The Case against LTCG Tax

What is the issue?

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- Long-term capital gains tax (LTCG) is flawed in design and it’s not likely to enhance tax revenues considerably.
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- Also, it will manifestly increase the discretionary power of taxman, which has its own set of governance problems.
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Why is the logic behind LTCG flawed?

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- There are well-known promoter-operator networks which manipulate the prices of penny stocks, and drive the price upward.
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- The operator-promoters then cash out at a higher price (a year or so later), and pay no tax, which is indeed a legitimate evasion concern.
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- While an element of double corruption is indeed involved in this, there is very little data available on the exact magnitude of such designs.
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- While tax authorities should get innovative to sabotage such networks, slapping a LTCG tax isn’t prudent as it can damage the entire eco-system.
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- Rather, the best tax policy is one that maximises revenue, and not that maximises morality, or discretionary powers of the ‘taxmen’.
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Why is the government’s estimated revenue form LTCG Tax false?

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- Based on IT returns filed, the government has claimed that the total exempted capital gains from listed shares is around Rs 3,67,000 crores for the FY-17.
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- This seems to suggest that if these revenue is taxed at 10% as proposed, a whooping Rs 36.7 thousand crores can be netted.
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- But some assessments have questioned the veracity of the government's claim as such high estimates are unlikely to correspond for an average year.
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- **Firstly -** Stock market gained an average amount of only 3.9% in FY17, the year which has been stated in the government's above estimate.
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- Significantly, even when the stock markets grew faster between 2011-15 at an average of 8.8% year on, the cumulative LTCG income (accruing from stocks, property, gold etc) for four years was merely Rs 279 thousand crores.
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- **Secondly -** The accumulated Short-Term Capital Gains income (at 15% tax), for these four years, was just Rs 125 thousand crores.
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- A reasonable liberal estimate is that long-term capital gains income for stocks alone is 1.5 times STCG income, which accounts to Rs. 188 crores for 4 years.
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- This accounts to an average of Rs 47 thousand crores a year (even when the sensex grew at 8.8%), which is merely 13% of government's claim for FY-17.
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- **Thirdly -** It is likely that in years of high stock market increases, more long-term sellers enter the market, in order to avail of a zero tax benefit on sale.
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- But even for a high market growth year like FY-14/15, the reported STCG income for this year was no more than Rs 73 thousand crores.
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- Even this is less than a fifth of that assumed by the MoF.
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- **The Conclusion -** All estimations reiterate that, Long-term capital gains income in 2016/17 is unlikely to have exceeded Rs 50 thousand crores.
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- Hence, the imposition of a 10 per cent LTCG tax rate is unlikely to yield more than Rs 5000 crore in tax revenue (against the estimated 36,000 crores).
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What then explains the IT filings regarding LTCG for FY-17?

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- If Rs. 367 thousand crores were actually declared in income-tax returns in 2016-17, it is clearly an outlier that needs probing into.
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- As this has happened when the stock market was not showing significant returns for the average investor, this seems peculiar.
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- There is a possibility that demonetisation could've caused this trend, i.e. stock markets could've been used to launder money outside the tax net.
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- Even if this is the case (like the promoter-operator nexus) it requires a very different policy response than the imposition of a LTCG.
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What is the way ahead?

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- A loss set-off is allowed against LTCG taxation, and this includes losses aginst business too, which furthers the scope for tax subversion by offenders.
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- **Case for STT -** The 2002 Kelkar report had advocated the abolishment of LTCG tax and dividend tax, but the retention of STCG tax at 10%.
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- Kelkar Report had also recommended the introduction of the Securities Transaction Tax (STT), to boost revenues.
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- Notably, over the years, regardless of market direction, it has been observed that STT generates considerably stable revenues.
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- Hence, it will be much simpler to increase the STT to 25%, and will enhance revenue collections by Rs 3,000 crores per year.
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- **New Direct Tax Policy -** A committee constituted by the government for evolving a new direct tax policy is already working under 'Arbind Modi'.
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- Hence, it would be prudent for the government to withdraw the proposed LTCG tax and wait for the committee's report.
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- Until then, Finance ministry should focus on mechanisms to identify penny stock manipulators and other nefarious designs within the capital markets.
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Source: The Indian Express

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