Common Mistakes not to be made for Tax Savings

A young married couple walks into the local branch of a private bank on a cloudy, cold weekday of January. Both of them are getting late for office, but have enough time to start a tax-saving fixed deposit (FD).

The bank executive, instead, sells them a 'better' product, whose gains are non-taxable, unlike FDs.

The product that he offers is a tax-saving plan that also gives them life cover, guaranteed returns and bonus. And guess what, they can withdraw the money after five years, when they will receive the premium along with added bonus. They think it's a good deal and write the cheque.

This story is repeated so many times every year between January and March. The ending, too, is always the same-people making costly financial mistakes while investing to save tax or declaring expenses against which they can claim tax deduction. We discuss a few such mistakes.

DELAYING TAX-SAVING INVESTMENTS:

The most vulnerable are those who consider tax saving as once-in-a-year ritual to be repeated at the end of every financial year.

The first casualty is the monthly budget, which may go haywire because of a large one-time investment. Therefore, the mantra is to plan early and invest in a staggered manner.

You can start systematic investment in a tax-saving fund or put a small amount every month in Pubic Provident Fund (PPF) or National Pension System (NPS). Both PPF and NPS allow 12 transactions a year.

INVESTING IN ENDOWMENT INSURANCE PLANS:

This usually happens when you walk into a bank and seek the advice of its executives. Banks usually prefer to sell a product that gets them the highest commission, which is invariably an endowment insurance plan. So, while they receive 30-35% of the first-year premium as commission and 5% in the subsequent years, the investor earns 6-7% a year if he pays premium for the full term.

Most people do not realise that an endowment plan is a long-term product with a maturity period of 10-20 years. If you pay premium for only five years and then redeem the investment, it's likely that you will get less than even your principal. They also do not realise that a part of the endowment plan premium goes towards mortality charges and distributor commission.

All you need is a simple investment plan such as a tax-saving mutual fund or PPF, both of which give taxfree returns. For insurance, buy a term plan. The premium is eligible for tax deductible.

Another common tax-saving strategy involves starting a fiveyear FD or purchasing national saving certificates (NSC). The interest earned on both is taxed, which makes these products less attractive. Interest earned on both FDs and NSCs is taxed as per the person's income tax slab. Besides, the interest rate on tax-savings FDs is lower than what normal FDs pay.

"FDs and NSCs give post-tax returns that are less than the inflation rate," says Tanwir Alam, CEO and founder, Fincart, a financial planning company.

TAX-SAVING OUT OF SYNC WITH OVERALL PORTFOLIO:

The tax-saving investment is a subset of your overall portfolio. The two should not be viewed separately.

"Not choosing tax-saving options keeping in mind the overall portfolio is wrong. It causes imbalance," says certified financial planner Pankaj Mathpal.

For example, if your overall portfolio is equity heavy, you may want to save tax using fixed income products such as PPF.

But most investors usually have a debt-heavy portfolio due to employee provident fund, fixed deposits, endowment plans, etc. So, they can look at tax-saving mutual funds, which have 100% exposure to equity, or NPS, where equity exposure is up to 50%.

You must figure out the ideal equity-debt ratio for your portfolio and allocate funds accordingly. The equity-debt ratio of your portfolio will depend upon your age, risk appetite and financial goals.

NOT LOOKING BEYOND SECTION 80 C:

People often do know that they can save tax over and above the Section 80C limit of Rs 1 lakh. Interest on housing and education loans, health insurance premium, medical expenses, etc, are also eligible for income tax deduction. Apart from these, donations to political parties and for scientific research, rural development and government relief works are also deductible.

"While making donations under Sec 80 G make sure you are doing it to institutions approved under Section 80G of the Income Tax Act.