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With tax arbitrage, FMPs enjoy an edge over FDs

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Indian investors, conventionally prefer to invest in debt products that guarantee both principal and returns. Inflation-led high interest rates have added to the allure of debt investments. Though a majority of savings flow into bank fixed deposits (FDs), there is a growing awareness about debt mutual funds, specifically fixed maturity plans (FMPs), owing to inherent features like low interest rate risks, tax arbitrage opportunities and regular portfolio disclosures.

Further, FMPs benefit in a high interest rate regime as they lock into portfolios offering higher yields. The key benefits of lower tax rates and double indexation benefits help FMPs score over FDs: **1) Lower tax rates:** While interest from bank FDs is subject to tax at the investor's marginal rate of tax (10% to 30%, plus 3% cess), returns from FMPs are subject to tax based on the options thus selected:

a) Dividend option: Dividend Distribution Tax (DDT) at 12.5% plus 5% surcharge and 3% cess (total 13.519%) is deducted at source.

What are FMPs?

FMPs are closed-ended mutual fund schemes with a pre-defined maturity. They invest in debt instruments — predominantly certificates of deposit (CDs) and commercial papers (CPs). The most commonly offered tenures are 30, 180, 370 and 395 days. FMPs invest in a portfolio of debt securities whose maturity or tenure matches that of the scheme. If the FMP is for 12 months, the fund manager will invest in instruments with a maturity of 12 months, thus locking the yield of the portfolio and lowering the interest rate risk. For liquidity purposes, FMPs are listed on stock exchanges, though trading is very minimal.

BENEFIT FROM DOUBLE INDEXATION

Particulars	FMPs (sans indexation)	FMPs (with double indexation)	Bank FDs
Amount invested	1,00,000	1,00,000	1,00,000
Returns p.a.	9%	9%	9%
Maturity*	14 months	14 months	14 months
Returns (Rs.)	10,500	10,500	10,948#
On maturity (Rs.)	1,10,500	1,10,500	1,10,948
Indexed cost	NA	1,12,360@	NA
Taxable income (a)	10,500	-1,860	10,948
Tax rate	10.30%	20.60%	30.90%^
Tax (Rs.) (b)	1,082	Nil	3,383
Post tax return (Rs.) (a-b)	9,419	10,500	7,565
Post tax return %	8.07%	9.00%	6.48%

b) Growth option: Long-term capital gains (LTCG) tax if units are held for more than one year and short-term capital gains tax otherwise. The latter is taxed at the investor's marginal rate of tax. In case of LTCG, the tax rate is 10.3% (without indexation benefits) or 20.6% (with indexation benefits) whichever is lower. Indexation allows investors to be taxed only if they generate returns over and above inflation by adjusting the purchase price for inflation.

The dividend option is more appropriate for FMPs with tenure of less than a year as it results in lower tax incidence compared to the growth option.

For a greater than one-year period, the growth option is more suitable.

2. Double indexation benefits: This comes into play when an FMP is purchased in one financial year and the maturity of the scheme is in the third financial year, as the inflation rate of two financial years can be used (called double indexation).

Thus, 14-month FMPs are very popular in March. If a 14-month FMP is launched in March 2011 (FY2010-11), it will mature in April 2012 (FY2012-13). Double indexation effectively reduces one's tax liability especially during the period of high inflation (see *Benefit from double indexation).*

One of the biggest advantages of fixed deposits is that, along with guaranteed returns, they come with a deposit guarantee of Rs 1 lakh in case the bank defaults.

However, FMPs offer no such guarantee and also carry a credit risk (possibility of default of securities in their portfolio). Investors must, therefore, monitor FMP portfolios that are available on the websites of mutual funds for their credit rating.

Further, FDs are relatively more liquid as premature redemption is allowed, albeit at a cost. FMPs have low liquidity despite the listing as trading volumes are very low. Investors should opt for FMPs only if they do not need premature redemption and benefit from high post-tax yields.

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