Capital gains on gifted asset shall be computed by taking CII of year in which asset held by previous owner

Summary – The Mumbai ITAT in a recent case of Nandlal R. Mishra, (the Assessee) held that In case of gains arising on transfer of a capital asset acquired under a gift or will, capital gains liability has to be computed by considering that assessee held said asset from date it was held by previous owner and on same analogy, indexed cost of acquisition has to be computed with reference to year in which previous owner first held asset

Facts

- The property in question was originally purchased by a partnership firm in the year 1975. The father of the assessee, who was a partner in the said firm, expired in 1976.
- For the purpose of claiming rights in the property, the accounts of the firm were made up on the date of sale and sale consideration so received was distributed among all the legal heirs of the partners of the firm. The assessee received 1/8th share out of the total sale consideration and the same was offered for tax in his return under the head income from long-term capital gain.
- The assessee had taken the cost of the property as on 1-4-1981, while computing long-term capital gain.
- The Assessing Officer held that the right on the property arose in the hands of the assessee after the dissolution of the firm and, therefore, cost inflation index would be allowable after the dissolution of the firm and not as on 1-4-1981.
- On appeal, the Commissioner (Appeals) directed the Assessing Officer to adopt the cost inflation index as on 1-4-2008.
- On revenue's appeal:

Held

- Where the assessee acquires any capital asset under a gift or will without incurring any cost of acquisition, there would be no capital gains liability. However, section 49(1)(ii) provides that in the case of an assessee acquiring an asset under a gift or will, 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. Thus, on account of the deeming fiction contained in section 49(1)(ii), gains arising on transfer of a capital asset acquired by the assessee under a gift or will would arise. In such a case, the capital gains under section 48 would have to be determined by deducting from the total consideration received by the assessee, *inter alia* the deemed cost of acquisition.
- The indexed cost of acquisition has to be determined with reference to the cost inflation index for the first year in which the capital asset was 'held by the assessee'. Since the expression 'held by the assessee' is not defined under section 48, that expression has to be understood as defined under

section 2. *Explanation* 1(i)(b) to section 2(42A) provides that in determining the period for which an asset is held by an assessee, period for which asset was held by the previous owner shall be included. As the previous owner held the capital asset from 1975, as per *Explanation* 1(i)(b) to section 2(42A), the assessee is deemed to have held the capital asset from 1975. By reason of the deemed holding of the asset from 1975, the assessee is deemed to have held the asset as a long-term capital asset. If the long-term capital gains liability has to be computed under section 48 by treating that the assessee held the capital asset from 1975, then, naturally in determining the indexed cost of acquisition under section 48, the assessee must be treated to have held the asset from 1975 and same would be applicable in determining the indexed cost of acquisition.

- If the argument of the revenue that the deeming fiction contained in *Explanation* 1(i)(b) to section 2(42A) cannot be applied in computing the capital gains under section 48 is accepted, then the assessee would not be liable for long-term capital gains tax, because it is only by applying the deemed fiction contained in *Explanation* 1(i)(b) to sections 2(42A) and section 49(1)(ii) that the assessee is deemed to have held the asset from 1975 and deemed to have incurred the cost of acquisition and accordingly made liable for the long-term capital gains tax. Therefore, when the legislature, by introducing the deeming fiction, seeks to tax the gains arising on transfer of a capital asset acquired under a gift or will and the capital gains under section 48 has to be computed by applying the deemed fiction, it is not possible to accept the contention of revenue that the fiction contained in *Explanation* 1(i)(b) to section 2(42A) cannot be applied in determining the indexed cost of acquisition under section 48.
- It is true that the words of a statute are to be understood in their natural and ordinary sense unless the object of the statute suggests to the contrary. Thus, in construing the words 'asset was held by the assessee' in clause (iii) of *Explanation* to section 48, one has to see the object with which the said words are used in the statute. On a reading of *Explanation* 1(i)(b) to section 2(42A) together with sections 48 and 49, it becomes absolutely clear that the object of the statute is not merely to tax the capital gains arising on transfer of a capital asset acquired by an assessee by incurring the cost of acquisition, but also to tax the gains arising on transfer of a capital asset *inter alia* acquired by an assessee as provided under section 49 where the assessee is deemed to have incurred the cost of acquisition. Therefore, if the object of the legislature is to tax the gains arising on transfer of a capital asset acquired under a gift or will or inheritance by including the period for which the said asset was held by the previous owner in determining the period for which the said asset was held by the assessee, then that object cannot be defeated by excluding the period for which the said asset was held by the previous owner while determining the indexed cost of acquisition of that asset to the assessee. In other words, in the absence of any indication in clause (iii) of the *Explanation* to section 48 that the words 'asset was held by the assessee' has to be construed differently, the said words should be construed in accordance with the object of the statute, that is, in the manner set out in *Explanation* 1(i)(b) to section 2(42A).

- Apart from the above, section 55(1)(b)(2)(ii) provides that where the capital asset became the property of the assessee by any of the modes specified under section 49(1), not only the cost of improvement incurred by the assessee but also the cost of improvement incurred by the previous owner shall be deducted from the total consideration received by the assessee while computing the capital gains under section 48. The question of deducting the cost of improvement incurred by the previous owner in the case of an assessee covered under section 49(1) would arise only if the period for which the asset was held by the previous owner is included in determining the period for which the asset was held by the assessee. Therefore, it is reasonable to hold that in the case of an assessee covered under section 49(1), the capital gains liability has to be computed by considering that the assessee held the said asset from the date it was held by the previous owner and the same analogy has also to be applied in determining the indexed cost of acquisition. For determining the capital gain, the cost of acquisition of capital asset is crucial. Thus, keeping in view the totality of facts, the long-terms capital gains has to be from the date from which the capital asset in question was held by the previous owner and the indexed cost of acquisition also has to be determined on the very same basis. Consequently, the indexed 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 in which the assessee became the owner of such asset.