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INSIGHTS

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New Rules for Long-Term Capital Gains Tax

Union Finance Minister of Government of India, Ms. Nirmala Sitharaman, while presenting the union budget for financial year 2024-2025, stated that the indexation benefits on real estate sales for the properties purchased on or after 1st April 2001 shall be abolished, along with reducing long - term capital gain tax ("**LTCG**") rate from 20% *(Twenty percent*) to 12.5% (*Twelve point five percent)*.

Following pushback from the real estate sector, the Government of India introduced an amendment to the initial proposal. The amendment allows taxpayers to choose between two options for calculating LTCG taxes on property purchases made before 23 July 2024:

- *Old Regime:* Apply the 20% LTCG tax rate with indexation benefits.
- *New Regime:* Apply the reduced 12.5% LTCG tax rate without indexation benefits.

This amendment provides taxpayers with the flexibility to select the option that is most financially advantageous**.**

(To provide clarity on these evolving regulatory changes, we've prepared this insight to help you navigate the proposed updates that impact daily financial decisions.)

Definition of Indexation:

Indexation is the process of adjusting an asset's purchase price for inflation, effectively raising the asset's cost base to account for the erosion of purchasing power over time. This adjustment reduces the taxable profit and, consequently, the tax liability when the asset is sold. Without indexation, taxpayers might end up paying higher taxes despite a reduced long-term capital gains (LTCG) rate.

For example, consider a property purchased for INR 100 in 2001 and sold for INR 500 in 2024. With indexation, the purchase price would be adjusted for inflation, significantly reducing the taxable gain. Indexation is a valuable tool for protecting investment returns from excessive taxation and is applicable to long-term investments, including debt funds and other asset classes.

Before applying indexation, it's crucial to understand two related concepts: inflation and capital gains.

Inflation	Capital Gains
Inflation is the rate at which the general level of prices for goods and services rises over time, leading to a decrease in the purchasing power of money. In other words, as inflation increases, each unit of currency buys fewer goods and services than it did before. Further, the Cost Inflation Index ("**CII**") as published by the Income Tax Department and reflects the rate of inflation for indexation purposes. CII is used to calculate the inflation-adjusted cost of a long-term capital asset.	**Capital Gains** are the profits realized when you sell an asset for more than its original purchase price. These gains represent the increase in value of the asset over time and are a key indicator of investment success.
Illustration: Imagine that today, you can buy a loaf of bread for INR 50. If the inflation rate is 10% over the next year, that same loaf of bread might cost INR 55. This means that your INR 50 is no longer enough to buy the loaf of bread, illustrating how inflation erodes the value of money. Over time, as prices continue to rise, the same amount of money will buy even less, reducing your overall purchasing power.	Illustration: Suppose you bought shares in a company for INR 1,000. A few years later, the value of these shares has increased, and you sell them for INR 1,500. The difference between the selling price (INR 1,500) and the purchase price (INR 1,000) is INR 500. This INR 500 is your capital gain, representing the profit you've made from your investment.

Working of Indexation:

- Original Cost of Acquisition: This is the price at which the asset was originally purchased. For instance, if you bought units of a mutual fund for INR 10,000, this amount represents the original cost of acquisition.

- Cost Inflation Index (**CII**): This is a measure published by the government to track inflation. Each year has a specific CII value. For accurate indexation, you need the CII for both the year of purchase and the year of sale.

- Calculating Indexed Cost of Acquisition: The formula to determine the Indexed Cost of Acquisition (ICoA) is:

$$\text{ICoA} = \text{Original Cost of Acquisition} \times \frac{\text{CII of the Year of Sale}}{\text{CII of the Year of Purchase}}$$

This formula adjusts the original cost of the asset based on the relative change in the CII.

- **Calculating Capital Gains**: Once you have the ICoA, you can calculate the capital gains by subtracting this adjusted cost from the sale price of the asset.

Consider an individual who invested INR 10,000 in a debt fund in July 2016, purchasing units at a NAV of INR 10. By August 2019, the NAV had increased to INR 20, and the value of their investments had grown to INR 20,000. Without indexation, the capital gains would be INR 10,000 (i.e., INR 20,000 - INR 10,000). To account for inflation, we use the Cost Inflation Index (CII) values: 264 for 2016 and 289 for 2019. Applying the indexation formula, the **ICoA** is calculated as:

$$10{,}000 \times \frac{289[\text{CII of 2019}]}{264\ [\text{CII of 2016}]} = 10{,}947$$

Their ICoA will be INR 10,947. Hence, instead of INR 10,000, their capital gains will now be INR 9,053, i.e. (20,000 – 10,947).

<u>Objective behind abolishing the Indexation Benefit</u>

The Union Budget for 2024 announced the abolition of the indexation benefit for the sale of property. This decision aims to simplify the computation of capital gains for both taxpayers and tax authorities. By removing the ability to adjust the purchase price for inflation, the new approach seeks to streamline the tax process and make it more transparent. Under the previous regime, indexation allowed taxpayers to inflate the original purchase price based on the CII, thereby reducing the reported capital gains. The removal of this benefit eliminates this adjustment, thereby ensuring that capital gains are calculated more straightforwardly based on the nominal difference between the purchase and sale prices.

To offset the impact of abolishing indexation, the budget has introduced a reduced tax rate of 12.5% LTCG from property sales. This is the lowest rate in several years and is intended to encourage investment in the property market by making it more attractive for investors despite the loss of indexation benefits.

Indexation as per New Regime

According to the new regime introduced by the Union Finance Minister, taxpayers now have two options for calculating their capital gains on property sales:

- **12.5% Tax Rate without Indexation:** Taxpayers can choose to compute their capital gains by directly subtracting the purchase price from the selling price. Under this option, the gains are taxed at a reduced rate of 12.5%, which simplifies the calculation process but does not account for inflation.
- **20% Tax Rate with Indexation:** Alternatively, taxpayers can opt to calculate their capital gains using the indexation method, applying the previous formula with the Cost Inflation Index (CII). In this case, the capital gains are taxed at a higher rate of 20%, but the gains are adjusted for inflation, potentially reducing the taxable amount.

Conclusion

Indexation has historically been a valuable mechanism for adjusting the gains from property sales to reflect inflation over the holding period. This adjustment helped reduce the effective tax burden by ensuring that only the real appreciation in value was taxed. However, the new regime announced on 23 July 2024, eliminates this benefit, which experts suggest could result in a higher tax burden for long-term property owners, particularly those who have held their assets for more than five years. While the reduction in the tax rate to 12.5% aims to offset this change, the overall impact may still lead to increased taxes for many property sellers due to the lack of inflation adjustment in the calculation of capital gains.

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