INDUSTRY SEEKS TAX PARITY WITH LISTED BONDS

Debt MFs may get tax relief on capital gains

RUN-UP TO THE **BUDGET** 2025-26

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INDUSTRY WISH LIST

- Industry wants LTCG tax rate on redemption of debt MF units held for more than one year to be **12.5%**
- Alignment in holding periods while calculating LTCG for gold-based investments sought
- Since April 1, 2023, capital gains on debt MFs are taxed at investors' respective tax slabs, irrespective of holding period
- Over the past 3-5 years, debt funds gave returns of **around 7%,** while inflation hovered around 5.5%
- According to Amfi, total assets under management for debt funds stood at ₹16.86 lakh crore as on November 30

THE MUTUAL FUND (MF) industry's demand for restoration of the indexation benefit when capital gains are computed on the sale of debt-oriented funds may be considered favourably by the government. An announcement to this effect is likely to be made in the Budget FY26.

The case for reintroduction of the benefit, which was withdrawn in the Finance Bill 2023, has strengthened in recent months as post-tax real rate of returns for investors in debt MF schemes has turned very low or even negative due to sticky inflation, sources said. This has resulted in debt funds losing any competitive advantage relative to fixed deposits in banks. Indexation is designed to adjust the cost of a capital asset to the inflation rates since its purchase.

The MF industry has also urged the finance ministry to align the capital gains tax rates of debt MF schemes with that of listed bonds. The government is closely looking at both the proposals, the sources said.

The industry wants the tax rate for long-term capital gains (LTCG) on redemption of debt MF units held for more than one year to be 12.5%, as applicable to listed bonds.

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SEPARATELY, THE INDUSTRY has sought alignment in holding periods while calculating LTCG for gold-based investments such as gold exchange traded funds (ETFs), gold mutual funds, sovereign gold bonds, and physical gold. Currently, gold MF and physical gold classify under LTCG on a holding period of over 24 months, and the rest on a holding period of more than 12 months.

Since April 1, 2023, capital gains on debt MFs are taxed at the investor's income tax (I-T) slab rate, irrespective of the holding period, which has resulted in increased tax liabilities for debt MF investors. Previously, LTCG on debt MF were taxed at 20% with indexation benefit or 10% sans indexation, and short-term capital gains (STCG) (holding period up to three years) were taxed at I-T slab rates. Debt funds are defined as those with 35% or less of their assets under management in domestic equities.

However, due to the changes introduced in the July 2024 Budget, investments made in debt MFs prior to April 1, 2023, also lost the indexation advantage.

The Budget for FY25 — presented on July 23, 2024 — had removed indexation benefits for LTCG tax for all asset classes, including that of bonds. But in August, following a backlash from the real estate sector, the government reintroduced the indexation benefit for LTCG for properties purchased by resident individuals before July 23, 2024.

The Association of Mutual Funds in India (Amfi) has requested the government to revisit the withdrawal of indexation on long term debt investments and restore the status quo ante by amending the tax laws re-introducing the indexation benefit on long term capital gains from debt funds in respect of all investments in debt funds made up to March 31, 2023.

The MF industry believes that indexation is not a tax relief but a neutraliser of the impact of inflation, and applying the new rates retrospectively can be detrimental to investor confidence and deter new investors from entering capital markets through MFs as well as the existing ones to make further investments, said Amfi.

Over the past 3-5 years, debt funds have given returns of around 7%, while the inflation has been hovering around 5.5%. Thus, the real income earned by the debt fund investors is only 1.5%, according to Amfi.

According to sources, the government may amend the Finance Act to consider debt MF units as "securities" and not as "special mutual funds" so that long-term investments can benefit from the same tax rate of 12.5% as listed bonds.

Anurag Mittal, head of fixed income at UTI MF, said that fixed income as an asset class has a long way to go in India, but the bond market lacks reasonable maturity and depth. "That's why it is important to encourage retail investors to invest in professionally run debt funds," he said.

Neeraj Agarwala, partner, Nangia & Co, said, "While the ministry's intention was tax simplicity, withdrawing indexation benefit for debt MF inadvertently introduced tax uncertainty. Reinstating it would not only restore investor confidence but also promote tax equality among various financial instruments."

According to the latest Amfi data, total assets under management (AUM) for debt funds stood at ₹16.86 lakh crore, while those of gold ETFs were ₹44,244.82 crore as of November 30. As of November 30, 2022, debt fund AUM was ₹12.57 lakh crore and gold ETFs were ₹20,832.77 crore.

TAX TALES

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