SWP vs. Dividend Pay-out- what works?

Many investors would look for consistent cash flows for their Regular Income needs. These investors usually encounter two types of options.

Dividend Pay-out Option.
Systematic Withdrawal Plan (SWP).

Dividend-paying mutual funds have been an attractive option for many investors. Though many mutual fund schemes have excellent dividend pay-out track records, we must understand that mutual fund dividends are not guaranteed. Mutual fund dividends are paid at the fund manager's discretion and from the reserves created for regular cash flows for investors.

Similarly, the Mutual fund Systematic Withdrawal Plan (SWP) is another option for investors to receive fixed cash flows from their investments. Though dividends and SWP may seem similar, we should understand the key differences.

One crucial parameter is the tax consequence between the SWP & Dividend Pay-out since FY2020-21 Union Budget.

Let's understand the two options in detail.

Dividend Pay-out

Asset Management Companies (AMCs) pay periodic dividends to the investors who opted for the dividend payout option. As per SEBI, mutual fund dividends must be paid from the accumulated profits of the scheme. Fund managers cannot pay dividends just because NAV has appreciated. They can pay dividends only from gains realized by selling stocks at a higher price than the purchase price.

Investors should also understand that the fund manager may not distribute the entire profits booked as dividends. They may keep a portion of gains realized in a reserve account and only pay a part of the profit as dividends. *This is done so that they continue paying dividends from the accumulated profits reserved during the periods where the scheme may not have realized gains*. If no money is left in accumulated profits reserve, the system will not be able to pay dividends until they make profits through portfolio churning.

Systematic Withdrawal Plan (SWP)

In a Systematic Withdrawal Plan (SWP), we can withdraw a fixed amount from our mutual fund investment every month or at any frequency (specified by the investor); we can determine the amount to be removed and the day of the month when the withdrawal should be made and the amount will be credited directly to our bank account on the specified day. We can continue our SWP if balance units are in your mutual fund scheme account.

Dividend Pay-out vs. SWP

Key parameters must be checked before selecting SWP or Dividend Pay-out Option.

Flexibility

SWP is more flexible compared to Dividend Pay-out Option.

The dividends are paid on a scheme only when the AMC decides to pay based on the accumulation of gains in the system. The duration & dividend yield may vary.

In SWP, investors can choose when they need the money and how much to withdraw in how many days/month. Depending on the investor's need & scheme performance, **one may increase or decrease the withdrawal amount & duration of the periodic withdrawals.**

Taxability

Dividends are now treated as income in the hands of investors. The dividends received by an investor are taxable as per his income tax slab rates. So, if an investor doesn't have any taxable income, including the dividend received, they need not pay any tax. However, if an investor falls into the top tax bracket, 30% plus CESS & Surcharge (if any), he is entitled to pay Tax on his dividend income.

On the contrary, the amount withdrawn through SWP is subjected to Capital Gains. Suppose the withdrawal is made from the units of debt-oriented MF schemes purchased within the past three years. In that case, If the withdrawal is made after three years from the date of purchase of the units of the debt-oriented MF scheme, **the gain is treated as long-term capital gain, and a 20 percent tax is levied after indexation.**

In the case of Equity oriented Mutual Funds, the amount withdrawn within one year from the date of investment of the profits is treated as short-term capital gain, and a 15 percent tax is levied on the profits. However, if the amount is withdrawn after one year from the date of investment, the profits are treated as long-term capital gain, and a 10 percent tax is levied on the increase over Rs 1 lakh in a financial year.

Let's understand the difference between SWP & Dividend Pay-out using an example. The below table consists of 3 scenarios.

- SWP through Equity Mutual Funds.
- SWP through Debt Mutual Funds.
- Dividend Pay-out.

In all the scenarios, the invested sum would be Rs.1,00,00,000/-. Let's assume funds NAV at the beginning of the period would be Rs.100/- and correspondingly, we receive 1,00,000 units at the beginning of investment in all three scenarios. The return rate for the three methods would be 10% for equity-oriented mutual funds (growth option), 8% for debt-oriented mutual funds (growth option), and 6% for the dividend payout option. (Rough return values are considered in reality, returns are subjected to market conditions), the withdrawal percentage would be around 6%, and the holding period will be ten years. The monthly cash flow for SWP would be Rs.50,000/- in both Equity & Debt cases. The monthly cash flow for the Dividend pay-out would also be Rs.50,000/-. The total amount received in ten years for each scenario can be seen in the table. Coming to the tax part in this example, we are considering a 30% tax slab. Also, we can see that the Tax is highest for the Dividend Pay-out Option.

Similarly, the Balance amount at the end of the term will be higher in Equity oriented mutual fund (growth Plan) as the withdrawal Percentage is lesser than the growth percentage.

Particulars	**SWP (EQUITY)**	**SWP (DEBT)**	**Dividend Funds**
Invested sum (Year of purchase-2011)	₹ 1,00,00,000	₹ 1,00,00,000	₹ 1,00,00,000
Return rate	10%	8%	6%
Holding period	10 Years	10 Years	10 Years
NAV Value at the end of 1 year	₹ 110	₹ 108	₹ 100
Monthly cash inflow	₹ 50,000	₹ 50,000	₹ 50,000
Market Value at the end of 1 year after withdrawals/dividends	**₹ 1,04,00,000**	**₹ 1,02,00,000**	**₹ 1,00,00,000**
Total amount received through SWP/Dividend in ten years	₹ 59,50,000	₹ 59,50,000	₹ 59,50,000
Total Tax paid	**₹ 1,27,835**	**₹ 1,47,268**	**₹ 18,56,400***
Returns after Tax	**₹ 58,22,165**	**₹ 58,02,732**	**₹ 40,93,600**
NAV Value at the end of 10 years	₹ 257.32	₹ 214.51	₹ 100.00
Units Left at the end of 10 years	61,665	58,515	1,00,000
Capital balance at the end of 10 years	**₹ 1,58,67,638**	**₹ 1,25,52,053**	**₹ 1,00,00,000**

**assumed 30% tax bracket.*

As always, there are pros and cons of both depending on our financial situation and investment experience: -

- We have more control in SWP. We decide how much cash flow we get. Mutual fund dividends, as mentioned before, are paid at the fund manager's discretion.

- Dividends are not assured, but in SWP, we get fixed cash flows irrespective of the market situation and NAV movements.

- One of the essential points about SWP is that the withdrawal rate should be lower than the average long-term return of the scheme if you want to continue your SWP for a long time. The withdrawal rate will also depend on what you need. You should consult your financial advisor to plan your SWP according to your needs.

- In a prolonged bear market, the fund manager may stop dividends, but we will continue to receive SWP cash flows (Remember, this will be at a cost). If the NAV falls substantially, the fund house will have to redeem more units to keep the SWP cash flows going, and our unit balance will diminish faster. This may harm our financial interests in the long term.

- From a taxation viewpoint, SWP is a clear winner over dividends for investors in the higher tax slabs.

- A final point to remember is that, while opting for SWP, the withdrawal rate should be lower than the average long-term return of the scheme if we want to continue our SWP for a long time. The withdrawal rate will also depend on what we need.

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