

A late amendment ended debt funds' tax edge. The case for owning them survived

Published by OneRightAI · 5 min read

Maxim: *Debt funds lost their tax edge — choose them on merit.* — Deepak Shenoy, in substance

For years, many investors bought debt funds mainly to pay less tax than on fixed deposits. That reason has gone. What remains is a better test: does the fund do a job a deposit cannot?

A product bought for a tax loophole is only as good as the loophole.

For most of a decade, the pitch for debt mutual funds was simple. Hold one for three years, and the gains were treated as long-term, taxed at 20% after indexation, which adjusted the purchase price for inflation. For an investor in a high tax bracket, that often meant paying far less tax than on a fixed deposit, whose interest was taxed every year at the full slab rate.

Then, in the last days of March 2023, an amendment to the Finance Bill changed it. As Deepak Shenoy of Capitalmind wrote at the time, the change was introduced on 23 March, “just a few days before the financial year ends”. For units bought from 1 April 2023 in funds holding no more than 35% in Indian equities, gains would be taxed at the investor’s slab rate, whatever the holding period. Indexation was gone, and with it the main reason many people owned debt funds at all, as [Capitalmind](#) explained.

Shenoy’s advice was not to abandon debt funds. It was to stop letting tax be the only criterion, because tax rules keep changing. That is the durable lesson here, and it applies far beyond debt funds.

What is left once the tax trick is gone

Strip out the old tax advantage, and a debt fund still differs from a fixed deposit in ways that matter.

The first is timing. Deposit interest is taxed every year as it accrues, even if you reinvest it and never touch it. A debt fund’s gains are taxed only when you sell, so the tax can be deferred for years and the untaxed portion keeps compounding. Shenoy made this point in 2023: debt funds are “not taxed on accruals”.

The second is cash flow. Capital gains on redeeming mutual fund units are not subject to TDS for resident investors, as [Scripbox](#) notes, whereas deposit interest above the threshold has tax deducted at source. The final tax may be the same, but money is not held back along the way.

The third is flexibility. You can withdraw part of a fund on any working day, usually without breaking anything, and plan withdrawals to suit your tax year. Gains and losses can also be set off against each other under the capital gains rules.

The fourth is choice. Debt funds span overnight and liquid funds that park money for days, through short-term and corporate bond funds, to long-duration gilt funds that rise and fall sharply with interest rates. A deposit offers one shape of risk; funds offer many.

The risks have not gone away either. Debt funds can lose money when interest rates rise or when a borrower defaults, and unlike a bank deposit they carry no deposit insurance. Under a [Sebi circular](#) of June 2021, every debt scheme must place itself in a potential risk class matrix, a grid showing the maximum interest-rate risk and credit risk the fund may take, as [Bajaj Finserv AMC](#) explains. It is the first thing to read.

Tax rules have been tweaked since 2023 as well, including which funds fall under the slab-rate treatment. Check the current position before you invest, and do not build a plan that only works under one set of rules.

Five questions to choose a debt fund on merit

1. **What job is this money for, and when will I need it?** Days to a few months points to overnight or liquid funds. One to three years points to short-duration or high-quality corporate bond funds. Money you will not touch for many years may not belong in debt at all.
2. **Where does the fund sit on the risk grid?** Read its potential risk class. Match the interest-rate risk to your time horizon and keep credit risk low unless you understand exactly why you are taking it.
3. **What does it own?** Check the portfolio: government securities and top-rated bonds behave very differently from lower-rated paper chasing a little extra yield.
4. **What does it cost?** In debt, where returns are modest, a difference of half a percentage point in expenses can be a large share of what you earn. Prefer direct plans and low-cost index or target-maturity options where they suit the goal.
5. **Would a deposit do the job just as well?** For a fixed sum needed on a fixed date, a deposit with an insured bank may be simpler. Choose the fund only when its deferral, flexibility or diversification is actually useful to you.

The decision rule follows from Shenoy's point. Judge a debt fund as if tax did not exist, then check the tax as a final step. If the fund only makes sense because of a tax rule, it does not make sense.

The March 2023 amendment was a lesson in how quickly an advantage written into law can be written out of it. Investors who had chosen debt funds for what they did, rather than for how they were taxed, had little reason to change course. Those who had bought them as a tax shelter found the shelter gone overnight.

Tax rules will keep shifting. A product chosen on its merits can survive the next change. One chosen for a loophole rarely does.

Sources

- [Capitalmind: Debt mutual funds will be taxed unfavourably after April 2023, Deepak Shenoy \(27 March 2023\)](#)
- [Sebi: Circular on potential risk class matrix for debt schemes \(7 June 2021\)](#)
- [Scripbox: Section 194K, TDS on mutual fund income \(updated 1 September 2025\)](#)
- [Bajaj Finserv AMC: A brief note on the mutual fund PRC matrix](#)

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