Capital Gains Tax Calculation on Inherited Property

First of all, any transfer of a capital asset under a gift or a will does not attract provisions of capital gains tax. In other words, you cannot be asked to pay capital gains tax just on account of the fact that you have inherited a property.

However If the inheritor were to eventually sell the property, capital gains tax would come in the picture.

The cost and the date of acquisition to calculate this capital gains tax are to be taken as that of the "the previous owner". For example, if you have inherited the property from say your father, you will have to adopt the cost that your father paid originally when he first purchased the property.

Section 48 makes things complicated. Explanation (iii) defines 'indexed cost of acquisition' to mean an amount which bears to the cost of acquisition the same proportion as the cost inflation index for the year in which the asset is transferred bears to the cost inflation index for the first year in which the asset was held by the assessee or for the year beginning April 1, 1981, whichever is later.

In simple terms, this means that for calculating long-term capital gains, you may use indexed cost or the cost on 1.4.81, whichever is higher.

There is yet another component of cost, which is the cost of improvement of the asset. Explanation (iv) defines 'indexed cost of any improvement' to mean an amount which bears to the cost of improvement the same proportion as the cost inflation index for the year in which the asset is transferred bears to the cost inflation index for the year in which the improvement to the asset took place.

Let's understand the concept by means of an example. Say Arun's father had bought a house on July 6, 1983, for Rs1 lakh. On July 6, 1986, he spent Rs2 lakh for adding another room to the house. It was on July 6, 1990, that he passed away leaving the house to his son. The market value of the property at that time was Rs10 lakh.

Arun eventually sold this house on July 6, 2011, for a net consideration of Rs50 lakh. Now, let's work out the capital gains

Let us first compute the indexed cost of the house.

The market value in FY 1990-91, the first year in which the asset first came into Arun's possession was Rs10 lakh. This value is of no consequence. His cost of acquisition, thanks to Sec 47(iii) is evidently Rs1 lakh, the same that his father paid in FY83-84.

Consequently, Arun's date of acquisition would also be July 6, 1983.

The cost inflation index of FY11-12 is 785 and that of FY 83-84 is 116. Therefore, the indexed cost is Rs6,12,931 (1,000,00 x 785/116). This calculation seems all right at face value. However, there is an oversight.

Examine the above mentioned explanation (iii) once again. Yes, the date of acquisition for the son is certainly July 6, 1983, but it does not come into the picture at all for any purpose whatsoever, including computation of indexed cost. The index for the year in which the son first held the asset is required to be taken for computation. The son came into possession of the house in FY 1990-91 and the index for that year is 182. Therefore, the indexed cost is Rs4,31,318 (1,00,000 x 785/182) and not Rs6,12,931 as computed earlier.

Now, let us work out the indexed cost of improvement. Ironically, if we extend the same principle here, we would be making a mistake. Re-examine explanation (iv) above. A minute reading will tell you that here, unlike in the previous case, the index to be considered is that of FY 1986-87, the year in which the improvement of Rs2,00,000 was carried out. The index for 86-87 is 140 and the indexed cost is Rs11,21,429 (200000 x 785/140).

Ergo, the total indexed cost is Rs15,52,747 (4,31,318+11,21,429).

It is this computed cost that will be reduced from the net sale proceeds. The tax will be 20.6% of this amount.

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