CASE STUDY - 2
DIRECT TAX PERSPECTIVE

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1. Whether profit / gain of Rs. 20 crores made by the Society on redevelopment shall be covered by the concept of Mutuality? (Considering Rs. 20 crores is an indicative figure, actual profit/gains is to be computes as per ensuing questions)

- At the outset, it would be useful to understand and discuss the principle of mutuality in the context of income tax law. The principle of mutuality is rooted on idea that a person cannot make a profit from himself. This also implies that a person cannot earn profit from an association that he shares a common identity with. The essence of this principle lies in the commonality of the contributors and the participants who are also beneficiaries. There has to be a complete identity between the contributors and the participants. Therefore, it follows, that any surplus in the common fund shall not constitute income but will only be an increase in the common fund meant to meet sudden eventualities.

- Applying the above ratio in case of the housing society which are primarily formed to manage, maintain, and administer the common areas and facilities of residential complexes or buildings. The contributors and the participants of the housing society are the member of the building. These members make a periodic contribution to enable the society to carry on the day-to-day expenses to maintain the building premises and facilities thereof, to carry on repair works required for the building, etc. Thus, the surplus so generated by the society is not taxable under the Principle of Mutuality. In the given case, the society is earning a profit of Rs. 20 crores from redeveloping the building and selling the residual additional area constructed (i.e. after allocation to existing members). Therefore, the issue is whether the profit so earned of Rs 20 crores can be said to be covered by the concept of mutuality and thereby not liable to income tax?

- The supreme court in case Bangalore Club vs. CIT (2013) 350 ITR 509 (SC), laid down the following triple test for applying the principle of mutuality:

  a. Complete identity between the contributors and participators- the contributors and participators in the surplus must be an identical body;

  b. Action of the participators and contributors must be in furtherance of the mandate of the association – the activities undertaken benefits the association, and in turn its members; and

  c. There must be no scope for profiteering by the contributors from a fund made by them which could only be expended or returned to themselves.

- Applying the aforesaid triple test in the facts of the present case, wherein the profit is earned by society on sale of residual additional area constructed to new purchasers:

  a. On the first condition, this arrangement will lack common identity of contributors and participants as amount towards the sale of flat will be contributed by new purchasers, who are non-participants.

b. The second condition demands the use of fund for the benefit of the society and in turn its members, the funds infused by the purchaser will be used to build the additional area for purchaser's residence, thereby giving no direct benefit to the society or its members.

c. Consequently, the third condition also fails, as the contributors (i.e. new purchasers) do not derive any profits from contributions made by themselves to a fund which could only be expended or returned to themselves as they are non-participants.

- The moot issue which needs to be answered here, would be at what point does the relationship of mutuality end? - If there is an entry of a third party or non-member who contributes to the fund of the society, then relationship of the parties is not on the basis of a privity of mutuality. The essential condition of mutuality, i.e., identity between the contributors and participators would end. When the flat is sold to new purchaser, the relationship would then be like any other commercial relationship such as that between a customer and a developer where the property is sold with an intent to earn profit.

- The aforementioned judgement of Bangalore Club (supra) is also upheld by SC in recent case of Secundrabad Club Etc. vs C.I.T-V (2023) 457 ITR 263 (SC). Thus, the profit/gain of Rs 20 crore earned by society, may not be covered under the Principle of Mutuality and consequently, liable to tax under the Income tax Law.

- Further, the entire cost of construction of Rs 100 crores may not be available for deduction and only the proportionate cost corresponding to area sold may be available for deduction.

2. If profit/gain earned by society is not covered by principle of mutuality, then, whether it will be taxable in the hands of Society as Business Income/Capital Gains?

- The issue of income arising on the sale of asset (whether taxable as capital gains or business income) is a fact sensitive exercise and has been a subject matter of litigation with the tax authorities.

- The assets held in nature of capital assets are taxed under the head 'Capital Gains' and the assets held in nature of stock-in-trade are taxed under the head 'business income'. The classification of stock-in-trade (circulating asset) or capital asset in the nature of investment (perpetual or long term asset) is a matter on which there can be two views once the facts become complex.

- As a general rule, it can be said that if the conduct of the assessee shows that the asset was acquired with the objective of turning it over through the medium of economic sale or disposal, as a profit making plan, the asset should be considered to be stock-in-trade.

- On the other hand, cleaner the nature of property and more pronounced the desire to hold on to the property as a source of income for a long period, instead of intending to resell it, tilts in favour of the asset being a capital asset. But it is possible that an asset intended as a capital asset may be sold off while and asset intended to be sold off may not have a been sold.

- The factors which may be evaluated to identify whether the land and building is held by society as 'stock-in trade' or 'investment' are as follows:

a. Whether the byelaws of the society permit/restrict the society to carry on any business? Further evaluation may also be required from State Co-operative Societies Law.

b. Whether the land was acquired by society or was it conveyed by the builder or members. What was the purpose behind it – to hold as asset for long period or to hold as stock-in-trade and commercialize it?

c. Whether society also purchases and sells properties other properties? If yes, what is the frequency?

d. How is the said asset classified in books of accounts, whether the same is treated as investment or current asset?

e. What was the duration of holding the asset? If an asset in nature of stock in trade is held for a longer period, then what was the reason for it (illustratively on-going litigation)?

f. What was the posture adopted before any other regulatory authorities?

g. Whether there was any conversion in preceding years from stock-in-trade to investment or vice-versa?

- It is noted that the building was constructed 50 years ago, however, a single principle cannot be decisive and the total effect of all the principles as enumerated above should be considered to determine whether, in a given case, the property (being land and building) is held by the society as investment or stock-in-trade.

3. Taxability in the hands of Society Members on exchange/transfer of old flat for new flat?

- In the facts of the given case, the society is undertaking self-redeveloping of the building and thus will appoint a contractor for a consideration. Further, there is no transfer of land to the contractor. Thus, it is possible to take a view that a member does not effect any transfer of any of his capital assets. He continues to hold on to his pre-existing right. He merely vacated the premises so as to enable the contractor to fulfil his obligations. He neither sells the old flat nor he purchases the new flat.

4. Tax implication u/s 56(2)(x) in the hands of Society Members on receiving additional area

- In a housing society, the member is provided with occupancy rights to a particular flat. Whether the occupancy rights also include the proportionate ownership of land and building will require a fact specific exercise or a legal counsel opinion basis the specific laws of the state, the type of housing society, and the terms outlined in the society's byelaws or the sale agreement.

- The following are the two common scenarios:

a. **Occupancy Rights Only:** In some cases, a flat owner in a housing society may have only occupancy rights. This means they have the right to live in their specific unit, but they do not own any specific part of the land or the common areas of the building. The society or a separate entity retains ownership of the land and common areas, and the flat owner is essentially a member with certain privileges and responsibilities as defined by the society's rules.

b. **Proportionate Ownership of Land and Building:** In other cases, a flat owner may have a proportionate share in the ownership of the land and the building. In this scenario, the flat owner not only owns their individual unit but also has an undivided interest in the common areas, such

as the land, lobbies, staircases, roof, etc. The extent of this ownership is usually proportional to the size of their flat relative to the total size of all flats in the society.

- On principles, if the member is also considered to be a proportionate owner of the land and building. then he is also entitled to proportionate additional FSI potential in his individual capacity. Thus, it is possible to state the member continues to hold on to his pre-existing right and there is no additional area received apart from what he was entitled.
- In case the member has only occupancy rights and society is the owner of land and building then the society will be entitled to additional FSI potential. In hands of members, so far as FSI rights appurtenant to old flat are concerned, those are paid for when the member had originally acquired flat from erstwhile developer or from outgoing member. Additional FSI right which has been allotted by Society before execution of self-development project is a transaction between society and members and arguably covered by principle of mutuality.

5. Considering that the gains are chargeable in the hands of society as capital gains, whether Society will be eligible to claim fair market value as on 01.04.2001 as the cost of the land and accordingly, claim proportionate deduction for the flats sold to new members/purchasers?

- In the present question, it is assumed that proportionate land is also sold to new purchasers along with the flat and it is not a case where the land is retained by the society and only occupancy rights are provided to new purchasers.
- However, first it is imperative to understand who holds the entitlement to land and thereby entitled to additional FSI potential which is proposed to be constructed and sold to new purchasers. As discussed in above question, either the members will be owner of land in proportion of the size of their flat or the society will be owner of the land.
- In case, the existing members are only entitled to occupancy rights and are not entitled to ownership in land, then the land being sold by the society, will be chargeable to tax in the hands of society.
- As the building is more than 50 years old, it is assumed the land may be acquired much earlier and thus, if the said land is sold as a capital asset then the fair market value as on 01.04.2001 can be taken as cost of acquisition by the society in accordance with section 55 of the Income tax Act.
- On the other hand, incase the members are entitled to proportionate ownership of land, then similar implication will arise in the case of members. This may require one on one nexus of the area sold to new purchaser resulting in a complex calculation or other avenues may be explored to tax the existing members as an unregistered AOP.
- The additional FSI potential is received by virtue of ownership of the land. Thus, it is possible that, while computing the cost of improvement of such additional FSI potential, there may be no cost directly attributable to it. However, considering the amendment of Finance Act 2023, the said right may be considered to be "any other right" u/s 55(1)(b)(1) and its cost shall be considered to be nil.

6. Considering that the profit/gains are chargeable in the hands of society, what will be tax implications u/s 43CA/50C in the hands of society on providing additional area to members and area sold to purchasers.

- The section 43CA and 50C are applicable where land, or building or both are transferred at a value less than the value adopted/assessable by the stamp duty valuation authority, then such adopted/assessable stamp duty value will be deemed to be full value of consideration for the purpose of computing the business profits or capital gains respectively.
- As indicated in Q4 above, the additional area provided to members by the society, may be covered under the principle of mutuality and thus, rendering the question of tax implications u/s 43CA and 50C academic.
- However, in case of sale of additional area to the new purchasers, it will be important to evaluate whether new purchasers are entitled only to occupancy rights or whether they will also be entitled to proportionate ownership in land and building.
- Incase, where the new purchasers are entitled to ownership in land and building, there is a transfer of both and thereby, triggering the provisions of section 43CA/50C.
- In case where mere occupancy rights are transferred to the new purchasers, then the issue arises whether the transfer of 'occupancy rights' fall within the ambit of 'land or building or both' in order to trigger the implications u/s 43CA/50C?
- It is possible to argue that 'occupancy right' do not fall within the description of land or building or both. Society being a separate legal entity, is the sole owner of the land and building and purchaser merely possesses a right of occupancy on allotment of shares of society. On becoming a member, he will have to follow and obey the rules and regulations set out by the byelaws of the society and doesn't have freedom which are typically possessed by an owner.
- On the other hand, it possible to suggest that the society is only a mutual concern, but formed for the benefit of the members. Some of the State Co-operative Society law recognizes that the member holds interest in property and capital of the society. Also, the same states levies stamp duty on the value of underlying flat. Further, the rights provided to members are not only occupancy rights but right to use and enjoy the common area, thereby suggesting substantial rights are transferred to the members.
- Considering the arguments under both the views above, it appears that the better view of the matter is that the provisions of section 43CA/50C are applicable in case the additional area is transferred to the new purchaser. However, it is pertinent to evaluate the State Co-operative Society Law and State Stamp duty Law respectively before concluding.

7. Taxability in the hands of Society Members on the corpus of Rs. 20 lacs received by each of them?

- The taxability of corpus may depend upon the intention with which it is paid. There are judicial precedents which taxes the mere corpus payment and there are judicial precedents which have held the corpus paid towards hardship suffered by the member as a capital receipt, not chargeable to tax.
- However, those judicial precedents may not be directly applicable here as the facts of the case are different. The corpus in those judgements is paid by a developer, however in the facts of present case the said corpus is paid by the society itself.

- It is further imperative to understand what is the source of funding the said amount? Whether the corpus is being paid to members from the surplus accumulated by the society? If yes, then whether the said amount of 20 Lakhs per member can be paid considering there may be restrictions on profit distribution prescribed under the respective statue of State Co-operative Societies Law. Thus, understanding of rights and entitlement of members in a co-operative society vis-à-vis properties of the society as per applicable Co-operative law is important to ascertain likely tax implications under payment of corpus. Prima facie, it appears that the payment of corpus by the society from the accumulated surplus may be considered as dividend in the hands of members and may be taxed accordingly.

8. If the Society intends to distribute the profit / gain of 20 crores among the old members. If yes, whether there would be any tax implications in the hands of the old members?

- As indicated above, understanding of rights and entitlement of members in a co-operative society vis-à-vis properties of the society as per applicable Co-operative law is important to ascertain likely tax implications under distribution of profit as indicated in this question. Prima facie, it appears that the payment of profits by society may be considered as dividend in the hands of members and may be taxed accordingly.

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