Direct Tax Implications
In Real Estate Development Contracts

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A PROFILE

He has a long experience of over 35 years in handling and attending **income tax** matters of corporate sector. For a long period of 20 years (since 1970 to 1990) he was handling matters of DCM Limited. After resigning from the services of DCM Limited he entered in the profession in 1990. As a consultant and advocate also he continued to attend corporate matters. During this period he has handled number of complicated and important issues in the field of direct taxation. He is rendering services to number of DCM Group Companies and other Corporate Clients. He is regularly appearing before various Appellate Authorities and Courts and arguing the appeals. It can be said with pride that in most of the cases appeals had been decided favourably and many of the cases argued by him are reported in various journals. He has also been participating and addressing Seminars, Conferences and Study Circle meetings on Taxation matters. He is also member office bearer of various associations, including All India Federation of Tax Practitioners, International Fiscal Association, Delhi Tax Bar, ITAT Bar Association, Delhi High Court Bar Association, Supreme Court Bar Association, Indian Law Institute etc.

Broadly there are two category of development contracts / transactions i.e.

1. Joint Venture Development contracts between owner of the land and the developer.

2. Contracts entered into during the course of carrying on the business of development and sale of properties.

Tax Issues, which normally arises in above category of contracts are being discussed herein.

Joint Ventures contracts may further be of two types i.e.

(i) Contracts in which after development of property area of built up structure is shared between land owner and the developer

(ii) Contracts in which sale proceeds of developed property is shared by the land owner and the developer.

Tax implications in respect of above types of Joint Venture contracts have to be seen with reference to land owner as well as the developer.

Following questions arise in the case of land owner and developer :-

(a) Taxability of income whether as capital gain or business income

(b) Stage / time when sale/transfer will be considered for the purpose of chargeability of tax

(c) Cost of acquisition of capital asset or cost of stock-in-trade, how to be determined.

TAX IMPLICATIONS IN THE CASE OF LAND OWNER WHEN THERE IS SHARING OF DEVELOPED PROPERTY I.E. BUILT UP STRUCTURE.

- Normally profit will be in the nature of capital gain. It will however depend upon facts of each case and intention of the land owner. In the case Sathappa Textilers P. Ltd. v. CIT, 263 ITR 371 (Mad.) assessee claimed that by passing the resolution it had converted land into stock-in-trade and therefore, there was business income. Court held resolution was not genuine and it was only capital gain.

- Transfer of land rights (proportionately) in favour of developer will take place at the stage when structure is completed and exchange takes place. Section 2(47) of Income-tax Act defines the transfer as including exchange. In this case though possession is given to developer immediately on entering into agreement but in terms of Section 2(47)(v) of the act possession will give rise to transfer only if

conditions of section of Section 53A of Transfer of Property Act are satisfied. Terms of agreement with developer are also required to be examined. In the case of CIT v. Smt. Radha Bai, 272 ITR 264(Del) it was held that though possession had been given to the developer alongwith right to start the booking of various flats and to receive sale price etc. from prospective buyers, land owners/assessee continued to be the owner of the land till development and receipts were not in the nature of business income from joint business venture with developer. In the recent decision of Authority of Advance Ruling in the case of Jasbir Singh Sarkaria reported in 294 ITR 196 (AAR) scope and implication of clause (v) of Section 2(47) of the Act has been analysed in order to decide whether giving of possession with GPA in favour of developer amounts to transfer to give rise to chargeability of capital gain. In the fact of above case initially agreement was entered into with developer for sharing of built-up area. Subsequently, supplementary agreement was executed to sell agreed share in built-up area also to developer for money consideration, payable in installments. In pursuant to above agreement GPA was executed to give total control to developer along with power to execute further agreements for sale of flats to buyers. AAR held that in view of the facts and terms of the agreement, there was transfer of capital asset and capital gain was payable in the year of execution of GPA, notwithstanding that some of the installments for the consideration were yet to be received. It is stated that by virtue of supplementary agreement this was a case of out-right sale of land and not a case of development of property. Recently in the case of CIT v. Ashok Kapoor (HUF) (ITR No. 395 of 1985) decided on 24.09.2007 (not yet reported) a question regarding transfer of rights in property and chargeability of capital gain had come up for consideration before the Hon'ble Delhi High Court. In the above case the Hon'ble High Court has taken a view that transfer has taken place at the time of entering into the Agreement with the developer for the reason that as per the

agreement the dealer had agreed to allocate 50% of share in the property to be built and the builder was allowed to sell the area comprised in the builder's allocation. On the basis of clauses of the agreement the Hon'ble High Court had held that clause of agreement have all the elements of transfer at the stage of entering into the agreement and, therefore, there was inescapable conclusion that there was transfer of property by the owner to the developer. Further the Hon'ble High Court observed that even if the agreement did not spell out the value of the property in the hands of the assessee the valuation of the property in question indicated by the assessee itself in its accounts should be sufficient for the purpose of computation of capital gain tax. In the facts of the above case assessee had firstly converted its capital assets to stock-in-trade. Then it had entered into development contract with developer. A.O. had taken a view that entering into agreement had resulted in partnership firm and therefore, considering transfer of asset by partner to firm, he had levied capital gain. CIT(A) had upheld order of A.O. ITAT, however, held that there was no partnership. Further, it was held that no transfer had taken place at the stage of agreement with developer and no capital gain was leviable at that state. Before the High Court there was no question regarding transfer to partnership firm. Questions for consideration before the Hon'ble Court were to the effect that whether there was transfer of property rights pursuant to agreement under which built-up area was to be shared between land owner and developer in equal proportion and whether capital gain was chargeable at that stage.

In this connection, with due respect to Hon'ble High Court of Delhi, it is submitted that certain important legal aspects have not been brought to the attention of the Hon'ble High Court during the course of arguments of above case. In fact, matter was not represented on behalf of assessee. Firstly, the term "transfer" has been defined in the Act in Section 2(47) including sale, exchange, relinquishment,

extinguishment etc. Clause (v) is applicable in case of possession only in the circumstances when it is a case of part performance in terms of Section 53 A of the Transfer of Property Act. Above Act provides that transfer would be deemed when possession has been given and consideration has been passed on to the transferor and the only thing remains is registration of the documents. In the case before the High Court consideration has not been passed on to the Transfer at the stage of agreement. Therefore, possession would not give rise to transfer under this Clause. As per Clause (vi) any transaction which has the effect of transferring or enabling the enjoyment of any immovable property would amount to transfer. Above Clause is applicable in the cases of transfer by agreement or arrangement by becoming a member of society, company etc. where registration of documents is not required. Further, above clause read with Explanation and provisions of clause (d) of Section 269 UA of the Act excludes the transactions of sale, exchange or lease from its scope. Hence, above clause would not be applicable in case of arrangement / agreement between the land owner and developer, as it is a case of exchange of property rights. In this regard it is also stated that as per provisions of Transfer of Property Act rights in immovable property would stand transferred only on execution of a Conveyance Deed. Right in immovable property cannot be transferred just by giving possession. Even entries in the account books are irrelevant. In this regard reference can be made to the decision of Supreme Court in the case of Alapati Venkataramiah v. CIT (1965) 57 ITR 185 (S.C.) It has, further been held by the Courts that date of registration of such document is not relevant for the purpose of transfer under Section 2(47) of the Act [CIT v. Mormasji Manchorji Vaid (2001) 250 ITR 542 (Guj.) (F.B.)]. Further, it has been repeatedly held by the courts that as regards transfer of immovable property date of sale deed is relevant not the date of agreement to sell. [Hall & Anderson (P) Ltd. v. CIT (1963) 4 ITR 790 (Cal.); CIT v. F.X. Periera & Sons (Travancore) (P.) Ltd.

(1980) 184 ITR 461 (Ker.) and CIT v. Ghaziabad Engg. Co. Ltd. (2001) 116 Taxman 268 (Del.)]. Further, in case of exchange of property asset should be in existence. In the case of arrangement between the land owner and the developer, property would come into existence later and not at the stage of entering into the agreement. Therefore, it cannot be said that exchange of the capital asset resulting in transfer in terms of Section 2(47) of the Act has taken place at the time of entering into the agreement. Further, in order to determine the amount of capital gain pursuant to transfer of capital asset, "Full value of consideration" should be available. It has been held by the Supreme Court in the cases of CIT v. George Henderson & Co. Ltd., 66 ITR 622 and CIT v. Gillanders Arbuthnot & Co. 87 ITR 407 that full value of consideration has been used in the law for the reasons that law does not deal only with case of sale in which case consideration in money would be available. Further, it has been held that full value of consideration is different then fair market value of the capital asset transferred. Accordingly, in the case of exchange in determining the amount of capital gain "Full value of consideration" would mean the value of the asset which has been received by the transferor in exchange of the capital asset transferred by him. In the case under consideration the land owner would transfer the land rights in exchange of built up area and, therefore, value of built up area which will be received by the land owner from the developer after completion of construction would be "full value of consideration". In case transfer is considered to be at the stage of entering into the agreement, it will be difficult to determine the full value of consideration at that stage for the obvious reason that property is yet to be constructed and there would be no basis available to determine the market value of the same. Moreover, time gap between the date of agreement and when the property will be ready for giving possession to the land owner would be uncertain and practically it has been seen that many times because of various reasons it takes quite long time to develop the

property and make the same available to the land owner in exchange of land rights. Many times because of dispute between the parties the project may have to be abandoned. More importantly, the land owner would have no resources for making payment of capital gain at the stage of entering into the agreement because at that stage he had not received any consideration from the developer in case agreement provides for sharing of built up area after the development of the property. Keeping in view above issues, in view of the author exchange would take place only at the stage when the property would be ready and built up area is actually made available to the land owner in exchange of land rights by him and relevant documents for transfer of property are executed.

- Cost of acquisition of proportionate land right transferred in exchange of built up area will be determined as per Section 55(2) of the Act and will also be indexed as per Section 48 of the Act. Fair market value as on 1.4.1981 will be adopted in case of land/property acquired prior to above date. In case land / property has devolved on the present owner by any of the modes specified in Section 49(1) of the Act, cost of previous owner will be taken. In case of corporate entities also when asset has been acquired on merger, demerger or succession, cost of acquisition of earlier company may have to be adopted.

- Consideration for exchange of land rights will be fair market value of built area acquired by the owner of the land, which can be reasonably determined on the basis of proportionate cost incurred by the developer on construction. Accordingly, capital gain would arise at the stage of transfer of proportionate land rights based on fair market value of proportionate built-up area received after excluding therefrom cost of acquisition of proportionate land rights transferred by the owner to developer.

- Cost of acquisition of the land owner for capital asset acquired / remained i.e. built-up area alongwith remaining land rights will be fair

market value of built-up area plus cost of acquisition proportionately of remaining land rights.

- In case land owner also transfer / sell his portion of built-up area, capital gain would arise as and when sale takes place. It can either be immediately or after a gap of time. Profit arising on transfer of his part would also be capital gain in case owner continues to hold the same as capital asset. Profit so arising can, however, depending upon circumstances be treated as "profit or gain from business and profession". In that case profit upto the stage of acquiring built-up area on exchange will be capital gain and thereafter, it will be business income.

POSITION IN CASE OF DEVELOPER WHEN THERE IS A SHARING OF BUILT UP AREA

- In case of developer the profit arising on sale of built up area will be in the nature of business income.

- In case of developer cost of acquiring built up area would be the amount spent by the developer in construction of total area, including the area transferred to the land owner in exchange of land right. Business receipts would be the actual sale price obtained by the developer from the sale of the property. All the expenses incurred by the developer in connection with sale etc. would be business expenses.

- In case, however, the developer does not intend to sell the property. In other words his intention is to hold the same for long term, it can be claimed that built up area acquired by him is capital asset. In that case cost of acquisition of the property would be the actual cost incurred by the developer. Date of acquisition would be the date on which property was ready and exchange between the land right and built up area has taken place.

POSITION OF LAND OWNER AS WELL AS DEVELOPER IN CASE SALE PROCEEDS OF THE PROPERTY ARE SHARED BY THEM.

In case contract is for development of property and sharing of sale proceeds between the land owner and the developer, position as mentioned hereinabove as regards sharing of built up area can be claimed. There is, however, a very high probability that in such a case the Income-tax Department can take a view that it is a case of joint venture by association of persons or it is a case of carry on of business in partnership. Accordingly, business income is chargeable to tax as A.O.P. or Firm. In this case land owner would be deemed to have converted his asset in stock in trade on the date of entering into the joint venture contract and accordingly till that time profit would be in the nature of capital gain on the basis of fair market value of the land as on that date. Subsequent thereto profit will be in the nature of business income. It can, however, be claimed that it is not a case of AOP or partnership as contract is on principal to principal basis and the intention of the land owner is to share the proceeds for the reason to get better sale consideration and profit of land owner as well as of developer are chargeable to tax separately. Sometimes even the assesses may like to claim that they have constituted partnership firm or AOP for the purpose of carrying on the activities of development and the land owner has contributed his land to the partnership firm or AOP. After constitution of the firm or AOP income would in the nature of business income from the activities of development. In this regard, reference can be to the provisions of Section 45(3) of the Act, which provides that in a case where a person transfer his personal property to the firm or AOP, capital gain shall be chargeable to tax as income of the previous year in which such transfer takes place. Further, above section provides that for the purpose of determination of capital gain amount recorded in the Books of Account of the firm or AOP as value of capital asset shall be deemed to be full value of consideration received or accruing as a result of transfer of the capital asset. Above Section makes a specific provision to the effect that capital gain will be determined with reference to value of the capital asset

recorded in the books of the firm or AOP. In this case the Assessing officer will have no discretion to disregard such value and adopt some other value for the purpose of computation of capital gain. Hence, in certain circumstances, it maybe advisable to constitute a partnership firm or AOP and pay tax on capital gain determined accordingly by the partner. This would avoid the controversy regarding quantification of capital gain as well as the date on which transfer takes place.

TAX IMPLICATIONS IN REGARD TO REAL ESTATE BUSINESS TRANSACTIONS/CONTRACTS

During the course of carrying on the business of real estate developer there are many issues which arises under Direct Tax laws in the case of real estate developer. These issues are briefly being discussed hereunder :-

- The first issue which normally arises in case of developer is regarding commencement of business. In this trade many times the developer acquires the property and start developing the same. Development of the property takes substantial time. During this period there may be no sale. Accordingly, the question repeatedly arises whether business has been commenced and expenses being incurred by the developer are allowable as business expenditure or not. In the case of Tetron Commercial Ltd. v. CIT, 261 ITR 422 (Cal) assessee acquired land and commenced construction. It was observed by the court that there are 3 stages : one is the acquisition of land and the other is the process of construction of building and the third is actual sale. Assessee had stepped into the second stage as soon as construction was started. Accordingly, business had commenced. Sale is not necessary. In the case of CIT v. Dalmia promoters Developers (P) Ltd. 281 ITR 346 (Del) interest earned on fixed deposit of fund received as security deposit taken from co-developers and interest earned on fixed deposits of margin moneys was held to be business income. Assessee was following projects completion method for determination of income from

real estate project and therefore, there was no income from real estate projects during the year.

- The other important aspect in the case of real estate business is determination of profit. There are two methods recognized as per accounting principles for determination of profit, i.e.

  (i) Project completion method;

  (ii) Percentage completion method

  In the case of project completion method the profit of a project is determined only on completion of project. All the expenses incurred in connection with development of project are debited to a separate account and receipts relating to that project are credited to that account. As and when the project is completed then only the profit is determined and offered for tax. In this case determination of profit is normally postponed for number of years in the case of big projects. Therefore, department generally disputes this method. This method is acceptable only in the cases where projects are for short durations. The other method adopted for determination of profit is percentage completion method. In this method percentage of profit with reference to the percentage of work completed and/or percentage of revenue received is recognized as income in the profit & Loss Account as well as for taxation. Under this method normally the difficulty arises in determination of cost of the project and also in quantification of escalation in the cost. In this method estimate is required to be made in respect of the cost to be incurred on the project till its completion. Cost is to revised/re-assessed every year for determination of project. Institute of Chartered Accountants of India has now prescribed that only percentage completion method should be followed. It has also been prescribed in the Accounting Standard (AS 7) that revenue as well as cost is to be re-worked out every year. In this case reference can be made to the decision of Delhi High Court in the case of Tirath

Ram Ahuja (P) Ltd. v. CIT, 103 ITR 15 (Del) in which case Hon'ble High Court observed that in case of contracts, one need not wait till the contract is completed in order to ascertain the income and it is open to revenue to estimate the profit on the basis of receipts in each year of construction though contract is not complete. Further, in the facts of above case, when there was impossibility of completion of project due to out-break of war with Pakistan, it was held that total receipts including advance deposit and total expenses should be taken as income and expenditure of relevant year. Profit or loss of the project was not required to be determined.

- The other important point which arises for consideration in the real estate business is the treatment of advance bookings made in the project. As per one view advance bookings taken by the developer in the property to be developed should normally be treated as advance against sale. Sale should be recognized only at the stage when the property has been developed and possession of the same has been given to the buyer. The other view, however, is that as soon as booking has been accepted by the developer, he has transferred rights in the property to the buyer and notwithstanding that possession will be given only after the property has been developed, it has to be considered as sale. One can also take a extreme view in this regard that the total amount for which sale has been made should be recognized as sale notwithstanding that amount will be receivable in subsequent periods corresponding to the development of the property. These aspects are subject matter of litigation and will have to be decided in each case with reference to the facts and circumstances. It, however, appears to be more appropriate that after the work on the project has actually commenced by the developer and developer is incurring cost, receipts from buyers should be considered as revenue receipts proportionate to the cost incurred on the project and profit should be determined following percentage completion method.

- Another aspect which normally arises in case of real estate business is allowability of payments made to tenants for getting the property vacated, getting the unauthorized occupants removed and also to parties assisting in the process of getting the property vacated. As a matter of principle all the expenses incurred in order to obtain the vacant possession of the property so s to develop the same would be allowable as business expenditure and/or will be considered to be the cost of the property, difficulty, however arises for the reason that such payments are made to persons who after getting the payments are generally not available to the Income-tax Department for verification/confirmation. Payments are also many times quite substantial. Many times these payments are also required to be made in cash because of business necessity. These points give rise to litigation. There is no ready solution to these problems. It can only be said that as far as possible complete evidence of the persons to whom payments are made should be kept and payments should be made through account payee cheques.

- In connection with purchase of property many times the developers have to make payment of brokerage at a much higher percentage for the reason that these middle men are quite influential and are instrumental in arranging the purchase/sale of the land/property for the developer. Normally the dispute arises and Income-tax Department doubts genuineness of these payments. It is normally disallowed saying that payment is excessive. In this regard reference can be made to the decision of Delhi high Court in the case of CIT v. Gopal Dass Estate, 267 ITR 149 (Del). The court held in the above case that amount of brokerage in each case is market driven and depends on the demand and supply situation. Disallowance can not be made on surmises, conjectures and suspicion.

- Dispute in case of real estate business also arises in respect of damages/penalties received/paid for non-fulfilment of commitments.

Dispute, therefore, arises in regard to allowability or taxability of amounts paid/received under these heads. It can generally be said that all these amounts should be allowed/taxed as business expenditure/income. Dispute would, however, arise when the amount paid/received a quite substantial. In many circumstances it can be received as a result of cancellation of contract which can be construed to be profit earning apparatus and, therefore, may be in the nature of capital receipt. Similarly, sometimes payments can also considered to be of capital nature not related to regular business.

POSITION IN THE CASE OF BUYERS OF THE PROPERTY FROM THE REAL ESTATE DEVELOPER

Property developer engaged in the business invites buyers for purchase/bookings of property at the much earlier stage than construction thereof. Accordingly, the intended buyers book the property rights and advance payment for booking is made. Further, payments are made to the developer as and when demanded and also with the progress in the construction. Possession of the property is made available to the intended buyers after 3-4 years of the booking and may be sometime even longer period. In between many times intended buyers transfer their rights to other parties. Similarly, many buyers transfer the property after they have obtained possession from the developer. The issue normally arises in the context of transfer of rights in the property under construction as well as transfer of property after taking the possession thereof as regard the point whether gain on transfer is short term or long term. In other words, question normally arises as regards date of acquisition of rights in the property. In this context it is stated that at the stage booking is made by the intending buyer with the developer many times even the specifications/description of project are not available and confirmation as regards the property rights is given by the developer after a lapse of time. In this regard one view can be that the intended buyer has acquired the rights as soon as he has given the initial advance though specification in regard to project/property are not available.

The other view can be that the right would come into existence when the developer confirms the bookings and issue necessary allotment letter to the intended buyers after the project has been properly described. It is stated that the date of acquisition of the rights would depend upon facts of each case and the documents executed/provided by the developer to the intended buyers. In case of initial advance if there is no commitment or allotment by the developer, same may not amount of acquisition of rights in the property. Property rights may generally be acquired by the intended buyer only when an allotment letter specifying the project etc. has been issued.

In case the intended buyer transfer his rights in the property during the period when construction is in progress and he has not obtained possession of the property, the right of the buyer would be in the nature of capital assets and accordingly, gain arising on such transfer would be in the nature of long term or short terms gain depending upon the period of holding. Indexation would be available with reference to each payment made by the buyer to the developer.

In case of transfer of property after possession has been obtained by the buyer from the developer on construction of the project, a question normally arises whether the period prior to taking of possession of the property, during which period it was only the right available to the buyer, is to be reckoned for the purpose of determining whether the capital gain is short term or long term or not. In this regard contention is normally raised that rights in the property is a capital asset of different nature than the property. Therefore, period prior to taking of possession is not to be considered. It is, however, stated that the buyer gets possession of the property in continuation of his holding of right in the property. It cannot be said that in terms of section 2(47) of the Act assessee has transferred his rights in the property held earlier to acquire the actual property. It is not a case of sale or exchange. Buyer continues to hold the capital asset. Only its form changes on getting actual possession of the property. Therefore, it cannot be said that period of holding would be counted only from the date of getting the

possession. Accordingly, the earlier period is also to be counted for the purpose or determination of nature of the capital gain, whether short term or long term.

In conclusion, it is stated that there are lot many other issues in regard to property development projects. Attempt has been made hereinabove to discuss some of the issues and views expressed hereinabove are personal views of the Author and in any case the conclusion in regard to each of the issues discussed hereinabove would depend upon the facts and circumstances of each case.