



Issues concerning Real Estate sector under Income Tax

CA PANKAJ K JAIN

Introduction

Real estate sector has always contributed immensely to the India's economic growth. However, it has been experiencing a fiscal slowdown in recent years which has aggravated during COVID pandemic.

Though such a slowdown is a result of interplay of multiple economic factors, market conditions etc, there have been some important tax & regulatory issues during the past couple of years, which has impacted the real estate sector.

We will discuss some of the recent tax issues under the income tax act which has resulted in unwarranted stress on the sector.

Coverage of the presentation

Issue	Section
Notional rent on stock in trade	23(5) Introduced w.e.f. AY 2018-2019 and subsequently amended w.e.f .AY 2019-2020
Conversion of stock to capital asset	28(via) Introduced w.e.f. AY 2019-2020
Project completion method	43CB Introduced w.r.e.f. AY 2017-2018

Section 23(5) Relief or Pain?

'Pain lets you know you are still alive.'

Man, I feel so, so, so Alive right now.

Section 23(5)- Introduced by Finance Act 2017- w.e.f.AY 2018-2019

*Where the property consisting of any building or land appurtenant thereto is held as **stock-in-trade** and the property or any part of the property is not let during the whole or any part of the previous year, the annual value of such property or part of the property, for the period up to **two years** from the end of the financial year in which the certificate of completion of construction of the property is obtained from the competent authority, shall be taken to be **nil**.*

FM Speech while presenting the Budget:

“At present, the houses which are unoccupied after getting completion certificates are subjected to tax on notional rental income. For builders for whom constructed buildings are stock-in-trade, I propose to apply this rule only after one year of the end of the year in which completion certificate is received so that they get some breathing time for liquidating their inventory”

Explanatory Memorandum

No notional income for house property held as stock-in-trade

Section 23 of the Act provides for the manner of determination of annual value of house property.

Considering the business exigencies in case of real estate developers, it is proposed to amend the said section so as to provide that where the house property consisting of any building and land appurtenant thereto is held as stock-in-trade and the property or any part of the property is not let during the whole or any part of the previous year, the annual value of such property or part of the property, for the period upto one year from the end of the financial year in which the certificate of completion of construction of the property is obtained from the competent authority, shall be taken to be nil

This amendment will take effect from 1st April, 2018 and will, accordingly apply in relation to assessment year 2018-19 and subsequent years.

Trigger point for this so called relief.....

It is an open secret that this amendment was made in view of the decision of Delhi High Court in the case Ansal Hosuing [2013] 29 taxmann.com 303 (Delhi) & [2018] 89 taxmann.com 238 (Delhi)

The Delhi High Court held that the levy of income tax in the case of one holding house property is premised not on whether the assessee carries on business, as landlord, but on the ownership. It rejected the argument of vacancy allowance relying on the decision of Andhra Pradesh High Court in the case of Vivek Jain v. Asstt. CIT [\[2011\] 14 taxmann.com 146](#) wherein it has been held that in case the property is not let out at all during the previous year, no vacancy allowance can be given under section 23(1)(c). The HC also rejected the reliance placed on the decision of SC in the case of *Chennai Properties and Investments Ltd. v. CIT* [2015] 373 ITR 673 (SC) while hearing the case of Ansal Properties for the subsequent assessment years.

The Supreme Court has admitted the SLP against the above order of the Delhi High Court (95 taxmann.com 17) (SC) which is pending for disposal as on date.

Analysis of various judicial precedents

Unfavorable decision	Favourable decision
<p><u>Ansal Housing [2013] 29 taxmann.com 303 (Delhi HC) (stock in trade).</u></p> <p>The levy of income tax in the case of one holding house property is premised not on whether the assessee carries on business, as landlord, but on the ownership. The incidence of charge is because of the fact of ownership</p>	<p><u>64 Taxman 342 [2007] Neha Builders (P.) Ltd (Gujarat) (stock in trade)</u></p> <p>If property is used as stock-in-trade, then said property would become or partake character of stock and any income derived from stock would be 'income from business' and not 'income from property</p>
<p><i>Bombay High Court in the case of Seimens India Ltd (156 ITR 11) (1985) has held that Where there is a conflict between different High Courts, the AO he must follow the decision of the High Court within whose jurisdiction he is, but if the conflict is between decisions of other High Courts, he must take the view which is in favour of the assessee and not against him.</i></p>	

Unfavorable	Favorable
Vivek Jain v. Asstt. CIT [2011] 14 taxmann.com 146 (AP HC) (vacancy)	Empire Capital (P.) Ltd [2020] 114 taxmann.com 180 (vacancy). Decision of Mum ITAT in case of Sachin Tendulkar was followed (96 Taxmann.com 253)
	Shivsagar Builders (P.) Ltd. [2020] 118 taxmann.com 349 (Delhi - Trib.) (stock)
	<i>Shree Balaji Ventures v. ITO</i> in ITA No. 1914/Pun/2018 dated 19.2.2019 (stock)

Chennai Properties and Investments Ltd. v. CIT [2015] 373 ITR 673 (SC).

This decision was relied upon by Delhi and Pune Tribunal in granting the relief.

In the case of Chennai Properties, the assessee-company was incorporated with main objective, as stated in the Memorandum of Association, to acquire the properties in the city and to let out those properties. The assessee had rented out such properties and the rental income received therefrom was shown as income from business. The Hon SC held that In aforesaid circumstances, it is concluded that letting of the properties is in fact is the business of the assessee. The assessee therefore, rightly disclosed the income under the head income from business. This decision of SC has come much after the decision of Delhi High Court in the case of Ansal Housing. However, the Delhi HC in its subsequent ruling has distinguished the decision of SC in case of Chennai Properties

Section 23 is a computational provision and not a charging section

Section 22

The annual value of property consisting of any buildings or lands appurtenant thereto of which the assessee is the **owner, other than** such portions of such property as he may **occupy for the purposes of any business or profession** carried on by him the profits of which are chargeable to income-tax, shall be chargeable to income-tax under the head "Income from house property".

Addl. CIT v. Hindustan Machine Tools Ltd (121 ITR 798) (1979) (Kar).

Hon' HC held that Section 22 itself indicates that mere ownership of the property does not lead to assessment of its income therefrom under the head "Income from house property".

It excepts portions of such property as may be occupied for the purpose of any business or profession carried on by him, the profits of which are chargeable to income-tax. The guidance to be sought is to find out the user of the property and the **character in which** that property is used.

CONCLUSION

In absence of amendment to the charging section (i.e. Section 22) the legal position concerning taxability of stock in trade has not changed.

The FM speech and explanatory memorandum makes it abundantly clear that the amendment to section 23 is a beneficial provision and is intended to extend the benefit to the taxpayer.

Therefore under no circumstances, the amendment to section 23 can be considered as the sanction to tax notional rent on inventory held by the Real Estate Developer.

If the legislature intends to tax the unsold stock in the manner as decided by Delhi High Court in Ansal's case then an amendment to section 22 is unavoidable.

It would have been prudent if the legislature had waited for final outcome in the case of *Ansal Housing Finance & Leasing Co. Ltd. (supra)*, the decision of Supreme Court would have been law of land and no amendment would have been necessary.

Section 28(via)

Conversion of Stock in trade to capital asset

Section 28(via) - (introduced by Finance Act 2018 w.e.f. 2019-2020)

28. The following income shall be chargeable to income-tax under the head "Profits and gains of business or profession":

*(via) the **fair market value** of inventory as on the date on which it is converted into, or treated as, a capital asset determined in the **prescribed manner**.*

Determination of Fair Market Value is prescribed under Rule 11UAB

(11UAB is reproduced only relevant to immovable property):

(1) For the purposes of clause (via) of section 28 of the Act, the fair market value of the inventory,—

*(i) being an immovable property, being land or building or both, shall be the value adopted or assessed or assessable by any authority of the Central Government or a State Government for the purpose of **stamp duty** in respect of such immovable property on the date on which the inventory is converted into, or treated, as a capital asset;*

Explanatory Memorandum

Rationalisation of provision relating to conversion of stock-in-trade into Capital Asset

Section 45 of the Act, inter alia, provides that capital gains arising from a conversion of capital asset into stock-in-trade shall be chargeable to tax. However, in cases where the stock in trade is converted into, or treated as, capital asset, the existing law does not provide for its taxability.

In order to provide symmetrical treatment and discourage the practice of deferring the tax payment by converting the inventory into capital asset, it is proposed to amend the provisions of —

(i) section 28 so as to provide that any profit or gains arising from conversion of inventory into capital asset or its treatment as capital asset shall be charged to tax as business income. It is also proposed to provide that the fair market value of the inventory on the date of conversion or treatment determined in the prescribed manner, shall be deemed to be the full value of the consideration received or accruing as a result of such conversion or treatment;

(ii) clause (24) of section 2 so as to include such fair market value in the definition of income;

(iii) section 49 so as to provide that for the purposes of computation of capital gains arising on transfer of such capital assets, the fair market value on the date of conversion shall be the cost of acquisition

(iv) clause (42A) of section 2 so as to provide that the period of holding of such capital asset shall be reckoned from the date of conversion or treatment.

These amendments will take effect, from 1st April, 2019 and will, accordingly, apply in relation to the assessment year 2019-20 and subsequent assessment years.

Status before amendments

Before the amendments, the courts have consistently held that the conversion of stock in trade to capital assets is allowed and there are no tax consequences on conversion. The issues in most of the cases were conversion of shares and securities held as stock in trade to avail the benefit of exemption or concessional tax rates. However, the general amendment to tackle such assessee has created a great hardship for the Real Estate Sector.

Express Securities (Del HC) 40 Taxmann.com 427

Where assessee claimed exemption under section 10(38) in respect of gain arising from sale of shares, in view of fact that shares in question were sold nearly two years after date of conversion of shares from stock in trade to capital assets, Assessing Officer could not reject assessee's claim by holding that aforesaid conversion was improper as it was carried out to avail of benefit of introduction of section 10(38) by Finance Act, 2004 with effect from 1-4-2005

Issues concerning Real Estate Sector

- Renting of property held as stock in trade.
- Using the property held as stock in trade as office unit.
- Retaining property held as stock in trade as investment.
- Withdrawal of property for personal use.
- “Fair market value” of inventory is taxable??
- Payment of tax in year of conversion
- No provision to challenge the stamp duty valuation

Instead of bringing symmetry, the amendment leads to some lop-sided outcomes

Tax planning tip

Be optimistic

- The section creates a legal fiction resulting in notional income or may be a loss as the case may be.
- This position of law can be used to the advantage whenever notional income is required to offset the loss which may expire.
- It can also be used to create a legitimate business loss where the purchase cost of inventory is higher than stamp duty value.
- It can also be used to convert business income to capital gains in almost all cases where the sale value is higher than stamp duty value. This can be done when b/fd capital losses are about to expire.



Assessee is caught between Devil and deep blue sea....

Interplay between 23(5) and 28(via)

The interplay between 23(5) & 28(via) in the case of Real estate sector will result in unwarranted and unnecessary financial burden and litigation.

If the developers rent the stock in trade, the department may allege that there is a conversion and tax the notional gain and if he do not rent the stock in trade (beyond 2 years moratorium period) the department will tax notional rent of the said inventory.

Representation to be made

- The tax shall be payable in respect of such converted asset only in the year in which such converted asset is transferred or realised since the provision was introduced to provide symmetric treatment vis-a-vis section 45(2).
- This change will ensure that there is a proper **symmetry** with section 45(2) which was the real intent behind this amendment and the assessee pays tax only on real income. **This one amendment will resolve major hardship of the Assessee.**
- In case of immovable property, since the fair value is presumed to be at stamp duty valuation, there should be a provision to challenge the stamp duty valuation as provided under section 50C(2).
- In respect of real estate developer, renting of property should not be considered as conversion.

Project completion Vs Percentage completion method of accounting

In project completion method, income and expenditure is not recognized until the project is completed leading to objective assessment of the result of the project

In percentage completion method, income and expenditure is recognized in proportion to stage of completion of the contract in order to reflect current performance.

There is always a tussle between the tax payer and the department concerning Project completion method as the department thinks that the Assessee is trying to postpone the tax liability by resorting to Project completion method.

However, various courts including the Supreme Court on several instances have accepted the rationale behind Project completion method in case of real estate sector.

Rationale behind project completion method

- i) The risk in the property remains with the Developers till the OC is received and possession is handed over to the buyer
- ii) In the transaction of advance received from customer, there is no transfer of property as envisaged in Sec. 2(47) of The Income Tax Act, 1961 read with section 53A of Transfer of Property Act, 1882. till possession is handed over.
- iii) Under RERA if the developer fails to give the possession with in the agreed time frame, the Developer is entitled to refund the entire amount with interest.
- iv) Ind AS 115 para 35 provides that *“A good or service is considered to be transferred when the customer obtains control”*
- v) Till date no AS has been issued mandating Percentage Completion Method or none of the AS provides for any principle basis which Project completion method can be rejected.

Why the discussion on a settled issue?

Section 43CB -introduced by Finance Act 2018 w.r.e.f.1.4.2017

*(1) The profits and gains arising from a **construction contract** or a contract for providing services shall be determined on the basis of **percentage of completion method** in accordance with the income computation and disclosure standards notified under sub-section (2) of section 145*

Provided that profits and gains arising from a contract for providing services,—

(i) with duration of not more than ninety days shall be determined on the basis of project completion method;

(ii) involving indeterminate number of acts over a specific period of time shall be determined on the basis of straight line method.

(2) For the purposes of percentage of completion method, project completion method or straight line method referred to in sub-section (1)—

(i) the contract revenue shall include retention money;

(ii) the contract costs shall not be reduced by any incidental income in the nature of interest, dividends or capital gains

Why Section 43CB was introduced ?

Section 43CB was introduced in order to provide the legal sanctity to the ICDS III (Construction contract) and ICDS IV (Revenue recognition), in view of the Delhi High Court decision in the case of Chamber of Tax Consultants v. UOI [\[2017\] 87 taxmann.com 92/\[2018\] 252 Taxman 77/\[2018\] 400 ITR 178 \(Delhi\)](#).

The term 'Construction contract' is not defined under the Act. However, it is defined under ICDS III

"Construction contract" is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use and includes:

(i) contract for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects;

(ii) contract for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

Plain reading of the above definition clearly suggests that the construction undertaken by real estate developer does not satisfy the above definition as the contract is not negotiated for the construction of asset. The real estate developer constructs the asset as per his scheme and contracts with the buyer to sell the asset

ICDS IV – Revenue recognition

ICDS IV deals with the basis for recognition of revenue arising in the course of the ordinary activities of a person from:

(i) the sale of goods

(ii) the rendering of services

(iii) the use by others of the person's resources yielding interest, royalties or dividends

Real Estate Developers deals with immovable property being building and land appurtenant thereto and therefore it cannot be said that he is engaged in the business of selling of goods or rendering of services.

In view of this fact, ICDS IV does not apply to Real Estate Developer.

CBDT vide Circular No. 10/2017, dated 23-3-2017 clarified as under:

"Question 12: Since there is no specific scope exclusion for real estate developers and Build -Operate- Transfer (BOT) projects from ICDS IV on Revenue Recognition, please clarify whether ICDS-III and ICDS-IV should be applied by real estate developers and BOT operators. Also, whether ICDS is applicable for leases.

Answer: At present there is no specific ICDS notified for real estate developers, BOT projects and leases. Therefore, relevant provisions of the Act and ICDS shall apply to these transactions as may be applicable."

The CBDT has tacitly accepted that ICDS III is not applicable to Real Estate Developers.

ICAI in its Technical Guide on ICDS in Chapter 4 para 1.3 has made the following relevant observation /comments

‘The differentiation between a contractor and a builder has also been accepted by ICAI in interpretation to AS 7 issued earlier.

The Tax Accounting Standards committee (‘TAS Committee’) in the final report published during August 2012 in para 8.1.5 observed that a separate ICDS dealing with income recognition by the real estate developers would be notified.

The CBDT has clarified in the FAQ issued on 23rd March, 2017 vide Circular No 10/2017 (Reply to Question No.12) that this ICDS is not applicable to real estate developers’.

Proposed ICDS by CBDT

A draft ICDS on Real Estate Transactions has been published for public comment on 11th May, 2017.

The said ICDS is in sync with the guidance note for accounting for real estate transactions issued by ICAI which only permits percentage completion method as a method for computation of business income for real estate developers.

The said ICDS is still under discussion.

Conculsion

In view of the above discussion, we can safely conclude that the provisions of section 43CB read with ICDS III and IV doesnot apply to Real Estate Developer.

This is strengthen by the fact that the CBDT has proposed the new ICDS for Real Estate Developer which is pending for public comments.

Question Answer session



ANY QUERIES??

You can also write to me @

PANKAJJAIN@SVPATKARCO.COM

