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.

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

- **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		*20% for specified financial* assets (previously 15%) taxed at applicable slab rate for other assets	Flat rate of ***12.5% for all*** asset classes
Indexation Benefit		Not applicable	*Removed* for all assets, simplifying the calculation
Exemption Limit		Not applicable	*Increased* 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