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Tax Planning

Common mistakes and Good practices in planning for taxes

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Tax Planning, Good Practices and Mistakes

As the calendar New Year begins, it also marks the final quarter of the financial year and when professionals begin their tax planning. To reduce their tax payment, professionals typically invest in tax deductible funds. While trying to save tax, professionals make financial decisions that may get them temporary relief but may have a negative impact in the long run.

In this report we examine the existing tax structure, how it should be used, the pitfalls that professionals should avoid and the essence of good tax planning. We also examine how professionals across age groups and various cities do their tax planning.

Understanding taxable income

The first step towards tax planning is to understand what sections of the income are taxable and then understand what part of their income should be used to calculate tax. For this the professional must examine his pay slip. The following sections of the payslip have tax exemption (Table 1).

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Exemptions	Limit
House Rental Allowance (HRA)	Least of 3 1. Actual HRA 2. 40% of basic in non-metro city 50% of basic in metro city 3. (Annual rent paid)-(10% of salary)
Conveyance allowance	Rs. 19,200 P/A
Medical allowance	Rs. 15,000 P/A
Child education allowance	Rs. 2,400 P/A
Child hostel allowance	Rs. 3,600 P/A

Table 1: The allowances in the payslip and their tax exemption limits

For example, consider a professional living in a metro earning Rs. 50,000 per month. The basic income as per his payslip is Rs. 10000, the HRA is Rs. 8000. If he pays a rent of Rs. 12000 per month, his taxable income can be calculated as follows:

Income Per month	50,000
HRA Per Month	-5,000 (50% of basic is the lowest)
Taxable income Per Month	45,000

① http://www.incometaxindia.gov.in/Charts Tables/Deductions.htm

Now if this professional sends his child to a school for a fees of Rupees 800 per month, his taxable income can be calculated as follows:

Annual Taxable income	45,000*12 = 5,40,000
Less Child Education Allowance	-2,400
Income less Exemptions	5,37,600

In addition to these exemptions, tax deductions can be claimed under various sections. The following table (Table 2) lists the tax deductibles, the returns on these tax deductible investments and the tax deduction limits that a professional can claim under various sections of the Income Tax law.

[1]

Sections	Tax Deductible	Returns	Limits
	1) Provident Fund (PF) Voluntary Provident Fund(VPF)	8.65%	
	2) Life Insurance Premium • ULIP • Endowment plan • Money back plan	5%-7% 4-5% 4-5%	
	3)Equity Linked Saving Scheme (ELSS)	15%	
	4)Fixed Deposits (FD)	6.25%	
80c	5)National Pension Scheme (NPS)	9%-11%	Rs 1,50,000
	6)National Saving Certificate (NSC)	8%	
	7)Sukanya Samriddhi Yojana	8.5%	
	8)Senior Citizen Saving Scheme (SCSS)	8.5%	
	9)Public Provident Fund (PPF)	8%	
	10) Repayment of Home Loans	-	
	11)Children's Tuition Fees	-	

[1] http://www.incometaxindia.gov.in/Charts Tables/Deductions.htm

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80CCD	1)National Pension Scheme (NPS)	9%-11%	Rs 50,000
80D	1)Medical Insurance	-	Rs 15,000
80DD	1) Medical Insurance for Parents 2) Medical Insurance for Handicapped	-	Rs 20,000
80DDB	1)Expenditure for specified disease	-	Rs 40,000
80E	1) Educational Loan Interest	-	No limit
24B	1) Payment of Interest on Home Loans	-	Rs 2,00,000

Table 2: The tax deductions allowed from various sections of the income tax and the tax deductible limits

Deductions under Section 80C

1) **Provident Fund:** An investment fund contributed by employees and employers. 12% of the basic income is a statutory contribution towards Provident Fund. The benefits of investments made through provident fund can be availed in the form of monthly pension which is provided to each employee on retirement.

- Voluntary Provident Fund: If the investor wants to invest more in Provident fund he/she can opt for the scheme of Voluntary Provident Fund by increasing his contribution to PF through the company itself.

2) **Life Insurance premium:** In India, insurance policies for life can be availed through 4 different schemes

- Pure Term: It only provides risk cover.
- ULIP: It provides risk cover with investment options to invest in stocks, bonds or mutual funds.
- Endowment plan: It is designed to pay a lump sum on its 'maturity' or on death. Typical maturities are ten, fifteen or twenty years up to a certain age limit. Some policies also pay out in the case of critical illness.
- Money back plan: The insured person gets a percentage of sum assured at regular intervals, instead of getting at the end of the term. It is an endowment plan with the benefit of liquidity.

3) **Equity Linked Saving Scheme (ELSS):** It is diversified equity mutual fund (MF). The investor gets an advantage of capital appreciation and tax benefits. It has a lock-in period of three years.

4) **Fixed Deposits (FD):** It is provided by banks which provide investors with a rate of interest, until the given maturity date. The lock-in period for this is about 5 years.

① http://www.incometaxindia.gov.in/Charts Tables/Deductions.htm

5) National Pension Scheme (NPS): It is a quasi-EET (investments and returns are tax exempt while withdrawals are taxed) investment where 60% of the corpus is taxable while 40% is tax free. It is a voluntary defined contribution pension system.

6) National Saving Certificate (NSC): It is primarily used for small savings and income tax saving investments in India. It is a part of postal savings system of Indian Postal Service (India Post).

7) Sukanya Samriddhi Yojana: It is Government of India backed saving scheme for the parents of girl children. Parents can use this fund for their future education and marriage expenses.

8) Senior Citizen Saving Scheme (SCSS): They are long term saving options that are usually associated with any government sponsored savings program. These schemes are available through certified banks as well as the network post offices. This account extends up to 5 years and upon maturity can be extended for a further 3 years.

9) Public Provident Fund (PPF): The Public Provident Fund is a savings-cum-tax-saving instrument. It is the provident fund availed outside the company through public offices such as banks and post offices.

10) Repayment of Home Loans: Repayment Amount is the minimum amount to be paid each month under the home loan contract based on the loan balance.

11) Children's Tuition Fees: Any person who pays his child's education fees is allowed to claim deduction of up to Rs. 1,50,000 per annum on his income.

Deductions Under Section 80CCD:
1) National Pension Scheme (NPS) If the limit under of Rs 1,50,000 is availed under section 80C a further deduction of up to Rs. 50,000 can be claimed under Section 80CCD through NPS.

Deductions under Section 80D
1) Medical Insurance: Health insurance reimbursements for medical and surgical expenses, or from illness or injury incurred by the insured.

Deductions Under Section 80E
1) Educational Loan Interest: It is the interest paid on money for education or school related expenses. Payments are often deferred while in school and for graduation, it has a six-month grace period.

Deductions Under Section 80G
1) Donations: Sum of money given as charity. The exemption amount and limit vary with the organization donated to. Examples include: Prime Minister's National Relief Fund, PM's drought relief fund, etc.

The income after the after exemptions and deductions have been claimed is used to calculate tax. This income is the taxable income. For example if the income after exemptions is Rs. 5,37,600

Income after exemptions:	5,37,600
Deductions claimed under Section 80C:	50,000
Net taxable income:	4,87,600

Calculating Income Tax

The tax rates differ by income and age. Professionals under the age of 60 can earn up to Rs. 2,50,000 per annum without having to pay an income tax. However 60-80 year old professionals can earn up to Rs 3 Lakhs without having to pay an income tax while 80+ year old professionals can earn up to Rs. 5 Lakhs without paying an income tax. It is therefore important to identify the tax slab in order to calculate the tax payment to be done.

INCOME TAX SLAB RATES FOR FY 2016-17 and AY 2017-18:

For men and women below 60 years

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INCOME TAX SLAB	RATE
Up to Rs. 2,50,000	Nil
Rs. 2,50,001-Rs. 5,00,000	10% of income exceeding Rs. 2,50,000
Rs. 5,00,001-Rs. 10,00,000	Rs. 25,000 + 20% of income exceeding Rs 5,00,000
Rs. 10,00,000 above	Rs. 1,25,000 + 30% of income exceeding Rs. 10,00,000

Table 3: Tax Slabs for professionals of age up to 60 Years

For senior citizen age 60-80 years

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INCOME TAX SLAB	RATE
Up to Rs. 3,00,000	Nil
Rs. 3,00,001-6Rs5,00,000	10% of income exceeding Rs. 3,00,000
Rs. 5,00,001-Rs. 10,00,000	Rs. 20,000 + 20% of income exceeding Rs. 5,00,000
Rs. 10,00,000 above	Rs. 1,20,000 + 30% of income exceeding Rs. 10,00,000

Table 4: Tax Slabs for professionals between the age 60 to 80 Years

② http://www.incometaxindia.gov.in/Tutorials/2 Tax Rates.pdf

For super senior citizen age 80+ years ②

INCOME TAX SLAB	RATE
Up to Rs. 5,00,000	Nil
Rs. 5,00,001- Rs. 10,00,000	20% of income exceeding Rs. 5,00,000
Rs. 5,00,001- Rs. 10,00,000	Rs. 1,00,000 + 30% of income exceeding Rs. 10,00,000

Table 4: Tax Slabs for professionals of age 80 Years and above

Consider a professional in his early 30s earning about Rs. 50,000/month with a basic of Rs. 100,00/month and an HRA of Rs. 8000/month. If his house rent is Rs. 12,000/month and his Child's school fees is Rs. 800/month, and he has made investments of Rs. 50,000 that are tax deductible under Section 80C, his taxable income is about Rs. 4,87,000.

From the above tax slabs, he falls in the category of persons below 60 years of age with an income between Rs. 2.5-5 Lakhs. In which case, the tax payment to be made is 10% of the amount exceeding Rs 2.5 Lakhs

Amount Exceeding Rs 2.5 Lakhs	4,87,600- 2,50,000 = 2.376 Lakhs
Tax to be paid: 10%	2.37*10% = Rs. 23,760

If the professional had not made tax deduction claims under section 80C his taxable income would have been Rs. 5,37,000. In which case, his income tax payment due would have been calculated as per the tax slab of Rs. 5-10 Lakhs. The tax to be paid would've been:

Amount Exceeding Rs 5 Lakhs	5,37,600- 5,00,000 = Rs. 37,600
Tax to be paid: 25,000 + 20% of income exceeding Rs. 5,00,000	25,000 + 20%*37,600 = Rs. 32,520

Thus by claiming Rs. 50,000 under section 80C, the professional made saved 32,520-23,760 = Rs. 8760.

There definitely are benefits to availing the deductions under various sections of the income tax. But sometimes tax saving decisions are made without considering the effects of these decisions on personal finance.

② http://www.incometaxindia.gov.in/Tutorials/2 Tax Rates.pdf

Tax Mistakes made:

In the haste to invest to save tax, financial decisions are made that give short term benefits but may not be the best decision as such. Following are the 6 most common mistakes that professionals tend to make while saving for taxes:

1. **Investing in a Public Provident Fund:** From Table 2, it can be seen that the return from provident fund is 8.65% when compared to PPF which yields only 8% returns. While the underlying assets are the same for both PF and PPF, the returns however are not the same.

2. **Buying an Endowment/ULIP/Money back insurance policy:** Tax paying professionals invest in insurance with the assumption that it serves as an instrument for both investment and insurance. But, it is no better than keeping your money in a savings account. Returns from an endowment plan for example is only 4-5%.

3. **Investing in low yield schemes:** The FD rates of most of banks are less than 7%. Yet in the hopes of tax saving, tax paying professionals invest in FDs/RDs despite the low yield. Central government savings schemes are low yield as well. The underlying assets of central government savings schemes such as PF, Sukanya Samriddhi, Senior Citizens Saving etc., are government bonds. When the RBI cuts the interest rates, the government bond yields fall as well. The fall in government bond yields will also result in the lower yield of central government savings schemes. The government revises the yields of these schemes. The most recent example of which is the reduction in the PF yield from 8.8% to 8.65% and the PPF yield reduced to 8%.

4. **Not claiming all sections:** There are over 2100+ income tax declarations were studied for this report. However, the number of declarations with deductions claimed under non 80C sections was only 256.

   - **Claims under section 80D:** Tax paying professionals of every age need a health check-up and they get it done every year but no one knows that we can claim a deduction for it Under section 80D we have a limit of Rs. 15,000 from which we can get a deduction of Rs. 5,000 from health check-up.

   - **Claims under section 80 CCD:** After deductions of up to Rs. 1,50,000 have been claimed under Section 80C, NPS has a special provision for saving an additional Rs. 50,000 Under section 80CCD.

   - **Claims under section 80E:** Deductions can be claimed on the interest paid on the education loan under this section. There is no limit to the amount of deduction that can be claimed.

   - **Claims under section 24B:** If a person has a home worth Rs 50,00,000 and has a home loan worth Rs 35,00,000 and it is a self-occupied home then he can claim a deduction up to Rs 2,00,000.

5. **Ignoring cash requirement:** An individual can avail a tax benefit of up Rs.1,50,000 under section 80C. However, for an individual with an income of Rs. 4 Lakhs per annum using up the entire limit of Rs. 1,50,000 under section 80C would mean a shortage of immediate access to cash. Similarly individuals invest more than the limit they can avail for deductions. For example, investing 2.5 Lakhs of premium on an endowment plan while the limit of tax benefit than can be availed is only Rs 1.5 Lakhs.

6. **Deciding not to pay tax:** Taxes are beneficial to the national financial health. Yet salaried professionals try to avoid paying tax by over investing in tax deductible schemes. Sometimes the professional attempts to save tax even if his current financial situation does not allow him to save or get a good return on his tax deductible investments.

In order to understand some of the tax planning behaviour of professionals, we studied the tax entries of over 2100 professionals across various cities. There are numerous aspects that determine the tax behaviour of individuals: the age, income, marital status, city, profession etc. However, income and marital status are a function of the age of the professional. Therefore, we examined the age-wise behaviour and the behaviour by city.

A study of tax behaviour across ages and cities

Claims made under Section 80C

Our study found about 42.32% of the individuals had claimed tax deductions under Section 80C. 80C allows a maximum of ₹1,50,00. In our study we found that the average tax deductions claimed under Section 80C was ₹79,583. The most preferred investment for claiming income tax deductions section 80C was found to be PPF followed by Children's education, Others and 5 Years of Fixed Deposit (Fig 1). The others comprises of tax saving schemes eligible under Section 80C such as ELSS, Sukanya Samriddhi Yojana and Senior Citizens Savings Scheme.

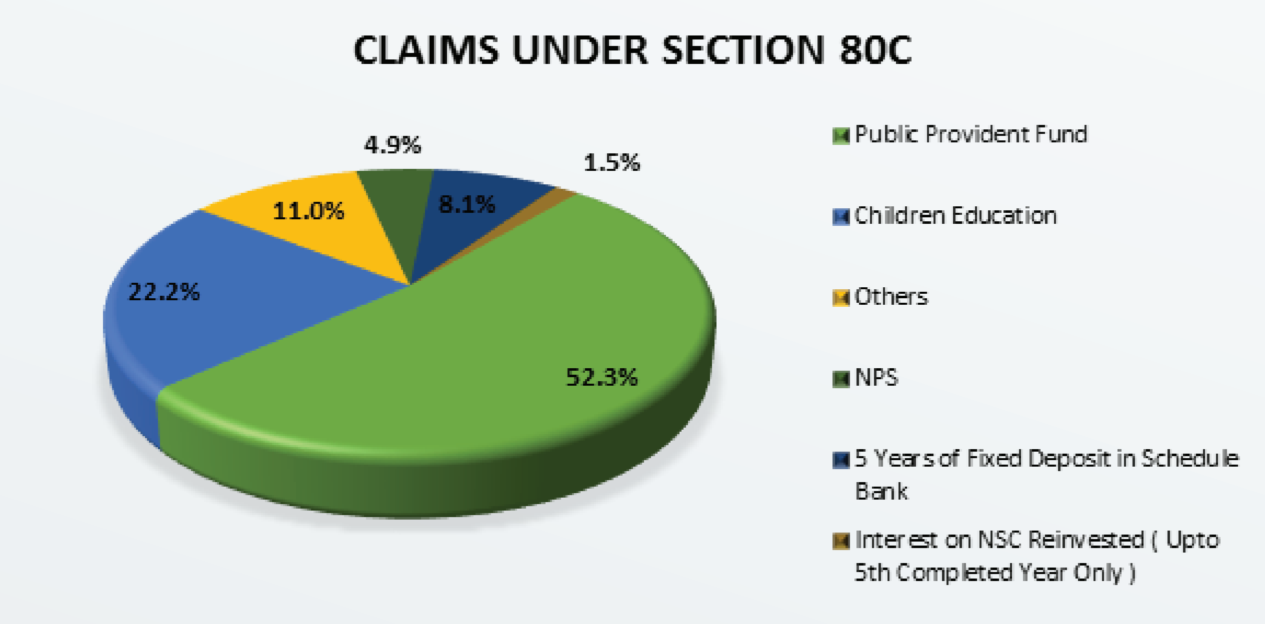

Fig1: The common deduction claims made under section 80C

Tax Deduction Claims made under Section 80C- by Age

Top 3 Preferred Tax Deduction claims under 80C by age						
20-25	25-30	30-35	35-40	40-45	45-50	50-55
Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund
5 Years of Fixed Deposit in Schedule Bank	Others	Children Education	Children Education	Children Education	Children Education	Children Education
Interest on NSC Reinvested (Upto 5th Completed Year Only)	5 Years of Fixed Deposit in Schedule Bank	Others	Others	Others	Others	Others

Table 4: The top 3 common claims made under section 80C by age

PPF is the most common method used by professionals for tax saving across all ages(Table 4). However, when it comes to using FD for tax saving purposes, it has been observed that as the age goes up, the dependence on FD as a savings scheme goes down (Fig 2). FD was the second most preferred means of claiming tax deductions under 80C for the age group of 20-25. 20-25 year olds are young professionals and typically the young professio-anl's first financial advice comes from their family, which is why the first investment made by young professionals is typically in FD.

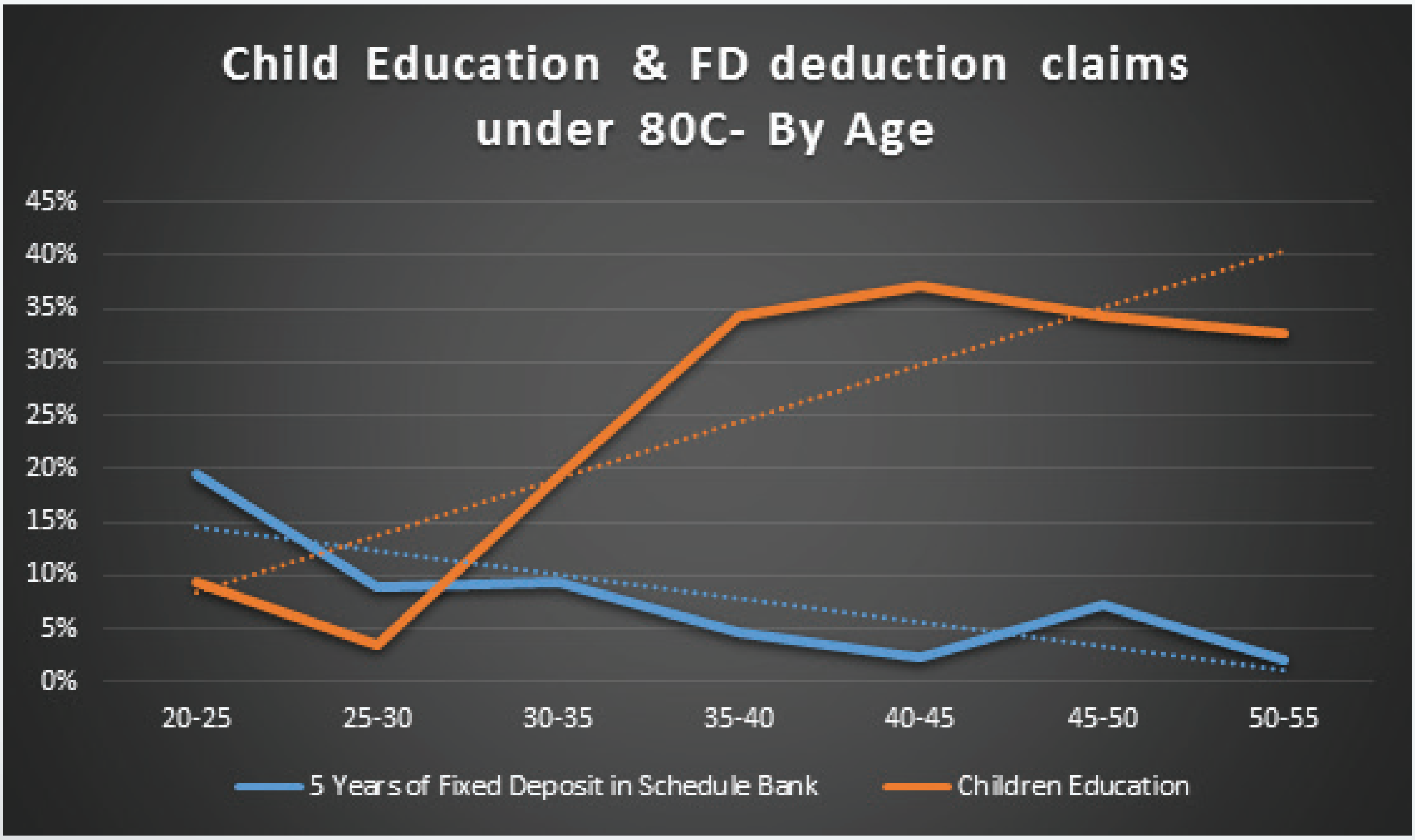

Fig 2: Use of FD for tax deduction decreases while Children's education increases with age

But over time Child's education claims becomes the second most preferred deduction under 80C. This is because the likelihood of a person having a school-going child becomes higher as the age of the person goes up. As the age goes up, the traditional FD is gradually replaced by Child's education claims to become the second most preferred deduction under 80C.

The tax deductions claimed through ELSS remains low irrespective of the age group of the professional.

AGE Group	20-25	25-30	30-35	35-40	40-45	45-50	50-55
% Availing	2.8%	3.2%	2.4%	1.4%	0.6%	3.6%	4.3%

Claims made under Section 80C- by City

We looked at the tax entries of professionals based out 7 major cities in India- Bangalore, Chennai, Delhi-NCR, Hyderabad, Kolkata, Mumbai and Pune.

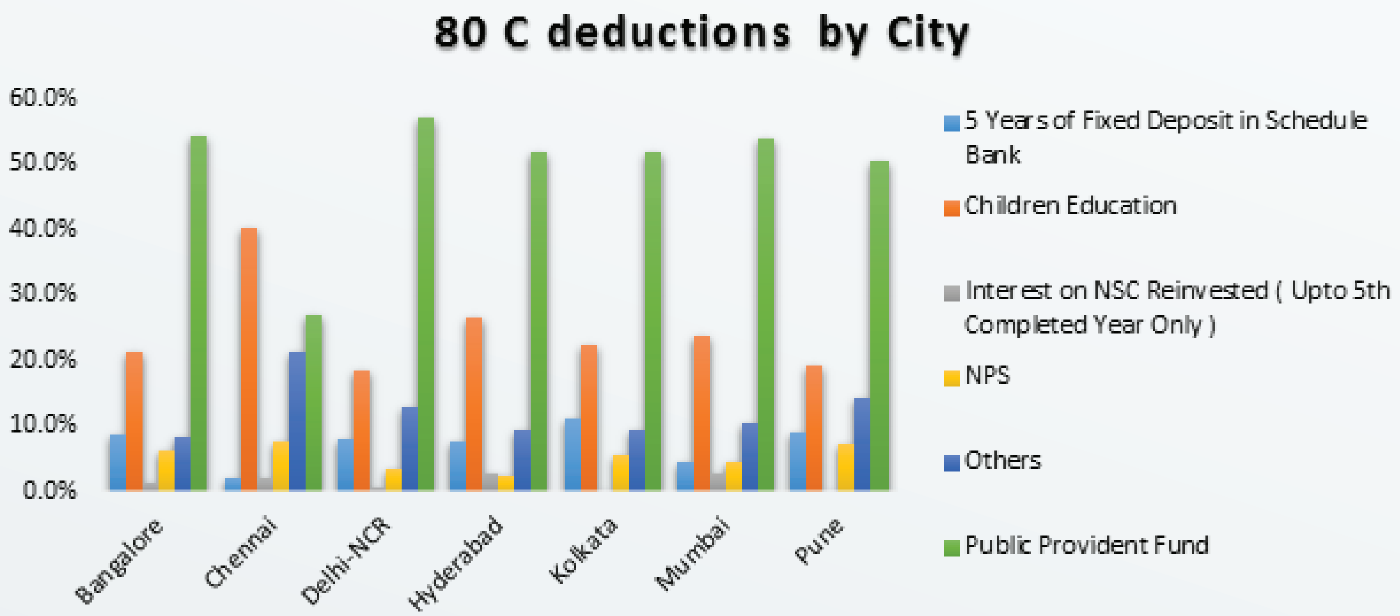

Fig 3: Deduction claims made under section 80C by city

In all cities, a common pattern emerges in that PPF becomes the preferred investment to save tax under section 80C followed by Children's education. The exception to this being Chennai where the most preferred tax deductible is in the Children's education followed by PPF. The preference for other tax deduction claims (ELSS, Senior Citizens Savings Scheme) is the highest in Chennai- at 21.2%- more than any other city.

The top three preferred tax deductions under 80C by city are given below

Bangalore	Chennai	Delhi-NCR	Hyderabad	Kolkata	Mumbai	Pune
Public Provident Fund	Children Education	Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund	Public Provident Fund
Children Education	Public Provident Fund	Children Education	Children Education	Children Education	Children Education	Children Education
5 Years of Fixed Deposit in Schedule Bank	Others	Others	Others	5 Years of Fixed Deposit in Schedule Bank	Others	Others

Table 6: Top 3 tax deduction claims under section 80C made by city

Tax Deductions Made Through Other Sections

The number of individuals with tax deductions claimed under non 80C sections was only a little over 12%. Of these the most common section that tax deduction claims were made in after 80C is section 80D, which is related to health/health insurance of self and family, followed by NPS (Section 80DD). The average claims made under all these sections combined was Rs. 15,237/-

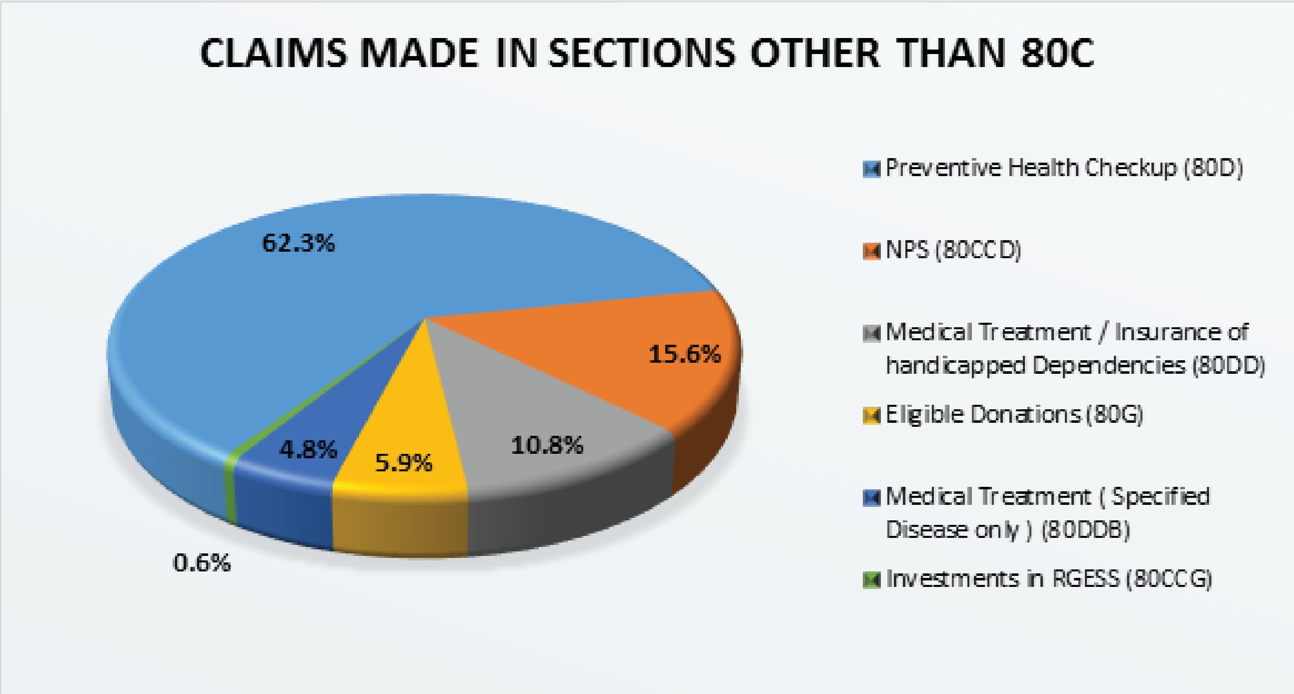

Fig 4: Non 80C deduction claims made

Claims made in all Sections other than 80C- by Age

The most preferred tax deduction claimed by all age groups is under section 80D for medical insurance and preventive Health Check Up. While every professional is eligible for tax deductions under 80CCD, which is the 50,000 Rupee deductible over and above the 1,50,000 tax deduction through Section 80C, the % of tax paying professionals actually availing this service is only 2.5% of the 12% of salaried professionals who save tax through sections besides 80C

The % of tax paying professionals investing in NPS decreases with age. This could because the NPS was rolled out more recently compared to the other schemes available under Section 80C. Until recently, NPS was eligible only for employees joining the workforce after January 1 2014.

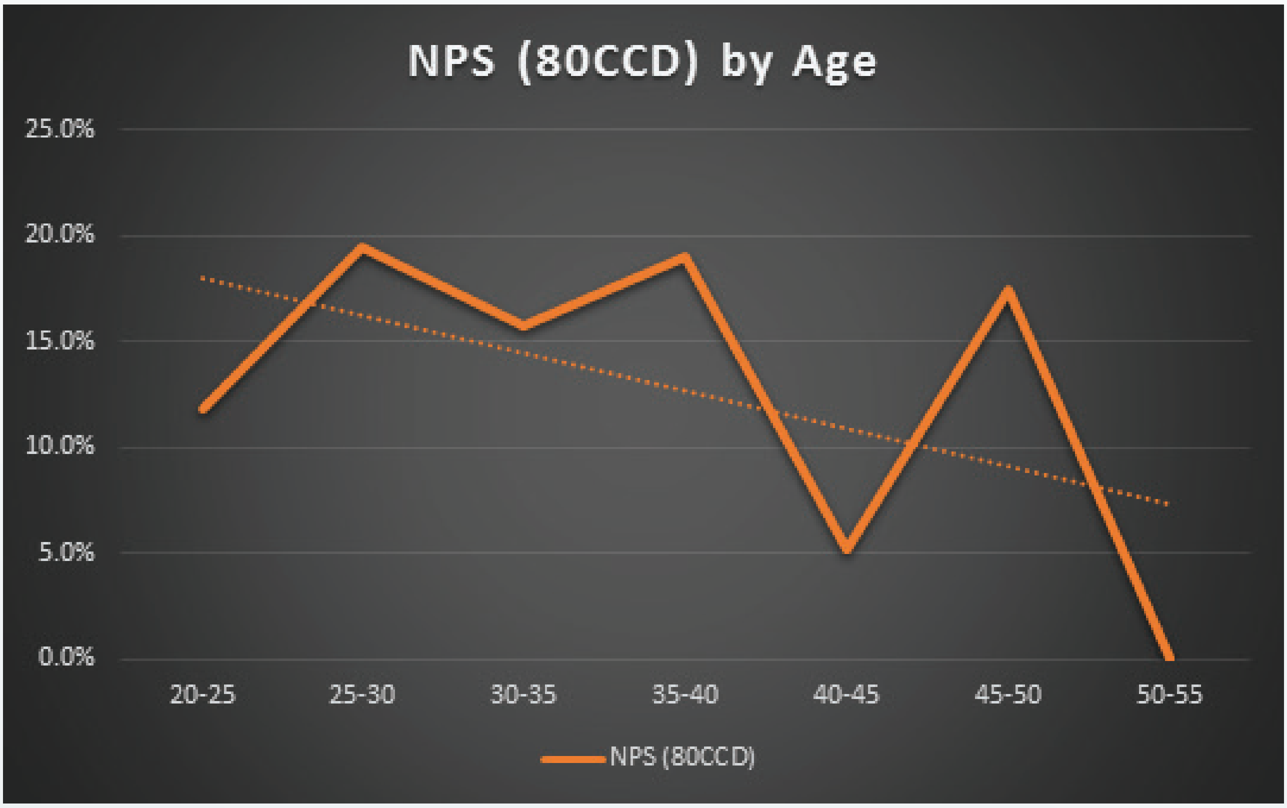

Fig 5: NPS claims made under section 80CCD by age

Claims made in all Sections other than 80C- by City

The most common claims in tax deductions outside of Section 80C across cities is through section 80D, namely the Preventive Health Check Up. Section 80CCD – deductions for NPS- is availed most in the city of Chennai (Fig 6).

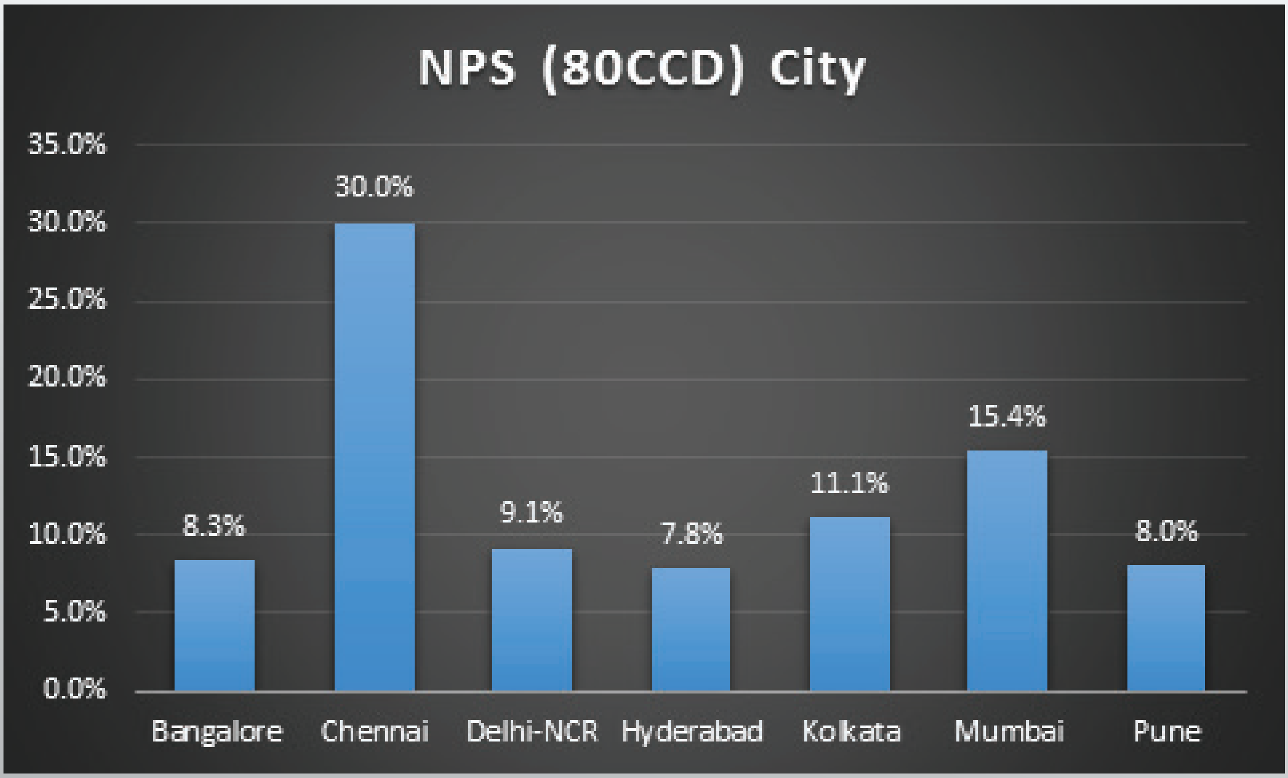

Fig 6: Occurrence of NPS claims made under section 80CCD by city

The tax filings by Chennai based professionals are distinctly different from that of the other major cities in India. This could be an indication of distinct financial values held by Chennai compared to other cities.

Good Tax Planning:

There is no 'one size fits all' approach in good tax planning. It varies based on every individual. Good investment planning might help you make better rates of return. Good investment coupled with good tax planning on the other hand can help you to earn benefits of up to 40%. Successful Tax planning starts by understanding the rules of the tax game. Tax planning requires multiple perspectives.

Planning your taxes has an impact on your personal finance. With bad tax planning you might end up paying excess tax or purchasing tax savers that yield poor returns. One problem with tax planning is that professionals often miss the opportunities to save further on their taxes.

Example: Payment of interest on home loan (24B):

If a person has a home worth Rs40,00,000 and has a home loan worth Rs25,00,000 and it is a self-occupied home, he can claim a deduction of up to Rs2,00,000 on interest paid under section (24B) and also save Rs1,50,000 for the payment of principal amount under repayment of home loan under section 80C which means he can save Rs. 3.5 Lakhs as against the Rs. 1.5 Lakhs under section 80C .

Tax Planning age wise:

23– 30: This age is the starting phase of career and is the right time to start saving for the future. Investing in a mix of ELSS and Pension related schemes like EPF, NPS is a good option but avoid falling in the trap of endowment plans and ULIP's for professionals of this age group.

31 – 36: The professionals can generally take advantage of avenues of tax savings other than investments. Contribution to PF by self and employer, required life insurance cover for self and family will form the major portion of 80C. Tuition fee of the children can also be claimed under the same section.

36 – 45: Non-investment related tax savings will play a major role in tax planning even during this phase. Principal repayment on existing home loan, contribution for PF, tuition fee of children, life insurance cover for self and family account for more than 1.5 lakh under section 80C for most of the professionals in this age group. The investors also have an option to choose VPF(Voluntary Provident Option) where they can contribute more than the existing for the provident fund.

46 – 60: This is generally the peak earnings phase of the professionals. Most of them try to pay off their existing debts and channelize their income towards savings for retirement. The same factors of home loan, tuition fee and PF account for majority of the tax savings. Most of the professionals do not opt for health insurance other than the one provided by their organizations. Avoid buying excessive insurance or tax saving investments.

60+: Capital protection should be the motto of the investments being made after retirement. All investments should be in debt. Retired employees can invest in Senior Citizen Saving Schemes (SCSS).

Cash Requirement:

Disposal of money is the second most important reason to have a good tax planning. This means that if the person requires access to money it should be easy for him/her. In the attempt to save taxes, investment decisions should be made considering the short term cash requirement. For this, tax paying professionals have to plan and invest in a scheme which will help them to withdraw their money with ease.

The best investment in this case would be investing in ELSS which has a lock in period of 3 years when compared to PPF which has a lock in period of 6 years. NSC has a lock in period of 5 years while LIC's endowment plan also has a lock in period of 5 years, etc.

Conclusion

Designing a tax plan requires multiple factors of consideration. A tax saving scheme may give you temporary relief from tax payment, but may also have bad consequences in other aspects of personal finances.

If you require assistance in understanding how to plan for your taxes, ask your personal financial adviser today. Tax season is about to begin!

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