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New Direct Tax Code & Its Impact on Mutual Fund Investment

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INTRODUCTION

Aimed at simplifying the country's direct tax laws, the government introduced Direct Tax Code (DTC) on 12th August 2009. This code was open for public discussion. After collecting the feedback from various sections of the society, the Government released a new simplified tax code in June 2010, which would now be applicable from April 1, 2012, instead of March 1, 2011.

Direct Tax Code Bill 2009 was introduced by our Finance Minister on 12th August 2009 with an intention to simplify the Direct Tax Law. The aim was to remove the technicalities prevailing in the earlier tax law. The Finance Minister made a claim that the New DTC is written from scratch, keeping in mind the vast experience gained over the period of 48 years. The result has been various changes that will have a direct bearing on the investment pattern and the existing portfolio of an individual. The New Direct Tax Code brought in some sweeping reforms, but if one has a closer look at it, it reveals that, it is a mixed bag for the individual tax payers. The government hopes that this will pave the way for better compliance and a substantial reduction in tax evasion. It would also result in higher disposable income in the hands of the tax payer.

REFORMS IN THE NEW DIRECT TAX CODE & ITS IMPACT

GENERAL IMPACT

Increase in the Disposable Income

The DTC has come up with new income tax slabs and tax rates which will reduce the tax burden to a great extent and will lead to increase in the disposable income in the hands of individuals. Though, the tax rates remain the same, income slabs show a significant change.

Income Tax Slabs (suggested in the original Draft)

Income	**Tax Rate**
Up to Rs 1.60 lakh	Nil
Between Rs 1.60 lakh & Rs 10 lakh	10% of the amount by which total income exceeds Rs 1.60 lakh
Between Rs 10 lakh & Rs 25 lakh	Rs 84,000 + 20% of the amount by which total income exceeds Rs 10 lakh
Above Rs 25 lakh	Rs 3,84,000 + 30% of the amount by which total income exceeds Rs 25 lakh

The above table shows the figures for individual. The tax exemption for women is up to Rs 1.90 lakh and for Senior Citizens is Rs 2.40 lakh.

Government is of the opinion that there will be more money left in the hands of the individuals which will lead to better compliance and collection of taxes.

When we analyse the impact of new direct tax code on the investments, the three main questions we should consider. These are:

1) Is there any tax benefit at the time of making investments?
2) Is the income earned from the investments is liable for tax?
3) Is the principal amount received at the time of maturity will be taxed?

The above three questions will give a clear picture with regards to the tax aspects related to the investments of an individual.

Introduction of Exempt - Exempt - Taxed (EET) Model

One of the DTC proposals that has been most debated is Exempt-Exempt-Tax (EET) regime for taxation of insurance products and other savings instruments. The EET method allows exemption at the first two stages, but provides for a tax on withdrawals at the personal marginal rate. The concept of EET is primarily prominent in developed countries, which have comprehensive social security schemes, but in India, in the absence such schemes, EET, if implemented, would come as a big blow to the individual tax payer.
According to the revised discussion paper (June 2010), " Investments made before the date of commencement of DTC, in instruments which enjoy exempt-exempt-exempt (EEE) method of taxation under the current law, would continue to be eligible for EEE method of tax treatment for the full duration of the financial instrument".
The New Tax Code proposes EET model in addition to EEE (Exempt-Exempt-Exempt) Model. As per EEE Model, the initial investments made are tax free, the interest earned on the investments are tax free and even the amount received at the time of maturity is tax free. If we consider, Public Provident Fund (PPF) investments, EEE model exempts the investments made in PPF, the interest earned on investments as well as the maturity amount received.
While in case of EET model, the initial investments are tax free, interest earned are also tax free but any withdrawals (maturity amount received) is taxable as per the income tax slab rates.
EEE Model v/s EET Model

	EEE Model	**EET Model**
Investments	Not Taxable	Not Taxable
Interest Earned	Not Taxable	Not Taxable
Withdrawal (Maturity Amount Received)	Not Taxable	Taxed at Income Tax Slab Rates

Source: Value Research, Mutual Fund Insight, Vol. VII, Number 11
Investments for which EEE Model is applicable: Government Provident Fund (GPF), Public Provident Fund (PPF), Employees Provident Fund (EPF), Recognised Provident Fund (RPF), New Pension Scheme (NPS), Pure Life Insurance Policies, Annuity Schemes.
Investments for which EET Model is applicable: Unit Linked Insurance Plans (ULIP), Traditional Endowment Insurance Policies, Traditional Money-back Insurance Policies, National Savings Certificates (NSC).

Home Loans

The draft tax code proposed to do away with the tax deduction on the interest paid on home loans. Revised direct tax code proposes to follow the existing method of tax deduction on home loans. Interest payments on home loans get a deduction up to Rs 1.50 lakh under Section 24 whereas; Principal payments on home loans no longer get a deduction under Section 80C.

Section 80C Revamped

Investments made under Section 80C are eligible for tax benefit. The original draft had proposed that, this Section will be renamed as Section 66 and the overall limit of Rs 1 lakh will be hiked to Rs 3 lakh. Certain new additions were made to the list under Section 66 are: education fees which will include play school and pre-school fees. Higher education will comprise of full-time studies graduation and post graduation studies. The New Pension Scheme will also be included under this Section. Payment towards the principal amount of a home loan, investment in ELSS and bank deposits of 5 yr tenure is scrapped from the list of approved tax saving investments.
The revised Direct Tax Code has continued with Rs 1 lakh limit on income tax deduction under Section 80C. However, there is a proposal to introduce a new limit of Rs 50,000 for individual tax payer over and above Rs 1 lakh permitted under Section 80C. The new limit is limited to investments in life insurance, health insurance and tuition fees.

As for the other investment avenues available under Section 80C viz., ULIP, ELSS, 5-year fixed deposits in banks and post offices and endowment plans of life insurance companies are no longer included in the list of tax saving instruments.

Principal payments on home loans will no longer get a tax deduction under Section 80C. Whereas, PPF continues to be under the EEE model, which is a good news for the individual investors.

IMPACT ON MUTUAL FUND INVESTMENTS & THE UNIT HOLDERS

The Direct Taxes Code, 2010 ('DTC') has brought some unpleasant surprises for the mutual fund industry. The most important ones include doing away with all tax exemptions, exempt-exempt-exempt (EEE) treatment of long-term investment products, taxing of capital gains on equity and abolishing of securities transaction tax (STT). The following are the selective areas which would directly affect the retail investor. Some of the key proposals impacting the investments are summarised below:

(i) Section 80C Loses Its Shine

New DTC has shrunk the avenues available for tax saving under section 80C. Most of the instruments are removed from the list viz., ULIPs, ELSS, 5-yr fixed deposits in banks and post-offices and endowment plans of life insurance companies. Tax saving schemes of mutual funds have been pulled out from the list of 'permitted saving intermediaries' which leads to disappointment as it is the only channel through which money was mobilised into stock markets.

(ii) Good Bye ELSS

An ELSS (Equity Linked Savings Scheme) is a mutual fund that has to invest a minimum of 80% in Equity Shares. The balance 20% can be in debt, money market instruments, cash or even more equity. There is a 3 year lock-in period for the ELSS mutual funds. Post the 36 months, the funds remain invested and work like any other open-ended mutual fund.

DTC proposes to deny tax benefits available to individuals and HUFs investing in ELSS. Equity Linked Saving Schemes of mutual funds have been removed from the list of approved tax-saving instruments. This is a blow to investors. As per the report of Association of Mutual Funds of India (AMFI) for the month July 2010, AUM under ELSS as on 31 July 2010 was Rs 25,257 crore and one of the key reasons that can be attributed for such a balance is the availability of tax benefits. This may have a substantial impact on mutual funds since the investors may shy away from investments in such schemes due to non-availability of the deduction. These schemes were the only tax saving instruments that combined tax saving with the higher return that is possible only through equity and the lowest lock-in period amongst all the other schemes. In fact, for many retail and young investors this was the route through which they could invest in stock markets and save tax simultaneously. It was actually, after exploring this avenue investors started began investing in mutual funds. Fund managers were also fond of these products. The 3-year lock-in period ensured that investors could not walk out anytime and so sudden or frequent redemptions were not the major concern here.

ELSS is part of the Section 80C instruments which are cumulatively eligible for a deduction from income up to Rs1 Lakh. The return (maturity and the dividend from the ELSS is also tax free under the present EEE (Exempt Exempt Exempt) regime. However, in the the DTC regime, tax benefits are likely to be phased out. The 3 year lock-in period makes sure one stays invested. The above logic is proved in the higher returns achieved by the ELSS funds when compared to the market returns. Wealth creation because of this is much better than most of the other mutual funds. Only some sector-based mutual funds have given better returns than the ELSS fund in the past 5 years.

Until now, ELSS has been one of the first-choice mutual funds for investors. Studies reveal that Rs 23,700 crores worth of ELSS schemes have been invested in May 2010 as compared to Rs

11,800 crores in May 2007. Between 60-120 lakh people regard ELSS as a tax-saving investment. But all this interest in ELSS is set to change very soon with the advent of the 2011-2012 Direct Tax Code (DTC). This is likely to hit the investors as well as the Mutual Funds industry hard.

(iii) Dividend Tax

Presently, the entire income of mutual funds is exempt from tax. All mutual funds (except equity-oriented funds) are liable to pay tax on income distributed to the unit holders at the prescribed rates (13.84% for individuals for debt funds and 27.68% for liquid/money market funds), i.e. dividend distribution tax (DDT). The income received by the unit holders in respect of the units of a mutual fund, is exempt from tax in their hands.

Under the DTC, it is proposed that the income of mutual funds would continue to be exempt from tax. Further, the mutual funds are also sought to be exempt from the payment of DDT, irrespective of the nature of their schemes. Also, the unit holders are also to be exempt from tax in respect of the income from units of a mutual fund.

According to new direct tax code, the long term equity holding of mutual funds will be taxed at the time of redemption and so also the dividends in the hands of the investors whether it is paid out or re-invested. This makes the investments less attractive. Current DTC will negatively impact the domestic inflow of rupees into equities.

Now, the investor has to pay a 5% tax on dividend earned from all equity mutual funds. At present, dividends earned from equity funds are tax free. The investor will not have to pay the tax directly, but it will be charged to the fund house. It does have impact on the returns. This Dividend Distribution Tax will be paid by the fund house before the credits the dividend to the investor.

In case of debt funds, the dividend received would be added to the total income and taxed as per the income tax slab that the individual falls under. In such a case, the individual himself pays the tax, not the mutual fund. As regards distribution in respect of non-equity funds (for example, debt funds, balanced funds, etc.), the distribution will not be subject to DDT, but the investors will have to pay tax at the normal applicable rates.

Mutual Funds and Life Insurance companies have been called "pass through entities". Income in their hands will not be subject to Dividend Distribution Tax (DDT) nor will they pay tax on income they receive on behalf of their investors. However, the investors will be liable to tax on "any" income which accrues to them from investment with any of the pass through entities.

Dividends paid out on equity investments are fully tax exempt and will continue to be. Dividend distributed by a company will attract tax of 15% which will be payable by the company and such amount will be tax free in the hands of the investor.

(iv) Treatment of Capital Gains

Long term capital gains arise on capital assets held for a period of more than one year from the end of the financial year in which they were acquired. This prevents 'double indexation benefits'. Long term capital gains are divided into; listed equity shares or units of an equity oriented fund and; from 'other assets', which would include house property, debt instruments and units of debt oriented funds. Long term capital gains on equity shares and units of an equity oriented fund shall be computed after allowing a deduction at a specified percentage of capital gains 'without any indexation'. This adjusted amount will be included in the total income of the tax payer and taxed at the rate applicable. Losses can be carried forward.

The base for long term capital gains on 'other assets' will firstly be moved to 1st April 2000 (from 1st April 1981) and then subjected to indexation before being taxed at the applicable rate. The proposed Capital Gains Savings Scheme will not be introduced. Currently, long term capital gains on transfer of units of equity funds are exempt from tax and short term capital gains are taxable at 15%, subject to payment of securities transaction tax ('STT'). While, in principle, this policy is retained in the DTC, the benefit has moved from an exemption-based mechanism to a deduction-based mechanism. Thus, in case of transfer of units of equity funds, a deduction of 100% is proposed from long term capital gains and a deduction of 50% is proposed from short term capital gains. Tax at normal rates will be levied on such net income. Levy of STT on transfer of such units are proposed to be continued.

There is no Long Term Capital Gains (LTCG) Tax. Also, no indexation would be allowed in the calculation of LTCG. Equity investors will not be happy. Currently, sale of shares and equity mutual fund units after a holding period of one year attracts no tax at all. Now, it will be taxed without indexation. Short Term Capital Gains (STCG) Tax will be taxed at 50% of the applicable slab rates. It means that the effective tax rate on STCG will be 5%, 10% or 15% depending on the income tax slab of the individual. Currently, STCG is taxed at a uniform rate of 15%. The DTC has proposed to do away with the Securities Transaction Tax (STT).

(v) Wealth Tax

The direct tax code proposed a considerable hike in the wealth tax limit as well. At present, wealth tax is charged at over Rs 30 lakh. This was hiked to over Rs 50 crore and the wealth tax rate was pegged at 0.25% of the amount by which the net wealth exceeds Rs 50 crore. Wealth would also include mutual fund holdings and investment in equities.

(vi) Deduction of Tax at Source

Mutual funds will now be required to deduct taxes at source on income distributed on units of funds, other than equity funds at the rate of 10% in case of resident individuals and HUFs and 20% in case of other resident deductees. In case of non-resident deductees, mutual funds will have to deduct tax at the rate of 20% on income distributed on such units and at the rate of 30% on any other sum, if taxable. Such deduction is required in case of persons other than companies; if the aggregate payment exceeds Rs 10,000.Payment of consideration to FIIs for sale of securities listed on stock exchange is not subject to deduction of tax at source. However, it is unclear whether only sale of listed units on recognised stock exchange will not be subject to deduction of tax at source or even redemption of listed units directly by the mutual funds will also not be subject to such deduction. Similarly, payment of brokerage for purchase and sale of securities will also be subject to deduction of tax at source. The above will lead to a substantial increase in operational aspects for the mutual funds.

(vii) Return of income distributed

DTC also proposes filing of return by the mutual funds in relation to income distributed to the investors of the equity oriented funds.

WHAT SHOULD THE INVESTORS DO?

(i) <u>Shift to Growth Options</u>

A mutual fund scheme comes with two options – dividend and growth. Under the dividend option, the fund house pays dividend where there is sufficient appreciation in the assets. The Net Asset Value (NAV) of the fund comes down by a similar proportion post-dividend. In growth option, the investor gets the total amount only at the time of redemption. Besides, saving dividend tax, investors gain more from growth options due to the compounding effect.

Year	Units	NAV			Amount		
		Growth Plan	Dividend plan				
			Pre-Dividend	Post-Dividend	Growth Plan	Dividend Plan	Dividend Payout
0	1000	10.00	10.00	10.00	10,000	10,000	-
1	1000	11.00	11.00	10.50	11,000	10,500	500

2	1000	12.10	11.55	11.05	12,100	11,050	500
3	1000	13.31	12.16	11.66	13,310	11,655	500
4	1000	14.64	12.82	12.32	14,461	12,321	500
5	1000	16.11	13.55	13.05	16,105	13,053	500
Total					**16,105**	**15,553**	**2500**

Source: Value Research, Mutual Fund Insight, Vol.VIII

(ii) Choose SWP on Equity Fund

The investor should opt for Systematic Withdrawal Plan (SWP). This allows him to withdraw money from his fund according to a pre-decided schedule. Depending on his need for a monthly or quarterly income an investor can choose withdrawal pattern. Alternatively, one can even opt for withdrawal only on capital appreciation, thus protecting the capital amount. Opt for an SWP only after the first year of the investment, as most funds levy an exit load on redemptions before completion of a year. In the case of equity funds, it also saves on short term capital gains tax.

(iii) Choose SWP on MIP

Monthly Income Plans (MIPs) are a regular source of income for many investors, especially retired individuals who park a part of their retirement corpus in MIPs and receive dividend payouts. As MIPs come under the debt fund category, the dividend would now be taxed as per an individual's income-tax slab. Investors in MIPs should also consider SWPs instead of dividends to save taxes on them. Again, opting for an SWP after a year of being invested helps in saving the exit load.

SWP v/s DIVIDEND

SWP

Month	**NAV**	**Units Outstanding**	**Units Redeemed**
March 2010	10.00	1000	-
April 2010	11.00	909	90.91
May 2010	12.10	826	82.64
June 2010	13.31	751	75.13
July 2010	14.64	683	68.30
August 2010	16.11	621	62.09
September 2010	17.72	564	56.45

Source: Value Research, Mutual Fund Insight, Vol. VIII

NAV appreciation/month	90.91
Gains adjusted for exit load of Rs 10/month	80.91
Total Income	6000
Exit Load @ 1%	60
Taxable Gain	485
Tax @ 30%	146
Net Income	5794
Investment	Rs 10,000
Monthly Withdrawal	Rs 1000

Monthly Dividend

Month	**NAV**		**Dividend**
	Pre-Dividend	**Ex-Dividend**	
March 2010	10.00	10.00	-
April 2010	11.00	10.00	1000
May 2010	12.10	11.10	1000

June 2010	13.31	12.31	1000
July 2010	14.64	13.64	1000
August 2010	16.11	15.11	1000
September 2010	17.72	16.72	1000

Source: Value Research, Mutual Fund Insight, Vol. VIII

Total Income 6000
Exit Load 0
Tax 1800
Net Income 4200

CONCLUSION

Finance Minister has remarked, it is wrong to read the new code by constantly referring to the Income Tax Act of 1961. In his opinion, it is not an amendment to the Act. It is radically a new reform. The Government hopes that this will pave the way for better compliance and a substantial reduction in tax evasion.

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