Why India's collective investment tax rules need an overhaul

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The lack of coherence in taxation across investment vehicles hurts transparency and creates loopholes. (Image: Pixabay)

Summary

A look at how India's tax rules for collective investment schemes create arbitrage — and why reform is overdue.

India's financial landscape offers a variety of collective investment schemes — mutual funds (MFs), unit linked insurance plans (ULIPs), real estate investment trusts (REITs), infrastructure investment trusts (InvITs), alternate investment funds (AIFs), and portfolio management schemes (PMS).

While all these vehicles pool investors' money for investment and are regulated by the Securities and Exchange Board of India (Sebi), they are governed by different sets of regulations — and taxed under strikingly different rules.

This fragmented approach has created opportunities for tax arbitrage, where investors can choose routes that offer more favourable tax outcomes for similar underlying investments.

While some of these loopholes — such as dividend and bonus stripping or gains on debt mutual funds — have been addressed through legislative amendments, a fundamental question remains: why should taxation differ based solely on the structure of the investment?

Although the government has taken steps to rationalise capital gains taxation, a comprehensive alignment of tax rules across all types of collective investment schemes is still lacking.

Mutual funds & ULIPs

MFs and ULIPs are treated as standalone investment products. The income generated within these schemes is not taxed at the fund level on a pass-through basis.

For MFs, any income distributed (such as dividends) is taxed as income from other sources, while gains made on selling MF units are taxed as capital gains.

ULIPs are taxed a bit differently. When a policyholder receives money from a ULIP, it is first treated as a return of capital. Only the amount received above the total premiums paid is taxed — and that too as capital gains, not regular income. Neither the mutual fund nor the insurance company pays any tax on the income generated inside the scheme; all of it is taxed only when it reaches the investor.

REITs & InvITs

While REITs and InvITs are different asset types, the income they distribute is taxed for investors in the year they receive it.

Importantly, the type of income (like interest or dividend) is taxed the same way it was for the REIT/InvIT. Selling REIT or InvIT units results in capital gains tax, as they are treated as securities.

However, any principal repayment beyond the initial investment is taxed as income from other sources, not as capital gains.

Category I & II AIFs

AIFs in Category I and II are taxed on a pass-through basis, meaning the income (except business income) is taxed directly in the hands of investors in the year it is earned, regardless of whether it is distributed or not.

Investors may also face separate capital gains or losses if they buy or sell units of an AIF at prices different from the original investment amount. However, there is no specific tax rule for such transfers — they are generally treated as capital gains or losses under regular principles.

Category III AIFs

Category III AIFs are not taxed on a pass-through basis, but are taxed at a flat rate of tax at the fund level. The income earned by the investor from such AIFs is therefore not taxed in the hands of investors at all.

However, if an investor buys or sells units of a Category III AIF in the secondary market, any gain or loss from the transaction is taxed as capital gains.

Portfolio management schemes

Under PMS, there is no pooled fund. Each investor owns individual securities in their account, and the portfolio manager acts only as an agent.

Here, the investor is directly taxed on each type of income — whether it is interest, dividends, or capital gains — just as they would be if they were managing the investments themselves.

Time for a uniform tax framework?

In essence, PMS and Category I and II AIFs reflect the most direct approach to taxation — income is taxed in the hands of the investor as and when it is earned, aligning closely with the principle of investor-level taxation.

REITs and InvITs also follow this principle to an extent, although their income is taxed only upon distribution, not when it is actually earned.

This raises a broader question: why can't a similar approach be applied uniformly across all types of collective investment schemes?

For instance, why should Category III AIFs be taxed at the fund level instead of passing the tax liability to the investors? Why shouldn't mutual fund income be taxed in real time, rather than only on distribution or sale? In many jurisdictions like the US, investor-level taxation — based on the nature and timing of income — is the norm.

Similarly, the taxation of ULIPs could reflect the actual nature of the income earned — whether interest, dividends, or capital gains — rather than following a return-of-premium model.

A uniform taxation regime across all collective investment schemes, based on income actually earned and attributable to investors, would simplify the tax system, eliminate arbitrage opportunities, and reduce the need for complex anti-avoidance rules.