

Budget 2023: Capital Gains Tax Tweaks Could Puncture Ballooning Market-Linked Debentures

Jaspreet Kalra & Hiral Dadia, 01 Feb 2023, 10:03 PM IST.

Proceeds from sale of market-linked debentures will be treated as long-term capital gains and taxed accordingly, Budget 2023 says.

Market-linked debentures may have been lauded as innovative and flexible products but Budget 2023 could puncture this ballooning category.

Proceeds from the sale of such debentures will be treated as long-term capital gains and taxed accordingly, as opposed to short-term capital gains currently, according to the budget for 2023-24. This would effectively move the rate from 10% to as high as 30%, depending on an investor's income level. The change will be applicable from April 1, 2024.

"These securities are in the nature of derivatives which are normally taxed at applicable rates," the budget document said.

These securities are a reasonably popular instrument for high-net worth individuals or other sophisticated investors, according to Vishal Dhawan, chief executive of Plan Ahead Financial Planners. The instruments have also increased in popularity over the last couple of years as they became a sizeable "source of financing for [non-banking financial companies]".

Crisil Ratings estimates total issuances almost doubling to around Rs 20,800 crore till date this fiscal from around Rs 11,000 crore in FY21, Krishnan Sitaraman, senior director at Crisil Ratings, told BQ Prime. Other industry executives BQ Prime spoke with pegged the size significantly larger. Many issuers of such instruments are mid-sized to smaller non-bank financial companies, for whom they represented a diversification of investor base, Sitaraman added.

Market-linked debentures had degenerated to instruments of blatant tax evasion, hence the government has taken such a move, a trader at an Indian financial services firm told BQ Prime on the condition of anonymity.

The change in taxation will lead to a rotation away from such instruments, Punit Shah, partner at Dhruva Advisors, told BQ Prime.

It is expected to significantly shrink the market for such debentures and could also hurt listed companies that issue such securities, executives at two Indian financial services firms told BQ Prime. Overall, the issuance of such debentures should see a decline, the first executive said. "The tax arbitrage no longer exists," Venkatakrisnan Srinivasan, founder of Rockfort Fincap, told BQ Prime. The issuance of such debentures should see a decline, the first executive said.

"The tax arbitrage no longer exists," Venkatakrisnan Srinivasan, founder of Rockfort Fincap, told BQ Prime. The sector has ballooned quite aggressively over the last couple of years and the restrictions were expected given the arbitrage and largely untracked nature of the market, he said.

While MLDs have appealed to investors by promising that the investment will in almost all cases deliver an index-beating performance, the new tax burden could very well wipe that charm away. Given that many of these debentures also tend to be linked to the Nifty, Shah said, the index may also face selling pressure.