Are Portfolio Management Fees Tax Deductible?

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Taxpayers must be taxed on real taxable incomes, not artificially inflated ones

Many investors, high net-worth individuals in particular, invest in the stock markets or debt markets through portfolio management services (PMS). The objective of investing through a PMS is to take advantage of the expertise of the portfolio manager and get a better rate of return on the portfolio. All portfolio managers charge a flat fee as a percentage of the value of the portfolio (generally at least 1%), while some also charge an incentive fee linked to the rate of return that an investor gets. To illustrate, the incentive fee may be 20% of the profits made by the investor, exceeding an 8% per annum return. For an investor who has invested ₹50 lakh in a PMS, the portfolio management fee (PM fee) would be at least ₹50,000 per annum, a sizeable amount in comparison with the return on the portfolio.

Are such PM fees tax deductible for the investor? The deductibility would depend upon the composition of the portfolio, and the type of income that the portfolio yields. If the income is taxable under the head “income from other sources", any expenditure incurred wholly and exclusively for earning such income would be tax deductible. The exception to this is in the case of income by way of dividends and income from units of mutual funds (MFs), where only interest expenditure is deductible, and that, too, restricted to only 20% of such income.

In the case of a debt portfolio, the income would normally be in the form of interest. Since the PM fees are earned wholly and exclusively for earning such interest, the fees would be deductible. However, if part of the interest is tax-free, only PM fees attributable to the taxable interest income would be tax deductible.

The problem arises in the case of an equity or MF portfolio. In such portfolios, the income would be by way of dividends or income from MFs, short-term capital gains (STCG) and long-term capital gains (LTCG). Till 2019-20, dividends and income from MFs were exempt from tax, as was LTCG till March 2018. All such income is, however, taxable since 2020-21. Therefore, the entire income from such equity or MF portfolio would be taxable.
The problem, however, is that the law now provides that no expenditure other than interest can be claimed as a deduction against dividends or income from MFs. Therefore, PM fees, though directly related to the earning of such income, cannot be deducted for tax purposes from such income.

Can the PM fees be claimed as a deduction against STCG or LTCG? The law provides that in computing STCG/LTCG, deduction can be claimed only for expenses in connection with transfer, cost of acquisition and cost of improvement. Can such PM fees be treated either as part of cost of acquisition or as expenses in connection with transfer?

Quite a few decisions of the Income Tax Appellate Tribunal have held that proportionate PM fees are deductible in computing the capital gains. However, quite a few tribunal decisions have also taken a contrary view, holding that such fees are not deductible in computing the capital gains. The issue of deductibility of such fees from capital gains is, therefore, a highly debatable one, likely to lead to litigation if one were to claim such a deduction.

In all fairness to taxpayers, such PM fees should certainly be allowed a tax deduction, as the investor’s return is really net of PM fees. There is in substance a diversion of so much of the investor’s income to the portfolio manager, as is attributable to the PM fees, even before it is earned by the investor (in fact, even before the money is invested). It is, in a sense, a diversion of income by overriding title from the investor to the portfolio manager. The portfolio manager also pays tax on such income, that too at the full rate of tax.

In the case of mutual funds, what is taxed as the investor’s income is only the amount received after deduction of the MF management fees. Why should a PMS investor suffer, merely because he/she has chosen to take the PMS route rather than the MF route, in order to maximize the return on his/her investments? Besides, an investor who uses the PMS route to invest in debt, instead of equity, can get a deduction for the PM fees paid by him/her. One fails to understand the reasoning for such discrimination against an equity or MF investor, by not allowing him/her a similar deduction.
It is such artificial tax disallowances that cause much heartburn among taxpayers. There is no logic behind disallowing such genuine expenditure, such as PM fees, while computing the investor’s taxable income.

Taxpayers deserve to be taxed on their real taxable incomes, and not on their artificially inflated taxable incomes. It is high time that it is clarified by the government that PM fees are deductible in computing the capital gains, if not allowed as a deduction in computing income from other sources.

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