Tax Planning for Real Estate Transactions

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Introduction:

Transactions in the Real Estate and its tax implication make a very interesting study. It is more interesting because trade practices are different in different parts of the country. Local laws (municipal and state laws) further modify the practices from time to time. High and cascading effects of the stamp duties have over a period of time evolved innovative and complex instruments through which the real estate transactions are carried out. Further, the real estate has been the matter of substantial litigation under common law. We continue to be governed by the provisions of the Transfer of Property Act, 1882 with its own baggage of several court decisions and amendments.

Income from real estate can be broadly classified into three areas.

a) Transactions of exploiting the property by way of letting out on lease or hire
b) Sale of real estate as a capital asset.
c) Treating real estate as a business asset and exploitation thereof

It is an established proposition of law that heads of income are mutually exclusive. The rules for computation under the different heads are materially different and therefore it is important to decide whether income arising from real estate transactions is chargeable to tax under the head Income from House Property, Business Income or Income from other Sources.

1) Income from House Property:

In this connection, the participants may consider the following issues:

a) If a company, which is incorporated with the object of developing and exploiting property, hires out premises, would income be business income?
b) If the building to be let out is of a special nature, would it make a difference to the head of chargeability?
c) If property is let out and certain additional services are also rendered, would it be possible to allocate the revenue between two heads or would it be taxed under one head?

d) If business assets are let out for a temporary period, what would be the head of taxability?

<u>2) Income in the nature of capital gain.</u>

For an Income to fall under this category, the requirements as to existence of capital asset, determination as to cost and consideration of such asset and transfer of capital asset are necessary conditions.

In this connection, following issues may be considered:

2.1 What would be the quantum of capital gain if the owner of the property enters into an agreement with a developer to develop his property in return for a consideration of which is partly monetary and partly in kind. Ancillary issues would be where the owner is provided with a temporary alternate accommodation (TAA) during the development phase along with the reimbursement of monthly rentals and also certain amount of compensation to meet increased cost of living or locational disadvantage etc. what could be the status of this rental reimbursement or compensation.

2.2 <u>As regards applicability of Sec 50C following issues arise for consideration:</u>

a) The section refers to the transaction giving rise to the transfer and difference in valuation rising in respect of such transaction. Therefore, if capital gains is paid on the basis of agreement to sale. Later on sale deed is executed and on the said sale deed difference in the valuation is determined then the said difference would not invoke provisions of section 50 C as the transaction giving rise to capital gains is agreement to sale on which no difference is arrived at.
b) The section covers only transactions of capital asset and not any other asset. Therefore in all cases where the land dealer or builder of land executes the transfer it is not a case of transfer of capital asset and therefore these transactions are not covered. Would the same logic also apply where the assessee converts the asset into stock in trade and thereafter sells it?
c) The paramount question arises is that whether section 50 C is a substantive provision or machinery provision dealing with the burden of proof. Therefore, valuation difference alone can lead to substitution of the actual consideration or there is a need to point out some other evidence to show that actual consideration transferred is more than the apparent consideration stated in the document and it is only for

the purpose of determination of extant of the under valuation section 50 C can be resorted to. The provision is now held to be constitutiona.

d) The amendment to section 50C and the 56 (2) (vii) is likely to compound problems of section 50C even further. Now the issue would be that the purchaser would be liable to be assessed on income, such income being the difference between the consideration as per the agreement and the value as assessed / assessable by the stamp duty authorities. The inequity is further enhanced by the fact that the cost of acquisition definition remains unchanged.
e) Whether the investment as required U/s. 54 / 54 E / 54 EC is to be made with reference to the consideration mentioned in the deed of sale or as per the stamp duty valuation? Reference in this regard may be made to the language of section 50 C, wherein the substitution is to be for limited purpose of section 48.

2.3 <u>As regards exemption available under sec 54/54F/54EC, the following issues must be considered.</u>

a) Can a legal heir claim exemption u/s 54F in respect of capital gain arising to deceased assessee if the net consideration is invested by the legal heir in residential property purchased in his name assuming that all other conditions of Sec 54F are satisfied?
b) What would be the consequences if a residential house acquired by the deceased assessee claiming exemption u/s 54 before his death is transferred by the legal heir, within the lock-in period of 3 years as stipulated in that section.?
c) Is it possible to claim exemption u/s 54 in respect of all newly acquired units, if more than one residential units are purchased.
d) Sec 54 requires the assessee to purchase the house. Is it necessary for the assessee to purchase the residential house in his own name to avail exemption.

2.4 <u>Tenancy Rights –</u>

In large number of cases, the holder of tenancy right is given an alternative accommodation in the building after reconstruction and the said building more or less correspond to the earlier building occupied by him. The only change is that earlier tenancy rights get converted into a full-fledged ownership rights. The argument advanced in these cases is that an immovable property (like building or land) is not one and single right but it is a bundle of right. In these bundle of right there is a right of occupying and right of ownership (i.e. the title). It is when the right to occupy is divested from the right of ownership (for payment of consideration like rent or premium) then the tenancy is created. Therefore, when a tenancy is converted into ownership, there is no transfer, but there is actually acquisition of rights. Original right of occupation continues and it is not surrendered. By conversion, what the assessee acquires is the title and therefore there is acquisition of rights and not transfer. This is known as sinking or drowning of inferior right (of tenancy) into superior right (of ownership). This concept is also recognized in section 111 (d) of the Transfer of Property Act, 1882. [Refer CIT Vs. Dr. D. A. Irani 234 ITR 850 (Bom)] On these lines it is argued that when there is acquisition of right and not surrender thereof, there cannot be question of any gain or transfer. Though this argument is very attractive does not hold good in case where the re-constructed property is allotted to the tenant. Since the tenancy was in one property and the ownership is in another property, it would be case of exchange of tenancy in X with ownership in Y. In view thereof it would be difficult to take the argument of the assessee further.

<u>The following issues arise which need to be considered.</u>

a) On surrender of a tenancy rights in respect of residential building, capital gain arises. Whether the assessee would be entitled to take benefit of section 54 against such gain? It may be observed that section 54 applies only to capital gain arising on transfer of residential house property. Since tenancy right is not the same as the house property (though it may be a right in respect of such property) the benefit of section 54 would not be available and the assessee may be required to take benefit of either section 54 E or section 54 EC of the Act.

b) Conversely, Will it be possible for a person who has sold a residential house to acquire a tenancy right in respect of a residential house and claim exemption u/s 54?

3) <u>Development Agreements:</u>

On execution of the conveyance deed, there is a heavy implication of the Stamp Duties. However, when a developer of the land, he acquires the right in respect of the property only for a limited period and he is expected to convey the property and interest in the land to the ultimate buyers of the property on or before completion of the project. The instrument devised for this type of activities is a development agreement. In some states, there is stamp duty imposed on the development agreements also. However, actually the development agreements do not amount to transfer of all the rights in respect of the land (depending upon the manner in which it is drafted) and therefore may not amount to transfer of the land in the ordinary parlance

3.1 <u>The following issues need to be considered in this regard.</u>

a) In the light of decisions in Vijayalaxmi Vs Appu Hotels Ltd 257 ITR 4, Jasbir Singh's Case reported in 294 ITR 196 & Chaturbhuj Dwarkadas's case reported in 260 ITR 491, what could be regarded as timing of transfer of immovable property? What is the exact import of Sec 2(47)(v) & 2(47)(vi) and whether they apply to the same category of immovable property.

b) Is the provision of Sec 53A of TOPA applicable to development agreements?

c) What is the meaning of term "possession" in the context of Sec 2(47)(v)? Whether granting of 'license' to the developer to enter upon the property to carry development activity has the effect of enabling the enjoyment of property as contemplated in Sec 2 (47)(vi)

d) If the property is a bundle rights, is it possible to transfer different parts of that bundle at different points of time.

e) What are the tax implications on Co-operative Housing Society or members thereof in respect of income from sale of transferable development rights (TDRs) and in the hands of recipient society where such rights are exercised and some compensation is paid to meet the inconvenience caused to such recipient society?

3.2 <u>Sale of Bungalow to a Builder</u>

These are typical transactions, which happen in a growing city. In these cases sprawling bungalows are replaced by commercial buildings or flats. The owner of the bungalow accordingly enters into an agreement with the builder for development of the bungalow and for that purpose brings down the bungalow and constructs other premises thereon. Disputes have been raised in this regard whether the transaction therefore would amount to a transaction of transfer of residential house or transfer of land. Accordingly, whether the assessee would be entitled to take the benefit of section 54 or he would be covered by the restrictions contained in section 54 F. The issue becomes acute when the transferor is owner of more than one residential property, income from which is chargeable to tax. It is advisable in this case that the owner of the house sells the house as such and the proceeds for bringing down the house is given away to the developer of the land. It should also be ensured that the capital gain on the said property is paid with reference to date anterior to the date on which the bungalow is demolished.

4) <u>Land converted into Plots and then Sold</u>

a) These are the cases where the assessee holding large piece of land decides to sale the same. However, for getting proper realization of the money, he decides to convert the large piece of land into several small plots in an organized manner and after obtaining the approval of the local authority. Thereafter, these small pieces of land are sold to different persons from time to time. Contention of the department generally in such cases is that this amounts to an adventure in the nature of trade and therefore the entire gain (i.e. the difference between the original cost of acquisition and the sales realization) is profits and gains from business or profession. In this case, it is possible to argue that merely conversion of land into several plots does not amount either to conversion of land into stock-in-trade nor makes the entire transaction as an adventure in the nature of trade and accordingly the entire transaction still falls under the head capital gains and the difference is chargeable to tax as capital gains only.

b) Even otherwise, if the provisions of section 45 (2) is applied then substantial portion of the gain arising on transfer shall still continue to be capital gains and appreciation in the value after the land is converted into plots would be assessable under the head "Profits and Gains". It is therefore be advisable in certain cases for the assessee to consider its case under Section 45 (2) and avoid substantial portion of the controversy.

c) An issue that may survive in these cases is the time of taxability. This is on account of the fact that when the asset is a capital asset, the provisions of section 2(47) will apply. When the same is converted into stock in trade the provisions of common law will apply.

5) <u>Turnover –Tax Audit</u>

a) Builders receive the advances exceeding Rs.40 Lacs. However, in the Profit & Loss Account, profit is computed by taking difference between opening Work-In-Progress (WIP), expenses incurred during the year and the market value of closing WIP. The question arises whether Tax Audit is necessary?

b) Sales, Turnover and Gross receipts, though not defined in Income-Tax Act, 1961, have to be considered in commercial sense. The Guidance Note on Tax Audit under 44AB published by the Institute has also expressed this view.

c) The Gross Receipts should include all the receipts in which income is embedded.

d) Retention money - Treatment while computing the total income and tax liability.

e) In case there is certainty of receipt of retention money, in the books of account, 100 % of the contract value can be shown on income side and retention money can be shown on the expense side. If receipt is uncertain, income can be booked net of retention money. In both these cases, only the amount net of retention money can be offered. However, an issue regarding tax deducted on retention money may arise.

6) Deduction under Sec 80IB

6.1 General Issues

a) The deduction is available to an undertaking developing and building housing projects. Will the deduction be available to

   i) A Construction Contractor
   ii) A landowner whose consideration is expressed as a percentage of profits of the project or a percentage of the sale proceeds.

b) The deduction is in respect of profits derived from the housing project. Will the deduction be available to
   i) Sale of TDR received in slum projects?
   ii) Consideration received on assignment of a part of the project?

c) Will the deduction be available if the IOD / CC is obtained before 1st October 1998, but actual construction work is commenced thereafter?

d) Will the deduction be available in respect of

i) A plot of 2 acres on which three bungalows are constructed?

ii) If on a plot of one acre the builder, developer has constructed 10,000 sq.ft. of constructed area in 1997 and the land has not been conveyed to the purchasers / condominium / cooperative society. Thereafter, in December 1998 a plan for construction or 30000 sq.ft. was approved. Will the same be eligible for deduction?

6.2 <u>The issues / points likely to arise out of the amendments are</u> –

The question for consideration is, whether the amendments which come into effect from A.Y. 2005-06, will apply only for the projects which are commenced after that date or will they apply also to projects commenced earlier?

i) In order to get exemption for slum development project, it should be as per the scheme framed by Govt., in the areas declared to be slum areas and "such scheme is notified by CBDT." Therefore, the projects unless are approved by the Govt. and notified by CBDT, will not be eligible for this benefit.

ii) In respect of slum development projects, Govt. grants TDR to utilize on any other projects. Developer receives the consideration on the sale of these TDRs which is considered for working out the profit. It is to be seen if the sale of TDR will constitute "profit" derived from the housing project under the SDR Scheme.

iii) For calculation of " built up area " of the residential units. It is only the "inner measurements" of the residential unit "at the floor level" be considered along with the areas of projections and balconies plus the thickness of walls. The term projection, and floor level are likely to raise a number of issues. They are

- Will terrace be covered ?
- Will a garden which is exclusive to the residential unit be covered?
- Will a parking under stilt be covered ?

iv) The area of the shops and commercial establishments should not be more than 5% or 2,000 sq.ft. whichever is lower. Here the question of retrospectivity will have substantial importance ? Question arises as to whether amenity is provided to the large housing projects like school, colleges, hospitals, club houses etc., are to be included or not. In any case restriction about area of 2000 sq. ft. will apply prospectively from A.Y. 2005-06 prior to it will be as sanctioned by local authority.

v) If there is non-satisfaction of any of the conditions like area of "shop" etc. or certain flats (very small % of total area) are bigger than 1,000 sq.ft. BUA (though majority flats are below 1,000 sq.ft.), deduction cannot be withdrawn for the whole projects, but can be disallowed only proportionately.
vi) If the developer purchases or acquires adjacent 4-5 plots, aggregate area of which is more than one acre and starts construction after Consolidation of the same, it is felt that deduction would be available in respect of the same.
vii) Completion of the project is one more bone of contention. The section contemplates a completion certificate. The issue really is if a part of the project is complete will the deduction be proportionate or will it be denied in entirety ?

Conclusion

The topic of Real Estate Business and its tax implication is a very vast subject. It is not possible to deal with all the aspects of the topic in a single paper. Even if it is possible to do so, I do not think that I am capable of doing so. Therefore, I have decided to stop at this stage, leaving other topics for discussion at another presentation.