

## **TAXABILITY UNDER THE HEAD CAPITAL GAIN ON CONVERSION OF RIGHTS OF LESSEE IN PROPERTY FROM LEASEHOLD RIGHT INTO FREEHOLD.**

It happens very often that a person holds a leasehold property and later on it got converted into freehold property. At times a person may have tenancy right over a flat and later on becomes the owner of the same flat.

The question arises when the said property is sold within 3 years after the conversion of property into freehold or after the conversion of tenancy right into ownership. Whether the period of holding during the time when the assessee was a lessee or a tenant will be considered while computing the period of holding for determining the tax liability under the head Capital Gain. These issues arose in number of cases, some of which are briefly discussed as below

(1) In the case of **[2013] 38 taxmann.com 176 (Allahabad)**, Commissioner of Income-tax v. Smt. Rama Rani Kalia

- The assessee purchased a property on leasehold basis in year 1984. The said property got converted into freehold property in year 2004 and thereupon it was sold. The capital gain arising from sale of said property was declared as long term capital gain.
- The Assessing Officer opined that since the property was acquired by converting the leasehold right into freehold right and was sold within three days, capital gain would amount to short-term capital gain. He thus added the amount of short-term capital gain to the taxable income of the assessee.
- The Commissioner (Appeals) held that the conversion of leasehold property into freehold property was nothing but improvement of the title over the property, as the fact remained that the assessee was owner even prior to conversion. He, thus, concluded that capital gain arising from sale of property was to be taxed as long-term capital gain.
- The Tribunal upheld the order of the Commissioner (Appeals).

**On revenue's appeal it was held that:**

- The difference between the 'short-term capital asset' and 'long-term capital asset' is the period over which the property has been held by the assessee and not the nature of title over the property.
- The lessee of the property has rights as owner of the property subject to covenants of the lease, for all purposes. He may, subject to covenants of the lease deed, transfer the leasehold rights of the property with the consent of the lessor.

- The conversion of the rights of the lessee in the property from having leasehold right into freehold is only by way of improvement of her rights over the property and it would not have any effect on the taxability of gain from such property, which is related to the period over which the property is held.
- If the period of holding is less than 36 months, the gain arising from such transfer would be of short-term capital gain.
- In the present case, the property was held by the assessee as a lessee since 1984, and the same was transferred on 31.3.2004, after the leasehold rights were converted into freehold rights on the same property which was in her possession. The conversion was by way of improvement of title, which would not have any effect on the taxability of profits.
- In view of above, there is no error of law in the impugned order of the Tribunal. The revenue's appeal was therefore dismissed.

(2) In the case of [2014] 51 taxmann.com 120 (Allahabad) **Amar Nath Agrawal v. Commissioner of Income-tax**

**Where in the facts of the case is that:**

- The petitioner along with four other persons had obtained a lease deed dated 25-12-1953 and was in possession since then. The lease expired on 7-6-1969 and was renewed for a period of 30 years with a further option of renewal for another term of 30 years. The lease deed permitted transfer of succession, sale, assignment, etc. with the previous approval of the State Government.
- The State Government introduced a policy for conversion of lease land into free hold. The petitioner applied for conversion of lease hold land into free hold land and, thereafter, a free hold sale deed was executed.
- The petitioner sold a portion of the property. The petitioner received a notice under section 133(6) directing the petitioner to furnish certain information. The petitioner *vide* his letter furnished the requisite information, in spite of which, the Assessing Officer issued the impugned notice under section 148. The reasons indicated that the petitioner after converting the lease land into free hold sold off the property within three years resulting into short-term capital gain.
- Subsequently, the petitioner received a notice under section 142. In response, the petitioner filed a copy of the return along with a detailed computation sheet of total income in respect of assessment year 2000-01. The petitioner also filed a detailed objection dated 24-8-2007 objecting to the notice under section 148 praying that the proceedings be dropped.
- In spite of filing the objection, the Assessing Officer did not decide the matter, instead issued a notice dated under section 143(2).

**On writ petition it was held that:**

- The reason so recorded by the Assessing Officer is, that the petitioner has indicated the computation of long-term capital gains tax liability, whereas the petitioner was liable to pay short-term capital

gains tax since the petitioner had sold off a portion of the property within three years from the date of conversion of lease land into a free hold land.

- The difference between 'short-term capital asset' and 'long-term capital asset' is the period over which the property has been held by the assessee. It has nothing to do with the nature of the title over the property. The petitioner already had rights as owner of the property subject to the covenant of the lease for all purposes such as transfer of the lease hold rights of the property with the previous consent of the lessor. The petitioner's father was the lessee since 1958. The conversion of the rights of the lessee in the property from lease hold to free hold was only an improvement of the rights over the property, which the petitioner enjoyed and this would not have any effect on the taxability of capital gains from such property. Since the property was held by the petitioner for more than three years, short-term capital gains would not be applicable. The conversion from lease hold to a free hold being an improvement of the title, does not have any effect on the taxability of profits as short-term capital gains
- For the reasons stated aforesaid, the notices issued under section 148 does not comply with the proviso to sections 147 and 149. The reasons recorded does not indicate that the assessee has failed to disclose fully and truly all material facts necessary for his assessment and that the escaped income was likely to be Rs. 1 lakhs or more.
- Consequently, the notice issued under section 148 cannot be sustained and is quashed. All proceedings initiated in pursuance of the notice under section 148 would be wholly illegal and without jurisdiction and are also quashed. The writ petition is allowed.

On the contrary when the tenancy right got converted into ownership in

- (3) In the another judgment of **Shri Sunil Kumar Soi in ITA No. 06/LKW/2012** of Lucknow Tribunal pronounced on 23/06/2014 where appeals are decided against the respective order of the Ld. CIT(A) on common grounds of conversion of leasehold property into freehold and taxability under the head capital gain. In the case of Shri Sunil Kumar Soi the assessee converted the property into freehold property on 09-08-2005 and was sold as freehold property within 3 months on 09-11-2005. The CIT(A) treated the Capital Gain as long term Capital Gain and allowed the claim of the assessee. The revenue went in appeal to Tribunal and raised the ground that the Ld. CIT(A) has erred on facts and in law in not following the judgment of Karnataka High Court delivered in the case of CIT vs. Dr. V.V. Mody 218 ITR 001 wherein the facts and issue involved are similar to that of instant case.

The tribunal vide its order dated 13/06/2014 decided the issue in favour of the assessee and against the revenue by referring the decision of Allahabad High Court of Rama Rani Kalia 358 ITR 499 as the present issue is squarely covered in the above decision of High Court and the High Court while deciding the issue made reference to the decision of Narang Dairy Products 219 ITR 478 where the supreme Court observed that the definition of Transfer u/s 2(47) of the Act is an inclusive definition

and does not rule out other mode of transfers. The Allahabad High Court also while deciding the issue also referred the decision of Karnataka High Court in the case of V.V Modi (supra).

Hence respectfully following the same the Tribunal decided the matter in favour of the assessee.

- (4) In the another case of [2000] 111 TAXMAN 600 (BOM.) of **Commissioner of Income-tax v. Dr. D.A. Irani** where the facts of the case are that:

The assessee jointly with his mother held a flat which was taken on lease in 1962-63 on monthly rental basis. They acquired ownership rights over it in January 1976 by paying a lump sum and sold it in May 1976. While computing capital gains, the Assessing Officer treated the same as short-term capital gain since the asset was sold within five months of acquisition. According to the assessee, the sale of the flat comprised of two capital assets, viz., occupancy right and the remaining rights of owner including title, and while the tenancy right was acquired in 1962-63, the ownership right was acquired in 1976. The assessee contended that the sale consideration should be apportioned between the two and the capital gain from the transfer of ownership right only should be treated as short-term capital gains. The Commissioner (Appeals), however, rejected the said contention. The Special Bench of the Tribunal accepted the contention of the assessee and allowed his appeal. The Tribunal held that what was sold or transferred was a composite asset which had admittedly come into existence as a result of fusion and merger of the smaller estate and bigger estate, assuming that the right of occupation as a tenant was smaller estate and the remaining interest of the landlord in the flat including the title constituted a bigger estate. The Tribunal, therefore, held that the cost of composite estate should be computed by taking into account the market value of the smaller estate as on the date of acquisition of the bigger estate and directed the Assessing Officer to recompute the surplus liable to short-term capital gain afresh.

**On reference it was held that**

The Tribunal, in the instant case, was wrong in holding that even after the purchase of the flat by the lessee, the leasehold right subsisted in the lessee. Because, once the lessee purchases the leased property from the owner, the lease is extinguished as the same person cannot at the same time be both landlord and tenant. The doctrine of merger applies resulting in 'drowning' and 'sinking' of inferior right into superior right. There is a complete union of the interest of the lessor in the lessee in such a case and the tenancy comes to an end. This principle has been statutorily recognised in section 111(d) of the Transfer of Property Act, 1882, which specifically provides for determination of lease in case the interests of the lessee and the lessor in the whole of the property become vested at the same time in one person in the same right.

From the above, it was clear that the asset transferred in the instant case was the flat acquired by the assessee by purchase from the owners with all the rights and interest therein including the occupancy right. The assessee was owner of the flat and not a tenant. The fact that the assessee was in occupation

of the flat as a tenant before its purchase was wholly irrelevant because on purchase, there was a union of the interests of the lessor and the lessee and the tenancy was extinguished. The said flat having been sold within 4 to 5 months of its purchase, the capital gain arising therefrom was rightly held by the Assessing Officer to be a short-term capital gain. Therefore, the Tribunal was not justified in reversing the said finding of the Assessing Officer.

From the analysis of judgments as discussed above so far conversion of lease hold property into freehold property the issue appears to be settled in favour of the assessee. So for the conversion of tenancy right is concerned the issue is debatable.

Thanking You,

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