Capital Gains – An overview

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Computation Of Total Income

Capital Gains is an important head of income

• Income from Salary	xxx
• Income from House Property	xxx
• Profits & Gains from Business/Profession	xxx
• Capital Gains (Section 45)	xxx
• Income from Other Sources	xxx

What is Capital Gains

Profits or gains arising from transfer of a capital asset are called "Capital Gains" and are charged to tax under the head "Capital Gains".

- There should be a **Capital Asset**
- Capital Asset should be **transferred** during the previous year
- **Gains/Loss** has to be computed
- **Tax** has to be paid on such gains

What are Capital Assets?

It includes all types of assets whether movable/immovable, tangible/intangible etc.,

but **<u>excludes</u>** the following

a) Stock in trade, consumable stores/raw materials held for the purpose of business/profession

b) Personal effects including wearing apparel and furniture **<u>other than</u>**

   i. Jewelry

   ii. Archaeological collections

   iii. Drawings/Paintings/any work of art

c) Agriculture land in India (Conditions applied)

d) Special Bearer Bonds

e) Gold Deposit Bonds issued under Gold Deposit Scheme 1999 or deposit certificates issued under Gold Monetization Scheme 2015

Types of Capital Assets

- **SHORT TERM**

  In case of shares of a company listed on a recognized stock exchange in India and Zero Coupon bonds, if the holding period does not exceed 12 months then Short Term

  In case of shares of unlisted company, if the holding period does not exceed 24 months then Short Term

  In case of other assets if it is held less than 36 Months then they are Short Term capital assets.

- **LONG TERM**

  As per Section 2(29A) of Income-tax Act, 1961, long-term capital asset means an asset which is not a short-term capital asset.

Meaning of transfer

- The term “Transfer” has got a very wide meaning under Income-tax Act

- It includes:
  - Sale, exchange or relinquishment of capital asset.
  - Extinguishment of any rights in the capital asset.
  - Compulsory acquisition of any capital asset under any law.
  - Conversion of a capital asset into stock-in-trade.
  - Distribution of capital assets on Dissolution.
  - Distribution of money or other assets by the company on liquidation.
  - Maturity or redemption of a zero coupon bond

What is not a transfer??

The following transfers will not be treated as transfers in the hands of transferor for the purpose of computing capital gains:

- Any capital asset distributed by the HUF to any member of the HUF in total or partial partition of a HUF.
- Transfer of a capital asset under a gift or will or irrevocable trust.
- Transfer by a Holding Company to its 100% Subsidiary Company and vice versa.
- Conversion of any bonds, debentures, debenture stocks, deposit certificates of a company into shares or debentures of that company.
- Conversion of all assets and liabilities of a Sole Proprietary concern into a Company immediately prior to conversion.
- Transfer in a transaction of Reverse Mortgage.

Relevance of bifurcation into Long term and Short term gains

- The taxability of capital gains depends on the nature of gain, i.e., whether short-term or long-term. Hence, to determine the taxability capital gains are classified into short-term capital gain and long-term capital gain.

- In other words, the tax rates for long-term capital gain and short-term capital gain are different.

Meaning of certain terms

- **Full Value Consideration:** It means the amount the transferor is entitled to receive on the sale of the property/asset which may be in cash or kind.

- **Cost of Acquisition:** It is the price which the assesse has paid for acquiring the asset.

- **Cost of Improvement:** It is the expenditure incurred by an assessee in making any addition/improvement to the asset.

Cost of acquisition of a capital asset

- Generally, cost of acquisition of a capital asset is the cost incurred in acquiring the capital asset. It includes the purchase consideration plus any expenditure incurred exclusively for acquiring the capital asset.
- However, in respect of **capital asset acquired before 1st April, 1981, the cost of acquisition will be higher of the actual cost of acquisition of the asset or fair market value of the asset as on 1st April, 1981**.
- In case the capital asset is acquired before 1st April 1981, indexation will be applied taking indexation rates as on 1st April 1981. The amount arrived at will be called the Fair Market Value of the asset as on 1st April 1981.
- This option is not available in the case of a depreciable asset.
- The cost of acquisition of bonus shares is always considered as nil.

Cost of acquisition in case of Gifted / Inherited properties

- Cost: The cost of acquisition of the asset acquired by way of gift/inheritance will be the cost to the previous owner.

- Period: In case of a capital asset which becomes the property of the assessee by way of gift or inheritance the period will be taken as the period for which the asset was held by the previous owner.

- Indexation: In case of long term capital asset which was acquired by way of gift or inheritance, the transferor will get the benefit of indexed cost of acquisition or indexed cost of improvement taking the indexation from the period when it was acquired by the previous owner and not from the period when it was received as gift or inheritance.

INDEXATION BENEFIT

Indexation is nothing but working out the value of asset based on cost inflation index.

This benefit is given to tax payers to ease the burden of inflation

The idea is to not tax the increase in value of an asset on account of inflation. What should get taxed is only the appreciation in the value and not the depreciation in the Rupee

Indexed Cost calculations

- **Indexed cost of acquisition is computed with the help of following formula:**

$$\text{Cost of acquisition} \times \frac{\text{Cost inflation index of the year of transfer of capital asset}}{\text{Cost inflation index of the year of acquisition}}$$

- **Indexed cost of improvement is computed with the help of following formula:**

$$\text{Cost of improvement} \times \frac{\text{Cost inflation index of the year of transfer of capital asset}}{\text{Cost inflation index of the year of improvement}}$$

Cost Inflation Index Rates

FINANCIAL YEAR	COST INFLATION INDEX	FINANCIAL YEAR	COST INFLATION INDEX
2016-17	1125	1998-1999	351
2015-16	1081	1997-1998	331
2014-15	1024	1996-1997	305
2013-14	939	1995-1996	281
2012-13	852	1994-1995	259
2011-12	785	1993-1994	244
2010-2011	711	1992-1993	223
2009-2010	632	1991-1992	199
2008-2009	582	1990-1991	182
2007-2008	551	1989-1990	172
2006-2007	519	1988-1989	161
2005-2006	497	1987-1988	150
2004-2005	480	1986-1987	140
2003-2004	463	1985-1986	133
2002-2003	447	1984-1985	125
2001-2002	426	1983-1984	116
2000-2001	406	1982-1983	109
1999-2000	389	1981-1982	100

Illustration for indexed cost calculation

Mr. Robert purchased a piece of land in Gurgaon in May, 2004 for Rs. 84,000 and sold the same in April, 2015 for Rs. 10 crores (Brokerage paid by him for sale is Rs. 100,000). What will be the indexed cost of acquisition?

Solution: The cost inflation index notified for the year 2004-05 is 480 and for the year 2015-16 is 1081.Hence, the indexed cost of acquisition, i.e., the inflated cost of acquisition will be as follows:

$$= \text{Cost of acquisition} \times \frac{\text{Cost inflation index of the year of transfer of capital asset}}{\text{Cost inflation index of the year of acquisition}}$$

$$= \frac{\text{Rs. } 84{,}000 \times 1081}{480} = \text{Rs. } 1{,}89{,}175$$

Computation of Long term Capital Gains

In this example, the computation of capital gains will be as follows:

Particulars	Rs.
Full value of consideration (i.e., Sales consideration of asset)	10,00,00,000
Less: Expenditure incurred wholly and exclusively in connection with transfer of capital asset (brokerage)	100,000
Net sale consideration	9,99,00,000
Less: Indexed cost of acquisition as calculated above	1,89,175
Long Term Capital Gains	9,97,10,825

Tax on long-term capital gain @ 10% in certain special cases

Generally, long-term capital gains are charged to tax @ 20% (plus surcharge and cess as applicable), but in certain special cases, the gain may be (at the option of the taxpayer) charged to tax @ 10% (plus surcharge and cess as applicable). This benefit is available only in respect of long-term capital gains arising on transfer of any of the following assets:

(a) Any security which is listed in a recognized stock exchange in India (other than units of mutual funds); and

(c) Zero coupon bonds.

It is left to the tax payer to select the option best suited to him

Illustration

Mr. Kanhaiya a young collegian aged 35 years purchased 100 equity shares (listed) of Bharat Mata Ltd. in December 2005 for Rs. 20,000. These shares are sold in August 2015 for Rs. 5,00,000 to his mentor Ms. Charkha Dot in an off market deal. What will be his tax liability on the capital gains?

In this situation, Mr. Kanhaiya has following two options:

Particulars	**Option 1** **(Avail indexation)**	**Option 2** **(Do not avail indexation)**
Full value of consideration	5,00,000	5,00,000
Less: Indexed cost of acquisition (Rs. 20,000 × 1081/497)	43,501	
Less: Cost of acquisition		20,000
Taxable Gain	**4,56,499**	**4,80,000**
Tax @ 20% on Rs. 4,56,500	91,300	
Tax @ 10% on Rs. 4,80,000		48,000

It's obvious that the tax payer will exercise Option 2

Computation of Short term Capital Gain

Mr. Cageywall is a salaried employee working in Permanent Agitations Ltd. at an annual salary of Rs. 4,20,000. In December, 2015 he purchased 10,000 equity shares of Nautanki TV Ltd. at Rs. 100 per share and sold the same in April, 2016 at Rs. 125 per share (brokerage paid - Re. 1 per share). The shares were sold through Bombay Stock Exchange and Securities Transaction Tax was paid. What will be the short term capital gains of Mr. Cageywall?

Particulars	Rs.
Full value of consideration (i.e., Sales consideration ,i.e., Rs. 125 × 10,000 shares)	12,50,000
Less: Expenditure incurred wholly and exclusively in connection with transfer of capital asset (i.e., brokerage)	(10,000)
Net sale consideration	12,40,000
Less: Cost of acquisition (i.e., purchase price, i.e., Rs. 100 × 10,000 shares)	(10,00,000)
Short Term Capital Gains	2,40,000

Exemption under Capital Gains – section 54

Available only to INDIVIDUALS & HUFS

Capital Gains from?	Conditions to be satisfied	Amount of exemption
Transfer of any residential house property	• It should be one residential house property • It should be a **long term** capital asset • New residential house to be purchased within one year before or 2 years after transfer or construction should be completed within 3 years from the date of transfer	Actual amount invested or capital gains whichever is less

Exemption under Capital Gains – section 54EC

Available to all assessees

Capital Gains from?	Conditions to be satisfied	Amount of exemption
Transfer of any Capital Asset	• The asset should be a **long term** capital asset • Capital gains should be invested within a period of 6 months from the date of transfer in bonds issued by NHAI or RECL redeemable after 3 years.	Actual amount invested or capital gains whichever is less subject to maximum of Rs. 50 lakhs total

Exemption under Capital Gains – section 54F

Available only to INDIVIDUALS & HUFS

Capital Gains from?	Conditions to be satisfied	Amount of exemption
Transfer of any Capital Asset **other than** a residential house property	• It should be a **long term** capital asset • New residential house to be purchased within one year before or 2 years after transfer or construction should be completed within 3 years from the date of transfer • The assessee should not hold more than one house property on the date of transfer • The assessee should not purchase within one year or should not construct within 3 years, any other residential house	• If the cost of new house property is more than the amount of net sales consideration, then whole amount of capital gains. • If the net sales consideration is more than the cost of new house amount of exemption will be calculated as: $\frac{\text{Capital gains x Amount invested}}{\text{Net sales consideration}}$

Section	Assessee	Conditions to be satisfied	Amount of exemption
54B**	Individual	• It should be an agricultural land • The land must have been used for agricultural purposes either by assessee or his parent in 2 years immediately preceding the date of transfer • Another agricultural land should be purchased within 2 years after date of transfer	Actual amount invested or capital gains whichever is less
54D**	Assessee should be an industrial undertaking	• There should be compulsory acquisition of land and building which forms part of an industrial undertaking • The asset should have been used in the 2 years immediately preceding the date of transfer for the business of the undertaking • Within 3 years after the date of compulsory acquisition any other land or building should be purchased or constructed for the use of existing or newly set up industrial undertaking	Actual amount invested or capital gains whichever is less

Section	Assessee	Conditions to be satisfied	Amount of exemption
54G**	Assessee should be an industrial undertaking	• Machinery, plant, building or land used for the business of an industrial undertaking situated in urban area should be transferred due to shifting to any area other than urban area • Plant/machinery should be purchased or land/building should be acquired and shifting should be completed within a period of 1 year before or 3 years after the date of transfer	• If cost of new assets and expenses incurred for shifting are more than the capital gains then the whole amount of capital gains • Otherwise capital gains to the extent of cost of new asset
54GA**	Assessee should be an industrial undertaking	• Machinery, plant, building or land used for the business of an industrial undertaking situated in urban area should be transferred due to shifting to any Special Economic Zone whether developed in any urban area or any other area • Plant/machinery should be purchased or land/building should be acquired and shifting should be completed within a period of 1 year before or 3 years after the date of transfer	• If cost of new assets and expenses incurred for shifting are more than the capital gains then the whole amount of capital gains • Otherwise capital gains to the extent of cost of new asset

** Exemption from short term capital gains is allowed only in case of these sections

Budget 2016 – Capital Gains Exemptions

- New section 54EE inserted to provide exemption from capital gains tax if the long term capital gains proceeds are invested in units of specified fund as may be notified by the Central Government. The investment in the units of the specified fund shall be allowed up to Rs. 50 lakhs. The investment has to be kept for three years failing which the exemption shall be withdrawn.

- The existing provisions of section 54GB is amended to extend the benefit of exemption from tax on long term capital gains in respect of the gains arising on account of transfer of a residential property, if such capital gains are invested in subscription of shares of a company which qualifies to be an eligible start-up subject to the condition that the individual or HUF holds more than fifty per cent shares of the company and such company utilizes the amount invested in shares to purchase new asset including computers or computers software.

Consequences if the new asset acquired is transferred within 3 years of its acquisition:

- **Under Sections 54, 54B, 54D, 54G and 54GA :**

➢ The new capital gains computed will be Short term capital gains.

➢ The cost of acquisition of such new asset shall be reduced by the amount of Capital Gain exempt under sections 54, 54B, 54D, 54G and 54GA.

- **Under Section 54F:**

➢ The new capital gains computed will be Short term capital gains.

➢ The capital gains exempt earlier under section 54F will be long term capital gain of the previous year in which asset is transferred

- **Under Section 54F:**

➢ If such security or bond is converted into money or if any loan is taken against it then the capital gains exempt earlier under Section 54EC shall be Long-term Capital Gain of the previous year in which such conversion takes place or loan is acquired.

Consequences if the amount deposited in Capital Gain Account Scheme is not utilized within the stipulated time of 3 years (2 years in case of Section 54B)

- The unutilized amount shall be Capital Gain (Long-term or short-term depending on original transfer) of the previous year in which such period has expired.

- However, in case of Section 54F, only the proportionate amount shall be taxable.

Capital Gains Account Scheme

- The Capital Gains Account Scheme was introduced in the year 1988, and as per the scheme the amount of capital gains to be claimed as an exemption should be either reinvested or deposited in the Capital Gains Account before the due date of filing of returns.
- As per the Income-tax Act, the taxpayer is allowed some time (2/3 years) to invest the capital gains in specified instruments. However in many cases the due date for filing income tax returns for the year in which the capital gains arises is before the expiry of the specified period.
- To avoid such issues, the Income-tax Act prescribes that the taxpayer should deposit the amount of capital gains in the capital gains accounts scheme on or before the due date of filing of income tax returns which can be easily withdrawn at the time of investment in the specified instrument.

Section 10(38) Exemption for Long Term Capital Gain

Section 10(38) of the Income tax Act, exempts following income:

Any income arising from the transfer of a long-term capital asset, being an equity share in a company or a unit of an equity oriented fund where such transaction is chargeable to Securities Transaction Tax (STT)

Therefore, the shares have got to be listed shares

Capital Gains or Business Income?

Surplus on sale of shares treated as capital asset will be taxed under “Income from Capital Gains” whereas those treated as stock-in-trade will be taxed under “Income from Business and Profession.”

What difference does that make?

- In case of listed shares it makes a huge difference!
  - If there is a LTCG, it is exempt from tax
  - If there is a STCG, it is taxable at only 15%
- But if it is treated as a business, then the tax concessions are **NOT** available. Exemptions u/s. 54, 54EC, 54F etc. are **NOT** available.

- In case of business, income, deductions can be claimed. In case of capital gains, only cost and expenses incurred to earn the income can be claimed.
- In case of business income, deductions under Chapter VI A can be claimed. In case of capital gains, against long term/short term capital gains.

Capital Gains or Business Income

So when can income be taxed as Capital gain or Business income?

- One of the most important criteria to be applied is the intention of the tax payer.
  - Where the purchase has been made with the sole intention of resale at a profit and the purchaser does not have any intention to hold the property, the presence of such an intention would raise a strong presumption that the transaction is in the nature of trade and such securities shall be treated as stock in trade and thus profit will be treated as business income.
  - However in case one invests in securities for the sole purpose of earning dividends/interest over the years, the same cannot be treated as stock in trade and any profit on sale of such asset will have to be treated as capital gains.
- In case of stock brokers, any purchase and sale of securities shall be treated as business income unless there are other circumstances to warrant other treatment like intention to hold it for generating regular income in future.

Capital Gain or Business Income – highly debatable issue

- High volume of transactions
- High frequency of transactions
- Whether delivery taken or not
- Period of holding
- Whether an organized activity?
- How much time is devoted to this activity?
- Whether borrowed funds used or own funds?

Capital Gain on conversion of Capital Asset into Stock-in-trade Section 45(2)

- Transfer includes conversion of capital asset into stock in trade u/s 2(47)(iv) of the Income Tax Act.
- Under section 45(2) Capital gains arising from the conversion of Capital asset into stock in trade shall be charged to tax in the year in which the stock in trade is sold or otherwise transferred by the assessee.
- For the purpose of computing capital gains, the fair market value of the assets on the date of the conversion shall be deemed to be sale consideration for the purpose of Section 48.
- Capital gains will be calculated as per the provisions of law applicable in the year in which the stock is sold.

Section 50C of the Income-tax Act

- Section 50C provides that if the value stated in the instrument of transfer is **less** than the valuation adopted, assessed or assessable by the stamp duty authorities, then the stamp duty value will be considered for computing the capital gains arising on transfer of land or building or both.
- For example if in the agreement for sale, the value of the flat is stated at Rs. 24 lacs but according to the stamp duty authorities the valuation of the flat is Rs. 34 lacs, then it will be considered that the flat has been sold for Rs. 34 lacs and capital gains will be computed on the basis of Rs. 34 lacs.
- Budget 2016 has proposed that where the date of the agreement fixing the amount of consideration for the transfer of immovable property and the date of registration are not the same, the stamp duty value on the date of the agreement may be taken for the purposes of computing the full value of consideration.

Treatment of Advance money received and forfeited

- An asset was subject to negotiations for transfer and a deal was made.
- The deal was firmed by receiving some amount as advance (token money)
- The advance was received by the assessee
- The deal is then cancelled & the advance is forfeited.
- The cost of the asset shall be reduced by such advance money received and forfeited by the assessee. In case FMV as on 01.04.1981 is adopted and advance money is received either before or after this date and is forfeited, it shall be reduced from the FMV.
- Cost of Acquisition for assessee forfeiting advance money = Cost of acquisition or W.D.V. or F.M.V. as on 01.04.1981 *less* Advance money received and forfeited

Capital gains on sale of Agricultural land

- Gain from sale of non-agriculture land is taxable as capital gain.
- Gain from sale of agriculture land is taxable only if it is located within 8 kilometers from the urban limits.
- Hence capital gains from sale of agricultural land situated in rural area is not liable to tax

Treatment of losses under the head 'Capital Gains'

- Short Term Capital Loss can be set off against gain any other Capital Gain (Long Term or Short Term) in the same year.
- Long Term Capital Loss can be set off **only against any other Long Term Capital Gain** of the same year.
- Capital Loss **CANNOT** be set off against any other income (salary, business etc.) It has to be carried forward to next assessment year separately as Short Term / Long Term Capital Loss.
- In the next year, the STCL can be set off against any capital gains (Long Term or Short Term) and the LTCL can be set off only against Long Term Capital Gains of that year. Any unabsorbed loss after such set off can be further carried forward to the next assessment year.
- Capital Loss can be carried forward for **eight assessment years** and set off as above.

Treatment of losses under the head 'Capital Gains'

- But what if you have made a Long Term Capital Loss from sale of listed shares?
- Can you set off taxable Long Term Capital Gains (say from house property) against such a loss?

Expenses in a share transaction

When we buy or sell shares through a broker, the following charges would be levied in the broker's contract note:

- The strike rate at which the transaction is carried out (purchase/sale rate)
- Brokerage
- Service tax on the brokerage & education cess thereon
- Stamp duty
- Securities Transaction Tax (STT)

The STT paid is not allowed as an expense. Everything else can be added to the cost or reduced from the sale price

Dividend Stripping

What is Dividend Stripping?

Dividend stripping was a strategy used by investors to reduce the tax burden. By this an investor would get tax free dividend by investing in shares shortly before the record date (date of receipt of dividend by the holder of shares) and exiting after the record date at a lower price, thereby incurring a short-term capital loss. This short-term capital loss is compensated with the tax free dividend. The investor would set off the loss against other capital gains or carry it forward.

Dividend Stripping

- Section 94(7) was introduced to curb the practice of dividend stripping.

- By virtue of this, if any person buys any shares/units of MF within a period of 3 months prior to the record date and transfers the shares/units within a period of 3 / 9 months respectively after such record date and earns dividend income (which would be exempt) then the loss, if any, arising out of the transaction to the extent of the dividend income earned from the same, shall be ignored & cannot be set off against other gains.

Bonus Stripping

Bonus stripping is similar to dividend stripping. Loss arising on account of sale of original **units** (and **not** shares) shall be ignored if the following conditions are satisfied:

- The person buys any units within a period of 3 months prior to the record date
- He is allotted additional units (bonus units) without any payment for the same
- He sells all or any of the units excluding bonus units within a period of 9 months after such date
- On date of sale or transfer he continues to hold all or any of additional units.

The amount of loss so ignored shall be deemed to be cost of purchase or acquisition of such additional units as are held by him on the date of such sale or transfer

Only Exempt Capital Gains? Filing of return may be compulsory!

Budget 2016 has provided for mandatory filing of return of income by a person if, such person has only earned exempt LTCG from equity shares / equity oriented funds which is exempt under Section 10(38) and who is otherwise not required to file return of income for the year.

Now such persons having taxable income below the threshold limit but if the total income including exempt income is above the limits then such person has to mandatorily file return of income in the prescribed form and in the manner prescribed under the Act.

Here, the importance of indexing the cost for computing gains gets highlighted!

Please note – the above does not apply to exempt income like dividend on shares, interest on PPF etc. So, if you have only such income and your taxable income is below threshold limit, you don't need to file a tax return.

Documents and records to be maintained

- Broker's contracts for sale and purchase of shares/securities.
- Proof of any expense that you wish to claim (e.g. brokerage, lawyer's fees etc.)
- Receipts for modifications and capital expenses such as addition or improvements.
- Sales deeds of property sold / purchase dee of property bought
- Statements from Depository Participants or D-mat statements from banks or transaction history from stock brokers.
- Pass book of capital gains account scheme
- Details of money borrowed and interest paid in relation to acquisition of capital asset.
- Records of fair market valuation carried out by a recognized valuer.
- Wills and trust deeds in case of capital asset received as inheritance

Its in the AIR !

- Remember that all high value transactions that you enter into (whether purchase or sale) are reported to the Income-tax department in the Annual Information Reports (AIR).
- So, ensure that what you report in the income-tax return is the correct information

Advance Tax

- Don’t forget to pay advance tax on the capital gains
- If you are a senior citizen and do not have business income then you are exempted from paying Advance Tax
- Be careful about interest u/s. 234C

Thank You

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