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Profit from Knowledge

How to manage your equity mutual fund investments under the new tax regime

With the introduction of a 10% tax on long-term capital gains and dividends, equity-oriented mutual funds will feel the pinch as their returns will now be reduced to some extent. However, investors should not feel demotivated because equities still remain efficient as compared to other asset classes in the long term. Also, investors who prefer the dividend option of equity-oriented funds can explore the Systematic Withdrawal Plan (SWP) feature in the growth option of mutual funds as an apt alternative.

What is the change in the tax treatment?

The Union Budget of 2018-19 has changed the tax treatment of all equity and equity-oriented mutual funds by introducing a 10% tax (plus surcharge as applicable and cess) on any Long-Term Capital Gain (LTCG) exceeding ₹ 1 lakh a year. It will be applicable from April 1, 2018, so any redemption of units from equity-oriented funds until March 31, 2018, will be exempt from the tax. Additionally, all the gains made on or before January 31, 2018 will be grandfathered, which means all gains made before the new provisions will be exempt from the tax. The short-term tax on equity mutual funds for less than a year continues to be 15% (plus surcharge as applicable and cess). The government has also introduced a Dividend Distribution Tax (DDT) of 10% (plus 12% surcharge and 4% cess), which will be deducted at source, on the dividend plans of equity-oriented funds.

Table 1: Tax reckoner 2018-19

	Equity-oriented mutual fund	Debt-oriented mutual fund
DDT	10% + 12% surcharge + 4% cess	25% + 12% surcharge + 4% cess
STCG	15% + surcharge as applicable + 4% cess	As per individual's tax slab + surcharge as applicable + 4% cess
LTCG	10% + surcharge as applicable + 4% cess	20% with indexation + surcharge as applicable + 4% cess

In equity-oriented mutual funds, units held for more than one year are considered for LTCG otherwise they are treated as STCG, while in debt-oriented mutual funds, units held for more than three years are considered for LTCG otherwise they fall under STCG.

Surcharge at 15% on base tax is applicable where the income of individual unit-holders exceeds Rs 1 crore and at 10% where the income exceeds ₹ 50 lakh but does not exceed ₹ 1 crore.

Certainly, these new changes will reduce returns in the hands of equity mutual fund investors opting for dividend as well as growth options. Investors looking at regular cash flows would be better off opting for the SWP feature in growth schemes rather than choosing the dividend option, while investors investing for the long term would be better off continuing with the growth option as the impact of the tax on returns will be marginal in the long term, as explained below.

SWP - An apt alternative to the dividend option

Investor who require a regular flow of income usually prefer the dividend option of equity mutual funds. However, dividends are declared at the discretion of the fund house and do not ensure a regular flow of income. Also, the quantum of inflows in terms of dividends is not fixed. With the introduction of DDT, any dividend paid by a fund house will now attract a 10% tax. Given these limitations, opting for an SWP in the growth option can be a saviour in two ways.

a) Even without the tax levy, the SWP is a superior option as investors can ensure a fixed amount of withdrawal in a pre-decided frequency and hence, can match his/ her specific requirements.

b) Investors can avoid the tax if the LTCG on units redeemed is less than ₹ 1 lakh in a year.

Illustration: An investor requires a cash flow of ₹ 50,000 a month from an investment of ₹ 20 lakh starting next year. A friend tells him to go for the dividend option of an equity mutual fund as it will give him tax-free cash flows. However, he is confused about the option following the recent announcement of a 10% DDT on dividend income applicable from April 1, 2018.

The investor can instead consider the alternative solution of investing in the growth option of an equity fund and then withdrawing ₹ 50,000 a month by redeeming an equivalent number of units via an SWP. At NAV of ₹ 100, he will get 20,000 units of an equity fund with initial investment of ₹ 20 lakhs. By opting SWP, he will have to pay tax of only ₹ 1,621 as compared with a tax of ₹ 60,000 in the case of the dividend option, assuming the fund pays the same amount of dividend every month. Yet, the fact is that the investor cannot ensure that he will get a specific amount of dividend at a regular frequency as it is declared at the discretion of the fund house.

Table 2: SWP in growth option versus dividend option

	SWP in growth option					Dividend option		
Month	**Amount withdrawn (₹)**	**NAV (₹)**	**Units redeemed**	**Purchase price of units redeemed**	**LTCG (₹)**	**Dividend declared by fund house (₹)**	**Amount received in hands of investor (₹)**	**10% DDT deducted at source by fund house (₹)**
13	50000	116	430	42956	7044	50000	45000	5000
14	50000	118	425	42457	7543	50000	45000	5000
15	50000	119	420	41964	8036	50000	45000	5000
16	50000	121	415	41477	8523	50000	45000	5000
17	50000	122	410	40995	9005	50000	45000	5000
18	50000	123	405	40519	9481	50000	45000	5000
19	50000	125	400	40048	9952	50000	45000	5000
20	50000	126	396	39583	10417	50000	45000	5000
21	50000	128	391	39124	10876	50000	45000	5000
22	50000	129	387	38669	11331	50000	45000	5000
23	50000	131	382	38220	11780	50000	45000	5000
24	50000	132	378	37776	12224	50000	45000	5000
Total LTCG (₹) in the year					12224			
Exemption limit of ₹ 1 lakh					10000			
Total taxable income in the year					16211			
Tax amount @ 10%					1621	Total tax paid		60000

Assuming growth of 15% (average of rolling returns of S&P BSE Sensex for 15-year holding period since 1979). For illustration purposes only.

Impact only marginal in long term

While it is imperative to invest in equity-oriented mutual funds for the long term to ward off short-term volatility and let the power of compounding work, it also makes sense to continue with this strategy despite the introduction of the LTCG tax. This is because the impact of the tax on returns will be marginal and it will also get reduced to some extent with the increase in the holding period (as seen in Table 3).

Table 1: Tax reckoner 2018-19

Redeemed at the end of period	Growth of ₹ 3 lakh	LTCG (₹)	Taxable income after exempting ₹ 1 lakh limit	Tax payable (₹) @ 10%	Final value (₹) of investment after deducting tax	Post tax returns
1	3,45,000	45,000	-	-	3,45,000	15.00%
5	6,03,407	3,03,407	2,03,407	20,341	583,066	14.21%
10	12,13,667	9,13,667	8,13,667	81,367	11,32,301	14.20%
15	24,41,118	21,41,118	20,41,118	2,04,112	22,37,007	14.33%
20	49,09,961	46,09,961	45,09,961	4,50,996	44,58,965	14.45%
25	98,75,686	95,75,686	94,75,686	9,47,569	89,28,117	14.54%

Assuming growth of 15% (average of rolling returns of S&P BSE Sensex for 15-year holding period since 1979). For illustration purposes only.

In a nutshell, equity mutual funds despite being taxed now will continue to remain a superior asset class in comparison with other asset classes. For investors who need a regular income, an SWP in the growth option of equity funds can be a better bet than the dividend option.

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