

# Capital Gains Tax Hike Makes Arbitrage Funds Less Attractive for Certain Investors — Here's Why

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Arbitrage funds, which gained traction after a change in the tax treatment of fixed-income mutual funds, has become less attractive after Finance Minister Nirmala Sitharaman raised the capital gains tax in the Union Budget 2024.

Short-term gains — which are gains made under a year — from arbitrage funds, will now be taxed at 20%, up from the earlier rate of 15%. Similarly, the long-term capital gains tax was raised to 12.5%.

This change will mean notable losses in tax benefits for investors belonging to certain income brackets. Here's how this change in taxation will affect investors across tax slabs. Investors in the 15% tax bracket or lower will lose the tax advantage. These are investors who earn between Rs 10 lakh and Rs 12 lakh under the new tax regime.

To illustrate, consider an investor who has a taxable income of Rs 11 lakh per year under the new tax regime. If they made capital gains worth Rs 1 lakh from short-term liquid funds held for less than a year, the gains would be taxed at 15%. As per the new norms, the same gain of Rs 1 lakh made from arbitrage funds in less than a year would now be taxed at 20%. Investors earning up to Rs 5 lakh under the old tax regime will also have a similar downgrade in taxation benefits for gains from arbitrage funds.

## Tax Treatment at Par with Other Funds

When it comes to investors under the new regime who earn between Rs 12 lakh and Rs 15 lakh, the impact is different the change will bring arbitrage funds and other fixed-income funds at par for these investors. Investors who fall into the Rs 5 lakh to Rs 10 lakh income bracket in the old tax regime will have a similar effect. The taxation of short-term gains from arbitrage funds will be the same as that of other fixed-income mutual funds for these investors.

For example, consider an investor who earns Rs 14 lakh under the new tax regime. If short-term capital gains worth Rs 1 lakh were made by the individual through liquid funds, then they would be taxed at 20% according to the slab rates.

If the gain was made from arbitrage funds instead, this will also now be taxed at 20%.

## Who Continues to Enjoy at Tax Advantage?

Investors in the highest tax bracket, that is those who earn above Rs 10 lakh under the old tax regime and above Rs 15 lakh in the new tax regime will continue to enjoy a tax advantage.

"The rationalisation of capital gains tax across asset classes will result in investment decisions being driven by asset class choices and not tax rates," said Vishal Dhawan, founder and chief executive officer of Plan Ahead Wealth Advisors.

Investors do use arbitrage funds to park funds for short-term requirements, but most often end up being held for more than a year, said Dhawan. In this scenario, arbitrage funds would enjoy a significant tax advantage over fixed-income mutual funds.

"When short-term parking money becomes long-term, the tax drops to 12.5% for long-term arbitrage funds," he said. "Still, there is still merit in these funds."

In conclusion, Dhawan said arbitrage funds should not be used for very short periods. Rather, they should be used for three to six months at least, he said.