

ET**IN THE
CLASSROOM**

Taxation in Mutual Funds

Investors must understand the tax implications of financial products while investing. This helps them optimise their post-tax returns. A look at how mutual funds are taxed.



HOW ARE INVESTMENTS IN MUTUAL FUNDS TAXED?

There is no tax while investing in or holding a mutual fund, like a fixed deposit. The tax incidence arises when you sell, switch from one scheme to another, or redeem the investment. The gains earned in a mutual fund scheme are subject to tax based on the type of scheme.

HOW ARE EQUITY MUTUAL FUNDS TAXED?

Any mutual fund scheme that is equity-oriented and has more than 65% of its portfolio invested in domestic equities qualifies for long-term capital gains (LTCG) tax of 12.5% if held for more than one year. If sold within one year, the investor will pay short-term capital gains (STCG) tax of 20%. In addition, long-term capital gains of up to ₹1.25 lakh in a financial year are completely exempt from tax.

WHAT ABOUT DEBT SCHEMES?

In debt funds, gains are taxed in line with the investor's income-tax slab, irrespective of the period of holding. A debt mutual fund is generally defined as one that invests less than 35% of its portfolio in equity shares of domestic companies.

HOW ARE HYBRID FUNDS TAXED?

Hybrid funds combine multiple asset classes, equity, debt and gold. Often, fund houses structure these schemes in a manner that allows investors to benefit from equity taxation even with relatively lower equity exposure.

The aggressive hybrid category maintains 65-75% in equity, with the balance in fixed income, and qualifies for equity taxation. In the balanced advantage and equity savings categories, the fund manager maintains the equity plus arbitrage component above 65% to qualify for equity taxation.

Multi-asset funds, which are required to have a minimum of 10% each in debt, equity and gold, have two variants. Funds that have 65% or more in equity, including arbitrage, with the balance in debt and gold, qualify for equity taxation. Those with equity allocation between 35% and 65% need to be held for more than two years to qualify for the LTCG tax of 12.5%. Similarly, the income plus arbitrage fund category, which combines debt and arbitrage, is taxed at 12.5% if held for more than 24 months.



Invesco Mutual Fund

An investor education and awareness initiative

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

HOW ARE PRODUCTS WITH PRECIOUS METALS AS UNDERLYING AND FUND-OF-FUNDS (FOFS) TAXED?

An equity FoF that invests a minimum of 90% of its total proceeds in equity exchange-traded funds qualifies for long-term capital gains tax of 12.5% if held for more than one year. Other equity-oriented funds, including international funds, attract LTCG tax of 12.5% if held for over 24 months.

If a gold ETF is sold after 12 months, the gains are treated as long-term capital gains. As per the new rule, LTCG on gold ETFs in India is taxed at a flat 12.5%. However, in the case of gold and silver FoFs, investors need to hold the investment for 24 months to qualify for LTCG.

HOW ARE DIVIDENDS IN MUTUAL FUNDS TAXED?

Investors who opt for the IDCW (Income Distribution cum Capital Withdrawal) option should note that this income is fully taxable in their hands. It is added to the investor's total income and taxed at the applicable income-tax slab rate. This applies regardless of whether the fund is an equity, debt or hybrid scheme.

HOW CAN INVESTORS USE MUTUAL FUND PRODUCTS TO MAXIMISE TAX EFFICIENCY?

Financial planners point out that investors should remember that long-term capital gains of up to ₹1.25 lakh per year are tax-free and can be utilised during a financial year. Investors seeking tax efficiency in fixed income could consider arbitrage funds and income plus arbitrage categories. Hybrid schemes may also be used for tax efficiency, in line with the investor's risk profile.

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