WEALTH WISHER
Right Plan Right Life

Financial Planning & Wealth Management

E-Book by WealthWisher Financial Planners & Advisor

MF Taxation - Updated March 2022
(Applicable for FY 2022-23)

Financial
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Introduction to WealthWisher & its Services

A Guide to Tax Efficient Mutual Fund Investing

Speaking of taxation, it is that time of the year when tax planning is on everyone's mind.

While one cannot avoid paying taxes, awareness about various aspects of taxation can help one to plan investments in a more tax efficient manner.

Bearing this in mind, we have come up with a comprehensive guide to tax efficient Mutual Fund investing prudent to understand taxation in respect to Mutual Fund investments. Here we decode some hidden aspects of tax advantages available for investments in Mutual Funds.

The true return on any investment is what we earn after payment of taxes. Taxes play a crucial role while selecting investment products. Mutual funds offer a wide variety of products and tax efficiency enhances their charm.

In the last quarter of the financial year, tax planning is on everyone's mind as we look for options to save taxes. While there is a buzz about Section 80C of Income Tax Act 1961, we thought it is prudent to understand taxation in respect to Mutual Fund investments.

Please read on & share your feedback.

1. So, first thing first, who pays the Tax? Is it Mutual Fund or Unit holders?

Since Mutual Funds are a pass through vehicle, one has to look at income at two levels:

- Income received / generated by the Mutual Fund scheme by way of dividend / interest received, etc or price changes in securities
- Income generated by Unit holders from Mutual Funds by way of NAV appreciation or Income Distribution cum Capital Withdrawal (erstwhile referred to as dividends on MF Units)

Since, Mutual Funds are registered with the Securities and Exchange Board of India and created as a Trust, the entire income earned by the Mutual Fund is exempt from Income tax in accordance with the provisions of Section 10(23D) of the Income Tax Act, 1961.

However, the unit holders pay tax on income from Mutual Funds as per prevailing tax laws.

2. How do unit holders earn from Mutual Funds?

Income Distribution cum Capital Withdrawal (IDCW) Option

IDCW is declared subject to availability of distributable surplus in the Scheme, as computed in accordance with SEBI (Mutual Fund) Regulations. Remember, the NAV of the Scheme reduces to the extent of the amount distributed. IDCW received by unit holders is added to their taxable income and taxed at their respective income tax slab rates.

Example: An investor holds 10,000 units in a Scheme and its NAV as on 31st December, 2021 is Rs 15. The Mutual Fund declares IDCW of Re 1 per unit. Post distribution of IDCW, the NAV drops to Rs. 14 (ie NAV on Dec 31, 2021 – IDCW per unit (Rs. 15 – Re. 1) on 1st January, 2022 assuming no change in market valuation of the Scheme the next day. In case of IDCW, Mutual Fund is liable to deduct TDS (Tax Deducted at Source) @ 10% on income distributed (i.e. dividend), if the income exceeds Rs. 5,000. In this case the Mutual Fund will deduct 10% TDS on Rs. 5000 (Rs. 10000 – Rs. 5000). The unit holder will have to pay tax on the IDCW received at the respective income tax slab rate (after deducting the TDS amount).

Note: While paying tax on IDCW, unit holder needs to be aware of applicability of surcharge and cess The surcharge is calculated on the base tax and cess is calculated on base tax and surcharge. Tax implication is same for both IDCW Payout and Re-investment options.

Capital Gains from Growth Option

Growth Option is one without any periodic payouts and is meant for long-term capital appreciation. Capital Gain arising on sale of Mutual fund units is charged to tax under the head Capital Gains.

Income from capital gains is classified as:

- Short Term Capital Gains (STCG); and
- Long Term Capital Gains (LTCG)

The STCG and LTCG are taxed at different rates, which depends on type of Scheme and holding period.

3. How Mutual Funds are classified based on taxation?

Mutual Funds are classified into two categories based on taxation:

- Equity-oriented mutual fund schemes and
- Other than-Equity oriented mutual fund schemes

Equity-oriented mutual fund schemes

Simply put Equity-oriented mutual fund schemes are ones with at least 65% asset allocation towards equity Equity shares of domestic companies listed on a recognized stock exchange.

If the unit holder has held the investment for more than 12 months, the gains from redeeming such investments will be classified as LTCG and for investments held for 12 months or less, the gains will be classified as STCG.

Other than Equity-oriented mutual fund schemes

Simply put other than Equity-oriented mutual fund schemes are ones not satisfying the above mentioned condition. If the unit holder has held the investment in such schemes for more than 36 months, the gains from sale of such investments will be classified as LTCG, and for investments held for 36 months or less, the gains will be classified as STCG.

4. What is the capital gain tax rate for Equity and Other than Equity oriented Mutual Fund Schemes?

When a Unit Holder redeems units of the mutual fund scheme, the difference in the selling price and purchase price will be called capital gain/(loss).

	STCG Tax	LTCG Tax
Equity Oriented Mutual Fund	@15%	@10%*
Other than equity oriented mutual Fund	As per the unit holder 's tax slab	@20% after indexation

*Tax at the rate of 10% (without indexation benefit) is levied on LTCG exceeding Rs. 1 lakh per annum provided transfer of such units is subject to securities transaction tax (STT).
Note: In addition to the above STCG and LTCG rate, surcharge and cess is applicable. The surcharge is calculated on the base tax and cess is calculated on base tax and surcharge.

5. Taxation on Capital Gains / Losses

In case of long term capital gain, unit holders can book capital gains up to Rs.1 lakh per annum, as the same is exempted under Income-tax Act 1961. This may be useful while doing a Systematic Withdrawal Plan (SWP) and is tax efficient when compared to IDCW.

In case of capital loss and while setting off losses, unit holders need to keep following points in mind:

- Capital Loss whether short term or long term cannot be set off against any other head of income
- Long-term capital losses can be set-off against only long-term capital gains.
- You cannot set-off long-term capital losses against short-term capital gain.
- Short-term capital losses can be set-off against either short-term capital gains or long-term capital gains.
- Both short term and long term capital losses can be carried forward for eight years immediately succeeding the year in which the loss is incurred.

6. What is Indexation and how it works?

Inflation, which reflects increase in prices, reduces our purchasing power over a period of time. In other words, the capital gains earned by an investor needs to be reduced by the amount of inflation. Indexation benefit is applicable while calculating capital gains on other than equity-oriented mutual funds.

Indexation is increasing the cost of acquisition by Cost Inflation Index (CII), which is notified by Ministry of Finance annually.

Indexed cost of acquisition is calculated as Cost of acquisition X (CII in the year of sale / CII in the year of purchase)

Example: Suppose Rakesh invests Rs. 100,000 in debt scheme i.e. “other than equity mutual funds scheme” on 1st July 2018 and redeems his investment for Rs. 125,000 on 1st December 2021. Rakesh has held the investment for more than 3 years so his gain is categorised LTCG and his indexed cost of acquisition will be

~Rs. 113,214 (100,000 X 317/280).

His taxable income will be ~Rs. 11,786 (125,000-113,214) and not Rs. 25,000 (125,000 - 100,000) because of indexation for computation of capital gain at applicable rates. Therefore, the incidence of tax is lower most of the time in assets held for longer than three years.

*Note: Cost of Inflation index FY 2018-19 is 280 and FY 2021-22 is 317.

7. Making the most of Indexation benefit – four indexation?

For the amount invested in 'other than equity oriented mutual fund scheme' in January 2022 (FY 2021-22) and redeemed in April 2025 (FY 2025-26) the investor is eligible to take four indexation benefits over 5 financial years viz.

2021-22,
2022-23,
2023-24,
2024-25 and 2025-26.

Assuming investment is for 1168 days, let us consider the below three scenarios of different per annum return:

Particulars	Fixed Deposits			Taxation on Other than Equity Oriented Mutual Fund Scheme (with Indexation)		
Amount Invested (in Rs.)	100,000			100,000		
Interest Rate / Returns p.a. (%)	6%	7%	8%	6%	7%	8%
Gross value at Maturity (in Rs.)	120,498	124,173	127,925	120,498	124,173	127,925
Indexed Cost of Acquisition (in Rs.)#	NA	NA	NA	116,986	116,986	116,986
Capital Gains/Interest on investments (in Rs.)	20,498	24,173	27,925	3,512	7,187	10,939
Applicable Tax Rate (%)*	31.20%$	31.20%	31.20%	20.80%#	20.80%	20.80%
Taxable Income (in Rs.)	20,498	24,173	27,925	3,512	7,187	10,939
Tax Liability (in Rs.)	6,395	7,542	8,713	730	1,495	2,275
Post Tax value at Maturity (in Rs.)	114,102	116,631	119,213	119,767	122,678	125,650
Post Tax Gain (in Rs.)	14,102	16,631	19,213	19,767	22,678	25,650
Post Tax Gain (CAGR %)	**4.21%**	**4.93%**	**5.65%**	**5.80%**	**6.60%**	**7.40%**

#Indexed Cost of acquisition is computed assuming an inflation rate of 4% p.a.
*The tax rate based on the current tax slabs for Individuals/HUFs with income more than Rs. 10 lakh but less than Rs. 50 Lakh.
$30% + 0% surcharge + 4% cess = 31.20%
#20% + 0% surcharge + 4% cess = 20.80%

Disclaimer: This is a hypothetical illustration to explain the concept of four indexations and its benefits and actual figures would vary. The features of Fixed Deposits and FMPs are not comparable. The comparison is limited to tax efficiency, which is subject to changes in prevailing tax laws.

8. Do Mutual Funds help in saving tax?

ELSS or Equity Linked Savings Scheme is a type of mutual fund scheme which helps unit holders in saving tax on investments made up to Rs. 1.5 Lakh in a Financial Year (along with the other prescribed investments) under Section 80C of the Income-tax Act, 1961.

This reduces the taxable income and therefore their tax liability.

Investing in ELSS is just like investing in any other equity oriented mutual fund scheme with additional benefit of tax savings. Also, these schemes come with a lock-in period of just 3 years (lowest lock-in period among other taxing saving instruments, under Section 80C of the Income Tax Act, 1961)

Example: Rajesh has a gross annual income of Rs. 1,200,000. He invests a total of Rs. 150,000 in ELSS schemes. Therefore, his taxable income is reduced to Rs. 1,050,000.

Since Rajesh falls under the tax bracket of 30% as he has opted for old regime, he is able to save Rs. 46,800 (including cess @4% and excluding surcharge)*.
This may be true for any other Section 80C option, however, ELSS schemes have potential to appreciate over time and generate real returns.

*The above example is for illustration purposes only Tax calculations shown above are as per income tax slabs for FY 2021-22 applicable for an individual assessee below the age of 60 with taxable income above Rs. 10 lakh but less than Rs. 50 lakh. The calculation is inclusive of cess.

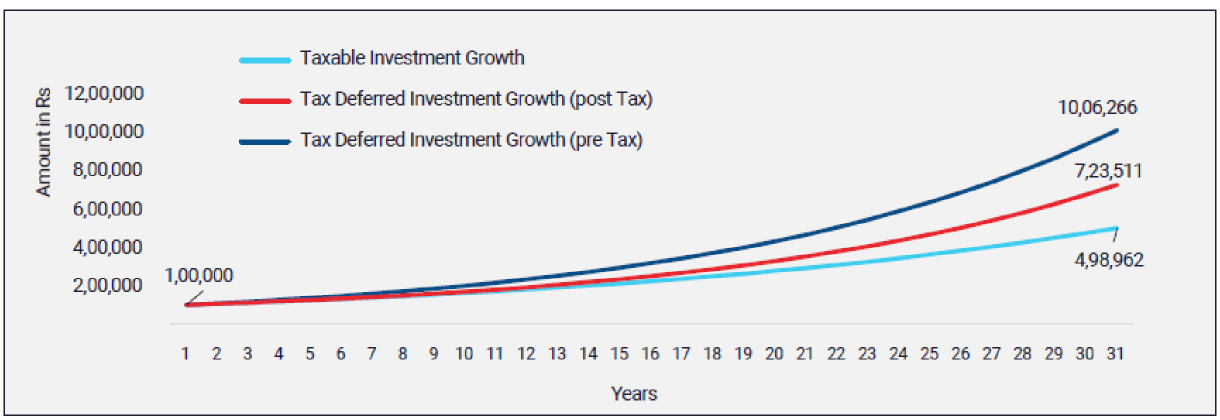
9. Remember, you are in it for the compounding!

Tax planning, while is an important part of financial planning, is only an accompaniment in your overall objectives. The real reason to invest is to create wealth and let it compound over the long term.

When we invest our money with Mutual Funds in the growth option, we tend to grow our investment tax-free as we pay tax only when we withdraw money by selling units. Tax-free compounding over long term may help you to generate more money on your investments.

The chart below explains a hypothetical illustration of power of tax deferral and the advantage such investments have over taxable investments over time. The chart assumes that Rs 100,000 investment compounding at 8% annually. The applicable tax rate of 31.20% would generate tax deferred investment return significantly greater than that of taxable investment.

After 30 years, as seen, the taxable investment grew to Rs. 498,962. The same investment would be valued at Rs 1,006,266 had the investor stayed put. Furthermore, if we pay the tax at the time of selling units, then post tax (assumed at 31.20%) amount would be at Rs. 723,511 which is 45% greater than taxable investment where we are paying tax every year.



Note: This is a hypothetical chart to explain the concept of tax deferral and actual figures would vary depending upon tax rates.

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WealthWisher Financial Planners & Advisors

Introduction

Established in 2017, by seasoned professional Madhupam Krishna, an Industry Expert with experience of 20 plus years.

Madhupam come from a humble background and hail from a small and famous city called Ajmer. Now settled in Jaipur with family and my bouquet firm WealthWisher Financial Planners & Advisors.

An alumnus from IILM with Masters in Business Administration in Finance/Marketing with an additional PG in Insurance Sales from Bhartiya Vidya Bhawan in 2002, Certified Financial Planning from FPSB India.

Around 17 year of experience of Sales & Distribution Management & had an opportunity to work with Financial Institutions like Bajaj Capital, Birla Sun Life AMC, Reliance Capital AMC, HSBC Global AMC & Principal PNB Mutual Fund.

Since April 2017, working in the capacity of Founder & Chief Business Officer at WealthWisher Financial Advisors, a Financial Planning firm engaged in Financial Advisory, Planning & Wealth Management. We specialize in Financial Plan making, implementing wealth management solutions for native & NRI investors.

Specialties: We are a fee-based SEBI Registered Financial Advisers (RIA) engaged in Financial Planning & Wealth Management for clients across India and abroad. Currently, we serve more than 900 Clients & their families manage their financial planning & investments. We specialize in Online Financial Planning & Wealth Management. Our clients are spread in more than 30 countries.

I manage the blog www.thewealthwisher.com to promote Financial Literacy. In the process, thewealthwisher.com also educates the consumers on how not to get cheated by unscrupulous agents while buying financial products.

Financial Planning Services & Wealth Management Services

We are fee-based Financial Planners & Advisors. We are registered with SEBI (INA100003899), hence follow the process which is laid by the regulator. You can be assured that we have no conflict of interest in our advice and our execution is also technology driven making the process completely stress free.

We make **Comprehensive Financial Plans** it covers all aspects like Budgeting, Risk Profiling, Goal Planning, Asset Allocation, Networth Check, Investment Strategy & Investment Recommendations Etc.

Then we have your Portfolio Constructed and Executed in The Wealth Management Service. The service is a long-term engagement covering all your Wealth Managements needs like Portfolio Tracking, Evaluation Reports, Unrealised Gain Reports & most importantly your Periodical Rebalancing & Review. In Wealth Management Service, various periodical reports and updates shall be made available and presented.

For detail coverage, fees and T&C please go through the following links on our website:

http://www.thewealthwisher.com/financial-planning/
https://www.thewealthwisher.com/wealth-management-service/

For any queries, do call me on 9229145054/9828156400 or write to me.

Top Class Advise & Seamless Implementation...
This is What We ARE...

Thank You