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Shri Anil Harish
Paper Writer

Shri Anil Harish is Partner of D. M. Harish & Co. Advocates. He passed BA from Elphinstone College, Mumbai in 1973, LLB from Government Law College, Mumbai in 1976, LLM from University of Miami, USA in 1978.

His area of Practice is Real Estate, Domestic Taxation & International Taxation, International Investments, Corporate Law, Personal Laws.

He is a member of Committee of Society of Indian Law Firms (SILF), Member of Editorial Panel of Magazine, "Property Scape", Member of Advisory Board of Accommodation, Times Institute of Real Estate Management and Member of Advisory Committee of All India Business Council.

He is on the Board of Directorship of Public Companies such as Unitech Ltd., Hotel Leelaventure Ltd., Pantaloon Retail (India) Ltd., Hinduja Ventures Ltd., Hinduja Global Solutions Ltd., Ashok Leyland Ltd., Mahindra Lifespace Developers Ltd., Mukta Arts Ltd., Future Ventures India Ltd., Ador Welding Ltd., Advani Hotels & Resorts Ltd., Valecha Engineering Ltd., Oberoi Realty Ltd.

He was President of Hyderabad (Sind) National Collegiate Board (Includes 17 Colleges and approximately 50,000 students), D. M. Harish Foundation, (Scholarships, Moot Court), Trustee of Venture Capital Fund, "CIG Realty" and Trustee of several other Charitable Trusts.

He contributed Articles in Times of India, Hindustan Times and several professional journals.

Given Professional Speeches such as Hypo Bank, London 2007, "India Calling" – Brussels 2009, In Dubai, Doha, Muscat and Jakarta on several occasions, International Fiscal Association - India Chapter, On FEMA, Taxation Collaborations, Stamp Duty, etc.

Tax Issues Relating to Redevelopment of Immovable Properties

— Anil Harish, Advocate

DEVELOPMENT AGREEMENTS

Till the 1970's, Builders often purchased land outright and did not enter into Development Agreements. However, Development Agreements in relation to immovable properties became very important in a legal sense, with the promulgation of the Urban land (Ceiling and Regulation) Act, 1976. Under this law, land in excess of 500 sq.m. (in large cities such as Mumbai) vested in the Government and a conveyance of land required approval which was very difficult to get. Therefore even though a transaction was, in commercial terms or in substance, a sale, it was often, in form, reflected as a Development Agreement. This was so that the land-owner (acting through the Developer) could apply for permission to construct flats for the benefit of a large number of persons, thereby satisfying the requirement of the law, which was to distribute land ownership and avoid concentration of holdings in a few hands.

Further, prices also began to rise and in order to avoid large investments, Builders would suggest a joint development.

land-owners on their part also wanted to participate in the increase in prices and therefore wanted to share in the revenues or profits or to receive part of the consideration in kind.

Development Agreements take different forms and the basis for sharing also varies. Development Agreements therefore may be of the following kinds:–

(1) Fixed Price Agreement;

(2) Sharing of Revenue;

(3) Sharing of Profits – AOP issues;

(4) Allotment of space in the building to the land-owner;

(5) Combinations of the above.

These are discussed below:–

(1) Fixed Price Agreement

L, a land owner, enters into an agreement to sell land for a fixed monetary consideration, but the nomenclature used is "Development Agreement". One reason for such a classification could have been the ULC Act which did not permit L to convey the property until such time as construction had taken place and flats had been made. Once the construction had been done, the land was no longer vacant and therefore fell outside the ULC Act. Therefore even though there was a fixed consideration and it was effectively an Agreement for Sale, it was called a Development Agreement.

A second reason for this nomenclature may be the tax angle. Section 2(47)(v) provides that if a person hands over possession in part performance of a contract, then the transfer has been completed. This amendment was made in 1988 and brought about a change in the earlier settled position which was in accordance with the decision of the Supreme Court in the case of Alapati Venkataramiah 57 ITR 185. Now, by entering into a "Development Agreement" and permitting construction to be commenced, L would state that he had merely given a licence to D (the Developer) to enter upon the property for the limited purposes of construction and had not handed over possession to D. This was intended to save L from the tax point of view. This is sometimes disputed, and the mere use of the word "licence" does not postpone the tax – it is the substance of the agreement which has to be studied.

A third reason was that this may also help L from the civil law point of view. If, for instance, D were not to make payment on the scheduled dates, then because "possession" had not been given, L would contend that he was in possession and that D had only a licence to enter and that in the event of a default, L could prevent D from entering, because the licence was revocable.

Issues do arise as to the true nature of a licence and whether on the facts of a case possession has been given.

Section 52 of the Indian Easements Act, 1882 defines a licence:

"Where one person grants to another, or to a definite number of other persons, a right to do or continue to do in or upon the immovable property of the grantor, something which would in the absence of such right, be unlawful, and such right, does not amount to an easement or an interest in the property, the right is called a licence."

In the case of *Associated Hotels of India Ltd. vs. R.N. Kapoor* AIR 1959 SC 1262 at p. 1269 it was said "The question in all these cases is one of intention: Did the circumstances and conduct of the parties show that all that was intended was that the occupier should have a personal privilege with no interest in the land."

This issue is often contested by the tax authorities. The decision of the Bombay High Court in the case of Chaturbhuj Dwarkadas Kapadia reported at (2003) 180 CTR (Bom) 107 related to an agreement for fixed consideration. This decision should be examined carefully.

Some important clauses were as under:

Clause 8: CDK would execute a limited Power of Attorney authorizing D to deal with the property and obtain permissions from the ULC authorities, BMC and CRZ authorities.

Clause 9: On D obtaining all necessary permissions and approvals and upon receipt of NOC under Chapter XXC of the Income-tax Act, CDK would grant an irrevocable licence to enter into the property.

Clause 11: After D was given an irrevocable licence and after obtaining all approvals, D would be entitled to demolish the buildings subject to D settling the claims of the tenants.

Clause 14: CDK was entitled to receive proportionate rent from the tenants till the payment of the last installment and till that time CDK was bound to pay all outgoings.

Clause 20: Clause 20 provides that sale shall be completed by execution of conveyance.

The relevant dates were:-

18.8.1994	:	Agreement for Development with right to the Developer to develop the property for a fixed consideration.
26-4-1995	:	D obtained ULC permission for redevelopment.
7-2-1996	:	D obtained clearance from the CRZ authority.
By 31-3-1996	:	D had paid 95% of the consideration.
5-9-1996	:	Layout Plan approved
Sep., 1996 to Nov., 1996	:	IOD granted by BMC
18-11-1996	:	BMC issued a Commencement Certificate.
30-3-1998	:	Building Plan amended
12-3-1999	:	Power of Attorney executed.

The question was whether the liability of CDK for capital gain accrued in assessment year 1996-97 or 1999-2000. The Department contended that the relevant year was Assessment Year 1996-97 whereas CDK contended that it was only when they executed an irrevocable licence in favour of the developer.

In para 8 of its decision, the High Court stated "it is precisely for this reason that the legislature has introduced section 2(47)(v) read with section 45 which indicates that the capital gain is taxable in the year in which such transactions are entered into, even if the transfer of the immovable property is not effective or complete under the general law."

It is respectfully submitted that section 2(47)(v) does not state that the gain is taxable in the year in which such transactions "are entered into".

In the same paragraph it is stated "in such cases of Development Agreement, one cannot go by substantial contract and in such cases year of chargeability is the year in which contract is executed in view of section 2(47)(v) of the Act".

It is respectfully submitted that section 2(47)(v) does not refer to the execution of a contract, but to handing over of possession in part performance of a contract.

Apart from that, in the present case, the Agreement was entered into on 18.08.1994, which was relevant to assessment year 1995-96 and not to assessment year 1996-97 being the year in which department contended was the year of accrual.

In para 9 therefore the Hon'ble High Court held:

"We do not find merit in the argument of the appellant and the court should see the actual possession and in this particular case the court should see the date on which irrevocable licence was given. If the contract, read as a whole, indicates the passing of or transferring of complete control over the property in favour of the developer then the date of contract would be relevant to decide the year of chargeability.

10. Having laid down the broad principle, we now come to the facts of the case".

The High Court then went on to state "we have gone through the compilation of documents and by mere substantial compliance of the Agreement, one cannot infer the transfer in the accounting year ended March 31, 1996".

And then in para 12 stated "taking into account the totality of the facts, we allow the appeal of the assessee."

It is therefore respectfully submitted that the tests referred to in para 8 are inconsistent with the Act, and that the conclusion in para 12 is correct, but is not consistent with the principles laid down in para 9.

(2) Sharing of Revenue

L may enter into an agreement in which he is to get a share of top line. Since this consideration is not quantified or quantifiable at the initial stage and he is participating in the process of the development, such a situation would normally result in the receipts by L being treated as business receipts. In the event the land has been held until then as a Capital Asset, L may convert the Capital Asset into Stock-in-Trade so that there is a clear classification and treatment of the revenues.

The leading decision on conversion of a Capital Asset into Stock-in-Trade was that of Shirinbai Kooka 46 ITR 86 (SC). In that case the assessee converted shares which were held by her as Capital Asset into Stock-in-Trade at the market value on the date of conversion. Later she sold the shares and contended that at the point of time of conversion, there was no sale to any other person and therefore no income or capital gain arose and then she later sold the shares. She contended that only the profit relating to the period after conversion could be brought to tax as business income and the appreciation until the point of time of revaluation was to be ignored. The Supreme Court accepted this contention.

Then in the case of Bombay Dyeing, the facts were that Bombay Dyeing held a certain plot of land for about 100 years. It then decided to carry out construction of the buildings now known as Twin Towers at Prabhadevi. The Company began to carry out the construction and when it sold the flats, it contended that the revenues must be split into (a) the value of the land which had been held for many years and (b) the value addition on account of construction. The ITAT agreed to this and on the basis of the decision in the case of Shirinbai Kooka, held that the amount relatable to the appreciation of the value of the land was not taxable and only the profit on the construction was taxable.

Soon after this decision, section 45 of the Income-tax Act was amended and sub-section (2) was introduced. The language of this is important. This states as under:–

"(2) Notwithstanding anything contained in sub-section (1), the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its treatment by him as Stock-in-Trade of a business carried on by him shall be chargeable to income-tax as his income of the previous year in which such Stock-in-Trade is sold or otherwise transferred by him and, for the purposes of section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset."

As can be seen, this states "..... the profits or gains arising from the transfer by way of conversion ....." or "its treatment by him as Stock-in-Trade of a business carried on by him .....". In the case of Shirinbai Kooka, there was a formal conversion into the Stock-in-Trade. In the case of Bombay Dyeing there was no formal conversion into Stock-in-Trade but there was a treatment of the asset as Stock-in-Trade.

Section 45(2) covers both situations. Even if you do not formally convert but merely treat the Capital Asset as Stock-in-Trade, the Assessing Officer has a right to treat this as a business activity from the date on which he considers that it is being treated as Stock-in-Trade. It is therefore generally better to formally convert the Capital Asset into Stock-in-Trade rather than to leave it open for the AO to decide the time and the value.

If there is a formal conversion of land into Stock-in-Trade, then the process followed should normally be:

(i) Get a Valuation Report of the land or otherwise determine the value of the land on that date. This may be the stamp duty reckoner value or may be a different value.

(ii) In the case of a Company, pass a resolution to convert the land and follow this up with a formal declaration or affidavit. If the land owner is an individual, then the question of passing a resolution does not arise and he should make a declaration. In the case of a Partnership Firm, it would be useful to have a document evidencing the decision of the Partners to convert the land into Stock-in-Trade and one or more of the Partners could execute a declaration for the conversion.

(iii) The necessary entries must be passed in the books of account.

A Capital Gain carries with it certain benefits in the form of indexation and in the form of lower rate of tax. In the case of an individual, there could be other benefits such as reinvestment under Section 54F and in the case of all assesses, a small benefit in terms of Section 54EC. However, where there is going to be a regular stream of income arising from the development, it is necessary to convert the land from Capital Asset into Stock-in-Trade. Issues, however, do arise. It must be noted that Section 45(2) provides that the conversion itself is a "transfer". This section states "............ from the transfer by way of conversion ....." Although a conversion is not normally a transfer, it is included within the scope of a transfer in this provision. Secondly, the section states that the Capital Gain itself shall be chargeable in the previous year in which Stock-in-Trade is sold or otherwise transferred by him.

The question which then arises is what the date of sale or transfer is, in the case of Stock-in-Trade.

In the case of a land owner who has converted the land into Stock-in-Trade and then entered into a Development Agreement under which the Developer has to pay a share of the revenue, what is the date of transfer of the Stock-in-Trade by the land owner?

Is it the date on which the land owner entered into the Development Agreement?

Is it the date on which the Developer entered into an agreement to sell a particular flat?

Is it the dates on which the Developer receives and installments of sale proceeds?

Is it the date on which the Developer hands over possession of a flat?

Is it the date on which the Developer conveys the building to the society?

The concept of transfer for the purposes of Capital Gain is different from the concept of accrual of income in the case of Stock-in-Trade. Whether a Developer offers his income for taxation on the basis of project completion method of accounting or on the basis of accrual is not actually dependent upon the "sale" or "transfer".

Since the language used in Section 45(2) is that the Capital Gain will be taxed in the event of "sale or transfer" it is not the receipt of consideration which determines the date of taxability under Section 45(2), but the event of sale or transfer of the Stock-in-Trade, that determines the date of taxability. If the Developer follows the accrual method of accounting for his project, does that mean that the land owner must necessarily follow that method as well? Therefore, if a land owner had bought land for ₹ 1 crore and then had converted it into Stock-in-Trade at a value of ₹ 2 crores and then entered into a Development Agreement under which he is to receive 50% of the revenue from the project and if the project takes five years and realizes a total ₹ 10 crores of which the land owner gets ₹ 5 crores, what is the date on which the land owner's capital gain arises and when does his liability in respect of business income arise?

In the example given above, if the land owner receives ₹ 1 crore in each of the five years of the construction, at what stage can he be held to have sold or transferred his stock? Should he appropriate the consideration first against the original cost and then against the Capital Gain which has arisen by way of conversion and then against business income? If that were to be so, then he could contend that the first ₹ 1 crore received represented only the original cost and therefore there is no tax liability in that year. The second ₹ 1 crore represented the Capital Gain and therefore would be taxable in year 2. Thereafter the business income would be taxable in years 3, 4 and 5 respectively. The land owner would not be able to adopt the project completion method because he is not himself carrying out the project. He had a definite cost. Since the expenditure required to be borne by him (in this example) is 'nil' or insignificant once he receives the share of the revenue, there is no uncertainty as to whether he has made a profit or not.

A strict interpretation of section 45(2) could even lead to the conclusion that the business income may be taxed as and when it arises, in years 3, 4 and 5 and since the Capital Gain is to be taxed only when the Stock-in-Trade is sold or transferred and since it is not sold

or transferred until year 5, the Capital Gain should be taxable in year 5, i.e. after the business income has been taxed! While this may be justified by the language of the statute, it would not be advisable to follow this method.

(3) Sharing of Profit

This is a method that is sometimes followed and it may happen that L is to get a certain basic price and thereafter a share of profit. If there is a sharing of profit, it is possible that the AO may contend that an AOP has come into being. Then, even though the land owner and the Developer were to specify that each is liable to pay its own tax, it is possible that the AOP issue could be raised. Where there is such a possibility, it may be advisable to actually form an AOP or, nowadays, an LLP. The land can then be introduced into the AOP or the LLP at the mutually agreed price (under Section 45(3)), and then the profit thereafter would be divided between the parties. Sometimes the parties do not wish to form an AOP or an LLP, particularly if one, or both, of the parties have losses which have been carried forward and wish to set off those losses against the business income arising from the project. In such a case, the document should bring out the fact that each is entitled to an independent share of the income. Also it may be advisable not to have a purely profit sharing percentage as this can give rise to the AOP issue. One may possibly have a combination of profit sharing and sharing of revenue or other such basis.

(4) Allocation of area

This is also very frequently done.

For example, L has two acres of land. L enters into an agreement with D under which D is to carry on construction at D's cost and give to L half of the built-up area and D is to retain or sell the remaining half himself. The structuring of the transaction and the documentation and the tax would depend to some extent on whether the property is residential or commercial and whether L wishes to sell his area or to retain it or to lease it out. If, for example, two towers are going to be made and one is to belong to L and the other to belong to D and if this is commercial space and L wishes to lease out his building, then certain possibilities arise. One possibility is that L signs a Development Agreement with D in respect of the entire 2 acres and sets out the terms, i.e. D's right to construct, and one building to be handed over to L etc. L in this case may want to retain the land as a Capital Asset. Since L has entered into a Development Agreement in respect of the entire 2 acres and if the reckoner value per acre is say ₹ 10 crores, then the total value is ₹ 20 crores and stamp duty would be payable with reference to ₹ 20 crores. In such a case, the Income-tax Department may contend, on the basis of Section 50C, that L has entered into an agreement and has agreed to transfer or create rights in respect of his entire 2 acres and that therefore it is ₹ 20 crores which is to be considered as L's notional sale proceeds. The AO would contend that because L has entered into a Development Agreement, L has parted with some rights which formerly belonged to him alone and that therefore there is a tax liability. In such a case the stamp duty reckoner value would be the value adopted by the AO for determining the capital gain.

Another possibility on the same facts could be that L specifies that out of the 2 acres he is allowing D to develop only 1 acre for D's benefit and that the consideration that

is paid by D to L will be in kind and not in cash. This consideration would be in the form of construction by D on the 1 acre retained by L. In this case L has not transferred any rights in respect of the first acre but only in respect of his second acre. The stamp duty would only be with reference to the second acre, i.e. on ₹ 10 crores. Accordingly the income-tax could only be with reference to ₹ 10 crores. The consideration would have flowed back in kind by way of construction on L's retained 1 acre.

The Development Agreement must, of course, contain safeguards in that L should give only a licence to D to enter. D should not be permitted to hand over possession of the area on D's 1 acre until such time as D has completed L's building and L has received the Occupation Certificate in respect of the same.

In this way the tax may be only on the component which L has actually parted with or transferred.

Redevelopment of Society Buildings

The FSI (Floor Space Index) in Mumbai for several decades has been 1.33 times the land area in the southern parts of Mumbai and 1 from Bandra northwards. The Development Control Regulations, 1991 which were introduced pursuant to the Mumbai Metropolitan Region Development Act, introduced the concept of TDR (Transferable Development Rights) was introduced. This permits additional construction to be carried on on a particular plot and effectively increases the FSI. A regulation was also then introduced to the effect that FSI under the TDR could not be utilized on an existing building, but only for a new building. Therefore if there was any unutilized FSI on a plot, it could be used to construct an additional floor on the building. However, if FSI under the TDR Scheme is purchased, then it would have to be used on a vacant plot or the existing building would have to be demolished and the regular FSI and the TDR could be used to construct the new building.

As a result of this regulation, the owners of many buildings have begun to enter into Redevelopment Agreements. A society would then identify a Developer and enter into an agreement. This agreement would normally have the following terms:-

(a) The flat owners will move out temporarily;

(b) (i) The Developer would pay for alternative accommodation for a certain period, or

(ii) Would pay the flat owners an amount to enable them to hire alternative accommodation themselves.

(c) The Developer would acquire TDR FSI from elsewhere and would have the same loaded or used on this particular plot. The Developer would then demolish the building at his own cost and reconstruct;

(d) The Developer would often give to the flat owners a somewhat larger area. If therefore a flat owner has a flat of 1000 sq.ft. in the old building, he may get about 1200 sq.ft. in the new building;

(e) The flat owners may get a certain monetary compensation;

(f) The Society may get a certain monetary compensation;

(g) The Developer would be able to sell the remaining flats and the new purchasers would be admitted as members by the Society.

There have been certain cases wherein some members of the society have not wanted to go ahead with the redevelopment, even though the majority wishes to do so. Litigation has resulted in some of these cases. The courts have however generally held that a small minority cannot hold up the entire redevelopment. A Notification has now been issued, being Circular No. CHS 2007/CR 554/14-C dated 3-1-2009, which provides that if proper procedure is followed, then a small minority cannot hold up the development.

Tax issues arise at each of the stages.

If the Developer pays directly to a Third Party Owner for alternate accommodation, this may not be subject to tax in the hands of the flat owner.

If the Developer pays any amount to the flat owner then this is likely to be taxed in the hands of the flat owner even if the flat owner pays rent for alternative accommodation.

When the Society/flat owners allow the FSI to be loaded and used on that particular flat, then a tax issue does arise. Has the Society or have the flat owners transferred any part of their interest in the property?

Ownership of immovable property is traditionally defined as a "bundle of rights". By giving up part of the bundle of rights, have the flat owners transferred and how is that to be evaluated?

There have been a number of decisions on this issue and variations thereon.

The Supreme Court in the case of B.C. Srinivasa Setty (128 ITR 294) had held that if an asset had no cost then no Capital Gain could be taxable upon the same.

Following this, in the case of *Jethalal D. Mehta vs. D. CIT* (2005) 2 SOT 422 (Mum), it was held that TDR which came into existence by operation of law pursuant to the Development Control Regulations of 1991 had no cost and therefore no Capital Gain was taxable in the event of sale.

In the case of *ITO vs. Lotia Court CHS Ltd.* (2008) 12 DTR (Mum.)(Trib) 396, it was held that allowing a developer to allow TDR and to use it on the Society's property would not result in any taxable income in the hands of the Society. Even in the case of flat owners, no Capital Gains could be taxed in view of the fact that they had acquired the rights by virtue of the D.C. Regulations.

In the case of *New Shaila CHS vs. ITO* (IT) No. 512/M/2007, Bench` B' dt. 2nd December, 2008 (Mum) viewable at www.itatonline.org, it was held that though the TDR was a Capital Asset, since there was no cost of acquisition, the sale proceeds could not be taxed.

It must be noted, however, that if an assessee had bought a property after 1991 then he acquired the rights to TDR as part of his cost and that situation must be distinguished from that of a person who acquired the property before 1991.

Another relevant decision is in the case of *Deepak S. Shah vs. ITO* (2009) 29 SOT 26 (Mum.) in which it was held that the Society entered into an agreement granting permission for development and constructing additional floors and members of the Society received a certain sum on account of such a grant, and the assessee was not liable to Capital Gains tax in view of the fact that there was no cost of acquisition to him.

If a flat purchaser gets a larger area, this again may fall within the scope of the same principles set out above and may not be taxed. However, another possibility is that if the assessee had acquired the flat after 1991 then the right of TDR was already embedded in its cost and therefore such an assessee would not be able to claim an exemption at all on this ground. It may, however, be possible for him to claim that he transferred his older flat of 1000 sq.ft. and received a new flat of 1200 sq.ft. and that therefore since he reinvested the entire Capital Gain u/s. 54 and there was no liability. This would, however, be subject to the conditions u/s. 54.

If the flat owners get a certain monetary compensation this would again have to be viewed on the principles above mentioned.

Likewise if the Society gets monetary compensation.

The law is constantly being refined and there are innumerable permutations and combinations of facts and because of the large amounts involved and the fact that everyone can be involved in such a situation of redevelopment, this is an extremely important and interesting subject.

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