



POWER
POINT

NEERAJ AGARWALA

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mlntmoney@livemint.com

MARGIN TRADING: TAX RULES AND BENEFITS DECODED

Margin trading facility (MTF) is a powerful financial tool, wherein the investor pays an initial margin, a percentage of the transaction value, while the broker extends a loan for the remaining amount to purchase stocks. The broker holds the units as security, and charges interest. The nature of tax treatment also depends on the type of income generated, and is categorized as follows:

Equity or equity-oriented MFs: If the securities purchased on a recognized stock exchange using MTF are sold within 12 months, the profit is treated as short-term capital gains (STCG), and is taxable at 20%. If the securities are held for more than 12 months, the profit qualifies as long-term capital gain (LTCG). If LTCG exceeds ₹1,25,000 in a fiscal year it is taxed at 12.5% without indexation benefits under Section 112A.

Business income: For frequent traders or those treating trading as a business, income from MTF transactions is classified as business income and is taxed at applicable income tax slab.

Debt-oriented funds: Under Section 50AA, gains from debt MFs are classified as short-term, regardless of the holding period, and are taxed according to the individual's income tax slab rate.

Deduction for interests paid on margin funding

A key aspect of MTF is interest paid to the broker on the borrowed amount and depends on whether the income from MTF transactions is categorized as capital gains or business income.

Deduction for capital gains: The deductibility of interest on borrowed capital for capital gains is unresolved. While interest costs on borrowed funds are capped at 20% of dividend income, the Income Tax Act does not allow deducting interest from capital gains. Courts have sometimes allowed taxpayers to include interest expenses in the acquisition cost, reducing taxable gains. However, the I-T department often challenges such orders, dis-

MTF offers potential for higher returns, but demands planning and tax compliance

allowing deductions. Considering rising popularity of MTF, it is anticipated that the I-T department will issue clarifications on treating interest costs associated with such transactions.

Deduction for business income: For traders treating MTF transactions as business activities, interest on margin funding is deductible as a business expense. Section 36(1)(iii) allows the deduction of interest on capital borrowed for business.

Tax on MTF transaction loss: Losses incurred from MTF transactions is classified into capital or business losses based on the nature of the trading activity. Short-term capital loss (STCL) can be set off against STCG and LTCG in a financial year. Long-term capital loss (LTCL) can be set off only against LTCG. Unused STCL and LTCL can be carried forward for eight assessment years, and set off against future capital gains.

Business loss: Business losses from MTF transactions can be set off against income from any other source, except salary, in the same year. Unabsorbed business losses can be carried forward for eight years and set off only against business income.

Compliance and reporting requirements

Maintaining records: Taxpayers should note that expenses, including interest, can be claimed at the time of selling the capital asset. Records of MTF transactions, including interest payments, brokerage charges, and stock details, must be maintained for accurate computation and claiming the applicable deductions.

Filing of tax return: Gains and losses from MTF transactions must be reported under the appropriate income head in the income tax return (ITR) form. ITR-2 is used for reporting capital gains, while ITR-3 is required for business income.

While MTF could increase your purchasing power, it carries the inherent risk of magnifying losses, as any depreciation in the stock value could lead to higher financial liabilities for the investors. Taxability of MTF hinges on the classification of the income generated and the treatment of associated expenses.

While MTF could be a lucrative tool for investors seeking to maximize returns, it requires careful financial planning and compliance with the tax regulations.

Neeraj Agarwala is a partner at Nangia & Co. LLP. Neetu Brahma, a consultant at the firm, contributed to this column.