Amendments Relating to the Capital Gains Taxation

Primary focus of the Finance Bill, 2012 was to plug possible leakages of the revenues arising on account of shortcomings of the provisions of the Income-tax Act, 1961. With respect to the provisions relating to the Capital Gains taxation, amendments were equally divided between some substantive provisions introducing new incentives and plugging the loopholes. There are various clarificatory amendments made in the provisions dealing with the Capital Gains. While some of these clarificatory amendments have been given retrospective effects, some have been given prospective effect. Read on to know more…

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The Finance Bill, 2012 ["the Bill"] seeks to make amendments which can be divided into the following broad topics:

i) Retrospective amendments dealing with capital gains arising from transfer of shares of a foreign company with primary objective or effect of transferring management and control of a company / interest situated in India;
ii) Retrospective amendments dealing with determination of cost of acquisition of capital assets in case of conversion of a proprietorship concern / partnership firm into a company;
iii) Extension of benefit of deduction U/s. 54 B[Capital Gains on transfer of Agricultural Land] to HUFs;
iv) Introduction of relief from capital gains tax on account of investment into MSME Company;
v) Amendment dealing with determining full value of consideration received or accrued as a result of transfer, in case where the consideration is not ascertained or determined at the time of transfer;
vi) Expanding scope of reference which can be made to the DVO U/s. 55 A;
vii) Clarificatory amendment to Section 47 (vii) dealing with cases of amalgamation;

Note: *The issue relating to the item (i), which primarily deals with the amendments to nullify the decision of the Hon'ble Supreme Court in the case of Vodafone, is dealt elsewhere in the journal and, therefore, that aspect has not been discussed herein.*

Cost of Acquisition on Conversion

With a view to providing tax neutrality to corporatisation of a proprietorship concerns and partnership firm, amendments were made to the Income-tax Act, 1961 ["the Act"] by the Finance (No. 2) Act, 1999 by inserting Clauses (xiii) and (xiv) to Section 47 of the Act.

Section 47 (xiii) covered two cases being (a) transfer of tangible or intangible asset by a firm to a company as a result of succession of a firm by a Company in the business carried on by the firm; and (b) transfer of a capital asset to a company as a result of demutualisation or corporatisation of a recognised stock exchange. Similarly, Section 47 (xiv) covered cases of transfer of capital asset or intangible asset by a proprietorship concern to a company as a result of succession of the sole proprietorship by a Company in the business carried on by the firm. By virtue of this provision, the transfer of assets involved was not regarded as transfer and was therefore not chargeable to capital gains tax.

However, to complete the tax neutrality, it ought to have been provided that cost of acquisition in the hands of the Company in such cases would be the same as the cost of acquisition of the assets so transferred would be the same as the cost of acquisition in the hands the firm or sole proprietor as the case may be immediately prior to its transfer to the Company. However, necessary provisions with respect to the same were not made in the provisions of section 49 of the Act, which otherwise dealt with such type of cases of succession, providing that the cost of acquisition in the hands of the successor will be the same as the cost in the hands of the previous owner. To ensure that no assessee takes undue advantage of these provisions, an amendment is sought to be made by the Bill to Section 49 (1)(iii)(e). With this amendment, it would not now be permissible to take higher value as cost of acquisition in the hands of Company, even where the assets are transferred by the Firm / Sole Proprietorship at higher value. This amendment is sought to be made with retrospective effect from 1st April, 1999 i.e. right from the date on which this tax neutrality was provided for in the Act.

Exemption U/s. 54 B [Agricultural Land]

If an assessee transfers a land, which in the two years prior to the date of its transfer was used by him or his parents for agricultural purposes, and earns capital gains thereon [including capital gains arising from transfer of short term capital asset], the Assessee would be eligible for exemption, if and to the extent of such capital gain being used for purchase of another land to be used for agricultural purposes. It was held in the case of *CIT vs. G. K. Devarajulu (1991) 92 CTR (Mad) 184 : (1991) 191 ITR 211 (Mad)* that benefit of section 54 B cannot be allowed if the transferor is an HUF, especially due to the usage of the words "or his parents" and it was held that the exemption U/s. 54 G is available only to an individual.. Similarly AP High Court[1] also took similar view and restricted exemption U/s. 54 G only to Individuals.

With a view to providing tax neutrality to corporatisation of a proprietorship concerns and partnership firm, amendments were made to the Act by the Finance (No. 2) Act, 1999 by inserting Clauses (xiii) and (xiv) to Section 47 of the Act.

The Bill proposes to grant benefit of section 54 B also to the land owned by an HUF, if the said HUF has used it in 2 years immediately preceding the date of transfer for agricultural purposes. This amendment is sought to be effective from 1st April, 2013 and shall accordingly apply with effect from A.Y. 2013-14.

Capital Gains Exemption on Investment in New MSME Company

A new section 54 GB is sought to be inserted for granting exemption from Capital Gains arising from transfer of a long term capital asset [LTCG] being residential property [a house or a plot of land], if the same is invested in a newly formed company. The Scheme of the exemption works in the following manner:

a) It applies to LTCG arising to an individual or an HUF on transfer of a residential property. Residential property for this purpose includes a house or a plot of land. Since the term a house or a plot of land are used as explaining the term "Residential Property", I am of the view that a house or a plot of land shall mean only residential house and residential plot. Accordingly a commercial house property or a plot of land for commercial purposes would be excluded from eligibility.

b) The Assessee earning the LTCG is required to invest the net consideration so accruing as a result of transfer by way of subscription of equity shares of an eligible company on or before due date of filing the return of income for the year in which the LTCG arises;

c) Eligible company for this purpose means, the company which fulfills each of the following conditions:

   (i) It is a Company which is incorporated in India between 1st April of the PY in which the residential property is transferred and due date of filing the return of income for the said PY.

   (ii) The Company is engaged in the business of manufacture of an article or thing;

   (iii) It is a company which qualifies to be a "Small" or "Medium" enterprise under the Micro, Small and Medium Enterprises Act, 2006 [MSME Act]. It must be kept in mind that investment in Micro Enterprises is not eligible.

[1] 291 ITR 98

The Bill proposes to grant benefit of section 54 B also to the land owned by an HUF, if the said HUF has used it in 2 years immediately preceding the date of transfer for agricultural purposes. This amendment is sought to be effective from 1st April, 2013 and shall accordingly apply with effect from A.Y. 2013-14.

(iv) The Assessee owns more than 50 % of the equity shares or more than 50 % of the voting power after subscription of shares.

d) Further, the Company is required to investment the money so subscribed in new plant and machineries [other than excluded machineries] within a period of 1 year from the date of subscription of money by the Assessee; Investment in plant and machineries used in or outside India, any office appliances including computer or computer software, vehicle or any plant or machinery 100 % of the cost of which is allowed as deduction [as depreciation or otherwise] is not allowed to be made.

e) Capital Gains exemption is available in proportion of the amount invested by way of subscription of equity shares to the net consideration. Accordingly if 100 % of the net consideration is invested in subscription of equity shares then 100 % capital gains is tax free, else proportionate amount would be allowed as exemption.

f) It is also provided that it is obligatory to subscribe for shares on or before the due date of filing the return of income. However, the Company is given time of 1 year from the date of subscription to investment in plant and machineries. Accordingly, if the Company has not made investment in new plant and machineries on or before the due date of filing the return of income of the Assessee [individual or HUF], then the Company should deposit the money [to the extent not utilized for purchase of plant and machineries] in a separate bank account opened under a scheme notified for this purpose [Capital Gains Account Scheme]. The money deposited in this Account is to be utilized in the manner to be prescribed.

g) Lock-in condition of 5 years is provided for the Assessee and also the Company, meaning that the Assessee cannot transfer the shares so subscribed for a period of 5 years from the date of subscription of shares and if the Assessee transfers these shares within the said period then capital gains exemption granted to that extent shall be taxed in the year in which the shares are sold in addition to the capital gains on sale of shares itself. Similarly, if the Company transfers the new plant and machineries purchased out of the money subscribed, within a period of 5 years from the purchase of the new plant and machineries, then also the Assessee would be liable to pay tax on the capital gains to that extent in the year of such transfer by the Company. The Company would be liable to capital gains tax arising on transfer of the new plant and machineries.

In this deduction it should be kept in mind that the exemption is available not only for investment in new plant and machineries, but it has to be ensured that the company in which the investment is made is a newly incorporated company. Condition of holding more than 50 % of the shares is required to be complied with directly by the transferor and it is not permitted to hold shares through or together with relatives.

There is presently a restriction on transfer of shares by the Assessee during lock-in period, however, there appears to be no restriction on reducing the shareholding below 50 % within the lock in period of 5 years.

This exemption is available with effect from A.Y. 2013-14 and would accordingly apply to transfer of residential property referred to herein on or after 1st April, 2013.

Determination of Full Value of Consideration – Section 50 D

One of the essential conditions for the levy of capital gains tax is to determine full value of consideration accruing as a result of transfer. It has been held time and again if one of the major components of computing provision is not possible to be determined then the whole machinery provision fails and accordingly the charge of tax fails[2]. There are times when the transfer of the Asset takes place based either on contingent payments on consideration payable based on future realisation, etc. In such a situation, since the consideration is not possible to be determined, alternative arguments were being taken that either the charge fails or capital gain tax is payable only when the consideration is finally ascertained. This resulted in either escapement of tax altogether or at least postponement of tax liability to a future date, when the transfer of the asset has taken place earlier.

It is proposed to insert Section 50 D by the Bill to provide that in cases where the consideration is not is not ascertainable or cannot be determined at the time of transfer then for computing capital gains, fair market value of such asset shall be treated as full value of consideration accruing or received as a result of such transfer.

This amendment will affect the case of joint development agreement done in the real estate, wherein similar arguments were being taken.

[2] B.C. Srinivasa Setty [1981] 128 ITR 294 and also Sunil Siddharthbhai 156 ITR 509

Reference to the Valuation Officer

Section 55A of the Act, provide that an AO is authorised to make a reference to a valuation officer for determining value of a capital asset, provided in his opinion the value ascertained by the Assessee is lower than the fair market value. Therefore, the AO was permitted to refer to valuation only cases of alleged undervaluation.

Section 55 (2)(b) of the Act, gives an option to the assessee to substitute fair market value as on 1st April, 1981 as cost of acquisition in case where the subject asset was held by him from a period anterior to 1st April, 1981. At times disputes have arisen, where in the opinion of the AO, the Assessee had taken higher FMV as on 1.4.1981 and accordingly taken higher indexed cost of acquisition and lower capital gains. In such an even the AO made references to the DVO for ascertaining the FMV as on 1st April, 1981.

It was held in several cases[3] that power to refer the valuation as on 1.4.1981 is not available with the AO, as the primary condition that the value adopted by the Assessee is lower than the FMV is not satisfied [in these cases, the allegation is the converse]. Therefore, the references to the DVO were struck down as without jurisdiction and consequent additions were deleted.

To enable the AO to also make a reference in cases where in his view the value adopted by the Assessee is higher than the FMV, it is not provided that the AO can make a reference where in his opinion the value adopted by the Assessee is at variance with the FMV.

This amendment is made effective only from 1st July, 2012. It may accordingly and possibly not apply to references made prior to 1st July, 2012.

Amalgamation Cases

Section 47 (vii) of the Act, provides that when a shareholder holding shares in an amalgamating company transfer his share in pursuance of a scheme of amalgamation, such transfer is not treated as a transfer and accordingly no capital gains is levied. The exemption is subject to the conditions that:

a) Transfer by him is in consideration of allotment of shares in the amalgamated company; and

It is proposed to insert Section 50 D by the Bill to provide that in cases where the consideration is not is not ascertainable or cannot be determined at the time of transfer then for computing capital gains, fair market value of such asset shall be treated as full value of consideration accruing or received as a result of such transfer.

b) The amalgamated company is an Indian Company.

In case where the Amalgamated Company holds shares of the Amalgamating Company, then in consequence of amalgamation no shares are allotted to the Amalgamated Company as a result of amalgamation, but the shares so held by it gets extinguished. As has been held in case of Anarkali Sarabhai[4] extinguishment of shares would amount to transfer. Since in this case, there would not be any consideration received by allotment of shares as a result of transfer, there could have been tax implication in the hands of the Amalgamated Company and possible claim of loss on account of extinguishment.

To remove this hardship an amendment is sought to be made for providing that there would not be any requirement for allotting shares of the amalgamated company to the extent the shares of the amalgamating company are held by the amalgamated company.

Similar issue was also there in case of demerger as defined U/s. 2 (19AA) of the Act. In case of a demerger the shareholders of the Demerged Company [the Company whose undertaking is demerged] are required to be allotted shares of the Resulting Company in proportion to their holding of shares of the Resulting Company [the Company to whom the undertaking is transferred]. However, when the Resulting Company itself is one of the shareholders of the Demerged Company, then it would be incorrect to allot shares of the Resulting Company to itself and, therefore, the shares will be allotted only to the shareholders of the Demerged Company other than the Resulting Company. To ensure that such types of demergers also meet the tests of the definition of demerger as contained in section 2 (19AA), the definition is amended to provide that the shares are to be allotted proportionate basis, except where the Resulting Company is the shareholder of the Demerged Company.

This amendment is also proposed to be made effective from 1st April, 2013.

Conclusion

There are various clarificatory amendments made in the provisions dealing with the Capital Gains. While some of these clarificatory amendments have been given retrospective effects, some have been given prospective effect. It is further seen that clarifications given for removing hardship to the Assessee are made only prospectively. However, when such clarifications are given for nullifying a decision of a ruling or judgement of a high court against the tax department, the same have been given retrospective effect. It is my view that a consistent approach should be adopted in all fairness. ■

[3] Umedbhai International [2011] 330 ITR 506 (Cal); HiabenJayantilal Shah [2009] 310 ITR 31 (Guj)
[4] [1997] 224 ITR 422 (SC), Also case of Mrs. Grace Collis [2001] 248 ITR 323 (SC)