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HOUSE GIFTED TO FATHER SOLELY TO GAIN SECTION 54F EXEMPTION IS A 'COLOURABLE DEVICE', RULES TRIBUNAL

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The Hyderabad Bench of the Income Tax Appellate Tribunal (Tribunal) recently ruled that "colourable" devices adopted to take undue benefit of law should be looked through to determine the real nature of the transaction and accordingly denied exemption from tax under Section 54F of the Income-tax Act, 1961 (IT Act).[1]

Background

In the tax year 2014 – 2015, the appellant (the Taxpayer) entered into three transactions:

i. Executed a gift deed dated 27 October 2014 of a residential property owned by him, to his father (Gift). At this time, the Taxpayer also held another residential property in his name.

ii. Executed an agreement of sale dated 3 November 2014 of land held by the Taxpayer with his mother, to a third party (Sale). The sale deed specified that on the date of the execution of the same, the Taxpayer had already received an advance against the sale consideration from the purchaser.

iii. Executed an agreement of sale dated 30 January 2015 for the purchase of a new residential property (Purchase).

Under Section 54F of the IT Act, where an individual within a period of one year after the date of transfer of a long term capital asset, not being a residential house (Old Asset), purchases a residential house (New Asset), the amount of capital gain arising from the transfer of the original asset (where cost of new asset is not less than net consideration of original asset) is not chargeable under capital gains tax (54F Exemption). This exemption may only be sought where the taxpayer has only one residential house in his name before investing in the New Asset.

For the relevant year, the Taxpayer filed his annual tax return claiming the 54F Exemption and did not declare his capital gains from the Sale. During the assessment proceedings, the Tax Authorities ultimately disallowed the exemption sought by the Taxpayer on the grounds that the Gift was made solely to show that the Taxpayer had only one residential house at the time of the Purchase, so as to be eligible for the Section 54F Exemption. Given that the Gift was made only 7 days prior to the Sale and the Taxpayer continued to reside in the

[1] Rachit V. Shah v ITO-7(3) [2023] MANU/IH/0073

transferred property, it was merely an action to avoid paying the appropriate capital gains tax.

On appeal by the Taxpayer to the Commissioner of Income-tax, Appeals (CIT (A)), the CIT (A) upheld the order of the Tax Authorities by placing reliance on the Supreme Court ruling which held that colourable devices cannot be part of tax planning. The CIT (A) observed that it was clear that the real intention of the Taxpayer was to ensure he only had one self-occupied property in his name and claim the 54F Exemption without actually alienating this residential property by gifting it to his father. Aggrieved, the Taxpayer appealed before the Tribunal.

Ruling

Before the Tribunal, the Taxpayer contended that (i) the Gift was made purely out of the love and affection he has toward his father, and was not impermissible under the law; (ii) the Gift was made prior to the Sale and the timing is simply coincidental; (iii) the Gift was sold by the father in tax year 2019-2020 to a third party and did not revert to the Taxpayer, which was assumed by the Tax Authorities; and (iv) he and his father were high net worth individuals who regularly declared high income taxes and there would be no reason to avoid tax.

Rejecting the arguments, the Tribunal held that where on a standalone basis a gift, made out of love and affection toward a family member might not usually raise eyebrows, the gift must be examined in light of prior and subsequent acts of the Taxpayer and the circumstances in which they were taken.

The Tribunal observed that in the present case, from the conduct of the Taxpayer and taking into consideration the Gift being made immediately before the date of the Sale, the knowledge of the impending Sale (given the receipt of an advance), his continued stay in the gifted property with his father, and that there was no commercial considerations for the Gift, the Taxpayer undertook these actions as a 'camouflage' in a concerted effort to avoid the due payment of taxes to the Government. The Tribunal further observed that abusive tax avoidance involves artificial schemes, such as the artificial transfer, in the present case, to the father prior to the Sale.

The Tribunal referred to Sections 23 and 24 of the Indian Contract Act, 1872, which provided that when the object is to defeat any provisions of law, and when consideration is of such nature that, if permitted, it would defeat the provisions of any law, the contract will be void. While not expressly declaring the Gift deed as void, the Tribunal stated that the artificial nature of the action cannot allow the Taxpayer to misuse the beneficial provisions of the IT Act.

Accordingly, the Tribunal upheld the order of the Tax Authorities and ruled that the Gift was a colourable device to avoid legitimate taxation and disallowed the 54F exemption sought by the Taxpayer.

Comments

The action of the Tax Authorities of piercing the veil if a transaction is driven purely by tax considerations and where there are no genuine commercial and familial considerations has found countenance with the Tribunal. In order to ascertain the real nature of a transaction, the same has to be looked as a whole leading to the ultimate result. While the Supreme Court ruling in McDowell[2] has been relied on by the Tribunal, interestingly, the Supreme Court in the later cases of Azadi[3] / Vodafone[4] has clearly delineated *tax mitigation* from *tax evasion*

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[2] *Mc Dowell & Company Limited v The Commercial Tax Officer* [1986] AIR 649, [1985] SCR (3) 791
[3] *Union of India v Azadi Bachao Andolan* [2004] 10 SCC 1
[4] *Vodafone International Holdings B.V. v Union of India & Anr* [2012] 1 SCR 573

and held that tax mitigation, that is, where a taxpayer is taking advantage or benefit of the tax code, to reduce his tax liability, all while being within the boundaries of the law, is an acceptable form of tax planning.

In the light of this ruling, it is prudent that where inter-se gifting is being undertaken by family members as a part of their succession planning, it is necessary to not only contemplate the legitimacy of the gift as a standalone transaction, but its implications on the ancillary activities undertaken by the family, and the possible ties that may be made by the tax authorities during the assessment.

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