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## CAPITAL GAINS AND BUSINESS INCOME IN SHARE TRANSACTIONS: A JUDICIAL AND STATUTORY ANALYSIS

A DOCTRINAL EXAMINATION OF THE SECTION 28 – SECTION 45 DICHOTOMY UNDER THE INCOME TAX ACT, 1961

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### **Abstract**

The classification of income arising from transactions in shares and securities as either “Capital Gains” under Section 45 of the Income Tax Act, 1961, or as “Profits and Gains of Business or Profession” under Section 28 of that Act remains, more than six decades after the enactment of the principal statute, the most enduring controversy in Indian direct tax jurisprudence. The dichotomy is not a sterile taxonomic exercise; it determines the rate of tax, the eligibility for concessional regimes under Sections 111A and 112A, the applicability of the speculation rules under Section 43(5) and the deeming provision of Explanation to Section 73, the manner of set-off and carry forward of losses under Sections 70 and 74, and the very ambit of an assessee’s compliance burden under Sections 44AA and 44AB. The proliferation of retail participation in Indian capital markets, the emergence of derivative trading at unprecedented volumes, the popularisation of portfolio management services, and the rise of algorithmic intra-day trading have transformed a once-recondite question into a matter of mass concern.

This paper undertakes a doctrinal and comparative examination of the regime. It traces the conceptual origins of the capital-revenue distinction to English common law and the badges of trade articulated by the Royal Commission of 1955, locates the Indian statutory architecture within its constitutional moorings, and analyses through the IRAC framework the line of Supreme Court authority extending from G. Venkataswami Naidu (1959) to Snowtex Investment (2019). It evaluates the multi-factor judicial test, the consolidation effected by CBDT Circulars Nos 4/2007 and 6/2016, and the persistent inconsistencies that survive them. Drawing upon comparative material from the United Kingdom, the United States, Australia and Singapore, the author argues that the Indian regime has reached the limits of judicial elaboration and that further coherence can be achieved only through legislative intervention. The paper concludes by proposing a statutory safe-harbour, a holding-period-based presumptive classification, a binding consistency rule with statutory force, and an elective mark-to-market mechanism for self-identified traders.

### **Introduction**

The Indian securities market has, in the three decades since the establishment of the Securities and Exchange Board of India in 1992 and the dematerialisation of securities under the Depositories Act, 1996, undergone a structural transformation of historic proportions.

As of March 2024, registered demat accounts in India crossed fifteen crore, a figure that at the time of enactment of the Income Tax Act, 1961, would have appeared scarcely conceivable. The democratisation of broking through discount platforms, the proliferation of derivative segments on the National Stock Exchange and the Bombay Stock Exchange, the

institutionalisation of mutual fund participation through systematic investment plans, and the emergence of algorithmic and high-frequency trading have together produced a heterogeneous body of taxpayers ranging from passive long-term investors holding blue-chip equities for capital appreciation, to high-frequency traders executing thousands of intra-day transactions, to hybrid participants who simultaneously maintain an investment portfolio and engage in active trading.

This transformation has placed an old jurisprudential question – whether profits arising from transactions in shares and securities are to be assessed under the head “Capital Gains” or under the head “Profits and Gains of Business or Profession” – at the centre of a mass tax practice. What was once a question that engaged a small cohort of corporate investors has become a routine concern for individual taxpayers across the income spectrum. The volume of litigation generated by this single classificatory question, both at the level of the Income Tax Appellate Tribunal and in the High Courts, is unmatched by any other issue under the Income Tax Act.

Section 14 of the Act classifies income under five heads, of which “Capital Gains” and “Profits and Gains of Business or Profession” are two. The Supreme Court has consistently held that these heads are mutually exclusive: a particular item of income cannot be assessed simultaneously under more than one head, and once it falls within a head, it must be computed in accordance with the rules applicable to that head. The dichotomy is not unique to Indian tax law. Its conceptual roots lie in English common law, where the courts evolved a series of ‘badges of trade’ to distinguish between accretions to capital that attract no tax (in the era preceding capital gains) and revenue receipts that did. Although the badges of trade were articulated comprehensively in the Final Report of the Royal Commission on the Taxation of Profits and Income in 1955, their substance was already firmly embedded in the case law inherited by Indian courts upon Independence.

The Supreme Court in Venkataswami Naidu transplanted this framework into Indian soil and adapted it to the conditions of an emerging economy.

The Act contains no statutory definition that distinguishes a “dealer” in shares from an “investor.” The terms “investment” and “trade” are not defined for this purpose. Section 2(13) defines “business” in inclusive and remarkably broad terms, encompassing any trade, commerce or manufacture, or any ‘adventure or concern in the nature of trade, commerce or manufacture’. Section 2(14) defines “capital asset” as property of any kind, with an exclusion only for stock-in-trade. The classification therefore turns upon a single, judicially elaborated, fact-sensitive enquiry: whether shares are held as a capital asset or as stock-in-trade. This judicial enquiry, while doctrinally rich, has been criticised for its indeterminacy. Identical patterns of conduct have been classified differently by different appellate forums; the same assessee has been re-characterised across assessment years; and the line between an ‘investor’ and a ‘trader’ frequently lies in the eye of the assessing officer. The resulting uncertainty disserves both the revenue, which incurs the costs of perpetual litigation, and the assessee, who is unable to plan affairs with confidence.

Chapter 2 traces the historical and conceptual foundations of the distinction. Chapter 3 examines the statutory framework. Chapter 4 evaluates the CBDT circulars. Chapter 5 sets out the judicially developed multi-factor test. Chapter 6 analyses landmark decisions through the IRAC framework. Chapter 7 addresses special categories of transactions. Chapter 8 considers practical and fiscal implications. Chapter 9 offers comparative perspectives. Chapter 10 sets out reform proposals. Chapter 11 concludes.

### Historical and Conceptual Foundations

The constitutional moorings of income taxation in India are found in Article 265, which provides that no tax shall be levied or collected except by

authority of law, and in Entry 82 of List I of the Seventh Schedule, which empowers Parliament to legislate in respect of ‘taxes on income other than agricultural income’. The constitutional validity of taxing capital gains as a species of income was settled at an early stage by the Supreme Court in *Navinchandra Mafatlal v CIT*, where the Court rejected the argument that the term ‘income’ in Entry 82 (then Entry 54 of List I of the 1935 Government of India Act framework) excluded capital accretions. The Court adopted a broad and inclusive construction of ‘income’, holding that the legislative entry must be given the widest connotation of which it is capable.

The Indian Income-tax Act 1922 originally taxed income under five heads, but did not at first include capital gains. The head was inserted into the 1922 Act by the Income-tax and Excess Profits Tax (Amendment) Act 1947, with effect from 1 April 1946, in the form of a then-novel Section 12B. The 1961 Act preserved the architecture of the 1922 Act and re-enacted the capital-gains regime in Sections 45 to 55, with the head ‘Profits and Gains of Business or Profession’ located in Sections 28 to 44. The structural separation of the heads, and the absence of any statutory test for distinguishing share-investment from share-trading, were thus features of the regime from its inception.

The conceptual distinction between capital and revenue receipts has been described as one of the most metaphorically rich in the law of taxation. Justice Pitney’s famous formulation in *Eisner v Macomber*, that income is ‘the gain derived from capital, from labour, or from both combined’, was adopted by the Privy Council in *Shaw Wallace* as the foundation of an analogy between capital and a tree, and income and the fruit which the tree yields. The metaphor, although later disapproved in part, captures an intuition that has proved resilient: that the realisation of an asset is fundamentally different in character from the receipt of a periodic yield from that asset.

This intuition supports the doctrinal architecture of the 1961 Act. The capital-gains charge is

imposed only upon the ‘transfer’ of a capital asset and is computed by reference to a difference between consideration received and cost of acquisition; the business charge, by contrast, taxes the periodic profits of a continuing activity. Where shares are held to be transferred as a capital asset, the receipt is the realisation of an investment and is taxed under Section 45. Where shares are held to be the stock-in-trade of an activity, the receipt is a revenue accretion of a continuing business and is taxed under Section 28.

### **The Statutory Framework Under the Income Tax Act, 1961**

Section 2(14) defines ‘capital asset’ as ‘property of any kind held by an assessee, whether or not connected with his business or profession’, but expressly excludes, inter alia, ‘any stock-in-trade other than the securities referred to in sub-clause (b), consumable stores or raw materials held for the purposes of his business or profession’. The exclusion of stock-in-trade is the linguistic pivot of the entire dichotomy: shares held as stock-in-trade are not capital assets, and therefore their transfer cannot give rise to a chargeable capital gain.

Sections 2(29A) and 2(42A) classify capital assets as long-term or short-term by reference to the period of holding. For listed equity shares of an Indian company and units of equity-oriented funds, the threshold period is twelve months. For unlisted shares, the threshold is twenty-four months. The period of holding is computed from the date of acquisition to the date immediately preceding the date of transfer.

Section 111A imposes a concessional rate of tax on short-term capital gains arising from the transfer of listed equity shares of an Indian company, units of an equity-oriented fund, or units of a business trust, where the transaction is chargeable to securities transaction tax (STT). The rate, which stood at 15 per cent for over a decade, was enhanced to 20 per cent with effect from 23 July 2024 by the Finance (No 2) Act 2024. Section 112A, introduced by the

Finance Act 2018 to fill the gap created by the omission of the erstwhile Section 10(38) exemption, taxes long-term capital gains on the same categories of assets at a concessional rate, currently 12.5 per cent on aggregate gains exceeding ₹1,25,000 in a financial year. These concessional regimes are unavailable where the same gains are recharacterised as business income.

#### **Administrative Guidance: The CBDT Circulars**

Recognising the persistent uncertainty in this area, the Central Board of Direct Taxes issued Circular No 4/2007, dated 15 June 2007. The Circular acknowledged that it was possible for an assessee to maintain two distinct portfolios – an investment portfolio comprising securities held as capital assets, and a trading portfolio comprising stock-in-trade – and that income from each must be classified separately. Drawing upon the principles articulated by the Authority for Advance Rulings in Fidelity Northstar Fund, the Circular set out three broad indicia: whether the purchase and sale of securities was allied to the assessee's usual trade; the frequency, magnitude and ratio of transactions; and the period for which the shares were held. The Circular preserved the role of the totality-of-circumstances test but offered the dual-portfolio doctrine as an explicit administrative endorsement of a position that had previously been disputed.

Circular No 6/2016, issued on 29 February 2016, effected a significant simplification in respect of listed shares. The Circular directed that where the assessee opts to treat listed shares and securities held for more than twelve months as a capital asset, the income arising on transfer shall be treated as capital gains and shall not be put to dispute by the Assessing Officer. A clarificatory communication issued shortly thereafter extended the principles of the Circular to unlisted shares as well, save in cases where the genuineness of the transaction was itself in question, where the transaction was sham, or where the lifting of the corporate veil revealed it to be a device of tax avoidance. The

Circular further provided that the position once adopted by the assessee in a particular year must be applied consistently in subsequent assessment years, and the assessee shall not be allowed to take a contrary stand in subsequent years.

It is well-settled that circulars issued by the CBDT under Section 119 of the Act are binding upon the income-tax authorities, although not upon the assessee or upon the courts. In *UCO Bank v CIT*, the Supreme Court reiterated that beneficial circulars must be given effect to even where they deviate from the strict letter of the statute. In *Dhiren Chemical Industries*, the Court qualified this position to the effect that circulars cannot extend the scope of a charging provision. The circulars discussed above are beneficial in character, and their binding force upon the revenue is therefore unquestioned.

#### **Judicial Tests for Classification**

In the absence of a statutory test, the courts have evolved a multi-factor enquiry, often described as the 'badges of trade' test, to determine the true character of share transactions. No single factor is decisive; the enquiry is one of cumulative impression. The leading factors are set out below.

The Supreme Court in *Venkataswami Naidu* authoritatively held that the intention of the assessee at the time of acquisition is a factor of 'prime importance'. Where the asset is acquired with the dominant intention of resale at a profit, the transaction partakes of the character of trade. Where the dominant intention is to hold the asset for the purpose of deriving income from it (such as dividend, interest or rent) or to hold it as a long-term store of value, the transaction is on the capital account. Intention is a question of fact, but it is to be inferred from objective circumstances rather than from the assessee's mere ipse dixit. As the Court observed in *Saroj Kumar Mazumdar*, 'the question of intention has to be ascertained from the conduct of the parties and the surrounding circumstances'.

Repetition and continuity of transactions are strong indicia of a trading activity. A high frequency of transactions, a large aggregate volume relative to portfolio size, and the conduct of the activity in a systematic and organised manner all point towards business. However, mere volume cannot be conclusive: an investor with a substantial portfolio may rebalance it actively without thereby converting himself into a trader. The Bombay High Court in Gopal Purohit accepted that an assessee may have both an investment portfolio and a trading portfolio, and that volume in the trading portfolio does not contaminate the character of the investment portfolio.

A short holding period suggests a profit motive, while a long holding period generally supports the inference of investment. This factor is illustrative rather than determinative. The Gujarat High Court in Rewashanker treated holding period as one of six factors to be weighed cumulatively. The CBDT Circular No 6/2016 has elevated the twelve-month threshold to a quasi-presumption in respect of listed equities, but only in respect of capital-account treatment.

### Landmark Decisions: An IRAC Analysis

The case law on the classification of share-transaction income is voluminous. This chapter undertakes a structured analysis of nine decisions of foundational importance, applying the IRAC method (Issue – Rule – Application – Conclusion). Each case is preceded by a brief statement of the material facts.

**Facts:** The appellant firm, which acted as the managing agent of a sugar mill, purchased four contiguous plots of land adjacent to the mill on dates between 1941 and 1942. In 1947, the entire holding was sold to the mill at a substantial profit. The Income-tax Officer assessed the profit as business income; the Tribunal upheld the assessment; the High Court upheld the Tribunal; the assessee appealed to the Supreme Court.

**Issue:** Whether the profit on the sale of the plots was a capital accretion or a profit arising from an adventure in the nature of trade.

**Rule:** The Court, in a judgment delivered by Gajendragadkar J, held that whether a transaction is an adventure in the nature of trade is a mixed question of fact and law to be decided on a consideration of all the relevant facts and circumstances. No single fact is decisive; the totality of the circumstances must be considered. The intention of the assessee at the time of acquisition is, however, a fact of 'prime importance'.

**Application:** The plots had no inherent capacity to yield income; the appellant had no use for them other than to sell them to the mill; the appellant's position as managing agent gave it a unique opportunity to engineer such a sale. These circumstances together established a dominant intention of profit-making at the time of purchase.

**Conclusion:** The profit was held to be assessable as profits of an adventure in the nature of trade. The decision laid the doctrinal foundation for the entire Indian jurisprudence in this area.

### Special Categories of Transactions

As established in Madan Gopal Radhey Lal, bonus shares take the character of the original holding. Section 55(2)(aa)(iiia) provides that the cost of acquisition of bonus shares allotted on or after 1 April 1981 shall be taken as nil. In respect of rights shares, the position is governed by the principle that the right to subscribe is itself a capital asset, and the cost of the rights shares acquired pursuant to it is the amount paid for them. Where rights are renounced, a separate capital gain may arise, the cost of the rights being nil.

The classification of income arising from futures and options transactions has proved particularly contentious. The proviso (d) to Section 43(5) excludes 'eligible derivative transactions' carried out on a recognised stock exchange from the definition of 'speculative

transaction'. The consequence is that profits and losses from exchange-traded derivatives are treated as ordinary business income or loss, eligible for set-off against any other head of income (other than salary). The position is settled at the level of statute, but the underlying enquiry – whether such derivative trading constitutes a business in the first place – remains a question of fact governed by the multi-factor test discussed in Chapter 5. In practice, derivative trading is almost invariably treated as business income, both because of the contractual character of the instruments and because of the speculative nature of the activity.

Where the assessee engages in intra-day trading without taking actual delivery, the resulting transactions fall within the four corners of the definition of 'speculative transaction' in Section 43(5). The profits and losses constitute the income of a 'speculation business', governed by the restrictive set-off and carry-forward rules of Section 73. Speculation losses can be set off only against speculation gains and may be carried forward for a maximum of four assessment years. This regime applies whether or not the assessee maintains a separate investment portfolio for delivery-based trades.

### Practical and Fiscal Implications

The fiscal stakes of misclassification are substantial. Long-term capital gains on listed equity shares attract concessional treatment under Section 112A at 12.5 per cent on aggregate gains exceeding ₹1,25,000. Short-term capital gains under Section 111A attract 20 per cent. Business income, by contrast, is taxed at the assessee's applicable slab rate – up to 30 per cent for individuals (plus surcharge and cess) and at the corporate rate of 25 or 30 per cent for companies (or 22 or 15 per cent under Sections 115BAA and 115BAB, where applicable). The differential between long-term capital-gains treatment and slab-rate business treatment for an individual in the highest tax

bracket can exceed twenty percentage points, before accounting for surcharge.

The set-off and carry-forward consequences also diverge sharply. Capital losses are governed by Sections 70(2), 70(3), 74(1)(a) and 74(1)(b). Long-term capital losses can be set off only against long-term capital gains; short-term capital losses can be set off against short-term or long-term gains. Capital losses can be carried forward for eight assessment years. Business losses (other than speculation losses) can be set off against any other head of income (excluding salary) and carried forward for eight assessment years. Speculation losses, governed by Section 73, are subject to the most restrictive treatment, being available for set-off only against speculation gains and carry-forward for a maximum of four assessment years.

In the case of corporate assessees, the classification has implications under the Minimum Alternate Tax provisions of Section 115JB. Capital gains exempt or concessionally taxed under the regular provisions may nevertheless enter book profits, complicating tax planning. The Supreme Court in *Apollo Tyres Ltd v CIT* held that the Assessing Officer has limited power to look behind the audited accounts for MAT purposes, but the position remains complex.

Chapter X-A of the Act, comprising Sections 95 to 102, contains the General Anti-Avoidance Rule (GAAR), in force since 1 April 2017. Where a transaction is recharacterised under GAAR, the consequence may include the disregard of the form of the transaction in favour of its substance. The interaction of GAAR with the classification enquiry has not yet been the subject of authoritative judicial pronouncement, but the potential for GAAR to reinforce the revenue's power to look behind the form is significant.

### Comparative Perspectives

The United Kingdom is the conceptual source of much Indian doctrine in this area. The Income Tax (Trading and Other Income) Act 2005

charges to tax the profits of a trade. The badges of trade, articulated by the Royal Commission on the Taxation of Profits and Income in 1955, comprise: the subject-matter of the realisation; the length of the period of ownership; the frequency of similar transactions; supplementary work done on or in connection with the asset; the circumstances responsible for the realisation; and the motive. The badges have been refined in a continuous line of authority. In *Salt v Chamberlain*, Oliver J held that a series of share transactions undertaken with a view to investment did not constitute a trade, even though the assessee made and lost large sums. In *Wisdom v Chamberlain*, the Court of Appeal held that a single transaction in silver bullion, undertaken as a hedge, constituted an adventure in the nature of trade. The UK regime is, in its conceptual structure, almost identical to the Indian regime; the practical difference lies in the more cautious application of the badges to share transactions in the United Kingdom, where the courts have generally been reluctant to find a trade in the absence of clear evidence.

The United States distinguishes between three categories: investors, traders, and dealers. The leading authority is *Higgins v Commissioner*, where the Supreme Court held that the management of one's own portfolio, however extensive, does not constitute a trade or business. Section 475(f) of the Internal Revenue Code permits a trader in securities to elect mark-to-market accounting, with the consequence that all gains and losses are treated as ordinary income or loss and are recognised at year-end without the need for actual disposition. The election is irrevocable without the consent of the Internal Revenue Service. The structured statutory regime stands in marked contrast to the Indian and UK frameworks, both of which leave the threshold question to a fact-sensitive multi-factor enquiry.

Australia takes a different conceptual approach. Under Section 25(1) of the Income Tax Assessment Act 1936 (now the principle survives in the Income Tax Assessment Act

1997), the High Court in *FCT v Myer Emporium Ltd* articulated a 'first strand' doctrine: profits arising from a business operation or commercial transaction undertaken with a profit-making intention are assessable as ordinary income. The doctrine has the practical effect of bringing within the income concept many transactions that, under the Indian or UK approach, would be classified as capital. Australia thus has a narrower capital-revenue boundary than India.

### Reform Proposals

This chapter sets out four principal reforms designed to bring greater coherence to the Indian regime.

The principles of CBDT Circular No 6/2016 should be elevated from administrative guidance to statutory safe-harbour. A new sub-section in Section 2(14) should provide that listed equity shares held for a period exceeding twelve months shall, at the option of the assessee, be conclusively treated as capital assets. The conferral of statutory force would eliminate the residual uncertainty arising from the 'genuineness' qualifier and the discretionary application of the Circular. The proposed safe-harbour should not displace the multi-factor test in respect of shares held for shorter periods, nor in respect of unlisted shares, where the existing case law would continue to apply.

Beyond the safe-harbour, a graded presumptive framework should be introduced. Shares disposed of within thirty days of acquisition should be presumed to be stock-in-trade, subject to rebuttal by the assessee on the basis of clear evidence. Shares held for more than twelve months should be presumed to be capital assets, subject to rebuttal by the revenue. The intermediate range – thirty days to twelve months – should continue to be governed by the existing multi-factor test, but with statutory recognition of the test's leading factors. The presumptive framework would resolve the great mass of uncontroversial cases at the assessment stage and confine litigation to the truly difficult cases.

Both the assessee and the revenue should be bound, by statutory mandate, by the classification adopted in earlier assessment years, save in cases of demonstrable change in facts. The principle of consistency, recognised in *Radhasoami Satsang v CIT*, should be elevated from a rule of practice to a statutory rule in this specific context. The CBDT Circular No 6/2016 already incorporates a consistency requirement in respect of the assessee's election; the proposed reform would extend the principle to bind the revenue with equal force.

### Conclusion

The classification of income from share transactions as either capital gains or business income remains, more than six decades after the enactment of the Income Tax Act, 1961, an unsettled area of Indian tax law. The statutory framework, by its silence on the threshold question of classification, has left the field to judicial creativity and administrative palliatives. The courts, drawing upon the seminal decision in *G. Venkataswami Naidu* and a long line of subsequent authority, have evolved a multi-factor test of considerable analytical sophistication, but the very fact-sensitivity of that test has bred uncertainty. The CBDT Circulars of 2007 and 2016, while a welcome development, are administrative measures of limited reach and contingent application.

The hypothesis advanced in this paper has been borne out by the analysis. The existing regime, founded upon a fact-sensitive multi-factor judicial test and palliated by non-binding administrative guidance, has reached the limits of its capacity to deliver legal certainty. The comparative survey of the United Kingdom, the United States, Australia and Singapore demonstrates that other jurisdictions confronting similar problems have found relief in legislative intervention of varying degrees. India, with its much larger population of retail investors and a far higher volume of routine share transactions, has a correspondingly stronger case for reform.

The way forward lies in a calibrated legislative intervention. A statutory safe-harbour for long-term holdings of listed equities; a presumptive framework keyed to holding period; a binding consistency rule with statutory force; an elective mark-to-market regime for self-identified traders; a specialised adjudicatory mechanism; and the codification of the multi-factor test – these measures, taken together, would produce a regime that balances the need for legal certainty against the residual flexibility necessary to address genuine cases of trading activity. Until such reform is undertaken, the dichotomy between capital gains and business income in share transactions will continue to be one of the most enduring controversies in Indian direct tax jurisprudence – a controversy that, in the words of one commentator, no taxpayer can confidently navigate and no Assessing Officer can authoritatively resolve. The time has come for Parliament to undertake the work that the courts and the Board, despite their best efforts, cannot complete.

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