WHY RETAIL INVESTORS ARE ADVOCATING TO SEE A CHANGE IN CAPITAL GAINS TAX

POWER POINT

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Capital gains tax has become a hot topic of conversation—after a video featuring the Union finance minister Nirmala Sitharaman and a broker went viral—ahead of the Union Budget 2024-25, likely to be presented in July end. While the capital gains tax is not new, its impact on market sentiments is significant. Capital gains tax is levied on the profit earned from the sale of an asset, such as equity, debt, real estate, gold or mutual funds, at the time of their transfer. However, the capital gains tax structure—with its complexity and varying rates based on asset class and holding period—has led retail investors to advocate for changes.

Taxation of capital gains: In India, depending on the holding period, capital gains are classified into two categories: short-term and long-term. Both attract different tax rates.

Long-term capital gains (LTCG): Profits from the sale of equity shares held for more than 12 months are classified as LTCG. But the same for land or real estate transactions are considered LTCG if the holding period is 24 months. LTCG, from the sale of equity exceeding ₹1 lakh in a fiscal year, is taxed at 10% without indexation benefit. For other assets, LTCG is taxed at 20% with indexation benefits.

Short-term capital gains (STCG): Capital gains not classified as LTCG are automatically considered STCG. STCGs from equity shares and equity-linked mutual funds are taxed at a flat rate of 15%, while other STCGs are taxed at the normal tax rates applicable to the taxpayer.

While the rules for the taxation of capital gains may seem straightforward, the practical application of the capital gains tax is far more complex. Recent revisions in the taxation of debt instruments, such as debt funds, market-linked debentures, and hybrid debt funds, have not only complicated the interpretation of the law, but also increased the risk of errors that could lead to interest, penalties and prolonged litigation. These complications, along with the reintroduction of tax on LTCG, have left the investors appealing to the government for relief and the rationalization of the capital gains tax regime.

How it compares to other countries

While most developed and developing nations tax capital gains, specific financial hubs like Singapore and Hong Kong do not levy capital gains tax to attract global investors. India's approach is more complex than some countries' relatively straightforward systems but is deemed suitable for its economic ecosystem. Indian retail investors argue that aligning the capital gains tax regime with international standards could enhance India's competitiveness as an investment destination.

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Challenges for the government

Many retail investors feel that the current tax system unfairly affects them. They argue that multiple types of taxes—securities transaction tax, goods and services tax, stamp duty and capital gains tax—are deterrents to a conducive investment environment essential for a stabilized long-term market economy.

However, the capital gains tax is a significant revenue source for the Indian government. According to income tax statistics for the assessment year 2021-22, 4% of the total gross income declared in income tax returns is attributable to capital gains from individuals alone. Unlike developed countries that charge estate tax, in India, tax is payable only at the time of sale of the property, not for holding the property. Any reduction or relief would need to be compensated by alternative revenue streams to avoid the fiscal burden.

Government measures

The government has several provisions in the Income Tax Act that exempt capital gains tax when the profits are reinvested in specified assets, primarily residential properties. These measures aim to alleviate the burden on taxpayers; however, they are not widely regarded as creating a highly investment-friendly environment. Additionally, in recent years, the applicability of these exemptions has been capped to prevent high-net-worth individuals or investors from exploiting multiple property investments.

> India's LTCG approach is more complex than some of the other countries

Retail investors in India present a compelling case for changes to the capital gains tax system. Simplifying the tax structure, lowering rates, and matching global standards could mitigate complexity, fairness and market participation issues. However, any reforms must be carefully balanced against the government's fiscal needs and broader economic priorities. By addressing these challenges, India can foster a more investor-friendly environment that promotes sustained economic growth and market stability.

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