

Accrual of Capital Gains Tax: Implications & Ambiguities



Owner and developer pool their resources to develop land. Ambiguities over the term 'transfer' under Income Tax Act, 1961, lead to tax evasion in such collaborations and raise important issues.

Jayshree Navin Chandra

There has been a rush of developmental activities in the real estate business in India, both in commercial as well as the residential sectors. The rapid expansion, witnessed over the last decade, is now beginning to settle into a more realistic pattern of growth. Various options are available with the land owner for development and exploitation of immovable property like outright sale wherein the owner transfers the land by an agreement for sale at the agreed consideration and upon agreed terms and conditions; sale of the right of utilisation of Floor Space Index (FSI) permitted by the

concerned local authority; partnership arrangement where the owner introduces the immovable asset into the partnership as his share of capital contribution among other options.

JOINT DEVELOPMENT AGREEMENT

It is a fairly common arrangement for an owner and developer to join hands to develop the land, wherein the owner provides the land and undertakes its development along with the developer who pools in his resources (like manpower, equipment, expertise and experience, etc.) to implement the project. Such arrangements are most sought after model in the real estate sector and termed as Joint Development Agreements (JDA).

The share of the owner and developer, in the built up space of the project or sale proceeds from the developed property depends on the terms of the JDA and is primarily based on the total cost of the project; the market value of the land; the funds to be invested by the developer towards development and construction of the project.

Ambiguities in JDAs and tax laws have contributed towards developing controversies. As regards to the tax implications under a JDA, the two important issues that a land owner and developer face are:

- Taxability of income whether as capital gains or business income; and
- The stage or time of occurrence of the taxable event i.e., when does the sale or transfer occurs for the purpose of determining the date and year of chargeability of tax.

WHAT IS CAPITAL GAINS TAX?

The Capital Gains Tax is defined under section 45 (1) of the Income-Tax Act, 1961 ('the Act') according to which two conditions are necessary for capital gains to be applicable, namely, transfer of capital asset effected in the previous year and the resultant profits or gains from such transfer.

Mere existence of a valid development agreement between a land owner and a developer does not attract levy of the Capital Gains Tax. For the purpose of chargeability of capital gains, there must be a 'transfer' of a capital asset. Although the term 'transfer' in normal parlance is understood as conveying, passing, making over the title from one owner to another; it is used in a much wider sense under the Act.

Section 2 (47) of the Act defines the term 'transfer' in relation to a capital asset to include:

- i. sale, exchange or relinquishment of the asset; or
- ii. extinguishment of any rights therein; or
- iii. compulsory acquisition of the asset under any law; or
- iv. conversion of the capital asset into stock-in-trade of one's own business;
- v. any transaction allowing possession of any immovable property to be taken or retained in part performance of the contract of the nature covered in section 53A of the Transfer of Property Act, 1882; or
- vi. any transaction, for example, by way of becoming a member of a society, company, etc. or any agreement or arrangement, which transfers or enables enjoyment of the immovable property to another person.

WHAT IS TRANSFER FOR THE LEVY OF CAPITAL GAINS TAX?

A transaction under a JDA definitely does not involve transfer as defined under section 2 (47) (i) to (iii) of the Act, since there is no transfer according to the generally accepted connotation of

Aditya Tiwari

Founder Partner, Themis Legal



"Usually, the agreement between the developer and the flat owners clearly provides that there is a transfer of proportionate undivided right, title and interest in the land on which the flat is built along with possession of the flat. Mere transfer of the right to build or the right to develop the land does not give rise to capital gains. In the event all the rights of the owners extinguish upon transfer with respect to the piece and parcel of land under consideration, such a transfer would give rise to the taxable event."

the term. Usually, the developer, instead of buying land outright, develops the land of the owners and raises constructions thereon and by an inter se arrangement, the owner, directly or through the developer, executes the transfer deeds to the buyers of units over a period of time.

What remains to be ascertained is, whether the JDA includes an element of transfer so as to be covered under (v) or (vi) of section 2 (47) of the Act (which were introduced in the Act since

Vinay Sawhney

Chartered Accountant



"Capital gain is chargeable to tax on the date in the previous year in which the transfer of immovable asset takes place and that unless such transfer takes place there is no liability to pay Capital Gains Tax. The dates of the parties entering into Memorandum of Understanding (MOU) or JDA do not constitute 'transfer' in general law because they are purely of business agreements. Therefore, when the owner of an immovable asset divested his proprietary right in the previous year, the question of capital gains comes into picture. The moment the owner of the property gives physical possession of the property and receives consideration, it tantamounts to transfer as per Income Tax Law under section 2 (47) (v) and attracts the Capital Gain Tax liability."

the assessment year 1988-89 to prevent avoidance of capital gains liability by recourse to transfers of rights). As a result, even arrangements confirming privileges of ownership, without transfer of the title, could fall under section 2 (47) (v) of the Act. To attract this section, there must be a transaction under which the possession of property is allowed to be taken or retained. The purpose of introducing clause (v) in conjunction with clause (vi) is to widen the net of taxation so as to include transactions that closely resemble transfers, but are not treated as such under the general law.

Furthermore, such taking or retention of possession must be in part performance of the contract. Likewise section 2 (47) (vi) brought into the ambit of 'transfer', the practice of enjoyment of property rights through what is commonly known as Power of Attorney (POA) arrangement. The legal ownership in such cases continues to be with the transferee, but the person holding the POA is given the powers of the owner, including that of undertaking construction or for that matter, allowing prospective purchasers to book space therein.

JDA IS A BUSINESS TRANSACTION

In a recent case, the Madras High Court held that there is no 'transfer' of any interest in the immovable property, when possession is given to the builder for construction for a specified period under the development agreement. There is no buyer or seller in the agreement. It is only a licence given to the builder to construct. The ultimate aim is only to share the profit; it is purely a business transaction and no transfer of interest in the immovable property is involved. Furthermore, the Bombay



High Court in various judgements has held that development agreements do not constitute 'transfer' in general law.

IMPOSITION OF CAPITAL GAINS TAX

Aditya Tiwari opines, "During the assessment proceedings, following issues could be raised by the assessee in support of his challenge to imposition of the Capital Gains Tax:

- (i) whether there is a transfer of vacant property or constructed flats;
- (ii) whether grant of the right to construct, if read along with other terms of the agreement, is of such nature that all the rights in the land that accrued to the owner have extinguished;
- (iii) whether the consideration for the purchase of land is completely paid to the owner;
- (iv) whether the possession of land is handed over."

Since the aim of these professional contractors is only to make profits by completing the building, therefore, no interest in the land stands created in their favour under such JDAs. It is pertinent to note that a JDA is only a mode of remunerating the builder for his services of constructing the building. It is precisely for this reason that the legislature has introduced section 2 (47) (v), read with section 45 of the Act, which indicates that capital gains are taxable in the year in which such transactions are entered into, even if the transfer of immovable property is not effected or complete under the general law. Also, where substantial payments have already been made in the year of execution itself, one can not go into the issue of substantial performance of contract and the year of chargeability would be

the year of execution of agreement itself. However, if the contract, read as a whole, indicates passing of or transferring of complete control of the property in favour of the developer, then the date of the contract would be relevant to decide the year of chargeability.

Vinay Sawhney, states that, "In a case where there is a breach or breakdown of a JDA, the landowner does not have to pay the Capital Gains Tax. If the landowner receives any compensation in the shape of damages, that is, damages for breach of the contract, the same amount would be treated as capital receipt in the

hand of the landowner and that too without transfer of a capital asset and there will be neither Capital Gain Tax liability nor any income to be assessed in the hands of the landowner."

WHEN CONTROL IS TRANSFERRED

Certain interesting and important observations were made by the Authority for Advance Ruling (the Authority) in the recent case of Jasbir Singh Sarkaria, wherein the scope and implication of section 2 (47) (v) of the Act were examined to decide whether giving of possession vide a General Power of Attorney (GPA) to the developer amounts to transfer so as to invoke chargeability of capital gains. The Authority concluded that:

- (a) Where the agreement for the transfer of immovable property by itself does not provide for immediate transfer of possession, the date of entering into the agreement cannot be considered to be the date of transfer within the meaning of clause (v) of section 2 (47) of the Act.
- (b) To attract clause (v) of section 2 (47) of the Act, it is not necessary that the entire sale consideration up to the last instalment should be received by the owner.
- (c) Once it is held that the transaction of the nature referred to in clause (v) of section 2 (47) had taken place on a particular date, the actual date of taking physical possession needs to be probed into. It is enough if the transferee has, by virtue of that transaction, a right to enter upon and exercise the acts of possession effectively.

The Authority clarified that it is not possible to lay down a rigid proposition that an agreement as such can never be construed as a transaction allowing possession to be taken in part performance.

CONFUSION PREVAILS

Accrual of capital gains is an extremely important facet for both the land owner and the developer. There is presently a lot of ambiguity in deciding the point in time during the JDA transaction when the capital gain liabilities accrue. There are conflicting views expressed by various courts and tribunals across the country on these issues. Certain amount of clarity emerges from the various judicial pronouncements, yet each case is peculiar and will need to be decided on its merits by the courts and tribunals. None of the judgements can be considered a binding precedent on the issues at hand for the reason that no document would be identically worded and the conduct of the parties would also differ from case to case, which certainly will have a bearing in drawing inferences and conclusions.

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