All you need to know about index fund taxation

Introduction

Investing in index funds can offer several advantages, like long-term growth potential, compounding benefits, diversification, and more. But they also have something you can't ignore – taxes. When it is time to sell your mutual fund units, the taxman comes knocking at your door, wanting a piece of your profits, too! You cannot escape taxes, but you can learn about index funds taxation to plan better and be prepared for what is in store for you at the end of the tunnel. Read on to know more about tax on index fund gains.

What are index funds?

Index funds are mutual funds that track and replicate the performance of a benchmark index, such as the NIFTY Next 50 index, BSE Sensex index, Nifty 50 index, etc. Index funds invest in the same securities as the index they track. They also invest in the same proportions as the underlying benchmark.

Index funds can be great for diversification as they offer exposure to a broad market. They are passively managed and, therefore, also carry lower costs. However, before investing in them, it is important to understand their taxation.

Taxation of index funds

Index funds are treated as equity funds for the purpose of taxation. Gains earned from index funds are subjected to long-term and short-term capital gains tax as explained below:

- **Short-term capital gains:** Gains earned from an index fund held for up to 12 months are taxed at 15%.
- **Long-term capital gains:** Gains earned from an index fund held for more than 12 months are taxed at 10%. However, long-term capital gains up to Rs 1 lakh in a year are exempt from any taxation.

In addition to this, you also pay tax on the dividends earned from index funds. These are added to your taxable income and taxed according to the applicable income tax slab you fall into for the year.

While capital gains and dividend taxes are obligatory, there are some ways to lower your taxability.

How do index funds help minimise taxes?

- Index funds are often held for the long term. When you invest in an index fund for the long term, you can benefit from paying less tax, as long-term capital gains are taxed at lower rates compared to short-term capital gains.
- Index funds replicate benchmarks and, as a result, usually hold a large number of securities. The turnover ratio in such cases is low. This means that the securities are not replaced frequently. This in turn means that there will be lower tax liabilities.
- Index funds also generally have lower dividend payouts compared to other actively managed funds. As a result, you receive fewer dividends and pay less in taxes.

Conclusion

Index funds can be a good choice of passive equity funds that can offer you great diversification, low costs, and other advantages. However, you may benefit from them more by following a long-term investment approach. It is also essential to understand that while taxes may seem like an unwanted expense, they are important and cannot be ignored. But planning your withdrawals and maintaining a tax-diversified portfolio, in general, can help you minimise the overall impact of tax liabilities on your investments.