CHAPTER 6

TAXATION OF CAPITAL GAINS

Treatment of Capital Gains

6.1 Under the existing law, profits and gains arising from the transfer of capital asset made in a previous year is taxable as capital gains. A capital asset is distinguished on the basis of the period of holding. A capital asset, which is held for more then three years, is categorised as a long-term capital asset. However, if the capital asset is in the nature of equity, it is categorised as a long-term capital asset if it is held for more then one year. All capital assets other then long-term capital asset is termed as a short-term capital asset.

6.2 The profits and gains arising from the transfer of a short-term capital asset are treated as short-term capital gains and included in the total income of the taxpayer for taxation at the rates applicable to him. Where a taxpayer incurs a loss from the transfer of a short-term capital asset (such loss is termed as "short-term capital loss") the same is allowed to be set off only against gain from the transfer of another short-term or long-term capital asset. In a case where the short-term capital loss remains unabsorbed, the same is allowed to be carried forward for set off only against gain from the transfer of another short-term and long-term capital asset in the subsequent year. However, such carry forward is restricted for a period of eight years. In other words, a short-term capital loss cannot be set off against income from salaries, house property, business or profession or income under the head "other sources".

6.3 Similarly, the profits and gains arising from the transfer of a long-term capital asset are treated as long-term capital gains. Since long-term capital gains represent accumulation of income over a period of time, these could turn out to be illusory in real terms. Accordingly, the cost of the asset is adjusted for inflation during the period of holding. The increased cost is set-off against the sale consideration of the long-term capital asset to determine the long-term capital gain. Such long-term capital gain is subjected to a concessional rate of tax to eliminate the bunching effect[74]. Furthermore, the long-term capital gains are fully exempt if the proceeds are invested in specified savings plan / schemes. In view of the liberalized personal income tax rate schedule comprising of only two rates, the adverse impact in the form of increased tax burden arising from bracket creep due to bunching of capital gains would be considerably reduced and in most cases eliminated. **Therefore, we recommend that concessional treatment of long-term capital gains through a reduced scheduler rate of tax must be abolished. In other words, the long-term capital gains would be aggregated with other incomes and subjected to taxation at the normal rates. Further, since we have recommended the abolition of various saving incentives, we do not consider necessary to allow any exemption for roll over of long-term capital gains.** However, we do recognise that a large number of small taxpayers feel the necessity to finance their basic requirement of a house by selling other capital assets like equity etc. Similarly, the financing of the construction of the Golden Quadrilateral and the North-South & East-West corridors is dependent on the funds mobilize through investment of the long-term capital gains. **Given the public nature of the project, it is necessary to maintain the flow of funds. Therefore, we recommend that long-term capital gains should continue to be exempt if invested in a house or in the bonds of National Highway Authority of India until completion of the Golden Quadrilateral and the North-South & East-West corridors.**

6.4 In the section on corporate taxation, we have recommended the elimination of all tax preferences thereby increasing the effective tax burden on corporate profits to the statutory rate of 30 per cent. The divergence between the effective corporate tax rate and the statutory tax rate would be eliminated. Consequent to these recommendations, the retained earnings of a company would bear the full impact of the corporate tax. A substantial portion, if not all, of the long-term capital gains on equity represent the value of retained earnings. Since the profits of the company would bear the full burden of the tax, the retained earnings would have also suffered full taxation. Any tax on such long-term capital gains on equity would tantamount to "double taxation" of the retained earnings.

[74] The rate of tax on long-term capital gains is 20 per cent. However, if the long-term capital asset is in the nature of listed securities (equity) or units, the rate of tax on long-term capital gains is 10 per cent of gains computed without inflation indexation or 20 per cent of gains computed after indexation, whichever is lower.

6.5 The case for taxation of capital gains on equity is often built around the argument that a part of the long-term capital gains on equity will represent the unrealized gains in the value of the assets, which would not have suffered taxation at the corporate level. Consequent to the exemption of long-term capital gains on equity, such unrealized gains would escape taxation. Such unrealized gains are assessed on realization at a future date, as part of the corporate tax base. The exemption of the long-term capital gain would essentially result in deferral of tax revenue. The revenue loss will be restricted to the extent of erosion in the time value of money. Given the simplification, which will follow from exemption of the long-term capital gains, there will be substantial reduction in dead weight loss. Therefore, the net loss from deferral of revenues may not be very significant. Similarly, the exemption will also not impair any equity. The buyer of the equity would have discounted the future value of unrealized gains to the extent of the potential tax liability resulting in lower long-term capital gains to the seller. Hence, the seller would have in any case suffered implicit taxation through lower prices.

6.6 Another argument offered against the proposal to exempt long term capital gains on equity is that part of such gains represent the "goodwill gains' – those arising from such factors as improved market position, technological developments and discoveries. Such goodwill gains will be reflected in the monopoly profits of the company, which in any case would suffer full taxation. Hence there is neither any loss of revenue or equity.

6.7 In view of the above, the case for taxation of long-term capital gains on equity is not sustainable. The Task Force recognizes that capital gains on equity could be related to a systemic shift in stock market prices, which may not in any way be related to the economic income of the company. Such gains would not have suffered any taxation at the corporate level. This is likely to be so only in the short term. **Accordingly, we recommend that while short-term capital gains on equity should continue to be taxed, the long-term capital gains on equity should be eliminated.** However, recognising the possibility of abuse by transferring real assets through the corporate vehicle, **we also recommend that the exemption on long-term capital gain on equity should be restricted to listed securities as defined in section 112 of the Income Tax Act.**

6.8 A large number of taxpayers pleaded before the Task Force that long-term capital gains on other assets should also be eliminated so as to give a boost to other asset markets.

We must clarify that the proposal to exempt long term capital gains on equity is founded on the argument of double taxation and not as an incentive to boost capital market. We do not find double taxation in any other asset market. For example in the case of a house, the investment in a house is essentially out of taxed income. The accumulation of the gain in the value of the house remains untaxed since unrealized gains are exempt. As and when the house is sold, the original investment in the house is allowed as a deduction in the computation of capital gains from the house since the original investment was out of taxed income. Hence, there is no double taxation of the investment in the house. Similarly, the taxation of capital gains on realization does not lead to any double taxation, since such gain was not subjected to any form of tax during the holding period.