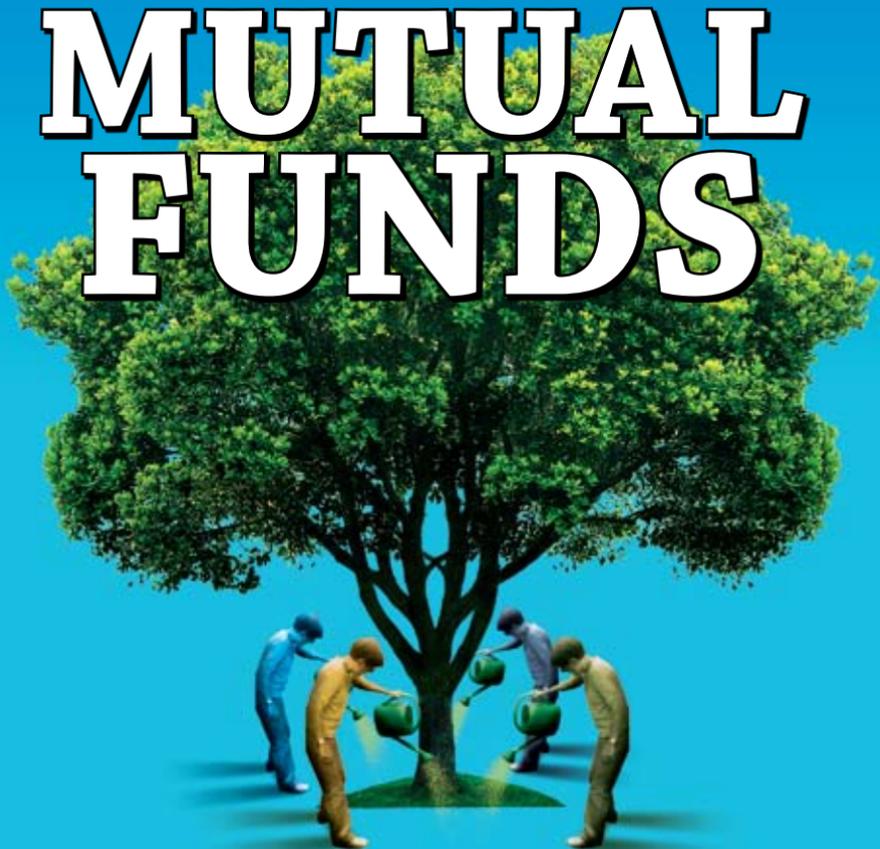


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EDGE WITH
**MUTUAL
FUNDS**



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Mutual Funds and Taxation

ROLE OF MUTUAL FUNDS IN MEETING LONG TERM GOALS

Most of us have a plan in mind to carve out a safe and secure future for ourselves and for our family members. But, do we know what is the right way to go about it or the right approach towards achieving our financial goals. Mutual funds (MF) becomes more relevant in this context. A MF is a financial product that pools money of different individuals and invest on their behalf into various assets such as equity, debt or gold. Based on one's financial goal or risk appetite, there are several MF schemes to choose from. Few startling features that they offer are simplicity, affordability, professional management, diversification along with liquidity.



Securing your financial goals may not be an easy process by itself. It calls for a clear picture of your financial goals, number of years left to achieve them and the amount you wish to save. Also, important is the product or a mix of products you will need to save money in creating that wealth for you. Rather than investing directly into the stockmarket you could choose to participate in the equity markets through MFs. Equity MFs have the potential to deliver returns in order to create wealth in the long run. For any long-term goal be it children's financial needs like education, marriage or buying a house or planning retirement, MFs offer choices for all. Ideally, if one's financial goal is ten years away, equity MFs could be the right choice of investment.

**SECURING
YOUR
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THEM AND THE
AMOUNT TO
SAVE**

WHY EQUITIES

For goals which are to be met over a longer term, equities fit the bill. Precisely because one needs to generate real returns higher to inflation. Else, inflation eats into returns and does not help accumulating corpus to see you through. Whatever the risk profile or the quantum of savings it's highly imperative to use equity backed investment products to cancel the effect of inflation especially over a

long term. The veracity of using equity to meet long-term goals have been proven time and again. Studies done in the past have always suggested that equity has delivered higher inflation-adjusted return than any other asset class over the longer horizon. The underlying message is the time horizon —the longer you remain invested in equities better the return. The advantage comes from the power of compounding because the earlier you start, the longer time for your money to grow. If you start saving early, even in small amounts, it will help build a sizeable savings portfolio. Keep investing regularly and keep investing the returns too. Your earnings, too, will fetch you returns.

IMPORTANCE OF POST-TAX REAL RETURNS IN ACCUMULATING WEALTH

A high rate of interest does not necessarily help in creating a decent corpus over the long term. This is mainly because of the implication of tax on the income earned and also the falling purchasing power of money due to inflation. From a gamut of instruments available, the choice inadvertently hinges on the aspects of safety, liquidity and the term. Whether the



In order to create wealth over long term, the post-tax return real returns assume greater significance.

income generated is subject to tax or not is something least talked about. However, in order to create wealth in the long run, the post-tax real returns assume greater significance.

The IT Act does not treat all financial savings uniformly, and the taxability of contributions, accumulations and withdrawals differ from one instrument to another. Investments in a public provident fund (PPF) scheme, for instance, enjoy tax savings in the form of deductions, while the interest escapes the tax man's axe. The money you get on maturity is not taxable either. This method of taxation is referred to as the 'exempt-exempt-exempt' (EEE) method since all three stages—contribution, accumulation and withdrawals—are exempt of tax.

On the other hand, while contributions to, and accumulations in, certain insurance products such as pension plans are not taxable, the amounts received by way of lump sum withdrawal

or periodical pensions are taxable in the year you receive it, i.e., pension plans are governed by the 'exempt-exempt-tax' (EET) method of taxation.

For example, for a bank fixed deposit that might give you a return of 8 per cent the effective post-tax return for someone paying 30.9 per cent tax would be a figure lower than inflation—a mere 5.5 per cent.

Therefore, the question that comes to mind is—financial planning or tax planning? Should I be saving in banks or in share markets or in MFs? A proper financial planning exercise, making full use of the tax provisions is what everyone wants.

TAX BENEFITS WHILE INVESTING IN MFS

Under Section 80 C of the IT Act 1961: If one invests in any of the specified instruments, his gross total income stands reduced by an equal amount, subject to a maximum of ₹1

lakh every year and tax is paid on the balance. For someone in the highest IT slab of 30.9 per cent, (Including the education cess of 3 percent which applies on tax plus surcharge) an investment of ₹1 lakh in one or a mix of Section 80C instruments reduces the individual's total taxable income by ₹30, 900. For those with income above ₹1 crore, there is a surcharge of 10 percent on tax payable in addition to education cess. Hence, for them the tax rate is 33.99 percent.

The list of specified instruments includes equity-linked savings scheme (ELSS), an equity-based MF scheme. As the name goes, ELSS is a savings scheme that is linked to equity. ELSS is a type of MF scheme that is formulated under ELSS guidelines and is similar to any diversified equity MF and routes investments into the equity market. However, it does come with some

intrinsic features that differentiate it from other MFs. ELSS gives tax benefit on the amount invested and hence comes with a lock-in period of three years. One can invest up to ₹1 lakh in a single or a combination of ELSSs.

There are two options to choose from in an ELSS—dividend and growth. One can buy units under

**ELSS
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this scheme with a minimum amount investment of ₹500 and in multiples of ₹500 thereafter. Investments can either be in lump sums or through the systematic investment plan (SIP) route. Investment

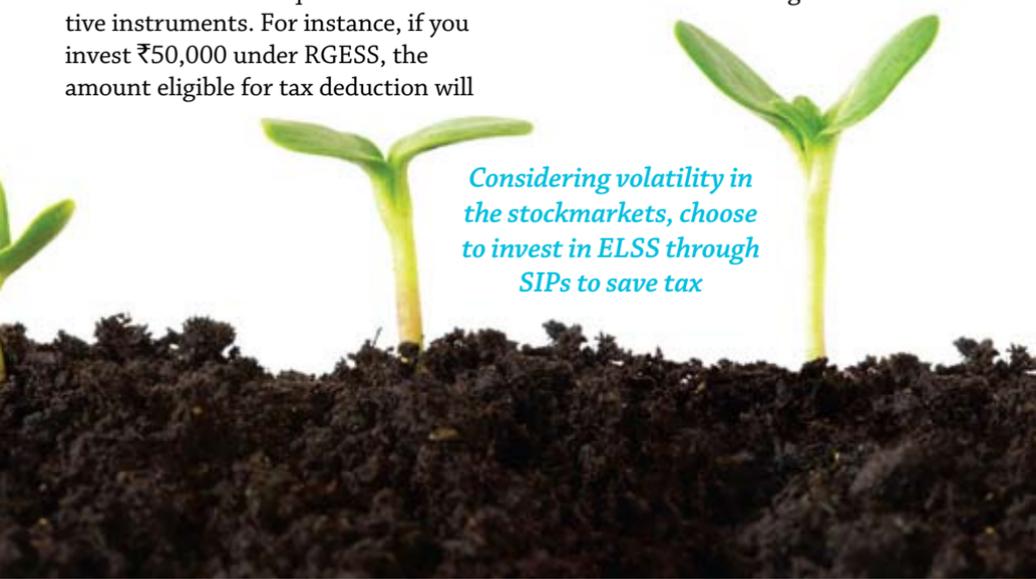
In ELSS Scheme has a lock-in period of 3 years. Considering the volatility in the stockmarkets, it is better to invest through SIPs, save tax and create wealth over the long term. Typically, they are known as tax plans, and can be bought through intermediaries, such as banks, distribution houses, brokers and indi-

vidual agents. One may also buy ELSS directly from fund houses or from the Websites of such fund houses. The entry load in ELSS, as in any other MF scheme, is nil. The entire investment participates in the stockmarket, and based on the scheme's net asset value (NAV), units get allotted. NAV is the applicable net value of each unit on any particular day.

Under Section 80 CCG of IT Act. By investing in Rajiv Gandhi Equity Saving Scheme (RGESS), first time retail investors with a gross total income for the financial year with less than or equal to ₹12 lakh would get 50 per cent deduction under Section 80CCG of the IT Act, 1961, on the amount invested, provided they have neither invested in equities or derivative instruments. For instance, if you invest ₹50,000 under RGESS, the amount eligible for tax deduction will

be ₹25,000 from your taxable income. This deduction will be over and above the ₹1 lakh-limit permitted under Section 80C of the IT Act.

Unlike ELSS, or any other similar tax-saving instruments that do not require any demat account to get the benefit under RGESS you will have to open a new demat account or designate your existing demat account under RGESS by filling out Form A. Even in the case of investing in RGESS-qualified MF schemes, you need to have a demat account because the units you will buy are listed on the stock exchanges. Units of Exchange Traded Funds (ETFs) or MF schemes with RGESS eligible securities are eligible provided they are listed and traded on a stock exchange and



Considering volatility in the stockmarkets, choose to invest in ELSS through SIPs to save tax

settled through a depository mechanism. The period of holding securities is three years for availing the benefit under section 80 CCG in the manner provided under the guidelines of RGESS.

INCOME RECEIVED DIVIDENDS AND GROWTH

There are two ways to receive income from MF schemes—as dividends or as growth. Under the dividend option, when you invest in a MF and the fund generates distributable surplus out of it, the fund manager may distribute such surplus among the Investors from time to time in the form of dividend. It is of two types - dividend payout and dividend transfer. In the first type the dividend amount goes to the investor. In the latter, the fund allots more units to the investor. The value of these units will be same as the dividend amount and is based on the prevailing NAV of the scheme. As the dividend is reinvested, the number of units in an investor's portfolio grows based on what the dividend amount is.

Under the growth option any profit arising from the investors' money remains invested in the scheme. The number of units will remain the same

and the NAV will grow with time. Hence the NAV of a growth option is always higher than the dividend version of the same scheme.

DIVIDEND DISTRIBUTION TAX (DDT)

According to the provisions of Section 10(35) of the Act, income received in respect of units of a MF is exempt from IT in the hands of the recipient unit holders and no tax deducted at source (TDS) will be deducted on it. While it is true that for income received by unit holders in the form of dividends from equity funds, for the debt funds, the dividend before reaching unit holders is subject to dividend DDT. The dividends declared by all the debt-oriented MFs attract DDT.

All equity-oriented schemes like equity-diversified, large-, mid-, small-cap equity funds, thematic and sectoral schemes, the dividend remain tax free and are not subjected to DDT. Equity-oriented MF is a fund where the investable corpus is invested through equity shares in Indian companies to the extent of more than 65 percent of the total proceeds of the fund.

On non-equity oriented schemes like debt funds, income funds, liquid funds, ultra short-term funds, float-

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ing rate funds, gilt funds, monthly income plan (MIP) and fixed maturity plans, the DDT stands at 28.325 per cent. (25 per cent+ 10 per cent of surcharge + 3 per cent of cess) on income distributed to an individual HUF and 33.99% on income distributed to any other person. The growth option for equity and non-equity MF schemes are not subject to DDT anyhow.

CAPITAL GAINS

As per section 2(42A) of the IT Act, units of the MF scheme held as a capital asset, for a period of more than 12 months immediately preceding the date of transfer, will be treated as long-term capital assets for the com-

putation of capital gains while for less than 12 months they would be treated as short-term capital assets.

The gains from the mutual scheme are taxed depending on the investment period in MFs. If the MF units are redeemed after a year, then the gains thereon are liable to long-term capital gains tax while the proceeds from the investments which redeemed before one year are taxed as short-term capital gains.

On debt schemes. Short-term capital gains is taxed according to the normal slab of investors. Short-term capital gains are included in your gross total income and after adjustments from deductions gains are subjected to tax

If you suffered short-term losses in MF investments, it can be set-off against any gains in other MF investments.



according to your tax slab. The long-term gains are subjected to 20 per cent tax with indexation and 10 per cent without.

On equity schemes. For equity shares or equity-oriented MFs, the short-term capital gain tax rate is 15 per cent and the long-term capital gain are tax free. According to chapter VII of the Finance (No. 2) Act, 2004 pertaining to securities transaction tax (STT), the STT shall be payable by the seller at the rate of 0.001% for delivery-based while 0.025% for non-delivery based transactions on the sale of a unit of an equity-oriented fund to the MF. Long-term capital gains arising on the transfer of units of an 'equity-oriented' MF is exempt from IT, if the STT is paid on this transaction i.e., the transfer of such units should be made through a recognised stock exchange in India (or such units should be repurchased by the relevant mutual fund).

CAPITAL LOSSES

If you have suffered short-term capital losses in MF investments, it can be set-off against any capital gain in other MF investments. The short-term capital losses resulting from the sale of units would be available for setting off against any capital gains which would bring down the tax liability of the unit holder to that extent. Further unabsorbed short-term capital losses shall be carried forward and



set off against the income under the head 'capital gain' in any of the subsequent eight assessment years. Losses on transfer of long-term capital assets would be allowed to be set-off only against gains from transfer of long-term capital assets and the remaining long-term capital loss shall be carried forward separately for eight assessment years to be set off only against long-term capital gains.

TAX ADVANTAGE OVER OTHER COMPETITIVE INVESTMENTS

Bank deposits. MF schemes both debt- and equity-based, provide tax-efficient returns compared to other



STRATEGIES

Using ELSS to meet goals. Put to use the tax benefit of ELSS to your advantage. Spread your investments in 2-3 ELSS for the sake of diversification across market capitalisation and fund managers. Consider the long-term performance as against its benchmark, volatility, small-, mid- and large-cap exposure before zeroing in on a particular scheme. The pedigree of the fund also plays an important role. Don't buy or invest in a fund simply because its NAV is lower than its competitors. Keep financial goals in mind. Every ELSS adopts different stock picking strategies. Some schemes maintain a large-cap focus and are suitable for investors who have a low risk profile. On the other hand funds that have greater exposure to small- and mid-cap stocks fit the portfolio of an investor willing to take some risk. Ignoring this aspect would mean a mismatch between the fund and the investor's profile.

If your ELSS investment made in the past is about to mature in the next 3-6 months, you need to decide carefully. Once you complete three years in an ELSS, review your investment. After all, one of your objectives (the tax deduction) has been met. Tax laws don't allow a rollover for claiming the Section 80C benefit—they insist on fresh investments. Hence, evaluate your "matured" ELSS investment as a normal equity

investments such as bank deposits. Let's look at someone in the highest tax slab, paying tax at the rate of 30.9 percent (For Income below ₹1 crore) with assuring returns from the bank, equity or debt MF scheme of 9 per cent. The effective post-tax yield in short-term investments (for the redemption of within a year) is 6.22 per cent for bank fixed deposits (FD) while it is 7.01 (please check this) (9% less 28.325%=6.45%) percent for a debt fund even after adjusting DDT. Similarly, effective post-tax yield in long-term investments (for the redemption of after a year) comes to 8.07 percent under the debt MF growth option.



APPLICABLE TAX RATES ON INVESTMENTS IN MUTUAL FUND SCHEMES

Tax implication on dividend received (In the case of investors / HUF)

Dividend

Equity-oriented schemes	tax free
Other than equity-oriented schemes	tax free

Dividend Distribution Tax (payable by the scheme) from 1 June 2013

Equity-oriented schemes*	Nil
Other than equity-oriented schemes	25% + 10% surcharge + 3% cess = 28.325%

Long-term capital gains (Units held for more than 12 months)

Equity-oriented schemes*	Nil
Other than equity-oriented schemes	10% without indexation OR 20% with indexation whichever is lower + 10% surcharge [§] + 3% cess
Without indexation	11.33%
With indexation	22.66%

Short Term Capital Gains (Units held for 12 months or less)

Equity-oriented schemes*	15% + 10% surcharge [§] + 3% cess = 16.995%
Other than equity-oriented schemes	30%^ + 10% surcharge [§] + 3% cess = 33.99%

*STT will be deducted on equity-oriented schemes at the time of redemption and switch to other schemes. Mutual funds would also pay Securities Transaction Tax wherever applicable on the securities sold

§ Surcharge at the rate of 10% would be levied in case of individual / HUF unitholders, where their income exceeds ₹1 crore

^Assuming the investor is in the highest tax bracket

For resident individual for FY 2013-14

investment—your decision to stay on or exit should be based on your perception of the market and the need for funds. You may reinvest proceeds in any other ELSS schemes. If there is a need for funds, you could liquidate some or all units. Remember, even partial units can be redeemed. However, if no such need exists, you may better postpone liquidation to few more months.

Investing for less than a year. If you are in the highest tax slab and paying 30.9 percent tax and wish to park idle money for a short while (holding overnight to a year), consider investing in dividend options of liquid, ultra short-term, short-term income funds or even debt funds. They are liable to pay a tax of 28.325 per cent on dividend income. On the other hand, 30.9 per cent of tax has to be paid if growth option is chosen or even when deposited in the bank.

Investing for more than a year. If you are in the highest tax slab and paying 30.9 percent tax, and wish to park money for a long duration (more than one year), the growth option of liquid, ultra short-term, short-term income funds or even debt funds can be a better choice. Under growth option, you will have to pay long-term capital gains tax of 10.3 per cent without indexation or 20.6 per cent with indexation whichever is lower while redeeming the units anytime after 12 months.



FOR RETIREES

Retirees need liquidity as well as regular returns on their corpus. Choosing liquid or debt funds over bank deposits gives them an extra tax advantage. After investing in liquid or debt scheme, they may choose the systematic withdrawal plan (SWP) that lets them withdraw pre-decided amounts from their investments at periodic intervals. There are two options in an SWP—fixed withdrawals where you specify the amounts you wish to withdraw from your investment on a regular basis and appreciation withdrawal where you can withdraw your appreciated amount. For those in the highest tax bracket, the fixed withdrawal option is more suitable and



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**FOR
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CHOOSING
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TAX-EFFICIENT
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INCOME**

bank deposits for interests above a certain limit. SWP, therefore, gives you a tax-efficient regular income even if you choose the growth option in these schemes.

CONCLUSION

It is imperative to take advantage of equities to tackle inflation in the long run. An equity MF fits the bill as they come with a number of options to choose from. Volatility in the stockmarket will help generate wealth in the long run while tax benefit on returns can give your investment portfolio the much-needed edge. Closer to your goals, using debt funds to manage and derisk portfolio is another advantage one should take from MFs.

It is the post-tax returns that decides how much you end up saving for your goals. No point accumulating wealth that sees its purchasing power fall with just capital safety. Therefore, take the MF route to meet your goals and say bye to tax worries!

that, too, after holding on to the scheme for a year.

The tax liability in SWP is lower than that of bank deposits. The applicable tax rate (for the investor who belongs to highest tax bracket) on the income from SWP is 10.3 per cent which is lower than the applicable tax rate of 30.9 per cent in Bank deposits. Further, no TDS is applicable to SWP withdrawals, however, it applies to

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Mutual Fund investments are subject market risks, read all scheme related documents carefully.

Tax saving or wealth creation? Why choose, when you have ELSS.

The smartest way to save tax is through ELSS. But if you continue with your investment even after the lock-in period of 3 years, it will help you create wealth in the long-run. So keep investing in your ELSS, and if you have any queries, you can always get in touch with me.

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