Times of India ND 22.10.2012

How earnest money impacts your tax

You don't have to pay income tax on earnest money received from a failed deal, but there are other tax implications you should be familiar with, says MK Agarwal

When you buy or sell a tangible asset, there is usually some earnest money given by the buyer before he arranges for the full payment. This can range from ₹5,000-10,000 for a used car to a couple of lakhs of rupees for a real estate transaction. The payment is meant to seal the deal and the rules of arrangement are simple. If the buyer backs out, the earnest money given to the seller is forfeited. If the seller changes his mind, he gives back double the amount to the buyer. To ensure that both the parties play fair, there is typically an intermediary who is known to both.

In normal circumstances, any amount received as advance for the purchase of an asset is a revenue receipt and is taxed in the year that it is received. What happens if the deal falls through? Will the forfeited amount become the income of the seller and will he have to pay tax on it? Under which income head will the amount have to be declared in the tax return form?

As per Section 51 of the Income Tax Act, 1961, if the owner of an asset has received money by forfeiting any advance money for the asset, this amount will be deducted from the purchase price of the asset. This is the cost for which the asset was acquired or its fair market value (if the property was purchased before 1 April 1981). Suppose you bought a property for ₹10 lakh about 15 years ago, and two years ago, you decided to sell it for ₹40 lakh. The deal was struck and the buyer gave you earnest money of ₹2 lakh, but later backed out. The ₹2 lakh will be treated as capital receipt and you will not be taxed in that year, but the amount will be deducted from the purchase price of your property when you sell it in the future. In this case, the purchase price will be taken as ₹8 lakh.

In some cases, deduction of earnest money from the cost price of the asset pushes up the capital gains tax of the owner substantially. In the example (How much tax...), the owner would not have had to pay any tax had he not forfeited the earnest money. The indexed cost of acquisition without deducting ₹50,000 from the cost price would have been ₹8.3 lakh. One would be better off including the earnest money in one's income from other sources and paying tax on it. Is this possible? The law is silent on this because the earnest money is a capital receipt, not income.

Also, the seller must know that this is a one-way street. If you backed out of the deal and paid the buyer ₹2 lakh compensation, it would be treated as a capital loss and not added to the purchase price of the property. You can claim tax benefit on this only if you were in the business of sale and purchase of the property. In such a case, the loss due to forfeiture would be treated as a revenue loss.

How much tax does a seller pay?

Mr X bought land in January 1987 for ₹2 lakh. He agreed to sell it to Mr Y in January 1998 and received ₹50,000 as earnest money. However, Mr Y backed out and his ₹50,000 was forfeited. Mr X sold the land on 1 January 2009 for ₹8 lakh to Mr Z. Here's how his gains will be taxed:

- **Purchase price:** ₹2 lakh
- **Earnest money received:** ₹50,000
- **Deemed purchase price:** ₹1.5 lakh
- **Indexed cost (in 2008-9):** ₹6.23 lakh
- **Selling price:** ₹8 lakh
- **Capital gain:** ₹1.77 lakh
- **Tax payable:** ₹35,400 (20%)

Earnest money is usually a very small percentage of the total value of the transaction, but sometimes it can be higher than the cost price of the asset. Under Section 48 (read with Section 51), if the amount forfeited is greater than or equal to the cost of acquisition, the cost of the asset will be taken as nil. In one such case involving Sunita N Shah (2005) 94 ITD 492 (Mumbai), the forfeited amount was higher than the cost of acquisition. In such cases, the excess amount is considered capital receipt and is not chargeable to tax.

Tax impact on buyer

In case the buyer defaults and the earnest money is forfeited, he will not be allowed to show it as a capital loss. This was the verdict in the case of CIT vs Sterling Investment Corporation Ltd (1980) 123 ITR 441. However, if the seller fails to honour the deal and pays the buyer double the compensation, this will be treated as capital gain because it amounts to relinquishment of a right by the buyer. In the case of CIT vs Vijay Flexible Container (1990) 186 ITR 693, it was held that giving up the right to -obtain conveyance of immovable property amounts to transfer of a capital asset.

What happens if the advance money was for the purchase of a commercial property? Can the loss be treated as business expenditure incurred by the purchaser? The amount cannot be claimed as -revenue expenditure. In CIT vs Jaipur Mineral Develop Syndicate (1995) 216 ITR 469 (Raj), it was held that if the payment is made for the pupose of acquiring a capital asset, the amount lost upon forfeiture will not be considered as revenue loss though the amount may not have the same consequence or character in the hands of the recipient or beneficiary.

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