Long-term debt funds still more tax efficient

They continue to enjoy a significant tax advantage over fixed deposits and bonds

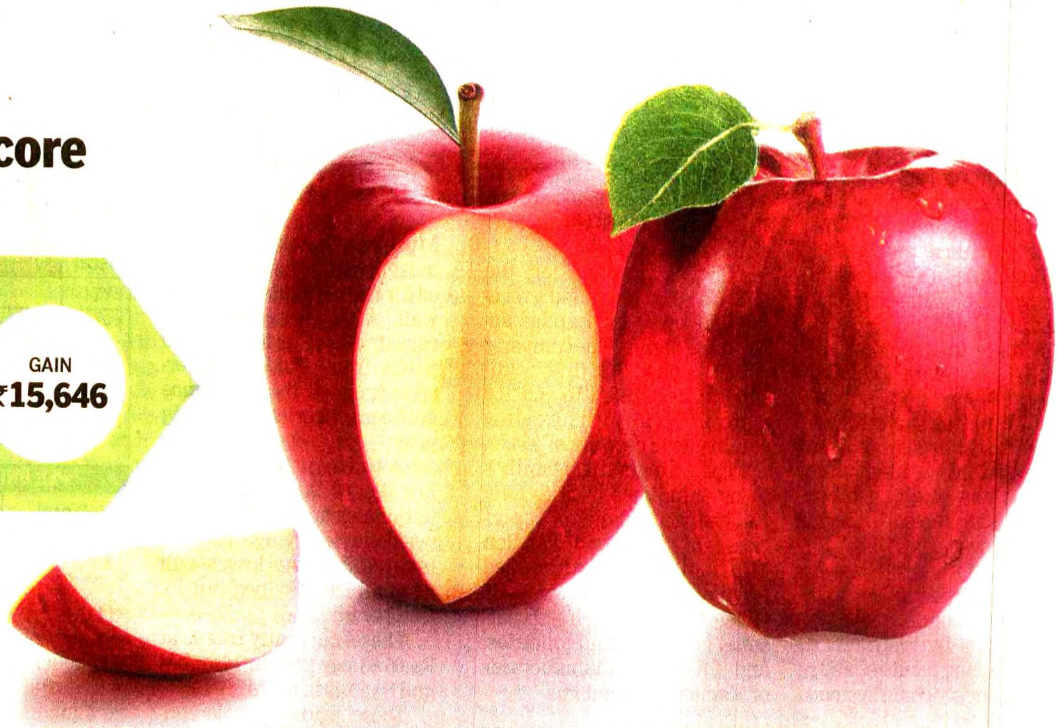
How 3-year FMPs score over fixed deposits

PRINCIPAL AMOUNT INVESTED **₹50,000**

MATURITY VALUE AFTER 3 YEARS **₹65,646**

ASSUMING 9.5% PRE-TAX RETURNS

GAIN **₹15,646**



	Fixed deposits	FMPs
INDEXED VALUE (ASSUMING 9% INFLATION)	Not applicable	₹64,751
TAXABLE GAIN	₹15,646	₹894
TAX PAYABLE	₹4,834*	₹185

*Calculation assumes investor is in the 30% tax bracket. Tax is payable on the interest accruing every year

Investors in short-term debt funds may be ruing the changes in tax rules but long-term investors have plenty to smile about. They are still eligible for a tax bonanza, thanks to the indexation benefit available on investments of more than three years. If you invested in a 3-year FMP in 2011 and earned a return of 9.5%, you will have to pay a paltry tax of 0.56% on the gains. High inflation in the past few years has reduced the tax payable on gains from debt funds to almost nil. No tax is payable even if the debt fund you bought in 2009 has earned 10% returns.

After the budget changed the rules for non-equity mutual funds, several fund houses junked their plans to launch one- and two-year FMPs. Some even returned to investors the money collected during recently closed NFOs of one-year schemes. These have now been replaced by 3-year FMPs on the market shelves. At least three 3-year FMPs closed last week and eight others are currently on offer (*see table*). Sources say more are in the pipeline.

Experts say that given the high bond yields, one can expect a pre-tax yield of over 9% from these FMPs. Given that you can claim indexation benefit on these schemes after three years, the tax will be significantly lower compared to what is payable on the interest earned on fixed deposits. "The budget killed 1-2 year FMPs but 3-year FMPs still have a significant tax advantage over fixed deposits," says a senior fund manager.

The interest on fixed deposits is fully taxable. It is added to the income of the investor and taxed as normal income. For those with a taxable income of over Rs 10 lakh a year, the tax is 30%. In stark comparison, the effective tax on the gains from a 3-year FMP is less than 2% if you assume a modest inflation of 9% (see graphic).

3-year FMPs on offer

Scheme	Tenure Days	NFO closes
HDFC Fixed Maturity Plans - July 2014 (1)	1,123	4 Aug
Reliance Fixed Horizon Fund - XXVII - Series 2	1,098	4 Aug
ICICI Prudential Fixed Maturity Plan - Series 75 Plan E	1,352	6 Aug
UTI Fixed Term Income Fund - Series XIX - XV	1,101	6 Aug
ICICI Pru Fixed Maturity Plan - Corporate Bond Series B	1,100	8 Aug
Sundaram Fixed Term Plan - GJ	1,095	8 Aug
HDFC Fixed Maturity Plans July 2014 (1)	1,116	11 Aug
DWS Fixed Maturity Plan - Series 75	1,099	11 Aug

Poor on liquidity

Though FMPs can give higher post-tax returns, they don't score very well on the liquidity front. They are closed-ended schemes and the fund house is not under any obligation to redeem the units before the maturity date. However, mutual funds do offer a small exit window to investors who want to redeem before maturity. FMPs are listed on the stocks exchanges and one can sell his investments to anyone willing to buy it.

But this exit route is only a theoretical possibility. In reality, there are hardly any FMPs traded on the exchanges. According to Value Research, during 2013, only eight of the 700 FMPs available in the market were traded on the BSE on 20 days. This year has been better but the volumes rarely cross a few hundred FMP transactions in a day. The scanty trading is not the only problem. The price offered by buyers is usually lower than the NAV of the scheme. If you need the money urgently, you will have to take a loss and sell at a discount. So, be ready to hold for the full term when you invest in an FMP because there is no way you can exit before maturity.

Banks waive penalties

On the other hand, an increasing number of banks is not levying any penalties on premature withdrawal of fixed deposits. The State Bank of India, for instance, does not charge any penalty on premature withdrawals from short-term deposits of Rs 15 lakh and above after seven days. In cases of tenure of more than one year, there is a small penalty. The deposit earns 0.5% below the rate applicable for the period the money remained with the bank or 0.5% below the contracted rate, whichever is lower.

Experts say this makes bank FDs a better proposition for those in the lower tax brackets. The tax on FMPs will only be marginally lower and not make a significant difference for someone whose earns less than Rs 5 lakh a year. Even though the tax will be higher on FDs, they will offer greater liquidity to the investor.