asset 360 ONE

An update on Indian Capital Gains Tax

Summary:

The Indian finance minister announced changes in the country's capital gains tax structure in the recent Union Budget on 23rd July 2024, increasing the tax rate on short-term capital gains (on positions held for less than 12 months) from 15% to 20% and on long-term capital gains (on positions held for more than 12 months) from 10% to 12.5%.

As 360 ONE Asset Management's investment approach is fundamental, bottom-up stock picking, we estimate these changes to have only a marginal impact on its fund's performance after tax.

However, the way these capital gains taxes are accrued varies across different UCITS funds, which makes it difficult to compare their performances. One approach followed by a few UCITS Fund is to accrue taxes on realised gains only. The second approach, which is a more conservative approach, is to accrue for taxation on both realised and unrealised gains. Our UCITS fund adopts a prudent approach by fully accruing both realised and unrealised capital gains tax in its reported net asset value (NAV). At the end of June 2024, the tax accrual on unrealised capital gains in our UCITS fund was estimated to be approximately 4.02%.

Therefore, managers who accrue unrealized capital gains tax in their daily NAVs will show underperformance vis-à-vis the funds which do not accrue them as well as the benchmark indices.

Approach to reporting capital gains tax:

Understanding the differences in the accounting treatment of the capital gains tax is very crucial as it has a direct impact on the reported NAV of a fund or the ETF.

Realized capital gains tax is normally accounted by funds in their daily NAV calculation as it is charged to the fund on an incurred basis as and when the stocks are sold from the portfolio.

However, with respect to unrealized capital gains tax, the treatment adopted by various funds and ETFs differ. One approach is to accrue the entire capital gains tax (both realized and unrealized gains) into the NAV. This is the most conservative approach and recommended by all regulators as the NAV represents a true value of the fund's net assets post any liability and capital gains tax is a liability which funds will have to eventually pay. The other approach followed by funds and ETFs is to accrue only realized gains and not account for unrealized gains in their daily reported NAVs. Instead, they defer it till the time an investor places a redemption in the fund and reduce the value of their final redemption proceeds by the amount of estimated unrealized capital gains tax at the fund level, either through dilution levy or swing pricing or by way of a redemption charge. Until this time, the investor is mostly unaware of how much tax will be deducted from his investment and has uncertainty on the final redemption value of his investment holdings. This practice also has the impact of inflating the reported NAVs of such funds and may be misleading for investors who are comparing performance amongst funds following different accounting practices.

Choosing the right benchmark for comparison:

Secondly, investors typically compare the returns of different funds to their nearest benchmark index when making their selection. However, it is vital to understand that index values are not adjusted for any tax at all whereas the fund returns will be (realized taxes in all cases and unrealized taxes in case of some funds). In a scenario of rising markets, this will always show underperformance by a fund as compared to its benchmark because NAV of the fund will get reduced by the amount of taxes that has been incurred or accrued in it.

Hence, the question arises - is it even right to compare a fund's performance to a benchmark index as the index values are gross of capital gains tax and purely show movement in prices of its constituent stocks. An alternative to this could be comparing the performance of funds with index ETFs instead, which account for taxes in addition to other real costs such as manager fee, trading costs and other operating costs. Although again it is important to note ETFs also handle unrealized capital gains tax in different ways.

Recent developments:

Both the above-mentioned approaches, be it the accounting treatment of realized vs unrealized capital gains tax or comparing performance to a benchmark that also captures taxes, will become even more pronounced now with the recent tax changes announced in the Indian Budget on 23rd July 2024. The increase in short-term capital gains tax rate from 15% to 20% and the long-term capital gains tax rate from 10% to 12.5% implies that managers who accrue unrealized capital gains tax in their daily NAVs will show greater "theoretical" underperformance vis-à-vis the funds which do not accrue them as well as the benchmark indices.

Investor takeaways:

Performance data reported by various funds and even benchmark indices is not always directly comparable. Therefore, investors should always exercise caution while evaluating fund performance and do a like-to-like comparison to be able to take an informed decision as part of their manager selection process.

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