WHAT POTENTIAL CONSEQUENCES WILL THE PROPOSED CAPITAL GAINS TAX HAVE ON YOUR WEALTH CREATION?

The Union Budget 2024 has brought about significant changes to the capital gains tax structure, affecting both short-term and long-term investors. This tax is applied to gains from the sale of capital assets such as stocks, mutual funds, real estate, and gold, with the rate varying based on the asset type and holding period.

Investment products are broadly classified based on their underlying assets and holding periods for applying the capital gain tax rate. These classifications are as follows:

1. Funds with more than 65 percent in debt instruments will be classified as specified mutual funds under section 50AA and taxed at the investor's slab rate. Debt funds, conservative hybrid debt funds, money market funds, or debt-oriented funds fall under this category.

2. Funds with less than 65 percent in debt instruments will be treated as long-term capital gains (LTCG) and taxed 12.5 percent after 24 months of holding. Gold, silver, unlisted securities, and international funds come under this category.

3. Equity-oriented funds with more than 65 percent in equities will be taxed 12.50 percent after 12 months of holding. All listed assets, including units of business trusts (REITs and Invits), gold ETFs, all ETFs, and Nasdaq 100 ETFs, fall under this category.

The details of the proposed capital gain tax across the asset classes are as follows:

Table-1

Proposed Capital Gain Taxes			
All Listed Assets:			
Name of the Assets	**Holding period**	**Proposed STCG (%)**	**Proposed LTCG (%)**
Stocks	12 months	20%	12.50%
Equity Mutual Funds	12 months	20%	12.50%
Debt & non-equity mutual funds	Not Applicable	Investor's Slab Rate	Investor's Slab Rate
Bonds(listed)	12 months	20%	12.50%
REITs/ InVITs	12 months	20%	12.50%
FOFs -Equity	24 months	20%	12.50%
International FOFs	24 months	Investor's Slab Rate	12.50%
ETF-Gold/Silver	12 months	20%	12.50%
Gold Funds	12 months	Investor's Slab Rate	12.50%
All Unlisted Assets:			
Real Estate(Physical)	24 months	Investor's Slab Rate	12.50%
Gold(Physical)	24 months	Investor's Slab Rate	12.50%
Stocks(unlisted)	24 months	Investor's Slab Rate	12.50%
Bonds(unlisted)	Not Applicable	Investor's Slab Rate	Investor's Slab Rate
Foreign Equity/ Debts	24 months	Investor's Slab Rate	12.50%

Note: The above rates are prepared based on the budget 2024. However, they may vary after clarifications from the government on some assets

Some experts believe the recent hike in the long-term capital gain tax will discourage long-term equity investing and enhance the appeal of other asset classes. Others view the capital gain tax rate as still lower and reasonable compared to global peers and other countries.

The vision to transform India into a developed economy by 2047, with a target of a $30 trillion economy, is not just a dream but a realistic possibility. To achieve this, GDP would need to grow nine times from today's $3.36 trillion, and per capita income would need to rise nearly eight times from today's $2392 per year. We can achieve this goal by augmenting infrastructure, increasing manufacturing capacity, boosting employment, and rationalizing taxation.

To increase employment in households and senior citizens' homes, the government should consider not imposing any tax on incomes up to ₹15 lakhs in a financial year. This initiative boosts disposable income, potentially encouraging greater consumption and investment and ultimately contributing to economic growth.

In addition, the government must provide facilities and establish business-friendly regulations for the unorganized sectors to boost employment.

The government needs to adhere to the fiscal deficit roadmap. In the financial year 2024, the fiscal deficit was 5.6 percent of the GDP. In the 2024 annual budget, the government set a target of 4.9 percent of GDP for the fiscal deficit in FY 2025, which may be challenging to achieve. Based on provisional figures, our debt-to-GDP ratio is about 58.2 percent for 2023-24. The government must reduce the debt-to-GDP ratio to meet the fiscal roadmap of below 4.5 percent.

Taxation on Equity & equity related instruments:

All listed assets, including units of business trusts (REITs and Invits), gold ETFs, all ETFs, and Nasdaq 100 ETFs, fall under this category.

In Budget 2024, the central government has raised the short-term capital gains (STCG) taxes on equities from 15 percent to 20 percent and also proposed a uniform long-term capital gains (LTCG) tax rate of 12.5 percent across all asset classes. As a result, the long-term capital gains (LTCG) tax on equity hiked from 10 percent to 12.5 percent.

While the 33 percent increase in the STCG tax on equity may seem significant, it's important to remember that equity investments are always for the long term. On the other hand, with the hike of LTCG tax by 25 percent, post-tax returns may impact 0.25% to 0.35%, assuming the rate of returns is from 10% to 14%.

The impact of long-term capital gains under varied return rates must be analyzed with an example.

Below are the detailed calculations and analysis of long-term capital gains.

Table-2

Impact of LTCG Tax on Investor's Return				
Invested Amount ₹	1,00,000.00	1,00,000.00	1,00,000.00	1,00,000.00
Estimated Return %	10.00	12.00	12.50	14.00
Estimated Return Amount ₹	10,000.00	12,000.00	12,500.00	14,000.00
Earlier Tax(10%) ₹	1,000.00	1,200.00	1,250.00	1,400.00
Proposed Tax(12.5%) ₹	1,250.00	1,500.00	1,562.50	1,750.00
Differential LTCG Tax ₹	250.00	300.00	312.50	350.00
Post Tax impact (%)	0.25	0.3	0.31	0.35

Suppose an investor earned a 10 percent pre-tax return on an equity mutual fund. According to the existing tax rate, his post-tax return would have been 9 percent. Under the proposed new tax rate of 12.5 percent, his post-tax return will be 8.75 percent.

Hence, the differential in post-tax returns at the end of the first year is 0.25 percentage points. The examples provided clearly show that as estimated return rates increase while other factors remain constant, the difference in post-tax returns also increases.

Let's take another example with the investment amount of ₹10 lakhs in an equity mutual fund.

Table -3

Impact of LTCG tax under proposed new rate			
Invested Amount ₹	10,00,000.00	10,00,000.00	10,00,000.00
Estimated Return	12%	12%	12%
Holding period	One year	Ten Year	Ten Year
Estimated capital Gain ₹	1,20,000.00	21,05,848.00	21,05,848.00
Exemption limit ₹ *	-	-	100000/125000
Earlier Tax (10%)	12,000.00	2,10,585.00	2,00,585.00
Proposed Tax (12.5%)	15,000.00	2,63,231.00	2,47,606.00
Differential LTCG Tax ₹	3,000.00	52,646.00	47,021.00
Post Tax impact (%)	0.30	5.26	4.70

*For illustration purposes, the capital gains exemption limit has not been considered in columns no-1 &2.

Suppose the investor invests ₹10 lakhs in an equity mutual fund today. It would be worth ₹ 31.06 lakhs after ten years, assuming that the rate of return is 12 per annum. Comparing the existing capital gain tax and the proposed new tax rate without deducting the capital gains exemption threshold limits the differential in post-tax returns at the end of the 10 years to 5.26 percent. The average annual differential will be 0.52 percentage points, which is higher than 0.3 percentage points for one year. In the long term, the difference in post-tax returns increases gradually due to the compounding effect of investment returns, as illustrated above in Table No-3.

When assessing their tax liability, investors need to consider the rise in the LTCG (long-term capital gains) tax rate and the increase in the capital gains exemption from ₹ 1 lakh to ₹ 1.25 lakh. Considering the limit for capital gains exemption, the impact of the LTCG tax burden decreases. However, in the given examples, the effect of differential capital gain taxes decreases to 4.70% from 5.26%.

Taxation on Property, Gold, Gold ETF and Gold Funds:

Budget 2024 has also reduced the long-term capital gain tax on property (land and buildings) and gold from 20% to 12.5% without indexation.

The proportion of a decent allocation in a portfolio became difficult earlier when Gold ETFs & Gold Funds were being taxed at a slab rate. As per Budget 2024, Gold, Gold ETF, & Gold Funds are now excluded from the purview of Specified mutual fund definitions.

After this rationalization of capital tax, Gold, Gold ETFs, and gold Funds will be taxed at 12.50 percent based on their holding period, which may be 12 months or 24 months. However, Gold funds of funds (FOFs) will become eligible for LTCG at 12.50 percent after 24 months of holding, and short-term capital gain will be taxed at a slab rate.

Taxation of Foreign Equity:

With effect from the next financial year, the proposed foreign equity funds' capital gain taxation has been reduced from the existing rates. This may lead to investors having more foreign funds allocated in their portfolios for geographical diversification and to take advantage of another equity market in a different market cycle.

Strategy to Minimize Capital Gain Tax:

- **Hold the investment for a longer period:**

Investors should regularly review their portfolios and hold onto their assets for a longer period of time to take advantage of the lower tax rate on long-term capital gains from equity investments.

2. Utilise exemption limits:

Investors should use the enhanced long-term capital gain tax exemption limit of ₹1.25 lakhs when booking profits in a financial year to maximize tax-free gains.

3. **Periodically evaluation of portfolio :**

Investors should regularly review their portfolios based on their needs and financial goals. They should identify assets that generate decent returns and those that underperform, leading to losses, and then decide whether to hold or sell these assets.

Aggressive mutual funds are investment vehicles that aim to maximize returns by taking a higher level of risk. These funds typically invest in a portfolio of stocks, bonds, or other securities with a higher potential for growth but also come with a higher degree of volatility.

The Conservative hybrid mutual funds are suitable for lumpsum investment and systematic withdrawal plans. This fund is ideal for investors who want a risk-adjusted return for regular income.

However, Aggressive balanced funds are a type of investment vehicle that aims to provide a higher potential for growth by investing in a mix of asset classes with a higher allocation to equities. This fund is ideal for investors who want a higher potential for growth.

4. Consult your tax advisor:

It is better to always consult your tax advisor while booking profits from your investment. Due to frequent changes in tax structures and rates, one can make more losses on his investment. Even now, there are many lacunae in the tax system. The tax advisor should inform the investors about the tax rate of the portfolio and provide maximum tax advantages by offsetting gains with losses from underperforming investments in their portfolio.

Summary:

The abolition of the angel tax for all classes of investors is a good initiative and may revive start-up ecosystem activity. The rapid increase in futures and options (F&O) trading volumes incurred losses for retail investors. The higher securities transactions tax (STT) on F&O is also relatively marginal, which will help to protect retail investors by safeguarding them from risks associated with uninformed trading in this market segment.

Proactive financial planning and a comprehensive understanding of tax regulations can significantly enhance post-tax returns. Mutual funds offer the flexibility to invest in various assets and are managed by professionals. They are less risky than direct equity, have strong regulation, operational transparency, and tax efficiency, and diversify investors' money into different asset classes, generating consistent returns over the long run.

Holding assets for over a year qualifies them for long-term capital gains rates (12.5%), which are lower than short-term rates (20%). After holding mutual funds for a year, you can redeem the units and enjoy tax-free limits of ₹1.25 lakhs.

On the other hand, diversifying your portfolio with different asset classes is tax-efficient and generates decent returns in the long run. Given the proposed capital gains tax rates, investors should consider strategic approaches to minimize tax liability. Market valuations are unlikely to be significantly affected despite increased capital gain taxes. The market is resilient, and any short-term impacts on investment behavior due to tax changes will likely be absorbed, leading to a return to balance.

However, take a cautious note, given current market valuations and geo-political issues. Investors should consider small and mid-caps only if they can handle market volatility and have a longer investment horizon.

Disclaimer:

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CMA R K MOHAPATRA

Consultant GM / Finance in IRCON and an "Eminent Author" awardee. He has 33 years of experience in finance and accounts, portfolio management, cash and wealth management, and tax planning. He is known for his work on individuals' financial and retirement planning