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Capital Gains Tax in Theory and Practice

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ABSTRACT

Capital gains arise from the sale of assets other than those held in the ordinary conduct of business. For example, gains from the sale of a house by the house owner are capital gains while gains from appreciation in the value of houses held by a real estate dealer are ordinary gains of business. A decrease in the value of an asset is called a capital loss. In India, capital gains tax is levied within the framework of Indian Income Tax Act, 1961. Sections 45 to 55A of the Act relate to the taxation of capital gains. Since capital gains are not annual accruals from a given source but represent appreciation in the market value of assets over a period of time, they are treated on a different footing. The preferential treatment is given to long-term capital gains only. This paper examines the various theoretical issues associated with the taxation of capital gains and the present system of taxing capital gains in India.

Keywords: *Capital gains, Inflation indexing, Transfer of assets.*

1.0 Introduction

Capital gains arise from the sale of assets other than those held in the ordinary conduct of business. For example, gains from the sale of a house by the house owner are capital gains while gains from appreciation in the value of houses held by a real estate dealer are ordinary gains of business. A decrease in the value of an asset is called a capital loss. The procedure to compute capital gains involves the following steps. Firstly, the full value of consideration received or accruing as a result of the transfer of the asset is ascertained. The second step is to deduct from the full value of consideration (a) the cost of acquisition of the asset including cost of any improvements made to the asset, and (b) expenditure incurred in connection with the transfer of such asset (brokerage, legal expenses etc.).

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1.1 Capital gains tax

It is a tax on the increase in capital value of an asset. Treatment of capital gains is a controversial issue in determining the scope of income for the purpose of taxation. What is the justification for taxing capital gains?

Justification for taxing capital gains

According to the widely accepted net accretion principle (attributed to Robert Haig and Henry Simons), income is defined as the net accretion to economic power between two periods of time, or what accrues to an individual over a period of time, as measured by the amount of his spending plus net accretion to his wealth. Stated comprehensively, this definition of income takes into account (a) cash income, e.g. wages, interest received, or dividends, (b) imputed income such as imputed rent from owner-occupied houses, and (c) accrued income like interest credited (instead of paid), and appreciation in the value of assets which continue to be held (capital gains). Capital losses should be set off against capital gains and net capital losses should be treated as a reduction in income (economic power) of an individual [1].

Thus, in terms of net accretion principle, capital gains should be taxed as part of income. Their taxation is justified both on equity and efficiency considerations. From equity angle, their inclusion in the income tax base is required because capital gains represent, like other sources of income, net accretions to spending power. The case for taxation of capital gains is further strengthened for they accrue unevenly among the population because wealth is unevenly distributed. On efficiency ground, the taxation of capital gains discourages investment in unproductive assets (like gold, paintings, antiques etc.) and speculative activities.

It is sometimes argued that capital gains are unexpected and unsought for and, therefore, should not form part of taxable income. Disagreeing, James Cutt in his book *Taxation and Economic Development in India* (1969) observed, "Even acceptance of the fact that a proportion of capital gains represent windfall or unexpected elements in no way diminishes the increase in satisfaction or increase in spending power derived from their acquisition. It is also far from certain that a substantial proportion of capital gains represent unintended, fortuitous receipts. Capital gains differ only in degree from other forms of income and are often deliberately sought." (Cutt, 1969).

The opponents of taxation of capital gains contend that gains resulting from inflation are illusory in real terms and therefore do not represent a real increase in the taxpayer's spending power. Taxes on capital gains which merely compensate for the rise in price level are more in the nature of taxes on wealth than on increments in the value of wealth. Undoubtedly, an inflation-proof tax system is more certain and equitable in an inflationary economy but this is an ideal situation for all sources of income and not only for capital gains alone. Pragmatically, the solution lies in revision of exemptions and allowances in the light of inflation rates. Moreover, it is not unreasonable to assume that real estate prices, during inflation, move upward more quickly than the general index of prices.

To compensate for the inflationary rise in the value of an asset, it might be suggested to increase the acquisition cost by the rate of inflation in the period between acquisition and realisation. However, taxation of capital gains only on realisation enables the taxpayer to postpone his tax liability until the date of realisation, and thus confers on him an interest earning advantage. According to J.E. Meade Committee Report on The Structure and Reform of Direct Taxation (1978), "The benefit of deferral is a loan free of interest of an amount equal to the tax liability on accrued gains. Thus, suppose that a gain of £100 accrues in 1975 and is realised in 1977. With a rate of tax of 30 per cent, £30 in tax is paid on a realisation basis in 1977 instead of in 1975. The taxpayer has kept the £30 for two years free of interest. If the tax paid in 1977 is to reflect this fact, then the £30 should be grossed up at compound interest for two years. To achieve this result, it would be necessary to mark up the deferred tax liability by an interest rate factor. This process can be contrasted with the allowance for inflation, where it is necessary to mark up the acquisition cost by an inflation factor." (Institute for Fiscal Studies, 1978)

The Meade Committee devised a formula for reducing the tax burden according to inflation factor and increasing it by interest factor. Apparently, the net effect will depend upon the rate of inflation and the interest rate assumed.

Critics argue that taxation of capital gains discourages the transfer of assets (e.g. selling and buying of shares or real estate) and therefore restricts the mobility of capital. Since transfers occasion a tax, investments remain tied up in their present form. The argument is untenable because most transfers are

speculative in nature and cancel out at the national level, and are not related to issues in economic development. It is the investment in new equity which is more relevant in ensuring a higher growth rate.

In short, there exists a case for taxing capital gains.

1.2 Realised versus unrealised capital gains

Normally, the scope of capital gains tax is restricted to realised capital gains. Even in the case of realised capital gains, a selective approach is followed because it is neither desirable nor practicable to tax capital appreciation of all types of assets. It would be unwise to ask a taxpayer to report capital gain arising from the sale of his washing machine or some other household article. In practice, the scope of the capital gains tax is restricted to realised capital gains from the sale of stocks, real estate, jewellery etc. Even these assets pose serious problems because valuation is required both when an asset is bought and when it is sold. Valuation is simple for shares quoted in the stock exchange but it is a difficult problem in case of assets which are not regularly traded in the market. There is no escape from the valuation problem and the tax administration has to grapple with it.

Taxation of unrealised capital gains is still more controversial. The various arguments against and for taxation of unrealised capital gains are best summarised by R.A. Musgrave and P.B. Musgrave. (Musgrave and Musgrave, 1985)

Arguments against taxation of unrealized capital gains

1. Unrealised gains should not be taxed because the owner has refrained from consumption.
2. Unrealised gains should not be taxed because in the absence of realisation we do not know whether they really exist.
3. Taxation of unrealised gains requires the owner to pay a tax even though he or she has not obtained cash with which to pay it.
4. For income to be received, it must be separated from the asset.

Arguments for taxation of unrealized capital gains

1. Absence of consumption is not relevant in defining the base of an income tax.

2. Measurement of unrealised gains may be difficult, but this is not an insuperable obstacle.
3. As would be necessary with other debts that may become due, it is not unreasonable to ask the tax payer to liquidate a part of his or her assets to make the tax payment if needed.
4. Separation is a matter of investment choice whereas income accrues when the asset value is increased.

Strictly speaking, unrealised capital gains are part of accretion (to wealth) and should be included in the definition of income for tax purposes. In the long-run, the distinction between unrealised and realised capital gains is not important because unrealised gain is realised at one time or the other during the life time of an individual or at the time of his death. Because the sums of unrealised and realised gains equal, the life-time tax obligation of an individual is said to remain the same provided there are no significant changes in the rate structure.

Despite the foregoing theoretical justification for taxing unrealised capital gains, it is difficult to incorporate them in tax laws in view of various practical problems. For one, it would require valuation of capital assets each year, imposing considerable burden on administration. It is, of course, relatively easy to estimate accrued capital gains each year for some assets (like regularly quoted ordinary shares) but for most other assets it would be a Herculean task. Therefore, tax laws of countries invariably exempt unrealised gains and bring under the purview of taxation only realised capital gains.

1.3 Short-term versus long-term capital gains

Incidence of tax on capital gains depends upon whether such gains arise from the sale of a short-term or a long-term capital asset. Gains from the sale of assets held for less than a specified period are short-term while gains from the sale of assets held over that period are treated as long-term. Generally, short-term gains are taxable like ordinary income while long-term gains enjoy tax concessions.

Is preferential treatment of long-term capital gains justified? One argument in favour of such preferential treatment is that capital gains are irregular and therefore tend to suffer under a system of progressive tax schedule. In other words, preferential treatment is a compensation for the absence of

income averaging provisions in tax laws. Juxtaposed against this disadvantage are certain advantages which are available to income only in the form of capital gains. As already noted, there is an interest earning advantage for deferred tax payment on capital gains. Moreover, tax liability can be postponed indefinitely by not realising capital gains. If the gains are allowed to accumulate in this manner, they will ultimately be transferred in the form of gifts or bequests to other persons. To deal with such eventualities, gift and estate taxes provide the second line of defence. However, gift and estate taxes are neither regular nor effective components of tax structure in most countries. These taxes, which apply to value rather than the change in the value of property, carry a wide amplitude of exemptions/concessions and therefore form a small proportion of total tax revenue even in the most developed countries of the world. In many countries these taxes do not exist and in others they have been abolished after unsuccessful experiments [2].

Moreover, as a proxy for income averaging provisions, it is common in the tax laws of countries to allow set off and carry forward of capital losses. In view of these safeguards, the concessionary tax treatment of capital gains is unjustified. Such preferential treatment provides a strong incentive, particularly at high bracket rate, to receive income in the form of capital gains rather than, say business profits, a tendency not conducive to positive entrepreneurship in an economy.

2.0 Taxation of Capital Gains in India

A tax on capital gains was in operation in India for a short period in respect of capital gains which arose during the period April 1, 1946 to March 31, 1948. Following the recommendations of British economist Nicholas Kaldor, the tax was revived in 1956 and made applicable on capital gains arising on or after April 1, 1956. It is levied within the framework of Indian Income Tax Act, 1961. Section l4 of the Act prescribes five broad heads under which the income of an assessee is classified for purposes of computation of total income and the charge of income tax. These are: salaries, income from house property, profits and gains of business or profession, capital gains, and income from other sources. Sections 45 to 55A of the Act relate to the taxation of capital gains. Since capital gains are

not annual accruals from a given source but represent appreciation in the market value of assets over a period of time, they are treated on a different footing. The preferential treatment is given to long-term capital gains only.

2.1 Meaning and scope of capital gains tax

According to Section 45 of the Act any profits or gains arising from the transfer of a capital asset are chargeable to tax under the head 'capital gains'. The term 'capital asset' means property of any kind, movable or immovable, held by an assessee but it does not include the following: stock-in-trade, consumable stores or raw materials held for the purpose of his business or profession, personal effects, i.e. movable property (clothes, motor car, furniture etc., but excluding jewellery) held for personal use, and agricultural land in India [Section 2(14)]. The gains on transfer of assets in relation to which there is no cost of acquisition like self-generated goodwill of a business are also liable to capital gains tax.

2.2 Transactions regarded as *transfer*

The act of transfer has special and extended meaning under the law [Section 2(47)]. Besides the sale of the asset or its exchange for another asset, it includes: relinquishment of the asset, extinguishment of any rights in the asset, compulsory acquisition of the asset under any law, conversion of the asset into stock-in-trade, handing over the possession of an immovable property in part performance of a contract for the transfer of that property, and transactions which have the effect of transferring, or enabling the enjoyment of any immovable property.

However, certain transactions, though falling within the foregoing meaning of transfer, are not regarded as transfers. These are: transfers under a gift, will, or an irrevocable trust, transfer of shares of the amalgamating company in consideration of allotment of shares in an Indian amalgamated company, and transfer of works of art, books, manuscripts etc., to the government, a university or any other notified museum or institution.

Prior to the assessment year 1988-89, distribution of assets on the dissolution of a firm, body of individuals or other association of persons was also not regarded as a transaction resulting in taxable capital gains. However, for and

from the assessment year 1988-89 the position has changed and such transactions are now regarded as transfers resulting in taxable capital gains.

2.3 Year of taxability

As regards the year of taxability, the basic rule is that capital gains are deemed to be income of the previous year in which the transfer giving rise to the gains takes place. Thus, the year of charge is the year in which the sale, exchange, relinquishment etc., takes place. In case of conversion of a capital asset into stock-in-trade, the gains are deemed to arise in the year in which such stock-in-trade is sold or otherwise transferred.

2.4 Short-term versus long-term capital gains

The incidence of tax on capital gains depends upon whether such gains arise from the transfer of a short-term or a long-term capital asset. Under Section 2(42A), a short-term capital asset is one which is held by the assessee for less than 36 months from the date of its acquisition. (However, in order to improve the mobility of capital, equity shares, units of the Unit Trust of India and other mutual funds are treated as short-term capital assets if they are held for less than 12 months). If the asset is held for more than 36 months, it is regarded as a long-term capital asset.

Capital gains arising from the transfer of a short-term capital asset are taxable like an ordinary income in the case of all assessees. However, capital gains relating to long-term capital assets are taken as a separate block and get lenient tax treatment (flat rate of 20 per cent).

2.5 Computation of short-term capital gains

Under Section 48, the procedure to compute capital gains involves the following steps: Firstly, the full value of consideration received or accruing as a result of the transfer is ascertained. If the transaction is in cash the full value of consideration is the cash payment received. In case the consideration for transfer is in the form of another asset, the fair market value of the asset received as consideration is ascertained. Also, the value of any debt settled by way of consideration is included in the full value of consideration. It is likely that the consideration is not paid in cash but by way of promise to pay after a period. In

such cases the full value of consideration will be the present value of the amount to be paid at maturity discounted at the market rate.

Secondly, the following deductions are made from the full value of consideration: (a) cost of acquisition of the asset including cost of any improvements made to the asset, and (b) expenditure incurred in connection with the transfer of such asset such as brokerage paid for arranging the deal, legal expenses incurred for preparing transfer documents, cost of inserting advertisement in newspapers for sale of the asset, and commission paid to auctioneer. However, it is necessary that the expenditure should be incurred wholly and exclusively in connection with the transfer. The balance is the amount of short-term capital gain to be included in the gross total income of the assessee.

2.6 Computation of long-term capital gains

Following the recommendations contained in the Interim Report of the Tax Reforms Committee (Chairman: Raja Chelliah), 1991, the scheme of capital gains tax was drastically recast in the following manner by the Finance Act, 1992: (a) The cut-off date for valuation of assets acquired in earlier years was shifted from April 1, 1974 to April 1, 1981, (b) a system of indexation was introduced for the first time under which long-term capital gains are now computed by allowing the cost of acquisition and the cost of improvement of the asset to be adjusted for general inflation, (c) a new section 112 was inserted in the Income Tax Act to provide that long-term capital gains would be subject to a flat rate of income tax. The rate of tax is 20 per cent. Presently, concessionary treatment to long-term capital gains is given through inflation indexing, relatively low flat rate of tax, and a set of exemptions.

In fact, the assessee has two options as regards the computation of long-term capital gains: (a) calculate the difference between the cost of acquisition and the sale price and pay the tax on the same at a flat rate of 10 per cent or (b) adjust the cost of the asset sold for inflation and pay tax at the rate of 20 per cent.

2.7 Inflation indexing

This new procedure to compute long-term capital gains effective from the assessment year 1993-94 is as follows. The full value of consideration received as a result of the transfer is ascertained. From the full value of consideration, the

Indexed Cost of Acquisition (I.C.A.) and the Indexed Cost of Improvement (I.C.I.) are deducted. Also, from the full value of consideration the expenditure incurred in connection with such transfer is deducted. Indexed cost of acquisition is actual cost of acquisition multiplied by Cost Inflation Index (C.I.I.) for the year of transfer and divided by C.I.I. for the year of purchase. Thus,

$$\text{I.C.A.} = \frac{\text{Cost of acquisition x C.I.I. for the year of transfer}}{\text{C.I.I. for the year of acquisition}}$$

and

$$\text{I.C.I.} = \frac{\text{Cost of improvement x C.I.I. for the year of transfer}}{\text{C.I.I. for the year of improvement}}$$

With 1981-82 as the base year (i.e. 1981-82 = 100) the Central Government notifies each year the C.I.I. having regard to 75 per cent of average rise in consumer price index for urban non-manual employees. C.I.I. notified by the Government from time to time is given in Table 1. The cost of acquisition is adjusted with reference to the rate applicable for the relevant year. There is similar indexation of cost of improvement. The index factors are applied uniformly to all assets without making any distinction between shares, buildings, and machinery. The new procedure is related to the period of time for which the asset is held and takes into account the inflation that may have crept in over time.

The cost of acquisition of an asset is the amount for which it was originally acquired by the assessee. However, where the capital asset became the property of the assessee before April 1, 1981, he has the option to substitute for the actual cost the fair market value of asset as on April 1, 1981. Furthermore, where the capital asset became the property of the assessee by succession, inheritance, or under a gift or a will etc., the cost of acquisition of the asset in the hands of the assessee is the cost for which the previous owner of the asset had acquired it. In case the asset was acquired by the previous owner prior to April 1, 1981, the assessee enjoys the option to substitute the fair market value of the asset as on April 1, 1981 for the cost of the asset to the previous owner. Any expenditure of a capital nature incurred by an assessee to increase the value of the asset is to be added to the cost of acquisition by way of cost of improvement.

Table 1: Cost Inflation Index Notified by the Income Tax Authorities from Time to Time

Financial Year	C.I.I.	Financial Year	C.I.I.
1981-82	100	1997-98	331
1982-83	109	1998-99	351
1983-84	116	1999-00	389
1984-85	125	2000-01	406
1985-86	133	2001-02	426
1986-87	140	2002-03	447
1987-88	150	2003-04	463
1988-89	161	2004-05	480
1989-90	172	2005-06	497
1990-91	182	2006-07	519
1991-92	199	2007-08	551
1992-93	223	2008-09	582
1993-94	244	2009-10	632
1994-95	259	2010-11	711
1995-96	281	2011-12	785
1996-97	305	2012-13	852

Deductions under chapter VI-A (Sections 80C to 80U) are not available in respect of long-term capital gains. Prior to the assessment year 1993-94, income arising under the head *capital gains* was included in the gross total income of the assessee and after allowing deductions under chapter VI-A, the total income was subject to tax and surcharge at the rates in force. Rebate under Section 88 was available from the tax computed on the total income in respect of deposits/payments made in approved schemes and instruments. As already noted, the Finance Act, 1992 inserted a new section 112 in the Income Tax Act to provide that long-term capital gains will be subject to a flat rate of income tax. The rate of tax is 20 per cent. Hence, deductions under chapter VI-A and rebate under Section 88 were withdrawn in respect of long-term capital gains.

3.0 Certain Long-term Capital Gains Exempt from Tax

Exemptions available to an assessee with regard to certain long-term capital gains are as under:

(i) Capital Gains from Transfer of a Residential House: Capital gains arising from the transfer of a residential house enjoy exemption if the assessee has purchased a new residential house within a period of 1 year before the date of transfer or within 2 years after the date of transfer or has constructed a residential house property within a period of 3 years after the date of transfer (Sec. 54). The amount of exemption available is equal to the amount so utilised or the amount of capital gain, whichever is less.

(ii) Capital Gains from Transfer of Agricultural Land: Capital gains arising from the transfer of agricultural land are exempt from tax if the assessee has purchased another land for agricultural purposes within a period of 2 years from the date of such transfer (Sec. 54B).

(iii) Capital Gains from Compulsory Acquisition of Industrial Undertaking: Where an industrial undertaking is to be shifted as a result of compulsory acquisition of its land or buildings by the Government, the capital gain arising from the payment of compensation is exempt from tax if the assessee has purchased any other land or building forming part of industrial undertaking within a period of 3 years from the date of acquisition (Sec. 54D).

(iv) Capital Gains from Shifting of an Industrial Undertaking from Urban Area to Rural Area: Capital gains made from the transfer of machinery, plant, land, and building etc., forming part of an industrial undertaking are exempt where transfer is effected for the shifting of the industrial undertaking from an urban area to any other area, provided these are reinvested in approved relocation schemes within 1 year before or 3 years after the date of transfer (Sec. 54G). The amount of exemption is equal to the amount so utilised or the amount of capital gain, whichever is less. The purpose of this exemption is to encourage industries to shift out of congested urban areas to reduce pollution and other hazards.

(v) Capital Gains from an Asset other than Residential House: Capital gains on the transfer of a long-term capital asset other than a house property are tax-exempt if the net consideration for the transfer is invested in a residential house (Sec. 54F). This exemption is available to an individual assessee provided he

does not own any residential house on the date of transfer of the original asset. The investment in residential house must be made in case of purchase within 1 year before or 2 years after the date of transfer and in case of construction within 3 years of such transfer.

Meanwhile, the amount of net consideration or the unutilised part of it must be kept in the Deposit Account like in other cases discussed above. If the cost of the newly acquired house is less than the net consideration in respect of the asset transferred, the exemption is allowed only in respect of part of the capital gain proportionate to ratio of the amount invested to the net consideration. In other words, the amount of exemption shall be equal to

$$\frac{\text{Capital gains} \times \text{Cost of new residential house}}{\text{Amount of net consideration}}$$

If the assessee transfers the newly acquired residential house within a period of three years of its purchase or construction, then the amount of capital gains arising from the transfer of the original asset which was not charged to tax, will be deemed to be the income from capital gains for the year in which the new asset is transferred. In addition to this, there is another circumstance when exemption granted may be withdrawn. This happens if the assessee within the time for acquiring new house (within 2 years of the transfer of original asset in case of purchase or within 3 years in case of construction) purchases or constructs another residential house in addition to the new house. In that case the capital gains earlier exempted from tax are charged to tax as income of the year in which that second house is purchased or constructed.

(vi) Capital Gains Invested in Certain Bonds: Any long-term capital gain is exempt if the whole of amount of such capital gain is invested in long-term specified assets (e.g. bonds issued by National Highway Authority of India (NHAI) and Rural Electrification Corporation Ltd.) within a period of 6 months from the date of transfer [Section 54EC]

(vii) Capital Gains from Shifting of an Industrial Undertaking from Urban Area to Special Economic Zone (SEZ): Any capital gains arising from the transfer of machinery, plant, land or building, in the course of shifting of an industrial undertaking in an urban area, to any SEZ, are exempt if the assessee has, within a period of 1 year before or 3 years after the date of transfer, purchased new plant or machinery, acquired or constructed land or building,

shifted the original assets and transferred the establishment , to the SEZ [Section54GA].

(viii) Capital Gains from the Transfer of a Residential Property Invested in a Manufacturing Small or Medium Enterprise: Any long-term capital gain from the transfer of a residential property effected up to March 31, 2017 is exempt if the net consideration is invested in the equity of a new start-up small and medium enterprise (SME) company in the manufacturing sector, which in turn is utilized by such company for the purchase of new plant and machinery [Section 54GB]

(ix) Capital Gains Account Scheme, 1988: This scheme is applicable to all the five types of exemptions mentioned above under sections 54, 54B, 54D, 54F, and 54G. However, an assessee has to open a separate account under each section if he wishes to avail the benefit under more than one section. Under this scheme, if the amount of capital gain is not utilised by the assessee for purchase or construction of the new asset before the due date for furnishing the return of income for the relevant year, it must be deposited by him on or before the due date of furnishing the return of income, in the Deposit Account in any branch (except rural branch) of a public sector bank in accordance with Capital Gains Account Scheme, 1988. The amount utilised for acquiring the new asset together with the amount so deposited is deemed to be the amount utilised for acquiring the new asset. If the amount deposited is not utilised fully for purchase or construction of the new asset within the stipulated period, then the amount not so utilised is treated as the capital gain of the year in which the period specified for investment in new asset (3 years from the date of transfer of original asset) expires.

4.0 Set Off and Carry Forward of Capital Losses

A capital loss represents the amount by which the full value of consideration for the transfer of an asset falls short of the sum of cost of acquisition and improvement of that asset and the expenditure incurred in connection with the transfer of that asset.

From the assessment year 2003-04, the provisions are as follows:

1. Any short-term capital loss can be set off against any capital gain (both long-term and short-term) and against no other income.

2. Any long-term capital loss can be set off only against long-term capital gain and against no other income.
3. Any short-term capital loss can be carried forward to the next 8 assessment years and set off against capital gains (both short-term and long-term) in those years.
4. Any long-term capital loss can be carried forward to the next 8 assessment years and set off only against long-term capital gain in those years.

It is noteworthy that if there is loss under any head, it can be set off against income from long-term capital gain and the balance of long-term capital gain is subject to tax at the rate of 20 per cent.

5.0 A Critique

How has the scheme of inflation indexing worked? There is a widespread feeling that introduction of inflation indexing for capital gains has unnecessarily complicated the income tax law.

The argument in favour of inflation indexing is that capital gains resulting from inflation are illusory in real terms. To offset the inflationary rise in the value of an asset, it is rational to increase the acquisition cost by the rate of inflation in the period between acquisition and realisation. True, an inflation-proof tax system is more certain and equitable in an inflationary economy but this is an ideal situation for all sources of income and not only for capital gains alone. Surprisingly, salary incomes which suffer the most due to inflation are left out and only capital gains are accorded the coveted treatment of inflation adjustment. Experience suggests that real estate prices move upward more quickly than the general index of prices while wage level adjustments not only lag but fall short of the rate of inflation.

The solution to the inflation problem lies in revision of exemptions and allowances for various types of income. Thus, the Finance Act, 1992, shifted the cut-off date for valuation of assets acquired in earlier years from April 1, 1974 to April 1, 1981. It means an assessee has the option of substituting the fair market value as on April 1, 1981 for the cost of acquisition where the asset had been acquired prior to that date. This concession itself offsets, though partially, the inflationary effect on capital gains.

Prior to the assessment year 1993-94, a basic exemption of Rs. 15,000 and a further deduction of 50/60 per cent depending on the category of asset was provided to individual assessees in computing long-term capital gains. This concession gave relief, particularly to assessees in the lower income group. It also provided a kind of incentive for new entrants to the capital market. Revival of the basic exemption would make the capital gains tax more equitable.

The flat rate of 20 per cent for capital gains as compared to the maximum marginal rate of 30 per cent for other incomes in the case of individuals has reduced the effective progressivity of income tax besides producing differential tax liabilities at given levels of income, violating the principle of horizontal equity. Moreover, this differential will induce people to earn income in the form of capital gains (often speculative) rather than as business profits, dividends, or interest. The inducement will be stronger at higher income levels because of the high tax rates applicable thereon.

End Notes

1. For an interesting comparison of Haig-Simons, and Irving Fisher's approaches to the concept of income, see J. Richard Aronson, *Public Finance* (New York: McGraw-Hill Book Company, 1985), pp. 335-343.
2. For example, estate duty, introduced in 1953, was abolished in India in 1985 in view of complications of law and meagre revenue yield.

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