Budget deals capital gains tax blow to investors

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The budget has delivered a rude shock to most taxpayers. In the guise of rationalization of the capital gains provisions, there has been a significant increase in capital gains tax liability in most cases.

Relatively straightforward is the increase in the rate of tax on long-term capital gains and short-term capital gains on listed equity shares and equity-oriented funds from 10% and 15% respectively to 12.5% and 20%. Given the buoyant stock markets in recent years, this may be a tax increase that investors may shrug off and bear with a little heartburn.

The big shock, however, lies in the complete elimination of indexation of cost for all other long-term capital assets, which include unlisted shares, immoveable property, gold, overseas shares and units, etc. The indexation benefit allowed asset owners to adjust purchase price for inflation, lowering tax liability. The reduction in rate on such capital gains from 20% to 12.5%, reduction of holding period of all assets to 24 months to qualify as long-term assets and increase in the exemption limit from ₹1 lakh to ₹1.25 lakh are extremely poor substitutes for elimination of this cost indexation benefit, which was quite significant. There would be many cases where cost indexation resulted in no taxable gains or minimal gains, and 20% tax on that would have been negligible. The tax now on the entire gains at the lower rate of 12.5% would be far higher.

The cost inflation index was notified each year so as to nullify 75% of the inflation of the preceding year. Therefore, only gains in excess of 75% of inflation were taxable. Inflation has the natural effect of enhancing the value of all assets, such as immoveable property, gold, investments, etc. The whole objective of indexation of cost was to tax only those gains which were over and above inflation rates, and not to tax the appreciation attributable to 75% of inflation.

An illustration

To illustrate, if you had bought a flat for ₹50 lakh in 2001, which has appreciated today after 23 years to ₹2.50 crore. The indexed cost of the flat would today be ₹1.815 crore, considering the capital gains index of 363 for 2024-25. If you were to sell the flat now for ₹2.50 crore, you would have to pay capital gains tax at 12.5% of ₹2 crore (ignoring surcharge and cess), amounting to ₹25 lakh. On the other hand, had you sold it before the budget, the tax would have been 20% of ₹68.5 lakh, amounting to only ₹13.70 lakh.

Therefore, now the longer you hold an asset, the worse off you are, since you pay tax on the annual appreciation due to inflation. Again, this provision does not apply only to assets acquired after the amendment – it applies to all assets that you may sell on or after 23 July 2024, irrespective of when you bought the asset. It also applies to assets that you may have inherited.

The only saving grace is that if you acquired an asset prior to April 2001, you are allowed to take the fair market value of the asset as on 1 April 2001, in place of its actual purchase cost, and may therefore get the benefit of not paying tax on appreciation till April 2001.

The distinction between capital gains tax rates on listed equity shares and equity-oriented mutual funds on the one hand, and other assets has now been eliminated, with long-term capital gains

from both being taxed at the rate of 12.5% without indexation of cost. The only difference lies in the holding period to qualify as long term – 12 months for listed equity and equity-oriented mutual funds, versus 24 months for others. Of course, the difference in tax rates for short-term capital gains continues with 20% for listed equity and equity mutual funds, versus the normal tax rate for other assets.

Correction on ETFs

A correction has also been made in relation to ETFs investing in overseas equity and gold funds, which were earlier classified as debt funds with all gains therefrom being treated as short term. This is now being rectified, and these would be long term if held for 24 months, but this amendment applies only with effect from April 2025. Gains from all unlisted bonds or debentures transferred or maturing on or after 23 July 2024 will also now be classified as short-term capital gains, irrespective of holding period, taxable at slab rates of tax.

Taxation on buyback of shares is another blow to investors. Instead of the company paying a 20% buyback tax, the entire buyback price would now be taxed as dividends in the hands of the shareholder, and he can only claim a capital loss in respect of the cost of his shares, which can be offset against other capital gains. A completely unfair method of taxation – ideally, only the difference between buyback price and cost should have been taxed as capital gains of the shareholder.

One hopes that the government reconsiders the elimination of cost indexation benefits. If it is not able to keep inflation in check below the targeted 4%, why should taxpayers suffer for this by paying higher taxes? Taxation of buyback amount as dividend also deserves to be reconsidered – at least the cost of shares should be deductible. It is unfair to expect taxpayers to pay tax on income which is higher than their real income.

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