CHAPTER - IV

ANALYSIS AND SIGNIFICANCE OF VARIOUS TERMS

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- CRITICAL ANALYSIS AND SIGNIFICANCE OF VARIOUS TERMS-

4.1 CAPITAL ASSET - 2(14)

"Capital Asset" is defined in clause (14) of section 2 of the Act and reads as under -

"Capital asset" means property of any kind held by an assessee, weather or not connected with his business or profession, but does not include -

(i) any stock-in-trade, consumable stores or raw materials held for purposes of his business or profession ;

(ii) personal effects, that is to say, movable property (including wearing apparel and furniture, but excluding jewellery) held for personal use by the assessee or any other member of his family dependent on him.

(iii) agricultural land in India, not being land situate -

(a) in any area which is comprised within the jurisdiction of a muncipality (weather known as a muncipality, muncipal corporation, notified area committee, town area committee or by any other name) or a cantonment board and which has a population of not less than ten thousand according to the last preceding census of which the relevant figures have been published before the first day of the previous year ; or

(b) in any area within such distance, not being more than eight kilometers, from the local limits of any muncipality or contonment board referred to in item (a) as the Central Government may, having regard to the extent of, and scope for, urbanisation of that area and other relevant considerations, specify in thisbehalf by notification in the official gazette ;

(iv) 6½ percent Gold Bonds, 1977, or 7 percent Gold Bonds,1980, or National Defence Gold Bonds,1980, issued by the Central Government ;

(v) Special Bearer Bonds,1991 issued by the Central Government;

The defination of a capital asset introduced first time by Act of 22 of 1947 and was amended by Act of 44 of

1947. This definition appears to be based on the corresponding provisions of the internal Revenue Code of U.S.A.

Meaning and Scope -

'Capital asset' means property of any kind held by an assessee, weather or not connected with his business. It is immaterial weather the property held by assessee is in any way connected with his business or profession weather directly or indirectly. It would appear that 'Capital asset' comprises property of every kind weather movable or immovable, tangible or intangible, fixed or circulating in nature.

The meaning of -

1) 'means'- The word used in the section is "means" and not "includes". Therefore definition is exhaustive.

2) 'Property of any kind'- The term 'property' has not been defined in the Income-tax Act. The term 'property' used in section 2(14) must be taken to be of a very wide meaning. 'property' is a term of widest import. The meaning of a term property includes a business or interest in business. Even property which is terminable after specified period is also regarded as property.

If assessee describes his property as capital asset, but on application of the tests laid down in judicial pronouncements the property represents an item of asset which does not constitute a capital asset within the meaning of section 2(14), the asset cannot and should not be regarded as a capital asset.

3) 'held' - This term does not mean the act of holding physically. It means holding legally. i.e.holding legal rights in the property.

4) 'Weather or not connected with business or profession'- These words indicates that it is not necessary that asset should be only business asset. Without use of these words business as well as non business asset were liable to be included. Use of these words appears way of abundant caution.

5) 'but does not include'- The kind of properties mentioned herein after this term are excluded from the defination of capital asset although they fall within the meaning of the term 'property'. 'Property' signifies every possible interest.

The following assets have been specifically excluded from scope of definition of 'Capital asset'.

(1) Stock-in-trade, consumable stores or raw material -

In the commercial sense 'Stock-in-trade' means the articles which are the subject matter of business transactions. The profit on sale of stock-in-trade will attract tax as business income. A share in the hands of an investor is a capital asset while in the hands of dealer-in-share, it will be his stock-in-trade. A motor car may by a capital asset in the hands of 'Chartered Accountant, a lawyer, a doctor or an author, but it constitute stock-in-trade of a company selling motor cars. Capital asset in the hands of one persons may be a stock-in-trade in the hands of another.

'Raw material' is the material which is changed in its form and is converted to stock-in-trade.

'Consumable stores' means a material which is used up in the process of conversion such as furnace oil, coal etc.

These are excluded as they are used by trader to prepare their stock-in-trade.

(2) Personal effects -

The words 'personal effects' are used to designate articles associated with person, as a property having more or less intimate relation to person of possessor. The expression "personal use" occuring in the definition is very significant. 'Personal use' shows only those effects can legitimately be said to be personal which pertain to the assessee's person.

"Jewellery" is excluded from the definition. Here "Jewellery"- includes -

1) Ornaments made of gold, silver, platinum or any other other precious metal or any alloy containing one or more of such precious metals, weather or not worked or sewn into any wearing apparel.

2) Precious or semi-precious stones, weather or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel.

With result that utensils or cutlery made of silver or any other precious metal or alloy is not included in the definition of capital asset. Also any furniture inlaid with precious metal or having a covering of precious metal is not a capital asset. On the sale of such utensils, furniture or wearing apparel no liability to capital gain tax would arise.

(3) <u>Agricultural land in India</u> -

Up to 1969-70, agricultural lands situated anywhere in India were excluded from the definition of capital asset and consequently the profits and gains on their transfer were wholly exempt from tax.

With effect from 1-4-1970, the Finance Act,1970, has brought urban agricultural lands within definition of a 'capital asset' by amending section 2(14).

Agricultural lands situated within the limits of any muncipality (weather known as a muncipality, muncipal corporation, notified area committee, town area committee or by any other name) or cantonment board having population of 10,000 or more according to last census for which figures have been published before 1st day of relevant accounting year.

Agricultural lands situated in areas lying within distance of not more than 8 kilometres from the local limits of such muncipalities or cantonment boards, if such areas are, having due regard to the extent and scope of their urbanisation and other relevant considerations, notified by Central Government in this behalf, should be treated as capital assets, consequently, profit arising on their transfer would be taxable as capital gains.

While determining weather a land is agricultural land or not, the factors which have to be considered are true nature of land, nature of developments and use of lands in the adjoining area and surroundings, the physical characterstics of land, the intension of owner as gathered from all relevant circumstances and weather the land is assessed for agricultural purposes.

(4) 6½ percent Gold Bonds,1977 or 7 percent Gold Bonds, 1980, or National Defence Gold Bonds,1980 issued by Central Government.

(5) Special Bearer Bonds,1991, issued by the Central Government.

Capital asset -

Capital gains tax is an important branch of Direct taxes. It affects very small trader to limited company. Capital gain arise on the sale of various "Capital assets" Hence, this assumes vital significance to the term "Capital asset".

From the above discussion, it is observed that it includes property of any kind connected with business or not and excludes certain assets within the meaning of section 2(14).

4.2 FAIR MARKET VALUE - 2 (22A)

The section 2(22A) reads as under -

"Fair market value", in relation to a capital asset, means -

(i) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

(ii) where the price referred to in sub-clause (i) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;"

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This clause was added in 1964, Its significance relates to section 52.

The expression"Fair market value" of a capital asset as defined in section 2(22A) of the Act means -

1) The price that the capital asset would ordinarily fetch on its sale in the open market on the date of transier. and

2) Where, however, such price is not ascertainable, it may be determined in accordance with the prescribed rules. The "fair market value" of an asset determined by Income-tax Officer may be disputed by the assessee. However, this power should be exercise by Income-tax Officer by substituting the 'fair market value' for the actual consideration

due to or received by tax payer as a result of transfer and thereby to levy tax on capital gains at a figure much higher than that declared by the assessee has been serious matter for litigation between the taxpayers and Income-tax Department.

Determination of "fair market value" for the purpose of tax on capital gain should be so designed that -

1) there should be simplicity in determining value.
2) the scope of litigation should be minimised.
3) the role of descretion should be minimised.

These suggestions are made because high pitched valuation is the battle ground before the Courts of Law where as lower valuation is a source of corruption. Hence, "fair market value" should be properly determined of the capital asset.

4.3 LONG-TERM CAPITAL ASSET - 2(29A)

The Section 2(29A) reads as under -

"Long term capital asset" means a capital asset which is not a short-term capital asset.

All capital asset which are not short-term (since they are held for 36 months or more before their transfer) are known as long-term capital assets.

In the case of capital asset (being equity shares or preference in the company) it would be treated as short-term capital asset if it is held by an assessee for not more than 12 months immediately prior to its transfer.

This clause is inserted by the Finance Act, 1987 and shall be effective from 1.4.1987. Before the insertion of this new clause in section 2, the term "long term capital asset" was defined in section 54.

The income derived from transfer of long-term capital asset is a long-term capital gain chargeable to tax.

4.4 SHORT-TERM CAPITAL ASSET - 2(42A)

The section 2(42A) reads as under -

"Short-term capital asset" means a capital asset held by an assessee for not more than thirty-six months immediately preceding the date of its transfer.

Provided that in the case of a share held in a company, the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted.

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A"Short-term capital asset" is a capital asset which is held by the assessee for a total period not exceeding

36 months immediately preceeding the date of its transfer. Equity shares and preference shares should be treated as short-term capital asset if it is held by an assessee for not more than 12 months immediately prior to its transfer.

To determine capital asset as it is necessary to determine the period for which capital asset is held by the assessee. To determine such period following points should be noted -

(A) (1) Shares held in a company in liquidation, the period subsequent to date on which the company goes into liquidation should be excluded.

(2) Under the circumstances specified in section 49(1) the cost of the capital asset to the assessee should be taken to be the cost for which the previous owner acquired it, in all such circumstances the total period of holding the asset by previous owner and the assessee, should be aggregated to determine the capital asset is short term or long-term.

(3) In the case of amalgamation also, to determine weather the shares held by the assessee shareholder are short-term or long-term, the total period of his holding of shares in the amalgamating and amalgamated companies must be aggregated.

(B) The assets mentioned under head A above should be excluded while determining the preiod of holding the capital asset by the assessee shall be determined subject to any rules which the Board may make in this behalf.

A new proviso to the 2(42A) shall be inserted by the Finance Act, 1987 with effect from 1.4.1988.

The profit or gain derived from the transfer of a short-term capital asset is a short-term capital gain which is taxable at the same rates as business income or other income.

4.5 "TRANSFER", IN RELATION TO A CAPITAL ASSET - 2(47)

The section 2(47) reads as under -

"transfer", in relation to capital asset, includes,-

(i) the sale, exchange or relinquishment of the asset;or

(ii) the extinguishment of any rights therein ; or

(iii) the compulsory acquisition there of under any law; or

(iv) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment ; or

(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 (4 of 1882); or

(vi)any transaction (weather by way of becoming a member of or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

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The term 'transfer' for the purposes of capital gains tax has been defined in section 2(47) appearing in section 45 of the Act, 'Transfer' covers every act by which property may pass from one person to another, the transfer may be effected eighter by the assessee or as a result of the operation of law. The use of words "in relation to capital asset" has limited the applicability of the term "transfer" to the transfer capital assets only. The term 'transfer' involves at least two parties to the contract. i.e. the transfer or and the transferee.

The term 'transfer' includes following -

(A) 1) Sale - "Sale" implies the exchange of commodity or thing for equivalent value. Thus, the ordinary conception of 'sale' is that something is handed over for a price as a result of negotiations and agreement.

2) exchange - when two persons mutually transfer the ownership of another, neighter thing or both things money, the transaction is called exchange.

3) relinguishment - 'relinguishment' means the act of leaving or quiting, for saking, renouncing a claim to.

(B) Extinguishment of any rights therein -

According to corpus Juris Secundum, the expression 'extinguishment' has been variously defined as meaning a complete wiping out, destruction, anhilation, termination, cancellation, or extinction and it is ordinarily used in relation to a right, title, interest, charge, debt, power, contract or estate.

The word "therein" appearing in the said clause (47) refers to 'capital asset' mentioned earlier in the definition.

The expression "any rights therein" appearing in the said clause is mentioned to take in all kinds of rights- qualitative and quantitative - in the capital asset concerned.

(C) Compulsory acquisition thereof under any law -

If any capital asset is acquired compulsory by Government under any law it may be regarded as transfer.

(D) In a case where the asset is converted by the owner thereof -

According to the amendment by taxation Law (Amendment) Act,1984, the definition "transfer" is enlarged w.e.f. assessment year 1985-86. It provides that, in a case where a capital asset is converted by the owner of capital asset into or if it is treated by him, as stock-in-trade of business carried on by him, such conversion or treatment of capital asset shall be regarded as 'transfer' of asset.

Hence, notional profit arising from transfer by way of conversion of capital asset into stock-in-trade will be chargeable to tax.

For the purpose of computing capital gain, fair market value of capital asset on the date of conversion or treatment shall be deemed to be the fullvalue of consideration, received or accruing as a result of 'transfer' of a capital asset.

(E) any transaction involving -

The definition of "transfer" is extended by Finance Act, 1987, w.e.f. 1988-89. Accordingly, any transaction involving the allowing of the possession of any immovable property to be taken or retained as a partly performance of contract as referred in section 53A of the Transfer of property Act, 1882, is included in the transfer.

(F) any transaction -

If any transaction has the effect of transferring or enabling the enjoyment of any immovable property by way of any immovable property by way of becoming a member of, or taking shares of a co-operative society, company or other association of persons, or by way of agreement or any arrangement or in any other manner is included in the 'transfer'.

Here, immovable property means property u/s 269 UA of Income-tax Act.

Hence term 'transfer' have high significance for the purpose of levy of tax on capital gains.

4.6 COST OF IMPROVEMENT - (Section 55(1)(b))

In addition to 'cost of acquisition' the meaning of term 'cost of improvement' is given in Section 55. The cost of improvement generally means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset by the assessee.

Section 55(1)(b) deals with the defination of ' 'cost of improvement'. The section reads as under -

"Cost of any improvement", -

(1) in relation to a capital asset being goodwill of a business shall be taken to be nil ; and

(2) in relation to any other capital asset,-

(i) where the capital asset became the property of the previous owner or the assessee before the [83](1st day of April, 1974), and the fair market value of the asset on that day is taken as the cost of acquisition at the option of the assessee, means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset on or after the said date by the previous owner or the assessee, and

(ii) in any other case, means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset by the assessee after it became his property, and, where the capital asset became the property of the assessee by any of the modes specified in [84](sub-section (1) of) section 49, by the previous owner,

but does not include any expenditure which is deductible in computing the income chargeable under the head "Interest on Securities", "Income from house property", "Profits and gains of business or profession", or "Income from other sources", and the expression "Improvement" shall be constructed accordingly.

In addition to cost of acquisition of capital asset, cost of any improvements thereto is also deducted from the full value of the consideration for the transfer of capital asset. The cost of improvement generally means all expenditure of a capital nature incurred in making any additions or alterations to the capital asset by the assessee.

Accordingly expenditure incurred in making improvements to capital asset, shall be added to cost of acquisition for the purpose of the compuation of the profits or gains chargeable under the head capital gains.

It includes all expenses incurred by the assessee to increase the value of the capital asset weather such expenditure are allowable or not allowable under sub-section (1) of section 37.

4.7 <u>COST OF ACQUISITION</u> - 55(2)

The Section reads as under -

"For the purposes of sections 48 and 49, "Cost of acquisition", -

(a) in relation to a capital asset, being goodwill of a business, -

(i) in the case of acquisition of such asset by the assessee by purchase from a previous owner, means the amount of purchase price ; and

(ii) in any other case, shall be taken to be nil;

(b) in relation to any other capit-al asset -

(i) where the capital asset became the property of the assessee before the 1st day of April,1974, means the cost of acquisition of the asset to the asseessee or the Fair market value of the asset on the 1st day of April,1974, at the option of the assessee ;

(ii) where the capital asset became the property of the assessee by any of the modes specified in sub-section (1) of section (49), and the capital asset became the property of the previous owner before the 1st day of April,1974, means the cost of the capital asset to the previous owner or the fair market value of the asset on the 1st day of April,1974, at the option of the assessee ;

(iii) where the capital asset became the property of the assessee on the distribution of the capital assets of a company on its liquidation and the assessee has been assessed to income-tax under the head "capital gains" in respect of that asset u/s. 46, means the fair market value of the asset on the date of distribution ;

(iv) (* * *)

(v) where the capital asset, being a share or a stock of company, became the property of the assessee on -

(a) the consolidation and division of all or any of the share capital of the company into shares of larger amount than its existing shares,

(b) the conversion of any shares of the company into stock,

(c) the re-conversion of any stock of the company into shares,

(d) the subdivision of any of the shares of the company into shares of smaller amount, or

(e) the conversion of one kind of shares of the company into another kind,

means the cost of acquisition of the asset calculated with reference to the cost of acquisition of the shares or stock from which such asset is derived.

The Finance Act,1987, amended the section 55(2) w.e.f. 1.4.1988. By way of amendment, the legal difficulties in respect of valuation of cost of goodwill of the business has come to an end.

The expression 'cost of acquisition' emphasise two aspects - one is 'acquisiton' and other is 'cost'. Normally the cost of acquisition of the capital asset to the assessee shall be the actual cost for which the assessee acquired the asset concerned.

The amount paid to purchase the goodwill to the third-party in the past is a purchase price of goodwill. It is the cost of acquisition of goodwill. The cost of self-generated goodwill shall be taken to be 'nil'.

In the following cases cost of acquisition is taken at notional figure -

1) cost to the previous owner
2) when the cost of acquisition can be taken as the fair market value on April,1974.

3) cost in the case of depreciable asset.

4) cost of acquisition inthe case of bonus shares and right shares.

5) cost of acquisition in cases covored by section 47A.

6) cost of acquisition in the case of Notional Defence Gold Bonds,1980.

7) cost of acquisition in the case of advance money received.

8) cost of acquisition in the case of goodwill.

9) cost of acquisition in the case of additional compensation.

The profit or gain arising on transfer of 'Capital asset' is calculated by deducting cost of acquisition of capital asset from the sale consideration. In order to avoide or reduce tax liability to tax on capital gains, the sale consideration might be undervalued or understated by the assessee. To block this loophole and to prevent such mischief high significance should be given to the term "Cost of acquisition".

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