A comparison of PMS, MF & AIF for taxation purpose

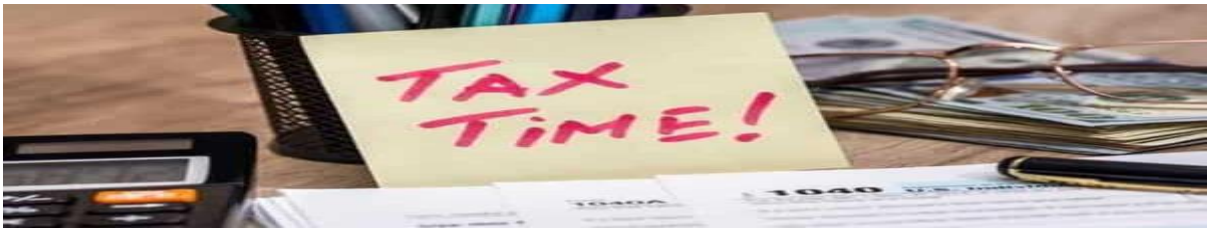

Photo: iStock3 min read . Updated: 04 Jul 2022, 06:12 AM IST **Gautam Nayak**

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If you are an investor who needs expert advice, you have a choice of three investment routes: invest in a portfolio investment scheme (PMS), a mutual fund (MF) or an Alternative Investment Fund (AIF). While each of these routes differs from the other in terms of minimum investment, lock-in and liquidity of funds invested, and management fees charged, they also differ in the tax treatment of the income earned through them. Often, the tax advantage of a particular route may impact the investor's post-tax yield.

In a PMS, you are taxed as if you have made the investments directly. You get the advantage of concessional tax rate on the long-term or short-term capital gains. But, one significant disadvantage with a PMS is that the tax authorities have been seeking to deny deduction of portfolio management fees paid to the portfolio manager from the income earned by the investor. There have been conflicting decisions of the tax tribunals on this, with some allowing the deduction of such fees and some others, not.

Similarly, if an AIF is carrying on an investment activity, and is a Category I or II AIF, its income would be a pass-through income, and investors will be taxed on their share of income of the AIF in the same manner as if they had made the investments directly. In such cases too, there has been some litigation as to deductibility of fees paid to the fund manager, though the tribunals have generally ruled in favour of the taxpayer.

On the other hand, if an AIF (Category II or Category III) is carrying out frequent transactions, the gains earned may be taxed as business income of the AIF at the maximum marginal rate, and the share of income that an investor earns would be exempt. Effectively, the investor bears the brunt of the proportionate tax paid by the

AIF at the maximum marginal rate. Such a rate may be higher than what investors would have paid had they made the investment directly. However, if the income is taxed as business income, the management fee paid to the fund manager is undisputedly an allowable business deduction, as it is an expenditure incurred wholly and exclusively for the purposes of business.

In contrast to the other two routes, investments in MFs by an investor are treated as a separate investment from those made by a mutual fund AMC. Unlike the tax provision in countries such as the US, such MF income is not a pass-through income and is taxable in the hands of investors. The mutual fund AMC of course does not pay any tax on its income. The investor is taxed on his investment at the difference between the selling price and acquisition cost of the MF units, and the type of MF invested in, rather than on the nature of income earned by the MF.

The investor therefore has the flexibility of converting interest into capital gains, by choosing the growth option of a debt fund, and of converting capital gains into regular income, by choosing the regular income option of an equity fund, depending on his tax needs. An MF gives the added advantage of automatically ensuring deduction of the asset management fees charged, since the net asset value at which units are bought and sold, is computed after deduction of all expenses, including asset management fees. Therefore, the net capital gains or the income distributed to the unitholder is the net amount after deduction of such expenditure.

An MF therefore is better from a tax perspective as compared to a PMS or an AIF. In principle however, this begs the question —why do the tax authorities not accept the fact that asset management fees, whether paid to an MF manager, a portfolio manager or an investment manager of an AIF, are all paid for earning a return on the investment, and should therefore be tax deductible, irrespective of whether the income is through an MF, PMS or AIF and whether it is by way of capital gains, interest or dividends? Investors would then be purely guided by commercial considerations, and not by tax benefits, as the case should be.

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