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Capital Gains Tax:
Some Insights Prior to Re-investing the Gains

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When an investment property was sold by my client Ashok, in October 2016, he had 6 months to either pay tax on his capital gains or invest the gains in Sec.54EC capital gain bonds to avail tax exemption on the property purchased by him in June 2005.

Readers may note that to avail exemption under Sec.54EC, the entire capital gains, that arise from the sale of a property, post-indexation, should be invested in bonds specified by the Government (NHAI, REC, NABARD) for a lock-in period of three years. This investment in the specified bonds must be done within 6 months from the transfer of the asset or the date of signing the sale deed. The investment in capital gains bond currently yields an annual interest of 5.25%, which is taxable.

Ashok wanted to pay tax on his capital gains and invest the remaining in any one of the fixed deposits as he was of the opinion that fixed deposits were paying higher rate of interest. But we probed him further "what if he does not pay the tax?" and invest the entire capital gain in one of the capital gains bonds. "How would that option look?"

Doing various scenario analysis, we explained to him how this could be a workable option where he could earn more and his investment would yield higher returns after 3 years.

Below are the case details of Ashok we worked on:

Sale	Rs.1,15,00,000
Sale date	October 2016
Purchase	Rs. 30,00,000
Purchase date	June 2005
CII - Year of sale: FY 16-17	1125
CII - Year of purchase: FY 05-06	497

Capital gains on the above case, after applying indexation, works out to **Rs.47,09,256.** The three possible scenarios are:

Scenario 1: Pay tax (@20% post-indexation) on the above capital gains (Rs.47,09,256) and invest the balance in FDs offering 8% annual interest for 3 years.

Scenario 2: Pay tax (@20% post-indexation) on the above capital gains (Rs.47,09,256) and invest the balance in fixed income debt funds assuming 9% annual return for 3 years.

Scenario 3: Invest the entire capital gains (Rs.47,09,256) in capital gain bonds.

In scenario 1, and 2, the amount - after payment of capital gains tax - is available for investment; whereas, in scenario 3 the entire capital gain forms the base for investment.

Scenario 1 – Investment in Fixed Deposit	
A. Capital Gains	Rs.47,09,256
B. Capital Gains (post-tax) i.e. amount invested	Rs.37,67,404
C. Corpus after 3 years @8%	Rs.47,45,845
D. Interest (C-B)	Rs.9,78,441
E. Tax Slab of Ashok (Assumed) (Excluding Cess)	20%
F. Tax (D*E)	Rs.1,95,688
G. Post-tax corpus after 3 years (C-F)	Rs.45,50,157

Scenario 2 – Investment in Fixed-income Debt Funds	
A. Capital Gains	Rs.47,09,256
B. Capital Gains (post-tax) i.e. amount invested	Rs.37,67,404
C. Corpus after 3 years @9%	Rs.48,78,898
D. #Indexed Cost of (B)	Rs.45,00,792
E. Capital Gains (C-D)	Rs.3,78,105
F. Capital Gains Tax (@20% post-indexation) (E*20%)	Rs.75,621
G. Post-tax corpus after 3 years (C-F)	Rs.48,03,277

(#CII for 2016-17=1125; assume CII for 2019-20=1344)

In scenario 2, since investments in fixed income debt funds are only subject to long-term capital gains tax, irrespective of the tax bracket, the net of tax returns after applying indexation benefit works out to be Rs.48,03,277.

Scenario 3 – Investment in Capital Gain Bonds	
A. Capital Gains	Rs.47,09,256
B. Capital Gains invested	Rs.47,09,256
C. Annual Interest @ 5.25%	Rs.2,47,236
D. Interest for 3 years (C*3)	Rs.7,41,708
E. Tax Slab of Ashok (Assumed) (Excluding Cess)	20%
F. Tax (D*E)	Rs.1,48,342
G. Post-tax interest after 3 years (D-F)	Rs.5,93,366
H. Post-tax corpus after 3 years (B+G)	Rs.53,02,622

In scenario 3, the entire capital gains amount, i.e. Rs.47,09,256, is assumed to be invested in a capital gain bond, with current annual interest rate of 5.25%, interest being taxable.

As is evident from the 3 scenarios, it makes a lot of financial sense to invest the entire capital gains in the Capital Gains Bond rather than paying capital gains tax and investing the balance in one or the other debt instrument. However, it isn't always in the best interest to invest in capital gains bonds. Rather, one should compare post-tax returns from alternative investment instruments before deciding where to invest the capital gains. FPJ