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ITAT rules TDR accruing to a plot holder through Development Control Regulation is an improvement to land, the consideration for transfer of which is not exigible to capital gain tax

Executive Summary

This tax alert summarizes the recent significant ruling of the Mumbai ITAT (ITAT) in the case of **Ishverlal Manmohandas Kanakia** (the Taxpayer)[1], on an issue whether consideration received by the Taxpayer from a developer for permitting development of a property owned by him by utilizing development potential (including TDR) is liable to capital gains tax under the Income Tax Act (the Act)?

The Taxpayer, an individual, owned leasehold rights over a plot with two co-owners. The building on the plot was occupied partly by Taxpayer and partly by tenants. Pursuant to Development Control Regulation, 1991 (DCR) the said plot became entitled to additional FSI of 8400 sq. fts. by loading of Transferable Development Rights (TDR)

The Taxpayer along with co-owners entered into an agreement with a developer to construct new building after demolishing the existing structure. The developer agreed to redevelop the property utilizing the FSI of the plot and TDR loaded thereon and agreed to give Taxpayer two flats in the new building aggregating to 2689 sq. fts. of carpet area in addition to the monetary consideration of INR 2.11 crores. The AO, applying the provision of section 50C of the Act, arrived at a sale consideration of INR 2.59 crores as the amount chargeable to long term capital gains tax. On an appeal, the first appellate authority held that TDR being an intangible property, the provisions of section 50C which applies to the transfer of immovable property, are not applicable. However, since the Taxpayer had transferred the plot FSI along with TDR for certain amount of money, provisions of long term capital gains are attracted. On an appeal by the Revenue and the Taxpayer, ITAT held that right to load and use FSI credit by way of TDR was an improvement to the capital asset viz., the plot of land. Since the said right vested to the Taxpayer by virtue of amendment to DCR, for which no cost was incurred by the Taxpayer, the consideration received by the Taxpayer was not liable to tax.

[1] ITA No. 3053/Mum/2010 and ITA No. 2650/Mum/2010

Background

- The Taxpayer, an individual, owned leasehold rights over a plot of land along with his two brothers as co-owners. The asset was acquired in year 1963.

- The residential units in the building constructed on the plot were occupied by the Taxpayer and tenants as well.
- The plot was capable of receiving TDR as per the provisions of DCR 1991
- The Taxpayer along with other co-owners entered into an agreement with a developer to construct new building after demolishing the existing structure. The developer agreed to redevelop the property utilizing the FSI of the plot and TDR loaded thereon and also agreed to give Taxpayer two flats in the new building aggregating to 2689 sq. fts. of carpet area in addition to the monetary consideration of INR 2.11 crores.
- The Taxpayer in its return of income declared capital gain of INR 29.54 lacs after claiming expenditure of the amount paid to the co-owners and fees paid to architect.
- The AO applied provisions of section 50C of the Act to adopt the value of consideration as Rs. 2.59 crores, the prescribed fair value of the property as per ready recknor for use by the authorities of the State Government. He also rejected the claim for deduction of expenditure for the reason that the Taxpayer did not furnish evidence to substantiate the claim.
- On an appeal to the first appellate authority, it held that the assessee had not only permitted the developer to load TDR which the receiving plot was entitled to, but also the inbuilt FSI of the plot which definitely has a cost of acquisition. Hence, it cannot be said that no capital gains could arise for want of cost of acquisition of the asset transferred. However, he held that TDR being an intangible asset, the provisions of section 50C would not apply.
- Aggrieved by the order of the first appellate authority, both, the Revenue and the Taxpayer filed appeal before the ITAT.

Tax Authority's contentions

- The additional FSI received by the Taxpayer on account of DCR, 1991 is inextricably connected with land and building and hence transfer of the same is as good as transfer of land and building. The cost of the asset is available and therefore it cannot be said that capital gain cannot be ascertained.
- Also, the provisions of section 50C are applicable to the TDR in the same manner as it is applicable to land and building since it is inseparable from the plot of land.

Taxpayer's contentions

- TDR received on account of DCR, 1991 is an improvement to the existing plot of land
- As held by the Supreme Court (SC) in B.C. Srinivasa Shetty[2], since the TDR which is the subject matter of transfer did not cost to him, the consideration received on its transfer has no element of capital gains that can be charged to tax

ITAT ruling

- For attracting capital gain charge the following conditions are necessary to be fulfilled:
  - There must be a capital asset

[2] 128 ITR 294

- There should be transfer of the capital asset
- The cost of acquisition of the capital asset or the cost of improvement should be determinative
- There must be accrual of consideration for the transfer of capital asset

- The right to construct building on the said plot is a capital asset acquired by the Taxpayer by paying cost while TDR was a right acquired by virtue of DCR, 1991 without payment of any cost.
- The TDR received by the Taxpayer was an improvement to the existing capital asset, for which there is no cost of acquisition
- As held by the SC in B.C. Srinivasa Shetty (supra), both, the cost of acquisition and cost of improvement should be capable of being ascertained and only then the computation of capital gains can be made.
- In the absence of there being cost of improvement of the capital asset, the computation mechanism for charge of capital gains tax has failed. Therefore, the consideration received by the Taxpayer for transfer of the said rights is not exigible to capital gains tax.

Our comments

- The Mumbai Tax Tribunal has been consistently affirming the tax position that consideration received by a Taxpayer on account of transfer of development rights which accrued by the virtue of amendment in DCR is not liable to capital gains tax.
- The redevelopment of properties in Mumbai by utilization of TDR mechanism is being effected under various schemes. In this case, the differentiating feature was the transfer of complete development rights which in the agreement with the developer was defined as comprising of FSI embedded to the plot prior to the amendment of DCR in 1991 and the TDR accruing to the plot post amendment to the DCR. Hence, the Revenue raised an argument that the transferred capital asset (i.e. development potential of the land) had a definite cost in terms of the original cost of the plot of land. It is imperative that the development schemes are carefully designed and drafted to ensure that they fall in line with tax rulings favorable to the taxpayers.
- While evaluating the tax risk of the transactions of such nature, it will be quite relevant to note that the favorable rulings of the Tribunal so far are susceptible to the review by the higher judicial forums. Hence, it would be advisable to adopt conservative approach in structuring the transactions.

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At your Service

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