A note on the Determination of Cost of Acquisition for Capital Assets

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Capital Gains

The Income Tax Act, 1961 prescribes five heads of income for taxation purpose. Among the five heads, income derived from transfer of capital asset attracts capital gains tax arising on transfer of the capital asset as per Sec. 45 of the Act. Where the gains arise on transfer of a short-term capital asset as defined under Sec. 2(42A) of the Act, the gains are taxed as short-term capital gains. Where the gains arise on transfer of long-term capital asset, as defined under Sec. 2(29A) of the Act, the said gains are taxed as long-term capital gains.

Method of Computation of Capital Gains

Sec. 48 prescribes the Mode of computing capital gains. As per Sec. 48, the income chargeable under the head "Capital gains" is liable to be computed by deducting from the full value of the consideration received on transfer of the capital asset, the amount of expenditure incurred wholly and exclusively in connection with such transfer and the cost of acquisition of the asset and the cost of any improvement thereto.

Full Value of Consideration received or accruing		XXX
Less: Expenditure on transfer	xxx	
Cost of Acquisition	xxx	
Cost of Improvement	xxx	XXX
Capital Gain		XXX

Cost of Acquisition

The term `cost of acquisition' though not defined under the Act denotes the price paid by the owner or the amount, which he has incurred for acquiring the property. While determining the taxable capital gains on sale of property, the owner is entitled to the benefit of cost of acquisition

as a deduction from the sale consideration. In simple words, 'cost of acquisition' includes all the expenses which is incurred by the owner in purchasing such capital asset.

Indexation of Cost of Acquisition

An amendment to Sec. 48 prescribing indexed cost of acquisition was enacted by the **Finance Act, 1992.** Sec. 48 was amended to include the meaning of the term *"indexed cost of acquisition"* which is stated as under:

> *"Expalanation (iii) "indexed cost of acquisition" means an amount which bears to the cost of acquisition 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 the 1st day of April, 1981, whichever is later;"*

The **Memorandum explaining the Provisions of Finance Bill, 1992** explained that old provisions relating to taxation of capital gain were unfair because the deduction under Section 48 was being allowed in respect of cost of acquisition which did not relate to the period of time for which the asset was held. The old system of computation of capital gain did not take into account the inflation which occurred over a period of time. The new system was therefore, enacted for computing capital gain which allowed the ***cost of asset to be adjusted for general inflation*** before deducting it from the sale proceeds. The statutory objective of the new system was to favour those assessees where capital gains accrued over a long period.

The CBDT, in **Circular No. 636, dt. 31st Aug., 1992** [(1992) 107 CTR (St) 1], explained the provisions of Finance Act, 1992 relating to amended scheme of capital gains. In this circular the Board explained that in the scheme prior to 1992 a specified percentage was allowed as deduction under s. 48(2) which was unrelated to the length of the period of holding of the capital asset. Under the new system a fair method of allowing relief was enacted to ***link the cost of acquisition to the period of holding.*** For this purpose the cost of acquisition and the cost of improvement of the asset were to be inflated to arrive at indexed cost of acquisition. The circular further clarified that if an asset was acquired before 1st April, 1981, the market value of the capital asset as on 1st April, 1981 would be taken for the purpose of indexation.

A combined reading of the Memorandum explaining the Finance Bill, 1992 and CBDT Circular No. 636 shows that the indexation is to be allowed in respect of period of holding of the asset and not in relation to the individuality of the assessee. For the purpose of determining the period of holding intermediate transfers on account of succession are to be ignored as it is clear from para 35 of the Circular No. 636, dt.31st Aug., 1992, which states that if an asset was acquired before 1st April, 1981 then the market value of the capital asset as on 1st April, 1981 is to be taken for indexation.

Cost of Acquisition with regard to certain modes of acquisition

Sec. 47 provides that certain transfer of capital assets occurring

i. by way of partition/ distribution of assets of HUF, gift,
ii. between subsidiary and holding company,
iii. at the time of amalgamation, mergers, or demergers, etc

shall not be regarded as capital transaction for the purpose of computation of capital gains as per Sec. 45.

However, when the capital asset acquired by the above modes is transferred, then capital gains will have to be computed as per Sec. 49:

"49. Cost with reference to certain modes of acquisition.

(1) Where the capital asset became the property of the assessee—

(i) On distribution of the assets of the HUF
(ii) Under gift or will
(iii) (a) By succession, inheritance or devolution or
(b) 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 the 1st day of April, 1987, or
(c) On any distribution of assets on the liquidation of a company, or

(d) Under a transfer to a revocable or an irrevocable trust, or

(e) Under any such transfer as is referred to in clause (iv) or clause (v) or clause (vi) or clause (via) or clause (viaa) or clause (vica) or clause (vicb) or clause (xiii) or clause (xiiib) or clause (xiv) of section 47;

(iv) Such assessee being a Hindu undivided family, by the mode referred to in sub-section (2) of section 64 at any time after the 31st day of December, 1969,

the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the assets incurred or borne by the previous owner or the assessee, as the case may be.

Explanation.—In this sub-section the expression "previous owner of the property" in relation to any capital asset owned by an assessee means the last previous owner of the capital asset who acquired it by a mode of acquisition other than that referred to in clause (i) or clause (ii) or clause (iii) or clause (iv) of this sub-section."

The above provision clearly envisages that the cost of acquisition in case of asset becoming the property of the assessee by gift/ will / inheritance/ trust/ etc., the cost of acquisition has to be computed with reference to the ***year in which the previous owner first held the asset*** and not the year from which the assessee became the owner.

Sub-sec. (3) of sec. 55 further provides that 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.***

Though the term 'cost of acquisition' reads simple and sounds non-controversial, the conflicting provisions, the Explanation (iii) of Sec. 48 and sec. 49(1) have often been the subject of judicial intervention. The reason behind it being that the taxpayer has not incurred any cost for acquiring the capital asset.

The Revenue department has been relying on the only contention, that the Explanation (iii) to Section 48, that the indexation has to be from the first year from which the asset is transferred to the tax payer. However, this argument seems to be irrational, as the tax payer having not paid any consideration to acquire the capital asset, the cost of acquisition is nil.

Whether Cost of acquisition should always be incurred by the assessee?

Section 48 states that:

> *"48. The income chargeable under the head 'capital gains' shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely :—...*
> *(ii) the cost of acquisition of the capital asset and the cost of any improvement thereto."*

On a thorough reading of Sec. 48, it can be understood that cost of acquisition need not necessarily be "in the hands of assessee" or "incurred by the assessee". It can be a cost in someone else's hands and not necessarily in that of the assessee.

In **ACIT vs. Madan Lal Jain & Sons** [(1983) 140 ITR 200 (DEL)], while interpreting Sec. 48 of the Act, Hon'ble Court viewed that,

> *"We do not find the words "in the hands of" or "to the assessee" in s. 48 of the Act. Therefore, the cost of acquisition contemplated by s. 48 has to be the cost of acquisition of the capital asset in someone's hands, not necessarily in the hands of the assessee. Sec. 45 speaks of profits or gains arising from the transfer of a capital asset which will be in contradistinction to any loss or cutting even when a capital asset is transferred. A profit or gain can accrue only when there is a cost of acquisition and not otherwise. The crucial question is cost of acquisition to whom."*

Further the Court explained by whom the Cost of Acquisition was incurred:

"No other section has been brought to our notice which would directly deal with computation of the income in the manner in which the Revenue wants us to read s. 48. We would like to read it in the manner, in which the Supreme Court has said, that if the asset is such which it is possible to acquire by spending money then what could be spent or what was actually spent by Madan Lal Jain would be the cost of acquisition within the meaning of s. 48.

We cannot read the words "to the assessee" as incorporated in s. 48(2) of the Act. Wherever the legislature has wanted such words to be part of a taxing provision, the legislature has specifically said so."

To explain this, Sec. 43, was cited as an example, which is below:

"43. In sections. 28 to 41 and in this section, unless the context otherwise requires—

(1) 'actual cost' means the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority....."

In Sec. 43, the words 'to the assessee' have been clearly mentioned. However, in Sec. 48, there is no there is no such wording. Further, taxing provisions have to be given a strict interpretation and words cannot be added or subtracted unless there is a compulsion in that context to do so.

Thus in Madan Lal Jain's Case *(supra)*, the revenue's contention that the cost of acquisition has to be the cost actually incurred by the assessee was turned down and it was held that cost of acquisition is cost of acquisition in some one's hands and not necessarily that of the assessee. Hence, where the karta acquired shares individually and threw in HUF hotchpot, cost of acquisition to HUF is the one which was incurred by Karta.

Cost of Acquisition 'to the previous owner' when the assessee has gratuitously accepted the capital asset without paying any consideration

In the case of **CIT v. N.N. Mohan & Sons** [(2001) 250 ITR 131], the Delhi High Court held that the expression **"previous owner of the property"** in Sec. 49(1) would obviously mean the person who purchased the property. When the previous owner had thrown the property into the common hotchpot of the HUF, and when the HUF later sold the property, its cost of acquisition was the amount spent by the person who threw the asset into the common hotchpot.

The Madras High Court considered the issue of assets received under family settlement in the case of **CIT v. Shanti Chandran** [(2000) 241 ITR 371]. In that case it was held that, when the assessee received certain shares under a settlement effected by her father, and subsequently sold the shares, it is the **"cost to the previous owner"** (father) that is to be taken into account as the cost of acquisition of the shares.

Even in **CIT V. s. Krishnamurthy** [(1985) 152 ITR 669 (MAD)], it was held that, in a case of devolution, viz., throwing of individual property into the common hotchpot of a joint Hindu Family and subsequent sale of the property, the cost of acquisition in the hands of HUF shall be the cost to the previous owner, namely, the individual and not the market value as on the date of devolution.

Deeming fiction in Sec. 49(1) and Explanation(1)(i)(b) of Sec. 2(42A)

Sec. 49(1) of the Act provides that in the case of an assessee acquiring an asset under a gift, inheritance or will etc., the cost of acquisition of the asset shall be deemed to be the cost for which the previous owner of the property acquired it, as increased by the cost of any improvement of the asset incurred or borne by the previous owner or the assessee as the case may be. Similarly, in Explanation(1)(i)(b) of Sec. 2(42A), while defining the term short-term capital asset, in determining the period of asset, where the asset is acquired under the circumstances stated in Section 49(1), then the **period of holding by the tax payer shall include the period of holding by the previous owner.**

Thus, on account of the deeming fiction contained in these provisions of the Act, gains arising on transfer of a capital asset acquired by the assessee under a gift, inheritance or will etc., would arise. In such a case, the capital gains under Sec. 48 of the Act would have to be determined by deducting from the total consideration received by the assessee, inter alia the **deemed cost of acquisition.**

In **Smt. Mina Deogun Vs. ITO** [(2008) 117 TTJ (Kol) 121], the Kolkata ITAT, discussed elaborately the issue and have held that the indexed cost of acquisition in the hands of previous have to be considered for computation of capital gains where the assessee has acquired the property under the instances stated in Sec. 49(1).

The Bench accepted the Assessee's contention that a **schematic and not literal interpretation** should be given while interpreting the provision of section 48. Further, reliance was placed on the Memorandum Explaining Provisions of the Finance Bill, 1992 and Circular No. 636, dt. 31st Aug., 1992 *(supra)* which explained the provisions of Finance Act, 1992, wherein, indexed cost of acquisition to the previous owner should be calculated for computing capital gains of asset received without paying consideration. The Court held as under:

> *"Considering the totality of the facts and the scheme of the IT Act relating to taxation of capital gains, we are of the considered opinion that as per the schematic interpretation, the cost of inflation index should be made applied with reference to the year in which the capital asset was first acquired by the previous owner. If only for the purpose of computing indexed cost of acquisition, the date of acquisition by the previous owner is excluded then it will lead to absurd result. Such interpretation of s. 48 will be against the intent and object of the enactment and will be against the overall scheme of taxation of capital gains in case of inherited assets. The cardinal principles of interpretation of statutes is that if literal meaning of the statute leads to an absurdity then the statute should be interpreted in a manner which will result in harmonious interpretation which avoids absurdity and promote the objective of an enactment."*

The Chandigarh Tribunal in **Pushpa Sofat V. ITO** [(2004) 89 TTJ (Chd) 499] and the Mumbai Tribunal in in the case of **DCIT V. Smt. Meera Khera** [(2004) 136 Taxman 174 (Mumbai)(Mag)] have also taken a view that, the indexed cost of acquisition as in the hands of the previous owner should be considered when the assessee inherits the property from the family.

In **Kamal Mishra V. ITO** [(2008) 19 SOT 251 (Del)], the Delhi Tribunal, while deciding the case in respect of shares devolved on the assessee on the death of her husband, held that,

> *"There cannot be two different dates in respect of the same asset devolving on the heir, one date to determine the date of cost of acquisition and another to determine the indexed*

cost of acquisition. Even otherwise the period of holding for determining long-term capital gains includes the period for which the original owner held the asset that devolved upon the legal heir. Accordingly, the AO is directed to recompute capital gains on sale of securities by indexing cost of acquisition with reference to the year in which husband of assessee acquired them."

Though majority of judicial decisions were having similar viewa, a contradictory judgment was given in **DCIT V. Kishore Kanungo** [(2006) 102 ITD 437], by the Hon'ble Mumbai Tribunal based on the literal and prima facie interpretation of Expln. (iii) to Sec. 48. The facts were that the assessee's HUF entered into an agreement in 1981 for constructing a flat. The construction was completed in 1988 and the HUF was partitioned in AY 1991-92. Even though the asset came into existence in 1988, the AO allowed indexation from the year 1991-92 and the High Court has upheld the same. The High Court took the view that:

"In the present case, there is no dispute that the asset in question, i.e., flat was held by the assessee only from financial year 1991-92, i.e., when the partition of HUF took place. As per provisions of s. 2(42A) r/w Expln. 1(i)(b), the period for which the asset was held by the previous owner has to be added to decide as to whether the asset is short-term capital asset or long-term capital asset and since, admittedly, construction of the house was completed in 1988, the asset is a long-term capital asset in view of this Explanation to s. 2(42A); but in view of the specific provisions of Expln. (iii) to s. 48, indexing has to be allowed from financial year 1991-92, i.e., the year from which flat was held by the assesseeson partition of HUF and hence, on this issue also, order of learned CIT(A) is reversed and that of the AO is restored."

Dissenting the opinion in the above case, the Vishakapatnam Tribunal in **M. Siva Parvathi & Ors. Vs. ITO** [(2011) 7 ITR 468], in deciding that the assessee having inherited the property purchased by the previous owner in the year 1974, cost of acquisition for the purpose of computing capital gains on sale of such property had to be computed by applying cost inflation index of financial year 1981-82 and not of financial year 1989-90 i.e., the year of inheritance by the assessee. The Court dissented the view taken in the case of Kishore Kanungo and held that the decision in Mina Deogun *(supra)* and Pushpa Sofat *(supra)* to be reasonable interpretation. The Bench made reference to **CIT vs. Vegetable Products Ltd.** [1973 CTR (SC) 177] in which

it has been held that when two views are possible, the view which is in favour of the assessee has to be adopted.

Bombay High Court Decision in Manjula J. Shah [(2012) 249 CTR (Bom) 270]

As divergent views were taken by the courts in the issue regarding the indexation of cost of acquisition to previous owner, a special bench was constituted in the matter of DCIT V. Manjula J. Shah (2009) 126 TTJ (Mumbai)(SB) 145 to decide on the question:

"While computing the capital gains in the hands of an assessee who had acquired the asset transferred under gift whether indexed cost of acquisition was to be computed with reference to the year in which the previous owner first held the asset or the year in which the assessee became the owner of the asset."

The facts of the case was that the assessee acquired a residential flat as a gift from her daughter under a gift deed dated 02-01-2003. The said flat was originally acquired by the previous owner on 29-01-1993. The assessee sold the flat on 30-06-2003 and offered long term capital gains. While calculating the capital gains she took the index of year 1993-94. The ITO recomputed the capital gains with index of 2002-03 and passed order accordingly. The appeal before CIT (Appeals) and the ITAT were decided in favour of the assessee.

The Special Bench of the ITAT observed that although a literal reading of Sec. 48 of the Income tax Act, suggests that one has to go by the year in which the asset was held by the tax payer, such an interpretation would be inconsistent with the scheme of the Act as reflected in the definition of 'short-term capital asset, in sec. 2(42A) which provides for inclusion of the period for which the asset is held by the previous owner. The Special Bench further observed that in case the cost of acquisition and period of holding is determined with reference to the previous owner, ***it is not logical to consider the indexation factor with reference to the date of acquisition of the tax payer instead of the previous owner and such an interpretation would defeat the purpose of the concept of 'indexed cost of acquisition'.***

Accordingly the Honorable Special Bench of the ITAT accepted the tax payer's contention and held that the indexed cost of acquisition has to be computed by taking into account the period for which the asset was held by the previous owner.

The revenue preferred further appeal before the High Court. While delivering the order the Bombay High Court, laid down that ***when the law provides to consider the period of holding of the previous owner also, then a different treatment cannot be accorded for calculation of the indexed cost of acquisition by not adopting the cost inflation index of the year in which the asset was acquired by the previous owner.*** Therefore, the court said, indexation should be allowed from the year in which such asset was acquired by the previous owner.

The ITAT Mumbai Special Bench decision upheld by the Bombay High Court has been followed in:

(i) ACIT V. Anjana Mohan [(2013) 36 CCH 008 CochinTrib]
(ii) Lalitha Rathnam Vs. ITO [(2013) 153 TTJ (Chd)(UO) 59]
(iii) ACIT V. Suresh Verma [(2012) 147 TTJ (Del) 81]
(iv) ACIT V. Syed Maqbul Hussain [(2010) 4 ITR (Trib) 44 (Chennai)]
(v) Asst. DIT v. Rajeev Ajmani [ITA No. 2057/Del/2011]

CIT V. Mira Exim Ltd. – A disturbance to the settled law?

Though the issue in this case relates to the question *"Whether imported cars originally purchased between 1st March, 1975 and 31st March, 2001, but transferred to the merged entity after the cutoff date of the merger i.e. 1st April, 2001 is entitled to depreciation?"*. The decision of the Delhi High Court in this case is likely to disturb the prevailing views taken by the various Courts and Tribunal that indexation should be allowed from the year in which such asset was acquired by the previous owner.

In this case, under a scheme of Amalgamation w.e.f. from 1.4.2004, a company merged with the assessee company. Though the assessee acquired the imported cars of the amalgamating company even before 1.4.2001, the Delhi High Court held that the assessee was not entitled to claim depreciation u/s. 32(1) as the amalgamation is only effective from 1.4.2004 and the cars became properties of the assessee company from such date.

Now, interpreting this decision in terms of determining cost of acquisition with reference to previous owner:

As per Section 47(vi), in an amalgamation, there is no transfer of capital assets. However, Section 49(1)(iii)(e) and Section 2(42A)(b), provides that in the transfer of assets under a scheme of amalgamation, the cost of acquisition shall be the cost for which the asset was acquired by the previous owner.

In **Mira Exim Ltd. 2013-TIOL-815-HC-DEL-IT**, the Delhi High Court has come to a conclusion that an imported car, which was owned by the amalgamating (Transferor) company is deemed to have acquired by the transferee company on the date of amalgamation.

The Courts have settled the issue in cases regarding gift, inheritance, devolution, will, etc, that indexation was allowed on the basis that the date of acquisition of the asset is the date of acquisition by the transferor (previous owner), whereas in the instant case, the imported car is deemed to have been acquired by the transferee on the date of amalgamation. The court held that imported cars acquired prior to amalgamation (though the cars were actually acquired by the assessee before 1.4.2001) is not entitled to depreciation.

Conclusion

In determination of cost of acquisition as regards the assets acquired under specified modes, cross-reference of various provision have to be followed.

Sec. 45(1), the charging provision, is not sufficient. Instead a hoard of provisions, Sec. 2(14) - which defines a capital asset, Sec. 2(42A) - which defines a short-term capital asset, Sec. 2(47) - which defines transfer, Sec. 48 - which provides decisive deductions, Sec.47 - which excludes certain transfers from the purview of capital gains and Sec. 49 & 55 - which lays down the cost of acquisition in certain specified circumstances - have to be gone through.

With all the cross references being made to determine the cost of acquisition, the judiciary through a catena of decision [most importantly Bombay HC in Manjula J. Shah Case *(supra)*] has settled the issue on application of indexation with regards to various modes of acquiring the asset. But, it is more likely that the controversy is rekindled in Mira Exim Ltd. Case *(supra)* as the department would be relying on this decision against granting indexation from the date on which the asset was acquired by the previous owner.