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Tax Flash News



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Donor's holding period relevant for long-term gains classification; indexation benefit from year of receipt of gifted shares

Executive summary

In the case of *Venkataswaroop Reddy*,[1] the Chennai Bench of the Income-tax Appellate Tribunal ('Tribunal') held that where shares received as a gift are taxed at fair market value ('FMV') under section 56(2)(x) of the Income-tax Act, 1961 ('the 1961 Act') and are subsequently sold, the period of holding of the previous owner must be included to determine whether the shares qualify as a long-term capital asset.

However, the indexation benefit on the deemed cost of acquisition under section 49(4) is available only from the financial year in which the FMV of the gifted shares was taxed in the taxpayer's hands, and not from the year in which the previous owner first acquired the shares.

The Tribunal observed that the provisions determining the period of holding and those determining the cost of acquisition operate independently. Accordingly, inclusion of the previous owner's holding period for classifying the asset as long-term does not automatically entitle the taxpayer to the benefit of indexation from that earlier period.

[1] *Venkataswaroop Reddy Siddavarapu* v. *DCIT* (ITA No. 1726/CHNY/2026)

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Facts of the case

In an earlier year (FY 2020-21), the taxpayer received the shares of an Indian company by way of gift from another individual under a gift deed dated 24 March 2021. The FMV of the gifted shares was offered to tax under section 56(2)(x) of the 1961 Act in the year of receipt (i.e., FY 2020-21).

During the year under consideration (i.e., FY 2021-22), the taxpayer sold these shares and treated the gains as long-term capital gains (including the period of holding of the previous owner/ donor). It claimed the deduction for indexed cost of acquisition which was computed using Cost Inflation Index ('CII') for the year in which the previous owner acquired the shares.

The Revenue treated the shares as a short-term capital asset on the ground that they had been acquired by the taxpayer only on 24 March 2021 and accordingly denied the indexation benefit.

The issues before the Tribunal were (a) whether the gifted shares constituted a long-term or short-term capital asset; and (b) whether the taxpayer was entitled to indexation benefit; and, if so, from which date such indexation was to be granted (i.e., date of acquisition by the previous owner or the gift date).

Relevant provisions

Section 49 deals with determining the cost of acquisition of the capital assets acquired through specified modes.

Section 49(1)(ii) provides that where a capital asset becomes the property of the taxpayer under a gift, the cost of acquisition will be computed with reference to the cost to the previous owner. Section 2(42A)[2] provides that in such cases, the period for which the asset was held by the previous owner is included while determining the taxpayer's period of holding.

Section 49(4) provides that where the value of an asset has been subject to tax under section 56(2)(x), the value taken into account for computing such income is deemed to be the cost of acquisition of the asset.

Section 56(2)(x) provides for the taxation of property (including shares) received without consideration or for inadequate consideration.

Section 48 provides the mechanism for computing capital gains. In this regard, the cost of acquisition of an eligible long-term capital asset is adjusted/ indexed using the prescribed CII ('indexation benefit').

[2] Explanation 1(b) to section 2(42A)

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Taxpayer's contentions

Period of holding

Section 49 is for the purposes of determining the cost of acquisition and not relevant for computing the period of holding or determining the eligibility for indexation benefit.

The fact that the FMV of the shares had been taxed under section 56(2)(x) did not alter the character of the transaction as a gift and thus, such transactions continue to be covered by section 49(1)(ii) as well.

Accordingly, the gifted shares constituted a long-term capital asset as the period of holding of the previous owner was required to be included.

Indexation benefit

Indexation benefit should be available from the year in which the previous owner first held the shares.

Reliance was placed on the Bombay High Court's decision in *Manjula J. Shah*.[3]

Without prejudice, even if indexation from the previous owner's holding period was not allowed, indexation should at least be granted from 24 March 2021, when the FMV of the shares was taxed under section 56(2)(x).

Revenue's contentions

Period of holding

Once the FMV of the gifted shares was taxed under section 56(2)(x), the specific and deeming provisions (i.e. section 49(4)) were applicable which prescribe a separate deemed cost of acquisition based on that FMV. It replaces the 'cost to previous owner rule' as provided in section 49(1).

The taxpayer cannot selectively invoke the benefit of section 49(1) for indexation and section 49(4) for determining the cost of acquisition.

Accordingly, sections 49(1) and 2(42A) were no longer applicable, and the period of holding of the previous owner was not includible for determining the taxpayer's holding period.

[3] *CIT* v. *Manjula Shah* [2011] 355 ITR 474. Other decisions relied by the taxpayer include *CIT* v. *Saroja Naidu* [2021] 128 taxmann.com 127 (Madras); *Rohan Developers* v. *ITO* [2022] 139 taxmann.com 32 (Bombay); *Sanjay Harichand Kumar* v. ITO [2017] 88 taxmann.com 355 (Chennai Tribunal)

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Indexation benefit

Indexation benefit is linked to the 'first year in which the asset was held by the assessee' with reference to the deemed cost and could not be allowed from the previous owner's holding period because the deemed cost under section 49(4) came into existence only on the date the shares were received by the taxpayer.

Allowing indexation from an earlier year would provide an unintended inflation adjustment for a period during which that deemed cost did not exist.

Distinguished *Manjula J. Shah* decision on the ground that the decision preceded the insertion of section 49(4) by the Finance Act, 2017.

Tribunal's decision



The period of holding of the previous owner must be included to determine whether the shares constitute a long-term capital asset.

However, the indexation benefit on the deemed cost of acquisition under section 49(4) is available only from the financial year in which the FMV on the gifted shares was taxed in the taxpayer's hands under section 56(2)(x), and not from the year in which the previous owner first acquired the shares.

Period of holding of gifted shares

The 1961 Act treats the cost of acquisition and the period of holding as distinct concepts governed by separate provisions.

The condition of acquisition of a capital asset under a gift continues to remain satisfied regardless of whether the gifted asset is also subjected to tax under section 56(2)(x). Such taxation did not alter the character of the underlying transaction as a gift.

Section 49(4), by its express terms, dealt with the cost of acquisition and did not modify the rules governing the period of holding under section 2(42A).

Accordingly, the previous owner's holding period had to be included, and the gains arising on sale of the shares were assessable as long-term capital gains.

Indexation on the deemed cost of acquisition

Distinguished the decision in *Manjula J. Shah* on the ground that, unlike section 49(1), the present case was governed by section 49(4), which prescribes an independent statutory cost based on the value already

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taxed under section 56(2)(x). Consequently, the period of holding and the cost of acquisition no longer arise from a common deeming fiction.

Unlike section 49(1), which adopts the previous owner's cost, section 49(4) provides for a separate statutory cost that comes into existence only upon taxation of the gifted shares in the taxpayer's hands.

The amendment to section 49(4), made by the Finance Act, 2017, was intended to treat the value already subjected to tax as the cost of acquisition, and therefore permitting indexation from the previous owner's holding period would apply an earlier CII to a cost that did not exist during that period.

Accordingly, indexation was allowable only from FY 2020-21, when the FMV was taxed under section 56(2)(x), and not from the year in which the previous owner acquired the shares.

Our comments



This ruling draws a clear distinction between the principles governing classification of a capital asset and those governing computation of indexed cost where gifted assets are taxed under section 56(2)(x).

While the previous owner's holding period continues to be relevant for determining whether the gifted shares constitute a long-term capital asset, indexation on the deemed cost of acquisition is available only from the year in which such value was subjected to tax. The ruling is significant because it distinguishes the principle laid down in *Manjula J. Shah* for the cases governed by the specific deemed-cost mechanism under section 49(4).

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