

Tax efficient investments-How to have your cake and eat it too....

Rising income levels in the country have brought more people in the tax net, which calls for tax efficiency at every level, including investments. Tax eats into a significant portion of income you earn on your investments. To avoid this, earning your incomes ‘tax-efficiently’ becomes important.

How to pick the right investment option -Tax-wise

While assessing investment options, consider the income that will remain with you *after* payment of taxes. For example, if you are getting 8% from an instrument whose returns are fully taxable, and if you are in the highest income tax slab, then you have to pay 30%+surcharge+education cess on the interest received by you. Your post tax returns dip to 5.28%. Suppose you have an avenue of investment where returns are tax free, then you need to get just above 5.28% return from the said investment, to make it a better avenue than a taxable investment.

Options Available

There are a number of tax-efficient investment options offered by mutual funds, where an investor can enjoy the twin benefits of good returns and tax benefits.

Before we elaborate on this, let’s take a look at the tax levied on the three broad mutual fund categories:-

Now that we’ve understood the tax implications on mutual fund categories, let’s understand the tax benefits

Tax	Equity Funds	Debt funds	Liquid funds
Dividend Distribution Tax	Nil	12.50%	25%
Short Term Capital Gain Tax	15%*	As per Income Tax Slab	As per Income Tax Slab
Long Term Capital Gain Tax	Nil	Lower of 10%* without indexation or 20%* with indexation	Lower of 10%* without indexation or 20%* with indexation

mutual funds offer investors.

- Tax benefits offered by equity funds– These funds predominantly invest in equities. As an equity fund investor, you can either receive income as dividends (dividend option) or you can allow the income to accumulate in your

investment and receive it when you liquidate your investment (growth option). Now, here are the tax benefits. Dividends earned from equity funds are fully exempt from tax. Long-term gains (when you hold your investment for more than one year) are exempt from tax while short-term gains (when you hold your investment for less than a year) are taxed at 15 per cent*.

-*Equity Linked Saving Scheme (ELSS)* -These are equity oriented funds, which offer you a tax deduction (under section 80C) on your investment amount. However, to take this tax deduction, you need to stay invested for 3 years. The maximum amount of investment that gets this tax deduction is Rs 1 lakh. Apart from tax deduction, these schemes have a lower ‘lock-in’ period as compared to other investment options such as PPF, NSC, etc.

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Mutual fund investments are subject to market risks. Please read the scheme information document carefully before investing.

- Tax benefits offered by debt funds** - Mutual funds that invest in fixed income securities are called debt funds. These funds attract a Dividend Distribution Tax (DDT) of 12.50 per cent (plus surcharge of 10 per cent and education cess of 3 per cent). Short-term capital gains are taxed at per normal slab rates applicable to an individual. Long-term capital gains are taxed at the 10 per cent (without indexation) or 20 per cent (with indexation), whichever is lower. Indexation increases the cost of your mutual fund investment to account for the effect of inflation.
 - *Fixed Maturity Plans (FMP)*:-These are close-ended funds, which invest in a portfolio of debt securities, whose maturity is similar to the fund. An FMP offers a very interesting tax benefit. By investing for 1 year and 1 day i.e. 366 days, you can avail of 'double indexation'. This simply means that your cost of investment will be taken at a higher value due to inflation since it would be assumed that you have stayed invested for 2 years instead of 1. Clearly, this benefit makes FMPs superior to comparative investment options like bank fixed deposits.
- Tax benefits offered by liquid funds** - These funds invest in very short-term debt investments such as money market instruments, short-term corporate deposits, treasury, etc. The DDT on liquid funds is 25 per cent (plus surcharge of 10 per cent and education cess of 3 per cent). Liquid funds have the same tax benefits as debt funds for capital gains.

Clearly, mutual funds, with their numerous tax benefits, permit you to have your cake and eat it too!

*(An additional 10 per cent surcharge and 3 per cent education cess is applicable)

Synopsis

- Tax eats into a significant portion of income you earn on your investments.
- While assessing investment options, consider the income that will remain with you *after* payment of taxes.
- There are a number of tax-efficient investment options offered by mutual funds, where an investor can enjoy the twin benefits of good returns and tax benefits.

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