Rationalizing Tax Savings

By Dhirendra Kumar | Feb 15, 2010

Its tax-saving season and the purveyors of tax-saving investments are out in full force. For the most part, this means insurance companies and unit-linked insurance plans (ULIPs). There was a time when tax time was driven by accountants asking salary-earners to invest in NSCs. That option is still open, but the sales pitch has been taken over by tele-marketers extolling the virtues of ULIPs from at least January onwards. In fact, the calls actually started in December this time. The reason was that from January 1st, new expense rules meant that only newer, lower-cost ULIPs could be sold. Th

erefore, the insurance industry made a special effort in December to ensnare as many people as possible in the older, higher-cost ULIPs.

Anyhow, the real problem is that many of us are still not planning our tax-saving savings systematically, which is what leaves us scrambling for options at this time of the year. As a result, I find that for tax-saving investments, we tend to think about tax first and investments later. As long as something saves tax, its characteristics as an investment are paid less attention to. Much of the time, waking up late to these investments means that they are chosen more for their convenience than for their suitability as investments. The time to plan tax-saving investments is much earlier in the financial year. In February, or March, it's much more likely that you will make hasty decisions.

When you evaluate tax-saving investments as investments, the most important parameters are returns, safety and liquidity. On safety, the government-guaranteed systems like PPF and the NSC score, but they have the longest lock-in. Given the mandatory lock-in of tax-saving investments, it makes sense for most investors to concentrate their investments in ELSS mutual funds. These funds have the lowest lock-in - three years - among all tax-saving possibilities. Given the term of the investments, the chances are that you would earn far better returns than in any other option.

There are other options that give equity-linked returns - ULIPs and the New Pension System. Of these, ULIPs have a long lock-in - at least ten years - coupled with high costs and poor transparency. Moreover, investors have to commit to continuous payments for a

certain period-if they can't keep up then the effective cost shoots up to a ruinous level. However, the money that you put into equity tax-saver funds is best spread out over the year in an SIP. At the end of the year you could end up catching a high point of the market and thus lose out on the advantage that cost averaging through the year will give you.

Anyhow, whether that happens this year or not, it's still not too late. Given the volatility in the markets, you could still do some cost-averaging to be on the safe side, perhaps by breaking up your investing into three equal parts till 31st March.

On a different note, there's a piece of bad news for honest and regular tax-payers who were looking forward to the Direct Tax Code. The draft DTC was released by the government last year. Although the document had some rough edges, its thrust at simplicity was refreshing. However, things are not looking so bright for the new code now. Within the government, there seems to be a lot of rethinking on the DTC. My belief is that within the government and the bureaucracy, as well as in the accounting profession, there are a lot of vested interests who don't welcome simplicity. These people's livelihood and influence depends on the taxation system being complex and open to abuse, and they will fight hard against its simplification. I hopetheir efforts fail but at the moment, things don't look very good.

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