Impact Of LTCG & DDT On Your Equity Mutual Funds

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What Changed about LTCG Tax?

The Union Budget 2018-19 might have been a shocker to equity stock and equity mutual fund investors.

And the deepest fears of Indian investors came to life when Finance Minister Arun Jaitely announced the proposal to levy a 10% tax on long-term capital gains over Rs 1 lakh——without indexation benefit——arising out of sale of listed equity shares and mutual fund units (where Securities Transaction Tax applies).

Until now, if you held your units of equity-oriented mutual funds for more than 12 months you didn't have to pay even a single paisa of tax on your gains. This was one of the most crucial aspects of equity investing that attracted thousands of investors.

The proposal on equity instruments certainly did not go down well with investors as seen in the sell-off on February 2, 2018. The S&P BSE Sensex tanked by 840 points or nearly 2.50% to 35,067. The S&P BSE SmallCap extended the losses further by nearly 5%, while the S&P BSE MidCap Index dropped about 4%.

Retail investors, who over the past couple of years were opening up to the equity market, are now wondering how to approach mutual fund investments in the present conditions.

To retain investors, fund houses in the last 4 years have been promoting equity-oriented schemes such as Arbitrage Funds and Equity Savings Funds. Main reason being these funds are a low risk investment option, which enjoy tax-free status after a holding period of 1 year.

As the investors' interest grew towards equity, the dividend plans of balanced funds too were aggressively promoted as an option to earn steady flow of monthly income.

Now four years later, Budget 2018 has created another disruption.

Now dividends on equity mutual funds too, will be taxed at a rate of 10%. This in turn will affect the senior citizens/ investors who invest in dividend option with an aim to earn regular income.

Top voices from the mutual fund industry rushed to assure their investors that nothing has changed fundamentally for India and one shouldn't look at LTCG taxation as a deterrent to invest in equity mutual funds.

Do you realise what the newly imposed tax can do?

It might unknowingly encourage people to trade.

Assume, you made some quick gains; you would tend to book them instead of carrying them over.

LTCG tax of 10% without indexation doesn't offer much incentives for not booking the profit and paying 15% Short Term Capital Gain (STCG) tax. **After all, a bird in hand is worth more than the one in the bush.**

With indexation you can calculate the purchase price of the mutual fund units by taking into account inflation, thus enabling them to reduce your tax outgo.

Either the long-term capital gain tax should have been 5% instead of 10%, or the short-term capital gains tax could have been be raised to 20% from the current 15%.

Things you should know:

The government has proposed to grandfather the gains made upto January 31, 2018. For any purchases made in the 6 months preceding January 31, 2018; the higher of actual cost or the fair market value as on January 31, 2018 would be taken.

For example, if you purchased a stock on September 01, 2017 for Rs 100 and it's quoted at Rs 135 on January 31, 2018; your cost will be treated as 135 and not 100. But if it reduced to Rs 80 on January 31, 2018; it will still be treated as Rs 100.

The new LTCG tax is further segregated into two parts:

Part 1 - LTCG made upto Jan 31, 2018

LTCG = NAV as on Jan 31, 2018 - Cost Of Acquisition

Part 2 - LTCG made after Jan 31, 2018

LTCG = Sale Value - NAV as on Jan 31, 2018

Now with the grandfathering clause investors who have parked their money keeping in mind the earlier tax regime are protected.

As mentioned earlier, with grandfathering clause, gains made in equity oriented mutual fund schemes till January 31, 2018 will be exempted. But the gains made post that will be charged 10% LTCG tax without any indexation benefit.

Wondering what to do?

Read on the next chapter to find out the investment strategy you should follow.

Your Investment Strategy

Before you invest in an equity-oriented mutual fund scheme, you now need to take in to account the tax implications.

Here are some strategies which you must follow:

- **Adopt a long-term approach**

Open-ended equity diversified funds have been able to generate returns of about 12% to 14% compounded over the long term of 5-7 years or more. Investors who have enjoyed these double-digit gains will now have to part 10% as Long Term Capital Gain Tax (LTCG) to the government on gains over Rs 1 lakh (without indexation benefit).

If the gains over a period of 12 months are below the exemption limit of Rs 1 lakh, there's no question of LTCG tax. However, if the gains are greater than the exemption limit, it would have bearing on the post-tax returns clocked.

Impact Of Holding Period On Post-tax Returns

		1 Year	3 Years	5 Years	10 Years
	Investment Period (Years)	1	3	5	10
	Investment Date	31-Oct-17	31-Oct-17	31-Oct-17	31-Oct-17
	CAGR	12%	12%	12%	12%
A	**Investment Amount (Rs)**	200,000	200,000	200,000	200,000
B	**Value as on 31-Jan-2018**	206,000	206,000	206,000	206,000
C	**Sale Value At End of Period**	224,000	280,986	352,468	621,170
D	**Long Term Capital Gains (C-B)**	18,000	74,986	146,468	415,170
E	**Exemption (Upto Rs 1 Lakh)**	18,000	74,986	100,000	100,000
F	**Taxable Long Term Capital Gains (E-D)**	0	0	46,468	315,170
G	**LTCG Tax @10% (10% of F)**	0	0	4,647	31,517
H	**Post Tax Gains (C-A-G)**	24,000	80,986	147,822	389,653
	Post-Tax CAGR	12.00%	11.99%	11.70%	11.41%

(Source: PersonalFN Research)

Nevertheless, a point to note is, the post-tax returns are still handsome double-digits (over 11% CAGR) to counter inflation, provided you select mutual funds carefully and set realistic post-tax return expectations.

Moreover, if you stay invested for the long-term, power of compounding can work to your advantage enabling you to earn a higher return.

Thus, have the best mutual fund schemes and avoid churning your equity mutual fund very often.

- **Adjust your financial plan if need be**

As seen in the table above, the post-tax return differs with the holding period. Do take this into consideration to readjust existing financial plans and when setting up new financial plans. Keep in mind, the rate of return assumptions you make will vary.

For example, if you have assumed a pre-tax return of 12% CAGR over 5-years, the post-tax return works out to 11.70%. If you assume a return of 15% pre-tax, the post-tax return will work out to 14.44%. And say, if the mutual fund schemes you choose do not perform, the post-tax returns will be lower.

Make The Right Post-tax Return Assumption

		5 Years	5 Years	5 Years	5 Years
	Investment Period (Years)	5	5	5	5
	Investment Date	31-Oct-17	31-Oct-17	31-Oct-17	31-Oct-17
	CAGR	6%	9%	12%	15%
A	**Investment Amount (Rs)**	200,000	200,000	200,000	200,000
B	**Value as on 31-Jan-2018**	203,000	204,500	206,000	207,500
C	**Sale Value At End of Period**	267,645	307,725	352,468	402,271
D	**Long Term Capital Gains (C-B)**	64,645	103,225	146,468	194,771
E	**Exemption (Upto Rs 1 Lakh)**	64,645	100,000	100,000	100,000
F	**Taxable Long Term Capital Gains (E-D)**	0	3,225	46,468	94,771
G	**LTCG Tax @10% (10% of F)**	0	322	4,647	9,477
H	**Post Tax Gains (C-A-G)**	67,645	107,402	147,822	192,794
	Post-Tax CAGR	6.00%	8.97%	11.70%	14.44%

(Source: PersonalFN Research)

- **Re-visit your existing STPs and SWPs**

Now is the time to review your Systematic Withdrawal Plans or Systematic Transfer Plans. Because, these redemptions or switches will come under the tax net after March 31, 2018.

You may want to continue existing SWPs or STPs only if it is absolutely necessary. And do calculate the tax impact when redeeming your equity mutual fund units.

- **Choose 'Growth option' over 'Dividend option'**

PersonalFN has never been in favour of the dividend option for equity mutual funds. More so, after the implementation of a Dividend Distribution Tax (DDT).

If your goal is to grow your wealth, choosing the dividend option will end up eating away the accumulated profit at regular intervals. This will have an adverse impact on your path to wealth creation, as your profits will not be reinvested —particularly in case of a dividend pay-out option.

Hence, if you are not seeking regular income, it will be best to opt for the growth option. Dividends are often touted to be a benefit as it is tax-free income; however, dividend pay-outs get in the way compounding.

- **Choose the right mutual fund**

Over the past 3-4 years, investors have flocked to arbitrage and equity savings schemes given the tax-free returns on a holding period of over 1 year. However, this has now changed.

Unlike debt schemes or rather non-equity schemes, Arbitrage Funds or Equity Saving Funds and other Aggressive Hybrid Funds will not enjoy the benefit of indexation on the long-term capital gains. Hence, the post-tax returns may work out to be lower for holding periods of three years or more. The LTCG tax for non-equity schemes is 20% with indexation. Here, long term is defined as a period of 36 months.

In addition, many may contemplate whether to invest in tax-saving Equity Linked Savings Schemes (ELSSs) or not. Especially as other tax saving product enjoy an Exempt-Exempt-Exempt status. However, even with the tax implications, the post-tax returns of ELSS are still attractive. Yes, you may lose out on additional returns, but you will still be better off than investing in other fixed income products.

Therefore, given the wealth creation potential of equity. Equity funds are still the best mutual funds for you to generate long-term wealth.

So, review your mutual fund portfolio regularly and stick to your financial plan.

The new tax laws should warrant only a few adjustments to your portfolio. If you are unsure about how to restructure your portfolio in the best way, do consult your investment consultant/advisor.

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