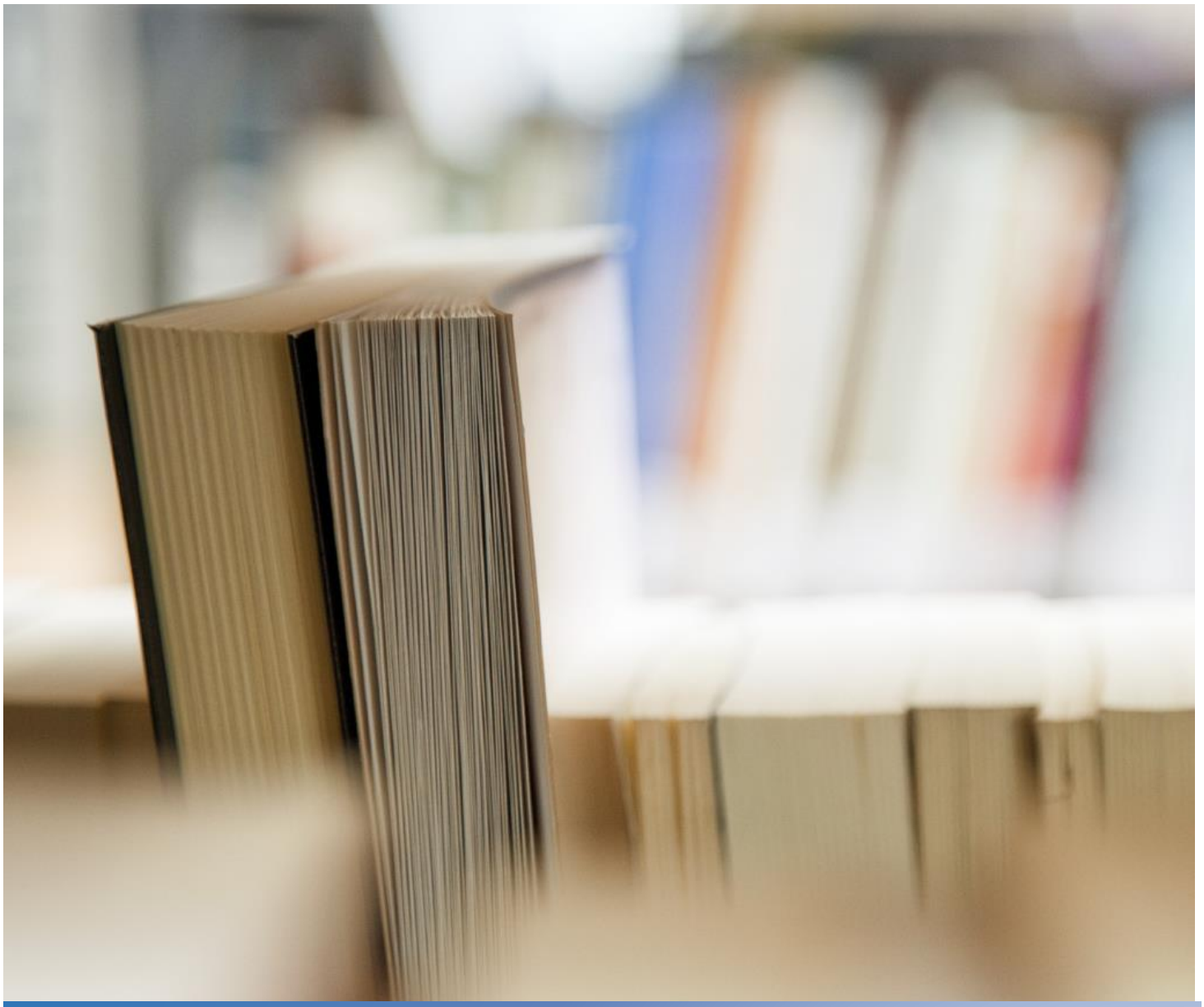

Development rights – taxability, timing and value perspective

S KHAITAN & ASSOCIATES

SHUBHAM KHAITAN

DEVELOPMENT RIGHTS – TAXABILITY, TIME AND VALUE OF SUPPLY

Introduction

Generally, the developers of any real estate project do not outrightly purchase land as it entails blockage of working capital and higher cost of capital for them. They enter into an arrangement with the landowners where a certain permission is obtained to investment monies to secure all approvals and put up a structure for sale such that out of the proceeds from sale, to share amongst themselves a fair compensation to the landowner for his contribution and to the developer for his enterprise in bringing this entire project into being. While this is the substance of the arrangement, the structure of the arrangement is put in effect in the form of an 'irrevocable general power of attorney' along with 'joint development agreement'.

Pursuant to this arrangement, the landowner may either receive constructed units on completion of the project, it is popularly known as area sharing agreement. On the other hand, where monetary consideration is paid by the developer by calculating a pre-decided percentage of revenue received, the same is called as a revenue sharing agreement.

Property Rights to Developer

Form in which the arrangement is entered into must be tested from the point of rights conferred on the Developer over the immovable property of the Landowner. As can be seen that no Developer would consent to investing in land that belongs to Landowners without any security from being ejected out of the project site. To this end, section 202 of Indian Contract Act comes to Developer's rescue if the agreement with Landowner admits to Developer operating as 'agency coupled with interest'. Once Developer enjoys 'interest' in the land, section 17 of Registration Act makes this agreement one that is compulsorily liable to registration. Registered instrument conferring interest in the immovable property completely secures the Developer's interest.

Immovable property is not limited to land. It extends to land and interest on land and benefits to arise out of land. Interests *in presenti* are not benefits because benefits that are yet to arise are not interests in present. In other words, benefits *in futuro* are the things that will be taken away from that land. Tree is part of the immovable property but the fruits that this tree will produce are benefits 'to arise' from the immovable property once the tree grows and starts

to yield its fruit. Development rights is an 'interest' that exists *in presenti* and not something to arise *in futuro*.

Legal definitions

Now adverting to CGST Act, reference may be had to point 5 of Schedule III excludes 'sale of land and completed building' from the ambit of supply. Sale of land can be basically categorized as neither supply of goods and nor supply of services and thereby not leviable to tax.

i. To find out if transfer of land development rights can be construed as sale of land, one should compare the said provision with the definition of service given under the Service tax law. As per the extract of the Section 65B (44) of the Finance Act, 1994:

"service" means any activity carried out by a person for another for consideration, and includes a declared service, but shall not include—

(a) an activity which constitutes merely—

(i) a transfer of title in goods or immovable property, by way of sale, gift or in any other manner

As per the definition of service under Service tax law, transfer of title in immovable property was not a service at all. The definition of immovable property was not given under the Service tax law. Thereby, one needs to borrow the definition of immovable property from other Acts.

ii. As per the Registration Act 1880:

"immovable Property" includes land, buildings, hereditary allowances, rights to ways, lights, ferries, fisheries or any other benefit to arise out of land, and things attached to the earth, or permanently fastened to anything which is attached to the earth, but not standing timber, growing crops nor grass

iii. As per the General Clauses Act 1897:

"Immovable property' shall include land, benefits to arise out of land, and things attached to the earth or permanently fastened to anything attached to the earth".

iv. As per 2(z) of RERA:

(z) "immovable property" includes land, buildings, rights of ways, lights or any other benefit arising out of land and things attached to the earth or permanently fastened to anything which is attached to the earth, but not standing timber, standing crops or grass;

What was excluded from service tax was immovable property i.e. land, building and rights, interest and benefits to such land and building. Development rights being in the nature of immovable property was excluded from the ambit of Service tax as well.

Levy of GST is on supply of goods and services. The definition of goods as per Section 2(52) of the CGST Act 2017 provides for inclusion of movable property only. The definition of services under Section 2(102) of the CGST Act 2017 starts with the expression 'anything other than goods'. 'Anything' includes everything and leaves nothing. Thereby, services include immovable property as well. Supply under Section 7(1) of the CGST includes supply of all goods and services including immovable property. However, an exception has been carved out for activities under Schedule III as per Section 7(2) of the CGST Act 2017. Within Schedule III, sale of land and completed building has been provided under 'activities treated as neither supply of goods nor supply of services'. Whether development rights can be classified within sale of land needs to be determined.

Since the word 'sale' is not defined under GST law, one may need to refer to Section 54 of the Transfer of Property Act to understand the context of sale of any immovable property. Section 54 of the Transfer of Property Act 1882 defines sale as follows:

"Sale" is a transfer of ownership in exchange for a price paid or promised or part-paid and part-promised.

Thereby, only an outright transfer of title in property including land can be classified within the term 'sale'. Transfer of immovable property may not only include transfer of title but also rights and / or interest in the property. When a person gets a title to the property, he becomes entitled to all the rights that come along with the property. One or more of such specific rights can be transferred to any other person without transfer of title. For this, we first refer to definition of license as per Section 52 of the Indian Easements Act, 1882:

"License" defined. -Where one person grants to another, or to a definite number of other persons, a right to do, or continue to do, in or upon the immovable property of the grantor,

something which would, in the absence of such right, be unlawful, and such right does not amount to an easement or an interest in the property, the right is called a license.

In the case of development rights, the developer not only gets the right to develop but also possesses the interest in the property. He would be undertaking the risk and rewards from the sale of properties in future which accrues upon him directly. This results in a creation of interest in the property in favour of the developer though the title of the land does not get transferred to him. Thereby, transfer of development rights is certainly more than a mere sale of license.

Section 17(b) of the Registration Act 1908 requires compulsory registration where there is creation of any right, title or interest in the immovable property. Once registered, the development rights become enforceable in law. One of the major aspects of enforceability has been discussed in Section 202 of the Contract Act 1872. As per the said provision:

"Where the agent has himself an interest in the property which forms the subject-matter of the agency, the agency cannot, in the absence of an express contract, be terminated to the prejudice of such interest"

Since, development rights results in creation of interest in the favour of the developer, such contract becomes irrevocable and cannot be terminated unilaterally by the landowner. Thereby, developer cannot be prejudiced through termination of contract against his will just like in case of transfer of title in property.

Having said this, development rights are actually given by the landowner to the developer which are for the limited purpose of construction, owning and reselling the building which arise out of the development. Thus, the developer does not get complete ownership of the land. He is bound by the terms of the development agreement in respect of his rights and interest created. In a complete transfer of title, there cannot be any limited rights over the use of the land. Further, the title to the land is conveyed by the landowner only when the buyer purchases the property within the project and that is when the levy of stamp duty as per the State laws comes into effect. Hence, title in the land is not acquired upon transfer of development rights. Thereby, mere transfer of development rights falls short of the Schedule III requirements of 'sale of land and completed building'

Once pushed outside the ambit of Schedule III, the wide coverage of the definition of supply engulfs the activity in the nature of transfer of development rights. Such activity now needs to be classified within goods or services. Though the interpretation of the definition of services captures immovable property within its fold, as a matter of abundant caution, the lawmakers have provided the classification under clause 2(a) of Schedule II of the CGST Act 2017. As per this entry, any lease, tenancy, easement and license to occupy land would be classified as supply of services. Thereby, supply of development rights should clearly be classified within supply of services.

Liability to pay tax on Development rights

Where there is a 'flow of rights' from Landowner to Developer 'for consideration' and such transaction is neither excluded by schedule III nor exempt under section 11 of CGST Act, it is clear that this arrangement is one for 'supply' under section 7 attracting levy of tax under section 9 of CGST Act. Given that the augmented definition of 'service' in section 2(102) covers 'anything other than goods', it appears the transaction of joint development for a consideration is a service and mention in para 2(a) of schedule II affirms this understanding. It has been provided under Notification no. 5/2019-CT (rate) dated 29th March 2019 that the tax on transfer of Development rights after 1st April 2019 is liable to be paid by the developer on Reverse charge basis. The landowner need not take registration for the purpose of discharging of taxes under the GST law for the transfer of development right made by him.

Time of supply of Development right

Construction satisfies the treatment as a continuous supply of services attracting payment of tax proportionately over the duration of such construction. This forms 'consideration' to Landowner for the 'supply' to Developer of the 'development rights', there is a clear indication that 'date of supply' by Landowner is NOT a continuous supply but supplied 'once only' on the date of registration of the agreement for joint-development. Thereby, the liability to make payment of tax should arise when such supply happens. However, this liability stands deferred as discussed below.

a. Area Sharing agreement - In case of an area sharing agreement, GST on the consideration paid to the landowner in the form of construction service of both commercial or residential apartments would be deferred till the completion certificate or first occupation (whichever is earlier). This move very efficiently allows the developer to be saved from the blocking of their working capital right at the beginning of the project when he already has significant amount of input tax credit getting accumulated. At the time of completion certificate when sufficient number of apartments may have been sold by the developer and has some liquidity available, the tax is to be discharged by him in cash on reverse charge basis.

In case of commercial apartments under area sharing agreement, this also allows the developer who would be paying taxes on development rights under reverse charge mechanism to immediately avail the input tax credit of the said taxes paid and use the said amount for discharge of the output tax on construction service provided to landowners. In case of residential apartments, the taxes paid on development rights would not be available as input tax credit to the developer.

Mismatch between input tax credit and output tax for landowners - On the construction service provided to landowners, the landowners can avail the input tax credit and utilize the same against construction service to final buyers. However, there is a mismatch of time between the availability of input tax credit and charging of output taxes for the landowner. This is because, the input tax credit is available at the end of the project for the landowner when he may have already discharged most of the output tax on construction service to third party buyers in cash. This may cause payment of tax through cash in the earlier stages of the project and accumulation of input tax credit at the later stage of project. To circumvent this, the landowner should explore the possibility of receiving construction service invoice at an earlier date than the date of completion of project. This may cause a tussle between the two as the developer may have to discharge taxes on construction service to the landowners at an earlier date.

b. Revenue Sharing agreement – where consideration is in the form of constructed area, the time of supply enjoys the special dispensation under section 148 but in a revenue sharing agreement, the consideration is NOT in the form of constructed area, the special dispensation is NOT available. As such, tax on supply of development rights is payable immediately on registration of joint development agreement. Where consideration is partly in constructed

area and partly in money, such arrangements also enjoy this special dispensation but views are divided where the whole of the consideration is in monetary form.

In case of revenue sharing agreement, deferment of payment of taxes on the monetary consideration paid by the developer against the transfer of development has been deferred only for residential apartments. Since, input tax credit is not available for residential apartments, the deferment of liability to pay under reverse charge ensures that the working capital does not get blocked for the project.

However, revenue sharing agreement for commercial apartments, requires the payment of taxes on development rights under the regular time of supply provisions i.e. the earlier of the date of payment as entered in the books and the date immediately following sixty days from the date of issue of invoice . However, it must be noted that the input tax credit can be immediately availed by the developer and he can use the same for setting off output tax liability against the construction service provided to the independent buyers.

Value of Development rights and Rate of taxes

Vide Notification no. 4/2019-Central Tax (rate) dated 29th March 2019, the valuation of development rights transferred on or after 1st April 2019 has been discussed. It also provides the calculation of the exemption amount within this value on which no GST is to be levied. The following aspects need to be kept in mind for determination of the value on which tax is to be paid:

1. Value of development rights before considering the exemption and ceiling limit

As per Para 1A of the aforesaid notification, Value adopted should be 2/3rd of the total amount charged for similar apartments nearest to the date of transfer of development rights i.e. the date provided in the Joint Development agreement wherein the right of development accrues in favour of the developer. In most of the cases, this would be the value of first apartments sold right after entering into the joint development agreement.

A school of thought emerges that the value of land should not be excluded while finding the value of the development right. However, the notification has deemed the value of development right on the same footing as that of the valuation of construction service which

obviously excludes the value of land. This also avoids the unnecessary accumulation of input tax credit in the hands of the developer on account of value of development right being more than the construction service.

Also, this puts to rest the widespread speculation that the value of development rights should be taken as the value of land being transferred by the landowner. This would not be correct also because the landowner is not simply selling land which would have been free from the encumbrances of allowing a third party to enter the land, undertake the risk of putting the development of land in the hands of the developer etc. The benefits received by the landowner is far greater than what would have been received if there was a simple sale of land.

2. Exemption on development rights w.r.t. residential apartments

It must be noted that the exemption is only applicable to the residential apartments. Full GST would be paid on the value of development rights (as provided under Point no. 1 above) as is attributable to the commercial apartments. The rate of GST applicable on such value of development rights would be 18%.

In respect of the residential apartments, the GST payable on development rights as attributable to already booked residential apartments as on the date of completion certificate or first occupation, whichever is earlier would be exempt. To determine the part on which GST is payable on the residential apartments, there are two steps to be followed as below:

a) To determine attribution to residential apartments – In a project, where the apartments are both commercial and residential in nature, the portion which is attributable to carpet area of the commercial apartments should be excluded while computing the total GST payable on TDR.

b) Once the GST on residential apartments is determined, the proportion as is attributable to the residential apartments, which remain un-booked on the date of issuance of completion certificate, or first occupation of the project would only be payable.

An issue emerges here as to whether the tax would be payable on the unbooked portion of the landowner's share of the apartments or not. It must be noted that once the developer parts with the landowner's share of the apartments, the booking takes place in favour of the landowner. Whether the landowner intends to keep such flats for his own use, intends to sell it before or after completion certificate etc. would not impact taxability of development rights in the hands of the developer. Further, that the landowner is himself required to reverse the input tax credit attributable to the unsold apartments in respect of the construction service received from the developer ensures that the effect of tax is taken on the landowner's share of the unbooked apartments. Thereby, no tax should be payable on development rights by the developer in respect of the unbooked apartments from the landowner's share.

From the above, it can be gathered that GST would be paid at the rate of 18% on all the commercial apartments and only on the unbooked portion of the developer's share of the residential apartments for which the calculation is given above.

3. Ceiling limit of tax payable on development rights *qua*. residential apartments

The tax as calculated on development right for the portion attributable to the residential apartments would have a further ceiling limit on the tax to be paid. This limit is of 1% in case of affordable housing and 5% in other than affordable housing schemes in respect of the unbooked apartments as on the date of completion certificate or first occupation on another base value.

Unlike Point 1 above, Para 1B of Notification no. 4/2019-CT (rate) dated 29th March 2019 provides for the value of similar apartments nearest to the date of issuance of completion certificate or first occupation (as the case may be). While the rate of tax on the value as per Para 1A is 18%, the rate of tax to be taken on value under 1B would be 1% or 5% depending on whether the apartments are under affordable housing or not.

It may be noted that this ceiling limit has been provided to equate the taxes with the maximum amount which would have been payable had all the residential apartments been booked before completion certificate or first occupation. On the booked portion, the tax had already been paid when collected from buyers. On the unbooked portion, the tax is payable on the above calculation *qua* valuation of development rights.

Further, it should be once again emphasized that such limits of 1% / 5% would not be applicable on the commercial apartments.

Conclusion

Summarizing the major aspects of analysis of the taxability of development rights, the following points should be considered:

1. Development rights cannot be considered as equivalent to sale of land and would be taxable under GST due to the limited scope of exclusion under Schedule III.
2. Deferment of the liability to pay tax on development rights ensures that the developers are saved from the huge burden of cash outflow at the inception of the contract.
3. Reverse charge provisions on development rights encourages the unstructured landowner not having sufficient infrastructure to not be bogged down by the rigorous compliances of GST.
4. Equating the value of construction service with the value of development rights saves the unnecessary accumulation of input tax credit in the hands of the developer for commercial apartments.
5. In respect of residential apartments where the tax on development rights becomes a cost in the hands of the developer, only taxing the unbooked portion of the apartments ensures that there is no double taxation on the flats which had already been sold prior to completion certificate.
6. Commercial projects do not enjoy the special rate regime that residential projects have been extended from 1 Apr 2019.

ADMIN OFFICE : MOOKERJEE HOUSE,
17, BRABOURNE ROAD, 2NDFLOOR
KOLKATA - 700001

PHONE NO : 03340687062, +919831912725

EMAIL ID : shubham@cakhaitan.com

WEBSITE : www.cakhaitan.com

FACEBOOK : https://www.facebook.com/shubham.khaitan.50

LINKEDIN : https://www.linkedin.com/in/shubham-khaitan-5a687064/

YOUTUBE : https://www.youtube.com/channel/UCU4QQj5MOuds0YR1REXzSTA