UNDERSTANDING INDEXATION

What does ‘Indexation’ mean?

Before we get started lets understand....

- 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.**
- If you sell the asset after 36 months from the date of purchase (12 months for Equity Shares and Equity Mutual Funds), it is called Long Term Capital Gains.

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 reduces the profit gap between purchase price and sale price which in turn reduces the net tax payable as the “tax” is a function of the profit gap.
- The idea behind this provision is inflation, it reduces asset value over a period of time.
- This benefit provided by Income Tax laws is called **‘Indexation’**.
- Under Indexation, you are allowed by law to inflate the purchase price 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 the purchase price of your asset price so that it reflects its true value in the year of taxation.
- In a way indexation 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.
- For example : **The cost inflation index (CII)** is calculated as shown:

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

This index is then multiplied by the purchase price of the asset to arrive at the inflated price representing the true value of the asset at the time of tax computation.

- In case of long-term capital gains, the tax liability is computed using two methods
    - with indexation (charged at 20% plus surcharge) and
    - without indexation (charged at 10% plus surcharge)
    - The tax liability will be the lower of the two.

For Example

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**

Cost Inflation Index in **2004-05 was 480**

So, indexed cost of acquisition would be:

$$\textbf{Rs. 2.50,000} \times \frac{480}{305} = \textbf{Rs. 3,93,443}$$

Long Term Capital Gains would be calculated as:

	Selling Price of an asset	-	**Indexed Cost**	=	**Capital Gains**
i.e.	**4,50,000**	-	**Rs. 3,93,443**	=	**Rs. 56,557**

Therefore tax payable will be **20%** of **Rs. 56,557** which comes to **Rs. 11,311**

Had it not been for indexation

Capital Gains tax would have been as follows:

	Selling Price of an asset	**-**	**Indexed Cost**	**=**	**Capital Gains**
i.e.	**4,50,000**	**-**	**Rs. 2,50,000**	**=**	**Rs. 2,00,000**

Therefore tax payable **@ 10%** of **Rs. 2,00,000** would have come to **Rs. 20,000**.

So you benefit by saving Rs. 8,689 in taxes by using indexation!!

***The above is only for illustration purposes only.

Summary:

What

Indexation means adjusting the cost of the capital asset by incorporating the impact of inflation during the period of holding i.e. the period between the purchase date and the date of transfer/sale.

Why

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.

When

This cost inflation index factor is notified by the government every year.

It is always advisable to consult your financial advisor before investing.

All Mutual Fund investors have to go through a one-time KYC (Know Your Cunstomer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance , you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Funds.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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