Historical Evolution of Capital Gains in India - A Study on Overview of Capital Gains and Its Exemptions

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ABSTRACT
Capital gains taxation is an important aspect of financial planning in India. Understanding the applicable tax rates, exemptions, and evaluation methods is crucial for maximizing returns and minimizing tax liability. Consulting with a tax advisor can provide valuable guidance in navigating the complexities of capital gains taxation. It is important to note that each exemption has its own set of eligibility conditions, such as holding period, investment period, and type of property.

This research is an attempt to evaluate the history and evolution of capital gains and taxation on capital gains in India and to analyse the capital gain evaluation on Stocks, Future & Options and also on other asset classes and overview the Capital Gain exemptions in India.

Keywords: History and Evolution of Capital Gains, Taxation on Stock, Future and Options, Taxation on Mutual Funds and Securities, LTCG & STCG Exemptions.

1. Introduction
In India, capital gains tax is a crucial tax component that is imposed when you sell certain assets for a profit. You can, however, use a number of legal tactics to reduce capital gains tax. We'll look at a number of scenarios in this blog and give real-world examples to assist you understand how to reduce your tax liability. One important element of the financial environment that affects both individuals and investors is capital gains taxation. The profits or gains you make from the sale or transfer of a "capital asset," like securities, are taxable. The purpose of this post is to demystify capital gains, how they are taxed, and how to pay less in taxes.

One of the most sought-after investments is a residential property, mainly because you get to own a house. Some investors, however, might do so with the goal of making money when they sell the property later on. It is significant to remember that, for income tax purposes, real estate is considered a capital asset. As such, any profit or loss realized from the sale of real estate may be liable to taxation under the "Capital Gains" heading. Similar to this, selling various kinds of capital assets can result in capital profits or losses. Here, we'll go into great detail on the "Capital gains" chapter.

Those who are thinking about investing in mutual funds or the equity markets are also interested in knowing about the relevant tax regulations and their implications in order to lower the amount of tax required upon the sale of these investments. The idea of discussing capital gains taxation using a question-answer or query-response format originated in this context.
2. Objectives of the study

- To evaluate the historical evolution of Capital Gains Taxation in India
- To analyze the Capital Gain evaluation on Stocks, Future & Options and on other asset classes.
- To overview the Capital Gain exemptions in India.

3. History of Capital Gains Taxation in India

The introduction of capital gains tax, which took effect in the 1947 Budget, was intended to stop speculative asset buying and selling in an inflationary climate following World War II. Section 12B of the Indian Income-tax Act, 1922 was then inserted, and the tax took effect in the 1947–1948 fiscal year. However, this levy was only in place for two years before being removed since it was thought to be impeding the expansion of the stock market.

On the advice of Professor Nicholas Kaldor, the Finance (No. 3) Act of 1956 reintroduced capital gains tax with respect to sales, exchanges, relinquishments, or transfers of capital assets made after March 31, 1956, with the goal of increasing tax revenue and based on the principle of equity in taxation. Since then, the capital gains tax has been a constant component of the Indian tax system. In the previous sixty years, India has made significant progress in the area of capital gains taxation.

4. The Evolution of Capital Gains Taxation in India

The capital gains taxation of listed securities has undergone significant changes over the past three decades, from the levy of a special tax rate of 20% on Long-Term Capital Gains (LTCG) after indexation in 1992 to the grant of exemption on LTCG earned from listed securities in 2004 [subject to levy of a nominal Securities Transaction Tax (STT)] and the reintroduction of LTCG tax on equities by the Finance Act, 2018. These changes have paved the way for increased investor participation in the stock market and, as a result, the deepening of the equity markets in India.

Capital gains taxation has, for the most part, always changed throughout history. The evolution of capital gains taxation has primarily taken two forms:

1. By rationalizing and streamlining the statutory provisions in order to close gaps and plug loopholes; and
2. By relieving the genuine hardship of taxpayers by occasionally loosening the strict application of the law.

Due to all of this, capital gains taxation in India has been able to adapt to the needs of a rapidly developing economy and to the changing times. In addition, capital gains taxation has proven to be a useful instrument for promoting economic development and growth by encouraging the allocation of capital gains towards high-priority economic sectors such as infrastructure, housing, agriculture, small and medium-sized businesses (SMEs), and rural electrification.

This often leads to confusion because equations do not balance dimensionally. If you must use mixed units, clearly state the units for each quantity that you use in an equation.

5. Legislative Measures to Improve Capital Gains Taxation

The Legislature has periodically taken the required actions to close the gaps and seal the openings in the current laws, suppressing any potential damage by enacting the necessary corrective measures to prevent tax evasion. For instance, Section 48 was replaced by the Finance Act, 1992 with effect from AY 1993–94 and forward, granting the benefit of indexation of cost of acquisition and cost of improvement on
transfer of long-term capital assets, in order to counteract the effect of price inflation over the period during which LTCG had arisen. This was done in response to recommendations made by the Chelliah Committee to rationalize the system of LTCG taxation. Some of the most crucial measures are as follows:

- Once again, section 50C was added to the law book with effect from AY 2003–04 in order to prevent widespread tax fraud through understating the consideration received for the sale of real estate at the time of transfer.
- Subsections (1) and (2) of section 55 were recently amended by the Finance Act, 2023 to state that the costs of acquisition and improvement of any intangible asset or other right—aside from those already mentioned in section 55(1)(b)(1) and section 55(2)(a)—of a capital asset shall be assumed to be nil.
- Over the years, the Legislature has also taken a number of actions to try to remove obstacles and lessen the actual suffering that the strict provisions of the Act have caused the taxpayers. Several notable instances in this context include the addition of a new section 45(5) to the Finance Act, 1987, effective January 04, 1988, which allows for the taxation of both initial and additional compensation in the year of receipt rather than the year of capital asset transfer through compulsory acquisition due to the significant time lag between the date of transfer and the date of compensation payment;
- The Finance (No. 2) Act, 1991, w.e.f. 01-10-1991, inserted a new section 54H, which states that the period for depositing or investing the capital gain in acquiring the new asset under sections 54, 54B, 54D, 54EC, and 54F shall be determined from the date of receipt of such compensation. The third proviso to section 50C (1) prescribes an exception limit of 5% as of 01-04-2019 and 10% as of 01-04-2021 for avoiding the substitution of stamp duty value for the declared sale consideration. Experts and observers on tax policy have long bemoaned and been hopeless about the complexity of direct tax legislation in India.
- The current income tax system has to be made more straightforward and sensible, both in terms of overall policy and the capital gains structure specifically. India's capital gains tax system, which applies to a variety of asset classes, including gold, real estate, and stock, and which specifies various holding periods, cost indexation procedures, and tax rates for each class, has been dubbed "a complex maze" in recent times.
- On the other hand, capital gains are the earnings that investor makes when they sell assets on the capital markets. Long Term Capital Gains (LTCG) tax applies to any stock held for longer than a year. Stocks held for less than a year are subject to the Short-Term Capital Gains (STCG) tax.
- At the moment, capital gains are subject to 15% tax on short-term capital gains and 10% tax on long-term capital gains (which are exempt up to ₹1 lakh).

6. Taxation on Stocks

- From 1948 onwards, capital gains were subject to progressive taxation, akin to the current income tax system, with taxes up to ₹15,000 being excluded. A progressive tax rate was applied on amounts over ₹15,000, with 31.3% tax applied to the highest category, which included amounts over ₹10,000,000.
- Capital gains taxation was eliminated in 1949 because it was thought to be impeding the expansion of the stock market.
- From 1957 to 1992: In an effort to raise tax income, capital gains were subject to permanent taxes.
- 1992–1999: Individuals were taxed at their slab rates up to 1991, but a significant drawback of this system was that inflation was not included in. Then, Dr. Manmohan Singh, the finance minister, established the idea of indexation, which raises procurement costs in line with the annual inflation rate
declared by the government. A unique LTCG provision was also implemented in the 1992 Union budget, imposing a 20% tax (indexed from April 1993 onwards). For stocks, the holding period under the LTCG was one year; for gold and real estate, it was three years.

- **From 1999 to 2004:** Yashwant Sinha, the finance minister, set a 10% tax ceiling. Taxpayers may choose to pay 10% of taxes without indexation benefits or 20% of taxes with it.

- **2004–2018:** P Chidambaram, the Minister of Finance, instituted STT (a tax imposed on the sale and purchase of shares) in 2004 in place of the LTCG tax. The ruling was historic and contributed to the growth of the Indian capital markets. (about five times growth between 2004 and 2018). Additionally, short-term capital gains were lowered from 15% to 10%. (which, in 2008, was raised to 15%).

- **2018–present:** A 10% LTCG tax rate was reinstated in 2018 (gains up to ₹1,00,000 excluded). The STCG tax is still 15%.

**Table 1: Valuation of short-term capital gain**

<table>
<thead>
<tr>
<th>Stock Name</th>
<th>BUY VALUE</th>
<th>SALE VALUE</th>
<th>GAIN (SALE-BUY) VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>L&amp;T</td>
<td>95,000</td>
<td>1,50,000</td>
<td>55,000</td>
</tr>
</tbody>
</table>

Short-term Gain on L&T is Rs. 55,000/-.
Short term capital gain tax = 55000 X 15% = 8250.

Example: Long term capital gain tax
Mr Peter bought 200 shares of TCS. At Rs 820 per share on 27th November 2017 and sold at Rs 1700 per share on 1st July 2021

Table-2: Valuation of short-term capital gain

<table>
<thead>
<tr>
<th>Stock Name</th>
<th>Buy Value</th>
<th>Sale Value</th>
<th>Gain (Sale - Buy) Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>TCS</td>
<td>164000</td>
<td>340000</td>
<td>176000</td>
</tr>
</tbody>
</table>

Long Term Gain on TCS = 176000 (Up to Rs 100000 is not taxed as per the provision)

Long term capital Gain Tax= (176000-100000) = 76000 X 10% = 7600

Table-3: Dividend Tax History

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax on Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>Taxed to shareholder</td>
</tr>
<tr>
<td>1997</td>
<td>Exempt</td>
</tr>
<tr>
<td>1999</td>
<td>Exempt</td>
</tr>
<tr>
<td>2002</td>
<td>Taxed to shareholder</td>
</tr>
<tr>
<td>2003</td>
<td>Exempt</td>
</tr>
<tr>
<td>2016</td>
<td>10% for dividends above ₹10 lakhs</td>
</tr>
<tr>
<td>2020 onwards</td>
<td>Taxed to shareholder</td>
</tr>
</tbody>
</table>

You have up to eight years to carry forward any unadjusted losses. If there is a capital loss, however, report it before the deadline in order to carry it forward and deduct it from any future capital gains. Before taxes, short-term capital losses are set off against both long-term and short-term capital profits and can be carried forward for up to eight years. Only before taxes can long-term capital losses be set off against long-term capital gains and carried forward for a maximum of eight years.

Intraday-day trading (speculative business income): Under income tax section 43(5), shares that are regularly acquired and sold within a brief period of time are classified as speculative business income rather than capital gains. This kind of income gain is subject to business income taxation, which is determined by the assesses tax slab rate.
7. Taxation on Futures and Options

Gains from F&O are not considered capital gains but business income. As these are considered non-speculative business gains, income tax is levied according to the applicable tax slab rates.

7.1 History of STT on Derivatives:
Since 2004, transactions involving equity and derivatives on the stock exchange are subject to securities transaction tax, or STT. After then, there have been significant adjustments to STT rates. For instance, compared to 2004, the rates of STT on equity and F&O have significantly decreased. Second, the concept of volumes in the case of derivatives has been refined. Due to this, the STT on futures transactions is still based on the transaction's notional value, but it is based on the premium value of options transactions. STT at the specified rate are now assessed on the intrinsic value rather than the settlement price as they were previously effective September 1, 2019, the date on which options are exercised. Furthermore, the distinction between the option's strike price and settlement price is known as intrinsic value.

![Figure-2: History of SST Derivatives](Source: icicidirect)

The accompanying graph illustrates how futures and options contribute to the turnover of equity derivatives. It is evident that the percentage of futures, which peaked at 89% in 2004–2005, has steadily decreased to 1% in the last several years. Compared to the STT payable on one lot of futures, the STT payable on one lot of options is significantly less. This is true even though the STT on options was just increased three times, from 0.017% to 0.05%. The rationale is that, although futures are charged STT on their notional value, options are charged STT on their premium value. One of the main causes of the option volumes' sharp increase in India has been this.

8. Taxation of Other Asset Classes

Popular asset classes among investors include stocks, bonds, mutual funds, fixed deposits, real estate, gold, and so forth. To reach their financial objectives, investors must allocate their assets properly. The
tax implications of different asset classes vary. distinct tax laws apply to the returns (or) gains produced by these distinct asset groups.

8.1 Gold and Immovable property
When it comes to real estate, assets kept for longer than 24 months are taken into account for LTCG. It is taken into account for gold held for more than 36 months. Both have a 20% tax rate.

8.2 Mutual Funds
Taxation on mutual funds is based on the classification they are in. The following lists various mutual fund types together with the relevant tax rates.

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Short-term capital gains</th>
<th>Long-term capital gains</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity funds</td>
<td>Shorter than 12 months</td>
<td>12 months and longer</td>
<td>STCG: 15%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LTCG: 10% (exempt up to 1 lakh)</td>
</tr>
<tr>
<td>Debt funds</td>
<td>Shorter than 36 months</td>
<td>36 months and longer</td>
<td>STCG: Tax Slab Rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LTCG: 20%</td>
</tr>
<tr>
<td>Hybrid equity-oriented funds</td>
<td>Shorter than 12 months</td>
<td>12 months and longer</td>
<td>STCG: 15%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LTCG: 10% (exempt up to 1 lakh)</td>
</tr>
<tr>
<td>Hybrid debt-oriented funds</td>
<td>Shorter than 36 months</td>
<td>36 months and longer</td>
<td>STCG: Tax Slab Rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LTCG: 20%</td>
</tr>
</tbody>
</table>

(Source: Cleartax)

8.3 Securities Transaction Tax (STT)
One type of financial transaction tax that resembles tax collected at source (TCS) is STT. Every purchase and sale of securities listed on recognised stock exchanges in India is subject to STT, a direct tax.

<table>
<thead>
<tr>
<th>Taxable securities transaction</th>
<th>Rate of STT</th>
<th>Person responsible to pay STT</th>
<th>Value on which STT is required to be paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery based purchase of equity share</td>
<td>0.10%</td>
<td>Purchaser</td>
<td>Price at which equity share is purchased*</td>
</tr>
<tr>
<td>Transaction Description</td>
<td>Tax Rate (%)</td>
<td>Party</td>
<td>Price at which equity share or unit is sold*</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------------------</td>
<td>--------------</td>
<td>-------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>Delivery based sale of an equity share</td>
<td>0.10%</td>
<td>Seller</td>
<td>Price at which equity share is sold*</td>
</tr>
<tr>
<td>Delivery based sale of a unit of oriented mutual fund</td>
<td>0.00%</td>
<td>Seller</td>
<td>Price at which unit is sold*</td>
</tr>
<tr>
<td>Sale of equity share or unit of equity oriented mutual fund in recognised stock exchange otherwise than by actual delivery or transfer and intraday traded shares</td>
<td>0.03%</td>
<td>Seller</td>
<td>Price at which equity share or unit is sold*</td>
</tr>
<tr>
<td>Derivative – Sale of an option in securities</td>
<td>0.02%</td>
<td>Seller</td>
<td>Option premium</td>
</tr>
<tr>
<td>Derivative – Sale of an option in securities where option is exercised</td>
<td>0.13%</td>
<td>Purchaser</td>
<td>Settlement price</td>
</tr>
<tr>
<td>Derivative – Sale of futures in securities</td>
<td>0.01%</td>
<td>Seller</td>
<td>Price at which such futures is traded</td>
</tr>
<tr>
<td>Sale of unit of an equity-oriented fund to the Mutual Fund – Exchange traded funds (ETFs)</td>
<td>0.00%</td>
<td>Seller</td>
<td>Price at which unit is sold*</td>
</tr>
<tr>
<td>Sale of unlisted shares under an offer for sale to public included in IPO and where such shares are subsequently listed in stock exchanges</td>
<td>0.20%</td>
<td>Seller</td>
<td>Price at which such shares are sold*</td>
</tr>
<tr>
<td>Purchase of Units of Equity Oriented Mutual Funds</td>
<td>Nil</td>
<td>Purchaser</td>
<td>Na</td>
</tr>
</tbody>
</table>

(Source: Cleartax)

9. Exemptions from Capital Gains

According to the Income-tax Act, capital gains or sale consideration may be exempt from capital gains tax if the gains are reinvested in new, designated assets. The following sections clarify how these exemptions are granted:

(a) **Section 54**: Investment in new residential house and transfer of residential house property are exempt from capital gains taxes.
Section 54B: Exemption from capital gains resulting from investing in new agricultural land and transferring land utilized for farming.

Section 54D: Exemption from capital gains resulting from the forced purchase of real estate and buildings that are used as a component of an industrial enterprise and that are purchased in order to establish or relocate the industrial undertaking.

Section 54EC: Investment in designated bonds and exemption from capital gains resulting from the transfer of land, building, or both

Section 54EE: Investment in designated assets and exemption from capital gains resulting from the transfer of any long-term capital asset

Section 54F: Exemption from capital gains resulting from investing in residential real estate and transferring a long-term capital asset other than a house

Section 54G: Capital gains exemption resulting from asset transfers during the relocation of an industrial enterprise from an urban to a non-urban area

Section 54GA: Capital gains exemption on asset transfers resulting from the relocation of an industrial enterprise from an urban area to a SEZ

Section 54GB: It provides an exemption from capital gains taxes on residential property transfers and investments in qualifying firms or eligible start-ups.

10. Findings

- It is found that to claim an exemption under Section 54 of the Income-tax Act, 1961, the taxpayer must utilize the capital gains to purchase or construct a new residential house within one year before or two years after the date of sale of the old property. The exemption is limited to the amount of capital gains used for the new property's purchase or construction subject to maximum of Rs 10 crore.
- In addition to Section 54, there are other provisions that offer rollover benefits or exemptions for capital gains arising from the sale of immovable property:
  - Section 54B: Exemption for reinvestment in another agricultural land
  - Section 54D: Exemption for reinvestment in another Industrial Land or Building
  - Section 54E: Exemption for reinvestment in specified bonds.
  - Section 54F: Exemption for reinvestment in another house property.
  - Section 54G: Exemption for reinvestment in Industrial Land & Building due to shifting from Urban area to Rural area
  - Section 54GA: Exemption for reinvestment in Industrial Land & Building due to shifting from Urban area to Special Economic Zone.
  - Section 54GB: Exemption for reinvestment in residential property in a notified area.
- Each exemption has its own set of eligibility conditions, such as holding period, investment period, and type of property. It's crucial to consult with a tax advisor to determine which exemption applies and whether you meet the eligibility criteria.
- The taxpayer must file a return disclosing the capital gains and the claimed exemption along with the required documentation. The tax authorities may scrutinize the claim and verify the utilization of sale proceeds for the specified purpose.
- The exemption is limited to the purchase or construction of one new residential house.
- The new property can be purchased in the joint names of the taxpayer and other family members. However, the exemption is granted only to the extent of the taxpayer's investment in the property.
• Capital gains from the sale of equity shares held for more than one year are taxed at a concessional rate of 10%, subject to certain conditions. For short-term capital gains (held for less than one year), the applicable tax rate is as per the individual's income tax slab.

• Investors can consider various strategies to minimize their tax liability:
  o Long-term holding: Holding equity shares for more than one year to avail of the lower tax rate.
  o Tax harvesting: Selling losing investments to offset capital gains from winning investments.
  o Investing in tax-efficient funds: Opting for equity mutual funds that follow a dividend reinvestment plan (DRIP) or tax-efficient index funds.
  o Utilizing capital losses: Utilizing capital losses from the sale of equity investments to reduce taxable income.

• It's important to consult with a tax advisor to tailor a tax-efficient investment strategy based on your individual circumstances and risk tolerance.

11. Recommendation
Capital gains arising from the sale of immovable property, such as residential houses or agricultural land, can be minimized or eliminated by taking advantage of various tax exemptions and rollover provisions under the Income-tax Act, 1961. These provisions typically involve reinvesting the sale proceeds into specific assets within a specified period. For capital gains from the sale of equity shares, the tax liability can be reduced by holding the shares for more than one year to avail of the lower long-term capital gains tax rate. Additionally, investors can employ strategies like tax harvesting and utilizing capital losses to further optimize their tax position. It is crucial to consult with a tax advisor to determine the most suitable tax-saving strategies based on your individual circumstances, investment goals, and risk tolerance.

12. References


