Area	Weight Factor	Construction Costs= Land Cost to Developer

Shops/Flats/Offices kept by developer	Area	Weight Factor	Construction Cost

Appendix B(1)
Examples

Land Development

Land cost= £40,000
Separation Expenses (estimated) = 15,000
Actual Separation Expenses
at the end of 2nd year= 20,000

Site	Est.Sell.Price	Actual Sell.Price	Cash Receipts Year 1	Cash Receipts Year 2
1	9,000	9,000	4,500	2,000
2	9,000	9,000	4,500	3,000
3	10,000	--	--	--
4	10,000	10,000	5,000	2,500
5	12,000	--	--	--
6	12,000	--	--	--
7	8,000	9,000	--	4,500
8	8,000	9,000	--	3,000
9	10,000	11,000	--	5,000
10	12,000	--	--	--
	100,000			

Year 1

$$\text{Est.Cost Site 1} = (40,000 + 15,000) \times \frac{9,000}{100,000} = 4,950$$

Profit Site 1 = 9,000 - 4,950 = 4,050

$$\text{Recognised Profit Site 1} = 4,050 \times \frac{4,500}{9,000} = 2,025$$

Likewise calculations carried out for Site 2 and 4 and the total profit assessed in year 1.

Year 2.

$$\text{Est.Cost Site 1} = (40,000 + 20,000) \times \frac{9,000}{100,000} = 5,400$$

Profit Site 1 = 9,000 - 5,400 = 3,600

$$\text{Recognised Profit Side 1} = 3,600 \times \frac{6,500}{9,000} = 2,600$$

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Appendix B(1)

Profit already recognised in Year 1 = 2,025
Year 2 Site 1 Profit Rec. = 2,600-2,025
= 575

Same calculations carried out for Site 2 & 4 and Sites 7,8, & 9, sold in Year 2.

Appendix B2
Example

Fixed Price Contract

Contract Price and Extras Agreed	= 500,000
Work Certified	= 300,000
Cost Attributable to Contract	= 250,000
Estimated Cost to Completion	= 150,000
Cash received to reporting date	= 200,000

Method (a) Substantially Completed Method.

Contract Expenditure to date	= 250,000
Est.Cost to Completion	= 150,000
Total Contract Expenditure	400,000

$$\frac{\text{Work Certified}}{\text{Contract Price Extras}} \times 100 = \frac{300,000}{500,000} \times 100 = 60.0\%$$

Therefore no profit recognised at this stage.

Method (b) Percentage of Completion Method

$$\frac{\text{Work Certified}}{\text{Contract Price}} \times 100 = \frac{300,000}{500,000} \times 100 = 60\%$$

Therefore profit is assessed to tax as follows:-

Contract Profit=500,000 - (250,000 + 150,000) = 100,000

$$\text{Profit to this date} = 100,000 \times \frac{300,000}{500,000} = 60,000$$

$$\text{Taxable profit} = \frac{60,000 \times 200,000}{300,000} = 40,000$$

Appendix B(3)
Example

DEVELOPMENT PROJECTS

YEAR 1

	Est.Sales	Actual Sales	Cash Receipts
Shop 1	30,000	30,000	15,000
" 2	20,000		
Flat 1	35,000	35,000	20,000
Flat 2	35,000		
Flat 3	35,000		
Flat 4	45,000		
	200,000	65,000	35,000

YEAR 2

	Actual Sales		Cum.Cash Receipts
Shop 1	30,000)		30,000
" 2	25,000)		25,000
Flat 1	35,000)		30,000
" 2	35,000)	£160,000	30,000
" 3	35,000)		30,000
" 4	50,000*)		-
	210,000		145,000

* Flat 4 was not sold, price estimated at £50,000

<u>Year 1:</u> Estimated Sales 200,000
Less: Est.Construction Cost 100,000
Land Cost 50,000

Estimated project profit 50,000

$$\text{Est.profit margin} = \frac{50,000}{200,000} \times 100 = 25\%$$

<u>Stage of project year 1</u>
Construction Cost to date = £70,000

$$\frac{\text{Construction Cost to date}}{\text{Est.Construction Cost}} \times 100 = \frac{70,000 \times 100}{100,000} = 70\%$$

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Appendix B(3)

Profit of Year 1 is taxable only under method (b) as follows:

$$25\% \times \frac{\text{Actual Sales} \times \text{Cash Receipts}}{\text{Actual Sales}} = 25\% \times \text{Cash Receipts}$$

$$= 25\% \times 35{,}000$$
$$= 8{,}750$$

Year 2: project completed

	Sales	210,000
Less:	Final Construction Cost	90,000
	Land Cost	50,000
	Project Profit	70,000

$$\text{Profit margin } \frac{70{,}000}{210{,}000} \times 100 = 33.3\%$$

Sales= £160,000

Cash receipts for the year =145,000 -35,000 =110,000

Taxable Profit under method (b)= 110,000 x 33.3% = 36,667

Taxable Profit under method (a) = 33.3% x actual sales
= 33.3% x 160,000
=£53,333

Year 1 method (b) revised as per final profit

Taxable profit = 33.3% x 35,000
= 11,667

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Appendix B(4)
Example

Total Sales	210,000
Actual Construction Cost	90,000
Value of land at outset of project	60,000
Profit	60,000

$$\text{Profit/ Cost} = \frac{60{,}000 \times 100}{150{,}000} = 40\%$$

Shop/Flat	Area	Weight Factor	Construction Cost	Const.Cost + Profit
Shop 1	20 sq.m x 0.8	= 16	2,215	3,101
" 2	20 sq.m. x 0.8	= 16	2,215	3,101
Flat 1	150 sq.m. x 1	= 150	20,769	29,077
" 2	150 sq.m. x 1	= 150	20,769	29,077
" 3	150 sq.m. x 1	= 150	20,769	29,076
" 4	168 sq.m. x 1	= 168	23,263	32,568
		650	90,000	126,000

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