Capital Gains under Income Tax Act, 1961 with a special note on Sale of Land & Building and Capital gains thereon (Part II)

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CASE LAWS REGARDING CAPITAL ASSETS UNDERSTANDING

The following judicial interpretations of the definition of 'capital asset' in clause (14) are noteworthy:

1. A 'capital asset' means property of any kind held by an assessee whether or not connected with his business or profession but does not include what is defined under sub-clauses (i) to (vi) of section 2(14) namely the definition clause of capital asset. A right to construct additional storeys on account of increase in available floor space index (FSI) is a capital asset and an assignment of the same is a capital receipt. However, where no consideration is paid and such right is not embedded in land, it would not be liable to tax as capital gains. [CIT v. Dinesh D. Ranka [2016] 68 taxmann.com 255/380 ITR 440/[2015] 280 CTR 224 (Kar.)]

2. The expression 'capital asset' has an all-embracing connotation and includes every kind of property as generally understood except those that are exclusively excluded from the definition. Thus, it includes every conceivable thing, right or interest or liability. [Shakti Insulated Wires Ltd. v. Jt. CIT [2003] 87 ITD 56 (Mum. – Trib.)]

3. The definition of 'capital assets' as provided in section 2(14) is an inclusive one, which brings within its ambit property of any kind held by the assessee, except what has been expressly excluded by sub-clauses (i) to (vi) thereunder; thus, the expression 'capital asset' has a wide connotation. [Jt. CIT v. Graphite India Ltd. [2004] 89 ITD 415 (Kol. – Trib.)]

4. The ITAT Mumbai Bench in the case of Asian PPG Industries Ltd v. Deputy CIT [2010] 38 SOT 114 (Mum. – Trib.) held that "according to section 2(14) of the Act, the word 'capital asset' means, 'property of any kind held by an assessee'. Therefore, it does not necessarily mean that the property, which the assessee holds, must be his own. As per the definition of capital assets under section 2(14) of the Act, any kind of property held by an assessee would come within the definition of 'capital asset'. It is not possible to read the definition of 'capital asset' in a restrictive manner to mean that the property which the assessee owned by himself alone would come within the meaning of 'capital asset'. In the case under consideration the agreement was executed, consideration was paid and possession of the plot was taken by the assessee. The assessee was having rights in the said plot which is evident from the fact that after sub division of plot, one of the portions of plot was given to M/s Lucas TVS Ltd. vide agreement dated 11-3.2004 wherein the assessee was one of the parties along with MIDC and consent of the assessee was taken. Under the circumstances surrender of rights of the assessee referred to above would amount to extinguishment of his rights in the land/ capital asset and therefore, it attracts capital gains/ loss."

5. The ITAT Delhi Bench in the case of Asstt. CIT v. Smt. Shabnam Sachdev [2013] 32 taxmann.com 22/141 ITD 730 (Delhi – Trib.) held that long-term advance booking of hotel suite, which gave assessee perpetual right of possession and right to transfer same, was a capital asset. In this case the assessee had long-term advance booking of a hotel suite permanently reserved for her use. During the assessment year 2007-08, she transferred such

advance booking for a certain sum and claimed the resultant surplus as long-term capital gains after deducting indexed cost of acquisition consisting of instalments of security deposit and maintenance charges. The Assessing Officer did not hold long term advance booking to be capital asset and taxed it as income from other sources, deducting only amount of instalments thereby disallowing maintenance charges as the same had been allowed in earlier years as deduction from rent under section 24(a) of the Act. The Commissioner of Income-tax (Appeals) however allowed the claim of the assessee treating the long-term booking as capital asset, even though he did not allow deduction of maintenance charges. The Commissioner of Income-tax (Appeals) relied on the decision of the Karnataka High Court in the case of Syndicate Bank Ltd. v. Addl. CIT [1985] 155 ITR 681/[1986] 29 Taxman 32 (Kar.) wherein it was held that "the term capital asset as defined in section 2(14) of the Income-tax Act, 1961 has a wide meaning and includes every kind of property as generally understood except those that are expressly excluded in the definition. A business undertaking as a whole would constitute a capital asset within the meaning of s. 2(14)." The Commissioner of Income-tax (Appeals) also relied on the decision of the Madras High Court in the case of Madathil Bros. v. Deputy CIT [2008] 301 ITR 345 (Mad.) for the proposition that the definition of 'capital asset' under the Income Tax Act, referring to 'property of any kind' would carry no words of limitation. The Commissioner of Income-tax (Appeals) also referred to the definition of 'capital asset' which uses the property of any kind 'held' by an assessee in contradistinction to the word 'owner' or 'owned' for arriving at a decision favourable to the assessee. The Tribunal confirmed the order of the Commissioner of Income-tax (Appeals) by holding at para.12 of its order that "the exclusive right of possessing, enjoying and disposing off a thing comes within the term of 'property'. The assessee had perpetual right of possession of suite and was entitled to transfer the same by virtue of seventh covenant noted above. Therefore, long-term advance booking by virtue of which assessee got right to possession was 'capital asset' within the definition of section 2(14) and, therefore, on transfer of the same long-term capital gain accrued to the assessee and assessee was, accordingly, entitled to indexation of cost of acquisition."

TAXABILITY OF CAPITAL ASSETS: CASE LAWS

Supreme Court rules revaluation of capital assets of a firm by credit to partners' capital accounts post admission of partners taxable as capital gains:

The Commissioner of Income-tax Vs Mansukh Dyeing and Printing Mills (Supreme Court)

Date - 24th November, 2022

Sub: Whether amount credited on account of revaluation of fixed assets and credited to the partners' account is liable to be taxed u/s 45(4) of the Income-tax Act,1961.

The IT department won the above case when the Supreme Court held that upon revaluation of fixed asset, the credit which is made to the Partners' capital account is liable to be taxed u/s 45(4) and approved the decision of the Bombay high Court in the case of CIT Vs A.N.Naik Associates and Ors (2004) 265 ITR 346 (Bom). This decision will have huge implications for all those assessees who had resorted to revaluation and credited partners' capital account.

Brief of the case:

The SC ruling, dated 24 November 2022 in the case of Mansukh Dyeing and Printing Mills (Taxpayer) on taxability of revaluation of capital assets of a firm by credit to partners' capital accounts in their profit-sharing ratio (PSR) as a deemed transfer of such capital assets by the firm to the partners under old section 45(4) of the Indian Tax Laws (ITL) as it stood before substitution vide Finance Act, 2021. Old section 45(4) stated that, with effect from (w. e. f.) tax year (TY) 1987-88, profits or gains arising from the transfer of a capital asset by way of distribution on the dissolution of a firm or otherwise shall be chargeable to tax as income of the firm.

In the present case, in TY 1992-93, the Taxpayer admitted four new partners who contributed small amounts of capital to the Taxpayer. Shortly thereafter, the Taxpayer revalued land and building (held as capital assets) and credited huge gains on revaluation to capital accounts of all the partners in their PSR and two of the existing partners withdrew small amounts from their capital balance. The tax authority invoked old section 45(4) on the basis that huge gains on revaluation of capital assets credited to partners' capital accounts was "in effect" a distribution of those capital assets by the Taxpayer to the partners, as the enhanced capital balance immediately became available to all the partners for withdrawal.

The Taxpayer contended that old section 45(4) was inapplicable as there was neither a transfer by way of distribution of capital assets by the Taxpayer to the partners, nor any transfer on account of dissolution of the Taxpayer or otherwise. The Taxpayer contended that there can be no income just due to revaluation of capital assets in the books of the Taxpayer, unless the capital assets themselves are also transferred.

SC held that, in the present case, credit of revaluation gain to partners' capital accounts can be said to be in effect distribution of the capital assets valued at their fair market value (FMV). SC held that the partners' capital accounts stood enhanced upon revaluation, which became available for withdrawal and in fact some of the partners had withdrawn such amounts subsequently from their capital accounts. Therefore, as per SC, such revaluation could be said to be a "transfer", falling in the category of "or otherwise", in terms of old section 45(4). SC also affirmed a Bombay High Court ruling in case of A.N. Naik Associates, which held that the word "or otherwise" covers not only distribution of capital assets on dissolution but also subsisting partners transferring the firm's capital assets in favor of a retiring partner. SC distinguished its earlier ruling in case of Hind Construction which regarded revaluation of goods to be non-taxable as inapplicable to the present case, as its earlier ruling dealt with pre-amended provisions where the term "or otherwise" was absent.

Case laws briefs in case of 'Profit on transfer of House Property used for residential purpose':

1. House includes part of the house: House property does not mean a complete independent house. It includes independent residential units also, like flats in a multi-storeyed complex. The emphasis is not on the type of the property, but, on the head under which the rental income is assessed. [CIT (Addl.) v Vidya Prakash Talwar (1981) 132 ITR 661 (Del)].

2. Release deed may also be treated as purchase: Where a property is owned by more than one person and the other co-owner or co-owners release his or their respective share or interest in the property in favour of one of the co-owners, it can be said that the property has been purchased by the releasee. Such release also fulfils the condition of section 54 as to purchase so far as releasee-assessee is concerned [CIT v T.N. Aravinda Reddy (1979) 120 ITR 46 (SC)]

3. Addition of floor to the existing house eligible for exemption under section 54: The assessee sold his residential property and invested the capital gain within the stipulated time in the construction of a new floor on another house owned by him by demolishing the existing floor, it was held that he was entitled to exemption under section 54. [CIT v Narasimhan (PV) (1990) 181 ITR 101 (Mad)].

4. No exemption under section 54 if land only is sold: The house property concerned must be building or land appurtenant to building. The basic test was whether the land appurtenant to building could be used independent of the user of the building. If so, it cannot be said to be land appurtenant to building. Further, the basic requirement is that the capital gain should arise from the transfer of building or land, the income of which is chargeable under the head Income from house property. If the land alone is sold, the provisions of section 54 will have no application inasmuch as the income from land is not chargeable under the head Income from house property. [CIT v Zaibunnisa Begum (1985) 151 ITR 320 (AP)].

5. Successor is entitled to benefit of exemption in case of death of the assessee: In case of assessee's death during the stipulated period, benefit of exemption under section 54(1) is available to legal representative if the required conditions are satisfied by the legal representative. [Ramanathan (CV) v CIT (1980) 155 ITR 191 (Mad)].

6. Purchase of limited interest in the house eligible for exemption under section 54: Where an assessee had sold the residential house and acquired only 15% interest in another house and such other house was already used for residence prior to purchase, it was held that the benefit should be available to the assessee. [CIT v Chandaben Maganlal (2000) 245 ITR 182 (Guj)]. In coming to the conclusion, the High Court followed its own earlier decision in CIT v Tikyomal Jasanmal (1971) 82 ITR 95 (Guj). In that case, what was purchased was a unit of house property, while in the present case before the High

Court, it was a limited interest in the property.

7. Construction in another property not eligible for exemption: An assessee gifted some land to his wife. He, thereafter constructed a building on the said land. The Government acquired the land and building and paid compensation for land to the wife and for the building to the assessee (husband). It was held that capital gain on land was assessable in the hands of the husband by virtue of section 64 but he was not entitled to exemption under section 54 in respect of capital gain on the acquisition of the land of the wife as the capital gain to the wife did not arise on transfer of a residential house. [T.N. Vasavan v CIT (1992) 197 ITR 163 (Ker)].

8. House of the firm used by partners: Where a firms property is used for residence of partners and thereafter distributed to the partners upon dissolution of the firm and the partner sells the same, exemption can be claimed by the partner under section 54. For this purpose, period for which this property was held by the firm shall also be taken into account for determining the question whether the house property in exemption was a long-term capital asset or not. [CIT v M.K. Chandrakanth (2002) 258 ITR 14 (Mad)].

9. There can be both purchase and construction: Where the assessee had partly invested the capital gains on the purchase of another house and partly on the construction of additional floor to the house so purchased within the prescribed time limit, it was held that the Income-tax Officer was not justified in restricting exemption to investment on purchase only, holding that the exemption under section 54 was admissible either for purchase or for construction but not for both. [Sarkar (B.B.) v CIT (1981) 132 ITR 661 (Del)].

10. Construction can start before the sale of asset: The construction of the new house may start before the date of transfer, but it should be completed after the date of transfer of the original house. [CIT v J.R. Subramanya Bhat (1987) 165 ITR 571(Karn)]. The very fact that purchase of another house as also the construction can take place before the sale means that cost of purchase or new construction need not flow from the sale proceeds of the old property. [CIT v H.K. Kapoor (Decd) 1998 234 ITR 753 (All) and CIT v M. Vasudevan Chettiar (1998) 234 ITR 705 (Mad)].

11. Where the assessee utilised the sale consideration for other purposes and borrowed the money for the purpose of purchasing the residential house property to claim exemption under section 54, it was held that the contention that the same amount should have been utilised for the acquisition of new asset could not be accepted. [Bombay Housing Corporation v Asst. CIT (2002) 81 ITD 454 (Bom). Also followed in Mrs. Prema P. Shah, Sanjiv P. Shah v ITO (2006) 282 ITR (AT) 211 (Mumbai)].

12. Where non-resident Indian sold property in India and purchased residential property in U.K. and claimed deduction under section 54, it was held that it was not necessary that residential property showed be purchased in India itself. [Mrs. Prema P. Shah, Sanjiv P. Shah v ITO (2006) 282 ITR (AT) 211 (Mumbai)]. But, After the Amendment vide Finance (No.2) Act, 2014, exemption is no longer allowed on Investment in residential house outside India.

Numerical examples:

Illustration:

X purchases a house property for ` 26,000 on May 10, 1982. He gets the first floor of the house constructed in 1987-88 by spending ` 40,000. He dies on September 12, 1998. The property is transferred to Mrs. X by his will. Mrs. X spends ` 30,000 and ` 26,700 during 1999-00 and 2005-06 respectively for renewals/reconstruction of the property. Mrs. X sells the house property for ` 21,50,000 on March 15, 2022 (brokerage paid by Mrs. X is ` 11,500). The fair market value of the house on April 1, 2001 is ` 1,60,000.

Solution:

Computation of capital gain

	₹	₹
Sale consideration		21,50,000
Less:		
Expenditure on transfer	11,500	

Indexed cost of acquisition [see Note 1]	5,07,200	
Indexed cost of improvement [see Note 2)	72,341	5,91,041
Long-term capital gain		15,58,959

Notes

Indexed cost of acquisition

	₹
Cost to the previous owner (Expended till 31.03.2001)	96,000
Fair market value on April 1, 2001	1,60,000
Cost inflation index for 2001-02	100
Cost inflation index for 2021-22	317
Indexed cost of acquisition (i.e., ₹ 1,60,000 × 317 + 100)	5,07,200

Indexed cost of improvement

	₹
Cost of improvement incurred prior to April 1, 2001 (not considered)	---
Cost of improvement incurred in 2005-06	26,700
Cost inflation index for 2005-06	117
Cost inflation index for 2021-22	317
Indexed cost of improvement (i.e., ₹26,700 × 317 + 117)	72,341

Illustration:

X purchased a house property on September 18, 2002 for ₹1,00,000. On April 4, 2003, he entered into an agreement to sell the house to A for ₹ 6,50,000 (after receiving an advance of ₹ 10,000). On A's failure to pay the balance within the stipulated period of 45 days, X forfeited the advance money. X died on October 12, 2003 and Mrs. X (as per his will) got the property.

Mrs. X enters into an agreement on January 13, 2005 to sell the property to B after receiving advance of ₹ 80,000 and on B's failure to pay the balance within 2 months, as per the agreement, the advance money is forfeited by Mrs. X. Further, Mrs. X enters into an agreement on April 6, 2020 to transfer the property to C after receiving advance of ₹1,00,000. C could not pay the balance consideration within the stipulated period of 45 days and Mrs. X forfeits the advance money.

Mrs. X ultimately sells the property to Y on June 26, 2021 for ₹42,90,000. Find out the tax consequences in the hands of X and Mrs. X for different assessment years. Also calculate net income of Mrs. X for the assessment year 2022-23, on the assumption that she is a businesswoman and her income from business is ₹20,00,000.

Solution:

Forfeiture of advance money o f ₹10,000 by X during the previous year 2003-04 - Since property is not transferred during the lifetime of X, advance forfeited by him is not taxable. It is not even deducted from cost of acquisition while calculating capital gain in the hands of Mrs. X.

Forfeiture of advance money of ₹ 80,000 by Mrs. X during the previous year 2004-05 - ₹ 80,000 will not be taxable in the previous year 2004-05. However, it will be deducted from cost of acquisition while calculating capital gain on transfer of the property in the hands of Mrs. X.

Forfeiture of advance money of ₹ 1,00,000 by Mrs. X during the previous year 2020-21 - Advance money is forfeited during the previous year 2020-21. It will be taxable in the hands of Mrs. X under section 56(2)(a) under the head "Income from other sources" for the previous year 2020-21 (assessment year 2021-22).

Computation of capital gain of Mrs. X for the assessment year 2022-23 –

	₹
Full value of consideration	42,90,000
Indexed cost of acquisition [cost of acquisition: ₹20,000 (see Note) × CII of 2021-22 : 317 ÷ CII of 2002-03 :105]	60,381
Long-term capital gain	42,29,619

Computation of income of Mrs. X for the assessment year 2022-23 -

	₹
Business income	20,00,000
Long-term capital gain	42,29,619
Net income	62,29,619

Note –

Cost of acquisition of the property in the hands of Mrs. X is ₹ 20,000. It is calculated as follows -

	₹
Cost of acquisition to the previous owner (as Mrs. X got the property after the death of her husband as per his will)	1,00,000
Less: Amount forfeited by X (amount forfeited by the previous owner is not to be considered)	Nil
Less: Amount forfeited by Mrs. X during the previous year 2004-05	80,000
Less: Amount forfeited by Mrs. X during the previous year 2020-21 (it is taxable in the hands of Mrs. X as income from other sources, for the assessment year 2021-22, consequently, it is not to be deducted from cost of acquisition)	Nil
Cost of acquisition	20,000

Tax deducted at source on the transaction of immovable property other than agricultural land

In order to create the safeguard measures in regards to the Government revenue, TDS is applicable to the buyer where the buyer is authorised under law to deduct tax at the time of payment to the seller of the property or at the time of credit of such transaction whichever is earlier provided the transaction is made or the Price is fixed as Rs.50 lac and more in comparison to the stamp duty value whichever is higher. TDS is also applicable even where the transaction amount even if is less than Rs.50 lac but the stamp duty value is Rs.50 lac or more. Therefore TDS is applicable to the buyer in respect of the transaction amount or the stamp duty value whichever is higher provided either the considerable amount or the stamp duty value is at least Rs.50 lac. Section 194IA defined immovable property which implies that any land other than agricultural land or any building or part of a building.

The term agricultural land means agricultural land in India, not being a land situated in any area referred to section 2(14)(iii). And TAN is not required to the buyer for such deduction and PAN of the deductor is sufficient to deduct tax. Rate of tax is 1%.

Provided that where the seller is a Non-Resident of India the rate of tax @ 1% will be replaced by 20% but the seller has a liberty to file application before the seller's jurisdictional A.O. through Form no.13 within the application of the income tax portal for the lower deduction of tax or at nil rate of tax. However if within the same F.Y. the seller received any compensation from the appropriate authority and the appropriate authority has deducted tax U/s 194LA of the Act for the said property section 194LA must prevail where the rate of tax is 10% and the limit of the deductible transaction is more than Rs.2.5 lac and the stamp duty value is not relevant thereon.

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