Tax avoidance: Dividend strippers put focus on mutual funds

It has consistently lagged the large-cap equity fund category and the benchmark Nifty in the past five years. Its past one year performance is ranked 141 out of 143 large-cap equity funds.

Mutual fund tracker Value Research has put it in the doghouse with a two-star rating. Yet, the Reliance Quant Plus Fund scheme attracted inflows of an estimated Rs 1,800 crore during June.

The trigger: the Rs 4.20 dividend announced by the fund. On a net asset value (NAV) of Rs 14.69, the dividend yield worked out to 28%. Within days of the announcement, the fund's corpus grew 5000% from Rs 36 crore to about Rs 1,850 crore as deeppocketed investors poured money into the scheme to escape tax through dividend stripping.

Though dividend from mutual funds is not really a gain, savvy HNI investors use such opportunities to reduce their tax on the capital gains from other investments.They put large amounts in funds that have announced big dividends just before the payout date.

A few days later they pocket the tax-free dividend and then show the reduction in the NAV as a capital loss that can be adjusted against capital gains from other investments.

"Dividend stripping is not an illegal practice but certainly a questionable one," says Manoj Nagpal, CEO of Outlook Asia Capital. By paying out very high dividends in obscure, underperforming schemes, fund houses are facilitating the exploitation of a legal loophole to avoid tax.

The DWS Investment Opportunity Fund from Deutsche Mutual Fund has been a listless per former, having underperformed the largeand mid-cap fund category and the BSE 200 index in the past five years. But the direct plan of the fund paid out Rs 7 dividend on June 25.

On an NAV of Rs 29.46 per unit, this works out to almost 24%. After the announcement, the fund's AUM jumped 150% from Rs 120 crore at the end of May to over Rs 300 crore in June.

The JM Balanced fund is another example of how the tax avoidance opportunity from dividend stripping can drive the AUM. A long-time also-ran hybrid scheme, it witnessed inflows of almost Rs 3,000 crore after its quarterly payout option declared a dividend of Rs 4.75 per unit in June.

The fund's regular dividend option paid Rs 5.20 in January (yield 18.7%) and Rs 8.87 in March (yield 40%). Anybody who invested in the fund in January has got back 50% of the invested amount as dividend and will be able to adjust the notional loss against other gains.

Experts feel such tactics can prove counterproductive for the mutual fund industry. "If fund houses indulge in practices that facilitate tax avoidance, the government may not offer the mutual fund industry any tax concession it is seeking," says Rajesh Krishnamoorthy, MD of iFast Financial India. The taxman has placed a few hurdles in this much-travelled route to tax avoidance.

The notional loss caused by the dividend payment can be claimed as a loss only if the units were bought three months before the record date or are held for at least nine months after the dividend payment. "If the units are sold before nine months, the loss will be disallowed under Sec 94(7) of the Income Tax Act," says Delhi-based chartered accountant Komal Agarwal.

This means an investor cannot use dividend stripping as a short-term affair. "The rule forces the investor to think long term. If he wants the tax adjustment benefit, he will have to remain invested for at least nine months," says Dhirendra Kumar, CEO of Value Research.

Though this means the investor will have to carry the risk for the next nine months, it's a problem that can be fixed easily by creating a hedge. If one had invested Rs 12 lakh in the Reliance Quant Plus Fund in June, the value of his investment after the dividend of Rs 3.4 lakh would be around Rs 8.6 lakh.

To guard this sum against a possible decline in the stock market till March 2016, he can sell two lots of the Nifty worth around Rs 8.5 lakh in the futures market.

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