equaliFi ACADEMY

FII

CERTIFICATE IN
FIXED-INCOME INVESTING

Session 9- Fixed Income Investing

Taxation of Bonds and Debt Funds

For efficient portfolio management, generating tax efficiency is crucial.

Note:

- **Investment decisions should be taken on merit. Subsequent to the decision, tax efficiency should be explored.**
- **Reason is, tax efficiency should not distort the risk-return profile for the investment decision.**
- **Let us go through some basics before we discuss tax efficiency in debt funds.**

Taxation - Bonds

For listed bonds, the holding period is 1 year to qualify for LTCG. For unlisted bonds, it is 3 years.

The rate for LTCG is 10% (plus surcharge and cess). There is no indexation available in bonds.

The rate for STCG is the marginal slab rate, which for most investors is 30% (plus surcharge and cess).

Coupon is taxable as interest.

Taxation - Bonds

For zero coupon bonds sold before maturity, the difference between issue price and sale price may be treated as capital gains, but obtain the opinion of your tax consultant.

For certain notified bonds of NABARD, REC and certain other PSU Issuers, the differential is taxable as capital gains.

In tax-free bonds, the coupon is obviously tax free. However, capital gains is taxable, even on tax-free bonds.

Dividend

Growth - Short Term / Long Term

Dividend v/s growth

Concept of Indexation

Dividend – earlier rule of distribution tax

(upto 31 March 2020)

In the dividend option, there used to be a dividend distribution tax (DDT)

This was deducted by the AMC on behalf of the investor and transferred to Government

Post deduction of DDT, dividends were tax free in the hands of the investor

The DDT rate was 29.12% for individuals and 34.94% for corporates

The DDT rate was same for all investors, irrespective of the tax bracket

Dividends from 1 April 2020

From 1 April 2020, dividends are taxable in the hands of the investor.

There is a TDS of 10%, but TDS is not an issue as it can be adjusted.

DDT (of earlier days) could not be adjusted or claimed for refund.

Hence depending on your tax slab and depending on which regime (old or new) you have opted for, your dividends will be taxable.

Growth - Short Term / Long Term

- Investments in growth option is taxable in the hands of the investor
- It is taxable as capital gains. Holding period of more than 3 years makes it eligible for long term capital gains
- For holding period of upto 3 years, it is taxable as short term capital gains
- For short term capital gains tax, the rate is the marginal slab rate, which for most investors is 30% + surcharge and cess
- Long term capital gains has the benefit of indexation. The tax rate is 20% + surcharge and cess, after indexation
- The most tax efficient debt fund investment is growth option, for a period of more than 3 years (except if you are in a very low tax bracket)

Dividend vs. Growth

Which one is preferable - Dividend v/s Growth

For a period of less than 3 years, there is nothing much to choose from, between dividend and growth. Growth option may be little better due to set-offs.

For a horizon of more than 3 years, growth option is better due to indexation, unless you are in a very low tax bracket.

For a horizon of less than 3 years, tax efficiency can be generated by set-offs. As per Income Tax rules,

- Short-term capital loss can be adjusted against long-term capital gains as well as short- term capital gains;
- Long-term capital loss can be adjusted only against long-term capital gains.

The investor has to consult his/her Chartered Accountant for advice on possible set-offs. If it is available, growth option is better.

Snapshot of Tax Rates for Mutual Funds - old

	Individual/ HUF	Domestic Company	NRI
Dividend			
Equity oriented schemes	Nil	Nil	Nil
Debt oriented schemes	Nil	Nil	Nil

Rate of tax on distributed income (payable by the MF scheme)**			
Equity oriented schemes*	10% + 12% Surcharge + 4% Cess = 11.648%	10% + 12% Surcharge + 4% Cess = 11.648%	10% + 12% Surcharge + 4% Cess = 11.648%
Money market or Liquid schemes / debt schemes (other than infrastructure debt fund)	25% + 12% Surcharge + 4% Cess = 29.12%	30% + 12% Surcharge + 4% Cess = 34.944%	25% + 12% Surcharge + 4% Cess = 29.12%
Infrastructure Debt Fund	25% + 12% Surcharge + 4% Cess = 29.12%	30% + 12% Surcharge + 4% Cess = 34. 944%	5% + 12% Surcharge + 4% Cess = 5.824%

Tax Rates - new
(from 1 April 2020)

CAPITAL GAINS TAXATION

	Individual/ HUF [$!]	Domestic Company [@!]	NRI [$]
Equity Oriented Schemes • Long Term Capital Gains (units held for more than 12 months) • Short Term Capital Gains (units held for 12 months or less)			
Long term capital gains	10%*	10%*	10%*
Short term capital gains	15%	15%	15%
Other Than Equity Oriented Schemes • Long Term Capital Gains (units held for more than 36 months) • Short Term Capital Gains (units held for 36 months or less)			
Long term capital gains	20%[&]	20%[&]	Listed - 20%[&] Unlisted - 10%**
Short term capital gains	30% ^	30%/25%^^/22% ^^^/15%^^^^	30%^

Tax Deducted at Source (Applicable to NRI Investors) [#]		
	Short term capital gains [$]	Long term capital gains[$]
Equity oriented schemes	15%	10%*
Other than equity oriented schemes	30%^	10%** (for unlisted) & 20%[&] (for listed)

Tax Rates - new
(from 1 April 2020)

Income-tax implications on income in respect of units of Mutual Fund

Type of Investor	Withholding tax rate
Resident	10%*
NRI	20%**

The Finance Bill, 2020 proposes to abolish income distribution tax and instead proposes to tax income from mutual fund units in the hands of the unit holders.

* Tax not deductible if dividend income in respect of units of a mutual fund is below Rs. 5,000 in a financial year.

** The base tax is to be further increased by surcharge at the rate of:

- 37% on base tax where specified income exceeds Rs. 5 crore;
- 25% where specified income exceeds Rs. 2 crore but does not exceed Rs. 5 crore;
- 15% where total income exceeds Rs. 1 crore but does not exceed Rs. 2 crore; and
- 10% where total income exceeds Rs. 50 lakhs but does not exceed Rs. 1 crore

Specified income – Total income excluding income under the provisions of section 111A and 112A of the Income-tax Act,1961 ('the Act')

Further, "Health and Education Cess" is to be levied at 4% on aggregate of base tax and surcharge.

Income Tax Rates

Option A

For Individuals, Hindu Undivided Family, Association of Persons, Body of Individuals and Artificial juridical persons

Total Income	Tax Rates
Up to Rs. 2,50,000 [a] [b]	NIL
Rs. 2,50,001 to Rs. 5,00,000[d] [e]	5%
Rs. 5,00,001 to Rs. 10,00,000[d]	20%
Rs. 10,00,001 and above[c][d]	30%

Option B

The Finance Bill, 2020 has proposed New Personal Tax Regime:

Total Income	Tax Rates
Up to 2,50,000	Nil
From 2,50,001 to 5,00,000	5%
From 5,00,001 to 7,50,000	10%
From 7,50,001 to 10,00,000	15%
From 10,00,001 to 12,50,000	20%
From 12,50,001 to 15,00,000	25%
From 15,00,001 and above	30%

Concept of Indexation

Indexation means the purchase cost is ‘indexed’ i.e. marked higher, to provide for inflation, and the differential is taxed.

The index number, called cost inflation index (CII) is announced by the Government (CBDT) every year, on the basis of inflation previous year.

For indexation, the CII of the year of sale / redemption is divided by the CII of the year of purchase.

The purchase cost being marked higher, the taxable capital gains is lower and consequently tax payable is lower.

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Cost of Inflation Index: Old

Financial Year	Cost Inflation Index
2016-17	1125
2015-16	1081
2014-15	1024
2013-14	939
2012-13	852
2011-12	785
2010-2011	711
2009-2010	632
2008-2009	582
2007-2008	551
2006-2007	519
2005-2006	497

Old Base Year: 1981 - 82

Cost of Inflation Index: Current

Financial Year (FY)	Cost of Inflation Index (CII)
2001-02	100
2002-03	105
2003-04	109
2004-05	113
2005-06	117
2006-07	122
2007-08	129
2008-09	137
2009-10	148
2010-11	167
2011-12	184
2012-13	200
2013-14	220
2014-15	240
2015-16	254
2016-17	264
2017-18	272
2018-19	280

Base Year: 2001 - 02

Exercise

Computation of LTCG

Amit Gupta invested in an FMP on 25 March 2013. It matured on 17 August 2016. Starting NAV was Rs 10, and terminal NAV was Rs 12.5. Calculate his LTCG tax.

1. Year of purchase: 2012-13
2. CII of year of purchase: 852
3. Year of sale/redemption: 2016-17
4. CII of year of sale/redemption: 1125
5. Indexed cost: 1125/852 = 1.32 X Rs 10 = Rs 13.2

Since indexed cost is more than redemption NAV, there is no tax, there is a notional loss, which can be adjusted.

New Series data
264/200 = 1.32 X Rs 10 = Rs 13.2

Computation of LTCG

Komal Nahata invested in ABC Dynamic Fund NFO on 5 April 2013. She redeemed it on 17 August 2016. Starting NAV was Rs 10, and redemption NAV was Rs 12.5. Calculate her LTCG tax.

1. Year of purchase: 2013-14
2. CII of year of purchase: 939
3. Year of sale: 2016-17
4. CII of year of sale/redemption: 1125
5. Indexed cost: 1125/939 = 1.198 X Rs 10 = Rs 11.98

LTCG: Rs 0.52 per unit
Tax Rate: 20% (ignoring surcharge and cess for simplicity) Tax: Rs 0.1 per unit
Pre Tax return: (Rs 12.5/Rs 10)^(1/3.37) = 6.85%
Post Tax return: (Rs 12.4/Rs 10)^(1/3.37) = 6.59%

New Series
264/220 = 1.2 X Rs 10 = Rs 12
LTCG: Rs 0.5 per unit

Quiz

To avail of indexation in a bond, for long term capital gains tax, the minimum holding period is:

A. 1 year
B. 3 years
C. Indexation is not available in bonds
D. Bond coupon is tax free

For long term capital gains tax on bonds, the holding period required is:

A. There is no capital gains tax on bonds
B. Three years for listed and unlisted bonds
C. One year for listed bonds and three years for unlisted bonds
D. One year for listed and unlisted bonds

Quiz

Interest earned from bonds may be taxed under which of the following heads?

A. Income from other sources
B. Income from Business and Profession
C. Both the above
D. None of the above

Over a horizon of 3 years, the more tax efficient option in debt funds is:

A. Dividend option
B. Growth option
C. Both are taxable at the same rate
D. SIP in dividend option

Quiz

The coupon or interest earned from Government Securities is:

A. Free from tax
B. Taxable as interest at your slab rate
C. Taxable at half the rate for corporate bonds
D. Only TDS is applicable to G-Secs, no other tax

For an investor in highest tax slab, debt mutual fund is more tax efficient (over three years) than investing in bonds because:

A. Bond coupon (interest) is taxable at the highest slab rate
B. Debt MF growth option gives indexation benefit over three years
C. In debt MF, the earnings from bonds, both coupon and capital gains, is part of NAV, which gets the benefit of indexation
D. All of the above

Thank You