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TAXATION OF MUTUAL FUNDS IN INDIA

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ABSTRACT

This paper systematically examines the taxation of mutual funds applicable for Assessment Year 2025-26, focusing on different categories of funds namely Equity-oriented schemes, Debt-oriented schemes, Hybrid schemes, Solution-oriented schemes and Others includes passively managed Index funds, Fund of Funds (FoFs), and Exchange Traded Funds (ETFs). It is perceived by most of the population in India, investment in mutual funds is the safer and getting the expected returns. Presently 3 to 5% of the total population in India has invested in various mutual fund schemes. It is always perceived by most of the households that investment in mutual funds is always considered low risk investment as compared to direct investment in stock market. Taxation in mutual funds is dependent upon the date of purchase and sale/ redemption of the units held by the investor. Under the Income Tax Act, depending upon the holding period of the units they are classified as short capital and long-term capital and thereby they are taxed accordingly. This paper also discusses on the taxation on dividend income.

KEYWORDS: Equity-oriented schemes, Debt-oriented schemes, Fund of Funds, Exchange Traded funds, Index funds.

INTRODUCTION

A Mutual fund is established as a Trust under Indian Trust Act ,1882. Mutual funds are investment products available to investors through which they can invest in an asset class of their choice such as equity, debt, gold or real estate. Investors who may not want to invest directly in financial markets may instead get exposure to the same securities through a mutual fund. The penetration of investors in mutual funds is around 3 to 4% of population in India. Mutual funds have become one of the most common vehicles for retail and institutional investment in India due to their diversification benefits, professional management, and wide range of products to suit different investor appetites. However, like other investment instruments, mutual funds are subject to taxation under the Income Tax Act, 1961. The incidence of tax liability arising from mutual fund investments under the head Capital Gains arises when units are sold or redeemed, and income tax on distributions such as dividends.

The essential conditions for taxing mutual funds under the Capital gains is there must be a capital asset



and that the capital asset must have been transferred and the result of such a transfer must be profits and further such capital gain should not be exempt under sections 54,54B,54D,54 EC,54EE,54F,54G, 54GA. Generally, if the Units are held before date of transfer or sale/ redemption for a period not exceeding 12 months from the date of purchase, known as short term capital asset and any transfer shall be resulting in short term capital gain. While Unitholder holding the units of mutual funds for a period exceeding 12 months from the date of purchase, known as long term capital asset and any sale/ redemption of the respective units result in long term capital gain. The very purpose of classifying the units of mutual funds into short term and long term is to understand the incidence of tax.

A mutual fund is considered Equity oriented if 65% or more of its assets are invested in equity shares of domestic companies. This includes funds such as pure equity diversified funds, thematic equity funds, equity index funds, and some hybrid funds with significant equity exposure. If the holding period of units is more than 12 months from the date of purchase, the gain shall be taxed at 12.5% plus applicable Surcharge and “Health and Education Cess” to be levied on long-term capital gains exceeding ₹1.25 lakh provided transfer of such units is subject to Securities Transaction Tax. Similarly, any short-term capital gains earned from the equity-oriented mutual funds, subject to STT, will be taxed at the rate of 20%. The rates of surcharge, Health and education cess depend on the amount of specified income. It is very important to understand the term specified income referring to Total income excluding income by way of dividend on shares and short-term capital gains in case of listed equity shares, equity oriented mutual fund units, units of business trust and long-term capital gains. Specifically, they are levied in the following structure of specified income, 37% specified income exceeds Rs. 5 crore, 25% specified income exceeds Rs. 2 crore upto Rs. 5 crore, 15% total income exceeds Rs. 1 crore upto Rs. 2 crore and 10% total income exceed Rs 50 lakhs upto Rs. 1 crore. Further Health and Education cess @ 4% on aggregate of base tax and surcharge.

With effect from April 1, 2025, the Income Tax Act define a specified mutual fund as a mutual fund that invests more than 65% of its total proceeds in debt and money market instruments, or a fund-of-fund where the underlying investments also invest a minimum of 65% in debt instruments.

Debt mutual funds include funds that invest primarily in bonds and money market instruments. Taxation on Debt mutual funds after the Budget 2025 in India depends primarily on the purchase date of the units. All capital gains from these investments are treated as Short-Term Capital Gains (STCG), irrespective of holding period. Therefore, the gains are added to the total income and taxed at applicable personal income tax slab rate. There is no benefit of indexation for these debt mutual fund units. However, the investor can claim Rebate under Section 87A for Capital Gains from these funds are eligible for the increased tax rebate under the new tax regime under section 115BAC, effectively making income up to ₹12 lakh tax-free for individuals in that income bracket. However, if investments in Debt mutual funds have been made before April 1st, 2023, If the units are held for a



period up to 24 months, they shall be classified as short term capital assets and any transfer/ sale/ redemption shall be short term capital gain and accordingly taxed at the personal income tax slab rate of the investor. However, the if the units are held for a period more than 24 months Then it shall be classified as a long term capital asset and any transfer/sale/redemption she'll be classified as long term capital gain handbags at flat rate of 12.5% and it should be noted that's the benefit of cost inflation index has been removed for the sales happening honour after July 23rd , 2024 for these funds.

The taxation on Hybrid mutual funds depends wholly on their equity exposure, which determines if they are treated as equity-oriented or debt-oriented for Income tax purposes. Funds with 65% or more equity are taxed like equity funds, while those with less than 65% equity are generally taxed like debt funds at respective slab rates for new investments. Securities Transaction Tax of 0.1% is levied on the purchase and sale of units of equity-oriented hybrid funds on a recognized stock exchange and STT is not applicable to debt-oriented funds. For all hybrid funds purchased after April 1, 2023, the benefit of indexation for calculating long-term gains has been removed.

Solution-oriented schemes are to be taxed according to period of holding units, thereby classified as short-term capital gain and long-term capital gain. In case of Equity-oriented funds greater than equal to 65% domestic equity, holding period of units less than equal to 12 months taxed at 20% as being short term capital gain and if the units have been held by the investor for more than 12 months taxed at 12.5% on long term capital gains above ₹1.25 lakh per year. In case of Debt oriented funds, i.e., less than 35% equity, purchased on/after 1 Apr 2023, on the transfer/ sale/ redemption of units shall be taxed as short term capital only disregarding the holding period of units by the investor.

The Exchange Traded Funds are those that invest in equities or related investment instruments. Short-term or long-term capital gains tax applies to these instruments depending on the period of time held and the date of sale.

Capital gains are considered short-term capital gains if the stocks or related instruments are held for less than or equal to one year. Likewise, capital gains are considered long-term capital if the stocks or related instruments are held for more than one year. For the purpose of Income tax classify mutual funds, including FoFs, into two categories - equity-oriented funds and other than equity-oriented funds. An equity-oriented fund must invest at least 65% in equity and equity-related instruments, but the classification criteria for Fund of Funds are more stringent. FoF can be classified as an equity-oriented fund if it invests at least 90% in Exchange Traded Funds (ETFs), which further invests at least 90% in shares of Indian companies listed on stock exchanges. For taxation purposes, all other FoFs are considered 'other than equity-oriented' schemes even if they invest 100% of their net assets in another equity fund of a mutual fund.



Taxability of dividend income from mutual funds under section 194K, TDS on dividend income for resident individuals is at the rate of 10% if the dividend amount exceeds ₹ 10,000 in a financial year while taxability of dividend income from equity shares is levied under Sec194 of the Income Tax Act,1961at the same rate.

CONCLUSION:

Though investment in mutual funds is considered as the best avenue for the risk-averse investors as they are professionally money managers but there is no guarantee as to the returns and existence of expense ratio since investments in mutual funds are subject to market risk. To boost the mutual fund industry, it is advised to reduce the expense ratio by removing exit load on transactions relevant to mutual funds. Investors can set off capital losses against capital gains. Short-Term Capital Losses (STCL) can be set off against both short term capital gain and long-term capital gain while Long-Term Capital Losses can be set off only against long term capital gain.

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