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Investment in ELSS: Plan in advance, take SIP route

B GOPKUMAR

WITH the March 31 deadline approaching, investing in tax planning schemes is a key priority for those who are yet to finalise their tax-related investments for the current financial year. Apart from investing in Public Provident Fund (PPF), mediclaim and term insurance, one should consider Equity Linked Saving Schemes (ELSS) for the purpose of tax planning. ELSS is one of the tax-saving vehicles that qualifies for deduction under Section 80C.

ELSS is a typical diversified mutual fund equity scheme that comes with tax breaks and requires a lock-in period of three years from the date of the investment. Capital gains in ELSS are tax exempt. Further, dividends paid by ELSS are also tax-free. If you invest in an ELSS through a systematic investment plan (SIP), each investment will be locked in for three years from its respective investment date.

What is special about ELSS funds

By investment in ELSS mutual fund scheme, one is eligible for tax deduction up to Rs 1.50 lakh u/s Section 80C. If your annual income is Rs 15,00,000, your total tax liability would be Rs 2,75,000.

However, if you invest Rs 1,50,000 in ELSS, you will save Rs 45,000 (30% on top tax bracket). ELSS equity funds are exempted from income tax under Section 80C of the Income Tax Act. So the amount that you plan to invest in ELSS can be deducted from your income before calculating taxes. This is subject to an overall cap of Rs 1.50 lakh on the investment amount. However, this cap is not restricted to ELSS but is also applicable to other tax-saving instruments. ELSS is classified as an EEE investment — Exemption from tax on invested amount, exemption from tax on gains and exemption from tax on withdrawal amount. However, you will get the last two benefits — tax free gains and tax-free withdrawal — with any equity fund if you are invested for more than one year.

Compared to other retirement planning investments under Section 80C, ELSS offers higher liquidity and potentially superior post-tax returns since the money is invested in equities. However, as with all equity-based mutual fund investments, ELSS is also subject to market risk. The following are key factors to keep in mind:

Start early

Many taxpayers normally tend to start investing in ELSS funds only towards the end of the financial year, when the time to submit investment proof is upon them. This is a bad investment and tax-planning strategy. In such a situation, one could face cash flow related problems towards the end of the financial year. One should always plan tax-related investments in advance and invest through SIP route in ELSS to get the benefit of rupee cost averaging.

Continue investing beyond 3 years

Of all the tax-saving products, ELSS funds offer the shortest lock-in of three years. In other products, the lock-in period varies from 5 to 15 years. A common mistake most investors make is to redeem their investments in ELSS as soon as the three-year lock-in period ends. Since the underlying asset class here is equities, they should stay invested for a time horizon of at least five-seven years to garner good returns. Hence, one should not pull out his money as soon as the three year lock-in period ends.

Betting on current best performers

The funds that are topping the charts currently (in terms of trailing returns over the past one or three years) may not be the best choice for you. Instead, investors should focus on funds that have a track record of consistency. To select a consistent fund, one must compare the fund's performance with the average returns generated by the category year-wise for the past five or seven years. Another alternative is to compare rolling returns. This is a good measure for capturing consistency.

New fund every year

Another commonly observed mistake is that investors put their money in a new ELSS fund every year. Over an 8-10 year period, they end up accumulating a large number of ELSS funds. This causes excessive diversification and results in cumbersome portfolios that become hard to monitor.

Key takeaways

To conclude, ELSS is an ideal tax-saving option for those who are willing to stay invested for the long term, understand volatility and are willing to ride through it. Further, one should plan these investments as early in the year as possible. If you haven't done so, then this is the right time to plan for the next financial year beginning April 1. And once you start, there's no need to stop investing next year. Since the best way to invest regularly in a fund is through SIP, you should just start one in a carefully-chosen ELSS fund and let it run for a long duration to generate superior returns.

The writer is CEO, Reliance Securities (Broking and Distribution Business arm of Reliance Capital). The views expressed in this article are his own