Tax loss harvesting: Reduce tax liability, improve quality of portfolio

Transaction costs, price fluctuations may nullify the benefits of this exercise

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Every investment cannot be a winner. Fortunately, loss-making investments have a silver lining — tax-loss harvesting.

Investors can sell a part of the stocks, mutual funds, exchange-traded funds, and other securities held in their portfolios at a loss and use this loss to offset tax on the capital gains made on the sale of other securities. Says Adithya Reddy, international tax lawyer: “It is the process of identifying loss-making and profit-making assets and offsetting them against each other.”

Adds Rajarshi Dasgupta, executive director and national head of tax, Aquilaw: “This strategy can reduce taxable income, which is important for taxpayers in the higher tax brackets.”

How it works

Harvesting tax losses begins with selling a stock or equity fund whose price is consistently declining. Upon realising the loss, you offset it against the capital gains you have made. This way tax loss harvesting reduces your capital gains.

If an investor has losses in his portfolio, he can sell shares that have profits and then re-purchase the same shares. Naveen Wadhwa, deputy general manager, Taxmann, says, “However, he should be mindful of the holding period of the shares he sells. If the losses are short-term capital losses, the investor can sell any shares, regardless of the holding period, as short-term capital loss can offset both short- and long-term capital gains.”

If the losses are long-term, the investor must sell shares held for more than 12 months, as selling these would result in long-term capital gains that can offset long-term capital losses.

Wadhwa says, "Alternatively, instead of setting off the losses immediately, the investor can carry forward the losses for up to eight years and offset them against capital gains in future years."

Pros and cons

Besides lowering tax liability, this strategy offers other benefits as well. Pallav Pradyumn Narang, partner, CNK says, "It also provides an opportunity to optimise your portfolio, retaining only the profit-making stocks."

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This strategy, however, involves a cost. Maneet Pal Singh, partner, I.P. Pasricha & Co, says, "You may incur transaction fees on the sale of assets." Price fluctuations within the market can at times render the exercise futile. Ankit Jain, partner, Ved Jain

& Associates says, "If there's a significant delay in repurchasing the stock, one may lose the benefit."

Suppose you sell a share and then repurchase it later. It is possible that in the interim the price of the security has increased, thereby negating the benefit of the exercise. Jain says, "Sometimes it may at best act as a means of deferring tax from one year to the next."

Who should go for it

It works for investors with large realised capital gains. According to Narang, "It can be useful to those looking for liquidity at the end of the year, and those who have a diversified portfolio with significant losses as well as profits in various stocks. They can mitigate the impact of selling specific holdings."

As for who should avoid, Singh says, "Investors in the low or zero tax bracket and those with a limited investment horizon and unwilling to make portfolio adjustments may avoid."

Avoid tax harvesting if long-term capital gains do not exceed Rs 1 lakh. Wadhwa says, "If capital gains are within the limit of Rs 1 lakh, no tax harvesting is needed."

Wait before buying back

There is some difference of opinion among experts regarding how long one should wait before buying back the same instrument. Some say an investor can repurchase the sold shares on the same day or in the following days. Others say it is prudent to allow a cooling-off period before repurchasing the same or similar asset.

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

Shashank Agarwal, advocate, Delhi High Court informs that tax loss cannot be adjusted against any other head of income tax (it must be adjusted against the same head).

Word Box:

Mr ABC's tax-loss harvesting strategy

· Mr. ABC invested in mutual fund X for Rs 10 lakh. Current value is Rs 13 lakh (gain of Rs 3 lakh)

· He invested in stock P and stock Q at Rs 10 lakh each, currently valued at Rs 8 lakh and Rs 14 lakh respectively

· During the year, Mr. ABC sold the mutual fund

· This led to a capital gain of Rs 3 lakh on which he would be liable to pay 10 per cent tax

· To offset these gains, Mr. ABC can sell stock P which has a loss of Rs 2 lakh

· The net gain after this sale would be Rs 1 lakh, which is exempt from taxation

· Mr. ABC can repurchase stock P at the lower price if he wishes to

Source: Ved Jain & Associates