Take advantage of ELSS this year

It will not provide the same benefits once the new DTC Bill takes effect

With gains from the BSE Sensex at eight per cent this year, close to all-time highs, this may be a good time to look at equities from a tax-saving perspective. Also, with the Direct Taxes Code (DTC) likely to be implemented soon, these will affect your investment in a tax-saving fund, too.

Under Section 80C of the Income Tax Act, tax-saving mutual funds, better known as equity-linked savings schemes (ELSS), and a few other investments are tax-exempt. An investment in these funds (with an overall ceiling of Rs 1 lakh) will reduce your tax by 20 per cent of the amount invested. Future returns (capital gains, dividends) from tax-saving equity funds are tax-free in your hands.

However, in the final draft of the new tax code, no tax breaks have been provided in case you invest; only retirement-oriented investments are eligible, ELSS are not. Sanjay Sinha, chief executive, Citrus Advisors, says, "ELSS will lose tax-saving advantage in the current form of the DTC, if passed. But there's a clear need for retail investors to participate in equity markets. So, you have to give them a financial incentive through tax savings." However, DTC provides tax exemption on long-term capital gains from equity funds. Therefore, the gains from investments will remain tax-free.

ELSS funds are similar to the closed-end equity funds in the market now. Experts say within the ELSS category, investors can choose the dividend option for a similar equity exposure. "Closed-end equity NFOs (new fund offers) have seen a significant collection, and it seems to suggest equity investors are not averse to locking in for three years or more," says Sinha.

Experts say now, too, investors willing to risk a little on their investments may consider ELSS. Harsh Roongta, chief executive of Apna Paise, says, "There are many goods to a tax-saving equity fund. One is these offer you tax savings. Second, good fund managers get time to invest for the long term due to the three-year lock-in. For investors who want tax breaks, this is definitely a good vehicle."

Tax-saving funds strive to make the most of the three-year lock-in, as a fund manager has time for long-term investment calls. Pankaj Sharma, executive vice-president, DSP Blackrock MF, says: "ELSS funds usually have a buy-and-hold kind of a portfolio due to the certainty of investment for some time; therefore, you don't find much churn in these funds."

But returns from equity investment depend on market movements. Equities offer better returns in the long run; in the short term, anything could go wrong. Data from valueresearchonline.com show tax-saving funds returned 19.26 per cent in a five-year period, beating peers in diversified funds by about 75 basis points. In a year's span, however, these returned just 4.4 per cent, against 5.44 per cent by diversified funds.

As market trends play a huge role in equity-fund returns, investors should invest in equities for periods of at least three years. Sinha says, "There's a case for locking-in money for more than three years in equities."

Sharma says: "It's a great way to save taxes, but risk-averse investors should not follow this route. For younger and risk-taking investors, this is a more potent investment. Indian markets have gone through a time correction, and the cycle looks much better from here."

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