Income Tax - Tax upon Income from Capital Gains

What is meant by the term "Capital Assets"?

S 2(14): Capital asset means property of any kind held by an assessee whether or not connected with his business or profession. It however does not include the following:

1) **Any stock-in-trade, consumable stores or raw materials held for the purpose of his business or profession;**

2) **Personal effects, i.e., movable property (including wearing apparel and furniture, excluding jewellery), held for personal use by the assessee or any member of his family dependent on him.**

3) **Agricultural land in India, not being land situated in the following:-**

    a) **In any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee, or by any other name) or a cantonment board and, which has a population of not less than ten thousand according to the last preceding census of which the relevant figures have been published before the first day of the previous year; or**
    b) **In any area within such distance, not being more than eight kilometers, from the local limits of any municipality or cantonment board referred to in item (a), as the Central Government may, having regard to the extent of, and scope for, urbanization of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette;**

4) **6.5 per cent Gold Bonds, 1977, or 7 per cent Gold Bonds, 1980, or National, Defence Gold Bonds, 1980, issued by the Central Government;**

5) **Special Bearer Bonds, 1991, issued by the Central Government;**

6) **Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.**

Which are the assets, which do not fall within the term "capital assets", and which can give rise to a tax-free surplus?

- **Any stock-in-trade, consumable stores or raw materials, held for the purpose of his business or profession;**
- **Personal effects, i.e., movable property (including wearing apparel and furniture, excluding jewellery), held for personal use by the assessee or any member of his family dependent on him;**

- **Agricultural land in India, not being land situated in the following: -**
    - **In any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee, or by any other name) or a cantonment board and which has a population of not less than ten thousand according to the last preceding census of which the relevant figures have been published before the first day of the previous year; or**
    - **In any area within such distance, not being more than eight kilometers, from the local limits of any municipality or cantonment board referred to in item (a), as the Central Government may, having regard to the extent of, and scope for, urbanization of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette;**

- **6.5 per cent Gold Bonds, 1977, or 7 per cent Gold Bonds, 1980, or National, Defence Gold Bonds, 1980, issued by the Central Government;**
- **Special Bearer Bonds, 1991, issued by the Central Government;**
- **Gold Deposit Bonds, issued under the Gold Deposit Scheme, 1999 notified by the Central Government.**

Are the gains, arising from sale or transfer of property, subject to Income tax?

Yes, gains, which arise from the transfer of capital assets, are subject to tax under the Income-tax Act. Section 14 of the Income-tax Act has classified Capital Gains as a separate Head of Income.

Further, certain other transactions are also included in the definition of transfer. These are as follows:

1) **In a case where a capital asset is converted by the owner thereof into (or is treated by him as) stock-in-trade of a business that is carried on by him, such conversion (or treatment) of the capital asset shall also be treated as "transfer of the asset" and hence chargeable to income tax.**
2) **Profits and gains arising from transfer made by the depository or the participant, having beneficial interest in respect of the securities, shall also be chargeable to income tax.**
3) **Profits and gains, arising from transfer of a capital asset by a person to a firm or other association of persons or body of individuals, in which he is or becomes a**

partner or member by way of capital contribution or otherwise, shall also be chargeable to income tax.

4) **Profits and gains, arising from transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm or other association of persons or body of individuals (not being a company or a co-operative society) shall also be chargeable to income tax as the income of a firm or other association or body.**
5) **Any money or assets, received by a person under an insurance policy from an insurer, on account of damage or destruction of any capital asset, any profits or gains arising from receipt of such money or other assets shall be taxable under the head "capital gains".**
6) **Capital gains, arising from the transfer of a capital asset, being a transfer by way of compulsory acquisition under any law or a transfer, the consideration for which was determined /approved by the Central Govt., or the RBI.**

What transactions are not regarded as transfers?

Certain transactions are not regarded as transfers and hence, the profits and gains arising from such transfer are not taxable under the head "Capital gains". Such transactions are as follows:

- **Distribution of assets in kind by a company to its shareholders on its liquidation (S 46(1)); · Any distribution of capital assets in kind by a Hindu undivided family to its members at the time of total or partial partition (S 47 (i)).**
- **Any transfer of a capital asset under a gift or will or an irrevocable trust. Nevertheless, this clause is not applicable to a transfer under a gift or will or an irrevocable trust of capital asset, being shares, debentures, or warrants, allotted by a company (directly/indirectly) to its employees under an Employees Stock Option Plan or Scheme of the company, in accordance with the guidelines issued by the Central Government (S 47 (iii)).**
- **Any transfer of a capital asset by a company to its subsidiary, provided the Company wholly owns such subsidiary company and the subsidiary company is an Indian company (S 47 (iv)).**
- **Any transfer of a capital asset by a subsidiary company to the holding company, provided such holding company wholly owns the share capital of the subsidiary company and the holding company is an Indian Company (S 47 (v)).**
- **Any transfer of a capital asset in a scheme of amalgamation by the amalgamating company to the amalgamated company, provided the amalgamated company is an Indian company (S 47 (vi)).**
- **Any transfer of shares in an Indian Company, held by a foreign company to another foreign company in pursuance of a scheme of amalgamation between the**

2 foreign companies, provided at least 25% of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company and such transfer does not attract tax on capital gains in the country, in which the amalgamating company is incorporated (S 47 (via)).

- Any transfer of a capital asset in a scheme of demerger, by the demerger company to the resulting company, provided that the resulting company is an Indian company (S47 (vib)).
- Any transfer of shares, held in an Indian company, by a demerged foreign company to the resulting foreign company, provided the shareholders, who hold not less than 3/4ths in value of the shares of the demerged foreign company, continue to remain shareholders of the resulting foreign company and such transfer does not attract tax on capital gains in the country in which the demerged foreign company is incorporated (S 47 (vic)).
- Any transfer or issue of shares by the resulting company in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of the demerger of the undertaking (S47 (vid))).
- Any transfer by a shareholder, in a scheme of amalgamation of share(s) held by him in the amalgamating company, if the transfer is made in consideration of the allotment to him of any shares(s) in the amalgamated company and the amalgamated company is an Indian company (S 47 (vii)).
- The transfer of a capital asset by a non-resident of such foreign currency convertible bonds or Global Depository Receipts as are referred to sub-section (1) of Section 115AC, held by him to another non-resident where the transfer is made outside India (S 47 (viia)).
- Any transfer of agricultural land in India, effected before March 1, 1970 (S 47 (viii)).
- Any transfer of a capital asset, being any work of art, archeological, scientific or art collection, book, manuscript, drawing, painting, photograph or print, to the Government or a University or the National Museum, National Art Gallery, National Archives or any such other public museum or institution as may be notified by the Central Government (S 47(x)).
- Any transfer by way of exchange of a capital asset, being membership of a recognized stock exchange for shares of a company to which such membership is transferred, provided such exchange is effected on or before December 31, 1998 and such shares are reflected by the transferor for a period of not less than 3 years from the date of transfer (S 47 (xi)).
- Any transfer of a land under a scheme, prepared and sanctioned under section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985 by a sick industrial company, which is being managed by its workers' co-operative, provided

such transfer is made during the period commencing from the previous year, during which it has become a sick industrial company under S17 (1) of that Act and ending with the previous year, during which the entire net worth of such company becomes equal to or exceeds the accumulated losses (S 47 (xii)).

- **Any transfer of a capital asset or intangible asset by a firm to a company as a result of succession of the firm by a company in the business carried on by the firm, or any transfer of a capital asset to a company in the course of corporatisation of a recognized stock exchange in India, as a result of which an association of persons or body of individuals is succeeded by such company, subject to the following conditions:**
- **All the assets and liabilities of the firm, relating to the business immediately before the succession, become the assets and liabilities of the company;**
- **All the partners of the firm, immediately before the succession, become the shareholders of the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the succession;**
- **The partners of the firm do not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company; and**
- **The aggregate of the shareholding in the company of the partners of the firm is not less than fifty per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of the succession. (S 47 (xiii).**
- **S.47 (xiiia): Any transfer of a capital asset, being a membership right, held by a member of a recognized stock exchange in India for acquisition of shares and trading or clearing rights, acquired by such member in that recognized stock exchange in accordance with a scheme for demutualization or corporatisation, which is approved by the Securities and Exchange Board of India, established under section 3 of the Securities and Exchange Board of India Act, 1992.**
- **Where a sole proprietary concern is succeeded by a company in the business, carried on by it as a result of which the sole proprietary concern sells or, otherwise transfers any capital asset or intangible asset to the company, provided that the following conditions exist:**
  a) **All the assets and liabilities of the sole proprietary concern, relating to the business immediately before the succession, become the assets and liabilities of the company;**
  b) **The shareholding of the sole proprietor in the company is not less than fifty per cent of the total voting power in the company and his shareholding continues to remain as such for a period of five years from the date of the succession; and**

c) The sole proprietor does not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of allotment of shares in the company. (S47 (xiv)).

- Any transfer in a scheme for lending of any securities under an agreement or arrangement, which the assessee has entered into with the borrower of such securities and which is subject to the guidelines issued by the Securities and Exchange Board of India, in this regard, which the assessee has entered into with the borrower of such securities. (S 47 (xv)).

In what circumstances are capital gains that arise from the transfer of house property exempt?

Under S 54, capital gains, arising from transfer of house property, are exempt from tax provided the following conditions are satisfied

1) The house is a residential house whose income is taxable under the head "income form house property" and transferred by an individual or a Hindu Undivided Family.
2) The house property, which may be self-occupied or let out, is a long term capital asset (i.e. held for a period of more than 36 months before sale or transfer.)
3) The assessee has purchased a residential house within a period of 1 year before the transfer (or within 2 years after the date of transfer) or has constructed a residential house property within a period of 3 years after the date of transfer. In case of compulsory acquisition, the above time limit of 1-year, 2 years and 3-years is applicable from the date of receipt of compensation (whether original or additional).
4) The house property, so purchased or constructed, has not been transferred within a period of 3 years from the date of purchase or construction.

The following points should also be kept in mind:-

a) Construction of the house should be completed within 3 years from the date of transfer. The date of construction is irrelevant. Construction may be commenced even before the transfer of the house.
b) A case of allotment of a flat under the self-financing scheme of DDA (or similar schemes of co-operative societies and other institutions) is taken as construction of house for this purpose.

What are the consequences if a new house is transferred within 3 years?

If the new house is transferred within a period of 3 years from the date of its purchase or construction, the amount of capital gain that arise, together with the amount of capital gains exempted earlier, will be chargeable to tax in the year of the sale of the new house property.

It is also provided that if the new house is transferred within 3years from the date of its acquisition or date of completion of construction, the amount of exemption under S 54 shall be reduced from the cost of acquisition of the new house, while calculating short-term capital gain on the transfer of the new asset.

What is the amount of exemption available on capital gains that arise from transfer of house property?

If the amount of capital gain is less than the cost of the new house property, including cost of land, the entire amount of capital gains is exempt from tax. Alternatively, if the amount of capital gains is more than the cost of the new house property, the difference between the amount of capital gains and the cost of the new house is chargeable to tax as capital gains.

What is the mode of computation?

The computation of capital gains depends upon the nature of capital asset that is transferred, i.e., whether it is a short-term or a long-term capital asset. Capital gain, arising on transfer of a short-term capital asset, is short-term capital gains whereas Capital gain, arising on transfer of a long-term capital asset, is long-term capital gains. As compared to long-term capital gain, the tax incidence is higher in the case of short-term capital gain.

The method of computation of short-term and long-term capital gain, as applicable from the assessment year 1993-94 onwards, is as follows:

Computation of Short-term capital gain Computation of Long-term capital gain	1. Find out the full value of consideration
	2. Deduct the following:
a. Expenditure incurred wholly and exclusively in connection with such transfer.	b. Cost of acquisition. c. Cost of improvement
	3. From the resulting sum deduct the exemption provided by section 54B, 54D and 54G.
	4. The balancing amount is the short-term capital gain. 1. Find out the full value of

	consideration
	2. Deduct the following:
a. Expenditure incurred wholly and exclusively in connection with such transfer	b. Indexed Cost of acquisition
c. Indexed Cost of improvement.	
3. From the resulting sum deduct the exemption provided by section 54, 54B, 54D, 54EC, 54ED, 54F and 54G.	
4. The balancing amount is the long-term capital gain.	

Full value of consideration: Whole price without any deduction whatsoever.

Expenditure incurred wholly and exclusively in connection with such transfer: Expenditure incurred which is necessary to effect such transfer e.g. stamp duty, registration etc.

Cost of acquisition of an asset: Value for which it was acquired. Expenses of capital nature for completing or acquiring the title to the property may be included in the cost of acquisition.

Cost of improvement:

a) **In relation to goodwill of a business or a right to manufacture, produce or process any article or thing, the cost of improvement is taken to be nil.**
b) **In relation to any other capital asset-**
    1) **Where the capital asset became the property of the assessee before April 1, 1981 the cost of improvement includes all expenditure of capital nature incurred in making any addition/alteration to the capital asset on or after April 1, 1981 by the owner.**
    2) **In any other case, the cost of improvement refers to all expenditure of a capital nature that is incurred in making any additions or alterations to the capital asset by the assessee or the previous owner.**

What is the indexed cost of acquisition?

S 48 defines "indexed cost of acquisition" as the amount, which bears to the cost of acquisition the same proportion as Cost Inflation Index for the year, in which the asset is transferred, bears to the Cost Inflation Index for the first year in which the asset was

held by the assessee or for the year beginning on the 1st day of April, 1981, whichever is later.

The Cost Inflation Index, in relation to a previous year, means such Index as the Central Government may, having regard to 75% of average rise in the Consumer Price Index for urban non-manual employees for the immediately preceding previous year to such previous year, by notification in the Official Gazette.

What is the indexed cost of improvement?

S 48 defines indexed cost of improvement as the amount, which bears to the cost of improvement the same proportion as Cost Inflation Index for the year, in which the asset is transferred, bears to the Cost Inflation Index for the year in which the improvement to the asset takes place.

Cost Inflation Index, in relation to a previous year, means such Index as the Central Government may, having regard to 75% of average rise in the Consumer Price Index for urban non-manual employees for the immediately preceding previous year to such previous year, by notification in the Official Gazette, specify in this behalf.

Is there any tax shelter for avoiding capital gains tax?

The Income Tax Act grants total/partial exemption of capital gains under Ss- 54, 54B, 54D, 54EC, 54F, 54G and 54H.

A) Under S 54 capital gains, arising from transfer of house property, are exempt from tax provided certain conditions are satisfied. (Refer to Q5)

B) Under S 54B capital gains, arising from transfer of land, being used by an individual or his parents for agricultural purposes for a period of 2 years, immediately preceding the date of transfer, are exempt from tax, provided the assessee has purchased another land for agricultural purpose within a period of 2 years from the date of such transfer. In the case of compulsory acquisition, a period of 2 years from the date of receipt of compensation (whether original or additional) is applicable.

C) Under S 54D, capital gains, arising on compulsory acquisition of any land or building forming part of an industrial undertaking, is exempt from tax, provided such land or building was used by the assessee for the purpose of the industrial undertaking for at least 2 years preceding the date of compulsory acquisition and, the assessee has, within a period of 3 years after that date, purchased any other land or building or right in any other land/ building or constructed any other building for the purpose of shifting or reestablishing the said undertaking or setting up another industrial undertaking.

D) Under S 54E, where the capital gain arises from the transfer of a long-term capital asset before the 1st day of April, 1992, and the assessee has, within a period of six months after the date of such transfer, invested or deposited the whole or any part of the net consideration in any specified asset.

E) Under S 54EA, where the capital gain arises from the transfer of a long-term capital asset before the 1st day of April, 2000 and the assessee has, at any time within a period of six months after the date of such transfer, invested the whole or any part of the net consideration in any of the bonds, debentures, shares of a public company or units of any mutual fund referred to in clause (23D) of section 10, specified by the Board in this behalf by notification in the Official Gazette.

F) Under S 54EB, where the capital gain arises from the transfer of a long-term capital asset before the 1st day of April, 2000, and the assessee has, at any time within a period of six months after the date of such transfer invested the whole or any part of capital gains, in any of the assets, specified by the Board in this behalf by notification in the Official Gazette. (I) Under S 54 F where, in the case of an assessee being an individual or a Hindu undivided family, the capital gain arises from the transfer of any long-term capital asset, not being a residential house, and the assessee has, within a period of one year before or two years after the date on which the transfer took place purchased, or has within a period of three years after that date constructed, a residential house.

G) S 54 G provides exemption on transfer of assets in the case of shifting of industrial undertaking from an urban area, provided the capital asset (being plant, machinery, land or building or any right in land or building), used for the purpose of the industrial undertaking situated in an urban area, is transferred in the course of or, in consequence of the shifting of such industrial undertaking to any area other than an urban area, and the assessee has, within a period of 1 year ,before or 3 years after the date on which the transfer took place, purchased a new machinery or plant for the purposes of business of the industrial undertaking in the area to which the said undertaking is shifted or, has acquired building or land or constructed a building for the purposes of his business in the said area or shifted the original asset and transferred the establishment of such under-taking to such area; and incurred expenses on such other purpose as may be specified in a scheme, framed by the Central Government for the purposes of this section.

H) S 54H, provides that where the transfer of the original asset is by way of compulsory acquisition under any law and the amount of compensation, awarded for such acquisition, is not received by the assessee on the date of such transfer, the period of acquiring the new asset under S 54, 54B, 54D, 54EC and 54F by the assessee or the period for depositing or investing the amount of capital gain shall be extended in relation to such amount of compensation as is not received on the date of transfer. The extended period shall be reckoned from the date of receipt of the amount of compensation. Moreover, when the compensation in respect of transfer of the original asset by way of compulsory acquisition under any law is received before April 1, 1991, the period(s) aforesaid, if expired, shall extend up to December 31, 1991.

If the asset has been inherited by the assessee or gifted to the assessee does that mean that the asset was acquired at no cost?

- S 49(1) states where the asset has been inherited by the assessee or gifted to the assessee, the cost of acquisition of the asset for which the previous owner acquired it, shall be deemed to be the cost of acquisition of the asset as increased by the cost of improvement of the assets if any, incurred or borne by the previous owner or the assessee as the case may be.

- (2) Where the capital asset is a share(s) in an amalgamated company, which is an Indian company, became the property of the assessee in consideration of a transfer in a scheme of amalgamation, the cost of acquisition of the asset shall be deemed to be the cost of acquisition to him of the shares(s) in the amalgamating company.

- (2A) Where the capital asset, being a share or debenture in a company became the property of the assessee in consideration of a transfer by way of conversion of bonds or debentures, debenture-stock or deposit certificates in any form, the cost of acquisition of the asset to the assessee shall be deemed to be that part of the cost of debenture, debenture- stock or deposit certificates in relation to which such asset is acquired by the assessee.

- (2AA) Where the capital gain arises from the transfer of the shares, debentures or warrants, the value of which has been taken into account while computing the value of perquisite under clause (2) of section 17, the cost of acquisition of such shares, debentures or warrants shall be the value under that clause.

- (2C) The cost of acquisition of the shares in the resulting company shall be the amount which bears to the cost of acquisition of shares, held by the assessee in the demerged company, in the same proportion as the net book value of the assets transferred in a demerger bears to the net worth of the demerged company immediately before such demerger.

- (2D) The cost of acquisition of the original shares held by the shareholder in the demerged company shall be deemed to have been reduced by the amount as so arrived at under sub-section (2C).
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- **What is the rule regarding period of holding if the assessee has inherited the property only six months ago? Can this be considered to be a short-term capital asset?**

- **Under the definition of short-term capital asset, given in section 2(42A), it is specifically provided in sub-clause (b) that in the case of an acquisition by the modes provided in Section 49, there shall be included the period for which the previous owner held the asset. Thus, if the present holder inherited it only 6 months ago, but the previous holder had held it for three years, it will be deemed that the present holder has held it for three and a half years.**