

Budget 2017: Arbitrage funds may lose tax advantage

Several mutual fund officials believe that the finance minister may propose to change the taxation of arbitrage mutual fund schemes in the coming budget. "We were anticipating it even during the last two budgets. But it looks very likely this year," said a CEO of a large mutual fund house. "A lot of money has flowed into these schemes because of the tax advantage. It seems, the government has taken a serious note of it," he adds.

Arbitrage schemes are treated as equity schemes for the purpose of taxation. This makes long-term capital gains from them tax-free. Capital gains from equity schemes held over a year are tax-free. If investments are sold before a year, short-term capital gains are taxed at 15 per cent. The finance minister is likely to change this: arbitrage funds may be taxed like debt funds.

Arbitrage funds are not exactly equity schemes. Their mandate is to invest in arbitrage opportunities. That is, they look to exploit arbitrage opportunities between the cash and derivative markets to generate returns. Since they do not invest directly in equity, they are considered safe. This has prompted many traditional debt mutual fund investors to seek refuge in these funds after the finance minister changed the taxation of debt mutual funds in 2015.

The holding period for debt mutual funds to qualify for long-term capital gains tax was increased to three years from one year. Long-term capital gains from debt mutual funds are taxed at 20 per cent with indexation benefit. If investments in debt funds are sold before three years, gains are treated as short-term capital gains and they are added to the income and taxed according to the income tax slab applicable to the investor.

"If the taxation is changed, it won't surprise anyone in the industry. Everyone knows it is bound to happen. In a way it would be better for us because the industry can focus on pure debt and equity funds," said a senior official at a mutual fund. "As for investors, it would be a loss of an investment avenue with very low risk, predictable returns and tax advantage."

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