

Indexation

Why in News?

The withdrawal of the indexation benefit in the long-term capital gains (LTCG) tax regime is one of the most contentious changes in the Union Budget 2024-25.

What is indexation?

- **Indexation**- It *adjusts the original purchase price* of an asset or investment *to neutralize the impact of inflation* over the holding period.
- **Purpose**- To ensure a more *realistic calculation of gains or losses* upon sale or redemption.
- **Calculation**- The income tax (I-T) department *uses cost inflation index (CII)* to calculate the inflation-adjusted cost of acquiring a specific assets.
- Every year, the central government publishes CII through its official gazette.

*The **cost inflation index (CII)** is a means to measure inflation, which is used in the computation of long-term capital gains concerning the sale of assets. It takes into account the Consumer Price Index (CPI) for a given year for urban non-manual employees for the preceding year.*

- The cost of acquisition thus arrived at, is called the indexed cost of acquisition.

Indexed Cost of Acquisition = $\frac{\text{Cost of Acquisition} * \text{CII of year of sale}}{\text{CII of year of purchase}}$

- **Base year** - Initially, I-T department had set 1981 as base year which was revised to **2001**, with a **base value of 100**.
- Each year's index is computed relative to this base.
- **Usage**- The adjusted purchase price after factoring in inflation, used as the base for calculating capital gains or losses.
- **Importance**- Adjusting to inflation increases the acquisition cost, thus reducing the long-term capital gains tax.

What are the positive and negative impacts of indexation?

Positive Impacts of Indexation	Negative Impacts of Indexation
Tax savings - Reduces tax liability by accounting for inflation.	Complex calculations - Requires detailed record-keeping and complex calculations.

Realistic gains- Provides a more accurate reflection of actual gains by adjusting for inflation.	Inequity- May benefit those with longer holding periods more than short-term holders.
Incentivizes long-term investment- Encourages holding assets longer to benefit from indexation.	Administrative burden- Adds administrative burden for both taxpayers and tax authorities.
Fair valuation- Ensures fair valuation of assets by considering inflation over the holding period.	Market distortion- May create distortions in asset prices and investment decisions.
Reduced tax evasion- Discourages underreporting of gains by aligning tax calculations with inflation.	Variable impact- Benefits vary widely based on inflation rates and holding periods, leading to uncertainty.

What is the recent changes in indexation?

- **Removal of indexation** - Budget 2024-25 eliminates indexation benefits for all assets like property, gold, and other unlisted assets.
- On exemption is on property acquired prior to 2001.
- **Tax rate** - After 23rd July 2024, sale of houses bought after 2001 will attract 12.5% (long-term capital gain) tax.
- Depending on the amount involved the actual tax rate could go up to 14.95% (12.5% + 15% surcharge + 4% cess).
- **Other changes in LTCG** - It is reduced from 20% to 12.5%.
- Investments in **Section 54EC bonds** or using gains for buying/constructing residential real estate continue to exempt LTCG from tax.
- **Impact** - This change is likely to lead to higher capital gains tax on sale of long-term capital assets.
- It will hurt middle-class investors who had diversified into real estate.
- Concerns were raised about higher LTCG tax liability, particularly in the residential real estate sector.
- **Lack of grandfathering-** Criticism for not extending indexation benefits for purchases made over the past 24 years.

What is the Government's justification?

- **Simplification of tax structure-** The changes simplify the capital gains tax structure.
- **Uniform tax rates-** The removal of differential tax rates for various assets benefits both taxpayers and tax authorities.
- **Taxpayer benefits-** The government claims the new regime benefits most taxpayers without causing financial loss.
- **Tax savings-** Substantial tax savings are expected for most taxpayers.

Quick Facts

What is Capital Gain Tax?

- **Capital asset** - It is any kind of property held by an individual, such as buildings, lands, bonds, equities, debentures, and jewelry.
- It excludes stock-in-trade, agricultural land, and certain specified bonds.
- **Capital Gain Tax** - Any profit or gain arising from the sale of a capital asset is deemed as capital gains.
- **In India** - It is charged by tax under the Income-tax Act, 1961.
- **Classification** - They are classified depending on the period for which the capital asset has been held
 - Short-term capital gains (STCG)
 - Long-term capital gains (LTCG)

		STCG Tax	LTCG Tax
Holding Period	Listed Asset	Less than 12 months	More than 12 months
	Others	Less than 24 months	More than 24 months
Tax Rate		<i>20% for specified financial assets (previously 15%) taxed at applicable slab rate for other assets</i>	Flat rate of 12.5% for all asset classes
Indexation Benefit		Not applicable	<i>Removed</i> for all assets, simplifying the calculation
Exemption Limit		Not applicable	<i>Increased</i> from ₹1 lakh to ₹1.25 lakh for equity-related investments
Applicable Assets		All assets, with specific rates for equity-related investments	All assets, including property, gold, and unlisted shares
Changes post-Budget 2024		Increase in rate for equity-related investments; holding period simplified	Uniform tax rate introduced; holding period simplified

References

1. [The Indian Express | What is indexation](#)
2. [The Economic Times | Budget implications on Indexation benefits](#)
3. [The Economic Times | Higher capital gains tax](#)