Rule Change On Debt MF Taxation: Where Does The Burden Fall?

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Who bears the burden of the change in the tax rules on mutual funds and what are the implications?

Last month, the Ministry of Finance introduced some modifications to the Finance Bill, including the tax treatment of mutual funds that have less than 35% invested in Indian equities. The new amendment has withdrawn the tax benefits of these debt mutual funds. The mutual fund industry worries that these changes will reduce interest in mutual fund investments and that it will eventually adversely affect the development of the debt market.

In public finance, it is important to understand "the incidence of a tax." Who ultimately bears the burden of each tax, and what is the magnitude involved? We look at the recent changes and find that the burden will be borne by households that were investors in the long-term debt schemes.

The Rule Change

Before the amendment, long-term capital gains arising from debt funds held for more than three years were taxed at a flat rate of 20%. They were also indexed, which means that the illusory gains owing to inflation were removed from the computation. The recent amendment has taken away these features and placed them on par with bank fixed deposits. Under the new rule, even beyond the three-year holding period, the income earned on a debt mutual fund, will be taxed at the ordinary income tax rate, without inflation adjustment similar to the interest income from a bank fixed deposit.

Basic Facts

AMFI reports that the total AUM of the mutual fund industry stands at around Rs. 40 trillion. Of this, the amount held in debt funds—including income and debt-oriented schemes, hybrid schemes, gold ETFs, and funds of funds—is less than half as shown in the table below. Within debt funds, long-term debt tends to have a much smaller share. Including both gilt and non-gilt, non-equity funds—with maturity greater than two years—the AUM in long-term debt mutual funds is around 30% today.

SHARE OF DEBT AND LONG-TERM DEBT AUM IN THE MUTUAL FUND CLASS

	Debt/Total	Long-Term Debt/Total Debt
31 Dec 2019	0.49	0.22
31 Dec 2020	0.51	0.20
31 Dec 2021	0.41	0.20
31 Dec 2022	0.43	0.30

Source: Authors' calculation from AMFI data

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During this time, there was no significant development in the debt markets. The share of debt funds dropped from 49% to 43%, but long-term debt funds grew slowly from 22% to 30% of total debt funds.

Who Holds Long-Term Debt Funds?

Sometimes, it is argued that the preferential tax treatment of long-term debt mutual funds vs. bank fixed deposits merely lends itself to tax arbitrage by firms and other professionals. Since the amendment, a shift has already been observed among certain institutional investors. It is therefore interesting to look at the nature of investors in debt funds.

SHARE OF AUM HELD BY INDIVIDUALS OF THE MUTUAL FUND CLASS

	Individual holdings as a fraction of Total debt funds	Individual holding as a fraction of Total long-term debt funds
31 Dec 2019	0.34	0.51
31 Dec 2020	0.32	0.47
31 Dec 2021	0.30	0.53
31 Dec 2022	0.38	0.59

Source: Authors' calculation from AMFI data

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Data shows that the main user of long-term debt mutual funds is the household. Table 2 shows that individuals make up 38% of the AUM of debt mutual funds and 59% of the AUM of long-term debt mutual funds. Further, both shares have been growing in recent years. While fixed deposits have traditionally been the most common across households, this has been changing, particularly in the last eight years, with households across the income spectrum shifting out of fixed deposits. Households have been shifting out into insurance and mutual funds, with mutual fund ownership being small but rapidly growing.

These facts add up to a picture of an important and growing role for households as users of long-term debt mutual funds, rather than a simple story of firms doing tax arbitrage by using tax-preferred mutual funds.

Implications

In general, tax policy should always treat similar activities similarly. By this reasoning, uniformisation of the treatment of LT debt mutual funds and bank fixed deposits is a good thing. Tax policy should also have a bias in favour of long-term savings. By this reasoning, it would have been better to give bank fixed deposits held for the long term preferential tax treatment rather than bring long-term debt mutual funds to parity with fixed deposits. Given that the main user of long-term debt funds is the household investor, they are the ones who will bear the burden of this higher tax.

Finally, there is the problem of the bank's risk. Banks are highly leveraged entities that try to offer assured returns and sometimes fail. When bank failure takes place, it introduces difficulties for households. Only a part of the bank is protected by deposit insurance, and there are delays in the payout of deposit insurance. To the extent that the Indian financial system moves away from mutual funds to banks owing to these tax ranges, there is an adverse impact on financial stability.

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