Indexation

What is indexation?

- Inflation reduces the value of money over a period of time. Therefore, to calculate tax on the investment return, purchase price should be adjusted to be on the same level with the current market price.
- Indexation is a process of adjusting the purchase price for inflation mainly for calculating long term capital gains tax. This is done so that the investor is taxed only on the capital gain over and above the price rise caused by inflation.
- Indexation helps in saving tax on capital gains as it allows investor to adjust for the effect of inflation on the gains made.
- In case there is a long term capital loss after adjusting purchase price for inflation, no tax is payable.
- Indexation can be applied on investments in real estate, gold, debt (fixed maturity plans).
- Investor can benefit from single or double indexation.
- Single indexation is applied on investments held for one financial year. For example, if investor invested in FMP on 1st April 2013 and sold 1st April 2014, can avail single indexation benefit.
- Double indexation is applied on investments held for two financial years. For example, if investor invested in FMP on 31st March 2013 and sold 1st April 2014, can avail double indexation benefit as his holding period falls in two financial years i.e. 2012-13 and 2013-14.

How indexation works?

- To avail benefit of indexation, one needs to increase the purchase price so it reflects inflation. For this, government releases the cost inflation index (CII) every year.
- CII is multiplied with the purchase price to arrive at the inflation adjusted purchase price for tax calculation on capital gain.
- Inflation adjusted purchase price is calculated as below

$$\textbf{Purchase Price} \times \frac{\textit{CII of the year sold}}{\textit{CII of the year purchased}}$$

- Let us understand how indexation helps in tax saving with help of an example.

- Let us assume for example, XYZ investor invest ₹ 1 lakh in 1 year FMP on 1st February 2013 with a return of 9% and maturity on 1st February 2014. Since investment is of duration of 1 year, the investor can avail single indexation benefit.

CII for FY 2011-12	785
CII for FY 2012-13	852
CII for FY 2013-14	939

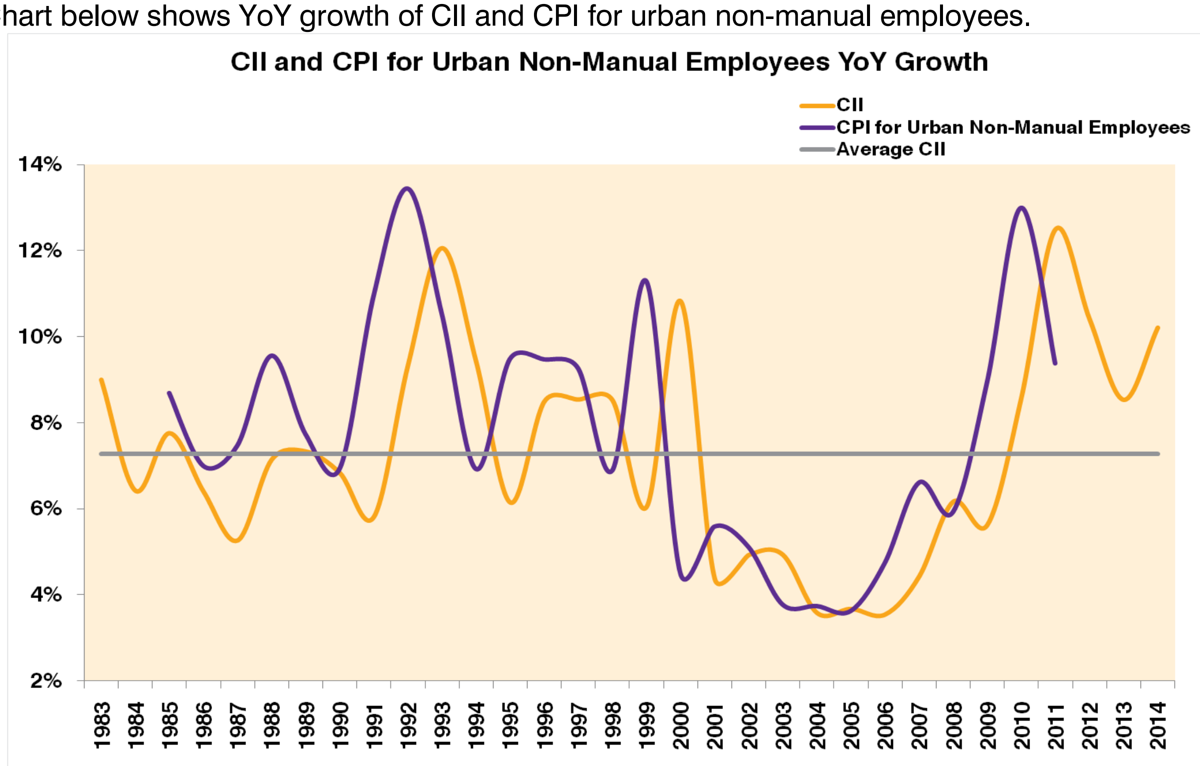
	Data	Single Indexation	Without Indexation
Amount of Investment (₹)	100,000	100,000	100,000
Assumed Rate of Interest	9.00%	9.00%	9.00%
Date of Investment	1-Feb-13	1-Feb-13	1-Feb-13
Date of Maturity	1-Feb-14	1-Feb-14	1-Feb-14
Tenor (in days)		365	365
Tenor (in years)		1.00	1.00
Amount at maturity (₹)		109,000	109,000
Return		9,000	9,000
Cost of Investment adjusted for Inflation		110,211	Not Applicable
Long term Capital Gain(Loss)		(1,211)	Not Applicable
Tax Rate (Assuming 10%)		20.6%	10.3%
Tax		0	927
Post Tax Gain		9,000	8,073
Total Amount Realised		109,000	108,073
CAGR Return (Post Tax)		9.00%	8.07%
Absolute Return (Post Tax)		9.00%	8.07%

- From the above example, we can see that with indexation investor gets full 9% return post tax[1] as compared to without indexation post tax return of 8.07%.
- Let's extend the above example to understand double indexation. Let us assume for example, XYZ investor invest ₹ 1 lakh in 14 month FMP on 1st February 2012 with a return of 9% annualized and maturity on 1st April 2013.

[1] Since no tax on long term capital loss investor gets full return post tax. However incase of long term capital gain tax is applicable but the amount is much lower due to indexation benefit.

	Data	Double Indexation	Without Indexation
Amount of Investment (₹)	100,000	100,000	100,000
Assumed Rate of Interest (annual)	9.00%	9.00%	9.00%
Date of Investment	1-Feb-12	1-Feb-12	1-Feb-12
Date of Maturity	1-Apr-13	1-Apr-13	1-Apr-13
Tenor (in days)		425	425
Tenor (in years)		1.16	1.16
Amount at maturity (₹)		110,555	110,555
Return		10,555	10,555
Cost of Investment adjusted for Inflation		119,618	Not Applicable
Long term Capital Gain(Loss)		(9,063)	Not Applicable
Tax Rate (Assuming 10%)		20.6%	10.3%
Tax		0	1,087
Post Tax Gain		10,555	9,468
Total Amount Realised		110,555	109,468
CAGR Return (Post Tax)		9.00%	8.08%
Absolute Return (Post Tax)		10.56%	9.47%

- Section 48 of the Income Tax Act 1961, as amended by Finance Act 2013, CII means such Index as the Central Government may, having regard to seventy-five per cent of average rise in the Consumer Price Index for urban non-manual employees for the immediately preceding previous year to such previous year.
- Chart below shows YoY growth of CII and CPI for urban non-manual employees.



Source: RBI, Income Tax of India. From 2012 CPI for urban non-manual employees has been discontinued

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