

Tax Alert | Delivering clarity

28 July 2020

Capital gains on land is chargeable to tax when individual flats are sold and not when land is transferred to co-operative society

The Bombay High Court has rendered its decision, holding that proportionate capital gains on sale of land is taxable in the year of sale of flat and not subsequently when the land is transferred to the co-operative society (formed by the flat owners)

Background:

- J.S & M.F Builders (taxpayer)¹ is a partnership firm engaged in real estate business.
- The taxpayer on 8 November 1977 had purchased a property in Mumbai (Property), consisting of seven structures and two garages, for a total consideration of INR 344,087 (includes stamp duty and registration charges of INR 44,087). The Property was mortgaged and all the tenements were let-out.
- The taxpayer reflected the Property as a fixed asset in the balance sheet / books of accounts.
- Subsequently, almost after a decade, the taxpayer entered into various agreements with the tenants to get the property vacated and incurred expenses to the tune of INR 992,427. Accordingly, the taxpayer's balance sheet as on 30 September 1987 reflected the Property as a fixed asset, value of which was disclosed at INR 1,336,514.
- On 1 October 1987, the taxpayer converted a portion of the Property into stock-in-trade and continued to retain the tenanted Property as fixed asset. The market value of the entire Property as on that day was INR 6,938,000 out of which, the value of the Property converted into stock-in-trade was INR 6,629,365.

As per the provisions of section 45(2) of the Income-tax Act, 1961 (ITA), the gain on conversion of fixed asset to stock-in-trade is chargeable to tax in the year in which such asset is sold. Further, the fair market value as on the date of conversion is treated as the full value of consideration for computing the gains.

- The taxpayer thereafter demolished the vacant structures and constructed multi-storied structure.
- During the Financial Years (FY) 1991-92 to 1994-95, corresponding to Assessment Years (AY) 1992-93 to 1995-96, the taxpayer sold the constructed flats.

The taxpayer declared income from sale of flats under the head 'profits and gains from business and profession' and 'capital gains' in the income-tax return. The taxpayer computed capital gain (pro-rata, basis per square feet) as the difference between the market value of the land converted into stock-in-trade as on 1 October 1987 and the actual cost incurred.

¹ [2020] 117 taxmann.com 228 (Bombay)

- The Assessing Officer (AO) accepted the method adopted by the taxpayer for computing the capital gains during the audit for all the concerned AYs.
- Subsequently, the AO on 25 February 2000 issued notices for reassessing the income of the taxpayer for all the concerned AYs, stating that there were reasons to believe that income relating to sale of flats had escaped assessment. The AO gave the following reasons in support of the belief that income had escaped assessment:
 - Closing stock of flats should have been valued at market price as on the date of closing of books of accounts for the years under consideration, instead of the market price as 1 October 1987. This resulted in under valuation of closing stock and consequent reduction of profits.
 - Even though the taxpayer had sold flats, the ownership of land continued with the taxpayer. The land being stock-in-trade should have been valued at the market price as on the date of closing of accounts for the years under consideration. Thus, the taxpayer had suppressed the market price of the closing stock thereby reducing the profit.
 - The taxpayer should have taken only fraction of the cost of land (arrived based on the cost of land of INR 300,000) as against the entire cost of land (arrived based on the cost of land of INR 1,336,514), for the purposes of computing capital gains.
 - ‘Capital gains’ under section 45(2) of the ITA (on conversion of land), was chargeable in the year when the land was sold to the co-operative society and not in the year of sale of flats.
- Aggrieved by the issuances of the notices for under section 148 of ITA, the taxpayer filed a writ petition before the Bombay High Court (HC).

Decision of the Hon’ble Bombay HC:

Reasons 1 and 2: Undervaluation of closing stock of flats and land

- The HC noted the decision of the Supreme Court (SC)², wherein it was held that:
 - The true purpose of crediting the value of unsold stock, was to balance the cost of goods entered on the other side of the accounts in order to cancel out and leave only those transactions, which are actually sold during the year.
 - Anticipated loss is taken into account, but anticipated profit in the shape of appreciated value of the closing stock is not brought into the account, as no prudent trader would care to show increased profit before its actual realisation.
 - Closing stock has to be valued at cost or market price whichever is lower as a generally accepted established rule of commercial practice and accountancy.
 - It would be a misconception to think that any profit arises out of valuation of the closing stock.

In view of the above, the HC rejected the AO’s reason that the stock-in-trade had to be valued at the present market value as on the date of closing of books of accounts for the years under

² Chainrup Sampatram v. CIT [1953] 24 ITR 481 (SC)

consideration, instead of the market price as 1 October 1987 (i.e. the date of conversion to stock-in-trade).

Reason 3: Mode of computation of capital gains

- The HC noted that for the purposes of computing capital gains under the provisions of the ITA, the full value of consideration (i.e. the fair market value on the date of conversion in the current case) on transfer of capital asset was to be deducted by the following:
 - The expenditure incurred in connection with such transfer;
 - The cost of acquisition of asset and the cost of any improvement thereof.
- The taxpayer had deducted the following cost incurred in acquiring the Property from the fair market value of the land converted into stock-in-trade:
 - Cost of acquisition of land of INR 300,000;
 - Stamp duty and registration charges of INR 44,087; and
 - The expenses incurred for getting the Property vacated of INR 992,427.
- The HC noted its decision in an earlier case³, wherein it was held that compensation paid to hutment dwellers for vacating the land was an allowable expenditure for computing capital gains, on the grounds that the said expense was incurred towards improvement of the land.

In view of the above, the HC held that the cost incurred on stamp duty, together with expenses incurred on vacating the property would add to the value of the asset and thus, the amount of cost of improvement was an allowable deduction while computing capital gains. Accordingly, the HC rejected the AO's reason that the taxpayer had inflated the cost of the land while computing the capital gains on sale of flats.

Reason 4: Year of chargeability of capital gains on sale of land

- The HC noted the following observations of the AO in forming a belief that income had escaped assessment:
 - Land as a stock was a different item than flats and therefore, the ownership of land remained with the taxpayer even though the flats were sold by the taxpayer.
 - Capital gains on sale of land were chargeable to tax only in the year when the land was sold or transferred to the co-operative society (formed by owners of the flats) in future and not in the year when individual flats are sold.
- The HC observed that if the taxpayer (as per the AO) could have offered capital gains tax on land in subsequent years, then the income for the years under consideration could not have escaped assessment.

³ CIT v. Piroja C. Patel, [2000] 242 ITR 582 (Bombay HC)

- The HC relied on the SC case⁴, wherein it was held that what the partner gets upon dissolution of the partnership or upon retirement from the partnership is the realisation of a pre-existing right or interest. The SC also noted that there was nothing strange in the law that a right or interest should exist in praesenti but its realisation or exercise should be postponed.
- The HC applying the same principle as laid down by the SC, held that the purchasers had acquired a right or interest in the proportionate share of land on purchase of flats. However, its actual realisation was deferred till formation of the co-operative society by the owners of the flats and eventual transfer of the entire property to the co-operative society.

In view of the above, the HC rejected the AO's contention that the taxpayer had erred in offering the capital gains (in relation to land) in the year in which the flats were sold.

Conclusion:

- In view of the above, the HC held that there was no justification for the AO to form a belief that any income chargeable to tax had escaped assessment. Accordingly, the HC quashed and set aside the notices issued by the AO for reassessment of income.

Comments:

- This ruling affirms / lays down the following principles:
 - In case of conversion of fixed assets into stock-in-trade, the fair market value as on the date of conversion has to be considered (and not the subsequent fair value) as full value of consideration for computing capital gains.
 - Compensation paid for vacating the property is an allowable expenditure for computing capital gains.
 - The proportionate share of land should be considered to be transferred on sale of flats and the capital gains are not to be deferred until transfer of such land to the co-operative society.

⁴ Sunil Siddharthbhai v. CIT, [1985] 156 ITR 509 (SC)



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmatsu India LLP (DTTI LLP) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This material contains information sourced from third party sites (external sites).

DTTI LLP is not responsible for any loss whatsoever caused due to reliance placed on information sourced from such external sites. None of DTTI LLP, Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this material, rendering professional advice or services. This information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this material.

©2020 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited