Rid portfolio of lemons, pare liability via tax harvesting

Avoid selling a quality stock: If its price is up at the time of repurchase, the entire exercise will end up being futile

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The equity market is going through a turbulent phase with the Nifty 500 Total Return Index, a gauge of the largest 500 stocks by market cap, registering a loss of 3.7 per cent year-to-date. Many stocks and equity mutual funds within your portfolio must be in the red. One way you can use these losses to your advantage is to go for tax-loss harvesting.

Income-tax provisions allow investors to set off their losses and thereby reduce their tax liability. "Tax-loss harvesting involves the sale of investment assets at a loss to offset the capital gains from selling other assets at a profit," says Naveen Wadhwa, deputy general manager, Taxmann.

HOW TO BENEFIT FROM TAX-LOSS HARVESTING

	Capital gains tax	
	With tax harvesting (₹)	Without tax harvesting (₹)
Long-term capital gain on listed shares	15,50,000	15,50,000
Less: Exempt up to ₹1 lakh	-1,00,000	-1,00,000
Less: Long-term capital loss	-5,00,000	-
Long-term capital gain subject to tax	9,50,000	1,450,000
Tax @ 10% under Section 112A**	95,000	1,45,000
Reduction in tax liability due to tax-loss harvesting		₹50,000

**plus applicable surcharge (if any) and cess. Note: We have assumed that a taxpayer has derived long-term capital gains of ₹15.5 lakh from the sale of listed equity shares and has harvested loss from long-term capital assets of ₹5 lakh

Source: RSM India

How it works

Investors who plan to benefit from tax-loss harvesting need to keep a close eye on the stocks and equity funds in their portfolios. "Identify the ones that have been declining consistently. While many investors use this strategy only towards the end of the financial year, you can do so throughout the year," says M Barve, founder, MB Wealth Financial Solutions.

The process begins with the sale of a stock or equity fund that you wish to remove from your portfolio. Once a loss is realised, it can be offset against capital gains (*see table*).

These losses can be set off either against the same income head or others.

"Tax-loss harvesting can be utilised to reduce the tax liability either in the current year or in a specified number of future years," says Suresh Surana, founder, RSM India. Wadhwa adds that losses can be carried forward for up to eight years.

Investors should be mindful of the holding period. Pallav Pradyumn Narang, partner, CNK says, "Long-term capital losses can be set off against long-term capital gains only and not against short-term capital gains. Short-term capital losses can be set off against either short-term capital gains or long-term capital gains."

Improve portfolio quality

One benefit of this strategy is that you can purge your portfolio of the lemons and thereby improve its quality. "The money you get from selling poorly performing investments can be put into better quality ones," says Surana.

Repurchase risk

One risk in following this strategy arises if you sell a high-quality security that you wish to repurchase. Dhawan says, "You should ideally wait for some time before you buy the same investment back. It is possible that while you are waiting the price of the security moves up, thereby negating the benefit of the entire exercise."

How long should you wait?

While all investors should make use of tax-loss harvesting, retail investors should get professional help. "Calculating the numbers can be complicated and even time-consuming," says Surana.

There is some difference of opinion among experts regarding how long one should wait before buying back the same instrument. Wadhwa is of the view that an investor can repurchase the sold shares on the same day or in the following days.

Vishal Dhawan, board member, Association of Registered Investment Advisors (ARIA), on the other hand, believes it is prudent to allow some cooling off period before buying the same or similar asset back.

"If you don't, the tax authorities may disallow the loss on the ground that the only intent of selling was to reduce tax," he says.

In the US, the wash-sale rule requires investors to purchase the same or identical security after a gap of 30 days from the date of the loss-making transaction. No such provision exists in the Income-Tax (I-T) Act.

Wadhwa also sounds a note of caution. "While tax harvesting is legal, it should be done in compliance with the tax regulations," he says.

Do consult your tax advisor on this count.

Beware the cost of churn

Tax-loss harvesting involves churning your portfolio. This will generate transaction costs and an exit load (in the case of mutual funds). These costs may nullify the gains from tax-loss harvesting, unless you do the calculations correctly.

The appropriate loss must be generated. Short-term capital loss can be set off against short- or long-term capital gains while long-term capital losses can only be set off against long-term capital gains. Tax-loss harvesting could prove futile if not done right. Dhawan says, "The purchase and sale date of each individual unit or share will be considered. The FIFO (first in, first out) principle will be followed to decide whether the gain is long- or short-term."

One expert points out that through tax-loss harvesting you are only deferring your tax burden. Sonam Chandwani, managing partner, KS Legal and Associates, says, "There is no assurance that tax-loss harvesting will achieve a specific tax result." Suppose that you sell a security at a loss today and take the benefit of tax-loss harvesting. You then buy the same security back. You will sell it again sometime in the future.

Whether you end up paying tax on it or getting the benefit of further tax-loss harvesting will depend on whether the security is in the green or in the red then. Chandwani, however, concedes that tax-loss harvesting is a good method for deferring tax liability.

Finally, Surana suggests avoiding tax-loss harvesting if your long-term capital gain during a financial year doesn't exceed ₹1 lakh (since you would anyway not pay any tax on gains below ₹1 lakh).