

# Tax Planning And Equivalent Returns: A Case Of Small Investor

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**Abstract:** In India tax saving and investment of savings for the future is the bigger concern. Most investors invest in GPF, Fixed Deposits, Recurring Deposits, Real Estate, Gold, etc. without considering the consequences of these alternatives on tax liability. For saving tax, Indians buy insurance policies and invest in GPF, PPF, etc. As per sec 80C of the Income tax act saving up to Rs 150000 in some of the instruments like GPF, PPF, ELSS, Life insurance premiums, etc. are tax deductible i.e., taxable income is reduced by this amount to calculate the tax liability. This Case Study will help the students and practitioners of wealth management to learn the practical aspects of dealing with the tax planning of small investors, particularly the salaried employees in the lower middle-class category. The case will also help to learn the calculation of the equivalent returns and comparison of various investment alternatives.

**Key Words:** Tax Planning, Equivalent Returns, Wealth Management, Tax Deductions, Tax Exemptions.

## Introduction:

Born on the 3<sup>rd</sup> of March 1980, Mr. Amit Sharma working in a reputed Multinational Corporation for almost a decade now. Mr. Sharma stays in Mumbai, India, in a company-provided residence. Today is the 15<sup>th</sup> of February 2017. As the financial year, 2016-17 is nearing the closing for the tax payments, Mr. Sharma's monetary matters started worrying him. His accountant has calculated the total annual net taxable income

from salary as Rs. 600,000 for the given financial year. His savings in the GPF (Government Provident Fund) were Rs. 50,000 which is exempted from tax and not included in the net taxable income. Mr. Sharma has no other tax-exempt savings and investments. He has no other sources of income and is solely dependent on his income from his salary for all financial decisions. Following is the income tax rates for the financial year 2016-2017 in India.

Individual residents aged below 60 years (i.e., born on or after 1st April 1957)		
Income		Tax Rates
i.	Taxable income less than Rs. 2,50,000/-.	NIL
ii.	Taxable income is more than Rs. 2,50,000/- but less than Rs. 5,00,000/-.	10% on taxable income more than Rs. 2,50,000/-.
iii.	Taxable income is more than Rs. 5,00,000/- but less than Rs. 10,00,000/-.	Rs. 25,000/- + 20% on taxable income more than Rs. 5,00,000/-.
iv.	Taxable income is more than Rs. 10,00,000/-.	Rs. 125,000/- + 30% on taxable income more than Rs. 10,00,000/-.

As per the above tax slabs, his total tax to be paid is Rs. 45,000. Living in a joint family with his wife, two children (one girl and one boy), his father, and his mother, Mr. Sharma is the only earning member of the family. After all the expenses Mr. Sharma is left with a small amount of savings for the future of the family. His total expenditure in this financial year is Rs 500,000. After-tax, he has left with only Rs 55,000 for savings. Additionally, the medical expenses of the family are borne by the employer. He has no insurance policy of any kind whether health or life. Mr. Sharma is very worried about the amount of tax he has to pay this financial year. He comes to you for help in tax planning.

**Tax Deductions:** Tax deductions reduce tax liability by reducing taxable income. Tax deductions relevant to Mr. Sharma are under 80C and under 80CCD only. Under 80C the taxpayer can claim Rs. 150,000 and under 80CCD additional Rs. 50,000 can be claimed as a deduction from the taxable income. Tax on the capital gain on real estate is 20%.

**Investment Options:** You gave him the following options to invest as a one-time investment and save tax.

1. **ELSS (Equity Linked Saving Schemes):** Almost all the mutual funds in India offer ELSS. Under ELSS mutual funds invest in equities. The lock-in period in this scheme is three years i.e., investors cannot withdraw from ELSS before three years. Tax deduction under 80C can be claimed for investment in ELSS. The ELSS is a risky investment as the mutual funds invest the funds in the stock markets, and although the portfolios are diversified the investor has to bear the market risk. Withdrawals on maturity after three years are exempted from tax. So, any dividend is reinvested, and the capital gain is exempted from taxes on maturity.
2. **PPF (Public Provident Fund):** Investors can open PPF account in any of

the nationalized banks in India. The lock-in period of the PPF is 15 years. A maximum of Rs 150,000 per annum can be invested in PPF and can be claimed as an income tax deduction under 80C. PPF is a secure form of investment and is guaranteed by the Government of India. So, it is the least risky. The entire amount including interest on the PPF is exempted from tax on maturity.

3. **GPF (Government Provident Fund):** Mr. Amit Sharma can save in GPF. Under GPF employee has to invest at least a minimum amount. At present Mr. Sharma is saving Rs 50,000 in GPF. But deductions under 80C can be claimed up to 150,000. No tax is paid on the interest and amount received by the employee at the time of withdrawal on retirement. Under certain conditions amount invested under GPF can be withdrawn before retirement but has to be repaid in installments. GPF is guaranteed by the Government of India.
4. **NPS (New Pension System):** NPS is a pension plan launched by the Government of India. It is a defined contribution plan regulated by the Pension Fund Regularity and Development Authority of India. Although Mr. Sharma is not covered under NPS he can invest any amount in the NPS account. NPS is managed by the fund houses approved by the Government of India. NPS is not guaranteed by the Government of India. Tax deduction under 80C and an additional deduction of Rs 50,000 under 80CCD can be claimed under NPS. Assume that the amount received under the NPS is taxable
5. **National Saving Certificates:** Investors can buy National Saving Certificates from the post office in the denomination of Rs 100, Rs 500, Rs 1000, Rs 5000, and Rs 10,000 for a tenure of five or ten

years. The interest rate on the ten-year is a little higher than the five-year National saving Certificates. These are guaranteed by the Government of India. The interest rate is compounded half yearly on these certificates and they are eligible for a tax deduction under 80C. Interest earned on the investment in these certificates is taxable in the year it is earned and the same can be claimed as a deduction. If claimed as a deduction than the total interest received on maturity is taxable.

6. **Term Deposits in Banks and Post Office:** Investment in the term deposit in banks and post office is not guaranteed by the government and is riskier than the investments guaranteed by the government. Generally, longer the time period higher the interest rate. If time period is five years or more than it is eligible for the tax deduction under 80C. Premature withdrawals are allowed with penalty. On maturity the interest earned is taxable.
7. **Term Insurance:** In case of Mr. Sharma, with the premium of Rs 15,000 the term policy of Rs 10 million can be purchased for the security of the family in case of uncertain death.
8. **Mutual Funds:** Mutual funds schemes can be broadly classified as debt and equity-oriented schemes. Equity oriented schemes are exempted from the long-term capital gain tax and the dividend received is also tax exempted. But the long-term capital gain tax of 20 % is levied on the other schemes except equity-oriented schemes.
9. **Equity Shares:** No long-term capital gain tax on the equity investments. Equity shares are highly risky.
10. **Corporate Bonds:** No tax exemption under this type of investment.
11. **Government Bonds:** Investment in Government bonds is not tax deductible. They are risk free investment.
12. **Gold:** No tax exemption on the gold. Capital gain on the gold is taxable.
13. **Land/Real Estate:** No exemption on capital gain on the investment in land or real estate. Capital gain on the Real Estate is taxable

For tax planning the following concepts are required to be explained:

1. **EEE (Exempt Exempt Exempt):** in EEE the tax deduction can be claimed at the time of investment, any intermediate income from investment is also exempted and the amount received at the time of expiry also tax deductible i.e., no tax is to be paid. The investment options like ELSS, PPF, GPF, EPF (Employees Provident Fund), etc. comes under EEE up to the limit under 80C.
2. **EET (Exempt Exempt Tax):** NPS comes under EET.
3. **TEE (Tax Exempt Exempt):** Investments like Equity shares, equity mutual funds etc. comes under TEE.
4. **ETT (Exempt Tax Tax):** Investments like National Saving Certificates, Term Deposits of five years or more comes under ETT.
5. **TTT (Tax Tax Tax):** Investments like real estate, gold, corporate bonds, government bonds, debt mutual funds etc. comes under TTT.

Inflation in the economy is assumed to be 5% per annum for next 15 years.

**Discussion Questions:** Use excel for solving the problems if required

1. As a financial Advisor, suggest how much insurance Mr. Sharma should buy if he is a risk averse investor and if he is a risk seeking investor.
2. How much maximum tax Mr. Sharma can save?
3. If Mr. Sharma invests in EEE option like, ELSS, PPF, GPF, EPF (Employees

Provident Fund), how much will he receive after 15 years?

4. How much equivalent returns Mr. Sharma requires from the real estate or any other TEE option so that the future value of the investment is same as in case of EEE?
5. How much equivalent returns Mr. Sharma requires from the EET option like NPS, National Saving Certificates so that the future value of the investment is same as in case of EEE?
6. How much equivalent returns Mr. Sharma requires from the TTT option like gold, real estate, corporate bonds etc. so that the future value of the investment is same as in case of EEE?
7. How different his tax planning will be if he is a risk averse investor and if he is a risk seeking investor?

### References:

Vinod K. Singhania, & Monica Singhania. (2016). Students Guide to Income Tax, Taxmann Publications Pvt. Ltd

### Teaching Notes for Instructors

1. Even if Mr. Sharma is risk seeking it is always good to buy term insurance. For term insurance he needs to pay premium every year. But if he pays premium he is at least insured for one year. If some uncertain event occur within one year his family will get Rs 10million. So buying insurance is a rational decision even if he is risk seeking.
2. Without any investment his tax is Rs 45,000, but with the investment of Rs 62,498 Mr. Sharma can reduce the tax to Rs 37,500 and save Rs 7500 from tax. So the maximum tax he can save is Rs 7500 which is clear from the Table I. Mr. Sharma cannot save more than Rs 7500

as a tax because he needs to have disposal income of Rs 50000 per year for his family expenditure after savings and tax.

3. After paying insurance premium Rs 47498 (62498-15000) are left for investment. If we assume that all EEE investment options except ELSS gives 8 percent return per annum compounded annually the future value of investment after fifteen years is as follows:

$$\text{Value of investment after 15 years} = 47498 * (1.08)^{15}$$

$$= 150,671.69$$

4. If he pays tax and invest in TEE options like Equity shares, equity mutual funds etc than the equivalent rate can be calculated as follows:

His savings after tax and insurance are Rs 40000 and the required future value is Rs 150,671.69.

We need to calculate rate of return on investment of Rs 40,000 for 15 years so that Rs 150,671.69 received at maturity. This can be calculated from the following equation:

$$\text{Future Value} = \text{Present Value} * (1+r)^{15}$$

$$\text{Therefore: } 150,671.69 = 40,000 * (1+r)^{15}$$

$$r = \left\{ \left( \frac{150,671.69}{40,000} \right)^{(1/15)} - 1 \right\}$$

So  $r = 9.244$  percent per annum compounded annually. This is 1.244 percent more than EEE options and without any tax planning. This is possible by investing in equity shares and equity mutual funds.

5. If he invest in EET options like NPS, National Saving Certificates etc. than he has to pay tax at the maturity. Assume that his tax bracket is 20 percent than the equivalent rate can be calculated as follows:

$$150,671.69 = \{ 47498 * (1+r)^{15} \} * .8$$

$$r = \left\{ \left( \frac{150,671.69}{(.8 * 47498)} \right)^{(1/15)} - 1 \right\}$$

So  $r=9.62$  percent per annum compounded annually. This is 1.62 percent more than EEE options and without any tax planning. It is not possible to earn 9.62 percent on National Saving Certificates and but possible through NPS.

6. If he invest in TTT options like gold, real estate, corporate bonds etc. than he has to pay tax at the maturity as well as at the time of investment. Assume that his tax bracket is 20 percent at the time of maturity than the equivalent rate can be calculated as follows:

$$150,671.69 = \{40,000 * (1+r)^{15}\} * .8$$

$$r = \{(150,671.69 / (.8 * 40000))^{(1/15)} - 1\}$$

So  $r=10.88$  percent per annum compounded annually. This is 2.88 percent more than EEE options and

without any tax planning. This seems little difficult to achieve the target. It is possible but higher risk in real estate and corporate bonds than PPF, GPF etc.

7. For the risk averse investor the EEE options like PPF, GPF etc. are good investment options. As it is clear from previous discussions that more returns are required if he goes for investment options other than EEE. Also the other options like corporate bonds, equity, etc. are riskier than the PPF and GPF.

For risk seeking investor ELSS scheme is better because of less lock in period and scope of increase in the value of investment. ELSS is equity linked scheme which also gives protection from the inflation.

**Table I**

Taxable Income	Investment including insurance	Tax	Disposable Income
600000	63000	37600	499400
600000	62937	37587.4	499475.6
600000	62874.063	37574.8126	499551.1244
600000	62811.18894	37562.23779	499626.5733
600000	62748.37775	37549.67555	499701.9467
600000	62685.62937	37537.12587	499777.2448
600000	62622.94374	37524.58875	499852.4675
600000	62560.3208	37512.06416	499927.615
600000	62497.76048	37499.5521	500002.6874
600000	62435.26272	37487.05254	500077.6847
600000	62372.82745	37474.56549	500152.6071
600000	62310.45463	37462.09093	500227.4544
600000	62248.14417	37449.62883	500302.227
600000	62185.89603	37437.17921	500376.9248
600000	62123.71013	37424.74203	500451.5478
600000	62061.58642	37412.31728	500526.0963
600000	61999.52483	37399.90497	500600.5702
600000	61937.52531	37387.50506	500674.9696
600000	61875.58778	37375.11756	500749.2947
600000	61813.7122	37362.74244	500823.5454
600000	61751.89848	37350.3797	500897.7218

600000	61690.14659	37338.02932	500971.8241
600000	61628.45644	37325.69129	501045.8523
600000	61566.82798	37313.3656	501119.8064
600000	61505.26115	37301.05223	501193.6866