VARIOUS INVESTMENT AND INCOME TAX SAVING OPTIONS

Mutual Funds

A Mutual Fund is a professionally managed type of collective investment scheme that pools money from many investors and invests in stock, bonds, short term money market instruments and other securities. Mutual funds have a fund manager who invest the money on behalf of the investors by buying / selling stocks, bonds etc.

Mutual fund in India follow a 3 tire structure. The sponsor who thinks of starting a mutual fund is the first tier. The sponsor creates a public trust as per the Indian Trust Act, 1882 and the Trust is the second tier. The Asset Management Company (AMC) which manages the investors' money is the third tier.

New Fund Offer(NFO) : Once the three tire structure is in place the AMC manages new schemes under the name of the trust after getting approval from the Trustees and Securities and Exchange Board of India(SEBI). The launch of a new scheme is known as New Fund Offer(NFO).

Equity Funds: Equity funds are those funds which invest at least 65% of their corpus in Indian equity. Equity Funds can either be open ended or closed ended. An Open Ended Scheme allows the investors entry and exit any time. Whereas the closed ended scheme restricts the freedom of entry and exit.

Long Term Capital & Short Term Capital Asset: An equity mutual fund scheme held by the investor for more than 12 months is long term capital asset and held for not more than 12 months is short term capital asset.

Long Term & Short Term Capital Gains : Capital gains means any profit or gains received on sale/transfer of a capital asset. Capital gain on sale/transfer of a long term equity mutual fund (held for more than 12 months) is exempt from income tax. Investors in all other schemes have to pay capital gains tax either short or long term. At the time of exiting the investor will have to bear security transactions tax @ 0.25% of the value of selling price.

Capital gains on sale / transfer of short term equity scheme is taxable at the marginal rate i.e. the capital gains are added to their income and the total income is taxed as per their applicable tax slab. Long term capital gains made by the investor in non-equity schemes, Tax is to be paid @ 10% or 20% depending on whether investors opt for indexation benefit or not.

Equity Linked Saving Scheme (ELSS) : These are Open Ended Schemes but have a lock in period of 3 years. This scheme serves the purpose of equity investment as well as Tax Planning.

They may be low on safety but score full points on all other parameters. Here returns are high, income is tax free, investor is free to alter the time and amount of investment, the lock-in period of three years is the shortest among all tax-saving investments (like PPF where the Lock-in is for 7 years, Tax-Saving Bank FDs- 5 years, etc.) and the cost is only 2-2.5% a year. Liquidity is higher if opted the 'Dividend' option and the cost gets lower if one go for the direct plans of these funds.

ELSS is a MF Scheme which invests at least 65% of its corpus in Equity. An individual investor can invest (with min. Locking period of 3 years) upto Rs.1.5 L each year via the ELSS route to avail Tax benefits u/Section-80CC of IT Act. According to Value Research Data, while funds from several other MF categories have given higher returns than the ELSS over a 5 year period, they carry higher risks.

Systematic Withdrawal Plan (SWP) is the facility by which an investor can withdraw a pre-determined amount from his existing investments in mutual funds at a pre-decided interval (weekly, monthly, quarterly, semi-annually or annually). Functionally, Systematic Withdrawal Plan is similar to Systematic Investment Plan but it gives an option to withdraw systematically. This helps in generating a regular cash flow for the investors. SWP in mutual fund is one of the most

effective and tax efficient way to earn potential returns. SWP can be utilized by those who are planning for their retirement in the coming years. Usually the large amount of money that one receives at the time of retirement is invested in traditional saving instruments which attract income tax at the normal rates. Instead, they can make a lump sum investment in mutual fund with SWP facility. In this case, along with earning capital appreciation on the invested amount, the pensioner can receive a fixed amount monthly. It will help the pensioner in getting a regular income like salary even after retirement.

FAQs on Mutual Fund -

Question 1 :- Whether to invest in a fund with a lower NAV (Net Asset Value).

Answer - Many investors feel that the NAV of a MF is similar to market price of stocks and therefore, buying funds at low NAV is better. They believe that because the NAV is low, you can buy more units and hence, there is a higher potential for appreciation, as compared to a fund with a higher NAV. In reality, a MF's NAV represents the market value of all its investments. Any appreciation in the NAV will depend on the price movement of its portfolio of companies. Say, you invest Rs.10,000 each in fund A (whose NAV is Rs.10) & Fund B (whose NAV is Rs.25). You will get 1000 units of Fund A & 400 Units of Fund B. Assume both schemes have invested their entire corpus in exactly same stocks in same proportions. If these stocks combined together appreciate by 10%, the NAV of the two schemes will also rise by 10% to Rs.11 and Rs.27.5, resp. The reason why Fund B's NAV is higher than Fund A's, could be merely because, it was launched much earlier than Fund A. Any subsequent rise and fall in the NAVs of both these funds will depend on how the underlying securities perform.

Hence, the level of a scheme's NAV should not be considered at the time of purchase.

Question 2 :- Dividends are an extra income. A Scheme that pays dividends is better than a scheme that doesn't.

Answer - When MF announces dividend, the NAV is adjusted accordingly. If you opt for the dividend option, a part of the profits made by the scheme are distributed to Investors. The dividend is substracted from the NAV which drops

down forthwith. So, a Fund which pays dividend is in no way better or worse than one that doesn't pay.

Question 3 :- Do I need to open a demat account or online account to start investing in a mutual fund?

Answer - To invest in a MF, one do not need any demat account. You need to be KYC compliant. Then all you need to do is fill up the relevant application form, attach a cheque of the amount you wish to invest and submit it at the MF office directly or through advisor. Once it's done, you will get a statement showing details of investments.

Question 4 :- MF invest only in Equities.

Answer - Investors need to understand that there are various kinds of MFs. While some invest their corpus in equity, others invest into debt schemes and money market instruments, such as, Govt. bonds, Bonds issued by Companies & Financial Institutions, etc. MFs, therefore, invests in all kinds of instruments and do not confine themselves to equity.

Question 5 :- Markets are at a peak, I should defer my investment.

Answer - Research shows that any time is good to invest, provided you invest for the long term. You could also invest using SIP (Systematic Investment Plan) method which helps you accumulate units in good bull and bear markets thereby optimizing your returns over a long period of time and creating wealth for you.

Question 6 :- Mutual funds with good performance in last 1 year are best choice.

Answer - This a common misconception among the MFs investors. People believe that if ABC mutual fund has given 50% return in past year and XYZ has given 30% return, the ABC is a better fund to invest in. Past performance is one of the things to look at performance across market cycles and for longer durations of 7-10 years or even more and not just recent past. In addition, investors should also consider the fund manager's experience, his track record and the fund house's track record.

Unit Linked Insurance Plans (ULIP) - An ordinary ULIP is still a costly proposition for a buyer. But the online avatar of these market-linked insurance plans is a low-cost option far removed from what was mis-sold to investors a few years ago. The Click2 Invest plan from HDFC Life, for instance, charges only 1.35% a year for fund management. Ulips can be used as a rebalancing tool by a savvy investor. He can switch from equity to debt and vice versa, without any tax implication. Buy a Ulip only if you can pay the premium for the full term. Also, take a plan for at least 15 years. A short-term plan may not be able to recover the high charges levied in the initial years.

Pubic Provident Fund (PPF) - Budget 2014 also hiked the annual investment limit in Public Provident Fund or PPF. Risk-averse investors can now stock away more in the ultra-safe scheme. PPF scores high on safety, taxability and costs but returns are not so attractive and liquidity is not very high. The scheme will give 8.7% this year, but may not guarantee in the following years. The interest rate on small savings schemes such as PPF is linked to the government bond yield and is likely to come down in the coming years.

Senior Citizens' Savings Scheme - The Senior Citizens' Saving Scheme (SCSS) is an ideal tax-saving option for people above 60. The money is safe and the returns and liquidity are reasonably good. However, the interest income received form the scheme is fully taxable. Interest rate is linked to government bond yield. It is one percentage point higher than the five-year government bond yield. Unlike in the case of PPF, interest rate will remain unchanged till the investment matures.

Bank FDs, NSCs - Bank fixed deposits, or FDs and National Savings Certificates, or NSCs, score high on safety, flexibility and costs but the tax treatment of income drags down the overall score. Interest rates are slightly higher than what the Public Provident Fund, or PPF, offers but the income is fully taxable at the slab rate applicable to the individual. FDs and NSCs suit taxpayers in the 10% bracket (taxable income of less than Rs.5 lakh a year). The big advantage is that these are widely available. Just walk into any bank branch and invest in its tax-saving fixed deposit.

Pension Plans - Pension plans from insurance companies remain costly investments that are best avoided. Instead, it may be a better idea to go for the

retirement fund offerings from mutual funds. They give the same tax benefits but don't force the investor to annuitise the corpus on maturity. She/he is also free to remain invested beyond the age of 60. Till now, all the pension plans were debt-oriented balanced schemes.

Insurance Plans - Traditional insurance plans are the worst way to save tax. They require a multi-year commitment and give very poor returns. The insurance regulator has introduced some customer-friendly changes but these plans still don't qualify as good investments. The only good thing is that the income is tax-free. But then, so is the income from the Public Provident Fund, or PPF, and tax-free bonds. Another positive feature is that you can easily get a loan against such policies, which gives some liquidity to the policyholder.

Exempt - Exempt - Taxable (EET) Rule :-

1. Three elements are taxable in a tax saving investment - The Amount being invested, the Income on Investment & Redemption of amount invested in the future.

2. PPF is EET - The Investment is eligible for Tax Deduction, the Income is exempt from Tax, and Redemption proceeds are not added to Income in that year.

3. NSCs and 5 year bank deposits are EET. Investment is eligible for deduction, but the interest is taxable and redemptions have to be added back to taxable income.

4. Tax Saving Schemes of mutual funds are EET. Investment is deductible, dividend income is exempt, but redemption proceeds are taxable.

5. The interest and redemption proceeds that are taxable, can, however, be used to make 80C investments in the year in which they are received, to enjoy tax deduction benefits.