Taxation of Debt Mutual Funds Post Indexation Removal - Strategy Guide

Updated for FY 2024-25

By Charvi Agarwal,
Articled Assisstant,
A.C. Bhuteria & Co,
Chartered Accountants

Introduction

As introduced in the Finance Act, 2023, “Specified Mutual Funds” u/s 50AA of the Income Tax Act, 1961 are defined as:

Mutual Fund by whatever name called, where not more than thirty five per cent of its total proceeds is invested in the equity shares of domestic companies:

Provided that the percentage of equity shareholding held in respect of the Specified Mutual Fund shall be computed with reference to the annual average of the daily closing figures.

What changed in Debt Mutual Fund?

Before 01.04.2023

- Long-term (holding >36 months) taxed at **20% with indexation benefit.**
- This reduced effective tax rate significantly.

After Finance Act, 2023

- No indexation benefit for funds investing **<35% in Indian Equity Shares**
- Applies **irrespective of holding period.**

New Tax Rules for Debt Mutual Funds

From 1st April, 2023:

- **No indexation,** irrespective of holding period
- **All gains (STCG or LTCG)** are taxed at s**lab rates** (similar to FDs)
- Applies to: Debt Funds, International Funds, Gold Funds, Conservative Hybrid Funds **(if equity < 35%)**.

Illustrations show-casing how the Rule change Impacts You

Example 1: Investments Bought Before 1 April 2023

Scenario: Investment grows from ₹10,00,000 → ₹12,00,000 in 3 years

Old Regime (with indexation):

- Indexed cost of Acquisition (assumed): ₹11,50,000
- LTCG: ₹50,000
- Tax @20% = ₹10,000

New Regime (without indexation):

- Full gain of ₹2,00,000 taxed at slab rate
- 30% slab → ₹60,000 tax

Impact: 6× increase in tax outflow!

Illustrations show-casing how the Rule change Impacts You

Example 2: Investments Bought After 1 April 2023

Scenrio: Investments bought on 1 Jan 2022 grow from ₹10,00,000 → ₹13,00,000 in 4 years

- Indexed cost (inflation-adjusted): ₹11,80,000
- LTCG = ₹1,20,000
- Tax @20% = ₹24,000 (much lower effective rate)

Strategy Guide: What should Investors Do Now?

Match Investments to Tax Profiles

- High Earners (30%+ slab):
  - Consider tax-free bonds, 54EC bonds, or equity-oriented hybrid funds.

- Low slab investors or retirees:
  - Debt MFs may still make sense over FDs due to potential higher returns and capital appreciation.

Strategy Guide: What should Investors Do Now?

Use Debt Funds for Liquidity & STP

- Use liquid/ultra-short funds for short-term parking
- Systematic Transfer Plans (STPs) to equity funds.
- No TDS for resident individuals in debt funds, unlike FDs.

Strategy Guide: What should Investors Do Now?

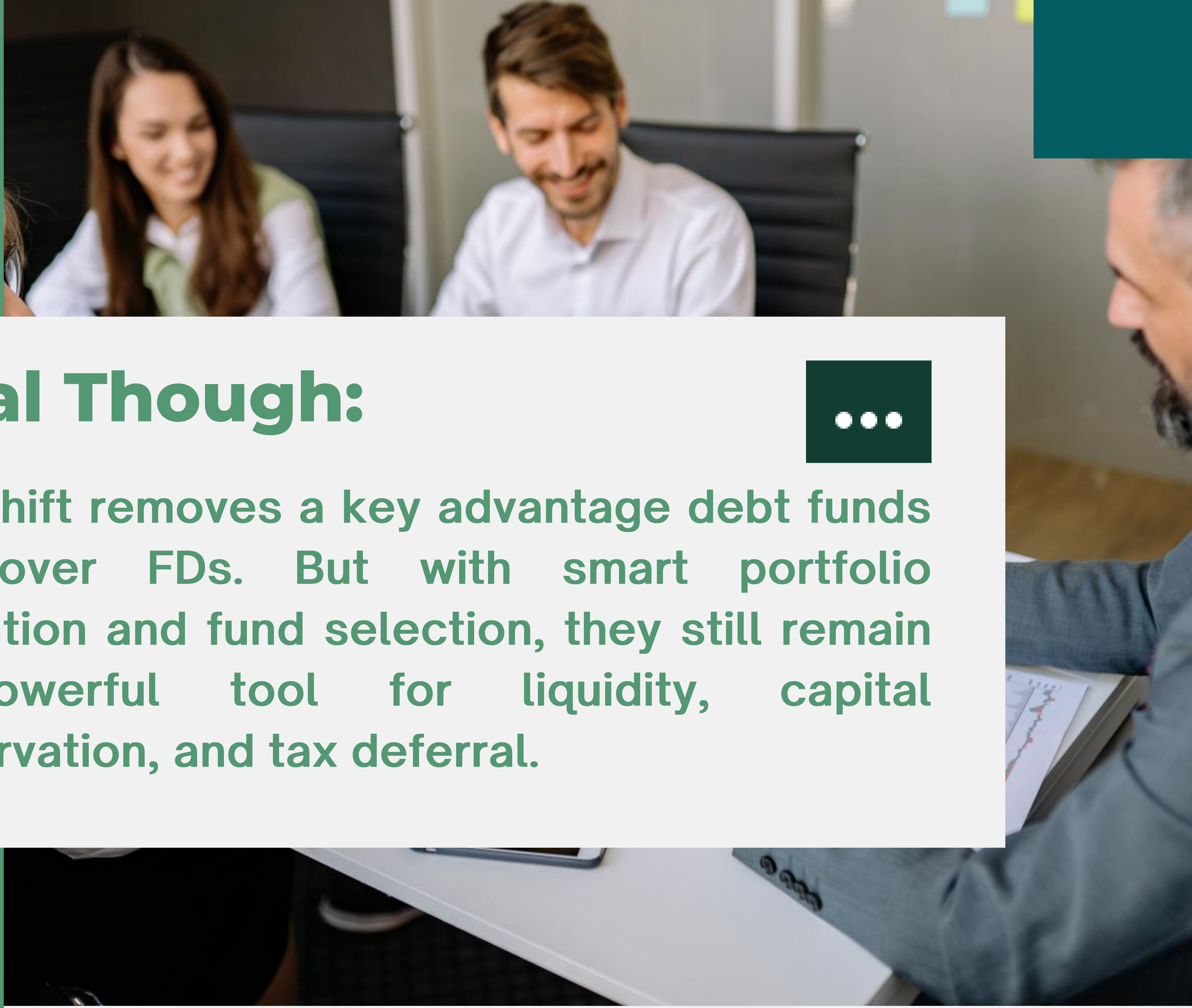
Rebalance Through Hybrid Funds

- Balanced Advantage Funds (BAFs) and Aggressive Hybrid Funds invest >65% in equity allocation, retaining equity taxation (10% LTCG over ₹1L).
- Great for long-term goals with moderate risk appetite.

Strategy Guide: What should Investors Do Now?

Goal-Based Tax Bucketing

GOAL HORIZON	SUGGESTED INSTRUMENT
<1 year	Liquid/ Ultra-short Debt Funds
1 - 3 years	Arbitrage/ Short-term Debt Funds
>3 Years	Equity Funds/ BAFs/ Hybrid Aggressive



Final Though:

This shift removes a key advantage debt funds had over FDs. But with smart portfolio allocation and fund selection, they still remain a powerful tool for liquidity, capital preservation, and tax deferral.

THANK TOU

A C Bhuteria & Co.
Chartered Accountants

info@acbhuteria.com

Need clarity on Debt Mutual Fund taxation or portfolio structuring?

Contact us today for personalized advisory and tax-efficient strategies.