SHARP & TANNAN

Sharp byTes

4 April 2023

Withdrawal of tax benefits on market-linked debentures and debt securities

Recently, the Finance Bill, 2023 was passed in the Parliament unanimously. There was an amendment to the bill outside the budget proposals relating to the taxability of long term capital gains arising out of the sale of market-linked debentures.

In this byte, we take a look at the new clause inserted by the Finance Bill and its implications going forward.

What is the new section to be inserted?

The Finance Bill, 2023 makes an insertion of section 50AA (with effect from assessment year (AY) 2023-24) in the Income Tax Act, 1961 (the Act).
Accordingly, transfer/sale/redemption of the following instruments will be taxed as short term capital gains:

1. a market-linked debenture or any security,
2. any security which has an underlying principal component in the form of debt security and where the returns are linked to the market returns on other underlying securities or indices,
3. any security classified or regulated as a market linked debenture by the Securities and Exchange Board of India (SEBI).

Tax implications

The sale/redemption/transfer was hitherto classified according to the holding period, i.e.

1. Held for less than 36 months: considered as a short-term asset (taxed at the slab rate applicable to the person/entity).
2. Held for 36 months and more: considered as a long-term capital asset (It was taxed at 20 % and was eligible for indexation benefit).

After the insertion of the new section 50AA, the gain/loss would be treated as a short-term capital gain/loss and would be taxable at the prevailing income tax rates applicable to the entity.

Holding period

Sales/transfers before 31 March 2023 will continue to be taxed depending upon the holding period. The new section 50AA applies for AY 2024-25, i.e. for the sale transactions done on or after 1 April 2023 and thereafter. Thus, a market linked debenture/unit of debt-fund even though purchased and held for more than 3 years (e.g. purchased in January 2020) and sold in April 2023, the gains would be taxed as short-term capital gains and would be taxed at the tax rates applicable for AY 2024-25.

However, if it is sold by 31 March 2023, the same would be taxed as per the holding period.

Withdrawal of tax benefits on market-linked debentures and debt securities

Effect of the amendment

Hitherto, the units of debt-oriented funds were attractive investment options for assesses wherein they enjoyed market-linked returns higher than the normal fixed deposit rates and also the transfers being taxed after considering the inflation (indexed cost) and a lesser rate of taxation.

From AY 2024-25, these benefits will vanish and the units/debentures will fetch lesser returns like FDs and time deposits.

Macro-economic scenario

Apart from individual investors, the amendment has many significant effects on the investments made by fund managers and corporate entities by investing such amounts in the debt market. Investors may sell/redeem the securities by 31 March 2023 to avoid the additional tax thus amounting to enormous withdrawals from the bond market (by personal as well as institutional investors.)

The sudden withdrawal may lead to liquidity issues of MF schemes by fund managers and other corporates.

The amount invested by fund managers in government securities and debt market may also see enormous withdrawals, thus negatively affecting the ongoing infrastructural projects.

Weblink http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/Finance%20Bill%20E%2020232120232742PM.pdf

Therefore

Apart from personal taxation, the withdrawal of indexation benefit and the taxing of the gains as short-term gains would also be unlucrative for corporates having inter-company investments and borrowings. Withdrawal of such money already invested in bonds by the corporates may have a cascading effect in terms of liquidity. On the face of the amendment, it seems that the bond and FD market will be at par in the short future in terms of the interest rate offerings. The withdrawal of bonds already invested may adversely affect the borrowers and the ongoing capital projects in which the government and private sector has invested.