Money Simplified

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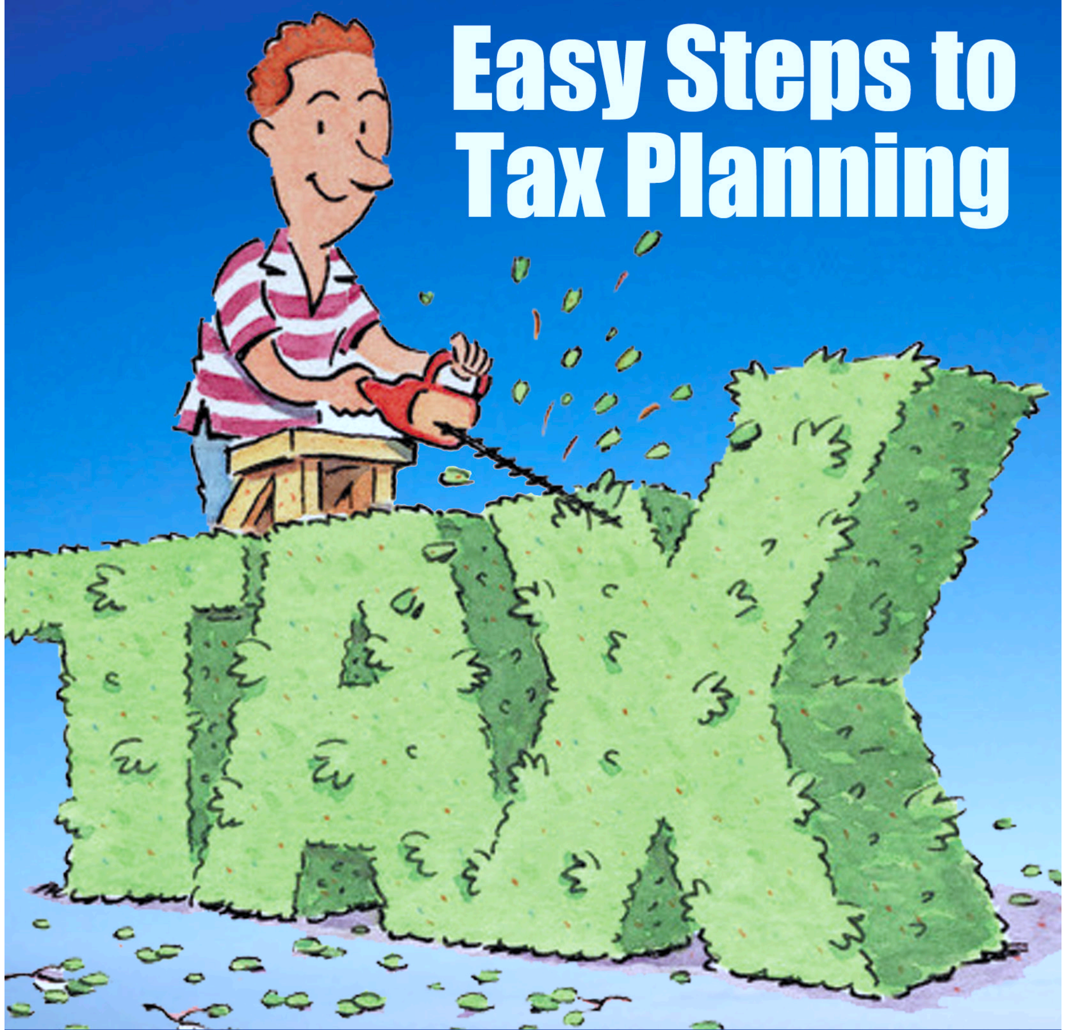
Easy Steps to Tax Planning



Preface

Money Simplified

The 2008 Guide to Tax Planning

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Investing to save tax is something that we all do. And we tend to do it the same way, year after year. After all, this is an 'end-of-the-year' exercise and free time is scarce. Personalfn's experience over the years suggests that in most instances, this practice simply amounts to making the same investment mistakes, year after year.

In our view, tax-planning is a part of financial planning and therefore it is very important to customise solutions to suit one's profile. There is no logic to investing monies in an insurance policy or a tax-saving mutual fund just because your friend did so! When you go about planning, you shouldn't be looking out for the best plan; instead, you need a plan which is best suited for your needs and profile. And to be able to do this, you need to invest time and resources to come up with what we call a smart investment plan.

There are only a few months left before the financial year draws to a close. But there is still ample time to draw up the ideal financial plan for you. In this guide we help you take several steps towards this goal.

In this issue, we discuss the various instruments which can help you save tax and suggest how you should go about selecting the same. Notably, we also discuss the tax liability arising out of capital gains and how one should deal with the same.

We are certain you will benefit from this issue. We encourage you to write in to us with your views and suggestions. It will be great if you can participate in our reader survey too!

Happy investing!

Team Personalfn
30th November 2007

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Ace your tax-planning in 3 easy steps

Much is made about how complicated tax-planning is. The endless investments and contributions that must be made and the complicated calculations that need to be done before you are relieved of tax-planning, all add to the misery. Therefore it's not surprising that most individuals have a very bleak view about the tax-planning process. For these individuals the annual tax-planning exercise is as cumbersome and exasperating as actually paying the tax!

To be sure, tax-planning is not exactly child's play. At the same time, if approached systematically, it can be aced. For this, individuals must a) be methodical and b) proactively initiate the tax-planning process in advance and not at the last moment.

It must be noted that while tax-planning can assume many forms (among others, Section 80C, Section 80D, Section 24(b)) we have considered the more flexible Section 80C because of the breadth of options available under it. For the uninitiated, Section 80C allows for a deduction of upto Rs 100,000 per annum (pa) from the gross total income. This amount (i.e. Rs 100,000) can compromise of select liabilities, investments and contributions.

If you feel your stomach churning already, relax, here is how you can ace your tax-planning in 3 easy steps:

1. Compute your liabilities

The first step for individuals, who have opted for a home loan, is to get a fix on what portion of their home loan EMI (equated monthly installment) can be apportioned under Section 80C. A home loan is the only liability that can avail a tax benefit under Section 80C. For that individuals must isolate the principal component in the home loan EMI from the interest component (this break up is provided to you by the institution/bank which lent you the money). The tax benefit on the repayment of the principal amount is capped at Rs 100,000 under Section 80C. For individuals with a principal repayment of over Rs 100,000, the tax-planning for the entire Section 80C is tied up and they can skip the other two steps. Individuals who are eligible for a tax benefit even after repaying the principal on their home loans, can proceed to the next step.

2. Compute your fixed investments/ contributions

The next logical step is to list down your fixed investments/contributions. These are mainly in the form of premiums/ contributions to be paid on life insurance policies and for the salaried class, the employees' provident fund (EPF). Add up the life insurance premiums and EPF contribution (your employer can help you arrive at this amount) and deduct it from the Rs 100,000 limit under Section 80C. While some individuals may feel tempted to include the PPF (public provident fund) investment over here,

we would recommend that they avoid it mainly because the PPF contribution is not a fixed amount (subject to a minimum of Rs 500 pa to keep the account active) as they can choose to increase/decrease it for a given year. Moreover, the PPF contribution is better tackled in the next step.

3. Invest the balance in suitable avenues

Although this is the last step in the tax-planning process, it is potentially the one that can give the maximum boost to your finances. Once you have calculated all your liabilities (step 1) and fixed investments/contributions (step 2), you must deduct the same from the Rs 100,000 limit under Section 80C. The balance amount, if any, must be invested in avenues that are suitable to your risk profile and in tune with your investment objectives. For instance, if you are the risk-taking kind looking to save for your child's education or marriage for instance, then investing in a tax-saving fund (or equity linked saving scheme - ELSS) is an apt decision. This is because tax-saving funds, although volatile in the short-term (which is what makes them risky), can add considerably to your wealth over the long-term (at least 3-5 years in our view). Investors who do not have the risk appetite for an equity-linked investment can consider investing in a low risk investment like the PPF.

IN A NUTSHELL

- The first step in the tax-planning process is to compute your liabilities.
- Then add up all your fixed investments and contributions.
- Eventually, deduct the amounts under step 1 and step 2 from the Rs 100,000 limit under Section 80C. The balance, if any, must be invested in avenues (like tax-saving funds, PPF) that are best suited to your risk profile.

All about Section 80C

An aversion for taxes ranks as one of the most universal emotions. Similarly, seeking opportunities for tax-planning, ranks as one of the most favourite activities. Simply put, tax-planning entails making investments and contributions that help minimise the tax liability.

However, minimising tax liability is just one aspect of tax-planning. The more important and often-ignored one is wealth creation. Investing in stipulated avenues and making contributions towards specified purposes, offers ample opportunities for creating wealth. In the Indian context, Section 80C is a defining chapter as far as tax-planning for individuals is concerned.

How Section 80C works

Certain investments and contributions have been specified as eligible ones for Section 80C. These investments/ contributions are eligible for deduction from gross total income. And a reduction in gross total income, leads to a reduction in the tax liability. Finally, the deduction limit for Section 80C has been pegged at Rs 100,000 per annum (pa). In other words, investors can make investments/contributions of upto Rs 100,000 every year and reduce their tax liability.

The eligible avenues under Section 80C are:

1. Payment of life insurance premium
2. Contribution to employee provident fund (EPF)
3. Repayment of principal amount on housing loan
4. Payment of tuition fees
5. Investments in Public Provident Fund (PPF)
6. Investments in National Savings Certificate (NSC)
7. Investments in tax-saving fixed deposits
8. Investments in tax-saving mutual funds (ELSS)
9. Investments in Infrastructure Bonds

How to create wealth

Investors are required to conduct tax-planning on an annual basis. Hence, investments/contributions of upto Rs 100,000 can be made annually. This can add up to quite a substantial sum over longer time frames. For example, investments in assured return schemes like PPF and NSC presently offer a return of 8.00% pa. Investments of Rs 100,000 over a 15-Yr period will amount to Rs 2,715,200 on maturity. Conversely, investments in tax-saving mutual funds, which are market-linked avenues (read high risk and no assured returns or safety of capital), are equipped to offer significantly higher returns over longer time frames. Assuming a return of 15.00% pa over a 15-Yr period, investments of Rs 100,000 pa in tax-saving funds will amount to Rs 4,758,000 on maturity.

So is it right to conclude that investors should snub PPF and NSC in favour of

tax-saving funds? Not at all! As with investing in the normal course, while investing for tax-planning not deviating from one's risk appetite is vital. Investors should abide by their risk appetite while conducting the annual tax-planning exercise and invest in appropriate investment avenues.

Beyond investments

Wealth creation doesn't necessarily mean just making investments (like PPF, NSC and tax-saving funds). Even creating an asset can lead to wealth creation. For example, opting for a home loan will eventually lead to creation of an asset i.e. a house property. The principal component in a home loan repayment is also eligible for deduction from Section 80C.

Similarly, payment of life insurance premium is another avenue that qualifies for a Section 80C deduction. Now a life insurance policy serves a purpose far more important than just wealth creation. It provides an opportunity to provide for the insured's dependants in his absence.

What should investors do?

Clearly, Section 80C has a lot to offer to investors. Investors on their part need to make the most of it. To begin with, they need to give the tax-planning exercise its due importance. Enough thought should be put into the exercise and appropriate choices must be made from the various Section 80C avenues.

Put simply, conducting tax-planning in the conventional manner i.e. invest the money in any avenue is flawed. The right approach to tax-planning includes carefully assessing one's needs and objectives and then allocating monies in line with the same.

It would be fair to state that Section 80C has ushered in a new era in tax-planning. The onus to gain from it is on the investors.

IN A NUTSHELL

- Tax-planning helps investors rationalise their tax liability.
- More importantly, tax-planning can aid in wealth creation.
- Investments and contributions of upto Rs 100,000 under Section 80C are eligible for tax benefits.
- Mutual funds offer the opportunity to indirectly invest in equities and fixed income instruments.
- Investors must give the tax-planning exercise due thought and make the most of the opportunities afforded by Section 80C.

Tax-saving avenues: An overview

Particulars	PPF	NSC	ELSS	Infrastructure Bonds	Tax-saving FDs
Tenure (years)	15	6	3***	3***	5
Min. investment (Rs)	500	100	500	5,000	100
Max. investment (Rs)	70,000	100,000	100,000	100,000	100,000
Safety/Rating	Highest	Highest	High Risk	AA/AAA**	Highest
Return - CAGR (%)	8.00	8.00	12.00 - 15.00*	5.50 - 6.00^	8.00 - 8.50
Interest frequency	Compounded annually	Compounded half yearly	No assured dividends/returns	Options available	Options available
Taxation of interest	Tax-free	Taxable	Dividend & capital gains tax free#	Taxable	Taxable

*Maximum investment indicates upper limit for the purpose of claiming tax benefits under Section 80C. ***Indicates lock-in period. *Approximate returns. ELSS is a market-linked investment avenue and returns are not assured.*

***AA/AAA are credit ratings indicating the degree of safety regarding timely payment of interest and principal, with AAA being the highest rating.*

^ Indicative returns.

 # Securities Transaction Tax (STT) of 0.025% is charged on redemption.

When tax-saving funds are a must

At Personalfn, by virtue of the fact that we offer personalised financial planning services, we are exposed to some of the most interesting clients. This interaction with clients continuously feeds us with issues the solution to which can benefit many other investors. In light of this fact, we have, from time to time, chosen to write on some of these issues being faced by our clients, without compromising their privacy. Here's one such case we came across with the learnings from the same.

We met a client recently; we will call him Vivek for the sake of convenience. Vivek, 32-Yr old, married, with a child, had approached Personalfn, with his tax-planning portfolio. That Vivek was an intelligent investor was evident in his thought process and portfolio composition.

Facts of the case

- Vivek was fully invested in the Rs 100,000 limit under Section 80C.
- He contributed Rs 35,000 towards EPF (Employees' Provident Fund).
- His contribution towards life insurance premium (on his term plan) amounted to Rs 5,000.
- He planned to invest the balance (i.e. Rs 60,000) in PPF for his child's college education, which was due15 years hence.

Certain points in this case made it apparent that in Vivek, we were dealing with an intelligent and disciplined investor. This was apparent from his investment and insurance portfolio and the thought process behind the same. Some points that were worth noting:

a) He had taken life insurance already. Significantly, he had opted for a term plan, which is not a very common sight among individuals. Term plans are the cheapest form of life insurance, but investors don't usually opt for it because term plans don't give a return on maturity. For that reason mainly (return on maturity) endowment plans are more popular with insurance-seekers. Our advice to individuals is to opt for a term plan like Vivek did, which is how he managed to get a life cover of Rs 1,500,000 (for a 30-Yr tenure) for just Rs 5,000 per annum (pa).

b) The other point about Vivek's portfolio that impressed us is the meticulous planning involved. Vivek had a well-defined investment objective i.e. planning for child's education. Again this is a rarity; most individuals invest aimlessly without a specific investment objective. Over the long-term this can hurt you, especially if your finances fall short of achieving the objective. Hence it's advisable to have an investment objective in place along with an amount and invest systematically towards achieving it. Vivek got this right part - he was clear that he wanted to save for his child's engineering degree 15 years hence and was investing diligently towards achieving it.

c) Of course, while Vivek's intention (saving for child's education) was noble, there was much scope for improvement on the execution part. Vivek was investing Rs 60,000 every year in PPF to achieve this objective. Our calculations showed that Vivek would not have been able to provide for his child's education given the growth rate of his PPF investment. Let's understand where Vivek was falling short.

One option for Vivek was to increase his investment in PPF so as to achieve the Rs 2.9 m target at the end of 15 years. For that Vivek would have to enhance his PPF investments to Rs 105,917 pa over a 15-Yr tenure. Increasing the PPF investment (from Rs 60,000) by over 76% to Rs 105,917 was not a financially viable option for Vivek; moreover investments in PPF are capped at Rs 70,000 pa.

Planning for child's education

			Case 1 - PPF	Case 2 - Tax-saving Funds
Cost of College Education today*	Input	Rs	1,200,000	1,200,000
Time to College	Input	Yrs	15	15
Expected inflation in fee	Input	%	6.0	6.0
Expected Cost of College Education		**Rs**	**2,875,870**	**2,875,870**
Solution				
Monies to be accumulated...		Rs	2,875,870	2,875,870
Assumed Return (Pre tax)	Input	%	8.0	15.0
Assumed Return (Post tax)	Input	%	8.0	15.0
Tenure		Yrs	15	15
Annual Saving Reqd		**Rs**	**105,917**	**60,442**
Or simply, Monthly investment of		**Rs**	**8,518**	**4,721**
Or a one-time investment of		**Rs**	**906,594**	**353,429**

The initial estimate of Rs 1,200,000 is for an Engineering degree from a ranked institute in India along with lodging expenses.

The table clearly indicates that Vivek's objective of saving for his child's education was in danger of being an unfulfilled dream if he persisted with his existing investments. Our projections indicated that Vivek needed nearly Rs 2.9 m, 15 years hence to finance his child's engineering degree. If Vivek continued investing Rs 60,000 every year in PPF, he would have accumulated Rs 1.8 m by the 15th year, short by over Rs 1 m of the Rs 2.9 target.

We recommended another option to Vivek, which was a lot more practical. We suggested that Vivek consider another investment avenue that not only gave a higher return, but also offered a tax benefit (under Section 80C). The sole investment avenue that met this dual criteria was the tax-saving fund (also referred to as equity linked saving scheme - ELSS). Tax-saving funds by virtue of investing in equity markets are well placed to offer a return that is considerably higher than comparable

fixed income options (within the tax-saving domain) like PPF and NSC (National Saving Certificate).

Investors like Vivek who are saving for the long-term can consider investing in a tax-saving fund as opposed to fixed income options like PPF and NSC. Of course, it is noteworthy over here that Vivek is young and can take risk; for low risk investors, investments like PPF and NSC must continue to dominate the portfolio.

Since Vivek had the requisite risk appetite and was looking for an apt investment that could help him accumulate Rs 2.9 m over a 15-Yr time frame, we recommended that he invest in tax-saving funds rather than PPF.

With tax-saving funds, it is evident how Vivek could achieve his investment objective (of providing child's education) without changing his investment amount and without compromising on the tax benefit. This was possible mainly because the return on PPF (i.e. 8% pa) is far lower than what tax-saving funds are capable of delivering over the long-term (i.e. 15% compounded growth). In our view, Indian stock markets are well positioned to grow at 15% CAGR (compounded annualised growth rate) over the long-term and well-managed tax-saving funds can be expected, to match, if not outperform this growth rate. More importantly from Vivek's perspective, by investing in tax-saving funds, he would not need to increase the investment amount from Rs 60,000. He could continue investing Rs 60,000 annually over 15 years and still accumulate Rs 2.9 m for his child's education.

It is clear from Vivek's case study how equities (in the guise of equity funds) can help investors with the requisite risk appetite not just get a tax benefit on their investments but more importantly, also achieve their investment objectives.

At the end, investors will appreciate what we recommended to Vivek was tailored to meet his investment objectives. Even if it applies accurately to Vivek, it cannot be replicated by other investors in isolation. Every investor will have to independently determine his own facts of the case carefully after taking his financial planner in close confidence. Only then must he embark on his investment/tax-saving plan.

IN A NUTSHELL

- Tax-saving is a good opportunity to achieve your investment objectives and get a tax benefit at the same time.
- While PPF and NSC are suitable for low risk investors looking for a tax benefit, tax-saving funds are an option worth considering for risk-taking investors.
- Tax-saving funds, based on the long-term performance of stock markets, are expected to outperform avenues like PPF and NSC over the long-term.

How to select a tax-saving fund

Selecting the best tax-saving fund (also referred to as equity linked saving scheme - ELSS) is never an easy task. For one, there are just too many funds, which only confuses the investor. Add to this the sometimes misrepresentative mutual fund advertisements that paint a rosier than warranted picture. At the end of the day, often investors end up being invested in the wrong tax-saving fund.

To reverse the effect of the misrepresentative advertisements and help investors take the decision-making in their own hands, we have drawn up a list of 5 parameters that they must consider before investing in a tax-saving fund.

1. Evaluate the fund house

Too often investors are so enamoured by the performance of the tax-saving fund that it's all they consider before investing in it. Among other points, they ignore the fund house and its investment style and philosophy. In our view, this is a serious oversight. Ignoring the fund house can prove to be a costly mistake over the long-term. This is because a tax-saving fund is only as good as the fund house and its investment processes. Fund houses that do not have well-defined investment systems and processes in place can never serve the long-term interests of investors effectively. In the short-term, some factors like a star fund manager may mask the poor quality investment processes, but take away these factors (i.e. when the star fund manager quits) and the fund house stands exposed. We recommend that investors first evaluate the fund house; only when it makes the grade on high quality investment processes and philosophy should investors look at its tax-saving offering.

2. Give restrictive mandates a miss

Building a tax-saving portfolio is a lot different from building a regular, diversified equity fund portfolio. While constructing a diversified equity fund portfolio, there is scope to include a variety of mutual funds - large caps, mid caps, flexi cap/opportunity style funds, growth style funds, value style funds, among others. However, it's a little different while building a tax-saving portfolio, which typically must have no more than 2-3 mutual funds to make it manageable for investors. Since investors usually have a limited corpus for tax-saving (maximum limit of Rs 100,000 per annum), having too many tax-saving funds can be self-defeating considering the time and effort that will go behind monitoring a large portfolio. Therefore it's best to go for 2-3 tax-saving funds that have very broad investment mandates in terms of stocks (large caps, small/mid caps) and investment style (growth and value). That way you will be able to make the most of opportunities across the market.

3. Insist on diversification

Since investing in tax-saving funds is no different from investing in regular diversified equity funds, the same yardsticks apply for selection. An important point to consider while evaluating equity funds is the level of diversification. At Personalfn we like diversified equity funds (including tax-saving funds) to be truly diversified i.e. maintain diversified portfolios. This is particularly important during choppy markets when being over-exposed to a particular stock/sector can prove fatal. Investors should short-list tax-saving funds that have well-diversified stock and sector portfolios. We have noticed that while many funds have well-diversified stock portfolios, they tend to hold concentrated sectoral portfolios. A concentrated sectoral portfolio can reverse all the good work done by a well-diversified stock portfolio; hence the need to diversify across both stocks and sectors. At Personalfn, we maintain that diversified equity funds should aim at investing no more than 40% of assets in the top 10 stocks; this can serve as a benchmark for investors while evaluating the level of diversification in tax-saving funds.

4. Check NAV returns

Another evaluation parameter that is common across regular diversified equity funds and tax-saving funds is performance on the NAV (Net Asset Value) returns. While the NAV return in isolation is incomplete (the risk-adjusted return which is the other factor to be considered is discussed in the next point), it is nonetheless a parameter worth considering. While evaluating the NAV returns consider three points - how the fund has performed vis-à-vis the benchmark index and comparable peers. Also apart from the compounded annualised growth rate (CAGR), it is important to note the fund's performance over the calendar year and over specific market phases like the downturns. Finally, ensure that comparisons are made over longer time frames like at least 3-5 years; this is pertinent given the 3-Yr lock-in that accompanies tax-saving funds.

5. Check risk-return

While performance over NAV returns is important, equally significant is the fund's showing on the risk-return parameters. Simply put, this means that while generating a return is critical it is important to note the 'price' investors have paid for that performance. The price that investors pay (apart from the fund's recurring expenses) is the risk the fund manager has exposed the fund to, in pursuit of NAV returns. The risk is reflected mainly through volatility in the NAV returns (which is measured through the Standard Deviation) and the risk-adjusted return (captured by the Sharpe Ratio). While evaluating the Standard Deviation, look for equity funds with a lower figure (which underlines lower volatility). It's the opposite with the Sharpe Ratio where a higher figure shows that the fund has given a higher return per unit of risk borne. The best tax-saving fund would be the one that has given a high NAV return at lower volatility (Standard Deviation) and higher Sharpe Ratio (risk-adjusted return).

IN A NUTSHELL

- Before investing in a tax-saving fund, ensure it belongs to a fund house that has well-defined investment processes.
- Go for funds that have broad investment mandates that permit them to invest across the market (large caps, small/mid caps) with any investment style (growth, value).
- The tax-saving fund must be well diversified across stocks and sectors.
- Note the NAV returns of the fund vis-à-vis the benchmark index and peers, over longer time frames.
- The best tax-saving fund would be the one that has given a higher NAV return at lower volatility and higher Sharpe Ratio.

Tax-planning for the risk-averse investor

The reason why we encourage investors to take tax-planning seriously is because it not only saves you tax, but it permits you to invest in avenues that are well-suited to your risk profile and investment objectives. So in a simple stroke, you have achieved two important objectives - tax-planning and financial planning.

As you have probably already read in this guide, Section 80C is nothing short of a boon to tax-payers. The Section embraces a variety of investment options ranging from tax-saving funds to life insurance to assured return schemes. The latter is of particular interest to us and forms the subject matter of this note.

If you are risk-averse and wish to evaluate the most suitable tax-saving options, there is plenty to choose from. In this note, we profile three investment avenues from the assured return schemes segment that you can consider adding to your tax-planning portfolio.

1. Public Provident Fund (PPF)

Investments in PPF are of a recurring nature and run over a 15-Yr period. Investors are required to make annual contributions to keep their PPF accounts active. The minimum and maximum investment amounts are Rs 500 and Rs 70,000 per annum (pa) respectively. Only contributions upto Rs 70,000 pa are eligible for a tax benefit. Any amount invested over the aforementioned sum is returned without interest. At present, investments in PPF earn a return of 8.0% pa, compounded yearly. It should be noted that investments in PPF offer an assured return, but the rate of return is subject to change. Hence you could find your investments earning a lower or higher return, depending on how the interest rates are revised.

Liquidity

PPF scores poorly on the liquidity front. Withdrawals are permitted only from the seventh financial year. Also, the amount that can be withdrawn is a factor of the balance in the PPF account in the earlier years.

Tax implication

Apart from Section 80C tax benefits at the time of investing, interest income from PPF is exempt from tax under Section 10(11) of the Income Tax Act.

Who should invest

With a 15-Yr investment horizon and the stipulation for making annual contributions, PPF can become an ideal avenue to build a corpus to meet your long-term needs like retirement or children's education.

2. National Savings Certificate (NSC)

NSC offers the opportunity to make lump sum investments for a 6-Yr period. The minimum investment amount is Rs 100, while there is no upper limit. Presently, investments in NSC earn a taxable return of 8.0% per annum, compounded on a half-yearly basis. Hence Rs 100 invested in NSC will grow to Rs 160.1 on maturity. The rate of return is locked in at the time of investment. Hence investments are insulated from any subsequent change in rates.

Liquidity

NSC scores poorly on the liquidity front. The interest income is received on maturity. Furthermore, premature withdrawals are only permitted under specific circumstances like death of the holder(s), forfeiture by the pledgee or under court's order.

Tax implication

Interest income on NSC is chargeable to tax. However, the interest accruing annually is also deemed to be reinvested, hence it qualifies for deduction under Section 80C.

Who should invest

Given that the rate of return is locked-in and that the investments run over a 6-Yr time frame, NSC can be used to gainfully invest one-time surpluses and to provide for needs that will arise over a corresponding timeframe.

Assured Return Schemes

	PPF	NSC	Tax-saving FDs
Coupon rate (pa)	8.00%	8.00%	8.00%
Interest frequency	Compounded annually	Compounded half-yearly	Compounded quarterly
Effective rate (pa)	8.00%	8.16%	8.24%
Interest receipt	On maturity	On maturity	Options available
Tax benefit on investment	Deduction under Section 80C	Deduction under Section 80C	Deduction under Section 80C
Tax benefit on interest earned	Exempt under Section 10	Eligible for deduction U/S 80C	Nil
Tax rates		**Post-tax returns***	
Nil	8.00%	8.16%	8.24%
10%	8.00%	7.32%	7.39%
20%	8.00%	6.48%	6.54%
30%	8.00%	5.64%	5.69%

**Education cess charged at 3.00% has been considered while computing post-tax returns.*
pa: per annum

3. Tax-saving fixed deposits

Tax-saving fixed deposits are conventional fixed deposits offered by banks; however investments therein (upto Rs 100,000 pa) are eligible for tax benefits under Section 80C. These fixed deposits have a locked-in investment tenure of 5 years and the minimum investment amount is generally Rs 100. At present, most banks offer a taxable rate of return in the range of 8.0%-8.5% pa. A higher rate of return (additional 0.5%) is offered on investments made by senior citizens.

Liquidity

Premature withdrawals are not permitted. However, investors can choose the regular interest payout options (subject to the same being offered by the bank) for liquidity.

Tax implication

Interest income from tax-saving fixed deposits is chargeable to tax. Also unlike PPF and NSC, the same is subject to TDS (tax deduction at source).

Who should invest

Investments in tax-saving deposits have a locked-in return and a pre-determined investment horizon. You can align your investments with your future needs.

As can be seen, the assured return segment has a wide range of investment avenues to offer. The onus for making the right choice and getting invested in an apt instrument lies with you.

IN A NUTSHELL

- There is no shortage of tax-saving options for the risk-averse investor.
- PPF is ideal for regular investments.
- NSC is apt for lump sum investments.
- Tax-saving fixed deposits are ideal for investors looking at a shorter investment horizon vis-à-vis NSC and PPF.

Life insurance: Get it right!

The conventional method of buying life insurance entails approaching the local insurance agent towards the end of the financial year for a recommendation about the best insurance plan. The agent usually suggests an endowment plan from the Life Insurance Corporation of India (LIC) . The next step is to determine the amount of the insurance cover based on the premium you can afford to pay. The final step is to complete the paper work and you are done.

As we said earlier, this is the conventional method. However, it isn't necessarily the best way of buying life insurance. Let's find out why this method need not be ideal for everyone.

1. Towards the end of the financial year

Unlike discount sales on consumer goods, buying life insurance is not an 'end of the financial year' activity. This only points to how tax-planning is being accorded priority and is dictating terms while buying insurance. Insurance should find place in your portfolio irrespective of the tax sops; life insurance premiums paid are eligible for deduction under Section 80C. In fact, the decision to buy insurance should be based on your needs; the tax benefits are only incidental. Waiting for the end of the financial year (read tax-planning season) and then making a hasty decision is not a good idea. Buy insurance when the real 'need' arises and not simply because it's tax-planning season.

2. Endowment plan offering returns

For far too long, insurance has been equated with investments and clocking returns has been seen as an important factor. The key goal of life insurance is to provide for your dependants in your absence. And the insurance product which does that best should be chosen. Term plans, which offer insurance in its cheapest form, are often given the thumbs down simply because they don't offer any returns if the policy holder survives the policy term. Conversely, endowment plans are preferred simply because they offer returns in both scenarios i.e. whether or not the policy holder survives the tenure. Both term plans and endowment plans have been dealt with in detail, later in the article. In our view, you must ignore factors like returns while evaluating your options; instead let your needs determine which insurance product should find a place in your portfolio.

3. LIC is the best option

At one point in time when there were no options, LIC was the default choice for buying life insurance. The present scenario is radically different. Now you have a number of insurance companies offering a vast number of options to choose from. On your part, you need to do some homework and gather information about various insurance plans and then make an informed choice. We aren't suggesting that there is anything wrong with buying insurance from LIC. All we are saying is that now that you have the benefit of multiple options, you must carefully evaluate all the insurance plans on offer and then make a choice.

4. Determine the insurance cover based on the premium

This is another common mistake committed while buying insurance. Don't let your ability to pay premiums determine your insurance cover. On the contrary, the insurance cover should be determined independently regardless of how much premium you can afford to pay. For this use the Human Life Value concept (simply put, your worth in monetary terms) to determine how much insurance cover you need. Then select an insurance policy that can provide you the same. You will probably realise that term plans are best equipped to help you attain the desired insurance cover in a cost-effective manner.

Clearly, by now you would have realised that there is much more to life insurance than just tax benefits under Section 80C. Also that looking at insurance from the perspective of tax benefits could mean that you end up with an unsuitable insurance policy.

Having understood how you should go about buying life insurance, now let's take a look at the various life insurance products that you can choose from.

1. Term Plans

Term plans are very straightforward i.e. they only provide an insurance cover. In other words, if the policy holder survives the policy term (i.e. the period for which the policy offers him insurance cover), then he gets nothing i.e. there is no maturity benefit. Conversely, if he meets with an eventuality (read passes away) during the policy term, then his dependants get the sum assured (this is the same as insurance cover). To better understand term plans, consider the premiums paid for medical insurance or vehicle insurance. The premiums are paid out regularly with the explicit intention of being compensated only in the event of any loss (to health or vehicle). But if there is no loss to health/vehicle in a particular year i.e. if no claims are made, then no compensation is offered. However, you must keep on paying the annual premium because you don't know when your health/vehicle will deteriorate. Similarly term plans offer compensation only if the eventuality occurs during the policy term, not otherwise.

Term plans differ from medical/vehicle insurance in one aspect. While medical/vehicle insurance are annual contracts and must be renewed every year, the tenure of a term plan contract tends to be much longer (the number of years vary depending on the life insurance company). Also, unlike medical/vehicle insurance, the premium for a term plan stays unchanged throughout the policy term.

2. Endowment Plans

If you have understood how term plans work, then understanding how endowment plans work isn't very difficult. Endowment plans differ from term plans in one critical aspect i.e. the maturity benefit. As mentioned earlier, term plans don't pay the policy holder the sum assured if he survives the policy term. On the other hand, endowment plans pay out the sum assured under both scenarios - death and survival.

Although instinctively, endowment plans appear to be the better choice because of the maturity benefits, there are certain points you need to keep in mind. Endowment plans do pay out the sum assured (along with profits, if any), but this comes at a cost. Since endowment plans have to pay out the maturity benefit, regardless of whether you survive the policy term or not, the insurance company builds this into the cost of the insurance plan i.e. the premium. So a part of the endowment plan premium is apportioned towards this. What the insurance company provides you (either on death or after the policy term) is not just the sum assured, it also provides you a return/ profit on the sum assured. It does this by investing the premiums in assets (stocks and debt) and paying out the return to you on death/maturity.

As mentioned, this comes at a cost. The cost is deducted from the premium. So everything else being the same, for the same sum assured, the premium on your endowment plan will be significantly higher than the premium on your term plan.

3. Unit Linked Insurance Plans (ULIPs)
ULIPs are variants of endowment plans and perhaps rank as the most popular and misunderstood insurance products. ULIPs invest in stock/debt markets (you have the option to choose the allocation). Since equity/debt markets fluctuate on a daily basis, the performance of the ULIP gets linked to the markets. The value is captured by the NAV (net asset value) of the ULIP. If you find that ULIPs are similar to mutual funds, then you are right, at least to the extent that both are market-linked.

ULIPs have been victims of much mis-selling largely on two counts. First, there is often lack of clarity in terms of the proposition they offer. Although the name suggests that they are insurance plans, they are essentially investment plans that offer life insurance. Hence, they are a combination of investment and insurance in that order.

The second reason for mis-selling is rooted in the expense structure of ULIPs. Most ULIPs have a complicated expense structure, which is rarely understood by individuals. Even the insurance regulator i.e. Insurance Regulatory and Development Authority (IRDA) has ticked off several insurance companies for having ULIPs with complex expense structures. Having said that, the expense structure of some ULIPs can make their expenses comparable to mutual funds over the long-term.

While ULIPs can add value to the portfolio, in our view it would be a

mistake to opt for ULIPs as a frontline life insurance policy. That role should be reserved for a term plan. Term plans work out the cheapest and it is something that everyone must consider taking, especially at a younger age. A ULIP can play the role of enhancing the investment portfolio and bridging the shortfall (if any), in the life cover.

In conclusion, ensure that you have the right perspective while buying insurance. Carefully evaluate your needs and then select an insurance policy that can help you fulfill those needs.

IN A NUTSHELL

- There is more to life insurance than just tax benefits under Section 80C.
- Insurance must be bought for the right reason i.e. to provide for your dependents in your absence.
- Extraneous factors like returns shouldn't play a part in the decision.
- Given the wide range of options to choose from, due homework must be done before buying insurance.
- Term plans offer insurance in its purest form and are cost-efficient as well.
- Endowment plans offer both returns and a life cover, but at a higher premium.
- ULIPs are variants of endowment plans and rank as the most popular and misunderstood products.

Should you invest in Capital Gains Bonds?

Capital gains bonds provide individuals an opportunity to save tax on long-term capital gains arising from the sale proceeds of a capital asset. Capital gains normally arise whenever a capital asset like a house property is sold at a profit. If the gains are made from let's say a house property, which was held for more than 36 months, then it qualifies as a long-term capital gain; if the property was held for less than 36 months, then it qualifies as a short-term capital gain. The capital gains arising out of such sale proceeds attract a tax liability.

When an individual makes long-term capital gains from the sale proceeds of an asset, he will typically have three options.

1. Invest the capital gains in instruments (like capital gains bonds), which help avoid tax liability
2. Pay up the capital gains tax
3. Invest the capital gains in a house property

Instinctively, it's the first option, which finds favour with most. From their perspective, it might not be a wrong decision. After all, it provides them an opportunity to save tax by investing and the investment in turn clocks a return. However, as far as financial prudence is concerned, this may not work out in the best interest of all individuals. Surprised? Let's probe further into this topic.

The most common mistake that individuals make is to consider tax-planning as a one-off year-end activity. This eventually leads to making investments at the last moment when there is no scope left to judge the suitability of the investment avenue. To be sure, investing for the purpose of tax-planning is like any other investment activity where one needs to carefully evaluate the suitability of the investment avenue and its prospective returns, among other factors, before making an investment decision. Therefore, the decision to pay tax or avoid it by investing in capital gains bonds should be made within the purview of financial prudence.

Table1

Cost of purchase	Rs	1,500,000
Date of purchase	-	5-Oct-95
Sale proceeds	Rs	4,000,000
Date of sale	-	5-Oct-07
Cost inflation index for the year of purchase	-	281
Cost inflation index for the year of sale	-	551
Sale proceeds	Rs	4,000,000
Less: Indexed cost of purchase	Rs	2,941,281
Long-term capital gains chargeable to tax	Rs	1,058,719
Long-term capital gains tax @ 22.66%	**Rs**	**239,906**

Capital gains tax charged at 20.00%, plus surcharge (10.00%) and education cess (3.00%).

But, before venturing into the topic of whether individuals will be better-off paying long-term capital gains tax or saving it by investing in capital gains bonds, let us first understand how capital gains and the tax liability thereon are computed with the help of an illustration (see Table 1).

In our example, a property purchased for Rs 1,500,000, is sold at Rs 4,000,000 after 12 years. After adjusting for inflation, the transaction yields a capital gain of Rs 1,058,719. With a tax rate of 22.66% (including surcharge and education cess), the tax liability will amount to Rs 239,906.

Broadly speaking, there are 3 ways of dealing with the tax liability.

1) Invest capital gains in capital gains bonds

This is the most convenient way of saving capital gains tax. Investments in capital gains bonds offer tax benefits under Section 54EC of the Income Tax Act; if the capital gains (Rs 1,058,719 in this case) are invested in stipulated bonds within 6 months of sale of asset, then individuals are exempt from the long-term capital gains tax liability. These bonds are issued by - Rural Electrification Corporation Limited (REC) and National Highway Authority of India (NHAI).

Capital gains bonds have a lock-in period of 3 years. While the minimum investment that an individual is required to make in these bonds is 1 bond (which costs Rs 10,000); the maximum amount that can be invested in these bonds is Rs 5 m (i.e. 500 bonds) per annum (pa). In other words, individuals have an opportunity to save tax on capital gains of upto Rs 5 m pa. If the capital gains are in excess of Rs 5 m, then they are required to pay capital gains tax on the excess amount. The interest earnings from capital gains bonds are taxed at the applicable tax rate.

With an illustration, let us find out how the investment in capital gains bonds for the case above will work out.

Table 2

Amount invested in capital gains bonds	Rs	1,058,719
Assumed return (pre-tax)	%	5.50
Tax rate	%	33.99
Return (post-tax)	%	3.63
Investment tenure	Yrs	3
Maturity proceeds	**Rs**	**1,174,031**

In the calculation we have assumed that the capital gains bonds offer a return of 5.50% pa. It should be noted that this rate is in line with the present issue of capital gain bonds from REC. As required, the entire capital gains have been invested in the bonds. Also it has been assumed that the individual falls in the highest tax bracket, so the interest earnings will be taxed at 33.99% (30.00% tax rate plus 10.00% surcharge and 3.00% education cess).

As evident from Table 2, if an individual invests Rs 1,058,719 in capital gains bonds, after 3 years (after accounting for the tax liability on the interest earnings), his investment will mature to Rs 1,174,031.

To whom this option will appeal - Individuals with a low risk appetite and those who do not want to pay the capital gains tax; in effect, they should be willing to invest in a low-risk, low-yielding investment avenue.

2) Pay tax and invest the remaining amount in other avenues

This option involves giving capital gains bonds a miss in favour of other, more lucrative, investment avenues. The investment avenues under consideration here are equity-oriented funds like diversified equity funds, for instance. Here, an individual pays capital gains tax and invests the remaining amount in these funds.

Of course, the pre-requisite for investing in these funds is that individual should qualify as a risk-taking investor. These funds, being market-linked investments, offer a high risk-high return investment proposition. Hence investing in them amounts to taking on some risk.

Although, it is difficult to comment with certainty on how much return stock markets (and therefore diversified equity funds) would deliver over the next 3 years; in our view, the broad market should return 15.00% CAGR (compounded annualised growth rate) over a 3-Yr time frame. However, individuals must expect volatility along the way and hence these returns may vary depending on the market conditions. The maturity proceeds that an individual will earn in this case are Rs 1,245,313 (see Table 3).

Table 3

Long-term capital gains	Rs	1,058,719
Less: Long-term capital gains tax paid @22.66%	Rs	239,906
Net amount invested	Rs	818,813
3-Yr returns*	%	15.00
Tenure	Yrs	3
Maturity proceeds	**Rs**	**1,245,313**

**Returns are compounded annualised*

To whom this option will appeal - Those individuals who wish for something more than just saving capital gains tax, even if it amounts to taking a higher degree of risk.

3. Invest the capital gains in a house property

Another option available to individuals (under Sections 54 and 54F) is to invest the capital gains in a residential property. It does not matter whether the property is acquired or constructed so long as the transaction adheres to the tax laws. This property must then be retained for

a minimum 3-Yr period to preserve the tax benefits claimed. If the individual were to sell the property before that, he will be required to pay the capital gains tax on the earlier property, (in addition to capital gains tax made on the second one, if any).

What should individuals do?

The decision to opt for the capital gains bonds route or to pay the tax liability and take a more risky route of investing in diversified equity funds should ideally depend on the individual's risk profile. If a low risk avenue that offers an assured return (even if it is unattractive), is what suits an individual then there is no need to look beyond capital gains bonds. However, if the individual is one who does not want to compromise on returns even if it amounts to taking on higher risk, then financial prudence demands to go the mutual funds way.

IN A NUTSHELL

- Capital gains bonds provide individuals an opportunity to save long-term capital gains tax arising from the sale proceeds of a capital asset.
- When an individual makes long-term capital gains, he has two major options - either pay up the capital gains tax or invest the gains in capital gains bonds and avoid tax liability.
- The decision to pay tax or avoid it should be taken based on the individual's risk profile and needs.

How medical insurance helps

This guide has largely focussed on avenues that provide tax benefits under Section 80C of the Income Tax Act. Medical insurance is one avenue that merits inclusion in the insurance portfolio. Also it offers tax benefits under Section 80D i.e. benefits can be availed over and above the Rs 100,000 benefit under Section 80C.

What is medical insurance?
Medical insurance helps cover the hospitalisation expenses incurred for illnesses/diseases suffered or accidental injuries sustained during the policy period. In other words, the insurance company undertakes to compensate the policy holder for hospitalisation expenses that he incurs during the policy period, subject to the insurance cover and the terms and conditions of the policy.

To avail of the insurance cover, the policy holder is required to pay a premium. The premium amount depends on factors like the policy holder's age and health. The premium amount rises in line with an increase in the insured's age, among other factors. In case of an existing policy, wherein a claim has not been made, the insurance company compensates the policy holder by offering a higher insurance cover (at the same premium) or by lowering the premium (for the same insurance cover) during subsequent years.

Tax benefits
Premium paid on medical insurance is eligible for deduction from gross total income under Section 80D of the Income Tax Act. At present, the eligible amount is Rs15,000 per annum (pa). In case of senior citizens, the limit is enhanced to Rs 20,000 pa. The premium payment has to be made by cheque, to keep in force or effect the medical insurance.

Additional benefits
Most insurance companies provide the facility of cashless hospitalisation by tying up with third party administrators (TPAs). In other words, policy holders can avail of medical treatment without incurring any expenses; of course, they are required to undergo hospitalisation in a hospital with which the insurance company has a tie-up. Alternatively, policy holders are required to undergo medical treatment at their expense and subsequently file a claim with the insurance company.

Also, insurance companies are known to offer discounts (on premiums), when members of a family opt for medical insurance collectively vis-à-vis applying in their individual capacities. Generally, most policies cover upto 30 days of pre-hospitalisation and upto 60 days of post-hospitalisation expenses; however an additional cost might have to be borne for the same, depending on the insurance company.

Starting early
It helps to buy a medical insurance policy at an early age, when the insurance seeker is not suffering from any ailment. This is important because as one ages, there is a likelihood of developing ailments. Existing ailments are not covered at the time of opting for medical insurance. Hence it would be prudent to opt for the insurance cover at an early age and thereby widen the scope of the insurance cover. Furthermore, taking a policy earlier can also save the trouble of undergoing a medical check up.

Another (rather disturbing) factor is that insurance companies have increasingly started giving a cold shoulder to individuals who apply for medical insurance at an advanced stage. This is ironic given that most individuals need hospitalisation/medical treatment at that age.

Checklist for buying medical insurance:
We present a checklist that will help insurance seekers make informed decisions while buying medical insurance.

- Check for the ailments/diseases that are excluded

- Check whether expenses arising for treatment due to war, riots or a terrorist attack are covered

- Check the ailments that will not be covered in the initial years of the policy

- Check if cashless hospitalisation is included and also the number of hospitals where this facility can be availed

- Enquire about the compensation provided in case of partial or total disability

- Ensure a complete understanding of the benefits accrued, in the event of no claims being raised

Beyond medical insurance
There is a need to understand that even medical insurance has its limitations. For example, the upper limit for medical insurance cover is pegged at Rs 500,000. Also, medical insurance cover is available only upto a certain age (for most insurance companies, the age limit is set at 65 years). Hence it makes imminent sense to have a medical corpus, over and above the medical insurance policy.

In conclusion, medical insurance has an important role to play in the insurance portfolio and opting for it at the earliest is very important. Nonetheless, having a separate medical corpus is also important.

IN A NUTSHELL

- Medical insurance helps cover the hospitalisation expenses incurred for illnesses/diseases.
- Tax benefits are available under Section 80D of the Income Tax Act.
- Some insurance companies provide the facility for cashless hospitalisation.
- Buying medical insurance at an early age widens the scope of the insurance cover.
- Medical insurance has its limitations in the form of an upper limit on the insurance cover and the age of the policy holder.
- It is pertinent to have a separate medical corpus apart from the medical insurance policy.