Revisit stock, MF portfolios as DDT rules change

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Among mutual funds, you can get some tax advantage by investing in the growth option

Topics

Mutual Funds

Now that the exemption for dividends and income from mutual funds has been phased out from 1 April 2020, investors need to understand the impact of this change and modify their investments suitably. What are the various aspects that one needs to keep in mind while doing so?

Dividends from companies will now be fully taxable in the hands of individual investors, and added to their total income. The budget didn't propose any concessional tax rate on such dividends. Since companies will save a little over 20% of the dividend distribution tax (DDT) that they were earlier liable to pay, they may enhance their dividend payouts by about 20%, assuming that they distribute the same percentage of profits as in the past. However, investors will pay tax on such dividends at their slab rates—those in the higher tax brackets will pay between 31.2% and 35.88% (given that the surcharge on dividends cannot exceed 15%). Unlike earlier, there will be no additional tax of 10%, payable by the investors, if the dividends exceed ₹10 lakh during the year.

Dividends on preference shares, which normally carry a fixed rate of dividend, would also now be taxable in the hands of investors at slab rates, while companies would save 20%-plus DDT. Preference shares may, therefore, no longer be an attractive yield investment, unless the dividend coupon rate is higher.

Mutual funds so far had different rates of DDT, depending upon the type of units, and income distribution was exempt in the hands of investors. Liquid or money market funds attracted a DDT of 29.12%, equity-oriented funds 11.65%, and other mutual funds had a DDT of 34.94%. Investors were able to employ tax arbitrage by buying an arbitrage fund, which qualifies as an equity-oriented fund, instead of a liquid or a short-term debt fund, paying DDT at 11.65%, instead of 29.12% or 34.94%.

Now since tax would be payable at slab rates, there would be no such tax arbitrage benefit on investing in different types of mutual funds. All the investor would need to look at while investing is the scheme's potential rate of return.

However, there is still some tax advantage to be gained by opting for the growth option of mutual fund schemes. Here, the investor would earn capital gains on redemption or transfer of the units. In case of long-term capital gains (LTCG) on the transfer of units of an equity-oriented fund, such gains are not taxable (along with similar gains on transfer of listed equity shares) up to ₹1 lakh, and the rate of tax is only 10% (plus applicable surcharge and cess). Short-term capital gains (STCG) on the transfer of units of an equity-oriented fund would also attract a concessional tax rate of 15% (plus applicable surcharge and cess). LTCG on the transfer of other units of mutual funds would also attract a tax rate of 20% (plus surcharge and cess) with the benefit of cost indexation, though STCG on other units would be taxable at the slab rates. A non-resident would be liable to tax on LTCG on such other units only at 10% (plus applicable surcharge and cess). So clearly, it is advantageous to opt for the growth option.

The only expense that you can claim against dividends or mutual fund income is interest, and that too only to the extent of 20% of such income. It seems this just ensures that taxpayers end up paying maximum tax on dividend and mutual fund incomes.

Today, the only investments where the income will continue to be fully exempt are tax-free bonds and Public Provident Fund. Investors in the tax slabs above 30% may find these attractive.

Each investor would now need to relook at his portfolio to align it with the amended tax position, and ensure that his post-tax return continues to be maximized.

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