Shouldn’t income tax be payable only on income?

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Taxpayers must not be taxed on amounts that primarily are not of income character

Income tax is a tax payable on income. Unfortunately, at times, the tax laws end up taxing receipts that are not really incomes, or which are really capital receipts or return of capital. What are these receipts, and how are they taxable?

Gifts are a classic form of capital receipt, which, under tax laws, are treated as a regular income, and are taxed at your slab rate of tax. Exemption for gifts is limited only to gifts up to ₹50,000 per year, or if they are from defined close relatives, or received at the time of marriage, etc. This often results in gifts from close friends or family members, such as cousins, being subjected to tax.

The provision, which is meant to plug loopholes for tax evasion through fictitious gifts, unfortunately, also impacts genuine cases. While there is an exemption on amounts received or paid by registered charitable trusts, it does not extend to socially responsible persons who may raise funds to help persons in distress. Though you may use all the funds you raised for its stated purpose, perhaps even making out-of-pocket contributions to it, tax authorities may seek to tax you under this provision. Instead of being rewarded for charity, you may end up being penalized for it. The income tax department can certainly help alleviate such difficulties by issuing a circular which clarifies that amounts raised by individual benefactors and spent by them on victims of natural calamities or pandemics would not be taxable.

According to the law, even if you help a stranger in need by paying him/her more than ₹50,000, that person is liable to be taxed on such receipts, although he/she may have used those funds and his/her own resources to fulfil the need. Fortunately, the government has realized, though belatedly, the harshness of this provision and announced on 25 June that amounts received by a taxpayer for medical treatment from his/her employer or from any person for treatment of covid-19 during FY20 and subsequent years would be exempt from tax. It also said ex-gratia (without any limit) a person receives from his/her employer is tax exempt. Further, amounts up to ₹10 lakh that the family members of a person who has succumbed to covid receive from any person will be exempt from tax. This is a welcome relaxation, which applies only to cases where a person contracts covid-19 or dies from the disease. A question that may arise in this context is whether such relief would be available in case a person dies within weeks of recovery from covid, as has happened in many cases. One hopes a legislative amendment would take care of such cases as well.

Another kind of capital receipt that is taxed is gains on sale of assets. While indexation of cost is permitted for computing capital gains on sale of property, such indexation neutralizes only 75% of the impact of inflation. Therefore, though your property may not have appreciated in real terms, if the impact of inflation is factored in, you still end up paying tax on part of your inflation-adjusted capital cost. Besides, on sale of listed shares, such indexation is now not available. Therefore, the longer you hold shares that rise at the same pace as inflation, the greater the tax you pay. Assume you bought shares in 2018 for ₹100,000, whose value of ₹125,000 today in real terms is the same as the value of ₹100,000 in 2018, you would still end up paying tax of ₹2,500 on gains of ₹25,000. But this gain is really nothing but an illusion created by inflation.

The third type of receipt of capital which is taxed is annuity or pension under a pension or annuity plan, where there is no return of capital on maturity or death. The annuity or pension that you receive, therefore, also involves a portion that is really return of your capital, but yet the entire amount of annuity is taxed as your regular income. Fortunately, in case of life insurance policies, due to recent amendments in the TDS provisions, it is now clear that only the excess amount received by you over and above the premium paid would be taxable as income. In case of pension fund policies issued by life insurance companies, there could be situations where you have been allowed deduction of only part of the amount of premium paid; but tax authorities may seek to tax the entire receipt on premature surrender of the policy. In such situations, an argument available is that only the amount received to the extent of the contribution allowed as deduction, and the appreciation, can be taxed and not the entire receipt.

These are anomalies in the tax laws that certainly need to be remedied. Taxpayers should not be taxed on amounts that are not primarily of an income character, or that do not result in an enhancement of their capital in real terms.

Otherwise, taxes are taking away a portion of taxpayers’ capital in the garb of taxing them on their incomes, which is not the hallmark of a reasonable or fair tax law.

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