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Tax alert: Long-term capital asset on which depreciation is claimed, eligible for exemption under section 54F

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The Mumbai Bench of the Income-tax Appellate Tribunal has held that capital gains on sale of long-term capital asset, though deemed to be considered as short-term capital gains under section 50 of the Income-tax Act, 1961 (ITA), would be eligible for exemption under section 54F of the ITA. The ITAT further held that in case of depreciable asset, where depreciation has been claimed in earlier years, the computation of income on sale of such asset shall be made after considering provisions of section 41 of the ITA.

In a nutshell

As per section 41(2) of the ITA, the building owned by the taxpayer and for which depreciation was claimed, is sold, in such case, the depreciation already allowed shall be chargeable to tax as business income.

As per section 50 of the ITA, excess realized by the taxpayer against WDV of the block of asset shall be deemed to be the capital gain arising from the STCA.

As per section 54F of the ITA, in the case of the taxpayer where capital gain arises from the transfer of any LTCA other than a residential house, the capital gain is granted as exemption in proportion to net consideration to the amount of investment in new house property, subject to certain terms and conditions.

Section 50 of the ITA characterizes the gain and not the capital asset. As per earlier rulings, the deeming fiction under section 50 of the ITA may be restricted to the chargeability of gain as STCG but the asset remains a LTCA and does not become a STCA by virtue of section 50 of the ITA.

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Background:

- The taxpayer[1] is an individual earning income from manufacturing of garments and interest income.
- In the return of income filed for the Financial Year (FY) 2013-14, corresponding to Assessment Year (AY) 2014-15 the taxpayer had claimed exemption under section 54F of the Income-tax Act, 1961 (ITA) [relating to capital gain on transfer of certain capital assets not to be charged in case of investment in residential house] on sale of property and consequent investment in new residential property.
- The taxpayer had sold an industrial *gala* (factory) on which depreciation was claimed in earlier years. The capital gain arising on sale of this depreciable asset was utilized by the taxpayer in purchase of a house property and the taxpayer claimed exemption under section 54F of the ITA.
- The property was purchased in March 2010 at a cost of say INR 2.1 million and depreciation on the same was claimed up to 31 March 2012. The capital gain computed by the taxpayer was sales consideration of say INR 5 million, less indexed cost of acquisition of say INR 3 million, resulting into capital gain of say INR 2 million. From this, the taxpayer claimed deduction of an amount for new house purchased and did not offer any capital gain in the return of income. Thus, the taxpayer sold a depreciable immovable property, on which depreciation is claimed and considered gain arising therefore as long-term capital gain (LTCG) and claimed exemption under section 54F of the ITA.
- During the course of audit proceedings, the Assessing Officer (AO) computed short-term capital gain (STCG) on such sale of depreciable asset and thus, did not grant exemption under section 54F of the ITA. Alternatively, the AO held that only part of the net sale consideration was invested for purchase of new house property by the taxpayer before due date of filing of the return. Thus, the remaining amount of capital gains was required to be deposited in capital gain account scheme which was not deposited and therefore, only proportionate exemption of capital gain was allowable to the taxpayer. Consequently, the assessment order was passed by denying the capital gains exemption under section 54F of the ITA.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)] who after considering the provisions of section 50 of the ITA [relating to sale of depreciable assets] and relying on an earlier ruling[2], held that the taxpayer had earned STCG and therefore, was not entitled to exemption / deduction under section 54F of the ITA.
- Aggrieved, the taxpayer filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Extracts of section 50, 54F and 41 of the ITA:

"Section 50:

50. Notwithstanding anything contained in clause (42A) of section 2, where the capital asset is an asset forming part of a block of assets in respect of which depreciation has been allowed under this Act or under the Indian Income-tax Act, 1922 (11 of 1922), the provisions of sections 48 and 49 shall be subject to the following modifications:

(1) where the full value of the consideration received or accruing as a result of the transfer of the asset together with the full value of such consideration received or accruing as a result of the transfer of any other capital asset falling within the block of assets during the previous year, exceeds the aggregate of the following amounts, namely

(i) expenditure incurred wholly and exclusively in connection with such transfer or transfers;

(ii) the written down value of the block of assets at the beginning of the previous year; and

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[1] Sonia Pathak Khanna vs ITO [2024] 16 taxmann.com 607 (Mumbai-Trib.)

[2] Sakthi Metal Depot v. CIT. [2010] 189 Taxman 329/333 ITR 492 (Kerala)

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(iii) the actual cost of any asset falling within the block of assets acquired during the previous year,

such excess shall be deemed to be the capital gains arising from the transfer of short-term capital assets;

(2) where any block of assets ceases to exist as such, for the reason that all the assets in that block are transferred during the previous year, the cost of acquisition of the block of assets shall be the written down value of the block of assets at the beginning of the previous year, as increased by the actual cost of any asset falling within that block of assets, acquired by the assessee during the previous year and ***the income received or accruing as a result of such transfer or transfers shall be deemed to be the capital gains arising from the transfer of short-term capital assets****…."*

"Section 54F:

(1) [Subject to the provisions of sub-section (4), where, in the case of an assessee being an individual or a Hindu undivided family], ***the capital gain arises from the transfer of any long-term capital asset****, not being a residential house (hereafter in this section referred to as the original asset), and the assessee has, within a period of one year before or [two years] after the date on which the transfer took place purchased, or has within a period of three years after that date [constructed, one residential house in India] (hereafter in this section referred to as the new asset), the capital gain shall be dealt with in accordance with the following provisions of this section, that is to say*

(a) if the cost of the new asset is not less than the net consideration in respect of the original asset, the whole of such capital gain shall not be charged under section 45;

(b) if the cost of the new asset is less than the net consideration in respect of the original asset, so much of the capital gain as bears to the whole of the capital gain the same proportion as the cost of the new asset bears to the net consideration, shall not be charged under section 45……….."

Section 41:

"……

(2) Where any building, machinery, plant or furniture,—

(a) which is owned by the assessee;

(b) in respect of which depreciation is claimed under clause (i) of sub-section (1) of section 32;and

(c) which was or has been used for the purposes of business,

is sold, discarded, demolished or destroyed86 and the moneys payable in respect of such building, machinery, plant or furniture, as the case may be, together with the amount of scrap value, if any, exceeds the written down value, so much of the excess as does not exceed the difference between the actual cost and the written down value shall be chargeable to income-tax as income of the business of the previous year in which the moneys payable for the building, machinery, plant or furniture became due…."

Decision of the ITAT:

The ITAT noted / observed as follows:

- The computation of total income by the taxpayer was incorrect for the reason that the taxpayer had claimed depreciation on the property sold and the provisions of section 41(2) of the ITA [relating to profit chargeable to tax in certain cases] applied. Therefore, the profit or loss on the property was required to be computed under the provisions of sections 41(2) read with 50 of the ITA.
- According to section 41(2) of the ITA, where the building which is owned by the taxpayer in respect of which depreciation was claimed, is sold, the excess of sale price over the written down value to the difference between actual cost and written down value shall be chargeable to income tax as income of the business of the

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previous year in which sale consideration is due. Therefore, to the extent of depreciation already allowed to the taxpayer was chargeable to tax as business income.

- According to section 50 of the ITA, excess realized by the taxpayer against written down value of the block of asset shall be **deemed to be the capital gain arising from the short-term capital asset (STCA)**. Thus, the benefit of indexation was not allowable to the taxpayer. Further, the taxpayer was allowed deduction only to the extent of written-down value of the asset transferred.
- In the case under consideration, the written-down value (WDV) of the asset as on 1 April 2013 was say INR 1 million, therefore, only the said sum was allowable to the taxpayer as deduction. Thus, the taxpayer had two components of income chargeable to tax:

  (i) Business income under section 41(2) of the ITA; and

  (ii) STCG under section 50 of the ITA.
- Hence, the question which arose was that though the capital gain was deemed to be the capital gain arising from the transfer of short-term capital asset (STCA), but still could taxpayer claim exemption under section 54F of the ITA on such capital gain.
- According to section 54F of the ITA, wherein the case of the taxpayer capital gain arises from the transfer of any long-term capital asset (LTCA) other than a residential house and if taxpayer purchases or constructs a residential house then subject to certain terms and conditions, the capital gain which arises is granted as exemption in proportion to net consideration to the amount of investment in new house property.
- Section 50 of the ITA determines the gain arising from any asset as STCG. **Thus, it characterizes the gain and not the capital asset**. Undoubtedly, the capital gain earned by the taxpayer under section 50 of the ITA may be chargeable to tax as STCG, however as the property was held for more than 36 months, the transfer of LTCA had resulted into the capital gain. Thus, the deeming fiction under section 50 of the ITA may be restricted to the chargeability of gain as STCG but the asset remains a LTCA and does not become a STCA by virtue of section 50 of the ITA, as also being considered by the earlier Bombay High Court ruling[3] with respect to exemptions under section 54E and earlier Supreme Court (SC) ruling[4].
- The earlier ruling[5] as relied upon by the CIT(A), dealt with the fact that when a depreciable asset is sold, the gain arising to the taxpayer shall be chargeable to tax as STCG as deeming fiction of section 50 of the ITA applies to the transaction.
- In current case, the claim of the taxpayer was that even if the capital gain is recharacterized by virtue of the deeming fiction as STCG but still the asset remains a LTCA. Therefore, the said ruling did not prevent the taxpayer from claiming exemption under section 54F of the ITA if the relevant conditions of that section were satisfied.

In view of the above, the ITAT restored the whole issue back to the AO to compute the income of the taxpayer considering the provisions of sections 41(2) and 50 of the ITA, and thereafter from the capital gains allow the claim under section 54F of the ITA, if the other conditions were satisfied.

Comments:

Sections 54 and 54F provide for exemption from LTCG on investment in residential house, subject to satisfaction of certain conditions. A question arises whether the exemption would be available in case of capital gains arising from sale of assets (which are held for the more than the threshold required for qualifying as a LTCA) on which

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[3] CIT v. Ace builders private limited [2005] 281 ITR 210 (Bombay HC)

[4] CIT v. V S Dempo Co Ltd in [2016] 387 ITR 354 (SC)

[5] Shakthi Metal Depot [2010] 189 Taxman 329/333 ITR 492 (Kerala)

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depreciation has been claimed as section 50 of the ITA deems the capital gains on sale of such capital assets to be STCGs.

The ITAT, in this ruling, has reiterated the following principles:

- As per section 41(2) of the ITA, the building owned by the taxpayer and for which depreciation was claimed is sold, in such case, depreciation already allowed shall be chargeable to tax as business income.
- As per section 50 of the ITA, excess realized by the taxpayer against WDV of the block of asset shall be **deemed to be the capital gain arising from the STCA**.
- As per section 54F of the ITA, in the case of the taxpayer where capital gain arises from the transfer of any LTCA other than a residential house, the capital gain is granted as exemption in proportion to net consideration to the amount of investment in new house property, subject to certain terms and conditions.
- Section 50 of the ITA **characterizes the gain and not the capital asset**. As per earlier rulings, the deeming fiction under section 50 of the ITA may be restricted to the chargeability of gain as STCG but the asset remains a LTCA and does not become a STCA by virtue of section 50 of the ITA.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

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