CHAPTER - II

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2.1 MEANING OF THE HEAD " CAPITAL GAINS " -

Any profit or gains arising from the transfer of 'Capital Asset' effected in the previous year shall, save as otherwise provided in sections 53, 54, 54B, 54D, 54E and 54F, be chargeable to Income-tax under head "Capital Gains".

A Capital gain means a gain on appreciation in the value of property. A capital gain is said to be realised if it arises from the sale of property at a higher price than was paid for it. It is said to be unrealised if the property is not sold. The capital gains tax is imposed on realised capital gains.

Suppose, a person buys a house for Rs. 10,000 and later sells it for Rs. 15,000. He makes a capital gain of Rs. 5,000. A capital gain is an irregular or unusual sort of gain, occuring outside a persons normal business. Thus, when a dealer in houses sells house and makes a profit it cannot be called as capital gain, as selling houses is his normal business. But if a doctor whose normal source of income is different, sells a house and makes a gain, it would be called a capital gain.

On one hand, it is contended that capital gains are irregular receipts. They represent capital and not income. Their inclusion in income leads to the raising of total income and therefore to the imposition of higher tax rates. On other hand, it is pointed out that capital gains are a part of persons total money receipts during a given period and hence should be treated and taxed as income. Capital gains are by nature fluctuating in character. Capital gains tend to be realised during period of rising prices and not during period of falling prices. The tax is more useful as an instrument for obtaining revenue and for obtaining other fiscal objectives.

Different countries have adopted different practices regard to the capital gains. They are not taxed at all in U.K.. In U.S.A. they are treated as a part of income and are subjected to income-tax.

The expression "Capital gains" has not been defined any where in the Income-tax Act. According to Mr. A. R. Illersic - "Capital gains are receipts in excess of cost arising from the sale, exchange, conversion or compensation for transfer or loss of assets otherwise than by way of trade."

In relation to the 'Capital gains' following points should be noted -

1) There should be profit or gain.

2) Profit or gain should be arise from transfer of capital assets.

3) Asset transferred should be of capital nature.

4) Transfer should be effective in the previous year.

5) The profit or gain is to be deemed to the income of that year.

2.2 LEGISLATIVE HISTORY OF TAX ON CAPITAL GAINS -

The law relating to the subject of tax on capital gains was first introduced in India, by the late Finance Minister of United India, Shri Liaquat Ali Khan. It was imposed by insertion of section 12-B in the Income-tax Act 1922, by the Income-tax and Excess Profit-tax (Amendment) Act (XXII of 1947.).

The present section 45(1) corresponds to section 12-B(1) of the 1922 Act.

The second Finance Minister abolished this tax by adding the exemption in sub-section 1 of section 12-B, The range of the taxable transfers was rather narrow being only "Sale, exchange or transfer". Levy was in respect of transfers made during the period 1.4.1946 to 31.3.1948.

Section 12B was substituted by new section with effect from 1.4.1957. It was provided that tax was to be paid under the head "Capital gains" in respect of profit & gains arising from the sale, exchange, relinquishment or other transfer taking place after 31.3.1956. This was based upon the recomendations of Mr. Nicholos kaldor. This reveals that there was no tax liability under the head "Capital gains" between 1st of April,1948 and 31st of March,1956.

The current Income-tax Act,1961 came into force from 1962-63 onwards. It has broken up the repealed section 12B into several sections from 45 to 55A. Short-lived amendments and modifications were made from time to time to enlarge the scope of tax on capital gains. Diverse changes have been made in (1) exclusions from, and inclusions in, the content of capital assets as well as in (2) exemptions.

2.3 CONSTITUTIONAL VALIDITY OF TAX ON CAPITAL GAINS -

The constitutional validity of tax on capital gains was first challenged in the case of Navinchandra Mafatlas Vs CIT 26 ITR 758 (1954)(S.C.). In this case, the Supreme Court held that the word 'income' in entry 54 in list of the Seven Schedule to the Government of India Act, 1935, shall be given its widest connotation so as to include capital gains and the levy of tax on capital gains.

Income-tax Act is an Act providing for tax on incomes. Entry No. 86 in the Union List (Seventh Schedule to the Constitution of India) runs as follows -

" Taxes on the capital value of the assets exclusive of agricultural land, of individuals and companies, taxes on capital of companies."

Thus, since parliament came to enact the Income-tax Act,of 1961, after the Constitution of India came into force, it was open to it, in an Act, dealing with tax on the capital value, to provide for tax on such capital value.

2.4 <u>SIGNIFICANCE AS A SEPARATE HEAD OF TAXATION</u> -

Tax on capital gains is a tax on receipt of a capital nature. Every receipt of capital nature is not liable to be taxed as a capital gain.

In order to attract liability to capital gains tax, it is not enough if the receipt in question is of capital nature, it is essential that receipt gives rise to capital gains chargeable to tax under section 45.

Capital gains are essentially a part of income. Tax on capital gains must be regarded as an intergral part of Income-tax.

Capital gains are very suitable objection of taxation. In a period of contineously rising prices and capital value it is suitable. The taxes serves to increase the yields from Income-tax. It plays some loopholes for evasion of the Income-tax. Capital gains tax helps to reduce inqualities in income.

2.5 INCIDENCE OF TAX ON CAPITAL GAINS -

Section 45 provides for taxation of profits or gain arising from certain types and "transfer" of capital asset". Person who owns a "Capital asset" and "transfer" it for a certain consideration and makes a capital gain or profit out of such transfer is liable to pay tax on such gain or profit.

If there is no 'transfer' within the meaning of section 2(47) of the Act, the transfer is not liable to tax on such gain.

The assessee is not liable to capital gains tax if there is no capital gain or the capital gain is nil in transferring the capital assets. Thus if an assessee earns no capital gain he incurs no liability to pay tax. Liability to pay tax arises only with respect to the transferor of a capital asset.

Capital asset of the assessee is the subject matter of assessment. The capital asset should give rise to gains or profit accruing or arising to assessee. Assessee is an individual, firm, company, H.U.F., an association of persons or body of individuals.

If the assessee, having never acquird any interest in the property, it never became his capital asset.

Capital gains accruising or arising from transfer of capital asset are assessable in an assessee's hand only to extent they accrue or arise to him.

If the capital asset is owned by number of persons as co-owners at the time of transfer, capital gains are taxable in the hand of each of the co-owners proportionately.

If the capital asset were sold by former members of a joint family to whom it was distributed on its partition, then only those members and not the family will be assessable to capital gains.

2.6 TYPES OF CAPITAL GAINS -

The type of capital gains depends on the type of the capital assets transferred during the previous year. It is important to ascertain the type of capital gain, as the computation of capital gains tax is dependant on it. Different rates are provided for different types of capital gains. Types of capital gains depend upon the types of capital assets.

Types of Capital Assets -

Capital assets are classified on the basis of period for which it has been held by an assessee. They are classified into two categories as under :

1) Short-term capital asset,
2) Long-term capital asset

The detailed discussion of these two terms is made in the Chapter IV of this study.

Types of capital gains -

for all purposes of taxation, capital gains are classified into two broad groups viz.

1) Short-term capital gain
2) Long-term capital gain

1) Short-Term capital gain

Section 2(42-B) of the Income-tax Act, 1961 inserted by the Finance Act,1987 w.e.f. 1.4.1988. It defines "Short-term capital gain" as capital gain arising from transfer of a short-term capital asset.

In the case of short-term capital gain, it is treated as any other income and will be included in the gross total income, like any other taxable income. No deduction under this Act are available in this respect.

2) <u>Long-term capital gains</u> -

The Finance Act,1987 has inserted a new subsection 2(29-B) w.e.f. 1.4.1988. The new subsection 2(29-B) defines "long-term capital gain" as capital gain arising from the transfer of a long-term capital asset.

Long-term capital gains are not straightway included in the gross total income of the assessee. It is included only after making adjustment into it in respect of deductions available u/s 48 and the exemptions u/s 53, 54, 54B, 54D, 54E, 54F or 54G.

Accordingly, distinction must be followed by all assessees and tax authorities for determining the tax payable on the capital gains, tax concessions available and purpose of set-off of losses.

2.7 TAX ON CAPITAL GAINS AND INFLATION -

There is no difficulty in principle in adjusting the taxation of capital gains to take account of inflation. At present taxable gain is the value on realisation minus the original acquisition cost. To index the gain all we have to do is to increase the acquisition cost by the rate of inflation during the period between acquisition and inflation. Each year the Government would publish a table of inflation factors showing the rate of inflation between any two rates, as measured by a suitable index. For example - Suppose an individual bought an asset in 1971 for Rs. 1000 and sold it in 1976 for Rs. 5000. The table of inflation factors might show that between 1971 and 1976 the rate of inflation was 90%. Thus increase the acquisition cost by 90% to obtain an indexed acquisition cost of Rs. 1900. This gives a taxable gain of Rs. 3100 as compared to a gain of Rs. 4000 under the current tax system. If on the other hand, the asset had cost of Rs. 3000, the notional acquisition cost would Rs. 5700 which exceeds the proceeds of the sale, and hence the result would be that many 'gains' would turn into losses. These calculations, although somewhat complex, are both simpler and more logical than alternative suggestions for 'tapering' the rate of tax according to the length of time for which asset has been held.

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