Should you use home sale value to get tax break?

A taxpayer can fund new house through a loan, and invest sales proceeds from the old house

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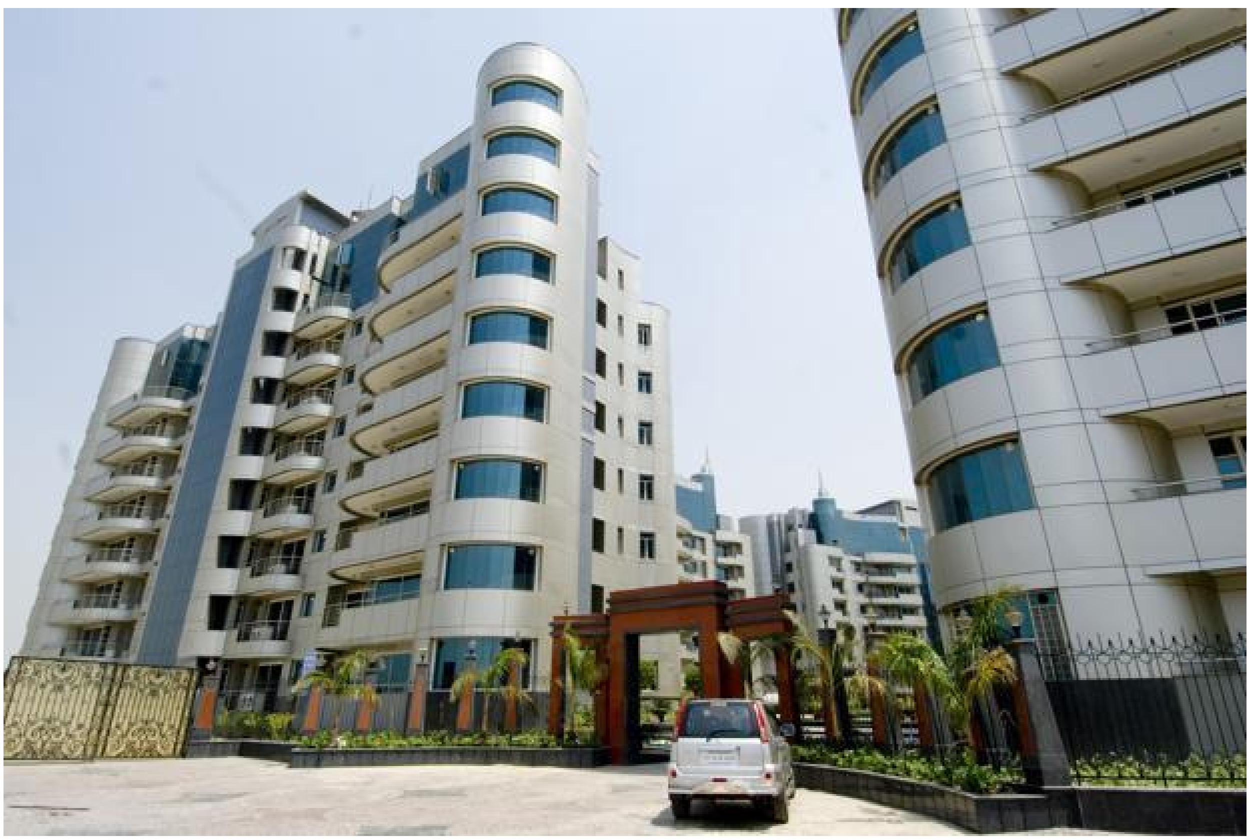

One of the common issues that most taxpayers face is whether the same sale proceeds that are received on sale of the old house are to be utilised for purchase or construction of the new house. Photo: Ramesh Pathania/Mint

One of the exemptions for **long-term capital gains** on sale of a residential house is available on purchase or construction of a new residential house within the specified period. This exemption is available to the extent of the capital gains on the sale of the old house, if the taxpayer purchases a new house within a period of one year before or two years after the date of sale of the old house, or constructs a new house within a period of three years after the date of sale of the old house.

One of the common issues that most **taxpayers** face is whether the same sale proceeds that are received on sale of the old house are to be utilised for purchase or construction of the new house, or whether the purchase or construction of the new house qualifies for the exemption, irrespective of the source of the funds utilised for such purchase or construction. For instance, a taxpayer may buy a new house to the extent of the capital gains by taking a housing loan, and may invest the sales proceeds of the old house in some investments. Would such a purchase qualify for the exemption?

There has been one Mumbai tribunal decision which has taken the view that such purchase does not qualify for the exemption, but there have been other tribunal decisions which have held in favour of allowability of the exemption.

If one looks at the provisions of the law, there is no specific requirement that only the sale proceeds of the old **house** are to be used. It merely stipulates purchase or construction of a new house within the specified period. Therefore, it appears that purchase or construction from another source may also meet the requirement to qualify for the exemption.

Further, if one looks at the requirements of purchase of a new **residential house**, such purchase can even be within the period of one year prior to the date of sale of the old house. Obviously, in such a case, the funds utilised for purchase of the new house would generally be from some other source, since the sales proceeds of the old house would normally flow in only at or around the time of sale of the old house, i.e. well after the purchase of the new house.

A Bombay high court decision has also confirmed this position, that the purchase or construction qualifies for the exemption, irrespective of the source of funds for purchase or construction. Only the fact of purchase or construction of the new residential house within the specified period was the relevant factor to be considered for the exemption.

In that case, the taxpayer utilised the sales proceeds of the old house to purchase a commercial office premises at Kolhapur, which he gave out on rent. Within the specified period, he also purchased two adjoining residential flats, which he claimed as purchase of a residential house. These flats were acquired out of his other sources.

The income tax authorities sought to deny the exemption, on the ground that the taxpayer had exhausted the sales proceeds in purchase of the office premises, and there were no sales proceeds left to buy the new residential house.

The tribunal, however, allowed exemption in respect of one residential flat, since the two flats were let out to two different tenants after purchase and were never intended to be used as one house. The Bombay high court confirmed the order of the tribunal since the purchase of the residential house was within the stipulated period, though not out of the same funds.

Therefore, irrespective of the source of funds for the purchase of the new house, whether out of own funds, out of income, or out of loans taken, the purchase or construction of the new residential house should qualify for the exemption so long as such purchase or construction is within the specified period. A taxpayer can, therefore, choose to fund the purchase of the new house through a housing loan, while investing the sales proceeds of the old house to earn an income. One, however, needs to keep in mind the risk and cost of possible litigation in such cases as tax authorities invariably try and deny exemption on some pretext or another, particularly when the tax impact of the loss of exemption is large.

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