RBI's IINSS-C promises to beat inflation, but is it tax-efficient?

A few months ago, the RBI fulfilled its promise of protecting Indian investors against inflation by launching the inflation indexed bonds (IIBs). The initial IIBs were aimed only at large investors, so the mark-up—the additional payment over and above the inflation rate or the real coupon—was arrived at via competitive bidding. While the RBI plans to pay this real coupon on a regular basis, the inflation component will be added to the principal and paid only at the time of redemption.

This structure of indexing the principal every year with the inflation rate for that year offers two benefits. One, it protects the principal from inflation and you get the real value of investment at the time of redemption.

Secondly, it results in an increase in cash inflow every year even when the real coupon rate remains constant. For instance, if you have invested Rs 1 lakh in IIBs, the real coupon rate is 1.5% and the inflation rate for the first year is 10%. In this case, the real coupon payout for the first year will be Rs 1,500 (1.5% of Rs 1 lakh), and that for the second year will be Rs 1,650 (1.5% of Rs 1.10 lakh).

Despite this, the IIBs did not raise much investor interest because it was linked to the Wholesale Price Index-based inflation, not the Consumer Price Index-based inflation. Traditionally, the WPI-based inflation is lower than the CPI-based one. Currently, these figures stand at 7% and 10.1%, respectively.

Recognising that there was not much scope for retail investors in the IIBs, the RBI has issued the Inflation Indexed National Saving Securities-Cumulative (IINSS-C). As promised, IINSS-C is based on the combined CPI, and since it is aimed at retail investors, the RBI avoided competitive bidding and announced a mark-up of 1.5% in advance.

However, retail investors are not enthused. This is because the IINSS-C is tax-inefficient compared to the earlier IIBs.

While the IIBs are listed in the wholesale debt market and on stock exchanges, the IINSS-C will not be listed. Under Section 112 of the Income Tax Act, capital gains on the transfer of long-term capital assets (listed securities) are subject to tax. This is calculated at the rate of 20% of capital gains after reducing the indexed cost of acquisition, or 10% of capital gains without indexation. The capital gains will be computed by deducting the expenditure incurred in the transfer and cost of acquisition/(indexed).

Though bonds do not get indexation benefits as per the third proviso of Section 48 of the IT Act since they get interest in the middle, the capital indexed bonds are an exception.

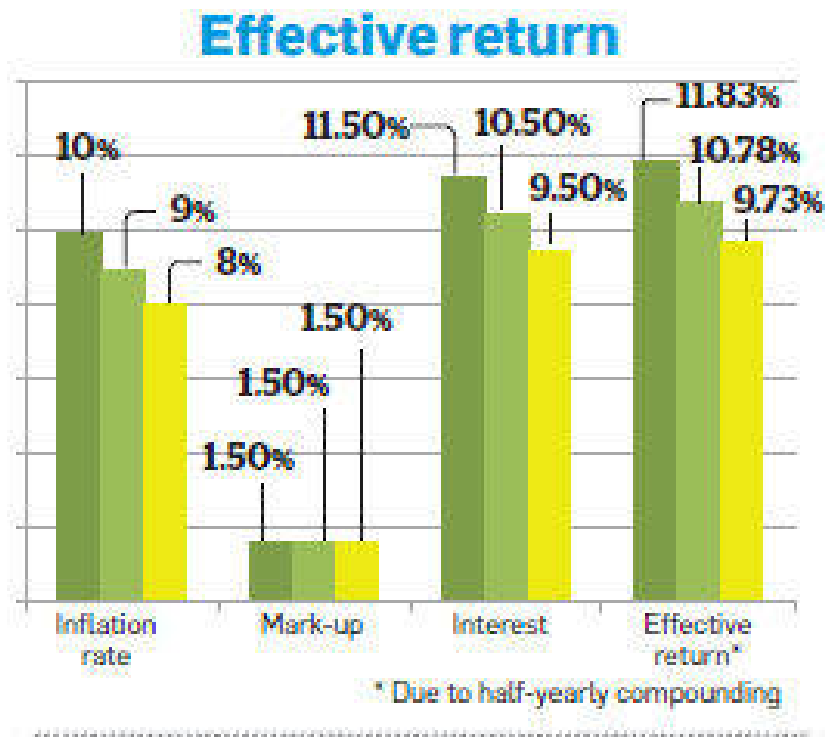
If one assumes that the inflation used by the RBI for capital indexing, and the cost inflation index set out by the Income Tax Department every year are close to each other, the entire inflation indexed part will be tax free for IIB holders. However, investors in IINSS-C don't get these benefits and will end up paying tax for the entire interest. So, the

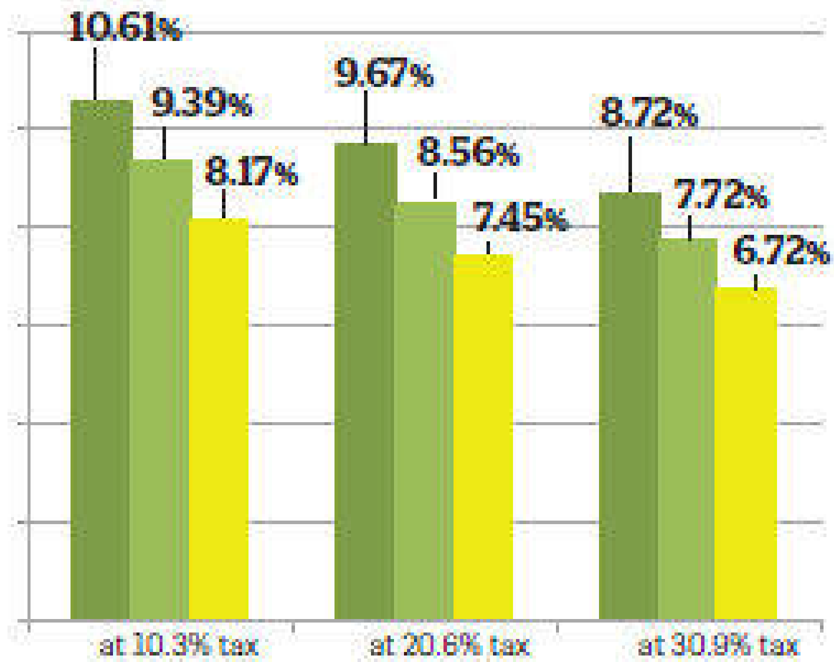
entire gain—the-inflation part and the 1.5% mark-up—will be given as interest in IINSS-C, and will be taxable at marginal rates.

Worse, this interest is accrued and compounded every six months. Hence, retail investors have to pay tax on it in that financial year despite not getting any interest. This is because the tax on interest is supposed to be computed on an accrual basis. After adjusting for inflation and tax, investors in the higher tax bracket will only get negative returns (see table).

One can only hope that the RBI will set right this anomaly at the earliest, thereby enabling all investors to take advantage of this new instrument. Till then, retail investors are advised to avoid the IINSS-C.

IINSS-C gives negative post-tax returns for higher tax bracket.





(Economic Times)