

# ***Development rights not transferred by member of AOP (formed only for efficient pooling of resources) not to be taxed under section 45(3)***

June 14, 2016

## ***In brief***

The Pune Bench of the Income-tax Appellate Tribunal (Tribunal) has held in a case where the capital asset (development rights) was not transferred by the member to the association of persons (AOP), and no amount was credited by the AOP to the account of such member, the AOP could not be taxed under section 45(3) of the Income-tax Act, 1961 (Act).

## ***In detail***

### ***Facts***

- The taxpayer<sup>1</sup> had acquired development rights of a land parcel.
- The taxpayer, along with A Enterprise and B Construction, formed an AOP for efficient pooling of resources. Each member's responsibilities were as given below:
  - Taxpayer: To contribute the development rights;
  - A Enterprise: To contribute the Transferable Development Rights (TDR);
  - B Construction: To provide all materials required for construction and finance for all the expenses.

- The taxpayer had not transferred the development rights to the AOP.
- The taxpayer had received an interest-free security deposit of INR 2.5 millions from B Construction for protection from any losses that might arise in the project. The security deposit was reflected as a liability in its balance sheet.
- This security deposit was refunded back to B Construction in the financial year (FY) 2014-15.
- The value of the property, as mentioned in the joint venture agreement, was INR 20 millions.
- The Tax Officer (TO) considered that the interest-free security deposit was received by the taxpayer for

assignment of development rights to the AOP. Accordingly, the TO taxed the difference between INR 2.5 millions and the cost of acquisition as capital gains in the taxpayer's hands.

- The Commissioner of Income-tax (Appeals) upheld the TO's order.

### ***Question before the Income-tax Appellate Tribunal***

Should the transaction of contribution of development rights to the AOP, but not actual transfer thereof, be subject to capital gains tax under section 45(3) of the Act?

### ***Taxpayer's contentions***

- For applying section 45(3) of the Act, two conditions should have been satisfied: (a) the amount of value

<sup>1</sup> TS-313-ITAT-2016 (Pune-Tribunal)

should have been shown as an asset; and (b) the amount should have been credited to the contributor.

- Since no asset was transferred to the AOP, no amount was recorded in the books of the AOP. Hence, section 45(3) was not applicable. The security deposit received by the taxpayer could not be regarded as the full value of consideration.

#### **Revenue's contention**

- The value of the property, i.e. INR 20 million mentioned in the joint venture agreement was the price at which the asset was transferred to the AOP.

#### **Tribunal's ruling**

- Since the taxpayer held the asset and did not transfer it to the AOP, there could not have been any capital gains under section 45(3) of the Act.

- Even otherwise, the entire security deposit was refunded to B Construction in a later FY. Hence, the security deposit was not chargeable to tax.

#### ***The takeaways***

The Tribunal has accepted the taxpayer's contention that section 45(3) is a deeming section and hence should be construed strictly. Thus, it has held that if a capital asset has not been actually transferred to the AOP, and no amount credited to the member's account [condition specified in section 45(3)], there can be no capital gains tax.

This decision may be helpful in situations where the tax authorities conclude that a particular arrangement should be treated as an AOP. In such cases, it may be possible to argue that there should not be any capital gains tax in the hands of members on deemed introduction of a capital asset to the AOP.

It is important to note that the Central Board of Direct Taxes has recently issued circular no. 7 dated 7 March, 2016 laying down the guiding principles for the formation of an AOP. In the light of these principles, if the tax authorities contend that the arrangement does not result in an AOP, then the implication under section 2(47)(v) of the Act on similar transactions may need to be evaluated.

#### ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact:

#### ***Tax & Regulatory Services – Financial Services***

Gautam Mehra, *Mumbai*  
+91-22 6689 1154  
[gautam.mehra@in.pwc.com](mailto:gautam.mehra@in.pwc.com)

Bhavin Shah, *Mumbai*  
+91-22 6689 1122  
[bhavin.shah@in.pwc.com](mailto:bhavin.shah@in.pwc.com)

## ***Our Offices***

### ***Ahmedabad***

1701, 17th Floor, Shapath V,  
Opp. Karnavati Club,  
S G Highway,  
Ahmedabad – 380051  
Gujarat  
+91-79 3091 7000

### ***Hyderabad***

Plot no. 77/A, 8-2-624/A/1, 4th  
Floor, Road No. 10, Banjara Hills,  
Hyderabad – 500034sx  
Telangana  
+91-40 44246000

### ***Gurgaon***

Building No. 10, Tower - C  
17th & 18th Floor,  
DLF Cyber City,  
Gurgaon – 122002  
Haryana  
+91-124 330 6000

### ***Bengaluru***

6th Floor  
Millenia Tower 'D'  
1 & 2, Murphy Road, Ulsoor,  
Bengaluru – 560 008  
Karnataka  
+91-80 4079 7000

### ***Kolkata***

56 & 57, Block DN.  
Ground Floor, A- Wing  
Sector - V, Salt Lake  
Kolkata - 700 091  
West Bengal  
+91-033 2357 9101/  
4400 1111

### ***Pune***

7th Floor, Tower A - Wing 1,  
Business Bay, Airport Road,  
Yerwada, Pune – 411 006  
Maharashtra  
+91-20 4100 4444

### ***Chennai***

8th Floor  
Prestige Palladium Bayan  
129-140 Greams Road  
Chennai – 600 006  
Tamil Nadu  
+91 44 4228 5000

### ***Mumbai***

PwC House  
Plot No. 18A,  
Guru Nanak Road (Station Road),  
Bandra (West), Mumbai – 400 050  
Maharashtra  
+91-22 6689 1000

### ***For more information***

Contact us at  
[pwctrs.knowledgemanagement@in.pwc.com](mailto:pwctrs.knowledgemanagement@in.pwc.com)

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