Capital Receipts vs Revenue Receipts

The following are some of the important criteria which may be applied to distinguish between capital and revenue receipts.

(1) A receipt referable to fixed capital would be a capital receipt whereas a receipt referable to circulating capital would be a revenue receipt. The former is exempt from tax while the latter is taxable.

(2) Profits arising from the sale of a capital asset are chargeable to tax as capital gains u/s 45 whereas profits arising from the sale of a trading asset being of revenue nature are taxable as income from business u/s 28 provided that the sale is in the regular course of assessee's business or the transaction constitutes an adventure in the nature of trade.

(3) Profits arising from transactions which are entered into in the course of the business regularly carried on by the assessee, or are incidental to, or associated with the business of the assessee would be revenue receipts chargeable to tax. For example, a banker's or financier's dealings in foreign exchange or sale of shares and securities, a shipbroker's purchases of ship in his own name, a share broker's purchase of shares on his own account would constitute transactions entered and yielding income in the ordinary course of their business. If transactions are partly in the course of and partly outside the regular trading activity of the assessee, the income arising therefrom must be segregated and allocated between the two parts and treated accordingly for tax purposes.

(4) In the case of profit arising from the sale of shares and securities the nature of the profit has to be ascertained from the motive, intention or purpose with which they were bought. If the shares were acquired as an investor or with a view to acquiring a controlling interest or for obtaining a managing or selling agency or a directorship the profit or loss on their sale would be of a capital nature; but if the shares were acquired in the ordinary course of business as a dealer in shares, it would be a taxable receipt. If the shares were acquired with speculative motive the profit or loss (although of a revenue nature) would have to be dealt with separately from other business.

(5) Even a single transaction may constitute a business or an adventure in the nature of trade even if it is outside the normal course of the assessee's business. Repetition of such transactions is not necessary. Thus, a bulk purchase followed by a bulk sale or a series of retail sales or bulk sale followed by a series of retail purchases would constitute an adventure in the nature of trade and consequently the income arising therefrom would be taxable. Purchase of any article with no intention to resell it, but resold under changed circumstances would be a transaction of a capital nature and capital gains arise. However, where an asset is purchased with the intention to resell it, the question whether the profit on sale is capital or revenue in nature depends upon (i) the conduct of the assessee, (ii) the nature and quantity of the article

purchased, (iii) the nature of the operations involved, (iv) whether the venture is on capital or revenue account, and (v) other related circumstances of the case.

(6) In the case of annuities which are payable in specified sums at periodic intervals of time the receipt would be of a revenue nature even though it involves the conversion of capital into income for an annuity means the purchase of an income. An annuity received from an employer is taxable as "Income from salaries" whereas all other annuities are chargeable under the head "Income from other sources".

Annual payments, as distinguished from annuities, are in fact annual installments of capital. The purchase price of a business or property may be agreed to be paid in installments annually or otherwise. In such cases, the amount of installment received would be of capital nature not liable to tax. Thus, on the sale of property or business in consideration of annual payment:

(i) if the sale is for a price which is to be paid in installments, the installments would be capital receipts;
(ii) if the property is sold for an annuity payable regularly, the property disappears and the annuity which takes its place would be chargeable to tax;
(iii) if the property is sold for what looks like an annuity but actually there is no transmutation of the principal sum into income and the annual payments are merely installments of the principal sum with interest only so much of the amount of installments as representing the interest payable would be income chargeable to tax, the balance being capital receipt; and
(iv) if the property is sold for a consideration which is share of the profits or gross receipt of a business, the receipt of the share of profits would be the sale price but still chargeable to tax as income provided that the true bargain was to secure an income and not a fixed capital sum. However, if the circumstances of the case show that the receipts were only installments of a capital nature, though fluctuating in amount and measurable with reference to profits, they would not be taxable.

(7) A receipt in substitution of a source of income is capital receipt not chargeable to tax. Thus compensation received for restraint of trade or profession is a capital receipt. Where an assessee receives compensation of termination of the agency business being the only source of income the receipt is a capital nature but taxable u/s 28(ii). But where the assessee has a number of agencies and one of them is terminated and compensation received therefore, the receipt would be of a revenue nature since taking agencies and exploiting the same for earning income is the ordinary course of business and the loss of one agency would be made good by taking another. Compensation received from the employer for premature termination of the service contract is a revenue receipt taxable u/s 15. In case where the compensation received is partly of a capital and partly of a revenue nature, the two will have to be segregated and treated accordingly for tax purposes.

A lump sum payment made gratuitously (i.e. gratuity, leave encashment) or by way of compensation or otherwise to the widow or other legal heirs of an employee, who dies while still in active service, is not taxable as income under the Act.

(8) A lump sum paid in commutation of salaries, pension, royalties or other periodic payments would be income taxable under the respective heads. Amount received under a policy of insurance would be a capital or revenue receipt depending upon the fact whether the policy was held by the assessee as a capital asset or as a trading asset. Likewise, subsidies or grants received from the Government would be generally of a revenue nature since they would be to supplement the income from business. But where a grant is received for specific purpose but not as a supplementary trading receipt (e.g., to enable the company to relieve unemployment or promote family planning) the receipt would be of a capital nature not chargeable to tax. Premium or discount received by a debenture holder, being a capital receipt, would not be chargeable to tax.

Mining royalties are revenue receipts taxable as income from other sources irrespective of the fact whether they are received in lump sum or by way of a fixed annual sum or a tonnage royalty or the minimum royalty. Similarly, royalties paid for use of whether paid in lump sum or in installments of fixed or varying amounts would be taxable as income whereas the payment received in lieu of total or partial assignment of patent under which the owner ceases to own the patent as a capital asset would constitute a capital receipt.

Premium on issue of shares or debentures, profit on forfeiture of shares and the fee charged on fresh issue of shares are capital receipts not chargeable to tax. The amount received by a shareholder on the winding up is a capital receipt (except where the receipt is a dividend u/s 2(22)). But in case of a partnership, the amount receivable by an outgoing partner in respect of his share of the firm's profit whether, before or after its dissolution would be a revenue receipt chargeable to tax. Compensation received by a partner for relinquishing all his interests in the firm and amounts received in settlement of claim to an interest in the capital of a firm are capital receipts.

It is necessary to note that the capital or revenue nature of a receipt would have to be determined on the basis of the particular facts and circumstances of each case and the question whether a certain item is capital or revenue would be a mixed question of law and fact.

(9) Normally, gifts constitute capital receipts in the hands of the recipient. However, it is possible that gifts may partake the character of income under certain circumstances.

Example:

(i) Gifts received by doctors from their patients is taxable under the head Profits and Gains from Business or Profession.

(ii) Any sum of money or value of property received without consideration or for inadequate consideration by an assessee from any person, other than a relative, is chargeable under the head “Income from Other Sources”.