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DEMYSTIFYING CAPITAL GAINS: ANALYSING SECTIONS 45, 48, AND 55 FOR TAX COMPLIANCE

Kritin Sardana & Anurag Jaiswal

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CONTENTS

S. No.	*Articles*	*Page No.*
1	TAXATION OF INDIVIDUAL INCOME WITH SPECIAL REFERENCE TO CITIZENSHIP BASIS: A COMPARATIVE OVERVIEW OF INDIAN AND USA SYSTEM OF TAXATION *Rakesh Kumar & Sonakshi Kashyap*	1
2	TAXING THE DIGITAL BUSINESS MODELS: REALIGNING OR REPLACING THE OLD NEXUS NORMS *Preeti Lakhera*	25
3	PROBLEMS ASSOCIATED WITH DOUBLE TAXATION AVOIDANCE AGREEMENTS: A GENERAL PERSPECTIVE *Manoj Kumar & Arpit Vihan*	33
4	ROLE OF GST IN INDIAN ECONOMY: AN ANALYSIS *Manjit Singh & Sahibpreet Singh*	49
5	CROSS-BORDER TAXATION IN PURSUIT OF GLOBAL CLIMATE EQUITY – COMPATIBILITY WITH THE CONCEPT OF FREE TRADE *Arunbaby Stephen & Ashima PA*	66
6	ANGEL TAX ON NON-RESIDENTS: DEVILISH ACT ON STARTUPS? *Ribhava Raj*	79
7	THE DIGITAL ERA: CRYPTOCURRENCY AND ITS (IN)EFFICIENT TAXATION AND REGULATION POLICY *Kumar Rishav & Divya Venugopalan*	91
8	DEMYSTIFYING CAPITAL GAINS: ANALYSING SECTIONS 45, 48, AND 55 FOR TAX COMPLIANCE *Kritin Sardana & Anurag Jaiswal*	116
9	IMPACT OF PRIORITIZING TAX CLAIMS IN CORPORATE INSOLVENCY: ANALYSING THE RAINBOW JUDGMENT *Aditi Dehal & Shubham Singh Bagla*	136
10	ROLE OF INDIAN JUDICIARY IN PREVENTING INTERNATIONAL TAX EVASION - AN ANALYSIS *Deepak B. D.*	155

DEMYSTIFYING CAPITAL GAINS: ANALYSING SECTIONS 45, 48, AND 55 FOR TAX COMPLIANCE

Kritin Sardana[*] & Anurag Jaiswal[**]

[***Abstract:*** *Taxation is a complex web of regulations, and an in-depth understanding of these sections is crucial for individuals and businesses seeking compliance and financial optimization. Section 45 addresses the computation aspects, providing a framework for understanding how various transactions impact tax liabilities. It explores the intricacies of calculating taxable income, ensuring that taxpayers are well-versed in the nuances of financial adjustments. In the realm of tax computation, Section 48 takes centre stage. It outlines the mode of computation, establishing the rules and methodologies governing taxable income calculation. A thorough exploration of this section is indispensable for professionals and taxpayers alike, as it forms the backbone of accurate and lawful tax reporting. The abstract also explores Section 55, unravelling the meaning of two critical terms: 'Adjusted Cost of Improvement' and 'Cost of Acquisition.' Understanding these terms is paramount in determining the tax implications of property transactions, ensuring that taxpayers adhere to the legal framework while making informed financial decisions. In conclusion, this paper provides a comprehensive overview of the intricate interplay between computation and transactions in tax law, specifically focusing on Sections 45, 48 and 55. It serves as a valuable resource for individuals, tax professionals, and businesses navigating taxation complexities, offering insights into compliance, financial planning, and strategic decision-making*.**]**

Keywords: Capital Assets, Capital Gains, Computation, Cost of Improvement and Acquisition.

I

Introduction

The Income Tax Act of 1961, a comprehensive legislation governing taxation in India, provides a detailed framework for the computation of income, especially concerning capital transactions. Sections 45 and 48 of the Income Tax Act delve into crucial aspects related to capital gains taxation. Understanding these sections is fundamental for taxpayers and professionals in navigating the complexities of capital

[*] Kritin Sardana is a Fourth Year B.A. LL.B.(Hons.) student at Himachal Pradesh National Law University, Shimla. Email: kritinbba2042@hpnlu.ac.in

[**] Anurag Jaiswal is a Fourth Year B.A. LL.B.(Hons.) student at Himachal Pradesh National Law University, Shimla.

transactions and ensuring compliance with tax obligations. Section 45 of the Income Tax Act establishes the framework for the computation of capital gains. It outlines the taxation on profits or gains arising from transferring a capital asset. These sections form the cornerstone for assessing the tax implications of various transactions involving the disposal of assets. Section 48 lays down the mode of computation for determining the taxable income arising from capital gains. It specifies the method for calculating capital gains by considering the full value of consideration received or accruing as a result of the transfer of a capital asset. Section 55 elucidates the meanings of 'cost of improvement' and 'cost of acquisition,' shedding light on the factors contributing to determining taxable gains.

II

Legal Aspects of Capital Gains Taxation

Profits or gains from the sale of a capital asset in a fiscal year are subject to taxation as capital gains in the subsequent assessment year, unless exempt under specific sections. The liability for capital gains tax arises when criteria such as the presence of a capital asset, its transfer by the taxpayer, the occurrence of transfer in the preceding fiscal year, and the realization of profit are met, and no exemptions under specified sections apply. Taxable capital gains are applicable in the assessment year corresponding to the transfer, but variations may occur, and capital gains might arise without a formal transfer. It underscores the importance of considering specific conditions for tax implications on capital gains.

Definition of capital asset [Sec. 2(14)]: The term "Capital asset" broadly encompasses a diverse range of properties, spanning fixed or circulating, movable or immovable, tangible or intangible assets. The Positive list includes rights related to Indian companies, various kinds of property associated with the assessee, and securities held by Foreign Institutional Investors. Conversely, the Negative list specifies exclusions from the "capital assets" definition, such as stock in trade, personal effects, agricultural land in rural areas, certain government-issued bonds, and gold deposit schemes. These distinctions guide the

taxation treatment of assets, emphasizing the need to carefully consider asset types under the specified exceptions and inclusions. [1]

According to the Income Tax Act, any property an assessee owns qualifies as a capital asset. This comprehensive definition covers various assets like movable and immovable properties, tangible and intangible items, incorporeal rights, and choices in action. The term 'property' holds a broad interpretation, encompassing all conceivable interests that an individual can rightfully possess and enjoy unless the context requires a restrictive interpretation.[2] For a property to be eligible for transfer, it must meet the criteria of being classified as a capital asset at the time of transfer. Importantly, it is not a requirement for the property to have been categorized as a capital asset when initially acquired by the assessee.[3]

The Supreme Court in the case of *Vodafone International Holdings B.V.* v. *Union of India*[4] held that it is previously determined that influence or persuasion exerted by a parent company over its subsidiary did not qualify as a legal right. Section 3 of The Finance Act of 2012 introduced an Explanation below Section 2(14) of IT Act, 1961 to rectify a prior decision stating that influence or persuasion by a parent company over its subsidiary lacked legal standing. With retrospective effect from April 1, 1962, this Explanation clarified that the term "property" includes rights related to an Indian company, such as management or control rights. For listed shares and securities held beyond 12 months before transfer, the Assessing Officer cannot dispute this decision if a taxpayer chooses to treat resulting income as capital gain. However, this stance must remain consistent across subsequent assessment years, with no allowance for contradictory positions. Notably, these principles do not apply when transaction authenticity is questioned, such as dubious claims of capital gain or potential fraudulent transactions.[5] Section 2(14)(i) clearly states that stock-in-trade,

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[1] Income Tax Act, 1961, S. 2(14).

[2] *Ahmed G.H. Ariff* v. *C.W.T.*, [1970] 76 I.T.R. 471 (S.C.).

[3] *Arun Sunny* v. *C.I.T.*, [2009] 184 Taxman 498 (Ker).

[4] *Vodafone International Holdings B.V.* v. *Union of India*, [2012] 204 Taxman 408, ¶ 76.

[5] Circular No. 6/2016, *Issue of taxability of surplus on sale of shares and securities - Capital Gains or Business Income - Instructions in order to reduce litigation* (CBDT, 29 Feb., 2016).

consumable stores, or raw materials are not considered capital assets. This means that any such items held for business or professional purposes are exempt from being classified as capital assets, except for securities held by a Foreign Institutional Investor. The underlying principle is that profits derived from the transfer or sale of these excluded items are taxable as business income under section 28.[6] Section 2(14)(ii) excludes personal effects, which are movable property, from the definition of capital assets. To qualify for this exclusion, certain conditions must be met: the property should be movable, including items like clothing and furniture; it must be held for personal use by the assessee or a dependent family member. Notably, this exclusion does not apply to specific items such as jewellery, archaeological collections, drawings, paintings, sculptures, or any other works of art.[7] Additionally, agricultural land in India is excluded from the definition of a capital asset when situated in a rural area. However, a crucial distinction is made when the land is in a village within a municipality. In such cases, the population criterion for determining whether the land qualifies as a capital asset is based on the municipality's population, not the village. If the municipality's population exceeds 10,000, the agricultural land is considered a capital asset, regardless of the village's population being less than 10,000.[8] For tax purposes, the classification of land as "agricultural land in India" is not contingent upon its historical agricultural use. The crucial factor is the current utilization of the land for agricultural purposes at the time of sale. If the land is actively engaged in agricultural activities during the sale, it qualifies as agricultural land for tax purposes, regardless of its past use.[9] The decisive factor in identifying land as agricultural for tax purposes is evaluating its current and actual use. If the land is presently utilized for agriculture or, even if its agricultural use has ceased, there is clear intent for future agricultural purposes, it qualifies as agricultural land. The emphasis is on the current and intended suitability of the land for agricultural activities.[10] The tax classification of land as "agricultural land" is typically determined based on its status

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[6] Income Tax Act, 1961, S. 2(14)(i).

[7] Income Tax Act, 1961, S. 2(14)(ii).

[8] *G.M. Omer Khan* v. *C.I.T.*, [1992] 63 Taxman 533 (S.C.) ¶ 15.

[9] *TSMO Mohamed Othuman* v. *C.I.T.*, [1957] 31 I.T.R. 480 (Mad).

[10] *Ranchhodbhai Bhaijibhai Patel* v. *C.I.T.*, [1971] 81 I.T.R. 446 (Guj.) ¶ 2.

during the sale. If the land is actively involved in agricultural operations on the sale date, it is considered agricultural land. The subsequent purchaser's intentions are of lesser importance; the crucial factor is the land's status and use at the time of the transaction. If the land is involved in agricultural activities during the sale, it is designated as agricultural land for tax purposes.[11] Even if rural agricultural land is transferred to a non-agriculturist in contravention of local laws, the land's classification as agricultural remains unaffected, and it continues to be treated as agricultural land.[12]

III

Classification of Capital Assets

Capital assets are divided into two categories: short-term and long-term.

Short-term assets, held for 36 months or less (24 months for immovable properties from the fiscal year 2017-18), include certain assets like listed equity shares, preference shares, listed securities, zero coupon bonds, UTI units, and equity-oriented mutual fund units, if held for less than 12 months (effective from July 10, 2014). Unlisted shares and immovable properties become short-term assets if held for less than 24 months. **Long-term assets** have a holding period exceeding 36 months. Shares granting flat occupancy rights are long-term assets unless sold within 36 months, resulting in short-term capital gain.[13]

The Calcutta Bench of the Tribunal in the case of *C.I.T.* v. *Sri Sekhar Gupta*[14] held that the land is acknowledged as a separate and distinct capital asset, preserving its identity even after the construction of the building. In this situation, a legal authority approved the separate calculation of capital gains for the land and the building by segregating the sale consideration. The holding period for an asset, which was initially stock-in-trade and later converted into a capital asset before being transferred, commences from when the assessee originally acquired the stock-in-trade, not from the date of its conversion into a

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[11] *M.S. Srinivasa Naicker* v. *I.T.O.*, [2007] 292 I.T.R. 481 (Mad.).
[12] *C.I.T.* v. *Rajshibhai Meramanbhai Odedra*, [2014] 222 Taxman 72 (Guj.) ¶ 3.3.
[13] *I.T.O.* v. *Nayana K. Shah*, [2000] 74 I.T.D. 419 (Mum.).
[14] *C.I.T.* v. *Sri Sekhar Gupta*, [2001] 114 Taxman 122.

capital asset.[15] However, in the case of *C.I.T.* v. *Abhinandan Investment Ltd.*[16], According to a ruling by the Delhi High Court, in the specified scenario, the holding period is to be considered from the date of transformation of stock-in-trade into a capital asset. Similarly, in cases where a housing board allocates a flat or plot, such as DDA or HUDA, the holding period is determined from the date of allotment, not from the date of possession or the execution of the conveyance deed.[17]

IV
Understanding Capital Asset Transfer

The transfer of a capital asset includes activities such as selling, exchanging, abandoning, surrendering the asset, waiving any rights related to the asset, or its compulsory acquisition under relevant laws.[18] The inclusive definition of "transfer" in section 2(47) provides examples but does not exhaustively cover all potential transfer forms. Forms of transfer not explicitly stated in the definition are not excluded.[19] Indeed, the term "transfer" as outlined in section 2(47) should be construed with a broad interpretation rather than a narrow one. The definition implies inclusiveness and should not be viewed as confined or restricted in its extent.[20] If a particular scenario is not expressly addressed in the section but is generally recognized as a transfer in ordinary language, it is deemed to fall within the definition of 'transfer.' The prevailing common understanding or interpretation applies, even if not explicitly stated in the legal provision.[21] The definition of "transfer" under section 2(47) is specifically applicable in the context of a "capital asset." It does not extend to situations where assets other than capital are transferred. The application of this definition is limited to transactions involving capital assets. Indeed, the term "transfer" includes a sale. A sale can be characterized as a contractual arrangement based on monetary consideration, through which the complete or general property in the subject of sale is

[15] *Kalyani Exports & Investment (P.) Ltd.* v. *C.I.T.*, [2001] 78 I.T.D. 95 (Pune).
[16] *C.I.T.* v. *Abhinandan Investment Ltd.*, [2015] 63 Taxman 263.
[17] *Madhu Kaul* v. *C.I.T.*, [2014] 225 Taxman 86 (Punj. & Har.).
[18] Income Tax Act, 1961, S. 2(47).
[19] *Sunil Siddharthbhai* v. *C.I.T.*, [1985] 156 I.T.R. 509 (S.C.) ¶ 13.
[20] *Blue Bay Fisheries (P.) Ltd.* v. *C.I.T.*, [1987] 166 I.T.R. 1 (Ker.).
[21] *C.I.T.* v. *Singla Rice & Gen. Mills*, [2002] 82 I.T.D. 778 (Delhi).

conveyed from the seller to the buyer. The fundamental elements of a sale comprise mutual agreement, competent parties, a money consideration, and the transfer of absolute or general property from the seller to the buyer. If any of these essential elements is absent, the transaction does not qualify as a sale.[22] An exchange entails the transfer of property from one person to another, and in return, the transfer of property from the second person to the first. It necessitates a mutual transfer of ownership, where one's ownership is exchanged for another's.[23] For instance, conversion of preference shares into ordinary shares is a transaction of the nature of "exchange".[24] The transaction of lending shares of same distinctive numbers and receiving back shares of some other numbers is not "exchange".[25] According to section 2(47), the term "transfer" encompasses not only the typical sale or exchange but also the relinquishment of the asset or the extinguishment of any associated rights. While the Act does not provide specific definitions for "relinquishment" and "extinguishment," their ordinary meanings can be derived from established case law. According to the Shorter Oxford English Dictionary, "relinquish" implies withdrawing from or abandoning, while "extinguish" refers to putting a total end to or blotting out of existence. In a relinquishment transaction, a person gives up, abandons, or surrenders their interest in a property, but the property itself continues to exist and remains owned by the same person or another after the relinquishment.[26] A relinquishment takes place when the proprietor withdraws from the property and forsakes their rights to it. The assumption in such a transaction is that the property persists even following the act of relinquishment. The concept of "transfer" implies the presence of both the asset and the transferee to whom it is conveyed. In situations involving damage, partial or complete destruction, or loss of property, there is no transfer to a third party, and it is not considered "extinguishment." Furthermore, the payment of an insurance claim following the destruction of property is

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[22] Income Tax Act, 1961, S. 2(47)(i).

[23] *C.I.T.* v. *Rasiklal Maneklal (H.U.F.)*, [1989] 177 I.T.R. 198 (S.C.).

[24] *C.I.T.* v. *Trustees of H.E.H. the Nizam's Second Supplementary Family Trust,* [1976] 102 I.T.R. 248 (A.P.).

[25] Circular No. 751/1997, *Securities Lending Scheme* (CBDT, 10 Feb. 1997).

[26] *C.I.T.* v. *Rasiklal Maneklal (H.U.F.),* [1974] 75 I.T.R. 656 (Bom.).

not subject to taxation.[27] In certain instances, the impact of the judgment has been negated through the inclusion of sub-section (1A) in section 45, introduced by the Finance Act, 1999, and effective from the assessment year 2000-01. The redemption of preference shares by a company is directly covered by the terms 'sale, exchange, or relinquishment of the asset.' As a result, it is considered a transfer for taxation purposes.[28] In the scenario where a company reduces its share capital by distributing a portion of the capital to its shareholders, it leads to the "extinguishment" of the corresponding rights in the shares held by the shareholders. Consequently, this transaction is subject to capital gains tax in the hands of the shareholders.[29] The distribution of capital assets during the dissolution of a firm is taxable, despite the absence of a formal "transfer." This taxation is applicable under section 45(4) starting from the assessment year 1988-89.[30]

When a partner contributes his personal asset to the capital of a partnership firm, it is considered a transfer for tax purposes. As a result, capital gains become chargeable to tax on this transaction.[31] In the Vodafone case, the Supreme Court made significant rulings, emphasizing:

1. Transferring shares in a foreign holding company does not eliminate the foreign company's control over the Indian company.
2. Such a transfer does not constitute the extinguishment and transfer of an asset located in India.
3. Offshore transfer of shares in the foreign holding company does not result in the extinguishment of the holding company's control rights over the Indian company, and it is not considered the extinguishment and transfer of an asset, including management and control of property, situated in India. Following this, the Finance Act of 2012 introduced amendments impacting tax regulations related to such transactions.[32]

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[27] *Vania Silk Mills (P.) Ltd.* v. *C.I.T.*, [1991] 59 Taxman 3 (S.C.).
[28] *Anarkali Sarabhai* v. *C.I.T.*, [1997] 90 Taxman 509 (S.C.).
[29] *Kartikeya V. Sarabhai* v. *C.I.T.*, [1997] 94 Taxman 164 (S.C.).
[30] Income Tax Act, 1961, S. 45(4).
[31] Income Tax Act, 1961, S. 45(3).
[32] *Supra* note 5, CBDT.

Transfer of capital asset by way of compulsory acquisition is a transfer.[33] Any transaction that involves allowing possession of any immovable property to be taken or retained as part performance of a contract, as referred to in section 53A of the Transfer of Property Act, 1882, is considered a transfer for taxation purposes. This has been applicable from the assessment year 1988-89 onwards.[34] According to section 2(47)(vi), a transaction qualifies as a "transfer" when the following criteria are satisfied:

1. The transferor is a member of a co-operative society, company, or AOP.
2. As a result of this membership, the transferor has been assigned or will be assigned an immovable property.
3. The transfer involves the transfer of membership rights, and this transfer results in the transfer or facilitation of enjoyment of the mentioned immovable property.[35]

V

Approach to Computation in Section 48

Section 48 of the Income Tax Act is designed to calculate the actual capital gain resulting from the sale of capital assets. The computation involves considering the seller's expenditure on acquiring the capital asset, sales consideration costs, and costs related to improvements made to the capital asset. Section 48 permits the inclusion of specific expenses when computing capital gains. These expenses are as follows:

1. Expenditure that is solely and directly related to the transfer.
2. The acquisition cost of the asset and any expenses incurred for its improvement.

The computation of capital gain hinges on the nature of the capital asset being transferred, whether it falls under the category of short-term or long-term capital asset. Short-term capital gains typically incur higher tax implications compared to long-term ones. When the consideration for the transfer of a capital asset is indeterminable, the fair market value of the asset stands as the full market value of

[33] Income Tax Act, 1961, S. 2(47(iii).
[34] Income Tax Act, 1961, S. 2(47)(v).
[35] Income Tax Act, 1961, S. 2(47)(vi).

consideration for computing capital gains under section 45.[36] Moreover, if the acquisition of a portion of a larger plot negatively impacts the value of the unacquired portion, any compensation received for this adverse effect on the unacquired portion is regarded as part of the full value of consideration. This means that when determining the total consideration for the transaction, the compensation for the adverse impact on the unacquired portion is included.[37] Indeed, Section 48 of the Income Tax Act does not explicitly specify that only the consideration mentioned in the sale deed is to be regarded as the full value of consideration received. The section does not prohibit the Assessing Officer from substituting the actual sale consideration for what is stated in the sale deeds, provided there is evidence demonstrating that the assessee had indeed received a higher amount. This allows for flexibility in assessing the actual gains and prevents manipulation by the taxpayer in reporting lower sale consideration.[38] In the scenario where a mill owned by the assessee-company is transferred through a public auction, and the purchaser makes payments in instalments along with interest, the interest amount is considered part of the sale consideration. Therefore, this interest is to be treated as capital gain under section 45 and not as income from other sources.[39]

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[36] Income Tax Act, 1961, S. 50D.

[37] *C.I.T.* v. *P. Mahalakshmi*, [1982] 134 I.T.R. 428 (Kar.).

[38] *Inderpal Singh Ahuja* v. *C.I.T.*, [2006] 103 I.T.D. 271 (Asr.).

[39] *Cauvery Spg. & Wvg. Mills Ltd.* v. *C.I.T.*, [2011] 200 Taxman 22 (Mad.).

VI

Expenditure on transfer

Under the provisions of the Income Tax Act, expenses that are directly related to the transfer of a capital asset can be deducted from the total consideration received. Specifically, the term "expenditure incurred wholly and exclusively in connection with such transfer" refers to costs essential for facilitating the transfer process. It's important to note that for an expense to qualify for deduction, it must be incurred solely and exclusively for the purpose of the transfer. In essence, the expenses must be directly linked and incurred solely to facilitate the transfer.[40] The wording in Section 48 of the Income Tax Act, specifically "expenditure incurred wholly and exclusively in connection with such transfer," has a broader connotation than the expression "for the transfer." This indicates that permissible deductions include a more extensive array of expenses directly and exclusively linked to the transfer of a capital asset. The objective is to encompass a comprehensive set of expenses directly tied to the transfer, offering a more inclusive scope for deductions.[41] Undoubtedly, any amount deemed essential for facilitating the transfer falls within the category of "expenditure in connection with the transfer" as per the applicable provisions. In simpler terms, if the elimination of encumbrances is necessary for the sale or transfer to proceed, the payment made to clear those encumbrances is included under this provision. The crucial criterion is the indispensable nature of the expenditure for the successful completion of the transfer transaction.[42] Allowable expenses for deduction encompass brokerage or commission for purchase, stamp costs, vendor-paid registration fees, transfer-related travel expenses, and legal costs incurred for increasing compensation in compulsory acquisition. Section 48 of the Income Tax Act permits taxpayers to compute capital gains, considering improvement and acquisition costs, thereby offering a more precise assessment of actual profits.

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[40] *Sita Nanda* v. *C.I.T.*, [2001] 119 Taxman 227 (Delhi).

[41] *C.I.T.* v. *Bradford Trading Co. (P.) Ltd.*, [2002] 125 Taxman 632 (Mad.).

[42] *Gopee Nath Paul & Sons* v. *C.I.T.*, [2005] 147 Taxman 629 (Cal.).

The First Proviso to Section 48 of the Income Tax Act is relevant for non-resident Indians, specifically in cases where they purchase assets like shares or debentures in foreign currency, which is later converted into INR. Upon selling such assets, the amount in INR is to be reconverted into the original foreign currency, neutralizing exchange rate fluctuations. The Second Proviso provides indexation benefits for long-term capital gains but is not applicable to non-resident Indians. The Third Proviso excludes the application of the First and Second Provisos when Rule 112A is considered. The Fourth Proviso excludes the Second Proviso for certain capital assets like indexed government bonds or Sovereign Gold Bonds. The Fifth Proviso is for eligible non-resident assesses, allowing them to ignore capital gains arising from currency fluctuations. The Sixth Proviso applies when debentures or shares are transferred as gifts, considering the market value on the transfer date as the total consideration. The Seventh Proviso disallows deductions under Section 48 if Securities Transaction Tax (STT) is applicable to the transactions.

VII

Deciphering 'Cost of Improvement' and 'Cost of Acquisition' given in Section 55

The acquisition cost of an asset is based on the value at which the assessee obtained it. However, only capital expenses incurred to finalize or secure title to the property are considered part of the acquisition cost. In this context, ground rent is not considered an expenditure incurred by the assessee for acquiring the capital asset. Consequently, ground rent is not factored into the computation of the actual cost of the capital asset for the assessee.[43] Indeed, interest on money borrowed to purchase an asset is considered part of the actual cost of the asset. This includes interest on borrowed capital, even if the loan was obtained from directors. The rationale behind this is to incorporate the full financial commitment made by the assessee in acquiring the asset, which includes not only the principal amount borrowed but also the interest paid on that borrowed capital.[44] While interest on money borrowed to purchase an asset is generally

[43] *C.I.T.* v. *Mithlesh Kumari*, [1973] 92 I.T.R. 9 (Delhi).

[44] *C.I.T.* v. *Sri Hariram Hotels (P) Ltd.*, [2010] 188 Taxman 170 (Kar.).

considered part of the actual cost of the asset, there are exceptions. In the case of interest payable on a provident fund loan, where the interest is credited to the provident fund account of the assessee, it is not considered a deductible expenditure. The treatment may vary based on the specific nature and purpose of the loan.[45] Expenses incurred for suits aimed at amending articles of association are considered of a capital nature. As a result, these expenses are regarded as part of the cost of shares.[46] The payment of estate duty concerning inherited property cannot be regarded as either the cost of acquisition or the cost of improvement of the property. Estate duty is a tax imposed on the estate of a deceased person, and it is not a direct expenditure in connection to acquisition or improvement of the property itself. Therefore, it is not included in the calculations for determining the cost basis of the inherited property.[47] Interest on a housing loan is considered part of the acquisition cost, even if it is allowed as a deduction under Section 24(b) of the Income Tax Act. While Section 24(b) allows for the deduction of interest on housing loans, to calculate the cost of acquisition under other provisions, the full interest amount is considered part of the overall cost associated with acquiring the property. The deduction under Section 24(b) is a separate provision aimed at providing relief to taxpayers on the interest paid on home loans.[48]

If land was originally acquired as agricultural land and later converted into non-agricultural land, the cost of acquisition for tax purposes is generally taken as the cost of acquisition of the agricultural land. This means that the notional cost as of the date the land is put to non-agricultural use is not considered for determining the cost of acquisition. The original cost incurred when acquiring the land as agricultural is retained as the basis for calculating capital gains or losses upon subsequent sale or transfer.[49] If a loan is taken from an associate company of the employer to finance the allotment of stock option shares, and later the loan is waived by the associate company,

[45] *Vashisht Bhargava* v. *I.T.O.*, [1975] 99 I.T.R. 148 (Delhi).
[46] *C.I.T.* v. *Bengal Assam Investors Ltd.*, [1969] 72 I.T.R. 319 (Cal.).
[47] *S. Valliammai* v. *C.I.T.*, [1981] 127 I.T.R. 713 (Mad.).
[48] *C.I.T.* v. *C. Ramabrahman*, [2012] 27 Taxman 104 (Chennai).
[49] *Meccane Industries Ltd.* v. *C.I.T.*, (2002) 254 I.T.R.175 (Mad.).

the amount of the waived loan is generally reduced from the cost of acquisition of the stock option shares. In such a scenario, the waived amount is treated as a benefit or gain received by the employee from the employer, and it is adjusted against the cost associated with acquiring the shares. This adjustment reflects the economic benefit received by the employee through the loan waiver and is factored into the overall cost calculation for tax purposes.[50] The costs associated with advocate fees and brokerage during the purchase of a property are to be considered as part of the cost of acquisition.[51]

The benefit of indexation will be available from the year in which the asset was first held by the current owner. However, the Bombay High Court in the case of *C.I.T.* v. *Manjula J. Shah*[52] and the Delhi High Court in the case of *Arun Shungloo Trust* v. *C.I.T.*[53], have recently held that indexed cost of acquisition has to be computed with reference to the year in which previous owner first held asset and not the year in which the assessee became owner of the asset. According to Section 55(3), if the cost at which the previous owner acquired the property cannot be determined, the cost of acquisition for the previous owner is considered to be the fair market value on the date when the capital asset became the property of the previous owner.[54] When the assessee owns an asset received under a mode specified under section 49(1), and subsequently, the assessee converts the asset into a new asset, the period of holding for the new asset would commence from the date of conversion. This implies that for the purpose of calculating capital gains, the holding period for the newly converted asset starts from the date of the conversion event.

Unearned increase in value of land is not to be deducted while determining fair market value or the property as on April 1, 2001.[55] In a scenario where the assessee acquired raw and uncut diamonds with cracks and spots during the assessment year 1975-76 and later, during the assessment year 1998-99, some of these diamonds were processed

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[50] *Ravi Kinar Sinha* v. *C.I.T.*, (2007] 15 S.O.T. 555 (Delhi).
[51] *S. Sudha* v. *C.I.T.*, (2011] 48 S.O.T. 335 (Chennai).
[52] *C.I.T.* v. *Manjula J. Shah,* [2012] 204 Taxman 691.
[53] *Arun Shungloo Trust* v. *C.I.T,* (2012) 205 Taxman 456.
[54] Income Tax Act, 1961, S. 55(3).
[55] *C.I.T.* v. *Rekha Mathur,* [2006] 152 Taxman 70 (Mad.).

and sold as finished diamonds, the cost of the original asset (raw and uncut diamonds) for determining capital gain shall be substituted by the fair market value of the same as of April 1, 2001. Therefore, for the purpose of calculating capital gains, the fair market value of the raw and uncut diamonds as of April 1, 2001, will be considered instead of the fair market value of the polished and finished diamonds.[56] A reference under section 50C to the Valuation Officer can be initiated solely for the valuation of an asset at the time of its transfer, which triggers the imposition of capital gains tax. It cannot be made for the purpose of evaluating the asset as of April 1, 2001. Section 50C of the Income Tax Act is primarily concerned with determining the fair market value of the property as on the date of its transfer for the computation of capital gains, especially in cases where the sale consideration declared by the parties is lower than the fair market value.[57]

VIII

Cost of Improvement

Cost of improvement refers to the capital expenditure incurred by an assessee to make additions or improvements to a capital asset. This also encompasses expenditures incurred to safeguard or complete the title to the capital asset or remedy such title. In essence, any expenditure undertaken to enhance the value of the capital asset is considered part of the cost of improvement. Special provisions outlined in section 55 of the Income-tax Act should be noted concerning the cost of improvement:

1. Expenditure before April 1, 2001 not considered - Any cost of improvement incurred before April 1, 2001, is not taken into account when calculating capital gain subject to taxation. This rule lacks exceptions, implying that only expenditures on improvement incurred on or after April 1, 2001, contribute to the cost of improvement. Expenditure on improvement before April 1, 2001, is always considered as zero.

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[56] *Hiralal Lokchandani* v. *I.T.O.,* [2007] 106 I.T.D. 45 (Kol.).
[57] *Neville De Noronha* v. *C.I.T.,* [2008] 26 S.O.T. 35 (Kol.).

2. Double deduction not permitted - The cost of improvement excludes any expenditure deductible in computing income under the categories "Interest on securities," "Income from house property," "Profits and gains of business or profession," and "Income from other sources.".[58]

Cost of Improvement in Different Situations

Only the expenses directly incurred by the assessee should be considered. In a situation where the assessee, as a partner in a firm, debited expenses related to the improvement of her self-occupied property to the firm, and only her share of the expenses was debited to her account in the firm, it was ruled that only the expenses actually borne by her should be taken into account. The share debited to the other partner's account was not to be considered for the calculation of cost of improvement.[59]

To classify an expenditure as 'cost of improvement,' the expenditure incurred in making additions and alterations to the capital asset must be of a capital nature.[60] There can be cost of improvement even in the case of an intangible asset.[61] In a case where the assessee made a payment to resolve a dispute and improve his title in response to a claim filed by another party, it was determined that this expenditure did not qualify as the cost of improvement to the asset. Consequently, it could not be deducted when calculating capital gains.[62] The payment of betterment charges under a town planning scheme, incurred for obtaining a lasting benefit, is considered a form of capital expenditure. This type of expenditure enhances the value of the land, making it eligible for inclusion under section 48 of the Income Tax Act.[63] When the assessee sold shares in other companies and asserted that the "negative cost" arising from the forfeiture of dividends due to the allocation of profits to reserves by those companies should be considered as "cost of improvement" for the purpose of computing

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[58] Income Tax Act, 1961, S. 55.
[59] *Parmanand Bhai Patel and Jyotsna Devi Patel* v. *C.I.T.*, [1984] 149 I.T.R. 80 (MP).
[60] *Industrial Credits & Development Syndicate Ltd.* v. *C.I.T.*, [2001] 251 I.T.R. 720 ¶ 14.
[61] *S. Valliammai* v. *C.I.T.*, [1981] 127 I.T.R. 713 (Mad.).
[62] *C.I.T.* v. *Indira*, [1979] 119 I.T.R. 837 (Mad.).
[63] *Mathuradas Mangaldas Parekh* v. *C.I.T.*, [1980] 126 I.T.R. 669 (Guj.).

capital gains under section 48, it was determined that the rejection of the assessee's claim was justified.[64]

RULE OF SECTION 45(2) - Starting from the assessment year 1985-86, the transformation of an investment into the stock-in-trade of a business conducted by the taxpayer is considered a transfer as per section 2(47). This conversion is treated as a 'transfer' in the year when the capital asset is changed into stock-in-trade. The hypothetical profit resulting from this transfer through the conversion of a capital asset into stock-in-trade is subject to taxation in the year when the stock-in-trade is sold [Section 45(2) inserted with effect from the assessment year 1985-86]. If the stock-in-trade is sold in multiple parts across different years, the capital gain tax on the conversion of the capital asset into stock-in-trade, as per section 45(2), is considered to arise in portions in different years rather than in a single year when the last portion of the stock-in-trade is sold.[65] The contention that the application of section 45(2) is relevant only in the presence of profit or gain, and not applicable in the case of a loss, lacks merit.[66]

IX
Navigating Contemporary Issues in Capital Gains Taxation Law

In recent years, the landscape of capital gains taxation in India has been marked by dynamic changes, driven by both domestic economic considerations and global trends. As India aims for sustained economic growth and fiscal stability, policymakers continually review and amend the taxation framework surrounding capital gains to ensure fairness, efficiency, and revenue generation. Here, we delve into some of the contemporary issues shaping capital gains taxation law in India.
One of the prominent contemporary issues in India's capital gains taxation is the rationalization of tax rates and structures. Over the years, there have been debates regarding the disparity in tax treatment between different asset classes and holding periods. For instance, while long-term capital gains on listed equities enjoy preferential tax rates, other assets such as real estate and unlisted securities face different tax

[64] *Investment corporation of India Ltd.* v. *I.T.O.*, [1982] 1 I.T.D. 880 (Bom.).
[65] *C.I.T.* v. *Crest Hotels Ltd.*, [2001] 78 I.T.D. 213 (Mum.).
[66] *C.I.T.* v. *Claridges Investments & Finances (P.) Ltd.*, [2007] 18 S.O.T. 390 (Mum.).

treatments. Policymakers are under pressure to streamline these variations to promote equity and efficiency within the tax system.

The emergence of digital assets and cryptocurrencies has posed significant challenges to traditional tax frameworks worldwide, and India is no exception. As these assets gain popularity among investors, regulators are grappling with questions regarding their classification and taxation. The absence of specific guidelines has led to ambiguity surrounding the tax treatment of gains from digital assets, necessitating urgent regulatory clarity to address potential revenue leakages and ensure compliance.

India's participation in international taxation agreements and initiatives, such as the Base Erosion and Profit Shifting (BEPS) framework, has implications for its capital gains taxation laws. The alignment of domestic tax regulations with international standards aims to prevent tax avoidance and ensure a level playing field for businesses operating across borders. However, the implementation of these agreements requires careful consideration to balance revenue objectives with the need to attract foreign investment and foster economic growth.

Capital gains taxation policies play a crucial role in shaping investor behaviour and fostering entrepreneurship. In India, there is ongoing discourse on incentivizing long-term investments and startups through favourable tax treatment of capital gains. Measures such as extending the holding period for qualifying as long-term capital gains or introducing tax breaks for investments in specified sectors are being explored to stimulate investment activity and promote innovation.

Ensuring compliance with capital gains taxation laws presents a persistent challenge for tax authorities in India. The complexity of tax provisions, coupled with the evolving nature of financial transactions, often leads to compliance gaps and potential tax evasion. Strengthening enforcement mechanisms, leveraging technology for data analytics, and enhancing taxpayer education and awareness are critical strategies to address these challenges and enhance tax revenue collection.

The contemporary issues surrounding capital gains taxation in India underscore the complexity and fluidity of the tax landscape in an

increasingly globalized and digital economy. As policymakers navigate these challenges, the overarching goals remain consistent – to foster economic growth, ensure tax equity, and maintain fiscal sustainability. Addressing these issues requires a holistic approach that balances the interests of various stakeholders while upholding the integrity and efficiency of the tax system.

X

Suggestions

Suggestions for Improving Computation of Capital Gains under Sections 45, 46-47, 48, and Interpretation of Sections 55 of the Income Tax Act, 1961 are as follows:

1. Enhance Clarity in Section 45: Provide clearer guidelines and examples within Section 45 to facilitate a better understanding of the computation of capital gains. This can help taxpayers and professionals navigate the complexities of this section more effectively.
2. Simplify Mode of Computation (Section 48): Consider simplifying the mode of computation outlined in Section 48, possibly through the use of standard formulas or calculators. This could reduce complexities in determining the full value of consideration and enhance accuracy in reporting.
3. Clarify Treatment of Specific Transactions (Section 47): Provide additional clarity on the treatment of specific transactions outlined in Section 47. This includes specifying conditions and scenarios where exemptions are applicable and ensuring a uniform interpretation of these provisions.
4. Conduct Awareness Campaigns: Initiate awareness campaigns to educate taxpayers, professionals, and relevant stakeholders about the nuances of Sections 45, 46-47, 48, and 55. Increased awareness can lead to improved compliance and a better understanding of tax implications.
5. Facilitate Training for Professionals: Provide training programs and resources for tax professionals to enhance their understanding of the intricacies involved in computing capital gains. This can contribute to more accurate and consistent interpretations of the Income Tax Act.

XI

Conclusion

The calculation of capital gains, as stipulated by Section 45, encompasses a multifaceted procedure. This involves various steps, including the assessment of the full value of consideration and the careful consideration of factors such as the cost of improvement and acquisition. Negotiating through this intricate process presents challenges for both taxpayers and professionals alike. The challenges in this process range from ambiguities in transaction classification under Sections 46-47 to the determination of fair market value, both of which can give rise to disputes and uncertainties. Section 48, which governs the mode of computation, carries its own set of challenges, requiring a delicate balance between precision and simplicity. The frequent changes in the base year for indexation, as highlighted in Section 55, add an additional layer of complexity, necessitating a stable and predictable mechanism to ensure consistency and fairness in tax assessments. As we delve into the conclusion, it is imperative to recognize the evolving landscape of financial transactions. The rise of digital assets and changing modes of commerce underscore the need for the Income Tax Act to adapt, ensuring inclusivity and relevance. Embracing technology for compliance and record-keeping can significantly alleviate the burden on taxpayers and enhance the accuracy of reporting.

In conclusion, a holistic review of the suggested improvements and challenges discussed throughout this exploration is paramount. The Income Tax Act, as a cornerstone of fiscal policy, must evolve to meet the demands of a dynamic economy. Initiatives such as awareness campaigns, training for professionals, and a commitment to regular legislative reviews can contribute to a more transparent, equitable, and taxpayer-friendly system.