

- 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



Types of Capital Gains...

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

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



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'.



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.



How is cost-inflation index computed??

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

Inflation Index for year in which asset is sold

CII = -----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.



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:



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.



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



So...

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

OR

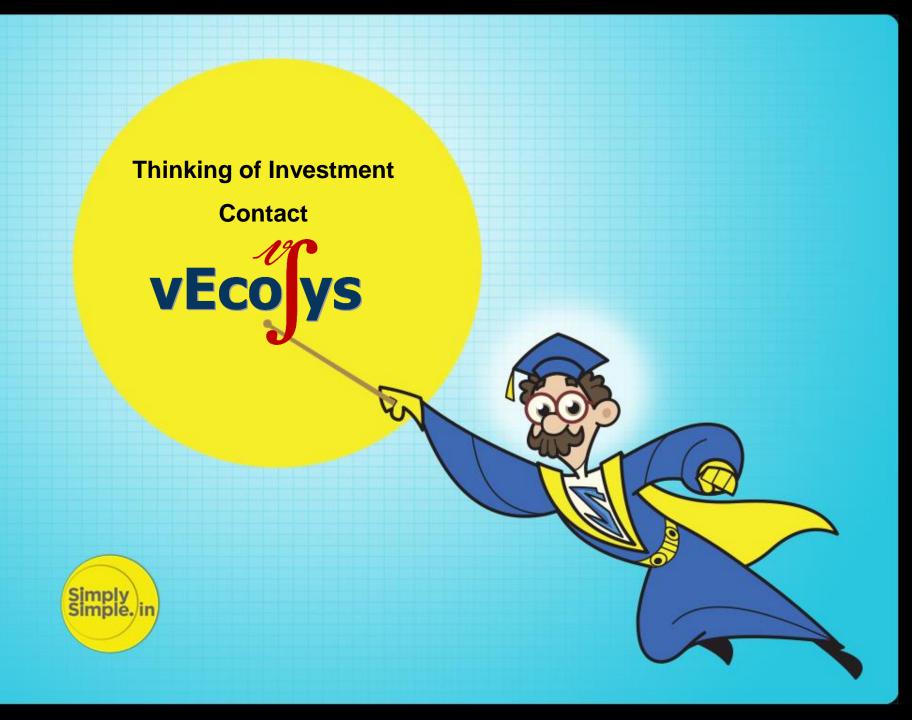
At the rate of 20% without indexation

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





Hope you have now understood the concept of indexation benefit.



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