

Capital Gains

Some Key Points : Recent Amendments

Conversion of company into LLP [Section 47(xiiiib)]

When a private company or unlisted public company is converted into a limited liability partnership or any transfer of a share as a result of such conversion, shall not be regarded as transfer. However, the following conditions are to be satisfied for having tax neutral situation.

- (a) All the assets and liabilities of the company immediately before the conversion must become the assets and liabilities of the LLP.
- (b) All the shareholders of the company immediately before conversion must become partners of the LLP and their capital contribution and profit sharing ratio in the LLP must be in the same proportion as their shareholding in the company on the date of conversion.
- (c) The shareholders of the company should not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of share in profit and capital contribution in the LLP.
- (d) The aggregate of the profit sharing ratio of the shareholders of the erstwhile company in the LLP shall not be less than 50% at any time during the period of 5 years from the date of conversion into LLP.
- (e) The total sales, turnover or gross receipts in business of the company in any of the three previous years preceding the year of conversion must not exceed ₹ 60 lacs.
- (f) No amount is paid either directly or indirectly, to any partner out of accumulated profit standing in the accounts of the company on the date of conversion for a period of three years from the date of conversion.

Withdrawal of exemption [Section 47(4)]

Where a company converted into a LLP has availed exemption as per section 47(xiiiib) but subsequently the conditions attached to the exemption are not complied with, the amount of profits and gains arising from the transfer of such capital asset not charged under section 45 previously, shall be deemed to be the profits and gains chargeable to tax in the hands of the successor LLP. It would become the deemed income from business of the successor LLP of the previous year in which the conditions are not complied with.

Cost of acquisition of sweat equity shares [Section 49(2AA)]

The cost of sweat equity shares referred to in section 17(2)(vi) shall be the fair market value which has been taken into account for the purpose of perquisite valuation. The capital gain

arising from the transfer of specified security or sweat equity share would be computed accordingly by adopting the cost of acquisition referred above.

Value of capital assets which were allowed deduction under section 35AD [Section 50B]

In the case of slump sale, clause (b) of the Explanation 2 to section 50B says that in respect of capital assets the whole of which was allowed deduction under section 35AD, shall be ₹nil' for computing the net worth of the undertaking.

In respect of other assets other than depreciable assets for which WDV is dealt with in section 43(6)(c)(i), it shall be the book value of such assets.

Question 1

"Any transfer of a capital asset or intangible asset by a private company or unlisted public company to a LLP or any transfer of share or shares held in a company by a shareholder on conversion of a company into a LLP in accordance with section 56 and section 57 of the Limited Liability Partnership Act, 2008, shall not be regarded as a transfer for the purposes of levy of capital gains tax under section 45 subject to fulfillment of certain conditions". Explain in the context of the provisions contained in the Act.

Answer

Any transfer of a capital asset or intangible asset by a private company or unlisted public company to a LLP or any transfer of a share or shares held in a company by a shareholder on conversion of a company into a LLP shall not be regarded as a transfer for a purpose of levy of capital gains tax under section 45 on fulfillment of the following conditions:-

- (1) the total sales, turnover or gross receipts in business of the company should not exceed ₹ 60 lacs in any of the three preceding previous years;
- (2) all the shareholders of the company immediately before the conversion become partners of the LLP and their capital contribution and profit sharing ratio in the LLP are also in the same proportion as their shareholding in the company on the date of conversion;
- (3) no consideration other than share in profit and capital contribution in the LLP arises to the shareholders of the company;
- (4) the erstwhile shareholders of the company continue to be entitled to receive at least 50% of the profits of the LLP for a period of at least 5 years from the date of conversion;
- (5) all assets and liabilities of the company immediately before the conversion become the assets and liabilities of the LLP; and
- (6) no amount is paid, either directly or indirectly, to any partner out of the accumulated profit of the company standing in the accounts on the date of conversion, for a period of 3 years from the date of conversion.

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Question 2

Hari has acquired a residential house property in Delhi on 1st April, 2000 for ₹ 10,00,000 and decided to sell the same on 3rd May, 2003 to Ms. Pari and an advance of ₹ 25,000 was taken from her. The balance money was not paid by Ms. Pari and Hari has forfeited the entire advance sum. On 3rd June, 2011, he has sold this house to Mr. Suri for ₹ 35,00,000. In the meantime, on 4th April, 2011, he had purchased a residential house in Delhi for ₹ 8,00,000, where he was staying with his family on rent for the last 5 years and paid the full amount as per the purchase agreement. However, Hari does not possess any legal title till 31st March, 2012, as such transfer was not registered with the registration authority.

Hari has purchased another old house in Chennai on 14th October, 2011 from Mr. X, an Indian resident, by paying ₹ 5,00,000 and the purchase was registered with the appropriate authority.

Determine the taxable capital gain arising from above transactions in the hands of Hari for Assessment Year 2012 -13. Cost inflation Index: 2000-01: 406; 2003-04: 463; 2011-12: 785.

Answer

Computation of taxable capital gain of Mr. Hari for the A.Y.2012-13

Particulars	₹
Sale proceeds	35,00,000
Less: Indexed cost of acquisition (See Note 1)	<u>18,85,160</u>
Long Term Capital Gain	16,14,840
Less: Exemption under section 54 in respect of investment in house at Delhi (See Note 2)	<u>8,00,000</u>
Taxable long-term capital gain	<u>8,14,840</u>

Notes:

1 Computation of indexed cost of acquisition

	₹
Cost of acquisition	10,00,000
Less: Advance taken and forfeited	<u>25,000</u>
Cost for the purpose of Indexation	<u>9,75,000</u>
Indexed cost of acquisition (9,75,000 x 785/406)	<u>18,85,160</u>

- 2 In order to avail exemption of capital gains under section 54, a new residential house should be purchased within 1 year before or 2 years after the date of transfer or constructed within a period of 3 years after the date of transfer. In this case, Hari has purchased the residential house in Delhi within one year before the date of transfer and paid the full amount as per the purchase agreement, though he does not possess any legal title till 31.3.2012 since the transfer was not registered with the registration authority. However, for the purpose of claiming exemption under section 54, holding of legal title is not necessary. If the taxpayer pays the full consideration in terms of the

purchase agreement within the stipulated period, the exemption under section 54 would be available. It was so held in *Balraj v. CIT*(2002) 254 ITR 22 (Del.) and *CIT v. Shahzada Begum* (1988) 173 ITR 397 (A.P.).

- 3 Exemption under section 54 can be availed only in respect of one house. The Bombay High Court, in *K.C. Kanshik v. P.B. Rane, ITO* (1990) 185 ITR 499, held that where the assessee purchases more than one house, then the assessee can claim exemption in respect of only one house. It would be more beneficial for Mr. Hari to claim exemption in respect of the Delhi house since the cost of the same is higher than the cost of the Chennai house.

Note – The decision of the Karnataka High Court in *CIT v. D.Ananda Basappa* (2009)309 ITR 0329 allowing exemption under section 54 in respect of investment in two houses was owing to the reason that the two flats were adjacent to each other and were suitably modified to be used as a single residential unit. However, in this case, one house is in Delhi and the other is in Chennai. Obviously, they cannot be used as a single residential unit. Therefore, the ruling of the Karnataka High Court would not apply in this case.

Question 3

A resident woman individual sold a house property on 16-01-2012. On the said transaction, she earned a long-term capital gain of ₹ 1,01,50,000. She invested a sum of ₹ 50,00,000 in capital gains bonds specified in section 54EC on 05-03-2012. She further invested a sum of ₹ 50,00,000 in the same bonds on 05-05-2012. Her other income for the financial year 2011-12 was ₹ 46,000. Compute the tax payable by her for the A.Y. 2012-13.

Answer

Computation of taxable income for the A.Y. 2012-13

	Particulars	₹
A	Long term capital gains	1,01,50,000
	Less: Deduction under section 54EC [See Notes 1 & 2 below]	<u>1,00,00,000</u>
	Long term capital gain	1,50,000
B	Other income	<u>46,000</u>
	Total Income	<u>1,96,000</u>

As per section 112, in case of an individual, being a resident where her total income includes long-term capital gain and other income, the tax payable on the total income is the aggregate of the amount of income tax on long-term capital gains@ 20% and the amount of income tax on the total income as reduced by the amount of long term capital gain, had the total income so reduced been her total income.

However, the unexhausted basic exemption limit can be exhausted against long-term capital gains, and tax would be leviable on the balance long-term capital gains@20%. Therefore, the basic exemption limit of ₹ 1,90,000 should be first adjusted against other income of ₹ 46,000 and the unexhausted basic exemption limit of ₹ 1,44,000 should be adjusted against the long-

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term capital gains of ₹ 1,50,000. The balance long-term capital gains of ₹ 6,000 would be taxable@20% plus education cess@2% and secondary and higher education cess@1%. Therefore, the tax payable by the assessee would be ₹ 1,236.

Notes:

- (1) In order to claim exemption under section 54EC, the assessee has to invest in specified bonds of RECL or NHAI within a period of 6 months from the date of transfer of the asset.
- (2) However, investments made on or after 1.04.2007 in such bonds by an assessee during any financial year cannot exceed ₹ 50 lacs.

In this case, the assessee has invested ₹ 50 lacs in the F.Y.2011-12 and ₹ 50 lacs in the F.Y.2012-13, both within six months from the date of transfer. She has, therefore, fulfilled both the conditions and hence, she is eligible to claim exemption of ₹ 100 lacs under section 54EC.

Question 4

Richie Rich Real Estates, a partnership firm engaged in real estate business, sold a land for ₹ 50 lacs. The buyer was a stranger to the assessee firm. The valuation adopted by the stamp valuation authority was ₹ 60 lacs. The Assessing Officer wants to adopt the value of ₹ 60 lacs for computing the profit arising from the sale of land, by invoking the provisions of section 50C. Is the same justified?

Answer

Section 50C(1) enjoins that where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by the "stamp valuation authority" for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed or assessable shall for the purposes of section 48, be deemed to be the full value of the consideration received or accruing as a result of such transfer.

In *CIT v. Thiruvengadam Investments Private Limited* (2010) 320 ITR 345 (Mad.), the issue under consideration was whether the provisions of section 50C are applicable where the property is held as a business asset.

The High Court pointed out that it was not in dispute that the assessee was engaged in real estate business. As the property in the hands of the assessee was treated as a business asset and not as a capital asset, there is no question of invoking the provisions of section 50C. Section 50C pertains to determining the full value of consideration of a capital asset.

Hence, the Assessing Officer is not justified in invoking the provisions of section 50C in this case.

Question 5

Kala purchased a residential flat from her friend Bala at ₹ 10 lacs in the city of Jaipur on 3rd October, 2011. The value determined by the Stamp Duty Authority for stamp duty purpose

amounted to ₹ 15 lacs. Bala had purchased the flat on 1st January, 2009 at a cost of ₹ 3.50 lacs. Kala sold the flat for ₹ 20 lacs on 30th March, 2012.

Determine the effect of the above transactions on the assessments of Bala and Kala for assessment year 2012-13, assuming that value for stamp duty purpose in case of the second sale was not more than the sale consideration.

Answer

Tax treatment in the hands of the seller, Mr. Bala

Section 50C provides that where the consideration received or accruing as a result of transfer of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by an authority of a State Government for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed or assessable shall be deemed to be the full value of the consideration received or accruing as a result of such transfer for computing capital gain.

In the instant case, Bala sold the residential flat at Jaipur to his friend Kala for ₹ 10 lacs, whereas the stamp duty value was ₹ 15 lacs. Therefore, stamp duty value shall be deemed to be the full value of consideration for sale of the property. Therefore, short-term capital gain arising to Bala for assessment year 2012-13 will be ₹ 11.50 lacs (i.e. ₹ 15 lacs - ₹ 3.50 lacs).

Tax treatment in the hands of the buyer, Ms. Kala

Section 56(2)(vii) includes within its scope the value of any immovable property, being land or building or both, received without consideration by an individual or HUF.

Transfer of immovable property for inadequate consideration, however, does not fall within the scope of section 56(2)(vii). Accordingly, the provisions of section 56(2)(vii) would not be attracted in such a case. The provisions of section 50C are also not attracted in this case since the stamp duty value is less than the sale consideration. The cost of acquisition of the flat to Ms Kala would be the actual cost of ₹ 10 lacs. Therefore, on sale of the flat by Ms. Kala, ₹ 10 lacs (i.e. ₹ 20 lacs – ₹ 10 lacs) would be chargeable to tax as short-term capital gains for A.Y. 2012-13.

Question 6

On 15.11.2011, Ram gave power of attorney and possession to Rahim in respect of a vacant land acquired 10 years ago. The sale deed was executed in April, 2012. In which assessment year, the capital gain is chargeable to tax?

Answer

Section 50C provides that where the consideration received or accruing as a result of transfer of a capital asset, being land or building or both, is less than the value adopted or assessed or assessable by an authority of a State Government for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed or assessable shall be deemed to

be the full value of the consideration received or accruing as a result of such transfer for computing capital gain.

Explanation 2 has been inserted after section 50C(2) to define the term 'assessable' to mean the price which the stamp valuation authority would have, notwithstanding anything to the contrary contained in any other law for the time being in force, adopted or assessed, if it were referred to such authority for the purposes of the payment of stamp duty.

The term "assessable" has been added to bring transfers executed through power of attorney within the scope of section 50C.

Thus, when the power of attorney is executed by Ram and possession is given in favour of Rahim, the transfer is chargeable to capital gains. The capital gains is, therefore, chargeable to tax in the A.Y.2012-13.

Question 7

Can reference be made to the Valuation Officer under section 55A of the Income-tax Act, 1961 where the Assessing Officer is of the view that in the context of computation of capital gains, the value of the asset as on 1.4.1981 adopted by the assessee, is more than the fair market value? If reference under section 55A is not permissible, is the Assessing Officer bound to accept the value as returned by the assessee?

Answer

As per section 55A, with a view to ascertaining the fair market value of a capital asset for the purposes of Chapter IV, the Assessing Officer may refer the valuation of the capital asset to a Valuation Officer -

- (a) in a case where the value of the asset, as claimed by the assessee, is in accordance with the estimate made by a registered valuer, if the Assessing Officer is of opinion that the value so claimed is less than its fair market value;
- (b) in any other case, if the Assessing Officer is of opinion, inter alia, that the fair market value of the asset exceeds the value of the asset as claimed by the assessee by more than such percentage of the value of the asset as so claimed or by more than such amount as may be prescribed in this behalf.

In the problem, it is stated that as per the Assessing Officer, the value of the concerned asset as on 1.4.1981 adopted by the assessee is more than the fair market value. In such a situation section 55A cannot be invoked.

This, however, does not mean that the Assessing Officer is bound to accept the value as returned by the assessee. He can make such enquiries as deemed fit, gather materials to show what is the correct value as on 1.4.1981 and after affording to the assessee, an opportunity of rebutting the evidence gathered, proceed to determine in a scrutiny assessment, the fair market value as on 1.4.1981.

Question 8

Discuss whether the benefit of exemption under section 54EC would be available in the following cases –

- (a) Capital gains on transfer of depreciable assets; and
- (b) Deemed capital gains on amount received on liquidation of a company.

Answer

- (a) Section 54EC provides exemption of capital gains arising from the transfer of a **long-term capital asset**, if such capital gains are invested, within a period of 6 months after the date of such transfer, in bonds of National Highways Authority of India or Rural Electrification Corporation Ltd., redeemable after 3 years. It may be noted that section 54EC provides for exemption of capital gains arising from the transfer of long-term capital asset.

By virtue of section 50, capital gain on transfer of a depreciable asset shall be treated as capital gain on transfer of short-term capital asset for the purpose of sections 48 and 49. Section 50 nowhere says that, for the purpose of section 54EC, the depreciable asset would be a short-term capital asset. Further, section 54EC is an independent section and section 50 does not have an overriding effect over section 54EC. Section 54EC has an application where a long-term capital asset is transferred. Therefore, capital gains on transfer of a depreciable asset held for more than 36 months would be eligible for benefit of exemption under section 54EC, if the conditions stipulated therein are fulfilled.

This view was upheld by the Bombay High Court in *CIT v. ACE Builders (P.) Ltd.* (2005) 281 ITR 210 and the Gauhati High Court in *CIT v. Assam Petroleum Industries (P.) Ltd.* (2003) 262 ITR 587 in relation to erstwhile section 54E. The Courts held that the deeming fiction created under section 50 is restricted only to the mode of computation of capital gains contained in sections 48 and 49 and does not extend to the exemption provisions.

Thus, exemption under section 54EC cannot be denied to the assessee on account of the fiction created in section 50.

- (b) The primary condition to be satisfied for claim of benefit under section 54EC is that there should be transfer of a capital asset. Section 46(1) clearly states that when assets are transferred by way of distribution to the shareholders of a company on account of liquidation, such distribution shall not be regarded as transfer in the case of a company. However, capital gains would be chargeable to tax in the hands of the shareholders under section 46(2). Since there is no transfer in respect of cases covered by section 46, the assessee would not be entitled to the benefit of section 54EC. This was held by the Rajasthan High Court in *CIT v. Ruby Trading Co. (P) Ltd.* (2003) 259 ITR 54, in relation to erstwhile section 54E. The ratio of the decision can be extended to section 54EC and consequently, the assessee would not be entitled to benefit of section 54EC since there is no transfer in respect of cases covered by section 46.

Question 9

Anish owns a residential house which is self-occupied and also a house plot. He sells the house on 28.2.2012 and the house plot on 4.3.2012 for ₹ 11 lacs and ₹ 9 lacs respectively. The house was purchased on 17.10.1999 for ₹ 5 lacs and the plot on 26.12.1998 for ₹ 3 lacs. Anish has purchased a new residential house on 3.5.2012 for ₹ 5 lacs. Compute the income chargeable under the head "Capital Gain" for the A.Y. 2012-13. Cost inflation indices for the financial year 1998-99, 1999-2000 and 2012-13 are 351, 389 and 785 respectively.

Answer**Computation of Capital Gains of Anish for the A.Y.2012-13**

Particulars	₹
Sale of house on 28.2.2012	
Sale consideration received	11,00,000
Less: Indexed cost of acquisition $5,00,000 \times 785/389$	<u>10,08,997</u>
Long term capital gain	91,003
Less: Exemption under section 54 (lower of capital gains or amount invested)	<u>91,003</u>
Taxable capital gain	<u>Nil</u>
Sale of house plot on 4.3.2012	
Sale consideration received	9,00,000
Less: Indexed cost of acquisition $3,00,000 \times 785/351$	<u>6,70,940</u>
Long term capital gain	2,29,060
Less: Exemption under section 54F	
Investment for the purpose of section 54F is ₹ 4,08,997 (i.e. ₹ 5,00,000 – ₹ 91,003), which is less than the net consideration on sale of plot. Therefore, only proportionate capital gain would be exempt under section 54F.	
[Capital gain $\times$ Amount invested / Net sale consideration] i.e., $[2,29,060 \times 4,08,997/9,00,000]$	<u>1,04,094</u>
Taxable capital gain	<u>1,24,966</u>

Question 10

"Section 50C can be invoked only in the case of registration of property pursuant to transfer. In a case where only an agreement for sale is entered into and no registration has taken place, the provisions of section 50C cannot be made applicable."

Discuss the correctness or otherwise of this statement.

Answer

This statement is not correct.

Earlier the scope of section 50C did not include within its ambit, transactions which are not registered with stamp duty valuation authority, and executed through agreement to sell or power of attorney. Therefore, in order to prevent tax evasion on this account, section 50C provides that where the consideration received or accruing as a result of transfer of a capital asset, being land or building or both, is less than the value adopted or assessed **or assessable** by an authority of a State Government for the purpose of payment of stamp duty in respect of such transfer, the value so adopted or assessed **or assessable** shall be deemed to be the full value of the consideration received or accruing as a result of such transfer for computing capital gain. The term "assessable" has been added to cover transfers executed through an agreement to sell or power of attorney.

Explanation 2 has been inserted after section 50C(2) to define the term 'assessable' to mean the price which the stamp valuation authority would have, notwithstanding anything to the contrary contained in any other law for the time being in force, adopted or assessed, if it were referred to such authority for the purposes of the payment of stamp duty.

Question 11

Mr. Ganesh sold his residential house in Mumbai and purchased two residential flats adjacent to each other on the same day vide two separate registered sale deeds from two different persons. The builder had certified that he had effected necessary modification to make it one residential apartment. Mr. Ganesh sought exemption under section 54 in respect of the investment made in purchase of the two residential flats. The Assessing Officer, however, gave exemption under section 54 to the extent of purchase of one residential flat only contending that sub-section (1) of section 54 clearly restricts the benefit of exemption to purchase of one residential house only and the two flats cannot be treated as one residential unit since –

- (i) the flats were purchased through different sale deeds; and*
- (ii) it was found by the Inspector that, before its sale to the assessee, the residential flats were in occupation of two different tenants.*

Discuss the correctness of the contention of the Assessing Officer.

Answer

This issue came up before the Karnataka High Court in *CIT v. D.Ananda Basappa (2009) 309 ITR 0329*. The Court observed that the assessee had shown that the flats were situated side by side and the builder had also certified that he had effected modification of the flats to make them one unit by opening the door between the apartments. Therefore, it was immaterial that the flats were occupied by two different tenants prior to sale or that it was purchased through different sale deeds. The Court observed that these were not the grounds to hold that the assessee did not have the intention to purchase the two flats as one unit. The Court held that

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the assessee was entitled to exemption under section 54 in respect of purchase of both the flats to form one residential unit.

Applying the ratio of the above decision to the case on hand, Mr. Ganesh is entitled to exemption under section 54 in respect of purchase of two flats to form one apartment. Therefore, the contention of the Assessing Officer is not correct.

Question 12

3 Star & Company, a partnership firm, entered into a contract to purchase an immovable property. The agreement was not honoured by the seller. Therefore, the firm filed a suit for specific performance of contract against the owner of the property. Ultimately, a compromise was arrived at. In terms of the compromise, the owner agreed to pay 3-Star & Company ₹ 15 lacs as consideration. State with reasons whether the receipt should be treated to be in the nature of capital gain in the hands of the firm.

Answer

The assessee, 3-Star & Company, entered into a contract to buy an immovable property,. On failure on the part of the seller, the assessee filed a suit for specific performance of the contract. Subsequently, the assessee received ₹ 15 lacs from owner in terms of a compromise agreed to by the parties.

In the case of *CIT v. Smt. Laxmidevi Ratani (2008) 296 ITR 363 (MP)*, the High Court, on identical facts, held that the receipt is exigible to capital gains tax as it involved transfer of property within the meaning of section 2(47). The action on the part of the assessee in giving up its right to claim the property and instead accepting money compensation is a clear case of extinguishment of right in the property resulting in transfer as defined in section 2(47).

Question 13

Aerochem, a partnership firm, transfers a piece of land situated in Thane district on 17.8.2011 for ₹ 60 lacs. The land, purchased on 6.3.1980 for ₹ 1 lac, was registered on 3.4.1983 on payment of stamp duty of ₹ 20,000. Expenses on land development and construction of boundary wall incurred in August, 1983 were of ₹ 1,50,000. The charges for the transfer of land paid to the broker were 2½% of the sale consideration. Fair market value of the land as on 1.4.81 was ₹ 1,50,000.

The firm invested ₹ 30 lacs on 1.12.2011 in the bonds issued by National Highways Authority of India redeemable after 3 years. Compute the amount of capital gain chargeable to tax for Assessment Year 2012-13 with the help of cost inflation index for F.Y. 1983-84 and 2011-12 of 116 and 785, respectively. Also, give in brief, the reasons and the applicable provisions for each of the items dealt with.

Answer**Computation of Capital Gains chargeable to tax for A.Y.2012-13**

Particulars	₹	₹
Gross sale consideration of the land		60,00,000
Less: Expenses on transfer of land paid to a broker @ 2.5% of the sale value [See Note 1]		<u>1,50,000</u>
Net Sale Consideration		58,50,000
Less: Indexed cost of acquisition and improvement.		
A) $1,50,000 \times 785/100$ [See Notes 2 & 4]	11,77,500	
B) $1,70,000 \times 785/116$ [See Notes 3 & 4]	<u>11,50,431</u>	<u>23,27,931</u>
		35,22,069
Less: Investment in bonds of NHAI eligible for exemption under section 54EC [See Note 5]		<u>30,00,000</u>
Capital Gains		<u>5,22,069</u>

Notes:

- (1) Brokerage paid is allowable as deduction under section 48(i) as held by Rajasthan High Court in the case of *Sah Roop Narain vs. CIT (1987) 32 Taxman 453*.
- (2) Cost of acquisition of the capital asset can be claimed as deduction under section 48 while computing capital gains. As per section 55(2)(b)(i), the cost of acquisition in case of a capital asset acquired before 1.4.81 shall be the actual cost of acquisition or the fair market value as on 1.4.81, at the option of assessee. Accordingly, in this case, the cost of acquisition would be the fair market value of the land on 1.04.81, as the same is more beneficial to the assessee.
- (3) Cost of improvement of the capital asset can also be claimed as deduction under section 48. The cost of improvement, in this case, would include the expenditure of ₹ 1,50,000 on land development and construction of boundary wall and expenditure of ₹ 20,000 on payment of stamp duty. Therefore, the total cost of improvement would be ₹ 1,70,000.
- (4) Since the asset transferred is a long-term capital asset, indexation benefit would be available and the indexed cost of acquisition and indexed cost of improvement are allowable as deduction while computing capital gains.
- (5) Under section 54EC, exemption is available for investment, made within a period of 6 months from the date of transfer, in bonds of NHAI or RECL, redeemable after 3 years. In this case, the transfer took place on 17.8.2011 and the investment was made in bonds of NHAI, redeemable after 3 years, on 1.12.2011, which is within the 6 month period. Therefore, the investment of ₹ 30 lacs qualifies for exemption under section 54EC.

Question 14

(a) *Discuss whether the following can be treated as transfer of capital asset for the purpose of levy of capital gains tax:*

- (i) *Transfer of house property in a transaction of reverse mortgage.*
- (ii) *Conversion of foreign currency bonds into shares.*

(b) *Examine the correctness of the following statement:*

Section 2(14) of the Act excludes all items of movable property which are held for personal use of the assessee or any member of his family.

Answer

- (a) (i) Clause (xvi) of section 47 provides that any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government would not amount to a transfer for the purpose of capital gains. Therefore, transfer of house property in a transaction of reverse mortgage will not be treated as a transfer of capital asset for the purpose of capital gains.
- (ii) Clause (x) of section 47 provides that conversion of, *inter alia*, bonds of a company into shares of that company would not amount to a transfer for levy of capital gains tax. Foreign Currency Convertible Bonds (FCCBs) fall within the ambit of this clause. Clause (xa) of section 47 provides that the conversion of Foreign Currency Exchangeable Bonds (FCEBs) into shares or debentures of any company shall not be treated as a 'transfer'. The difference between FCCBs and FCEBs is that whereas FCCBs can only be converted into shares of the issuing company, FCEBs can also be converted into or exchanged for the shares of a group company.
- (b) Sub-clause (ii) of section 2(14) provides that personal effects, that is, movable property including wearing apparel and furniture held for the personal use by the assessee or any member of his family dependent on him are not capital assets. However, the following movable property held for the personal use by the assessee or any member of his family dependent on him are capital assets -
- (a) jewellery
 - (b) archaeological collections
 - (c) drawings
 - (d) paintings
 - (e) sculptures, or
 - (f) any work of art

Hence, the statement "Section 2(14) of the Act excludes all items of movable property which are held for personal use of the assessee or any member of his family" is incorrect.

Question 15

Explain in brief about the treatment to be given in the following case under the Income-tax Act, 1961 for A.Y. 2012-13:

A farmer resident of Jaipur sold his rural agricultural land situated in Nepal and received Indian Rupees 2 lacs over the cost of acquisition of this land.

Answer

The definition of capital assets under section 2(14) specifically excludes rural agricultural land in India. Therefore, it follows that if such land is situated outside India, it would fall within the definition of capital asset under section 2(14). Accordingly, capital gains on sale of rural agricultural land situated in Nepal would be subject to tax in the hands of the farmer, since he is a resident in India.

Question 16

Sridhar purchased a residential flat from Devraj in December 2011. However, the deed of conveyance has not been registered in the name of Sridhar till 31.03.2012. Sridhar has let out the flat at a monthly rent of ₹ 25,000 to Mohan.

Sridhar claims that rent received is not chargeable under the head "Income from house property", but the same is chargeable under the head "Income from other sources" and he can claim deduction for expenses on repair and insurance premium on actual basis and also depreciation. Examine the correctness of Sridhar's claim.

Answer

In order to assess income under the head "Income from house property" the assessee must be the owner of the house property. The need for registration of document in favour of a person to enable him to be treated as the owner of the house property for the purpose of section 22, was considered by the Supreme Court in the case of *CIT vs. Poddar Cement Pvt. Ltd.* (1997) 226 ITR 625.

It was held that so long as a person is entitled to receive income from the house property in his own right and not on behalf of someone else, it is not necessary that the sale deed must be registered in favour of the person to treat him as the owner of the property for the purpose of section 22. In such a case, the income derived from the property is chargeable to tax under the head "Income from house property". The fact that registration is not yet complete does not affect the chargeability of such income under the head "Income from house property".

Therefore, the claim of Sridhar that rent should be assessed under the head "Income from other sources" and deduction of various expenses and depreciation should be allowed therefrom is not tenable.

Question 17

A shareholder of a demerged Indian company received shares from the resulting company in the scheme of demerger. The shareholder wants to transfer the said shares received

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subsequent to the demerger for consideration. Your advice is sought on the tax consequences as to the shares received on demerger and sought to be transferred.

Answer

As per the provisions of section 47(vii), any transfer or issue of shares by the resulting company to the shareholders of the demerged company in a scheme of demerger is not regarded as a transfer for the purposes of capital gains under section 45, if the transfer or issue is made in consideration of the demerger of the undertaking.

As a consequence of the demerger, the existing shareholders of the demerged company will receive shares in a resulting company. When the shareholder subsequently intends to transfer the said shares, the cost of such shares will have to be arrived at as per the provisions of section 49(2C). According to the said provision, the cost of acquisition of shares in the resulting company will be the amount which bears to the cost of acquisition of shares held by the assessee in the demerged company, 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.

As per the provisions of section 2(42A)(g), for determining the period of holding of such shares, the period for which the shares of the demerged company were held by the assessee would also be considered.

If the shares are held for more than one year, and transferred through a recognized stock exchange and securities transaction tax has been paid on such sale, the long-term capital gain arising therefrom would be exempt under section 10(38). If the total holding period does not exceed one year, then the short-term capital gains arising on sale of such shares would be taxable @15% under section 111A.

Question 18

Sri Sajjan converted the capital asset, acquired by him in the year 1988, into stock-in-trade at the fair market value on 1st March, 2011. Sri Sajjan sold the entire stock-in-trade so converted, on 25th November, 2011. Sri Sajjan seeks your advice as to the tax implications of the transaction with reference to the provisions of Indian Income-tax Act for the assessment year 2012-13.

Answer

Conversion of a capital asset into stock-in-trade falls within the definition of transfer under section 2(47). Therefore, in this case, transfer has taken place during the previous year 2010-11.

However, as per section 45(2), the capital gains liability arises only in the year in which the stock-in-trade is sold i.e. previous year 2011-12 in this case. It is a long-term capital gain since the asset was acquired in 1988. The fair market value (FMV) on the date of conversion i.e. on 1.3.2011 is deemed to be the full value of consideration accruing as a result of transfer of the capital asset.

Therefore, in the year of sale of stock-in-trade (i.e. P.Y. 2011-12), both business income and capital gains would arise.

Business income =	Sale consideration of stock-in-trade	– FMV on the date of conversion
Capital gains =	FMV on the date of conversion	– Indexed cost of acquisition / improvement

Question 19

A piece of land owned by Mr. Mishra located on Jaipur-Delhi highway was acquired by NHAI in the F.Y.2007-08, but the award ordered in F.Y. 2008-09 was paid in the F.Y. 2011-12. This land was purchased by him on 2.4.1977 for ₹ 10,000. The fair market value of the land as on 1.4.1981 was ₹ 9,000. Compensation paid was ₹ 15 lacs.

The other piece of land located in Chennai purchased in April, 2003 for ₹ 25 lacs was also sold by him in February, 2012 for ₹ 35 lacs, but sale deed thereof could not be executed by 31.3.2012. The value for the purpose of stamp duty applied by the stamp valuation authority was ₹ 40 lacs.

Compute the income chargeable to tax arising as a result of these transactions in the A.Y.2012-13.

The CILs for the F.Y: 2003-04, 2007-08, 2008-09 and 2011-12 are 463, 551, 582 and 785 respectively.

Answer

Computation of taxable income of Mr. Mishra for A.Y.2012-13

Particulars	₹
Capital Gains	
(A) Long-term capital gain derived from transfer of land on Jaipur-Delhi highway acquired by NHAI in F.Y. 2007-08 for which award was paid in F.Y. 2011-12 is chargeable to tax in A.Y.2012-13 [See Note (i) below]	
Sale consideration i.e. compensation paid	15,00,000
Less: Indexed cost of acquisition [See Note (ii) below]	
(10000×551)	<u>55,100</u>
100	
	<u>14,44,900</u>
(B) Sale of land at Chennai in February 2012 [See Note (iii) below]	
Full value of consideration as per section 50C [See Note (iv) below]	40,00,000
Less: Indexed cost of acquisition	
$(25,00,000 \times 785)/463$	<u>42,38,661</u>
	<u>(2,38,661)</u>

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Total income chargeable to tax arising as a result of these transactions in the A.Y.2012-13 is equal to ₹ 12,06,239 (i.e. ₹ 14,44,900 - ₹ 2,38,661). Long term capital loss can be set-off from the long term capital gain.

Notes:

- (i) The capital gains arising on compulsory acquisition shall be charged to tax in the year in which the compensation is first received as per section 45(5)(a).
- (ii) The option of fair market value as on 1.4.81 is not exercised by the assessee since the fair market value is lower than the cost.
551 is the cost inflation index of F.Y.2007-08 i.e. the year in which the property was compulsorily acquired.
- (iii) The execution of sale deed is not compulsory for the purpose of charge of capital gain because the transfer of right enabling enjoyment of immovable property gives rise to charge of capital gains as held by the Kerala High Court in the case of *CIT v. C.F. Thomas (2006) 284 ITR 557*.
- (iv) As per section 50C, the value applied by the stamp valuation authority is deemed to be the full value of consideration received or accruing as a result of such transfer, since such value is higher than the sale consideration of ₹ 35 lacs. 785 is the cost inflation index of F.Y.2011-12 i.e. the year in which the property at Chennai was sold.

Question 20

Vijay, an individual, owned three residential houses which were let out. Besides, he and his four brothers co-owned a residential house in equal shares. He sold one residential house owned by him during the previous year relevant to the assessment year 2012-13. Within a month from the date of such sale, the four brothers executed a release deed in respect of their shares in the co-owned residential house in favour of Vijay for a monetary consideration.

Vijay utilised the entire long-term capital gain arising out of the sale of the residential house for payment of the said consideration to his four brothers. Vijay is not using the house, in respect of which his brothers executed a release deed, for his own residential purposes, but has let it out to another person, who is using it for his residential purposes.

Is Vijay eligible for exemption under section 54 of the Income-tax Act, 1961 for the assessment year 2012-13 in respect of the long-term capital gain arising from the sale of his residential house, which he utilised for acquiring the shares of his brothers in the co-owned residential house? Will the non-use of the new house for his own residential purposes disentitle him to exemption?

Answer

The long-term capital gain arising on sale of residential house would be exempt under section 54 if it is utilized, *inter alia*, for purchase of a new residential house within one year before or two years after the date of transfer. Release by the other co-owners of their share in co-owned

property in favour of Vijay would amount to “purchase” by Vijay for the purpose of claiming exemption under section 54 [*CIT v. T.N. Aravinda Reddy* (1979) 120 ITR 46 (SC)]. Since such purchase is within the stipulated time of two years, Vijay is eligible for exemption under section 54. As Vijay has utilised the entire long-term capital gain arising out of the sale of the residential house for payment of consideration to the other co-owners who have released their share in his favour, he can claim full exemption under section 54.

There is no requirement in section 54 that the new house should be used by the assessee for his own residence. The condition stipulated is that the new house should be utilised for residential purposes and its income is chargeable under the head house property. This requirement would be satisfied even when the new house is let out for residential purposes.

Question 21

Sanjay, an individual, purchased a site on 21.4.2002 for ₹ 2,00,000. He completed construction of a building thereon on 14.2.2009 at a cost of ₹ 10,00,000. He sold the property consisting of site and building on 7.12.2011 for ₹ 20,00,000. Sanjay seeks your opinion on the nature of capital gain arising to him from the sale of the property for the assessment year 2012-13.

Computation of capital gain is not necessary.

Answer

Site and building are separate capital assets for the purpose of capital gains. This distinction is clear from the scheme of the Income-tax Act, 1961. For the purpose of section 32, a building which is entitled to depreciation means only the superstructure and does not include the site on which it is built. This was held by the Apex Court in *CIT v. Alps Theatre* (1967) 65 ITR 377.

In this case, the site is a long-term capital asset since it is held by Sanjay for more than 36 months and the building is a short-term capital asset since it is held by Sanjay for less than 36 months. The site is an independent capital asset and continues to be so even after the construction of the building thereon. Even though the property consisting of site and building was sold as a single asset for a consolidated price of ₹ 20,00,000, such price can be attributed to the site and building separately.

Therefore, in the case of Sanjay, the capital gain attributable to the site is assessable as long-term capital gain and the capital gain attributable to the building is assessable as short-term capital gain for the assessment year 2012-13. On identical facts, the Rajasthan High Court in *CIT v. Vimal Chand Golecha* (1993) 201 ITR 442, the Madras High Court in *CIT v. Dr. D. L. Ramachandra Rao* (1999) 236 ITR 51 and the Karnataka High Court in *CIT v. C.R. Subramanian* (2000) 242 ITR 342 have taken this view.

Question 22

- (i) John inherits a house property from his father, who had mortgaged it. John discharges the mortgage debt. John later sells the property. Can he claim the amount paid to the mortgagee as cost of improvement in computing the capital gain?
- (ii) Laxman mortgaged his house property and utilized the mortgage amount to perform the marriage of his son. He paid the amount to the mortgagee later. Upon sale of the said property thereafter, he claims the mortgage debt discharged as forming part of the cost of acquisition. Can capital gain be computed accepting his claim?

Answer

- (i) John inherited the house property with the liability to discharge the mortgage debt. He can, therefore, claim the amount paid to the mortgagee as cost of improvement while computing the capital gain on sale of the said property. The decision of the Supreme Court in *RM. Arunchalam v. CIT (1997) 227 ITR 222* supports this view.
- (ii) Laxman has himself created the mortgage in respect of his house property. It is a self-created mortgage. Therefore, the debt discharged by Laxman on the property under mortgage created by him does not form part of cost of acquisition. The decision of the Supreme Court in *V.S.M.R. Jagadish Chandran v. CIT (1997) 227 ITR 240* supports this view. Therefore, capital gain on sale of the property cannot be computed on the basis of the claim made by him.

Note – This question can also be answered with reference to the Bombay High Court ruling in *CIT v. Roshanbabu Mohammed Hussein Merchant (2005) 144 Taxman 720 / 275 ITR 0231*. This case highlights the difference in tax treatment in respect of allowability of the expenditure incurred on removing an encumbrance in two different cases, namely –

- (i) In a case where the mortgage is created by the previous owner and
- (ii) In a case where the mortgage is created by the assessee himself.

The Bombay High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to the mortgage created by the previous owner, the assessee acquires absolute interest in that property only after the discharge of mortgage debt. In such a case, the expenditure incurred by the assessee to discharge the mortgage debt created by the previous owner to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property. However, where the assessee acquires property which is unencumbered, the assessee gets absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove the encumbrance created by the assessee himself on the property

(which was acquired by him without any encumbrance) is not an allowable deduction under section 48.

Question 23

State the cases where the benefit of indexation of costs is not available for determination of capital gains.

Answer

In the following cases, the benefit of indexation is not available for determination of capital gains on transfer of long-term capital assets –

1. Transfer of bonds/debentures other than capital indexed bonds issued by the Government (*Proviso 3 to section 48*).
2. Transfer of shares or debentures acquired by a non-resident in foreign currency in an Indian company (*Proviso 1 and 2 to section 48*).
3. Transfer of undertaking or division in a slump sale (*Section 50B*)
4. Transfer of units of Unit Trust of India or a Mutual Fund specified under section 10(23D) purchased in foreign currency by an overseas financial organisation referred to as offshore funds (*Section 115AB*)
5. Transfer of Global Depository Receipt purchased in foreign currency by an individual resident in India and employee of an Indian company or its subsidiary engaged in specified knowledge based industry or service (*Section 115ACA*).
6. Transfer of securities by Foreign Institutional Investors (*Section 115AD*).
7. Transfer of a foreign exchange asset by a non-resident Indian (*Section 115D*)

Further, indexation benefit is not available on capital gains arising on transfer of a depreciable asset since such capital gains would always be short-term capital gains.

Question 24

Redemption of preference shares amounts to "transfer" within the meaning of Section 2(47) of the Income Tax Act, 1961 in the hands of the shareholder. Discuss.

Answer

The definition of the term "transfer" u/s 2(47) is not an exhaustive definition but an inclusive one. "Transfer" in relation to capital asset includes, *inter alia*, sale, exchange or relinquishment of capital asset.

When shares are redeemed by a company, it only means that the concerned shareholder is giving up his or her ownership or claim with reference to the shares in favour of the company. The consideration received by the shareholder from the company is certainly for sale/relinquishment of the interest in the shares and therefore, the redemption of preference shares amounts to "transfer" and the gain arising therefrom, being the excess realization over the cost of acquisition, shall be charged to tax under the head "Capital Gains". This was

upheld by the Supreme Court in *Anarkali Sarabhai vs CIT* (1997) 224 ITR 422. If the redemption is after a period of 12 months from the date of acquisition of shares by the shareholder, the long term capital gain shall be computed by deducting the indexed cost of acquisition. The resultant long term capital gain shall be charged to tax in accordance with the provisions of section 112.

Question 25

What is meant by the term "Demerger"? What are the exemptions and benefits available as a result of a demerger transaction?

Answer

According to section 2(19AA), demerger in relation to companies, means the transfer pursuant to a scheme of arrangement under section 391 to 394 of the Companies Act, by a demerged company of one or more of its undertakings to any resulting company in such a manner that:

- (1) All the property of the undertaking, being transferred by the demerged company, immediately before the demerger, must become the property of the resulting company by virtue of the demerger;
- (2) All the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;
- (3) The property and liabilities are transferred by the demerged company to the resulting company at their value appearing in the books of account immediately before the demerger;
- (4) In consideration of the demerger, the resulting company issues shares to the shareholders of the demerged company on a proportionate basis;
- (5) Shareholders holding not less than three-fourth in value of the shares of the demerged company become shareholders of the resulting company by virtue of the demerger;
- (6) The transfer of the undertaking is on a going concern basis;
- (7) The demerger is in accordance with the conditions, if any, notified under section 72A(5) by the Central Government in this behalf.

Some of the exemptions and benefits available as a result of the demerger transaction are enumerated hereunder -

- (i) There will be no capital gains tax liability in respect of transfer of capital assets by the demerged company to the resulting Indian company [section 47(vib)];
- (ii) Shareholders of the demerged company are not chargeable to capital gains tax with reference to shares transferred to the resulting company in return for allotment of shares. [section 47(vi)];

- (iii) Any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company shall not be treated as deemed dividend as per section 2(22)(v), and hence there will be no tax liability on this account;
- (iv) As per section 72A(4), in the case of a demerger, the accumulated loss and unabsorbed depreciation of the demerged company, as attributable to the demerged undertaking, shall be allowed to be carried forward and set-off in the hands of the resulting company.

Question 26

Aries Tubes Private Ltd. went into liquidation on 01.06.2011. The company was seized and possessed of the following funds prior to the distribution of assets to the shareholders:

Share Capital	5,00,000
Reserves prior to 1.6.2011	3,00,000
Excess realization in the course of liquidation	5,00,000
Total	13,00,000

There are 5 shareholders, each of whom received ₹ 2,60,000 from the liquidator in full settlement. The shareholders desire to invest the resultant element of capital gains in long-term specified assets as defined in section 54EC. You are required to examine the various issues and advice the shareholders about their liability to income tax.

Answer

Under section 46(1), where the assets of a company are distributed to its shareholders on its liquidation, such distribution shall not be regarded as transfer in the hands of the company for the purpose of section 45.

However, under section 46(2), where the shareholder, on liquidation of a company, receives any money or other assets from the company, he shall be chargeable to income-tax under the head "capital gains", in respect of the money so received or the market value of the other assets on the date of distribution as reduced by the amount of dividend deemed under section 2(22)(c) and the sum so arrived at shall be deemed to be the full value of the consideration for the purposes of section 48.

As per section 2(22)(c), dividend includes any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalized or not.

In this case, the accumulated profits immediately before liquidation is ₹ 3,00,000. The share of each shareholder is ₹ 60,000 (being one-fifth of ₹ 3,00,000). An amount of ₹ 60,000, is therefore, taxable under section 2(22)(c) in the hands of each shareholder.

Therefore, ₹ 2,00,000 [i.e. 2,60,000 minus 60,000 taxed as deemed dividend u/s 2(22)(c)] is the full value of consideration in the hands of each shareholder as per section 46(2). Against this, the investment of ₹ 1,00,000 by each shareholder is to be deducted to arrive at the

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capital gains of ₹ 1,00,000 of each shareholder. The benefit of indexation is available to the shareholders, but could not be computed in the absence of required information. Since the equity shares are not listed, it would not be liable for Securities Transaction Tax and hence the capital gain (long term) is not exempt under section 10(38). Also, the rate of tax on such long term capital gain would be 20% and subject to the provisions of section 112.

Exemption under section 54EC is available only where there is an actual transfer of capital assets and not in the case of deemed capital gain as per the decision rendered in the case of *CIT v. Ruby Trading Co (P) Ltd* (2003) 259 ITR 54 (Raj).

Note - It is assumed that the above capital gain is a long-term capital gain.

Question 27

Xavier had taken a loan under registered mortgage deed against the house, which was purchased by him on 26-03-81 for ₹ 5 lacs. The said property was inherited by his son Abraham in financial year 2007-08 as per Will.

For obtaining a clear title thereof Abraham paid the outstanding amount of loan on 12-02-08 of ₹ 15 lacs. The said house property was sold by Abraham on 16-03-11 for ₹ 50 lacs. State with reasons the amount chargeable to capital gains for A.Y. 2012-13

(Cost Inflation Index 2007-08 = 551 and 2011-12 = 785).

Answer

The cost of inherited property to Mr. Abraham shall be the cost to the previous owner as per provisions of section 49(1)(iia) and therefore, ₹ 5 lacs, being the cost to his father (amount paid by his father on 26.3.81 for acquiring the property) shall be the cost to Mr. Abraham, who is the new owner. Payment of outstanding loan of the predecessor by the successor for obtaining a clear title of the property by release of Mortgage Deed shall be the cost of acquisition of the successor under section 48 read with section 55(2) of the Act as held by the Apex Court in case of *RM. Arunachalam v. CIT* [1997] 227 ITR 222.

Taxable Capital Gain for the A.Y. 2012-13

	₹
Sale consideration of house property	50,00,000
Less:	
Indexed cost of acquisition (see Note below)	
(i) Cost to previous owner (₹ 5,00,000 X 785 / 551)	7,12,341
(ii) Loan amount paid by Mr. Abraham (Benefit of CII is available since the loan amount was paid in the financial year 2007-08) (15,00,000 X 785 / 551)	<u>21,37,024</u>
Capital gains	<u>21,50,635</u>

Note: Since the property was acquired by Mr. Abraham through inheritance, the cost of acquisition will be cost to the previous owner. Indexation will be from the year in which the assessee i.e. Abraham, in this case, first held the asset.

Question 28

'X', purchased on 18.6.2002, house property for ₹ 22,25,000 which was sold to A on 18.10.2011 for ₹ 38,75,000. The sub-registrar, at the time of registration of sale deed, charged stamp duty on ₹ 50,00,000 which was paid by the buyer.

The Assessing Officer while assessing for capital gain referred the matter to the valuation officer as per the request of vendor. The Valuation Officer determined the value of property at ₹ 45,00,000 on the date of transfer. X seeks your advice on the following:

- (i) On what value the Assessing Officer could compute capital gain chargeable to tax?
- (ii) The amount of capital gain on which 'X' is required to pay capital gains tax. (The CII for F.Y. 2002-03 is 447 and of F.Y. 2011-12 is 785).

Answer

- (i) According to section 50C, the Assessing Officer can refer the property to the valuation officer, only when the following two conditions are satisfied:

- (a) The value fixed by the stamp valuation authority is not disputed in appeal or revision etc.
- (b) The assessee claims before the Assessing Officer that the value adopted or assessed by the stamp valuation authority exceeds the fair market value (FMV) of the property as on the date of transfer.

In the instant case, though the assessee paid the stamp duty as fixed by the stamp valuation authorities, he had requested the Assessing Officer to refer the property to the valuation officer for valuation. The value determined by the Valuation Officer is less than the value adopted by the stamp valuation authority. Therefore, such value only could be adopted for computing chargeable capital gains.

- (ii) The amount on which the assessee is required to pay capital gains tax will be as under:-

Sale consideration of the house property to be adopted u/s 50C(1)	₹ 45,00,000
Less: Indexed cost of acquisition $22,25,000 \times 785/447$	<u>₹ 39,07,438</u>
Long term capital gain	<u>₹ 5,92,562</u>

Question 29

Specify the items of capital assets in respect of which the cost of acquisition shall be taken as 'nil' under the provisions of the Income-tax Act, 1961 while computing capital gains.

Answer

According to section 55 of the Income-tax Act, 1961, the cost of acquisition shall be taken to be 'nil' in the case of the following capital assets:

1. Self generated goodwill of a business
2. Bonus shares
3. Right to subscribe to rights issues
4. Tenancy rights
5. Stage carriage permits
6. Loom hours
7. Any right to manufacture, produce or process any article or thing; and
8. A trademark or brand name associated with the business.

Question 30

Dalal entered into an agreement with Shroff for the sale of his property and received earnest money of ₹ 1,00,000 on 1.4.2011. The balance of ₹ 4,00,000 was to be paid within 3 months, failing which Dalal was entitled to a compensation of ₹ 50,000. The earnest money was also liable to forfeited. Shroff defaulted in the payment of the balance within the time specified and therefore the earnest money was forfeited. A suit was also filed for breach of contract and ₹ 50,000 was awarded, which was received on 28.3.2012. Discuss the nature of the two receipts from the point of view of liability to tax.

Answer

Forfeiture of earnest money: The matter relating to the liability to tax of earnest money and compensation has arisen for consideration by the Apex Court in *Travancore Rubber and Tea Co Ltd v. CIT* 243 ITR 159. The quality and nature of receipt for income-tax purposes are fixed once and for all when the subject of the receipt is received and subsequent operations do not change that nature. Section 51 preserves this rule enunciated in *Morley (Inspector of Taxes) v. Tattersall* 7 ITR 316. There is a distinction between earnest money and compensation, but it loses its significance in the context of section 51 which includes "other moneys" in addition to earnest money. Accordingly, the amount received by way of earnest money is not taxable but would go to reduce the cost of acquisition of asset at the time of its ultimate sale.

Compensation for breach of contract: The compensation received for breach of contract is also not chargeable to tax at the time of receipt but would go to reduce the cost of acquisition of the asset while reckoning capital gain at the time of its ultimate sale.

Question 31

- (i) *Chand Ltd decided to effect buy-back of share capital by purchase of shares in open market. During the year ended 31.3.2012, Chand Ltd, purchased its own 10,000 shares. Discuss the tax implications in the hands of Chand Ltd and shareholders.*

(ii) Discuss the tax treatment of surplus arising out of deep discount bonds:

- (a) On sale of such bonds
- (b) On realization of such bonds on maturity.

Answer

- (i) Section 46A provides for the taxability of capital gains in the hands of shareholders, when the shares are purchased by the company in the open market in order to buy-back its shares. In the hands of Chand Ltd, there shall be no liability to tax as the payment is on capital account.

In the case of shareholders, the difference between the consideration received by the shareholders and the cost of acquisition will be chargeable to tax as capital gains. Any payment made by a company on purchase of its own shares in accordance with section 77A of the Companies Act, 1956 will not constitute dividend section 2(22). Hence, there is no liability on the part of the company to deduct tax at source.

- (ii) The CBDT has clarified vide *Circular No.2/2002 dated 15-02-2002*, that the difference between the cost of acquisition and market value as on 31st March immediately succeeding shall be taxable as interest income. In respect of subsequent assessment years, the difference in market values as on the closing dates of the respective previous years shall be taken as interest income.

Where the bonds are sold before maturity, the sale price less the market value as on the closing date of the immediately preceding financial year shall be taken as the capital gain/loss. If the bonds are transferred within 12 months from the date of acquisition, the resultant will be short term capital gain/loss. Where it is transferred after 12 months, it will be a long term capital gain/loss.

In the year of redemption, the redemption price and the market value as on 31st March immediately preceding the date of redemption will be compared and will be treated as interest income.

If the bonds are kept as trading asset instead of interest income, the income will obtain the character of business income.

The *Circular No.2/2002* has stated that small non-corporate investors having deep discount bonds upto an aggregate face value of ₹ 1 lac can continue to offer income for tax in accordance with the earlier *Circular F.No.225/45/96 dated 03-12-1996*, which clarifies that the difference between purchase price and redemption price is taxable as interest income. If the bonds are transferred before maturity, the sale consideration less cost of acquisition is taxable as capital gain.

Question 32

Mukherjee furnishes the following information:

<i>Purchase of shares No. of shares</i>	<i>Month & Year of purchase</i>	<i>Shares dematted month and year</i>
1,000	March, 1995	July, 2002
500	March, 1998	---
1,000	December, 1999	October, 2001

He sold 1,500 shares in January, 2012 out of the dematted shares. He seeks your advice as to the taxability towards capital gains for the assessment year 2012-13.

Answer

Assuming that the shares dematted represent equity shares of a company, the resultant long term capital gain on transfer in respect of which Securities Transaction Tax is paid, is exempt under section 10(38).

It is assumed that the long term capital gain arising from the transfer of shares is not exempt under section 10(38), the following could be taken as the guidance for deciding the tax implication.

Section 45(2A) is to be applied and it says that any profits and gains arising from the transfer made by the depository shall be chargeable as the income of the beneficial owner in the previous year in which the transfer takes place. The Central Board of Direct Taxes, by its *Circular No.768 dated 24.6.1998* has directed that the cost of acquisition of shares and the period of holding shall be determined on the basis of first-first-out method (FIFO). The FIFO method will apply only to the dematted shares and not to those held in physical form. The dematted shares were acquired in the years 1995 and 1999 and therefore as per the provisions read with the circular, the shares dematted first will be construed as sold first.

As per the given facts of the case, the shares sold were 1500. For arriving at the liability to capital gains tax:-

- (a) The purchase cost of 1000 shares acquired in December, 1999 (first dematted) and the proportionate purchase cost of 500 shares out of the shares acquired in March 1995 will be taken as cost of shares. The transfer has to be construed in the same manner and not the year of their acquisition.

The indexation of the cost is permissible as per section 48 of the Income-tax Act, 1961. The loss or gain shall be arrived at after deducting the indexed cost.

Question 33

A Manufacturing company was transporting two of its machines from unit 'A' to unit 'B' (which is at a distance of 100 miles) on 1st September, 2011 by a truck. On account of a civil disturbance, both the machines were damaged. The insurance company paid ₹ 5 lacs for the damaged machines. On these facts, for submitting the return of income for the previous year ending 31st March, 2012, your advice is sought as to:

- (i) Whether the damage of machines result in any transfer?
- (ii) How the amounts received from the insurance company are to be treated for taxability?
- (iii) Would there be any impact on the written down value of the block of plant and machinery as at 31st March 2012?

Answer

As per section 45(1A), receipt of insurance compensation in the form of money or any asset is to be treated as consideration and capital gain is accordingly to be charged to tax. The two qualifying conditions prescribed are (a) the compensation should have been received because of damage or destruction of capital asset and (b) the damage or destruction is as a result of circumstances mentioned therein.

In the facts of the case, both the conditions are satisfied and therefore, the compensation is to be treated as consideration. Applying section 45(1A) the answers to the issues are:

- (i) in the case of damage or destruction, there is no actual transfer;
- (ii) the receipt of insurance compensation of ₹ 5 lacs has to be treated as consideration in accordance with the provisions of section 45(1A).
- (iii) in the instant case, as per the provisions of section 43(6)(c) the receipt of compensation of ₹ 5 lacs calls for adjustment in the written down value of the block of assets. If the written down value is more than ₹ 5 lacs, then ₹ 5 lacs should be deducted from written down value. On the other hand, if the written down value is less than ₹ 5,00,000, the difference would be treated as short term capital gain.

Question 34

Gama Ltd, located within the corporation limits decided in December, 2011 to shift its industrial undertaking to non-urban area. The company sold some of the assets and acquired new assets in the process of shifting. The relevant details are as follows:

(₹ in lacs)

	Particulars	Land	Building	Plant & Machinery	Furniture
(i)	Sale proceeds (sale effected in March, 2012)	8	18	16	3
(ii)	Indexed cost of acquisition	4	10	12	2
(iii)	Cost of acquisition in terms of section 50	--	4	5	2
(iv)	Cost of new assets purchased in July, 2011 for the purpose of business in the new place	4	7	17	2

Compute the capital gains of Gama Ltd for the assessment year 2012-13.

Answer

Section 54G deals with deduction in respect of any capital gain that may arise from the transfer of an industrial undertaking situated in an urban area in the course of or in consequence of shifting to a non-urban area.

If the assessee purchases new machinery or plant or acquires a building or land or constructs a new building or shifts the original asset and transfers the establishment to the new area, within 1 year before or 3 years after the date on which the transfer takes place, then, instead of the capital gain being charged to tax, it shall be dealt with as under:

1. If the capital gain is greater than the cost of the new asset, the difference between the capital gain and the cost of the new asset shall be chargeable as income 'under section 45'.
2. If the total gain is equal to or less than the cost of the new asset, section 45 is not to be applied.

The capital assets referred to in section 54G are machinery or plant or land or building or any rights in building or land. Capital gains arising on transfer of furniture does not qualify for exemption under section 54G. No exemption is therefore available under section 54G in respect of investment of ₹ 2 lacs in acquiring furniture.

1. The first step therefore is to determine the capital gain arising out of the transfer and thereafter apply the provisions of section 54G.

(a)	Land – Sale proceeds (Non depreciable)	8,00,000
	Less: Indexed cost	4,00,000
	Long term capital gain	4,00,000
	Less: Cost of new assets purchased within one year before the transfer (under section 54G) (See note 1 below)	3,00,000
	Taxable Long term capital gain	1,00,000
(b)	Building – sale proceeds (depreciable assets)	18,00,000
	Less :W.D.V. is deemed as cost of acquisition u/s.50	4,00,000
	Short term capital gain	14,00,000
(c)	Plant & machinery sale proceeds (depreciable asset)	16,00,000
	Less: WDV is deemed cost under section 50	5,00,000
	Short term capital gain	11,00,000
(d)	Furniture sale proceeds (depreciable asset)	3,00,000
	Less: WDV is deemed cost under section 50	2,00,000
	Short term capital gain(see note 2 below) (A)	1,00,000
Summary		
Short term capital gain : Building		14,00,000
Short term capital gain : Plant & machinery		11,00,000

	25,00,000
Less: New assets purchased U/s.54G (See Note below)	25,00,000
Net short term capital gain (B)	Nil
Total short term capital gain (A)+(B) = 1 lac	

Note – Total exemption available under section 54G is ₹ 28 lacs (₹ 4 lacs + ₹ 7 lacs + ₹ 17 lacs). The exemption should first be exhausted against short term capital gain as the incidence of tax in case of short-term capital gain is more than in case of long term capital gain. Therefore, ₹ 25 lacs is exhausted against short term capital gain and the balance of ₹ 3 lacs against long term capital gain.

Question 35

Anand entered into an agreement for sale of certain properties in which there were tenants subject to vacant possession. He had accordingly to pay certain consideration to the tenants for their agreeing to vacate the properties and claimed such payments to secure vacant possession as incurred in connection with the transfer of the property within the meaning of section 48(1) of the Act. Would Anand succeed in his claim?

Answer

Anand's claim is valid in law. Under the agreement, the assessee had to give vacant possession. Payments made to tenants to obtain vacant possession was incurred wholly and exclusively in connection with the agreement of sale which preceded the transfer and in fulfillment of a condition of sale. The amount paid to the tenants is, therefore, deductible as expenditure under section 48(1).

Question 36

The assessee was a company carrying on business of manufacture and sale of art-silk cloth. It purchased machinery worth ₹ 4 lacs on 1-5-2006 and insured it with United India Assurance Ltd against fire, flood, earthquake etc., The written down value of the asset as on 01.04.2011 was ₹ 2,08,800. The insurance policy contained a reinstatement clause requiring the insurance company to pay the value of the machinery, as on the date of fire etc., in case of destruction of loss. A fire broke out in August, 2011 causing extensive damage to the machinery of the assessee rendering them totally useless. The assessee company received a sum of ₹ 6 lacs from the insurance company on 15th March, 2012. Discuss the issues arising on account on the transactions and their tax treatment.

(Cost inflation index for financial year 2006-07 and 2011-12 are 519 and 785 respectively)

Answer

Under section 45(1A) provision, where any person receives any money or other assets under an insurance from an insurer on account of damage to or destruction of capital asset, then, any profits and gains arising from the receipt of such money or other assets, shall be chargeable to income tax under the head "Capital Gains" and shall be deemed to be the income of such person of the previous year in which such money or asset was received.

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For the purpose of section 48, the money received or the market value of the asset shall be deemed to be the full value of the consideration accruing as a result of the transfer of such capital asset. Since the asset was destroyed and the money from the insurance company was received in the previous year, there will be a liability to capital gains in respect of the insurance moneys received by the assessee.

The written down value of the asset as ₹ 2,08,800 as on 01.04.2011 the computation of capital gain and tax implication is given below:

Under section 45(1A) any profits and gains arising from receipt of insurance moneys is chargeable under the head "Capital gains". For the purpose of section 48, the moneys received shall be deemed to be the full value of the consideration accruing or arising. Under section 50 the capital gains in respect of depreciable assets had to be computed in the following manner assuming it was the only asset in the block)

Full value of the consideration	₹ 6,00,000
Less: Written down value as on April 1 st , 2011	<u>₹ 2,08,800</u>
Short term capital gains	<u>₹ 3,91,200</u>

Self-examination Questions

- Discuss the conditions to be satisfied for claiming exemption of tax in respect of -
 - Capital gains on compulsory acquisition of agricultural land situated within specified urban limits
 - Capital gains on sale of listed equity shares/units of an equity oriented fund.
- Write short notes on -
 - Capital gains in the case of slump sale under section 50B
 - Reference to Valuation Officer under section 55A
- What is the tax treatment, under the Income-tax Act, of capital gains arising on transfer of assets in case of shifting of industrial undertaking from an urban area to any special economic zone? Discuss.
- List ten transactions which are not regarded as transfer for the purpose of capital gains.
- Ganesh, a resident individual, bought 1,000 equity shares of ₹ 10 each of XYZ Ltd. at ₹ 50 per share on 3.4.2011. He sold 700 equity shares at ₹ 35 per share on 31.8.2011 and the remaining 300 shares at ₹ 25 per share on 1.11.2011. XYZ Ltd. declared a dividend of 50%, the record date being 30.6.2011. Ganesh sold on 5.1.2012, a house from which he derived a long-term capital gain of ₹ 75,000.
Compute the amount of capital gain arising to Ganesh for the A.Y. 2012-13.
- Can the expenditure incurred by an assessee to remove an encumbrance be allowed as a deduction under section 48, in the following cases -

- (a) where the mortgage was created by the assessee himself;
- (b) where the mortgage was created by the previous owner.

Discuss with reference to a recent case law.

7. Where a holding company receives assets on voluntary liquidation of its subsidiary company by virtue of being a shareholder of the subsidiary company, would the value of assets received by the holding company on the date of distribution be liable to tax?
8. The word 'otherwise' used in section 45(4) takes into its fold not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of a retiring partner. Discuss.
9. What is the cost of acquisition in a case where the previous owner himself acquired the asset by any of the modes set out in section 49(1)?

Answers

6. This question came up before the Bombay High Court in *CIT v. Roshanbabu Mohammed Hussein Merchant* (2005) 144 Taxman 720 / 275 ITR 0231. The High Court pointed out that there is a distinction between the obligation to discharge the mortgage debt created by the previous owner and the obligation to discharge the mortgage debt created by the assessee himself. Where the property acquired by the assessee is subject to mortgage created by the previous owner, he acquires absolute interest in that property only after the discharge of mortgage debt. In such a case, the expenditure incurred by the assessee to discharge the mortgage debt, created by the previous owner, to acquire absolute interest in the property is treated as 'cost of acquisition' and is deductible from the full value of consideration received by the assessee on transfer of that property.

However, where the assessee acquires a property which is unencumbered, he gets absolute interest in that property on acquisition. When the assessee transfers that property, he is liable for capital gains tax on the full value realized, even if he has himself created an encumbrance on that property. The assessee is under an obligation to remove that encumbrance for effectively transferring the property. In other words, the expenditure incurred by the assessee to remove an encumbrance created by himself on the property, acquired by him without any encumbrance, is not an allowable deduction under section 48.

7. This question was answered by the Gujarat High Court in *CIT v. Brahmi Investments (P.) Ltd.* (2006) 286 ITR 66. In this case, the High Court held that if a holding company had received assets on voluntary liquidation of its subsidiary company by virtue of being a shareholder of the subsidiary company, the value of assets received by the holding company on the date of distribution was liable to tax under section 46(2). Section 47(v), which provides that transfer of a capital asset by a subsidiary company to its 100% holding company (being an Indian company) would not be regarded as a transfer for the purpose of charge of capital gains tax, would not be applicable in this case.

8. The Bombay High Court made a landmark judgment in deciding this issue in *Commissioner of Income-tax v. A.N. Naik Associates (2004) 136 Taxman 107*. The Court applied the “mischief rule” about interpretation of statutes and pointed out that the idea behind the introduction of sub-section (4) in section 45 was to plug in a loophole and block the escape route through the medium of the firm.

The High Court observed that the expression ‘otherwise’ has not to be read *ejusdem generis* with the expression ‘dissolution of a firm or body of individuals or association of persons’. The expression ‘otherwise’ has to be read with the words ‘transfer of capital assets by way of distribution of capital assets’. If so read, it becomes clear that even when a firm is in existence and there is a transfer of capital asset, it comes within the expression ‘otherwise’ since the object of the amendment was to remove the loophole which existed, whereby capital gains tax was not chargeable. Therefore, the word ‘otherwise’ takes into its sweep not only cases of dissolution but also cases of subsisting partners of a partnership, transferring assets in favour of retiring partners.

9. The Madras High Court, in *CIT v. Theatre Sri Rangaraja (2004) 135 Taxman 269*, observed that the *Explanation* to section 49(1) makes it clear that where the previous owner of an asset which was sold had himself acquired it by any of the modes set out in section 49(1)(i) to (iv), it is the cost incurred by the owner who had owned the asset prior to the previous owner that is required to be taken into account and not the cost incurred by the previous owner at the time he received the asset in any of the modes set out in sub-clauses (i) to (iv) of section 49(1).