

Should you invest in tax-free bonds? Find out

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Note that it is important to start investing as early as possible so you can benefit from the power of compounding.

One of my friends, who had already decided to invest his retirement savings in such a way so that he does not have to pay any tax after his retirement and wanted to invest in tax-free bonds, had called me to know about the tax-free bonds available in the market. I discussed the matter threadbare with him to understand why he was adamant to invest his retirement funds in tax-free bonds so that he does not have to pay any tax.

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What are tax-free bonds and how are these priced

Subject to a few, all the interest income received by you whether from banks or bonds of various companies are taxable in your hands.

However, interest received on certain bonds issued by Government enterprises and as notified under Section 10 is tax-free. These bonds were issued a few years back to help government enterprises to raise funds but nowadays such bonds are not issued. So, your only option to own such bonds is to buy them from the open market. The bonds have an issue price which is generally their face value. The bondholder gets interest on bonds at the rate specified at the time of issue of bonds. This rate is called coupon rate and generally remains the same during its tenure.

The interest rates keep on changing depending on various factors. The bonds though are issued at face value but once these are issued, are not traded at face value. These bonds are either traded at a discount or at a premium, depending on whether the market interest rate is lower or higher than the coupon rate of such bonds. In case of tax-free bonds, the interest is tax-free and therefore such bonds are priced higher than the taxable bonds. So, the yield on such bonds is lower than other products like fixed deposits or other bonds having the same level of safety.

Who should invest in RBI bonds and who should invest in tax-free bonds

Just because interest on such bonds is tax-free in your hands, it does not mean that you should buy them blindly. These bonds are for a very long period and are not so frequently traded and, therefore, are not as liquid as other investments. So, in case you need money urgently, you may have to sell them at a price lower than what you should get in normal circumstances.

The present yield on AAA-rated bonds of government enterprises is around 4.90%-5%. Against these tax-free bonds individual investors have an alternative option to invest in equally-secured product i.e. [RBI Floating Rate Savings bonds](#). The RBI bonds presently offer you interest rate of 7.15% which is floating and is fixed every six months and is benchmarked against interest rate payable on National Saving Certificates. So as and when the interest rate cycle reverses, the interest payable on such RBI bonds will also go up.

the interest on these bonds is taxed at the slab rates, post tax, net interest in the hands of individuals is tabulated for persons in different tax slabs. Though the basic exemption limit still remains Rs 2.50 lakh, but due to rebate available under Section 87A all the taxpayers with taxable income below Rs 5 lakh do not have to pay any tax. Hence people in the income group up to Rs 5 lakh have been clubbed under the zero tax rate group.

| Income Range Rs. | Effective tax rate | Post tax returns of 7.15% RBI bonds |
|----------------------|--------------------|-------------------------------------|
| 2 to 5 lakhs | 0% | 7.15% |
| 5 lakhs to 10 lakhs | 20.80% | 5.66% |
| 10 lakhs to 50 lakhs | 31.20% | 4.92% |
| 50 lakhs to 1 Crore | 34.32% | 4.70% |
| 1 Crore to 2 Crore | 35.88% | 4.58% |
| 2 Crores to 5 Crores | 39.00% | 4.36% |
| Over 5 Crore | 42.74% | 4.09% |

From the above table it becomes apparent that the post-tax return on the RBI bonds is lower as compared to the yield on tax-free bonds for persons with income higher than Rs 10 lakh. So, for those with taxable income up to Rs 10 lakh, it does not make sense to invest in tax-free bonds. Even if we take into account the brokerage charges payable on purchase of these bonds, I feel even the cut off limit for investments will go higher to those with income over Rs 50 lakh. The interest rate offered by RBI bonds is externally linked to NSC. It is perceived that the interest rates have reached their bottom except for the maximum one or two small rate cuts. So, the interest rate cycle will reverse sooner than later. Once the interest rate cycles reverses, the coupon rate on these bonds will go up and post tax yield will also go up. So in case you wish to invest your money for seven years, and your income does not exceed Rs 50 lakh, it makes sense for you to put your money in RBI bonds than going for tax-free bonds just to have no tax liability, taking into account the indicative yields and the probability of interest rates going up in the near future.

After the detailed discussion, my friend was convinced and threw away the idea of investing his retirement savings in tax-free bonds as his income post retirement was not going to exceed the threshold of Rs 50 lakh.

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