Chapter III

BASE EROSION FROM JUDICIAL TESTS OF INCOME:
"INCOME OR CAPITAL?"
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Consequences of capital gain exclusion

Among the various factors responsible for eroding the income tax base perhaps none undermines the efficacy of the income tax as an instrument of redistribution more than exclusion of capital gain from the category of income. It is well known that capital gain is the main avenue for the rich to get richer. To quote Seltzer, the author of the celebrated work on capital gains, "The fortunes accumulated by Rockefeller, Harriman, Mellon, Guggenheim, Carnegie, Morgan, Baruch and many others were not built primarily by the year by year receipt, saving and investment of ordinary income, but by 'realized' and 'un-realized' capital gains." Among the factors listed by Atkinson as responsible for the persistence of inequality in Britain the foremost are inheritance and capital gain. In the developing countries the greatest beneficiaries of public development programmes are usually the real estate owners. Failure to provide for adequate taxation of capital gains is one of the main reasons for which Due considers it unwise for developing countries to


go in for Western-type income-tax.

Exclusion of capital gains from the tax base creates problems not only for the equity but also for the effective administration of the income tax because the distinction between capital gain and ordinary income is not easy to draw. Both are essentially of the same category, being in the nature of a flow, and the line between the two is usually drawn on the basis of principles which are not very well defined. This not only creates inequities but opens up wide avoidance opportunities. In U.S.A., although capital gains are subjected to tax almost from the inception of the income tax, conversion of as much of ordinary income into capital gain as possible is believed to be a fundamental objective of tax planning because of the tax advantage associated with capital gain. For all these reasons exclusion or inadequate taxation of capital gain has caused much uneasiness among public finance experts.

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4 Except during the period of Civil War income taxes.
5 Sommerfeld, Anderson & Brock, *An Introduction to Taxation* (1972), p. 289. Fifty per cent of net long term gains are deducted and there is an option to the taxpayers to take the deduction or allow the gains to be taxed at the alternative rate of 25 per cent. This option is however applicable, subject to certain conditions.
Position in Indian income tax

Indian income tax provides for taxation of capital gains since 1957-58 (the earlier experiment of 1946 was only for a short spell). At present capital gains from assets held for more than five years are taxed like ordinary income. It is however doubtful if even the fringe of the problem has been touched. For, first of all, the existing system provides no way of taxing the gains so long as they remain unrealized and, as we have seen (in the Appendix to Ch. II), such gains account for 85-90 per cent of the capital appreciation accruing every year. There is no arrangement to capture these gains at the time of transfer through gifts and bequests either. As a result wealth can be accumulated over generations without much hindrance. What causes concern is that

Wealth-tax, gift tax and estate duty, it might be thought, provide a means of taxing unrealized gains. The taxes raised through these taxes however do not cover even 10 per cent of the unrealized capital gains of the taxpayers accruing annually as would be evident from the following table:

<table>
<thead>
<tr>
<th></th>
<th>Wealth Tax</th>
<th>Estate Duty</th>
<th>Gift Tax</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965-66</td>
<td>8.50</td>
<td>4.46</td>
<td>2.18</td>
<td>15.14</td>
</tr>
<tr>
<td>1966-67</td>
<td>8.41</td>
<td>9.33</td>
<td>1.69</td>
<td>19.43</td>
</tr>
<tr>
<td>1967-68</td>
<td>9.30</td>
<td>10.54</td>
<td>1.30</td>
<td>21.14</td>
</tr>
<tr>
<td>1968-69</td>
<td>7.81</td>
<td>6.23</td>
<td>1.75</td>
<td>15.79</td>
</tr>
<tr>
<td>1969-70</td>
<td>13.68</td>
<td>9.42</td>
<td>2.01</td>
<td>25.11</td>
</tr>
<tr>
<td>1970-71</td>
<td>15.00</td>
<td>8.00</td>
<td>3.00</td>
<td>26.00</td>
</tr>
<tr>
<td>1971-72</td>
<td>25.00</td>
<td>9.00</td>
<td>4.00</td>
<td>38.00</td>
</tr>
<tr>
<td>1972-73</td>
<td>36.00</td>
<td>9.00</td>
<td>4.00</td>
<td>49.00</td>
</tr>
<tr>
<td>1973-74</td>
<td>40.00</td>
<td>10.00</td>
<td>4.00</td>
<td>54.00</td>
</tr>
<tr>
<td>1974-75</td>
<td>40.00</td>
<td>9.00</td>
<td>4.00</td>
<td>53.00</td>
</tr>
</tbody>
</table>

(B.E.) (f.n. contd.)
taxation of even realized capital gains has failed to provide what little was expected of it.

When Kaldor proposed the revival of the capital gains tax in India, he thought, the long-term yield of the tax would be around Rs.25-40 crores a year. The average annual accrual of capital gains to owners of estates of over Rs.1 lakh (excluding agricultural land), according to his calculations, would be about Rs.60-100 crores. As we have already seen, the actual yield of the tax during the years 1960-61 to 1971-72 averaged only a little over Rs.5 crores and the amount of capital gains subjected to tax, Rs.16.8 crores. As late as 1971-72, the amount of capital gain brought under taxation was only Rs.39.9 crores and the tax levied, Rs.15 crores. Considering that Kaldor made his estimate in 1956 and that prices have gone up by more than hundred per cent during this period, the yield seems to be less than one-third of what Kaldor had anticipated.

(Previous footnote contd.)

Note: Figures for the years 1965-66 to 1969-70 relate to demand raised while those for 1970-71 to 1973-74, to collections.


7 N. Kaldor, India Tax Reform (1956), para 59.
8 Ibid.
9 Vide Table 2.1 in Ch. II.
10 With 1961-62 as the base the wholesale price index stood at 78.4 in March, 1956 and 181.6 in March, 1971 (Government of India, Pocket Book of Economic Information 1972, Table 11.1).
It was hoped that treating 'short term' gains as ordinary income (which has been the practice since 1962) would raise the yield significantly. But that too does not seem to have materialised. The tax on capital gain (both short-term and long-term) accounts for barely 1 per cent of the total income tax revenue. In USA, in the case of individuals and fiduciaries the estimated revenue from capital gains tax formed about 6.8 per cent of the total income taxes in 1965. Another disappointing feature of the capital gains tax in India is that the variation in the proportion of capital gain in taxable income as between the lower and the upper income ranges is much less pronounced than what one might expect. Averages of three years (1968-69, 1969-70 and 1971-72) show that the proportion goes up from 1.05 per cent in the lowest bracket to 10.28 per cent in the income range Rs.4-5 lakhs, but decreases again to 5.14 per cent in the bracket 'above Rs.5 lakhs' (Table 3.1). In USA the contribution of capital gain in large incomes is more than 50 per cent. We propose to investigate in this chapter what has gone wrong with capital gains taxation in India and what could be done to improve its yield without sacrificing equity or inhibiting growth.

12 Martin David, Alternative Approaches to Capital Gains Taxation (1968) Table 4.2.
13 Ibid., Table 4.17.
TABLE 3.1
PROPORTION OF CAPITAL GAIN IN TOTAL INCOME OF INDIVIDUALS

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3.1</td>
<td>3.1</td>
<td>3.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Below 4000</td>
<td>48244</td>
<td>307</td>
<td>0.63</td>
<td>32027</td>
</tr>
<tr>
<td>4001 - 5000</td>
<td>3807937</td>
<td>2778</td>
<td>0.07</td>
<td>4003380</td>
</tr>
<tr>
<td>5001 - 7500</td>
<td>2305709</td>
<td>3510</td>
<td>0.15</td>
<td>2321707</td>
</tr>
<tr>
<td>7501 - 10000</td>
<td>1286312</td>
<td>5786</td>
<td>0.44</td>
<td>1525480</td>
</tr>
<tr>
<td>10001 - 15000</td>
<td>1786248</td>
<td>5807</td>
<td>0.32</td>
<td>1854160</td>
</tr>
<tr>
<td>15001 - 17500</td>
<td>1175051</td>
<td>6475</td>
<td>0.55</td>
<td>1128536</td>
</tr>
<tr>
<td>17501 - 20000</td>
<td>849776</td>
<td>5110</td>
<td>0.40</td>
<td>944883</td>
</tr>
<tr>
<td>20001 - 25000</td>
<td>1386760</td>
<td>7156</td>
<td>0.50</td>
<td>1429525</td>
</tr>
<tr>
<td>25001 - 30000</td>
<td>88924.4</td>
<td>9240</td>
<td>1.04</td>
<td>1008165</td>
</tr>
<tr>
<td>30001 - 40000</td>
<td>1301331</td>
<td>16304</td>
<td>1.34</td>
<td>1404604</td>
</tr>
<tr>
<td>40001 - 50000</td>
<td>700125</td>
<td>9968</td>
<td>1.28</td>
<td>735584</td>
</tr>
<tr>
<td>50001 - 60000</td>
<td>499671</td>
<td>9687</td>
<td>1.94</td>
<td>541285</td>
</tr>
<tr>
<td>60001 - 70000</td>
<td>331766</td>
<td>7156</td>
<td>2.15</td>
<td>350210</td>
</tr>
<tr>
<td>70001 - 100000</td>
<td>555075</td>
<td>13957</td>
<td>2.51</td>
<td>594391</td>
</tr>
<tr>
<td>10001 - 200000</td>
<td>546849</td>
<td>19631</td>
<td>3.59</td>
<td>534496</td>
</tr>
<tr>
<td>20001 - 300000</td>
<td>169526</td>
<td>9952</td>
<td>5.87</td>
<td>161917</td>
</tr>
<tr>
<td>30001 - 400000</td>
<td>93114</td>
<td>6288</td>
<td>6.76</td>
<td>85019</td>
</tr>
<tr>
<td>40001 - 500000</td>
<td>52172</td>
<td>8275</td>
<td>15.88</td>
<td>54316</td>
</tr>
<tr>
<td>Above 500000</td>
<td>220909</td>
<td>18008</td>
<td>5.89</td>
<td>236068</td>
</tr>
</tbody>
</table>

**TOTAL:** 19331070 163574 0.85 2022755 154589 0.76 24296665 187265 0.77 0.79

**SOURCE:** All India Income Tax Revenue Statistics (Government of India).
Treatment of Capital Gains in India - Evolution of the Law

One possible explanation for such poor showing of the capital gains tax could be that several kinds of receipts which are categorized as capital gain elsewhere (e.g. in USA) are treated as income in India. Facts however do not seem to bear out this impression. From an examination of the legal position it would appear that the British tendency to look upon income as the harvest of a field, which came to influence judicial approach to income here, led to the exclusion of anything which looked like 'capital'. As in Britain, the traditional way of judging whether a particular receipt is income or not is to ask if it is income or capital. The presumption however is that a receipt is capital unless the contrary is proved. As we will presently see there are instances where a receipt taxed as income in U.S.A. is treated as 'capital' in India. The definitional ambiguities of capital gain however have been as acute in India (as well as in U.K. whose legal precedents were followed here till 1947) as in U.S.A. To counter avoidance through conversion of income into capital certain categories of receipts were included in income by legislation. Even so it is doubtful whether the scope for capital gain is significantly narrower (or the coverage of ordinary income correspondingly wider) here compared to the position obtaining in other countries.

14 Simon's Taxes A 1.201.
The result of such legislation has perhaps been, as may be seen from the review of the case law presented below, to accentuate the inequities caused by the definitional ambiguities of 'capital gain'.

One of the earliest cases involving the question of the character of a receipt, viz., whether it is capital or revenue, arose in India out of a dispute about the nature of compensation received by a company for termination of a selling agency. In a ruling which proved to be a landmark in the evolution of income tax in India the Privy Council held the receipt to be 'capital'. It was this decision that made it clear that capital gain could not be treated as income under the Indian income tax but it created much uncertainty about the taxability of receipts like compensation. In the subsequent rulings the Supreme Court made it clear that compensation for termination of an agency would not be capital unless it resulted in the impairment of the trading structure of the concern or in the loss of a source of the assessee's income, and that if acquiring agencies and their termination took place in the ordinary course of business the compensation would be 'income'. But the uncertainty persisted. For whether

15 CIT v. Shaw Wallace & Co. Ltd., 6 ITC 78.
16 Kettlewell Bullen & Co. Ltd. v. CIT (1964) 53 ITR 261.
17 Gillanders Arbuthnot v. CIT (1964) 51 ITR 283.
or not in a given situation the trading structure is impaired by the termination of an agency, can be a matter of opinion. Decisions on the nature of compensation for abrogation of business agreements seemed equally ambiguous. In a case where an agreement for mutual co-operation in business was terminated, compensation received by one of the parties to the agreement was held by the House of Lords to be capital. In another British case where, under an agreement, the taxpayer (a company) used to receive a commission from another company for the latter's business flowing from a connection secured by the former company's managing director, compensation for the termination of the agreement was pronounced 'revenue'. But compensation for termination of a similar agreement was held by the Indian Supreme Court to be capital. The fact that all such compensation contained a large element of gain and did not always represent mere realisation of an investment does not seem to have been considered. All that was looked for was whether the receipt arose in the course of business or not. This approach led to the exclusion of several other categories of gains, e.g., those arising from currency devaluation, and compensation for temporary takeover

19 Shove v. Dura Manufacturing C. Ltd. 23 T.C. 779.
21 Canara Bank Ltd. v. CIT (1963) 47 ITR 529.
or requisition of business premises by the Government, and in certain circumstances even consideration for transfer of know-how. Reasons were of course advanced in support of the decision in each case. Thus, compensation for requisition of business premises during the war was held to be capital on the reasoning that such takeover led to the 'sterilization of an asset'. But the logic was not always very clear or consistent and in any case had little to do with the ability to pay principle.

Sometimes a compensation was regarded as revenue if it happened to be a receipt in extinguishment of income and capital if it was for the extinguishment of an asset though conceptually such a distinction makes little sense as both are stock and only the gain element (i.e., excess over cost if any) is the flow that is income. Profits from currency devaluation were adjudged capital or revenue depending on the intended use of the funds in question (that is, whether meant for acquiring a capital asset or for trading), though ordinarily the incidence of the gain from devaluation has nothing to do with these factors, such gain being in all cases a pure windfall.

23. Evans Medical Supplies Ltd. v. CIT (1959) 35 ITR 707 (H.L.).

24. CIT v. Tata Locomotive and Engineering Co. Ltd. (1966) 60 ITR 405. In this case the gain arose from the taxpayer's funds lying in USA. The funds were made up of (i) amounts remitted to USA for purchase of capital goods, (ii) commission earned abroad which was also intended to be utilized in acquiring capital goods abroad and (iii) sums received in USA (f.n. contd.)
These ambiguities in the distinction between capital and revenue paved the way for avoidance by converting ordinary income into capital. It is difficult to say whether the conversion of ordinary income into capital was as widely resorted to in India as in countries like USA and Canada. It would however be surprising if this was not the case, for, unlike in USA capital gains in India were totally excluded from the tax base until 1957 (barring the two years 1946-48) and the onus is on the Revenue to show that a particular receipt is income, the presumption being that they are generally capital. In USA capital gains are the exception to the general rule of ordinary income treatment and therefore the definition of a capital asset is narrowly applied while its exclusions are applied broadly. Thus while consideration for the sub-lease of land was held to be capital in India, the U.S. Supreme Court held (previous footnote contd.)

in return for funds made available to an American concern's representative in India. The Appellate Tribunal thought the gains on items (i) and (iii) only were capital but not on item (ii). The High Court however treated the entire gain as capital and this view was upheld by the Supreme Court.


27 D. D. Khanna v. CIT (1969) 72 ITR 736. In this case the view taken by the High Court and the Tribunal was reversed by the Supreme Court.
that the gain on the sale of oil or other mineral payment
rights carved out of larger interests retained by the grantors
was ordinary income. Similarly, whereas compensation for
temporary acquisition of business premises was held to be
capital in India, in USA a similar receipt was pronounced by
the Supreme Court of that country to be revenue on the ground
that it was in the nature of a substitute for rent. So easily
are the courts in India persuaded that a receipt is capital
that even the sale proceeds of loom hours (that is, the working
time available by running the loom in textile manufacturing) by
a jute company were pronounced capital, even though it bore all
the marks of ordinary income. In a comparable case the Privy
Council had taken the opposite view, and in another case even
accretion to stock-in-trade was treated as capital. All these
28 See note 26 ante.
30 Of course in the Indian case the period of requisition was a few years while in the American case it
was six months. The decision of the Indian Supreme Court however did not turn on that fact. It is worth
noting that one commentator felt it necessary to observe while referring to this case that “it should
not be understood as deciding that there was no revenue element in the compensation awarded”. (Tyengar on
31 CIT v. Maheshwari Devi Jute Mills Ltd. (1965) 57
ITR 36.
32 Commissioner of Taxes v. Nchanga etc. Mines Ltd.
(1965) 58 ITR 24. Unable to defend this as well as
the decision in the preceding case the commentators
Kanga v. Palkhivala were constrained to remark that
they are incorrect (Kanga & Palkhivala, op. cit.,
pp. 110 & 122-123).
go to show that the range of receipts considered by the courts in India as 'capital' can hardly be regarded as narrow. It remains to be seen how far the impact of the court rulings was modified by legislation.

Legislative action

The legislature at first attempted to contain the base erosion from the widening of the area of 'capital' by bringing under taxation certain receipts which were declared 'capital' by the courts. Thus the law was changed in 1955 on the recommendations of the TEC to include in the income from business lump sum receipts like compensation for loss of managing agency or termination of similar business agreements. These receipts were thus rendered taxable, subject however to certain relief which was allowed originally in the form of a rebate from tax, and afterwards through a deduction of a portion of the amount so received. Compensation for loss of employment was also made taxable as income from salary, subject again to certain reliefs.

While helping to counter avoidance such selective taxation of capital gains as ordinary income gave rise to inequity. Extension of the income tax net to capital gains in

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35 Sec. 28 (ii) read with Sec. 80 S. The deduction is limited to 25 per cent of the receipt or Rs.1,00,000, whichever is less.

36 Sec. 17(3).
general which took place in 1957-58 (leaving aside the earlier experiment of 1946-48) did not remove this inequity completely as certain varieties of gains were exempted while the ordinary income treatment was retained for some. Thus the provisions regarding the taxation of compensation receipts which had been introduced earlier were allowed to continue even after the introduction of the capital gains tax. Relief is no doubt provided in respect of nearly all categories of capital gains but the basis varies. At present, gains arising from sale or transfer of capital assets held for not more than five years - the 'short-term' gains - are treated as ordinary income. In the case of long-term capital gains, deduction is allowed in terms of specified fractions of the gain, the fraction depending on the nature of the asset. While relief is provided in the form of straight deduction from capital gains of most varieties when subjected to tax, in the case of compensation for termination or modification of terms of employment the relief takes the form of abatement in the rate of tax where it exceeds the average of the preceding three years with the compensation spread over those years pro rata.

37 In the case of lands and buildings deduction is allowed on the following scale: ₹5,000 plus 25 per cent of the excess of the gains over ₹5,000.
   In the case of other assets: ₹5,000 plus 40 per cent of the excess. (Sec.80T of the Act).

38 Sec. 17(3).

39 Rule 21A.
Annuities on the other hand are taxed as ordinary income without making any allowance for the element of capital included in such payments.

It would however be unrealistic to explain away the poor showing of capital gains taxation in India simply in terms of definitional ambiguities. For one thing is clear. The ambiguities did not in any way narrow down the scope of capital gains, rather widened it and the legislation to prevent conversion of ordinary income into capital gain was confined only to a few selected categories of receipts. Compared to the position obtaining in USA the coverage of capital gain in India is no doubt narrower, but in some respects it is certainly wider. Reasons for the tardy progress of capital gains tax in India should be looked for elsewhere.

Many would be inclined to think that the main factor behind such poor results is large-scale under-reporting and undervaluation of assets, especially immovable properties. Predominance of physical assets (particularly real estate) lends weight to the question of undervaluation. There are of course drastic provisions in the law enabling the tax authorities to

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40 See for a comparison of the coverage V. V. Borkar, *Income Tax Reform in India* (1971), Ch. IV. Absence of any provision for stepping up the cost basis of assets on gifts and bequests in the Indian law by itself constitutes an important factor widening the net of capital gains tax here as contrasted with the position in USA.

41 See Appendix to Ch. II.
disregard the values disclosed in transactions. But it is not known in how many cases these powers are invoked. Relative infrequency of transactions in immovable properties raises doubt as to whether undervaluation could be the only reason for the low yield of capital gains tax. An important factor is probably the fact that though capital gains are taxed, not all gains arising from capital transactions are allowed to be taxed. Some get excluded because of definitional ambiguities while some are left out by virtue of specific provisions in the law. In fact, quite a few varieties of capital gain remained untouched even after the introduction of the capital gains tax because the courts were not inclined to regard such gains as 'capital'. (It was of course nobody's case that they were ordinary income). The manner in which the area of these exclusions and exemptions is getting expanded of late strengthens this suspicion.

The scheme of the capital gains tax is such that not every kind of capital transaction gives rise to taxable capital gain. If it is to be taxed, the gain must arise from the disposition of a 'capital asset' as defined in the Income-tax Act,

42 Sec. 52 of the Act. In addition, Government now possesses the power to acquire immovable property (of more than $25000) changing hands if the understatement of its value on the transfer deed exceeds twenty-five per cent of the fair market value (Ch.XXA of the Act). For various reasons however the potency of these powers seems to be rather limited. (See Gulati & Krishnan, "On Deterring Undervaluation of Property", EPW Annual Number 1973).

43 Sec. 2 (14).
and the definition provides for a number of exclusions. Again, not all transactions in or transfers of assets occasion a taxable capital gain. Certain dispositions are specifically excluded from the category of taxable events. Gifts, bequests, receipt of property on the break-up of a Hindu joint family, distribution of capital assets on the dissolution of a firm do not come within 'taxable event'. As indicated already, certain deductions are also allowed from gains which are otherwise taxable.

Definition of 'Capital Asset'

'Capital asset' as defined in the Income-tax Act comprises property of every kind held by an assessee whether or not connected with his business or profession. Certain assets are however excluded. These are, stock-in-trade, consumable stores and raw materials of business, personal effects (but not jewellery), agricultural land located beyond a specified limit of urban areas and certain bonds of the Central Government.

Gains from transfer of house property are not taxed unless the consideration for the transfer exceeds twenty-five thousand rupees. Gains from transfer of certain assets are

44 Sec. 46(1).
45 Sec. 80T.
46 Sec. 2(14).
47 Sec. 53. The exemption however does not apply when the total value of house property owned by the taxpayer exceeds fifty thousand rupees.
allowed to go untaxed if they are 'rolled over', that is, reinvested in the acquisition of similar assets within a specified period. These assets are, residential house property, agricultural land not excluded from the definition of capital asset (that is, those located within or in the vicinity of urban areas) and jewellery. A similar facility for tax-free roll-over was available for shares in Indian companies between 1965 and 1970.

There is no means of determining how the potential of the capital gains tax is affected by exclusions enumerated above. Exclusion of assets like agricultural land alone could however be responsible for weakening the potential seriously. On a very rough calculation it would appear that the appreciation in the value of agricultural lands held by the top 10 per cent of the households in the rural areas would be around Rs.300 crores per annum. Till 1970, agricultural land located

48 Secs. 54, 54B and 54C.
49 Sec. 54A omitted from 1.4.1970.
50 As of 1965-66, value of agricultural land, according to an RBI estimate was about Rs.12,000 crores (RBB, Oct., 1972). If even 50 per cent of these are assumed to be held by the top 10 per cent of the households, the value of land in the possession of the rural rich would appear to be about Rs.6,000 crores and at the rate of 5 per cent the annual appreciation in value of these holdings would seem to be Rs.300 crores.
even within urban areas was not liable to capital gains tax. For there is no definition of 'agricultural land' in the Act and the expression was interpreted by the courts to include lands which are used or capable of being used for agricultural purposes. Lands situated on the fringe of growing cities and townships - acknowledgedly a potent source of capital gain - thus remained unaffected by the capital gains tax for a long time. There are instances where even lands situated well within urban areas were held to be agricultural. The amendment in the law made in 1970 to exclude lands within specified limits of municipal areas has removed the scope for such interpretation. But the exclusion of agricultural land itself continues to erode the base.

Some of the exemptions, though by themselves not very substantial, seem to provide scope for avoidance, e.g., the exemption of gain from house property when the consideration happens to be less than Rs.25,000. Properties can be sold in parcels of less than Rs.25,000 to take advantage of this exemption. The exemption extended to gains which are re-

52 Court of Wards v. CWT (1960) 72 ITR 552. In this case a full bench of the Andhra Pradesh High Court held that land forming part of a well-known palace compound and located within the limits of the Hyderabad Municipal Corporation was 'agricultural'.
53 Sec. 53.
invested in similar property in the case of certain assets also acts as a source of erosion in that such exemption goes beyond what is required by the logic of tax free roll-over. For, strictly speaking, by the roll-over rule, exemption should be available only if the entire consideration and not merely the gain is reinvested. The provisions which implement the exemption for roll-over of gains from residential house and agricultural land are however so framed that the tax can be avoided if only the capital gain resulting from the sale is reinvested. As Borkar has pointed out, this seems to be quite unnecessary according to the roll-over rationale. In the case of jewellery, the exemption is given with reference to the entire sale proceeds, but where the cost of the new asset acquired falls short of sale proceeds, exemption is available only in respect of a fraction of the gain. Such liberal roll-over provisions can be an important source of leakage.

Over and above those excluded expressly by the statute, certain receipts clearly in the nature of capital gain have got excluded from the purview of the capital gains tax because of judicial rulings on what constitutes a 'capital asset' form of this tax. A notable instance of this kind is gain from transfer of goodwill.

54 Borkar, op. cit., pp. 50-51.
55 This fraction is equal to the proportion of the cost of the new asset to the sale proceeds of the old one.
Several High Courts in India seem to think that goodwill is not a capital asset as contemplated in the Indian Income-tax law except when it is acquired for a price. In the case which set the trend for this line of thinking - CIT v. K. Rathnam Nadar - what led the court (Madras High Court) to conclude that the proceeds of transfer of goodwill are not chargeable as capital gain (there was no question of taxing them as ordinary income) is that, though it is a capital asset, its acquisition did not cost anything to its owners. Looking at the mode of computation of capital gain laid down in the Act, the Court reasoned that the capital gains tax provisions could not apply to transfer of a capital asset which did not cost anything to the assessee in terms of money in its acquisition. Some of the observations made by the Court in this connection reveal how judicial thinking proceeds in these matters. The Court said -

Goodwill is created by the trading activities of the assessee, and probably by the name he has earned and the goodwill he has created among his customers. Goodwill of a firm is an intangible asset. It is difficult to say that it costs anything in terms of money for its coming into existence. Goodwill of a firm can probably be compared to a seed which is planted on the day that the firm begins its business and sprouts and grows as the firm grows in its dealings in its stature and its reputation.

Calcutta High Court has declared that goodwill fails even in the test of a capital asset for it is not a kind of asset with which a business is started. Moreover,

56 (1969) 71 ITR 433.
Unlike capital assets goodwill as an asset is indivisible and cannot be sold, transformed or dealt with in fragments or fractions.  

Following the logic advanced by the Madras High Court in Rathnam Nadar's case, Delhi High Court too decided in a case where a taxpayer's business was transferred to a limited company that the excess of the price received for machinery and furniture over cost— that is, goodwill in the accountancy sense—was not liable to capital gains tax since such excess did not come within the purview of capital gain. Significance of these rulings for capital gains taxation stems from the fact that in the case of business it is goodwill which normally gives rise to capital gain. Moreover, if the logic which has prevented the taxation of the proceeds of goodwill prevails, gains on the transfer of patents, know-how and copyrights too would seem to fall outside the category of capital gains since no cost can be imputed to their acquisition. Nor would they be taxable as ordinary income. Though there is no decision bearing directly on the point this seems to be the logical conclusion which the court rulings on the treatment of goodwill would seem to lead to. One author on the subject suggests as much.

58 J. S. Mumick v. CIT (1971) 81 ITR 500.
59 N. Kaldor, op. cit., para 59. A large part of share gains (more than one-third) is accounted for by goodwill (Report of the Canadian Royal Commission on Taxation (1966), vol. 4, p. 40).
To remove the uncertainty regarding tax treatment of sale of know-how, British income tax law has been changed to provide that if the vendor is a trader and has used the know-how in a trade which he continues to engage in after the sale, the consideration is to be treated as a trading receipt, and if the vendor is not a trader, the consideration, if not otherwise taxable, will be charged to tax as 'other' income. Of course, by making a dichotomy between that part of the consideration which is attributable to know-how and the part which is meant to compensate for a restrictive covenant (for giving up existing business) the new provisions allow some scope for discretion and thus avoidance on the part of the taxpayers. But there is at least a guarantee that the sale of know-how will not go completely untaxed. In the present position of the law in India, there is no such assurance. An additional problem in the taxation of these gains is posed by the question of classification under 'long-term' and 'short-term'. The law being silent on the point it is hard to classify such receipts under either category but such classification is essential if any capital gain is to be brought under taxation.

Exemption with reference to nature of transfer

Some of the limitations of the capital gains tax in

61 Income and Corporation Taxes Act, 1970, Sec. 386.
India stem from the fact that not every kind of disposition gives rise to a taxable gain and certain types of transactions are not recognized as taxable event. These restrictions again are partly built deliberately in the law, partly they are the product of judicial interpretation.

When capital gains were first brought under taxation, gains from any sale or transfer of capital assets were stated to be taxable. No definition was however provided for the term 'transfer'. So when a gain arose to a taxpayer through relinquishment of certain rights - and such gains could in no case be treated as ordinary income - its taxation as capital gain was held by the Supreme Court to be against the law. The law was changed in 1956 to define the term 'transfer' and widen its coverage. But even now not all kinds of dispositions give rise to a capital gain. The important ones among the excluded transactions or occasions are, (i) transfer by gifts and bequests (ii) distribution of assets on partition of a Hindu Undivided Family, (iii) distribution of capital assets on the dissolution of a firm, body of individuals or other associations of persons, (iv) transfer by a parent company to a wholly owned subsidiary if the subsidiary is an Indian company (v) transfer by a subsidiary to a holding company if the

63 Sec. 12B of the IIT Act 1922 as it stood before the amendment of 1955.

64 CIT v. Provident Investment Co. Ltd. (1957) 32 ITR 190.

65 Sec. 2(47) of the Act of 1961.
latter happens to be an Indian company and (vi) amalgamation of companies. Also no capital gain arises to a company when it distributes assets on winding up.

Apart from the statutory exceptions to the transactions liable to give rise to taxable gain, narrow construction of the term 'transfer' in judicial rulings has also circumscribed the coverage of the capital gains tax significantly. A recent example of this is the decision of the Gujarat High Court whereby the excess of the amount received by a shareholder from a company in liquidation over the cost price was held not chargeable to capital gains tax on the ground that such receipt did not result from a 'transfer' in spite of the fact that 'transfer' now includes extinguishment of any right in a capital asset. This judgement seems to nullify even the effect of the provision of the Act [Sec.46(2)] which seeks to bring to charge the gain arising to shareholders/distribution of assets of a company at the time of liquidation.

As indicated already, certain transfers are left out of the ambit of capital gains charge by the statute itself, e.g., distribution of assets on the partition of a HUF and on the dissolution of a firm. But here too the courts seem to have gone beyond the intention underlying the

66 Sec. 47.
67 Sec. 46(1).
exceptions and thus paved the way for an undue extension of
the scope of exempt transactions. This has happened particu­
larly in the case of gains derived by partners from dis­
tribution of assets on the dissolution of firms. While the
exemption seems designed to apply only when the distribution
is made in specie, courts have refused to recognize capital gain
even where payment is made to a partner in cash.

Much more damaging to the efficacy of the capital gains
tax is the exclusion of gifts and bequests from the category
of taxable events. While proposing the reintroduction of
the tax in 1956, Kaldor had emphasized the need for recogniz­
ing gain on the transfer of assets through gifts and inheritance
and warned that exclusion of these occasions from taxable event
might easily cut the potential long term yield of the tax by
two-thirds or three-quarters. There is no justification in
equity for these exclusions. Problems of administration also
cannot be invoked as an argument against imputation of realiza­
tion of gain on transfers and bequests as valuation is undertaken
any way on these occasions for purposes of estate duty and gift
tax. Non-recognition of gains to shareholders on the issue of

Also see CIT v. Agarwal & Co. (1970) 77 ITR 894.

69 Kaldor, op. cit., para 53.

70 In Britain, it may be noted when the capital gain
tax was introduced realization was imputed on passing
of property by bequests. This has been given up
recently. The abrogation of the provision seems to
have been acted more by political considerations
on the part of the Conservative Government than any in­
herent drawback of the system.
bonus shares is also a weak spot in the scheme of capital gain taxation. The rationality of the existing arrangement for taxation of bonus shares is discussed in the next chapter.

Suggestions for improving the efficacy of the Capital Gains Tax

From the above discussion it is evident that if the efficacy of the capital gains tax is to be improved several measures are called for. The more important of these are:

1. The area of exclusions from the definition of 'capital asset' should be curtailed. Agricultural land, in particular, should be brought within the purview of capital asset. There does not seem to be any bar in the Constitution to the taxation of capital gains from transfer of agricultural land under the Central income tax since the constitutionality of gift and wealth taxes levied by the Centre on agricultural land has been upheld. There is nothing in the history of the taxation of agricultural income either which justifies the exclusion of agricultural land from capital gains taxation.

2. Gain from transfer of any asset used in business or transfer of business as a whole should be treated as taxable.

71 CIT v. H.T. Date (1971) 82 ITR 71.

72 See Chapter VIII for a fuller consideration of this issue.
One attractive suggestion is that, as in Germany, all such gains should be treated as ordinary income. This will obviate the need for distinguishing between speculative transactions, (gains from which are liable to be taxed like ordinary income) and simple transfer of capital assets of business. It will also help to do away with the recapture provisions relating to depreciable business assets which are difficult to operate.

3. (No tax exemption need be given for capital gain of any kind except for an initial exemption of Rs.5,000. The tax free roll-over provisions should either be withdrawn or at least rationalized.)

4. All transfers and distribution of property should be regarded as taxable occasions. Constructive realisation should be imputed at the time of gifts and bequests. Unless

Even with all this, all gains whatever the source are treated on the same footing, disparate treatment of different types of capital gain will remain. Moreover, so long as capital gain is accorded preferential treatment, the definitional problems of distinguishing between capital and revenue cannot be avoided. The distinction between ordinary income, casual gain, speculative profit and capital gain will continue to trouble taxpayers and tax collectors. The present system

73 Borkar, op. cit., pp. 64-65.
74 The distinction between casual gain and regular income has been particularly difficult to draw. Two things seem to have accentuated the difficulty.

(f.n. contd.)
of taxing all these on different footing is the result of piecemeal legislation over the years and presents a confusing maze.

Case for treating capital gain like ordinary income

For a rational solution it is necessary to recognize that all additions to wealth or consumption constitute a gain, and it is futile to distinguish between them as casual or regular, expected or unexpected. On examination many kinds of gain regarded as income now would be found to contain large elements of windfall and vice versa. It is hard to draw the line between capital gain and ordinary income even conceptually.

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First, the test of casualness applied by the courts did not always follow consistent principles. Much reliance was placed on unexpectedness as a test of casual gain. It appeared however that the essence of unexpectedness lay not in non-recurrence but lack of legal right on the part of the recipient to claim it. Secondly, to counter avoidance, it was provided in the law that any receipt arising from business or coming by way of addition to an employee's remuneration would be treated as income even if it was casual. What constitutes business or trading however led to numerous disputes. The confusion still prevails [See Sec. 10(3) of the Act]. For example, capital gain is mentioned as a sub-set of casual gain in Sec. 10(3). If true, this calls for parity of treatment of all casual and capital gains, which however is not the position in the law.

To define pure capital gain as unforeseen and unexpected addition to one's wealth also does not help since then the question arises, should the term be taken to mean gains which are utterly beyond the range of possibilities or only those which exceed one's expectations? (See Saltzer, op. cit., Ch. 3).
Several arguments are of course advanced against taxation of capital gains like ordinary income. Capital gain, it is said, is not 'income' and taxation of capital gain, apart from being iniquitous, affects growth by inhibiting risk-taking. The definitional argument, however, cannot be regarded as decisive. Arguments based on growth are also not beyond question. Fears of lock-in effect seem exaggerated. If the idea is to treat savings softly, then the problem should be dealt with more generally. The equity case against full taxation of capital gain also does not seem convincing except on the ground that they tend to be bunched. If all gains are to be brought under progressive taxation, the fact of bunching as well as irregularity surely needs to be given due consideration. The solution however lies not in the exclusion of certain gains from the base - for they invariably proceed on an arbitrary basis - but in some equitable method of taxation.

Alternative ways of taxing capital gains

At a conference of experts convened by the Brookings Institution in 1966, four alternatives were considered for a general revision of the capital gains tax. These are:

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76 See for a discussion of this point H. C. Wallich's article "Taxation of Capital Gain etc", in NIT, June 1965, W. J. Blum's observations and Wallich's "Rejoinder" in NIT, Dec. 1965.

77 See for a discussion of these arguments, M. David, Alternative Approaches to Capital Gains Taxation (1968)

78 Blum, op. cit., p. 212.
(1) taxation of gains on an accrual basis; (2) cumulative averaging with interest adjustment; (3) prorating gains and (4) tax-free roll-over.

Accrual taxation was welcomed by economists at the Conference as it would make for a dramatic simplification of the tax laws and eliminate the lock-in effect completely. But it was considered impracticable not so much on account of the problem of illiquidity of the taxpayer which is one of the arguments advanced against it—-for that could be got over by permitting deferment of tax payment— as for difficulties of notional valuation. Difficulty of valuing infrequently traded assets like shares in closely held companies has been the main stumbling block to the acceptance of this proposal.

Proposals for meeting the difficulty put forward long ago by treating closely held companies as partnerships did not evoke a favourable response even from those who were critical of the realization basis of income recognition. Hence for a practical solution one has to turn to alternatives like averaging.

80 The next few paragraphs are based largely on the summary of the proceedings of this conference, as given in M. David, *op. cit.*, Ch. X.


82 Twentieth Century Fund, *Facing the Tax Problem* (1937).

For averaging, several suggestions have been discussed over the years. The cumulative averaging plan of Vickrey envisaged taxation of gains on realization with an interest adjustment so that the income would include an imputed value of the interest that could have been earned on the amount payable in taxes. Though attractive in some ways, this proposal is considered unacceptable because of problems of compliance and administration and also of defining a proper tax unit. Marriage, movement in and outside the taxable unit etc. would present difficulty. Such averaging would also not deter one from realizing losses and postponing that of gains. One way of getting over these problems could be to permit averaging for a limited period only as was suggested in the Simons-Groves plan. Administrative burden of interest computation and systematic record keeping over long periods is however a drawback of all averaging plans.

Another alternative is to permit tax free roll-over of realized gains with full taxation at death. While this proposal has the merit of doing least violence to decisions of the private sector regarding saving and investment, it gives rise to serious problems of documentation. Roll-over proposals also fail to indicate any satisfactory method of handling losses. The scheme which seemed to be favoured by


85 David, *op. cit.*, p. 185.
the majority at the Brookings Conference is the plan for proratoning and imputing constructive realization on death. A simple prorationing scheme had been suggested earlier by Goode also.

Of all the plans suggested so far, prorationing is undoubtedly the simplest. But one drawback of this scheme is that it does not help to do away with the troublesome capital-revenue distinction. Further, in equity, any such scheme should apply also to all casual or irregular incomes, which again involves defining casual gain - a far from simple task.

Averaging alone provides a complete answer to the definitional problem. It also removes the needless disparity in the treatment of capital gain and casual receipts. Adoption of a system of averaging in some of the income tax systems gives rise to the hope of its consideration elsewhere. To reduce the administrative burden however, a simple averaging system such as that in vogue in U.S.A. may be followed. With averaging, the exemptions and deductions given in respect of capital gains of certain categories may go. An option may be given to the taxpayer to ask for averaging if his income of a


87 Under this system individuals are allowed to average their incomes if the income of a particular year exceeds $3,000 and also exceeds the income of the preceding four years by more than 20 per cent (Secs. 1301 to 1305 of the IRC). Averaging is secured by adding one fifth of the current year's income to 120 per cent of the

(footnote contd.)
particular year happens to exceed the preceding three years' average by say 30 per cent. Alternatively, a system of prorating may be introduced in respect of all capital receipts. The onus of proving that a gain is in the nature of 'capital' should be on the assessee. The prorationing should be allowed over a period of 3 to 5 years. Gifts and bequests may be treated as income and allowed to be prorated under this system over a period of 5 years for gifts and over 20 years in the case of bequests. With averaging or prorating all average of the preceding four years (called the base period). Next, tax on this total is computed. The difference between this and the tax payable on 120 per cent of the base period income is then multiplied by five and this is added to the tax on 120 per cent of the averageable incomes to arrive at the net tax payable.

This is how it will work:

Take an individual having an income of say Rs. 30,000 per annum. Now suppose he receives a bequest of Rs. 3 lakhs one year. His tax liability would be worked out as follows:

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rs. 30,000</td>
<td>Rs. 6303</td>
</tr>
<tr>
<td>(at 1975-76 rates)</td>
<td></td>
</tr>
</tbody>
</table>

Adding 1/20th of Rs. 3 lakhs to his regular income, the tax comes to Rs. 14553

(B) - (A) = Rs. 8250

Hence tax on the bequest would be equal to Rs. 8250 x 20 = Rs. 1,65,000.

If A happens to be one of three legatees of the estate, each similarly placed and having equal share, the aggregate tax on the estate would add up to Rs. 4,95,000. The burden of tax imposed in this way would of course be considerably higher than the incidence of estate duty on an estate of Rs. 9 lakhs which

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realized gains whatever the source can be brought under taxation without any distinction. At the same time effort should be made to reduce the area of divergence between accrued income and realized income. For at bottom it is this gap which accounts for the phenomenon of bunching. How far this can be achieved is considered in the next chapter.

(Previous footnote contd.)

is Rs. 3,12,000. To mitigate the severity, a basic exemption of say Rs. 50,000 may be allowed in respect of bequests while including the same in the legatees' income.

An alternative method of integrating bequests (and all 'capital sums') in income for taxation has been put forward recently by Graeme Macdonald. This method envisages the conversion of a capital sum received into an income stream on the basis of life expectancy of the recipient and annuity tables. Such a system is however unsuitable where the family is the tax unit. (Graeme Macdonald, "From Estate Duty to Inheritance Tax Towards an Income Tax on Capital?", BTR, 1973, No. 5).