

# IMPACT OF DEMONETIZATION AND CAPITAL GAIN TAX : A CRITICAL ANALYSIS

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**Abstract:** *Demonetization is a process through which the currency of a country is declared null and void and is replaced by the new currency. In India demonetization has been introduced three times. But most recent instance has affected majority of the people in India. The objective of this process as stated in the notification authorising demonetization was to restrict terrorist activities in the country which were being funded by antisocial elements through fake currency notes. In the beginning the people were supporting this activity but later on while facing the consequences of unplanned activity; public at large opposed it and even number of petitions were filed in the High Court and Supreme Court challenging validity of demonetization. But the important point to be considered here is that all black money is not in cash. Rather it is being converted into other forms such as precious metals and property. The government should make effective policy to broaden tax base and provide adequate relief to the tax payers. The provisions relating to application of capital gain tax must be revised and checks in the system must be included to eliminate occurrence of black money at different stages.*

**Index terms:** *Demonetization, Black money, Capital gain, Income Tax*

Demonetization is a process through which the currency of a country is declared null and void and is replaced by the new currency. In India demonetization has taken place for the first time in 1946. The currency notes of Rs. 1000 and Rs. 10,000 were removed from circulation. Although looking at the financial condition of the people at that time such demonetization was not much relevant because majority of people were not indulged into this. But in the year 1954 the notes were re-introduced in market. Next demonetisation took place in the year 1978, BJP lead government; represented by the then Prime Minister Mr. Morarji Desai announced it and currency notes of Rs. 1000, 5000 and 10000 were taken back from the market. The intention of the government was to curb the problem of black money<sup>1</sup>.

Recently, in India demonetization was declared by the government on Nov 8, 2016. The government announced that all currency notes of denomination Rs. 500 and Rs. 1000 of Mahatma Gandhi Series shall not be considered to be a legal tender after mid night. The information was given to the general public just four hours prior to demonetization through a television address by Prime Minister Narendra Modi. It was also announced that such notes shall be replaced by new notes of Rs 500 and Rs. 2000. Such circulation amounted to rupees 15.4 trillion<sup>2</sup>. At the same moment of time the government was struggling with terrorist activities in the State of J & K. As per a report the Pakistani links were involved in spreading such activities in valley. The terrorist used to fund the stone throwers in Kashmir against the Indian government. Similarly in southern regions the government was affected due to Naxalite activities. All these problems were stopped immediately after the demonetization process. The government claimed that fake currency was already in circulation and motivates people to indulge into anti national activities.

## PUBLIC OPINION

The public opinion at the time of demonetization was mixed. Majority of the people, at the time of demonetization people of the country under the charisma of PM Narendra Modi welcomed the regime. But later on looking at the consequences people started criticising the scheme. In the beginning it was projected and accepted by the people as a mechanism to curb black money but as per the reports of RBI 99% cash was deposited back in the bank. The quantum of 1% notes which did not come back to the bank was comparatively cheaper than the cost suffered by ordinary man who stood up in ques to exchange the old notes. In the beginning, the government claimed that the action would curtail the shadow economy and crack down on the use of illicit and counterfeit cash to fund illegal activity and terrorism<sup>3</sup>. As per the reports submitted by IB, R&AW, Directorate of revenue and CBI Pakistani spy agency ISI has profited around Rs. 500 crore by circulating counterfeit currency notes.<sup>4</sup>

Majority of the people faced problems in satisfying their daily needs. As per reports some of the people also faced fatal effects of demonetization. For instance, Mr Ram of Breily suffered heart attack due to none availability of cash at the time of wedding of his daughter.

## Problems caused by demonetization

1. The sudden nature of the announcement and the prolonged cash shortages in the weeks that followed created significant disruption throughout the economy, threatening economic output.<sup>5</sup>

<sup>1</sup> <http://www.freepressjournal.in/featured-blog/indias-history-with-demonetisation-from-1946-to-2016/988212>

<sup>2</sup> <https://www.cbre.com/research-and-reports/ahead-of-the-curve--demonetization-in-india>

<sup>3</sup> <http://timesofindia.indiatimes.com/india/Rs-500-and-Rs-100-notes-pulled-out-of-circulationimmediately-PM-Narendra-Modi/articleshow/55315473.cms>.

<sup>4</sup> <http://euroasiapub.org> Vol. 6 Issue 12, December - 2016, pp. 274~284

<sup>5</sup> <http://economictimes.indiatimes.com/markets/stocks/news/demonetisation-to-drag-india-behind-china-in-gdp-growth-rob-fastest-growing-economy-tag/articleshow/55492970.cm.s>

<sup>6</sup> <https://www.economist.com/news/finance-and-economics/21711035-withdrawing-86-value-cash-circulation-india-was-bad-idea-badly>

2. It has caused severe inconvenience to the general public and several deaths were caused due to this.
3. By the end of August 2017, 99% of the banned currency had been deposited in banks: only approximately ₹14,000 crore of the total demonetised currency had been discarded, leading analysts said to the state that the effort had failed to remove black money from the economy<sup>6</sup>

### Legal provisions concerning demonetization

Demonetization was introduced through a notification stating the objective of the said activity was to eliminate fake currency used for financing terrorism and to address the problem of “unaccounted money” in the economy.

The act of demonetization has been authorised by Reserve Bank of India Act, 1934. Section 26 of the Reserve Bank of India, 1934 specifies legal tender character of notes. It provides that every banknote shall be legal tender at any place in India in payment or on account for the amount expressed therein and shall be guaranteed by the central government. Moreover, on the recommendation of Central Board the government is authorised to declare from a specified date any series of notes to be ceased to be legal tender. But this act of the government must be exercised as per the notification of the central government<sup>7</sup>. In the recent process of demonetization adequate notice was not served to general public. It was given effect without adequate planning and necessary instructions for its disposal leading towards harassment of public at large.

### Demonetization: Petition in Supreme Court

The general public was supposed to deposit currency notes in bank before the due date i.e. Dec. 30, 2016. It was assured by Attorney General KK Venugopal while appearing for a petition filed in court that no citizen shall be punished for conducting criminal offence of possessing demonetized currency. A constitutional bench was settled to hear the cases of inconvenience caused to citizens due to said act of demonetization. The central government denied to grant any kind of grace period for depositing scrapped notes as it would defeat the purpose of entire exercise.<sup>8</sup>

Though there was no immediate relief to the common man, the court has however started a debate on the constitutionality of passing such notifications. Government’s action was challenged in the Supreme Court of India questioning validity of demonetization. It was further discussed in other petition that there was also a prima facie case of abridgement of fundamental rights to movement under Article 19(1)(d); trade or business under Article 19(1)(g); livelihood and, in case of those dead, life under Article 21; equality under Article 14; and the constitutional right to property under Article 300A<sup>9</sup>.

A three-judge bench comprising of the Chief Justice AM Khanwilkar and DY Chandrachud refused to “interfere” underlining that these were “matters of fiscal policies” and declined to issue any interim direction. The top court placed their faith in the government’s assurances that things would look up at the end of the 50th day on December 31. The apex court also stayed all ongoing petitions in the various high courts across the country and transferred them to a five-judge constitutional bench.

### Impact of demonetization

The agenda on which NDA government get into the power was eradication of corruption and bringing back the black money so deposited in the Swiss Bank Accounts. The present government made all promises to lure the voters on the name of black money. But ultimately government announced demonetization and projected it to be a solution to control black money. If we get into the detailed analysis of the situation than it can be said that it was merely destruction of black money and not the discovery of it. The offenders who accumulated black money over the years were never caught and left out on the cost to the country. Government also announced to submit the black money in bank accounts to convert the old currency in the new one. In the beginning government emphasised on opening of bank accounts and accordingly under Pradhan Mantri Jan Dhan Yojna (PMJDY) even the rural populations were given a bank account. The bank accounts so opened were there with zero or near to zero balance. But after the announcement of demonetization suddenly Rs. 170 crores were deposited in accounts opened under PMJDY. Were the people become rich overnight or something else had happened? Basically the currency hoarders get their black money converted into white money through their servants/ relatives or other persons. Even various cases were reported where the bank employees were also involved to convert the currency from old to new for illegal gratifications. The benefit to the economy while demonetization process can be analysed while taking the example of a person having black money would have exercised any of the following three options:

#### 1. Deposited the money in bank

If the money was deposited in bank, the government might charge income tax on the said money in future. But the government would have to bear the cost of printing new notes to replace the unaccounted income. Even the person got converted his black money into white while paying one time tax on said income.

#### 2. Destroyed the money

If the person decided to destroy this currency then the money would have been lost and had not benefitted the economy at any stage.

#### 3. Adjusted the money through illegal means

This option was again not good for the economy as the government would not be benefitted out of the process of demonetization.

<sup>7</sup> [//economictimes.indiatimes.com/articleshow/55921020.cms?utm\\_source=contentofinterest&utm\\_medium=text&utm\\_campaign=cppst](http://economictimes.indiatimes.com/articleshow/55921020.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

<sup>8</sup> <https://www.livemint.com/Politics/i2HFNZCdECO3Hn1qqXpyLI/SC-refers-individual-cases-against-demonetisation-to-constit.html>

<sup>9</sup> [//economictimes.indiatimes.com/articleshow/55916594.cms?utm\\_source=contentofinterest&utm\\_medium=text&utm\\_campaign=cppst](http://economictimes.indiatimes.com/articleshow/55916594.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

Thus, ultimately the entire process of demonetization costed more than the accrued benefits out of it. The assumed advantages from demonetization are limited as compared to cost to the entire economy at large<sup>10</sup>.

### **Problem of black money- Is demonetization a solution?**

Thus it is clear that huge steps have been taken by the governments at different point of times to curb the problem of black money. But the black money is not only available in the form of cash or is not deposited in bank accounts only. But it is invested in various other things like bullion, gold and property. All these are the subject matter of capital gain tax in India. The government has made a lot of efforts but it has not proved to be a fruitful activity causing problem to 86% people of India to satisfy their daily requirements. Moreover, various businesses have been affected through this process.

### **Impact on real estate business**

The real estate sector has been highly influenced by this process. The rate of property was quite higher before the initiation of demonetization but the demand in market for properties has reduced and ultimately the genuine buyers are in a better negotiating position. Earlier the people had a tendency to invest in properties but looking at the decreased demand the market rate of the properties have fallen down thus it proved to be beneficial to the people who have invested in the properties. Great fall in prices of residential units in major cities have been reported by various reports.<sup>11</sup>

### **Impact on gold**

In India people have the tendency to invest in gold. Even at the time of marriages the gold is given as a wedding gift. While the country was facing challenges on all fronts, those with the bulk of unaccounted cash found ways to escape the effects of demonetization. One of the ways was purchasing gold in cash. It was found that gold sales increased in India soon after the demonetization announcement. Experts speculated that in order to block such channels, the government might restrict gold ownership in the coming years<sup>12</sup>. People were apprehending that the next target after currency notes would be gold. There has been a sharp decrease in gold importation after demonetization. As per statistics import had reduced to 54.1 tones in December and 53.2 tones in January. This decline was 43% as compared to same period in the contemporary period in last year. As per experts the reason is the massive cash crunch impacting commodities and precious metals.<sup>13</sup>

As per an article published in Business Standard the import of the gold was much higher last year but in the year 2018 at least 15% fall in gold importation is expected.<sup>14</sup>

### **Tax on real estate and jewellery**

Any capital asset may it be the immovable property or precious metals like gold etc. if sold are subject to be taxed as per the Indian taxation system. As per section 2(14) of Income Tax Act, 1961 the term capital asset means *property of any kind held by an assessee, whether or not connected with his business or profession*<sup>15</sup>. It also includes property of any kind, whether fixed or circulating, movable and immovable, tangible and intangible. It further specifies that ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stone, and whether or not worked or sewn into any wearing apparel are included in capital assets and hence is subject matter of capital gain tax.

The capital asset may further be classified into long term capital asset and short term capital asset. Generally if an asset is held for duration of 36 months or more than it would be termed as long term capital asset otherwise it would be termed as short term capital asset. But in case of immovable property the time duration to be considered is 24 months and in case of shares and other securities the time considered time duration is 12 months.

<sup>10</sup> An Analysis of Impact of Demonetization on Black Money in India Dr. Neeraj Emmanuel Eusebius, *IOSR Journal Of Humanities And Social Science (IOSR-JHSS) Volume 22, Issue 5, Ver. 8 (May. 2017) PP 73-75 e-ISSN: 2279-0837, p-ISSN: 2279-0845.*

<sup>11</sup> <https://economictimes.indiatimes.com/wealth/real-estate/this-could-be-the-turnaround-year-for-real-estate-heres-why/articleshow/62490034.cms>

<sup>12</sup> <http://www.icmrindia.org/casestudies/catalogue/Economics/India%E2%80%99s%20Demonetization-Excerpts.htm#UPCOMING%20CHALLENGES%20FACING%20INDIA>

<sup>13</sup> <https://www.thehindubusinessline.com/markets/gold/gold-imports-fall-sharply-postdemonetisation/article9581453.ece>

<sup>14</sup> Available at [https://www.business-standard.com/article/economy-policy/gold-import-likely-to-fall-by-15-118061100031\\_1.html](https://www.business-standard.com/article/economy-policy/gold-import-likely-to-fall-by-15-118061100031_1.html) last visited on 31/07/2018

The purpose to distinguish between long term and short term capital asset is to apply different tax provisions on different types of properties. The profit or gain from sale of long term capital asset is long term capital gain and similarly the gain on sale of short term capital asset is short term capital gain. In India with regard to their taxation long term capital gain is subject to 20% tax at flat rate. It also provides benefit to the person of indexed price at the time of calculating profit or gain. Short term capital gain is included in the total taxable income of the person and is taxed as per the prevalent slab rates as applicable to the relevant finance year.

But majority of the transactions pertaining to sale and purchase of jewellery are not under screening of the authorities. Even in case of real estate the documentary value of the asset is understated. Every individual attempts to evade governmental dues while making any of the above stated transactions and also succeed in his attempt. This unaccounted income is the black money. But unfortunately all such kinds of transactions are unaccounted.

### **Conclusion**

It can be concluded that the political agenda of the government was to bring back the black money held in Swiss Bank Accounts and it also won election on the said agenda. Later on, to show the black money discovery the demonetization process was introduced. From the stated facts it can further be concluded that this step was a temporary step. The objective as stated in the preamble of notification was to control the terrorist activities through demonetization. Temporarily for few days it was able to control the situation but it was a failure on part of government to eradicate this problem permanently. On the contrary the loss caused to common man was much higher as compared to the benefits. It ultimately restricted for months the genuine and small transaction in which beneficiary was a common man. It should also be that all the black money is not in currency rather it is converted in other forms like precious metals or real estate. Both these items are subject to capital gain tax under the Indian Income Tax Act, 1961. As per the existing rules there is no check on purchase and sale of these assets. The available mechanism is not sufficient to control investment of black money in these assets. If the government actually desires to control circulation of black money then the purchase and sale of capital assets must be controlled. There must be availability of efficient tax system to levy and collect adequate amount of taxes. The endeavour of the government must be to increase the tax base and give maximum possible benefits to the tax payers. It must also ensure that none of the transactions must be left unaccounted and reported adequately. Demonetization is not a permanent solution to the existing problems rather constructive efforts and strong strategic decisions with strong political will must be introduced to actually control the problem of black money.

