IMPLICATION OF INCOME TAX ON MUTUAL FUND INCOME

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As a popular adage goes, there are two things certain in life; death and taxes. And yet, most of us are either ignorant of our tax liabilities or are trying to save taxes by numerous ways and mechanisms. Investing in mutual funds is supposed to be one of the ways to save tax. While, there is truth to it (like for instance by investing in ELSS schemes), largely there is a tax liability to take care of as well. In this article we would try to elaborate about what you should know about taxes and mutual funds, especially capital gains tax. Know all about it and stay invested:

Mutual funds combine the savings of a large number of investors and manage it as a single pool of money. Instead of investors worrying about which stock or bond or commodity to invest in, professional fund managers do the job.

For the individual investor who doesn't have much time to study and research investments himself, mutual funds are a great way to reap the benefits getting easy access to different types of investments with a minimum effort and a relatively low minimum investment. In most funds, it is possible to start investing with as little as a thousand rupees or even less.

Also, unlike many other investments, mutual fund investments are highly liquid. This means that an investment can generally be withdrawn without any delay. When an investor wants to withdraw money from a mutual fund, he can put in an order on any weekday and he will generally receive the money in his account in a matter of few days.

There are many types of funds with a wide range of risk levels, profit potential, and quality of fund management. There are funds that invest in equities and there are funds that invest in bonds and there are funds that combine the two asset classes. They all offer varying degrees of risk and return. There are also funds that invest in gold and some have investments outside of India.

There are many advantages of investing mutual funds, which include:

Convenience: You can easily invest as well as withdraw from them in any amount. Investments can be made by filling up a simple form or even online with direct debit from your bank account. Similarly, redemptions can be made directly into your bank account and take no more than three days.

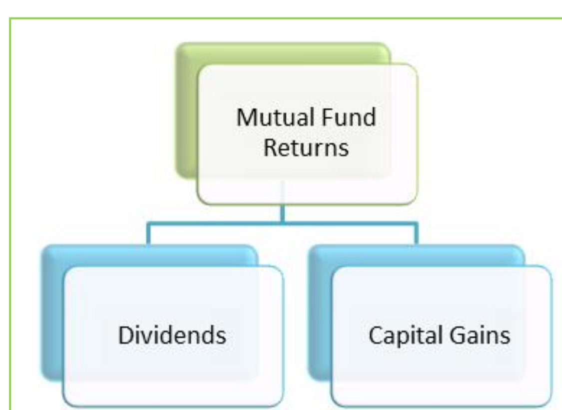
Diversification: One of the basics of safe investing is to spread your money across different investments. Mutual funds are an easy way to do this. Each mutual fund spreads the money across a large number of investments. In any well-managed fund, this spread is balanced not just across different companies but also across different sectors and sizes of companies, thus providing optimum safety.

Variety: There are mutual funds available for every kind of return and risk level and suitable for every kind of time horizon. No matter what kind of investment you want, there's likely to be a variety of funds that suit you.

Professional Research and Management: Investing is a lot of work. There are hundreds of companies to track and their prospects could change without warning. While you could do it all yourself, you may not have the time or the resources to spare. Mutual funds employ professional, whole-time investment managers and research staff. Their cost and effort gets shared 'mutually' among all the investors in a fund.

Tax Efficiency: When you buy or sell any investment, you have to pay tax on the profit you make. However, this doesn't happen when that buying and selling is being done on your behalf by a mutual fund. To maximise profits, the fund manager could keep buying and selling stocks as needed, but you have to pay tax only when you redeem your investments from the fund.

Transparency: Mutual funds are obligated by law to release comprehensive data about their operations and investments. Almost all funds release NAVs daily and most release their complete portfolio every month. Sebi regulates the fund industry very tightly and is constantly refining the applicable rules to protect investors better.



Capital gains

Capital gains in mutual funds is simply the difference between the market value of the fund unit at the time of redemption and purchase. In other words, it is the profit the investor makes when they sell their mutual fund units. There are two types of capital gains i.e long-term capital gains (LTCG) and short-term capital gains (STCG). As the name suggests, the category is bifurcated depending on the term period. However, the term period can differ based on the type of fund. The tax applied on these capital gains is known as capital gains tax.

Tax on equity mutual funds

Taxation on equity mutual funds or equity oriented schemes is fairly simple. To qualify as an equity oriented scheme, the portfolio must contain 65% or more of its holdings in domestic equity shares. Even ELSS funds would be classified as equity with the difference being that you get Section 80C deduction for it.

Any capital gain for a unit held for longer than 12 months is considered as a long-term capital gain. There is no tax on long-term capital gains.

A short-term holding (12 months or less) has a flat tax rate of 15% on the capital gains, whether you are a domestic investor or an NRI.

Similarly, any dividends or distributed income from equity funds are exempt from, irrespective of when you receive it.

	Individual & HUF investors	Non-individual investors
Equity Oriented funds	Nil	Nil
Non - equity oriented funds (Debt Funds)	**28.84%** (25% + 12% Surcharge + 3% Education cess)	**34.61%** (30% + 12% Surcharge + 3% Education cess)

Dividends are declared on face value of the mutual fund units i.e. Rs. 10/-. If a mutual fund declares a dividend of 40%, it means an investor would get Rs. 4/- as dividend for every unit he is holding.

Details	Amount (in Rs.)
Dividend declared 40% (per unit)	4.00
DDT @ 28.84% of Rs 4.00	1.15
Net Dividend in the hands of the investor after deducting DDT	**2.85**

The post DDT amount of Rs. 2.85 would be passed on to the investor, which is tax free in his hands.

Taxation on interest income: The common misunderstanding on treatment of interest income earned from bank deposits is that it is exempted if the interest earned is less than Rs 10,000/-p.a and taxed at 10% if the earning is more than Rs. 10,000/- p.a which is deducted by the bank before paying the interest.

Tax on non-equity mutual funds

Non-equity mutual funds include debt funds, liquid funds, money market funds and infrastructure debt funds.

For non-equity mutual funds, units need to held for more than 36 months to be classified as long term. Long-term capital gains are taxed at 20% with indexation. Basically, indexation can be defined as adjusting the price of a particular value for inflation. And then, inflation is calculated every financial year, and the value is called the Cost Inflation Index (CII). The primary idea is to factor in the rise of prices so that investor has to pay tax only on the "real gains".

Also, capital gains realised on debt fund units held for less than 36 months would be categorised as short-term capital gains. It is perhaps the only scenario where the investor would be taxed according to their respective tax slabs. Capital gains will be added as part of the income and if the investor falls in the 10% tax bracket, the tax rate on CG will be 10%. Similarly, if the investor falls under the 30% tax bracket, any STCG will be taxed at 30%. Any domestic company, however, will be taxed at a flat 30% for STCG on non-equity schemes.

While dividends in debt oriented schemes are nil, there is a catch known as the dividend distribution tax (DDT). As per the Union Budget of 2016, there is a dividend distribution tax (DDT) for retail investors at 28.33% including surcharge and cess. It can be broken up as

25%+ (12% *0.25)+ 3% *(0.25+ 12% *0.25)
= 28.84

However, the investor does not pay this tax, at least not directly. The fund house deducts it from the NAV of the scheme to the extent of statutory levy (if applicable) and pursuant to the payout of the dividend the NAV of the scheme would fall to the extent of payout and statutory (if applicable) .

The returns earned from mutual funds are taxed under the head 'Income from Capital Gains.'

Many mutual fund investors are a bit confused about the taxation of returns from investments. Many mutual fund investors are a bit confused about the taxation of returns from investments. Investment experts are always busy answering questions like should I pay tax on my mutual funds or will my investment qualify for a tax deduction. Experts say the different treatment of MF returns for calculating the tax liability is the main reason for the confusion. The returns earned from mutual funds are taxed under the head 'Income from Capital Gains.' And capital gains can be short-term.

<u>Taxation of equity schemes</u>

A mutual fund scheme qualifies to be taxed as an equity scheme if it invests at least 65 per cent of the total corpus in equity and equity related instruments.

Returns from an equity mutual fund are treated as long term capital gains if investments are held for more than a year. Such returns are completely exempt from income tax according to the current laws.

However, if investments are held for one year or less, the returns are taxed under short term capital gains. Such returns are taxed at 15 per cent.

<u>Taxation of debt schemes</u>

Mutual fund schemes that invest less than 65 per cent of the corpus in equity are categorised as non-equity funds for the purpose of taxation. Your debt mutual funds fall under this category.

Also, gold funds, fund of funds, international funds, etc are categorised as non-equity schemes for the purpose of taxation.

Returns from non-equity funds are treated as long-term capital gains if investments are held for more than three years. And the returns are taxed at 20 per cent with the indexation benefit. Indexation is a procedure of inflating the purchase cost to account for inflation with the help of a price index. The process reduces the taxable profits.

If investments are held for three years or less, the returns are treated as short-term capital gains. Such gains are added to the income and taxed as per the income tax rate applicable to the investor.

<u>Taxation of hybrid schemes</u>

Hybrid schemes can be either equity-oriented or debt-oriented. The scheme information document would clearly specify the investment pattern, making it clear whether the scheme qualifies to be an equity fund or a debt fund.

Needless to say, you should pay attention to this factor while investing in a hybrid scheme because the tax liability is very different for equity and non-equity schemes.

<u>How to calculate the holding period?</u>

Holding period is determined from the date of purchase of mutual fund units till the day you sell them. In case of a Systematic Investment Plan (SIP), you are purchasing certain number of units every month or quarter and the period of holding has to be calculated individually for all these purchases.

Investing in mutual funds generates capital gains which can be taxed. Taxation on

- **Tax-Saving Equity Funds**
- **Non-tax Saving Equity Funds**
- **Debt Funds**
- **Balanced funds**
- **SIPs**

1. Mutual Funds Holding Period

The basic motivation behind investing in mutual funds is to earn interest/dividends and capital gains. You need to know that these capital gains are taxed by the income tax authorities. The amount of tax to be paid on capital gains depends on the time for which you stay invested in them. It is referred to as the holding period of mutual funds.

The holding period of mutual fund units can be short-term or long-term. In case of equity mutual funds and balanced mutual funds, a holding period of 12 months or more is regarded as long-term. In case of debt mutual funds, a holding period of 36 months or more is regarded as long-term. A holding period of less than 36 months for debt funds and less than 12 months for equity and balanced funds is defined as short-term.

The following table gives a glimpse of holding period classification of mutual funds:

	Short-term	Long-term
Equity funds	Less than 12 months	12 months and more
Balanced funds	Less than 12 months	12 months and more
Debt funds	Less than 36 months	36 months and more

Now let's have a look at the taxation of short-term gains and long-term capital gains on different types of mutual funds.

Taxation on Mutual Funds

<u>Tax-Saving Equity Funds</u>

Equity-Linked Saving Scheme (ELSS) are the most efficient tax-saving instruments under Section 80C of the Income Tax Act 1961. These are diversified equity funds which invest in equity shares of companies across market capitalization.

ELSS comes up with a lock-in period of 3 years. It means that once you invest in ELSS, you cannot redeem your units before expiration of 3 years. You can claim a tax deduction of up to Rs 1.5lakh and save taxes up to Rs 45000 by investing in ELSS.

Upon redemption after 3 years, the long-term capital gains (LTCG) up to Rs 1 lakh are tax-free in your hands. LTCG in excess of Rs 1 lakh is taxed at the rate of 10% without the benefit of indexation.

Non-tax Saving Equity Funds

Long-term capital gains (LTCG) on non-tax saving equity funds of up to Rs 1 lakh are tax-free in your hands. LTCG in excess of Rs 1 lakh are taxed at the rate of 10% without the benefit of indexation.

Just in: Budget 2018 Proposals
1st February 2018

Currently, equity mutual fund investors need not pay any tax on long term capital gains on investments made before a year. If investments in equity mutual funds are sold within a year, gains will be treated as short term capital gains and taxed at 15 per cent.

However, all gains up to January 31, 2018 will be grandfathered, said the finance minister. For example, if an equity share is purchased six months before 31st January, 2018 at Rs 100 and the highest price quoted on 31st January.

- To tax Long-term capital Gains on sale of Equity shares/units of Equity oriented Fund if more than Rs 1 lakh at @ 10% without the benefit of indexation.
- Relief to existing investors to exempt amount of capital gains up to 31 Jan 2018. The amount of Gains made thereafter this cut-off date will be taxed.

For Example, Mr A purchased shares for Rs. 100 on 30th September 2017 and sold them on 31st December 2018 at Rs 120. The Value of the Stock was Rs. 110 as on 31st January 2018. Out of the capital gains of Rs. 20 (i.e 120-100), Rs. 10 (i.e 110-100) is not taxable. Rest Rs. 10 is taxable as Capital gains @ 10% without indexation.

Short-term gains from equity funds, if the units are redeemed before 12 months, are taxed at the rate of 15% (No changes in the Budget 2018 in this regard)

Debt Funds

Long-term capital gains on debt fund are taxed at the rate of 20% after indexation. Indexation is a method of factoring in the rise in inflation between the year when the debt fund units were bought and the year when they are sold.

Indexation allows inflating the purchase price of debt funds so as to bring down the quantum of capital gains. come down significantly. Short-term gains from debt funds are added to your income and are subject to short-term capital gains tax (SCGT) as per the income tax slab you fall under.

Balanced funds

Balanced funds are equity-oriented hybrid funds that invest at least 65% of their assets in equities. This is why their tax treatment is exactly the same as non-tax saving equity funds.

Taxation on different types of mutual funds		
	Short-term capital gains (STCG) tax	Long-term capital gains (LTCG) tax
Equity mutual funds	15%	10% on LTCG in excess of Rs. 1 Lakh
Balanced mutual funds	15%	10% on LTCG in excess of Rs. 1 Lakh
Debt mutual funds	As per tax slab	20% after indexation

Systematic Investments Plan (SIPs)

An SIP or a systematic investment plan is the method of investing a fixed amount in a mutual fund in a periodic manner. An SIP can be fortnightly, monthly, quarterly or yearly. Gains made from SIPs are taxed as per the type of mutual fund and the holding period. For the purpose of taxation, each individual SIP is treated as a fresh investment and gains on it are taxed separately.

Suppose you begin an SIP of ₹10,000 a month in an equity fund for 12 months. Each individual SIP is considered to be a fresh investment. Hence, after 12 months, if you decide to redeem your entire accumulated corpus (investments plus gains), all your gains will not be tax-free. Only the gains earned on the first SIP would be tax-free because only that investment would have completed one year. The rest of the gains would be subject to short-term capital gains tax.

Apart from these, there is also something called the Securities Transaction Tax (STT). An STT of 0.001% is levied by the fund company itself when you sell units of an equity fund or balanced fund. There is no STT on the sale of debt fund units.

Conclusion

The longer we hold onto the mutual fund units, the more tax-efficient they become as the tax on long-term gains is much lesser than tax on short-term gains.