A SMART TAX PLAN

Dual benefit of tax savings and wealth creation with old tax regime

An investor education and awareness initiative

Invesco Mutual Fund

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Make Friends with Tax

Tax is a short three letter word, but the very mention to it causes anxiety among many taxpayers. To make matters worse, tax terms and phrases could be daunting to understand; only adding to the worries of taxpayers. But, once you understand tax terms and rules, income tax planning is a breeze. At the same time, you should not forget that once you fall under the ambit of income tax, there is no way you can avoid income tax; though there are ways to reduce your tax outgo by committing your money into select financial instruments.

As a taxpayer, it is essential that you know what tax deductions, tax exemptions and rebates mean, as these are ways to reduce your income tax liability. You could take a lesson from the proverb, "If you teach a man to fish, he eats for a lifetime" to learn a few things about income tax related terms that will help you through your life time. In doing so, you may not only learn how to optimise your tax outgo, you may also be able to make income tax savings work with your financial goals. With a new tax regime introduced in the financial year 2020-21; it becomes pertinent to also understand the difference between the old and the new tax regime.

Tax Savings and You

If you were to look up the internet to understand income tax, you will come across several articles. It's also highly likely that you will be intimidated or be put off by what you read. The reason – income tax lingo is not easy to understand for most people. A way around this situation is to understand what a taxpayer needs to know, such as income tax slab rates, tax benefits under the old and the new tax regime and how much in tax you actually need to pay.

For instance, in the old tax regime, there are avenues to save on income tax, which is not the case with the next tax regime. However, the new tax regime has six slab rates instead of three in the old tax regime, which could reduce the tax outgo for many taxpayers. The choice of opting to either of the two tax systems is left to taxpayers' judgement.

In the old tax regime; many tax saving avenues were standardised. For instance, the standard deduction of ₹50,000 is available to all salaried taxpayers from their gross income. Likewise, all individual taxpayers and HUF can claim tax deduction on the interest earned from savings bank accounts under Section 80TTA up to ₹10,000. This limit includes the sum total of all the interest income earned from all the savings accounts that one may have.

Old Vs New Tax Slab

Income Tax rates for individuals for FY 2020-21

Income slabs (₹)	Tax Rate (Old Regime)	Tax Rate (New Regime)
Up to 2.5 lakh	Nil	Nil
2.5-5 lakh	5%	5%
5-7.5 lakh	20%	10%
7.5-10 lakh	20%	15%
10-12.5 lakh	30%	20%
12.5-15 lakh	30%	25%
Above 15 lakh	30%	30%

The above rates are subject to surcharge and cess, as applicable. The new tax regime is spread over six different slab rates, compared to three in case of the old regime.

There is a flexibility to plan the way you wish to reduce your tax liabilities when it comes to using the many tax deduction ways available under the Income Tax Act. But to claim these deductions, you need to save, spend or invest money in the instruments that qualify for a reduction in your gross taxable income.

SECTION 80C MENU
(FY 2019-20)

Fixed return savings-oriented products

- Employee Provident Fund (EPF)
- Public Provident Fund (PPF)
- National Saving Certificate (NSC)
- Sukanya Samriddhi Yojana (SSY)
- 5-year Tax Saving Fixed Deposit
- Senior Citizens Savings Scheme (SCSS)
- Infrastructure Bond

Where can you Save Tax?

While there are many avenues to save income tax liabilities; the most popular avenue among taxpayers is possible savings under Section 80C. The attraction for saving money in the available financial products under Section 80C runs across both the young and old, as much as it does among taxpayers across tax slabs. Under Section 80C, taxpayers can contribute a maximum of ₹1.5 lakh in a financial year to claim tax deductions. The benefit of contributions in financial products that qualify for deductions under this section can be availed by individual taxpayers and Hindu Undivided Family (HUF). There are over a dozen avenues that taxpayers could use (See: Section 80C menu (FY 2019-20) to save tax under Section 80C. The structure of the product ranges from those, in which money could be saved, invested and options where expenses are also treated as tax savings. The attractiveness of Section 80C is such that for those in the lower tax bracket, it is perhaps also the only savings and investments that they make.

Market-linked investment-oriented products

- Equity Linked Saving Scheme (ELSS)
- National Pension System (NPS)
- Unit Linked Insurance Plans (ULIPs)

Miscellaneous

- Life Insurance Premium
- Contribution to pension plan by insurers
- Repayment towards principal of Home Loan
- Children Tuition Fees

Additional Tax Deductions

Other than the Section 80C deductions, there are a few more deductions that one could claim. For instance, investments in the NPS finds additional tax deduction of ₹50,000 under Section 80CCD (1B) for investments made in the Tier 1 of NPS.

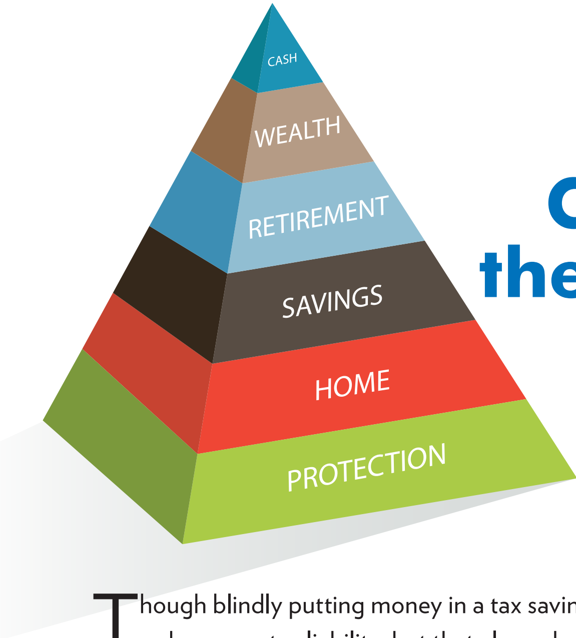
Likewise, one could claim tax deduction on premiums paid towards health insurance under Section 80D. The deduction is up to ₹25,000 in case of a family of two adults and two children, when all of them are under 60 years old; ₹50,00 in case the family includes parents of the primary insured and all six people being under 60 years old. It is ₹75,000 when the primary insured is under 60, but has senior citizens parents and ₹1 lakh, when the primary insured and their parents are all senior citizens.

Moving to New Tax Regime

The choice of which tax regime you wish to follow is left to you. To maintain continuity, certain deductions and exemptions are available under both the tax regimes. For instance, you will continue to enjoy income tax exemption on employer contribution to Employees' Provident Fund (EPF), employer's contribution to NPS (up to 10% of their basic salary and dearness allowance), maturity amount and bonus from life insurance policies, conveyance allowance, etc.

Likewise, there will not be any tax applicable on the amount received on maturity of PPF (Public Provident Fund) or in case of withdrawal by an employee from the EPF after 5 years of continuous service. Withdrawal from the NPS on maturity or premature closure up to 40% of the amount received on such withdrawal remains tax free for all. In case of partial withdrawal from NPS, up to 25% of the contributions made by the individual will be tax free. Employer's contribution to NPS up to 10% of their basic salary and dearness allowance also remains tax free.

Similarly, under Section 10 (10D) of the Income Tax Act, the sum assured, and any bonus paid on maturity or surrender of the life insurance plan is tax free. Maturity proceeds continue to be exempt under Section 10(10D). The maturity amount including interest received on the Sukanya Samriddhi Yojana will not attract any tax. Gratuity received from the employer up to ₹20 lakh after rendering 5 years of continuous service. Redemption proceeds from ELSS, subject to applicable capital gains.



Choosing the Right Tax Saver

Though blindly putting money in a tax saving product under Section 80C will reduce your tax liability, but that alone shouldn't be the approach to adopt. When you look into the hierarchy of financial needs; the base rests on protecting the financial interest of your family, which can be achieved through adequate life insurance. In the same vein, the need for health protection through medical insurance is possible by going for a policy and using the deduction benefits under Section 80D.

To realise one's financial dreams of owning a house, one could use the available tax benefits on a home loan towards repayment of the loan. Likewise taxpayers with children could use the expenses towards children's tuition fee. The next financial need is towards creating a retirement savings corpus. The EPF in case of most salaried taxpayers' works towards retirement savings and so does the NPS.

At the top of the financial needs pyramid sits wealth creation. We all know that wealth creation is possible with equity investments and the one tax saving financial product that allows you to achieve this goal is the equity linked savings scheme (ELSS).

What's ELSS?

The ELSS is an equity mutual fund, in which investments qualify for tax deductions under Section 80C of the income tax up to ₹1.5 lakh in a financial year. Investment in ELSS has a minimum 80% equity exposure that could technically go up to as much as 100%. But unlike other equity mutual fund schemes that are classified based on their market capitalisation or investment style by the regulator, ELSS has no such restrictions.

Basically, fund managers operating an ELSS can invest across market capitalisation and sectors, as defined in the scheme's stated objective. As an investor in ELSS, you could look into the investment style that the fund would follow before investing in them to save tax under Section 80C. Moreover, the ELSS allows you to plan your tax savings from the beginning of the financial year, as you can invest in them anytime through the year.

The ELSS Advantage

Among the many tax savings products under the Section 80C menu, the ELSS is less appreciated than it deserves. Being an equity mutual fund it has the potential for wealth creation in the long run. The high equity exposure may seem risky, but in the long run over different market cycles, the return from ELSS has the potential to beat inflation. This aspect makes it a favoured tax savings choice among the many tax savings products in the Section 80C menu.

The ELSS also has the shortest lock-in of three years, making it the most liquid compared to other options.

Further, there is convenience to start an SIP (systematic investment plan) with ELSS to make tax savings a regular and round the year exercise than rush towards end of the financial year. With ₹12,500 monthly SIP you can plan your tax savings from the beginning of the financial year to exhaust the entire ₹1.5 lakh Section 80C limit. However, in case of an ELSS SIP, each SIP instalment is locked in for a period of 3 years, making each instalment have a different maturity date.

Other than the tax savings advantage, ELSS could also be used for first time equity investment by tax savers. The short lock-in allows taxpayers to observe how SIP investments allocated and how equity investments fare to explore other avenues to invest their monies. The ELSS could be used as a stepping stone to develop a portfolio of equity investments for other financial goals as well.

3 Steps to Invest in ELSS

1 STEP
Be KYC compliant (Know your customer) to invest in mutual funds. Fill up a KYC form, attached with a copy of an address proof, PAN, identity proof and passport size photograph. You could also get an online eKYC.

2 STEP
Look for an ELSS which follows an investment approach which matches your risk profile. Then look for its performance history over different market cycles. Lastly, select a fund that has consistently fared better than its benchmark.

3 STEP
You could invest through an SIP or spread the investments in multiple tranches and not invest the entire ₹1.5 lakh to save taxes is one go.

Having understood the advantages of investing in ELSS, the last step is to select a fund. Selecting an ELSS is no rocket science. It can be done by anyone. Yes, it does require a bit of effort, but the process of investing is straight forward and easy to follow.

Dual Benefit

There is no guaranteed return when investing in ELSS. But, investments in ELSS qualify for tax deduction under Section 80C and have the potential to build wealth over time. Although, the gains from ELSS are taxable as long term capital gains (LTCG) are applicable. In case of ELSS funds LTCG is applicable if the gains exceed ₹1 lakh and the holding period is over a year at 10%.

Why ELSS Scores?

The dual advantage of tax savings cum wealth creation structure of ELSS makes it suitable for all taxpayers. Moreover, it is a good fit for first time equity investors with its mandatory lock-in and tax savings feature providing the encouragement for taxpayers to prefer it over other options. First time equity investors have little to lose when investing in ELSS, as they get multiple benefits – tax savings, equity investment and wealth creation. They could also use their experience of investing in ELSS to consider investments in other types of mutual funds.

☑ **Shortest lock-in:** Among the tax savings options under Section 80C; the three year lock-in of the ELSS is the shortest. On an average most tax saving instruments have a five year lock-in, with many others being much longer like the 15-year maturity in case of the PPF.

☑ **Ease of investment:** You can invest in lump sum or through an SIP. You could invest directly on your own or through an intermediary. You could hold your investments in ELSS beyond the lock-in period too.

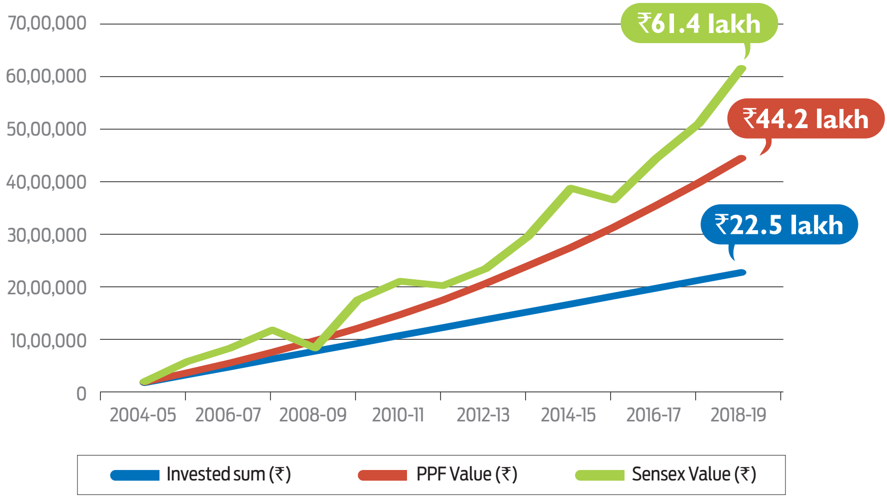
☑ **Transparency:** The value of your investments in ELSS could be tracked each passing day, as long as you hold on to your investments. When you choose to redeem your investments, you can do so online or through an intermediary. The redemption value of your investment is based on the prevailing NAV of the fund and the same is credited to your linked bank account within 3-4 working days.

☑ **Potential for higher returns:** As investments in ELSS are market linked; they have the potential to offer significantly higher returns. For instance, the 3-year ELSS category average returns is about 6.57% currently (as on Dec 9, 2020); with the best performing fund posting 15.88% returns compared to the -7.79% posted by the worst performer (**Source**: Morningstar India). In contrast, the best that an assured return tax saving instrument like the Senior Citizen Savings Scheme (SCSS) currently earns is 7.4% (**Source**: Department of Economic Affairs, Ministry of Finance).

☑ **Tax efficient:** Except the PPF, gains in case of all other tax savings avenues are taxed partially or totally. However, the ELSS offers better post-tax returns, because the long term capital gains of up to ₹1 lakh a year from ELSS mutual funds are exempt from income tax, with gains above this limit being taxed at 10%. If you opt for the dividend option, the dividends would be taxed at applicable slab rates in your hands.

All these traits make ELSS a favourable tax saving option compared to the other available products. The all-round features of ELSS have the necessary traits to find way into every taxpayer's portfolio.

PPF vs ELSS



Source: PPF returns from dailytools.in/PPFCalculator; BSE Sensex data to represent equity returns

Among the guaranteed return products, the PPF has the longest lock-in of 15 years and is also one of the oldest available tax saving products. To evaluate the long-term wealth creation potential of ELSS, we compared it with PPF. We took the past 15-year data to invest ₹1.5 lakh each year on April 1 in PPF as well as the Sensex, to get a flavour of how investment ELSS may fare. The evaluation period is from 2004-5 to 2018-19, with a total ₹22.5 lakh investment; going with the maximum possible annual tax savings investments.

This time period was witness to stock market volatility as well as change in PPF rules where annual interest rates were done away with and quarterly interest rates introduced. Nevertheless, the outcome (See: PPF vs Sensex) favourably points towards investing in ELSS to benefit from tax savings and wealth creation.

ELSS Essentials

₹1 lakh
The threshold up to which there is no tax on long-term capital gains

₹12,500
Monthly SIP to automate tax savings every financial year

3 years
The lowest lock-in period among the many tax savings options under Section 80C

₹500
The minimum sum needed to start investing in an ELSS

₹1.5 lakh
The maximum tax deduction a taxpayer can claim under Section 80C of the Income Tax Act in a financial year

₹46,800
Annual tax savings for taxpayers at the 30% tax slab including 4% cess

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