LTCG Tax

Creating a Level Playing Field

The Long-Term Capital Gain (LTCG) tax should be viewed more as a measure which seeks to equalize the tax structure across instruments, thus bringing them on a par in course of time. As far as investors are concerned, while there is reason to believe there will be some movement back to deposits, the fact remains that post-tax equity would still deliver better net returns compared with alternatives.

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The Long-Term Capital Gains (LTCG) tax has probably been the most interesting proposal announced in the budget on the taxation side. It would be incorrect to say that it was not expected as there were strong views put forward that LTCG tax on equity was needed for two reasons. First, it would bring about a more equitable framework of taxation across various savings and investment instruments and second, the government would be able to garner more revenue. It is clear that when this proposal has been mooted in the budget, there is a tacit acceptance that the market is mature and does not need any further support for bringing in the equity culture. Therefore, the earlier argument for giving such incentives in the form of tax exemption no longer holds where it was felt that it was required to develop the equity culture in the country which in turn would lead to higher primary issuances and hence investment.

The basic argument to tax LTCG is compelling because it is the only class of investment which does not pay capital gains tax (besides Securities Transaction Tax (STT) which is paid when transacted on an exchange). Debt is subject to such a tax with a longer tenure of three years needed to qualify for the same. Equity still enjoys the benefit of a shorter duration for being classified as long-term i.e., one year. All other savings end up paying tax either on income earned or on capital gain made. The one-year timeframe may be considered as being the first step towards moving this across to three years over a period of time to bring it on a par with debt instruments. In fact, even the rate of 10% has been termed as being a concession provided in the budget which means that there are strong chances of this being raised over a period of time if deemed fit.

The budget has quite pragmatically offered the buffer of using January 31 as the cut-off date for valuation purposes. This helps a lot because the stock market had peaked in January and if this was not done, there would have been large-scale selling and buying back to escape the tax. This would have caused a lot of disturbance in the market considering that the last few months had witnessed some of the highest increase in stock prices which would have led to substantial selling as future tax flows would be high. By providing the grandfathering clause, stability was achieved in the market as all sales made post-April would use the higher of either the purchase price or January 31 price. Therefore, the introduction of LTCG tax on equity was done after considerable deliberation in terms of implementation so that it comes out as being fairly well balanced. There can be no complaint here in terms of the rollout of this tax.

It was rather coincidental that the markets dropped sharply after the budget. On closer analysis, it was evident that while the LTCG tax proposal did play its role, the main driving factor was the disturbance in the US market on account of change in perceptions of the economic environment which in turn led to a contagion across all markets.

Will this affect investment?

There are two aspects here. The first pertains to whether equity markets (including equity-oriented or balanced funds in the mutual funds industry) would continue to be attractive. The 10% capital gains tax will definitely mean lower effective returns for the investor who holds on to the instrument for above one year. However, given that equity returns tend to range between 12-15% on an annual basis, which is far superior to that of any kind of debt instrument, it would still be attractive. It should be remembered that debt continues to be taxed at a similar rate (without indexation) and 20% with indexation provided held for at least three years, and hence equity scores over such instruments. Hence, even though the effective real return comes down, it would still be better than other comparable instruments and should not affect the flow of funds on this score.

The other aspect is the migration of large scale funds from bank deposits to equity mutual funds in the last year. This has happened due to the surplus deposits which flowed into the banking system following demonetization which was followed by lowering of deposit rates. Higher influx of deposits had caused interest rates to be lowered by banks with liquidity becoming excessive with few lending opportunities. Households have since migrated to mutual funds (especially equity and balanced segments) and equity markets for better returns. Therefore, the possibility of reverse migration cannot be ruled out depending on the preferences of investors. This is more psychological in nature as the effective return post-tax would still be higher than that on deposits which are being taxed at the individual's slab rate.

This becomes important for two reasons. First interest rates are posed to go up which means that return on deposits would rise. The other is that the stock market has already achieved very high levels with limited upside expected in the next year or so unless something dramatic happens. This means that from now on, the returns on the equity market may not go up to the same extent and fresh investment made would earn lower returns thus narrowing the return differential between debt and equity. The next few months would be important as there will be a clear idea on how the market would be behaving. Presently, there have not been signs of a major sell-off in the market as a preemptive measure and the next month or so would be important to get a better idea.

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How about foreign investors?

Here it would be interesting to see how funds behave as there are signs of interest rates moving up in the west which means that debt preferences could change away from India unless rates move up. On the equity side, the differential with Indian returns would also tend to diminish and the movements in exchange rate and expectations of the same would hold the clue to whether or not the flow would be affected significantly. Presently, it does appear that under stable conditions, there should not be any significant change in the direction of flows. FII flows into equity so far are negative post-budget.

Increasing the STT was clearly an option which was there. It may be recollected that when the STT was brought in the idea was to substitute capital gains tax with this tax. The STT works well on volumes of trade, while the LTCG works if gains are made. Now with January 31 being the cutoff date, a lot depends on the upside of the market. Will the Sensex go to 38,000 or 40,000 during the financial year? If the answer is not in the affirmative, then it means that the limited upside will not garner the kind of revenue which the government is targeting. Therefore, from the perspective of revenue generation, the STT would have been a better option. Further, it would have also been scalable and not a new adjustment for investors which the LTCG is.

It is still 'advantage equity'

Therefore, the LTCG tax should be viewed more as a measure which seeks to equalize the tax structure across instruments thus bringing them on a par in course of time. Such harmonization cannot be dismissed because it makes the system easier to understand and makes the structure equitable. The impact on investors is still divided, and while there is reason to believe there will be some movement back to deposits, the fact remains that post-tax equity would still deliver better net returns compared with alternatives. Foreign investors would weigh their options closely as the exchange rate movements would also play a role in deciding on the ultimate return received on their investments. Above all, the future movement in the market prices will hold a clue on which way things will go. ■

Reference # 20M-2018-03-06-01