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Select Issues in Capital Gains

As is generally understood, revenue receipts constitute income whereas a capital receipt is not an income. But, under the provisions of the Indian tax law, a capital receipt can be charged to tax, if the following three conditions are satisfied:

1) There is a capital asset;
2) There is a transfer of a capital asset;
3) The capital gain is computed in accordance with the provisions of the Indian tax law

Let us briefly understand the above three conditions.

A capital asset means *property of any kind* held by an assessee. However, certain properties are excluded viz., stock-in-trade, rural agricultural land, personal effects, such as wearing apparel, furniture etc. held for personal use and certain bonds.

Transfer in relation to a capital asset includes inter alia, the sale, exchange or relinquishment of the asset, extinguishment of any right therein, conversion of a capital asset into stock-in-trade etc. Further, the Indian tax law also specifies certain transactions that are not to be treated as transfer for the purpose of capital gain. The date / year of transfer is material for levy of capital gain tax.

Capital Gain is computed by deducting following from the full value of consideration:

1) Cost of Acquisition;
2) Cost of Improvement; and
3) Expenditure incidental to transfer

Prior to AY 2012-13, as per judicial pronouncements, where the full value of consideration could not be determined, the above machinery provision would fail and therefore there would be no capital gain. However with effect from AY 2012-13, the fair market value on the date of transfer shall be deemed to be the full value of consideration where the actual consideration cannot be determined or is not ascertainable.

In this article, I shall cover some relevant updates / issues on the below:

1) Revised distance limits for Urban Agricultural Land

2) Shares and Securities Test – Held as Stock in trade vs. Investment

3) Depreciable Assets – Claim of Depreciation, Exemption benefits and set-off of losses

4) Family Arrangement – Asset acquired by Succession, Inheritance, Gift, Will etc.

5) Business Restructuring – Succession of a Sole Proprietary concern / Firm by a company

1. Revised distance limits for Urban Agricultural Land

An urban agricultural land is not excluded from the definition of a capital asset and as a result, profit and gain on sale of urban agricultural land is liable to capital gains tax. An Urban land is a land situated within the jurisdiction of municipality or cantonment board having population of more than ten thousand. Urban land also includes a land outside the urban area and situated within the specified distance from local limits of such urban area.

Upto AY 2013-14, such specified distance was eight kilometres.

From AY 2014-15, such specified distance is divided into three parts:

Urban Area Population	Specified Distance
Between 10,000 and 1,00,000	2 Kms
Between 1,00,000 and 10,00,000	6 Kms
More than 10,00,000	8 Kms

Further, upto AY 2013-14, the above distance was measured by road. However, from AY 2014-15, the distance has to be measured aerially.

2. Shares and Securities Test - Held as Stock in trade vs. Investment

The Indian tax law makes a distinction between a capital asset and a trading asset. Gain / Loss on sale of capital asset is taxable as capital gain and gain / loss arising of a trading asset is taxable as a business income.

The issue of whether shares and securities were held as investment or as stock-in-trade is often questioned by the income tax department and there are various judicial pronouncements laying down the factors for determining the same. A CBDT circular

has provided guidance in determining the nature of shares and securities as investment or stock-in-trade.

Though the issue is a mixed question of law and fact, yet the below tests help in establishing the nature of the share and securities:

i. **Claim accepted in earlier year accepted by department - principles of consistency**

   Under the same facts and circumstances, where the department has accepted holding the shares as investment, as per principle of consistency, the position cannot be allowed to change, merely because a different view is possible.

ii. **Holding Period of Shares**

   Holding period is not conclusive but it does indicate whether the transaction is for investment or for earning motive. The length of time, nature of dealings, how proceeds of sale are dealt with etc. would determine the question whether a particular transaction is in realization of investment or a sale in ordinary course of business.

iii. **Two separate portfolios**

   To establish the nature of investment vis-a-vis business activity, assessee may maintain two separate portfolios i.e. one for investment and another for stock-in-trade.

iv. **Intention of the assessee**

   Intention at the start of the activity, which is reflected in the conduct of the assessee and the way he treats the transaction is the most important factor to be considered keeping in view the adjoining circumstances.

v. **Volume and number of transactions, quantum of investments**

   The frequency, volume and value of transaction though critical cannot be the only criteria for determining the nature of activities carried on by the assessee.

vi. **Use of borrowed funds**

   The use of borrowed funds for the purpose of buying shares has often been considered by Courts as an indication as to the share transaction activity being in the nature of investment or business.

3. **Depreciable Assets - Claim of Depreciation, Exemption benefits and set-off of losses**

Where the capital asset is an asset forming part of a block of asset in respect of which depreciation has been claimed, in computing capital gain, the cost of acquisition of such a depreciate asset shall be computed as under:

i. Written down value of such block of assets at beginning of the previous year;

ii. Actual cost of any asset acquired during the previous year and falling in block;

iii. Expenditure incurred wholly and exclusively for such transfer(s).

The difference between the full value of consideration and cost of acquisition as computed below shall be deemed to be short term capital gain.

The intention behind this provision is that assessee should not enjoy double benefits i.e. depreciation as well as indexation.Accordingly, judicial pronouncements have held that where depreciation has neither been claimed nor been allowed on a particular asset, the above computation provision is not applicable.

Further, the above provision is only to deem the transaction of capital gain on depreciable asset as short term capital gain and not to deem an otherwise long-term capital asset as short-term capital asset. Accordingly, when an assessee transfers an asset for which depreciation has been allowed but the asset is a 'long term', as per various judicial pronoun cements, the assessee is eligible for relevant exemptions under the Income tax law. Also, brought forward loss out of long term capital asset can be set off against gains computed above.

4. Family Arrangement – Asset acquired by succession, inheritance, gift, will etc.

A family arrangement does not amount to transfer and hence not exigible to capital gain.

Further, where the capital asset has become the property of the assessee by way of gift, will, succession, inheritance or the asset is acquired at the time of partition of family or under a revocable or irrevocable trust or under amalgamation, etc., the period of holding shall include the period for which the asset was held by the previous owner. And the cost of acquisition shall be deemed to be the cost for which the previous owner of the property acquired it.

5. Business Restructuring – Succession of a Sole Proprietary concern / Firm by a company

As per provisions of the Indian tax law, where a sole proprietary concern / partnership firm is succeeded by a company in the business carried on by it as a result of which the sole proprietary concern / partnership firm sells or otherwise transfers any capital asset or intangible asset to the company, the same shall not be liable to capital gains tax provided that certain conditions are fulfilled.

The cost of acquisition of the capital asset in such a case shall be deemed to be the cost for which the previous owner acquired it plus the cost of any improvements of the assets incurred or borne by the previous owner or the assessee.

If the conditions specified are violated, the profits and gains from the transfer of capital asset not charged to tax earlier shall be deemed to be income chargeable under the head capital gain of the successor company for the previous year in which the conditions are not complied with.

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