Opinion | No capital gains tax liability on creation of side-pocket in a mutual fund

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There is no transfer or redemption of units held by the investor in side-pocketing

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In December 2018, in the light of various defaults by issuer companies on debt instruments held by mutual funds, the Securities and Exchange Board of India (Sebi) introduced the concept of side-pocketing. Under side-pocketing, such downgraded instruments are hived off into a separate portfolio, termed a side pocket of the scheme, and the investor in the scheme is allotted units of the side-pocket, in the same ratio as the investment in the scheme. Two mutual funds have already announced the creation of side-pockets in respect of certain securities where the redemption is likely to be delayed beyond the life of the scheme. What is the tax impact of such side-pocketing on investors?

If one examines the mechanism of a side-pocket, the tainted portfolio is segregated from the main portfolio. Separate units in the side-pocket are allotted to investors in the same ratio as units held by the investors in the main scheme as of the date of side-pocketing. Net asset values (NAVs), separate from the NAVs of the scheme, are computed and announced for these units in the side-pocket. The units in the side-pocket can be transferred separately from and independent of the units in the main scheme, though they are not redeemable. It is, therefore, fairly clear that the units in the side pocket are distinct and separate from the units in the main scheme from which the side-pocket was created.

Is there any tax liability to the investor on the creation of the side-pocket by segregation of the portfolio of the main scheme? To an investor, capital gains tax liability on investment in mutual fund units can arise only on redemption or transfer of the units. In this case, the number of units remains unchanged—only the NAV of the units reduces, to the extent of the portfolio segregated from the main portfolio. There is, therefore, no transfer or redemption of the units held by the investor. Hence, there is no question of any capital gains tax liability on the creation of the side-pocket.

Can this be taxed under the provision for taxation of gifts, as a security received without consideration? In this case, the units in the side-pocket are received on account of the holding of units in the main scheme, and there is a diminution in value of units held in the main scheme on account of the creation of the side-pocket due to transfer of securities to the side-pocket. Therefore, such units in the side-pocket cannot be said to have been received without consideration by the investor and cannot, therefore, be taxed as income under that provision.

The next issue that arises is the date of acquisition of the side-pocket units. Is it the date of allotment of the side-pocket units, or the date of acquisition of the original units of the mutual fund scheme? In this case, since the units of the side-pocket are being allotted on account of holding of the units of the main scheme, the date of allotment of such units of the side-pocket, viz, the date of creation of the side-pocket, would be the date of acquisition of such units.

What would be the cost of acquisition of the side-pocket units? Is the cost of the units of the main scheme to be spread over and divided between the original units and the units of the side-pocket? In this case, by virtue of holding a security (the units of the main scheme), the investor is allotted additional financial asset (units in the side-pocket) without any payment. By virtue of application of the same provision as that applicable to bonus shares, the cost of the original units would remain unchanged, while the cost of units in the side-pocket would be taken as nil.

This would, therefore, mean that in case the units in the side-pocket are redeemed by the mutual fund on part or full realization of the downgraded investments within a period of three years of creation of the side-pocket, the entire proceeds received by the investor on such redemption would be taxable at the slab rate of tax as short-term capital gains, and not at the concessional rate applicable to long-term capital gains, even though the original units of the main scheme in respect of which the side-pocket was created were long-term capital assets.

One more provision that one needs to keep in mind in respect of side-pocket units is the provision relating to bonus stripping in units. The provisions of that section apply to cases of allotment of additional units without any payment on the basis of holding of the original units and, therefore, apply not only to cases of allotment of bonus units but also to cases of allotment of side-pocket units. Therefore, if the original units in the main scheme have been acquired by the investor within three months before the creation of the side-pocket, and redeemed within nine months after the creation of the side-pocket, while continuing to hold the side-pocket units, any loss on such redemption would not be allowable, but would have to be treated as the cost of the side-pocket units.

Effectively, therefore, units allotted in side-pockets would have the same tax treatment as bonus units, though the purpose behind allotment of such units is quite different from the purpose behind allotment of bonus units.

Gautam Nayak is a chartered accountant