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Impact of Taxation on the Investment Habits of Individual

Thejesvini K[1], Swetha M E[2], Siddharth Gandhi[3]
BCom P, Department of Professional Studies, Christ (Deemed to be University), Karnataka, India
Associate, Mergers and Acquisitions (Tax), PricewaterhouseCoopers Private Limited
Corresponding author: Thejesvini K

ABSTRACT; *The study focuses on four securities which are equity, bonds, mutual funds and ULIPS and the various tax exemptions and deductions available for each type of securities. We want to study and analyze the most tax efficient security among these four. The study involves analysis of various sections of the Income Tax Act, 1961. The study also includes the various provisions to avail the tax benefits under each security.*

KEY WORDS: *Equity, Bonds, Mutual funds, ULIPS, Income Tax Act, 1961*

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I. INTRODUCTION

The four major investment types we are focusing on is Equity, Bonds, Mutual Funds and ULIPS. In a company's balance sheet Equity represents the balance available for the shareholders after setting off the assets against the liabilities. It is the amount contributed by the owners/ shareholders of the company for which they expect dividends in return. Bonds is form of borrowing for government and public sector undertakings. Just like any other borrowing, interest is paid on the bond over a period of time by the government or PSUs. The buyers of the bond become the lenders to whom the company repays the loan over time. Mutual funds is a method of investment wherein the money managers collect a pool of money from the investors and the former invests this money across securities in order to give capital gains in return. Such an investment benefits small or individual investors who now have access to professionally managed portfolio of securities. ULIP stands for unit linked insurance plans. ULIP is a combination of insurance and investment. Here policyholder can pay a premium monthly or annually. A small amount of the premium goes to secure life insurance and rest of the money is invested just like a mutual fund does. ULIP offers investors options that invest in equity and debt. (Academy, 2016) One can claim benefits under the various sections of the Income Tax Act, but the most popular section for such deductions is section 80C, which is used for specific investment instruments and expenses. These include investment in equity shares of a public company or public financial institution, subscription to any notified bonds of NABARD, Equity linked saving scheme (ELSS) which is a kind of mutual fund with a lock in period of 3 years, Unit linked insurance policy sold with life insurance and includes premium paid on Unit Linked Insurance plans, etc. However, only □ 1,50,000 is available as the permissible deduction for all the above-mentioned investments put together. From this, we aim to conclude how the various tax benefits and rates have an impact on these investments.

II. REVIEW OF LITERATURE:

(a) According to (Hegemann, Kunoth, Kristina, & Sureth-sloane, 2016) investment has an exit flexibility that attracts capital gains tax which majorly impacts the decision on the holding period. Tax on capital gains delays exit decisions to some extent. But this theory loses its relevance for very long term holdings. Predicting investors' behavior based on changes in the capital gains taxes help tax policy makers to fix a rate that are in interest of both the policy makers as well as the investors. This is a base for the study as it concludes that taxes on both corporate and shareholder levels can significantly affect investment and divestment decisions.

(b) A study on cost of direct taxation on investment(Paesa, 2017)used two parameters to calculate effective tax rates. One being effective marginal tax rate (EMTR) and this measures the increase of cost of capital due to corporate income tax. The effective average tax rate on the other hand (EATR) represents a measure of the average tax rate levied on an investment that has a predetermined economic profit. The country represented high rates which attracted less number of foreign investors. This also have a similar conclusion stating that there has been a decline in tax rates to attract more investors.

(c) (Schreiber, Spengel, & Lammersen, 2002)state that the business managers demand a summarized but sophisticated information on investment tax burdens and this is where effective tax rates becomes a useful tool for both the business managers as well as policy makers. They also used the Devereux and Griffith approach as reference and came up with their own standard measure of effective average tax rate. This was used in comparison to the statutory tax rate in order to denote if the investment is tax advantaged or not.

(d) (Edmiston, 2004)suggest that it is not only the investments that have an uncertain nature, but also the effective tax rates or tax policies can be uncertain. This has been tested and analyzed across 15 countries of the European Union, the United States and Japan. While the policy makers try to amend the tax codes to promote investment by adjusting rates, altering depreciation schedules or offering a portfolio of tax incentives, all of these are still temporary in nature. Thus, effective tax rates on capital which account for investment tax incentives as well as statutory rates can be quite volatile over time and this volatility was proved even in relatively stable countries of the European Union, United States and Japan and this volatility in effective tax rates has discouraged investments.

III. RESEARCH OBJECTIVE

The following are the objectives of our research:

(a) To identify various tax exemptions/deductions available for the above listed investments.

(b) To understand the best investment option available among the investors based on the tax exemptions.

Hypothesis

H0 - Tax regimes do not affect the investment habits.

H1-Tax regimes have significant effect on investment habits

Research Methodology:

The study is causal in nature as we are investigating on the cause and effect relationship between investment and tax.

Limitation of study:

(a) The study focuses only on individual investment habits.

(b) Only selected four securities from the market are being studied on.

IV. DATA ANALYSIS

1. Equity:

By investing in shares the investors contribute to the capital of the company. In return, they earn through dividends and capital appreciation/ gain. Dividend is the distribution of profits of the company whereas capital gain is the difference between the price at which the share was sold and the price at which the share was bought. The taxation for the same is shown below. Please note that for the purpose of this study, we have limited investment in equities being in listed stocks only and accordingly the analysis has been done.

a. Dividends

Dividends from Indian companies/ mutual funds are tax free in the hands of the investor up to □10,00,000 as per section 10(34) of Income Tax Act, 1961 (IT Act) and when the aggregate dividend is more than □ 10,00,000, 10% tax isleveiable as per section 115BBD of the IT Act. Dividends from foreign companies are fully taxable in the hands of the investor as per the marginal tax rate applicable to the tax payer.

b. Capital Gains

The tax rates on capital gains is subject to the period of investment of the stocks. Short term capital gains are earned when the shares are sold within one year from the date of purchase. These are taxed at 15%. Long term capital gains are made when the shares are sold after one year from the date of purchase. These are taxed in excess of □ 1,00,000 at 10% without the benefit of indexation.

Case 1: In case the amount is invested in Equity

The amount invested in equity in a financial year is □ 50,000 for 500 shares at □ 100 eachin a domestic company.

a. **Dividend-**If the dividend yield is 1.57% [average dividend yield in India for BSE Sensex] (meangingful minutes: what you should know about dividend yield stocks), then each share receives a dividend of □1.5 (annual payment) and thus a total of □ 750 is earned by way of dividend forall the shares.

Particulars	**Amount (□)**
Dividend received	750
Less : Exemption available	750
Balance	nil
Tax payable	Nil

Thus, no tax is paid for dividends.

b. **Capital gains-**If X purchased 500 shares for □ 50,000on 1st January 2013 at □ 100each and sold the shares on 1st January 2018 at □ 400 each, then the long-term capital gains to be taxed will be □300 for each share (400-100). Thus, the total long-term capital gains will be □1,50,000 for 500 shares and will be taxed at 10% without indexation, in excess of □ 1,00,000.

Hypothetically, if X bought the 500 shares for □ 50,000 on 1st August 2017 at □ 100 each and sold it on 1st May 2018 at □ 400 each, then the short-term capital gains to be taxed will be □ 300 each (400-100). Thus, the total short-term gains will be □ 1,50,000 for 500 shares and will be taxed at 15%, but because there is no exemption of □ 1,00,00 unlike long-term gains, the taxable amount will be higher for the same capital gain value.

Particulars	**Amount (□)**
Total long-termcapital gains	1,50,000
Less : exemption available	1,00,000
Balance	50,000
Tax payable @ 10%	5000

Thus, the long-term tax payable is □ 5000.

Particulars	**Amount (□)**
Total short-term capital gains	1,50,000
Less: exemption available	Nil
Balance	1,50,000
Tax payable @ 15%	22,500

Thus the short term tax payable is □ 22,500

2. Bonds:

Tax free bonds has a lock in period of 10-20 years andare generally offered by government entities and the government invests the money collected from the investors on infrastructure and housing projects.The interest that the investor earns on these bonds is tax free whereas the amount invested in purchasing the bond is not tax free. However, when the investor trades such tax-free bonds in the secondary market, any capital gain made on it, is taxable. If the investor sells the tax-free bonds within 12 months from the date of purchase, the capital gains made on it will be taxed as a normal income for the investor. If the tax-free bonds are sold after 12 months from the date of purchase, the capital gains will be taxed at 10% without the benefit of indexation and 20% with indexation (post one year). Following are six tax-free bonds available in India:(Fernandes, 2019)

Bond name	Interest rates (%)
Indian railways finance corporation N1 series	8
HUDCO N2 bonds	8.2
HUDCO N3 Bonds	8.1
National highways authority of India	8.2
Rural electrification corporation N6 bonds	8.46
Indian railway N7 series	8.23

Case 2: If the amount is invested in Bonds.

If the bonds were bought for □50,000 on 1st April 2016 and sold for □60,000 on 1st April 2018 receiving an annual interest of 8%, then the interest earned in the two years before sale is tax free, but the capital gain of □10,000 (60,000-50,000) on the sale is taxed at 10% without the indexation and 20% with indexation.

Particulars	**Amount (□)**
Total capital gains	10,000
Less: exemption available	Nil
Balance	10,000
Tax Payable @ 10%	1000

Thus, □1000 is payable as tax for bonds.

3. Mutual funds:

The basic inducement to invest in mutual funds is to earn interest/dividends and capital gains. However these capital gains are subject to taxation. The rate of taxation is based on the holding period of the mutual funds. The holding period can be either short term or long term. In case of balanced and equity mutual funds a holding period of 12 months are more is regarded a long term and less than 12 months is short term. In case of debt mutual fund, a holding period of 36 months or more is considered as long term and a holding period of less than 36 months is short term.

a. Tax-saving equity funds:

ELSS (Equity-linked savings scheme) is most efficient tax saving instruments under 80C deductions of Income Tax Act, 1961. These are funds that are invested in equity capitalization of a company. ELSS has a lock-in period of 3 years. An individual can save taxes up to □45000 by investing in ELSS and also gets a deduction of □150,000 under 80C. Also, on redemption after 3 years, a long term capital gain of □100,000 is tax-free in the hands of the individual. In case the long term capital gain is more than □100,000 the amount in excess of one lakh is taxable at the rate of 10% without the benefit of indexation. Hence, these are the most preferred securities in the market due to the various tax deductions and exemptions.

b. Non tax-saving equity funds:

Unlike tax-saving equity funds, these funds do not have deduction under section 80c of the income tax Act 1961 and also the tax savings of □45000. However, the long term capital gains pertaining to these units are tax free up to □100,000. The long term capital gains over and above □100,000 is taxable at the rate of 10% without the benefit of indexation. The short term capital gain is taxable at the rate of 15%. The exemption of □100,000 does not apply to the short term capital gains that is when the securities are sold before 12 months.

c. Debt funds:

Mutual funds that invest in debt funds have neither a tax deduction nor any exemption. The entire long term capital gain is taxable at a rate of 20% after indexation. Indexation allows inflating the purchase price of the debt funds, which in turn helps in bringing down the capital gains. Thus, taxable amount on capital gain is minimized, resulting in lower amount of tax.

d. Balanced funds:

Balanced funds are mutual fund units that make equity- oriented hybrid investments. Almost 65% of their total assets will be invested in equities. And thus have similar tax exemptions of non tax- saving equity funds. That is the long term capital gain of □100,000 is tax free and the amount in excess of □100,000 is taxable at the rate of 10% without the benefit of indexation.

e. Systematic investment plan (SIPs):

A SIP is investing a fixed amount of mutual fund in a periodic manner. The slab rates foe taxation is based on the type of mutual funds and the holding period. For taxation purpose each SIP is treated as a fresh investment and taxed separately. If an individual investor redeems his accumulated corpus after 12 months, then the gains earned on the first SIP is tax-free. The rest of the gains would be considered as short term capital gains and are subject to taxation.

Apart from the tax mentioned above there is a securities transaction cost of 0.001% which is levied by the fund company on sale of equity and balanced mutual funds. Such securities transaction cost is not levied on debt funds.
(clear tax, 2018)

Case 3: In case the amount is invested in mutual funds.
ELSS: If the amount of □50,000 is invested for a lock-in period of 3 years. The long term capital gain after 3 years is say □150,000. Then the exemptions that the investor is eligible to receive are as follows:

The investor gets a deduction under section 80C of □150,000 (in case the investor do not have any other savings or insurance policies that are eligible for deduction under this section) in the year of investment. Thus, if the investor's taxable income is □10,00,000 then he get a deduction of □150,000 which will make the taxable income as □850,000.

The tax payable on capital gain after 3 years is:

Particulars	**Amount (□)**
Total capital gains payable	150,000
Less : Exemption available	100,000
Balance	50,000
Tax @ 10% Payable	5000

Therefore, the net tax payable is □5,000 in the above situation.
Non-tax saving equity funds: if the investor invest Rs.50,000 in non-tax saving equity funds and the long term capital gain is Rs.100,000. Then the exemptions that the investor is eligible to receive are as follows:

In this case, the investor doesn’t get the deduction of Rs.150,000 under section 80C. Thus, if his taxable income is Rs.10,00,000 then that will remain the same without giving any tax benefit.

The tax payable on long term capital gain is:

Particulars	**Amount (□)**
Total capital gains payable	150,000
Less : Exemption available	100,000
Balance	50,000
Tax @ 10% Payable	5000

The tax payable on short term capital gain is:

Particulars	**Amount (□)**
Total capital gains payable	150,000
Less : Exemption available	0
Balance	150,000
Tax @ 15% Payable	22,500

The tax payable on long term capital gain is less as compared to the short term capital gain. This is because in these type of mutual funds the exemption of □100,000 is not available in case of short term capital gains and the tax rate is also 15%.

Debt funds: if an amount of □50,000 is invested in debt funds and the capital gains after indexation is □100,000.

In this case the tax exemptions are not available and thus the tax payable would be:

Particulars	**Amount (□)**
Total capital gains payable	100,000
Less : Exemption available	0
Balance	100,000
Tax @ 20% Payable	20,000

Thus the tax payable on in case of debt funds is □20,000.

SIP: if an investor makes an investment of□50,000 in a year in 5 equal installments of □10,000. The gain on each SIP that is installments is □20,000 and the prevailing short term capital gains tax rate is 15%.

In the above case the total tax payable is:

Particulars	**Amount (□)**
Total capital gains payable (20,000*5)	100,000
Less : Exemption available	20,000
Balance	80,000
Tax @ 15% Payable	12,000

4. Unit Linked Insurance Plan (ULIPs)

ULIPS stands for unit linked insurance plan and is an investment cum insurance plan. The premium paid is invested in equity, debt and money market instruments. Thus, it enables the user to the advantage of the insurance as well as the benefits derived from these investments.

The premium paid under ULIPS is allowed as a tax deduction under section 80C of Income Tax Act 1961. Under this section a deduction of □150,000 is allowed in aggregate for all the insurance policies and savings made by the individual.

a. ULIPS purchased after 1st April 2012:

For ULIPS plans purchased after 1st April 2012, the above mentioned deduction of □150,000 is available only if the premium paid at any time is less than 10% of the sum-assured. In case the premium paid exceeds 10% of the sum-assured at any point in time, then the sum-assured is fully taxable on the year in which it is received. However, in case of death the sum-assured received is not taxable under any circumstances.

b. ULIPS purchased after 1st April 2013, for disabled:

For ULIPS purchased after 1st April 2013, specifically for insuring the life of a person who is either a person with disability or severe disability under section 80U or a person affected by the diseases specified in section 80D. If the above condition is satisfied, then the deduction under 80C is allowed if the premium paid at any time does not exceed 15% of the sum- assured. In case if it exceeds 15% of the sum-assured then the entire sum-assured is taxable on the year it is received. If the sum-assured is received on the death of the person, then the amount received is not taxable under any circumstances.

c. ULIPS purchased before 1st April 2012:

For the ULIPS purchased before 1st April 2012, the limit for the premium paid is 20% of the sum-assured. That is if the premium paid is more than 20% of the sum-assured at any point in time, then the entire sum-assured is taxable on the year of receipt. In case the amount is received on death of the person then the amount is not taxable under any circumstances.

Tax on amount received on maturity of ULIP in case of early redemption

The amount received on maturity is not taxable if the insurance is held for the minimum period of 5 years. In case of early redemption either by giving notice or for non-payment of the premium, the amount claimed as exemption under section 80C before would be fully taxable on the year in which the policy is terminated due to any of the above mentioned reasons.
(batra, 2018)

Case 4: ULIPS
ULIPS purchased after 1st April 2012:
If an amount of □500,000 is assured after 5 years, whose annual premium is
a) □30,000
b) □60,000

The prevailing tax rate is assumed to be 10%.
Then the tax payable is:
a) In case the premium is □30,000.

The premium paid is less than 10% of the sum-assured that is □50,000 (□500,000*10%). Thus, the investor is eligible for deduction under section 80C of □150,000.

b) In case the premium is □60,000

The investor is not eligible for deduction under section 80C and the sum-assured is taxable as follows in the year of receipt:

Particulars	**Amount (□)**
Sum- assured	500,000
Less : Exemption available	0
Balance	500,000
Tax @ 10% Payable	50,000

In case the amount is received on the death of the investor, then it is fully exempted.

ULIPS purchased after 1st April 2013, for disabled:
If an amount of □500,000 is assured after 5 years, whose annual premium is
a) □30,000
b) □80,000

The prevailing tax rate is assumed to be 10%.
Then the tax payable is:
a) In case the premium is□30,000
The premium paid is less than 15% of the sum-assured that is □75,000 (□500,000*15%). Thus, the investor is eligible for deduction under section 80C of □150,000.
b) In case the premium is □80,000
The investor is not eligible for deduction under section 80C and the sum-assured is taxable as follows in the year of receipt:

Particulars	**Amount (□)**
Sum- assured	500,000
Less : Exemption available	0
Balance	500,000
Tax @ 10% Payable	50,000

In case the amount is received on the death of the investor, then it is fully exempted.

ULIPS purchased before 1st April 2012:
If an amount of □500,000 is assured after 5 years, whose annual premium is
a) □30,000
b) □101,000

The prevailing tax rate is assumed to be 10%.
Then the tax payable is:
a) In case the premium is □30,000
The premium paid is less than 20% of the sum-assured that is □100,000 (□500,000*20%). Thus, the investor is eligible for deduction under section 80C of □150,000.

b) In case the premium is □101,000
The investor is not eligible for deduction under section 80C and the sum-assured is taxable as follows in the year of receipt:

Particulars	**Amount (□)**
Sum- assured	500,000
Less : Exemption available	0
Balance	500,000
Tax @ 10% Payable	50,000

Thus, the exemption under ULIPS is determined by the amount paid as premium during the lock-in period.

V. CONCLUSIONS:

Income Tax Act, 1961 has provided for various deductions and exemptions for the various securities discussed above. One of the common deduction available under section 80C is an aggregate amount of □ 150,000. Apart from this there are other exemptions on long term capital gains and short term capital gains. In light of the above analysis, Equity can be considered as a tax efficient security as the dividends are tax free in the hands of the individual and the other taxes on purchase of sale of an equity like capital gains, STT, etc., are same as ELSS. Interest received from bonds are tax free in the hands of the investor but are taxed at 10% if traded in the secondary market without indexation and at 20% with indexation, and this kind of investment can be preferred by risk averse investors, since they will earn stable returns. If the investor has a risk seeking ability, ELSS is a tax efficient security as there are various deductions as well as exemptions available for the same. The long term capital gains on ELSS is also tax free if it is below □ 100,000, which adds to the tax advantage. Diversely, ULIPS are also securities that provide for deduction under section 80C of the Income Tax Act, 1961 on the premium paid subject to few conditions as discussed above. Thus, based on the desired lock in period of the security and the risk appetite of the investor, one can choose from the above tax saving securities.

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