An Investor's Budget

The latest budget will go down in history as a budget for the stockmarket investor. Several important changes have been proposed by the Finance Minister which will not only affect expected returns and valuation of securities but will also affect the investment attitude of the public as well as the capital allocation decisions of companies and mutual funds. Here, I will discuss four such changes relating to capital gains, mutual funds, share buybacks, and business reorganisations.

Capital Gains

For resident Indians, long-term capital gains will be taxed at 10%. This is the same rate at which corporate dividends are being taxed. The *first* implication of this major change is that investors should now become tax-indifferent towards receiving the rewards from the ownership of equities through dividends or capital gains. Every one rupee of dividends is worth the same as every one rupee of long-term capital gains.

The *second* implication of this change is that long-term ownership of equities has become far more attractive than the ownership of other asset classes such as bonds and real estate. A simplified example: Suppose you had Rs 100 to invest and were considering three asset classes - bonds, real estate, and long-term equities. At today's prices, and on a pre-tax basis, your Rs 100 investment in long-term, high-grade corporate bonds would earn approximately Rs 14 annually. The same Rs 100 investment in real estate should fetch a rental income of approximately Rs 10 annually. Before you could get your hands on that interest or rental income however, you would have to pay 33% (30% marginal tax rate plus 10% surcharge) to the government as taxes. That would leave you with a post-tax earnings of Rs 9.33 from your investment in bonds and Rs 6.67 from your investment in real estate.

Now consider the implication of an identical investment in equities. For the same Rs 100, today you can easily buy long-term earning power of approximately Rs 12.50 (implying a PE multiple of 8). This earning power will become available to you either through dividends or long-term capital gains. Since the tax rate on both is now the same, you should be indifferent between the two. Assuming every rupee of earnings retained by the companies in your portfolio shows up as one rupee of incremental market value, and also assuming that corporate earnings remain flat, the post-tax returns from your investment in equities should approximate 11.25% a year. Therefore, even if one ignores the inherent growth in long-term corporate earnings, you will still earn substantially more from long-term investment in stocks than from long-term investments in bonds or real estate. Long-term corporate earnings are unlikely to remain flat, however. If we were to consider the impact of this growth, then the equation becomes even more attractive for equities.

Put simply, because of (1) an increase in the effective tax rate on interest and rental income to 33%, due to the 10% surcharge; and (2) a reduction in the effective tax rate on long-term capital gains from equities to only 10%, the earning power available to an investor in long-term equities is going to be taxed at one-third the rate applicable to the earning power from an identical investment made in long-term bonds or real estate. That makes equities as the most attractive asset class for long-term investors.

The *third* implication of this change is that long-term capital gains have become even more attractive than short-term capital gains. The effective tax rate on short-term capital gains has gone up from 30% to 33%. The effective tax rate on long-term capital gains has gone down to a mere 10%. This measure should go a long way in persuading investors to focus on long-term wealth creating companies, rather than short-term speculation.

Mutual Funds

Dividends received from mutual funds will now be tax-free in the hands of investors. The mutual funds, however, will have to pay a 10% tax on all income distributions. The US-64

and other open-ended equity oriented schemes of UTI and other mutual funds will be exempt from paying this 10% tax for a period of three years.

This three year exemption means that equity-oriented, open-ended mutual funds have become very tax efficient investment vehicles for converting taxable income into tax-free income for three years, provided they distribute all their realised gains to their unitholders. The reason is that these realised gains, if distributed to the unitholders, will escape from taxation for a period of three years. It remains to be seen as to how many funds will take this action in the interests of their unitholders.

Even investors in other mutual funds which do not enjoy the benefits of this three-year exemption should benefit from this change. For example, closed-ended mutual funds approaching redemption could distribute a dividend, just before maturity. Such an act could greatly reduce the tax liabilities of the unitholders who have held the units for less than one year.

Similarly bond funds which make frequent distributions would effectively become very tax efficient vehicles for converting interest income which will be taxed at 33% into dividend income which will be taxed at 10%. In my opinion, fixed-income investors holding bonds in their portfolios, should sell them and buy units of well-managed bond funds which make frequent distributions.

Share Buybacks

By clarifying a major tax issue relating to buy-back of shares by companies, the Finance Minister has removed a major hurdle in the buyback programs of several companies. Cash paid to shareholders who tender their shares to a company in response to its buyback offer will not be treated as deemed dividend. This should result in several buyback programs to be completed by companies in 1999. For the economics of share buybacks, please refer to my earlier article on the subject.

Business Reorganisations

By making business reorganisations such as demergers tax neutral, the Finance Minister has hugely increased the chances of sensible reorganisation plans to be announced and implemented. This development is very encouraging as it would not only make Indian businesses restructure in sensible ways which could increase their values in a dramatic way, it will also produce several interesting investment opportunities for investors.

<u>Note</u>

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