How to make the most of the extra Rs 50K tax deduction under Section 80C

Imagine you have won a gift voucher worth Rs 50,000 at the local hypermarket. When you go to the store, there is a vast array of items you can purchase with it. Salespersons try to draw your attention to their counters, pitching their merchandise aggressively. Will you buy whatever new gizmo they are trying to sell? Or will you utilise the money to purchase something you actually need for the household?

The additional Rs 50,000 deduction given to taxpayers under Section 80C in this year's budget is like a gift voucher from the government. It has come as a relief to millions of taxpayers.

However, with mis-sellers moving in for the kill, there is reason to be cautious. Instead of investing at random, a taxpayer should assess his needs and invest to fill the gaps in his financial planning. Here's how you can make the most of the Rs 1.5 lakh deduction under Section 80C.

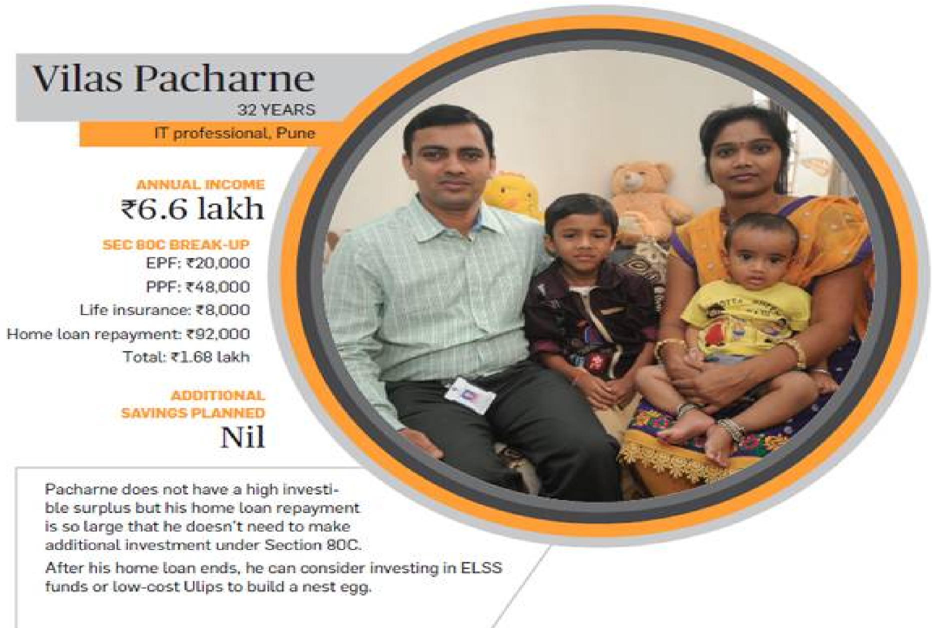
Do you need to invest more?

Before you start planning your investments, find out if you actually need to invest more. Section 80C is an overcrowded deduction, which includes more than a dozen instruments. Besides, it has the principal repayment of home loans and tuition fees of up to two children. Many taxpayers may find that their Section 80C investments already exceed the enhanced deduction of Rs 1.5 lakh.

In the lower income segments, taxpayers may not need to save too much. Keep in mind that the basic exemption limit has also been raised by Rs 50,000 to Rs 2.5 lakh for ordinary citizens and to Rs 3 lakh for senior citizens. So, if a person has a taxable income of Rs 3.5 lakh, he needs to invest only Rs 1 lakh to reduce his tax liability to zero. Even otherwise, a person earning less than Rs 4 lakh a year might find it difficult to invest an additional Rs 50,000 under Section 80C just to save tax. Unfortunately, many people are either not aware of their actual tax liability or are fooled into investing more.

How much more you need to save under Section 80 C

For many home loan customers, the loan repayment alone can take care of the investments under Section 80C. Pune-based IT professional Vilas Pacharne ***(see picture***) will reap three benefits from the budget proposals but won't have to invest even a rupee more to avail of them. He gains from the increase in the basic exemption, the raising of the Section 80C limit and the increase in the home loan deduction under Section 24(b) to Rs 2 lakh.



Though he does not contribute a very large amount to his EPF and PPF, his home loan repayment adds up to around Rs 92,000 a year. "My Section 80C investments are already more than Rs 1.5 lakh and the home loan interest is close to Rs 2 lakh," he says.

On the other hand, there are taxpayers with higher incomes who may want to invest more to save tax. Salaried employees who contribute to the Provident Fund often find they have to invest very little under Section 80C. Delhi-based finance professional Puneet Narang ***(see picture***) contributes nearly Rs 92,000 to his Provident Fund.

"I have never had to do any tax planning because my PF and an insurance policy take care of it," he says. But now that the limit has been enhanced by Rs 50,000, Narang is contemplating investing in ELSS funds to gain the equity exposure that's missing in his portfolio. "If you do not have any equity exposure, an ELSS fund can be the first step towards this asset class," says Nisreen Mamaji, founder of Moneyworks Financial Advisors.

Choose instruments carefully

The enhanced deduction limit is certainly an opportunity for taxpayers to reduce their tax liability, but how much you benefit from it will depend on how you deploy the money. With a wider window now available, there is a danger that taxpayers may direct the additional money towards unwanted and unnecessary investments. Financial experts say that tax planning is no different from financial planning and the same principles should apply here. "Insurance companies and agents will now become more aggressive and push bundled products under the pretext of helping you save tax," cautions Neeraj Chauhan, CEO of Delhi-based Financial Mall.

Investment-linked insurance policies, also known as Ulips, may be offered to you for their 'triple benefit' of meeting your tax-saving goal as well as to help you 'accumulate wealth', while providing life cover. Even those with adequate insurance will be coaxed into buying more. Insurance-cum-investment products neither offer you adequate cover nor give good returns. The worst part is that you are forced to continue with the product over the full term. Nisreen Mamaji, founder, Moneyworks Financial Advisors, insists taxpayers must be careful while choosing their Section 80C basket of products. "Buying a highcost product with a long lock-in period many not be the best idea," she adds.

The good part is that Section 80C offers enough choices to fulfill all your financial needs. You can invest in long-term retirement products such as PPF or the Voluntary Provident Fund. You can buy insurance policies for life cover and ELSS funds for equity exposure. There are medium term instruments such as bank fixed deposits and NSCs as well. The key is to choose an option that fills a gap in your financial planning. "Align your Section 80C investments to your goals and objectives," suggests Chauhan.

Is your insurance in place?

Before taxpayers like Narang allocate money to ELSS, they should assess their insurance needs. Most experts say that adequate life insurance cover is the first step in a financial plan. A pure protection term plan can be useful here. It offers a large insurance cover at a low price. Narang is grossly underinsured and should buy a term plan of Rs 1 crore for himself. That will cost him around Rs 18,000 a year. The balance amount of the additional limit can be put in ELSS funds. If he needs more equity exposure, he can go for diversified equity funds instead of ELSS plans.

If you already have adequate life insurance, move to other tax-saving avenues. Do consider the tenure of the instrument you invest in. The lock-in ranges from three years for ELSS funds to 15 years for the PPF. Choose a tenure that coincides with the financial goal. For long-term goals such retirement, you may choose to invest in the 15-year PPF or the NPS. The Budget has also raised the ceiling for investments in the PPF to Rs 1.5 lakh, which may entice some to invest more in this vehicle. "Enhanced contribution to the PPF is needed in the absence of a retirement system in the country," says Vivek Rege, managing director, VR Wealth Advisors. The PPF is currently offering 8.7% (***see graphic***).

Why a term policy plus PPF is better than a savings-cum-insurance plan

	TERM POLICY	ENDOWMENT PLAN
Age of policyholder	30 years	
Term of plan (years)	25 years	
Annual premium	₹3,540	₹46,750
Sum assured	₹10 lakh	
Total premium paid over policy term	₹88,500	₹11.69 lakh
Amount invested in PPF per year	₹43,210*	Nil
Amount at maturity	**₹38.08 lakh****	**₹24.5 lakh**

The illustration assumes that instead of buying an endowment policy, the difference in premium between the two is invested in PPF for 25 years.

** ₹46,750 — ₹3,540*

*** Assuming return of 8.7% for 25 years.*

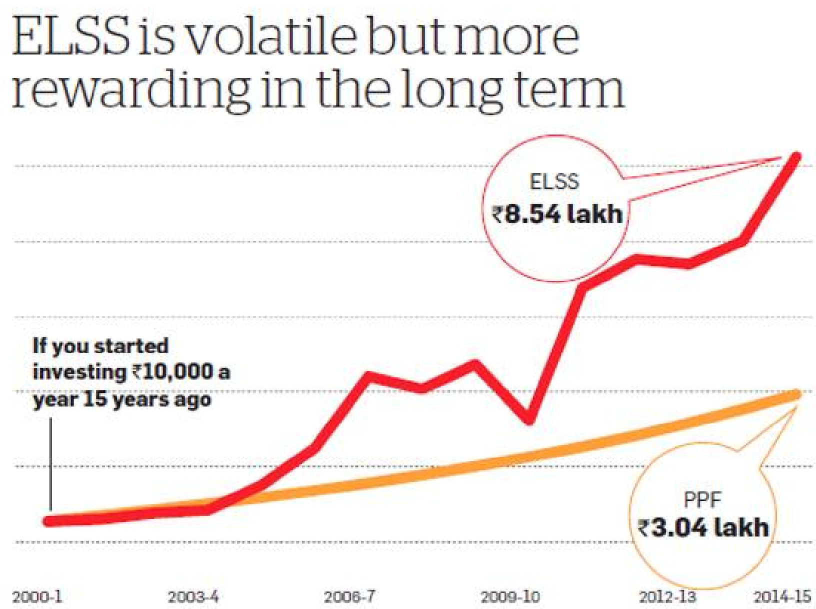
Saving for retirement

Before deciding to invest more in the PPF, consider adding more to your EPF. The 12% of your basic salary that you contribute every month will help in building your retirement kitty. You also have the option of contributing a higher amount through the VPF. Both the PPF and EPF enjoy exempt-exempt-exempt tax status, which means that the initial contribution, interest earned and the maturity proceeds are all tax-free. However, if you encash your EPF before five years, the interest component is added to your total income and taxed at the rate corresponding to your tax slab. The 80C benefit you claimed in earlier years is also reversed.

Pension plans offered by insurers are back in the market. However, the charges of these policies are significantly higher than those of the government-promoted NPS. Also, given that annuity income is still fully taxable, these pension plans are not attractive.

Harness the power of equities

Experts advise against depending purely on the EPF and PPF for retirement needs. They are debtbased instruments and their returns will not be able to beat inflation. "People have been depending on the PPF for too long," says Mamaji. "It is time investors realised that these are not sufficient for their retirement needs." Those hoping to build a decent corpus for retirement may have to step out of their comfort zone and invest in equities. As mentioned earlier, ELSS funds can be an investor's first step in the equity market.



Calculation based on actual returns from PPF and Pru ICICI Tax Plan in the past 15 years.

Experts insist that young investors should especially use the additional investment limit to enhance their exposure to equities through ELSS funds. Says Hemant Rustagi, CEO, Wiseinvest Advisors: "Besides your compulsory savings towards PF and insurance, investors should make use of this enhanced limit to take exposure to a different asset class like equity."

Ideally, you should start an SIP in an ELSS from the beginning of the financial year, spreading investments over 12 months. Narang plans to invest Rs 5,000 a month in ELSS funds till March 2015 to use up the Rs 50,000 additional limit.

The best thing about ELSS funds is the flexibility they offer. The minimum investment is very low at Rs 500 and the investor can put in money on any trading day of the year.

Unlike a Ulip or a pension plan, there is no compulsion to invest every year. Turn to page 15 to know more about the advantages of ELSS funds.

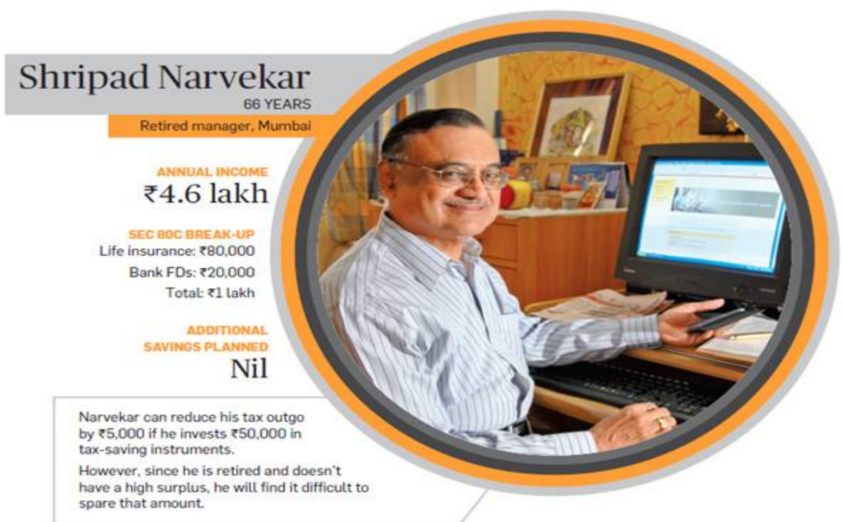
You can take equity exposure through other instruments, such as Ulips, unit-linked pension plans and the NPS, as well. However, the high charges of Ulips and pension plans make them poor choices. On the other hand, the NPS is a low-cost product that can be effectively used for retirement planning. You can decide the allocation to equity, corporate bonds and government securities, as per your risk profile and asset allocation.

Saving for short-term goals

ot all financial goals are 15-20 years away. For taxpayers who need the money sooner, NSCs and five-year tax-saving bank fixed deposits can be useful options. NSCs can be purchased from designated post office branches. The tax-saving FD is offered by most nationalised banks and the rate currently on offer is 9-9.5%. However, the interest earned through NSCs and tax-saving bank FDs is fully taxable as income at the applicable rate. So, for an individual in the highest 30% tax slab, the post-tax returns from a five-year NSC will be only 5.95%. This makes them tax-inefficient compared to the PPF and EPF.

Tax-saving options for senior citizens

Senior citizens looking to save tax should consider their cash flows carefully. Many, like Mumbai-based Shripad Narvekar (***see picture***) may not find it easy to spare for tax-saving investment. They should also steer clear of long-term invetsments. "It would not make sense for retirees to keep their money locked for long tenures," says Chauhan. The Senior Citizens' Savings Scheme is a perfect option. There is a five-year lock-in period but interest is paid out every quarter to generate an income stream for the individual. Though premature withdrawals from the scheme are allowed, there is a penalty if the amount is withdrawn before five years.



(Economic Times)