Chapter : 3

A REVIEW OF TAX SHELTERS AND TAX-SAVING TECHNIQUES

CHAPTER 3

A REVIEW OF TAX SHELTERS AND TAX-SAVING TECHNIQUES

3.1 A round-up

Income tax saving schemes and strategies that apply generally revolve around the following :-

1. Rebate-yielding investments
2. Measures to minimize taxable current income
3. Strategies to minimize taxes on capital gains
4. Others that yield tax benefits such as buying a medical insurance policy, donations to specified charities etc.

At the time that the questionairre was administered, that is, during Finvest '95, held in Baroda in November, 1995, the assessment year prevailing was 1995-96. Hence, the schemes and strategies relate to the laws in force during financial year 1994-95. However, most questions are of a general nature which can extend to situations in previous years. In what follows, an overview of the relevant schemes and strategies is given. However, it is preceded by a simplified presentation of how the amount of taxable income is determined.

3.1.1 COMPUTATION OF INDIVIDUAL TAXABLE INCOME FROM ALL SOURCES

1. Income from salary (gross)
2. Income from house property
3. Profits and gains of business or profession
4. Capital gains
5. Income from other sources

minus

Deductions from Gross Total Income
under the above heads separately

These include

1. a. Standard deduction
   b. Entertainment allowance
   c. Professional tax
2. Deduction under Section 24
3. Allowable business expenditure
   e.g. Section 30 onwards
4. Allowable exemptions & deductions with benefit of indexation
5. Deduction under Section 57

minus

Adjustment on account of set off
and carry forward of losses

equals

Gross Total Income

Less : Deductions under Section
80 C to 80 U

equals

Net Income liable to tax

Computation of tax liability

Tax on net income

Less : Rebate under Sec. 88 etc.

Balance

Less :

Tax deducted at source

Tax paid in advance

Tax liability

When one scans the different heads for aggregating the gross total income, it is clear that for most individuals sources numbered 4 and 5, i.e., capital gains and income from other sources would be relevant. What is likely to differ from one tax-payer to the other is that one might be a salary earner while the other a businessman and the third perhaps a property owner earning rental income. Hence, the questionairre which was randomly administered laid emphasis on what would be common to all – – rebate-yielding investments, strategies to minimize taxable current income, capital gains, etc.

3.2 Rebate-yielding investments

An individual contributing to a provident fund or a life insurance policy or other specified investments becomes entitled to a rebate of 20% of such outlays, subject to a maximum ceiling of rebate (Rs.12,000 in A.Y. 1995-96) under Section 88 of the Income Tax Act. (For authors, playwrights, musicians and some others, the rebate was higher at 25% with the ceiling at 17,500) The list of eligible investments for the above-mentioned assessment year included the following:[1]

1. Premium paid on life insurance policies
2. Contributions to provident funds
3. 10-year and 15-year deposits under Post Office Savings Bank (CTD) Rules, 1959
4. National Savings Certificates (NSC) (VI & VII issues)
5. Unit-linked insurance plan of UTI (ULIP)
6. Subscriptions to the Home Loan Account Scheme of the National Housing Bank or its notified pension fund
7. Payment towards purchase/construction of a new house or instalment repayment on housing loans from approved agencies

8. Contribution to effect or keep in force a contract for notified annuity plans of the LIC (i.e. Jeevan Dhara/Jeevan Akshay)

9. Contributions to NSS

10. Contribution to ELSS subject to a maximum of Rs.10,000

3.2.1 LIFE INSURANCE

There are a variety of life insurance policies as was mentioned in the previous chapter. The premium paid on such policies (on own life or life of spouse or child including a married daughter -- but restricted to 10% of the sum assured) and contributions to Jeevan Akshay and Jeevan Dhara are eligible for rebate. Since a life insurance policy is a unique financial product in that it provides protection against financial loss due to premature death, it is not quite comparable to the other rebate-yielding investments except, perhaps, for ULIP and Dhanraksha. Incidentally, if a taxpayer discontinues his LIC policy in less than two years, he forfeits all tax benefits with respect to the policy.

3.2.2 PROVIDENT FUNDS

Provident fund contributions can be either those made by an employee to his statutory or recognised provident fund account or by any individual -- employee, businessman, professional, etc., -- to a PPF account.

As mentioned by Singhania[2], the provident fund scheme is a retirement benefit scheme. Under this scheme, a stipulated amount is deducted from the salary of the employee as his/her contribution towards the fund. The employer provides a matching contribution to the fund. The corpus so created is invested in a prescribed manner. The interest earned thereon is credited to the provident fund (PF) account of employees. Thus, the credit balance in the employee's PF account comprises the contributions of the employee and employer and the interest thereon. The accumulated sum is paid to the employee at the time of his retirement or resignation. In the event of death of the employees, the accumulated balance is made over to the legal heirs. Additionally, there are related aspects such as the following: If an employee has rendered continuous service for 5 years or more, the accumulated balance that is due and payable is excluded from his total income. However, here too, there are relaxations. For example, if the employee's ill-health caused his service to be prematurely terminated, he would still receive the beneficial tax treatment mentioned above. It is quite clear that the PF scheme encourages thrift (voluntary contributions above the stipulated amount are possible) and gives rise to a substantial pool of funds. That helps in fuelling economic growth. Thus, contributions to the provident fund qualify for the tax rebate under Section 88. Incidentally, the prescribed pattern of investment for the year 1994-95 was as follows :

Prescribed investment	Prescribed percentage
Government Securities	15
Special Deposit Scheme	55
PSU Bonds	30

As for the PPF account, it is among the more attractive of the tax-saving schemes, that an individual can invest ın. Briefly, its features are as under :[3]

1. Any individual may open a PPF account in his own name, or on behalf of a minor for whom he is a guardian and HUF. By the Finance Act 1994, contributions on behalf of spouse and major children also qualify for rebate. But it needs to be noted that contributions on behalf of spouse or children are subject to gift tax laws.

2. The account may be opened at any branch of the State Bank of India and its subsidiaries or at certain branches of nationalised banks and designated post offices.

3. It is a fifteen-year scheme, wherein the annual subscription may range from Rs.100 to Rs.60,000, payable either as a lumpsum or in instalments as permitted. The interest earned on the balance is compounded annually. For the financial year 1994-95, the rate of interest notified was 12% p.a.

4. Nomination facilities are available.

5. The full balance may be withdrawn after the expiry of 15 years from the completion of the financial year in which the subscription is first made.

6. Three years after opening the account, the depositor becomes eligible for a loan as per the rules. However, after the end of the fifth year, following the expiry of the year in which the initial subscription was made, no loan is obtainable.

7. Account holders are permitted to make one withdrawal every year from the seventh financial year. The amounts that can be withdrawn are subject to the rules specified for the same.

8. In the event of the account holder's death, the amount standing to his/her credit will be repaid on demand to his/her legal heirs or the nominee.

9. At the subscriber's option, the scheme may be extended beyond its maturity for terms of five years at a time.

10. The PPF account cannot be attached under any order or decree of court.

11. The PPF scheme carries multiple tax benefits. These are:

a. Rebate under Section 88 on the yearly contributions.

b. Total exemption on the interest earned under Section 10.

c. Exemption from wealth tax on the entire deposit in the account.

3.2.3 POST OFFICE SAVINGS SCHEMES

Contributions to ten- (discontinued) or fifteen-year Post Office Savings Bank (Cumulative Term Deposit) Account standing in the name of an individual (assessee), or a minor of whom the assessee is the guardian, or any member of the family where assessee is an HUF, are eligible for rebate.

3.2.4 NATIONAL SAVINGS CERTIFICATES

The NSC VI and VII series were discontinued with effect from April 1, 1989. Thereafter, NSC VIII series began to be issued. The salient features of NSC VIII series are as follows :

1. They can be bought by any adult individual either singly or jointly. Besides, non-resident Indians, parents and guardians on behalf of a minor and trusts may also purchase these certificates.

2. NSCs are issued by authorized post-offices.

3. Nomination facility is available.

4. The denominations are Rs.100, Rs.500, Rs.1,000, Rs.5,000 and Rs.10,000.

5. The interest rate is 12% p.a. compounded semi-annually. It works out to an effective rate of 12.39%.

6. They are encashable at any post office, subject to verification of the holder's claim. Premature encashment is permitted only under specific conditions such as the death of the holder(s), forfeiture by the pledgee

or under court's order. Further, no interest is payable in the event of encashment within one year.

7. Transfers are permitted subject to certain conditions/rules.

8. The amount invested is eligible for rebate under Section 88 @ 20% (25% in case of authors, artists and others), subject to a maximum overall rebate of Rs.12,000 (Rs.17,500 for authors, artists, etc.). The interest accruing during the interim years shall be deemed to have been reinvested and so yield the benefit of rebate. Further such interest is also deductible under Section 80L upto Rs.10,000 (revised subsequently).

3.2.5 ULIP AND DHANRAKSHA

ULIP or Dhanraksha contributions may be made in the names of the following persons:

1. the assessee himself/herself
2. the assessee's spouse and child
3. for HUF, any one member

ULIP provides life insurance, accident insurance cover and a medium to save money. Its features are as follows :

1. It offers a choice of two maturities viz., 10 years and 15 years.
2. Any resident in India above 18 years may apply. However, the upper age limits prescribed are 50 $^1/_2$ for the 15-year plan and 55 $^1/_2$ for the 10-year plan.
3. No medical examination is necessary. Women having a regular income of their own may enroll in the plan provided they are not pregnant at the time of entry.

4. ULIP may be in joint names, but the benefits of insurance would go to the first-named.

5. The target amount can be as low as Rs.3,000 or as much as Rs.60,000. It should be in multiples of Rs.1,000 under the 10-year plan and Rs.1,500 under the 15-year plan. The annual contribution may be deposited either on a semi-annual or annual basis.

6. The annual contribution is one-tenth of the target amount for the 10-year plan and one-fifteenth of the target amount for the 15-year plan.

7. At the termination of the period, the cash equivalent of units standing to the subscriber's credit will be paid alongwith the maturity bonus applicable.

8. If death occurs within the first year due to natural causes, the amount of insurance is limited only to the premia paid to LIC out of the contribution. But if death occurs due to accident in the first year, then the full life insurance cover which is the difference between the target amount and the sum total of all contributions paid or due till death will be available from the very beginning. Full life cover as mentioned above will also be available in case of natural death from the second year onwards.

9. The personal accident insurance cover is in addition to the life insurance provision. The accident cover is restricted to Rs.15,000, regardless of the target amount.

10. Nomination facility is not available, although as mentioned earlier, joint subscription is possible.

11. The amounts of yearly subscription qualify for tax rebate. The dividends that are declared yearly and reinvested are deductible under Section

80L. However, the benefit of rebate is not available on the reinvested dividends.

12. When a member participating in ULIP terminates his participation before making contributions for a period of five years, no tax benefit is allowed in respect of contribution(s) made in such year. Moreover, an amount equal to an aggregate of tax benefits allowed in respect of contributions in the past years shall be deemed as tax payable by the assessee of the previous year in which he terminates his participation in the plan.[4]

The Dhanraksha plan is very similar to ULIP as it bears the following features:

1. A maximum target amount of Rs.60,000 and a choice of ten-year and fifteen-year plans.
2. The option to contribute annually or semi-annually.
3. The provision of life insurance and accident cover.
4. Tax benefits of rebate on the contributions and deduction of dividends under Section 80L.

3.2.6 HOME LOAN ACCOUNT

The Home Loan Account (HLA) scheme is for a very specific purpose. It is a vehicle to cumulate savings which would in future constitute the margin money for a housing loan. Hence, this tax shelter would interest only those who have a specific time-bound goal of buying a house. Nevertheless, some features of the HLA scheme are looked at below.

1. The scheme has been promoted by the National Housing Bank, the apex institution for housing finance in India. An HLA can be opened at a bank.

2. There is flexibility on the amount of contribution, subject to a certain minimum. Further, the contributions can be at monthly/quarterly/half-yearly/yearly intervals.
3. The money in the account earns interest @ 10% p.a. compounded annually.
4. The minimum time period is three years, with no specified terminal period.
5. The amount of the loan is a pre-fixed multiple of the accumulated savings depending upon the size of the house. However, the amount of the loan cannot exceed Rs.300,000.
6. The repayment may be spread over 15 years or less depending upon the borrower's capacity.

The scheme suffers from certain infirmities. The upper limit of Rs.300,000 is not in step with the galloping cost of houses. Also, there has been a gradual increase in the size of housing loans in percentage terms i e. a reduction in the margin requirement. This has resulted in the HLA losing appeal to house buyers in general.

3.2.7 PURCHASE OR CONSTRUCTION OF A HOUSE

Any payment effected towards the cost of purchase/construction of a new residential house property is eligible for rebate. The rebate is permitted on payments up to Rs.10,000 for the aforesaid purpose. More specifically, the following payments will qualify for rebate.

1. Any instalment or part payment of the amount due under any self-financing or other scheme of any development authority, housing board or other authority engaged in the construction and sale of house property, on ownership basis; or

2. Any instalment or part payment of the amount due to any company or co-operative society, of which the assessee is a shareholder or member, towards the cost of the house property allotted to him; or

3. Repayment of the amount borrowed by the assessee from -

   a. the Central Government or any State Government, or

   b. any bank, including a co-operative bank; or

   c. the Life Insurance Corporation of India; or

   d. the National Housing Bank; or

   e. any public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes which is approved for the purposes of Section 3b(1)(viii), or

   f. any company in which the public are substantially interested or any co-operative society, where such company or co-operative society is engaged in the business of financing the construction of houses.

   g. the assessee's employer where such employer is a public company or public sector company, or a university established by law or a college affiliated to such university or local authority or a co-operative society.

The aforesaid benefit is contingent upon investment in a real asset, i.e., a house. Hence, it is not comparable to the other tax-saving financial assets.

3.2.8 JEEVAN DHARA AND JEEVAN AKSHAY

The Jeevan Dhara is a monthly pension scheme for one's life along with the repayment of accumulated premiums on death to his heirs. As per the example given in Nabhi's Income Tax guidelines[5], if a thirty-year old individual pays a premium of Rs.1,107 every year for 25 years, he/she will get an annuity of Rs.12,000 after attaining 55 years, for the remainder of his life. On his death after the annuity starts, his heirs will receive a payment of GIVE (Gross Insurance Value Cover) of Rs.119,640 with additional lumpsum bonus. Likewise, a thirty five-year old paying a premium of Rs.1,938 every year for 20 years will get the same annuity at the age of 60 years and a lumpsum GIVE on his death. There are certain other features relating to the eventuality of death during the deferment period; for example, the total amount of all premiums is paid if death occurs during the first three policy years. As regards the bonus, the participation in profits is at the rate declared by actuaries at certain stages.

Under the Jeevan Akshay (JA) plan, the premium is a lumpsum amount which subsequently yields a monthly annuity. The amount of annuity is the same as in the case of Jeevan Dhara plan. The JA plan is suitable for those who may receive a lumsum amount by way of gratuity, provident fund, leave encashment, etc. on their retirement. The plan also bears a money-back feature. Seven years after the pension payment begins, one gets 30% of the purchase price. The pension continues at the same rate.

3.2.9 NATIONAL SAVINGS SCHEME (NSS)

The salient features of the NSS 1992 are as follows:

1. An adult individual, HUF or an association of persons/body of individuals as specified may invest in the scheme by making deposits in a savings account opened with any Head/authorised sub-post offices.

2. A separate account needs to be opened by depositors every year.

3. The account may be jointly with another adult individual; alternatively it may also be on behalf of a minor, with the adult as guardian.

4. The minimum deposit is for Rs.100. Further deposits are to be in multiples of Rs.100. There is no maximum ceiling. Also deposits need not be made every year.

5. Interest is earned @ 11% p.a. on the lowest balance to the credit of an account between the eleventh day and the last (both days inclusive) of each calendar month. The interest is to be computed and credited in the account on March 31 annually.

6. The provision relating to withdrawals are as follows:

   a. The interest credited in the account may be withdrawn at any time at the option of the depositor.

   b. The deposits made in an account may be withdrawn after the completion of four years from the end of the year in which the account was opened. The deposits that remain even after withdrawals become allowable, will earn interest @ 11% p.a.

7. The depositor is given a passbook for recording all entries of deposits, interest and withdrawals.

8. An account may be closed at any time after the passage of four years from the end of the year in which the account was opened. In the event of a depositor's death, the account may be closed at any time thereafter and interest @ 11% p.a. will be added up to the date of withdrawal.

9. The amounts deposited qualify for a rebate of 20% thereof (25% for authors, actors, etc.). Further, the interest earned is taxable on accrual

basis subject to deduction under Section 80L (in A.Y. 1995-96, the limit stood at Rs.10,000).

3.2.10 EQUITY-LINKED SAVINGS SCHEME (ELSS)

The ELSS can be described as a tax-saving closed-end fund that is floated every year by different mutual funds promoted by UTI, Indian Bank, Canara Bank and others. The salient features of the scheme are enumerated below:

1. It is open for subscription to individuals including non-resident Indians and HUFs.
2. The plan has a life of 10 years with an initial lock-in-period of 3 years.
3. There is a provision for repurchase by the issuing institution after 3 years, at prices to be set from time to time. The units shall also be listed on major stock exchanges after 3 years.
4. Dividends may be declared on the units by the fund managers, at their discretion.
5. The investment in ELSS qualifies for rebate under Section 88 at 20% and 25% as in other cases discussed above. Additionally, the dividends declared on the units are deductible under Section 80L subject to the ceiling in force.

Apart from the aforesaid key tax shelters that yield the benefit of rebate, there are a few others in this category. They are as follows :

1. Payment by a person in respect of non-commutable deferred annuity. This may be taken in the individual's name, spouse or child.
2. Any sum deducted from salary payable by or on behalf of the Government to an individual for the purpose of securing to him a

deferred annuity or making provision for his wife or children provided the sum so deducted does not exceed 20 per cent of salary.

3. Contribution by an individual towards an approved superannuation fund.
4. Contribution by an individual to any notified pension fund set up by a Mutual Fund or by the UTI.
5. Any sum paid as subscription to a notified deposit scheme (excluding those bearing Section 80L benefits) of specified companies/authorities engaged in providing or financing housing/construction, town and village developments etc.

3.3 Techniques to minimize taxable current income

A number of means can be adopted to minimize taxable income. They are as follows:

1. Give priority to investment in shares, units, bank deposits and other specified outlets so as to derive benefits under Section 80L.
2. Acquire shares of prospering companies but whose dividend payout is lower.
3. Acquire shares of good companies which are inclined to issuing bonus shares rather than paying high dividends.
4. Investing in tax-free securities.
5. Substituting ordinary income by capital gains through the acquisition of deep discount bonds of an appropriate maturity.

3.3.1 BENEFITS UNDER SECTION 80L

The benefit of deduction under Section 80L is available to individuals or HUF. The ceiling for A.Y. 1995-96 stood at Rs.10,000 (subsequently revised upwards). The following categories of current income are eligible for deduction under this section.

1. Securities of the Central Government or a State Government.
2. NSCs
3. Debentures/Bonds issued by a co-operative society or any other notified institutions (including a public sector company with effect from the assessment year 1987-88).

   These include debentures issued in the past by State Electricity Boards, Housing Boards and some other entities including bonds of some financial institutions and public sector companies.
4. Deposit under notified National Deposit Scheme, 1992.
5. Deposit under the Post Office (Monthly Income Account) Rules 1987 [with effect from the assessment year 1989-90 onwards].
6. Shares in any Indian company.
7. Units in the Unit Trust of India.
8. Units of Mutual Funds specified under Section 10(23D).
9. Deposits with a bank or a co-operative bank.
10. Deposit with an approved bank established by a law made by Parliament vide Notification No. GSR 86(E).
11. Deposits with a financial corporation engaged in providing long-term industrial finance in India and approved by the Central Government Also, interest on deposits with a public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of residential houses in India.
12. Deposits with State Housing Boards.

13. Deposits with a co-operative society of which the assessee is a member.

14. Shares in a co-operative society.

15. Deposits made under the Compulsory Deposit (Income-tax payers) Act, 1974 and the Additional Emoluments (Compulsory Deposits) Act, 1974.

A helpful development in respect of Section 80L benefits has been a steady upward revision in the ceiling. For example, with effect from April 1, 1996, the limit was raised to Rs.13,000. Therefore, investors ought to try and take the maximum possible advantage of this section by giving priority to the specified investments.

3.3.2 BUYING LOW PAYOUT STOCKS

As discussed above, although the ceiling for Section 80L benefits is fairly high, once it is breached, the benefit of deduction is no longer available. Hence, an interesting way to stay within the ceiling or to circumvent it when it has been fully availed of, is to acquire shares of prospering companies which, for certain reasons, tend to have a lower dividend payout. Two types of such companies can be identified. The first would comprise growth companies that expect sales and profits to burgeon in the years ahead for which production capacities have to be augmented. This calls for conserving and ploughing back profits. Hence, dividends tend to be modest in the growth years. Examples that come to mind are S&S Industries and EPC Irrigation. The former is into sunrise industries such as pollution control equipment, acquaculture and edible oil while the latter is into drip irrigation systems. Both are profit-making companies which have been paying gradually rising dividends in the modest range of 10% to 15%. The important point is that the substantial of plough back of profits besides a modest level of dividends would tend to boost the share price upwards and thus confer capital gains to investors. In terms of tax treatment, (long-term) capital gains are dealt with more favourably as compared to current income (dividends). The second type of company are what are commonly known as FERA Companies, that is, the Indian arm of multinational giants. These include examples like Reckitt & Colman, Hindustan Lever and Colgate. More appropriately, these can be discussed under the following point.

3.3.3 BUYING BONUS CANDIDATES

Another way to dodge the dividend ceiling is to seek shares of good companies which are inclined to issuing bonus shares rather than high dividends. This would against tilt the balance towards the more favourably taxed capital gains rather than current income (dividends). In this context, a reference was made in the previous paragraph to FERA Companies. These multinationals naturally attract scrutiny from the Reserve Bank of India (RBI) and other government agencies on account of apprehensions concerning outward remittance of foreign exchange, through huge dividend payments. Consequently, these firms have hit upon an interesting technique to meet their foreign investors' expectations without being frowned upon by the RBI.

Instead of declaring large dividends, at the rate of say 50% which would be conspicuous, a multinational could announce a 1:1 bonus and then declare dividends @ 25% on the increased share capital. This clever yet little known improvisation results in the same amount of dividend being paid to the shareholders, foreign and Indian as desired at the outset. What was intended is accomplished without causing alarm in certain quarters. The offshoot of this technique is that Indian shareholders are bestowed with bonus shares on which capital gains may materialize in future even though there is no real creation of value. To remain under the dividend ceiling, one could consider liquidating a part of the shareholding, at an appropriate point in time. However, this may not be necessary if the level of dividends are reduced somewhat.

3.3.4 ACQUIRING TAX-FREE SECURITIES

Investing in tax-free securities is yet one more way of bypassing the dividend net. The avenues are Relief Bonds and (Notified) PSU Bonds. A look at the salient features of these securities may be in order :

1. Relief Bonds 1993

   a. These may be purchased by any individual in his own name (or jointly with another individual) or on behalf of a minor and/or HUF.

   b. There is no maximum limit on the investment.

   c. Application for the bonds may be made to the designated offices of the Reserve Bank of India or to designated branches of the State Bank of India, its subsidiaries or nationalized banks.

   d. The bonds have a maturity of five years.

   e. The interest rate is 9% (it was briefly at 10%) and interest is payable at half-yearly intervals, or is compounded at half-yearly rests at the option of the subscriber.

   f. The bonds are transferable.

   g. Nomination facility is available.

   h. The interest is fully exempt from tax under Section 10(15)(iic) and it also bears wealth-tax and gift-tax benefits.

2. The other set of tax-free securities are (Notified) PSU Bonds which have been referred to in the previous chapter. Generally, they have the following features:[6]

   a. The interest income is exempt from income tax.

b. Their life is seven years.

c. Coupons are paid semi-annually.

d. The issuers are engaged mainly in infrastructure activities such as the Railways and Power Utilities.

e. In 1993, the coupon was raised to 10.5%, which translates into a taxable equivalent yield (formula given in previous chapter) of 17.5% for an individual in the 40% tax bracket. While yield of 17.5% per se may not seem impressive, especially in a situation of a liquidity crunch, it must be remembered that PSUs are perceived as quasi-sovereign risks and therefore, yields on PSU Bonds will be lower than those on corporate bonds whose default risk is considered to be higher.

3.3.5 BUYING DEEP DISCOUNT BONDS

Substituting ordinary income by capital gains through the acquisition of deep discount bonds of an appropriate maturity could be yet one more device to minimize taxable current income. However, recent developments suggest that this strategy needs to be carefully employed, going by what was indicated to IDBI in a clarification by the Government. According to it, "the difference between the issue price and the redemption price of Deep Discount Bonds will be treated as interest income."[7] This is corroborated in an article in The Chartered Financial Analyst[8]. It mentions : "The issuers assumed that the income is taxed at a rate applicable for capital gains upon maturity. However, the recent RBI and CBDT guidelines specified that the income is taxed on the basis of accrual and is treated as interest income. Both issuers and investors are seeking a redressal in this regard. According to the guidelines, for an investor who invested Rs.5,300 to get Rs.300,000 at the end of 25 years will be getting only Rs.142,300."

Yet, capital gains may arise on account of yield declines, which would be distinct from the 'cum-interest' value adjustments that would occur routinely every year. This is, however, contingent upon changes in yields, which may even work adversely to impose a capital loss on the holder. Moreover, capital gains would be an additional benefit besides accruing interest income, rather than a substitutive benefit in lieu of interest income.

A reading of the advertisement[9] of IDBI Flexibonds 2, currently (January 1997) on offer helps to clear the air somewhat. For the IDBI DOUBLE MONEY BOND (money doubles in 57 $^{1}/_{2}$ months) following is mentioned regarding tax treatment: "The redemption amount is computed by cumulating interest annually at 15.48% p.a. Interest so accrued may be treated as income by the investor every year. Tax will be deducted at source as per prevailing tax laws. If tax becomes deductible, the redemption amount will be reduced accordingly." In case of IDBI DEEP DISCOUNT BOND, the issue price is Rs.5,500 and at maturity after 25 years, it will be redeemed at its face value of Rs.200,000. There is, however, a call provision resting with IDBI. As for its tax treatment, the following is stated: "If the bond is sold by way of transfer before maturity, the profit on sale will be treated as capital gains and taxed accordingly. If the bond is redeemed with IDBI, the difference between the redemption value and the issue price will be taxed as interest and will also be subject to deduction of tax at source as per prevailing tax laws."

In the same advertisement, a footnote item reads as follows: "Features common to all bonds : Interest income eligible for deduction under Section 80L of the Income Tax Act, 1961 (subject to declaration by the Central Government)." Presumably, this applies to the DOUBLE MONEY BOND and others on offer, except the DEEP DISCOUNT BOND. Based on the aforesaid, acquisition of deep discount bonds would help to substitute capital gains for ordinary income that would have been earned on alternative investments, provided the bonds are sold prior to maturity !

3.4 Strategies to minimize taxes on capital gains

A number of strategies may be adopted to minimize taxes that may arise due to capital gains. These are:

1. Postponing the sale of an asset so as to defer realization of capital gains, at a time when current income is on the higher side.
2. Making capital gains long-term by extending the holding period appropriately for shares, debentures and other securities.
3. Extending loans to relatives who are not tax-payers for making investments in shares. This is a mode of transferring capital gains, so as not to impose additional taxes on oneself.
4. Making capital losses short-term by selling an asset within the designated period.
5. Making gifts of securities/money (to relatives) within the prescribed annual limit. This is another mode of curbing taxes on capital gains to individuals in the non-taxable bracket.

3.4.1 A REVIEW OF TAX PROVISIONS AND TERMINOLOGY

At this stage, a quick review of the salient aspects of the capital gains tax provisions may be in order.[10]

Capital receipts are not liable to tax. However, certain gains on the transfer of capital assets are taxable under Section 45. The taxability of any capital gain is dependent on two factors -- whether there is a 'capital asset' and whether there has been a 'transfer'. Moreover, capital gains would be 'short-term' or 'long-term' depending upon the holding period. There are additional complexities to be dealt with such as indexation in computing the adjusted cost, capital gains on bonus shares and so on.

3.4.1.1 Taxability. Any profits or gains arising from the transfer of capital assets effected during the previous year is chargeable to income-tax under the head 'Capital Gains' and shall be deemed to be the income of that previous year in which the transfer takes place.

3.4.1.2 Capital Asset. It refers to property of any kind held by an assessee including property of his business or profession, but excludes non-capital assets. [Non-capital assets include stock-in-trade, consumable stores or raw materials held for the purpose of business or profession, personal effects such as wearing apparel, furniture, motor vehicles, etc., held for personal use of the assessee or his family, and also agricultural land and bonds as specified. However, jewellery that is part of personal effects is a capital asset. Consequently, any gain arising on the sale of any personal effect is not taxable.] Although "property of any kind" is deemed to be a capital asset, property that is stock-in-trade is not a capital asset. Thus, if an individual deals in house properties, then such properties are stock-in-trade and are not capital assets. So is the case with jewellery manufactured by a jeweller.

3.4.1.3. Transfer. A transfer refers to the act by which a person conveys property to one or more persons. It includes the following :

1. Sale or exchange of an asset, resulting in a transfer of title in a property.
2. Relinquishment of an asset. This is a surrender of one's rights in a property.
3. Extinguishment of any rights in an asset. This covers any transaction which results in destruction, annihilation, extinction, termination, cessation or cancellation of all or any bundle of rights in a capital asset.
4. Compulsory acquisition of the asset under any law.

5. Conversion of the asset into stock-in-trade of a business carried on by the owner of the asset.

6. Handing over the possession of an immovable property in part performance of a contract for the transfer of that property.

7. Transactions involving transfer of membership of a group -- housing society, company, etc., which have the effect of transferring or enabling enjoyment of any immovable property or any rights therein.

8. Distribution of assets on the dissolution of a firm, body of individuals or association of persons; and

9. Transfer of a capital asset by a partner or member to the firm or AOP, whether by way of capital contribution or otherwise.

Certain transactions are not regarded as a "transfer" and are therefore, exempt from capital gains tax. Some of such transactions are:

1. Any transfer on account of total or partial partition of H.U.F. or under gift or will or an irrevocable trust.

2. Any conversion of bonds or debentures, debenture stock or deposit certificates, of a company into shares or debentures of that company.

3.4.1.4 Year of Taxability. Capital gains become a part of the taxable income of the previous year in which the transfer resulting in gains takes place. Accordingly, the year of taxability is the year in which the sale, exchange, relinquishment, etc. has taken place.

3.4.1.5 Classification of Capital gains. The two categories are :

1. Short-term

These are gains on transfer of capital assets held by the assessee for not more than 36 months [12 months for shares held in a company or any other security listed at a recognised stock exchange in India, or a unit of the UTI or of a mutual fund specified under Section 10(23D)], immediately preceding the date of its transfer.

2. Long-term

This refers to capital gains on the transfer of capital assets held by the assessee for more than 36 months [12 months in the case of shares held in a company or any other listed security or a unit of the UTI or of a specified mutual fund].

3.4.1.6 Holding Period. This is the interval between the date of acquisition of the asset and the date of its transfer. While this is the general norm, there are specific yardsticks in certain cases. For example, in the case of bonus shares, the period is reckoned from the date of allotment of such bonus shares.

3.4.1.7 Computation of Capital Gains. It differs according to the term :

1. Short-term

   a. Ascertain the full value of the consideration

   b. Deduct therefrom the following :

      (1) Transfer expenditure like brokerage, legal expenses, etc., and

      (2) the cost of acquisition of the capital asset including the cost of any improvement thereto.

   c. The difference is the amount of Gross (short-term) Capital Gain/ Loss.

   d. Claim permissible exemptions under Sections 54B, 54D and others.

e. The balance is the amount of Net Capital Gain/Loss chargeable to tax.

2. Long-term

   a. Ascertain the full value of consideration

   b. Deduct from the value of the consideration,

      (1) Indexed cost of acquisition of the capital asset

      (2) 'Indexed cost of improvement' to the capital asset and transfer expenses such as brokerage, legal expenses and others.

      (3) The difference is the gross capital gain/loss.

      (4) Claim permissible exemptions under Sections 54, 54B and others.

      (5) The balance is the amount of Net Capital Gain/Loss.

3.4.1.8 Full Value of Consideration. It is the amount for which a capital asset is transferred. So, in the case of a sale, it is the sale price actually paid by the transferee to the transferor.

3.4.1.9 Transfer Expenses. These include brokerage paid for arranging the deal, legal expenses incurred for preparing the conveyance deed and other documents wherever applicable, cost of advertisement inserted in a newspaper for sale of the asset, etc.

3.4.1.10 Cost of Acquisition. The cost of acquisition is the amount paid by the assessee for purchase of the asset.

3.4.1.11 Cost of Improvement. This refers to all capital expenditure incurred in making additions or alterations to the capital asset by the assessee.

3.4.1.12 Indexed Cost of Acquisition/Improvement. While computing long-term capital gains, the Indexed Cost of Acquisition and the Indexed Cost of Improvement need to be deducted, from the full value of consideration of a capital asset. The indexation is with regard to the Cost Inflation Index as outlined below:

$$\text{Indexed cost of acquisition} = \frac{\text{Cost of acquisition x Cost Inflation Index for the year of transfer}}{\text{Cost Inflation Index for the year of acquisition or 1981-82 whichever is later}}$$

$$\text{Indexed cost of improvement} = \frac{\text{Cost of improvement x Cost Inflation Index for the year of transfer}}{\text{Cost Inflation Index for the year of improvement}}$$

3.4.1.13 Rates of Taxes. Income in the form of short-term capital gains is included in the gross total income of an assessee which, after allowable deductions under Chapter VI-A becomes income on which taxes are calculated. The total rebate on specified investments under Section 88 goes towards setting off in part or in whole, the tax liability calculated.

In contrast, long-term capital gains are not clubbed with gross total income but instead are subject to a flat rate of income-tax at 20% in the case of resident individuals and HUFs. The deductions under Chapter VI-A and rebate under Section 88, do not, therefore, figure in the process. Also, it is worthwhile noting, that the rebate is allowable under Section 88 only against taxes payable on taxable income (other than long-term capital gains). Therefore, in a year when such income is likely to be below the taxable limit, (irrespective of the amount of long-term capital gain), an assessee may avoid rebate-yielding investments.

3.4.1.14 Capital Loss. This is the excess of the (indexed) cost of acquisition and improvement plus transfer expenses over the value of consideration in the transfer of an asset. Such capital loss may be short-term or long-term depending upon the holding period of the asset.

3.4.1.15 Features of setting off/carrying forward Capital Loss. Any capital loss (short- or long-term) may be used to offset capital gains of any tenure from any other source but against no other income of the assessee. The amount of capital loss (short- or long-term) that still remains may be carried forward to offset capital gains in the next eight assessment years.

Incidentally, certain exemptions are permitted in some cases such as the transfer of a residential house, of agricultural land, asset other than a residential house, etc. For instance, any long-term capital gains resulting on the transfer of a residential house to an individual or HUF will be exempt from tax if the assessee has within a period of one year before or two years after the date of such transfer purchased, or within a period of three years, constructed a residential house. The amount of exemption available is equal to the amount thus utilized, or the amount of capital gain, whichever is less. If any part or the entire capital gain cannot be utilized in acquiring a residential house before filing the return, such unused amount should be deposited in Capital Gains Accounts Scheme, 1988 in order to claim exemption, prior to the due date for furnishing the return.

For availing the exemption, the assessee must not transfer the new house in the period of three years from the date of its purchase or construction. However, if such a transfer takes place, the exemption allowed shall be reduced from the cost of the new house, in computing the capital gains arising therefrom.

As mentioned above, exemptions are also available in other instances. However, the opportunity to employ tax-saving devices are contingent upon certain events (e.g. the sale of a house) and do not arise in the ordinary course. Hence, it is not the objective here to cover such devices in great detail.

3.4.2 STRATEGIES FOR CAPITAL GAINS

The commonly applicable strategies for minimizing taxes on capital gains were spelt out earlier. These are examined below. A point that must be remembered, however, is that tax considerations ought not to outweigh sound investment decisions in buying or selling securities.

3.4.2.1 Deferring the sale of an asset. Where current income is expected to be higher, it is advisable to postpone the sale of an asset and defer realization of capital gains. This is especially important with short-term assets, since as was mentioned above, short-term capital gains get added to the gross total income, which can push an individual up into a higher tax bracket. Even with long-term assets, although the applicable tax rate is a flat percentage, whenever possible, it is desirable to realize the gains in the year in which current income is below the taxable limit so that the amount of long-term capital gains that becomes actually taxable is reduced.

3.4.2.2 Extending the holding period. An adage is "Make capital gains long-term" by deferring the point in time when sale is made so that the holding period gets appropriately extended. The risk here is that in deferring the sale transaction, the assessee is speculating that the price of the security will not fall so steeply as to nullify the tax differential advantage. Obviously, this strategy can be adopted only in cases where the period of extension required is not longer than a few months so that the assessee feels confident enough to speculate against a sharp price fall in the event of deferment of the sale. In future, as investors become more savvy and with advancements in India's capital markets like stock lending, they may be able to take precautions like the hedging strategy of selling-short-against-the-box so that they are able to lock in profits on a long transaction. As Gitman says, one "would like to ride things out for a while and still protect the profit"[11] one has earned up to now. It remains to be seen, however, whether such a hedging strategy, will be allowed by tax authorities to convert a short-term profit to a long-term capital gain. Another pertinent question is: What will be their stand on taxation of gains on the short sale ?

Another point to bear in mind while contemplating a deferment of the sale is the difference between an individual's marginal tax rate (which comes into the picture in case of a short-term gain) and the tax rate on long-term gains. If this is not high, then there is not much to look forward to by taking the price risk of deferment of a sale. That is, if the marginal tax rate of individual A is 40% while that of B is 30% with the long-term capital gains tax rate at 20%, A has a greater incentive to try and extend the holding period and convert short-term gains into a long-term profit.

3.4.2.3 Giving loans. The idea of extending loans to one's relatives who are not tax-payers, for the express purpose of having them undertake investments in shares, etc., is straightforward. Capital gains would accrue to the relatives which would be shielded from taxes. The flip side, however, is that in such cases, tax authorities expect such transactions to be genuine; for example, the loan must be documented and the interest rate must relate to prevailing market rates. This is where the catch lies. In shifting the burden of capital gains, a tax-payer should not unwittingly take on a large burden in the form of taxable interest income. In any case, the likely net benefit from taxes saved versus taxes increased would need to be carefully assessed.

3.4.2.4 The case for short-term losses. There is apparently no distinction between short-term losses and long-term losses in as much as both can be used to offset capital gains, whether short-term or long-term. Further, any capital loss that is still available, whether short-term or long-term may be carried forward to offset capital gains in the next eight assessment years. That being the case, it seems advisable to realize a capital loss early (i e short-term) so that this loss becomes available to offset any capital gains in the same year. Besides, the money locked up in the investment is freed and becomes available for reinvestment. As against this, what may favour a long-term loss is the opportunity to amplify such a loss (and offset a larger amount of capital gain) through cost indexation. It must be remembered though that Re.1 saved in taxes today is more valuable than Re.1 saved after a year. And so, the case rests in favour of registering a short-term loss rather than a long-term one.

3.4.2.5 Gifts. Gifts of securities to relatives within the prescribed limit is perhaps a superior strategy as compared to loans made to non-taxable relatives to undertake investments. However, in doing so, one must not fall into the net of clubbing provisions that become applicable in the case of donees being minor children who are not mentally or physically handicapped. For example, one way to circumvent this is to open a PPF account in the minor child's name. Since the interest would be tax-exempt, the clubbing provision is rendered impotent. Besides this, one could explore avenues which produce long-term capital gains for the minor so that the incidence of tax is minimized even as clubbing provisions apply. In any case, another advantageous dimension of gifts to minors (even if the amounts are going to be invested in taxable income-producing vehicles) is that when minors attain the age of 18 years, the clubbing provisions would cease to apply and the income would be assessed separately. So, depending on the amount of such income, what was previously taxable (because of clubbing) may cease to be taxable. It may be pertinent to note that year after year, the tax-free income level has been raised due to inflation, so when a minor attains majority, he may experience a happy coincidence.

Another route would be to make a gift to one's spouse e.g., from husband to wife. Although according to Section 64(1)(iv) of the Income-tax Act, income from assets transferred without adequate consideration by an individual to his/her spouse shall be included in the total income of the individual, there is an interesting fallout. As pointed out by Shanbag, "the advantage lies in the fact that any income arising from accumulated income or from accretions to such transferred assets is treated as income and wealth of the donee. Thus, interest on interest is income of the transferee. Similarly, bonus shares received by the donee after the original shares were donated to him by the donor constitute the wealth of the donee and any dividends on them would be income of the donee."[12] In fact, Nabhi's Income-tax Mini Ready Reckoner has pointed out that even "the income from savings made by a wife out of moneys given by her husband for household expenses cannot be assessed in the hands of the husband [R. Dalmia vs. CIT (1982) 133 ITR 169 (Del.)]."[13]

In a nutshell, what emerges from the foregoing is:

1. Investment in minor's name should be directed toward PPF account and tax-free bonds.
2. Subordinate to the previous suggestion, investments in a minor's name may be directed to shares and other assets on which long-term gains that accrue are taxed at the lower rate of 20%.
3. Inspite of the discouraging provision under Section 64(1)(iv), there is some benefit to be had by making gifts to one's spouse. In fact, one could identify those shares in one's portfolio which are more likely to proliferate through bonus shares, and gift away such securities, so as to take advantage of the allowable benefits.

3.4.3 OTHER TAX PROVISIONS FOR CAPITAL GAINS

At this point, it would be of some interest to look at the provisions with respect to capital gains tax in the case of some other transactions:

3.4.3.1 Bonus Shares. The date of acquisition of bonus shares is the date of allotment of such shares. In A.Y. 1995-96, the cost of acquisition was worked out by averaging the cost of original shares on which bonus shares were issued. This was done by the following formula :

$$\frac{\text{Cost of acquisition of original shares}}{\text{No. of original shares} + \text{No. of bonus shares}}$$

The average cost of acquisition so calculated will apply in computing capital gains on the original shares as well. But, from A.Y. 1996-97, this has undergone a change. In computing the capital gains arising on transfer of any bonus shares, the cost of acquisition shall be taken as 'nil', and the rule of averaging has been dispensed with. Thus, the full sale price less allowable transfer expenses becomes taxable as capital gain.

3.4.3.2 Rights shares and renouncements. The rules are:

1. In case of the sale of a right offer, the cost of acquisition to the original shareholder will be nil.
2. To the buyer of the rights offer, the cost of acquisition is the aggregate amount paid which includes the purchase price of the rights offer from an original shareholder and the subscription price later paid to the company.
3. When a rights offer has been subscribed to by the original shareholder, the cost of acquisition is simply the subscription price paid to the company.

3.5 Other Strategies that yield Tax Benefits

These include the following :

1. Medical insurance for self/family members that enables deduction under Section 80D.

2. Donations to specified charities.

3. PPF deposit(s) on behalf of minor children.

4. Purchasing an insurance policy for one's spouse or child out of one's income.

Of the above, the last two have already been mentioned previously under the section dealing with tax rebate. Moreover, the strategy of making PPF deposits on behalf of minor children was also cited in the preceding section as a technique to circumvent clubbing provisions. Hence, in what follows, only the first two devices mentioned above are discussed.

3.5.1 MEDICAL INSURANCE

Deduction is permissible for medical insurance premium (under an approved scheme of General Insurance Corporation which is popularly known as MEDICLAIM) paid by cheque from the assessee's taxable income during the "previous year" upto a limit of Rs.6,000. This deduction can be availed of in the following instances :

a. In the case of an individual, insurance for the assessee or spouse, dependent parents and dependent children.

b. In the case of an HUF, insurance on the health of any member of the unit.

Incidentally, it is mentioned in a MEDICLAIM prospectus of the National Insurance Company Limited that the policy covers reimbursement of hospitalization/domiciliary hospitalization expenses for illness/diseases or injury sustained. This is followed by very specific clauses giving other details and spelling out the benefits as well as the restrictions. The insurance is available to persons between the age of five years and 75 years, and children as specified.

What is of some interest is that a discount of 10% in the total premium will be allowed on policies comprising the insured and any one or more of the following :-

1. Spouse
2. Dependent children including legally adopted one
3. Dependent parents

Also, there is a cumulative bonus provision whereby the sum insured under the policy shall be progressively increased by 5% in respect of each claim-free year of insurance, subject to a maximum accumulation.

3.5.2 DONATIONS

There are two categories of specified bodies of which donations made qualify for deductions from gross total income:

1. In certain cases, a 100% deduction is allowed. These include the following donees :
   a. Prime Minister's National Relief Fund
   b. An approved University or educational institution of national eminence
   c. National Foundation for Communal Harmony
2. For other specified recipients, donations qualify for a 50% deduction. These include the following :
   a. National Defence Fund
   b. Prime Minister's Drought Relief Fund
   c. Any fund or institution which satisfies conditions mentioned in Section 80G(5).

The number of funds/institutions falling in the second category above are many more compared to the first. In fact, in some cases, it is more than a mere donation as the assessee may receive some benefits in return. For example, a donation to a charitable organization like the United Way not only yields a 50% deduction, but also membership benefits such as the services of a plumber, T.V. repairman, etc. So, if an assessee wishes to examine the option in narrow financial terms, there is something to be gained by being selective even in giving donations.

END–NOTES

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