Taxman sends notices to MFs on securitised product income

The income tax (I-T) department has sent fresh notices to mutual funds, asking them to pay taxes on income from pass through certificates (PTCs), a securitised product.

The move comes less than two months after the Union Budget clarified that returns from PTCs were tax-exempt.

PTCs are bank loans that are bundled as securities and sold to financial institutions such as mutual funds. The interest on these securities comes to the investor (mutual funds). Long-term and medium-term bond funds of MF houses invest in these certificates.

In March 2012, the Bombay High Court had quashed the I-T department’s demand for tax on income from mutual funds’ investments in securitised instruments such as PTCs, in response to an appeal filed by UTI Mutual Fund. The court also dismissed the department’s demand to freeze accounts of mutual funds.

However, industry officials said petitions of some mutual funds on this matter filed last year are still pending in court, although this could not be independently verified.

The I-T department has maintained that income from securities instruments such as PTCs is taxable. Mutual funds are arguing they are exempt from taxes on investment income as these are held on behalf of unitholders.

In India, securitisation is done through a special purpose vehicle, formed as a trust. The loans are sold to the trust, which issues the PTC to various investors such as mutual funds. The income the trust receives from the loans is paid to the investors.

Mutual fund industry officials allege tax authorities are giving an impression that the trusts have been formed to avoid taxes. “When fund houses are exempt from taxes, why would we form a body like this just to avoid taxes?” said the chief executive officer of a mutual fund.

Following the confusion, the mutual fund industry had approached the finance ministry last year seeking clarity on the matter. “At that time, the minister understood the matter and it got plugged in the Budget,” said an official of the Association of Mutual Funds in India (AMFI).

The change in the tax rules will take effect only after the Finance Bill is introduced. According to mutual fund officials, the matter is not retrospective.

Several mutual funds have already reduced exposure to PTCs in the past few years. This is after the collapse of US investment bank Lehman Brothers in September 2008, which resulted in several mutual funds facing liquidity problems due to their exposure to illiquid PTCs.

(Business Standard)