

# TAX FLASH NEWS

27 March 2019

## Compensation paid to the property buyers for surrender of their rights is allowed as business expenditure

Recently, the Delhi High Court in the case of *Gopal Das Estates & Housing Pvt Ltd*<sup>1</sup> (the taxpayer) dealt with the issue of allowability of compensation paid to property buyers for surrendering their rights in the property.

The taxpayer is engaged in the business of construction and sale of commercial space. During the Financial Year (FY) 1994-95, the taxpayer developed a 17 storied building and allotted flats to the respective buyers. As per the original plan, Lower Ground Floor (LGF) of the said building was approved by the Municipal Corporation as air-conditioned space,' and hence while booking that space, prospective buyers proceeded on the basis that it would be a commercial space. However, in terms of the completion certificate issued by the Municipal Corporation, the LGF was sanctioned as 'storage'. Therefore, some of the allottees have refused to take the flats. Subsequently, on negotiation with buyers, the taxpayer decided to repay the advance money received from these flat buyers. Further, the taxpayer decided to pay additional compensation in lieu of surrender of their rights in the flat. The taxpayer claimed that this expenditure was of revenue in nature and charged to the profit and loss account. The taxpayer contended that the space to be sold was its stock and trade and it cannot be considered as capital expenditure or capital loss.

The Assessing Officer (AO) held that the taxpayer had not paid any compensation to the allottees but had in fact repurchased these flats since the allottees had surrendered their rights in those flats. The AO held that the compensation paid to the flat owners

could not be said to be a business expenditure but rather was 'capital investment'. The AO observed that the taxpayer was free to include the cost of compensation in the cost of the flats so acquired and claim a deduction of the amount at the time of sale as the cost of purchase of the flats. Accordingly, the AO held that it could not be allowed as business expenditure. The Commissioner of Income-tax (Appeals) [CIT(A)] and the Income-tax Appellate Tribunal held in favour of the taxpayer treating the compensation as revenue in nature.

The High Court observed that the taxpayer had followed a consistent accounting policy by following the completed contract method (CCM). One of the basic principles of accountancy is that expenditure incurred in relation to stock-in-trade would be of revenue nature. In the present case, the unsold flats that had been surrendered to the taxpayer were part of its stock-in-trade. It had not repurchased the flats from the buyers. The stage of parting with title/ownership in relation to commercial space allotted to the buyers had not been reached.

On a perusal of AS 2, it has been observed that the compensation paid subsequent to the completion of the project was an 'extraordinary item'. It was not 'cost' of completion of the project and, therefore, such compensation could not be added to the value of the stock-in-trade of the taxpayer. Under AS 2, not everything that relates to stock can be added to its value. Certain costs have to be 'excluded from cost' and 'recognised as an expense'. Therefore, the compensation paid to the flat buyers upon surrender of the respective allotted commercial spaces cannot be added to the value of 'stock-in-trade'.

<sup>1</sup> *Gopal Das Estates & Housing Pvt Ltd v. CIT* (ITA No. 210/2003) – Taxsutra.com

Note: The High Court in this case has dealt with various other issues. However, this flash news deals with the issue of allowability of compensation paid to flat buyers for surrendering their rights in flat.

Relying on various decisions<sup>2</sup> it has been held that the compensation paid by the taxpayer to the allottees of the commercial spaces for the surrender of rights therein cannot be said to be disallowable on the ground that such payment having been made for 'extraneous considerations'. Kanga and Palkhivala in their Commentary have brought out the distinction between the expressions 'for the purpose of earning profits' and 'for the purpose of the business'. In the present case, the taxpayer had a plausible explanation for making such payment of compensation to protect its 'business interests'. While it is true that there was no 'contractual obligation' to make the payment, it is plain that the taxpayer was also looking to build its own reputation in the real estate market. The mere fact that the recipients treated the said payment as 'capital gains' in their hands would not be relevant in deciding the issue whether the payment by the taxpayer should be treated as 'business expenditure'.

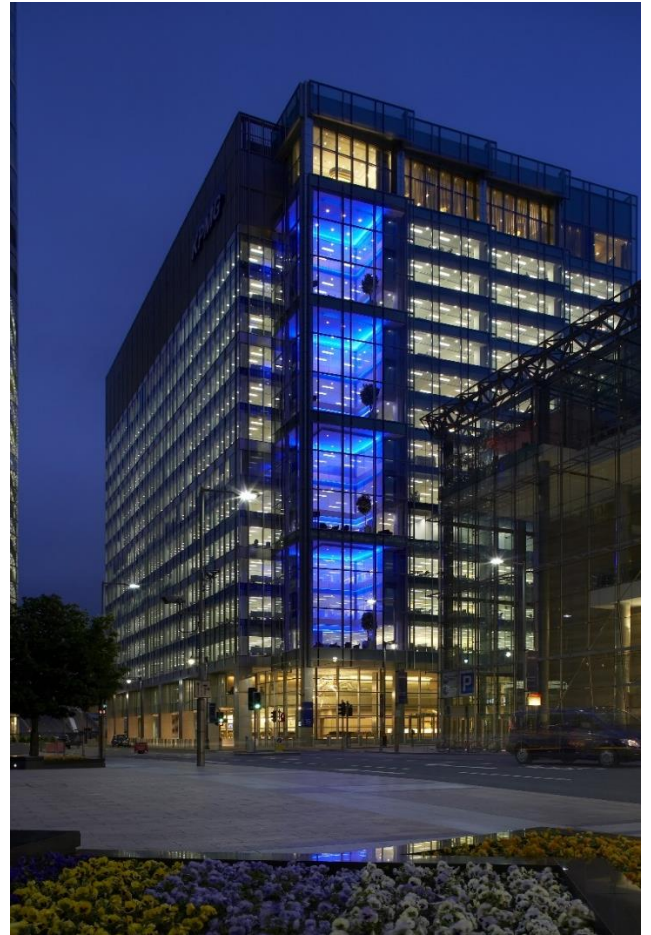
The High Court relied on the decision of Mangal Tirth Estates Ltd.<sup>3</sup> and observed that the payment of compensation is to be allowed in full in the year of payment of such compensation. Accordingly, it has been held that the payment made by the taxpayer to the allottees of the flats for surrendering their rights should be allowed as business expenditure.

## Our comments

The deductibility of the compensation paid for giving up the right, title and interest in the property has been a matter of debate before the Courts/Tribunal.

The Delhi Tribunal in the case of Vatika Township (P.) Ltd<sup>4</sup> held that the compensation paid for cancellation of plots is to be treated as revenue expenditure. However, Courts in the various cases<sup>5</sup> have held that such expenditure was capital in nature since the taxpayer had paid the compensation amount in one go to re-possess property from the allottees. There was no loss to the plot owners and there was no previous contract between the allottees and the taxpayer for payment of compensation.

The High Court in the present case has observed that the compensation paid by the taxpayer to the allottees of the flats for surrendering of their rights is allowed as business expenditure.



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<sup>2</sup> Shahzada Nand & Sons v. CIT [1977] 108 ITR 358 (SC), CIT v. Nainital Bank Ltd. [1966] 62 ITR 638 (SC)

<sup>3</sup> CIT v. Mangal Tirth Estates Ltd. [2008] 303 ITR 366 (Mad)

<sup>4</sup> CIT v. Vatika Town Ships (P.) Ltd. [2013] 60 SOT 115 (Del)

<sup>5</sup> Ramakrishna & Co. v. CIT [1973] 88 ITR 406 (Mad), New Precision (India) (P.) Ltd v. CIT [1969] 72 ITR 657 (MP)

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