

LESSON - 8

CAPITAL GAINS

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STRUCTURE

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8.0 INTRODUCTION

When we buy any kind of property for a lower price and then subsequently sell it at a higher price, we make a gain. The gain on sale of a capital asset is called capital gain. This gain is not a regular income like salary, or house rent. It is a one-time gain; in other words the capital gain is not recurring, i.e., not occur again and again periodically.

Opposite of gain is called loss; therefore, there can be a loss under the head capital gain. We are not using the term capital loss, as it is incorrect. Capital Loss means the loss on account of destruction or damage of capital asset. Thus, whenever there is a loss on sale of any capital asset it will be termed as loss under the head capital gain.

8.1 OBJECTIVE

After going through this lesson you will be able to understand the meaning of capital asset, types of capital asset, what is not capital asset, computation of capital gain, types of capital gains etc. You will also be learning how to calculate the capital gain of simple problems. The capital gain is also an income and it is taxable too, at the end of the chapter you will also learn the tax treatment of the capital gain.

8.2 BASIS OF CHARGE

The capital gain is chargeable to income tax if the following conditions are satisfied:

1. There is a capital asset.
2. Assessee should transfer the capital asset.
3. Transfer of capital assets should take place during the previous year.
4. There should be gain or loss on account of such transfer of capital asset.

8.3 CAPITAL ASSET

Any income profit or gains arising from the transfer of a capital asset is chargeable as capital gains. Now let us understand the meaning of capital asset.

Capital Asset means property of any kind, whether fixed or circulating, movable or immovable, tangible or intangible, held by the assessee, whether or not connected with his business or profession, but does not include, i.e., Capital Assets exclude:

1. Stock in trade held for business
2. Agricultural land in India not in urban area i.e., an area with population more than 10,000.
3. Items of personal effects, i.e., personal use excluding jewellery, costly stones, silver, gold
4. Special bearer bonds 1991
5. 6.5%, 7% Gold bonds & National Defence Bonds 1980.
6. Gold Deposit Bonds 1999.

8.3.1 TYPES OF CAPITAL ASSET

There are two types of Capital Assets:

1. Short Term Capital Assets (STCA): An asset, which is held by an assessee for less than 36 months, immediately before its transfer, is called Short Term Capital Assets. In other words, an asset, which is transferred within 36 months of its acquisition by assessee, is called Short Term Capital Assets.
2. Long Term Capital Assets (LTCA): An asset, which is held by an assessee for 36 months or more, immediately before its transfer, is called Long Term Capital Assets. In other words, an asset, which is transferred on or after 36 months of its acquisition by assessee, is called Long Term Capital Assets.

The period of 36 months is taken as 12 months under following cases:

- Equity or Preference shares,
- Securities like debentures, government securities, which are listed in recognised stock exchange,
- Units of UTI
- Units of Mutual Funds
- Zero Coupon Bonds

8.3.2 TYPES OF CAPITAL GAIN

The profit on transfer of STCA is treated as Short Term Capital Gains (STCG) while that on LTCA is known as Long Term Capital Gains (LTCG).

While calculating tax the STCG is included in Total Income and taxed as per normal rates while LTCG is taxable at a flat rate @ 20%.

The taxability is discussed in details later in this lesson.

CHECK YOUR PROGRESS

Activity A: Name any five items, which are not included in the definition of capital asset.

Activity B: State whether the following are the capital Asset or not:

1. Bicycle
2. Horse
3. Car
4. House for self residence
5. Jewellery
6. House let on hire
7. Silver utensils
8. Air Conditioner used as stock in trade
9. Air Conditioner not used as stock in trade
10. Rural Agricultural Land
11. Urban Agricultural Land

8.3.3 TRANSFER

Capital gain arises on transfer of capital asset; so it becomes important to understand what is the meaning of word transfer. The word transfer occupy a very important place in capital gain, because if the transaction involving movement of capital asset from one person to another person is not covered under the definition of transfer there will be no capital gain chargeable to income tax. Even if there is a capital asset and there is a capital gain.

The word transfer under income tax act is defined under section 2(47). As per section 2 (47) Transfer, in relation to a capital asset, includes sale, exchange or relinquishment of the asset or extinguishments of any right therein or the compulsory acquisition thereof under any law.

In simple words Transfer includes:

- Sale of asset
- Exchange of asset
- Relinquishment of asset (means surrender of asset)
- Extinguishments of any right on asset (means reducing any right on asset)
- Compulsory acquisition of asset.

The definition of transfer is inclusive, thus transfer includes only above said five ways. In other words, transfer can take place only on these five ways. If there is any other way where an asset is given to other such as by way of gift, inheritance etc. it will not be termed as transfer.

Activity C: Whether the following transactions are transfer in relation to capital asset.

1. A house transferred by way of will to son.
2. Bonus shares given by a company to its shareholders.
3. Giving away jewellery for a piece of land.
4. Getting money in lieu of shop in a shopping complex.
5. Giving the rights to use the asset.

8.4 COMPUTATION OF CAPITAL GAINS

The capital gain can be computed by subtracting the cost of capital asset from its transfer price, i.e., the sale price. The computation can be made by making a following simple statement.

Statement of Capital Gains	
Particulars	Amount
Full Value of Consideration	-
Less: Cost of Acquisition*(COA)	-
Cost of Improvement*(COI)	-
Expenditure on transfer	-
Capital Gains	-
Less: Exemption U/S 54	-
Taxable Capital Gains	-

* To be indexed in case of LTCA

8.4.1 FULL VALUE OF CONSIDERATION

Full value of consideration means & includes the whole/complete sale price or exchange value or compensation including enhanced compensation received in respect of capital asset in transfer. The following points are important to note in relation to full value of consideration.

- The consideration may be in cash or kind.
- The consideration received in kind is valued at its fair market value.
- It may be received or receivable.
- The consideration must be actual irrespective of its adequacy.

8.4.2 COST OF ACQUISITION

Cost of Acquisition (COA) means any capital expense at the time of acquiring capital asset under transfer, i.e., to include the purchase price, expenses incurred up to acquiring date in the form of registration, storage etc. expenses incurred on completing transfer.

In other words, cost of acquisition of an asset is the value for which it was acquired by the assessee. Expenses of capital nature for completing or acquiring the title are included in the cost of acquisition.

$$\text{Indexed Cost of Acquisition} = \text{COA} \times \frac{\text{CII of Year of transfer}}{\text{CII of Year of acquisition}}$$

The indices for the various previous years are given below:

Year	Index	Year	Index
1981-82	100	1994-95	259
1982-83	109	1995-96	281
1983-84	116	1996-97	305
1984-85	125	1997-98	331
1985-86	133	1998-99	351
1986-87	140	1999-2000	389
1987-88	150	2000-01	406
1988-89	161	01-02	436
1989-90	172	02-03	447
1990-91	182	03-04	463
1991-92	199	04-05	480
1992-93	223	05-06	497
1993-94	244		

If capital assets were acquired before 1.4.81, the assesses has the option to have either actual cost of acquisition or fair market value as on 1.4.81 as the cost of acquisition. If assesses chooses the value as on 1.4.81 then the indexation will also be done as per the CII of 1981 and not as per the year of acquisition.

8.4.3 COST OF IMPROVMENT

Cost of improvement is the capital expenditure incurred by an assessee for making any addition or improvement in the capital asset. It also includes any expenditure incurred in protecting or curing the title. In other words, cost of improvement includes all those expenditures, which are incurred to increase the value of the capital asset.

$$\text{Indexed Cost of improvement} = \text{COA} \times \frac{\text{CII of Year of transfer}}{\text{CII of Year of improvement}}$$

Any cost of improvement incurred before 1st April 1981 is not considered or it is ignored. The reason behind it is that for carrying any improvement in asset before 1st April 1981, asset should have been purchased before 1st April 1981.

If asset is purchased before 1st April we consider the fair market value. The fair market value of asset on 1st April 1981 will certainly include the improvement made in the asset.

8.4.4 EXPEDITURE ON TRANSFER

Expenditure incurred wholly and exclusively for transfer of capital asset is called expenditure on transfer. It is fully deductible from the full value of consideration while calculating the capital gain. Examples of expenditure on transfer are the commission or brokerage paid by seller, any fees like registration fees, and cost of stamp papers etc., travelling expenses, and litigation expenses incurred for transferring the capital assets are expenditure on transfer.

Note: Expenditure incurred by buyer at the time of buying the capital assets like brokerage, commission, registration fees, cost of stamp paper etc. are to be added in the cost of acquisition before indexation.

Illustration 8.1 X purchased a house property for Rs. 1, 00,000 on 31st July 2000. He constructed the first floor in March 2003 for 1, 10,000. The house property was sold for Rs. 5, 00,000 on 1st April 2005. The expenses incurred on transfer of asset were Rs. 10,000. Find the capital gain.

Solution: Since the house property is a capital Asset therefore the capital gain will be computed. The house property was sold after 36 months of its acquisition therefore the capital gain will be long term capital gain (LTCG). Date of improvement (i.e., additional construction of first floor) is irrelevant.

Statement of capital Gain

Particulars	Amount (Rs.)
Full Value of Consideration	5,00,000
Less: Indexed Cost of Acquisition (COA) 1,00,000x 497/406	1,22,413
Indexed Cost of Improvement (COI) 1,10,000x497/447	1,22,304
Expenditure on transfer	10,000
Long Term Capital Gains	2,45,283
Less: Exemption U/S 54	NIL
Taxable Long Term Capital Gains	2,45,283

Illustration 8.2

If in the above question the property was acquired by Mr. X on 31st January 2003, then what will be your answer?

Solution: In this case the house property was sold before 36 months of its acquisition therefore the capital gain will be short-term capital gain (STCG). Date of improvement (i.e., additional construction of first floor) is irrelevant.

Statement of capital Gain

Particulars	Amount (Rs.)
Full Value of Consideration	5,00,000
Less: Cost of Acquisition (COA) 1,00,000	1,00,000
Cost of Improvement (COI) 1,10,000	1,00,000
Expenditure on transfer	10,000
Short Term Capital Gains	2,90,000
Less: Exemption U/S 54	NIL
Taxable Short Term Capital Gains	2,90,000

Illustration 8.3

Mr. X acquired gold jewellery for Rs. 6,000 in 1979 (Market Value as on 1st April 1981 was Rs. 10,000). The jewellery was sold by Mr. X for Rs. 49,800 in June 2005. Calculate the taxable amount of capital gain, if the expense on transfer is ¼%.

Solution: Since the jewellery was purchased before 1st April 1981, therefore the assessee has the option to choose actual cost or FMV as on 1st April was his cost of Acquisition. Since the FMV is higher therefore, it will be beneficial for Mr. X to choose FMV as his COA.

Particulars	Amount (Rs.)
Full Value of Consideration	49,800
Less: Indexed Cost of Acquisition (COA) 10,000x 497/100	49,700
Indexed Cost of Improvement (COI)	NIL
Expenditure on transfer (0.25% x 50,000)	125
Long Term Capital Gains	- 25
Less: Exemption U/S 54	NIL
Taxable Long Term Capital Gains	- 25

This is a loss of Rs. 25, we are not using the word long-term capital loss, as it is incorrect, it means loss due to damage etc.

Illustration 8.4

Mr. X invested Rs. 50,000 in gold jewellery and Rs. 50,000 in equity shares on 1st June 2004. The jewellery was sold by Mr. X for Rs. 1, 20,000 and shares for Rs. 1, 80,000 on 4th August 2005. There was a ½% brokerage on both the investments, both at the time of purchase and sale. Calculate the taxable amount of capital gain.

Solution: Since it is more than 12 months in case of share since its acquisition therefore, shares are long-term capital asset and in case of gold jewellery it is less than 36 months therefore it is a short-term capital asset.

Particulars	Gold	Shares
Full Value of Consideration	1,20,000	1,80,000
Less: Indexed Cost of Acquisition		
Gold 50,000 + ½%x 50,000	50,250	
Shares (50,000 + ½%x 50,000) x 497/480		52,030
Indexed Cost of Improvement (COI)	NIL	NIL
Expenditure on transfer		
Gold (0.5% x 1,20,000)	600	
Shares (0.5% x 1,80,000)		900
Long Term Capital Gains	69,150	1,27,070
Less: Exemption U/S 54	NIL	NIL
Taxable Long Term Capital Gains	69,150	1,27,070

Note: Expenses on acquisition are added to COA before indexation, while expenses on transfer (sale) are subtracted separately to find capital gain.

CHECK YOUR PROGRESS

[illegible][illegible]

Amount of Exemption: will be the least of: -

1. Capital Gains
2. Cost of new house.

Withdrawal of exemption: If the newly acquired house property is transferred within three years of acquisition. Thus the earlier exempted capital gain will be charged to tax in the year in which the newly acquired house property is transferred. For that the cost of acquisition of the newly acquired house property will be reduced by the amount of exemption already availed thus the cost will reduce and thus the capital gains on the new house property will be more. Above all the new house property will be a STCA since for withdrawal of exemption it should had been sold within three years of its acquisition thus now the capital gain of the new house property will be STCG which is charged as per the normal rates which may be 30% (a higher rate as compare to the flat rate of LTCG of 20%) in the case of individuals.

Illustration 8.5 Assume in Illustration 7.1 the assess purchases a new house property for Rs. 2,00,000 on 30th April 2004 how much exemption will be available to him under section 54.

Solution: Since Mr. X has purchased a new house within one year before of the date of sale of old house property, therefore, he will be eligible for exemption u/s 54. The exemption is least of:

1. Cost of new house property , i.e., Rs. 2,00,000
2. LTCG i.e., Rs. 2,45, 283

Therefore, the exemption will be Rs. 2, 00,000 and the taxable capital gain shall be

Particulars	Amount (Rs.)
Full Value of Consideration	5,00,000
Less: Indexed Cost of Acquisition (COA) 1,00,000x 497/406	1,22.413
Indexed Cost of Improvement (COI) 1,10,000x497/447	1,22,304
Expenditure on transfer	10,000
Long Term Capital Gains	2,45,283
Less: Exemption U/S 54	2,00,000
Taxable Long Term Capital Gains	45,283

Illustration 8.6 Assume in illustration 7.5 Mr. X sell the new house property in June 2005 for Rs. 7, 00,000 what will be the tax implication.

Solution: In this case since the new house property has been sold within 3 years of its acquisition, therefore the exemption on the purchase new house property will be withdrawn by reducing the cost of acquisition of the new house property, in the following manner.
 Since the new house property is sold within 36 months of acquisition therefore it is a short term capital asset.

Statement of capital gain of new house property

Particulars	Amount (Rs.)
Full Value of Consideration	7,00,000
Less: Cost of Acquisition (COA) 5,00,000	
Less: Exemption on old house 2,00,000	3,00,000
Cost of Improvement (COI)	NIL
Expenditure on transfer	NIL
Short Term Capital Gains	4,00,000
Less: Exemption U/S 54	N.A.
Taxable Short Term Capital Gains	4,00,000

CHECK YOUR PROGRESS

Activity F: X owns a house, used for his self-residence. He purchased it on November 30, 1979 for Rs. 2, 00,000. Its fair market value on April 1, 1981 was Rs. 3, 00,000. He spent Rs. 50,000 on its improvement on September 10, 2004 and sold it on December 30, of previous year for Rs. 20, 00,000. He purchased another house on February 25, of previous year for Rs. 4, 00,000.
 Compute taxable capital gain. B. Com (P) 2005

8.6 CAPITAL GAIN ON DEPRECIABLE ASSESTS

Income Tax Act does not defines the term depreciation. However depreciation means a permanent delivery in the original cost of the asset due to wear and tear, constant use, new technology etc.

- In Income Tax Act depreciation is provided on only four types of assets:
1. Buildings
 2. Furniture
 3. Machinery and plant
 4. Intangible Assets

For calculating depreciation different blocks are made based on the name of asset and then the rate of depreciation, thus a block will contain only that asset which will have the same name and same depreciation.

Depreciation = (WDV of the block as on 1st April of PY + Addition to the block – Selling price of the assets sold) * Depreciation rate.

If an asset is used for less than 180 days during a P.Y. then only ½ of the depreciation will be provided on that asset.

Illustration 8.7 Mr. X has following assets as on 1st April 2005:

Assets	Rate of depreciation	W.D.V		
Building -A	10%	10, 00,000		
Building – B	20%	50, 00,000		
Building – C	10%	12, 00,000		
Plant - X	20%	24, 00,000		
Following Assets were purchased during the year:				
Assets	Rate of depreciation	Purchase price	Purchase/Sale	
Date				
Building –D	10%	10, 00,000	Purchase	1/5/05
Building – F	10%	2, 00,000	Purchase	1/2/06
Plant -Y	20%	4, 00,000	Purchase	2/2/06

Following Asses were sold during the year:

Assets	Rate of depreciation	Sale Price
Building -A	10%	8, 00,000
Building – C	10%	3, 00,000
Plant - X	20%	12, 00,000

Calculate the depreciation as per income tax act.

Solution:

Particulars	Building – 10%	Building – 20%	Plant – 20%
W.D.V as on 1/4/05	22,00,000	50,00,000	24,00,000
Add: Purchases before 180 days of end of year	10,00,000	nil	nil
	2,00,000	nil	4,00,000
Purchases after 180 days of end of year	34,00,000	50,00,000	28,00,000
	11,00,000	nil	12,00,000
Total	23,00,000	50,00,000	16,00,000
Less: Sale			
Balance	1,00,000		
Depreciation	2,10,000		
Building 10%- 2,00,000 x 10% x ½		10,00,000	
Building 10%- 21,00,000 x 10%			nil
Building 20%- 50,00,000 x 20%	19,90,000	40,00,000	nil
Plant 20%- nil *			
W.D.V as on 31/03/06			

* Depreciation on plant is not charged as there was only one plant in the block and it is sold thus physically the block cease to exist. In this case there will be a short term capital gain which will be computed as below:

Particulars	Amount (Rs.)
Full Value of Consideration	12,00,000
Less: Cost of Acquisition (COA)	28,00,000
Cost of Improvement (COI)	NIL
Expenditure on transfer	NIL
Short Term Capital Gains	-16,00,000

Illustration 8.8 In the illustration 7.7 if the sale price of plant X is 32, 00,000 and Building C is 29, 00,000 what will be answer.

Solution: In this case there will be short term capital gain on plant X for Rs. 4, 00,000 and in case of building block – 10 % there will be short term capital gain again because the sale price of asset is more than the opening WDV and the purchases, even though the block physically exist there will not be any depreciation since the whole cost of the block has been recovered.

Particulars	Building 10%	Plant 20%
Full Value of Consideration	38,00,000	32,00,000
Less: Cost of Acquisition (COA)	33,00,000	28,00,000
Cost of Improvement (COI)	NIL	NIL
Expenditure on transfer	NIL	NIL
Short Term Capital Gains	5,00,000	4,00,000

Check Your Progress

Activity G: Mr X purchased a new office building for Rs. 12, 00,000 on 1st June of Previous year. The opening block of building as on beginning of the previous year was Rs. 5, 00,000 with rate of depreciation of 10%. During the year an old building costing Rs. 7, 00,000 was sold for Rs. 2, 00,000. Find out the depreciation chargeable and the amount of capital gain if any.

8.7 TAXATION OF LTCG

The LTCG is taxable at a flat rate of 20%, however in case of individual the taxation is as follows:

If the other incomes except LTCG is less than Rs. 1, 00,000 (maximum non taxable limit)

Then Tax on LTCG = 20% (LTCG – (1, 00,000 – other income))

If the other incomes except LTCG is greater than Rs. 1, 00,000

Then Tax on LTCG = 20% LTCG

Illustration 7.9 Compute the tax on LTCG under following cases:

- i) Business income Rs. 4,00,000 LTCG Rs. 1,20,000
- ii) Business income Rs. 40,000 LTCG Rs. 1,20,000

Solution:

If Business income Rs. 4, 00,000 LTCG Rs. 1, 20,000

Tax on LTCG = 20 % of LTCG
= 20% (Rs. 1, 20,000) = Rs. 24,000

If Business income Rs. 40,000 LTCG Rs. 1, 20,000

Tax on LTCG = 20% (LTCG – (1, 00,000 – other income))
= 20% (1, 20,000 – (1, 00,000 – 40,000))
= 20% (60,000) = Rs. 12,000

Check Your Progress

Activity H: Mr. S furnishes the details of his income compute the tax on LTCG under following cases:

Business income Rs. 2, 00,000
Income from Other sources Rs. 1, 00,000
LTCG Rs. 20,000

Activity I: Mr. S furnishes the details of his income compute the tax on LTCG under following cases:

Business income Rs. 20,000
Income from Other sources Rs. 10,000
LTCG Rs. 20,000

8.8 LET US SUM UP

Gain on sale of any capital asset is called Capital Gain, if the capital asset is long term then the gain is LTCG and if the asset is short term then the gain is STCG. However, gain on sale of depreciable asset is always STCG. The STCG is taxed at normal rates while LTCG is taxed at flat rate of 20%.

8.9 GLOSSARY

Asset: Means any property which can be realised into cash or some other valuable item, e.g., land, building, car, jewellery, T.V., computer etc.

Debentures: Debentures are financial document of title, which states that the person whose name is written on it has given a certain sum of money to the company as loan and he is entitled to get interest on that money till maturity.

Bearer Bonds: Against debentures, bearer bonds does not have any name on it, any person who will hold these documents will be eligible to get the money and interest. These bonds do not exist now days these have already matured.

Equity Shares: Equity shares are also financial documents of title, which states that the person whose name is written on it (not in case of demat shares) has contributed to the capital fund of the company and will be eligible for dividend.

Preference Shares: preference shares are also like equity shares with the difference that the dividend in their case is fixed and it is paid first to preference shareholders, and later to equity shareholders.

Recurring: Means to recur to occur again and again, e.g., salary, rent etc. occurs again and again, while non recurring means something which does not occur again and again which occurs once in a while, although it can occur again but there is no certainty of its occurrence again e.g., loss on account of road accident, gain on sale of house etc.

8.10 SELF ASSESSMENT EXERCISE

- Q-1 What is capital Asset?
- Q-2 Write short note on:

a. Cost of Acquisition

b. Cost of improvement

c. Expenditure on transfer

d. Transfer
- Q-3 Explain the deduction u/s 54.

Q-4 Mr. X purchased a house property for Rs. 80,000 on July 31, 1970. The following expenses are incurred by him for making addition to the house property:

- i) Cost of construction of first floor in 1975-76 Rs. 1, 00,000
- ii) Cost of construction of Second Floor in 1983-84 Rs. 2, 40,000

For market value of the property on April 1, 1981 is Rs. 4, 00,000. X sells the house property on August 20, 2004 for Rs. 30, 00,000 (expenses incurred on transfer: Rs. 10,000). Find out the capital gain chargeable to tax.

B. Com (P) 2006.

8.11 FURTHER AND SUGGESTED READINGS

1. Dr. Vinod K. Singhania and Monica Singhania; *Students' Guide to Income Tax*; Taxmann Publications Pvt. Ltd.; latest edition.
2. Mahesh Chandra & D.C. Shukla; *Income-tax Law and Practice*; Pragati Publications; latest edition.
3. H.C. Mehrotra; *Income-tax Law and Accounts*; Sahitya Bhawan; latest edition.
4. Girish Ahuja and Ravi Gupta; *An Elementary Approach to Income Tax & Sales Tax*; Bharat Publications; latest edition.
5. Dinkar Pagare; *Law and Practice of Income Tax*; Sultan Chand & Sons; latest edition