Mutual Fund Analyst

22 April 2022

Agenda

- Valuation & Taxation
- How are mutual funds valued?
- Valuation of suspended security / unlisted securities / liquid securities / debt securities / gold ETFs
- Mutual fund tax provisions – securities transaction tax (STT), capital gains tax, tax on income distributed, tax deducted at source (TDS), withholding tax
- Double indexation
- Setting off & carry forward of losses
- Taxation of segregated units

Fair Valuation Principles

- In order to ensure such a fair treatment to all investors, SEBI has laid down certain fair valuation principles specified in the 8th Schedule of SEBI (Mutual Funds) Regulations, 1996.

- The asset management companies are required to compute and carry out valuation of investments made by its scheme(s) in accordance with the investment valuation norms.

- SEBI has laid down 10 fair valuation principles.

Valuation

- **Traded Securities other than money market and debt securities:**
  - The securities shall be valued at the last quoted closing price on the stock exchange.
  - When the securities are traded on more than one recognised stock exchange, the securities shall be valued at the last quoted closing price on the stock exchange where the security is principally traded.
  - When on a particular valuation day, security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.
  - When a security is not traded on any stock exchange on a particular valuation day, the value at which it was traded on the selected stock exchange or any other stock exchange, as the case may be, on the earliest previous day may be used provided such date is not more than **30 days** prior to the valuation date.

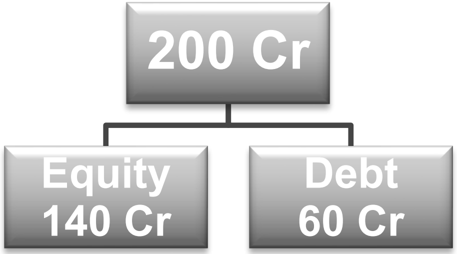
Valuation …

- **Non-traded Securities' other than money market and debt securities:**
    - When a security is not traded on any stock exchange for a period of **30 days** prior to the valuation date, the scrip must be treated as a 'non-traded' scrip.
    - Non-traded securities shall be valued "in-good faith" by the asset management company on the basis of appropriate valuation methods based on the principles approved by the Board of the asset management company.

- **Value of Gold:**
    - The gold held by a Gold ETF scheme shall be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 parts per thousand.

Computation of Net Assets of Mutual Fund Scheme and NAV

Investors have bought 20 crore units of a mutual fund scheme at Rs. 10 each. The scheme has thus mobilized Rs. 200 Crs.



- Equity investment has appreciated by 10%, current value Rs. 154 Crs.
- Total Interest and dividend received by the scheme is Rs. 8 Crs.,
- Scheme expenses paid is Rs. 4 Crs., and payable Rs. 1 Cr., total 5 Cr.

The unit-holders' funds in the scheme is commonly referred to as "Net Assets".

Net Assets of Scheme & NAV

In the above example, it can be calculated as:

Market Value of Equities (140 × 110%)	154 Crore
Add: Principal Value of Bank Deposits	60 Crore
Add: Interest & Dividend earned	8 Crore
Less: Expenses incurred	4 Crore
Less: Expenses Payable	1 Crore
Net Assets of the Scheme as on date:	**217 Crore**

In the market, when people talk of NAV, they refer to the value of each unit of the scheme. Hence, **NAV** is Rs. (217 ÷ 20) = **Rs. 10.85 per unit.**

Class Work:

(i) Calculate the NAV given the following information:

- Value of stocks: Rs. 150 cr,
- Value of bonds: Rs. 67 cr
- Value of money market instruments: Rs. 2.36 cr,
- Dividend accrued but not received: Rs. 1.09 cr,
- Interest accrued but not received: Rs. 2.68 cr
- Fees payable: Rs. 0.36 cr,
- No. of outstanding units: 1.90 cr.

Answer

- Rs. 117.25 per unit.

Class Work:

(ii) Calculate the NAV given the following information:

- Value of stocks: Rs. 230 cr,
- Value of money market instruments: Rs. 5 cr,
- Dividend accrued but not received: Rs. 2.39 cr,
- Amount payable on purchase of shares: Rs. 7.5 cr
- Amount receivable on sale of shares: Rs. 2.34 cr
- Fees payable: Rs. 0.41 cr,
- No. of outstanding units: 2.65 cr

Answer (ii)

- Rs. 87.48 per unit

Mark to Market

- The process of valuing each security in the investment portfolio of the scheme at its market value is called **'mark to market'** i.e. marking the securities to their market value.

- **Why is this done?**
    - If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought.
    - Investors buy or sell units on the basis of the information contained in the NAV.
    - Helps in assessing the performance of the scheme / fund manager.

Total Expenses in Mutual Fund Scheme

- **Investment and Advisory:**
  - Investment and Advisory Fees are charged to the scheme by the AMC.

- **Recurring Expenses:**
  - In addition to the investment and advisory fee, the AMC may charge the mutual fund scheme with recurring expenses including:
    - ✓ Marketing and selling expenses including agents' commission,
    - ✓ Brokerage and transaction cost,
    - ✓ Audit fees,
    - ✓ Costs related to investor communication,
    - ✓ Insurance premium paid by the fund,
    - ✓ Costs of statutory advertisements etc.

The total expense …

- **In case of fund of funds scheme:**

    i. Investing in **liquid schemes, index fund scheme and ETFs,** the TER of the scheme including weighted average of the TER levied by the underlying scheme(s) shall not exceed **1%** of the daily net assets of the scheme.

    ii. Investing a minimum of 65% of assets under management in **equity oriented schemes** as per scheme information document, the TER of the scheme including weighted average of the TER levied by the underlying scheme(s) shall not exceed **2.25%** of the daily net assets of the scheme.

    iii. Investing in schemes **other than as specified above**, the TER of the scheme including weighted average of the TER levied by the underlying scheme(s) shall not exceed **2%** of the daily net assets of the scheme.

The total expense …

- **In case of an index fund scheme or exchange traded fund:**
  - In case of an **index fund scheme or ETF**, the TER of the scheme including the investment and advisory fees shall not exceed **1%** of the daily net assets.

The total expense …

- **In case of other open-ended schemes:**

AUM Slab (of the daily net assets)	TER limits for Equity oriented schemes (%)	TER limits for other than equity oriented Schemes (%)
On the first Rs. 500 crore	2.25	2.00
On the next Rs 250 crore	2.00	1.75
On the next Rs 1,250 crore	1.75	1.50
On the next Rs 3,000 crore	1.60	1.35
On the next Rs 5,000 crore	1.50	1.25
On the next Rs.40,000 crores	Total expense ratio reduction of 0.05 percent for every increase of Rs.5,000 crores of daily net assets or part thereof.	
On the balance of assets	1.05	0.80

The total expense …

- **in case of close ended and interval schemes:**

    i. The TER of **equity-oriented scheme(s)** shall not exceed **1.25%** of the daily net assets of the scheme.
    ii. The TER of **other close ended and interval scheme(s)** than schemes specified in clause (i) above shall not exceed **1%** of the daily net assets of the scheme.

Additional allowable expenses

- **In addition to the above-mentioned limits, the following expenses may be charged to the scheme:**
    - Brokerage and transaction cost are incurred for the purpose of execution of trade and is included in the cost of investment to the extent of 0.12% for cash market transactions and 0.05% for derivatives transactions.
    - If the new inflows from beyond top 30 cities are at least, beyond certain limits set by SEBI (refer NISM Book for further details in this regard).

Valuation of perpetual bonds

- Tier 1 and Tier 2 bonds that are issued by banks and are perpetual in nature fall under this category. These are also popularly known as AT 1 or AT 2 bonds.

- The valuation of such bonds has also been guided by SEBI.

Dividends & Distributable Reserves

- SEBI guidelines stipulate that dividends can be paid out of Distributable Reserves. In the calculation of distributable reserves:
  - All the profits earned are treated as available for distribution,
  - Valuation gains are ignored. But valuation losses need to be adjusted against the profits,
  - That portion of sale price on new units, which is attributable to valuation gains, is not available as a distributable reserve.

Concept of Entry and Exit Load and its impact on NAV

- A distinctive feature of open ended schemes is the ongoing facility to acquire new units from the scheme (sale transaction) or sell units back to the scheme (re-purchase transaction).

- The difference between the NAV and re-purchase Price is called the “exit load”.

- Exit loads have to be credited back to the scheme immediately i.e., they are not available for the AMC to bear selling expenses.

- SEBI has banned entry loads w.e.f. 1st August 2009.

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Key Accounting and Reporting Requirements

- The accounts of the schemes need to be maintained distinct from the accounts of the AMC. The auditor for the AMC has to be different from that of the schemes,
- NAV is to be calculated upto 4 decimal places in the case of index funds, liquid funds and other debt funds,
- NAV for equity and balanced funds is to be calculated upto at least 2 decimal places,
- Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.

NAV, Total expense ratio and pricing of units for the Segregated Portfolio

- To ensure fair treatment to all investors in case of a credit event and to deal with liquidity risk, SEBI has permitted creation of segregated portfolio of debt and money market instruments by mutual funds schemes.

- AMC shall not charge investment and advisory fees on the segregated portfolio,

- TER (excluding the investment and advisory fees) can be charged, on a pro-rata basis only upon recovery of the investments in segregated portfolio,

- The Net Asset Value (NAV) of the segregated portfolio shall be declared on a daily basis.

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Time

1. **What is the maximum Total Expense Ratio chargeable in case of index funds.**
   a) 1 percent of the daily net assets
   b) 1.5 percent of the daily net assets
   c) It depends as the TER changes in line with the size of the scheme
   d) Any amount that the AMC may deem appropriate

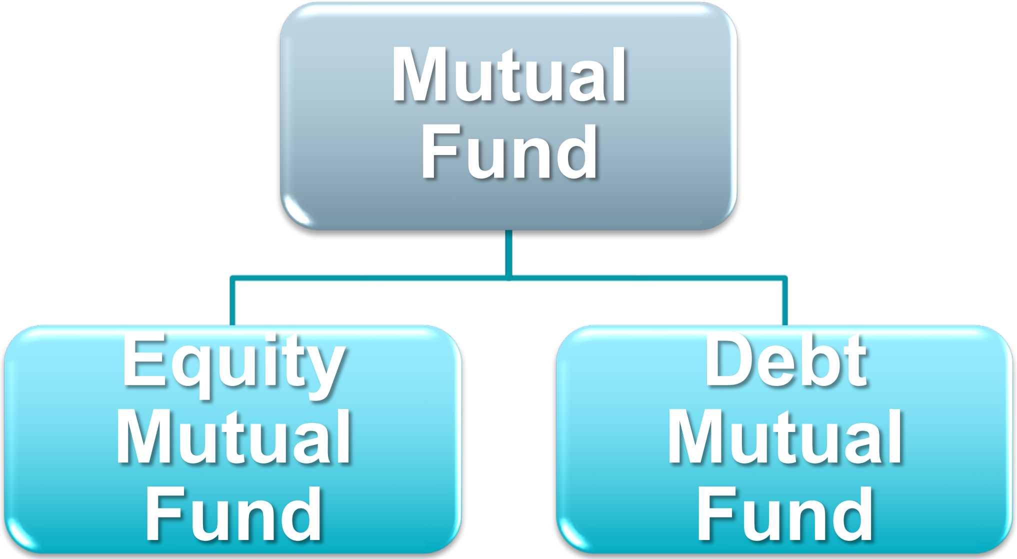
2. **In case of mutual fund schemes, dividends can be paid only out of ___________?**
   a) Premium reserve account
   b) Unit capital
   c) Distributable surplus generated by the scheme
   d) Mark-to-market profits

Taxation

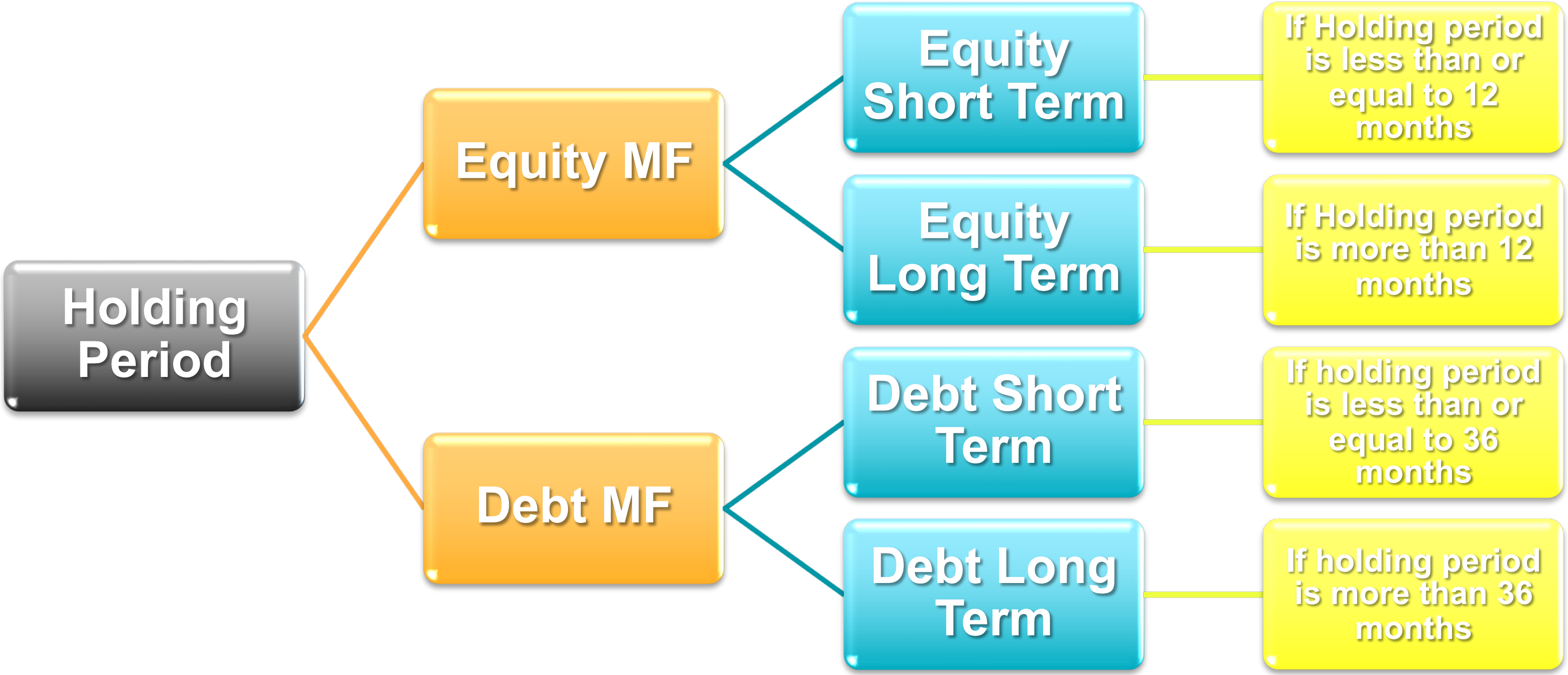
Applicability of taxes in respect of mutual funds

- **Income from investment in mutual fund units**
  - **Income earned by mutual fund schemes**
    - Exempt from income tax, because of Trust
  - **Income earned by the investor from investment in mutual fund units**
    - Capital appreciation is taxable as “Capital “Gain
    - Dividend / IDCW is taxable as “Income from Other Sources”

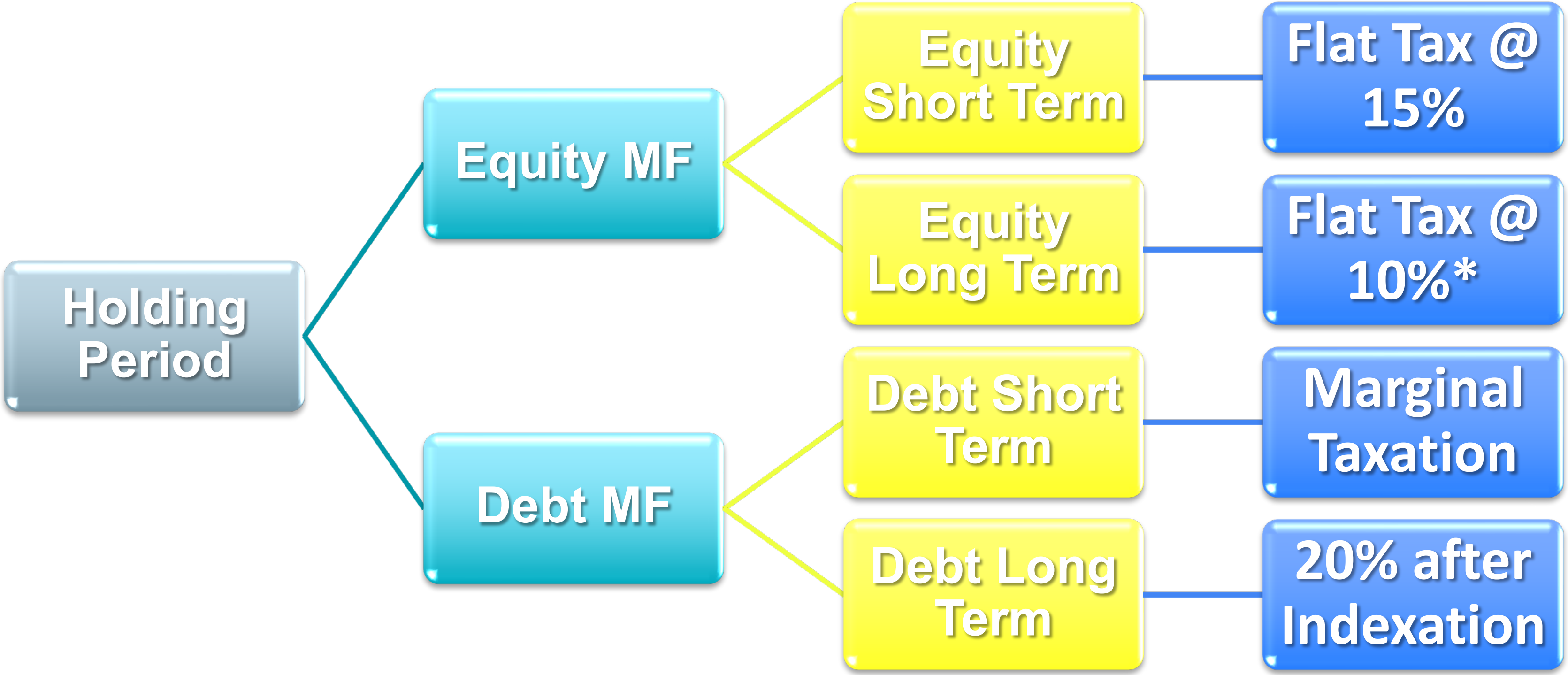
Capital Gains



Capital Gain (Holding Period)



Capital Gain (Tax Rates)



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Capital Gains (Other Points)

- In addition to the above, surcharge and cess is applicable. The surcharge is calculated on the base tax and the cess is calculated on the aggregate of base tax and surcharge,
- Equity mutual funds were exempt from long term capital gains tax earlier. In the Union Budget of the year 2018, this was changed,
- **Exemption upto Rs. 1 lakh:** In case of long term capital gains arising out of equity shares and equity-oriented mutual funds, the tax is applicable only on the capital gains above Rs. 1 lakh. The first Rs. 1 lakh worth of long term capital gain from this category is tax-exempt.
- **Grandfathering of capital gains:** This meant that the capital gains earned till January 31, 2018 would not be taxable.

Understanding the benefit of indexation

- Assume that an investor invested a sum of Rs. 10 Lacs in a debt fund during the financial year 2017-18, and sold the same after 3 years during financial year 2020-21. He got Rs. 13 Lacs as the redemption proceeds. Hence, the capital gain is Rs. 3 Lacs.
- Though the actual gain is Rs. 3 Lacs; tax is not payable on the entire gain, due to the benefit of indexation.

  - **Here, Indexed cost of acquisition =**
    - Actual cost of acquisition × [CII in the year of sale / CII in the year of purchase]
    - In our example, indexed cost of acquisition =
    - Rs. 10,00,000 X [301/272]* = Rs. 11,06,618/-

- **Hence, LTCG tax payable = 20% of (13,00,000-11,06,618) = Rs. 38,676/-**

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Income distribution cum capital withdrawal (IDCW) / Dividend income

- From Financial Year 2020-2021 (AY 21-22), dividends is taxable in the hands of the recipient at the applicable tax rate.

- Tax on dividend would be a function of the applicable rate of tax based on total income for the year, and hence the tax rate goes up for those in higher income.

- The dividend income would be tax exempt for investors in various tax-exempt categories, for example: charitable trusts, mutual fund schemes and individuals in the tax exempt slab.

Stamp Duty on Mutual Fund Units

- With effect from July 1, 2020, mutual fund units issued against Purchase transactions (whether through lump-sum investments or SIP or STP or switch-ins or dividend reinvestment) would be subject to levy of stamp duty **@ 0.005%** of the amount invested.

- Transfer of mutual fund units (such as transfers between demat accounts) is subject to payment of stamp duty @ 0.015%.

Setting off of Capital Gains and Losses under Income Tax Act

- Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries).

- Short term capital loss is to be set off against short term capital gain or long term capital gain.

- Long term capital loss can only be set off against long term capital gain.

Taxation of segregated (side-pocketed) portfolio units

- Initially, there was confusion about taxation of the proceeds from recovery in the side-pocketed portfolio. In the Union Budget presented on 1 February 2020, clarification was provided on this.

- It was provided that “for taxation purposes, the period of holding in the segregated portfolio will include the earlier period of holding of the units in the main scheme”.

- That is, as an example, if you purchased the units on say 31 March 2017 and segregation happened on 31 March 2020, for taxation purposes, your date of acquisition is 31 March 2017.

- It was also provided that “for computing the cost of acquisition of the units in the segregated portfolio, the cost of acquisition in the main scheme will be pro-rated in the ratio of the NAV of the assets transferred to the segregated portfolio.

- Simultaneously the cost of acquisition of the units in the main scheme will be reduced by the cost of acquisition in the segregated portfolio”.
- To take an illustration, let us say the value of a scheme is Rs 100. Of this, Rs 5 worth of assets goes bad (e.g. IL&FS, DHFL, ADAG) and the valuation becomes Re 1. Hence the value of the portfolio becomes Rs 96. The MF segregates the bad assets into a side-pocketed portfolio. Here the cost of acquisition in the segregated portfolio will be Re 1/ Rs 96 and the cost of acquisition in the main portfolio will be reduced by that amount.
- In the above example, Rs 5 goes bad, valuation is brought down to zero, and is segregated. If your holding period, as per the original (i.e. initial) date of acquisition is more than three years, you are eligible for indexation for long-term capital gains.
- However, mathematically, the formula of indexation number of the year of sale (or redemption) divided by the indexation number of the year of purchase, would still be zero. In other words, you will get the benefit of indexation on the main portfolio (Rs 95 in the example) but not on the other component (Rs 5 in the example), though you are eligible for it.

Securities Transaction Tax (STT)

- When an investor **sells units** of an equity fund in the **stock exchange**, or offers them for **repurchase** to the fund, he will have to incur Securities Transaction Tax (STT).

- STT is not applicable on purchase of units of an equity scheme.

- It is also not applicable to transactions in debt securities or debt mutual fund schemes.

Tax benefit u/s 80C of the Income Tax Act

- Equity Linked Savings Schemes (ELSS) are eligible for deduction under Section 80C of the Income Tax Act.
- The benefit is available up to Rs. 1.50 lacs per year per taxpayer in case of individuals and HUFs.
- The scheme has a lock-in period of three years from the date of investment.
- If one is investing in this scheme through SIP, each investment would be locked-in from the date of the respective investment.
- The tax benefit would be available to the first holder, in case of a joint holding.
- There are also a few retirements oriented funds which have the benefit of Section 80C.

Tax Deducted at Source (TDS)

- There is no TDS on re-purchase proceeds to resident investors.
- For certain cases of non-resident investments (NRI), the same is applicable.
- In case of dividends from mutual fund schemes, even for resident Indians, TDS is applicable.
- The tax is required to be deducted at 10% on the dividend amount if it exceeds Rs. 5,000.

Applicability of GST

- AMC(s) can charge GST, as per applicable Taxation Laws, to the schemes within the limits prescribed under SEBI (Mutual Fund) Regulations. These are:
    - On investment management and advisory fees,
    - On all the fees other than investment and advisory fees,
    - On brokerage and transaction cost,
  - within the maximum limit of TER.

- GST on exit load, if any, shall be deducted from the exit load and the net amount shall be credited to the scheme.

- The commission payable to the distributors of mutual funds may be subject to GST, as applicable in case of the ARN holder. Such tax cannot be charged to the scheme.

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Time

1. **Redemption from which of the following mutual fund schemes would attract Securities Transaction Tax (STT) for an investor?**
    a) Multi-cap mutual fund
    b) Government Securities Fund
    c) Liquid Fund
    d) Overnight Fund

2. **The Income Tax Act allows setting-off of the short-term capital loss against long term capital gains. State whether True or False?**
    a) True
    b) False

It’s

QUIZ!

Time

1. **What term is used to describe the Net Asset Value (NAV) of the scheme after the dividend is paid out (Remember the NAV would have dropped to the extent of the dividend paid)?**
   a) Ex-Dividend NAV
   b) Cum-Dividend NAV
   c) Lower NAV
   d) Dividend NAV

2. **How many (maximum) bank accounts can a resident individual investor register with a mutual fund folio?**
   a) 1
   b) 2
   c) 3
   d) 5

Thank You