Finance (No. 2) Bill, 2014— Proposals Relating to Capital Gains

The Finance Bill, 2014 has introduced a series of changes relating to computation of capital gains. The major areas affected would include housing, capital market and compensation on compulsory acquisition. Barring some relief relating to taxation of compensation on compulsory acquisition, the proposals relating to capital gains have been largely adverse to the taxpayer. A more friendly tax regime would have encouraged taxpayers to report their capital gain transactions, thereby ensuring that all such transactions come into the main stream. Read on to know more...

It was widely believed that the retrospective amendment relating to indirect transfer introduced by the Finance Act, 2012 would be withdrawn. However, there is no such proposal in the Finance Bill. The speech of the Finance Minister states that all fresh cases arising out of such retrospective amendments and coming to the notice of the assessing officers will be scrutinised by the high-level committee constituted by the CBDT before any action is initiated in such cases. It is interesting to note that scrutiny by the high-level committee would apply only to the fresh cases and not to the existing disputes.

Changes Affecting Housing

1) Section 54 provides for relief in respect of reinvestment of capital gains arising from transfer of long-term residential house into a residential house. Similarly, Section 54F provides for relief in respect of reinvestment of net consideration arising from transfer of long-term capital asset other than a residential house into a residential house.
2) Disputes arose as regards meaning to be attributed to 'a residential house.' While the Department insisted on attributing the meaning of 'one residential house,' the taxpayers insisted on attributing the meaning of 'any or many residential houses'. The interpretation of the taxpayer was supported by the analogous provisions like Section 23(2)/(4) relating to computation of income from self-occupied/vacant house property. Such interpretation was also supported by a different language adopted in Section 5(vi) of Wealth Tax Act. Section 13(2) of the General Clauses Act also supported the case of the taxpayers.
3) On the basis of the aforesaid reasoning, several courts have held that multiple adjoining flats constitute to one residential house. The

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following are some of the important rulings in this regard:

- *CIT vs. D. Ananda Basappa* [2009] ITR 329 (Karn. – HC) [S.L.P. (C) No. 20867 of 2009/[2010] 320 ITR (St.) 19; dismissed]
- *CIT vs. Joe B. Fernandes:* SLP (C) No. 23581 of 2009/[2010] 322 ITR (St.) 8;
- *CIT vs. Smt. Rashmi Khanna:* SLP (C) No. 30894 of 2009/[2010] 322 ITR (St.) 8;
- *CIT vs. Late Khoobchand M. Makhija* [2014] 223 ITR 189 (Karn. - HC)(Mag);
- *CIT vs. Gita Duggal* 2013-TIOL-143-HC-DEL-IT;
- *Dr. Smt. P. K. Vasanthi Rangarajan vs. CIT* [2012] 209 Taxman 628 (Mad.);
- *K. C. Kaushik vs. P. B. Rane*, ITO (1990) 185 ITR 499 (Bom - HC);
- *CIT vs. Mr Raman Kumar Suri* 2012-TIOL-982-HC-MUM-IT;
- *Vittal Krishna Conjeevaram vs. ITO* [2013] 144 ITD 325 (Hyderabad - Trib.);
- *Smt. V. R. Karpagam vs. ITO* [2013] 143 ITD 126 (Chennai - Trib.);
- *R. Gopinath (HUF) vs. ACIT* [2010] 5 taxmann.com 80 (Chennai);
- *Prabhandam Prakash vs. ITO* [2008] 22 SOT 58 (Hyd.).

4) While holding so, the Honourable Karnataka High Court interpreted the meaning of 'a residential house' as meaning more than one. A reference may be made to the following decisions in this regard:
   - *CIT vs. D. Ananda Basappa* [2009] ITR 329 (Karn. – HC) upheld by the Supreme Court in S.L.P. (C) No. 20867 of 2009/[2010] 320 ITR (St.) 19;
   - *CIT vs. Late Khoobchand M. Makhija* [2014] 223 ITR 189 (Karn. - HC)(Mag);
   - *CIT vs. Smt. K.G. Rukminiamma* [2011] 196 Taxman 87 (Kar.) - "…it was not the intention of the legislation to convey the meaning that it refers to a single residential house. If that was the intention, they would have used the word "one"…"

5) The Honourable Delhi High Court in the case of *CIT vs. Gita Duggal* 2013-TIOL-143-HC-DEL-IT held that multiple flats scattered in an apartment complex may also constitute a single residential house. While holding so, the Honourable Delhi High Court sought to distinguish 'a residential house' from 'a residential unit.'

It is proposed to amend both Sections 54 and 54F to restrict the benefit of rollover to one residential house. This amendment being prospective would apply only from the assessment year 2015-16 onwards. Despite aforesaid amendment, in respect of adjacent multiple flats bought for holding them as one residential house, one may contend that the ratio of some of the earlier decisions may be applied to claim the benefit of relief in respect of all such flats.

6) All the aforesaid cases dealt with the fact situation of multiple flats situated in the same apartment complex. In *CIT vs. Late Khoobchand M. Makhija* [2014] 223 ITR 189 (Karn.-HC) (Mag), a case came up before the Honourable Karnataka High Court where investments were made in two separate house properties located in different areas. Applying the ratio of the earlier decisions and considering the fact that the assessee had two sons, the Honourable Karnataka High Court ruled in favour of the taxpayer. However, a *caveat* was added indicating that while 'a' cannot mean 'one,' it can also not mean multiples.

7) It is proposed to amend both Sections 54 and 54F to restrict the benefit of rollover to one residential house. This amendment being prospective would apply only from the assessment year 2015-16 onwards. Despite the aforesaid amendment, in respect of adjacent multiple flats bought for holding them as one residential house, one may contend that the ratio of some of the earlier decisions may be applied to claim the benefit of relief in respect of all such flats. However, in respect of scattered flats or residential houses located in different areas, it may be difficult to claim the benefit in respect of all the houses.

8) The first portion of Section 54(1) which contains the reference to 'a residential house' is not proposed to be amended. This means that taking analogy from various decisions, 'a' includes more than one and if an assessee sells more than one residential house and invests the aggregate capital gains in one residential house, he would continue to get the benefit of exemption under Section 54.

9) It is proposed that in order to claim benefit of exemption under Section 54/54F, the new asset

should be in India. This amendment is to undo the following decisions:

- *Vinay Mishra vs. ACIT* [2012] 20 ITR (Trib) 129 (Bangalore)
- *N. Ranganathan vs. ITO* (ITA 863/ Mds/2014)
- *Prema P. Shah vs. ITO* [2006] 282 ITR (AT) 211 (Mum.)
- *ITO vs. Girish M. Shah* [ITA 3582/M/ 2009]

10) While capital gains arising from transfer of a residential house situated outside India is taxable in the hands of a resident like any other residential house, denial of rollover benefit in case the property is situated outside India appears harsh.

Changes Affecting Capital Market

1) An unlisted share is presently regarded as long-term if held for more than 12 months under the proviso to Section 2(42A). Similarly, a unit of a mutual fund would also be regarded as long-term if held for more than 12 months. It is proposed to amend the aforesaid *proviso* to remove unlisted share and units of mutual fund so that they have to be held for more than 36 months to be regarded as long-term capital assets. However, units of equity oriented mutual fund continue to be kept in the aforesaid *proviso* so that the same would be regarded as long-term if held for more than 12 months.
2) The holders of shares of private company, unlisted public company and foreign company would be affected by the aforesaid amendment. Similarly, holders of units of mutual fund other than equity oriented mutual fund would also be affected. This has removed the time arbitrage between such units and other bonds on deposits making the former no more attractive. It is always considered that the investment in mutual funds is more transparent than investment in bonds and deposits. Because of KYC norms, it is easier to track the investments in mutual funds than elsewhere. In any case, there is no scope for escapement of tax in respect of income arising from such units. Therefore, the proposed amendment to make investment in units of mutual fund less attractive appears retrograde.
3) The long-term capital gains from transfer of units of equity oriented mutual fund would enjoy exemption under Section 10(38) subject to conditions therein. The long-term capital gains from transfer of units of other mutual funds would suffer the concessional tax of 20% after indexation under Section 112(one). In terms of the *proviso* thereunder, such tax is limited to 10% without indexation. This effectively meant that the capital gains tax on transfer of such units does not exceed 10% of the arithmetical gain. It is proposed to amend the aforesaid *proviso* to remove reference to such units. This would mean that henceforth, long-term capital gains from transfer of such units would necessarily suffer tax at 20% after indexation. It may be noted that there is no change in the manner of taxation of short-term capital gains arising from transfer of units other than units of equity oriented mutual fund. Such capital gains continue to be taxed as normal income in the hands of the taxpayer. Short-term capital gains arising from transfer of units of equity oriented mutual funds in recognised stock exchange would continue to be taxed at 15% under Section 111A.
4) There has been a controversy as regards characterisation of income arising to the FIIs between capital gains and business profits. In the case of *LG Asian Plus Ltd. vs. ADIT* (International Taxation) [2011] 11 taxmann.com 414 (Mum.-ITAT)/*Platinum Investment Management Ltd. vs. Dy. DIT* (International Taxation) [2014] 44 taxmann.com 208 (Mumbai - Trib.), it was held that such income is in the nature of capital gains and the same is chargeable to tax at the concessional rate provided in Section 115AD. However, in the case of *XYZ/ ABC Equity Fund*, (2001) 250 ITR 194 (AAR) and *Morgan Stanley & Co. International Limited*, [2005] 272 ITR 416 (AAR), it was held that the same is in the nature of business profits. As the FIIs are non-residents covered by respective double taxation avoidance agreements, the taxability of the business profits would depend on existence of a permanent establishment in India. In order that no permanent establishment

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In order to encourage overseas listing of government securities, it is proposed to exempt transfer of government security carrying a periodic payment of interest, made outside India through an intermediary dealing in settlement of securities by a non-resident to another non-resident by inserting a new Clause (viib) to Section 47.

is constituted, the FIIs attempt to place their managers outside India. The Finance Bill proposes to amend Section 2(14) to the effect that from the assessment year 2015-16 onwards, the securities held by FIIs would always be regarded as capital assets.

5) This amendment would remove any ambiguity in the matter of characterisation of income in so far as the Income-tax Act, 1961 is concerned. It has also adversely affected those FIIs who would prefer to characterise the gain as business profits and avoid incidence of taxation by claiming that no business operations are carried out in India in terms of Section 9 (1)(i) read with Explanation 1(a). The question that is still open is whether such characterisation of domestic tax law would apply even when applicable DTA is pressed into service. Except in rare cases like in the case of USA, in most cases, taxation of capital gains is separately provided in the Treaty. In such case, the domestic law characterisation may not prevail over distinct characterisation provided by the Treaty. One has to see how the authorities would use Article 3(2) providing for adoption of domestic tax law meaning of the terms used but not defined in the Treaty to impose domestic law characterisation.

6) In order to encourage overseas listing of government securities, it is proposed to exempt transfer of government security carrying a periodic payment of interest, made outside India through an intermediary dealing in settlement of securities by a non-resident to another non-resident by inserting a new Clause (viib) to Section 47.

Changes Affecting Taxation of Compensation on Compulsory Acquisition

1) Compulsory acquisition is regarded as a transfer under Section 2(47) (iii). Capital gains arising from such compulsory acquisition are chargeable to tax under Section 45. Sub-Section 5 provides for separate scheme of taxation in respect of such capital gains. Although, it appears that Section 45(5) deals with the case of compulsory acquisition involving enhancement of compensation and not other compulsory acquisition, it is widely believed that this provision would deal with all cases of compulsory acquisition irrespective of whether there is been a claim for enhancement of compensation. Under Section 45(5), it is provided that capital gains will be charged to tax in the previous year in which the compensation awarded in the first instance is received by allowing full cost of acquisition and improvement. In the subsequent previous year of receipt of enhanced compensation, the same would be charged to tax without allowing any deduction whatsoever. It is also provided that in the event of any reduction in the compensation already charged to tax as a result of subsequent court order, the previously assessed capital gain should be re-computed.

2) Even after insertion of 45(5), several courts held that enhanced compensation should not be taxed as the same is contingent in nature as may be noted in the following cases:
   - *CIT vs. Hindustan Housing & Land Development Trust Ltd.* [1986] 161 ITR 524 (SC)
   - *CCIT vs. Smt. Shantavva* [2004] 267 ITR 67 (Karn. - HC);
   - *CIT vs. A.B.V. Gowda* [1986] 157 ITR 697 (Karn. – HC);
   - *Chandi Ram vs. CIT* [2009] 312 ITR 139 (Punjab & Haryana);

3) However, the Apex Court in the case of *Ghanshyam* 315 ITR 1 has held that the receipt of enhanced compensation although subject to further appeal is to be charged to tax under Section 45 (5).

4) It is now proposed to introduce the *proviso* under Section 45(5) (b) so that any amount of compensation received in pursuance of interim order of the court, tribunal or other authority shall be deemed to be income chargeable under the head 'capital gains' of the previous year in which the final order of such court, tribunal or other authority is made. *Vide* this amendment, the decision of the Supreme Court in *Ghanshyam's* case has been partially neutralised in a case of interim order. This would enable the taxpayers to defer the payment of tax in respect

of receipt of such enhanced compensation till such time the final order is made by the very same court that passed the interim order. However, this would not enable the taxpayers to defer the payment of tax in respect of receipt of such enhanced compensation where such enhancement is challenged in a higher forum till such enhancement becomes final. Therefore, this proposed amendment gives only a marginal relief to the tax payers.

5) Section 54H has not been suitably amended to take care of the above amendment. This will lead to a peculiar situation. The time limit for making investment would be reckoned from the compensation/consideration received whereas the taxability happens in the year in which the final order is passed. It is ideal that a proper link is created between Section 54H and Section 45(5).

6) Throughout Section 45(5), reference has been made to consideration (expression used for transfer where consideration is determined or approved by Central Government or RBI) and compensation (expression used for transfer by way of compulsory acquisition under any law). However, the proposed *proviso* makes reference only to consideration.

Other Amendments Relating to Capital Gains

1) A new scheme of taxation of business trusts, sponsors and unit holders of the business trusts has been proposed. Taxation of capital gains in the hands of the business trusts would be governed by Sections 10(38), 111A, 112 and other applicable provisions including newly proposed Chapter XII-FA. The sponsor who exchanges his shares in SPV against units of a business trust is not liable to tax upon such exchange in terms of proposed Section 47(xvii). In determining the period of holding of such units, the period during which shares in SPV were held is also to be considered in terms of proposed Clause (hc) to Explanation to Section 2(42A). Further, the cost of acquisition of the shares in SPV would be taken to be the cost of acquisition of units as per Section 49(2AC). However, the capital gains arising from transfer of such units in the hands of sponsor would not be eligible for exemption under Section 10(38) or concessional tax treatment under Section 111A as per the proposed *provisos* under the respective Sections. However, capital gains on transfer of units by the unit holders other than the sponsors would be governed by Section 10 (38) and Section 111 A.

2) It is proposed to amend Explanation (v) to Section 48 to replace 'consumer price index for urban non-manual employees' by 'consumer price index (urban).' Henceforth, while notifying the indexation figure, the Central government will have to have regard to 75% increase in 'consumer price index (urban).'

3) Any advance received against proposed sale of a capital asset but forfeited is to be reduced from the actual cost of the capital asset while computing the capital gains arising on eventual transfer of the capital asset. This caused difficulty in determining the indexed cost of acquisition/improvement as the law does not provide for factoring such advance forfeited while computing indexed cost. It is now proposed to dispense with the present system of reduction of forfeited advance from the actual cost by providing for taxation of such forfeited amount as income from other sources by introducing Section 56(2)(ix) with a corresponding insertion of Section 2(24)(xvii). A *proviso* has been inserted under Section 51 for ensuring that there is no double taxation.

4) If the asset involved is a short-term capital asset, it does not make any difference whether advance is reduced from cost while computing capital gains or if the advance is liable to tax under the proposed Section 56(2)(ix). In both the case the tax rate would be 30%. If the asset involved is a long-term capital asset, it would make a difference. This is because the tax rate is 20% in case of LTCG and 30% in case of income from other sources. If the assessee offers the advance under Section 56, he might be liable to pay tax at 30%. On the other hand, if he reduces

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it from cost of acquisition or indexed cost of acquisition, the incremental gain would be liable to tax at 20%.

5) It is interesting to note the difference between the language used in the main provision of Section 51 and the proposed *proviso* or Section 56(2)(ix). The language used in Section 51 is "any advance or other money received and retained." The language used in the proposed *proviso* or Section 56(2)(ix) is 'any sum of money, received as advance or otherwise'. Further, conditions specified in Section 56(2)(ix) are not found in Section 51. The scope of these two expressions is different thereby retaining relevance of Section 51 under circumstances when Section 56(2)(ix) is not attracted.

6) The first *proviso* to Section 54 EC provided for a ceiling of ₹50 lakh of investment in respect of long-term capital gains. The aforesaid ceiling was fixed with reference to a financial year which enabled taxpayers effecting transfer after 30th September to invest ₹50 lakh in that financial year and another ₹50 lakh in the next financial year (but within six months from the date of transfer of original asset). This was upheld in the following cases:
   - *Vivek Jairazbhoy vs. Dy. CIT* [ITA No. 236/Bang/2012, dated 14-12-2012];
   - *Aspi Ginwala vs. ACIT* [2012] 20 taxmann.com 75 (Ahmadabad – Trib.);
   - *Coromandel Industries (P.) Ltd. vs. Asst. CIT* 2013] 145 ITD 171 (Chennai – Trib.);
   - *Smt. Sriram Indubal vs. ITO* [2013] 32 taxmann.com 118 (Chennai – Trib.);
   - *ITO vs. Ms. Rania Faleiro* [2013] 142 ITD 769 (Panaji – Trib.).

7) In order to neutralise the aforesaid decisions, it is proposed to introduce second *proviso* to Section 54 EC. As per the second *proviso*, the investment from capital gains arising from one or more original assets during the financial year in which such assets are transferred and in the subsequent financial year shall not exceed ₹50 lakh. Thus, the limit of ₹50 lakh is now pegged with reference to transfer of one or more original assets in a particular financial year irrespective of how such investment of ₹50 lakh is spread between that financial year and next financial year. However, care should be taken to see that the spilled over part of ₹50 lakh in the next financial year is not reckoned for determining the ceiling of ₹50 lakh relating to transfer of original asset/assets taking place in the next financial year. In other words, a separate limit of ₹50 lakh would be available in respect of transfer of original assets taking place in the next financial year.

A new scheme of taxation of business trusts, sponsors and unit holders of the business trusts has been proposed. Taxation of capital gains in the hands of the business trusts would be governed by Sections 10 (38), 111A, 112 and other applicable provisions including newly proposed Chapter XII-FA.

8) Section 194LA provides for deduction of tax at source at 10% in respect of payment of compensation on acquisition of certain immovable property. Similarly, 194 IA provides for deduction of tax at source at 1% in respect of any sum by way of consideration of transfer of any immovable property. While there is no change in these provisions, there has been an amendment to Section 40(ia) providing for disallowance of 30% in respect of any sum payable to a resident requiring deduction of tax at source, if the tax is not deducted and paid. Presently, these two sections are not found in Section 40(ia) and therefore non-deduction of tax at source would not have entailed disallowance in the hands of payer businessman. As a result of proposed amendment to Section 40(ia), a businessman who pays the aforesaid sums towards purchase of immovable property to be held by him as stock in trade, will have to suffer the disallowance of 30% if tax is not deducted at source.

Conclusion

On going through the aforesaid comments, the author is certain that the readers would agree with him that the proposals are largely non-friendly to the taxpayer. Given that the new government did not have sufficient time to appreciate the nuances associated with taxation of capital gains, it is hoped that in the next budget, appropriate corrective measures would be taken. ■