

IN THE HIGH COURT OF JUDICATURE AT MADRAS

Reserved on : 25.03.2019

Pronounced on : 03.04.2019

CORAM

THE HONOURABLE DR. JUSTICE **VINEET KOTHARI**

AND

THE HONOURABLE MR. JUSTICE **C.V.KARTHIKEYAN**

T.C.A.No.2582 of 2006

Tmt.D.Zeenath

... Appellant/ Appellant

Vs

The Income Tax Officer
Ward-I(1),
Nagapattinam

... Respondent/ Respondent

PRAYER: The Tax Case Appeal filed under Section 260A of the Income Tax Act, 1961 (for brevity 'the Act') against the order of the Income Tax Appellate Tribunal, 'B' Bench, Chennai, in I.T.A.No.659/Mds/2002 for the A.Y.1995-96, dated 16.12.2005.

WEB COPY

For Appellant

: Mr.Subhang Nair

Assisted Ms.Shobana Krishnan

For Respondent

: Mr.M.Swaminathan

(Senior Standing Counsel)

Assisted by Ms.V.Pushpa

JUDGMENT**C.V.KARTHIKEYAN,J.**

The assessee has filed the present appeal under Section 260A of the Act, challenging the order of the Income Tax Appellate Tribunal, Chennai, in I.T.A.No.659/Mds/2002 dated 16.12.2005, with respect to Assessment Year 1995-1996 dismissing the appeal of the assessee.

2. This appeal had been admitted on 23.06.2008, on the following two substantial questions of law:

"1. Whether on the facts and in the circumstances of the case, the Income Tax Appellate Tribunal was right in not appreciating that no part of the consideration for sale was received by the appellant and same was directly paid to the Bank by the purchaser in discharge of the mortgage amount and therefore no capital gains arises in the hands of the appellant?"

2. Whether on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in not holding that there was a diversion of the sale proceeds towards redeeming the interest of the mortgagor and therefore the amount so diverted was not liable to capital gains tax?"

3. The assessee Smt. D.Zeenath along with two other co-owners, namely, Smt. S.A.Kathija Nachial and Smt. Zubaida had originally purchased land measuring 43,596 sq.ft. at Saram Village, Pondicherry, by two sale deeds dated 11.07.1980 and 04.02.1981 for a total consideration of Rs.2,01,000/-.

4. The property had been offered as collateral security in a loan obtained by M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd., from State Bank of India, Pondicherry, to an extent of Rs.3.75 Crores, and the assessee and the other two co-owners stood as guarantors, for the said loan. Mortgage was by deposit of title deeds. No registered mortgage deed was executed. Since the loan was not repaid, the assessee and the other two co-owners consented for sale of the property by Bank to realize its dues. This was purchased by M/s. Royal Park, Tiruchirapalli, for a total consideration of Rs.1,96,18,200/-. The sale was effected during the Assessment Year 1995-1996. The total sale consideration was paid to the Bank by the purchaser M/s.Royal Park, Tiruchirapalli.

5. The assessee did not file her Returns under section 139(1) of the Act, till 05.03.1998. She filed it belatedly on 06.03.1998 declaring a total income of Rs.55,26,120/-. The assessment was re-opened under Section 147 of the Act and notice was issued under Section 148 on 24.03.1998. The assessee in her reply initially sought to treat the return filed on 06.03.1998 as the one filed in

response to the notice under Section 148 of the Act. She then filed a revised return admitting an income of Rs.74,580/-. She claimed that since the entire sale consideration had been paid towards the loan account of M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd to the State Bank of India, Pondicherry, she had not earned any capital gains on the sale of the property.

6. The Assessing Officer rejected the said contention and the relevant portions of the assessment order are quoted below for ready reference:

"The assessee and the two other co-owners stood as guarantors against the loan of Rs.3.75 crores given by the State Bank of India, Pondicherry to M/s.M.O.Hassan Kuthoos Maraicar Ltd., Pondicherry. The mortgage deed had not been registered and it is ascertained that the State Bank of India, Pondicherry has never been vested with the power to alienate the property and appreciate the sale proceeds towards the loan given by it. The three co-owners have themselves come forward voluntarily and sold the property in question and the buyer of the property M/s.Hotel Royal Park have deposited the sale consideration by way of a demand draft in the loan account of the company, M/s.M.O.H.Hassan Kuthoos Maraicar Ltd., Pondicherry with the State Bank of India, Pondicherry. Thus, it is only an application of income and not a case of diversion of income as agitated by the assessee. This is amply corroborated with the fact that all the three co-owners are the creditors

of the company, M/s.M.O.Hassan Kothoos Maraicar Ltd., Pondicherry, consequent on the appropriation of the sale proceeds as stated above. Here the bank has not taken any initiative to sell the property but only the guarantor i.e. the assessee along with the two co-owners have taken the initiative to sell the property towards the loan taken by the company, M/s.M.O.Hassan Kuthoos Maraicar Pvt. Ltd.,."

7. The Assessing Officer had computed the total consideration of the land sold amounting to Rs.1,96,18,200/- as income from capital gains and had computed the cost of acquisition adding cost inflation index at the original cost of Rs.2,01,000/- to arrive at the sum of Rs.5,20,590/- and the cost of improvement which was incurred for building a compound wall of Rs.5,80,717/- and finally assessed the total capital gain at Rs.1,85,16,893/-. He computed 1/3rd of the Assessee's share at Rs.61,72,298/-.

8. This assessment was challenged in appeal before the Commissioner of Income Tax (Appeals) by the Assessee. The CIT(A) dismissed the appeal by order dated 30.01.2002.

9. The Assessee then filed a further appeal before the Income Tax Appellate Tribunal. Another co-owner Smt.Zubaida had also preferred a similar appeal. The Tribunal took up both the appeals and by order dated 16.12.2005,

dismissed both the appeals. The relevant portions of the order of the Tribunal are quoted below for ready reference:

"4. We have perused the grounds of appeal and the records available before us. We have also heard the learned counsel for the assessee and considered his submission. It is not disputed that the assessee never incurred the expenditure wholly and exclusively in connection with such transfer. No doubt it has wider connotation than the expression for the transfer. In the decision of the Hon'ble Jurisdictional High Court in the case of CIT Vs. N.Vajrapani Naidu, 241 ITR 560 a mortgage had been created by the vendor-assessee and the amount paid to the other creditors by the vendee was for the discharge of the debts which had been incurred by the assessee. The amount was paid as part of consideration to the sale. Hence the assessee's claim was held to be rightly rejected by the Income Tax Officer. Section 48 of the Income Tax Act clearly lays down the condition that **to compute capital gain the expenditure must be incurred wholly and exclusively in connection with such transfer and cost of acquisition of the asset and the cost of improvement thereto.** These are the expenses available for deduction while computing capital gains. Here in this case the sale consideration was paid directly to the company M/s.M.O.H (P) Ltd., towards the loan from the bank. It is hit by Section 48 of the Act as it is not an allowable deduction under section 48. Therefore

*the claim of the assessee that there is no capital gain since the assessee has not received any consideration, is to be brushed aside. The decision of the Hon'ble Supreme Court in the case of **R.M.Arunachalam V. CIT, 227 ITR 22** is directly on the point at issue. However, the learned counsel for the assessee attempted to impress us that according to the aforesaid decision of the Hon'ble Supreme Court at page 225 of the decision the payment for the purpose of acquiring the interest of the mortgagee in the property by the heir was held to be regarded as cost of acquisition under section 48 read with section 55(2) of the Act. But in this case there is no liability attached to the succession. The assessee purchased the property without any encumbrance and the subsequent encumbrance created as a guarantee to the company M/s.M.O.H.(P) Ltd., has nothing to do and it cannot be deducted as it never comes within the allowable deduction under section 48 of the Act."*

10. That order of the Tribunal is in appeal before us. Heard arguments advanced by Mr.Subhang Nair assisted by Ms.Shobana Krishnan, learned counsel for the Assessee/Appellant and by Mr.M.Swaminathan learned Senior Standing Counsel for the Respondent/Revenue assisted by Ms.V.Pushpa, learned counsel.

11. Mr.Subhang Nair in the course of his arguments, took the Court through the facts of the case and pointed out that the assessee along with two other co-owners had offered their property as collateral security which they had purchased by two sale deeds dated 11.07.1980 and 04.02.1981 for the loan of Rs.3.75 Crores obtained by M/s. M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd., from State Bank of India, Pondicherry. Learned counsel stated that in view of default in repayment of the loan, the property was brought to sale and was sold to M/s.Royal Park, Tiruchirapalli, for a total consideration of Rs.1,96,18,200/-. The entire consideration had been paid to the bank to the credit of the loan account of M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd. It was stated that the assessee did not receive even a single pie from the sale consideration. Consequently, the learned counsel stated that she cannot be taxed on the sale consideration paid by M/s.Royal Park, Tiruchirapalli, and the sale consideration cannot be treated as income taxable as capital gains.

12. Learned counsel further stated that since the sale consideration had been paid towards the discharge of the loan it was actually the cost of acquisition and it was not capital gains in the hands of the assessee. Learned counsel stated that there was a diversion of the sale proceeds towards redeeming the interest of the mortgagor and therefore the amount so diverted was not liable to capital gains tax. Learned counsel stated that no part of the consideration had been

received by the assessee and consequently, there was no question of capital gain arising to be taxed in the hands of the assessee.

13. Learned counsel placed heavy reliance on the ratio laid down in ***CIT Vs. Thressiamma Abraham, [1997] 227 ITR 802 (Ker)***. The learned counsel stated that in the facts of that case also, a property was the subject matter of a mortgage in favour of the Kerala Financial Corporation (KFC) and in exercise of its rights under the mortgage, KFC had brought the property for sale. Even in that case, the entire sale consideration had been paid directly to KFC by the purchaser and it was only thereafter only that the mortgaged property was released. The assessee was the guarantor. The Division Bench of the Kerala High Court held that there had been no income earned by the assessee, much less capital gains in regard thereto.

14. Learned counsel also relied on ***Commissioner of Income Tax Vs. Attili N.Rao., 2001 Vol. 252 ITR 880 (SC)***. In that case, the assessee had carried on Abkari business and had mortgaged immovable property in favour of the Excise Department of the State Government of Andhra Pradesh as security for amounts of 'kist' due to the State. On sale by the State Government of the immovable property by public auction, a sum of Rs.5,62,980/- was realised, wherefrom the Government deducted a sum of Rs.1,29,020/- due towards the

'kist' and paid over the balance to the assessee. The High Court had held that, by the mortgage, an interest had been created in favour of the State and when the property was sold by auction its value had to be reduced to the extent of the interest created in favour of the State. However, it must be pointed out that Hon'ble Supreme Court had reversed the decision of the High Court and had held that the capital gains had to be computed on the full value, less admitted deductions. This judgment, in our considered opinion does not advance the case of the assessee in the present case.

15. Learned counsel also relied on ***CIT Vs. Shakuntala Kantilal [1991] 190 ITR 56 (Bombay)***. The facts in that case were that the assessee purchased a plot of land in the year 1948. She then entered into an agreement of sale with Radia and Sons (Pvt) in 1963. Differences arose between the parties. Radia and Sons Pvt. Ltd., filed a suit seeking specific performance. There was a settlement between the parties and the assessee agreed to pay compensation of Rs.35,504/- to Radia and Sons Pvt. Ltd. Thereafter, the assessee entered into another Agreement of Sale with respect to the same property with a Co-operative Housing Society. The property was also sold. However out of the sale consideration the sum of Rs.35,504/- was paid directly to Radia and Sons Pvt. Ltd. It was claimed by the assessee that this amount should be allowed as deduction for the purpose of computing her income under the head "capital gain"

either as expenditure incurred in connection with the transfer or as cost of improvement or under Section 48 itself. The Bombay High Court answered the issue in favour of the assessee holding that without removing the encumbrance, particularly, the encumbrance of the type involved in that case, sale or transfer could not be effected.

16. Learned counsel also relied on ***CIT Vs. Sunil J. Kinariwala, [2003] 1 SCC 660***. In that case, the assessee was a partner in the partnership firm. He created a Trust. He assigned 50% of his interest as partner in the firm in favour of the Trust. He claimed that since 50% of the income attributable to his share from the firm stood transferred to the Trust, which resulted in diversion of income at source, the same could not be included in his total income for the purpose of his assessment. The Hon'ble Supreme Court negated the same and held as follows:

"8.so much of the income which an assessee is not entitled to receive by virtue of an overriding title created in favour of a third party would get diverted at source and the cannot be added in computing the total income of the assessee.....When a third party becomes entitled to receive the amount under an obligation of an assessee even before he could lay a claim to receive it as his income, there would be diversion of income by an overriding title; but when after receipt of the income by the assessee, the same

is passed on to a third person in discharge of the obligation of the assessee, it will be a case of application of income by the assessee.....”

17. Learned counsel also relied on ***Commissioner of Income Tax Vs. Abrar Alvi, [2001] 247 ITR 312 (Bom)***, wherein, the assessee had paid an amount of Rs.8 lakhs to his son Abrar Alvi. The son had instituted a suit seeking injunction restraining the assessee from selling the property called “Janki Kutir.” The assessee then entered into an Agreement of Sale with Sameer Mehta(HUF) for sale of the property. The amount of Rs.8 lakhs was paid to the son to remove the encumbrance. The High Court did not interfere with the finding of the fact that there was a dispute between the father and son and the amount had been paid to effect the transfer.

18. Placing heavy reliance on the above judgements, Mr.Subhang Nair learned counsel, urged that this Court should answer the substantial questions framed in this appeal in favour of the assessee, particularly, since no part of the consideration from the sale of the property had been received by the assessee and the entire consideration had actually been paid directly to State Bank of India, Pondicherry to the credit of the loan account of M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd., and consequently, no capital gain had arisen in the hands of the assessee and there was a diversion of sale profits towards remitting the

interest of the mortgagor and consequently, the amount was not liable to capital gains tax.

19. Mr.M. Swaminathan, learned Senior Standing Counsel for the Revenue strongly disputed the contentions raised. According to the learned counsel, the facts of the present case indicated that the assessee and the other two co-owners had voluntarily offered the property as collateral security and a mortgage by deposit of title deed was created in favour of the bank. The bank had no independent authority to sell the property. The assessee and other two co-owners had consented for sale of the property. It was stated that consideration received was for the value of the property and it was immaterial whether it was paid directly to the mortgagee bank or not. The assessee was liable to be taxed for capital gains for the consideration received, and payment to Bank was only application of their income, subject to capital gains tax liability.

20. Learned senior standing counsel for the Revenue, placed reliance on ***R.M.Arunachalam Vs. CIT [1997] 227 ITR 222***. In that case, the Hon'ble Supreme Court held as follows:

"The Supreme Court had an occasion to consider the question as to whether the sum paid by the assessee for discharging the mortgage by the assessee is a sum which would go to reduce the cost of acquisition. The court held

that such payment would go to reduce the cost of acquisition only where the mortgage had not been created by the assessee, but was created by the person from whom the assessee had acquired the title and the mortgage was subsisting at the time title was acquired by the assessee.....

The position is, however, different where the mortgage is created by the owner after he has acquired the property, the clearing off of the mortgage debt by him prior to transfer of the property would not entitle him to claim deduction under section 48 of the Act because in such a case he did not acquire any interest in the property subsequent to his acquiring the same."

21. Mr.M.Swaminathan, also relied on the decision in ***CIT Vs.N.Vajrapani Naidu, [2000] 241 ITR 560 (Madras)***. In that case the facts were that the assessee sold immovable property under 13 sale deeds and bona fide paid certain amounts to the creditors of the vendor assessee, including mortgages on the property, which was the subject matter of sale. The Income Tax Officer and the Commissioner rejected the claim for deduction in terms of Section 48(1). While the Tribunal reversed the view, the High Court rejected the view of the Tribunal, in the following manner:-

"That view of the Tribunal is wholly unsustainable. The burden had been created by the vendor on the property sold by him. As the burden had been created for his own benefit

by offering the property as security to his lenders, the amounts spent for discharging that burden of the vendor whether prior to sale, or at the time of sale, by payment to such creditors including the mortgagees, directly by the vendee cannot be regarded as expenditure wholly and exclusively in connection with the transfer.

When the mortgaged property is sold, if the consideration for the sale comprises the consideration for the sale of equity of redemption, and the amount required for the discharge of mortgage, it is the aggregate of both these sums that constitutes the consideration for the sale. The fact that the vendee makes the payment directly to the mortgagee, instead of the vendor doing so, after receiving the money from the vendee, does not make any difference for the purpose of determining consideration for the sale and the extent of capital gain."

22. Learned counsel also relied on **[2016] 286 CTR 538 (Madras), Sri Kanniah Photo Studio Vs. Income Tax Officer, Ward-I (1) 31, Kumbakonam**, wherein, a Division Bench of this Court had also approved the reasoning given in **N.Vajrapani Naidu**, case (supra) and held as follows:

"We find no reason to depart from this finding of this Court in N.Vajrapani Naidu's case (supra). In the present case, mortgage has been created by the present appellant/assessee and consequent to the sale, the assessee has discharged the mortgage to City Union Bank.

As the burden had been created for his own benefit by offering the property as security to City Union Bank, the amount spent for discharging that burden whether prior to sale, or at the time of sale, by way of one-time settlement to the Bank, cannot be regarded as expenditure wholly and exclusively in connection with the transfer. In the present case, the discharge was in the course of sale. We find that the payment of the outstanding amount in discharge of mortgage by the vendor, viz., appellant herein, cannot partake the character of an expenditure. It is not a case where the assessee had discharged the mortgage created at the time of acquisition of the property by the present appellant/assessee, to make a distinction otherwise."

23. The learned counsel also relied on **[1997] 227 ITR 420 (SC), V.S.M.R. Jagadishchandran (Decd.) Vs. Commissioner of Income-Tax.** In that case the Hon'ble Supreme Court held as follows:

"Where a mortgage was created by the previous owner during his lifetime and the same was subsisting on the dated of his death, the successor obtained only the mortgagor's interest in the property and by discharging the mortgage debt he acquired the mortgagee's interest in the property, and therefore, the amount paid to clear off the mortgage was the cost of acquisition of the mortgagee's interest in the property which was deductible as cost of acquisition under section 48 of the Act. But if the mortgage

was created by the assessee himself, then it was not a case where the property had been mortgaged by the previous owner and the assessee had acquired only the mortgagor's interest in the property mortgaged and by clearing the same, he had acquired the interest of the mortgagee in the said property."

24. Mr.M.Swaminathan, learned Senior Standing Counsel for the Revenue finally urged that the order of the Tribunal does not warrant any interference and stated that the sale consideration of the property was liable to be taxed as capital gain in the hands of the assessee.

25. We have given our deep consideration to the submissions made by both the sides. Section 48 of the Act is as follows:

"[48.Mode of Computation:- *The income chargeable under the head "Capital gains" shall be computed, by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely:*

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

(ii) the cost of acquisition of the asset and the cost of any improvement thereto:]

....."

The said Section provides the mode of computation for the income chargeable under the head "capital gains". It shall be computed by deducting from the full value of the consideration received, the expenditure incurred wholly and exclusively in connection with such transfer and also the cost of acquisition of the assets and the cost of any improvement.

26. In the instant case, the cost of acquisition of the assets in the year 1981 had been suitably computed by the Assessing Officer and similarly, the cost of improvement which was stated to be construction of compound wall had also been computed by the Assessing Officer and both the costs had been deducted. However, the assessee seeks to take advantage of Clause (i) of the Section 48 and seeks deduction of the entire sale consideration claiming that, since the entire sale consideration has been paid directly to the mortgagee/bank, it should be considered as expenditure incurred wholly and exclusively in connection with such transfer. The assessee claimed that the amount had been paid, since by creation of mortgage, the bank had acquired overriding title to the property and therefore, when the property was brought for sale, the amount paid towards clearing the cloud over the title should be deducted as provided under Section 48 of the Act.

27. In the present case, to reiterate the facts, the assessee Smt.D.Zeenath along with two other co-owners, namely, Smt.S.A.Kathija Nachial and Smt.Zubaida had originally purchased land measuring 43,596 sq.ft. at Saram Village, Pondicherry by two sale deeds dated 11.07.1980 and 04.02.1981 for a total consideration of Rs.2,01,000/-. They had offered the said property as collateral security towards the loan of Rs.3.75 Crores obtained by M/s.M.O.Hassan Kuthoos Maricar Pvt. Ltd., with State Bank of India, Pondicherry. Mortgage was by deposit of title deeds. In a mortgage by deposit of title deeds, the mortgagee, in this case, the State Bank of India, Pondicherry, does not acquire title, much less overriding title to the property. The charge created over the property was to the extent of the mortgage amount or not to the extent of value of the property. Since the mortgage had been created voluntarily, the balance sale consideration paid to discharge the mortgage would also be the total value of the property and capital gains is to be computed on the full value of consideration received or agreed as a result of transfer of the capital assets.

28. In the present case, the assessee and the two co-owners had consented for sale of the property. They were the vendors. The bank was not the vendor. They sold the property to M/s. Royal Park, Tiruchirapalli, for a total consideration of Rs.1,96,18,200/-. The loan obtained was Rs.3.75 Crores. Consequently, the entire sale consideration which was the full value of the capital

assets was paid directly to the bank. This was not paid to clear a cloud over the title. This was paid to clear the interest or charge over the property which had been offered as collateral security. In this case, the loan amount of Rs.3.75 Crores was far higher than the full value of the capital assets. Consequently, the full value of the capital assets namely, Rs.1,96,18,200/- was paid directly to the bank. The purpose of the sale was only to clear the loan. The value of the property which had accrued on such sale has to be created as capital gains in the hands of the assessee and the two co-owners.

29. In our opinion, the ratio in **R.M.Arunachalam Vs. CIT [1997] 227 ITR 222 (SC)**, squarely applies to this case. As held by the Hon'ble Supreme Court, **such payment would go to reduce the cost of acquisition only where the mortgage had not been created by the assessee, but was created by the person from whom the assessee had acquired the title and the mortgage was subsisting at the time title was acquired by the assessee. The position is, however, different where the mortgage is created by the owner after he has acquired the property. The clearing off of the mortgage debt by him prior to transfer of the property would not entitle him to claim deduction under section 48 of the Act because in such a case he did not acquire any interest in the property subsequent to his acquiring the same.**

30. This position had been reiterated by the Hon'ble Supreme Court in **[1997] 227 ITR 420 (SC), V.S.M.R. Jagadishchandran (Decd.) Vs. Commissioner of Income-Tax**. The facts in that case were as follows. The facts and the judgment of the Hon'ble Supreme Court are extracted below:

"This appeal by the assessee is directed against the order dt. 25th July, 1984 passed by the Madras High Court in TC No. 145 of 1983 wherein the High Court on an application filed under s. 256(2) of the Act declined to direct the Tribunal to state a case and refer the following questions of law to the High Court :

"1. Whether the Tribunal was right in holding that the levy of the capital gains of Rs. 68,400 is proper under the facts and circumstances of the case ?

2. Whether the Tribunal was right in holding that mortgage debts does not constitute diversion at source ?

3. Whether the debts discharged by the applicant on the properties cannot be said to enhance the cost of acquisition."

The assessee sold a house property No. 22, Chairman Muthurama Iyer Road, Madurai for a sum of Rs. 90,000

*subject to incumbrance in the assessment year 1975-76 and for the same assessment year he sold plot Nos. 1, 3 and half of plot No. 4 in T.S. No. 831/1 for a sum of Rs. 12,600. The Income-Tax Officer computed the capital gains in respect of the said properties at Rs. 68,400. The assessee questioned the computation of capital gains before the Appellate Assistant Commissioner and contended that the debts in respect of which mortgage had been executed were discharged by the buyer himself out of the sale proceeds, that the debts should be considered as increase in cost of acquisition of the properties and that in any event the debts may be treated as improvement to the property or as the cost of obtaining clear title to the property. The Appellate Assistant Commissioner rejected the said contention. He, however, upheld the contention of the assessee that there was an overriding title of the creditors in respect of the sale proceeds and, therefore, there was diversion at source on the basis of such overriding title and the assessee was not liable to charge under the capital gains in respect of the sale of the properties and, therefore, he deleted the capitals gains of Rs. 68,400 as computed by the ITO. The Tribunal, following the decision of the Kerala High Court in *Ambat Echukutty Menon vs. CIT* (1 (1978) 111 ITR 880 (Ker) , and the decision of the Madras High Court in *CIT vs. V. Indira* (1979) 119 ITR 837 (Mad) held that clearing of the mortgage debt could neither be treated as "cost of acquisition" nor as an "cost of improvement" made by the*

assessee. The Tribunal, therefore, held that the deduction of the capital gains was not justified. Since the Tribunal declined to refer to the High Court the questions referred to above, the assessee filed an application under s. 256(2) of the Act before the High Court which has been rejected by the impugned order. The High Court has relied upon the decision of the Full Bench of the High Court in S. Valliammai & Anr. vs. CIT (1981) 127 ITR 713 (Mad) and has held that by discharging the mortgage debt subsisting on the property which was the subject-matter of a sale, the assessee was not either improving or perfecting his title or improving the property in any manner and, therefore, the amount paid for discharging the mortgage debt cannot be taken to be for the cost of acquisition as contended by the assessee.

In Civil Appeals Nos. 6098-6101 of 1983 [since reported as R. M. Arunachalam etc. vs. CIT (1997) 141 CTR (SC) 348 filed against the judgment of the Full Bench of the Madras High Court in S. Valliammai & Anr. vs. CIT (supra) we have examined the correctness of the view of the Kerala High Court in Ambat Echukutty Menon vs. CIT (supra) and have held that the said decision does not lay down the correct law in so far as it holds that where the previous owner had mortgaged the property during his life time the clearing off the mortgage debt by his successor can neither be treated as cost of acquisition nor as cost of improvement made by the assessee. It has been held that where a mortgage was created by the previous owner during his time and the

same was subsisting on the date of his death, the successor obtains only the mortgagors interest in the property and by discharging the mortgage debt he acquires the mortgagees interest in the property and, therefore, the amount paid to clear off the mortgage is the cost of acquisition of the mortgagees interest in the property which is deductible as cost of acquisition under s. 48 of the Act. In the present case, we find that the mortgage was created by the assessee himself. It is not a case where the property had been mortgaged by the previous owner and the assessee had acquired only the mortgagors interest in the property mortgaged and by clearing the same he had acquired the interest of the mortgagee in the said property. The questions raised by the assessee in the application submitted under s. 256(2) of the Act do not, therefore, raise any arguable question of law and the said application was rightly rejected by the High Court. In the circumstances, even though we are unable to agree with the reasons given in the impugned order, we are in agreement with the order of the High Court dismissing the application filed by the assessee under s. 256(2) of the Act.

The appeal is, therefore, dismissed. No order as to costs."

31. It is thus seen that the Hon'ble Supreme Court had held that where the mortgage had been created by the owner after he had acquired the property, the clearing of the mortgage by him prior to the transfer of the property would

not entitle him to claim deduction under Section 48 of the Act because, in such a case he did not acquire any interest in the property subsequent to his acquiring the same.

32. The position had been reiterated in **[2016] 286 CTR 538 (Madras), Sri Kanniah Photo Studio Vs. Income-tax Officer, Ward-I (1)31, Kumbakonam**. A Coordinate Bench of this Court relied on **CIT Vs. N.Vajrapani Naidu, [2000] 241 ITR 560 (Madras)**. The reasonings are quoted below:

"11.On a careful reading of the above provision, it is evident that Section 48 provides that income chargeable under capital gains shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset such amounts, viz., expenses, incurred wholly and exclusively in connection with such transfer. The object behind such a provision is mainly for excluding those expenses incurred wholly or exclusively in connection with the transfer of the property.

The facts in the present case reveal that for further

development of the property, loan had been obtained by the appellant/assessee from City Union Bank and for the purpose of clearing the mortgage loan, the appellant/assessee had sold the property and effect the one-time settlement with the bank. The Assessing Officer had held that since the mortgage loan had been long time after the acquisition of the property, the same would not stand covered under Section 48(1) of the Act. That being the case, it does not appeal to us that the explanation relating to discharge of the mortgage to the bank, as submitted by the assessee, can be termed as expenditure, as the property had been acquired long time before taking the mortgage loan from the bank.

12. The Tribunal, to come to the finding that the said discharge of mortgage to the bank cannot be termed as expenditure, has placed reliance on the jurisdictional Court's decision in N.Vajrapani Naidu's case (supra). In that case, the assessee sold immovable property under 13 sale deeds and bona fide paid certain amounts to the creditors of the vendor assessee, including mortgages on the property, which was the subject matter of sale. The Income Tax Officer and the Commissioner rejected the claim for deduction in terms of Section 48(1).

While the Tribunal reversed the view, this Court rejected the view of the Tribunal, in the following manner:-

'That view of the Tribunal is wholly unsustainable. The burden had been created by the vendor on the property sold by him. As the burden had been created for his own benefit by offering the property as security to his lenders, the amounts spent for discharging that burden of the vendor whether prior to sale, or at the time of sale, by payment to such creditors including the mortgagees, directly by the vendee cannot be regarded as expenditure wholly and exclusively in connection with the transfer.

*When the mortgaged property is sold, if the consideration for the sale comprises the consideration for the sale of enquiry of redemption, and the amount required for the discharge of mortgage, it is the aggregate of both these sums that constitutes the consideration for the sale. **The fact that the vendee makes the payment directly to the mortgagee, instead of the vendor doing so, after receiving the money from the vendee, does not make***

any difference for the purpose of determining consideration for the sale and the extent of capital gain.

The Supreme Court in the case of **R.M.Arunachalam V. CIT [1997] 227 ITR 222**, had an occasion to consider the question as to whether the sum paid by the assessee for discharging the mortgage by the assessee is a sum which would go to reduce the cost of acquisition. The court held that such payment would go to reduce the cost of acquisition only where the mortgage had not been created by the assessee, but was created by the person from whom the assessee had acquired the title and the mortgage was subsisting at the time title was acquired by the assessee. The court further observed in that case as under (page 239):

"The position is, however, different where the mortgage is created by the owner after he has acquired the property, the clearing off of the mortgage debt by him prior to transfer of the property would not entitle him to claim deduction under section 48 of the Act because in such a case he did not

acquire any interest in the property subsequent to his acquiring the same."

It is undisputed that in this case, a mortgage had been created by the vendor-assessee and the amounts paid to the other creditors by the vendee was for the discharge of the debts which had been incurred by the assessee. The amount was paid as part of the consideration to the sale. The distinction that was sought to be made by the Tribunal between the case where the mortgage is discharged by the vendor prior to the sale and the case where the discharge of the mortgage is effected at the time of the sale by payment of the outstanding amount to the mortgagee by the vendor and the sale free from encumbrance, is untenable. The only point of relevance is whether the mortgage was created by the vendor or whether it subsisted at the time of acquisition of title thereto by the vendor and was burdened with the same at the time of such acquisition of title.'

13. We find no reason to depart from this finding of this Court in N.Vajrapani Naidu's case (supra). In the present case, mortgage has been created by the present appellant/assessee and consequent to

the sale, the assessee has discharged the mortgage to City Union Bank. As the burden had been created for his own benefit by offering the property as security to City Union Bank, the amount spent for discharging that burden whether prior to sale, or at the time of sale, by way of one-time settlement to the Bank, cannot be regarded as expenditure wholly and exclusively in connection with the transfer. In the present case, the discharge was in the course of sale. We find that the payment of the outstanding amount in discharge of mortgage by the vendor, viz., appellant herein, cannot partake the character of an expenditure. It is not a case where the assessee had discharged the mortgage created at the time of acquisition of the property by the present appellant/assessee, to make a distinction otherwise."

33. We fear that the judgments relied on by the learned counsel for the assessee are distinguishable on facts. In **[2001] 247 ITR 312 (Bom) CIT Vs. Abrar Alvi**, even though judgment is very brief, from a reading of the judgment, it is evident that the assessee had entered into an agreement on sale of property "Janki Kutir" with Sameer Mehta (HUF). He had also paid a sum of Rs.8 lakhs to his son, Abrar Alvi. The son had instituted the suit in the City Civil Court and sought injunction restraining the assessee from selling the property. When the

property had to be sold, out of the total sale consideration a sum of Rs.8 lakhs was paid to the son, Abrar Alvi. This was the amount paid to clear the encumbrance. The Tribunal actually found that there was a dispute between father and son and the amount was paid to effect the transfer. The facts in the present case are totally different.

34.The facts in **[1991] 190 ITR 56 (Bom) CIT Vs. Shakuntala Kantilal**, are also different. In that case, the assessee had entered into an agreement of sale to the property with M/s.Radia and Sons Pvt. Ltd., @ Rs.29 per sq. yard. There were differences and M/s.Radia and Sons Pvt. Ltd. filed a suit for specific performance and ultimately a compromise was entered and the assessee agreed to pay a sum of Rs.35,504/- @ Rs.7 per sq. yard as compensation. Subsequently, the assessee entered into another agreement of sale with M/s.Cosmos Co-operative Society @ Rs.51 per sq. yard. Out of the sale consideration the sum of Rs.35,504/- was paid to M/s.Radia and Sons Pvt. Ltd. In that case the necessity of making such a payment was not disputed by the Revenue. Without removing that encumbrance, the sale or transfer could not be effected. There was a cloud over the title since M/s.Radia and Sons Pvt. Ltd., had a pre-existing agreement of sale in their favour. It is under those circumstances, that the amount was deducted from the capital gains tax payable by the assessee.

35. In ***CIT Vs. Sunil Kinariwala, [2003] 1 SCC 660***, again the facts were different. In that case, the assessee had created a Trust and transferred 50% of his right over title and interest in a partnership firm to the benefit of the Trust. The Hon'ble Supreme Court negated the claim of the Assessee that the income so transferred resulted in diversion of income at source. The Hon'ble Supreme Court held that,

"8.when after receipt of the income by the assessee, the same is passed on to a third person in discharge of the obligation of the assessee, it will be a case of application of income by the assessee....."

This reasoning does not advance the case of the Assessee herein.

36. The facts in ***CIT Vs. Thressiamma Abraham, [1997] 140 CTR 540 (Ker)***, are also distinguishable. In that case, a company by name National Tyre and Rubber India Limited, had raised a loan of Rs.20 lakhs from Kerala Financial Corporation. The property of Thressiamma Abraham was offered as mortgage for the loan. A registered mortgage deed had been entered into giving right to Kerala Financial Corporation to bring the property to sale, in the event of failure of repayment of the loan.

37. In the present case, mortgage deed was never registered and State Bank of India, Pondicherry did not have a right to bring the property to sale. The assessee in the present case, continued to have title over the property along with her co-owners. They brought the property to sale through Bank. In **Thressiamma Abraham's** case, the mortgagee/financier namely, Kerala Financial Corporation sold the property in auction and realized the sale consideration. Thressiamma Abraham did not voluntarily sell the property.

38. In view of the above reasonings, we hold that in the present case, there was no diversion of sale proceeds by virtue of overriding title, but on the contrary, there was only a mere application by the owners themselves of the profits realized on the sale of land towards the discharge of loan obligations of same firm. We also hold that the assessee cannot claim any part of such application as cost of acquisition for the purpose of computing capital gains as per the provisions of Section 48 of the Act. We hold that the ratio laid down in the Hon'ble Supreme Court in the case of **V.S.M.R. Jagadishchandran (Decd.)** (cited supra) and of the Madras High Court in **N.Vajrapani Naidu** (cited supra) and in **Sri Kanniah Photo Studio** (cited supra) which followed the ratio in the judgment of **R.M.Arunachalam** (cited above) laid down the correct position of law.

39. We therefore hold that the Authorities below had correctly held that the claim of the assessee had to be rejected. We answer the substantial questions of law framed against the Assessee and in favour of the Revenue. The appeal filed by the Assessee has no merits and consequently has to be dismissed.

40. In the result, the Tax Case Appeal by the assessee is dismissed. No costs.

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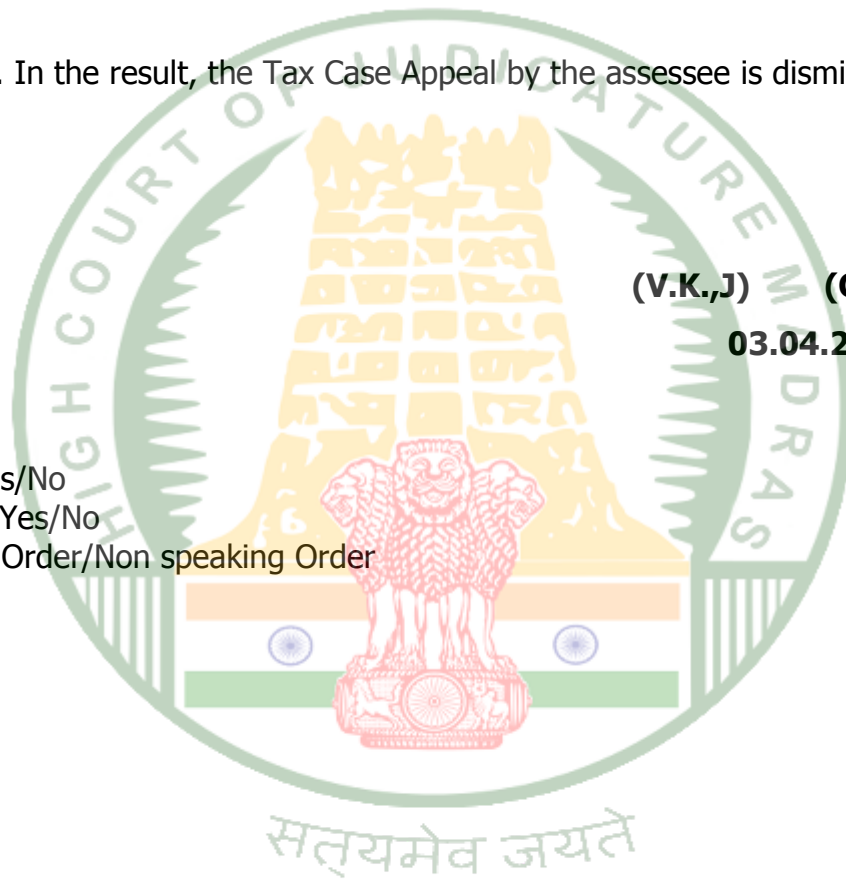
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Internet: Yes/No

Speaking Order/Non speaking Order

(V.K.,J) (C.V.K.,J.)

03.04.2019



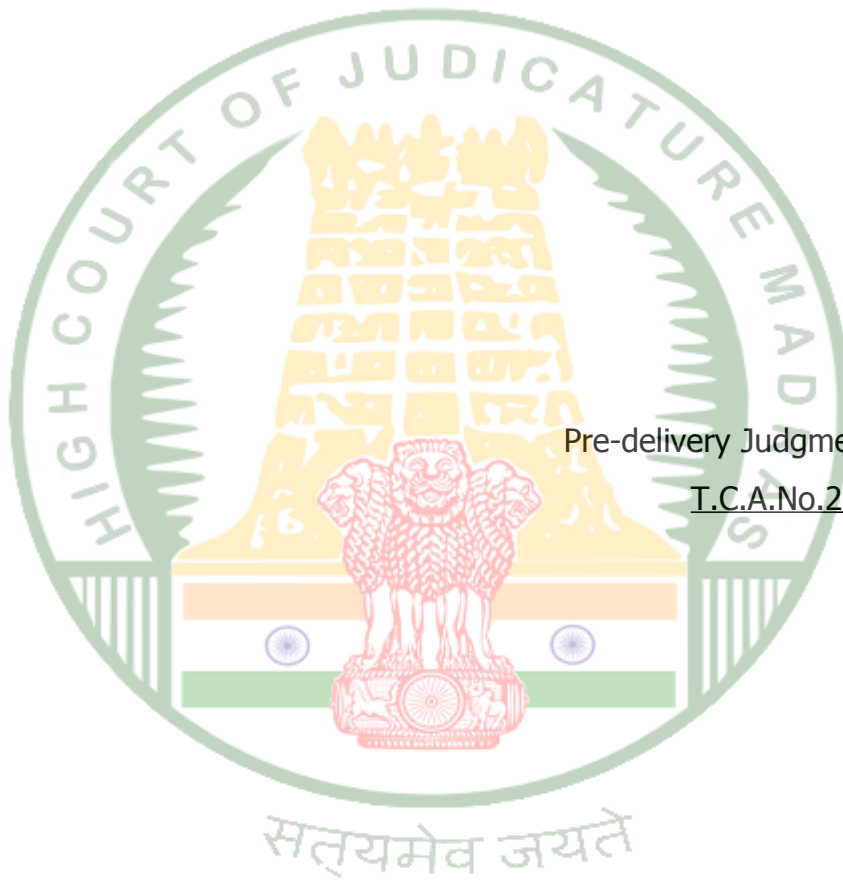
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DR.VINEET KOTHARI,J.

and

C.V.KARTHIKEYAN,J.

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T.C.A.No.2582 of 2006

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