

Pay Less for Patience: A Tiered Capital Gains Tax for India

There has been an ongoing debate on long term capital gains (LTCG) tax versus capital inflows into India. I believe both are important. LTCG has become a significant source of government revenue, but the outflow of foreign capital from Indian equities is equally a matter of concern. The question is not whether we should choose revenue or capital inflows, but how we can balance the two. Is there a middle path that encourages investors to stay invested longer, attracts patient capital and protects a meaningful part of government revenue? I believe there is, and this article explores one such approach.

The debate has acquired urgency. Foreign portfolio investors have withdrawn approximately ₹3.07 lakh crore from Indian equities in 2026 up to mid-October. The Finance Minister has also expressed a willingness to hear views on LTCG and securities transaction tax (STT). The issue deserves serious consideration, not merely as a tax question but as part of a broader discussion on how India attracts and retains capital.

At the same time, we must recognise the government's perspective. Equity LTCG tax collections increased from approximately ₹29,220 crore in FY2018–19 to ₹1.29 lakh crore in FY2024–25. This is a substantial source of revenue. Abolishing the tax altogether would mean potentially giving up a significant sum, any proposal to reduce this revenue must also explain how the gap can be bridged.

The solution, in my view, lies in changing the structure of the tax rather than abolishing it outright. We should move away from a flat rate that treats all long term investors alike, regardless of how long their capital remains invested. Instead, the tax should reward patience. The longer an investor stays invested, the lower the tax rate should be.

My proposal is straightforward. Leave STT unchanged, as well as the 20% tax on short term capital gains. Replace the current 12.5% LTCG tax on listed equities, applicable after a holding period of one year, with a graduated structure: 10% on gains from investments held for more than one year, 5% on gains from investments held for more than two years, and zero tax on gains from investments held for more than three years.

The principle is simple: pay less for patience.

This would create a clear incentive to invest with a longer horizon rather than make decisions driven by short term market movements.

Such a structure would also send an important signal to global investors. India wants capital that participates in its long term growth, not merely capital that enters and exits at the first sign of volatility. Tax policy alone cannot determine foreign investment flows, but it can contribute to making India a more attractive and predictable investment destination.

The obvious question is what happens to government revenue. The answer requires us to look at the entire capital market ecosystem rather than LTCG collections in isolation.

First, there is STT. Unlike LTCG tax, which is payable on realised gains, STT is linked to transactions. Higher trading activity can therefore generate additional revenue even when a transaction does not result in a taxable long term gain. STT collections rose from approximately ₹11,528 crore in FY2018–19 to ₹57,522 crore in FY2025–26, while the Budget estimate for FY2026–27 is ₹73,700 crore. This demonstrates the growing importance of transaction-related revenue alongside the expansion of India's capital markets.

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Second, LTCG collections depend on market performance, investor participation and the gains investors eventually realise. The increase from ₹29,220 crore in FY2018–19 to ₹1.29 lakh crore in FY2024–25 reflects a period of substantial market expansion and rising participation. A lower tax rate could encourage longer holding periods and potentially greater investment activity. However, higher turnover does not automatically translate into higher taxable gains. The objective must be to create the conditions in which a larger and more durable capital market can support government revenues over time.

Third, patient capital has benefits beyond tax collections. More stable foreign investment can deepen India's equity markets, support capital formation and reduce vulnerability to abrupt changes in investor sentiment. It may also help moderate pressure on the rupee during periods of heavy portfolio outflows. LTCG taxation is not the sole determinant of foreign investment decisions; global interest rates, valuations, currency expectations and India's growth prospects all matter. Nevertheless, taxation is one policy lever worth examining.

Let us consider the arithmetic. We don't have LTCG collections by the holding period of the underlying investments, making a precise estimate of the cost of a tiered structure difficult. However, since the proposed rates are roughly half the current rate on average, we can use a simplified illustration. Applying an average rate of 6.25%, compared with the current 12.5%, to the FY2024–25 collection base of ₹1.29 lakh crore would imply collections of approximately ₹64,600 crore, a potential reduction of a similar amount.

This is an illustration, not a revenue forecast. The actual impact would depend on the distribution of holding periods, the gains realised and how investors respond to the new structure.

Could additional market activity help bridge this gap? Consider an illustrative scenario in which STT revenue and LTCG collections under the proposed regime increase in proportion to market activity and taxable gains. Using the FY2026–27 STT Budget estimate and the simplified LTCG calculation, a 10% increase would generate approximately ₹7,400 crore in additional STT and ₹6,500 crore in additional LTCG collections. Together, this would recover about 21% of the estimated ₹64,600 crore difference.

This is just a scenario, not a forecast. The point is not that additional activity will necessarily bridge the gap, but that the fiscal cost should be assessed against the potential gains from greater participation and a deeper capital market.

There are also legitimate concerns about fairness and tax neutrality across asset classes. Therefore a tiered tax for long term equity gains can be justified within the wider tax system.

Ultimately, we should aspire to make India a market where investors want to stay invested, not simply one in which they want to invest. A well designed tax policy can contribute to that outcome. The principle is worth considering: reward patience and encourage long term capital formation.

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