2007-08, Rs. 15,000 is taxable by virtue of section 41(1) for the previous year 2007-08. It is taxable even if it is a unilateral act and the other party has not discharged liability of the taxpayer.

156.1-5 *SECTION 41(1) IS APPLICABLE EVEN IF THE BUSINESS IS NOT IN EXISTENCE* - The rules given above are applicable even if in the year of recovery, the business is not in existence.

156.1-6 *REVENUE HAS TO PROVE THAT CONDITIONS ONE AND TWO ARE SATISFIED* - If the revenue fails to discharge its burden to prove deduction or allowance has been made in any of the earlier years (*i.e.*, condition one), section 41(1) cannot be invoked—*Steel & General Mills Co. Ltd.* v. *CIT* [1974] 96 ITR 438 (Delhi), *CIT* v. *Nathubhai Desabhai* [1981] 130 ITR 238/5 Taxman 214 (MP). Section 41(1) creates liability only in those cases where an allowance has been actually granted and not where income has been merely estimated.

For instance, the assessee has returned his income for the assessment year 2006-07 after deducting Rs. 70,000 as liability towards bonus payable to employees. However, the assessment is completed under section 144 and there is no evidence to show that, while making the best judgment assessment, the Assessing Officer has taken the liability to pay bonus into consideration. Later on in the previous year 2009-10, only Rs. 20,000 is paid as bonus, as full and final payment. Rs. 50,000 is not taxable as deemed income of the previous year 2009-10—*Tirunelveli Motor Bus Service Co. (P.) Ltd.* v. *CIT* [1970] 78 ITR 55 (SC).

Similarly where, as a result of a successful suit, the assessee-firm gets a refund of the sales tax paid by it in earlier years for which it has not been granted any deduction in earlier years, the amount of sales tax refunded cannot be brought to tax under section 41(1)—*CIT* v. *Nathabhai Desabhai* [1981] 5 Taxman 214 (MP).

156.1-6a EVEN CONDITION TWO SHOULD BE SATISFIED - Unless it is proved by the revenue that *Condition two* is satisfied (*i.e.*, there has been remission or cessation of liability), section 41(1) cannot be pressed into action. The factum of remission or cessation cannot be presumed.

It can be discharged by the revenue with the help of positive evidences and not on the basis of inference drawn by the revenue (*e.g.*, failure of the assessee to co-operate with the Assessing Officer for which there are other penal remedies with the revenue).

156.1-7 *PROVISIONS ILLUSTRATED* - To clarify the above provisions, one can analyse the following examples —

1. Rs. 1,50,000 is paid as sales tax by X during the previous year 2007-08 and the same is allowed as deduction. The taxpayer claims a refund of Rs. 10,000 on June 16, 2008 from the sales tax department after getting a favourable verdict from the Delhi High Court. Rs. 10,000 is taxable for the previous year 2008-09, even if the business is not in existence during 2008-09.

2. Suppose in *1 supra* before the verdict of the Delhi High Court, X dies and the business is continued by his son Y who gets a refund of Rs. 10,000 from the sales tax department, then Rs. 10,000 is taxable as business income of Y.

3. Suppose in *1* (*supra*), the sales tax department refunds Rs. 10,000 on June 16, 2008 (after the Delhi High Court judgment) but the department files an appeal to the Supreme Court and the appeal is pending before the Supreme Court. In this case the refund of Rs. 10,000 obtained by X is taxable as business income of the previous year 2008-09. If the Supreme Court upholds the levy of sales tax later on and X pays Rs. 10,000 on January 25, 2010, then Rs. 10,000 will be deductible for the previous year 2009-10 by virtue of section 43B.

4. X Ltd. purchases goods on credit from different parties and claims deduction on "accrual" basis. Generally, these bills are paid at the Bombay office within 6 months of submission of delivery documents signed by the incharge of the Pune depot. As some of these documents are misplaced by A, one of the suppliers, he could not claim payment of a bill of Rs. 20,000 pertaining to 2004-05, although X Ltd. has claimed deduction during the same year. After the expiry of limitation period of three years, during 2008-09 the company credits the same in its profit and loss account, although A, the supplier, has not discharged the liability of the company. Rs. 20,000, in this case, is chargeable to tax by virtue of section 41(1) as business income of the assessment year 2009-10.

156.1-8 *JUDICIAL PRONOUNCEMENTS* - The following points also need consideration—

- *Order of refund by sales tax authority* - Where by virtue of a High Court judgment, the assessee becomes entitled to refund of sales tax which had been granted deduction in an earlier year, the amount so refunded is assessable in the assessment year relevant to the previous year in which order of refund is passed by the Sales Tax Officer and not with reference to the year in which judgment is given by the court—*CIT* v. *Rashmi Trading* [1976] 103 ITR 312 (Guj.).
- *Refund of sales tax as development subsidy* - Where sales tax is refunded as development subsidy as part of the State Government scheme for State's development, it would be deemed to be the

assessee's income if such sales tax has been allowed deduction earlier—*CIT* v. *Sahney Steel & Press Works Ltd.* [1984] 17 Taxman 403 (AP).

▪ *Insurance compensation* - Where loss of stock-in-trade destroyed in fire has been allowed to the assessee as deduction in earlier year and subsequently the assessee receives insurance compensation for such loss, the entire amount of insurance award is taxable under section 41(1)—*Investors Corporation* v. *CIT* [1993] 201 ITR 378 (Cal.).

▪ *Gratuity liability* - Where the assessee-company sells its tea estate to another company which also takes over the assessee's liability to pay gratuity, gratuity liability already allowed as deduction to the assessee cannot be taxed under section 41(1)—*CIT* v. *Jay Shree Tea & Industries Ltd.* [1993] 68 Taxman 334 (Cal.).

▪ *Partnership firm* - X is a partner in a firm : A Co. He has contributed Rs. 15,000 as capital. He retires from the firm with effect from April 1, 2008. During the period of three preceding years ending with March 31, 2008, the firm had run into losses ; the share of X being Rs. 21,000. Under the agreed terms of the retirement of X, the capital contribution of Rs. 15,000 paid by him is returned and his share of loss of Rs. 21,000 is forgiven. The loss of Rs. 21,000 forgiven by the firm, is not taxable under section 41(1). In the instant case, the share of loss can hardly be regarded as a benefit or a remission given to him in respect of any loss incurred by him for which any allowance/deduction has been granted earlier within the meaning of section 41(1)—*CIT* v. *N. Rudrappan* [1983] 15 Taxman 43 (Mad.).

▪ *Separate account* - Provisions of section 41(1) can be invoked to tax excise duty refunds received in the relevant assessment year even when the part of excise duty was not claimed as expenditure in the profit and loss account of earlier years and the assessee had kept a separate account in respect of collection and payment of excise duty—*Mysore Thermo Electric (P.) Ltd.* v. *CIT* [1996] 221 ITR 504/89 Taxman 558 (Kar.).

▪ *Refund of sales tax* - Refund of sales tax or excise duty which the assessee is required to pass on to customers cannot be brought to tax under section 41(1)—*CIT* v. *East Asiatic Co. India (P.) Ltd.* [1996] 217 ITR 347 (Mad.), *CIT* v. *Wolkom (P.) Ltd.* [1996] 136 CTR (Raj.) 125. Sales tax refund received by the assessee which is not refunded by it to the customers will, however, be a revenue receipt liable to tax under the express provisions of section 41(1)—*CIT* v. *Thirumalaiswamy Naidu & Sons* [1998] 98 Taxman 57/230 ITR 534 (SC).

Where refund of excise duty received by the assessee is taken to balance sheet in an account described as "excise duty refundable to customers retained as deposit against free services to be rendered" and thus, the assessee has acknowledged balance owed to its customers, such refund of excise duty is not taxable in the assessee's hands under section 41(1)—*Navjivan Udyog Mandir (P.) Ltd.* v. *CIT* [1994] 117 CTR (Guj.) 360.

▪ *Refund of tax collected under unconstitutional provision of a law* - Refund of litre fee to the assessee, collected by the State Government pursuant to certain legislation which was declared invalid by the High Court, is assessable under section 41(1)—*K.G. Subramanyam* v. *CIT* [1991] 100 CTR (Kar.) 135.

▪ *Time barred liability* - Section 41(1) will not be attracted for an assessee (being entitled to make payment in respect of a debt) when debt becomes time barred. But it shall be attracted if a liability or a time barred liability is written off in the books of account.

▪ *"Expenditure" under section 41(1) covers even capital expenditure* - The Bombay High Court in ***Nector Beverages (P.) Ltd.*** v. ***CIT*** [2004] 139 Taxman 70, held that the expression 'expenditure' under section 41(1) is wide enough and it would include not only revenue but also capital expenditure.

▪ In ***Jehangir Gullabbhai*** v. ***CIT*** [2008] 21 SOT 603 (Mum.) the assessee-firm, following cash system of accounting on regular basis, had some amounts outstanding from its clients on the liability side of the balance sheet.

The amount representing outstanding from the clients is not an income and, hence, cannot be taxed, as the method of accounting followed by the assessee is cash basis. Provisions of section 41(1) can be applied only where the assessee has obtained in cash or in any other manner a benefit in respect

of loss, expenditure or trading liability, which was allowed as a deduction in any earlier previous year.

156.2 ***Balancing charge [Sec. 41(2)]*** - *See* para 109.11-2.

156.3 ***Sale of assets used for scientific research [Sec. 41(3)]*** - Where any capital asset used in scientific research is sold *without having been used for* other purposes and the sale proceeds, together with the amount of deduction allowed under section 35, exceed the amount of the capital expenditure, such surplus or the amount of deduction allowed, whichever is less, is chargeable to tax as business income in the year in which the sale took place.

For instance, a company purchases scientific research equipment for Rs. 75,000 during the previous year 1999-2000 and claims Rs. 75,000 as deduction under section 35 for the assessment year 2000-01. If the company sells the equipment (without using it for purposes other than scientific research) in 2008-09 for Rs. 40,000, then Rs. 40,000 will be chargeable to tax for the assessment year 2009-10 even if the assessee's business is not in existence during the previous year 2008-09.

It may be noted that section 41(3) is applicable only if an asset is sold without having been used for other purposes. In other words, if an asset which is initially purchased for the purpose of scientific research is utilised for business purposes on completion of scientific research, and later on it is sold or transferred, then section 41(3) is not applicable [*see* para 114.3 for detailed study].

156.4 ***Recovery of bad debt [Sec. 41(4)]*** - Where any bad debt has been allowed as deduction under section 36(1)(*vii*) and the amount subsequently recovered on such debt is greater than the difference between the debt and the deduction so allowed, the excess realisation is chargeable to tax as business income of the year in which the debt is recovered. For this purpose, it is immaterial whether the business of the assessee is in existence (or not) during the previous year in which recovery is made. Under section 41(4), the relevant criterion is the identity of the assessee remaining the same and not the continued existence of the business. If there is a succession in business by way of amalgamation, demerger, or on death of a person by his son, or where a firm is succeeded by another firm then recovery of bad debt is taxable as business income if the bad debt was earlier allowed as deduction to the predecessor [sec. 41(1), *see* para 156.1].

- *See* problem 132.5-P1.

156.5 ***Amount withdrawn from special reserve [Sec. 41(4A)]*** - *See* para 134.3.

156.6 ***Adjustment of loss [Sec. 41(5)]*** - *See* para 229.1-3.

156.7 ***Recovery after discontinuance of business or profession [Sec. 176(3A), (4)]*** - Where any business or profession is discontinued by reason of the retirement or death of the person carrying on such business or profession, any sum received after the discontinuance of the business or profession is deemed to be the income of the recipient and charged to tax in the year of receipt.

It may be noted that, if accounts are maintained on mercantile basis, any receipt after discontinuance of the business or profession must necessarily have accrued and been charged during the continuance of the business or profession and nothing would be chargeable to tax in the year of receipt of income. If, however, books of account are maintained on cash basis and some of the profits are received after the discontinuance of business or profession, it would be chargeable to tax under section 176(3A), (4) in the year of receipt of income even if business or profession is not carried on during that year.

Income from undisclosed sources

157. The following are treated as income from undisclosed sources :

157.1 ***Cash credit [Sec. 68]*** - Where any sum is found credited in the books of an assessee maintained for any previous year and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year.

157.2 ***Unexplained investments [Sec. 69]*** - Where in the financial year immediately preceding the assessment year, the assessee has made investments which are not recorded in the books of account, if any, maintained by him for any source of income and the assessee offers no explanation

about the nature and source of the investments or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the value of the investments may be deemed to be the income of the assessee for such financial year.

157.3 ***Unexplained money, etc. [Sec. 69A]*** - Where in any financial year the assessee is found to be the owner of any money, bullion, jewellery or other valuable article and such money, bullion, jewellery or valuable article is not recorded in the books of account, if any, maintained by him for any source of income, and the assessee offers no explanation about the nature and source of acquisition of the money, bullion, jewellery or other valuable article, or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the money and the value of the bullion, jewellery or other valuable article may be deemed to be the income of the assessee for such financial year.

157.4 ***Amount of investments, etc., not fully disclosed in the books of account [Sec. 69B]*** - Where in any financial year the assessee has made investments or is found to be the owner of any bullion, jewellery or other valuable article and the Assessing Officer finds that the amount expended on making such investments or in acquiring such bullion, jewellery or other valuable article exceeds the amount recorded in this behalf in the books of account maintained by the assessee for any source of income and the assessee offers no explanation about such excess amount or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the excess amount may be deemed to be the income of the assessee for such financial year.

157.5 ***Unexplained expenditure, etc. [Sec. 69C]*** - Where in any financial year, an assessee has incurred any expenditure and he offers no explanation about the source of such expenditure or part thereof, or the explanation, if any, offered by him is not, in the opinion of the Assessing Officer, satisfactory, the amount covered by such expenditure or part thereof, as the case may be, may be deemed to be the income of the assessee for such financial year.

The proviso to section 69C provides that notwithstanding anything contained in any other provision of the Act, such unexplained expenditure which is deemed to be the income of the assessee shall not be allowed as a deduction under any head of income.

157.6 ***Amount borrowed or repaid on hundi [Sec. 69D]*** - Where any amount is borrowed on a hundi from, or any amount due thereon is repaid to, any person otherwise than through an account payee cheque drawn on a bank, the amount so borrowed or repaid shall be deemed to be the income of the person borrowing or repaying the amount aforesaid for the previous year in which the amount was borrowed or repaid, as the case may be. To avoid double taxation, it has been provided that if any amount borrowed on a hundi has been deemed under the provisions of the section to be the income of any person, such person should not be liable to be assessed again in respect of such amount under the provisions of this section on repayment of such amount. Moreover, for the purpose of this section, the amount repaid includes the amount of interest paid on the amount borrowed.

Maintenance of accounts by certain persons [Sec. 44AA]*

158. To understand provisions of compulsory maintenance of books of account by certain persons, one must know the meaning of terms "specified professions" and "non-specified professions".

158.1 ***"Specified profession"*** - For the purpose of section 44AA and rule 6F legal, medical, engineering, architectural, accountancy, technical consultancy, or interior decoration or any other notified professions [*i.e.*, authorised representative, film artist, company secretary and information technology] are specified professions.

For this purpose "authorised representative" means a person, who represents any other person, on payment of any fee or remuneration, before any Tribunal or authority constituted or appointed by or under any law for the time being in force, but does not include an employee of the person so represented or a person carrying on legal profession or a person carrying on the profession of accountancy.

*Section 44AA cannot be said to offend article 14 of the Constitution— *H.A.K. Rao* v. *Union of India* [1991] 189 ITR 322 (Kar.).

"Film artist", for the aforesaid purpose, means any person engaged in his professional capacity in the production of a cinematograph film, whether produced by him or by any other person as an actor, a cameraman, a director, a music director, an art director, a dance director, an editor, a singer, a lyricist, a story writer, a screen play writer, a dialogue writer, and a dress designer.

158.2 *"Non-specified profession"* - A non-specified profession is a profession other than a "specified profession" mentioned above.

158.3 *Requirement of compulsory maintenance of books of account* - The requirement of section 44AA and rule 6F for compulsory maintenance of books of account may be summarised by grouping different taxpayers in the following categories :

Different categories	*Taxpayers who come under these categories*	*Requirement of maintenance of books of account*
Category A	Persons carrying on "specified professions" if their gross receipts in the profession do not exceed Rs. 1,50,000 in any of the three years immediately preceding the previous year (or where the profession has been newly set up in the previous year, his gross total receipts in the profession for that year are not likely to exceed the said amount).	Persons coming under this category are required to maintain such "books of account and other documents" as may enable the Assessing Officer to compute their taxable income under the Income-tax Act. The Board has not prescribed specified books of account which should be maintained for the persons falling under this category.
Category B	Persons carrying on "specified professions" if their gross receipts in the profession exceed Rs. 1,50,000 in all† the three years immediately preceding the previous year (or where the profession has been newly set up in the previous year, his gross total receipts in the profession for that year are likely to exceed the said amount).	Persons coming in this category are required to maintain such books of account as are prescribed by rule 6F [*see* para 158.4 *infra*]
Category C	Persons carrying on a "non- specified profession". It also includes persons carrying on any business if their income from such profession or business does not exceed Rs. 1,20,000, and the total sales, turnover or gross receipts thereof are not in excess of Rs. 10,00,000, in all the three years immediately preceding the previous year (or when the profession or business is newly set up, income/total sales, turnover or gross receipts are not likely to exceed the said amount).	Persons coming under this category are not required to maintain any books of account.
Category D	Persons carrying on a "non-specified profession". It also includes persons carrying on any business if their income from such profession or business exceeds Rs. 1,20,000 or the total sales, turnover or gross receipts thereof are in excess of Rs. 10,00,000 in any of the three years immediately preceding the previous year (or when the profession or business is newly set up, income/total sales, etc., are likely to exceed the said amount). Moreover, this category includes, an assessee, covered under section 44AD or 44AE or 44AF or 44BB or 44BBB if it is claimed that the profits and gains from the business are lower than the profits and gains computed under these sections.	Persons falling under this category are required to maintain such "books of account and other documents" as may enable the Assessing Officer to compute their taxable income under the Income-tax Act. However, the Board has not prescribed specified account books to be maintained for this category.

Conclusion - In brief, it can be said that all taxpayers (except those falling under *Category C supra*) are required to maintain books of account for computation of taxable income by the income-tax department, though the Board has prescribed specific account books only for those who come under *Category B*.

†*See A. Keshava Bhat* v. *ITO* [2001] 115 Taxman 208 (Ker.).

158.4 ***Specified books of account*** - The Board has specified certain books of account under rule 6F for the professionals‡ falling under *Category B supra.* The prescribed books are as follows—

a. a cash book (*i.e.*, a record of all cash receipts and payments, kept and maintained from day-to-day and giving the cash balance in hand of each day or at the end of a specified period not exceeding a month) ;

b. a journal, if the accounts are maintained according to the mercantile system of accounting ;

c. a ledger ;

d. carbon copies of bills (whether machine numbered or, otherwise serially numbered) exceeding Rs. 25, issued by the person and carbon copies or counterfoils of machine numbered or otherwise serially numbered receipts issued by the person ;

e. original bills wherever issued to the person and receipts in respect of expenditure incurred by the person or, where such bills and receipts are not issued and the expenditure incurred does not exceed fifty rupees, payment vouchers prepared and signed by the person (preparation of vouchers is not necessary where cash books contain adequate particulars of expenditure).

Apart from the aforesaid books of account and documents, a person carrying on medical profession (*i.e.*, a practitioner of any system of medicine—physicians, surgeons, dentists, pathologists, radiologists, vaids, hakims, etc.) is required to keep the following additional books/documents :

a. a daily case register in Form No. 3C showing date, patient's name, nature of professional services rendered (*i.e.*, general consultation, surgery, injection, visit, etc.,) fees received and date of receipt ; and

b. an inventory under broad heads, as on the first and the last days of the previous year, of the stock of drugs, medicines, and other consumable accessories used for the purpose of his profession.

The following points also need consideration :

▪ The aforesaid books of account and documents (other than those relating to a previous year which has come to an end) should be kept and maintained by the person at the place where he is carrying on the profession or, where the profession is carried on in more places than one, at the principal place of his profession. If, however, the person keeps and maintains separate books of account in respect of each place where the profession is carried on, such books of account and other documents may be kept and maintained at the respective places at which the profession is carried on.

▪ The aforesaid books of account and documents should be kept and maintained for a period of 6 years from the end of the relevant assessment year.

▪ Where, however, the assessment in relation to any assessment year has been reopened under section 147, all the books of account and other documents which were kept and maintained at the time of reopening of the assessment should continue to be so kept and maintained till the assessment so reopened has been completed.

Audit of accounts of certain persons [Sec. 44AB]

159. The provisions of section 44AB are given below —

159.1 ***Who has to get his accounts audited on compulsory basis*** - The following persons are required to get their accounts compulsorily audited by a chartered accountant —

Different taxpayers	*When they are covered by the provisions of compulsory audit under section 44AB*
A person carrying on business	If the total sales, turnover or gross receipt in business for the previous year(s) relevant to the assessment year exceed or exceeds Rs. 40 lakh*.
A person carrying on profession	If his gross receipts in profession for the previous year(s) relevant to the assessment year exceeds Rs. 10 lakh.

‡These rules do not apply to a company since a company cannot carry on profession—***ITO*** v. ***Ashalok Nursing Home (P.) Ltd.*** [2006] 156 Taxman 86 (Mag.) (Delhi).

*For purpose of attracting section 44AB, receipts of an assessee by way of sale or trading business and receipts for doing job work can be clubbed to find out whether limit of Rs.40 lakh prescribed for attracting provisions of section 44AB is made out—***Bajrang Oil Mills*** v. ***ITO*** [2007] 163 Taxman 154 (Raj.).

Different taxpayers	*When they are covered by the provisions of compulsory audit under section 44AB*
A person [covered under section 44AD, 44AE, 44AF, 44BB or 44BBB]	If such person claims that the profits and gains from the business are lower than the profits and gains computed under these sections (irrespective of his turnover).

Note : Section 44AB is not applicable in the case of assessees who come within the purview of section 44B or 44BBA.

159.2 ***Due date for getting books audited/submission of audit report and Form No.*** - These provisions are given in the table below—

Different taxpayers	*Audit Form No.*	*Statement particulars*	*Due date for getting books audit*	*Due date for submission of audit report*
In the case of a person who carries on business or profession and who is required by or under any law to get his accounts audited	Form No. 3CA	Form No. 3CD	September 30 of the assessment year	September 30 of the assessment year
In the case of a person who carries on business or profession but not being a person referred to above	Form No. 3CB	Form No. 3CD	September 30 of the assessment year	September 30 of the assessment year

Notes :

1. In cases where accounts are required to be audited by or under any other law (as in the case of companies and co-operative societies), it is sufficient if accounts are audited under such other law before September 30 of the assessment year and the assessee obtains before the said date, a report of the audit as required under such law and also a report of audit from a chartered accountant in the forms given above.

2. After the introduction of new return forms, the report of audit under section 44AB shall not to be attached with the return. It should not be furnished separately also before or after the due date. However, an assessee should get the report of audit before the due date of the furnishing of the return and should fill out the relevant columns of return forms on the basis of such report. The assessee should retain the report with himself. It may be furnished in original during the assessment proceedings. No penalty under section 271B shall be initiated or levied for not furnishing the tax audit report on or before the due date. However, if the audit report has not been obtained before the due date, provisions of section 271B shall be attracted.

159.3 ***Other points*** - One should note the following—

- *Penalty* - If any person fails to get his accounts audited or to furnish a report of such audit as required under the aforesaid provision, the Assessing Officer may impose penalty. The penalty can be a sum equal to one-half per cent of the total sales, turnover or gross receipts, subject to a maximum of Rs. 1 lakh.
- *Exemptions* - If income is exempt under sections 10 to 13A, then audit under section 44AB is not required—*CIT* v. *India Magnum Fund* [2002] 81 ITD 295 (Mum.). If, however, income is chargeable to tax, audit under section 44AB is applicable (when turnover is above Rs. 40 lakh or gross receipt etc., is above Rs. 10 lakh) even if in a particular year no tax is payable (*e.g.*, income is lower than exempted slab or income is negative).
- *Work-in-progress* - Value of work-in-progress in case of the assessee engaged in construction of shops/flats would not constitute 'turnover' within meaning of section 44AB—*CIT* v. *B.K. Jhala & Associates* [1999] 69 ITD 141 (Pune).

■ *Brokers* vis-a-vis *turnover*- Transactions by a shareholder of sale and purchase of shares on behalf of parties cannot amount to 'sale turnover or receipt' of sharebroker himself within meaning of section 44AB—***CIT*** v. ***Hasmukh M. Shah*** [2003] 85 ITD 99 (Ahd.).

159.4 ***Clarification from the Board*** - On the basis of various court pronouncements, the following principles of distinction can be laid down between a *kachha arahtia* and a *pacca arahtia*:

■ A *kachha arahtia* acts only as an agent of his constituent and never acts as a principal. A *pacca arahtia*, on the other hand, is entitled to substitute his own goods towards the contract made for the constituent and buy the constituent's goods on his personal account and thus he acts as a principal as regards his constituent.

■ A *kachha arahtia* brings a privity contract between his constituent and the third party so that each becomes liable to the other. The *pacca arahtia*, on the other hand, makes himself liable upon the contract not only to the third party but also to his constituent.

■ The remuneration of a *kachha arahtia* consists solely of commission and he is not interested in the profits and losses made by his constituent which is not the case with the *pacca arahtia*.

■ The *kachha arahtia*, unlike the *pacca arahtia*, does not have any dominion over the goods.

■ The *kachha arahtia* has no personal interest of his own when he enters into a transaction and his interest is limited to the commission agent's charges and certain out of pocket expenses whereas a *pacca arahtia* has a personal interest of his own when he enters into a transaction.

■ In the event of any loss, the *kachha arahtia* is entitled to be indemnified by his principal as is not the case with *pacca arahtia*.

The above distinction between a *kachha arahtia* and *pacca arahtia* may also be relevant for determining the applicability of section 44AB in the cases of other types of agents. In the case of agents whose position is similar to that of *kachha arahtia*, the turnover is only the commission and does not include sales on behalf of the principals. In the case of agents of the types of *pacca arahtia*, on the other hand, the total sales/turnover of the business should be taken into consideration for determining the applicability of the provisions of section 44AB—Circular No. 452, dated March 17, 1986.

Special provisions consequential to changes in the rate of exchange of currency [Sec. 43A]

160. The salient features of section 43A (as modified by the Finance Act, 2002) are given below—

1. An assessee acquires an asset in any previous year. The asset may be a depreciable asset or otherwise. Section 43A is not applicable if an asset is not acquired.

2. The asset is acquired from a country outside India.

3. The asset is acquired for the purpose of business or profession of the taxpayer.

4. In consequence of a change in the rate of exchange during any previous year after the acquisition of such asset, there is an increase or reduction in the liability of the assessee as expressed in Indian currency (as compared to the liability existing at the time of acquisition of the asset) at the time of making payment—

a. towards the whole or a part of the cost of the asset ; or

b. towards repayment of the whole or a part of the moneys borrowed by him from any person, directly or indirectly, in any foreign currency specifically for the purpose of acquiring the asset along with interest, if any.

5. The amount by which the liability as stated in (*4*) (*supra*) is increased/reduced during the previous year and which is taken into account at the time of making the payment (hereinafter referred to as

"year of payment") irrespective of the method of accounting adopted by the assessee, shall be added to, or, as the case may be, deducted from—

a. the actual cost of the asset as defined in section 43(*1*);

b. the amount of expenditure on scientific research of a capital nature referred to section 35(1)(*iv*);

c. the amount of expenditure of capital nature referred to in section 35A;

d. the amount of expenditure on family planning of capital nature referred to in section 36(1)(*ix*);

e. the cost of acquisition of a capital asset (not being a depreciable asset referred to in section 50) for the purposes of section 48.

6. The amount arrived at after such addition (or deduction) shall be taken to be the actual cost of the asset or the amount of capital expenditure or, as the case may be, the cost of acquisition of the capital asset.

160.1 ***Adjustment already made*** - If to the extent an adjustment has already been made under the old version of section 43A (applicable up to the assessment year 2002-03) on "accrual" basis, no adjustment can be made at the time of actual "payment" towards the cost of asset, or repayment of loan, etc.

160.2 ***AS-11*** **vis-a-vis** ***section 43A*** - As per AS-11 of ICAI, the liability expressed in foreign currency at the close of the year has to be increased/decreased based on the rates prevailing at the close of the year when corresponding increase/decrease has to be effected in the value of assets. The amendment of section 43A as stated above provides for increase/decrease only for currency fluctuation at the time of payment. This will have a major implication for increase/decrease in unpaid foreign currency liability as though value of assets for the same has to be increased/decreased in the books of account, the same would not be eligible for depreciation under the income-tax computation.

160.3 ***Extra liability met by other persons*** - Where a whole or a part of such liability is to be met directly or indirectly by any other person or authority, it is to be ignored. Further, where an assessee has entered into a contract with an "authorised dealer" in foreign exchange for providing him with a specified sum in foreign currency on or after a stipulated future date at an agreed rate of exchange, to enable the assessee to meet the whole or part of the liability referred to above, the increase or reduction in the assessee's liability in respect of sum specified in the contract is to be worked out with reference to the rate of exchange at which the assessee is to receive foreign currency from the authorised dealer under the contract.

160.4 ***Capitalisation is not a must*** - For the applicability of section 43A, it is enough that increase in liability must relate to the capital asset and it would not make any difference as to whether the assessee capitalises the said increase in liability or not—*CIT* v. *Tata Hydro Electric Power Supply Co. Ltd.* [1986] 159 ITR 28 (Bom.).

160.5 ***Tax treatment of foreign exchange fluctuations under different circumstances*** - Tax treatment of gain or loss because of foreign exchange fluctuations is given in the Table below—

Loss/gain due to exchange fluctuation	*Mode of maintaining books of account by the taxpayer*	
	Mercantile	*Cash*
■ REVENUE ACCOUNT		
❑ Gain on revenue account	Taxable under section 28 on accrual basis	Taxable under section 28 on receipt basis
❑ Loss on revenue account	Deductible under section 28 or 37(1) on accrual basis	Deductible under section 28 or 37(1) on payment basis

Loss/gain due to exchange fluctuation	*Mode of maintaining books of account by the taxpayer*	
	Mercantile	*Cash*
■ CAPITAL ACCOUNT		
❑ *Section 32 read with section 43(1)* - Increase/decrease in the cost of depreciable asset due to exchange fluctuation [*See* Note]	Added/deducted in the block in the year of actual payment	Added/deducted in the block of asset in the year of actual payment
❑ *Section 35(1)(iv), 35A or 36(1)(ix)* - Increase/decrease in the amount of capital expenditure due to exchange fluctuation	Taken into account in the year of payment	Taken into account in the year of payment
❑ *Section 48* - Increase/decrease in cost of acquisition of a capital asset	Added to, or deducted from, the cost of acquisition in the year of payment	Added to, or deducted from, the cost of acquisition in the year of payment
❑ *Any other* - Gain or loss of capital nature (not covered by the sections noted above) due to foreign exchange fluctuation	Not taxable or deductible	Not taxable or deductible

Note - Any increase/decrease in the cost of a depreciable asset due to exchange fluctuation is added (deducted) in the block of asset in the year of payment.

If the aforesaid increase/decrease in cost due to exchange fluctuation arises after the depreciable asset is transferred (but block of asset exists), then the increase/decrease in the cost will be adjusted in the written down value of block of asset. If, however, the increase/decrease in cost due to exchange fluctuation arises after the depreciable asset is transferred and the block of asset does not exist, then increase/decrease will be capital receipt/expenditure which is not chargeable/deductible under any other provision of the Act.

160.6 ***Section 43A overrides other provisions*** - The above provisions of section 43A contain a special provision consequent to changes in rate of exchange of currency. The section starts with the *non obstante* clause and enables capitalisation of the loss due to fluctuations in foreign exchange rate. This section overrides all other provisions of the Act—*Oil & Natural Gas Commission* v. *CIT* [1999] 69 ITD 69 (Delhi).

Special provision for deduction in the case of trade, professional or similar associations [Sec. 44A]

161. To understand the implications of section 44A, one should note that if a loss arises from a business whose income is taxable, it can be set-off against taxable income. Where income from a particular source is not chargeable to tax, a loss from such source cannot be set-off against income chargeable to tax. To this general provision, an exception is provided by section 44A.

Under section 44A, in the case of a trade, professional or similar association [other than an association mentioned in section 10(*23A*)—*see* para 38.44] which does not distribute any part of its income to its members, the amount of any deficiency [being excess of revenue expenditure[1], incurred for the advancement of the common interest of the members of the concerned association, over receipts from its members, exclusive of remuneration for rendering any specific services to such members] is allowed as deduction from the assessable income of the association to the extent of 50 per cent of the assessable income as arrived at before allowing the aforesaid deduction.

The aforesaid deduction is allowed first from the income of the association chargeable under the head "Profits and gains of business or profession", and for the balance amount, if any, from the assessable income of the association under any other head. This deduction is allowable from the net assessable income of the association as computed after giving effect to the provisions in the Act for the carry forward of depreciation, investment allowance, development rebate and past business losses.

1. Expenditure includes depreciation—*CIT* v. *Indian Jute Mills Association* [1981] 6 Taxman 354 (Cal.).

Provisions illustrated - X Chamber of Commerce is an association of traders of South India.
The following data is availabl —

	Situation 1 Rs.	Situation 2 Rs.
Income derived from performing specific services for members (which is taxable) (a)	86,000	90,000
Surplus from other activities (not taxable) (b)	50,000	(—)1,60,000
Taxable income		
Income mentioned at (a)	86,000	90,000
Less : Loss from other activities but subject to maximum of 50% of (a)	-	45,000
Net income	86,000	45,000

Special provisions

162. Special provisions under sections 42, 43C, 43D, 44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, 44C, 44D, 44DA, 115A, 115AB, 115AC, 115AD, 115BBA and 115D are given below :

162.1 ***Computation of income of business for prospecting of mineral oil [Sec. 42]*** - Section 42 is applicable if the following conditions are satisfied—

1. The taxpayer may be a resident or a non-resident.

2. The taxpayer has a business consisting of the prospecting for or extraction or production of mineral oils. For this purpose "mineral oil" includes petroleum and natural gas.

3. In relation to the above business, the Central Government has entered into an agreement with the taxpayer for the association or participation of the Central Government (or any nominee of the Central Government) in such business.

4. The agreement has been laid on the Table of each House of Parliament.

If the above conditions are satisfied, then the following deduction shall be allowed as are specified in the agreement (these deductions may be in addition to, or lieu of, the allowances admissible under the Act)—

a. expenditure by way of infructuous or abortive exploration expenses in respect of any area surrendered prior to the beginning of commercial production;

b. after the beginning of commercial production, expenditure incurred by the assessee (whether before or after such commercial production) in respect of drilling or exploration activities or services or in respect of physical assets used in that connection;

c. allowances in relation to the depletion of mineral oil in the mining area in respect of the assessment year relevant to the previous year in which commercial production is begun and for such succeeding year or years as may be specified in the agreement;

The aforesaid allowances shall be computed in the manner specified in the agreement. It will be assumed that the other provisions of the Act are modified to give effect to the terms of the agreement. Section 42 cannot override the provisions of section 115JB—*Niko Resources Ltd.* v. *CIT* [1998] 101 Taxman 6/234 ITR 828 (AAR - New Delhi).

162.1-1 *TAX CONSEQUENCES WHEN BUSINESS IS TRANSFERRED* - The following provisions are applicable where the business of an assessee (or any interest therein) consisting of the prospecting for or extraction or production of petroleum/natural gas is transferred wholly or partly during a previous year—

Different situations	*Tax treatment*
■ Sale proceeds are less than the expenditure remaining unallowed.	Expenditure remaining unallowed *minus* sale proceeds shall be deductible in the year in which sale taken place.
■ Sale proceeds is more than the expenditure remaining unallowed	Sale proceeds *minus* the expenditure remaining unallowed (to the extent of deduction already allowed) is taxable as business*.

*No deduction shall be allowed in the previous year in which the business or any interest therein is transferred in case the proceeds of transfer are not less than the expenditure remaining unallowed.

- *Consequences in the case of amalgamation or demerger* - The provisions in relation to transfer of aforesaid business or any interest therein shall not apply in a scheme of amalgamation or demerger whereby the business or interest therein is transferred by the amalgamating company (or demerged company) to the amalgamated company (or resulting company), the latter being an Indian company.

Provisions illustrated - X Ltd. is engaged in the business of prospecting/production of mineral oils. It claims deduction under section 42. On March 10, 2009, X Ltd. transfers the aforesaid business. The following data is noted from the records of the company—

(*Rs. in lakh*)

	Situation 1	Situation 2	Situation 3	Situation 4
Total expenditure incurred	10,00	10,00	10,00	10,00
Expenditure allowed as deduction up to March 31, 2008 (a)	4,00	4,00	4,00	4,00
Expenditure remaining unallowed (b)	6,00	6,00	6,00	6,00
Proceeds of transfer (c)	5,00	7,00	15,00	6,00
Surplus [(c)—(b)] (d)	(-) 1,00	1,00	9,00	*Nil*
Amount allowable as deduction in the previous year 2008-09 [(b)—(c)]	1,00	*Nil*	*Nil*	*Nil*
Amount allowable as deduction in subsequent year	*Nil*	*Nil*	*Nil*	*Nil*
Amount chargeable to tax as business income for the previous year 2008-09 [(d) or (a), whichever is lower]	*Nil*	1,00	4,00	*Nil*

162.2 ***Computation of cost of acquisition of certain assets [Sec. 43C]*** - Section 43C is applicable in the following two cases—

1. Amalgamation [*see* para 516.4]

2. Transfer under gift, will, etc. [*see* para 162.2-1]

162.2-1 *GIFT, WILL, ETC.* - When an asset [not being an asset referred to in section 45(2)] which has been acquired by the assessee on transfer, either by way of total or partial partition of a Hindu undivided family or under a gift or will or an irrevocable trust, is sold after February 29, 1988, as stock-in-trade, then, in computing the profits and gains from the sale of such asset, the cost of acquisition shall be the cost of acquisition in the hands of the transferor or the donor, as increased by the cost of any improvement made and the expenditure incurred wholly and exclusively in connection with such transfer including the payment of gift-tax, by the transferor or the donor, as the case may be.

Provisions illustrated - X purchases a capital asset on May 1, 1981 for Rs..1,00,000 and for making some alteration he incurs an expenditure of Rs. 50,000. He gifts the asset to Y on June 5, 1994 (value of the asset being Rs. 2,30,000) and pays Rs. 54,000 as gift-tax on the same day. Y sells the asset as stock-in-trade on April 20, 2008 for Rs. 8,40,000. Business income of Y for the assessment year 2009-10 will be determined as follows—

	Rs.
Sale price of stock	8,40,000
Less :	
Cost to X	1,00,000
Cost of improvement	50,000
Gift-tax paid by X	54,000
Business income	6,36,000

162.3 ***Special provision in the case of income of financial institutions [Sec. 43D]*** - In the case of a public financial institution or a scheduled bank or a State financial corporation or a State industrial investment corporation, income by way of interest on such categories of bad and doubtful debts as may be prescribed [*see* rule 6EA of the Income-tax Rules] having regard to the guidelines issued by the Reserve Bank of India in relation to such debts, shall be chargeable to tax in the previous year in which it is credited to the profit and loss account by the said institutions for that year or in the previous year in which it is actually received by them, whichever is earlier.

- With a view to improving the viability of the housing finance companies, and to provide a boost to the housing sector, the above provisions have been extended with effect from the assessment year 2000-01 to companies registered with the National Housing Bank [*see* rule 6EB].

162.4 ***Computation of income on estimated basis in the case of taxpayers engaged in the business of civil construction [Sec. 44AD]*** - The provisions of section 44AD are given below —

162.4-1 WHO IS COVERED BY THE SCHEME OF SECTION 44AD - Section 44AD is applicable only if the following conditions are satisfied —

Condition 1	The taxpayer may be an individual, HUF, AOP, BOI, firm, company, co-operative society or any other person. He or it may be a resident or a non-resident.
Condition 2	The taxpayer is engaged in the business of civil construction or supply of labour for civil construction work.
Condition 3	Gross receipts from the above business do not exceed Rs. 40 lakh. Gross receipts are the amount received from the clients for the contract and will not include the value of material supplied by the client.

Notes—

1. What is civil construction - General meaning - The business of civil construction is broadly classified in three categories, developer, builder and contractor. A developer purchases land or rights therein and entrusts the work of actual construction to a contractor and sells the constructed flats. A builder is actively involved in the activity of construction and sale of flats. A contractor is engaged only in the construction. The provisions of section 44AD do not apply to a developer, as he is not involved in civil construction. It applies to builders and contractors .

2. Civil construction as defined in the Act - The expression "civil construction" includes the construction (or repair) of buildings, dams, bridges or other structures, or of roads or canals. It also includes the execution of any other work contract. It thus includes work related to electrical fittings, plumbing job, landscaping work, etc. The taxpayer may be a contractor or sub-contractor.

3. Interior decorator - Section 44AD has no application for computing income of an interior decorator as the business of interior decoration does not come under the business of civil construction—***CIT*** v. ***Sanjay Kataria*** [2004] 3 SOT 18 (Delhi).

162.4-2 CONSEQUENCES IF SECTION 44AD IS APPLICABLE - If the aforesaid three conditions are satisfied then section 44AD is applicable. The following are the consequences if section 44AD is applicable:

162.4-2a INCOME TO BE CALCULATED ON ESTIMATED BASIS @ 8 PER CENT - The income from the above mentioned business is estimated at 8 per cent of the gross receipts paid or payable to a taxpayer. A taxpayer can voluntarily declare a higher income in his return.

162.4-2b RATE OF 8 PER CENT IS COMPREHENSIVE - All deductions under sections 30 to 38 including depreciation and unabsorbed depreciation, are deemed to have been already allowed and no further deduction is allowed under these sections. However, in the case of a firm, the normal deduction in respect of salary and interest to partners under section 40(*b*) shall be allowed. The written down value is calculated, where necessary, as if depreciation as applicable has been allowed. Moreover, it will be assumed that disallowance, if any, under sections 40, 40A and 43B has been considered while calculating the estimated income @ 8 per cent.

After calculating income in accordance with the aforesaid provisions, one has to follow the following steps —

Step 1	The income as calculated above will be aggregated with income of the assessee from any other business or under other heads of income in accordance with the normal provisions of the Income-tax Act.
Step 2	The brought forward business losses (not being unabsorbed depreciation) and other losses shall be deducted according to the normal provisions of the Income-tax Act.
Step 3	All deductions permissible under sections 80C to 80U shall be allowed.
Step 4	Tax on net income shall be calculated according to the normal provisions and rebate under section 88E should be allowed.

162.4-2c PROVISIONS FOR MAINTENANCE OF BOOKS OF ACCOUNT/COMPULSORY AUDIT - NOT APPLICABLE - The following privileges are available to a taxpayer who declares his income from the aforesaid business at the rate of 8 per cent of gross receipts (or at a higher rate)—

Privilege 1	He is not required to maintain books of account according to the provisions of section 44AA in respect of the aforesaid business.
Privilege 2	He is not required to get his books of account audited under section 44AB in respect of the aforesaid business.

It may be noted that the above privileges are available only in respect of the aforesaid business.

While computing income of assessee under section 44AD, the Assessing Officer does not have power to assess anything in excess of returned income if returned income is more than 8 per cent of total receipt/sale consideration—***Abhi Developers*** v. ***ITO*** [2007] 12 SOT 444 (Ahd.).

An assessee has to comply with the requirements of both sections 44AA and 44AB in respect of his business which are not covered by this scheme.

Provisions illustrated - A person has gross receipts of Rs. 30 lakh from civil construction business and of Rs. 25 lakh from trading in scrap. Although his total gross receipts are Rs. 55 lakh, he will not be required to have his accounts audited, since his gross receipts after excluding those from the business of civil construction are still less than Rs. 40 lakh, the limit provided in section 44AB.

162.4-3 ***IS IT POSSIBLE TO DECLARE LOWER INCOME*** - A taxpayer can declare his income to be lower than the deemed profits and gains as stated above. The following consequences are applicable if the taxpayer declares his income which is lower than the deemed profits and gains as stated above—

Consequence 1	The taxpayer will have to maintain the books of account as per section 44AA (irrespective of income or turnover)
Consequence 2	The taxpayer will have to get his books of account audited under section 44AB (irrespective of turnover).†

162.4-P1 *X & Co., a firm, is engaged in the business of civil construction (turnover of 2008-09 being Rs. 37,80,000). It wants to claim the following deduction —*

	Rs.
Salary and interest to partners [as permitted by section 40(b)]	*60,000*
Salary to employees	*4,90,000*
Depreciation	*2,70,000*
Cost of material used	*25,90,000*
Other expenses	*3,45,000*
Total	*37,55,000*
Net profit (Rs. 37,80,000 minus Rs. 37,55,000)	*25,000*

Determine the net income of X & Co. for the assessment year 2009-10 assuming that (a) taxable income from other business is Rs. 1,90,000, (b) long-term capital gain is Rs. 40,000 and (c) the firm is eligible for a deduction of Rs. 5,000 under section 80G.

†Nowhere in section 44AD it is mentioned that the assessee will be denied the benefit of claiming lower profits and gains than profit and gains as specified above if it furnishes the audit report beyond due date as mentioned in section 44AB.

SOLUTION :

	Rs.
Income from the business of civil construction (8% of Rs. 37,80,000)	3,02,400
Less : Expenses	
Salary/interest paid to partners as permitted by section 40(b)	60,000
Other expenses [except salary/interest to partners in the case of a firm, no other expenditure is deductible]	*Nil*
Income from civil construction	2,42,400
Other business income	1,90,000
Profits and gains from business or profession	4,32,400
Capital gains	40,000
Gross total income	4,72,400
Less : Deductions under sections 80C to 80U	5,000
Net income	4,67,400

162.5 ***Computation of income on estimated basis in the case of taxpayers engaged in the business of plying, leasing or hiring trucks [Sec. 44AE]*** - The provisions of section 44AE are given below —

162.5-1 *WHO IS COVERED BY THE SCHEME OF SECTION 44AE* - Section 44AE is applicable only if the following conditions are satisfied —

Condition 1	The taxpayer may be an individual, HUF, AOP, BOI, firm, company, co-operative society or any other person. He or it may be a resident or a non-resident.
Condition 2	Taxpayer is engaged in the business of plying, hiring or leasing goods carriages.
Condition 3	The taxpayer owns not more than 10 goods carriages at any time during the previous year. For this purpose, a taxpayer, who is in possession of a goods carriage, whether taken on hire purchase or on instalments and for which the whole or part of the amount payable is still due, shall be deemed to be the owner of such goods carriage.

162.5-2 *CONSEQUENCES IF SECTION 44AE IS APPLICABLE* - If the aforesaid conditions are satisfied then section 44AE is applicable. The following are the consequences if section 44AE is applicable:

162.5-2a INCOME TO BE CALCULATED ON ESTIMATED BASIS - Income from the aforesaid business shall be calculated as follows—

Type of goods carriage	*Estimated income*
Heavy goods vehicle	Rs. 3,500 for every month (or part of a month) during which the goods carriage is owned by the taxpayer
Other than heavy goods vehicle	Rs. 3,150 for every month (or part of a month) during which the goods carriage is owned by the taxpayer

Notes:

- *Goods carriage* - "Goods carriage" means any motor vehicle constructed or adapted for use solely for the carriage of goods, or any motor vehicle not so constructed or adapted when used for the carriage of goods.
- *Heavy goods vehicle* - "Heavy goods vehicle" means any goods carriage the gross vehicle weight of which, or a tractor or a road-roller the unladen weight of either of which exceeds 12,000 kilograms.
- *Ownership is the criteria* - Income on the aforesaid basis is calculated for the period during which the goods carriage is owned by the taxpayer (not on the basis of the period during which the goods carriage is put to use). For instance, income of a taxpayer who is engaged in the aforesaid business and who purchases a "heavy goods vehicle" on May 16, 2008 (the goods carriage is put to use on June 12, 2008) shall be Rs. 38,500 (*i.e.*, Rs. 3,500 for 11 months).
- *Hire declaration of income possible* - A taxpayer can claim his income from the aforesaid business at a higher amount then that specified in the table above.

162.5-2b ESTIMATED INCOME IS COMPREHENSIVE - All deductions under sections 30 to 38 including depreciation and unabsorbed depreciation, are deemed to have been already allowed and no further deduction is allowed under these sections. However, in the case of a firm, the normal deduction in respect of salary and interest to partners under section 40(*b*) shall be allowed. The written down value is calculated, where necessary, as if depreciation as applicable has been allowed*. These provisions are similar to the provisions of section 44AD [*see* para 162.4-2b]

162.5-2c PROVISIONS FOR MAINTENANCE OF BOOKS OF ACCOUNT/COMPULSORY AUDIT - NOT APPLICABLE - These provisions are similar to the provisions contained in section 44AD [*see* para 162.4-2c]

162.5-3 *IS IT POSSIBLE TO DECLARE LOWER INCOME* - These provisions are similar to the provisions contained in section 44AD [*see* para 162.4-3]

162.5-4 *OTHER POINTS* - The following points should be noted -

- Section 44AE does not permit an assessee to apply provisions of section 44AE in case of some lorries and to go for the regular assessment on the basis of books of account in respect of remaining lorries—***CIT*** v. ***C.P. Kunhimohammed*** [2005] 94 ITD 278 (Coch.).
- Where the Assessing Officer has applied provisions of section 44AE for estimating the assessee's income from truck plying, he is not justified in making addition separately on account of sale proceeds of scrap because the receipt from scrap is not a separate source of income—***Mohd. Aslam*** v. ***ITO*** [2005] 94 TTJ (Jodh.) 282.

162.5-P1 *X Ltd. is engaged in the business of carriage of goods. On April 1, 2008, it owns 10 trucks (6 out of which are "heavy goods vehicle"). On May 6, 2008, one of the heavy goods vehicles is sold by X Ltd. to purchase a light goods vehicle on May 10, 2008 which is put to use only from June 17, 2008.*

Find out the net income of X Ltd. for the assessment year 2009-10 taking into consideration the following data —

	Rs.
Freight collected	*8,90,000*
Less :	
Operational expenses	*6,40,000*
Depreciation as per section 32	*1,90,000*
Other office expenses	*15,000*
Net profit	*45,000*
Other business/non-business income	*70,000*

SOLUTION : Income shall be computed under section 44AE as follows —

Type of carriage	*Period during which trucks are owned*	*Number of months (including a part of month)*	*Rate per month*	*Amount (1) × (3) × (4)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
4 Light goods vehicles	April 1, 2008 to March 31, 2009	12	3,150	1,51,200
1 Heavy goods vehicles	April 1, 2008 to May 6, 2008	2	3,500	7,000
5 Heavy goods vehicles	April 1, 2008 to March 31, 2009	12	3,500	2,10,000
1 Light goods vehicles	May 10, 2008 to March 31, 2009	11	3,150	34,650
Total				4,02,850

*For this purpose depreciation shall be calculated notionally at the rate applicable at the time when the trucks were used—***ITO*** v. ***S. Rajendran*** [2007] 15 SOT 26 (Chennai).

Computation of income —	Rs.
Income from carriage of goods	4,02,850
Other incomes	70,000
Net income	4,72,850

162.6 ***Scheme for computing profits and gains of retail traders [Sec. 44AF]*** - The provisions of section 44AF are given below —

162.6-1 ***WHO IS COVERED BY THE SCHEME OF SECTION 44AF*** - Section 44AF is applicable only if the following conditions are satisfied —

Condition 1	The taxpayer may be an individual, HUF, AOP, BOI, firm, company, co-operative society or any other person. He or it may be a resident or a non-resident.
Condition 2	The taxpayer is engaged in the business of retail trade in any goods or merchandise.
Condition 3	Total turnover from the above business does not exceed Rs. 40 lakh.

162.6-2 ***CONSEQUENCES IF SECTION 44AF IS APPLICABLE*** - If the aforesaid three conditions are satisfied then section 44AF is applicable. The following are the consequences if section 44AF is applicable:

162.6-2a INCOME TO BE CALCULATED ON ESTIMATED BASIS @ 5 PER CENT - The income from the above mentioned business is estimated at 5 per cent of the total turnover. A taxpayer can voluntarily declare a higher income in his return.

162.6-2b RATE OF 5 PER CENT IS COMPREHENSIVE - All deductions under sections 30 to 38 including depreciation and unabsorbed depreciation, are deemed to have been already allowed and no further deduction is allowed under these sections. However, in the case of a firm, the normal deduction in respect of salary and interest to partners under section 40(*b*) shall be allowed. The written down value is calculated, where necessary, as if depreciation as applicable has been allowed. These provisions are similar to the provisions contained in section 44AD [*see* para 162.4-2b].

162.6-2c PROVISIONS FOR MAINTENANCE OF BOOKS OF ACCOUNT/COMPULSORY AUDIT - NOT APPLICABLE - Some privileges are available to a taxpayer who declares his income from the aforesaid business at the rate of 5 per cent of gross receipts (or at a higher rate). These provisions are similar to the provisions given under section 44AD [*see* para 162.4-2c]

162.6-3 ***IS IT POSSIBLE TO DECLARE LOWER INCOME*** - These provisions are similar to the provisions given in section 44AD [*see* para 162.4-3]

162.6-P1 *Find out the net income in the cases of X (32 years) and Y (28 years) (both are retail traders at Delhi) from the following data for the assessment year 2009-10 :*

	X Rs.	Y Rs.
Sales turnover	40,00,000	60,00,000
Less : Expenses		
Cost of goods sold	36,00,000	54,00,000
Depreciation	10,000	15,000
Other expenses	3,20,000	4,80,000
Business income	70,000	1,05,000
Other income	2,15,000	2,30,000
Public provident contribution	30,000	60,000

SOLUTION : In the case of X, income shall be computed under section 44AF as his turnover does not exceed Rs. 40 lakh. In the case of Y, however, the normal provisions of the Act will be applicable —

	X Rs.	Y Rs.
Business income [5% of Rs. 40 lakh in the case of X]	2,00,000	1,05,000
Other incomes	2,15,000	2,30,000
Gross total income	4,15,000	3,35,000
Less: Deduction under section 80C	30,000	60,000
Net income	3,85,000	2,75,000
Tax	32,000	12,500
Add : Surcharge (not applicable if net income does not exceed Rs. 10 lakh)	—	—
Tax and surcharge	32,000	12,500
Add: Education cess (2% of tax and surcharge)	640	250
Add : Secondary and higher education cess (1% of tax and surcharge)	320	125
Tax liability	32,960	12,880

162.7 ***Taxation of shipping profits derived by non-residents [Sec. 44B]*** - The provisions of section 44B are given below—

162.7-1 CONDITIONS - Section 44B is applicable if the following conditions are satisfied—

1. The assessee is non-resident in India.

2. The assessee is engaged in the business of operation of ships.

162.7-2 *CONSEQUENCES IF THE ABOVE CONDITIONS ARE SATISFIED* - If the above conditions are satisfied, then following provisions given by section 44B are applicable—

1. The provisions of sections 28 to 43A are not applicable.

2. Income shall be calculated at the rate of 7.5 per cent of the aggregate of the following—

a. the amount paid or payable (whether in or out of India) to the assessee or to any person on his behalf on account of carriage of passengers, livestock, mail or goods shipped at any port in India ; and

b. the amount received or deemed to be received in India by or on behalf of the assessee on account of the carriage of passengers, livestock, mail or goods shipped at any port outside India.

The amounts paid or payable or the amounts received or deemed to be received also include the amount received by way of demurrage charge or handling charge or any other amount of similar nature.

162.2-7a SECTION 44B OVERRIDES ONLY SECTIONS 28 TO 43A - It should be noted that section 44B overrides the provisions of sections 28 to 43A only and, accordingly, other provisions (including those relating to aggregation of income and set off or carry forward and set off of losses) will be applicable in the case of non-residents deriving profits from shipping business.

162.2-7b SECTION 44B *VIS-A-VIS* SECTION 172 - Section 172 [*see* para 2.2-1] entails recovery mechanism for non-residents engaged in a shipping business. However, such assessee can opt for being governed by the provision of section 44B, and accordingly, in such cases taxes paid under section 172 shall be adjusted in light of the tax liability computed under section 44B.

The Table given below highlights to the scope of sections 172 and 44B—

	Section 172	Section 44B
■ Overriding effect	It overrides all other provisions of the Act subject to availing the facility of regular assessment under section 172(7).	It overrides sections 28 to 43A.
■ Set off and carry forward of losses	Not available	Available
■ Deductions from gross total income under sections 80C to 80U	Not available	Available
■ Tax liability	7.5 per cent of amount received on account of carriage of goods, passengers, etc., is taxable at the rate applicable to a foreign company [if not opted for regular assessment under section 172(7)]	7.5 per cent of such collection is taken as business income; other provisions will be applicable to find out taxable income which will be taxable at the rate applicable to a non-resident.

162-7-P1 *X (45 years), a non-resident, is engaged in the business of shipping. During the previous year 2008-09, one of the ships owned by X collects freight as follows :*

a. on August 6, 2008, a sum of Rs. 40 lakh for shipping goods from Cochin Port (it includes demurrage of Rs. 10,000 and handling charges of Rs. 60,000); and

b. on January 10, 2009, a sum of Rs. 25 lakh for shipping goods from Bombay (it is paid to X in New York).

Besides, X collects Rs. 20,70,000 in India on March 3, 2009 for shipping goods from Karachi to California.

Barring the cases noted above, X does not have any other income in India. X incurs an expenditure of Rs. 2,40,000 in India (out of which Rs. 65,000 is paid in cash). X has brought forward loss of Rs. 5,000 from a trading business in India which was discontinued in 2007. Compute the tax liability of X for the assessment year 2009-10.

SOLUTION : *Ad hoc assessment under section 172(4)*

	Shipping of goods from Cochin Rs.	Shipping goods from Bombay Rs.
Deemed income (7.5% of amount of freight including demurrage)	3,00,000	1,87,500
Less : Expenses (not deductible)	—	—
Business income	3,00,000	1,87,500
Less : Brought forward loss [not to be adjusted section 172(4)]	—	—
Income	3,00,000	1,87,500
Tax payable including surcharge at the rate applicable to a foreign company [41.2% of income is tax payable under section 172(4)]	1,23,600	77,250

For Rs. 20,70,000, X will submit his return of income and tax will be computed under section 44B as follows-

	Rs.
Income (under section 44B it is computed @ 7.5%)	1,55,250
Less : Brought forward business loss	5,000
Net income	1,50,250
Tax (including surcharge, EC and SHEC) at the rate applicable to an individual	30
Aggregate tax liability of X (Rs. 1,23,600 + Rs. 77,250 + Rs. 30)	2,00,880

If X opts for normal assessment under section 172(7), then tax will be computed as under—

Computation under section 172(7) read with section 44B

	Rs.
Income [by virtue of section 44B, 7.5% of receipt is taken as business income, *i.e.*, 7.5% of (Rs. 40 lakh + Rs. 25 lakh + Rs. 20.70 lakh)]	6,42,750
Add : Disallowance under section 40A(3) (not applicable)	---
Total	6,42,750
Less : Brought forward business loss	5,000
Net income	6,37,750
Tax (according to the rate applicable to an individual)	96,325
Add : Surcharge (not applicable in case net income does not exceed Rs. 10 lakh)	*Nil*
Tax and surcharge	96,325
Add: Education cess (2% of tax and surcharge)	1,927
Add : Secondary and higher education cess (1% of tax and surcharge)	963
Tax liability	99,215
Less : Tax paid under section 172(4) which is treated as advance tax—*A.S. Glittre* v. *CIT* [1997] 225 ITR 739 (SC)	2,00,850
Balance to be refunded	(–) 1,01,640

Note - X is entitled to get interest under section 244A—*Circular No. 9/2001*, dated July 9, 2001. X should opt for normal assessment under section 172(7).

162.8 *Computation of taxable income from activities connected with exploration of mineral oils [Sec. 44BB]* - The provisions of section 44BB are given below—

162.8-1 CONDITIONS - Section 44BB is applicable if the following conditions are satisfied.

1. The assessee is non-resident. He may be an Indian citizen or a foreign citizen.

2. The assessee is engaged in the business of providing services and facilities in connection with, or supplying plant and machinery on hire, used or to be used in the exploration for, and exploitation of, mineral oils.

162.8-2 *CONSEQUENCES IF THE ABOVE CONDITIONS ARE SATISFIED* - The following provisions are applicable, if the above conditions are satisfied—

1. The provisions of sections 28 to 41, 43 and 43A are not applicable.

2. Income is calculated at the rate of 10 per cent of the amounts given below.

3. The amounts in respect of which the provisions apply are the amounts paid or payable to the taxpayer or to any person on his behalf whether in or out of India, on account of the provision of aforesaid services or facilities or supplying plant and machinery for the aforesaid purposes. This amount also includes the amounts received or deemed to be received in India on account of such services or facilities or supply of plant and machinery.

4. The aforesaid provision shall not, however, apply to any income to which the provisions of section 42, 44D, 115A or 293A apply.

5. It is elementary that any sum which is to be assessed under section 44BB must be connected with the activity of providing of services and facilities in connection with supply of plant and machinery on hire, used or to be used in prospecting for mineral oils, or extraction or production of mineral oils and if such receipts are not connected with such activity, the same cannot be assessed under the provisions of section 44BB—***CIT*** v. ***Pride Foramer France SAS*** [2008] 22 SOT 205 (Delhi).

162.8-3 *IS IT POSSIBLE TO DECLARE LOWER INCOME* - The provisions are given below—

1. An assessee may claim lower profits and gains than the amount specified above.

2. In such case—

a. the assessee will have to maintain books of account under section 44AA(2);

b. the assessee will get his books of account audited under section 44AB (irrespective of turnover); and

c. the Assessing Officer will complete the assessment under section 143(3).

162.8-4 *OTHER POINTS* - One should also keep in view the following points—

1. Income-tax paid on behalf of the assessee by the main contractor shall be added to the receipt of the assessee for the purpose of section 44BB—*McDermott International Inc.* v. *CIT*[1994] 49 ITD 590 (Delhi).

2. Reimbursement of actual expenditure cannot be treated as a contract receipt for computing the taxable profit under section 44BB—*Sedco Forex International Drilling Inc.* v. *Dy. CIT*[2000] 72 ITD 415/67 TTJ (Delhi) 670.

3. The activity of a non-resident placing helicopter services in India at the disposal of a non-resident company which is engaged in the business of exploration of mineral oils in India is covered by section 44BB (and not by section 44BBA)—*Lloyed Helicopters International Ltd.* v. *CIT* [2001] 115 Taxman 334 (AAR—N. Delhi).

4. Section 44BB does not provide that separate consideration mentioned in agreement for transportation should be excluded from aggregate amount of gross receipts on which 10 per cent profit rate is to be applied—*Sedco Forex Internationals Drilling Inc.* v. *CIT*[2000] 72 ITD 415 (Delhi).

5. Amount withheld from gross contract payments for certain reasons cannot be deducted from gross contract payments for purposes of computing income under section 44BB—*Sedco Forex International Drilling Inc.* v. *CIT*[2000] 72 ITD 415 (Delhi).

162.8-P1 *ONGC has agreements (approved by the Government) with the following three foreign companies which provide services and facilities to ONGC in connection with prospecting for (or extraction/production of) mineral oils in India —*

	A Inc.	B Inc.	C Inc.
Date of agreement	*June 10, 1982*	*June 10, 1992*	*June 10, 2002*
Amount paid by ONGC during 2008-09 on account services provided by foreign companies (in Rs.)	*90 crore*	*90 crore*	*90 crore*
Tax liability borne by ONGC (in Rs.)	*Nil*	*3.8007 lakh*	*3.96828 lakh*

Find out the taxable income and tax liability of the foreign companies. Discuss whether tax liability borne by ONGC would be perquisite arising to B Inc. and C Inc. under section 28(iv) and would be taxable separately in addition to income computed under section 44BB.

SOLUTION :

Income of the foreign companies would be taxable as under—

Rs. in crore

	A Inc.	B Inc.	C Inc.
Income from business providing services and facilities to ONGC	90	90	90
Add: Income-tax paid by ONGC [*exempt under section 10(6B)]	-	*Nil**	3.96828
Total receipts (a)	90	90	93.96828
Taxable income as per section 44BB [i.e., 10% of (a)] (b)	9	9	9.396828
Income-tax and surcharge (including EC and SHEC) on (b) [42.23% of (b)]	3.8007	3.8007	3.96828
Less: Tax paid by ONGC	*Nil*	3.8007	3.96828
Tax to be borne by the foreign companies	3.8007	*Nil*	*Nil*

Note - In *Oil India Ltd.* v. *CIT* [1995] 212 ITR 225/78 Taxman 226 (Ori.), it was held that tax liability of non-resident firm which has been undertaken by the Indian firm and has been paid by the Indian firm would be a perquisite arising from the business of oil exploration under the agreement entered into by the non-resident firm with the Indian firm and would be taxable as such. The computation of the same would have to be made under section 44BB(1) and, therefore, only 10% of the same would be deemed to be the profits of such business chargeable to tax and not the entire sum.

162.9 ***Computation of income in respect of foreign airlines [Sec. 44BBA]*** - This section is a *non obstante* provision and consequently sections 28 to 43A are not applicable in the case of a non-resident engaged in the business of operation of aircraft. Income from such business is calculated at a flat rate of 5 per cent of the following :

a. amount received (in or out of India) by the taxpayer or on his behalf on account of carriage of passenger, livestock, mail or goods from any place in India ; and

b. amount received or deemed to be received in India by or on behalf of the taxpayer on account of carriage of passenger, livestock, mail or goods from any place outside India.

■ *Business of operation of aircraft* - Section 44BBA is applicable in a case where the assessee, a non-resident, is engaged in the business of operation of aircraft. The qualifying condition is that the assessee must be engaged in the business of operation of aircraft. The expression "business of operation of aircraft" is a comprehensive term visualizing the carrying on of the entire activities necessary for running the business of airlines engaged in the carriage of passengers, livestock, mail or goods. For instance, where a non-resident, enters into a wet leasing agreement with Air India under which it leases out its aircrafts to Air India and not carrying on business of operation of aircraft, rental income received by the non-resident from Air India cannot be brought to tax under provisions of section 44BBA—***Caribjet Inc.*** v. ***CIT*** [2005] 4 SOT 18 (Mum.).

162.10 ***Computation of profits and gains of foreign companies engaged in the business of civil construction [Sec. 44BBB]*** - Section 44BBB is applicable if the following conditions are satisfied-

1. The taxpayer is a foreign company.

2. The taxpayer is engaged in the business of civil construction or the business of erection of plant or machinery or testing or commissioning thereof, in connection with a turnkey power project.

3. The aforesaid project is approved by the Central Government. The approval should be obtained from the Department of Power in the Ministry of Energy—Circular No. 552, dated February 9, 1990.

4. The above project is financed under any international aid programme. With effect from the assessment year 2003-04, section 44BBB will be applicable even in respect of those turnkey power projects which are not financed under any international aid programme.

If all the aforesaid conditions are satisfied, provisions of sections 28 to 44AA are not applicable and 10 per cent of the amount paid or payable (whether in or out of India) to the said assessee (or to any person on his behalf) on account of such civil construction, erection, etc., shall be deemed to be the profits and gains of such business chargeable to tax under the head "Profits and gains of business or profession."

162.10-1 *IS IT POSSIBLE TO DECLARE LOWER INCOME* - An assessee can claim lower profits and gains than the amount specified by section 44BBB. However, in such a case—

a. the assessee will have to maintain books of account under section 44AA(2);

b. the assessee will get his books of account audited under section 44AB (irrespective of turnover); and

c. the Assessing Officer will complete the assessment under section 143(3).

162.11 ***Head office expenditure in the case of non-resident [Sec. 44C]*** - Head office expenditure in the case of a non-resident is allowed in accordance with the provision of section 44C. This section is a *non obstante* provision and anything contrary contained in sections 28 to 43A is not applicable. Deduction in respect of head office expenditure is restricted to the least of the following :

a. an amount equal to 5 per cent of "adjusted total income", or in the case of loss, 5 per cent of "average adjusted total income", or

b. the amount of so much of the expenditure in the nature of head office expenditure incurred by the assessee as is attributable to the business or profession of the assessee in India.

162.11-1 *MEANING OF ADJUSTED TOTAL INCOME* - "Adjusted total income" means the total income computed in accordance with the provisions of the Act without giving effect to the following :

- Allowance under section 44C
- Unabsorbed depreciation allowance under section 32(2)

- Expenditure incurred by a company for the purpose of promoting family planning amongst its employees under the first proviso to clause (*ix*) of section 36(1)
- Business loss brought forward under section 72(1)
- Speculation loss brought forward under section 73(2)
- Loss under the head "Capital gains" under section 74(1)
- Loss from certain specified sources brought forward under section 74A(2)
- Deductions under sections 80C to 80U.

162.11-2 *AVERAGE ADJUSTED TOTAL INCOME* - Where the total income of the assessee is assessable for each of the three assessment years immediately preceding the relevant assessment year, one-third of the aggregate amount of the adjusted total income in respect of the previous years relevant to the aforesaid three assessment years is average adjusted total income.

- Where the total income of the assessee is assessable only for two of the aforesaid three assessment years, one-half of the aggregate amount of the adjusted total income in respect of the previous years relevant to the aforesaid two assessment years is taken as average adjusted total income.

- Where the total income of the assessee is assessable only for one of the aforesaid three assessment years, the amount of the adjusted total income in respect of the previous year relevant to that assessment year is average adjusted total income.

162.11-3 *HEAD OFFICE EXPENDITURE* - "Head office expenditure" means executive and general administration expenditure incurred by the assessee outside India, including expenditure incurred in respect of :

a. rent, rates, taxes, repairs or insurance of any premises outside India used for the purposes of the business or profession ;

b. salary, wages, annuity, pension, fees, bonus, commission, gratuity, perquisites or profits in lieu of or in addition to salary, whether paid or allowed to any employee or other person employed in, or managing the affairs of, any office outside India ;

c. travelling by any employee or other person employed in, or managing the affairs of, any office outside India ; and

d. such other matters connected with executive and general administration as may be prescribed.

162.11-4 *SECTION 44C - WHEN NOT APPLICABLE* - Section 44C is not applicable where the computation of non-resident's Indian income is made in accordance with rule 10(*ii*)—*CIT* v. *Saudi Arabian Air Lines* [1985] 155 ITR 65 (Bom.).

Rule 10(*ii*) requires the computation of the total world income of the non-resident assessee from business in accordance with the provisions of the tax laws applicable in India. After such computation, one has to determine the proportion between the receipts accruing or arising within the taxable territories and the total world receipts of the business. The next step requires the determination of the profits or gains of business by application of that proportion for the purposes of assessment to income-tax. The income so arrived at is taken as the taxable income without any further allowances.

162.12 ***Computation of income by way of royalties and technical service fees in the case of foreign companies [Sec. 44D]*** - The provisions are given below—

162.12-1 *AGREEMENT MADE BEFORE APRIL 1, 1976* - Where such income is received under an agreement made before April 1, 1976, the deduction in respect of expenses incurred for earning such income is subject to a ceiling limit of 20 per cent of the gross amount of such income, as reduced by the amount, if any, of so much of the royalty income as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property.

The aforesaid ceiling limit is applicable in relation to all royalties and technical service fees received by foreign companies from Indian concerns, irrespective of whether such royalties or technical service fees are received under agreements which have been approved by the Central Government or not.

For this purpose, an agreement made by a foreign company with an Indian concern on or after April 1, 1976 is regarded as agreement made before that date if such agreement is made on the basis of proposals approved by the Central Government before that date and the foreign company has exercised an option in this behalf under section 9(1)(*vi*).

162.12-2 *AGREEMENT MADE ON OR AFTER APRIL 1, 1976 NOT BEING COVERED BY SECTION 44DA [SEC. 115A]* - Royalties and technical service fees received under an agreement made on or after April 1, 1976 not being covered by section 44DA, are chargeable to tax @ 10 per cent† (+SC+EC) by virtue of section 115A in following four cases —

a. where such agreement is with the Government of India ; or

b. where such agreement is with an Indian concern, the agreement is approved by the Central Government ; or

c. where such agreement relates to a matter included in the industrial policy, for the time being in force, of the Government of India, the agreement is in accordance with that policy ; or

d. where such royalty is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copyright in any book on a subject referred to in the proviso to sub-section (1A) of section 115A to the Indian concern or in respect of computer software referred to the second proviso to section 115A(1A) to a person resident in India.

In other words, the gross amount of income by way of royalties or fees for technical services received by a non-resident from an Indian concern is chargeable to tax. In the aforesaid four cases, the gross amount of such income is chargeable to tax at the flat rate of 30/20/10 per cent (*plus* surcharge *plus* education cess) by virtue of section 115A. In other remaining cases, such gross income is taxable at the normal rate [*i.e.*, 40 per cent (+SC+EC)].

■ According to section 44D, while calculating the aforesaid income no deduction under sections 28 to 44C shall be allowed to foreign companies having income by way of royalty or fees for technical services received from Central Government or Indian concern for agreement with them after March 31, 1976 but before April 1, 2003 [applicable even if the agreement is not approved by the Central Government].

■ *Whether tax paid on behalf of foreign companies is to be grossed up* - If tax is payable on the aforementioned income by the Indian counterpart on behalf of foreign companies, then in few cases tax shall not be grossed up in the hands of foreign company [*see* paras 38.12 and 38.13].

■ *Indian Concern* - An 'Indian concern' in section 115A should be taken as a business carried on in India which may include a business carried on in India even by a non-resident—***Joint Official Liquidator of Bank of Credit & Commerce (Overseas) Ltd.*** v. ***CIT*** [2006] 6 SOT 391 (Mum.).

162.12-3 *SECTION 44DA* - Section 44DA has been inserted to harmonise the provisions relating to the income from royalty or fees for technical services attributable to a fixed place of profession or a permanent establishment in India with similar provisions in the various Double Taxation Avoidance Agreements. The provisions of section 44DA are given below.

162.12-3a WHEN SECTION 44DA IS APPLICABLE - Section 44DA is applicable if the following conditions are satisfied—

1. The taxpayer is a foreign company or non-resident non-corporate-assessee.

2. The taxpayer carries on a business in India through a permanent establishment situated in India. Alternately, the taxpayer performs professional services from a fixed place of profession situated in India. "Permanent establishment" includes a fixed place of business through which the business of an enterprise is wholly or partly carried on.

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†30 per cent if the agreement is made on or before May 31, 1997 or 20 per cent if the agreement is made after May 31, 1997 but before June 1, 2005.

3. The taxpayer gets income by way of royalty or fees for technical services. One may refer to section 9(1) for meaning of "royalty" and "fees for technical services".

4. The aforesaid royalty or technical fees is received from—

a. Government (*i.e.*, the Central Government or a State Government); or

b. an Indian concern.

5. The income mentioned in (*3*) (*supra*) is received in pursuance of an agreement made by the taxpayer with the Government or the Indian concern after March 31, 2003. If such agreement is made before April 1, 2003, then section 44D is applicable (not section 44DA).

6. The right, property or contract in respect of which the royalties or fees for technical services are paid to the taxpayer is effectively connected with permanent establishment or fixed place of profession [as mentioned in (*2*) (*supra*)].

162.12-3b CONSEQUENCES IF SECTION 44DA IS APPLICABLE - Section 44DA is applicable if the above-mentioned six conditions are satisfied. Under section 44DA the following special provisions are applicable—

1. Deduction will not be allowed in respect of any expenditure or allowance, which is not wholly and exclusively incurred for the business of permanent establishment or fixed place of profession in India.

2. Moreover, deduction will not be allowed in respect of amounts, if any, paid by the permanent establishment to its head office or to any of its other offices. However, reimbursement of actual expenditure will be allowed as deduction even if such amount is paid by the permanent establishment to its head office or to any of its other offices.

3. Barring the aforesaid two cases, income of the taxpayer shall be computed according to the normal provisions of the Act.

4. The taxpayer shall keep and maintain books of account and other documents in accordance with the provisions contained in section 44AA.

5. The books of account should be audited by a chartered accountant and the audit report (in Form No. 3CE) should be submitted along with the return of income.

162.12-4 CONCLUSIONS - The cumulative impact of sections 44D, 44DA and 115A is given below—

Royalty or fees for technical service received by a foreign company or a non-resident non-corporate assessee from Government or an Indian concern	*Deductions under sections 28 to 44D and 57*	*Deductions under sections 80C to 80U*	*Rate of tax on such royalty or fees [on 1-2-3]*
1	*2*	*3*	*4*
A Such royalty is received under an agreement made before April 1, 1961 or such technical fee is received under an agreement made before March 1, 1964			
A1 Where the agreement is approved by the Government	*Note 1*	Deduction is available	40 per cent†
A2 Where the agreement is not approved	*Note 1*	Deduction is available	40 per cent†
B Such royalty is received under an agreement made after March 31, 1961 but before April 1, 1976 or such technical fee is received under an agreement made after February 29, 1964 but before April 1, 1976			
B1 Where agreement is approved by the Central Government	*Note 1*	Deduction is available	50 per cent†
B2 Where such agreement is not approved by the Central Government	*Note 1*	Deduction is available	40 per cent†
C Such royalty or technical fee is received under an agreement made after March 31, 1976 but before April 1, 2003			

†*Plus* surcharge, education cess and SHEC - *See* Footnote on page 426.

1	2	3	4
C1 Where such agreement is with the Government	No deduction	Deduction is available	10 per cent*†
C2 Where such agreement is with an Indian concern, the agreement is approved by the Central Government	No deduction	Deduction is available	10 per cent*†
C3 Where the agreement relates to a matter included in the industrial policy, for the time being in force, of the Government of India, the agreement is in accordance with that policy	No deduction	Deduction is available	10 per cent*†
C4 Where such royalty is in consideration for the transfer of all or any rights (including the granting of a licence) in respect of copyright in any book on a subject referred to in the proviso to sub-section (1A) of section 115A to the Indian concern or in respect of computer software referred to in the second proviso to section 115A(1A) to a person resident in India	No deduction	Deduction is available	10 per cent*†
C5 In any other case	No deduction in the case of foreign company. Deduction is, however, available if taxpayer is non-resident non-corporate assessee	Deduction is available	Applicable rate
D Such royalty or technical fee is received under an agreement made after March 31, 2003			
D1 Where royalty or technical fees is effectively connected to Permanent Establishment (PE) in India	Deduction is available	Deduction is available	Applicable rate
D2 Where PE is absent but the case is covered by section 115A(1) [*i.e.*, C1 to C4 (*supra*)]	No deduction	Deduction is available	10 per cent‡†
D3 In any other case	Deduction is available [*see* Note 3]	Deduction is available	Applicable rate

*30 per cent is applicable if the royalty or technical fees is received under an agreement made before June 1, 1997 or 20 per cent is applicable if agreement is made after May 31, 1997 but before June 1, 2005.

†*Plus* Surcharge and education cess. Surcharge is as follows— *(% of income-tax)*

	Assessment year 2009-10
a. if the taxpayer is an individual/HUF/BOI/AOP	
- if net income does not exceed Rs. 10,00,000	*Nil*
- if net income is above Rs. 10,00,000	10%
b. if the taxpayer is an artificial juridical person	10%
c. if the taxpayer is a firm/domestic company	10%
- if net income does not exceed Rs. 1 crore	*Nil*
- if net income exceeds Rs. 1 crore	10%
d. if the taxpayer is a non-domestic company	2.5%
- if net income does not exceed Rs. 1 crore	*Nil*
- if net income exceeds Rs. 1 crore	2.5%
e. if the taxpayer is a co-operative society of local authority	*Nil*

Education cess is 2 per cent of (income-tax and surcharge)

Secondary and higher education cess is 1 per cent of (income tax and surcharge).

‡20 per cent if the agreement is made before June 1, 2005.

Notes :

1. Deduction shall not exceed in the aggregate 20 per cent of the gross amount of such royalty or fees as reduced by so much of the gross amount of such royalty as consists of lump sum consideration for the transfer outside India of, or the imparting of information outside India in respect of, any data, documentation, drawing or specification relating to any patent, invention, model, design, secret formula or process or trade mark or similar property.

2. The tax rates given in the column 4 of the table *supra* are not applicable where a lower rate is prescribed under an Avoidance of Double Taxation Agreement entered into by the Central Government under section 90 [*see* Annex 1].

3. Neither section 44D (agreement is made after March 31, 2003) nor section 115A(3) (it is not agreement covered by C1 to C4) will apply in such a case. In other words, the computation will be governed by the normal provisions of the Act.

4. Provisions of sections 70, 71, 72 will be applicable before computing the aforesaid income—*Hitachi Zosen Corpn.* v. *CIT* [1999] 68 ITD 235 (Delhi).

162.13 ***Computation of income and tax under sections 115A, 115AB, 115AC, 115AD, 115BBA and 115D*** - The chart given below highlights the provisions of sections 115A, 115AB, 115AC, 115AD, 115BBA and 115D regarding computation of income and tax thereon :

Sections	*Nature of income*	*Deductions under sections 28 to 44C and 57*	*Whether the benefit of computing capital gain in foreign currency as provided by the first proviso to section 48 and the rule of indexation as provided by the second proviso to section 48 are applicable*	*Deductions under sections 80C to 80U*	*Tax rate*	*Is it necessary to submit return of income*
1	*2*	*3*	*4*	*5*	*6*	*7*
115A(1)(*a*)	The following incomes in the case of a non-resident non-corporate assessee or a foreign company—					
	a. dividend (not being dividend covered under section 115-O)	Not available	—	Not available	20 per cent‡	*Note 1*
	b. interest received from Government or an Indian concern on moneys borrowed or debt incurred by Government or the Indian concern in foreign currency	Not available	—	Not available	20 per cent‡	*Note 1*
	c. income received in respect of units, purchased in foreign currency, of a Mutual Fund specified under clause (*23D*) of section 10 or of the Unit Trust of India	Not available	—	Not available	20 per cent‡	*Note 1*
115A(1)(*b*)	Royalty or technical fees of a non-resident non-corporate assessee or a foreign company	*See* para 162.12-4	—	*See* para 162.12-4	*See* para 162.12-4	*Yes*

‡*Plus* Surcharge, education cess and secondary and higher education cess, *see* Foot Note para 162.12-4.

1	2	3	4	5	6	7
115AB	The following incomes of an assessee, being an overseas financial organisation -					
	a. income received in respect of units purchased in foreign currency	Not available	—	Not available		*Yes*
	b. income by way of long-term capital gains arising from the transfer of units purchased in foreign currency	—	First proviso is not relevant (as it is applicable only in the case of shares/debentures)		10 per cent‡	
		—	Second proviso to section 48 is not applicable£	Not available	10 per cent‡	*Yes*
115AC†	The following incomes[1] of a non-resident :					
	a. income by way of interest or dividends (not being covered by section 115-O), on bonds or Global Depository Receipts of an Indian company issued in accordance with the notified scheme, *i.e.*, Foreign Currency Convertible Bonds and Ordinarily Global Depository Receipts (Through Depository Receipt Mechanism) Scheme, 1993/Issue of Foreign Currency Exchangeable Bonds Scheme, 2008 or (with effect from October 1, 1996) on bonds/Global Depository Receipts of a public sector company sold by the Government and purchased by him in foreign currency	Not available	—	Not available	10 per cent‡	*Note 1*
	b. income by way of long-term capital gains arising from transfer of bonds or, as the case may be, Global Depository Receipts referred above	—	First and second provisos£ to section 48 are not applicable	Not available	10 per cent‡	*Yes*
115ACA	Income from Global Depository Receipts held by a resident individual who is an employee of an Indian company engaged in specified knowledge based industry or service[2] or an employee of its subsidiary engaged in specified knowledge based industry or service					

1. Where an assessee acquires shares or bonds, as the case may be, in a resulting or amalgamated company by virtue of his holding shares in the amalgamating or demerged company in accordance with the provisions of section 115AC(1), the provisions of section 115AC(1) shall apply to such shares or bonds.

† The concessional tax rate of 10 per cent has been extended to GDRs issued under notified schemes of the Central Government also.

‡ *Plus* surcharge, education cess and secondary and higher education cess, *See* Foot Note para 162.12-4.

2. Specified knowledge based industry or service means information technology software/services, entertainment service, pharmaceutical industry, bio-technology industry or any other notified industry or service.

£ The taxpayer is not entitled (no option) to the benefit of indexation—***Universities Superannuation Scheme Ltd. In re*** [2005] 145 Taxman 141 (AAR - New Delhi).

1	2	3	4	5	6	7
	■ Dividend (not being covered by section 115-O) on Global Depository Receipts of an Indian company engaged in specified knowledge based industry/service issued under notified* employees stock option scheme and purchased in foreign currency	Not available	—	Not available	10 per cent‡	*Yes*
	■ Long-term capital gain on transfer of such receipts	—	First and second provisos£ to section 48 are not applicable	Not available	10 per cent‡	*Yes*
115AD	The following income of a notified Foreign Institutional Investor*:					
	a. income (not being dividend covered by section 115-O) received in respect of securities (other than units referred to in section 115AB) listed in a recognised stock exchange in India in accordance with the provisions of the Securities Contracts (Regulation) Act, 1956, and any rules made thereunder	Not available	—	Not available	20 per cent‡	*Yes*
	b. income by way of short-term or long-term capital gains arising from the transfer of such securities	—	First and second provisos£ to section 48 are not applicable	Not available	Long-term: 10 per cent‡, short-term u/s 111A: 10 per cent‡ (15 per cent‡ from the assessment year 2009-10), any other short-term: 30 per cent‡	*Yes*
115BBA (1)(*a*)	The following income of non-resident sportsman who is a foreign citizen					
	i. participation in India in any game (other than a game the winnings wherefrom are taxable under section 115BB) or sport; or	Not available	—	Not available	10 per cent‡	*Note 1*
	ii. advertisement ; or	Not available	—	Not available	10 per cent‡	*Note 1*
	iii. contribution of articles relating to any game or sport in India in newspapers, magazines or journals	Not available	—	Not available	10 per cent‡	*Note 1*
115BBA (1)(*b*)	Any amount guaranteed to be paid or payable to a non-resident sports association or institution in relation to any game (not being a game referred to in section 115BB) or sports played in India	Not available	—	Not available	10 per cent‡	*Note 1*

*For notified institutions, *see Taxmann's Direct Taxes Circulars*, Vol. 2, 2008 edition.

‡*Plus* surcharge, education cess and secondary and higher education cess, *see* footnote para 162.12-4.

£The taxpayer is not entitled (no option) for the benefit of indexation — ***Universities Superannuation Scheme Ltd. In re*** [2005] 145 Taxman 141 (AAR - New Delhi).

1	2	3	4	5	6	7
115D	The following incomes of a non-resident Indian					
	a. investment income from foreign exchange assets	No deduction under any provision	—	Not available	20 per cent‡	*Note 1*
	b. long-term capital gain on transfer of foreign exchange assets	—	First proviso to section 48 is applicable but not the second proviso£	Not available	10 per cent‡	*Note 1*

Note 1 - It is not necessary for an assessee referred to in section 115A(1), 115AC(1), 115BBA or 115D to furnish his return of income under section 139(1) if :

a. his income in respect of which he is assessable under the Act during the previous year consisted only of income referred to in section 115A(1)(*a*), or 115AC(1)(*a*), or 115BBA or section 115D ; and

b. the tax deductible at source under the Act has been deducted from such income.

Valuation of stock

163. Valuation of stock is a vital factor in determining the taxable income of an assessee from business as correct profits cannot be ascertained unless the opening and closing stocks are valued correctly. Though the valuation of stock does not generate funds, it does affect taxable income of the business.

163.1 ***Cost or market price whichever is less*** - Neither the Income-tax Act nor the Income-tax Rules prescribes or permits any particular method of valuation of stock. An assessee may value its stock either at cost price or at market price, whichever is less.

It is now well-settled law that the assessee has a right to value his closing stock at cost price or market price, whichever is lower. Where the goods are saleable only in certain foreign markets and there is no demand for the goods in such foreign markets, the assessee is entitled to value the goods at *nil*. In such a case he is not bound to show that he had made efforts to sell the goods in other foreign markets or in the local market before valuing the stock at *nil*—*K. Mohammad Adam Sahib* v. *CIT* [1965] 56 ITR 360 (Mad.).

163.1-1 *Individual/global method* - If valuation of closing stock is made on the basis of the lower of cost or market price, it can be done on the basis of individual method or global method. Under the individual method one has to take cost or market price, whichever is less, in respect of each item of stock on the closing day of the previous year, whereas in the case of global method value of stock is taken at the total cost of all items of stock or market price of all items of stock, whichever is less. For instance, in the following case, Rs. 61,830 is the valuation of stock on the basis of individual method, while Rs. 69,800 is the valuation of stock on the basis of global method. In both cases the method adopted is cost or market price, whichever is less :

Stock items	*Cost price* Rs.	*Market price* Rs.	*Cost or market price, whichever is less* Rs.
A	600	550	550
B	1,800	2,000	1,800
C	21,770	29,540	21,770
D	52,840	37,710	37,710
Total	77,010	69,800	61,830

‡*Plus* surcharge, education cess and secondary and higher education cess, *see* footnote para 162.12-4.

£The taxpayer is not entitled (no option) to the benefit of indexation—***Universities Superannuation Scheme Ltd. In re*** [2005] 145 Taxman 141 (AAR - New Delhi).

Though in the above case, the value of stock is higher under the global method as compared to the individual method, it does not mean that the result will be the same in all the cases. However, both the closing stock and opening stock should be valued on the same basis—*Mahendra Mills Ltd.* v. *AAC* [1975] 99 ITR 135 (SC).

163.1-2 WHAT IS COST - Any system of accounting which does not include all costs (other than the cost of raw material for the goods in process and finished products) is likely to result in a distorted picture of the true state of the business for the purpose of computing the chargeable income. The profit of one year is likely to be shifted to another year which is an incorrect method of computing profits and gains for the purpose of assessment—*CIT* v. *British Paints India Ltd.* [1991] 54 Taxman 499 (SC).

163.2 *Change of method of stock valuation* - Once a particular method of valuation is adopted, the same should be continued in subsequent year—*CIT* v. *A. V. Appu Chettiar* [1962] 45 ITR 152 (Mad.). The method of valuation of stock may, however, be changed. The new method of stock valuation cannot be rejected merely because there would be loss of revenue in the year of change. What is relevant is to consider whether the method adopted is one of the recognised methods and further whether the changed method of stock valuation is followed consistently year after year. Change in the method of stock valuation cannot be restricted to a particular year. If the new method of stock valuation is followed consistently year after year, the tax authorities have no option but to accept such method notwithstanding the fact that, in the initial year when the changed method is brought about, it may result in a prejudice or detriment to the revenue. The change of method must be *bona fide* and must not be restricted to a particular year—*CIT* v. *Delta Plantation Ltd.* [1993] 71 Taxman 329 (Cal.). The change has to be effected by adopting the new method for valuing the closing stock of the current year (in which change takes place), which will, in its turn, become the value of the opening stock of the next year. If, instead, a procedure is adopted for changing the value of the opening stock of the current year also, it will lead to a chain reaction of changes in the sense that the closing value of the stock of the year preceding will also have to change and correspondingly the value of the opening stock of that year and so on—*CIT* v. *Travancore Cochin Chemicals Ltd.* [2000] 111 Taxman 692 (Ker.). Any change in any method of stock valuation is bound to make some change in the taxable income. Simply because, by virtue of the change introduced by the assessee, the taxable income of the assessee had been reduced, by no stretch of imagination, it could be said that the assessee had an intention to deliberately undervalue its stock so as to reduce its tax burden.

It has been held by the Calcutta High Court in the case of *CIT* v. *Delta Plantation Ltd.* [1993] 71 Taxman 329 that when the change is made by *an assessee* in the method of valuation of stock, so as to follow the method of stock valuation adopted by the entire industry, the revenue should not reject the method, merely because there would be loss to the revenue in the year in which the method of stock valuation was changed. When the accounting method is changed with a *bona fide* intention, the change should be accepted by the revenue—*CIT* v. *Atul Products Ltd.* [2002] 125 Taxman 727 (Guj.). However, it is not permissible for any assessee to adopt a system of stock valuation notionally for income-tax purpose alone when such method is different from the one which has consistently been followed by it for preparing and presenting its final accounts—*CIT* v. *UCO Bank* [1993] 200 ITR 68 (Cal.).

163.3 *Valuation of work-in-progress* - The value of closing stock may be determined either by the direct cost method or by on-cost method. Under the direct cost method, direct cost of material and labour is alone taken into account, whereas in the case of on-cost method, factory and office overhead expenses are added to the direct cost. There is no general and universal rule that work-in-progress should be valued either under direct cost method or on-cost method. In adopting either of the two methods, the main consideration should be that the assessee should not be put to risk of being charged with a higher amount of profit than that can be determined with a reasonable certainty—*Duple Motor Bodies Ltd.* v. *Ostime* [1961] 39 TC 537 (HL). If an assessee adopts direct cost method, he cannot be compelled to shift over to on-cost method.

163.4 ***Valuation of stock acquired by inheritance or gift*** - If stock is acquired by inheritance, gift or will, the stock is valued at the market price on the last day of the previous year. The cost of previous owner is not relevant.

163.5 ***Valuation when capital investment is converted into stock-in-trade*** - When an assessee converts his capital assets into stock-in-trade and starts dealing in them, he is entitled to value the investments so converted into stock-in-trade at the market value prevailing on the date of such conversion. In other words, the assessee is not bound to value the investment so converted at the original cost—*CIT* v. *Bai Shirinbai K. Kooka* [1962] 46 ITR 86 (SC).

163.6 ***Valuation of stock withdrawn from business*** - If stock-in-trade is entered in the accounts at cost and is carried forward from year to year at cost, it must be taken out of the accounts also at cost when it is withdrawn from the business—*Kikabhai Premchand* v. *CIT* [1953] 24 ITR 506 (SC).

163.7 ***Valuation of stock in the case of dissolution of firm*** - In *G.R. Ramachari & Co.* v. *CIT* [1961] 41 ITR 142 (Mad.), it was held that the principle of valuing the closing stock of a business at cost or market value at the option of the assessee is a principle that would hold good only so long as there is a continuing business and that where a business is discontinued, whether on account of dissolution or closure otherwise, by the assessee, the profits cannot be ascertained except by taking the closing stock at market value—*Mohammed Hussain Sahib* v. *Abdul Gaffoor Sahib* [1950] 1 MLJ 81. Thus, where on dissolution of assessee-firm, its stock-in-trade is revalued and certain amount is shown as 'difference on revaluation' in the profit and loss account, such surplus on valuation shall be charged to tax as profits of firm—*A.L.A. Firm* v. *CIT* [1991] 189 ITR 285 (SC). Where, however, on the dissolution of the firm the business is taken over by a partner without discontinuance and the value of the closing stock determined under the regular method of accounting is accepted by the partners in the settlement of accounts for dissolution purposes, the Assessing Officer cannot substitute the market value in respect of the closing stock alone for the purpose of determining the income of the firm up to the date of dissolution—*Sakthi Trading Co.* v. *CIT* [2001] 118 Taxman 301 (SC).

For the purpose of valuation of closing stock in a case where there is a dissolution, market value is to be adopted only where such dissolution is accompanied by discontinuance of business and not otherwise—***CIT*** v. ***Kwality Steel Suppliers*** [2004] 141 Taxman 177 (Guj.). Likewise, in case of conversion of proprietary business into partnership firm closing stock cannot to be valued at market price—***CIT*** v. ***M.K. Kathiresan*** [2007] 160 Taxman 402 (Mad.).

163.8 ***Valuation of stock in the case of taking over of a business*** - Where the assessee-company has taken over assets and liabilities of vendor-company, there is no principle of law by which the taxing authority can insist that the assessee should value opening stock not at price it paid to acquire such stock but at manufacturing cost incurred by vendor-company—*CIT* v. *Doom Dooma India Ltd.* [1993] 200 ITR 496 (Gauhati).

163.9 ***Valuation of chicks and birds in the case of poultry farming*** - Section 43(*6*) defines "plant". Under this definition, birds being "livestock" cannot be taken as "plant". Therefore in the case of poultry farming, chicks and birds are required be valued as stock-in-trade. It is a settled law that in case of running business, the stock-in-trade has to be valued either on cost basis or on the basis of market price, whichever is lower— ***L.G. Balakrishnan*** v. ***CIT*** [2003] 129 Taxman 854 (Mad.).

163.10 ***Securities held by a bank*** - The Government securities held by a bank in compliance with provisions of Banking Regulation Act for the purpose of maintaining SLR are stock-in-trade of business of banks and notional loss suffered on account of revaluation of the said securities at close of year, is an allowable deduction in computation of total income of the bank—***CIT*** v. ***Nedungadi Bank Ltd.*** [2003] 130 Taxman 93 (Ker.).

163.11 ***Valuation of stock when MODVAT credit is available [Sec. 145A]*** - According to section 145, the books of account and financial statements is to be prepared in accordance with the regular method of accounting followed by the assessee. However, according to section 145A while determining the income chargeable under the head "Profits and gains of business or profession",

valuation of purchase and sale of goods and inventory should be not only in accordance with the method of accounting regularly employed by the assessee but should also be further adjusted as follows :

i. sale and purchase of goods should be shown at gross amount including duty, tax, cess, etc. ;

ii. while valuing opening and closing inventory tax, duty, cess, etc., should be included as part of cost (or value) of the inventory.

■ *Duty* - Duty should be incurred or actually paid by assessee. Such duty should be incurred for bringing the goods to the place of its location and condition as on the date of valuation. For example, adjustment of duty, tax, etc., arising in a sale can be of excise duty, sales tax, octroi, cess, fee, etc. However, such tax or duty should either be actually paid or incurred for bringing the goods to the place of its location and valuation. This view is also supported by various Accounting Standards and Guidance Notes of the Institute of Chartered Accountants of India (ICAI).

■ *"Net basis"* - In some cases, if a business is accounting for purchases and sales on net basis (*i.e.*, the amount of sales or purchases are shown net of excise, the sales tax, etc.), then for accounting purposes there is no bar on continuing the same but for income-tax purposes, the assessee will have to re-cast the accounts on gross basis as required by section 145A.

■ *MODVAT* - According to the *Explanation* to section 145A, any duty, tax, etc., under any law for the time being in force shall include all such payments notwithstanding any right arising as a consequence to such payment. There can be two views regarding the inclusion of MODVAT in this *Explanation*—

1. According to the first view, MODVAT is not a right arising out of payment. The assessee is not as such paying the duty directly, rather, duty is claimed along with the purchase price. Similarly, MODVAT can be claimed in respect of certain eligible raw materials used in manufacturing the notified excisable goods. Therefore, there exist a relationship between the manufacture of excisable goods and the MODVAT credit but no relationship seems to exist between the payment of duty and the MODVAT credit. Hence, MODVAT cannot form part of adjustments provided by section 145A.

2. According to the second view, memorandum explaining the Finance (No. 2) Bill, 1998, provided for MODVAT adjustment. If MODVAT credit is not taken into account, the basic intent behind enacting this provision may be lost. Accordingly, adjustment should be made regarding MODVAT credit.

The Institute of Chartered Accountants of India has issued a Guidance Note, whereby it has recommended two alternative methods for accounting for MODVAT. According to this Guidance Note, MODVAT can either be included in all purchases and stocks, and finally adjusted it from raw material consumption or in an alternative method, MODVAT can be excluded where accounting is done on "net-basis". However, with effect from April 1, 1999 the accounting for MODVAT can be done only on the "net-basis" as the ICAI has withdrawn the other method of accounting for MODVAT from the guidance note. Similarly, with the insertion of section 145A, only first method of accounting for MODVAT seems to be appropriate. This view is also supported by (Revised) Accounting Standard-2 [AS-2] issued by ICAI.

■ *Guidance note on tax audit under section 44AB* - According to the Guidance Note issued by the ICAI, section 145A provides that the valuation of purchase and sale of goods and inventory for the purpose of computation of income from business or profession shall be made on the basis of the method of accounting regularly employed by the assessee but this shall be subject to certain adjustments. Therefore, it is not necessary to change the method of valuation of purchase, sale and inventory regularly employed in the books of account. The adjustments provided in this section can be made while computing the income for the purpose of preparing the return of income. These adjustments are as follows :

a. any tax, duty, cess or fee actually paid or incurred on inputs should be added to the cost of inputs (raw materials, stores, etc.) if not already added in the books of account ;

b. any tax, duty, cess or fee actually paid or incurred on sale of goods should be added to the sales, if not already added in the books of account ;

c. any tax, duty, cess or fee actually paid or incurred on the inventory (finished goods, work-in-progress, raw materials, etc.) should be added to the inventories, if not already added while valuing the inventory in the accounts.

The following illustration is based upon the guidance note on tax audit under section 44AB—

Particulars	*Qty.*	*Rate excluding excise duty Rs.*	*Rate of excise duty Rs.*
Opening stock	20	10	2
Raw material purchased	180	10	2
Other manufacturing cost	160	10	-
Finished goods manufactured	160	-	-
Sales of finished goods	120	25	3
Closing stock of raw material	40	10	2
Closing stock of finished goods	40	20	3

The input-output ratio of raw material to finished goods is 1 : 1.

The profit and loss account on "net basis" would be as under :

Particulars	*Unit*	*Rate Rs.*	*Amount Rs.*	*Amount Rs.*	*Particulars*	*Unit*	*Rate Rs.*	*Amount Rs.*
Opening Stock	20	10	200		Sales	120	25	3000
Purchase of raw material	180	10	1800		Closing stock of finished goods	40	20	800
Total	200	10	2000					
Less : Closing stock of raw material	40	10	400					
Raw material consumed	160	10	1600	1600				
Manufacturing cost	160	10		1600				
Excise duty				0				
Gross profit				600				
Total				3800	Total			3800

The computation of total income would appear as under :

	Rs.	*Rs.*	*Rs.*
Profit as per profit and loss account on the basis of exclusive method			600
Add : Adjustments required under section 145A :			
- Excise duty on sales (Rs. 3 per unit for 120 units)	360		
- Excise duty on closing stock of raw material (Rs. 2 per unit for 40 units)	80		
- Excise duty on closing stock of finished goods (Rs. 3 per unit for 40 units)	120		
- MODVAT credit utilised on consumption of raw materials (Rs. 2 per unit for 160 units)	320	880	
Less : Adjustment			
- Excise duty on opening stock of raw material (Rs. 2 per unit for 20 units)	40		

	Rs.	*Rs.*	*Rs.*
- Excise duty on purchase of raw materials (Rs. 2 per unit on 180 units)	360		
- Excise duty on sales (paid or incurred as per section 145A)	360	760	120
Less : Deduction under section 43B on the assumption that Rs. 120 (added in the valuation of closing stock of finished goods) is paid on or before due date of filing return of income in respect of excise duty payable on finished goods			120
			600

Hints for tax planning

164. For the purpose of tax planning the following propositions should be borne in mind. However, these propositions would hold good only for the assessment year 1998-99.

164.1 ***Investment in depreciable assets - How much can be financed out of resultant tax savings*** - The factors which determine effective tax savings are :

a. rate of depreciation ; and

b. marginal tax rate.

Case study - An assessee, who carries on a business, acquires a plant and machinery costing Rs. 1,00,000 in year one. This plant and machinery is utilised for the business of the company till year ten when it is discarded and sold at the depreciated price. In this case, the taxpayer can claim depreciation from year one to year ten under section 32. Effective tax benefits depend upon maximum marginal rate of tax. For this purpose, it is assumed that the maximum marginal rate of tax is 33.99 per cent. Tax savings are discounted at the rate of 10 per cent to find out present worth in year one. This case study is based on two plans, namely, (*i*) when owned funds are invested, and (*ii*) when 75 per cent cost of plant is financed by deposit taken from public.

When own funds are invested in plant and machinery - Table 1 presents tax savings on account of deductions available under different circumstances, when own funds are invested in plant and machinery. One can finance 18.84 per cent of investment in plant and machinery by tax savings.

When borrowed funds are invested in plant and machinery - Tables 2 and 3 give data regarding the extent of tax savings when Rs. 75,000 is borrowed from public by accepting deposit at the rate of 9 per cent per annum to finance the investment of Rs. 1,00,000 in plant and machinery. While interest is paid annually, principal is repaid in year nine.

One can finance 23.17 per cent of investment by tax savings.

Table 1

Tax savings under the scheme of depreciation at 15 per cent†

(*Tax rate : 33.99 per cent*)

Year	*Amount of depreciation (investment : Rs. 1,00,000)*	*Tax saving on depreciation*	*Present worth of tax savings (discount rate : 10 per cent)*
	Rs.	*Rs.*	*Rs.*
Year one	15,000	5,099	4,635
Year two	12,750	4,333	3,579
Year three	10,838	3,684	2,767
Year four	9,212	3,131	2,138
Year five	7,830	2,661	1,652
Year six	6,656	2,262	1,275
Year seven	5,657	1,922	986

†Assumed that additional depreciation is not applicable.

Year	*Amount of depreciation (investment : Rs. 1,00,000)*	*Tax saving on depreciation*	*Present worth of tax savings (discount rate : 10 per cent)*
Year eight	4,809	1,635	763
Year nine	4,087	1,389	589
Year ten	3,474	1,181	456
			18,840

Table 2

Present value of differential outflows on purchase of plant and machinery with borrowed funds (Amount of investment : Rs. 1,00,000, amount borrowed : Rs. 75,000)

Year	*Interest at the rate of 9 per cent*	*Own investment and principal repaid*	*Present value of total outflow on principal and interest (discount rate : 10 per cent)*	*Present value of total outflow on principal and interest net of tax (discount rate : 10 per cent) Tax rate : 33.99 per cent*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Year zero	—	25,000	25,000	25,000
Year one	6,750	—	6,136	4,050[2]
Year two	6,750	—	5,576	3,681[2]
Year three	6,750	—	5,069	3,346[2]
Year four	6,750	—	4,610	3,043[2]
Year five	6,750	—	4,192	2,767[2]
Year six	6,750	—	3,807	2,513[2]
Year seven	6,750	—	3,463	2,286[2]
Year eight	6,750	—	3,152	2,081[2]
Year nine	6,750	—	2,862	1,889[2]
Year ten	6,750	75,000	31,556[1]	30,670[3]
Total	67,500	1,00,000	95,423	81,326

Notes :

1. Present worth of Rs. 6,750 : Rs. 2,606 + present worth of Rs. 75,000 : Rs. 28,950.

2. 66.01% of column (*4*).

3. 66.01% of Rs. 2,606 + Rs. 28,950.

Table 3

Contribution of deduction under section 32 when borrowed funds are invested in plant and machinery (Tax rate : 33.99 per cent)

a.	Present worth of total outflow on principal and interest net of tax (*see* Table 2)	Rs. 81,326
b.	Present worth of tax savings on account of deduction under section 32 (*see* Table 1)	Rs. 18,840
c.	(*b*) as % of (*a*)	23.17%

164.2 ***Lease* v. *purchase*** - With the concept of leasing gaining immense popularity in recent times, any business management is faced with the choice to purchase assets or to go in for leasing the asset. One must resolve this issue on economic consideration taking into account the different tax shield effects.

If asset is purchased, the assessee can claim depreciation. Besides, interest on capital borrowed to finance investment in plant and machinery can also be claimed as deduction. If, however, asset is obtained on lease, deduction can be claimed in respect of lease rentals and lease management fees.

For this purpose a case study on the following data has been made. A plant is to be purchased for Rs. 1,00,000. The depreciation rate is 15 per cent and the corporate tax rate 33.99 per cent. The weighted average cost of capital is 10 per cent. The life of the machine is 10 years. A loan of Rs. 75,000 can be had by accepting public deposits at the interest rate of 18 per cent for financing the investment in plant. It is assumed that the public deposits are repaid after 10 years. On the other hand, the asset can be obtained on lease. The lease rentals are at the rate of Rs. 34,000 per annum for the primary lease period of 5 years. Beyond this peppercorn rentals of Rs. 600 per annum are to be paid. A lease management fee of Rs. 1,000 is payable on inception of the lease. In all, three situations have been studied :

Situation 1 - Purchase with own funds - The following results one can obtain on the basis of data presented in Table 1 [para 164.1].

Table 4

Present value of outflow of cash when plant is purchased out of own funds

	Rs.
Investment in plant and machinery	1,00,000
Tax savings on account of depreciation	18,840
Outflow of cash	81,160

Situation 2 - Purchase with borrowed funds - To finance purchase of plant and machinery, a loan (by way of public deposits) of Rs. 75,000 is obtained at the rate of 9 per cent. While interest is paid annually, principal is repaid in year ten. The following results one can obtain on the basis of information presented in Table 3 [Para 164.1].

Table 5

Present value of outflow of cash when plant is purchased out of borrowed funds

	Rs.
Present worth of total outflow on principal and interest net of tax	81,326
Present worth of tax savings on account of deduction under section 32	18,840
Outflow of cash (net of taxes)	62,486

Situation 3 - Taking asset on lease - Table 6 presents data when plant is obtained on lease from own funds.

Table 6

Present value of differential cash outflow on leasing with own funds

Year	*Lease management fee* *Rs.*	*Lease rentals* *Rs.*	*Tax saving on fee and rentals (tax rate : 33.99 per cent)* *Rs.*	*Differential cash outflow* *Rs.*	*Present value of differential cash outflow (discount rate : 10 per cent)* *Rs.*
Year zero	1,000	34,000	11,897	23,103	23,103
Year one	—	34,000	11,557	22,443	20,401
Year two	—	34,000	11,557	22,443	18,538

Year	*Lease management fee*	*Lease rentals*	*Tax saving on fee and rentals (tax rate : 33.99 per cent)*	*Differential cash outflow*	*Present value of differential cash outflow (discount rate : 10 per cent)*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Year three	—	34,000	11,557	22,443	16,855
Year four	—	34,000	11,557	22,443	15,329
Year five	—	600	204	396	245
Year six	—	600	204	396	223
Year seven	—	600	204	396	203
Year eight	—	600	204	396	185
Year nine	—	600	204	396	168
Year ten	—	—	—	—	—
Total					95,250

Conclusion - From the above it would be evident that purchase of plant out of own fund is the best alternative.

164.3 ***Purchase by instalment* v. *Hire*** - If an asset is purchased by instalments, then the taxpayer can claim depreciation under section 32. Besides interest payable on unpaid purchase price can also be claimed as deduction. In the case of obtaining an asset on hire, deduction can be claimed in respect of hire charges. By comparing present value of cash outflows a correct decision can be taken.

Case study - X Ltd., an Indian company, engaged in the business of manufacture of transformers and switchgears, negotiates for the purchase or taking on hire a machine from a concern in U.K. If it acquires the machine, then the total cost will be Rs. 60,00,000 payable in 5 annual (interest-free) instalments of Rs. 12,00,000 each, the payments to be made on July 1 each year beginning with the year 2008. If it takes the machine on hire, it has to pay an annual rent of Rs. 8,00,000 also payable on July 1 each year starting from the same year 2008. The company proposes to use the machine for 10 years from 2008.

The following assumptions have been made :

1. The company is a widely-held company and tax rate is 33.99 per cent.

2. Rate of depreciation on machinery is 15 per cent.

3. Cost of capital is assumed as 10 per cent.

The following chart highlights the tax implication under the two alternatives :

Purchase	*Rs.*
Present value of cash outflow on account of payment of instalments (*see* Note 1)	(-)50,02,800
Tax saving on account of depreciation (*i.e.*, 18.84% of Rs. 60,00,000 - *see* Table 1, para 164.1)	(+)11,30,400
Present value of cash outflow	(-)38,72,400

Hire :	*Rs.*
Present value of cash outflow on account of payment of rent (Note 2)	(–)54,06,400
Present value of tax saving on account of payment of rent	18,37,635
Present value of cash outflow	(–)35,68,765

Conclusion : The machine should be taken on hire.

Note 1 : Present value of cash outflow on account of payment of instalments :

Date of payment	*Amount of instalment* *Rs.*	*Discounted value at 10%* *Rs.*
July 1, 2008	12,00,000	12,00,000
July 1, 2009	12,00,000	10,90,800
July 1, 2010	12,00,000	9,91,200
July 1, 2011	12,00,000	9,01,200
July 1, 2012	12,00,000	8,19,600
Total	60,00,000	50,02,800

Note 2 : Present value of cash outflow on account of payment of hire charges :

Date of payment	*Hire* *Rs.*	*Discounted value* *@ 10%* *Rs.*	*Tax* *@ 33.99%* *Rs.*
July 1, 2008	8,00,000	8,00,000	2,71,920
July 1, 2009	8,00,000	7,27,200	2,47,175
July 1, 2010	8,00,000	6,60,800	2,24,606
July 1, 2011	8,00,000	6,00,800	2,04,212
July 1, 2012	8,00,000	5,46,400	1,85,721
July 1, 2013	8,00,000	4,96,800	1,68,862
July 1, 2014	8,00,000	4,51,200	1,53,363
July 1, 2015	8,00,000	4,10,400	1,39,495
July 1, 2016	8,00,000	3,73,600	1,26,987
July 1, 2017	8,00,000	3,39,200	1,15,294
Total	80,00,000	54,06,400	18,37,635

164.4 *Capital structure decisions* - Before commencing a new project a vital managerial decision regarding selecting right type of capital structure has to be taken. An optimum capital structure is one which maximises shareholders' return. The advantages of having an optimum capital structure are two-fold. It maximises the value of the assets of the company and wealth of its owner and minimises the cost of capital which, in turn, raises its ability to find inbuilt additional investment opportunities. Problem of planning capital structure is of crucial importance and has long-term implications. The tax planner should properly balance risk, cost, control and tax consideration. In capital structure decisions, the cost of capital is an important consideration along with risk factor. One of the main reasons for raising finance through borrowing (as against issue of equity shares) is to increase earning on equity share capital. But excessive use of debt capital increases the financial risk of the company.

Under the tax laws, dividend on shares is not deductible, while interest paid on borrowed capital is allowed as deduction under section 36(1)(*iii*) [*see* also para 127]. Cost of raising finance through borrowing is deductible in the year in which it is incurred (if, however, it is incurred during pre-commencement period, it has to be capitalised). Cost of issue of share is allowed as deduction in five years under section 35D [*see* para 121]. Because of the aforesaid provisions, corporate taxation plays an important role in determining the choice between different sources of financing.

164.4P1 *X Ltd. is a widely-held company. It is currently considering a major expansion of its production facilities and the following alternatives are available :*

	Alternative one Rs.	Alternative two Rs.	Alternative three Rs.
Share capital	*50,00,000*	*20,00,000*	*10,00,000*
Debentures (14 per cent)	—	*20,00,000*	*15,00,000*
Loan from financial institution/bank (@ 18 per cent)	—	*10,00,000*	*25,00,000*

Expected rate of return (before tax) is 25 per cent. The rate of dividend of the company since 1980 is not less than 20 per cent and the date of dividend declaration is June 30 every year.

SOLUTION : *Capital structure decision*

	Alternative one Rs.	Alternative two Rs.	Alternative three Rs.
Return on Rs. 50,00,000	12,50,000	12,50,000	12,50,000
Less :			
Interest on debenture	—	2,80,000	2,10,000
Interest on loan	—	1,80,000	4,50,000
Taxable profit	12,50,000	7,90,000	5,90,000
Tax @ 30% (*plus* 2% of tax as education cess *plus* 1% of tax as secondary and higher education cess)	3,86,250	2,44,110	1,82,310
Return on equity share capital	8,63,750	5,45,890	4,07,690
Rate of return on equity share capital (before dividend tax)	17.28%	27.29%	40.77%

The company should, therefore, opt for the third alternative.

Problems on computation of income from business/profession

165-P1 *X Ltd., carrying on business in manufacture and sale of textiles, showed a net profit of Rs. 8,50,000 in its Profit and Loss Account for the period ending March 31, 2009. On the basis of the following particulars noted from the company's accounts and ascertained on enquiry, compute, giving reasons, the total income of the company for the assessment year 2009-10. The company maintains books of account on the basis of mercantile system.*

1. The general reserve account shows a credit of Rs. 1,75,000 under the head "Surplus on devaluation". The enquiries show that the company had exported textile to U.S.A. during the year 1986-87. The sale proceeds were placed in a separate bank account in U.S.A. which were utilized for import of cotton from time to time. After obtaining permission from the Reserve Bank of India, in January 2009 the company remitted to India a sum of Rs. 5 lakh, being the balance standing to its credit in the said bank account which included the above surplus realized on account of devaluation of the rupee in June 1987. The company claims that the said surplus is not taxable, firstly, on the ground that the said surplus did not relate to the previous year and secondly, the said surplus is not a trading receipt.

2. The company had imported automatic looms under a special permission granted by the Textile Commissioner under the Cotton Textile (Control) Order, 1948. One of the conditions laid down while granting the permission was that the company should execute a bond in favour of President of India agreeing to export an agreed quantity of cloth and in default pay a sum calculated at the rate of 10 paise per metre to cover the shortfall. The company fell short of the target during the previous year as a result of which it was required to pay a sum of Rs. 40,000 towards the shortfall. The company has debited the said amount to "General expenses account".

3. The company has set up a laboratory for conducting research in textile technology. It has incurred a capital expenditure of Rs. 1,00,000 for the said purpose. The amount is shown in the balance sheet as "Laboratory equipment account" but is claimed as deduction in the return of income for the assessment year 2009-10.

4. The interest account includes payments amounting to Rs. 50,000 on deposits made by non-resident buyers of textile manufactured by the company. The said payments were made outside India without deduction of tax.

5. The legal charge includes a sum of Rs. 60,000 paid to solicitors for framing a scheme of amalgamation of another textile mill with the assessee-company. The scheme is approved by the Central Government in public interest.

6. Travelling expenses include a sum of Rs. 1,25,000 being expenditure incurred by the directors of the company in connection with their tour to USA and UK for the purchase of new machinery for setting up a new plant for manufacture of caustic soda.

7. Rs. 1,00,000 (debited to profit and loss account) is paid to an approved National Laboratory with a specific direction that it shall be used for an approved scientific research programme.

8. Rs. 52,400 (debited to profit and loss account) is paid on account of fringe benefit tax.

SOLUTION :

	Rs.
Net profit as per Profit and Loss Account	8,50,000
Adjustments	
Surplus arose on conversion of foreign currency into Indian currency (since foreign currency was kept for purchasing stock-in-trade, it will be revenue receipt)	(+) 1,75,000
Payment of Rs. 40,000 towards the shortfall in export (allowable as deduction since the payment is not penalty)	—
Capital expenditure on scientific research	(–) 1,00,000
Interest to non-residents [not deductible under section 40(a) since tax is not deducted at source]	(+) 50,000
Legal charges for framing amalgamation scheme (deductible under section 35DD in five years)	(+) 48,000
Travelling expenses of directors [section 37(1) does not permit a deduction of capital expenditure]	+ 1,25,000
Weighted deduction under section 35(2AA) in respect of Rs. 1,00,000 paid to a National Laboratory [amount deductible is 1.25 of Rs. 1,00,000, whereas amount debited to P&L a/c is Rs. 1,00,000, excess amount is deducted]	(–) 25,000
Fringe benefit tax (not deductible)	(+) 52,400
Net income	11,75,400

165-P2 *X Ltd., carrying on business in manufacture, sale and export of tyres, tubes and accessories, has disclosed a net profit of Rs. 12,00,000 in its P & L account for the period ending March 31, 2009. On the basis of the following particulars furnished by the company and ascertained on inquiry, compute, giving reasons, its total income for the assessment year 2009-10. The company follows the mercantile system of accounting :*

1. A sum of Rs. 50,000 is debited to compensation account. The company had placed an order for machinery to manufacture tyres with a UK company. However, due to a sudden increase in the price of machinery by the UK company, the assessee cancelled the contract. It was required to pay Rs. 50,000 as compensation. The company claims the said amount as deduction on revenue account or, in the alternate, as loss under the head "Capital gains" as the payment was made towards extinguishment of right to acquire a capital asset.

2. "Loss on export of tyre account" shows a debit of Rs. 2 lakh. In this connection it is explained that two trucks belonging to the company carrying tyres and tubes valued at Rs. 2 lakh were intercepted at the international border and seized by customs authorities for illegal export of tyres and tubes. The goods were confiscated by the customs authorities and a fine of Rs. 1 lakh was levied. The company claims the value of confiscated goods as a trading loss under section 28 and the payment of the fine of Rs. 1 lakh which is debited to rates and taxes account as an expenditure in the course of business under section 37(1).

3. The company had set up a separate unit for manufacture of plastic tubes at Bangalore in 1995. The said unit suffered heavy losses. As a result the same was closed down and the plant and machinery were sold away. The company, however, claims unabsorbed depreciation amounting to Rs. 5 lakh in its return of income. It is not debited to the profit and loss account.

4. During the previous year 1991-92, the assessee-company acquired 5,000 shares of E Ltd., an Indian company, as a result, the entire share capital of the said company is now held by the assessee-company. In May 2008, the assessee-company sold to E Ltd. plant and machinery for Rs. 6,00,000. The actual cost is ascertained at Rs. 4,00,000 and written down value at Rs. 1,50,000.

5. In the years 1997-98 and 1998-99, the Government of India arranged exports of tyres and tubes through the Federation of Tyre Dealers of which the company was a member. The exports which were made to Far Eastern countries resulted in loss which was shared by all members including the company. The Federation thereafter took

up the questions of reimbursement of losses with the Government, which after protracted discussion and correspondence agreed to grant a subsidy calculated at a certain percentage of exports. The assessee-company received its share of subsidy amounting to Rs. 3 lakh in the previous year. The amount stands credited to the "Capital reserve account" and claimed as exempt.

6. Under voluntary retirement scheme framed by the company, four of its employees take voluntary retirement during the previous year 2008-09. A compensation of Rs. 28 lakh is paid to them. The entire amount is debited to the P & L account. The scheme is not in accordance with the guidelines framed under section 10(10C).

SOLUTION :

	Rs.
Net profit as per P & L Account	12,00,000
Adjustments :	
Payment of compensation [not allowable since payment is in the nature of capital expenditure, being made to avoid unnecessary investment in capital asset—*Swadeshi Cotton Mills Co. Ltd.* v. *CIT* [1967] 63 ITR 65 (SC) ; nor can it be allowed as capital loss as there is no transfer of capital asset]	(+) 50,000
Loss arising out of confiscation of stock by customs authorities [not deductible by virtue of *Explanation* to section 37(1)]	(+) 2,00,000
Fine [not allowable as penalty paid for breach of law is not normal incidence of business—see *Haji Aziz & Abdul Shakoor Bros.* v. *CIT* [1961] 41 ITR 350 (SC)]	(+) 1,00,000
Unabsorbed depreciation of a unit closed before the commencement of previous year [allowable as deduction]	(–) 5,00,000
Recovery of loss [taxable under section 41(1)]	(+) 3,00,000
Compensation paid on voluntary retirement of employees [under section 35DDA, one-fifth of such compensation is deductible in the year in which the expenditure is incurred and the balance is deductible in the next four years; section 35DDA is applicable even if the voluntary retirement scheme has not been framed in accordance with the guidelines given under section 10(10C); amount deductible is 1/5 of Rs. 28 lakh]	(+) 22,40,000
Business profit	35,90,000
Capital gain on sale of machinery to wholly owned subsidiary company [since transferee-company is wholly owned Indian subsidiary company of the assessee, the transaction is not treated as transfer under section 47(iv) and surplus arising on transfer is not taxable as capital gain]	—
Net income	35,90,000

165-P3 *The published accounts of X Ltd., a public limited company, for the year ending March 31, 2009 contains the following notes :*

1. The debit for sales tax payment of Rs. 8 lakh relates to a demand issued by the sales tax department in respect of which a stay has been obtained from the High Court on a petition under article 226 of the Constitution disputing the liability.

2. An amount of $12,000 due to the company on account of the agency commission from a foreign company has not been taken into account as income for the year ending March 31, 2009 as the payment of the amount has been withheld by the foreign company on the ground that X Ltd. is liable for damages for breach of certain conditions in relation to the terms of agency agreement.

3. The provision for bonus payable to workers includes additional bonus of Rs. 10 lakh calculated on a claim of increased wages which is the subject-matter of dispute with the Industrial Tribunal, the order of the Tribunal has not yet been received.

4. The company had acquired a building in a rural area near its factory for purpose of promoting rural development and the building has not yet been used for any programme of rural development nor has the company been using it for its business.

For preparing its return of income for the assessment year 2009-10, the company desires to know from you how the items mentioned above are to be treated so as to get the maximum advantage in regard to its tax liability.

SOLUTION :

1. Any sum payable by way of tax is deductible only in the year in which tax is actually paid [sec. 43B - see para 155 for detailed discussion].

2. The income of $12,000 has accrued during the previous year 2008-09. It is, therefore, chargeable to tax for the assessment year 2009-10. The liability for payment of damages is a contingent liability till it is ascertained.

3. Bonus is deductible on payment basis [see para 155].

4. Nothing is deductible under section 35CC from the assessment year 1989-90. Deduction may be claimed under section 35CCA [for detailed discussion, see para 119].

165-P4 *X Ltd. is engaged in the business of manufacture of goods in India for domestic market. The audited profit and loss account for the year ending March 31, 2009 is as follows :*

	Rs.		Rs.
Cost of goods sold	*13,78,100*	*Sales*	*42,70,500*
Office expenses	*1,30,000*	*Rent of quarters near factory given to workers*	*60,000*
Salary to employees	*12,80,000*		
Expenditure on scientific research	*84,000*	*Rent of commercial property given on rent to a foreign bank*	*1,30,000*
Bad debts	*10,000*		
Entertainment expenses	*57,000*	*Sale proceeds of gold (not being stock-in-trade)*	*2,60,000*
Advertisement expenditure	*2,27,000*		
Travelling expenses	*3,20,000*	*Amount charged from persons using guest house of company*	*10,000*
Interest	*82,000*		
Advance Fringe Benefit Tax	*30,000*		
Income and wealth taxes	*86,400*		
Sales tax, excise duty and customs duty	*1,76,000*		
Municipal tax of quarters given to workers	*16,000*		
Municipal tax of commercial property	*12,000*		
Repairs of workers' quarters	*12,000*		
Repairs of commercial property given on rent	*7,000*		
Repairs of factory	*10,000*		
Insurance	*36,000*		
Land revenue of workers' quarters	*2,000*		
Land revenue of commercial building	*6,000*		
Depreciation	*1,86,000*		
Other expenses	*1,10,710*		
Net profit	*4,72,290*		
	47,30,500		*47,30,500*

Other information :

1. *Cost of goods sold includes the following :*

a. *goods of Rs. 3,80,000 purchased on May 10, 2008 from B Ltd. in which Mrs. X holds 70 per cent equity capital (Mrs. X does not hold any share in X Ltd., but X holds 25 per cent share capital in X Ltd., similar goods were purchased on May 11, 2008 from market for Rs. 2,86,000) (out of Rs. 3,80,000, Rs. 3,50,000 is paid by an account payee cheque and Rs. 30,000 is paid in cash) ;*

b. *goods purchased from Y Ltd. of Rs. 90,000 which is paid by a bearer cheque.*

2. *Out of salary to employees of Rs. 12,80,000—*

a. *Rs. 30,000 is employees' contribution to recognised provident fund, Rs. 17,500 of which is credited in the employees' account in the relevant fund before the "due date";*

b. *Rs. 28,600 is bonus which is paid on September 13, 2009 ;*

c. *Rs. 36,000 is commission which is paid on December 1, 2009 ;*

d. *Rs. 10,000 is incentive to workers which is paid on December 10, 2009 ;*

e. *Rs. 40,000 is paid outside India on which tax is not deducted at source ;*

f. *Rs. 6,100 being capital expenditure for promoting family planning amongst employees ; and*

g. *Rs. 30,000 being entertainment allowance given to employees.*

3. Expenditure on scientific research, includes Rs. 30,000, being cost of land and Rs. 16,000 paid to an approved National Laboratory for undertaking scientific research under an approved programme.

4. Entertainment expenses include the following :

a. expenses at a five-star hotel : Rs. 14,000 ;

b. expenses on providing food/beverages to employees in office, factory or other place of their work : Rs. 6,000 ;

c. expenses (directly paid to catering service) on providing food/beverages to employees during working hours in place other than place of work : Rs. 8,000 (i.e., Rs. 47 per day for 6 employees for 20 days plus Rs. 10 per day for 4 employees for 59 days) ;

d. club bills for entertaining customers : Rs. 9,000 ;

e. entertainment expenditure incurred outside India : Rs. 4,700 (permission of RBI has been taken).

5. Advertisement expenditure includes the following :

a. expenditure incurred outside India : Rs. 46,000 (permitted by RBI to the extent of Rs. 31,800) ;

b. articles presented by way of advertisement (60 articles cost of each being Rs. 900, 36 articles cost of each being Rs. 1,700) ;

c. Rs. 16,000 being cost of advertisement which appeared in a newspaper owned by a political party ;

d. Rs. 11,400 being capital expenditure on advertisement ;

e. Rs. 22,000 paid in cash ;

f. Rs. 7,000 paid to a concern in which X has substantial interest (amount is excessive to the extent of Rs. 2,400).

6. Travelling expenses include the following :

a. Rs. 1,60,000 being expenditure incurred on a foreign tour, Rs. 9,000 out of which is incurred in Indian currency and Rs. 1,51,000 in foreign currency (Rs. 1,40,000 permitted by RBI under foreign exchange regulations) for a visit of 8 days to Germany, out of 8 days 2 days are utilised by X for attending personal work ;

b. Rs. 40,000 being expenditure on air fare in India by a sales manager (who is otherwise entitled for a first class rail travel);

c. Rs. 6,000 incurred for purchasing a machine for factory (machine is yet to put to use);

d. Rs. 58,000 being hotel expenses as follows :

i. 4 days visit to Madras : Rs. 16,000 ;

ii. 3 days visit to Bombay : Rs. 6,000 ;

iii. 17 days visit to Bangalore : Rs. 32,000.

7. Out of Rs. 82,000 (being interest) Rs. 60,000 is payable outside India (no tax is deducted at source) and Rs. 15,000 is payable to IDBI (amount is paid on December 6, 2009).

8. Taxes debited to P & L a/c have been paid as follows :

a. income/wealth-tax on May 31, 2009 ;

b. sales tax, excise duty and customs duty : Rs. 1,70,000 on March 31, 2009 and Rs. 6,000 on December 10, 2009 ;

c. municipal tax (workers' quarters) on June 30, 2009 ;

d. municipal tax (commercial building) on June 30, 2009.

9. Out of insurance of Rs. 36,000, Rs. 6,000 is fire insurance premium of workers' quarters (paid on April 10, 2009) and Rs. 4,000 is fire insurance premium of commercial building (paid on April 10, 2009).

10. Land revenue of Rs. 8,000 is paid on September 10, 2009.

11. Other expenses include the following :

a. repairs of guest house : Rs. 6,000 ;

b. cost of facilities provided in the guest house : Rs. 41,200 ;

c. cost of maintaining a holiday home for the benefit of 140 employees of the company : Rs. 30,000 ;

d. amount not deductible under section 37(1) : Rs. 4,000.

12. Indexed cost of acquisition of gold : Rs. 2,41,000.

Determine the amount of net income of X Ltd. for the assessment year 2009-10.

SOLUTION :

	Rs.
Net profit as per P & L a/c	4,72,290
Adjustment	
Advance fringe benefit tax	(+) 30,000
Income-tax and wealth-tax	(+) 86,400
Excess cost of purchasing goods from B Ltd. [not allowed under section 40A(2)]	(+) 94,000
Payment of Rs. 30,000 to B Ltd. in cash [no adjustment is required as Rs. 94,000 paid to B Ltd. is disallowed under section 40A(2)]	—
Payment of Rs. 90,000 by bearer cheque [*i.e.*, 100% of Rs. 90,000]	(+) 90,000
Employees' contribution to provident fund (treated as income)	(+) 30,000
Amount credited to employees' provident fund before "due date"	(–) 17,500
Commission paid after September 30, 2008 (not allowed by virtue of section 43B)	(+) 36,000
Salary paid outside India on which tax is not deducted at source [not allowed by virtue of section 40(a)]	(+) 40,000
Capital expenditure on family planning (one-fifth of such expenditure is deductible in 5 years)	(+) 4,880
Cost of land (not deductible under section 35)	(+) 30,000
Payment to an approved National Laboratory (amount deductible is 1.25 of Rs. 16,000)	(–) 4,000
Entertainment expenses [now fully deductible under section 37(1)]	—
Advertisement expenses incurred outside India to the extent not permitted by RBI (now fully deductible)	—
Advertisement appeared in a newspaper owned by a political party	(+) 16,000
Articles presented of exceeding Rs. 1,000 per article (now fully deductible)	—
Advertisement expenses exceeding Rs. 20,000 paid in cash [100% is disallowed under section 40A(3)]	(+) 22,000
Advertisement expenses paid to a relative [to the extent it is excessive]	(+) 2,400
Capital expenditure on advertisement	(+) 11,400
Travelling expenses incurred outside India [amount deductible is 6 ÷ 8 × (Rs. 1,60,000), *i.e.*, Rs. 1,20,000; amount not deductible is Rs. 1,60,000 – Rs. 1,20,000]	(+) 40,000
Expenditure on air fare for inland travel (fully deductible)	—
Capital expenditure on travelling (not deductible)	(+) 6,000
Hotel expenses (fully deductible)	—
Interest payable outside India on which tax is not deducted at source	(+) 60,000
Interest payable to IDBI paid after the due date of furnishing of return	(+) 15,000
Sales tax, etc., paid after the due date of furnishing of return	(+) 6,000
Municipal tax of commercial property given on rent	(+) 12,000
Repairs of commercial property given on rent	(+) 7,000
Fire insurance premium of commercial property given on rent	(+) 4,000
Land revenue of workers' quarters paid before the due date of furnishing of return (deductible)	—
Land revenue of commercial property given on rent (not deductible)	(+) 6,000
Repairs of guest house (deductible under section 30)	—
Cost of providing different facilities in the guest house (now it is fully deductible)	—
Amount not deductible under section 37(1)	(+) 4,000
Rent of quarters given to workers [treated as business receipt as quarters are generally given to workers for running the business smoothly]	—
Rent of property given to a foreign bank (it is taxable as house property income)	(–) 1,30,000
Sale proceeds of gold (it is taxable under section 45)	(–) 2,60,000
Income under the head "Profits and gains of business or profession" (a)	7,13,870

	Rs.
Income from house property	
Gross annual value (being rent of commercial property)	1,30,000
Less : Municipal tax (not deductible as not paid during the previous year)	*Nil*
Net annual value	1,30,000
Less : Deduction	
Standard deduction (30% of Rs. 1,30,000)	39,000
Income from property (b)	91,000
Capital gain	
Sale proceeds of gold	2,60,000
Less : Indexed cost of acquisition	2,41,000
Long-term capital gain (c)	19,000
Gross total income [(a) + (b) + (c)]	8,23,870
Less : Deductions under sections 80C to 80U	*Nil*
Net income	8,23,870

165-P5 *XYZ Ltd., a company mainly engaged in the business of manufacturing, shows a profit of Rs. 7,86,000 after debiting the following :*

	Rs.
1. *Payment of gratuity voluntarily and on account of commercial expediency to an employee who died abroad while on company's business tour*	*27,900*
2. *Fees paid to an architect for valuation of buildings of the assessee*	*12,500*
3. *Compensation paid to a director on termination of his service*	*1,30,000*
4. *Lump sum consideration paid for obtaining a licence in respect of a technical information from a foreign company to improve quality of products*	4,80,000
5. *Payment made to eliminate underbidding for the purpose of keeping up remunerative prices*	*65,000*
6. *Interest on unpaid purchase price of a business asset*	*14,000*
7. *Expenses incurred to eliminate a drain under statutory obligation*	*1,47,000*
8. *Expenses paid to management consultant for preparation and formulation of budgeting formats*	*34,000*
9. *Expenditure incurred on foreign tours to attend business conferences*	*18,700*
10. *Payment of income-tax in foreign countries*	*82,000*
11. *Payment in advance for a new telephone connection under OYT scheme*	*15,000*
12. *Travelling expenses of a director with the object of negotiating a collaboration with foreign manufacturers for initiation of new line of business*	*80,000*
13. *Payment in annual instalment for a period of 20 years under an approved agreement to a foreign collaborator for technical know-how and for right to manufacture and sell products in India*	*1,80,000*
14. *Betterment charges paid under a Town Planning Scheme*	*12,000*
15. *Expenditure incurred for repairing a property taken on lease*	*4,000*
16. *Legal expenses incurred in connection with issue of capital*	*32,750*
17. *Expenses incurred for registration of a trade mark*	*11,150*
18. *Shares issued at par to employees to further its interest (difference between market price and par value is debited to P & L a/c, and claimed as revenue expenditure)*	*66,750*
19. *Insurance premium paid against consequential loss policy*	*38,000*
20. *Anticipated loss under forward contract for purchase of raw material as a result of decrease in market price*	*1,20,780*

	Rs.
21. Loss on account of non-recovery against a bill due to dishonesty and negligence of employees	*36,000*
22. Loss caused by depreciation of investment in securities	*17,210*
23. Loss caused by non-recovery of tax paid by the assessee as a statutory agent of a non-resident	*8,300*
24. Initial expenditure on installation of fluorescent tube lights	*800*
25. Payment of salary to a foreign technician approved by Government	*1,07,000*
26. Expenditure on accommodation at the place where the factory is situated for directors and officers	*40,000*
27. Lunch at five-star hotel where four representatives of suppliers were taken to lunch and purchase manager and secretary of the company accompanied them	*3,800*
28. Payment of State Electricity Board for providing service lines	*19,000*
29. Payment in respect of income-tax proceedings —	
a. payment for preparation of return of income	*6,000*
b. payment for filing income-tax appeals/reference (the recipient is not an employee of the company)	*11,000*
c. payment of salary @ Rs. 9,000 per month to an employee for dealing with income-tax matters	*1,08,000*
d. payment to a tax consultant (not being an employee) @ Rs. 500 per month for advising company in connection with different obligations/liabilities under the Act	*6,000*
30. Loss on account of non-recovery of advance given to 100 per cent subsidiary company engaged in business of financing subsidiary companies	*1,06,000*
31. Payment of advance fringe benefit tax	*20,000*

Determine the taxable income of the company for the assessment year 2009-10.

SOLUTION :

Net profit as per Profit & Loss Account	7,86,000
Add : Inadmissible expenses	
1. Payment of gratuity on account of commercial expediency is deductible even if there is no express contract or there is no past practice, as it will engender confidence of employees in management—*CIT* v. *Laxmi Cement Distributors (P.) Ltd.* [1976] 104 ITR 711 (Guj.)	—
2. Fee for valuation of buildings is deductible if valuation is required in the course of carrying on business (*i.e.*, for computing insurable value, for ascertaining amount of security offered); if however, valuation is made for the purpose of selling of building it is not deductible	—
3. Compensation paid to a director is deductible if service is terminated in the interest of business of the assessee—*F.E. Dinshaw Ltd.* v. *CIT* [1959] 36 ITR 114 (Bom.)	—
4. Depreciation is deductible @ 25%	3,60,000
5. Payment made to eliminate underbidding to keep remunerative prices is deductible as it is a revenue expenditure	—
6. In the case of existing business interest paid on unpaid purchase price of business asset is deductible as revenue expenditure—*Bombay Steam Navigation Co. (1953) (P.) Ltd.* v. *CIT* [1965] 56 ITR 52 (SC)	—
7. Expenses incurred to eliminate a drain is capital expenditure—*Bean* v. *Doncaster Amalgamated Collieries Ltd.* [1946] 1 All ER 642 (HL)	1,47,000
8. Payment made to a management consultant for devising formats for budgeting is deductible as it is incurred for improvement and rationalisation of administration of assessee's business	—
9. Expenditure incurred for keeping abreast of least techniques and developments in business is deductible—*CIT* v. *S. Krishna Rao* [1970] 76 ITR 664 (AP)	—
10. Income-tax is not deductible ; however, the assessee can claim double taxation relief in respect of doubly taxed income	82,000
11. OYT advance money is allowable as deduction in the year of payment	—

	Rs.
12. Expenditure incurred in connection with initiation of a new venture is a capital expenditure ; it is, therefore, not deductible under section 37(1) [it may be capitalised]	80,000
13. Payment of annual instalment for technical know-how is a revenue expenditure—*ACC Vickers Babcock Ltd.* v. *CIT* [1976] 103 ITR 321 (Bom.)	—
14. Betterment charges are capital expenditure—*CIT* v. *Mihir Textiles Ltd.* [1976] 104 ITR 167 (Guj.)	12,000
15. Expenditure on repairs of leased property is deductible	—
16. Legal expenditure incurred for issue of capital is not deductible—*India Cements Ltd.* v. *CIT* [1966] 60 ITR 52 (SC)	32,750
17. Expenditure on registration of trade mark is a revenue expenditure—*CIT* v. *Finlay Mills* [1951] 20 ITR 475 (SC)	—
18. Premium forgone by a company while issuing shares is not a trading transaction; hence it is not deductible—*Lowry* v. *Consolidated African Selection Trust Ltd.* [1940] 8 ITR (Supp.) 88 (HL)	66,750
19. Amount paid to insure business against loss of profits is deductible	—
20. Anticipated loss in a forward contract is not deductible	1,20,780
21. Loss on account of negligence or dishonesty of employees is deductible—*Curtis* v. *J. & G. Oldfields Ltd.* [1925] 9 TC 319	—
22. Loss on account of depreciation of investment in securities is a capital loss—*Punjab National Bank Ltd.* v. *CIT* AIR 1926 Lahore 373	17,210
23. Loss on account of non-recovery of tax paid by the assessee as a statutory agent is not deductible— *CIT* v. *Abdullabhai Abdul Kadar* [1961] 41 ITR 545 (SC)	8,300
24. Expenditure incurred initially on installation of fluorescent tube lights is a capital expenditure	800
25. Payment of salary to a foreign technician is deductible	—
26. Expenditure on accommodation for directors and officers at the place where the factory is situated is expenditure on maintenance of a guest house [now it is deductible under section 37(1)]	—
27. Expenditure on lunch for representatives of suppliers, purchase manager and secretary is "entertainment expenditure"; it is, however, fully allowed as deduction under section 37(1)	—
28. Payment to State Electricity Board for providing service lines is a revenue expenditure because it is incurred to increase the income of the company	—
29. Expenditure on income-tax proceedings is not disallowed under section 40A(12)	—
30. Loss on account of non-recovery of advances relates to carrying on business ; as business of the 100 per cent subsidiary company relates to financing of subsidiary companies and is allowable as deduction—*CIT* v. *Gillanders Arbuthnot & Co. Ltd.* [1982] 9 Taxman 76 (Cal.)	—
31. Advance fringe benefit tax (not deductible)	20,000
Net income	17,33,590

165-P6 *Discuss the guidelines issued by the Central Board of Direct Taxes regarding taxation of income of non-resident artists, entertainers, sportsmen, etc., from international, national or local events.*

SOLUTION : A few situations given in the Circular No. 787, dated February 10, 2000 are given below —

1. If an artist performs in India gratuitously without any consideration, there would be no income and, consequently, no tax.

2. Where the artist performs in India to promote sale of his records and no consideration is paid for this performance by the record company or anyone else; there will be no tax as he does not receive any income for performance in India.

3. Any consideration received by an artist or performer for the live performance or simultaneous live telecast or broadcast (on radio, television, internet, etc.) in India would qualify as income and, consequently, should be taxable.

Even if separate consideration is received for simultaneous live telecast, etc., of performance, the same shall be taxable in India and is to be treated under the Article on 'Artists and Sportsmen' in the Avoidance of Double Taxation Agreement (DTAA).

4. The consideration paid to the artist to acquire the copyrights of performance in India for subsequent sale abroad (of records, CDs, etc.) or the consideration paid to the artist for acquiring the license for broadcast or telecast overseas is not taxable in India due to exclusions provided in section 9(1)(*vi*).

5. The consideration paid to the artist to acquire the copyrights of performance in India for subsequent sale in India (as records, CDs, etc.) or the consideration paid to the artist for acquiring the license for broadcast or telecast in India is taxable in India as per section 9(1)(*vi*) as royalties. Under the DTAA also, this would fall under the "Royalties" Article.

6. The portion of endorsement fees (for launch or promotion of products, etc.) which relates to artist's performance in India shall be taxable in India in accordance with the provisions of section 5. Under the DTAA, this would fall under the Article on "Artists and Sportsmen".

CHAPTER SEVEN

Capital gains

Chargeability [Sec. 45(1)]

166. Any profit or gain arising from the transfer of a capital asset during a previous year is chargeable to tax under the head "Capital gains" in the immediately following assessment year, if it is not eligible for exemption under sections 54, 54B, 54D, 54EC, 54F, 54G and 54GA. In other words, capital gains tax liability arises only when the following conditions are satisfied :

Condition 1	There should be a capital asset.	*See* para 167.
Condition 2	The capital asset is transferred by the assessee.	For meaning of transfer, *see* para 169.
Condition 3	Such transfer takes place during the previous year.	*See* para 169.3.
Condition 4	Any profit or gain arises as a result of transfer.	For computation of capital gain, *see* para 170.
Condition 5	Such profit or gain is not exempt from tax under sections 54, 54B, 54D, 54EC, 54F, 54G and 54GA.	*See* paras 179 to 185.

If the aforesaid conditions are satisfied, then capital gain is taxable in the assessment year relevant to the previous year in which the capital asset is transferred. However, the following points should be considered —

1. In some cases capital gain is taxable in a year other than the year in which the capital asset is transferred—*see* paras 176.1 and 176.4.

2. In some cases capital gain arises even if there is no "transfer" of capital asset—*see* para 183.3.

Meaning of capital asset [Sec. 2(14)]

167. The expression "capital asset" means property of any kind held by an assessee, whether or not connected with his business or profession. However, the following assets are excluded from the definition of "capital assets" :

	Assets not treated as "capital asset"
Exception 1	Any stock-in-trade, consumable stores or raw material held for the purposes of business or profession.
Exception 2	Personal effects of the assessee, that is to say, movable property including wearing apparel and furniture held for his personal use or for the use of any member of his family dependent upon him—*See* para 167.3.
Exception 3	Agricultural land in India provided it is not situated— *a.* in any area within the territorial jurisdiction of a municipality or a cantonment board, having a population of 10,000 or more ; or *b.* in any notified area.
[illegible]	6½ per cent Gold Bonds, 1977 or 7 per cent Gold Bonds, 1980 or National Defence Gold Bonds, 1980 issued by the Central Government.
Exce[illegible]	Special Bearer Bonds, 1991.
Exception 6	Gold Deposit Bonds issued under Gold Deposit Scheme, 1999.

167.1 ***Property of any kind is a capital asset*** - Property of any kind held by an assessee [except the six cases enumerated above] is a capital asset for the purpose of the Income-tax Act. It includes movable assets, immovable assets, tangible/intangible assets, incorporeal rights, and chooses in action. The term "property" is a term of the widest import and subject to any limitation which the context may require, it signifies every possible interest which a person can clearly hold and enjoy—*Ahmed G.H. Ariff* v. *CWT* [1970] 76 ITR 471 (SC).

167.2 ***Stock-in-trade, raw material, etc., is not a capital asset [Sec.2(14)(i)]*** - By virtue of section 2(*14*)(*i*), any stock-in-trade, consumable stores or raw material held for the purpose of business or profession is not a capital asset. This is because of the fact that any surplus arising on sale or transfer of stock-in-trade, consumable stores or raw material is chargeable to tax as business income under section 28.

167.3 ***Personal effects being movable property are not capital assets [Sec. 2(14)(ii)]*** - Personal effects are not capital assets under section 2(*14*)(*ii*), if the following conditions are satisfied :

1. It should be movable property (including wearing apparel, and furniture).

2. It should be held for personal use by the assessee or any member of his family dependent on him.

3. It should not be jewellery, archaeological collections, drawings, paintings, sculptures, or any work of art.

167.3-1 JUDICIAL RULINGS - One should also keep in view the following judicial pronouncements :

- *Must be intended for personal and household use* - Gold and silver coins and bars used for puja of deities as a matter of pride or ornamentation and normally not intended for personal or household use are not "personal effects" and are, therefore, treated as capital assets—*Maharaja Rana Hemant Singhji* v. *CIT* [1976] 103 ITR 61 (SC). A property intended for personal or household use (may be for ceremonial occasions only), is always a "personal effects". For instance, clothes meant for use at weddings or formal occasions are not used daily. Yet, they are stitched for personal use of the wearer. As such, they would form a part of his personal effects—*CIT* v. *H.H. Maharani Usha Devi* [1998] 98 Taxman 309 (SC). Likewise, silver utensils held by an assessee which are not in use ordinarily and normally by the assessee, but only on certain occasions are personal effects—*Jayantilal A. Shah* v. *K.N. Anantharama Aiyar, CIT* [1985] 23 Taxman 14 (Bom.).

- *Furniture* - Furniture can be said to be movables held for personal use—*CIT* v. *Sitadevi N. Poddar* [1984] 17 Taxman 345 (Bom.).

- *Stamp* - A foreign stamp collection is not a personal effect—*Tibbils* v. *Federal Ins. Co.*, D.C. Mun App. 119 A. 2d. 114, 115.

- *Car, scooter* - Personal effects include car, cycle, scooter, motor-cycle owned and used by the taxpayer—*Re.Tormey* v. *Tormey* [1935] VLR 300, *Re. Fortlage, Ross* v. *Fortlage* [1916] 60 Sol. Jo 527, *Re. Pridham* [1953] 1 DLR 782, *Re. Liverton* v. *Liverton* [1954] NZLR 612.

- *Securities* - Securities are not personal effects—*In re. Burnside's Will* 59 NYS 2d. 829, 831, 185, Misc. 808.

- *Loose diamonds* - Loose diamonds held by an assessee are not personal effects—*CIT* v. *Saroj Goenka* [1983] 140 ITR 88 (Mad.).

- *Goats* - Where the assessee purchases 1172 goats and holds them mainly for grazing on its lands and for procuring their wastes as natural manure to increase agricultural production, goats held by the assessee cannot be said to be personal effects of the assessee— *V. Kalirajan* v. *ITO* [2001] 77 ITD 31 (Mad.).

167.3-2 JEWELLERY - "Jewellery" is a capital asset. "Jewellery" for this purpose includes the following :

a. ornaments made of silver, gold, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stones and whether or not worked or sewn into any wearing apparel ;

b. precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel.

167.4 ***Agricultural land situated in rural area is not a capital asset*** - Agricultural land in India is not a capital asset provided it is not situated —

i. in any area within the territorial jurisdiction of a municipality or a cantonment board having a population of 10,000 or more ; and

ii. in any area specified by the Government *vide* Notification No. 9447, dated January 6, 1994 (*see Taxmann's Direct Taxes Circulars*, Vol. 1, 2006 edition).

If agricultural land is situated in a village which comes within a municipality, then population of the municipality shall be considered (and not of village). In such a case if population of the municipality *exceeds* 10,000, then agricultural land is a capital asset, even if population of the village is less than 10,000—*G.M. Omer Khan* v. *CIT* [1992] 63 Taxman 533 (SC).

167.4-1 WHAT IS AGRICULTURAL LAND - In order to qualify for "agricultural land in India", it is not necessary that land was once agricultural land. It must be agricultural land at the time of sale—*T.S.M.O. Mohamed Othuman* v. *CIT* [1957] 31 ITR 480 (Mad.). True test to be applied for the purpose of determining whether a particular land is agricultural land or not is first to ascertain what is the use to which the land is being actually put. If it is being used for agricultural purpose or even if the agricultural use has ceased but it is apparent that the land is meant to be used for agricultural purpose, it would be agricultural land—*Ranchhodbhai Bhaijibhai Patel* v. *CIT* [1971] 81 ITR 446 (Guj.).

Where land is under agricultural operation on date of sale, it is taken as "agriculture land" and it matters very little how the subsequent purchaser intends land in question to be put to use—***M.S. Srinivasa Naicker*** v. ***ITO*** [2007] 292 ITR 481 (Mad.).

167.4-2 FACTORS TO BE CONSIDERED WHILE DETERMINING WHETHER A PARTICULAR LAND IS AGRICULTURAL LAND OR NOT - The Gujarat High Court in *CIT* v. *Siddharth J. Desai* [1982] 10 Taxman 1 laid down the following guiding factors to be considered while determining the nature and character of the land :

- Whether the land was classified in the revenue record as agricultural and whether it was subject to the payment of land revenue, but this factor alone will not be conclusive.
- Whether the land was actually or ordinarily used for agricultural purposes at or about the relevant time.
- Whether such user of the land was for a long period or whether it was of a temporary character or by way of stop-gap arrangement.
- Whether the income derived from the agricultural operations carried on in the land bore any rational proportion to the investment made in purchasing the land.
- Whether the land, on the relevant date, had ceased to be put to the agricultural use ; if so, whether it was put to an alternative use ; whether, such cesser and/or alternative user was of a permanent or temporary nature.
- Whether the land, though entered in revenue record, had never been actually used for agriculture, whether the owner meant or intended to use it for agricultural purposes.
- Whether the land itself was developed by plotting and providing roads and other facilities.
- Whether there were any previous sales of portions of the land for non-agricultural use.

All these factors would not be present or absent in any case. In each case one or more of these factors may make appearance and the ultimate decision will have to be reached on a balanced consideration of the totality of circumstances.

167.5 *Gold Bonds are not capital assets* - 6½ per cent Gold Bonds, 1977 ; 7 per cent Gold Bonds, 1980, and National Defence Gold Bonds, 1980, issued by the Central Government are not capital assets. It is not necessary that the assessee should be the initial subscriber to the Gold Bonds.

167.6 *Special Bearer Bonds, 1991* - Special Bearer Bonds, 1991, issued by the Central Government are not capital assets by virtue of section 2(*14*)(*v*). In order to avail the benefit of section 2(*14*)(*v*), it is not necessary that the assessee should be the initial subscriber of these bonds.

167.7 *Gold Deposit Bonds, 1999* - Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999, notified by the Central Government are not capital assets by virtue of section 2(*14*)(*vi*) from the assessment year 2000-01.

Types of capital assets

168. There are two types of capital assets—long-term capital asset and short-term capital asset. The following provisions may be noted—

168.1 *Short term/long term capital assets* - "Short term capital asset" means a capital asset held by an assessee for not more than 36 months, immediately prior to its date of transfer. In other words, if a capital asset is held by an assessee for more than 36 months, then it is known as "long term capital asset".

168.1-1 *WHEN SUCH PERIOD IS TAKEN AS 12 MONTHS* - In the following cases, an asset, held for not more than 12 months, is treated as short-term capital asset—

Case 1	Equity or preference shares in a company	Shares may or may not be quoted.
Case 2	Securities (like debentures, Government securities)	Should be quoted in a recognised stock exchange in India.
Case 3	Units of UTI	Units may or may not be quoted.
Case 4	Units of a mutual fund specified under section 10(*23D*)	Units may or may not be quoted.
Case 5	Zero coupon bonds	Bonds may or may not be quoted.

In the aforesaid cases, if an asset is held for more than 12 months immediately prior to its transfer, then it is long-term capital asset.

168.1-2 *HOW TO DETERMINE PERIOD OF HOLDING* - The period of holding shall be determined as follows :

Different situations	How to calculate the period of holding
■ Shares held in a company in liquidation	The period subsequent to the date on which the company goes into liquidation shall be excluded.
■ Capital asset which becomes the property of the assessee in the circumstances mentioned in section 49(1) read with section 2(*42A*)/47 [*i.e.*, when an asset is acquired by gift, will, succession, inheritance or the asset is required at the time of partition of family or under a revocable or irrevocable trust or under amalgamation, etc.]	The period for which the asset was held by the previous owner should be included (such cases are given in column 5 of the table given under para 169.2).
■ Allotment of shares in amalgamated Indian company in lieu shares held in amalgamating company	The period of holding shall be counted from the date of acquisition of shares in the amalgamating company.
■ Right shares	The period of holding shall be counted from the date of allotment of right shares.
■ Right entitlement	The period of holding will be considered from the date of offer to subscribe to shares to the date when such right entitlement is renounced by the person.
■ Bonus shares	The period of holding shall be counted from the date of allotment of bonus shares.

[illegible]	How to calculate the period of holding
■ Issue of shares by the resulting company in a scheme of demerger to the shareholders of the demerged company	The period of holding shall be counted from the date of acquisition of shares in the demerged company [*see* example 1 (*infra*)].
■ Membership right held by a member of recognised stock exchange	*See* column 5 of the table given under para 169.2 [*see* example 2 (*infra*)].
■ Flat in a co-operative society	The period of holding shall be counted from the date of allotment of shares in the society—***CIT* v. *Jindas Panchand Gandhi*** [2005] 279 ITR 552 (Guj.)
■ Sweat equity shares allotted by employer	The period of holding shall be reckoned from the date of allotment or transfer of such equity shares (applicable from the assessment year 2008-09)
■ Transactions in shares and securities not given above—	
1. Date of purchase (through stock exchanges) of shares/securities	Date of purchase by broker on behalf of investor.
2. Date of transfer (through stock exchanges) of shares and securities	Date of broker's note provided such transactions are followed up by delivery of shares and also the transfer deeds.
3. Date of purchase/transfer of shares/securities (transaction taken place directly between parties and not through stock exchanges)	Date of contract of sale as declared by parties provided it is followed up by actual delivery of shares and the transfer deeds.
4. Date of purchase/sale of shares/securities purchased in several lots at different points of time but delivery taken subsequently and sold in parts	The first-in-first-out (FIFO) method shall be adopted to reckon the period of the holding of the security, in cases where the dates of purchase and sale cannot be correlated through specific number of the scrips. In other words, the assets acquired last will be taken to be remaining with the assessee while assets acquired first will be treated as sold.
5. Transfer of a security by a depository (*i.e.*, demat account)	The period of holding shall be determined on the basis of the first-in-first-out method [*see* para 176.11].

Example 1 - X holds 1,000 shares in A Ltd. (date of purchase being June 10, 1996). A Ltd. has two undertakings. One of the undertakings is transferred to B Ltd. in a scheme of demerger. Under the scheme of demerger, on May 6, 2008, B Ltd. issues shares to the shareholders of A Ltd. Consequently, on May 6, 2008, X gets 400 shares in B Ltd. In this case, if X transfers shares in B Ltd., then the period of holding shall be counted from June 10, 1996.

Example 2 - X is a member of DEL Stock Exchange. He purchased the membership ticket on March 2, 1956. The Stock Exchange is converted into a company on November 1, 2008. Consequently, on November 1, 2008, X is allotted 1,000 shares in DEL Stock Exchange Ltd. and a ticket to trade in DEL Stock Exchange Ltd. If X transfers shares in (or ticket to trade in) DEL Stock Exchange Ltd., then period of holding shall be calculated from March 2, 1956.

168.1-3 ***OTHER JUDICIAL PRONOUNCEMENTS*** - One should also keep in view the following judicial pronouncements :

■ *Shares in a company entitling right of occupancy in a flat* - Where the assessee held certain shares in a company by virtue of which a right of occupancy in a flat is conferred on him, these shares cannot be treated as a 'share' mentioned in proviso to section 2(*42A*) and as such where such shares are sold after being held for a period of less than 36 months, gain arising therefrom is to be treated as short-term capital gain—*ITO* v. *Nayana K. Shah* [2000] 74 ITD 419 (Mum.).

■ *Transfer of land after construction of building* - The Calcutta Bench of the Tribunal in the case of *CIT* v. *Sri Sekhar Gupta* [2001] 114 Taxman 122 held that the land is an independent and identifiable capital asset and it continues to remain as an identifiable capital asset even after construction of the building. In this case the Bench approved the capital gains calculations separately for land and building after splitting up the sale consideration for the land and building. The same view is taken by the Rajasthan High Court in *CIT* v. *Vimal Chand Golecha* [1993] 201 ITR

442 and later by the Madras High Court in *CIT* v. *Dr. D.L. Ramachandra Rao* [1999] 236 ITR 51 and *CIT* v. *T.C. Itty Ipe.* [2001] 119 Taxman 137.

- *Transfer of depreciable asset* - In the case of transfer of a depreciable asset (other than an asset used by a power generating unit eligible for depreciation on straight line basis), capital gain (if any) is taken as short-term capital gain, irrespective of period of holding.
- *Conversion of stock-in-trade into capital asset* - When stock-in-trade is converted into a capital asset and thereafter such capital asset is transferred, the holding period of such asset would commence from the date when stock-in-trade was acquired by the assessee and not from the date when the same was converted into a capital asset—*Kalyani Exports & Investment (P.) Ltd.* v. *CIT* [2001] 78 ITD 95 (Pune) (TM).

168.2 ***Why capital assets are divided in short/long-term assets*** - The tax incidence under the head "Capital gains" depends upon whether the capital gain is short-term or long-term. Long-term capital gain is generally taxable at a lower rate. If the asset transferred is short-term, capital gain will be short-term capital gain. Conversely, long-term capital gain arises on transfer of long-term capital asset.

168-P1 *State, giving reason, whether the asset is short-term or long-term in the cases given below—*

1. X purchases a house property on March 10, 2006 and transfers it on June 6, 2008.

2. Y purchases shares in an Indian company on March 10, 2006 and transfers it on June 6, 2008.

3. Z acquires units of a mutual fund on July 7, 2007 and he transfers these units on July 10, 2008.

4. A purchases diamonds on September 12, 2005 and gifts the same to his friend B on December 31, 2006. B transfers the asset on October 20, 2008.

5. B purchases shares in a company through a NSE broker (date of purchase by the broker : November 21, 2007; the company transfers shares in the name of B : January 5, 2008). These shares are transferred by B on December 20, 2008.

SOLUTION :

Taxpayer	*Asset*	*Minimum period to become long-term capital asset*	*Period of holding*	*Short-term or long-term*
X	House property	36 months +	March 10, 2006 to June 6, 2008 (*i.e.*, 26 months and 27 days)	Short-term
Y	Shares	12 months +	26 months and 27 days	Long-term
Z	Units of a mutual fund	12 months +	12 months and 3 days	Long-term
B	Diamonds	36 months +	September 12, 2005 to October 20, 2008	Long-term
B	Shares	12 months +	November 21, 2007 to December 20, 2008	Long-term

Notes :

1. If an asset is acquired by gift, will, etc. [*i.e.*, circumstances mentioned under section 49(1)—see para 173.1-1], then the period of holding of the previous owner is also taken into consideration.
2. In the case of shares, the purchase date by the broker is taken as the date of acquisition.

Transfer of capital asset [Sec. 2(47)]

169. Transfer, in relation to a capital asset, includes sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law.

169.1 ***What is included in transfer*** - The definition of "transfer" under section 2(*47*) is merely inclusive and does not exhaust other kinds of transfer—*Sunil Siddharthbhai* v. *CIT* [1985] 156 ITR 509 (SC). In other words, the expression "transfer" in section 2(*47*) must be read widely and not

narrowly. The definition denotes extension and cannot be treated as restricted—*Blue Bay Fisheries (P.) Ltd.* v. *CIT* [1987] 166 ITR 1 (Ker.). If a particular situation has not been contemplated specifically in section but is otherwise understood as transfer in common parlance, it clearly stands covered within the definition of term 'transfer'— *CIT* v. *Singla Rice & Gen. Mills* [2002] 82 ITD 778 (Delhi).

169.1-1 *DEFINITION IS APPLICABLE ONLY IN THE CASE OF CAPITAL ASSET* - The definition of "transfer" under section 2(*47*) is applicable only in relation to a "capital asset". In other words, the definition is not applicable when an asset (other than capital asset) is transferred.

169.1-2 *TRANSFER INCLUDES SALE OF CAPITAL ASSET [SEC. 2(47)(i)]* - Transfer includes sale. A sale may be defined as a contract founded on money consideration by which the absolute or general property in the subject of sale is transferred from the seller to the buyer. The essentials of a sale are : (*1*) mutual agreement ; (*2*) competent parties ; (*3*) a money consideration ; (*4*) a transfer of the absolute or general property from the seller to the buyer. If any of these ingredients be wanting, there is no sale.

169.1-3 *TRANSFER INCLUDES EXCHANGE* - An exchange involves the transfer of property by one person to another and reciprocally the transfer of property by that other to the first person. There must be a mutual transfer of ownership of one thing for the ownership of another—*CIT* v. *Rasiklal Maneklal (HUF)* [1989] 177 ITR 198 (SC). For instance, conversion of preference shares into ordinary shares is a transaction of the nature of "exchange"—*CIT* v. *Trustees of H.E.H. the Nizam's Second Supplementary Family Trust* [1976] 102 ITR 248 (AP).

- *Lending of securities is not " transfer"* - The transaction of lending shares of same distinctive numbers and receiving back shares of some other numbers is not "exchange"—Circular No. 751, dated February 10, 1997.

169.1-4 *TRANSFER INCLUDES RELINQUISHMENT* - Under section 2(*47*), the word "transfer" includes relinquishment of the asset or the extinguishment of any rights thereon. As the terms "relinquishment" and "extinguishment" are not defined under the Act, one has to depend upon the decided case law for understanding their ordinary meaning.

According to the *Shorter Oxford English Dictionary*, while the word "relinquish" means : to withdraw from, desert, abandon ; to cease to hold, adhere to, the word "extinguish" means : to put a total end to, blot out of existence. In other words, in a transaction of relinquishment, the interest of a person in a property is either given up, abandoned, or surrendered ; but the property in which interest is relinquished continues to exist and the property continues to be owned by some person or persons after the transaction of relinquishment—*CIT* v. *Rasiklal Maneklal (HUF)* [1974] 95 ITR 656 (Bom.).

A relinquishment takes place when the owner withdraws himself from the property and abandons his rights thereto. It presumes that the property continues to exist after the relinquishment—*CIT* v. *Rasiklal Maneklal (HUF)* [1989] 177 ITR 198 (SC).

Extinguishment refers not to extinguishment of asset itself but to extinguishment of holder's right to the assets—*CIT* v. *East India Charitable Trust* [1994] 206 ITR 152/73 Taxman 380 (Cal.).

169.1-4a AMOUNT RECEIVED FROM INSURANCE ON ACCOUNT OF DESTRUCTION OF ASSET - WHETHER AMOUNTS BE TREATED AS EXTINGUISHMENT OF RIGHT - Transfer presumes both the existence of the asset and of the transferee to whom it is transferred. In the case of the damage, partial or complete, or destruction or loss of the property, there is no transfer of it in favour of a third party. It is not taken as "extinguishment". The payment of insurance claim in the case of destruction of property is not chargeable to tax—*Vania Silk Mills (P.) Ltd.* v. *CIT* [1991] 59 Taxman 3 (SC). The effect of the judgment has been nullified in some cases by inserting sub-section (1A) in section 45 (with effect from the assessment year 2000-01) by the Finance Act, 1999—*see* para 176.15 for detailed discussion.

169.1-4b WHETHER REDEMPTION OF PREFERENCE SHARES AMOUNTS TO "TRANSFER" WITHIN SECTION 2(47) - Redemption of preference shares by a company squarely comes within the phrase 'sale, exchange

or relinquishment of the asset' and, consequently, it is treated on transfer—*Anarkali Sarabhai* v. *CIT* [1997] 90 Taxman 509 (SC).

169.1-4c WHETHER REDUCTION OF SHARE CAPITAL AMOUNTS TO "TRANSFER" WITHIN SECTION 2(47) - If there is a reduction of share capital by a company by paying a part of capital to its shareholders, it would result in "extinguishment" of proportionate right in shares held by shareholders and chargeable to capital gains tax in the hands of shareholders—*Kartikeya V. Sarabhai* v. *CIT* [1997] 94 Taxman 164 (SC), *CIT* v. *G. Narasimhan* [1999] 102 Taxman 66 (SC).

169.1-4d DISTRIBUTION OF CAPITAL ASSETS ON DISSOLUTION OF A FIRM - Distribution of capital assets on dissolution of a firm is chargeable to tax [though there is no "transfer"] by virtue of section 45(4) from the assessment year 1988-89—*see* para 176.3-2.

169.1-4e WHEN A PARTNER BRINGS HIS CAPITAL ASSET INTO PARTNERSHIP AS CAPITAL CONTRIBUTION - When a partner brings in his personal asset into the capital of the partnership firm as his contribution to its capital, it amounts to transfer and capital gain is chargeable to tax [sec. 45(3)]—*see* para 176.3-1.

169.1-5 *TRANSFER INCLUDES COMPULSORY ACQUISITION OF AN ASSET [SEC. 2(47)(iii)]* - Transfer of capital asset by way of compulsory acquisition is a transfer [*see* also para 176.4].

169.1-6 *TRANSFER INCLUDES CONVERSION OF CAPITAL ASSET INTO STOCK-IN-TRADE [SEC. 2(47)(iv)]* - *See* para 176.1.

169.1-7 *TRANSFER INCLUDES REDEMPTION OF ZERO COUPON BONDS* - From the assessment year 2006-07, redemption of Zero Coupon bonds will be treated as "transfer". For meaning of Zero Coupon bonds, *see* para 127A.1.

169.1-8 *TRANSFER INCLUDES GIVING POSSESSION OF IMMOVABLE PROPERTIES UNDER PART PERFORMANCE OF A CONTRACT [SEC. 2(47)(v)]* - Any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882, amounts to transfer from the assessment year 1988-89 onwards [*see* para 86.2-4 for provisions of section 53A of the Transfer of Property Act].

Possession need not necessarily be sole and exclusive possession. So long as the transferee is, by virtue of the possession given, enabled to exercise general control over the property and to make use of it for the intended purpose, the mere fact that the owner has also the right to enter the property to oversee the development work or to ensure performance of the terms of agreement does not introduce any incompatibility—***Jasbir Singh Sarkaria, In re*** [2007] 164 Taxman 108 (AAR - New Delhi).

169.1-9 *TRANSFER INCLUDES ANY TRANSACTION WHICH HAS THE EFFECT OF TRANSFERRING AN IMMOVABLE PROPERTY [SEC. 2(47)(vi)]* - Under section 2(47)(*vi*), if the following conditions are satisfied, the transaction is treated as "transfer" —

Condition 1	The transferor is a member of co-operative society/company/AOP.
Condition 2	By virtue of his membership, he has been allotted an immovable property or he will be allotted an immovable property.
Condition 3	The membership right is transferred which has the effect of transferring, or enabling the enjoyment, of the aforesaid immovable property.

169.1-10 *OTHER JUDICIAL PRONOUNCEMENTS* - The following other judicial pronouncements should be kept in view :

- *Auction sale* - Sale includes an auction sale—*CIT* v. *Jagdish Sugar Mills* 1974 Tax LR 526 (All.).
- *Tenancy rights* - Transfer of tenancy right is a "transfer" — *A. Gasper* v. *CIT* [1979] 117 ITR 581 (Cal.).
- *Forward contract* - Receipt arising from the cancellation of a forward contract with a bank is not taxable under section 45 as what actually happens in such a case is transformation of a contractual

right into a monetary right and neither any transfer nor any element of profit is involved—*CIT* v. *Anglo India Jute Mills Co. Ltd.* [1981] 129 ITR 352 (Cal.).

■ *Sham transactions* - A registered document has no doubt evidentiary value, but it cannot be taken as conclusive to prove that the transfer has become effective. Thus, where the assessee had executed a registered sale deed, purporting to sell its factory to a society but, in assessment proceedings, it contended that the sale was a sham transaction and also produced evidence to prove that fact, it was *held* that the Tribunal was not right in ignoring such evidence on the ground that the registered sale deed was a sacrosanct document—*Hira Lal Ram Dayal* v. *CIT* [1980] 122 ITR 461 (Punj. & Har.).

■ *Sales consideration from a party other than buyer* - Section 45 would be applicable even if consideration is received from a party other than the one in whose favour transfer is effected—*see A. Gasper* v. *CIT* [1979] 117 ITR 581 (Cal.).

■ *Temporary transfer* - The expression "transfer" would include even temporary transfer of property—*Rajendra Mining Syndicate* v. *CIT* [1961] 43 ITR 460 (AP). It also includes involuntary transaction (*i.e.*, transfer as a result of operation of law).

■ *Cancellation of agreement* - Where the assessee has paid advance for purchase of a property and as seller avoids performance of contract of sale, the assessee finally receives compensation from seller in terms of deed of cancellation, it is a case of relinquishment of right by the assessee and, therefore, the sum received by the assessee is subject to capital gains tax— *K.R. Srinath* v. *CIT* [2002] 80 ITD 193 (Mad.).

■ *Revaluation of asset* - Simple revaluation of assets does not lead to "transfer". Accordingly, mere revaluation of assets of the firm will not result into any liability under the Income-tax Act— ***Well Pack Packaging*** v. ***CIT*** [2003] 130 Taxman 215 (Mag.).

■ *Family arrangement* - Realignment of interest by way of effecting family arrangement among the family members would not amount to transfer—*CIT* v. *Al. Ramanathan* [2000] 245 ITR 494 (Mad.).

169.2 *Transactions which do not constitute transfer* - For the purpose of section 45, the following transactions are not regarded as transfer :

Section	*Transaction not treated as transfer*	*Conditions to be satisfied*	*What is the cost in the hands of transferee*	*If the transferee subsequently transfers the asset, whether period of holding by the previous owner should be included*
46(1)	Distribution of asset in kind by a company to its shareholders at the time of liquidation	*See* para 169.2-1	Market value of the asset on the date of distribution	Yes
47(*i*)	Distribution of capital asset on total or partial partition of Hindu undivided family	*See* para 169.2-2	Cost to the previous owner	Yes
47(*iii*)	Transfer of capital asset under a gift or will or an irrevocable trust	*See* para 169.2-3	Cost to the previous owner	Yes
47(*iv*)	Transfer of a capital asset by a company to its 100 per cent subsidiary company	*See* paras 169.2-4 and 521	Cost to the previous owner	Yes
47(*v*)	Transfer of a capital asset by a 100 per cent subsidiary company to its holding company	*See* paras 169.2-5 and 521	Cost to the previous owner	Yes
47(*vi*)	Transfer of capital assets in a scheme of amalgamation	*See* paras 169.2-6 and 516	Cost to the previous owner	Yes
47(*via*)	Transfer of shares in an Indian company held by a foreign company to another foreign company under a scheme of amalgamation of the two foreign companies	*See* para 169.2-7	Cost to the previous owner	Yes

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
47(*viaa*)	Transfer of capital assets in a scheme of amalgamation of a banking company with a banking institution	*See* para 169.2-7A	Cost to the previous owner	Yes
47(*vib*)	Transfer in a demerger of a capital asset by the demerged company to resulting company	*See* paras 169.2-8 and 517	Cost to the previous owner	No
47(*vic*)	Transfer of shares held in an Indian company by a demerged foreign company to the resulting foreign company	*See* para 169.2-9		No
47(*vica*)	Any transfer in a business reorganization, of a capital asset by the predecessor co-operative bank to the successor co-operative bank (applicable from the assessment year 2008-09)	—	Cost to the previous owner	No
47(*vicb*)	Any transfer by a shareholder, in a business reorganization, of a capital asset being a share or shares held by him in the predecessor co-operative bank if the transfer is made in consideration of the allotment to him of any share or shares in the successor co-operative bank (applicable from the assessment year 2008-09)	—	Cost to the previous owner	No
47(*vid*)	Transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company	*See* paras 169.2-10 and 517	Proportionate cost of acquisition of shares in demerged company	Yes
47(*vii*)	Allotment of shares in amalgamated company in lieu of shares held in amalgamating company	*See* paras 169.2-11 and 516	Cost of shares in the amalgamating company	Yes
47(*viia*)	Transfer of a capital asset (being foreign currency convertible bonds or GDR) by a non-resident to another non-resident	*See* para 169.2-12		No
47(*viii*)	Transfer of agricultural land in India before March 1, 1970	*See* para 169.2-13		-
47(*ix*)	Transfer of a capital asset (being work of art, manuscript, painting, etc.) to Government/University/national museum, etc.	*See* para 169.2-14		-
47(*x*)	Transfer by way of conversion of bonds or debentures into shares	*See* para 169.2-15	Cost of shares would be cost of bonds/ debentures	No
47(*xa*)	Transfer by way of conversion of bonds [referred to in section 115AC(1)(*a*)] into shares or debentures of any company		Cost of shares/ debentures would be cost of original bonds	No
47(*xi*)	Transfer by way of exchange of a capital asset being membership of a recognized stock exchange for shares of a company	*See* para 169.2-16		No
47(*xii*)	Transfer of land by a sick industrial company which is managed by its workers' co-operative	*See* para 169.2-17		No
47(*xiii*)	Transfer of a capital asset by a firm to a company in the case of conversion of firm into company	*See* paras 169.2-18 and 519		No

Section	*Transaction not treated as "transfer"*	*Conditions to be satisfied*	*What is the cost in the hands of transferee*	*If the transferee subsequently transfers the asset, whether period of holding by the previous owner should be included*
47(*xiiia*)	Transfer of a capital asset, being a membership right held by a member of a recognised stock exchange in India	*See* para 169.2-19	In case of shares, the cost of acquisition would be cost of acquisition of original membership of the exchange. Cost of trading and clearing rights would be *nil*	In case of shares as well as trading/ clearing rights, the period for which the person was a member of the stock exchange immediately prior to such demutualisation/corporatisation
47(*xiv*)	Transfer of a capital asset to a company in the case of conversion of proprietary concern into a company	*See* paras 169.2-20 and 518		No
47(*xv*)	Transfer involved in a scheme of lending of securities	*See* para 169.2-21		No
47(*xvi*)	Transfer of a capital asset in a transaction of reverse mortgage made under a scheme notified by the Government			

The aforesaid transactions are not recognised as "transfer" for the purpose of section 45. Therefore, any profit or gain arising on the above-noted transactions is not chargeable to tax under section 45 ; conversely, any loss arising therefrom is not liable to be set off against other income of the assessee.

169.2-1 ***TRANSFER OF CAPITAL ASSET AT THE TIME OF LIQUIDATION [SEC. 46(1)]*** - If the capital assets are distributed—

a. in kind;
b. by a company;
c. to its shareholders; and
d. on its liquidation,

then such a distribution is not treated as a "transfer".

169.2-2 ***TRANSFER OF CAPITAL ASSET AT THE TIME OF PARTITION OF FAMILY [SEC. 47(i)]*** - Any distribution of capital asset—

a. in kind;
b. by a Hindu undivided family;
c. on total or partial partition of the family,

is not treated as a "transfer".

169.2-3 ***TRANSFER OF CAPITAL ASSET BY GIFT [SEC. 47(iii)]*** - If a capital asset is transferred in kind by any of the modes given below, then it is not treated as "transfer"—

a. under gift;
b. under will; or
c. under an irrevocable transfer.

Provisions illustrated - X gifts a house property to B. It is not treated as a "transfer".

■ EXCEPTION - The aforesaid rule is not applicable, if the following conditions are satisfied—

a. taxpayer is an employee;
b. he has been allotted (directly or indirectly) shares/debentures/warrants by the employer company under a notified Employees' Stock Option Plan/Scheme in accordance with the guideline issued by the Central Government; and
c. the aforesaid shares/debentures/warrants are gifted by the concerned employee to any person.

In the aforesaid case, the gift of shares/debentures/warrants will be treated as "transfer".

Provisions illustrated - X is employed by A Ltd. On June 10, 2007, A Ltd. has given an option to each employee to get 1,000 shares in the company at a pre-determined price of Rs. 15 per share under a notified Employees' Stock Option Plan (ESOP). Consequently, X has been allotted 1,000 shares @ Rs. 15 per share on June 20, 2007 (market value at the time of vesting is Rs. 100 per share, the difference is not taxable as perquisite). However, the difference is taxable in the hands of the employer under fringe benefit tax.

On November 1, 2007, X gifts ESOP shares to a friend (market value Rs. 210 per share). On November 2, 2007, he gifts a house property to another friend. On gift of house property, there is no capital gain as there is no "transfer". However, gift of ESOP shares will be treated as "transfer" and X will have to pay tax on short-term capital gain of Rs. 1,10,000 [*i.e.*, 1,000 x (Rs. 210 – Rs. 100)].

169.2-4 ***TRANSFER OF CAPITAL ASSET BY HOLDING COMPANY TO SUBSIDIARY COMPANY [SEC. 47(iv)]*** - One has to satisfy the following conditions—

Condition 1	Capital asset is transferred by a parent company or its nominee.
Condition 2	It is transferred to a wholly owned‡ subsidiary company†
Condition 3	The subsidiary company is an Indian company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer". It may, however, be noted that if capital asset is transferred as stock-in-trade after February 29, 1988, then the aforesaid rule is not applicable and it will be treated as "transfer".

169.2-5 ***TRANSFER OF CAPITAL ASSET BY SUBSIDIARY COMPANY TO HOLDING COMPANY [SEC. 47(v)]*** - One has to satisfy the following conditions—

Condition 1	The whole of the share capital of a subsidiary company is held by the holding company‡.
Condition 2	Capital asset is transferred by the aforesaid subsidiary company† to its holding company.
Condition 3	The holding company is an Indian company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer". It may, however, be noted that if capital asset is transferred as stock-in-trade after February 29, 1988, then the aforesaid rule is not applicable and it will be treated as "transfer".

169.2-6 ***TRANSFER OF CAPITAL ASSET IN A SCHEME OF AMALGAMATION [SEC. 47(vi)]*** - One has to satisfy the following conditions—

Condition 1	Capital asset is transferred in a scheme of amalgamation.
Condition 2	It is transferred by the amalgamating company.
Condition 3	It is transferred to the amalgamated company.
Condition 4	The amalgamated company is an Indian company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-7 ***TRANSFER OF CAPITAL ASSET IN A SCHEME OF AMALGAMATION OF TWO FOREIGN COMPANIES [SEC. 47(via)]*** - One has to satisfy the following conditions—

Condition 1	The capital asset is shares in an Indian company.
Condition 2	Such shares are held by a foreign company (amalgamating company).
Condition 3	Such shares are transferred in a scheme of amalgamation.

†It covers only the immediate subsidiary company of the holding company. There is no justification for transplanting the definition of 'holding company' under the Companies Act into the provisions of section 47 automatically—*Kalindi Investment (P.) Ltd.* v. *CIT* [2002] 120 Taxman 896 (Guj.).

‡Requirement of section 47(*v*) that whole of the share capital of the subsidiary company should be held by the holding company is certainly not the same thing as whole of the share capital being held in the name of holding company; shares held by holding company jointly with its director are to be treated as held by holding company—***CIT* v. *Papillon Invest. (P.) Ltd.*** [2005] 4 SOT 304 (Mum.).

Condition 4	Such shares are transferred to another foreign company (amalgamated company).
Condition 5	Persons holding at least 25 per cent (in value) shares in the amalgamating foreign company should become shareholders in the amalgamated foreign company.
Condition 6	The above transaction does not attract tax on capital gains in the country in which the amalgamating company is incorporated.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-7A *TRANSFER IN A SCHEME OF AMALGAMATION OF BANKING COMPANY [SEC. 47(viaa)]* - Section 47 has been amended with effect from the assessment year 2005-06 to insert a new clause (*viaa*). It provides that any transfer of a capital asset by a banking company to a banking institution in a scheme of amalgamation of such banking company with such banking institution is not treated as "transfer".

169.2-8 *TRANSFER OF CAPITAL ASSET IN A SCHEME OF DEMERGER [SEC. 47(vib)]* - One has to satisfy the following conditions—

Condition 1	Capital asset is transferred by the demerged company.
Condition 2	It is transferred to the resulting company.
Condition 3	The resulting company is an Indian company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

Provisions illustrated - X Ltd. has 2 industrial units - Unit A and Unit B. In a scheme of demerger, Unit A is transferred to Y Ltd. X Ltd. will be known as demerged company and Y Ltd. will be known as resulting company. If Y Ltd. is an Indian company then transfer of capital asset by X Ltd. to Y Ltd. will not be treated as "transfer".

169.2-9 *TRANSFER OF SHARES IN INDIAN COMPANY IN A SCHEME OF DEMERGER OF A FOREIGN COMPANY [SEC. 47(vic)]* - One has to satisfy the following conditions—

Condition 1	A foreign company (demerged company) holds shares in an Indian company.
Condition 2	Such shares are transferred in a scheme of demerger by the aforesaid demerged company to the resulting foreign company.
Condition 3	Persons holding at least 75 per cent (in value) shares in the demerged foreign company should become shareholders in the resulting foreign company.
Condition 4	The above transaction does not attract tax on capital gains in the country in which the demerged company is incorporated.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-10 *ISSUE OF SHARES BY THE RESULTING COMPANY TO THE SHAREHOLDERS OF THE DEMERGED COMPANY [SEC. 47(vid)]* - One has to satisfy the following conditions—

Condition 1	Shares are issued in a scheme of demerger.
Condition 2	Shares are issued by the resulting company.
Condition 3	Shares are issued to the shareholders of the demerged company.
Condition 4	Shares are issued in consideration of demerger of undertaking.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-11 *ALLOTMENT OF SHARES IN AMALGAMATED COMPANY IN LIEU OF SHARES HELD IN AMALGAMATING COMPANY [SEC. 47(vii)]* - One has to satisfy the following conditions—

Condition 1	There is an amalgamation of 2 companies.
Condition 2	The amalgamated company is an Indian company.
Condition 3	To the shareholders of amalgamating company, shares are allotted in the amalgamated company.
Condition 4	Such shares are allotted in consideration of surrender of shares in the amalgamating company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

Provisions illustrated - The business of X Ltd. (amalgamating company) is transferred in a scheme of amalgamation to Y Ltd. (amalgamated company). Y Ltd. is an Indian company. A person holding 10 shares in X Ltd. is allotted 3 shares in Y Ltd. (in consideration of surrender of shares in X Ltd.). A holds 1,000 shares in X Ltd. He has been allotted 300 shares in Y Ltd. in lieu of 1,000 shares in X Ltd. The allotment of shares in Y Ltd. in lieu of surrender of shareholding in X Ltd. is not treated as a "transfer".

169.2-12 ***TRANSFER OF FOREIGN CURRENCY CONVERTIBLE BONDS OR GDR BY A NON-RESIDENT TO ANOTHER NON-RESIDENT [SEC. 47(viia)]*** - One has to satisfy the following conditions—

Condition 1	Capital asset is foreign currency convertible bonds or Global Depository Receipts.
Condition 2	Capital asset is held by a non-resident.
Condition 3	It is transferred outside India.
Condition 4	It is transferred to another non-resident.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-13 ***TRANSFER OF AGRICULTURAL LAND BEFORE MARCH 1, 1970 [SEC. 47(viii)]*** - If agricultural land is situated in India and it is transferred before March 1, 1970, then it is not treated as "transfer".

169.2-14 ***TRANSFER OF WORK OF ART, MANUSCRIPT, PAINTING, ETC., TO GOVERNMENT/UNIVERSITY/ NATIONAL MUSEUM, ETC. [SEC. 47(ix)]*** - One has to satisfy the following conditions—

Condition 1	Capital asset is any work of art, archaeological, scientific or art collection, book, manuscript, drawing, painting, photograph or print.
Condition 2	It is transferred to the Government or a University or the National Museum, National Art Gallery, National Archives or any other notified institution (*i.e.*, Indira Gandhi National Centre of Art for the assessment years 1987-88 to 2008-09).

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-15 ***CONVERSION OF BONDS OR DEBENTURES INTO SHARES [SEC. 47(x)]*** - One has to satisfy the following conditions—

Condition 1	The capital asset is bonds or debentures or debenture-stock or deposit certificate in any form of a company (the company may be Indian company or foreign company).
Condition 2	The above-noted capital asset is converted into shares or debentures of that company.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer". It may be noted that conversion of preference shares into equity shares is treated as "transfer", as it is not covered by the aforesaid conditions.

169.2-16 ***TRANSFER BY WAY OF EXCHANGE OF MEMBERSHIP OF A RECOGNISED STOCK EXCHANGE FOR SHARES OF A COMPANY [SEC. 47(xi)]*** - One has to satisfy the following conditions—

Condition 1	The taxpayer is a person other than a company.
Condition 2	The capital asset is membership of a recognized stock exchange.
Condition 3	It is transferred to a company in exchange of shares allotted by that company to the transferor.
Condition 4	It is transferred on or before December 31, 1998.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer". It may be noted that if the transfer is made after December 31, 1998 then such a case may be covered by section 47(*xiv*) [*see* para 169.2-20].

169.2-17 ***TRANSFER OF LAND BY A SICK INDUSTRIAL COMPANY WHICH IS MANAGED BY ITS WORKERS' CO-OPERATIVE [SEC. 47(xii)]*** - One has to satisfy the following conditions—

Condition 1	The capital asset is land of a sick industrial company.
Condition 2	The sick industrial company is being managed by its workers' co-operative.
Condition 3	The land is transferred under a scheme prepared and sanctioned under section 18 of Sick Industrial Companies (Special Provisions) Act, 1985.
Condition 4	The above transfer is made during the period commencing from the previous year in which the said company has become a sick industrial company and ending with the previous year during which the entire net worth of such company becomes equal to or exceeds the accumulated losses.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer". "Net worth" for this purpose is paid-up share capital and free reserve. "Free reserves" for this purpose means all reserves credited out of the profits and share premium account but does not include reserves credited out of re-evaluation of assets, write back of depreciation provisions and amalgamation.

169.2-18 *TRANSFER OF CAPITAL ASSETS IN THE CASE OF CONVERSION OF FIRM INTO COMPANY [SEC. 47(xiii)]* - Section 47(*xiii*) covers the following two cases—

Case 1	Conversion of a partnership firm into a company.
Case 2	Demutualisation or corporatisation (as approved by SEBI) of a recognised stock exchange in India as a result of which AOP/BOI which owns the stock exchange is converted into a company.

In any of the aforesaid two cases, transfer of capital assets is not taken as "transfer" if the following conditions are satisfied—

Condition 1	All the business assets and liabilities of the firm/AOP/BOI immediately before conversion are taken over by the company.
Condition 2	All the partners of the firm immediately before conversion become the shareholders of the company.
Condition 3	The partners of the firm do not receive any consideration/benefit (directly or indirectly) in any form other than by way of allotment of shares (may be equity or preference) in the company.
Condition 4	The partners of firm become shareholders in the company in the same proportion in which their capital accounts stood in the books of the firm on the date of the conversion.
Condition 5	The aggregate of the shareholding in the company of the partners of the firm is not less than 50 per cent of the total voting power in the company and their shareholding continues to be as such for a period of five years from the date of succession.

169.2-19 *TRANSFER OF A CAPITAL ASSET, BEING A MEMBERSHIP RIGHT HELD BY A MEMBER OF A RECOGNISED STOCK EXCHANGE IN INDIA [SEC. 47(xiiia)]* - Most of the stock exchanges in India have the concept of membership cards for their members. The twin rights (*i.e.*, right of trading and undivided interest in the ownership of the stock exchange) are embedded in the membership card of a stock exchange. The process of demutualisation of the stock exchange involves segregation of these two twin rights into two separate and independent rights, *viz.*, (*i*) the right to participate in the ownership of assets of the stock exchange by issuance of shares in the new corporate body; and (*ii*) the right to trade on stock exchanges. Thus, the membership card will be exchanged for the shares and the right to trade on the stock exchange.

In order to make the process of demutualisation and corporatisation of stock exchanges tax neutral section 47(*xiiia*) has been inserted. Under this provision, if the following conditions are satisfied, the transfer is not taken as "transfer"—

Condition 1	Capital asset is membership right held by a member of a recognised stock exchange in India.
Condition 2	It is transferred for acquiring shares and trading/clearing right in the stock exchange in accordance with a scheme (approved by SEBI) for demutualisation or corporatisation of stock exchange.

169.2-20 *TRANSFER OF A CAPITAL ASSET IN THE CASE OF CONVERSION OF PROPRIETARY CONCERN INTO A COMPANY [SEC. 47(xiv)]* - One has to satisfy the following conditions—

Condition 1	A sole proprietary concern is converted into a company.
Condition 2	All the business assets and liabilities of the sole proprietary concern immediately before conversion is taken over by the company.
Condition 3	The sole proprietor does not receive any consideration or benefit directly or indirectly, in any form or manner other than by way of allotment of shares in the company.
Condition 4	The shareholding of the sole proprietor in the company is not less than 50 per cent of the total voting power in the company and shareholding shall continue to so remain for a period of five years from the date of succession.

If the aforesaid conditions are satisfied, then the transaction is not treated as "transfer".

169.2-21 *TRANSFER INVOLVED IN A SCHEME OF LENDING OF SECURITIES [SEC. 47(xv)]* - Any transfer involved in a scheme for lending of any securities under an agreement or arrangement subject to the guidelines issued by the SEBI or RBI in this regard, which the assessee has entered into with the borrower of such securities is not treated as "transfer".

169.2-P1 *State, giving reasons, whether the capital gain is taxable in the following cases—*

1. A house property is purchased by a Hindu undivided family in 1950 for Rs. 40,000. It is given to one of the family members in 2008-09 at the time of partition of the family.

2. Y purchases gold in 1974 for Rs. 10,000. In 2008-09, it is gifted to his son at the time of his marriage.

3. Z purchases 10 convertible debentures in 1985 which are converted into 100 shares in 2008 by the company.

4. A Ltd. is 100 per cent holding company of B Ltd. A Ltd. transfers a capital asset (acquired in 1947 for Rs. 50,000) to B Ltd. on June 16, 2008 for Rs. 2,70,000. B Ltd. is an Indian company, while A Ltd. is a foreign company. The capital asset is transferred as capital asset.

5. Suppose in 4 the capital asset is transferred as stock-in-trade.

SOLUTION

1. Distribution of a capital asset by a Hindu undivided family to its members at the time of partition is not treated as "transfer". As the element of "transfer" is missing, capital gain is not chargeable to tax [see, however, para 173.1-1].

2. Transfer by way of gift is not treated as "transfer". Therefore, no capital gain tax liability arises in the case of gift [see, however, para 173.1-1].

3. No capital gain tax liability will arise in the case of conversion of bonds into shares as such conversion is not treated as transfer [see, however, para 176.10].

4. Any transfer between a holding company and 100% subsidiary company is not treated as transfer if the transferee company is an Indian company. In this case, therefore, the element of "transfer" is missing, and hence capital gains tax liability does not arise [see, however, para 521.4].

5. The rule stated in 4 *supra* is not applicable if a capital asset is transferred as a stock-in-trade. Therefore, in this case, capital gain is chargeable to tax.

169.3 ***Transfer when complete and effective*** - Generally, capital gain is taxable in the year in which capital asset is transferred. Different rules are applicable in the case of movable/immovable assets to find out when a capital asset is "transferred".

1. Immovable property when documents are registered - Title to immovable assets will not pass till conveyance deed is executed and registered—*Alapati Venkataramiah* v. *CIT* [1965] 57 ITR 185 (SC). A document on subsequent registration will take effect from the time when it was executed and not from the time of its registration.

2. Immovable property when documents are not registered - Even if the documents are not registered but the following conditions of section 53A of the Transfer of Property Act are satisfied, ownership in the property is "transferred"—

a. there should be a contract in writing ;

b. the transferee has paid consideration or is willing to perform his part of the contract ; and

c. the transferee should have taken possession of the property.

When these conditions are satisfied, the transaction will constitute "transfer" for the purpose of capital gains.

3. Movable property - Title to a movable property passes at the time when property is delivered pursuant to a contract to sell. Entries in the books of account are not relevant for determining the date of transfer—*Alapati Venkataramiah* v. *CIT* (*supra*).

169.3-P1 *State, giving reasons, the assessment year for which capital gain is chargeable to tax in the cases given below —*

1. X sells a house property to Y as per sale deed dated March 30, 2009. The documents are, however, registered on April 6, 2009.

2. Z sells a house property to A as per agreement to sale dated May 6, 2008. A pays the consideration on the same day. The possession is given on June 1, 2008. The sale deed is yet to be registered.

3. B sells shares to C on March 1, 2009. Transfer deed is signed on the same day. Share certificates are delivered at the time of signing the transfer deed. Shares are, however, transferred in the name of C in the records of the company on May 10, 2009.

SOLUTION : *1.* In the case of immovable property, ownership is transferred when sale deed is registered. In such a case, "transfer" takes effect from the date of execution of the sale deed (and not from the date of registration)—*CIT* v. *Ghaziabad Engg. Co. (P.) Ltd.* [2001] 116 Taxman 268 (Delhi). Therefore, in this case transfer takes place during the previous year 2008-09 and, consequently, capital gain is taxable for the assessment year 2009-10.

2. Even if sale deed is not registered, an immovable property is transferred when the conditions of section 53A of the Transfer of Property Act [see para 169.3] are satisfied. These conditions are satisfied on June 1, 2008. Therefore, capital gain is taxable for the assessment year 2009-10.

3. When a movable property is delivered pursuant to a contract to sell, the ownership is transferred. In this case, ownership is transferred on March 1, 2009 and, consequently, capital gain is taxable for the assessment year 2009-10.

Computation of capital gain [Sec. 48]

170. Computation of capital gain depends upon the nature of capital asset transferred, *viz.*, short-term capital asset or long-term capital asset. Capital gain arising on transfer of a short-term capital asset is short-term capital gain, whereas transfer of long-term capital asset generates long-term capital gain. The tax incidence is generally higher in the case of short-term capital gain as compared to long-term capital gain.

The method of computation of short-term and long-term capital gain is as follows :

Computation of short-term capital gain	*Computation of long-term capital gain*
1. Find out full value of consideration [*see* para 171]	*1.* Find out full value of consideration [*see* para 171]
2. Deduct the following :	*2.* Deduct the following :
a. expenditure incurred wholly and exclusively in connection with such transfer [*see* para 172] ;	*a.* expenditure incurred wholly and exclusively in connection with such transfer [*see* para 172] ;
b. cost of acquisition [*see* para 173] ; and	*b.* indexed cost of acquisition [*see* para 175] ; and
c. cost of improvement [*see* para 174]	*c.* indexed cost of improvement [*see* para 175]
3. From the resulting sum deduct the exemption provided by sections 54B, 54D, 54G and 54GA [*see* paras 180, 181 and 184]	*3.* From the resulting sum deduct the exemption provided by sections 54, 54B, 54D, 54EC, 54F, 54G and 54GA [*see* paras 179 to 185]
4. The balancing amount is short-term capital gain	*4.* The balancing amount is long-term capital gain

Note : No deduction will be allowed in respect of payment of securities transaction tax in computing income under the head "Capital gains".

170.1 ***When the benefit of indexation is not available in the case of long-term capital asset*** - In the following cases, the benefit of indexation is not available even if such asset is a long-term capital asset—

Capital assets	Who is the transferor
Bonds or debentures (other than capital indexed bonds issued by the Government)	Any person
Shares in or debentures of an Indian company acquired by utilizing convertible foreign exchange as mentioned first proviso to section 48	Non-resident
Depreciable asset (other than an asset used by a power generating unit eligible for depreciation on straight line basis)	Any person
Undertaking/division transferred by way of slump sale as covered by section 50B	Any person
Units purchased in foreign currency as given in section 115AB	Offshore fund
Global depository receipts (GDR) purchased in foreign currency as given in section 115AC	Non-resident
Global depository receipts (GDR) purchased in foreign currency as given in section 115ACA	Resident individual
Securities as given in section 115AD	Foreign Institution Investors

In these cases, the provisions relating to indexed cost of acquisition and indexed cost of improvement are not applicable.

170.2 ***Capital gains exempt from tax under section 10*** - In the cases given below, capital gains are not chargeable to tax by virtue of section 10. Conversely, in the cases given below if assets are transferred at a loss, such capital loss is not taken into consideration—*CIT* v. *S.S. Thiagarajan* [1981] 129 ITR 115 (Mad.), *Ramjilal Rais* v. *CIT* [1965] 58 ITR 181 (All.).

170.2-1 *CAPITAL GAIN ON TRANSFER OF US64 [SEC. 10(33)]* - Any income arising from the transfer of a capital asset being a unit of US 64 is not chargeable to tax where the transfer of such assets takes place on or after April 1, 2002. This rule is applicable whether the capital asset (US64) is long-term capital asset or short-term capital asset.

170.2-2 *LONG-TERM CAPITAL GAIN ON TRANSFER OF BSE-500 EQUITY SHARES [SEC. 10(36)]* - This exemption does not have any practically utility in view of another exemption given by section 10(*38*) which is explained in para 170.2-4 given below.

170.2-3 *CAPITAL GAIN ON COMPULSORY ACQUISITION OF URBAN AGRICULTURE LAND [SEC. 10(37)]* - Section 10(*37*) is applicable if the following conditions are satisfied—

1. The assessee is an individual or a Hindu undivided family.

2. He or it owns an agriculture land situated in urban area mentioned in section 2(*14*)(*iii*)(*a*)/(*b*).

3. There is transfer of the agriculture land by way of compulsory acquisition or the consideration for transfer is approved or determined by the Central Government or RBI.

4. The agriculture land was used by the assessee (and/or his parents if the land was owned by an individual) for agricultural purposes during 2 years immediately prior to the date of transfer.

5. The asset may be long-term capital asset or short-term capital asset.

6. Capital gain arises from compensation (and/or additional compensation) or consideration which is received by the assessee after March 31, 2004.

■ If the above conditions are satisfied, capital gain (short-term or long-term) is exempt from tax.

170.2-4 *LONG-TERM CAPITAL GAIN ON TRANSFER OF SECURITIES NOT CHARGEABLE TO TAX IN CASES COVERED BY TRANSACTION TAX [SEC. 10(38)]* - Section 10(*38*) is applicable if the following conditions are satisfied—

1. Taxpayer is an individual, HUF, firm or company or any other taxpayer.

2. The asset which is transferred is a long-term capital asset.

3. Such asset is equity share in a company or units of equity oriented mutual fund.

4. Such transaction takes place on or after October 1, 2004.

5. At the time of transfer, the transaction is chargeable to securities transaction tax.†

■ If the above conditions are satisfied, long-term capital gain is exempt from tax. It may be noted that in the case given above if the capital gain is short-term capital gain, by virtue of section111A, it is taxable at the rate of 15 per cent (+ SC + EC + SHEC).

■ For the above purpose "equity oriented fund" means a fund which satisfies the following points—

a. the investible funds are invested by way of equity shares in domestic companies to the extent of more than 65 per cent of the total proceeds of such fund (the percentage of equity shareholding of the fund shall be computed with reference to the annual average of the monthly averages of the opening and closing figures); and

b. the fund has been set up under a scheme of a mutual fund specified under section 10(*23D*).

Full value of consideration [Sec. 48]

171. The dictionary meaning of the word "full" is whole or entire, or complete. The word "full" has been used in this section in contrast to "a part of the price". The expression "full value" means the whole price without any deduction whatsoever. The following points should be noted —

1. Full value of consideration is the consideration received or receivable by the transferor in lieu of assets, which he has transferred. Such consideration may be received in cash or in kind. If it is received in kind, then fair market value of such assets is taken as full value of consideration.

2. The full value of consideration does not mean market value of that asset which is transferred.

3. Adequacy or inadequacy of consideration is not a relevant factor for the purpose of determining of full value of consideration (*see*, however, the provisions of section 50C given in para 176.21).

4. It makes no difference whether (or not) "full value of consideration" is received during the previous year. Even if the full value of consideration is received in instalments in different years, the entire value of consideration has to be taken into account for computing the capital gains, which become chargeable in the year of transfer.

5. Where by acquiring a portion of a larger plot, the value of the unacquired portion is injuriously affected, compensation received for injurious affection of unacquired portion is also part of full value of consideration— *CIT* v. *P. Mahalakshmi* [1982] 134 ITR 428 (Kar.).

6. Section 48 does not show that only consideration shown in sale deed is to be regarded as full value of consideration received; there is nothing in section, which precludes Assessing Officer from substituting actual sale consideration for sale consideration shown in sale deeds, if there is evidence to show that assessee had indeed received higher amount—***Inderpal Singh Ahuja*** v. ***CIT*** [2006] 103 ITD 271 (Asr.).

171.1 ***Cases when "full value of consideration" is determined on notional basis*** - In the cases given below "full value of consideration" is determined on notional basis according to different provisions given in the Income-tax Act—

Different situation	*The amount which is taken as full value of consideration*	*Section*	*Para No.*
Money or other asset received under any insurance from an insurer due to damage or destruction of a capital asset.	Value of money or the fair market value of the asset (on the date of receipt)	45(1A)	176.15

† If these conditions are satisfied and the transaction of sale of equity shares or units of equity oriented mutual fund is recorded in a stock exchange in India or units of equity oriented mutual fund are transferred to the mutual fund, securities transaction tax is applicable [*see* para 533 for detailed discussion].

Different situation	The amount which is taken as full value of consideration	Section	Para No.
Conversion of capital asset into stock in trade	Fair market value of the capital asset on the date of conversion	45(2)	176.1
Transfer of capital asset by a partner/member to firm/association of persons/body of individuals as his capital contribution	Amount recorded in the books of account of the firm/association of persons/body of individuals as the value of the capital asset	45(3)	176.3-1
Distribution of capital asset by firm/association of persons/body of individuals to its partners/members on its dissolution	Fair market value of such asset on the date of transfer	45(4)	176.3-2
Money or other assets received by shareholders at the time of liquidation of the company	Total money *plus* market value of assets received on the date of distribution less amount assessed as deemed dividend under section 2(22)(*c*)	46(2)	176.9
Shares/debentures/warrants/allotted by an employer to an employee under notified Employees Stock Option Plan/Scheme and such shares, etc., are gifted by the concerned employee to any person	Market value at the time of gift	Fourth proviso to section 48	169.2-3
In case of transfer of land or building and sale consideration declared in the conveyance deed is less than the value adopted for the purpose of stamp duty by stamp valuation authority of the State Government	The value adopted by the Stamp Valuation Authority of the State Government	50C	176.21

Expenditure on transfer

172. Expenditure incurred wholly and exclusively in connection with transfer of capital asset is deductible from full value of consideration. The expression "expenditure incurred wholly and exclusively in connection with such transfer" means expenditure incurred which is necessary to effect the transfer. Even if an expenditure has some nexus with the transfer, it does not qualify for deduction unless it is wholly and exclusively in connection with the transfer—*Sita Nanda* v. *CIT* [2001] 119 Taxman 227 (Delhi).

The expression used in section 48, *viz.*, "expenditure incurred wholly and exclusively in connection with such transfer" has wider connotation than the expression "for the transfer"—*CIT* v. *Bradford Trading Co. (P.) Ltd.* [2002] 125 Taxman 632 (Mad.). Any amount, the payment of which is absolutely necessary to effect the transfer will be an "expenditure in connection with transfer". In other words, if without removing any encumbrances, sale or transfer cannot be effected, the amount paid for removing that encumbrance will fall under the aforesaid provision—***Gopee Nath Paul & Sons*** v. ***CIT*** [2005] 147 Taxman 629 (Cal.).

Examples of deductible expenses are : brokerage or commission paid for securing a purchase, cost of stamp, registration fees borne by the vendor, travelling expenses incurred in connection with transfer, litigation expenditure for claiming enhancement of compensation awarded in the case of compulsory acquisition of assets, etc.

One should also keep in view the following propositions :

- *Expenses after passing of title* - Expenditure in connection with transfer need not necessarily have been incurred prior to passing of title—*CIT* v. *P. Rajendran* [1981] 127 ITR 810 (Kar.).
- *Double deduction not possible* - If a sum has already been the subject-matter of deduction under other heads, the same cannot be allowed as deduction under section 48—*CIT* v. *Maithreyi Pai* [1985] 152 ITR 247 (Kar.).

■ *Tenant* - Payment made to a protected tenant of land out of compensation received for acquisition of land is not deductible—*CIT* v. *T. Srinivasa Rao* [1987] 166 ITR 593 (AP). However, amount paid to tenant to get property vacated is deductible from gains arising from sale of property—*CIT* v. *A. Venkataraman* [1982] 137 ITR 846 (Mad.).

■ *Legal expenses* - Legal expenses incurred by the assessee for obtaining compensation for compulsory acquisition of his land can be properly considered as an expenditure incurred wholly and exclusively in connection with such transfer under section 48(1) and it is immaterial whether the expenditure is incurred subsequent to or prior to the award—*CIT* v. *R. Ranga Setty* [1985] 22 Taxman 192 (Kar.).

■ *Expenditure for enhancement of compensation* - Proceedings in a civil court for enhancement of compensation are an integral part of proceedings for transfer of a property in the case of compulsory acquisition. Expenditure incurred in such proceeding is incurred wholly and exclusively in connection with such transfer—*CIT* v. *P. Rajendran* [1981] 127 ITR 810 (Kar.).

■ *Repayment of loan* - Where the assessee-company had taken a loan on security of immovable property and the liquidator sold this property in liquidation proceedings against the assessee, the repayment of the aforesaid loan cannot be said to be an expenditure incurred in connection with transfer of property so as to be allowed as deduction in computation of capital gains—*CIT* v. *S.R.V. Press & Publications (P.) Ltd.* [1999] 107 Taxman 458 (Ker.).

■ *Discharge of mortgage* - Where a property has been mortgaged by the vendor, the amounts spent for discharging that burden of the vendor, whether prior to sale, or at the time of sale, by payment to such creditors including the mortgagees directly by the vendee, cannot be regarded as expenditure wholly and exclusively in connection with the transfer so as to be deductible from capital gains arising on sale of such property in the hands of vendor—*CIT* v. *N. Vajrapani Naidu* [1999] 107 Taxman 277 (Mad.), *CIT* v. *Attili N. Rao* [2001] 119 Taxman 1030 (SC).

■ *Brokerage* - Where assessee had agreed to sell her flat but she could not sell it because it was acquired by appropriate authority but brokerage had become due and was paid by assessee, payment made to brokers was an expenditure incurred wholly and exclusively in connection with transfer of asset and, hence, same was deductible while working out capital gain—***CIT* v. *Leela P. Nanda*** [2006] 102 ITD 281 (Mum.).

■ *Payment to co-operative society to get NOC* - An assessee sells a flat and in computing capital gains claims a sum of Rs. 4 lakh as expenditure under section 48, being payment made to the society for getting NOC from the society for the sale of flat. A sum of Rs. 25,000 is paid as transfer charges and balance of Rs. 3,75,000 is voluntary contribution to the society but to get "no objection certificate" from the society. Since entire amount of Rs. 4 lakh is a necessary expenditure for transfer of flat, it is allowable under section 48—***Damodar G. Nagalia* v. *CIT*** [2007] 12 SOT 600 (Mum.).

Cost of acquisition

173. Cost of acquisition of an asset is the value for which it was acquired by the assessee. Expenses of capital nature for completing or acquiring the title to the property are includible in the cost of acquisition.

One should keep in mind the following propositions taken from judicial rulings :

■ *Ground rent* - Ground rent cannot be said to be expenditure incurred by the assessee for the acquisition of the capital asset and it cannot, therefore, be included in computing the actual cost to the assessee of the capital asset—*CIT* v. *Mithlesh Kumari* [1973] 92 ITR 9 (Delhi).

■ *Interest on money borrowed* - Interest on moneys borrowed to purchase an asset is part of actual cost of asset. However, interest payable on provident fund loan (interest so payable is credited to the provident fund account of the assessee) is not deductible expenditure— *Vashisht Bhargava* v. *ITO* [1975] 99 ITR 148 (Delhi).

■ *Amendment of articles* - Expenses for suits for amending articles of association are of capital nature and are part of cost of shares—*CIT* v. *Bengal Assam Investors Ltd.* [1969] 72 ITR 319 (Cal.).

■ *Litigation expenses for registration of shares* - Litigation expenses incurred for compelling the company to register the shares in the name of the assessee would be of capital nature, forming part of cost of acquisition of the shares—*Bengal Assam Investors Ltd.* (*supra*).

■ *Estate duty* - Estate duty paid in respect of inherited property can neither be treated as part of cost of acquisition of property nor as cost of improvement— *S. Valliammai* v. *CIT* [1981] 127 ITR 713 (Mad.), *R.M. Arunachalam* v. *CIT* [1997] 93 Taxman 423 (SC).

■ *Mortgage* - On June 1, 2004, X took a loan of Rs. 5 lakh by mortgaging his house property. X could not repay the loan during his lifetime and after his death on July 2, 2006, the property (with mortgage) is transferred to Mrs. X. Mrs. X transfers the property on May 2, 2008 and before transfer a sum of Rs. 7.2 lakh is paid to clear of the mortgage. Rs. 7.2 lakh will be deductible as part of cost of acquisition of the property while calculating capital gains in the hands of Mrs. X.

If, however, loan is taken by Mrs. X, then repayment of loan will not be deductible as part of cost of acquisition of the property while calculating capital gains in the hands of Mrs. X—***CIT*** v. ***Roshanbabu Mohammed Hussein Merchant*** [2005] 144 Taxman 720 (Bom.).

■ *Conversion of agriculture land into non-agriculture land* - Where when land was acquired, it was agricultural and later it is sold after being converted into non-agricultural land, the cost of the acquisition is to be taken as cost of acquisition of the agricultural land and not the notional cost as on the date the land is put to non-agricultural use—*Meccane Industries Ltd.* v. *CIT* [2002] 254 ITR 175 (Mad.).

4. Loan is taken from an associate company of the employer to finance allotment to stock option shares. Later on the loan is waived by the associate company. The amount of loan so waived shall be reduced from cost of acquisition—***Ravi Kumar Sinha*** v. ***CIT*** [2007] 15 SOT 555 (Delhi).

173.1 *Notional cost of acquisition* - In the cases given below, the cost of acquisition is taken at a notional figure :

Different situations	*Notional cost of acquisition*	*For detailed discussion, refer to para given below*
1. Additional compensation in the case of compulsory acquisition	*Nil*	176.4-3
2. Assets received by a member on liquidation of the company	Fair market value of such asset on the date of distribution	176.9
3. Stock or shares becoming property of the assessee on consolidation, conversion, etc.	Cost of acquisition of such stock or shares from which such asset is derived	
4. Allotment of shares in an amalgamated Indian company to the shareholders of amalgamating company in a scheme of amalgamation of the two companies	Cost of acquisition of shares in the amalgamating company	516.3-3
5. Conversion of debentures into shares	That part of the cost of debentures in relation to which such asset is acquired by the assessee	176.10
6. Allotment of shares/securities by a company to its employees under Employees' Stock Option Plan/Scheme approved by the Central Government	■ If the option is exercised by the employee during the previous year 1999-2000: Market value at the time of subscription ■ If the option is exercised in any other year: but up to March 31, 2007 : Amount actually paid by the employee	176.17

Different situations	*Notional cost of acquisition*	*For detailed discussion, refer to para given below*
	■ If option is exercised on or after April 1, 2007: Fair market value of shares/securities on the date on which the option vests with the employee	
7. Allotment of shares in Indian resulting company to the shareholders of demerger company before demerger	Cost of acquisition of shares in demerged company × Net book value of assets transferred in demerger ÷ Net worth of the demerged company immediately	517.3-2
8. Cost of acquisition of original shares in demerged company after demerger	Cost of acquisition of such shares *minus* amount calculated above	517.3-2
9. Depreciable assets covered by section 50	The opening balance of the block of assets on the first day of the previous year *plus* actual cost of the assets acquired during the year and which fall within the same block of assets	173.1-3
10. Depreciable assets of a power generating unit as covered by section 50A	The written down value of the asset *minus* terminal depreciation *plus* balancing charge	109.11
11. Undertaking/division acquired by way of slump sale as covered under section 50B	Net worth of such undertaking	520.3
12. New asset acquired for claiming exemption under section 54, 54B, 54D, 54G or 54GA if it is transferred within three years	Actual cost of acquisition *minus* exemption claimed under these sections	179.3, 180.3, 181.3, 184.3
13. Goodwill of business or trade mark or brand name associated with business or right to manufacture, produce or process any article or thing or right to carry on any business, tenancy right, stage permits or loom hours	■ If these assets were acquired by gift, will, etc., under section 49(1) and the previous owner had purchased these assets: Cost of acquisition to the previous owner ■ If the owner has purchased these assets: Actual cost of acquisition is taken ■ If these assets are self-generated: Zero	176.6-1
14. Right shares	Amount actually paid by assessee	176.8
15. Right to subscribe to shares (*i.e.*, right entitlement)	*Nil*	176.8
16. Bonus shares	■ If allotted to the assessee before April 1, 1981: Fair market value on that date ■ In any other case: *Nil*	176.7
17. Allotment of equity shares and right to trade in stock exchange, allotted to members of stock exchange under a scheme of demutualisation or corporatisation of stock exchanges in India as approved by SEBI	■ Cost of acquisition of shares: Cost of acquisition of original membership of the stock exchange ■ Cost of acquisition of trading or clearing rights of the stock exchange: *Nil*	176.20
18. Any other capital asset		
- If it became the property of the assessee before April 1, 1981 by gift, will, etc., in modes specified in section 49(1)	Cost of acquisition to the previous owner or fair market value as on April 1, 1981, whichever is higher	173.1-2

Different situations	*Notional cost of acquisition*	*For detailed discussion, refer to para given below*
- if it became the property of the assessee before April 1, 1981	Cost of acquisition or fair market value as on April 1, 1981 whichever is more	173.1-2
- if it became the property of the assessee after April 1, 1981 by gift, will, etc., in modes specified in section 49(1)	Cost of acquisition to the previous owner	173.1-1
- if it became the property of the assessee after April 1, 1981	Actual cost of acquisition	

173.1-1 *COST OF ASSET TO THE PREVIOUS OWNER [SEC. 49(1)]* - Before discussing the provisions of section 49(1) regarding cost to the previous owner, it is imperative to understand the reasons behind this provision which is explained with the help of a case study given below —

Case study - X(HUF) is a Hindu undivided family having two members — A and B. The family is undergoing a partition. Balance sheet of the family immediately before the partition on March 31, 2008 is as follows—

	Rs.		Market value Rs.
Capital account of—			
X	60,000	House I (cost Rs. 10,000, date of acquisition : May 31, 2005)	60,000
Y	1,50,000	House II (cost : Rs. 40,000, date of acquisition : July 10, 2005)	1,50,000
	2,10,000		2,10,000

For partition, the family has the following two options —

Option one - The family may sell House I and House II and the sale consideration after meeting capital gains tax liability shall be divided between X and Y.

Option two - The family may distribute House I and House II to X and Y at the market value of Rs. 60,000 and Rs. 1,50,000, respectively. In this case, capital assets will be transferred at the time of partition by the family to the members, there will not be any capital gain tax liability, as the element of "transfer" is missing [sec. 47(*i*)—*see* para 169.2]. In other words, if House I (which was purchased by the family for Rs. 10,000) is transferred to X at the market value of Rs. 60,000 at the time of partition, then the surplus of Rs. 50,000 is not treated as capital gain in the hands of the family, as this transaction is not treated as "transfer". However, this exemption of Rs. 50,000 is not a permanent exemption. It will remain valid so long as X does not sell House I to an outsider. Suppose X sells House I on April 30, 2008 for Rs. 67,000, then not only his own capital gain but also the tax free capital gain of the family, will be taxable as capital gain in the hands of X (*i.e.*, Rs. 7,000, being capital gain of X *plus* Rs. 50,000, being gain of the family which was exempt earlier). Therefore, Rs. 57,000 will be taken as capital gain in the hands of X out of the sale consideration of Rs. 67,000 and the cost is taken as Rs. 10,000 which is nothing but cost to the previous owner. The same may be determined as under —

	Rs.
Sale consideration	67,000
Cost of asset to the previous owner (*i.e.*, the family)	10,000
Capital gain in the hands of X	57,000

■ *Provisions of section 49(1)* - Cost to the previous owner is deemed to be the cost of acquisition to the assessee in cases where capital asset became the property of the assessee under any mode of transfer described below [one may also refer to column (3) of the table given in para 169.2]—

a. acquisition of property on any distribution of assets on the total or partial partition of a Hindu undivided family ;

b. acquisition of property under a gift or will ;

c. acquisition of property —

i. by succession, inheritance or devolution, or

ii. on any distribution of assets on the dissolution of a firm, body of individuals or other association of persons (where such dissolution had taken place at any time before April 1987), or

iii. on any distribution of assets on the liquidation of a company [*see* para 176.9], or

iv. under a transfer to a revocable or an irrevocable trust*, or

v. on any transfer, by a wholly-owned Indian subsidiary company from its holding company, or

vi. on any transfer, by an Indian holding company from its wholly-owned subsidiary company, or

vii. on any transfer, in a scheme of amalgamation, by the amalgamated company from the amalgamating company satisfying conditions of section 47(*vi*)/(*via*)/(*viaa*); or

d. acquisition of property, by a Hindu undivided family where one of its members has converted his self-acquired property into joint family property after December 31, 1969.

■ *Other points* - The following points should be duly considered —

1. If a capital asset was acquired in any one of modes given above, then cost to the previous owner shall be taken as "cost of acquisition". There is no option in this regard.

2. In the aforesaid circumstances, cost to the previous owner would be taken as cost to the assessee. Where the previous owner has acquired the property in the aforesaid manner, the previous owner of the property means the last previous owner who acquired the property by means other than those discussed above. Cost of any improvement of the asset borne by the previous owner, or the assessee, will be added to such cost. For instance, if X acquires a house property from his father under a will, the cost of property to the father will be taken as the cost of acquisition at the time of sale of property by X. If, however, the father of X had acquired the property by gift from his friend, cost to the friend will be taken as the cost of acquisition at the time of its sale by X.

3. In order to find out whether a capital asset is a short-term or long-term capital asset in the above cases, the period of holding of the previous owner shall be taken into consideration.

4. The benefit of indexation will be available from the year in which the asset was first held by the current owner [*see* paras 175.2-3, 175.2-4 and 175.2-5].

5. By virtue of section 55(3), where the cost for which the previous owner acquired the property cannot be ascertained, the cost of acquisition to the previous owner means the fair market value on the date on which the capital asset became the property of the previous owner.

6. When the assessee is owner of an asset received under a mode specified under section 49(1) and thereafter the asset is converted by the assessee into a new asset, the period of holding would commence from the date of conversation. In *CIT* v. *Debmalya Sur* [1994] 207 ITR 996/77 Taxman 313 (Cal.), it was held that section 49(1)(*ii*) applies only in relation to cost of the asset which was received by the assessee as a gift. The converted new asset has no nexus with the gift and, therefore, section 49(1)(*ii*) has no application for the purpose of determination of the cost of the converted new asset.

173.1-1P1 *X (HUF) is a Hindu undivided family. The family acquires a residential house at Delhi for Rs. 5,10,000 on April 1, 2006. The family undergoes complete partition on November 1, 2006 and the residential house is allotted to Y, a member of the family (fair market value on November 1, 2006 is Rs. 6,00,000). Y sells the house on March 15, 2009 for Rs. 6,90,000. Determine the amount of chargeable capital gains in the case of X (HUF) and Y.*

*It deals with a situation where the capital asset becomes the property of the assessee under a transfer to a revocable or an irrevocable trust; this clause applies to a situation where any asset is transferred to a revocable or an irrevocable trust; it does not apply where the capital asset becomes the property of any assessee on revocation of the trust—***Jayakumar B. Patil** v. ***CIT*** [2007] 108 ITD 439 (Pune).

SOLUTION : *X (HUF)* - X (HUF) has transferred a house property to Y at the time of partition. Since the transaction is not treated as transfer under section 47(*i*) [see para 169.2], surplus arising thereon is not taxable.

Y - Since Y has transferred a house property, he is chargeable to tax as follows :	Rs.
Sale consideration	6,90,000
Less : Cost of acquisition [since capital asset is acquired in one of circumstances mentioned in section 49(1), cost to the previous owner is taken as cost of acquisition]	5,10,000
Short-term capital gain	1,80,000

Note - Capital gain will be short-term capital gain as the period of holding *i.e.*, April 1, 2006 to March 15, 2009, does not exceed 36 months.

173.1-2 *WHEN COST OF ACQUISITION CAN BE TAKEN AS THE FAIR MARKET VALUE AS ON APRIL 1, 1981 [SEC. 55(2)]* - In the following cases, the assessee may take at his option either actual cost or the fair market value of the asset (other than a depreciable asset), as on April 1, 1981 as cost of acquisition :

a. where the capital asset became the property of the assessee before April 1, 1981 ; or

b. where the capital asset became the property of the assessee by any mode referred to in section 49(1) [*see* para 173.1-1] and the capital asset became the property of the previous owner before April 1, 1981.

Provisions illustrated - Suppose X purchases shares on April 30, 1970 @ Rs. 40 per share. Fair market value on April 1, 1981 is Rs. 90 per share. Now if he sells the shares in 2008-09 at the rate of Rs. 200 per share, he has an option. He can either take actual cost of Rs. 40 per share as cost, or fair market value on April 1, 1981, *i.e.*, Rs. 90 per share. As the fair market value on April 1, 1981 is higher, the resulting capital gain will be lower if it is taken as the cost of acquisition.

■ *Other points* - The following points should be duly considered :

1. The option is available only when an asset was acquired by the assessee [or by the previous owner in case section 49(1) is applicable] before April 1, 1981.

2. The option is not available in the case of depreciable assets.

3. When option is available, the cost of the asset or fair market value as on April 1, 1981, whichever is higher, is taken as the cost of acquisition.

4. For goodwill of business, trade mark or brand name associated with business, or right to manufacture, produce or process any article or thing or right to carry on a business, tenancy rights, stage carriage permits or loom hours, option to take fair market value is not available [whether such asset is self-generated or purchased]. However, if bonus shares are allotted prior to April 1, 1981, the aforesaid option is available.

5. Unearned increase in value of land is not to be deducted while determining fair market value of the property as on April 1, 1981—***CIT*** v. ***Rekha Mathur*** [2006] 152 Taxman 70 (Mag.)/[2005] 98 TTJ (Delhi) 900.

6. Where the assessee had acquired certain pieces of diamond with cracks and spots during the assessment year 1975-76, and during the assessment year 1998-99, a few of such diamonds were got processed and after processing finished diamonds were sold, cost of original asset, *viz.*, raw and uncut diamond shall be substituted by fair market value of the same as on April 1, 1981 and, therefore, for determining capital gain, fair market value of raw and uncut diamonds as on April 1, 1981 shall be taken and not fair market value of polished and finished diamonds—***Hiralal Lokchandani*** v. ***ITO*** [2007] 106 ITD 45 (Kol.)(SB).

173.1-3 *COST OF ACQUISITION IN THE CASE OF DEPRECIABLE ASSETS [SEC. 50]* - The provisions of section 50 are given below. These provisions are applicable in the case of transfer of a depreciable asset in respect of which depreciation was allowed to the assessee in past. However, these provisions are not applicable in the case of transfer of a depreciable asset by a power-generating unit claiming depreciation on the basis of straight-line basis method.

By virtue of section 50, computation of capital gain/loss can be made in the case of transfer of a depreciable asset only in the following two situations—

Situation	Description	Section	Para No. for detailed discussion
Situation one	On the last day of the previous year, written down value of the block of assets is zero	50(1)	173.1-3a
Situation two	When the block of assets is empty on the last day of the previous year	50(2)	173.1-3b

Section 50 provides mode of computation of capital gains in the aforesaid two situations. It may be noted that section 50 would only apply to the cases where an assessee has obtained depreciation—*Kali Aerated Water Works* v. *CIT* [2000] 242 ITR 79 (Mad.).

173.1-3a SITUATION ONE - COMPUTATION WHEN WRITTEN DOWN VALUE IS ZERO [SEC. 50(1)] - In simple words, it can be said that section 50(1) is applicable when the written down value of a block of assets on the last day of the previous year is zero. However, technically speaking, section 50(1) is applicable only if *Step 1* is more than *Step 2* given below—

Step 1	Find out full value of sale consideration of those depreciable assets which have been transferred during the previous year and which fall within the same block of assets.
Step 2	Find out the total of the following— *a.* expenditure incurred wholly or exclusively in connection with such transfer or transfers; *b.* the written down value of the block of assets at the beginning of the previous year; and *c.* the actual cost of any asset(s) falling within the block of assets acquired at any time during the previous year.

For the purpose of *Step 2(c) (supra)*, it is not necessary that—

i. the asset should be put to use during the previous year; and

ii. the assessee should carry on business/profession during the year.

If *Step 1* is more than *Step 2*, then the difference is taken as short-term capital gain. Conversely, if *Step 1* is equal to *Step 2* or *Step 1* is less than *Step 2*, then section 50(1) is not applicable and capital gain is not chargeable to tax (unless the case comes under *Situation 2* which is given below) [*see* problem 173.1-3P1].

173.1-3b SITUATION TWO - COMPUTATION WHEN BLOCK IS EMPTY [SEC. 50(2)] - Section 50(2) is applicable only when a block of assets ceases to exist on the last day of the previous year because all assets in that block are sold during the previous year.

■ *Cost of acquisition* - Cost of acquisition in such a case shall be the aggregate of the following :

Step 1	Find out written down value of block of assets at the beginning of the previous year.
Step 2	*Add*: Actual cost of any asset(s) falling within that block of asset acquired by the assessee during the previous year.

■ *How to compute capital gain/loss* - Capital gain/loss in the respect of the block of assets which ceases to exist on the last day of the previous year shall be calculated as follows—

Find out full value of sale consideration of those depreciable assets which have been transferred during the previous year and which fall within the same block of assets	xxxx
Less:	
Cost of acquisition [as computed above under section 50(2)]	xxxx
Expenditure incidental to transfer	xxxx
Short-term capital gain/loss	xxxx

173.1-3c OTHER POINTS - The following points should be noted—

1. For cost of acquisition, as per section 50A, in the case of transfer of depreciable asset of a power unit (claiming depreciation on a straight line basis), *see* para 109.11.

2. If a depreciable asset in respect of which depreciation was allowed in past (not being the case of power unit as stated above) is transferred and the case does not fall under any of the above two situations, then capital gain is not chargeable to tax.

3. In the above two situations, the capital gain/loss is always short-term capital gain/loss.

4. If two or more depreciable assets falling in the same block of assets are transferred, short-term capital gain or loss cannot be separately calculated. In such a case, the computation of capital gain/loss can be made for the entire block of assets.

5. It is not necessary that depreciation is allowed for the year under consideration. If the depreciation is allowed in the current year (or any of the earlier years), the above provisions of section 50 would be applicable. The above provisions are not applicable if in respect of an asset depreciation was never claimed in past. In other words, if depreciation was claimed in past under section 32, the provisions of section 50 is applicable. For instance, in the year 1986-87, bottles costing less than Rs. 5,000 was acquired and depreciation was claimed @ 100 per cent. These bottles (costing less than Rs. 5,000) constitute part of "block of assets" as contemplated under section 2(*11*) and thereby attract provisions of section 50 at the time of sale—***Jaihind Bottling Co. (P.) Ltd.*** v. ***CIT*** [2005] 1 SOT 1 (Mum.) (SB), ***Raptakas, Brett & Co. Ltd.*** v. ***CIT*** [2004] 141 Taxman 15 (Mum.) (Mag.).

6. When a single asset like the building is transferred, consideration has to be apportioned between the depreciable portion (*i.e.*, superstructure) and the non-depreciable portion (*i.e.*, land) for implementing section 50—***CIT*** v. ***Yamuna Syndicate Ltd.*** [2007] 162 Taxman 167.

7. Where an assessee is running vehicles on hire in earlier years as well as in current year and he declares income under section 44AE, deemed depreciation at the applicable rate shall be treated as allowed and written down value shall be accordingly computed for working out capital gains—***ITO*** v. ***S. Rajendran*** [2006] 104 TTJ (Chennai) 408.

8. Where an assessee sold land with building and the purchaser got building demolished, it was clear that the consideration was only for land and as such even though depreciation had been claimed on building that got demolished, section 50 is inapplicable and gain arising from sale transaction was assessable as long-term capital gain—***CIT*** v. ***Union Co. (Motors) Ltd.*** [2006] 283 ITR 445 (Mad.).

If the entire business is transferred as a going concern against a lump sum consideration and further no part of sale consideration is attributable to any particular asset including any depreciable assets, it is a slump sale and not an itemized sale and, therefore, provisions of section 50(2) cannot be applied to sale transaction in question—***ECE Industries Ltd.*** v. ***CIT*** [2007] 15 SOT 671 (Delhi). Capital gain on slump sale is covered by section 50B [*see* para 520.3].

173.1-3P1 *X Ltd. owns the following assets on April 1, 2008 :*

Asset	Cost of acquisition (Rs.)	Date of acquisition	Written down value on April 1, 2008 (Rs.)
FIRST BLOCK PLANT (RATE OF DEPRECIATION : 15* PER CENT)			
Plant A	3,15,000	*April 1, 1975*	20,000
Plant B	2,30,000	*April 10, 1965*	30,000
Plant C	5,10,000	*May 5, 1971*	25,000
Plant D	1,00,000	*May 21, 1949*	15,000

*25 per cent up to the assessment year 2005-06.

173.1-8 *COST OF ACQUISITION IN THE CASE OF ADVANCE MONEY RECEIVED [SEC. 51]* - In computing cost of acquisition, where any capital asset was, on any previous occasion, subject to negotiations for its transfer, any advance, or other money received and forfeited by the assessee in respect of such negotiation is to be deducted from the cost for which the asset was acquired or from the written down value or fair market value, as the case may be. However, the amount forfeited by the previous owner shall not be considered.

■ For this purpose, no distinction is made between money received or retained by way of 'advance' and 'other money'. The phrase 'other money' would cover, for example, deposits made by the purchaser for guaranteeing the performance of the contracts and not forming part of the consideration. The money received on the previous occasions and retained by the vendor/assessee cannot, therefore, be treated as a revenue receipt—*Travencore Rubber & Tea Co. Ltd.* v. *CIT* [2000] 109 Taxman 250 (SC).

■ Words 'indexed cost of acquisition' are nowhere mentioned in section 51. Where after deducting "advance" received for sale of property the result is a *minus* figure, the cost of acquisition will be *nil* —***Smita N. Shah*** v. ***CIT*** [2005] 94 ITD 492 (Mum.).

173.1-8P1 *X purchases a house property on October 10, 1976 for Rs. 70,000. On May 20, 1982, he enters into an agreement to sell the property to A for Rs. 3,00,000 (after receiving an advance of Rs. 10,000). On A's failure to pay the balancing amount within the stipulated period of 30 days, X forfeits the advance of Rs. 10,000. X sells this property for a consideration of Rs. 21,00,000 on June 1, 2008. Fair market value of the property on April 1, 1981 is (a) Rs. 50,000, or (b) Rs. 4,00,000.*

SOLUTION :

	Fair market value is	
	Rs. 50,000 Rs.	Rs. 4,00,000 Rs.
Sale consideration	21,00,000	21,00,000
Less: Indexed cost of acquisition [*(Rs. 70,000 – Rs. 10,000) × 582 ÷ 100, **(Rs. 4,00,000 – Rs. 10,000) × 582 ÷ 100]	3,49,200*	22,69,800**
Long-term capital gains	17,50,800	(-)1,69,800

Cost of improvement

174. The provisions regarding cost of improvement are given below—

174.1 ***General meaning*** - Cost of improvement is capital expenditure incurred by an assessee in making any additions/improvement to the capital asset. It also includes any expenditure incurred to protect or complete the title to the capital assets or to cure such title. To put it differently, any expenditure incurred to increase the value of the capital asset is treated as cost of improvement.

174.2 ***Special provisions under the Income-tax Act*** - The following special provisions given under section 55 in respect of cost of improvement should be noted—

1. Expenditure incurred before April 1, 1981 not considered - Any cost of improvement incurred before April 1, 1981 is not taken into consideration for calculating capital gain chargeable to tax. This rule does not have any exception. In other words, cost of improvement includes only expenditure on improvement incurred on or after April 1, 1981. Expenditure incurred on improvement of a capital asset before April 1, 1981 is always taken as equal to zero.

2. Double deduction not permitted - Cost of improvement does not include any expenditure which is deductible in computing the income chargeable under the heads "Interest on securities", "Income from house property", "Profits and gains of business or profession" and "Income from other sources".

174.2-1 *COST OF IMPROVEMENT IN DIFFERENT SITUATIONS* - Keeping in view the above provisions, cost of improvement shall be determined in the different situations as follows—

Different situations	*When the capital asset was acquired by gift, will, etc., under the provisions of section 49(1)*	*In any other case*
■ Cost of improvement in relation to goodwill of a business or a right to manufacture, produce or process any article/thing or right to carry on any business—		
a. when these assets are self-generated	*Nil*	*Nil*
b. when these assets are purchased and later on transferred	*Nil*	*Nil*
■ Cost of improvement in relation to any other asset acquired—		
a. before April 1, 1981	Cost of improvement incurred by the assessee and/or the previous owner (ignoring the expenditure incurred before April 1, 1981)	Cost of improvement incurred by the assessee (ignoring the expenditure incurred before April 1, 1981)
b. on or after April 1, 1981	Cost of improvement incurred by the assessee and/or the previous owner.	Cost of improvement incurred by the assessee

The following points should also be kept in view :

■ *Only expenses incurred by assessee* - Only expenses incurred by the assessee are to be taken into account. Where the assessee was a partner in a firm and expenses on the improvement of her self-occupied property were debited to the firm and thus only the assessee's share of the expenses came to be debited to her account in the firm, it was *held* that the expenses actually borne by her were to be considered and the share debited to the other partner's account was not to be taken into consideration—*Parmanand Bhai Patel and Jyotsna Devi Patel* v. *CIT* [1984] 149 ITR 80 (MP).

■ *Capital expenditure* - To bring an expenditure within the meaning of 'cost of improvement', the expenditure in making the addition and alteration to the capital asset has to be an expenditure of capital nature—*Industrial Credits & Development Syndicate Ltd.* v. *CIT* [2001] 251 ITR 720/118 Taxman 705 (Kar.)

■ *Intangible asset* - There can be cost of improvement even in the case of an intangible asset—*S. Valliammai* v. *CIT* [1981] 127 ITR 713 (Mad.).

■ *Compromising of a suit* - Where the assessee had paid an amount to improve his title by compromising a suit filed by a disputant claiming title to the property, it was held that this was not cost of improvement to the asset and could not be deducted for computation of capital gains—*CIT* v. *Indira* [1979] 119 ITR 837 (Mad.).

■ *Betterment charges* - The expenditure in the shape of betterment charges paid under the town planning scheme for acquiring an enduring benefit are in the nature of capital expenditure and go to improve the value of the land ; hence, they would fall under section 48—*Mathuradas Mangaldas Parekh* v. *CIT* [1980] 126 ITR 669 (Guj.).

■ *Forgoing of dividend* - Where the assessee sold shares held by it in other companies and claimed that, in computing capital gains, "negative cost" incurred by way of forgoing of dividends due to appropriation of profits to reserves by said companies should be treated as "cost of improvement" to the assets under section 48, it was held that assessee's claim was rightly rejected—*Investment Corporation of India Ltd.* v. *ITO* [1982] 1 ITD 880 (Bom.) (SB).

■ *Estate duty* - Estate duty paid in respect of inherited property cannot be a part of cost of acquisition/improvement.

Indexed cost of acquisition and indexed cost of improvement

175. *Explanation (iii)* to section 48 defines the term "indexed cost of acquisition" as the amount which bears to the cost of acquisition [for meaning, *see* para 173], the same proportion as cost inflation index for the year in which the asset is transferred bears to the cost inflation index for the first year in which the asset was held by the assessee* or for the year beginning on April 1, 1981, whichever is later.

Similarly, indexed cost of improvement is defined as an amount which bears to the cost of improvement [for meaning of cost of improvement, *see* para 174], the same proportion as cost inflation index for the year in which the asset is transferred bears to the cost inflation index for the year in which the improvement to the asset took place.

175.1 ***Cost inflation index*** - Cost inflation index† as notified by the Central Government for different previous years is given below.

Previous year	Cost inflation index	Previous year	Cost inflation index
1981-82	100	1995-96	281
1982-83	109	1996-97	305
1983-84	116	1997-98	331
1984-85	125	1998-99	351
1985-86	133	1999-2000	389
1986-87	140	2000-01	406
1987-88	150	2001-02	426
1988-89	161	2002-03	447
1989-90	172	2003-04	463
1990-91	182	2004-05	480
1991-92	199	2005-06	497
1992-93	223	2006-07	519
1993-94	244	2007-08	551
1994-95	259	2008-09	582

175.2 ***Computation of indexed cost of acquisition and indexed cost of improvement*** - Indexed cost of acquisition may be computed under any of the following situations —

Situation 1 - Capital asset acquired by the assessee [in the circumstances other than those specified in section 49(1)**], before April 1,1981 [for computation, *see* para 175-2-1].

Situation 2 - Capital asset acquired by the assessee [not being in circumstance specified in section 49(1)**], on or after April 1,1981 [for computation, *see* para 175.2-2].

Situation 3 - Capital asset acquired by the assessee before April 1, 1981 in one of the circumstances specified in section 49(1)** and originally acquired by the previous owner before April 1, 1981 [*see* para 175.2-3 for computation].

Situation 4 - Capital asset acquired by the assessee on or after April 1,1981 in one of the circumstances specified in section 49(1)** and originally acquired by the previous owner before April 1,1981 [*see* para 175.2-4 for computation].

Situation 5 - Capital asset acquired by the assessee on or after April 1,1981 in one of the modes referred to in section 49(1)** and originally acquired by the previous owner on or after April 1, 1981 [*see* para 175.2-5 for computation].

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*In case a property is acquired by making payments by instalments, the benefit of indexation is available from the date of acquisition and not from the date of payment of various instalments —***Charanbir Singh Jolly** v. ***ITO*** [2006] 5 SOT 89 (Mum.)

**For section 49(1), *see* para 173.1-1.

†It is notified by the Central Government for a previous year having regard to seventy-five per cent of average rise in the Consumer Price Index for urban non-manual employees of the immediately preceding previous year to such previous year.

175.2-1 *SITUATION 1* - This situation covers the case where capital asset is acquired by the assessee [not being in modes referred to in section 49(1)] before April 1,1981.

Indexed cost of acquisition will be determined as under :

Fair market value of the asset on April 1,1981 or cost of acquisition, whichever is more / Cost inflation index for 1981-82 (*i.e.*, 100)	×	Cost inflation index for the year in which the asset is transferred

Indexed cost of improvement will be determined as under :

Cost of improvement (ignoring any cost of improvement incurred prior to April 1,1981) / Cost inflation index for the year in which improvement took place	×	Cost inflation index for the year in which the asset is transferred

175.2-1P1 *X purchases a house property for Rs. 76,000 on June 30, 1967. The following expenses are incurred by him for making addition/alteration to the house property :*

	Rs.
a. Cost of construction of first floor in 1975-76	*1,10,000*
b. Cost of construction of the second floor in 1982-83	*4,40,000*
c. Alteration/reconstruction of the property in 1989-90	*2,90,000*

Fair market value of the property on April 1, 1981 is Rs. 6,50,000. The house property is sold by X on June 15, 2008 for Rs. 75,00,000 (expenses incurred on transfer : Rs. 50,000).

SOLUTION : *Computation of long-term capital gain*

	Rs.	Rs.
Sale consideration		75,00,000
Less :		
Expenses on transfer	50,000	
Indexed cost of acquisition (Note 1)	37,83,000	
Indexed cost of improvement (Note 2)	33,30,637	71,63,637
Long-term capital gain		3,36,363

Notes :

1. Indexed cost of acquisition is computed as follows :

Rs. 6,50,000* ÷ 100** × 582*** = Rs. 37,83,000

*Fair market value on April 1, 1981 (actual cost of acquisition is ignored as it is lower than fair market value on April 1,1981).

**Cost inflation index for 1981-82.

***Cost inflation index for 2008-09, *i.e.*, the year in which asset is transferred.

2. Indexed cost of improvement is determined as under :

Construction of first floor in 1975-76 (expenses incurred prior to April 1, 1981 are not considered)	*Nil*
Construction of second floor (*i.e.*, Rs. 4,40,000* × 582** ÷ 109***)	23,49,358
Alteration/reconstruction in 1989-90 (*i.e.*, Rs. 2,90,000* × 582** ÷ 172****)	9,81,279
Indexed cost of improvement	33,30,637

*Cost of improvement

**Cost inflation index for 2008-09

***Cost inflation index for 1982-83

****Cost inflation index for 1989-90

175.2-2 *SITUATION 2* - It covers the case where a capital asset is acquired by the assessee [not being in modes referred to in section 49(1)], on or after April 1, 1981.

In this case indexed cost of acquisition is determined as under :

$$\frac{\text{Cost of acquisition}}{\text{Cost inflation index for the year in which asset is acquired}} \times \text{Cost inflation index for the year in which asset is transferred}$$

Indexed cost of improvement will be determined as under :

$$\frac{\text{Cost of improvement incurred by the assessee}}{\text{Cost inflation index for the year in which improvement took place}} \times \text{Cost inflation index for the year in which asset is transferred}$$

175.2-2P1 *X sells the following capital assets during the previous year 2008-09 :*

	Shares Rs.	Self-generated goodwill Rs.	House property Rs.
Sale consideration	8,50,000	15,00,000	3,15,700
Year of acquisition	1991-92	N.A.	1983-84
Cost of acquisition	2,90,000	Nil	18,000
Cost of improvement incurred in 1989-90	—	—	10,000
Computation of capital gain			
Sale consideration	8,50,000	15,00,000	3,15,700
Less :			
Indexed cost of acquisition	8,48,141[1]	Nil	90,310[2]
Indexed cost of improvement	Nil	Nil	33,837[3]
Long-term capital gain	1,859	15,00,000	1,91,553
Income under the head "Capital gains"			16,93,412

Notes :

1. Indexed cost of acquisition of share is determined as under :
Rs. 2,90,000* × 582** ÷ 199*** = Rs. 8,48,141
*Cost of acquisition
**Cost inflation index for 2008-09
***Cost inflation index for 1991-92.
2. Indexed cost of acquisition of house property is determined as under :
Rs. 18,000* × 582** ÷ 116*** = Rs. 90,310
*Cost of acquisition
**Cost inflation index for 2008-09
***Cost inflation index for 1983-84
3. Indexed cost of improvement is determined as under :
Rs. 10,000* × 582** ÷ 172*** = Rs. 33,837
*Cost of improvement
**Cost inflation index for 2008-09
***Cost inflation index for 1989-90.

175.2-3 *SITUATION 3* - This situation covers the case where capital asset is acquired by the assessee before April 1, 1981 in one of the circumstances specified by section 49(1) and the same is originally acquired by the previous owner prior to April 1, 1981.

Indexed cost of acquisition will be determined as under :

Fair market value of the asset on April 1, 1981 or cost of acquisition to the previous owner, whichever is more / Cost inflation index for 1981-82 (*i.e.*, 100)	× Cost inflation index for the year in which the asset is transferred

Indexed cost of improvement will be determined as follows :

Cost of improvement incurred by the assessee (ignoring the expenses incurred prior to April 1, 1981) / Cost inflation index for the year in which improvement took place	× Cost inflation index for the year in which asset is transferred

175.2-3P1 *X purchases a house property for Rs. 26,000 on May 10, 1962. He gets the first floor of the house constructed in 1967-68 by spending Rs. 40,000. He dies on September 12, 1978. The property is transferred to Mrs. X by his will. Mrs. X spends Rs. 30,000 and Rs. 36,700 during 1979-80 and 1984-85 respectively for renewal/ reconstruction of the property. Mrs. X sells the house property for Rs. 24,50,000 on March 15, 2009 (brokerage paid by Mrs. X is Rs. 24,500). The fair market value of the house on April 1, 1981 is Rs. 2,68,000.*

SOLUTION : *Computation of capital gain*	*Rs.*	*Rs.*
Sale consideration		24,50,000
Less : Expenditure on transfer	24,500	
Indexed cost of acquisition (see Note 1)	15,59,760	
Indexed cost of improvement (see Note 2)	1,70,875	17,55,135
Long-term capital gain		6,94,865

Notes :

1. Indexed cost of acquisition	
Cost to the previous owner	26,000
Fair market value on April 1, 1981	2,68,000
Cost inflation index for 1981-82	100
Cost inflation index for 2008-09	582
Indexed cost of acquisition (*i.e.*, Rs. 2,68,000 × 582 ÷ 100)	15,59,760
2. Indexed cost of improvement	
Cost of improvement incurred prior to April 1, 1981 (not considered)	—
Cost of improvement incurred in 1984-85	36,700
Cost inflation index for 1984-85	125
Cost inflation index for 2008-09	582
Indexed cost of improvement (*i.e.*, Rs. 36,700 × 582 ÷ 125)	1,70,875

175.2-4 *SITUATION 4* - This situation covers the case where capital asset is acquired by the assessee on or after April 1, 1981 in one of the modes referred to in section 49(1) but it was originally acquired by the previous owner before April 1, 1981.

Indexed cost of acquisition will be determined as under :

Fair market value of the asset on April 1, 1981 or cost of acquisition to the previous owner, whichever is more / Cost inflation index for the year in which asset was first held by the assessee	× Cost inflation index for the year in which asset is transferred

Indexed cost of improvement will be computed as under :

$$\frac{\text{Cost of improvement incurred by the assessee and previous owner (ignoring the expenses incurred prior to April 1, 1981)}}{\text{Cost inflation index for the year in which improvement took place}} \times \text{Cost inflation index for the year in which asset is transferred}$$

175.2-4P1 *X purchases a property on April 1, 1976 for Rs. 95,000. He enters into agreement for sale of the property to A on November 1, 1982 and receives Rs. 10,000 as advance. A could not, however, keep his promise and the advance of Rs. 10,000 given by him is forfeited by X. Later on he gifts the property to his friend Y on May 15, 1984. The following expenses are incurred by X and Y for renewals of the property :*

	Cost Rs.
Addition of two rooms by X during 1978-79	*35,000*
Addition of first floor by X during 1982-83	*45,000*
Addition of second floor by Y during 1989-90	*1,25,000*

Fair market value of the property on April 1, 1981 is Rs. 2,45,000.

Y enters into an agreement to sell the property for Rs. 8,50,000 to B on April 1, 1994 after receiving an advance of Rs. 50,000. B could not pay the balance within the stipulated time of two months and Y forfeits the advance of Rs. 50,000 as per agreement with B. Y ultimately finds a buyer in C to whom property is transferred for Rs. 23,75,000 on December 1, 2008. Compute the capital gain chargeable to tax in the hands of Y for the assessment year 2009-10.

SOLUTION : *Computation of capital gain in the case of Y*

	Rs.
Sale consideration	23,75,000
Less : Indexed cost of acquisition (Note 1)	9,07,920
Indexed cost of improvement (Note 2)	6,63,240
Long-term capital gain	8,03,840

Notes :

1. Indexed cost of acquisition is determined as under :

Cost of acquisition to the previous owner (a)	95,000
Fair market value on April 1,1981 (b)	2,45,000
Cost to the previous owner or fair market value on April 1,1981 [(a) or (b), whichever is more]	2,45,000
Less : Advance money forfeited by Y (amount forfeited by the previous owner shall not be considered)	50,000
Amount to be considered for indexation	1,95,000
Cost inflation index for 1984-85 (*i.e.*, the first year in which property is held by the assessee)	125
Cost inflation index for 2008-09	582
Indexed cost of acquisition (*i.e.*, Rs. 1,95,000 × 582 ÷ 125)	9,07,920

2. Indexed cost of improvement is determined as under :

Expenditure incurred prior to April 1,1981 (it shall be ignored)	*Nil*
Expenditure incurred on or after April 1, 1981 :	
- during 1982-83 (indexed cost of improvement : Rs. 45,000 × 582 ÷ 109)	2,40,275
- during 1989-90 (indexed cost of improvement : Rs. 1,25,000 × 582 ÷ 172)	4,22,965
	6,63,240

175.2-5 ***SITUATION 5*** - This situation covers the case where capital asset is acquired by the assessee on or after April 1,1981 in one of the modes referred to in section 49(1) and it was originally acquired by the previous owner on or after April 1, 1981.

In this situation indexed cost of acquisition is computed as under :

Cost of acquisition to the previous year / Cost inflation index for the year in which the asset was first held by the assessee	×	Cost inflation index for the year in which asset is transferred

Indexed cost of improvement will be determined as under :

Cost of improvement incurred by the assessee and the previous owner / Cost inflation index for the year in which improvement took place	×	Cost inflation index for the year in which asset is transferred

175.2-5P1 *X Ltd. owns the following assets :*

	Goodwill	*Shares (non-listed)*	*House property*
Cost of acquisition	*Self-generated*	*Rs. 1,38,600*	*Rs. 96,000*
Date of acquisition	*—**	*March 10, 2006*	*March 10, 2006*

*(*Since the commencement of business on November 1, 1981).*

These capital assets (no depreciation is claimed) are transferred by X Ltd. to its wholly-owned Indian subsidiary company S Ltd. on April 1, 2007. On July 7, 2008, these assets are transferred by S Ltd. for consideration of Rs. 10,50,500 (i.e., goodwill : Rs. 6,00,000, shares : Rs. 2,15,700, house property : Rs. 2,34,800). Compute the capital gain chargeable to tax in the case of S Ltd. for the assessment year 2009-10.

SOLUTION :	*Goodwill* Rs.	*Shares* Rs.	*House property* Rs.
Sale consideration	6,00,000	2,15,700	2,34,800
Less :			
Cost of acquisition to the previous owner	—	—	96,000
Indexed cost of acquisition (*i.e.*, Rs. 1,38,600 × 582 ÷ 551)	*Nil*	1,46,398	—
Short-term capital gain	—	—	1,38,800
Long-term capital gain	6,00,000	69,302	—

Computation of capital gain in certain special cases

176. In the following cases, the method of computation is different from what is discussed in the above paras :

176.1 *Computation of capital gain in the case of conversion of capital asset into stock-in-trade [Sec. 45(2)]* - The provisions of section 45(2) are given below :

176.1-1 ***SUPREME COURT RULING RESPONSIBLE FOR THIS RULE*** - The Supreme Court in *CIT* v. *Bai Shirinbai K. Kooka* [1962] 46 ITR 86 had held that *no transfer was involved where the assessee, holding by way of investment shares in companies, commenced a business in shares converting the shares into stock-in-trade of the business* and when he subsequently sold these shares at profit, the assessable profit was the difference between the sale price of the shares and market price of the shares prevailing on the date when shares were converted into stock-in-trade of the business in shares. In other words, the appreciation in the value of capital asset between the date of purchase of shares and date of its conversion into stock is not chargeable to tax.

176.1-2 ***RULE OF SECTION 45(2)*** - The effect of former part of this judgment (italicised portion) has been nullified by the Taxation Laws (Amendment) Act, 1984 by amending sections 2(*47*) and 45 on the following lines :

- With effect from the assessment year 1985-86, conversion of investment into stock-in-trade of a business carried on* by the taxpayer is treated as transfer under section 2(*47*). It will be treated as "transfer" in the year in which capital asset is converted into stock-in-trade.†
- The notional profit arising from transfer by way of conversion of capital asset into stock-in-trade is chargeable to tax in the year in which stock-in-trade is sold [sec. 45(2) inserted with effect from the assessment year 1985-86].

If stock-in-trade is sold in parts in different years, tax on capital gain on conversion of capital asset into stock-in-trade as per section 45(2), can be said to arise in parts in different years and not in one year in which last of stock-in-trade is sold—*CIT* v. *Crest Hotels Ltd.* [2001] 78 ITD 213 (Mum.).

- For the purposes of computing the capital gain in such cases, the fair market value of the capital asset on the date on which it was converted or treated as stock-in-trade shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.
- There is no force in the argument that the provisions of section 45(2) would come into play only when there is profit or gain and not when there is loss—***CIT*** v. ***Claridges Investments & Finances (P.) Ltd.*** [2007] 18 SOT 390 (Mum.).

176.1-P1 *X converts his capital asset (acquired on June 10, 1967 for Rs. 70,000, fair market value on April 1, 1981 : Rs. 1,80,000) into stock-in-trade on March 10, 1984 (fair market value : Rs. 4,80,000) and, subsequently, sells the stock-in-trade so converted for Rs. 7,30,000 on June 10, 2008. Determine the amount of assessable profits.*

SOLUTION : Since capital asset in this case is converted into stock-in-trade during the previous year relevant to the assessment year 1984-85, it will not be treated as transfer under section 2(*47*) (the amended definition is applicable from the assessment year 1985-86). Nothing is, therefore, chargeable to tax under section 45. Business profits, as per ruling of the Supreme Court in *CIT* v. *Bai Shirinbai K. Kooka* [1962] 46 ITR 86, chargeable to tax for the assessment year 2009-10 is Rs. 2,50,000 (*i.e.*, Rs. 7,30,000 — Rs. 4,80,000).

176.1-P2 *In the problem 176.1-P1, assume, that the capital asset is converted into stock-in-trade during the previous year relevant for the assessment year 1985-86 (say on April 1, 1984), other things remaining the same, find out assessable profits.*

SOLUTION : Since capital asset is converted into stock-in-trade during the previous year relevant to the assessment year 1985-86, it will be treated as "transfer" under section 2(*47*) for the assessment year 1985-86.

However, by virtue of section 45(2) such capital gain will be taxable for the assessment year 2009-10 (*i.e.*, relevant to the previous year in which stock-in-trade is transferred).

	Rs.
Full value of consideration (*i.e.*, fair market value on the date of conversion)	4,80,000
Less : Cost of acquisition (being fair market value on April 1, 1981) (*i.e.*, Rs. 1,80,000 × 125 ÷ 100)	2,25,000
Long-term capital gain	2,55,000

Business profit chargeable to tax for the assessment year 2009-10, will, however be Rs. 2,50,000 as computed earlier.

176.2 ***Withdrawal of exemption given by section 47(iv)/(v) [Secs. 47A, 49(3) and proviso to sec. 47(iv)/(v)]*** - *See* para 521.4.

176.3 ***Computation of capital gains on transfer of firms' assets to partners and vice versa [Sec. 45(3),(4)]*** - The provisions of sub-sections (3) and (4) of section 45 are given below—

176.3-1 *TRANSFER OF CAPITAL ASSET BY A PARTNER TO A FIRM [SECTION 45(3)]* - Section 45(3) is applicable if the following conditions are satisfied —

†The period of 6 months for making investments in specified assets for the purpose of sections 54EA, 54EB and 54EC should be taken from the date such stock-in-trade is sold or otherwise transferred, in terms of section 45(2)—Circular No. 791, dated June 2, 2000. However, the benefit given by Circular No. 791 cannot be extended for claiming exemption under sections 54, 54B, 54D and 54F.

*It may be a new business or an existing business.

Condition 1	A person is a partner in a firm or he becomes a partner in a firm.
Condition 2	He transfers a capital asset (maybe short-term/long-term, depreciable/non-depreciable) to the firm. If the asset transferred is not a capital asset, then section 45(3) is not applicable. For instance, if a personal car is transferred, then section 45(3) is not applicable as a personal car is not a "capital asset".
Condition 3	The transfer may be by way of his capital contribution or otherwise.

- *Consequences if the above condition are satisfied* - If all these conditions are satisfied then —

a. the capital gain is chargeable to tax in the previous year in which such transfer takes place ; and

b. the amount recorded in the books of account of the firm as the value of the capital asset shall be taken as full value of consideration received as a result of transfer.

- *Points to be noted* - The following points should be duly considered —

1. The above rules are also applicable when a member transfers a capital asset to an association of persons/body of individuals.

2. These rules are not applicable when a member transfers a capital asset to a company or a co-operative society.

3. If the conditions mentioned above are satisfied, then the amount recorded in books of account of the firm/association as value of the capital asset is taken as sale consideration. For instance, if X joins a firm of two partners A and B by transferring a capital asset to the firm whose market value is Rs. 10 lakh but in the books of the firm, it is recorded at Rs. 8 lakh (out of which Rs. 6 lakh, Rs. 1 lakh and Rs. 1 lakh is credited in the accounts of X, A and B respectively), then Rs. 8 lakh is taken as sale consideration.

4. As per section 45(3) there is no requirement that in the case of transfer of an asset by a partner to the firm in which he is a partner, the amount of sale consideration has got to be credited to his capital account; crediting of purchase consideration to current account of the partners is sufficient—***Mafatlal Holding Ltd.*** v. ***CIT*** [2004] 85 TTJ (Mum.) 821.

176.3-2 ***DISTRIBUTION OF CAPITAL ASSET ON DISSOLUTION [SEC. 45(4)]*** - Section 45(4) is applicable if the following conditions are satisfied —

Condition 1	The taxpayer is a firm.
Condition 2	It transfers capital assets (maybe short-term/long-term, depreciable/non-depreciable). If the asset transferred is not a capital asset, then section 45(4) is not applicable. For instance, if rural agricultural land is transferred (which is not a "capital asset"), then section 45(4) is not applicable.
Condition 3	The transfer is by way of distribution of capital assets on the dissolution of the firm or otherwise.

- *Consequences if the above conditions are satisfied* - If the above conditions are satisfied, then —

a. the capital gain is taxable in the hands of the firm ;

b. it is taxable as income of the year in which the transfer takes place ;

c. for computing capital gain the fair market value of the asset on the date of transfer is taken as full value of consideration.

- *Points to be noted* - The following points should be duly considered —

1. The above rules are also applicable when an asset is transferred by an association of persons or body of individuals.

2. These rules are not applicable when an asset is transferred by a company or a co-operative society.

3. If a firm distributes a depreciable asset, the capital gain/loss shall always be short-term capital gain/loss.

4. If the above conditions are satisfied, then the fair market value of the asset on the date of transfer (and not the agreed consideration between the firm and partners or not the amount recorded in books of the firm or partner) shall be taken as full value of the consideration. In the hands of the partner, however, cost shall be the agreed consideration.

5. If property of a firm is vested in a limited company (at the time of conversion of firm into limited company under Part IX of the Companies Act) it does not amount to distribution and transfer of such assets on dissolution of firm under section 45(4)—***CIT*** v. ***Texspin Engg. & Mfg. Works*** [2003] 129 Taxman 1 (Bom.).

6. Amount credited in capital account of retired partner upon revaluation of assets of firm is not taxable as capital gain as there is no transfer—***ITO*** v. ***Ramesh M. Shah*** [2004] 2 SOT 558 (Mum.). Section 45(4) is not applicable where some partners retire and the firm continues to carry on the business with remaining partners and with new partners or without new partners—***CIT*** v. ***G.K. Enterprises*** [2003] 131 Taxman 181 (Mag.), ***CIT*** v. ***Sohrabji Khanna & Co.*** [2003] 133 Taxman 112 (Asr.) (Mag.). The Bombay High Court in ***CIT*** v. ***A.N. Naik Associates*** [2004] 136 Taxman 107/265 ITR 346 has held that the word "otherwise" appearing in section 45(4) not only includes cases of dissolution but also takes into its sweep cases of retirement of partners even though there is no dissolution and the business is a continuing one. With due respect it is submitted that if the intention of the Legislature is to tax the firm in each and every case of distribution of assets whether the partnership is subsisting or not, then there is no need for the words "on dissolution or otherwise" in section 45(4) and the expression would itself lose its usefulness. The whole relevance of section 45(4) is lost if the reasoning of the Bombay High Court is accepted. If the Legislature wanted to include retirement under the expression "or otherwise", the same would have been expressly provided.

176.3-P1 *X, Y and Z are three partners of a firm. On March 10, 2009, the firm is dissolved. The following assets are distributed to partners :*

	Residential house (taken by X) Rs.	Non-listed shares (taken by Y) Rs.	Land (taken by Z) Rs.
Fair market value on March 10, 2009	18,90,000	60,000	42,000
Agreed value as per dissolution deed	12,70,000	66,000	42,000
Cost of acquisition	50,000	15,000	8,000
Year of acquisition	1949-50	1992-93	1984-85
Fair market value on April 1, 1981	3,20,000	N.A.	N.A.

Determine the amount of chargeable capital gains of the firm for the assessment year 2009-10.

SOLUTION :

	Residential house Rs.	Shares Rs.	Land Rs.
Sale proceeds (being fair market value on the date of transfer; agreed value not relevant)	18,90,000	60,000	42,000
Less : Indexed cost of acquisition (*Rs. 3,20,000 × 582 ÷ 100 ; **Rs. 15,000 × 582 ÷ 223 ; ***Rs. 8,000 × 582 ÷ 125)	18,62,400*	39,148**	37,248***
Long-term capital gain	27,600	20,852	4,752

176.3-P2 *The assessee-firm originally had five partners. Subsequently, there was a change in the constitution of the partnership, when two more partners were admitted. At the time of admission of new partners, there was a revaluation made in respect of the assets of the firm. The fixed assets of the firm had been revalued and that revaluation surplus was credited equally in the accounts of the original five partners. During the accounting year relevant to the assessment year 2009-10, the original five partners retired and the business was continued by the partnership consisting of the surviving two partners. The retiring partners were entitled to the credit balances in their accounts with the firm. The Assessing Officer invoked section 45(4) on the ground that on retirement of five partners taking of the enhanced value for the assets amounted to a transfer of capital assets and, thus, the profit arising from the transfer was liable to tax as the income of the assessee.*

SOLUTION : In the instant case, the firm was the assessee while it had five partners or seven partners or even when it had only two partners. There was no change in the status of the assessee. In a case of this nature what happens is that with the admission of new partners, the rights of the existing partners were reduced and that a right was created in favour of the newly inducted partners. But the ownership of the property did not change even with the change in

the constitution of the firm. As long as there was no change in ownership of the firm and its properties merely for the simple reason that the partnership of the firm stood reconstituted, there was no transfer of capital asset. Likewise, if a partner retires, he does not transfer any right in the immovable property in favour of the surviving partner because he has no specific right with respect to the properties of the firm. What transpires is that the right to share the income of the properties stands transferred in favour of the surviving partners, and there is no transfer of ownership of the property in such cases. In light of above it can be said that when a partnership is reconstituted by adding a new partner, there is no transfer of assets within the meaning of section 45(4)—*CIT* v. *Kunnamkulam Mill Board* [2002] 125 Taxman 802 (Ker.).

The Gujarat High Court in *CIT* v. *Bharatkumar R. Panchal* [2002] 125 Taxman 183 held that both sections 28(*iv*) and 41(2) have no application in the manner of assessment of sums received by the partners from the partnership firm on their separation.

On the other hand, in the case of *CIT* v. *Singla Rice & Gen. Mills* [2002] 82 ITD 778 (Delhi) there were two partners in a firm and one of them stepped out. The Bench upheld the application of section 45(4) for obviously no partnership firm remained into existence after split.

Hence, firms with two partners have reason to be cautious in managing exit arrangements.

176-3-P3 *X, on retirement from two firms on June 1, 2008 of which he was a partner, received a sum of Rs. 46,500 in excess of the amount due to him towards his capital and profits. Is the concerned Assessing Officer legally correct while treating the sum of Rs. 46,500 as capital gains in the hands of the assessee ?*

SOLUTION : It is settled that there is no distinction between a case of a retirement of the partner from and dissolution of the partnership firm. When, therefore, a partner retires from a partnership and the amount of his shares in the net partnership assets after deduction of liabilities and prior charges is determined on taking accounts on the footing of notional sale of the partnership assets and given to him, what he receives is his share in the partnership and not any consideration for transfer of his interest in the partnership to the continuing partners. There is, thus, in the given problem, no element of transfer of interest in the partnership assets by the retiring partner to the continuing partners. The Assessing Officer is, therefore, not legally correct to treat Rs. 46,500 as capital gains in the hands of X—*CIT* v. *R. Lingmallu Raghukumar* [2002] 124 Taxman 127 (SC).

176.4 ***Computation of capital gains in the case of compulsory acquisition of an asset [Sec. 45(5)]*** - The provisions of section 45(5) are given below —

176.4-1 *WHEN SECTION 45(5) IS APPLICABLE* - In any of the following cases, section 45(5) is applicable —

1. When the transfer of a capital asset is by way of compulsory acquisition under any law.

2. When a capital asset is transferred (not by way of compulsory acquisition) and the consideration is approved or determined by the Central Government (not by a State Government) or the Reserve Bank of India.

If there is compulsory acquisition of an asset (other than capital asset), section 45(5) has no application.

176.4-2 *WHEN INITIAL COMPENSATION IS RECEIVED - TAX TREATMENT* - In any of the following two cases, capital gain shall be computed as follows—

Different questions	*Tax treatment*
What is taken as sale consideration	Initial compensation is taken as full value of sale consideration
In which year it is chargeable to tax	Capital gain is chargeable to tax in the previous year in which initial compensation (or part thereof) is first received.

Notes:

1. Capital gain is not taxable in the year in which capital asset is transferred but it is taxable in the first year in which initial compensation (or part thereof) is first received.

2. If compensation is subsequently increased, then the tax consequences are given in the para given below.

176.4-3 *WHEN ENHANCED COMPENSATION IS RECEIVED* - In any of the two cases given in para 176.4-1 if any compensation is enhanced by a court, tribunal or any authority, then it will be taxable as follows —

1. It shall be taxable in the previous year in which enhanced compensation is received by the assessee.

2. In this case, the cost of acquisition and the cost of improvement shall be taken as *nil.*

3. Litigation expenses for getting the compensation enhanced are deductible as expenses on transfer—*Chakiri Ashok Kumar* v. *ITO* [2002] 80 ITD 410 (Hyd.).

4. If the enhanced compensation is received by any other person (because of the death of the transferor or for any other reason), it is taxable as income of the recipient.

The aforesaid rules are applicable whether the compensation is enhanced by the court/tribunal/ authority on an appeal of the taxpayer or because of any other reason.

5. Where land of the assessee was not capital asset within the meaning of section 2(*14*) at time of acquisition, at time of receiving enhanced compensation the same land would not fall in definition of capital asset—***ITO*** v. ***Chaman Lal Nagpal*** [2006] 7 SOT 887/102 TTJ (Asr.) 890.

176.4-3a WHEN ENHANCED COMPENSATION IS PAID BUT IT IS SUBJECT-MATTER OF DISPUTE - The provisions are given below—

1. If compensation or additional compensation is received from the Government, it will be considered while calculating capital gains of the year in which such compensation is received, even if such compensation is subject-matter of dispute by the Government.

2. Where such amount of such compensation or consideration is subsequently reduced by any court, Tribunal or other authority, the capital gain of that year, in which the compensation received was taxed, shall be recomputed accordingly.

3. The Assessing Officer shall amend the order of assessment to revise the computation of said capital gain of that year by taking the compensation so reduced by the court, Tribunal or any other authority to be the full value of consideration. The Assessing Officer has power to recompute capital gain within 4 years from the end of the previous year in which the order reducing the compensation was passed by the court, Tribunal or other authority [*see* problem 176.4-P2].

176.4-4 ***OTHER POINTS*** - One should also keep in view the following points—

1. Where compensation awarded under the Land Acquisition Act is enhanced by the order of Court interest on enhanced compensation cannot be taxed all in lump sum as having accrued on the date on which the Court passes the order for enhanced compensation ; the interest has to be spread over on an annual basis right from the date of delivery of possession till the date of the order of the Court on a time basis—*K.S. Krishna Rao* v. *CIT* [1990] 181 ITR 408 (SC).

2. Enhanced compensation can be short-term capital gains or long-term capital gains depending upon the nature of original capital gains.

3. Merely because the assessee is required to furnish security with regard to 50 per cent of payment of additional compensation received, it would not by itself lead to a conclusion that such payment cannot be construed as additional compensation in terms of provisions of section 45(5)—***CIT*** v. ***Trilok Singh (HUF)*** [2004] 3 SOT 56 (Delhi)

4. See problem 188-P10.

176.4-P1 *The Central Government acquires a house property owned by X on October 17, 1995. This property was purchased on April 10, 1976 for Rs. 76,000 (cost of improvement incurred during 1986-87 : Rs. 40,000 and fair market value of the property on April 1, 1981 was Rs. 1,42,000). The Government awards Rs. 5,77,000 as compensation which is received partly (Rs. 77,000) on May 13, 2008 and partly (Rs. 5,00,000) on April 1, 2010. Being aggrieved against the award, X files an appeal. The Court, as per order dated August 12, 2010, enhanced the compensation from Rs. 5,77,000 to Rs. 9,50,000 (legal expenses incurred by X : Rs. 20,000). X receives the additional compensation of Rs. 3,73,000 on April 15, 2011. Compute the income of X under the head "Capital gains". Does it make any difference if the additional compensation is received by his sons A and B (share of each being 50 per cent) on April 15, 2011 after the death of X ?*

SOLUTION : *Assessment year 2010-11 (i.e., relevant to the previous year 2009-10 in which a part of initial compensation is first received) :*

	Rs.
Initial compensation	5,77,000
Less : Indexed cost of acquisition (Note 1)	3,99,020
Indexed cost of improvement (Note 2)	80,286
Long-term capital gain	97,694

Notes :

1. Indexed cost of acquisition is computed as follows :

Rs. 1,42,000* × 281** ÷ 100*** = Rs. 3,99,020

*Fair market value on April 1,1981

**Cost inflation index for 1995-96 (*i.e.*, the year in which property is acquired)

***Cost inflation index for 1981-82.

2. Indexed cost of improvement is computed as follows :

Rs. 40,000* × 281** ÷ 140*** = Rs. 80,286

*Cost of improvement

**Cost inflation index of the year in which property is acquired (*i.e.*, 1995-96).

***Cost inflation index of the year in which improvement took place.

Assessment year 2012-13 (i.e., relevant to the previous year 2011-12 in which additional compensation is received)

	Rs.
Additional compensation	3,73,000
Less :	
Cost of acquisition	*Nil*
Cost of improvement	*Nil*
Expenses on transfer (*i.e.*, legal expenses[1])	20,000
Long-term capital gain	3,53,000

Note - If the additional compensation is received by A and B, after the death of X, then 50% of Rs. 3,53,000 will be taxable in the hand of A and likewise 50% will be taxable as income of B for the assessment year 2012-13.

176.4-P2 *X purchases a house property in 1995. It is compulsorily acquired by the Government on April 20, 2007 (indexed cost of acquisition is Rs. 40,000). Compensation paid by the Government on May 6, 2008 : Rs. 6,00,000. The Delhi High Court increases the compensation from Rs. 6,00,000 to Rs. 9,30,000 on the appeal filed by X (legal expenditure incurred by X : Rs. 10,000). The Government on June 10, 2010 pays the additional compensation of Rs. 3,30,000 but Government files an appeal in the Supreme Court against the judgment of the Delhi High Court. The Supreme Court reduces the quantum of compensation from Rs. 9,30,000 to Rs. 7,50,000 by its judgment dated March 20, 2012. X repays Rs. 1,80,000 to the Government on April 6, 2012. Legal expenditure incurred by X in Supreme Court is Rs. 25,000.*

SOLUTION : *Assessment year 2009-10*

	Rs.
Sale consideration (being the original compensation)	6,00,000
Less : Indexed cost of acquisition	40,000
Long-term capital gains	5,60,000
Assessment year 2011-12	
Sale consideration (being the additional compensation awarded by Delhi High Court)	3,30,000
Less : Indexed cost of acquisition	*Nil*
Less : Expenses on transfer	10,000
Long-term capital gains	3,20,000

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1. See Kerala High Court's rulings in *CIT* v. *P. Rajendran* [1981] 127 ITR 810. The ruling was given before insertion of sub-section (5) in section 45. However, it is applicable in the present case, as section 45(5) does not debar deductibility of expenses on transfer from additional compensation.

	Rs.
Recomputation of income of the assessment year 2011-12 after the verdict of Supreme Court	
Sale consideration (Rs. 7,50,000 *minus* Rs. 6,00,000 being the original compensation)	1,50,000
Less : Indexed cost of acquisition	*Nil*
Less : Expenses on transfer (Rs. 10,000 + Rs. 25,000)	35,000
Long-term capital gains	1,15,000

Note -The Assessing Officer can re-compute the income of the assessment year 2011-12 within 4 years from the end of the year in which order of the Supreme Court, reducing the compensation, is passed (*i.e.*, March 31, 2016, being 4 years + last of the year in which March 20, 2012 falls).

176.5 *Computation of capital gain in the case of non-resident [First proviso to sec. 48]* - First proviso to section 48 is applicable only in the case of a non-resident. Under this provision, capital gain is calculated in foreign currency in some cases.

■ *Conditions* - To avail the benefit of this provision, the following conditions should be satisfied —

Condition 1	The taxpayer is a non-resident (maybe an Indian or foreign citizen, or a corporate-assessee or a non-corporate assessee but not being an assessee covered by sections 115AC and 115AD) at the time of sale of capital asset.
Condition 2	He acquires shares in (or debentures of) an Indian company (maybe public limited or private limited) by utilising foreign currency.
Condition 3	The asset may be short-term or long-term.

■ *Rule of computation* - If the aforesaid conditions are satisfied, then the following procedure shall be adopted to determine capital gain (it may be noted that the procedure given below is applicable without any exception whenever the above conditions are satisfied)† —

1. Capital gain shall be computed in the same foreign currency which was initially utilised in acquiring shares or debentures.

2. Capital gain so calculated in the foreign currency shall be reconverted into Indian currency.

3. The benefit of indexation shall not be available.

4. The aforesaid manner of computation of capital gain shall be applicable in respect of capital gain accruing or arising from every re-investment thereafter in (and sale of) shares in (or debentures of) an Indian company.

5. The aforesaid mode of computation is applicable only when the conditions above-mentioned are satisfied. In no other case, the above procedure is applicable.

Even if the aforesaid provisions are applicable, the option of adopting fair market value on April 1, 1981 is available—***Alcan Inc.*** v. ***DIT*** [2007] 16 SOT 8 (Mum.).

□ *How to determine capital gain* - In order to understand the method of computation of capital gain, it is imperative to know the meaning of (*a*) average exchange rate and (*b*) buying rate.

1. Average exchange rate - It is the average of the telegraphic transfer buying rate and telegraphic transfer selling rate of the foreign currency initially utilised in the purchase of the said asset.

For this purpose, telegraphic transfer buying/selling rate in relation to a foreign currency is rate of exchange adopted by the State Bank of India for purchasing or selling such currency where such currency is made available by that bank through telegraphic transfer.

2. Buying rate - It is telegraphic transfer buying rate of such currency.

□ *Mode of Computing* - Capital gain shall be determined as under —

† In some cases, capital gain on transfer of equity shares is not chargeable to tax—*see* para 170.2-4.

	Conversion rate	*Conversion rate of which date is applicable*	*Computation*
Sale consideration	Average exchange rate	Date of transfer	Find out sale consideration in Indian currency and convert it into foreign currency at "average exchange rate" on the date of transfer (suppose it is *x*).
Cost of acquisition	Average exchange rate	Date of acquisition	Find out the cost of acquisition in Indian currency and convert it into foreign currency at "average exchange rate" on the date of acquisition (suppose it is *y*).
Expenditure on sale	Average exchange rate	Date of transfer	Find out the expenditure on transfer in Indian currency and convert it into foreign currency at "average exchange rate" on the date of transfer (not on the date when expenditure is incurred) (suppose it is *z*).
Capital gain	Buying rate	Date of transfer	(*x*—*y*—*z*) will be reconverted into Indian currency at "buying rate" on the date of transfer.

▪ *How to find out tax liability* - If the capital gain is short-term capital gain and securities transaction tax is applicable, the capital gain is taxable at the rate of 15 per cent*. If the capital gain is long-term capital gain and securities transaction tax is the applicable, capital gain is exempt from tax under section 10(*38*). If the capital gain is long-term capital gain and securities transaction tax is not applicable, such gain would be taxable at the rate of 20 per cent* [in some cases at the option of taxpayer at the rate of 10 per cent* under proviso to section 112(1)—*see* para 186.2].

176.5-P1 *X, a non-resident foreign citizen, remits US $ 60,000 to India on August 10,1990. The amount is partly utilised on August 17,1990 for purchasing 50,000 preference shares in Lotus Ltd., an Indian company, at the rate of Rs. 12 per share (brokerage paid : Re. 1 per share). These shares are sold for Rs. 28 per share on April 10, 2005 (brokerage paid on April 16, 2005 @ Rs. 1.50 per share). The sale consideration is utilised on April 25, 2005 for purchasing 40,000 preference shares in Indian Sugars and Chemicals Ltd. at the rate of Rs. 34 per share (brokerage paid : Re. 1 per share). Shares in Indian Sugars and Chemicals Ltd. are transferred on April 20, 2008 @ Rs. 40 per share : (brokerage paid @ Rs. 1.55 per share on June 30, 2008).*

Find out the capital gains chargeable to tax for the assessment years 2006-07 and 2009-10 on the assumption that telegraphic transfer, buying and selling rates of US dollars adopted by the State Bank of India are as follows :

	Buying (1 US $) Rs.	Selling (1 US $) Rs.
August 10, 1990	*18.30*	*19.10*
August 17, 1990	*18.40*	*19.30*
April 10, 2005	*25.90*	*26.40*
April 16, 2005	*26.10*	*26.60*
April 25, 2005	*26.10*	*26.60*
April 20, 2008	*28.30*	*29.10*
June 30, 2008	*30.10*	*31.15*

SOLUTION : For computing capital gains, one has to find out the average of the telegraphic transfer buying rate and telegraphic transfer selling rate on the date of purchase and sale of shares. Date of making expenditure in connection with transfer is not relevant.

These rates are as follows :

Average rate on	*Rs. (1 US $ =)*
August 17, 1990	18.85
April 10, 2005	26.15
April 25, 2005	26.35
April 20, 2008	28.70

**Plus* SC+EC+SHEC.

	Rs.	US$
Assessment year 2006-07		
Sale consideration (*50,000 × Rs. 28) ;	14,00,000*	
**(Rs. 14,00,000 ÷ Rs. 26.15)	—	53,537.28**
Less :		
Cost of acquisition (*50,000 × Rs. 13 ; **Rs. 6,50,000 ÷ Rs. 18.85)	6,50,000*	34,482.76**
Expenditure on transfer (*Rs. 75,000 ÷ Rs. 26.15)	75,000	2,868*
Long-term capital gain	N.A.	16,186.45
Long-term capital gain in Indian currency ($ 16,186.45 × Rs. 25.90)	4,19,229.05	—
Assessment year 2009-10		
Sale consideration		
*Rs. 40 × 40,000, **Rs. 16,00,000 ÷ Rs. 28.70	16,00,000*	55,749.13**
Less :		
Cost of acquisition [*Rs. 35 × 40,000, **Rs. 14,00,000 ÷ Rs. 26.35]	14,00,000*	53,130.93**
Expenditure on transfer [*Rs. 1.55 × 40,000, **Rs. 62,000 ÷ Rs. 28.70]	62,000*	2,160.28**
Balance	N.A.	457.92
Long-term capital gain chargeable to tax for the assessment year 2009-10 (*i.e.*, $ 457.92 × Rs. 28.30)	12,959.14	—

Notes :

1. The benefit of deduction of indexed cost of acquisition is not available in the aforesaid case.
2. The aforesaid procedure is applicable even in the case of short-term capital gain.

176.5-1 ***SPECIAL PROVISIONS IN THE CASE OF A NON-RESIDENT INDIAN [SEC. 115F]*** - If the following conditions are satisfied, one can take the benefit of section 115F—

- The taxpayer is a non-resident Indian (*i.e.*, an individual being a citizen of India or a person of Indian origin who is non-resident ; a person shall be deemed to be of Indian origin if he, or either of his parents or any of his grand-parents, was born in undivided India) at the time of sale of capital asset.
- He has transferred a specified asset [*i.e.*, shares in an Indian company, debentures of an Indian public limited company, deposits with an Indian public limited company or Central Government securities (hereinafter referred to as "original asset")] which has been acquired or purchased with, or subscribed to in, convertible foreign exchange.
- Such asset is a long-term capital asset.
- Within six months of transfer of original asset, the taxpayer has invested the whole or any part of net consideration (*i.e.*, consideration received less expenses on transfer) in any of the following assets (hereinafter referred to as "new asset") —

a. shares in an Indian company ;
b. debentures of an Indian public limited company ;
c. deposit with an Indian public limited company ;
d. Central Government securities ; or
e. National Savings Certificates VI and VII issue.

176.5-1a AMOUNT OF EXEMPTION - If all the above conditions are satisfied, exemption is available as follows :

$$\text{Amount invested in new asset} \times \frac{\text{Capital gains}}{\text{Net sale consideration}}$$

Notes:

1. The amount of exemption cannot exceed the amount of capital gain.
2. Net sale consideration is sale consideration *minus* expenditure on transfer.

176.5-1b CONSEQUENCES IF THE NEW ASSET IS TRANSFERRED WITHIN 3 YEARS - In case the new asset acquired by the assessee is transferred or converted into money within a period of three years from the date of its acquisition, the capital gains exempted by virtue of the provisions given above is deemed to be income by way of long-term capital gains of the previous year in which such new asset is so transferred or converted into money.

176.5-1c OPTION TO AVAIL OR NOT TO AVAIL THE BENEFIT OF SECTION 115F - A non-resident Indian may elect (by virtue of section 115-I) not to be governed by the provision of section 115F for any assessment year by giving a declaration in the return of income to this effect.

176.5-1P1 *In problem 176.5-P1, assume that X is a non-resident Indian and he wants to avail the benefit of section 115F.*

SOLUTION : *Assessment year 2006-07*

Since X has invested the entire net consideration received on the sale of 50,000 shares in Lotus Ltd. (i.e., Rs. 14,00,000 – Rs. 75,000) in acquiring a new asset (i.e., shares in Indian Sugar and Chemical Ltd.) within 6 months from transfer, the resulting long-term capital gain of Rs. 4,19,229 is not chargeable to tax for the assessment year 2006-07.

Assessment year 2009-10

Shares in Indian Sugars and Chemical Ltd. has been transferred within three years from the date of acquisition. Consequently, the exemption given for the assessment year 2006-07 will be revoked and income under the head "Capital gains" for the assessment year 2009-10 will be as follows :

	Rs.
Long-term capital gain on transfer of shares in Indian Sugars & Chemical Ltd. [as computed earlier]	12,959.14
Deemed long-term capital gain	4,19,229.05
Income under the head "Capital gains"	4,32,188.19

176.6 ***Computation of capital gain in the case of self-generated assets*** - Before discussing the tax incidence on transfer of a self-generated asset, it is better to define first the term "self-generated asset".

Self-generated asset - An asset which does not cost anything to the assessee in terms of money in its creation or acquisition is a self-generated asset.

176.6-1 *WHEN TRANSFER OF A SELF-GENERATED ASSET IS CHARGEABLE TO TAX* - By virtue of the specific provisions under the Act, transfer of the following self-generated assets is chargeable to tax under the head "Capital gains"—

Self-generated assets	*Sale consideration*	*Cost of acquisition*	*Cost of improvement*	*Expenses on transfer*	*Capital gain*
1. Goodwill of a business (not of a profession), right to manufacture, produce or process any article or right to carry on any business	Actual	*Nil*	*Nil*	Actual	Sales consideration *minus* expenses on transfer
2. Tenancy rights, route permits, loom hours, trade mark, brand name associated with a business	Actual	*Nil*	Actual	Actual	Sales consideration *minus* cost (or indexed cost) of improvement and expenses on transfer

1. Only self-generated asset is covered by above provisions - If any asset is purchased and later on sold, then the actual purchase price and improvement cost are taken as cost of acquisition and cost of improvement. In other words, the rules given in the above table are applicable only in respect of self-generated asset.

2. When goodwill, right to manufacture, etc. are purchased - If goodwill of a business (or right to manufacture, produce or process any article/thing or right to carry on any business) is purchased and later on transferred, the purchase price will be taken as cost of acquisition and cost of improvement is taken as *nil.*

3. Fair market value on April 1, 1981 - Option not available - Even if the aforesaid assets were acquired before April 1, 1981, the option of adopting the fair market value on the said date is not available.

4. Brand name is goodwill - The brand name associated with a business is taken in expression 'goodwill'—***Vysali Chemotherapeutics (P.) Ltd.*** v. ***CIT*** [2004] 134 Taxman 445 (Ker.).

176.6-2 *WHEN TRANSFER OF A SELF-GENERATED ASSET IS NOT CHARGEABLE TO TAX* - Transfer of any other self-generated asset which is not given in the table *supra* (like self-generated goodwill of a profession, a new formula patented by the inventor to grow seedless oranges) is not chargeable to tax. The rule is based upon the Supreme Court's ruling in *CIT* v. *B.C. Srinivasa Setty* [1981] 5 Taxman 1, wherein it was pointed out that the income chargeable to capital gains tax is to be computed by deducting from the full value of the consideration "the cost of acquisition of the capital asset and the cost of any improvement thereto". If it is not possible to ascertain cost of acquisition and/or cost of improvement, then transfer of such asset is not taxable under the Act.

The above ruling of the Supreme Court is not applicable in the case of self-generated assets mentioned in para 176.6-1 because of the modifications made in the Act after the above verdict of the court.

176.7 ***Capital gain on transfer of bonus shares*** - Capital gain on transfer of bonus shares shall be calculated as follows:

Different situations	*Special provisions*
Cost of acquisition of bonus shares allotted before April 1, 1981	Fair market value on April 1, 1981 is taken as cost of acquisition
Cost of acquisition of bonus shares allotted on or after April 1, 1981	Cost of acquisition is taken as zero [*see* also para 229.7]
Period of holding bonus shares	The period of holding shall be determined from the date of allotment of bonus shares (and not from the date of acquisition of original shares)

Notes :

1. The above rules given in the table are also applicable in respect of shares, securities, debentures, bonds, units allotted without any payment on the basis of holding of any other financial assets.

2. If securities transaction tax is applicable at the time of transfer, long-term capital gain is not chargeable to tax and short-term capital gain is taxable @ 10 per cent (*plus* surcharge *plus* education cess).

176.7-P1 *X purchases 1,000 equity shares in A Ltd. at the rate of Rs. 16 per share (brokerage : 1 per cent) on December 10, 1979. He gets 500 bonus shares (by virtue of his holding of 1,000 shares) on January 10, 1984. Fair market value of shares of A Ltd. on April 1, 1981 is Rs. 24. On April 13, 2008, he transfers 1,000 original shares @ Rs. 81 per share (brokerage 1.5 per cent).*

On April 15, 2008, he transfers 500 bonus shares @ Rs. 87 per share (brokerage : 1.5 per cent). These shares are transferred in the Bombay Stock Exchange.

SOLUTION : *Assessment year 2009-10*	*Rs.*
Sale proceeds of 1,000 original shares (*i.e.*, Rs. 81 × 1,000)	81,000
Less : Indexed cost of acquisition (*i.e.*, Rs. 24,000 × 582 ÷ 100)	(-) 1,39,680
Less : Brokerage on transfer	(-) 1,215
Long-term capital gain on transfer of 1,000 original shares	(-) 59,895
Sale proceeds of 500 bonus shares (*i.e.*, Rs. 87 × 500)	43,500
Less : Cost of acquisition	*Nil*
Less : Brokerage on transfer	(-) 653
Long-term capital gain on transfer of bonus shares	42,847

Note - In the aforesaid case, as (*a*) shares are long-term equity shares, and are (*b*) transferred in a recognised stock exchange in India, the long-term capital gain is not chargeable to tax—see para 170.2-4.

176.8 ***Capital gain on transfer of right shares and right entitlement*** - Cost of acquisition in different situations is as follows :

Different situations	*Cost of acquisition*
Original shares (on the basis of which the taxpayer becomes entitled to right shares)	Amount actually paid for acquiring shares
Rights entitlement (which is renounced by the assessee in favour of a person)	*Nil*
Rights shares acquired by the taxpayer by exercising his rights entitlement	Amount actually paid by the taxpayer for acquiring asset
Rights shares purchased by the person in whose favour the rights entitlement has been renounced	Purchase price paid to renouncer of rights entitlement *plus* amount paid to the company which has allotted the rights shares.

Note - The amount realised by the original shareholder by selling his rights entitlement is taken as short-term capital gains in his hands (as cost is taken as *nil*). The period of holding the rights entitlement is reckoned from the date of offer made by the company to date of renouncement.

176.8-P1 *X holds 1,000 equity shares in A Ltd. since 1978 (cost of acquisition : Rs. 10,000, fair market value on April 1, 1981 : Rs. 16,000). A Ltd. offers 2,000 rights shares of Rs. 10 each to X on May 1, 2008 at a premium of Rs. 50. X subscribes for 800 rights shares and renounces 1,200 shares in favour of C by transferring the right entitlement for a consideration of Rs. 4,800. X sells 1,800 shares in A Ltd. on March 30,2009 @ Rs. 110 per share. C also transfers his 1,200 shares @ Rs. 111 per share on March 31, 2009.*

SOLUTION : *Assessment of X for the assessment year 2009-10*	Rs.
Sale proceeds of 1,000 original shares	1,10,000
Less : Indexed cost of acquisition [Rs. 16,000 × 582/100]	93,120
Long-term capital gain [it is not chargeable to tax if the transfer takes place in a stock exchange in India—see para 170.2-4.]	16,880
Sale proceeds of 800 right shares [Rs. 110 × 800]	88,000
Less : Cost of acquisition [*i.e.*, Rs. 60 × 800]	48,000
Short-term capital gain	40,000
Sale proceeds of right entitlement of 1,200 shares	4,800
Less : Cost of acquisition	*Nil*
Short-term capital gain	4,800
Assessment of C for the assessment year 2009-10	
Sale proceeds of 1,200 shares	1,33,200
Less : Cost of acquisition [*i.e.*, (Rs. 60 × 1,200) + Rs. 4,800]	76,800
Short-term capital gain	56,400

176.9 ***Capital gain on distribution of assets by companies in liquidation [Sec. 46]*** - The provisions of section 46 are given below—

176.9-1 TAX TREATMENT IN THE HANDS OF THE COMPANY [SEC. 46(1)] - Section 46(1) is applicable if the following three conditions are satisfied—

Condition 1	Assets are distributed by a company.
Condition 2	Assets are distributed at the time of liquidation.
Condition 3	Assets are distributed to the shareholders.

If all the three conditions are satisfied, there is no "transfer" in such distribution and capital gain is not chargeable in the hands of the company.

Where, however, the liquidator sells the assets and distributes the cash so realised to the shareholders, then section 46(1) shall not apply. The company shall be liable to tax on the capital gains arising from sale of the assets—*Sri Kannan Rice Mills Ltd.* v. *CIT* [1954] 26 ITR 351 (Mad.).

176.9-2 *TAX TREATMENT IN THE HANDS OF SHAREHOLDERS [SEC. 46(2)]* - When a shareholder receives money or other assets at the time of liquidation of the company (in which he is a shareholder), section 46(2) is applicable. Capital gain under section 46(2) shall be determined as follows —

1. Find out the money received and the market value of other "assets" on the date of distribution. The word "asset" does not mean "capital asset". It may be "capital asset" or any other asset—***N. Bagavathy Ammal*** v. ***CIT*** [2003] 127 Taxman 422 (SC).

2. Find out the amount treated as dividend under section 2(*22*)(*c*) [*see* para 193.2-7, any distribution by a company at the time of liquidation is treated as dividend to the extent of accumulated profit of the company].

3. The excess of (*1*) over (*2*) is treated as full value of consideration received on transfer of shares.

4. From the consideration [as calculated at *3 supra*], deduct cost of acquisition/indexed cost of acquisition, expenditure on sale, etc. to find out capital gain.

The following points should also be kept in mind —

1. When a distribution is made by the liquidator, the distribution is deemed to take place in same proportion in which share capital and accumulated profits stood in the accounts of the company immediately before the distribution. Therefore, that part of receipt which is attributable to the accumulated profit is treated as dividend [*see* para 193.2-7]—*CIT* v. *Girdhardas & Co. (P.) Ltd.* [1967] 63 ITR 300 (SC).

2. When money is received from liquidator in instalments, then the cost of acquisition has to be deducted from earlier payments and once the cost of acquisition is wiped off, any sum received thereafter will be capital gain—*CIT* v. *Inland Agencies (P.) Ltd.* [1983] 143 ITR 186 (Mad.).

176.9-P1 *X purchases 4,000 equity shares in Y Ltd. on April 16, 1985 at the rate of Rs. 2 per share. Y Ltd. goes into liquidation on June 30, 2008. The balance sheet of the company as on June 30, 2008 is as follows —*

	Rs.		Rs.
40,000 equity shares	*4,00,000*	*10,000 Debentures (non-listed) of Z Ltd. (cost : Rs. 9,00,000) at the time of acquisition on May 1, 2007*	*28,00,000*
Accumulated profit	*30,00,000*	*Cash in hand*	*11,09,850*
Provision for dividend tax	*5,09,850*		
	39,09,850		*39,09,850*

The assets are distributed to the shareholders. Consequently, X gets 1,000 debentures in Z Ltd. (market value Rs. 2,80,000) and Rs. 60,000 in cash on June 30, 2008. He transfers 1,000 debentures on April 6, 2009 for Rs. 3,10,000. Find out the tax consequences of these transactions.

SOLUTION : *Y Ltd.* - During the previous year 2008-09, the company has distributed assets (being debentures in Z Ltd.) to its shareholders at the time of liquidation. Even if the cost of debentures is Rs. 9 lakh and the market value is Rs. 28 lakh, the surplus is not taxable, as by virtue of section 46(1) distribution of capital asset in kind to shareholders at the time of liquidation is not treated as "transfer". It may be noted that the difference of Rs. 19 lakh is tax-free income.

	Rs.
Total distribution to shareholders [*i.e.*, debentures in Z Ltd. of Rs. 28 lakh + Rs. 6 lakh]	34,00,000
Out of which amount to be treated as dividend under section 2(22)(c) to the extent of accumulated profit	30,00,000
Tax on dividend [15% (*plus* surcharge + EC + SHEC financial year 2008-09) of Rs. 30 lakh]	5,09,850
Income of X at the time of liquidation of the company [assessment year 2009-10] —	
Amount received by X on June 30, 2008 (*i.e.*, market value of 1,000 debentures + Rs. 60,000)	3,40,000
Less : Dividend on which Y Ltd. has paid dividend tax [dividend is not taxable in the hands of X]	3,00,000
Balance which is treated as full value of consideration on transfer of 4,000 shares in Y Ltd.	40,000
Less : Indexed cost of acquisitior [4,000 × Rs. 2 × 582/133]	35,008
Long-term capital gain	4,992

	Rs.
Income of X for the assessment year 2010-11 —	
Sale consideration of 1,000 debentures in Z Ltd. on April 6, 2009	3,10,000
Less: Cost of acquisition on June 30, 2008 (being the market value on June 30, 2008)[1]	2,80,000
Short-term capital gain	30,000

176.10 ***Conversion of debentures into shares [Sec. 49(2A)]*** - Any transfer by way of conversion of debentures, debenture-stock, or deposit certificates in any form, of a company into shares or debentures of that company is not regarded as a transfer giving rise to any capital gains. On sale of shares or debentures received on such conversions, the capital gain shall be computed by taking the cost of acquisition as that part of the cost of debentures, debenture-stock or deposit certificates which has been appropriated towards the shares or debentures.

One has to keep in view the following points in the case of conversion of debentures into shares —

1. Cost of debentures shall be taken as "cost of acquisition" of shares.

2. To find out whether or not shares are long-term capital asset or short-term capital asset, the period of holding shall be determined from the date of allotment of shares.

3. The indexation will start from the date of conversion of debentures into shares.

4. The aforesaid rule is not applicable if preference shares are converted into equity shares.

176.10-P1 *X gets 1,000 partly convertible debentures (face value Rs. 100) of A Ltd. (cost being Rs. 200 per debenture) at the time of original allotment to him on May 16, 1984. As per terms of allotment, A Ltd. converts 60 per cent portion of each debenture into 2 equity shares of face value of Rs. 10 on July 1, 1992. On September 10, 2008, X transfers 2,000 equity shares in A Ltd. @ Rs. 300 per share and 1,000 (non-convertible portion) debentures @ Rs. 310 per debenture. Find out the amount of capital gains chargeable to tax for the assessment year 2009-10.*

SOLUTION : Immediately after conversion of debentures into equity shares, X holds the following—

No. of scrip	Type of scrip	Face value (per scrip) Rs.	Total cost Rs.
2,000	Equity shares	10	1,20,000*
1,000	Debentures	40	80,000**
Total			2,00,000

*60% of original investment of Rs. 2,00,000, *i.e.*, Rs. 1,20,000

**Rs. 2,00,000 – Rs. 1,20,000

Computation of capital gains

	Shares Rs.	Debentures Rs.
Sale consideration	6,00,000	3,10,000
Less: Indexed cost of acquisition [*(Rs. 1,20,000 × 582 ÷ 223)]	3,13,184*	80,000
Long-term capital gains	2,86,816	2,30,000

Note - If equity shares are transferred in a stock exchange, long-term capital gains of Rs. 2,86,816 will be exempt under section 10(38). However, X will pay securities transaction tax (0.125% of Rs. 6,00,000).

1. When the shareholder sells the asset (which was received at the time of liquidation of the company) he would be assessable under section 45 on the excess of sale price over market value of asset on the date of distribution by liquidator if he has been assessed to tax on the basis of such market value under section 46(2) [sec. 55(2)(*b*)(*iii*)]. If however, he was not charged to tax under section 46(2) on the basis of market value of assets received at the time of liquidation, then cost to previous owner will be taken to compute capital gain chargeable to tax [sec. 49(1)(*iii*)(*c*)].

176.11 ***Transfer of security in demat form [Sec. 45(2A)]*** - The provisions of section 45(2A) are given below—

1. Section 45(2A) is applicable if shares/securities are transferred in "demat" form.

2. If shares/securities are transferred in "demat" form, beneficial owner of shares/securities is chargeable to tax.

3. For computing capital gain chargeable to tax, the cost of acquisition and period of holding of any security shall be determined on the basis of first-in-first-out (FIFO) method.

176.11-1 *BOARD'S CLARIFICATION ON FIFO SYSTEM* - The Board has issued the following clarification *vide* Circular No. 768, dated June 24, 1998 —

1. FIFO method will be applied only in respect of the dematerialised holdings because in case of sale of dematerialised securities, the securities held in physical form cannot be construed to have been sold as they continue to remain in possession of the investor and are identified separately.

2. In the depository system, the investor can open and hold multiple accounts. In such a case, where an investor has more than one security account, FIFO method will be applied account-wise. This is because in case where a particular account of an investor is debited for sale of securities, the securities lying in his other account cannot be construed to have been sold as they continue to remain in that account.

3. If in an existing account of dematerialised stock, old physical stock is dematerialised and entered at a later date, under the FIFO method, the basis for determining the movement out of the account is the date of entry into the account. This is illustrated by the following examples :

Date of credit	*Particulars*	*Quantity*
June 1, 1997	Purchased directly in dematerialised form on May 25, 1997	2,000
June 5, 1997	Dematerialised share originally purchased in November, 1985	5,000
June 10, 1997	Purchased directly in dematerialised form on June 10, 1997	4,000
June 15, 1997	Dematerialised shares originally purchased in May, 1962	3,000

If say, 2,500 shares were sold* from out of this account, then the period of holding and the cost of acquisition of the first 2,000 shares should be as from May 25, 1997 and the cost thereof, whereas the balance 500 shares will be treated as having been acquired in November 1985, at the relevant cost. This is the effect of the FIFO method.

176.12 ***Transfer of shares in lieu of shares of amalgamating company [Secs. 47(vii) and 49(2)]*** - *See* para 516.3-4.

176.13 ***Withdrawal of exemption under section 47(xiii)/47(xiv) [Sec. 47A(3)]*** - *See* para 519.1-1.

176.14 ***Withdrawal of exemption given by section 47(xi) [Sec. 47A(2)]*** - *See* para 519.2.

176.15 ***Computation of capital gain when insurance claim is received [Sec. 45(1A)]*** - In *Vania Silk Mills (P.) Ltd.* v. *CIT* [1991] 59 Taxman 3, the Supreme Court *held* that insurance claim received on account of destruction of asset is not chargeable to tax as "destruction" does not amount to transfer. The effect of the judgment has been nullified to some extent by inserting sub-section (1A) in section 45 with effect from the assessment year 2000-01.

176.15-1 *WHEN SECTION 45(1A) IS ATTRACTED* - The following two conditions should be satisfied—

■ *Condition one* - The first condition is that the compensation is received because of 'damage to' or 'destruction of' any capital asset. If it is not a capital asset, then section 45(1A) is not applicable[1].

■ *Condition two* - The damage or destruction is a result of four categories of circumstances, *viz.*, (*i*) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or (*ii*) riot or civil

1. In such case, compensation may be taxable under section 28, if it is a revenue receipt.

*If securities transaction tax is applicable, long-term capital gain is not chargeable to tax.