Date : 08-11-2018

From :

Silver oak Realty

5-4-187/3 & 4, 2nd floor

Soham Mansion, M.G Road

Secunderabad – 500003.

To :

Income tax Officer

Ward 10(3)/Hyd

IT Towers, A.C Guards

Hyderabad.

Sir/Madam,

Sub : Reply to Show Cause Notice (SCN) dated 31-10-2018 IT Asst. Proceedings-own case- AY.2016-17-PAN ACXFS3783R.

Ref : Notice No. ITBA/AST/F/143(3)(SCN)/20/18-19/1013416039(1) dated 31-10-2018.

In the above referred SCN, we are asked to furnish show cause as to why the sale consideration of Rs.1,20,00,000/- should not be assessed under the head income from 'Capital Gains' and taxes levied accordingly. In reply, the following is submitted for your kind consideration.

1. The issue involved is in respect of sale of land admeasuring 16.5 Gts for Rs.1,20,00,000/-. The said land being part of inventories held since FY 2005-06, the sale consideration is credited to Construction account and is considered as forming part of Business Income. In the show cause notice a view is taken that profit arising out of this sale of land should be considered as Capital Gains.
2. It is gathered from the SCN issued that the above view is taken mainly on following 2 grounds, viz.,
   i) The land sold is a capital asset as per section 2(14) of the Income Tax Act, and
   ii) As the land is sold to one of the partners of the firm, certain provisions of Partnership Act are relied upon to form a view that there is extinguishment of the "common interest" of the partners of the firm and the creation of "absolute ownership" to one of its partners is nothing but a "transfer of property" as per section 2(47) of the IT Act 1961.

3. Our submissions/objections to the view taken by you that the land sold is a capital asset as per section 2(14) of the Income Tax Act, 1961 are as under :

   a. The nature of business for which the Partnership firm is formed is contained in clause 4 of the Reconstitution Deed dated 25-08-2015. The same is reproduced below:

      "The nature of business of the firm shall be to do the business of real estate developers, managers, advisors, underwriters, retailers, promoters of group housing scheme etc or any such other business(s) that may be mutually agreed upon".

   b. The partnership firm originally carried on its business under the name and style as "Mehta & Modi Homes" and subsequently the name got changed to "Silver Oak Realty". The Projects are named as 'Silver Oak Bungalows'

   c. The firm since its inception carried on its business that of real estate developers.

   d. It may be appreciated that the business of real estates involves many types of activities such as constructing and building complexes (both commercial and residential), building houses, villas, apartments either on own land and/or on lands belonging to others and taken on development. The real estate business also include activities that of buying and selling lands. The lands may be either agricultural land or non agricultural land. Further, the land may be either developed before selling or it may be sold without developing. The real estate activity also involves buying large lands and plotting them into small lots. It is therefore submitted that real estate business involves various types and kinds of activities.

   e. In para 2 of SCN, the following is stated at the start of the para.

      On perusal of the agreement of sale date 31-03-2016, it is noticed that the land sold '**as per the schedule of the property is Agricultural land and as such no development nor work in progress was made by the assessee from the date of acquisition of the property till the date of sale'**. (Text in bold is our emphasis).

      The above bold portion is giving an impression that since the property was an agricultural land, no development nor work in progress was made by the assessee. This is factually not correct. Developing and incurring expenditure on a comparatively small parcel of land was not meaningful and prudent business decision till we were able to acquire adjoining areas for a larger development. Because of this reason, no development have been taken up. **It is not the case that because of land being agricultural land no development is undertaken.**

f. For your kind perusal Schematic Plan for lands in Phase I, II, III is attached herewith as **Annexure-1.** It may be noted from the Schematic Plan that the land parcel of 16.5 Gts is surrounded by other parcels of land which got developed by the firm in Phase I, Phase II & also in Phase III.

g. As submitted earlier, total land available in Phase III which is on the east & north of Phase I was about 15 acres and were acquired in bits and pieces. The small strip of land between Phase I & Phase III of 16.5 Gts was purchased with a view to acquire the balance 4.5 Acres. Upon the successful acquisition of surrounding land, the intention of the firm was to extend its housing project activities. The firm's presence as a real estate developers in the vicinity would have facilitated the acquisition of balance land of about 4.5 acres. It may be noted that the small bit of land admeasuring 16.5 Gts is located in the nearby vicinity of the housing projects that are being undertaken by the firm. It is to be noted that the land is acquired with an intention to extend the real estate development activities of the firm which is being carried in that locality for years.

h. It is stated in Para 2 of SCN that since, no development nor work in progress was made and the land is purchased with a view to acquire the adjoining areas of land, there is no intention of the assessee to develop this particular land and held the same as an asset/investment to acquire some more lands in future.

i. We are unable to subscribe to your above view as the purchase of the land is in pursuance for the firm's business of real estate. This fact, situation and intention can never be negated only because no development is done on small bit of land. Further, the intention to acquire some more adjoining land in future does not tantamount to or lead to a conclusion that the land first purchased is meant to be held as an asset/investment. What the man of ordinary business prudence would do, we have also done so i.e, to acquire land inventory in the locality where we have been successfully developing the housing projects over years.

j. The entries in the books of accounts as stock-in-trade is not 'mere entries' but are backed by the actual activity, actions and is in conformity with the nature of business for which the firm is established.

k. The main object of the firm is to carry on the business that of a real estate developers etc. There is no other income except that is arising out of real estate activities. The objects of the firm must also be kept in view to interpret its activities.

In support of this, reliance is placed on certain judicial pronouncements of the Apex court as below:

- Chennai Properties & Investments Ltd v/s CIT [373 ITR 673(SC)2015]
  (Copy of Judgment is enclosed in Annexure-2).
- Karanpura Development co Ltd v/s CIT, West Bengal [44 ITR 362(SC)1962]
- Rayala Corporation (P) Ltd v/s ACIT [386 ITR 500(SC)[2016]
  (Copy of Judgment is enclosed in Annexure-3).

In the case of Chennai Properties & Investments Ltd v/s CIT [373 ITR 673(SC)2015], it has been held that if an assessee is having his house property and by way of business he is giving the property on rent and if he is receiving rent from the said property as his business income, the said income, even if in the nature of rent, should be treated as "Business Income" because the assessee is having a business of renting his property and the rent which he receives is in the nature of his business income.

The above ratio has been again upheld in the Honorable Supreme Court in Rayala Corporation (P) Ltd v/s ACIT [386 ITR 500(SC)[2016].

l. The Honorable Supreme Court has held the ratio that the activities that are carried out in pursuance of its main objects, is a determinate factor to decide the character of the income that is arising out of the activities.

m. The above ratio has full force in our case as our predominant object is to earn business income out of real estate activities.

n. Further to above, it is submitted that the Capital Asset is defined u/s 2(14). Clause 2(14)(a)(i) excludes any stock-in-trade held for business. The relevant portion of the section is reproduced below;

2(14) "Capital Asset" means

(a) Property of any kind held by an assessee, whether or not connected with his business or profession;

(b) -------------------------

But does not include :

(i) Any stock-in-trade[other than the securities referred to in sub clause (b)], consumables stores or raw materials held for the purposes of his business or profession

(ii) -------------------------

o. 'Property of any kind' is a Capital Asset and as per the definition, it categorially excludes 'any stock-in-trade' held for the purpose of business.

p. It may be noted that chargeability under the head 'Capital Gains' arises only where there is a transfer of a capital asset.

q. **Capital gain arises on a transfer of a capital asset. Transfer is considered to be 'sine qua non' of capital gains. The essential condition is therefore that the transfer should be of a capital asset.**

r. The land since the date of its purchase in FY 2005-06 till the year of sale in FY 2015-16 has been part of the Inventories all along. Further, there have been scrutiny assessments u/s 143(3) for the assessment years relevant to previous years between FY 2005-06 to FY 2014-15 and the details of Inventories held at every end has been submitted, scrutinized and accepted. There is a change of opinion on your part now to hold that the land is not a stock-in-trade.

s. Keeping in view the above facts and circumstances and relying upon the judicial pronouncements, it is submitted that the income arising out of sale of land is rightly considered as business Income.

4. In the SCN, a view is taken that since the land is sold to one of the partner there is an extinguishment of the "common interests" of the partners of the firm and creation of "absolute ownership" to one of its partner is nothing but a "transfer of property"" as per section 2(47) of the IT Act,1961.

   Our submissions/objections in this regard are as follows:

   a) At the outset, it may be noted that the sale of the land by the firm to one of its partners is in the ordinary course of business of the firm. The transfer is arising by virtue of Agreement of Sale dated 31-03-2016 and therefore the transfer is not extinguishment of any rights. Generally in relation to a partnership firm, the extinguishment of rights arises upon its dissolution, retirement and/or distribution of assets. Further, the transfer is of a land which is held as stock-in-trade and not as a capital asset/investment.

   b) Partnership Act nor Income Tax Act prohibits or restricts the right of the firm to sell its inventories to partner of the firm in the normal course of its business.

   c) In the SCN at para 4 it is stated that as per the Partnership Act, a partnership firm is not a separate legal entity distinct from its member. On this view, it is stated that there is a extinguishment of the "common interest" and is nothing but a "transfer of property" as per section 2(47) of the IT Act.

d) Assuming that there is an extinguishment of 'common interests', such extinguishment can be a type of a property within the meaning of section 2(14) which says 'property of any kind'. But by definition, 'property of any kind' excludes stock-in-trade held for business. Assuming further, that there is an extinguishment, the question to be answered is what the firm has extinguished? In our view, the firm has extinguished its rights over a land which is a land which is a stock-in-trade and nothing beyond that. However, the fact remains that there is no extinguishment but a sale of stock-in-trade in the ordinary course of business of the firm.

e) We have accordingly considered the sale of land as transfer and the consideration thereof is rightly credited to Construction account. To this extent, there is no contrary view as to the transaction involves transfer or not. The only difference is according to us transfer is effected under a Registered Sale Agreement and not as extinguishment of rights.

f) The term 'transfer' is defined by section 2(47) of the act. The section starts as under: 2(47) - **"transfer" in relation to a capital asset**, include------------

   It clearly defines 'transfer' in relation to a **'capital asset'**.

   'Capital asset' is defined u/s 2(14) of the Act and in the definition as submitted above. It excludes stock-in-trade held for business.

g) It is stated in the SCN that there is extinguishment of the common interests of the partners of the firm. Assuming that there is an extinguishment of rights, the same of is covered in clause (ii) of section 2(47) which reads as under :

   (i) ------------

   (ii) "2(47) the extinguishment of any rights therein".

   The above extinguishment has to be in relation to a "capital asset" and not for every asset.

h) Chapter IV – Computation of Income from Capital Gains is provided u/s section 45 to 55A and it provides for transfer of a capital asset.

i) We assume that the relevant Section for your proposal to compute capital gains will attract provisions of section 45(4). This section also provides for computing the **'profits or gains from the transfer of a capital asset'**.

Keeping in view the above facts, circumstances and relying upon the judicial pronouncements, it is submitted that the income arising out of sale of land is rightly considered as Business Income. Your proposal to tax the same as 'Capital Gains' under the SCN therefore kindly be dropped.

Yours faithfully,

For Silver Oak Realty

(Partner)