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Article

Valuation of asset - A tax riddle faced by real estate firms

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Backdrop

When a partnership firm is formed for carrying on real estate business and a partner contributes land or building therein then the tax consequence of contribution of such land or building becomes a tricky issue. The computation of the capital gain on this transaction is a challenge because of two Sections that are apparently applicable but conflicting in their approach. This article seeks to analyse the issue and attempts to provide some thoughts towards the solution thereto.

As per Section 45(3) of the Income tax Act, 1961 ('the Act') when *any capital asset* is contributed to the firm by a partner then the '*value*' of that asset as '*recorded in the books of account*' of recipient firm *is taken as full value of consideration* of the transfer of that asset for levy of capital gains tax. On the other hand, if a *land or building* is transferred *by any person to any other person*, then as per Section 50C, value adopted for levying stamp duty is to be considered as full value of consideration, for computing capital gains, provided such value is higher than declared transaction value.

When a partner contributes land or building to the firm then whether the amount recorded in books of account of the firm is to be adopted [as required under Section 45(3)] or value adopted for stamp value [as per Section 50C] is a question that requires careful consideration.

Legal framework

Section 45(3) creates a deeming fiction and was introduced by the Finance Act, 1987 with the objective[1] to overrule the Supreme Court decision in *Sunil Sidharthbhai* v. *CIT*[2]. Supreme Court in that case had held that when the assets are transferred from partner to a firm, no *determinable consideration* is received by that partner within the meaning of Section 48, nor does any profit or gain accrue to him in commercial sense, and therefore, chargeability under Section 45 doesn't arises. To get over the conundrum of determinability, the law provided that value recorded in books of account be adopted. On the other hand, the provisions of Section 50C of the Act is a special provision intended to deal with unaccounted money generated by under - reporting of the sale price.

Our analysis

The issue before hand came up for consideration in the case of *Carlton Hotel (P) Ltd.* v. *ACIT*[3]. However, the controversy was resolved by stating that Section 50C is not applicable on a standalone basis. Following *Navneet Kumar Thakkar* v. *ITO*[4] it was held that despite contribution of land to

[1] Circular No. 495 dated 22/09/1987

[2] (1981) 156 ITR 509

[3] (2009) 122 TTJ 515 (Luck)

[4] (2007) 110 ITD 525 (Jodhpur SMC)

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the firm it continues to be legally owned by the partner since registration of the property has not been carried out. The ITAT was of the view that for want of registration, stamp duty has not actually been assessed as a result Section 50C does not apply. Resultantly only Section 45(3) was held as applicable. Now the provisions of Section 50C stand amended[5] and if the stamp value is not actually assessed then the value at which it would have been assessable[6] is required to be adopted under Section 50C. This amendment, in effect, impliedly overruled the aforesaid decision pronounced by Lucknow and Jodhpur benches of Tribunal. Hence the problem of resolving conflict between Section 45(3) and 50C has become acute.

Similar conflict was resolved denying the applicability of Section 45(3) when contrasted with applicability of transfer pricing provisions. AAR held that the value of consideration shall not be the value as recorded in the books of the firm, but the same shall be determined on the basis of arm's length price in accordance with transfer pricing provisions[7].

We have hereunder independently interpreted the provisions in dispute and provided our preliminary conclusion.

Harmonious interpretation: It is a settled principle that a statute must be read as a whole and one provision of the Act should be construed with reference to other provisions in the same Act so as to make a consistent enactment of the whole statute[8]. The rule of construction is well settled that when there are, in an enactment, two provisions which cannot be reconciled with each other, they should be so interpreted that, if possible, effect should be given to both[9]. Looking from this perspective one would feel that objective of Section 45(3) was to bring the transaction within tax net by providing computation mechanism and objective of Section 50C is to ensure that the tax is levied on the proper sum of money. Therefore the value adopted for Section 50C should be adopted so that the objectives of both the sections are met.

General v. special provision: Another well known rule is to classify two apparently conflicting provisions as general and special. The rule requires that specific provision should be read as overruling the general one, and the general enactment must be taken to affect only the other parts of the statute to which it may properly apply[10].

Examined from this perspective, we find that the provisions of Section 50C are specific with respect to class of assets (being land or building), whereas the provisions of Section 45(3) are general as far as the class of assets is concerned, but specific to a category of transaction (between partner and firm). It appears difficult to arrive at a conclusion based on this rule.

Scope of a legal fiction: Legal fictions are

5 Finance (No. 2) Act, 2009

6 Clause 25 of the Memorandum explaining the Finance Bill, 2009

7 In Re : *Canoro Resources Ltd.,* 313 ITR 2 (AAR)

8 *M. Pentiah* v. *Veeramallappa Muddala,* (1961) 2 SCR 295

9 *Sultana Begum* v. *Prem Chand Jain,* 1997 AIR 1006, p. 1009,1010

10 Narain Das Paramanand Das v. ITO, (1979) 117 ITR 174 (Cal)

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created only for a definite purpose and they are limited to the purpose for which they are created and should not be extended beyond their legitimate field[11]. Even from this perspective one would say that objective of Section 45(3) was to bring the transaction within tax net while objective of Section 50C is to ensure that the tax is levied on the proper sum of money and therefore value adopted for Section 50C should be adopted so that both the objectives are met.

Literal rule is the 'Golden Rule': The opening part of Section 50C reads as "where the consideration received or accruing as a result of the transfer....... is less than the [stamp] value". Therefore, for invoking the provisions of Section 50C, there must be a 'consideration' received or accruing. It needs to be carefully examined whether any consideration is received or accruing as a result of transfer, in real sense, when an incoming partner contributes land and building as his capital in the firm. The Supreme Court in *Sunil Sidharthbhai v. CIT*[12] *made an important observation in this regard, "It is impossible to conceive of evaluating the consideration acquired by the partner when he brings his personal asset into the partnership firm.....In the circumstances, we are unable to hold that the consideration which a partner acquires on making over his personal asset to the partnership firm as his contribution to its capital can fall within the terms of Section 48."*

The proposition that the consideration received or accruing cannot be determined when a land and building is transferred by a partner to a firm was thus affirmed in Supreme Court judgment (supra) and in real sense, no determinable consideration is received or accrued as a result of transfer in such a case where an incoming partner introduces capital asset as his contribution to the firm. It is for this reason Section 45(3) was introduced to provide for deeming an amount as 'full value of consideration' an expression different from 'consideration' appearing in Section 50C. The former is a deemed one which can neither be *received* nor *accrued.*

Conclusion

Based on a detailed analysis of the relevant provisions of the Act as well as the relevant decisions of various Courts and Tribunals in this context, followed by the amendment that was introduced by Finance (No.2) Act, 2009; it can be contended that Section 50C could not be invoked in such a case, which as a matter of fact can be invoked in cases where an *actual sum of consideration is received or accrued* as a result of transfer in real sense and not a fictitious amount. The adverse ruling of *Canoro Resources* (supra) can be independently supported by a different legal reasoning and in view of the authors should not affect the conclusion herein above.

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[11] *CIT* v. *T.S. Rajam,* (1980) 125 ITR 207 (Mad), *Cambay Electric Supply Ind. Co. Ltd.* v. *CIT,* (1978) 113 ITR 84(SC)

[12] (1981) 156 ITR 509

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Circular

Revised criteria for selection of cases for scrutiny

CBDT has notified revised criteria for manual selection of returns for scrutiny during the financial year 2014. The most significant change is that merely because the value of international transaction is beyond a limit (earlier INR 15 crores) the same would not be necessarily selected for scrutiny. Other aspects remain largely un-altered. Broadly stated, cases in which in the earlier year addition exceeding Rs. 10 lakhs were made, addition exceeding Rs. 10 crore made in transfer pricing, assessments after survey under Section 133A, all cases involving search and seizure will be selected for scrutiny. Cases where the tax exemption has been wrongly claimed under Section 10(23C) will also be selected for scrutiny assessment. Cases selected under Computer Aided Scrutiny Selection (CASS) will also be notified shortly.

Ratio decidendi

Services rendered by a non-resident agent are not 'technical services'

The tax payer, a manufacturer-exporter entered into an agency agreement with a non-resident agent to secure orders from customers outside India, for which he was paid commission. The revenue authority contended that the foreign agent had rendered technical services and that the tax payer had defaulted in deducting tax on the sums remitted. The High Court held that the instant case was that of a 'commission simpliciter' and did not fall within the definition of 'Fees for technical services'. The High Court further held that the payment was not liable to tax in India and hence the tax payer was not at default for not deducting tax. [*CIT* v. *Faizan Shoes (P) Ltd.*, ITA No. 789 of 2013, Madras High Court, Judgement dated 22-7-2014]

Discount given to buyers for advance payment is in the nature of 'Interest'

The tax payer allowed discount to its foreign buyer in consideration of receiving advance payment. The revenue authority treated it to be constructive payment of interest and contended that the tax on the same ought to have been deducted under Section 195. The Tribunal held that the discount is in nature of 'interest' since it is the benefit allowed to the foreign buyer as consideration of receiving advance payment. The Tribunal further held that merely because a different nomenclature is given, character of a transaction does not change. [*DCIT* v. *Kothari Food & Fragrances*, ITA No. 92 of 2012, ITAT Lucknow, Order dated 5-9-2014]

Secondary adjustments are not permissible under Indian Transfer Pricing regulations

The tax payer had invested in the shares of its subsidiary. The revenue authority re-characterized the investment as an advance to the subsidiary. In addition, the revenue authority imputed notional interest on the said investment, treating the investment as advancement of loan. The Tribunal held that imputing interest

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to a transaction of investment in subsidiary should be regarded as a 'secondary adjustment' which is not permissible under Indian Transfer Pricing regulations and accordingly deleted the adjustment made for notional interest. [*PMP Auto Components Pvt Ltd* v. *DDIT*, ITA No1484/Mum/2014, ITAT Mumbai, Order dated 22-8-2014]

Only 50% of interest saving on account of guarantee given by AE can be attributed to the AE

The tax payer, part of a Multi National Enterprise (MNE), had availed certain credit facility from a financial institution in India. Due to a guarantee extended by an Associated Enterprise (AE), the sum was advanced by the financial institution at a concessional interest rate. The tax payer passed on the entire interest saving to the AE which had extended the guarantee. Following the international practice of sharing such cost saving equally between transacting parties, the Tribunal restricted the deduction to 50% of the interest saved. [*DSM Anti-Infectives India Ltd* v. *ACIT* , ITA No. 1139/Chd/2011, ITAT Chandigarh, Order dated 7-8-2014]

STPI approval is a prerequisite for claiming Section 10B benefit

The tax payer, a company engaged in software development, applied for STPI approval in March 2005 and obtained approval in May 2005. It claimed deduction under Section 10B for the AY 2005-06 which was denied by the revenue authority. The High Court held that, there is no ambiguity in the provisions of Section 10B as Explanation 2(iv) to the section clarifies that 100% export oriented undertaking means the undertaking which has been approved by the Board, and therefore, approval by the competent authority is a pre-requisite for grant of benefit under Section 10B. [*CIT* v. *Live Connection Software Solutions Pvt. Ltd.*, ITA No. 1328 of 2009, Madras High Court, Judgement dated 25-8- 2014]

IT Enabled HR Services are eligible for Section 10A deduction

The tax payer, a unit registered under STPI, was engaged in providing services relating to recruitment of overseas consultants for foreign companies. It claimed its income to be exempt under Section 10A. The revenue authority denied the claim contending that the tax payer rendered services as an employment agent and merely forwarded list of shortlisted candidates with minimum use of computers and IT enabled services. The High Court observed that the tax payer was using information technology in scanning the data and processing it for short-listing candidates and held that the impugned activities to be squarely covered under clause (vii) of Notification S.O. 890(E) issued by Board. The High Court thus held that the tax payer was entitled to deduction under Section 10A. [*CIT* v. *ML Outsourcing Services (P) Ltd.* ITA No. 1255 of 2011, Delhi High Court, Judgement dated 3-9-2014]

Expression 'held' embraces actual lawful possession

The tax payer declared long term capital gains in the year 1997 on account of surrender of tenancy rights which it acquired in 1973 under an agreement for 3 years, which was not renewed thereafter. However, the possession continued

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to be with tax payer. The revenue authority contended it to be a short term capital asset on the count that tenancy rights are extinguished and re-recreated on month-to-month basis. On these facts, the High Court held that, the expression 'held by the assessee' appearing in the definition of 'short term capital asset', means the date from when the assessee acquired the right. The High Court observed that the word 'held' embraces the idea of lawfully holding or possessing by legal title and therefore, for the purpose of calculating period of holding of an asset, the date when the tax payer assessee got the beneficial interest in the property has to be considered as the date of acquisition. [*CIT* v. *Frick India Ltd.* , ITA No.146 of 2002, Delhi High Court, Judgement dated 2-9-2014]

Income taxable if it is real income and not on notional basis

The tax payer advanced certain sums to some parties, the interest on which, due to some reasons was not received and consequently nor offered to tax. The revenue authority however, added such sum as notional interest being accrued to the assessee. On these facts, the Tribunal held that income cannot be taxed on hypothetical basis and only real income can be brought to tax. The Tribunal observed that unless the revenue is (i) measurable and (ii) collectable with certainty, no income can be said to have arisen irrespective of the method of accounting followed. [*CIT* v. *Maruti Securities Ltd.*, ITA No. 468 of 2009, ITAT Hyderabad , Order dated 5-9-2014]

Section 80IB benefit to be allowed to industrial undertakings taking P&M on hire

The claim of the tax payer, a film production unit, under Section 80IB was denied by the revenue authority on the ground that the condition that the undertaking shall not be formed by transfer to the new business any plant and machinery used for any purpose was not fulfilled. On appeal, the High Court held that, Section 80IB permits an undertaking to be formed by 'hire' of plant and machinery and does not necessarily require the tax payer to own the same. The High Court held that a film production unit formed by engaging cameraman, editor, sound technicians etc. and using their equipments on contract basis is an 'industrial undertaking' eligible for section 80-IB deduction. [*CIT* v. *Shri Jyoti Prakash* Dutta ITA No. 540 of 2012, Bombay High Court, Judgement dated 25-7-2014]

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