Double Indexation: Save Taxes on Your Investments

What is Indexation?

Indexation is defined as adjusting the purchase price of your asset (essentially your investment) to reflect the impact of inflation and the capital gains are taxed accordingly.

How do you calculate Indexation?

All you need to reduce the taxes payable on your capital gains, are the following numbers:

1. Cost of Inflation Index (CII). This is released every year.

   e.g.: 2010-11 : 711

   2011-12 : 785

   2012-13 : 852

   2013-14 : 939

2. The amount invested and

3. The amount on Maturity

Once you have all these numbers, you will need a simple equation to calculate your indexed capital gains. The equation is expressed like this :

Amount Invested x (CII for current year (Year of maturity) /CII for year of purchase)

E.g.: If you had invested Rs. 10,000 in a FMP on 1st April 2011 which matured for Rs. 11,100 (interest @about11%) on 1st April 2012, then you will calculate your capital gains tax with indexation like this:

10,000 x (852/785) = 10,853 (Indexed capital amount)
Thus 11,100-10,853 = 247 (Total capital gain)
247*20 (20% long term capital gains tax)/100 = 50 will be shown in Annual return of tax as Long Term Capital Gains. Still the effective rate of interest post tax will be about 10.50%

DOUBLE INDEXATION

Now there is another concept called Double Indexation, the reason for which Fund Houses launch FMPs in the month of March. Double Indexation means that the indexation benefit is available for 2 years even if you have invested one day or one month before a financial year ends.

Confused? Let's illustrate double indexation by taking the above example forward:

E.g.: If you had invested Rs. 10,000 in a FMP on 31st March 2011 which matured to Rs 11,100 on 1st April 2012, then this means that you essentially invest in FY 2010-11 while the investment matures in FY 12-13.Thus you will calculate your capital gains tax with double indexation benefit will be like this:

10,000 x (852/711) = 11,983.

In this case, the actual return for the purpose of taxation will be 11,100-11,983 which will be negative and hence no capital gain tax to be paid.

It is important to note here that timing your investments is crucial to make this method work effectively for saving your taxes.

Hence, as interest rates are currently on the higher side, it would make sense for conservative investors to invest into FMPs which comes with the double indexation benefit. These FMPs will not only help the investor to take advantage of the high interest rates but will also be beneficial from taxation point of view.

DISCLAIMER: MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.