HDFC MF - *INVESTING ESSENTIALS*

LEARNING FOR THE SMART INVESTOR

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Understanding Four years of Indexation

Four years of indexation means getting benefit of four indexation when the holding period for debt mutual fund is just above three year but substantially less than four year and covering five financial year. Let us understand this with an example:

Ramesh and Suresh are two childhood friends. Their parents have taken LIC policy many years back which got matured March 2017. Both of them received policy maturity of Rs 2,00,000 into their Bank account. They plan to invest this amount in Debt Mutual Funds for a little over 3 years. Suresh invested the money in March 2017 while Ramesh invested the money in April 2017 as he could not locate his cheque book. Assuming both of them got similar returns, the table below illustrates the calculation for post-tax gains:

Particulars	Taxation of Debt Scheme investments (with 3 Indexation)			Taxation of Debt Scheme investments (with 4 Indexation)		
Name of the Investor	**Ramesh**			**Suresh**		
Amount Invested	200,000			200,000		
Date of Investment	3 April, 2017	3 April, 2017	3 April, 2017	26 March, 2017	26 March, 2017	26 March, 2017
Assumed Annualized Rate of Returns (%)	6%	7%	8%	6%	7%	8%
Date of Redemption	10 April, 2020	10 April, 2020	10 April, 2020	2 April, 2020	2 April, 2020	2 April, 2020
Total Number of Days	1,103	1,103	1,103	1,103	1,103	1,103
Gross value at Redemption (in Rs.)	238,508	245,372	252,368	238,508	245,372	252,368
Indexed Cost of Acquisition (in Rs.) #	221,324	221,324	221,324	228,030	228,030	228,030
Capital Gains (in Rs.)	17,184	24,049	31,044	10,477	17,342	24,337
Applicable Tax Rate (%) ^	28.496% ##			28.496% ##		
Tax Liability (in Rs.)	4,897	6,853	8,846	2,986	4,942	6,935
Post Tax value at Redemption (in Rs.)	233,611	238,519	243,521	235,522	240,430	245,433
Post Tax Gain (in Rs.)	33,611	38,519	43,521	35,522	40,430	45,433
Post Tax Gain (CAGR%)	**5.27%**	**6.00%**	**6.73%**	**5.56%**	**6.28%**	**7.01%**

Disclaimer: This is a hypothetical illustration to explain the concept of indexation and its benefit and actual figures would vary. Numbers are rounded off to the nearest whole number. #Cost of Inflation Index 2016-17 – 264; 2017-18 – 272; 2020-21 – 301. ^Assuming the investor falls into highest tax bracket and surcharge. ## 20% with indexation + 37% Surcharge + 4% Cess = 28.496%.

Although, Ramesh and Suresh have invested for similar number of days with similar return, but Suresh made the investment in last quarter of the financial year 2016-17 and his investment was covering five Financial years (ie 2016-17, 2017-18, 2018-19, 2019-20, 2020-21) which helped him getting four years of indexation. This four years of indexation helped Suresh to have a better Post tax return than Ramesh who had three years of indexation.

In Debt Mutual Funds, Indexation plays an important tool to save tax as it reduces inflationary gains while calculating gain from the investment. Hence planning debt investment during last quarter (Q4FY21) but before last working day (31 March 2021) of financial year, helps in getting extra indexation, thereby helping to reduce your capital gain tax liability.