Tax tweak dulls debt funds

Product development and fund management to sway investments

The government's amendment to the Finance Bill, 2023, has done away with the long-term tax benefit of indexation for debt mutual funds. This will make them on par with similar investment options.

Indexation benefit

This was applied to debt mutual fund investors with an investment horizon of more than 3 years.

Investors were subject to taxation at 10% without indexation and 20% with indexation, thus reducing the overall tax liability from their capital gains in debt mutual funds.

Indexation was applied based on the cost inflation index (CII), and took into account the prevalent inflation in the country based on the consumer price index (CPI).

Institutional investors accounted for 70% of investments in debt mutual funds as of December 2022. Individual investors, particularly high-networth individuals, also raised their stakes in the category, with 27% share.

Moreover, the passive fund category of target maturity funds was gaining traction.

The new rule could prompt investors to reassess their investments in debt mutual funds.

All gains from such funds with less than 35% exposure to equity would be treated as short-term capital gains and taxed as per the investor's income tax slab level. This rule is applicable from April 1, 2023, with all investments till then grandfathered as per the previous tax regime.

The amendment divides mutual fund categories into three segments, as opposed to two previously. The new segment consists of funds that invest between 35% and 65% in equities.

On the positive side, in the newly formed segment, mutual funds could introduce more asset-allocation products, thereby expanding the range of products available to investors in the medium to long term.

Furthermore, with the tax advantage for debt mutual funds gone, product development and fund management (i.e. returns) will become the focal point determining investment flow among the available options.

Tax segmentation of mutual fund capital gains for individual investors

Taxation regime	Pre-amendment	Post-amendment
• Short-term capital gains @15% for holding period of less than 1 year • Long-term capital gains for holding period of more than 1 year: @10% for gains exceeding Rs 1 lakh per financial year	Mutual funds with investments of 65% and more in equity and equity-related securities	Mutual funds with investments of 65% and more in equity and equity-related securities

• Progressive tax slab rates as per the income tax of the individual for capital gains accumulated in holding period of less than 3 years • Taxation at 10% without indexation and 20% with indexation	Mutual funds with investments of less than 65% in equity and equity-related instruments	Mutual funds with investments between 35% and 65% in equity and equity-related instruments
• Progressive tax slab rates as per the income tax of the individual for capital gains in any holding period		Mutual funds with investments of less than 35% in equity and equity-related instruments

At present, in accordance with the Securities and Exchange Board of India's categorisation and rationalisation of mutual fund categories, only balanced hybrid funds by structure are permitted investments between 40% and 60% in equity and equity-related instruments.

A mutual fund house is allowed to offer either an aggressive hybrid fund or a balanced fund. Considering the preferential treatment given to equity mutual funds, most fund houses have chosen the former.

Debt mutual funds worked on three principles as an investment: returns, liquidity, and tax arbitrage.

The tax benefit distinguished them from conventional debt instruments such as bank fixed deposits, which could now get a boost.

For further information,

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