

Opinion | How proceeds from the units of discontinued mutual funds will be taxed

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Every time money gets paid, the investor'll have to compute gains or losses

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Recently, a large mutual fund house announced the discontinuance of six of its debt fund schemes. As per the decision of the fund house, the assets of the scheme would be gradually realized over a period of two or three years, and would be paid to investors on realization. All repurchases and sales of the schemes would be stopped, and it would be only the existing investors who would receive the proceeds.

The Securities and Exchange Board of India, meanwhile, came up with the clarification that such units could be listed on the stock exchanges to provide liquidity to investors. However, till date, the fund house has not yet decided as to whether the units would be listed or not.

What is the tax treatment of the receipt of proceeds of realization of assets in respect of such units for investors? Is this a distribution of income by the scheme? Is the entire capital loss allowable in the year of discontinuance of the schemes, or in the final year in which the last of the assets is realized, or should the capital loss be claimed proportionately over the period of realization?

One needs to understand that discontinuance of a mutual fund unit scheme is different from the practice of side-pocketing of units, which certain schemes adopted when faced with deterioration in the value of certain assets held by the scheme that would probably take some time to realize. In case of side-pocketing of units, there are now specific provisions in the law, whereby the existing units are regarded as having been split up into two different categories of units, and capital gains computed accordingly.

In case of discontinued scheme units, if the units are listed and disposed of on the stock exchanges, then obviously the capital gains will be computed on the sale of such units. In case the units continue to be unlisted, then the only manner of realization for the investors is when the mutual fund scheme realizes its assets and distributes the proceeds among investors from time to time.

What is the character of this receipt of realization of proceeds of assets for investors? It is not a distribution of income by the scheme. By paying amounts from time to time out of the proceeds of

realization of its assets, the scheme is really repaying the investors the value of their units. It is, therefore, a part redemption of the units. Every time an investor receives a certain amount from the mutual fund scheme towards the proceeds received from the realization of the assets, a part of the value of his units is being redeemed. He will, therefore, have to compute his capital gain or loss in the year of receipt of the proceeds.

How does an investor determine what percentage of the value of his units is being redeemed when he receives certain amounts, to compute his capital gains? The proportionate part of the unit being redeemed will be that proportion of the net asset value (NAV) of the unit being realized. To illustrate, if the NAV of the unit is ₹8 prior to the distribution of the proceeds, and ₹2 out of the NAV is realized and distributed, one-fourth of the unit would be regarded as redeemed, and capital gains would be computed in relation thereto. The gain or loss would be the amount realized less 25% of the cost of the unit to the unitholder. Of course, if the units have been held for more than 36 months, the benefit of indexation of cost would be available to the unitholder, and this may result in an enhancement of the loss or reduction of the gains.

Most unitholders may find it difficult to determine what is the proportion of units being redeemed each time they receive a distribution of the realization proceeds. Ideally, the fund house should provide such a statement to the unitholder along with the distribution to facilitate such computation of capital gain or capital loss. This would make life easier for the unitholders, who in any case are facing a likely loss of part of their capital investments.

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