Form No: HCJD/C-121.

JUDGEMENT SHEET

IN THE ISLAMABAD HIGH COURT, ISLAMABAD
JUDICIAL DEPARTMENT

Income Tax Reference No. 34 of 2013

M/s Emaar DHA Islamabad Limited

Vs

Commissioner Inland Revenue (Legal), Large Taxpayers Unit Islamabad and others

APPLICANT BY: Hafiz Muhammad Idrees and Syed Farid Bukhari, Advocates

RESPONDENTS BY: Dr. Farhat Zafar, Advocate

DATE OF HEARING: 04.10.2022

BABAR SATTAR, J.- This reference emanates from the judgment of the learned Appellate Tribunal Inland Revenue, Islamabad (***"Tribunal"***) dated 13.03.2013. There were a number of questions framed by the applicant in this reference but the one admitted for hearing by order dated 13.06.2013 was the following:

> *Whether income of the petitioner has to be assessed, under section 36 of Income Tax Ordinance, 2001 or not?*

2. During the course of arguments the learned counsel for the applicant furnished arguments on the following additional questions:

1. *Whether under the facts and circumstances of the case the learned ATIR was justified in confirming the amended assessment U/s 122(5) being made on the basis of definite information*?

2. *Whether the sale of land/property falls within the definition of long terms contracts as defined in section 36(3) of the Income Tax Ordinance, 2001?*

3. *Whether all types of persons who are involved in sale/purchase and construction fall under the definition of section 36(3) of Income Tax Ordinance, 2001?*

4. *Whether under the facts and circumstances of the case the learned ATIR was justified in confirming the addition under section 21(c) whereas the amounts under the head "developed properties" and "developments and construction" were capitalized and not claimed in profit and loss account?*

5. *Whether the addition under section 111(1)(a) is legal and confirmation by the learned ATIR is justified?*

6. *Whether the learned ATIR was justified in remanding the addition under section 111(1)(b) instead of deleting the same?*

7. *Whether the levy of Workers Welfare Fund is justified and within lawful jurisdiction?*

8. *Whether the case of applicant fall under the definition of industrial establishment and levy of Workers Welfare Funds is justified?*

3. The background facts are that the applicant was selected for audit under section 177 of Income Tax Ordinance, 2001 **("Ordinance")**, by letter dated 06.10.2010. During audit proceedings opportunities were

provided to the applicant to satisfy the tax department as to why proceeds of sale of developed property would not attract section 36 of the Ordinance. After the audit proceedings notices were issued to the applicant under section 122(9) read with section 122(5) of the Ordinance. And after granting the applicant an opportunity to be heard the tax assessment was amended by the tax department under section 122(1) read with section 122(5) of the Ordinance. Various additions were made in the revenue reported for the said tax year, *inter alia,* under sections 36, 21(c) and 111 of the Ordinance, which are relevant for purposes of this reference. The applicant filed an appeal before the learned Commissioner Inland Revenue (Appeals), who by order dated 21.06.2012 upheld the treatment of revenue under section 36 of the Ordinance, the additions made under sections 21(c) and 111 of the Ordinance as well as the levy of Workers Welfare Fund by treating the applicant as an industrial establishment. The order of the Commissioner (Appeals) then challenged before the learned Tribunal, which by order dated 13.03.2013 also upheld the aforementioned additions.

4. Learned counsel for the applicant submitted that the applicant was a developer and not a construction contractor. He submitted that section 36 of the Ordinance applied to contracts of manufacture, installation and construction, and not to contracts for sale of land and developed property. He submitted that the applicant had no

long-term contract for sale within the meaning of section 36 of the Ordinance as the only long-term contract of the applicant was with construction contractors and it was such construction contractors hired by the applicant to undertake construction of property within the development project being undertaken by the applicant who were required to treat their revenue under section 36 of the Ordinance in view of funds received for construction purposes. He submitted that the land and property being developed by the applicant would be treated as stock-in-trade under section 35 of the Ordinance and the revenue in relation to which would be offered for tax at the time that such property was sold to customers and the title in relation to land including (risks and rewards in relation to the property built on such land) was transferred to third party customers.

4. In relation to additions made under section 21(c) of the Ordinance the learned counsel for the applicant submitted that as all the amounts received by the applicant were treated as stock-in-trade and no expenses were reflected in the profit and loss account and any expenses being incurred were being capitalized, the expenses would be charged against income once it is accrued upon sale of developed property units to third party customers. Consequently additions under section 21(c) of the Ordinance were not sustainable.

5. In relation to additions made under section 111(1)(a) and 111(1)(b) of the Ordinance, the learned

counsel for the applicant submitted that the tax department, the Commissioner Appeals and the learned Tribunal had not appreciated the relevant facts while making additions on account of creditors and other receipts of the applicant for which satisfactory explanation had been furnished by the applicant. He submitted that to the extent of additions under section 111 of the Ordinance it was a case of misreading of the relevant record.

6. Lastly in relation to levy under the Workers Welfare Fund Ordinance, 1971 **("WWF Ordinance")**, the learned counsel for the applicant submitted that the applicant had been treated as an industrial establishment pursuant to insertions made under section 2(f) of the WWF Ordinance through Finance Acts of 2006 and 2008. The said amendments had been declared *ultra vires* the Constitution by the august Supreme Court in ***Workers' Welfare Funds, M/o Human Resources Development, Islamabad Vs. East Pakistan Chrome Tannery (Pvt) Ltd. (PLD 2017 SC 28)***, wherein it was held that the levy under WWF Ordinance was not a tax and amendments to the WWF Ordinance could not be introduced through a money bill and any amendments in the said Ordinance ought to be made through ordinary legislative mechanism. As the amendment pursuant to which the applicant had been regarded as an industrial establishment had been declared *ultra vires* the Constitution, the levy on the basis of such amendment could not stand.

7. The learned counsel for respondents submitted that the question with regard to definite information was misconceived as the information on the basis of which it had been found by the tax department that section 36 of the Ordinance was applicable had been procured during audit proceedings and complete opportunity had been provided to the applicant to convince the department that section 36 of the Ordinance was not applicable. The question involved related to applicability of section 36 to admitted facts and consequently no question of there being that no definite information was made out. The learned counsel for the respondents submitted that section 36 of the Ordinance was applicable as discussed in detail in the Order-in-Original after discussing the relevant provisions of the law as well as International Accounting Standards. With regard to additions made under section 111 of the Ordinance it was submitted that the learned Tribunal was the last forum for determination of facts and given that the gripe of the applicant was that the facts had not been properly appreciated by the tax department and the appellate forums, no question could be famed on such basis as no jurisdictional defect had been pointed out in relation to section 111 of the Ordinance. It was submitted that appropriate opportunity was provided by the tax department by framing questions and granting opportunity to adduce evidence and once the explanation of the applicant was not found convincing the relevant additions under section 111 of the Ordinance were made.

8. We are not convinced that any question with regard to non-availability of definite information is made out in the instant case. The Order-in-Original details how the tax affairs of the applicant in the relevant tax year were subjected to an audit and during such audit proceedings sufficient opportunity was provided to the applicant to convince the tax department as to why provisions of section 36 of the Income Tax Ordinance was not applicable to the applicant. The notice under section 122(5) read together with section 122(9) of the Income Tax Ordinance was therefore not issued on the basis of conjecture or information created by the tax department itself but on the basis of admitted facts and information as ascertained during the audit proceedings. The question underlying in the matter before us relates to application of law (i.e. application of section 36 of the Ordinance to admitted facts), therefore, the question framed by the applicant in relation to non-availability of definite information is misconceived in our view.

9. Similarly the challenge to additions made under section 111 of the Ordinance also appears to be misconceived. The additions were made by the tax department after issuing notices to the applicant and providing opportunity to satisfy the tax department as to the source of various deposits and receipts. And it was upon the failure of the applicant to satisfy the tax department that additions under sections 111(1)(a) and 111(1)(b) were

made. The said facts were then scrutinized by the Commissioner (Appeals) as well as the learned Tribunal and the submissions of the applicant on factual plain were not found satisfactory and consequently the said additions were upheld. It is now settled that the learned Tribunal is a last fact-finding forum within the tax hierarchy and it is not for this court to reappraise facts and second guess the factual determinations made by the relevant appellate forums within the tax hierarchy. As no illegality or jurisdictional flaw has been pointed with regard to how section 111(1)(a) and 111(1)(b) additions have been made and no information has been pointed out by the applicant that was presented before the tax department and in the appellate forums but was not considered, this Court cannot second guess the factual finding made by the learned Tribunal. Consequently, the question with regard to additions made under section 111 is found to be misconceived.

10. The question of whether the revenue received by the applicant from customers was pursuant to long-term contracts as defined under section 36(3) of the Ordinance, the tax department concluded that the contract for sale of property in relation to which payments were received from customers in the form of installments were long-term contracts, the income in relation to which was to be offered for tax on the basis of percentage of completion method in accordance with section 36(1) of the Ordinance. While reaching such conclusion the tax department took into

account the scope of International Accounting Standards (IAS) No. 11 and 18 as well as Interpretation No.15 of the International Financial Reporting Interpretations Committee (IFRIC) to conclude that where a contract for sale of property included construction of real estate, the tax treatment to be accorded to such contract would be pursuant to IAS No. 11. The tax department also took into consideration the fact that tax year 2009 was the first year in which the applicant had claimed that revenue received from customers was not in relation to long-term contracts. But in the previous year such revenue had been offered up for tax in accordance with section 36 of the Ordinance.

11. Let us reproduce section 36 of the Ordinance:

> ***36. Long-term contracts**.— (1) A person accounting for income chargeable to tax under the head "Income from Business" on an accrual basis shall compute such income arising for a tax year under a long-term contract on the basis of the percentage of completion method.*
>
> *(2) The percentage of completion of a long-term contract in a tax year shall be determined by comparing the total costs allocated to the contract and incurred before the end of the year with the estimated total contract costs as determined at the commencement of the contract.*
>
> *(3) In this section, —*
> *"long-term contract" means a contract for manufacture, installation, or construction, or, in relation to each, the performance of related services, which is not completed within the tax year in which work under the contract commenced, other than a contract estimated to be completed within six months of the date on which work under the contract commenced; and*

> *"percentage of completion method" means the generally accepted accounting principle under which revenue and expenses arising under a long-term contract are recognised by reference to the stage of completion of the contract, as modified by sub-section (2).*

12. Section 36(1) provides that where the income from business of a company arises under a long-term contract it shall be computed on the basis of percentage of completion method. Section 36(3) then defines a long-term contract and includes therein a contract of construction as well as the performance of services related to construction that is not completed within the tax year in which work under the contract commences. Section 36(3) also includes the definition of percentage of completion method and brings into play the relevant international accounting standards under which the revenue and expense arising under a long-term contract is recognized.

13. Let us consider the facts of the instant case. The applicant claims that it is a developer and not a construction contractor. And consequently its contracts for sale of developed real estate ought not be treated as long-term contracts within the meaning of section 36(3) of the Ordinance. Let us note here that the definition of a long-term contract does not define the term 'developer' or otherwise create any distinction between a contract for construction versus a contract for developed real estate. The Dictionary of Real Estate Terms (Jack P. Friedman, Jack C. Harris, J. Bruce Lindeman 6th Edition) defines 'developer' as

"one who transforms raw land to improved property by use of labor, capital and entrepreneur efforts." And 'development' is defined as *"the process of adding improvements on or to a parcel of land. Such improvements may include drainage, utilities, subdividing, access, buildings and any combination of these elements. Also the project where such improvements are being made."* It is obvious that any development project necessarily includes a construction component pursuant to which raw land is developed by the developer. The Income Tax Ordinance did not separately provide for taxation of builders and developers up until section 100D was introduced in the Ordinance by Finance Act, 2020. Section 100D is therefore not applicable for our present purposes as we are dealing with the applicant's tax affairs for the year 2009. Section 100D is, however, relevant to understand the current legislative understanding of a builder and developer as defined under section 100D(9) which defines a builder as someone *"engaged in the construction and disposal of residential or commercial buildings*". And it defines a developer as someone *"engaged in the development of land in the form of plots of any kind either for itself or otherwise."* Section 100D(9)(c) also defines 'capital investment' to mean *"investment as equity resources and does not include borrowed funds."*

14. Before we revert to the scope of section 36 let us note that in relation to the work of a builder and a developer

as defined under section 100D(9)(a) and 100D(9)(c), respectively, the Ordinance now envisages a construction component. And further, under section 100D, what is regarded as capital investment of a builder or developer is the equity investment of such taxpayer and not borrowed funds. This is relevant because in relation to development projects undertaken by developers and builders the three main sources for funding, include capital investment, loans from financial institutions or other creditors and advances from customers who enter into contracts for purchase of developed property with the builder or developer and pay advances in the form of installments which then become equity investment of such third party purchasers in the property being developed. In the present circumstances we are considering whether the contracts between the applicant and third party purchasers for sale of developed property fall within the definition of long-term contracts under section 36 of the Ordinance. The contracts for sale of property between the applicant and third party customers from whom installments were received by the applicant can be viewed as contracts comprising two discernable components. One component deals with the sale of ownership rights in the land upon which the property is to be built. And the second deals with construction of the property which is to be delivered to the customers. The applicant has placed on record a sample agreement entered into the applicant and third party purchasers. Such purchasers have made installment payments to the applicant, which installments

have been treated as revenue received by the applicant pursuant to long-term contract as defined under section 36, which revenue according to the Tax Department was to be offered for tax in accordance with the percentage of completion method with reference to the stage of completion of the contracts.

15. The sample agreement for sale offers customers a choice between two finishing preferences. Article 1 of the agreement for sale describes the agreement as one where the applicant undertakes to *"construct and sell the property to the purchaser."* The terms and conditions of the contract listed under Schedule-1 to the agreement of sale allows the purchaser rights to 'Common Use Facilities' including, *"open areas, services, in-road, pavements, water features, utility and administrative offices or areas, installations, improvements and common assets of the project or the property that are intended for facilitating all occupants and owners of the Units in the Project and do not form part of any Unit or of the property."* The agreement to sell further provides that the purchaser would be under an obligation to pay service charges towards the management, administration, maintenance and control of the Common Use Facilities. Clause 2 confirms sale of the property and states that the applicant *"agrees to construct the Unit and sell the property to the purchaser and the purchaser agrees to purchase the property from Emaar …"* Clause 3 deals with consideration and payment, and provides that payment by

installments is to be made during construction phase as well as payment of service charges to be made on an annual basis, the first such payment become due prior to the date of completion of the construction of the property. Clause 11 of the agreement provides for default by the applicant and describes the inability to deliver possession of the property on the completion date as default and empowers the customer to terminate the agreement for sale if the default is not cured within a certain described period, after which the applicant would be under an obligation to refund all payments made by the purchaser along with liquidated damages. Clause 12 deals with default by the purchaser which includes the failure of the purchaser to pay installment payment and empowers the applicant to impose liquidated damages, and under some circumstances terminate the agreement and recover liquidated damages up to 30% of the purchaser price and return the remaining amount to the purchaser. The two points to note here are that (i) the contract as defined by the agreement for sale of property includes within it a contract for construction of the property, and (ii) the installment payment received by the applicant from the purchaser are treated as the equity of the purchaser, which, subject to certain penalty, the applicant is under an obligation to return to the purchaser in the event that the agreement is terminated.

16. Before we revert to the application of section 36 to the facts of the instant case, let us consider the distinction

drawn by courts between a contract for sale versus a contract for service. The question of the distinction between a contract for work and a contract for sale came before the learned Sindh High Court in ***Pakistan Petroleum Ltd. Vs. SPEC Energy DMCC and others (2022 CLC 1412)***. While the question before the learned Sindh High Court was related to a procurement issue, the discussion on how a contract for sale can be distinguished from a contract for service is useful for our purposes. The relevant dicta is as follows:

> *With reference to the case laws a contract for sale has to be distinguished from a contract of work. Whether a particular agreement falls within one or the other category depends upon the object and intent of the parties, as evident by the terms of the contract, the circumstances in which it was entered into and the custom of the trade. The substance of the matter and not the form is what is of importance. If a contract involves the sale of moveable property as moveable property, it would constitute a contract for sale. On the other hand if the contract primarily involves carrying on of work involving labor and service and the use of materials is incidental to the execution of the work, the contract would constitute a contract of work and labor. One of the circumstances which is of relevance is whether the article which has to be delivered has an identifiable existence prior to its delivery to the purchaser upon the payment of a price. If the article has an identifiable existence prior to its delivery to the purchaser, and when the title to the property vests with the purchaser only upon delivery, that is an important indicator to suggest that the contract is a contract for sale and not a contract for work.*

17. The question of distinguishing a contract for sale and a contract for work and labour was addressed by the Supreme Court of India in the context of sales tax. In considering how a contract of sale and a contract for work/labour are to be distinguished, the discussion and the test laid out may be relevant for our present purposes. The Indian Supreme Court in ***Commissioner of Sales Tax, Madhya Pardesh Vs. Purshottam Premji (1970) 2 SCC 287)*** held the following:

> *The primary difference between a contract for work or service and a contract for sale of goods is that in the former there is in the person performing work or rendering service no property in the thing produced as a whole… In the case of a contract for sale, the thing produced as a whole has individual existence as the sole property of the party who produced it, at some time before delivery, and the property therein passes only under the contract relating thereto to the other party for price.*

18. The same question came before the Supreme Court of India in ***Sentinel Rolling Shutters Vs. Commissioner of Sale Tax (1979 AIR 1747)***, wherein the court was considering whether a contract for installation of rolling shutters was a contract for sale or a contract for work and labour. It took into account the fact that the installation of purpose-built shutters could not be treated as incidental to the manufacture of such shutters and such work relating to erection and installation of the shutters was an integral part of the contract because without it the rolling shutters did not come into being. Consequently, the contract for fabrication,

supply and erection of rolling shutters was held to be a contract for work and labour and not a contract for sale. The Indian Supreme Court described the form that contracts could take as follows:

> *The contract may be for work to be done for remuneration and for supply of materials used in the execution of the work for a price; it may be a contract for work in which the use of materials is necessary or incidental to the execution of the work; or it may be a contract for supply of goods where some work is required to be done as incidental to the sale. Where a contract is of the first type, it is a composite contract consisting essentially of two contracts, one for the sale of goods and the other for work and labour. The second type of contract is clearly a contract for work and labour not involving sale of goods, while the third type is a contract for sale where the goods are sold as chattels and some work is undoubtedly done, but it is done only as incidental to the sale. No difficulty arises where a contract is of the first type because it is divisible and the contract for sale can be separated from the contract for work and labour and the amount payable under the composite contract can be apportioned between the two."*

19. In the jurisprudence produced in relation to the distinction drawn between a contract for sale versus contract of work and labour in India, as discussed above, the main test applied seems to be whether the main object of the contract was transfer of property in a chattel wherein some work may be required as ancillary or incidental to the sale or whether the work and labour was an integral part of the contract itself, leading to the conclusion that without such

work the property to be sold could not have come into existence.

20. In the present case it is obvious that there is no preexisting property that is the subject matter of the agreement for sale between the applicant and the purchaser in relation to which installment payments were received by the applicant. The contract for sale affords a purchaser limited finishing options. But it cannot be said that the purchaser does not acquire any right in relation to the property that forms the subject matter of the agreement for sale till such time that the title to the property and underlying land is transferred by the applicant to the purchaser upon completion of construction of the property. The agreement for sale can at best be described as two contracts rolled into one. One for the sale of ownership rights in the underlying land. And the second for sale of property to be constructed by the applicant and delivered to the purchaser within a certain period of time during which the purchaser is obliged to pay consideration in the form of installment payments reflecting the progress being made in the construction of the property by the applicant leading toward the completion of the developed and finished property. The installment payments constitute consideration for construction and sale of property the completion of which takes longer than a tax year. In such sense the contract for sale essentially includes contract of construction and performance of services by the applicant in relation to such

construction, which contract is spread over more than one tax year and consequently falls within the definition of a long-term contract under section 36 of the Ordinance.

21. Such interpretation of the ordinary words used in the definition of long-term contract provided under section 36(3) of the Ordinance is also in accord with the purpose behind requiring taxpayers to offer revenue on the basis of percentage of completion method. The receipts of the applicant in lieu of installment payments can neither be regarded as equity nor as debt of the applicant. The installment payments constitute the sale consideration paid by purchasers in lieu of property to be constructed and sold by the applicant to such purchasers. Such receipts can therefore at best be described as advances by purchasers, which do not form part of the equity investment by the applicant but form part of the equity investment by the purchasers of such property that is being made to order under the contract for sale by the applicant for the benefit of the purchasers. It therefore make sense that the taxpayer is not allowed to withhold such revenue receipts as its own capital investment. But instead the taxpayer is required to offer up such revenue for tax to the State in proportion to the amount of work completed.

22. This Court also feels that the Commissioner Inland Revenue has correctly appreciated the object of IAS No.11 which provides the following:

> *The object of this standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activities are completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting period in which the construction work is performed."*

While it was the applicant's contention before the tax department that the relevant standard applicable to the payments received in lieu of agreement for sale entered into by the applicant with purchasers was IAS No. 18, the scope of such standard clarifies that revenue arising from contracts for service such as those of project managers and architects is not dealt with under IAS No. 18, but in accordance with requirements of construction contracts as specified in IAS No. 11 construction contract.

23. In the instant case the agreement between the applicant and the purchasers who made installment payments which formed the stream of revenue that the tax department insisted must be offered up by the applicant for tax in the relevant tax year, was in relation to a property which was not preexisting but was being constructed pursuant to the contract for sale for the benefit of the purchaser. In the absence of preexisting property the applicant could not insist that the agreement for sale related to developed real estate and that the purchaser would only

acquire an interest in such property after the completion date when the title in such property was formerly transferred in the name of the purchaser.

24. As has been discussed above, purchasers continue to acquire an interest in the property proportionate to the installment payments. The applicant is under an obligation to transfer such property upon completion. And in case of failure to complete the construction of such property, the applicant is under an obligation to return the consideration received from such purchasers. The consideration received could therefore not be treated by the applicant as its own equity which it could capitalize. What the applicant could do at best was to distinguish the cost of land, the title to which was to be transferred at the time of completion and the cost of construction of the property in lieu of which installment payments were being received, and then offer up the revenue receipts in lieu of the construction component of the agreement for sale for tax under section 36(1) read together with section 36(3) of the Ordinance.

25. For the aforementioned reasons, we find that the agreement for sale fell within the definition of a long-term contract within the meaning of section 36(3) of the Ordinance and the applicant was under an obligation to offer up such revenue for tax on the basis of percentage of completion method. This conclusion also addresses the questions in relation to capitalization of expenditure pursuant to section 21(c) of the Ordinance in computing the

income arising for the relevant tax year. The applicant was obliged to account for the cost allocated to the contract and incurred before the end of the year, which could not be capitalized either. We therefore answer the questions in relation to sections 36 and 21(c) of the Ordinance accordingly.

25. A copy of this order is directed to be sent to the Registrar of the learned Tribunal under the seal of this Court.

(SAMAN RAFAT IMTIAZ)
JUDGE

(BABAR SATTAR)
JUDGE

Announced in the open Court on 10/01/2023.

JUDGE

JUDGE

Saeed.