Capital Gain Tax in India

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1. History of Income Tax in India

It is a matter of general belief that taxes on income and wealth are of recent origin but there is enough evidence to show that taxes on income in some form or the other were levied even in primitive and ancient communities. In India, the system of direct taxation as it is known today, has been in force in one form or another even from ancient times. There are references both in Manu Smriti and Arthasastra to a variety of tax measures. However, Kautilya's Arthasastra was the first authoritative text on public finance, administration and the fiscal laws in this country. His concept of tax revenue and the on-tax revenue was a unique contribution in the field of tax administration.

The organisational history of the Income-tax Department starts in the year 1922. The Income-tax Act, 1922, gave, for the first time, a specific nomenclature to various Income-tax authorities. The foundation of a proper system of administration was thus laid. However, the present , Income-tax Act, 1961 came into existence w.e.f. 1-4-1962.

2. Structure of Income Tax Act, 1961

The Income Tax Act, 1961 is consists of 298 sections contained in 23 chapters. Besides, there are 14 schedules and 1 annexure to it. Moreover, there is Income Tax Rules, 1962 which contains over 125 rules relating to Income Tax Act. Chapter IV of the income tax, which

contains section 14 – 59, is the most important chapter as it deals with the computation of total income for the purpose of calculation of income tax. This is one act which is amended at least once every year i.e. when the Finance Bill is passed in the parliament. However, there may be up to 3 amendments each year. Finance Bill 2009 promises to introduce new income tax code by December this year.

For the purpose of computation of total income, the income is assessed under five different heads being:

- Salary Income (section 15-17)
- Income from house property (Section 22-27)
- Profits and gains from business and professions (section 28 – 44 DB)
- Capital Gains (section 45 -55A); and
- Income from other sources (section 56-59)

3. Introduction to Capital Gain Tax

The origin of capital gains tax in India dates back to 1956, following the recommendations of Prof Kaldor to levy tax on profits arising on sale/transfer of specified non-inventory asset.

As a result of constant evolution, capital gains tax, as it stands today, is levied on transfer of all capital assets (other than held as stock-in-trade) with a computation mechanism prescribed under sections 45 – 55A of the Income Tax Act.

Over the past two decades, several exemptions were incorporated in the statute to rationalise the levy with a view to mitigate 'undue hardship' to taxpayers. In the past few years, the levy (or non-levy) of capital gains tax on profits or gains arising on transfer of capital market instruments (shares, units, etc) has emerged as an effective tool to foster the growth of capital market.

4. Basis of Charge

Basis of Charge of an Income let's us know that on what grounds Income earned by a person is chargeable to tax. It specifically defines whether Income so received is tax chargeable on receipt basis or accrual basis, or in case of variations in accounting method how tax should be

charged. All five heads of Income have different Basis of Charge which you will come to know as you surf through each head of Income. The bases of charge of Capital Gains are:

- There must be a Capital asset owned by the assessee
- The assessee must have transferred the Capital asset.
- Such transfer should have taken place during the previous year
- Profit or Loss arises from such transfer
- Such Capital gains should not be exempt u/s 54, 54B, 54D, 54EC, 54F, 54G or 54GA.

5. What are Capital Assets?

Section 2 (14) of the Act, defines the term Capital Assets. It is defined to include property of any kind, whether fixed, circulating, movable, immovable, tangible or intangible and whether or not used for the purpose of his business and profession. However it also specifies the following exclusions:

- Any stock in trade, consumable stores, raw material held for the purposes of Business or Profession
- Personal Assets of the assessee, i.e., movable property, including wearing apparels of the assessee & furniture held for his/ other family members personal use, but excludes:
    - Jewellery;
    - Archaeological collections;
    - Drawings;
    - Paintings;
    - Sculptures;
    - Any work of art.
- Rural agricultural land in India.
- 6.5% Gold Bonds 1977; 7% Gold Bonds 1980 or National Defense Gold bonds 1980 issued by the Central Govt.
- Special Bearer bonds 1991 issued by the Central Govt.
- Gold Deposit bonds issued under Gold Deposit scheme 1999.

6. What is transfer of Capital Asset?

Section 2 (47) of the Income Tax defines the term 'transfer'. Transfer in relation to capital asset includes sale, exchange, relinquishment, or compulsory acquisition of the asset or extinguishment of any rights therein. However, the following transactions are not transfer:

- Distribution of asset in kind by a company to its shareholders at the time of liquidation
- Distribution of Capital Asset on total or partial partition of a Hindu Undivided Family
- Transfer of Capital asset under a gift or will or an irrevocable trust
- Transfer of Capital asset by a Company to its 100% subsidiary company.
- Transfer of Capital asset by a Subsidiary Company to its 100% Holding company
- Transfer of capital asset in a scheme of amalgamation
- Transfer of shares of an Indian company held by a foreign company to another foreign company in scheme of amalgamation of two foreign companies
- Transfer of capital asset in a scheme of amalgamation of banking company with a banking institution
- Transfer in a demerger of a capital asset by the demerged company to resulting company
- Transfer of shares held in an Indian company by a demerged foreign company to the resulting foreign company
- Transfer or issue of shares by the resulting company in a scheme of demerger to the shareholders of the demerged company
- Allotment of shares in an amalgamated company in lieu of shares held in amalgamating company.
- Transfer of Capital asset (being foreign currency convertible bonds or GDR) by a non resident to another non resident.
- Transfer of Agricultural land in India before March 1st, 1970.
- Transfer of Capital asset (being work of art, manuscript, painting etc.) to Govt./ University/ National Museum etc.
- Transfer by way of Conversion of Bonds or Debentures into Shares

- Transfer by way of exchange of a Capital asset being membership of a recognized stock exchange for shares of a company.
- Transfer of land by a sick industrial company which is managed by its workers' co-operative
- Transfer of a Capital asset by a firm to a company in case of conversion of firm into a company
- Transfer of capital asset, being a membership right held by a member of a recognized stock exchange in India
- Transfer of capital asset to company in the case of conversion of a proprietary concern into a company
- Transfer involved in a scheme of lending securities.

Usually, Capital gain is taxable in the year of transfer of capital asset. However following are the basic rules framed to determine that whether transfer of asset is actually a transfer as per the Income Tax Act:

- Transfer of immovable property when documents are registered: Title to Immovable assets will not pass till the conveyance deed is executed or registered.
- Transfer of immovable property when documents are not registered: On satisfaction of the following conditions of Section 53A of the Transfer of Property Act' 1882, the transfer is considered as completed as per Income Tax Act provisions:
    1. There should be a contract in writing;
    2. The transferee has paid consideration or is willing to perform his part of the contract;
    3. The transferee should have taken possession of the property.
- Movable Asset: Title to a movable asset passes at the time of delivery of the asset in pursuance to a contract of sale.

7. Types of Capital Assets

For the purpose of computation of income tax the capital assets are classified under two heads.

- Short Term Capital Assets; and
- Long Term Capital Assets

It is essential as the method of computation of income chargeable to tax and rates of taxes are different for both the types of capital gains. Short term capital assets means any Capital asset held by an assessee for ***not more than 36 months***, immediately prior to its date of transfer. On the other hand, lonh term capital assets means any Capital asset held by an assessee for ***more than 36 months***, immediately prior to its date of transfer. However the above rule of 36 months has certain exceptional situations wherein such period is taken as 12 months:

- Equity / Preference Shares in a Company, which may be quoted or unquoted;
- Securities like Debentures, Govt. Securities etc., which should be listed on a recognized Stock Exchange;
- Units of UTI, which may be quoted or unquoted;
- Units of a Mutual fund, which may be quoted or unquoted;
- Zero Coupon Bonds, which may be quoted or unquoted.

8. Computation of Capital Gains

Section 48 of the Act deals with the computation of the Capital Gains. Accordingly, the computation is done as follows:

a. Taxable short term capital gains=

Full Value of Sale consideration

Less:

- Expenditure incurred wholly & exclusively relating to such transfer
- Cost of Acquisition
- Cost of Improvement
- Exemptions available under Sec. 54B, 54D, 54G, 54GA

b. Taxable long term capital gains

Full Value of Sale consideration

Less:

- Expenditure incurred wholly & exclusively relating to such transfer
- Indexed Cost of Acquisition
- Indexed Cost of Improvement
- Exemptions available under Sec.54, 54B, 54D,54EC, 54F, 54G, 54GA

However, there are certain circumstances in which an assessee can avail the benefit of indexation, which are discussed later on.

9. What is full value of consideration?

Full value of consideration is the consideration received/ receivable by the transferor in respect of Capital asset being transferred and which may be received in Cash/ Kind. However, it should be noted that:

- Adequacy or Inadequacy of Consideration is not a relevant factor for the purpose of determining the full value of consideration.
- It does not make any difference whether full value of consideration is received in totality or, in installments during the previous year, since in both cases full value of consideration due will be taken for the purpose of calculation of computing capital gains; and
- In case of exchange, the full value of consideration will be the market value of the property transferred.

Besides, there are circumstances where instead of actual consideration, full value of consideration shall be the deemed value. Such circumstances and their deemed values are as specified below:

Circumstances	**Deemed value of consideration**
Money/ Asset received from an insurer on account of damage/ destruction of capital asset.	Value of money received &/or Full market value of asset on the receipt date
Conversion of or treatment of Capital Asset into Stock in Trade	Full market value of asset on the date of its conversion or treatment
Introduction of Capital in kind into Firm or AOP/ BOI by a partner/ member	Amount recorded in the books of accounts of Firm or AOP/ BOI as the value of Capital Asset
Distribution of Capital Asset in kind on dissolution of Firm or AOP/ BOI	Full market value of assets on the date of distribution
Shareholders receiving assets from liquidator on the liquidation of a company	Market Value of the assets on the date of distribution ***less*** amount assessed as deemed dividend
Gift etc. of shares/ debentures allotted under ESOP	Market value on the date of gift
Transfer of Land &/ or Building	Value declared by the assessee ***or*** Value as assessed by Stamp valuation authority whichever is higher

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10. What is Cost of Acquisition and Improvement?

Cost of acquisition of an asset is the value for which it was acquired by the transferor. Expenses incurred for completing title are a part of the cost of acquisition. Section 49 of the Act enumerates certain circumstances where deemed cost is taken as cost of acquisition.

- Where the Capital asset became the property of the assessee in any of the below mentioned cases then cost to the previous owner shall be the deemed Cost of Acquisition for the purpose of computation of Capital gains:

  a. On distribution of assets on total/ partial partition of Hindu Undivided Family;

  b. Under a Gift/ Will;

  c. By succession, inheritance, or devolution;

  d. On distribution of assets on liquidation of the company;

  e. Under a transfer to a revocable or irrevocable trust;

  f. On transfer by a wholly owned subsidiary company to its holding company or *vice versa*;

  g. On conversion of self acquired property of a member of a HUF to the Joint Family property;

  h. On any transfer in a scheme of amalgamation of two Indian companies subject to conditions specified U/s 47(vi);

  i. On any transfer in a scheme of amalgamation of two foreign companies subject to certain conditions;

  j. On any transfer of a Capital asset by the banking company to the banking institution in a scheme of amalgamation.

B. Cost of Acquisition in the case of shares/ debentures acquired on conversion of Debentures [Section 49(2A)]:

   a. The cost of acquisition of the shares/ debentures on such conversion shall be deemed to be that part of the cost of the debenture / debenture stock/ deposit certificate, in relation to which such an asset is acquired by the assessee.

b. The period of holding of such converted shares/ debentures will be from the date of conversion of such Debenture bonds into shares/ debentures till the actual date of transfer.

c. Shares or Debentures or Warrants which were treated as perquisite under Section 17(2) the cost shall be the fair market value on the date of exercising ESOP taken for calculation of perquisite.

D. Shares or Debentures or Warrants allotted if same have been subject to Fringe benefit tax (FBT) then the cost of acquisition shall be taken as the fair market value of such securities determined earlier for charging FBT.

E. Stock or Shares becoming property of the assessee on consolidation, conversion etc.:Deemed acquisition cost is the cost of such stock or shares from which asset is derived.

Cost of Improvement is Capital Expenditure incurred by an assessee in making any additions/ improvement to the Capital Asset. Any expenditure incurred by the assessee with a view to make value addition in such asset after its acquisition is termed as Cost of Improvement. It should be noted that, cost of improvement in relation to goodwill of a business or right to manufacture or produce any article the cost of improvement is nill.

Indexed Cost of Acquisition/ Improvement refers to the actual cost incurred by the owner, inflated to the extent of current cost levels. However there are certain situations where indexation is not permitted such as:

- Transfer of Bonds & Debentures of a company other than capital indexed bonds issued by Govt
- Transfer of Shares or Debentures acquired by a Non Resident in foreign currency in an Indian company
- Transfer of an Undertaking in a Slump Sale;
- Transfer of Units of Unit Trust of India or Mutual fund covered u/s 10(23D) purchased in foreign currency by Offshore Funding Companies

- Transfer of Global Depository Receipts (GDR's) or bonds of an Indian company or share or bonds of a Public sector company sold by the Govt. and purchased in foreign currency by a Non Resident
- Transfer of Global Depository Receipts (GDR's) purchased in foreign currency by an Individual resident in India and employee of an Indian company
- Transfer of securities by Foreign Institutional Investors (FII's)
- Transfer of a Foreign Exchange Asset by a Non Resident Indian.

In cases where deemed cost of acquisition is taken as cost, in order to find out whether the asset is short term or long term period of holding of previous owner is to be considered. Moreover, the benefit of Indexation will be available from the year in which the asset was held by the previous owner.

11. Eligible Expenses

As we has seen earlier, expenses incurred wholly and exclusively in relation to transfer of capital assets are allowable as deduction from value of consideration for computation of capital gains. The expenses incurred & claimable as deduction are:

§ Brokerage or Commission

§ Cost of Stamp.

§ Registration Fees borne by the vendor.

§ Traveling expenses related to transfer.

§ Litigation expenses for claiming enhancement in compensation.

12. Exemptions

Section	Kind of asset transferred	Eligible Assessees	Min. period of holding original Asset	Condition of utilization of consideration	Exempt Amount	Other requirements
54	LTC Asset being House Property used for residential purpose	Individual & HUF	3 yrs	Purchase of Residential House within 2 years after or 1 year prior to date of transfer; or construction of residential house within 3 years from the date of	The amount of gain or, the cost of new asset, whichever is less	See Notes 1, 2 & 4

				transfer		
54B	Land used for agricultural purposes	Individual	2 yrs	Purchase of Agricultural Land within 2 years from the date of transfer	Lower of the Capital Gain or the Cost of acquisition	Assessee or his parents must have used the land for preceding two years for agricultural purpose.
54 D	Land or Building or any right therein used by an industrial undertaking (compulsory acquisition)	All	2 yrs	Purchase/ construction of Land, Building, or any right therein in within 3 years from the date of transfer by way of compulsory acquisition for the purposes of shifting/ re-establishing/ setting up another industrial undertaking	-do-	See Notes 1, 2 & 4
54 EC	Any LTC asset	All	1 yr/ 3 yrs	Investment of whole or any Part of Capital Gain 'specified assets' as stipulated in the section. Investment should be made within 6 months from the date of tra	Lower of the Capital Gain or the Cost of acquisition Subject to Max of Rs. 50 lakhs	Must have been used for business of industrial undertaking for preceding 2 years. See Notes1, 2 and 4 Rebate u/s 88 or deduction u/s 80C not to be granted for the same investment. New Asset must be retained for a period of 3 years See Note 4
54 F	All LTC Assets other than residential house		1 yr/ 3 yrs	Purchase of Residential House within 2 years after or 1 year prior to date of transfer; or construction of residential house within 3 years from date of transf	Refer Note No. 5	Must not own more than 1 residential house other than the new asset on the date of transfer of original asset; See Notes 2, 3, 4
54 G	Land or Building or any right therein or Plant or Machinery in Urban Area used for the business	All	**-**	Acquire similar assets & incur expenses on shifting original asset, within 1 year before, or 3 years from the date of transfer	The amount of gain or the aggregate cost of new asset, and shifting expenses, whichever is lower	Must have been shifted to non urban area; See Notes 1 & 2
54 H	-do-	all		-do-	-do-	Must have been shifted to Special Economic Zone; See Notes 1 & 2

NOTES

1. In case New Asset is transferred before 3 years from date of purchase/construction, the Capital Gains exempted earlier will be chargeable to tax in year of transfer.
2. In order to avail the exemption, gains are to be reinvested, before the due date of return u/s 139(1). If the amount is not so reinvested, it is to be deposited on or before that date in account of specified bank/institution and it should be utilized within specified time limit for purchase/construction of New Asset.
3. U/s 54F Capital Gains exempted earlier shall be chargeable to tax if a) If the assessee purchases within 2 year or constructs within 3 years any residential house other than the one in which reinvestment is made & b) If the new asset is transferred within a period of 3 years from the date of its purchase/construction.
4. As per Section 54 H, where the transfer is by way of compulsory acquisition, the period available for acquiring the new asset u/ss. 54, 54B, 54D, 54EC and 54F shall be computed from the date of receipt of compensation
5. If cost of new house is more than the net consideration of original asset, the whole of the gains. If cost of specified asset is less than net consideration, the proportionate amount of the gains will be exempt

13. Tax Computation

1. Short term capital gains arising on transfer of Equity Share or Units of an Equity Oriented Mutual Fund on satisfaction of the following conditions would be taxable @ **15% from AY 2009-10 onwards**, whereas Income other than Short term Capital Gains of the assessee shall be taxed as per the Normal prevailing Slab Rates for specific assesses. The conditions whereof are:
   - The Transaction of sale of such equity share/ unit is entered into on or after October 1^{st,} 2004;
   - Such transaction is chargeable to Securities Transaction tax;
   - Such Equity shares are transferred through a Recognized Stock Exchange or sold to a Mutual Fund.

2. In any Other Case the Short term capital gains shall be computed after including same in Total Income and charging Tax as per assessee specific Slab Rates.
3. Any Long term Capital Gains made by an assessee other than on transfer of listed securities on any recognized stock exchange or units of UTI/ Mutual funds covered u/s 10(23D)/ Zero Coupon Bonds shall be taxed under this section at a **flat rate of 20%** in case of any assessee. However in case of Long term capital gains u/s 115AB, 115AC, 115AD and 115AE the rate of tax shall be specified @ **10%**
4. In case of transfer of listed securities on any recognized stock exchange or units of UTI/ Mutual funds covered u/s 10(23D)/ Zero Coupon Bonds:

   The Long term capital gains shall be computed as minimum of the following:

   1. Tax @ 20% on Long term capital gains computed after indexation of cost of such shares, securities or units;

      OR

   2. Tax @ 10% on Long term capital gains computed without indexation of cost of such shares, securities or units.

5. Long Term Capital gains in case of transfer of Listed equity shares or units of equity oriented mutual funds on or after October 1st, 2004 is exempt