Frequent-churn PMS strategies face tax dilemma as budget hikes capital gains tax

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MUMBAI : Portfolio Management Services (PMS) are navigating new challenges after the Union Budget for 2024-25 increased capital gains tax rates. The budget raised the short-term capital gains (STCG) tax rate to 20% from 15%, impacting PMS investors who face higher taxes if a stock is sold within 12 months of purchase.

This tax hike will significantly affect PMS strategies with high churn rates, where frequent trading doesn't yield post-tax returns that justify the increased activity.

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“Due to the higher tax rate on both short-term and long-term capital gains, portfolio management services (PMS) strategies with frequent buying and selling (high churn rate or portfolio turnover) will be at a disadvantage compared to mutual funds," explained Rohan Samant, principal officer and chief investment officer at Multi-Act PMS.

“To remain competitive on a post-tax basis, PMS strategies will need to generate higher returns (alpha) than mutual funds to offset the additional tax liability from the investor’s perspective," Samant added.

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In contrast, mutual funds offer a more tax-efficient structure. When a fund manager sells a stock, it doesn't immediately trigger a tax event for the investor. Instead, the gains are reflected in the fund's net asset value (NAV), and investors are only taxed on gains when they redeem their holdings. This differs from PMS, where stocks are held in the investor's demat account, leading to a tax impact with each sale.

Under the new rules, the effective STCG tax rate, including the 4% cess, is 20.8%, while the long-term capital gains (LTCG) tax rate, also including the cess, is 13%.

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Portfolio managers acknowledge that tax considerations are always kept in mind due to the structure of PMS.

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“When it comes to investors, they are more concerned about their returns on a post-tax basis. As long as these returns are better than other investment vehicles, they will continue to invest in such PMS strategies. The new rules will increase competition, and we could see consolidation in the PMS industry. The weaker ones will have to eventually move out, and stronger players will get stronger," said Aniruddha Naha, chief investment officer-alternatives at PGIM India Asset Management.

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“The PMS industry has seen several changes over the years. The experienced portfolio managers should be able to navigate under this new tax regime," added R Pallavarajan, founder of PMS Bazaar.