CAPITAL GAINS AND INDEXATION

vEcoSys

Capital Gains and Indexation

– By Prof. Simply Simple™

CAPITAL GAINS AND INDEXATION

- **If you sell an asset such as bonds, shares, mutual fund units, property etc; you must pay tax on the profit earned from it.**
- **This profit is called Capital Gains.**
- **The tax paid on this capital gains is called capital Gains tax.**
- **Conversely, if you make a loss on sale of assets, you incur a capital loss**

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Types of Capital Gains…

<u>Short Term Capital Gains</u> – If you sell the asset within 36 months from the date of purchase (12 months for shares and mutual funds).

<u>Long Term Capital Gains</u> – If you sell the asset after 36 months from the date of purchase (12 months for shares and mutual funds).

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But…

- **Income Tax laws have a provision of reducing the effective tax burden on long term capital gains that you earn.**
- **This provision allows you to increase the purchase price of the asset that you have sold.**
- **This helps to reduce the net taxable profit allowing you to pay lower capital gains tax.**
- **The idea behind this is inflation – since we know inflation reduces asset value over a period of time.**
- **This benefit provided by Income Tax laws is called 'Indexation'.**

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What is Indexation?

- Under Indexation, you are allowed by law to inflate the cost of your asset by a government notified inflation factor.
- This factor is called the 'Cost Inflation Index', from which the word 'Indexation' has been derived.
- This inflation index is used to artificially inflate your asset price.
- This helps to counter erosion of value in the price of an asset and brings the value of an asset at par with prevailing market price.
- This cost inflation index factor is notified by the government every year. This index gradually increases every year due to inflation.

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How is cost-inflation index computed? ?

- **The cost inflation index (CII) is calculated as shown:**

$$CII = \frac{\text{Inflation Index for year in which asset is sold}}{\text{Inflation Index for year in which asset was bought}}$$

This index is then multiplied by the cost of the asset to arrive at inflated cost.

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So let us assume…

- An asset was purchased in FY 1996-97 for Rs. 2.50 lacs
- This asset was sold in FY 2004-05 for Rs. 4.50 lacs
- Cost Inflation Index in 1996-97 was 305 and in 2004-05 it was 480
- So, indexed cost of acquisition would be:

$$\text{Rs. } 2{,}50{,}000 \times \frac{480}{305} = \text{Rs. } 3{,}93{,}443$$

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So…

Long Term Capital Gains would be calculated as:-

Capital Gains = Selling Price of an asset – Indexed Cost

i.e. Rs. 450000 – Rs. 393443 = Rs. 56557

Therefore tax payable will be 20% of Rs. 56557 which comes to Rs. 11311.

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Had it not been for indexation…

Capital Gains tax would have been as follows:-

Capital Gains = Selling Price of an asset – Cost of acquisition

i.e. Rs. 450,000 – Rs. 250,000 = Rs. 200,000

Therefore tax payable @ 10% of Rs. 200,000 would have come to Rs. 20,000 !!!

So you save Rs. 8,689 in taxes by using the benefit of indexation

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So…

- **You can pay tax on long term capital gains by either of the two methods:-**
  - **At the rate of 10% with indexation**

    OR

  - **At the rate of 20% without indexation**

Therefore, you need to ascertain which of the two methods would yield lower tax incidence on your capital gains.

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Hope you have now understood the concept of indexation benefit.

Thinking of Investment

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