NISM CERTIFICATION EXAMINATION WORK BOOK

X-B

Investment Adviser

Level-2

National Institute of Securities Markets
A Capacity Building Initiative of SEBI

Workbook for
NISM-Series-X-B: Investment Adviser (Level 2)
Certification Examination

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This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Level 2 Certification Examination for Investment Advisers.

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The NISM certification programs aim at enhancing the quality and standards of professionals employed in various segments of the financial sector. NISM develops and conducts certification examinations and Continuing Professional Education (CPE) programs that aim at ensuring that professionals meet the defined minimum common knowledge benchmark for various critical securities market functions.

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NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations.The book covers all important topics to enhance the quality of investment advisory and related services in the financial services industry. It covers topics related to aspects of insurance planning, insurance products and risk management. Various retirement products and their features along with the role of Investment Advisers in retirement planning are also discussed. The book also provides an in-depth understanding of estate planning tools and taxation aspects of different financial securities. It also discusses about the role of behavioural finance and risk profiling in providing comprehensive financial advice by the Investment Adviser. It will be immensely useful to all those who want to learn about the various aspects of investment advisory domain.

Sashi Krishnan
Director, NISM

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While the NISM Certification examination will be largely based on material in this workbook, NISM does not guarantee that all questions in the examination will be from material covered herein.

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About NISM Certifications

National Institute of Securities Markets (NISM) is a capacity building initiative of Securities and Exchange Board of India (SEBI), the securities market regulator. The Institute was established in 2006 pursuant to the Union Budget of 2005-06.

NISM is engaged in developing and administering Certification Examinations and Continuing Professional Education (CPE) Programmes for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programmes are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. NISM seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and CPE Programmes on Mutual Funds, Equities, Derivatives, Securities Operations, Compliance, Portfolio Management etc.

These Certifications create quality market professionals and catalyzes greater investor participation in the markets. They also provide structured career paths to students and job aspirants in the securities markets.

About the Level 2 Certification Examination for Investment Adviser

NISM-Series-X-B: Investment Adviser (Level 2) Certification Examination along with the NISM Series-X-A: Investment Adviser (Level 1) Certification Examination seeks to create a common minimum knowledge benchmark for individual investment adviser, principal officer of a non-individual investment adviser and all persons associated with investment advice.

An associated person shall be required to pass both the levels (i.e. NISM-Series-X-A: Investment Adviser (Level 1) Certification Examination and NISM-Series-X-B: Investment Adviser (Level 2) Certification Examination) to fulfil the requirements under Regulation 7(2) of the SEBI (Investment Advisers) Regulations, 2013.

The certification aims to enhance the quality of investment advisory and related services in the financial services industry.

Examination Objectives

On successful completion of the examination, the candidate should:

- Know the aspects of insurance planning, insurance products and risk management.
- Understand the various retirement products and their features along with the role of Investment Advisers in retirement planning.
- Understand the importance of estate planning and the role of estate planning tools.
- Know the taxation aspects of different financial securities.
- Know the role of behavioural finance and risk profiling in providing comprehensive financial advice by the Investment Adviser.

Assessment Structure

The examination consists of 90 multiple choice questions and 6 case-based questions (each case having 5 sub questions). The assessment structure is as follows:

Multiple Choice Questions [90 questions of 1 mark each]	90*1 = 90
Case-based Questions [6 cases (each case with 5 sub-questions of 2 mark each)]	6*5*2 = 60

The examination is of 150 marks and should be completed in 3 hours. The passing score on the examination is 60%. There shall be negative marking of 25% of the marks assigned to a question.

How to register and take the examination

To find out more and register for the examination please visit www.nism.ac.in

Important

- Please note that the Test Centre workstations are equipped with either Microsoft Excel or OpenOffice Calc. Therefore, candidates are advised to be well versed with both of these softwares for computation of numericals.
- The sample caselets and multiple-choice questions illustrated in the book are for reference purposes only. The level of difficulty may vary in the actual examination.

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MODULE 7: RISK MANAGEMENT AND INSURANCE PLANNING

Chapter 1: Basics of Insurance
Chapter 2: Features of life insurance products
Chapter 3: Features of non-life insurance products

CHAPTER 1: BASICS OF INSURANCE

LEARNING OBJECTIVES:
After studying this chapter, you should know about:

- Need of Insurance
- Fundamental Principles of Insurance
- Concepts in Insurance
- Role of Insurance in personal finance
- Investing through Insurance
- Role of Insurance Advisor
- Regulations pertaining to Insurance

1.1 Some Simplistic/ Common Examples

These examples have been mentioned for the purpose of illustrating specific Insurance concepts. These examples will be referred later in the study material to understand and illustrate the concepts of Insurance.

Example 1 – Merchant Ships
Sometime in the 19th century, every month merchants in London would send out ships filled with cloth to the distant ports in India and the ships would come laden back with spices and other exotic goods for sale in Europe. A round trip took approximately 30 days. Some ships would be lost at sea.

For the purpose of this example, it is assumed that 100 merchants sent one ship each month. The loss to the merchant in case a ship was lost was Rs. 10,00,000. On an average, 2 ships were lost at sea every month.

So, the total loss suffered by all merchants together was Rs. 20,00,000 (i.e. Rs. 10,00,000 multiplied by 2 ships that were lost). If all 100 merchants got together and paid Rs. 20,000 each into an Insurance fund, it would collect Rs. 20,00,000 (i.e. 100 merchants multiplied by Rs. 20,000 paid by each merchant).

This fund of Rs. 20,00,000 would be paid to the 2 merchants whose ships were lost at sea. So effectively each merchant would be assured that his loss of Rs. 10,00,000 would be covered if his ships were lost at sea by paying Rs. 20,000 each.

From this, come the following concepts:
Risk covered: Ship lost at sea
Sum assured: Rs. 10,00,000
Premium amount: Rs. 20,000
What could go wrong:

a) Not all the 100 merchants agree to pay the premium (i.e. Law of large numbers -- explained subsequently).

b) Some merchants do not want to "waste" their premiums in case their ship is not lost and want to get their premiums back in that case. (i.e. Investment cum Insurance policies -- explained subsequently).

Example 2 – King's employees

A king has 500 employees in his court. All employees will earn Rs. 2 lakhs per year for the next 10 years. All the employees will retire after 10 years. Each employee is the sole earning member of his family. The family is fully dependent on the employee's earnings. Ignoring interest calculations, the gross earnings of each employee is thus Rs. 20,00,000 (i.e. Rs. 2 lakhs multiplied by 10 years).

It is estimated that two of the employees are likely to die during the year. Thus, the loss of employee income during the year is Rs. 40,00,000 (i.e. Rs. 20,00,000 per employee multiplied by 2 employees). The king devises a simple scheme. He contributes an additional Rs. 8,000 per employee totalling to Rs. 40,00,000 (i.e. Rs. 8,000 multiplied by 500 employees) into a separate Insurance fund which would be paid to the family members of the employees who die during the year. Thus, by paying an additional amount of Rs. 8,000 per employee (4% of the annual salary of Rs. 2,00,000) the king is able to assure all his 500 employees that their families will be financially taken care of in case of their deaths.

From this come the following concepts:
Risk covered: Loss of Income due to death
Sum assured: Rs. 20,00,000
Premium amount: Rs. 8,000 per employee

1.2 Need for Insurance

These simplistic examples give a glimpse of why Insurance needs arise. Insurance is a basic form of risk management that provides protection against the loss of the economic benefits that can be enjoyed from assets. These assets may be physical assets, such as ships (in the merchant ship example) or buildings and machinery, or they may be human assets such as employees (in the King's employees' example).

In the above examples, assets are subject to the risk that their ability to generate benefits could be lost or reduced due to unforeseen or unexpected events. There is a financial or economic consequence to the risk, and insurance indemnifies or protects against these consequences. For example, the ability of King's employees (example 2) to generate income from occupation may be affected by illness, disabilities and death. The merchant ships (example 1) could be lost at sea due to storms, piracy, mutiny, leading to loss. The events themselves can only be minimised by taking precautions but not totally prevented. Thus, the consequences of the loss can either be borne by the person to whom the benefits accrue (risk retention) or they can be transferred to another (risk transfer).

Insurance enables risk transfer from the beneficiary (Insured) to the insurance company (Insurer), which undertakes to indemnify the insured for the financial loss suffered. In

return, the insured pays a periodic fee, called premium, to the Insurer to receive this protection. To be insurable, the event being insured against, such as death, accident or fire must result in a financial loss that can be quantified and insured against. The premium payable will depend upon this expected loss and the probability of the event occurring during the period of contract.

For example, the premium payable on a health policy for an individual whose parents have a history of ill-health that are considered genetic, such as ailment of heart, cancer or diabetes, may be much higher than that for an individual coming from parents with no such history. This is because the probability that the insurance company will be required to pay medical expenses in the first case is much higher than what it is in the second case.

In the absence of insurance, the loss arising out of the event has to be borne by the person who would have otherwise enjoyed the benefit from the asset.

1.2.1 Requirements of an Insurable risk

There are certain requirements for a risk to be insurable.

a. Large number of exposure units

Large groups of similar, though not necessarily identical, units are subject to the same peril or group of perils. An insurance company is able to offer the protection against such perils, because it operates a common pool in which only a few is expected to suffer loss in any one year. The entire pool pays premium but the liability for the insurance company will be only to a few in a year. In the absence of a large number of people being exposed to the same risk, the premium payable would be much higher and it would be unviable for the insurer and the insured. If the pool of people likely to suffer the loss is large but the number of them who are willing to pay a premium for covering that loss is a fraction, then also the insurance premium would be larger for the people who are willing to pay the premium. In the merchant ships example, if only 40 of the merchants agree to pay the premium, it can increase to Rs. 50,000 per merchant (i.e. Rs. 20,00,000 loss divided by 40 merchants), as against Rs. 20,000 (if all 100 merchants participate). It is not sure of the risk of 2 ships being lost will be from these 40 merchants or the balance 60 merchants who did not participate in the Insurance pool.

b. Insurable Interest

Insurable interest implies that the individual seeking insurance will face financial loss in the event of loss or destruction of the subject matter of insurance. The loss should be monetary in nature and not merely emotional or related to feelings. The interest must be lawful. In the merchant ship example, the merchants have an insurable interest in the ship.

c. Accidental and unintentional

Loss must be accidental, unintentional and uncertain. The only exception is life insurance where the event being insured against, namely death, is certain. However, the time of death is uncertain, which makes it insurable. Loss should be fortuitous and outside the insured's control.

d. Determinable and measurable

Loss should be definite as to cause and amount. The cause must be known, such as death in the case of Life Insurance or fire in the case of property Insurance. It means that loss must be calculatable based on some definite evidence. For example, in case of health insurance, it is determinable with the help of medical bills.

e. No prospect of gain or profit

A further characteristic of the insurable risk is that it does not involve any prospect of gain or profit. In other words, it must be pure risk with only the possibility of full or partial loss. Speculative risk is not insurable. For example, investing in the stock market may result in loss, but it may also result in gain and as such this is a speculative risk and therefore not insurable.

The 'Principle of Indemnity' implies that insurance will restore the financial situation of the insured to where it was before the event that caused the loss or damage. The intent of insurance should not be to make a profit or gain. If it were possible to insure against not making a profit from selling goods in a shop, there would be very little incentive to try to sell the goods if the owner knew the insurance company would step in and pay up anyway.

f. Chance of loss must be calculable

Insurer must be able to calculate with some accuracy, average frequency and average severity of future losses.

g. Premium must be economically feasible

Premiums should not only be affordable but also far less than the value of the risk covered. Else, the option to retain risk will be more feasible than transfer risk through insurance.

1.3 Fundamental Principles of Insurance

Insurance is a unique form of a contract that enables the transfer of risk from one party (the insured) to another party (the insurer). Given the unique circumstances, there are two fundamental principles:

1.3.1 Utmost good faith (*Uberrimae Fidei*)

Since the insured is better informed about himself or herself than the insurer, there is an information asymmetry between the two parties.

The party that has less information i.e. insurer, therefore impose certain screening processes before entering into the contract. Medical test is a typical screening process. However, medical test has its limitations. It does not reveal all ailments or the family history. Therefore, the insurer agrees to enter into the insurance contract based on utmost good faith in the insured.

The obligation is on the insured to disclose all relevant information truthfully. Family history of medical conditions, medical history of the insured, habits regarding smoking and drinking, nature of the profession etc. have implications on risk perception. These need to be disclosed by the Insured before getting covered by the insurer. If this is not done, the Insured is said to have acted in breach of good faith.

At times, the insured does not reveal the relevant information. On that basis, the insurance policy may be issued. However, when a claim comes up, investigation by the insurer may throw up the facts about the information that were suppressed. Based on that, the insurer has the right to reject the claim entirely.

It is therefore in the interest of the insured to share all material information. What is material can be subjective. Anything that can influence the insurer's risk perception on the insured is material. When in doubt, it is safer for the insured to reveal the information, rather than suppress it.

An Insurance policy is a promise from the Insurance Company to pay on the happening of certain risk that causes loss. It is better to fully disclose everything and pay a higher premium to cover the additional risk factor and be sure that the policy will pay up when the risk occurs. In the absence of full disclosure, the Insurance Company may reject the claim. The lower premium paid would be a complete waste and more importantly the loss will not be reimbursed.

1.3.2 Insurable interest

The insurer will cover the risk only if the insured has an insurable interest in the subject matter of insurance. The test of insurable interest is that the insured should be better off if the risk does not materialise but will be adversely affected if the risk materialises.

For example, a business owner has an insurable interest on his inventory, but not in the inventory of a competitor. Family members i.e. direct dependents and relationships of blood and marriage have insurable interest in each other. In other blood relationships, such as aunts and uncles, cousins, nieces, and nephews, the insurable interest would not exist unless there is a proof of financial dependence. Lender has insurable interest in the borrower to the extent of the amount outstanding. Employers have insurable interest in their key employees.

1.4 Concepts in Insurance

a) Indemnity Insurance

Indemnity is defined as "a duty to make good any loss, damage, or liability incurred by another". An insurance contract is thus a classical contract for Indemnity. A good example would be health insurance that normally promises to make good the losses incurred due to hospitalisation expenses.

Thus, any indemnity policy will require a determination of actual loss suffered by the insured person before a pay-out of a claim is made under the indemnity policy.

b) Benefit Insurance

A defined benefit insurance plan is different from an Indemnity Insurance. In a defined benefit insurance plan a fixed sum of money, based on pre-estimated amount of loss, is paid on the happening of a covered event. A life Insurance policy is a good example of a defined benefit insurance as it pays a pre-fixed sum of money on the death of the insured person without really trying to ascertain the exact actual loss caused due to the death of the insured person.

A defined benefit plan is used in situations where it is certain that a loss has been incurred due to the happening of the covered event but:

- it is difficult to ascertain the exact actual loss caused - such as the example of life insurance where the exact loss of future income caused due to the untimely death of the insured person is difficult to ascertain. Another example could be a critical illness policy where again there is a loss of future income due to a critical illness but it is difficult to ascertain the exact loss caused due to this.
- the amount of loss is small and the cost of determining the "actual loss" might not be worth the actual amount of loss caused. An example is a fixed amount paid as daily hospital allowance in some health insurance policies. This amount is to reimburse the losses caused due to personal expenses of the attendant or travelling expenses from residence to hospital, or lost wages of the insured and/or attendant etc. which might be difficult to ascertain on an exact basis. Thus, if there is a fixed daily hospital allowance as a part of a health insurance policy then this portion is a defined benefit plan in contrast to the main policy, which is an indemnity policy that reimburses the actual loss caused due to the expenses paid to the hospital directly.

Table 1.1 highlights the difference between indemnity and benefit policies.

Table 1.1: Difference between Indemnity and Benefit Policies

Sr. No.	Type of Policy	Whether Indemnity or Defined Benefit	Remarks
1	Life Insurance Policy	Defined Benefit	Difficult to ascertain exact loss due to loss of earnings

2	Health Insurance policy for reimbursement of expenditure incurred in hospitalisation (popularly referred to as Mediclaim policies)	Indemnity	Bills are available to ascertain actual loss
3	Daily Hospital Cash benefit allowing a specified sum per day of hospitalisation	Defined Benefit	Losses not easily ascertainable or too small for individual ascertainment
4	Critical Illness Policy that pays a lump sum on occurrence of specified critical Illnesses	Defined Benefit	Difficult to ascertain exact loss due to loss of earnings
5	Property Insurance to pay for losses caused due to fire, earthquake, flood, etc.	Indemnity	Loss is ascertainable
6	Car Insurance	Indemnity	Loss is ascertainable

c) Subrogation

Subrogation means the insurance company steps into the shoes of the insured person after paying the claim and taking all actions that the insured person could have taken. An example could be loss incurred by the insured person due to the accident caused by another car that was at fault. In such cases, the insurance company pays the claim to the insured person; and then steps into the shoes of the insured person and pursues the claim with the "at fault" driver or her insurance company and recovers the loss from them.

Subrogation allows the insurance company a chance to reduce/ recover its losses and the insured person to get her claim from her own insurance company faster without waiting for completing the process to enforce her right against third parties.

A policy without Subrogation rights for the insurer would be more expensive for the insured person.

d) Contribution

When the insured person has more than one insurance policy covering the same risk, contribution is the right of one insurer to get a proportionate share of the claim payable to the insured person. The concept of contribution is applicable only to indemnity policies as the loss amount is ascertainable and the total claim amount cannot exceed the ascertained loss.

The following example will explain the concept of contribution. The insured took two policies of Rs. 5 lakhs each from Company A & Company B respectively to cover the risk of loss arising from floods. Floods occurred and the ascertained loss was Rs. 30,000/-. If

Company A is paying this, it may require Company B to chip in with the proportionate amount of Rs. 15,000/- (based on the share in the Sum Assured).

Contribution is also used in the context of Health Insurance policies (relating to reimbursement of hospitalisation expenses incurred). As per IRDAI regulations, in health insurance policies when the insured person has covered the risk with more than one company, it is the choice of the insured person to choose from which company to get her claim. Thus, the chosen insurer has no option to apply the contribution clause where the claim amount is less than the sum insured in the chosen policy. However, if the amount of claim exceeds the sum insured under the chosen policy, the insured person can choose another policy(ies) under which the claim can be made. In such cases, the claim is settled by the chosen insurers by applying the Contribution provisions.

e) Co-Pay

Co-Pay is the proportion of the claim amount that will be met by the insured person. It is used in the context of car insurance and health insurance. For example, if the insured person has agreed on a co-pay of 15% and the ascertained claim amount is Rs. 2,00,000, then the insured person will pay Rs. 30,000 (i.e. 15% of Rs. 2,00,000) and the insurer will pay only the balance amount of Rs. 1,70,000.

The concept of co-pay is to make the insured person sensitive to the claim amount as she will also be bearing a part of the eventual claim amount. Co-Pay also allows the insured person to lower the premium amount for the same degree of coverage. Higher the co-pay, lower will be the premium.

However, in practise, it is not very popular with insured persons as they have very little control over what the hospitals/ garages charge for their services.

f) Deductible

Deductible is that portion of the claim that is paid by the insured person after which the claim becomes admissible. For example, car insurance in India has a compulsory deductible of Rs. 1,000 for cars with an engine capacity of upto 1600 CC.

Suppose, a car insurance policy has a deductible of Rs. 1,000 and the claim amount is ascertained at Rs. 25,000. The amount that will be paid by the insurer will be Rs. 24,000 after deducting Rs. 1,000. The insured person can accept a larger deductible to reduce the premium. This is popular in car insurance as most insured persons are loath to make small claims, given the time and effort involved with making claims.

Similarly, in health insurance policies the concept of Deductible applies. The claim from these policies is payable only when the insured has paid the deductible amount either from his own funds or from any other health insurance policy. The company will be liable to pay the claim only if the claim exceeds the Deductible amount.

Health insurance deductibles are of 2 types:

1. Compulsory Deductible - The amount of deductible is either fixed by the insurance company, or expressed as a percentage of sum assured. For example, if compulsory deductible is Rs. 30,000 and the hospitalization bill is Rs. 80,000, then the company will pay Rs. 50,000 and the insures will borne the fixed deductible portion i.e. Rs. 30,000. The premium for health insurance policies are calculated after factoring in the deductible of the policy. Top-up and Super Top-up policies are designed with a fixed deductible amount and the premiums are generally lower than the basic health plan of same coverage amount.
2. Voluntary Deductible – The insured, based on his affordability or medical expenses, choose an amount which he/she would like to pay from his own pocket. In this case, the premium is based on the deductibles. If the insured choses a higher deductible, then the premiums of the health policy will be lower.

Difference between Deductible and Co-Pay

An example will help to explain this. Policy 1 has a deductible of Rs. 1,000 and Co-Pay of 10%. Policy 2 only has a deductible of Rs. 5,000 and no co-Pay. The ascertained claim amount is Rs. 40,000.

In this case, Policy 1 will pay Rs. 35,100, which is calculated as Rs. 40,000 less deductible of Rs. 1,000 equals Rs. 39,000 less Co-Pay Rs. 3,900 equals Rs. 35,100.

Policy 2 will pay Rs. 35,000, which is calculated as Rs. 40,000 less Deductible of Rs. 5,000 equals Rs. 35,000.

g) Other Concepts

Cashless claim payment

This is relevant for indemnity insurance and mostly used in the context of health insurance and car insurance. Under normal circumstances, the insured person first incurs the expenditure at the hospital/ garage and then files a claim for reimbursement with the insurer. This blocks the cashflow of the insured person. In many cases, the insured person may not have that amount of cash available to make the payment to the hospital/ garage. The uncertainty about the timeframe of the reimbursement process may also worry the insured person. Hence, an arrangement is made where the insurer approves the claim amount as soon as the bill is submitted to the insurer and the payment is made by the insurer directly to the hospital/ garage. Also, as the claim amount to be paid remains the same, whether the amount is paid directly to the hospital/ garage or reimbursed to the insured person, there is no impact on the premium.

If the insurer selected by the insured person has a cashless arrangement with the insured person's favoured garage/ hospital, then it is a big positive for the insured person in selecting the insurer.

However, a few words of caution on using this as a major reason for selecting an insurer for Health Insurance/ Car Insurance:

- Cashless claim payment is a one-on-one arrangement between the insurer and the Hospital/ Garage. The list of hospital/ garages approved by the insurer for cashless payment keeps changing and even though the favoured hospital/ garage of the insured person is on the approved list at the time of taking the insurance policy, it may no longer be on the list at the time of the claim.
- Where the claim occurs, (location) is not in the hands of the insured person and the treatment/ repair is required to be done at any convenient hospital/ garage, not necessarily the one favoured by the insured person.
- The cashless payment process has still not stabilised and leads to delays in releasing the patient/ car as the approval by the insurer takes time.
- Since the cashless process has not stabilised many hospitals/ garages will require a deposit from the insured person before releasing the patient/ car. This deposit is refunded once the hospital/ garage actually receives the claim from the Insurance company. This deposit process defeats the whole purpose of cashless claims. It is also administratively cumbersome to get the deposit refunded from the hospital/garage.
- There will be certain expenditures like pre-hospitalisation and post-hospitalisation expenses incurred in a health Insurance policy that requires submitting a re-imbursement claim in any case.

For all these reasons, if cashflow is not an issue, then this feature may be considered less important while making a choice of the insurer. Note: In recent times the Insurance regulator has laid a lot of emphasis on cashless settlements and the percentage of claims being settled in this manner is increasing. In any case it is happening across the board and hence is not a material parameter for selecting your health insurer/ car insurer.

Cashless payment on health insurance policies bought for employees and their family members by the Employer (generally referred to as Corporate policies)

Cashless payment on Corporate policies is a little different from cashless payments under policies bought by the Individuals directly from the insurance company. The main reason for this difference is that most Corporate policies allow hospitalisation expenditure incurred on pre-existing disease to be reimbursed. This contrasts with policies bought by the individuals directly from the Insurance companies where this may not be reimbursed for the first 3-4 years.

Most disputes on claim payments for individual policies are due to this pre-existing disease clause. Since that is not a factor for most Corporate policies, the cashless payment process works far more smoothly in the case of Corporate policies.

Corporates pay large premiums to the insurer for all the risks covered by them. That is one more reason why the cashless process works smoother for the corporate policies than it does for individual health policies.

Nominee and Legal Heirs

Under normal law, the Nominee holds any property in trust for the legal heirs of the person. In other words, if Mr. Rich nominates Mrs. Rich as his nominee in a bank fixed deposit of

Rs. 1 lakh then on his death the bank will pay over the amount of Rs. 1 lakh to Mrs. Rich in discharge of its liability to pay back the fixed deposit. However, Mrs. Rich holds the amount in trust for all the legal heirs of Mr. Rich. Further assume, Mr. Rich died without leaving a will and as per the personal law applicable to him the bank fixed deposit is to be equally divided among Mrs Rich and their two children. In such a case, Mrs. Rich holds the children's share in trust for them and she will be accountable to them for that money.

However, there are exceptions to the "Nominee is a trustee for the Legal Heirs" rule. The Insurance Act, 1938 was amended in February 2015 to introduce the concept of "Beneficial Nominee". Under this provision if the nominee of a Life Insurance Policy is "*the parent, or spouse, or his children, or his spouse and children, or any of them, the nominee or nominees shall be beneficially entitled to the amount payable by the Insurer to him or them*" (Section 39(7) of the Insurance Act, 1938).

For example, Mr. Rich had a Life Insurance policy of Rs. 1 lakh and the nominee was his spouse Mrs. Rich. Mr. Rich died without making a will. Mrs. Rich will be beneficially entitled to the claim amount of Rs. 1 lakh without being accountable to the legal heirs who may include the two children also.

Life Insurance contract not to be called-in question after 3 years on any grounds

Section 45 of the Insurance Act, 1938 provides that no life insurance policy can be called into question 3 years from the date of the policy. It means that 3 years after the policy is issued or risk commences or from a revival date (whichever is later) a death claim cannot be denied on any ground whatsoever. However, during the 3-year period the claim can be denied (repudiated) or the policy can be cancelled on grounds of fraud. In fact, any large death claim during the first 3 years will invariably result in a full-fledged investigation irrespective of the Life Insurance company involved.

Hence, it makes sense to follow the principle of *Uberrimae fide* (utmost good faith) and make full and complete disclosure of all relevant facts while taking an insurance policy.

Health Insurance Policies not contestable post moratorium period[1]

A moratorium period, which is 5 continuous years, is applied in health insurance policies. If insured has paid premiums during this moratorium period, without any breaks, then no health insurance claim shall be contestable, except for proven fraud and permanent exclusion as specified in the policy. In case of any enhancement in the basic sum insured of the first policy year, then 5 continuous years will be applicable from the date of enhancement of sum insured for the enhanced limit.

[1] Vide Ref No.: IRDAI/HLT/CIR/PRO/84/5/2024 dated May 29, 2024 on Master Circular on IRDAI (Insurance Products) Regulations 2024 - Health Insurance.

1.5 Role of Insurance in Personal Finance

Insurance removes the risks to the income of a household from situations such as loss of income, reduction in income or an unplanned and unexpected charge on income, which will upset the personal financial situation of the household. Consider the following situations:

- Siddesh died young leaving his dependent wife and kids without financial support.
- Manohar is an architect who suffered from a stroke and is now unable to practise his profession.
- Arushi is a Computer Aided Design professional who met with an accident in which she lost her eyes and thus is unable to continue with her profession.
- Sindhu's car met with an accident and requires a large sum for repairs.
- Mohit suffers from arthritis and has to spend a large sum each month on physiotherapy.
- Jayant's daughter is getting married in a few days. The house is full of gifts and valuables. There is a burglary in the house and the valuables are stolen.

In all the situations described above, there is either a loss or reduction of income or a large expense that has to be met out of available income. Income is at the base of all financial plans and any event that affects income of the individual will affect the achievement of the goals that the financial plan seeks to achieve.

Insurance can be used to protect the income so that the financial goals are not at risk. If Siddesh had a life insurance policy for a sum adequate to meet his family's financial needs and goals, then he would have protected them from the financial effects of his death. Similarly, a critical illness policy would have provided a corpus to Manohar to compensate for the lost income from his architectural practise. A personal accident disability insurance would have provided a corpus that could generate the income that Arushi lost due to her accident; and a motor insurance policy would have covered the cost of repairs to Sindhu's car and his income would not have been affected. There are insurance policies available to provide cover against most situations that can cause disruption to the income and affect the financial situation of the individual.

Prioritizing insurance needs and investment needs

Insurance comes before Investments. A simple analogy can explain this. In cricket, a batsman wears protective gear. An abdomen guard and leg pads will slow down the batsman's movement and the running between the wickets. Yet even the greatest batsman in the world will never play an innings without wearing the protective gear. That is because one hit could finish his cricket career.

Similarly paying an insurance premium to cover the risk of the financial plans getting derailed, is acceptable before any investments are made to realize the financial goals.

1.6 Investing through Insurance

Insurance is also seen as a way to save and invest. Some insurance policies include a saving component along with the risk protection. The premium collected will be higher, with one portion assigned for risk protection (insurance component) and the other for the saving component (investment component). The type of investment envisaged will determine the risk and return from the investment.

1.6.1 Should investments be done via insurance

Carrying the earlier cricket batting analogy further, the protective gear and the bat together can be bought as a single kit or separately. To win the match, both good protective gear and good bat are required. However, a combined kit consisting of the protective gear and bat should not be bought just because it is convenient or cheap, if either the protective gear or the bat is not as per the required quality.

Using the merchant ship example cited earlier, if the merchant desires that the premium be returned in case the ship comes back unharmed, the premium amount payable will go up astronomically. Assuming the rate of return on investments is 12% per annum (or 1% per month) the merchant will need to pay a premium of Rs. 20,20,000 (which is higher than the value of the ship itself) to be able to get the premium amount back. Here is how the math works out. The merchant pays a premium of Rs. 20,20,000 out of which the Insurance company allocates Rs. 20,000 to the insurance pool and the balance Rs. 20,00,000 is invested. The investment amount becomes Rs. 20,20,000 (original amount of Rs. 20,00,000 plus interest earned at 1% pm) after one month which is then returned to the merchant.

This is an extreme example to illustrate some of the pitfalls of combining investment and insurance together without doing a detailed analysis. As premiums rise astronomically in investment cum insurance policies that provide adequate insurance as well, the insured person who insists on getting her premium back typically compromises by reducing the amount of coverage, which effectively compromises the basic purpose of insurance.

1.6.2 Prioritizing insurance needs and investment needs

The primary job of any insurance company is to provide risk coverage not investment products. There are other entities that specialize in providing investment products. Risk coverage (Insurance) products can be bought only from Insurance companies. Investment products can be bought from entities that specialize in investment products.

Even if an insurance cum investment product is being considered, it can be evaluated as an insurance product that also has investment elements in it. The first thing is to decouple the insurance and investment elements of the instrument. Then, the adequacy of the risk coverage needs to be examined. If the risk coverage is not adequate, then the instrument does not meet its primary goal and should be eliminated. Only after this primary requirement is met, should the investment return be considered separately to see if it is suitable for the investor and meets her requirements; and also comparable with investment products with similar profiles.

1.7 Role of Insurance Adviser

1.7.1 Steps in Insurance Planning

An essential part of financial planning is insurance planning. Just like financial planning, insurance planning is also specific to the individual and their situation. The steps in insurance planning include identifying the protection needs and quantifying them, buying the type of insurance that suits the requirement and setting in place a review of insurance needs periodically.

a. Identify insurance need

Insurance is primarily a tool for protection from financial loss. Identifying insurance needs therefore requires identifying all those situations that can result in a loss of income or an unexpected charge on income. Insurance needs can be broadly categorized as:

- Income replacement needs in the event of risk to the earning ability of an asset, which includes the life of an individual as well as his earning ability as an asset generating income. Life insurance, critical illness and accidental disability insurance for the maintenance and replacement of plant and machinery and annuities are all examples of insurance products that meet this need.
- Income protection needs protect the available income from an unexpected charge. Health insurance and motor insurance are examples of insurance products that will take over such expenses if they occur, and thereby protect the income from a large and unplanned outflow.
- Asset protection needs include the need to protect assets created from theft or destruction. Household insurance is one such product.

The type of insurance required depends upon the age and stage in the life of the individual. Insurance implies a cost and buying insurance that is not required is a wasteful use of income.

A young individual without any dependents may probably need a personal accident disability insurance policy or a critical illness policy that will give him an income in the event of his being incapacitated in an accident or suffering from a critical illness, more than a life insurance policy. The life insurance policy will replace his income in the event of his death, but since he has no dependents, it may not be as relevant at this stage in his life. For an individual with dependents, the primary need is income replacement to support his family in the event of his death and therefore a life insurance policy that does this will be more relevant.

b. Estimate the insurance coverage

- **Estimate the amount of insurance required**

  The purpose of insurance is to compensate the financial loss suffered from a specified event. It is not to profit or gain from it. The amount of insurance required must be calculated by giving due consideration to factors such as the future value of the costs being sought to be replaced, the period for which protection is required and the ability to bear the cost of insurance. Under-insurance implies the beneficiary, who is likely to

suffer the loss, is retaining a portion of the risk with themselves. On the contrary, over-insurance imposes unnecessary costs in the form of higher premiums.

- **Estimate the tenure for which the insurance is required**

The purpose of any income replacement policy is to replace income that would otherwise have been generated. By definition, income replacement policy is required during the earning phase of the insured person's life and not after her retirement. In some cases the additional premium payable from the first year of coverage is pretty low even if the coverage term is extended. For example: For somebody aged 30 years they are able to get a 30 year (till age 60) term insurance policy for Rs. 13,800/- per year versus a 40 year (till age 70) term insurance policy for Rs. 16,200/- per year. It effectively means that the person is paying additional premium of Rs. 2,400/- per year to get an option to continue the policy beyond their earning years (assuming they retire at 60 years). The person may find it worthwhile to pay that price for the option to continue renewing the policy even after reaching the age of 60 years.

c. Identify the most suitable insurance product

Having decided on the insurance coverage, the next decision is the choice of product. Various types of insurance products are discussed in the next section.

d. Optimise the insurance premium

Within the same insurance product and coverage, there are choices that help the insured reduce the insurance premium.

For example, in motor insurance, it is common to ask for non-mandatory information relating to the insured that help in understanding the risk better. Insurance policy will be issued even if the additional information is not shared; but the insured can reduce the premium by sharing the information.

Another avenue for reducing premium in the case of non-life policies is in the choice of 'deductible'. The insured can agree that in the event of a claim, a certain amount (the deductible) will be borne by the insured. Thus, the insured is sharing the risk with the insurer. This is compensated through a lower insurance premium. Higher the deductible that the insured is prepared for, lower the insurance premium. The 'no claim' bonus can be used to reduce premiums in the following years.

Insurers may also offer discount on premiums to policyholders on E-Insurance policies, i.e. insurance policies issued in electronic forms that are exempt for issuance in physical form

e. Monitor the insurance coverage

Insurance is not a one-time activity. The exposure and coverage need to be monitored continuously. Where necessary, the policy coverage would need to be modified to mitigate additional risks. Reviewing insurance cover is advised whenever there is a big change in life, which alters the demands on your income. Marriage, children, buying a house and even a large raise, are situations that require a review of the adequacy of the insurance cover. Life insurance cover may even be reduced over time as goals are met and there are fewer goals to be provided for.

1.8 Regulations pertaining to Insurance

Some aspects of regulations pertaining to life insurance have been discussed earlier. Below is a glimpse of certain regulatory aspects pertaining to health insurance and ULIPs.

1.8.1 Health Insurance

- Standard terminology should be used in all Health Insurance policies to impart common understanding to the insured persons. Important terms such as pre-existing diseases, portability, co-payment, deductible etc. have been standardized.
- There is standardization of what can be excluded from coverage in a health insurance policy. The insurance company can have lesser exclusions than provided for but cannot exceed the exclusions provided in the prescribed regulations.
- Many illnesses, like mental illness, genetic disorders, congenital disease and others have been removed from exclusion list.
- Any health insurance policy (other than a group policy or a super top-up or a top-up policy) can be ported from one company to another company.
- Group health insurance policies can also be ported to individual policies within same company in first year of leaving the company, and to any other company from second year onwards.
- The insurance company must provide fair justifiable and transparent reason in writing for any rejection of health insurance coverage.
- A health insurance company cannot reject a claim if policy is continued for 5 years without any break by the policyholder.
- Telemedicine is now covered under health insurance.
- If there is any delay in claim settlement, insurance company is now liable to pay interest on claim amount.
- All general and health insurers are required to offer a standard individual health insurance product mandated by IRDAI with the following objectives:
    - Health Insurance policy to take care of basic health needs of insuring public.
    - To have a standard product with common policy wordings across the industry.
    - To facilitate seamless portability among insurers.
    - The standard product shall have the basic mandatory covers as specified in IRDAI Guidelines which shall be uniform across the market.
    - No add-ons or optional covers are allowed to be offered along with the standard product.

1.8.2 Unit Linked Insurance Products (ULIP)

- Insurers must provide the prospect/policyholder all relevant information about various charges for each policy year.
- Insurers must provide benefit illustrations giving two scenarios of interest – at 4% and at 8%.
- The prospect is required to sign on the illustration also while signing the proposal form.
- The lock-in period is 5 years to reflect the long-term, protection function of the policy.

- All regular premium/ limited premium ULIPs shall have uniform/ level paying premiums.
- Any additional payment shall be treated as single premium for the purpose of insurance cover charges on ULIPs should be evenly distributed during the lock-in period so that the expenses are not excessively front-ended.
- All limited premium paying term unit linked insurance products, other than single premium products, shall have premium paying term of at least 5 years.
- All unit linked products, other than pension and annuity products should have a mortality or health cover.
- The minimum cover to be offered has been specified for these segments.
- A cap on charges has been imposed from the 5th year onwards to smoothen the charge structure for the policyholder.
- Discontinuance charges are capped as a percentage of fund value and premium and also as an absolute value.
- The Grace Period for different modes of premium payment is clearly defined.
- No Surrender charges are applicable after 5 policy years.
- The partial withdrawals from ULIPs are allowed to a certain limit after 5 years of lock-in is over.
- A lapsed ULIPs can be revived within a period of 3 years from the date of lapsation.

1.8.3 Regulatory aspects for insurance intermediaries[2]

1. "Intermediary or insurance intermediary" includes insurance brokers, reinsurance brokers, insurance consultants, surveyors and loss assessors.
2. Insurance Brokers: Brokers represent the client and assist the client in matching their needs with multiple Insurance companies.
3. There are various types of Insurance Brokers:
    a. “Direct Broker” means an Insurance Broker who can charge a fee to his clients or earn a commission from the Insurance companies. Direct Insurance Brokers solicits and arranges insurance business for its clients with multiple insurers located in India and/or provides claims consultancy, Risk Management services or other similar services.
    b. Reinsurance is the practice whereby insurance companies transfer portions of their risk to other parties/Reinsurance firms by some form of agreement to reduce the likelihood of paying a large obligation resulting from a single insurance claim or similar risks. Reinsurance is done so as to spread the risk widely among as many parties as possible so that no single party is affected in case of a large claim. “Reinsurance Broker” means an insurance Broker who solicits and arranges reinsurance for its clients/Insurance companies with multiple insurers and/or reinsurers located in India and/or abroad; and/or provides claims consultancy, Risk Management services or other similar services.
    c. “Composite Broker” means an Insurance Broker who is both – Direct Broker as well as a reinsurance broker.

[2] Vide IRDAI (Insurance Brokers) Regulations, 2018, IRDAI (Appointment of Insurance Agents) Regulations, 2016 and IRDAI (Registration of Corporate Agents) Regulations, 2015.

d. "Insurance Agent" means an individual appointed by an insurer for the purpose of soliciting or procuring insurance business including business relating to the continuance, renewal or revival of policies of insurance.
e. “Composite Insurance Agent” means an individual who is appointed as an insurance agent by two or more insurers subject to the condition that he/she shall not act as insurance agent for more than one life insurer, one general insurer, one health insurer and one each of the mono-line insurers.[3]
f. Corporate Insurance agent - Corporate entities represent an insurance company and sell its policies. Usually, they are engaged in a particular business and sell insurance policies to their existing customers based on the situation. For example, a travel agent may offer you a travel insurance policy or a vehicle dealer a motor insurance policy.
g. Corporate Agent (composite) can work with a maximum of three life insurers, three general Insurance companies and three health Insurance companies.
h. When a bank becomes the corporate agent of an insurance company it is referred to as a bancassurance arrangement or partnership.

4. Insurance Web Aggregators are insurance intermediaries who maintain a website for providing online price comparison and information of products of different insurers and other related matters.

Table 1.2: Difference between Insurance Agent and Direct Insurance Broker

Parameters	**Direct Insurance Broker**	**Insurance Agent**	**Corporate Insurance Agent**
Who he Represents	The client	Insurance Company	Insurance Company(ies)
Can work with	Multiple Insurance Companies	More than one Insurance company in each line of business – Life, general and health; provided he dispassionately advices the policyholder on the products of all Insurers whom he is representing and the product best suited to the specific needs of the prospect	Corporate Agent (composite) can work with a maximum of three life insurers, three general insurance companies and three health Insurance companies

[3] Mono-line insurer means insurer, as defined under section 2(9) of Insurance Act, 1938, and carrying on one particular specialized line of business such as agriculture insurance, export credit guarantee business

Parameters	Direct Insurance Broker	Insurance Agent	Corporate Insurance Agent
Can Charge	Fees to the Client and get commission from the Insurance Company	Get commissions from the Insurance Company	Get commissions from the Insurance Company(ies)

1.8.4 Regulations for Insurance Intermediaries under IRDAI Regulations

In order to make insurance intermediaries such as agents and brokers more accountable and reduce instances of mis-selling, insurance agents have to ensure that they sell policies based on product suitability parameters such as risk appetite and financial goals of their clients.

Insurance agents will have to justify product suitability before selling it to clients. Suitability analysis has been optional for quite some time. As a result, most agents skip this section in the proposal form.

Insurance companies cannot issue an investment cum insurance policy until their agents ensure that the policy is sold after suitability analysis. Such suitability will have to be ascertained through a series of questions such as age, income, family status, life stage, financial and family goals, investment objectives, insurance portfolio already held and so on. Suitability is to be determined based on information collected at the time of sale. Such a determination should be based on prospect's risk profile, financial situation and investment objectives. However, agents can skip this requirement only if they get a written consent from policyholders saying that they have consciously chosen to bypass suitability module despite recommendation of their agents.

On benefit illustration, agents will have to clearly state what the policy is all about. Agents and insurance companies can give benefit illustration by taking 4% and 8% return into account. Also, agents are required to sign the benefit illustration form along with policyholder to ensure that they have not lured investors with attractive returns. In addition, agents will have to clearly state what is guaranteed and non-guaranteed benefits attached to a policy.

1.8.5 Do's and Don'ts under SEBI (Investment Advisers) Regulations, 2013

SEBI (Investment Advisers) Regulations (IA regulations) provide an exemption to an insurance agent or insurance broker registered with IRDAI who offers investment advice solely in insurance products. However, if the insurance agent or insurance broker also offers investment advice on non-insurance securities or investment products then such advice would be covered by IA regulations. In that case, while advising on insurance based security or Investment products also the IA cum insurance intermediary would need to keep the principle of risk profiling, suitability and fiduciary responsibility to the client in mind.

CHAPTER 2: LIFE INSURANCE PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Elements of Life Insurance Products
- Life Insurance Need Analysis
- Types of Life Insurance Products
- Insurance under Married Women's Property Act (MWPA)
- Criteria To Evaluate Various Life Insurance Products
- Global coverage for Different Life Insurance Products

2.1 Life Insurance Products

Life insurance products provide cover for the life of the insured.

Elements of Life Insurance Products

Life insurance products can be defined by the benefits that they provide to the insured. The insured would get the following benefits from life insurance products:

- **Death cover:** Where the benefit is paid only on the death of the insured within a specified period. If death does not occur, then no benefit will be paid.
- **Survival benefit:** Where the benefit is paid when the insured survives a specified period.

Term Insurance policies provide for only death benefit. Investment cum insurance policies will provide a combination of the above two features.

An insurance contract has the following several elements, the definitions of the key ones are as follows:

- **Insured:** This refers to the person whose life is being insured and can be individuals, minors or joint lives. If the life being insured is different from the person buying the insurance policy, such a buyer is called the proposer or policy holder and such person should have an insurable interest in the individual being covered.
- **Term of the contract:** This is the time period during which the insurance cover is available to the insured. In some cases, the insurance company may specify an upper age limit at which the term of the policy would end.
- **Sum assured:** This is the amount being insured. The IRDAI Regulations require all life insurance products with terms of more than 10 years to provide a minimum sum assured of 10 times the annual premium for individuals below 45 years of age and 7 times the annual premium if age is above 45 years. If the term is less than 10 years the minimum sum assured shall be 5 times the annual premium for all individuals. The insurance contract may also specify situations, if any, when the sum assured will change. For example, if a reducing term insurance policy taken to cover outstanding mortgage payments, the sum assured will decrease as the outstanding loan decreases.
- **Payment of sum assured:** The payment of sum assured will be on the occurrence of a specific event such as death of the life insured (death benefit) or expiry of the

term of the policy (survival benefit). The mode of payment of the sum assured, whether lump sum or as instalments is specified in the contract.

- **Premium payable:** This depends on the sum assured and the term of the policy. The mode of payment of premium, such as monthly, quarterly, half-yearly or annually are included in the contract. Some policies involve the payment of a single premium at the start. Non-payment of premium due on a policy within the grace period allowed makes the policy lapse. The policy can be revived/ reinstated during the timeframe provided by the insurance companies by paying the pending premiums along with penalty.
- **Bonus:** This is relevant only to investment cum insurance policies. Bonus is an amount that is added to the sum assured, announced periodically as a percentage of the sum assured. It is paid out along with the maturity value or on the occurrence of the insured event.
- **Guaranteed bonus:** This is relevant only to investment cum insurance policies. Guaranteed bonus is paid for the first few years of the policy period, say, five years and is paid as a percentage of the sum assured. It forms part of the benefits of the policy and is generally received at the end of the term.
- **Reversionary bonus:** This is relevant only to investment cum insurance policies. This is based on the performance of the insurance company and is declared for policy holders at the discretion of the insurer. Reversionary bonus is declared after the completion of the guaranteed bonus period and is applicable to those policies that are called participating policies. The premium for such policies is higher than those policies that are non-participating.
- **Policy lapse:** If the premium due on a policy is not paid, even within the applicable grace period, then the policy lapses and no claim is payable on a lapsed policy. However, in a traditional investment cum insurance policy that has been in force for at least 3 years (2 years if the term of the policy is less than 10 years), on which full premiums have been paid, may acquire a cash value or surrender value. This value is returned to the policy holder. The minimum surrender value will be 30% of all premiums paid and goes up to 90% in the last two years.
  For a single premium policy, the guaranteed surrender value will range from 70% of total premium paid if surrendered within the first three years to 90% in the last two years. For ULIPs, surrendering a policy before 5 years is possible even though there is a lock in of 5 years. There is a discontinuation charge levied which is maximum of Rs 6000. Post deducting this charge, the balance fund is transferred to a discontinuation policy fund.

  - Along with this, the insurers may also pay an amount based on the current value of the assets held against the policy. In case of unit- linked insurance plans, the policy has a lock-in of 5 years and the surrender value is paid only at the end of the lock-in period.

  - The other option in investment cum insurance policies when there is a lapse in premium is to make the policy paid-up. This means the sum assured is proportionately reduced to the same proportion that the number of premiums paid bears to total premiums due. For example, Surinder had taken a 25-year life insurance policy (investment cum insurance policy) with a sum assured of Rs. 10,00,000, premiums being paid in a half-yearly mode. After paying the

premium for 5 years, Surinder is unable to continue paying the premiums. In the example the sum assured would be Rs. 10,00,000 only if premiums are paid for 25 years; on a half yearly basis, that would be 50 premium payments. Since only 10 premiums have been paid over a period of 5 years, the sum assured will be readjusted to Rs. 2,00,000 (i.e. Rs. 10,00,000*10/50).

- **Nomination**: It is the right of a policy holder to identify the person(s) entitled to receive the policy money, in the event of the policy becoming a claim by death. The nomination can be made at the time of taking the policy or subsequently at any time during the term of the policy, and can also be changed any number of times.

2.2 Life Insurance Needs Analysis

The amount of life insurance cover required depends on the economic value that can be attached to human life. This is called the Human Life Value (HLV). This is the value that insurance needs to compensate for, if there is a loss to life, or disability that results in a reduction in the ability to generate income. HLV is the present value of the expected income over the working life of the individual that is available for the dependents. There are different ways in which the HLV are calculated.

2.2.1 Estimate the life insurance coverage

Insurers have their techniques for estimating human life value. One simple approach is given in Table 2.1.

Table 2.1: Estimating Human Life Value

E15 =PV(E14,E11,-E8)

	A	B	C	D	E	F
7						
8				Current Annual income of insured (Rs)	₹ 10,00,000.00	
9				Proposed Retirement Age (years)	60	
10				Current Age (Years)	33	
11				Years to Retieremnt (Yrs)	27	60-33
12				Estimated Return on Investment	8%	
13				Expected inflation rate	6%	
14				Discounting rate	1.89%	((1+8%)/(1+6%))-1
15				Estimated Human Life Value	₹ 2,10,04,210.30	
16						

Note: The discounting rate shown in the table is only upto 2 decimals. The calculations are based on the formula given in the table, whose result goes into several more decimals.

The HLV calculations are relatively easy to calculate as it has only 2 basic assumptions – (i) by how much does the current income increase (the inflation rate of 6% in the above example) and (ii) what is the post-tax return on the sum assured (8% in the above example).

Question 1: If we do the same calculations but now assume that the income will increase by 8% every year the Human Life Value will go down. Is this statement True or False?

Answer: It is a False statement as the following calculations will show:

Discounting rate is 0 as (1+8%)/(1+8%)-1 = 0

That means the HLV becomes Rs. 2,70,00,000 where discounting rate is 0, Nper is 27 and PMT is 10,00,000. In other words, where the rate of increase in income is assumed same as the post-tax return on investment, the HLV will always be equal to the current income multiplied by the number of years left for retirement.

This is an easy thumb rule to remember. It is also the origin of the basic thumb rule that the HLV of younger people is higher (as both the number of years left for retirement are higher and the increase in income also tends to be higher).

Question 2: All other things being equal in the above example and the income actually going up as assumed – the HLV will fall as the person gets older. Is this statement True or False?

Answer: The statement is True because the discount rate will remain the same but the Nper will fall and hence the calculated PV will fall.

An alternative approach is called the needs-based approach. It assumes that the insurance proceeds will be used for the expenditure needs and meeting the liabilities of the insured, as calculated in Table 2.2. These needs and liabilities are first met out of the value of investments and other assets (other than personal assets such as residential house and personal jewellery that the insured person's family will not want to sell even if the insured person dies). The difference between these figures constitutes the insurance requirement. The current insurance requirement will be calculated after deducting the existing life insurance from this figure.

Table 2.2: Estimating Insurance based on Needs analysis

G37 =PV(G35,G29,G23)

	A	B	C	D	E	F	G	H	I	J
21										
22										
23	a			Current annual expense of the family (Rs)			₹ 10,00,000	(net of loan repayments,		
24								insurance premia etc.)		
25	b			Life Expectancy of beneficiary (years)			80			
27	c			Current age of beneficiary (years)			49			
29	d			Years to provide for (years)			31	b - c		
31	e			Estimated Return on Investment			8%			
33	f			Expected annual inflation rate			6%			
35	g			Discounting rate			1.89%	{(1+e)÷(1+f)}-1		
37	h			Estimated Insurance to cover expenses			₹ -233,09,243	based on PV formula in Excel		
39	i			Loans outstanding			-₹ 20,00,000	(housing loan, car loan etc.)		
41	j			Estimated Insurance Need			₹ -253,09,243	h+i		
43	k			Coverage in insurance already taken			₹ 50,00,000	(on life of earning member		
44								to cover the beneficiary)		
45	l			New insurance required			₹ -203,09,243	j+k		

Note: The discounting rate shown in the table is only upto 2 decimals. The calculations are based on the formula given in the table, whose result goes into several more decimals.

Example: Anil currently has a monthly income of Rs.1,50,000. He pays an insurance premium of Rs.25,000 per month and an EMI of Rs.32,000 on a loan of Rs.40 lakhs that he has taken for this house. His personal expenses are Rs.10,000. He wants to provide insurance protection for his wife who is currently 49 years old and is expected to live till 80. If the expected inflation is 6% and return on investment is 8%, what is the insurance cover he should take? His current insurance cover is for Rs.1 Cr and he has other investments amounting to Rs.50 lakhs. His house is worth about Rs.50 lakhs.

Income Replacement Method

The first step is to calculate the current value of the income required to be provided for Anil's wife. The next step will calculate the corpus required that will generate the income required. For this the applicable rate will be the rate adjusted for inflation and expected rate of return from the investment of the corpus. To this, the values of any other obligations or needs are added to come to the total funds required to meet the needs. The values of the existing investments are deducted to arrive at the corpus that needs to be created. This will be the insurance amount.

Steps for Calculation

1. Calculate the current value of the income required to be provided.
    a. Total income - (Portion of income used by Anil for personal needs+ EMI payments+ Insurance Premium)
    b. = Rs.1,50,000 - (Rs.10,000+Rs.32,000+Rs.25,000)
    c. = Rs.1,50,000 - Rs.67,000= Rs.83,000 per month
    d. =Rs.9,96,000 per annum
2. Calculate the applicable rate after adjusting for inflation and investment return
    a. Inflation rate =6%
    b. Investment rate= 8%
    c. Adjusted rate= ((1+8%)/(1+6%))-1= 1.89%

    (The result, based on the formula, goes into several more decimals. However, for the calculation, we consider the discounting rate upto 2 decimal places only.)
3. Use the PV function in excel to calculate the corpus
    a. Rate is the adjusted rate of 1.89%
    b. Nper is the number of years for which the income has to be provided. In this case it is 31 years (80 years – 49 years)
    c. PMT is the income that has to be provided, starting at Rs.9,96,000
    d. The value calculated is the corpus that will generate the income required when invested at a rate of 8%. This is Rs.2,36,43,984.
4. To this corpus value calculated, the loan outstanding of Rs.40,00,000 has to be added. The total sum required is Rs.2,76,43,984.
5. From the total amount required, the existing insurance cover of Rs.1,00,00,000 and Rs.50,00,000 of investments is deducted to arrive at the amount of insurance cover that will be required for Anil so that all the needs are met. This amount is Rs.1,26,43,984.

Need based approach -- Calculation of Insurance Need

		Formula
Current income to be replaced	Rs.9,96,000	Rs.83,000 x 12
Adjusted rate	1.89%	((1+8%)/(1+6%))-1
Period over which income has to be provided	31 years	(80 years- 49 years)
Corpus required	Rs. 2,36,43,984	PV(1.89%, 31,-996000,,1)*
Add loan outstanding of Rs.40 lakhs	Rs. 2,76,43,984	
Deduct insurance available of Rs.1 Cr and investments of Rs.50 lakhs	Rs. 1,26,43,984	
Additional insurance cover required	Rs. 1,26,43,984	

*The calculation considers payment at the beginning of each year. This is indicated in excel by putting in '1' in the PV function for the argument 'Type'.

Note: The amount of additional insurance taken along with the existing insurance cover and investment will be adequate to take care of the needs and the value of the corpus created will be drawn down completely by the end of the period.

Question: Other things remaining equal the needs-based calculation for Life insurance requirements will be lower where the insured has a higher amount of investments. Is this statement True or False?

Answer: This statement is true, as already mentioned in the example.

Therefore, from the above discussion it is clear that the insurance requirement calculated as per the HLV method will always be higher or equal to the insurance requirement calculated as per the needs-based approach, as overall expenditure cannot exceed income.

2.3 Types of Life Insurance Products

Life insurance policies can be categorized based on the benefit patterns. The payment of benefits from the policy, at death or on maturity, are used to differentiate the policies.

Term Insurance

Term insurance is a pure risk cover product. It pays a benefit only if the policy holder dies during the period for which one is insured. Term life insurance provides for life insurance coverage for a specified term of years for a specified premium. The premium buys protection in the event of death and nothing else. Term insurance premiums are typically low because it only covers the risk of death and there is no investment component in it. It offers the most affordable form of life insurance and is an ideal way to cover the Life Insurance needs because the entire protection needs of the Insured can be covered as the premiums are affordable.

The three key factors to be considered in term insurance are:

- Sum assured (protection or death benefit)
- Premium to be paid (cost to the insured), and
- Length of coverage (term)

Various insurance companies sell term insurance with many different combinations of these three parameters. The term can be for one or more years. The premium can remain the same every year (level premium) or increase as the insured gets older. A policy holder insures his life for a specified term. If he dies before that specified term is over, his estate or named beneficiaries receive a payout. If he survives the term nothing is payable.

The payouts under the term insurance policies has many variants. The insurance company can pay a lumpsum amount or a fixed regular monthly amount for a specific period say 10 years or both lumpsum and fixed monthly amount (for a specified period). The tenure of the policy too has been extended with some companies providing coverage up to 85 or 100 years. The premium for such "term" policies with extended coverage is much higher than those term policies that cover only the earning years.

- **Term insurance with return of premiums**

Several variants of term policies are available in the market such as a term policy with return of premium. In this variant, normally the premium is much higher than a regular term policy; and the difference is invested by the insurance company to provide for the return of premium at the end of the term. The inherent investment return on this policy can be calculated by using the 'Rate' formula in Excel:

The following real-life example of pure term plan and return of premium term plan from the same insurance company will illustrate this:

Need for Insurance or Sum Assured: Rs. 1,00,00,000

Policy tenure: 30 years

Policy premium if pure protection policy: Rs. 9416 per annum

Policy premium if premiums returned in the end: Rs. 17,473 per annum

Difference between the 2 premiums (Rs. 17,473 less 9,416) = Rs. 8057

Amount of Premium returned on maturity: Rs. 5,24,190 (i.e. 30 times the annual premium of Rs. 17,473)

Nper = 30

PV = 0

PMT = 8057 (17,743 less 9,416)

Future Value = - 5,24,190

Payment at the beginning of each period

Rate is = 4.61%

In this example, it means that the insured person is getting a return of 4.61% p.a. on the extra premium paid by him to choose the 'return of premiums' policy. This working can be

done for any set of pure term plan and term plan with return of premiums from the same company.

Endowment

Endowment is an investment cum insurance plan with the same premium being paid every year. If the insured person survives the tenure of the plan, the insurance company returns the investment portion of the premium along with actual returns realised on them. This actual return is normally calculated and declared every year (called accrued bonus) but paid only at the end of the tenure. After the insurance period is over, a lump sum is paid out, equal to the sum assured plus any accrued bonus as above. Accrued bonus is a figure that is not pre-defined at the commencement of the policy but is generally calculated at the end of every year. If death occurs during the term of the policy, then the sum assured and any bonus accrued till death are paid out.

There are many products in the market that offer various options in terms of tenure, type of bonuses, payout options at various times (popularly called Money back policies) etc.

The inherent investment return on such policies are calculated by using the official illustration offered by the insurance company on the Investment cum Insurance plan. This official illustration obtained from the insurance company's website is the only official document that clearly lays down what are the probable returns on an Investment cum Insurance policy, and also lays down which portion is "guaranteed" and which portion is not guaranteed.

Again, we can use either the 'RATE' function in Excel (where the amounts received on survival are in a lumpsum) or the 'XIRR' function in Excel (where the amounts are received over a period) to work out the inherent investment return from the investment cum insurance policy.

A real-life example is given below:

Sum Insured: Rs. 1 crore

Tenure of coverage: 30 years

Policy premium if Endowment policy: Rs. 3,16,332 per annum

Policy premium if pure protection policy: Rs. 9416 per annum

The higher of the two amounts shown as payable after 30 years as per official illustration of the Insurance company: Rs. 2,14,00,000

Nper = 30

PV = 0

PMT = 3,06,916 (3,16,332-9416 i.e. the term plan premium)

Future Value = - 2,14,00,000

Payment at the beginning of each period

Rate is = 5%

In this example, it means that the insured person is getting a return of 5% p.a. on the extra premium paid by him to choose the endowment policy. This working can be done for any set of pure term plan and endowment plan from the same company.

The premium for a pure term plan (Rs. 9416) is very affordable as compared to Rs. 3,16,332 payable for the endowment plan for a similar amount of insurance coverage. Since the primary function of an insurance policy is protection, and if the premium is not affordable, an endowment plan can be ruled out of the consideration. The inherent investment return on such policies based on the official illustration is normally around 3-5% p.a. (it is 5% in the above example) and even that is not guaranteed. The actual return can be lower or higher than that shown in the official illustration.

Whole Life insurance

Whole Life insurance policies are investment cum insurance policies that provide life insurance cover for the entire life of the insured person or upto an upper age limit specified by the insurer, whichever is earlier, provided the premiums are paid as contracted. Premium amount is fixed through the entire period. There are variations to the whole life policy such as shorter premium payment periods and return of premium option. For a traditional whole life policy, the entire sum assured plus any bonuses will be paid on death of the policy holder. Whole Life Policies were originally designed primarily to pass on wealth to the next generation without payment of estate duty since life insurance payments on death were normally exempt from estate duty. With the abolition of estate duty, the whole life insurance policy is like any other investment cum insurance policy that needs to be evaluated based on adequacy of coverage and the inherent investment return.

Unit-Linked Insurance

In the case of both whole life and endowment policies, the insured has no say in deciding how the savings component in the policy will be managed. Unit-linked insurance policies allow the insured to decide on the kind of portfolio (mix of asset classes, such as debt and equity) that the insurer should maintain for the savings portion.

The risk cover charges are deducted from the regular premium paid by the insured during the period of insurance. The balance is invested as per the agreed asset allocation. The value of the investment portfolio (savings portion) will keep changing in line with the market. The insurer announces a Net Asset Value on a daily basis.

In the event of death of the insured, the sum assured (or net asset value or higher of both or total of both, depending on structure of the policy) is paid to the beneficiaries. If the insured survives the insurance period, then the net asset value is returned.

Single premium policies allow the insured to pay a one-time premium for the coverage. There are no indicated inherent investment returns in ULIPs and they are more transparent than their endowment or whole life counterparts.

Below is the Case study for comparison of using Term policy for protection plus mutual funds for investments as compared to a Unit Linked plan that provides same level of protection and invests for the same amount.

Case Study: Assumptions for Case study of Mr Jeevan

Age: 35 years
Life Insurance policy required: Rs. 100 lakhs
Tenure: 20 years
Term Life Premium: Rs. 1100/- per month

Investment amount per month: Rs. 25,000 pm
Investment period: 300 months (25years)
Tax benefit sought: No tax benefit is sought on the investment amount

Option 1: Pay term life premium of Rs. 1,100/- per month and invest Rs. 25,000 per month in a mutual fund scheme

Option 2: Invest Rs. 26,100/- per month in a Unit Linked Insurance plan of type II (which means on death before maturity the ULIP will pay the sum assured amount plus the fund value; on maturity the fund value is payable). Sum assured is Rs. 100 lakhs. Policy term is 25 years. Monthly premium is Rs. 26,100.

Based on the above set of assumptions the comparison works out as under:

Sr. No.	**Particulars**	**Option 1 (Term Policy plus investment in Mutual Fund)**	**Option 2 (Unit Linked Insurance Plan Type 2)**
1	Divisibility of Insurance contract from Investment contract – this is an important consideration since most of outgo is on account of investment.	Completely divisible as these are 2 separate contracts. A break can be taken in the investment portion without any cost implications. It can then be restarted when able. The insurance portion can also be discontinued if not needed at a future stage.	For the first 5 years, these 2 contracts are indivisible. During this 5-year period if the monthly premium is not paid (within allowed grace period) the entire contract moves into discontinued policy account and the insurance coverage stops. Even after 5 years, whilst investments can be discontinued insurance cannot be discontinued even if not needed.
2	Liquidity of investment	No lock in period. There can	The investment portion is

Sr. No.	Particulars	Option 1 (Term Policy plus investment in Mutual Fund)	Option 2 (Unit Linked Insurance Plan Type 2)
	portion	be an exit load on the investment portion if money is withdrawn within 12/18 months.	locked in till 5 years from inception date.
3	Risk in the Investment portion	Mutual funds are available for whatever risk profile is required.	Most Insurance companies will also have a variety of possible investment options that will meet with the risk profile of the client.
4	Movement between schemes of one provider to the schemes of another provider	This is easily possible though there could be exit load and capital gains tax cost implications.	This is not possible.
5	Movement between different schemes of the same provider	This is easily possible but could have exit load/capital gain tax implications.	This is possible with the added benefit that it has no tax implications and normally most providers provide a few shifts every year free of cost.
6	Transparency of information, rules around costs, creation/cancellation of units, availability of independent monitoring information in the public domain	The regulatory infrastructure has evolved over the years and is quite sophisticated. Large number of independent monitoring agencies ensure that performance of each schemes are widely monitored leading to a competitive environment. Maximum costs that can be debited are known. Units cannot be created disproportionately or cannot be cancelled for meeting any costs. This allows for proper comparison of returns for a scheme and inter-scheme comparison.	The reporting and regulatory infrastructure is still evolving making it relatively less transparent than mutual funds. Most costs such as mortality charges (for insurance), policy administration costs are debited by cancellation of units rather than embedded in the NAV itself making return comparison difficult. There is less competitive pressure on the funds of insurance companies from independent monitoring agencies. Also, creation of bonus units for loyal investors means that the newer contributors to the fund are subsidising the older investors. This again makes return comparison across schemes difficult.

Sr. No.	Particulars	Option 1 (Term Policy plus investment in Mutual Fund)	Option 2 (Unit Linked Insurance Plan Type 2)
7	Tax on maturity value	Capital gains tax is chargeable at maturity.	If the sum assured is at least 10 times the annual premium no tax is payable on the maturity value. In the given example, the maturity value will be exempt as the sum assured of Rs. 1 crore is higher than 10 times Rs. 3,13,200 (annual premium). As per the Finance Act 2021, the maturity proceeds of ULIPs having annual premium of more than Rs 2.5 lakh shall be treated as capital gains and taxed accordingly. This, however, is applicable only for the policies taken on or after 01.02.2021.

The parameters to evaluate any Investment cum Insurance policy remain that it should first serve its primary purpose, which is providing life cover. Thus, the big assumption in the above comparison remains that the insurance cover is required. Based on that, both options seem to be comparable in the above example, with the lack of flexibility and lower transparency of the ULIP being balanced somewhat by better tax treatment of its maturity value (for policies issued before February 1, 2021).

If however, the insurance is not required then the mortality charge (insurance premium part) of the ULIP becomes an additional cost. Large investments typically come from relatively older investors who may not need a large insurance cover based on a needs analysis calculation since they would have already accumulated sufficient assets to meet their goals. Additionally, they find it difficult to be eligible for the 10 times life insurance required based on their health parameters and even where they are able to get the required insurance amount it would come at a stiff cost.

In summary, a ULIP should be considered in place of a term policy plus mutual fund only where insurance cover is required in the first place.

Mortgage Insurance

This is a special kind of insurance policy, where the sum assured keeps going down with time. This is suitable when the insurance policy is taken to cover a housing loan, which will keep reducing with loan repayments.

If the insured seeks a policy for the entire amount borrowed, then there will be over-insurance viz. insurance amount will be greater than the loan outstanding after repayments. In theory, by reducing this over-insurance, the insured is able to reduce premium costs as compared to a term plan that covers the full amount of loan from the beginning till the end of the loan tenure.

This, though, is in theory only. In practise, reducing balance mortgage insurance is not much cheaper than level term insurance plan. Ironically, in many cases the mortgage insurance plan that is supposed to be cheaper than a level term plan is actually more expensive than a level term plan for the full value of the loan. In many cases, the sum assured is the lower of the outstanding home loan or the reducing sum assured as per the mortgage plan. Since home loans are prepaid in a majority of cases, the premium paid for the extra coverage that is not available because the home loan has been prepaid, goes waste. This is the reason these plans are not popular.

Insurance companies also offer various riders that the insured can benefit from, by paying an extra premium.

- Double sum assured rider, which provides twice the amount insured in case of death before the term of the policy.

- Critical illness rider, which provides a pre-specified sum on diagnosis of a life-threatening illness and survival for 30 days after such diagnosis. In some cases, the life insurance cover is reduced by the amount of money paid out under this rider. This is called the accelerated sum insured. It is cheaper than a rider that pays out the pre-specified sum independent of the death claim. Ironically, in most cases, the premium on a term insurance policy with an equal critical illness cover (on an accelerated sum insured basis) is cheaper than just a standalone critical illness policy from a general insurance company.

- Accident death benefit or disability rider, which enables the insured to receive a periodic payout if temporarily disabled, for a limited period of time or a specified sum on permanent disability caused due to accident.

- Waiver of premium rider, which is triggered if there is a disability or loss of income that makes it difficult to pay the premium.

- Guaranteed insurability option rider, which enables enhancing the insurance cover without further medical examination. This is very useful for young persons who expect to have increased income in the future but may also suffer from medical issues as they age.

- Income Benefit Rider is the rider that allows the policyholder's nominee to get a specific amount of sum periodically as a fixed income in the event of the policyholder's death

during the duration of the plan instead of getting it as lumpsum on the death of the policy holder.

Group insurance is another option for cheaper insurance. For example, the insurance company may cover all employees of a company under a group insurance policy. The premium in that case turns out to be lower than for individual policy offering the same coverage. Further, the claim processing may be simpler, with the employer facilitating the process.

2.4 Facilities available under Life Insurance Policies

Loan against insurance policy

Pure protection policies do not acquire any surrender value and hence it is not possible to get a loan against them. Most insurance companies offer a loan against the surrender value of Investment cum Insurance policies. Banks and Non-Banking finance companies may also offer loans against the security of such Investment cum Insurance policies. Normally the interest rates charged by the insurance companies on the loans provided by them against the security of their own policies are lower than those charged by banks/ NBFCs. So, it makes sense to take the loan from banks/ NBFCs against security of life insurance policy only if a number of such policies are being combined to get a larger loan which is more convenient than taking separate loans from different insurance companies.

Taking loan from bank/ NBFC against the security of Investment cum Insurance policies is also a good way to rebuild credit score after it may have been damaged due to a past default.

Nomination and change of nomination

Nomination is the right of a policy holder to identify the person(s) entitled to receive the policy money, in the event of the policy becoming a claim by death. The nomination can be made at the time of taking the policy or subsequently at any time, and can also be changed any number of times.

Under normal law, the nominee holds any property in trust for the legal heirs of the person. However, the Insurance Act, 1938 has been amended in 2015 to provide that if the nominee is the spouse, parent or children or any combination of them, then such nominee(s) will inherit on a beneficial basis rather than as trustees. Refer to section 1.4 for example of nomination.

Policy assignment

- Assignment means transferring the interests in the policy.
- Assignment normally done for taking loan against the policy but can also be done for other reasons.
- An assignment cancels an existing nomination in the policy.
- However, if assignment is to the insurance company itself for loan taken from the insurance company then the nomination does not stand cancelled just affected to the extent of the insurance company's interest in the policy.

- Nomination gets reinstated after policy is re-assigned back to policy holder.
- Assignation has to be recognised by the insurance company by way of endorsement on the policy after receiving a written notice in this regard.

2.5 Insurance under Married Women's Property Act (MWPA)

The normal purpose of taking a life insurance policy is to make sure that the family members get a certain sum of money on the death of the income earner so that they have a financially secure future and the same standard of living can be maintained even after the death of the income earner.

In most cases, the spouse, children or parents are listed as nominees on the life insurance policy and on death of the policy holder the amount is paid to the nominee(s) as a beneficial owner – which means that they hold the money as owners and not as trustees for the legal heirs. However, the nominees can be changed at any time during the policy period. Also, if the creditors of the insured person may be able to lay claim to the proceeds of a life insurance policy even from such "beneficial nominees". All these risks can be avoided if a married man takes a life insurance policy and does the appropriate declaration of buying it under the Married Women's Property Act, 1874. When any life insurance policy is bought under the MWP Act, the nominees can only be the spouse or children or both (but not parents) of the insured person. When the life insurance policy is bought under the MWP Act the nominees named therein acquire all rights to the claims in the policy. The nominees cannot be changed after the policy has been bought. Even if the insured person divorces his wife, she continues to be the nominee in the policy. The insured person himself cannot lay any right to the amounts payable under the policy. If a MWP policy has any survival benefit (amounts payable even as the insured person is alive), the same will be paid to the nominees and not to the insured person. The declaration of the policy being bought under the MWP Act has to be made only at the time of buying the policy. The declaration can be made in respect of any life insurance policy, including term policies bought both online and offline.

With the amendment of the Insurance Act made in 2015 making nominees the beneficial nominees holding the money in their own right, some of the relevance of the MWP Act has been lost especially because of the rigidity around not being able to change the nominees. Policies under MWP Act are useful to ensure that the benefits of the insurance policy stay with the nominees despite any claim on the assets of the insured by his creditors.

2.6 Benefits, Limitation and Provisions when insurance taken from multiple companies

Life insurance premiums are telescopic which means that the premiums do not go up in the same proportion as the sum assured. A larger sum assured can be insured for a lower rate of premium per thousand of sum assured and hence it makes sense to buy policies from the same company.

Telescopic rates stop after a certain level, say Rs. 2 crores for a particular life insurance company. If the insured person is buying term insurance for Rs. 8 crores then it might be advisable to buy 4 policies of Rs. 2 crores each from the same company. This enables the

insured to have the option to give up certain policies as the insurance needs come down in the future.

Insurance proposal form should list all existing insurance policies and any pending proposals for life insurance with any other insurance company. This enables the insurance company to take an informed view of the possible amount of risk cover being sought by the insured vis-à-vis the insured's financial standing and need for insurance. Any omission to provide these facts might be treated as omission to provide a material fact and may be grounds for repudiation of a claim or cancellation of the policy within the first 3 years after the policy is issued.

2.7 Criteria to evaluate various life insurance products

2.7.1 Online versus offline Term Plans

- It's a long-term commitment from both sides. The faith the insured person has in the brand of the Insurance Company that it will still be around when the claim arises.
- Availability of amount of risk cover for the sought tenure. In some cases, the insurers are not comfortable with large sum insured despite those being shown as available in their online or offline sales material.
- Premium payable after evaluation of the insured's health and financial profile. In some cases, the declared premiums are meant for super healthy individuals and additional premiums are charged even for minor deviations from the standard health profile for a given age.
- Availability of other riders such as accelerated sum insured for critical illnesses or permanent disability rider.
- Claim settlement ratio published by IRDAI (although if full disclosure has been made by the insured then it may not be a very important criteria).

2.7.2 Traditional life insurance policy or unit-linked plans

If investment cum insurance policy is to be opted for then:

a) In traditional policies the insured person cannot choose the type of investment that can be made by the insurance company. In that case the inherent investment return can be calculated based on the methodology described earlier by using the higher possible maturity value shown in the official illustration from the insurance company. The investment returns from a traditional life insurance policy is normally low. For such policies issued on or after April 1, 2023 where the insurance premium is higher than Rs. 5 lakhs, the maturity proceeds are taxable as "Income from other sources".

b) In Unit linked insurance plans (ULIPs) the insured person can choose from among the various types of funds offered by the insurance company, which will typically be a mix of fixed income instruments, equities or both. In ULIPs, the investment risk is borne by the insured person. The insured person can reduce (not eliminate) the risk by choosing the low risk funds offered by the insurance companies.

2.7.3 Investment linked insurance plans or pure term insurance

The primary job of any insurance company is to provide risk coverage and not investment products. There are other entities that specialize in providing investment products. Ideally, risk coverage (insurance) products should be bought from insurance companies and investment products from entities that specialize in investment products.

Even if insurance cum investment product is being considered, it can be evaluated as an insurance product that also has investment elements in it. The first thing is to de-couple the insurance and investment elements of the instrument. Then the adequacy of the risk coverage needs to be examined. If the risk coverage is not adequate, then the instrument does not meet its primary goal and should be eliminated. Only after this primary requirement is met, should the investment return be considered separately to see if it is suitable for the investor and meets her requirements and is also comparable with investment products with similar profile.

2.7.4 Online Insurance plans and offline Insurance Plans

Most Insurance companies now offer their plans online where clients can apply directly. In many cases, specific policies have been tailor made for online which are also cheaper than the offline counterparts. Many also offer instant policy issuance after payment of premium online.

Many Insurance Brokers and Insurance Web Aggregators offer online comparisons of various insurance policies. They have tie-up with the insurance companies to offer online premium payment and policy issuance services for convenience of the insureds.

2.8 Global coverage for different Life Insurance Products

Does a life insurance policy pay if the death occurs outside India?

Normally, defined benefit policies such as life insurance, critical illness policies, accidental death policies, etc will pay wherever the covered risk occurs. It is relatively easy to verify that the covered risk (death or critical illness or accident) has occurred and the circumstances surrounding the incident are ascertainable wherever in the world they happen.

Are resident Indians allowed to buy life insurance policies provided by Insurance companies, not registered in India?

Indian residents can use their Liberalised Remittance Scheme (LRS) entitlement of up to USD 2,50,000 per annum to buy life Insurance policies of foreign companies. These policies are denominated in foreign currency. Some insured persons use investment cum insurance policies, denominated in foreign currencies, to provide for their goals such as children's education that may be denominated in foreign exchange.

However, these policies and the grievance redressal mechanism in case of refusal to pay claim amounts are governed by the regulations of the countries where they are issued. So, caution must be exercised in using this option.

Secondly, if insurance cum investment policy is being bought, it should be evaluated like any other investment cum insurance policy with protection needs being covered first. If that is sufficient only then the investment portion can be considered for risk profiling, suitability and comparing it with similar foreign exchange denominated investment instruments that are also available under the Liberalised Remittance Scheme.

CHAPTER 3: NON-LIFE INSURANCE PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Elements Of Non-Life Insurance Products
- Benefits/Limitations and Provisions When Insurance is Taken from Multiple Companies
- Criteria To Compare Various Insurance Products
- Global coverage for Different General Life Insurance Products

3.1 Non-Life Insurance

Non-Life insurance provides risk cover from loss or destruction of assets. It provides cover against unexpected large expenses that can be a drain on the available income of the individual.

3.1.1 Elements of Non-Life Insurance Products

- Sum insured is the amount specified in the policy that represents the insurer's maximum liability for claims made during the policy period. The minimum and maximum sum may be specified by the insurer.
- Term of the insurance is typically 1 year. In some cases, such as health/ two wheeler policies, the term may be two/three years.
- Premium payable is a function of the sum insured and the assessed risk. The risk is determined based on the type of insurance cover such as: age, gender and health history for medical cover; cubic capacity of the vehicle, place of registration and age of the vehicle for motor insurance etc. Premium is typically paid at the inception of the policy.
- Deductible is a term used to denote the portion of the claim that is met by the insured.
- Restore and Recharge are two benefits available in health insurance policies. In restoration benefit, the health insurance company restores the sum insured to 100% in case of either partial or full exhaustion of the sum insured amount (as the case may be). Alternatively, in recharge benefit, the sum insured is restored to 100% only when it gets reduced due to a claim.
- No claim bonus is the benefit of lower premiums enjoyed in subsequent years for each year of no claims being made. It can also be offered as an additional bonus cover, as another way of reflecting this benefit.

3.1.2 Types of Non-Life Insurance Products

a. Property Insurance

Property insurance provides protection against most risks to property such as fire, theft etc. Property insurance generally means insuring the structure and the contents of the building against natural and man-made disasters. Wilful destruction of property, loss/ damage due to normal wear and tear is generally not covered. Valuables such as jewellery and art and antiques typically require an add-on or separate insurance policy. These kinds

of policies are normally taken along with a home loan, as the lender insists on such a policy to be taken by the borrower.

b. Health Insurance

Health insurance policies reimburse the medical expenses incurred for the policy holder and identified family members who are covered under the policy. This policy provides for reimbursement of hospitalization or domiciliary treatment expenses for illness or accidental injury up to the sum insured under the policy. The expenses that can be claimed, such as consultation fees, medicine and treatment costs, room costs, are specified in the policy and sub-limits may be fixed for each head. Claim is typically allowed only for "In-patient" (patients who are admitted in a hospital for treatment that requires at least overnight or 24 hours of stay in hospital) treatments and domiciliary treatments (patients can be treated at home when they are not in a condition to be moved to the hospital), according to the terms of the policy. Now many policies cover day care treatment for certain procedures which require hospitalisation but due to advancement of technology the insured may be released on the same day. Pre-existing illnesses may be excluded from cover for a fixed period when insurance is being taken for the first time or if it is being renewed after a lapse.

Health policies provide cashless facility too where the bills are directly settled with the hospital and the insured is not required to pay upfront, upto the sum approved for this facility. There is also the option to take a family floater policy that will cover multiple family members under the same policy upto the sum insured.

The premium payable on the policy is a function of the sum insured, age and medical history of the insured, among others. Premiums may be adjusted for continued health cover and record of no-claim. Portability of health policies are available under which the benefits of no-claim, bonus and time-bound exclusions for existing conditions can be transferred, if the insured chooses to switch the insurance company. To benefit from portability, the previous policy should have been maintained without a break.

c. Motor Insurance

Under this insurance, the company indemnifies the insured in the event of accident caused by, or arising out of the use of the motor vehicle, anywhere in India, against all sums, including claimant's cost and expenses, which the insured shall become legally liable to pay in respect of (i) death or bodily injury to any person, (ii) damage to the property other than property belonging to the insured or held in trust or custody or control of the insured. Though the insurance of motor vehicles against damage or theft is not compulsory but the insurance of third-party liability arising out of the use of motor vehicles in public places is compulsory. No motor vehicle can be used in a public place without such Third-party insurance.

Some lesser known facts about Car Insurance:

i. "No claim" bonus means a reduction in next year's car insurance premium for own damage when no claim has been made for a specific number of years and can go up to 50% of the premium amount where no claims have been made for 5 years. The "No Claim" bonus is available to the insured person and is not attached to the car. Thus, when an insured sells an existing car, the new owner will not be eligible for

the no-claim bonus. The original owner can transfer the no claim bonus on the own damage premium to the new car he purchases.

ii. The own damage portion of the car insurance premium is not fixed and varies from insurance company to insurance company. An online comparison from an Insurance Broker or Insurance Web Aggregator can save substantial amounts on premium while buying a policy for a new car or renewing the policy on an old one.

iii. The new insurance company provides the "no claim" bonus if a policy is shifted at the time of renewal of the new policy.

d. Personal Accident Insurance

This type of policy provides that if the insured shall sustain any bodily injury resulting solely and directly from accident caused by external violent and visible means, then the company shall pay to the insured or his legal personal representative, as the case may be, the sum defined in the policy. Following types of disablement are covered under this policy:

- Permanent total disablement
- Permanent Partial disablement
- Temporary total disablement

The need for calculating permanent total disability due to accident, just like calculating life insurance need, is often over-looked and hence permanent disability cover due to accident is often inadequate.

e. Critical Illness Insurance

This policy provides for a lump sum benefit to be paid if the insured contracts certain specified diseases such as cancer, heart attack, stroke, kidney failure or multiple sclerosis etc. It differs from life insurance in that there is no payment on death. Reimbursement is usually subject to a minimum survival period of 30 days after diagnosis of the critical illness. The lump sum payment under the critical illness policy can be used in whatever way the claimant chooses, such as for generating income, or for repaying a mortgage, etc. Currently, these are available either with life insurance policies or as standalone policies.

Critical illness policies are mostly thought of as an additional coverage to receive a much smaller lump sum to spend on items that are not covered in health insurance plans. There is a lack of awareness about the importance of critical illness policy as an income replacement policy. The calculation for amount of critical illness coverage required has to be done like life insurance policy. Normally such large sum will not be available as a rider to a health insurance policy but only as a stand-alone critical illness policy or as an accelerated sum insured rider on a life Insurance policy.

f. Overseas Travel Insurance

Travel insurance provides medical, financial and other assistance in case of an emergency during international travel. The cover will typically be provided for medical help required, delay in baggage clearance, accident and any additional cover required. The cover will be in the form of reimbursement upto the maximum amount mentioned in the policy. Travel insurance may be mandatory for travel to some countries.

g. Liability Insurance

The purpose of liability insurance is to provide indemnity in respect of damages payable under law for personal injury to third parties or damage to their property. This legal liability may arise under common law on the basis of negligence or under statutory law on no fault basis i.e. when there is no negligence.

Most common example of liability insurance is professional indemnity plans taken by various professionals like Doctors, Lawyers or Investment Advisers. Liability insurance provides cover for legal expenses incurred in defending suits or payment of damages to third parties for which the insured is found liable. Liability insurance will not cover intentional damage or damages caused due to criminal activities.

h. Fidelity Insurance

A fidelity insurance policy covers losses sustained by the employer as a result of an act of forgery, fraud or dishonesty from an employee. The loss can be of money or goods, for the duration of the policy. The policy is usually taken where large sums of cash or other valuables are being handled by the employees.

i. Directors and Officers Liability Insurance

The Directors & Officers liability insurance policy insures members of the board of directors, the management and employee performing a supervisory or managerial role in a company against personal liability and defence costs incurred from claims alleging them to have committed a wrongful act in the line of their duties for the company.

Some specific exposures that make the policy necessary include vulnerability to shareholder and their claims, discrimination allegations, regulatory investigations, corporate governance requirements, compliance with legal statuses and other employment practice violations.

j. Keyman Insurance

Keyman insurance is a life insurance policy that a company purchases to cover itself in case of the loss of life of a key executive. The company is the beneficiary of the policy and pays the insurance policy premiums.

3.2 Benefits and Limitations of having multiple Insurance Policies

Multiple indemnity policies such as Health Insurance Policies make very little sense as the total claim amount cannot exceed the sum insured on all policies put together. Multiple policies also mean having to deal with multiple insurance companies at the time of claim settlement that brings added complications.

In health insurance the premium rate per additional lakh of coverage drops significantly as the coverage increases and becomes almost negligible after a certain amount of coverage. For example, the premium payable on a health insurance policy for Rs. 100 lakhs may be

just a few single digit thousand rupees more expensive than a Rs. 50 lakhs health insurance policy.

Sometimes multiple health insurance policies are unavoidable as the employer may offer policies upto a certain amount and the employee may wish to cover a larger sum insured or to have an independent policy of their own. In such cases, the contribution clause is not applicable except where the sum insured of the policy chosen by the insured is lower than the claim amount.

The insured person needs to choose from which company to get her claim from, and normally she should choose the employer policy first. The chosen insurer has no option to apply the contribution clause if the claim amount is less than the sum insured in the chosen policy. However, if the amount of claim exceeds the sum insured under the chosen policy, the insured person can choose another policy(ies) under which the claim can be made. In such cases the claim is settled by the chosen insurers by applying the contribution provisions.

In many a times, the insured may choose to buy a base policy (say Rs. 5 lakhs) and a super top up policy (say Rs. 10 lakhs) with a deductible (say Rs. 5 lakhs). Using this strategy, the insured is able to get a total coverage of Rs. 15 lakhs at an economical premium (as the premium on the super top up policy is quite low). The total premium paid on base policy plus the super top up policy as above can be compared with the premium on single policy of Rs. 15 lakhs. Interestingly, the premium of the second option (single policy of Rs. 15 lakhs) is not much higher than the first option (base policy plus super top up policy with a deductible totalling to Rs. 15 lakhs). The small difference in the premium is due to the administrative simplicity of having to deal with a single insurance policy. However, super top up policies remain ideally suitable for employees seeking additional cover over and above that provided by their employer. In that case, the employee chooses the deductible as per the amount provided by the employer and the super top up policy only covers the claim if the amount is above that value. Many health insurance companies are selling a combination of Base Health Plan and Top up/ Super top up plan, bundled as a single policy to provide higher coverage at a lower premium.

If there are multiple defined benefit policies such as life insurance policies, critical illness policy, accidental death or disability policies, all of them will pay irrespective of how many such policies the insured person has.

Top up Policy V/s Super Top up Policy

The terms “Top up Policy” and “Super Top up Policy” are not legal terms. They are generally used to describe a Health Insurance Policy that pays for claims arising from hospitalisation expenses incurred over and above a pre-agreed threshold limit. The difference between the two types of plan is in how the threshold limit is applied. In a Top up plan the threshold limit is applied for every claim whereas in a super top up plan the threshold limit is applied on the total of all hospitalisation claims for the year.

The following example will illustrate the difference between how the threshold limit is applied:

In this example we assume:

Case 1: Base Health plan of Rs. 5 lakhs and a Top up health plan of Rs. 10 lakhs above a threshold (called deductible in many plans) of Rs. 5 lakhs.
Case 2: Base Health plan of Rs. 5 lakhs and a Super top up health plan of Rs. 10 lakhs above a threshold (called deductible in many plans) of Rs. 5 lakhs.

Here is how the threshold will apply in different situations:

Sr. No.	**Particulars**	**Case 1 – Top up Plan**	**Case 2 – Super Top up plan**
1.	If there is a single claim of Rs. 8 lakh	Rs. 5 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 3 lakhs will be paid from the Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Top up plan is Rs. 7 lakhs.	Rs. 5 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 3 lakhs will be paid from the Super Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Super Top up plan is Rs. 7 lakhs.
2.	If there are Multiple claims as follows:		
	First claim of Rs. 3 lakhs	Rs. 3 lakhs paid from Base plan. Limit left in base plan is Rs. 2 lakhs.	Rs. 3 lakhs paid from Base plan. Limit left in base plan is Rs. 2 lakhs. Aggregate threshold limit already applied is Rs. 3 lakhs and balance threshold limit to be applied is Rs. 2 lakhs for the purpose of the Super Top up plan.
	Second claim of Rs. 6 lakhs	Rs. 2 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 1 lakhs will be paid from the Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Top up plan is Rs. 9 lakhs.	Rs. 2 lakhs will be paid from the Base plan. No limit left in the Base plan. Threshold limit of Rs. 3 lakhs has already been applied earlier. Rs. 4 lakhs will be paid from the Super Top up plan after the balance threshold of Rs. 2 lakhs is applied. Balance limit left in the Super Top up plan is Rs. 6 lakhs. Aggregate threshold limit already applied is Rs. 5 lakhs.
	Third claim of Rs. 2 lakhs	No Limit left in the Base plan. Claim amount of Rs. 2 lakhs is less than the threshold limit of Rs. 5 lakhs and nothing is	No limit left in the Base plan. Threshold limit of Rs. 5 lakhs has already been applied. Hence, Rs. 2 lakhs is payable from the

Sr. No.	Particulars	Case 1 – Top up Plan	Case 2 – Super Top up plan
		payable under the Top up plan. Limit left in the Top up plan is 9 lakhs.	Super Top up plan. Balance limit left in the Super Top up plan is Rs. 4 lakhs.
	Fourth claim of Rs. 4 lakhs	No Limit left in the Base plan. Claim amount of Rs. 4 lakhs is less than the threshold limit of Rs. 5 lakhs and nothing is payable under the Top up plan. Limit left in the Top up plan is 9 lakhs.	No limit left in the Base plan. Threshold limit of Rs. 5 lakhs has already been applied. Hence, Rs. 4 lakhs is payable from the Super Top up plan. Balance limit left in the Super Top up plan is Nil.
	On total claims of Rs. 15 lakhs	Rs. 5 lakhs paid on Base plan and Rs. 1 lakh paid on Top up plan – total Rs. 6 lakhs.	Rs. 5 lakhs paid on Base plan and Rs. 10 lakhs on Super top up plan. Total Rs. 15 lakhs.
3.	Administrative issues in dealing with separate insurance companies and separate Insurance policies	If the Base plan and the Top up plan are from different insurance companies then the insured need to deal with both of them in cases where the claim amount exceeds the threshold limit. Hence, it is always advisable to have the Base plan and the top up plan from the same insurance company as far as possible.	In the case of Super top up plans, apart from the point mentioned under Top up plan, there is an additional requirement. In the multiple claims example given above for the first claim of Rs. 3 lakhs the company that is handling the super top up policy also needs to be informed so that it can mark the threshold used levels even though no claim is payable by the company on the Super top up policy.

3.3 Comparison between Insurance Policies

3.3.1 Health Insurance Policy vs. Critical Illness Policy

Parameters	Health Insurance Policy	Critical Illness Policy
Type of policy	Indemnity Policy	Defined Benefit Policy
Primarily designed to cover	Reimburses actual expenditure incurred in hospitalization.	Provides a lump sum that can be used either to generate lost income or to meet any other purposes/ expenses, including meeting hospitalization expenditure.

Parameters	Health Insurance Policy	Critical Illness Policy
Claim paid	On incurring covered hospitalization expenditure.	On contracting pre-specified disease/ illness and surviving for 15-30 days.

3.3.2 Offline Insurance versus Online Insurance Policies

Most insurance policies can be bought online nowadays. All insurance companies offer online policies on their websites. In fact, many insurance companies charge lower premiums for policies bought online directly from their websites. There are also 'web only' policies offered by some insurance companies.

Many Insurance Web Aggregators or Insurance Brokers provide convenient online comparison of policies to enable informed choice by the insured person. Given the rapid uptake of buying policies online by the insured population, these web aggregators/ online insurance brokers have also become major sources of selling insurance policies for the insurance companies.

3.4 Global coverage for different General Insurance Products

Will a health insurance policy pay if hospitalisation expenses are incurred outside India?

Normally, defined benefit policies such as life insurance, critical illness policies, accidental death policies will pay wherever the covered risk occurs. It is relatively easy to verify that the covered risk (death or critical illness or accident) has occurred and the circumstances surrounding the incident are ascertainable wherever in the world they happen. Indemnity policies, such as health insurance policies, involve ascertaining the expenses/ losses incurred. The insurer already has the necessary systems to ascertain the expenses (loss) that are incurred in India but ascertaining losses in an unfamiliar location outside India is difficult. Hence, indemnity policies like health insurance (covering reimbursement of hospitalisation expenses incurred) normally provide coverage for expenses incurred in India only.

However, there are some exceptions too. Overseas travel policies are indemnity policies that are designed specifically for each country. The insurer designs such policies after making specific arrangements to ascertain expenses (losses) in each foreign country.

Are resident Indians allowed to buy general insurance policies provided by Insurance companies, not registered in India?

Indian residents can use their Liberalised Remittance Scheme entitlement of up to USD 2,50,000 per annum to buy insurance policies of foreign companies. In many cases where Indian students go overseas to study, it is usual for them to buy such policies from the foreign insurer recommended by the concerned university.

However, these policies and the grievance redressal mechanism in case of refusal to pay claim amounts, are governed by the regulations of the countries where they are issued. So, caution must be exercised in using this option.

For students going overseas, is it beneficial to buy a health appropriate policy from an Indian insurance company or should they buy from an insurance company of that country?

This will depend on the specific country and the University to which the student is going for studies.

Some Universities in US, UK, Europe, Australia/ NZ do not give an option of buying a separate insurance policy. Their cost includes the cost of compulsory insurance policy bought through them. Some require students to buy it from a designated insurer. Many will just lay down the conditions that the policy should cover for it to be treated as an eligible buy. However, some universities do not have any requirement of compulsorily buying health insurance. As treatment cost can be very high overseas and therefore, even in such cases, it is advisable to buy appropriate insurance.

Most Indian insurance companies are well aware of the requirements of major countries/ universities and have appropriate policies available to suit the requirements with various add-on policies.

Generally, universities allow prospective students to interact with their existing students in a bid to familiarise and ease the way for incoming students in matters such as subjects to choose, housing, food etc. Such forums help in understanding the requirements, costs, etc. in deciding upon insurance. Other things being equal, Indian policies tend to be cheaper than similar policies issued by foreign companies.

Module 7: Risk Management and Insurance Planning I Module-end Questions

1. Which of the following characteristics are required for a risk to be insurable?
    a. The risk does not involve any prospect of gain
    b. The loss incurred should be definite and quantifiable
    c. The loss must be accidental and uncertain
    d. **All the options given**

2. In a/an _____ insurance plan, the exact losses incurred by an insured are not ascertainable or are difficult to ascertain.
    a. Indemnity
    b. **Defined benefit**

3. The lock-in period for unit-linked insurance policy is _____ to reflect the long-term, protection function of the policy.
    a. 3 years
    b. **5 years**
    c. 7 years
    d. 10 years

4. When a bank becomes the corporate agent of an insurance company it is referred to as a _____.
    a. Direct Insurance Broker
    b. Re-insurance Broker
    c. **Bancassurance Arrangement**
    d. Insurance Agent

5. The insured would get which of the following benefits from investment cum insurance policies?
    a. Death cover
    b. Survival benefits
    c. **Both (a) and (b)**
    d. Either (a) or (b)

6. Which of the following products is a pure insurance product?
    a. ULIP
    b. Money back policy
    c. **Term insurance policy**
    d. Whole life policy

7. In which of the following situations will the insured not have insurance cover?
    a. **Surrendered policy**
    b. Paid-up policy
    c. Term policy
    d. Both (a) and (b)

8. The premium payable on a ULIP is higher for the same sum assured as a term policy because:

a. The period of cover is shorter
b. **A portion of the premium is used for investment**
c. The pool of insured is smaller
d. The risk is higher

9. The term of insurance in non-life insurance is typically _____.
    a. Decided by the insured
    b. Decided based on sum insured
    c. **One year**
    d. Flexible

10. A _____ policy covers losses sustained by the employer as a result of an act of forgery, fraud or dishonesty from an employee.
    a. Keyman Insurance
    b. **Fidelity Insurance**
    c. Liability Insurance

MODULE 8: RETIREMENT PLANNING

Chapter 4: Retirement planning basics
Chapter 5: Retirement products
Chapter 6: Miscellaneous aspects of retirement planning

CHAPTER 4: RETIREMENT PLANNING BASICS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Need for Retirement Planning
- Difference between various financial goals and retirement
- Retirement planning
- Global coverage for Different General Life Insurance Products
- Estimating Retirement Corpus
- Employee benefits and superannuation benefits

4.1 Need for Retirement Planning

Retirement planning pose a critical role for an individual due to increase in life expectancy. Life expectancy is referred to the number of years an individual is expected to live and is dependent on various factors such as health condition, scientific advancements etc. With the increase in average life expectancy coupled with difficulty to estimate accurately, has led to the need for retirement planning to sustain expenses post-retirement.

For example, X, who is in his 20s, has a total working life of 40 years (assuming 60 years being the retirement age). If the life expectancy is 80 years, then X has to spend 20 years of post-retirement life, without any commitment to work. Thus, to sustain the expenses during his retired life, X needs to plan for his retirement.

Retirement planning is not only about money accumulation, but living a life of one's choice, post-retirement. That can happen only when retirement planning is started early in life. People generally make the mistake of waiting for too long to begin and thereby fall short of time for sufficient fund accumulation.

The biggest roadblock for retirement planning is accumulating enough money at retirement. At younger age/ during start of the working life, too many responsibilities, such as house, marriage, kids and their associated expenses keep the idea of retirement planning at the back burner. But these responsibilities are the reasons why retirement planning is important. Inflation, taxes, pension receivable by family, and many more factors have to be considered while planning for retirement.

Previously, retirement was looked at a period when a worker is unable to do anything. This can happen by a job loss or a layoff. As time progresses the definition of retirement has also changed and now retirement is defined as a period when there is no work involved. Everyone wants to enjoy their retirement years through travel, leisure, social activities, pursuing hobbies, or spending time with their children. Thus, the definition of retirement has undergone a drastic change where people now look more for relaxation or sometimes changeover of employment which can be financially remunerative too.

Retirement planning, like any other life process, has various phases or stages: (a) Preparation stage, (b) period of Initial Retirement/ Pre-retirement stage and (c) Final

Retirement. These phases are characterized with different aspects that any individual who is planning for his/her retirement has to understand. For instance, the preparation stage includes need for child education, buying house for living, adequate life and health insurance and recognizing the impact of ageing. Similarly, at the pre-retirement phase, the physical and psychological changes will happen and one gets familiarize with the retirement regulations and procedures. The final is the retirement phase where one should have completed all necessary arrangements and are in a good position to decide about their life.

However, things are not that simple as it looks. Our society is getting more complex in terms of both its structure and operational challenges. There are various issues connected with the society such as longer life expectancy, decreasing retirement benefits, multiple job changes, rising healthcare cost, etc. which have made retirement planning one of the most important and critical element of financial planning.

All this demands a careful planning for retirement regardless of what stage of life one is in. If retirement planning starts early, one will be able to take steps towards the retirement income he/she wants.

4.2 Financial Goals and Retirement

Generally, when people plan their financial goals, they often mix retirement goal with other financial goals. Goals such as children education, retirement, buying a house or a car, etc. are planned simultaneously. Though all of these goals are important for any individual, there is a difference in meeting retirement goal than any other goals.

Many goals can be met comfortably through loans, if one does not have enough assets accumulated. Based on earnings and work profile, financial institutions approach individuals with their best offers. Thus, for all these goals one has easy finance available. That is not the case with retirement, since no company gives loans for meeting retirement needs. Still, most people do not want to talk about it.

Goals like children education have a defined time horizon as they have to be achieved within a specified timeframe. For example, the goal of college education is generally at a horizon of 14 to 15 years from the day the child starts going to school. There is hardly an option to delay this goal by 4 to 5 years if enough funds are not available. However, when it comes to retirement often it is delayed for any adjustment towards any other life goals. Take the case above for children education. If adequate funds are not available either loan will be availed or the retirement kitty will be withdrawn, thus delaying retirement goal by few years. This delay in planning for retirement can be catastrophic as financial requirements increases manifold and sometimes difficult to achieve if one misses the early benefits.

4.3 Retirement Planning

The retirement goal has certain features that are unique to it. It is the goal with the longest accumulation and distribution periods and requires the largest corpus.[4] Though the income required to meet expenses in retirement can be defined with certainty only close to the time of transition to retirement, the accumulation of the corpus has to be done from the beginning of an individual's working years. There are many variables in estimating the goal and these variables are likely to change multiple times given the long periods associated with the goal. Therefore, it becomes important to put in place adequate rigour in determining the variables that affect the retirement goal and periodic monitoring to incorporate changes, if any, into the goal.

The process of determining the retirement goal is about defining the income that will be required to meet living expenses in the period when there is no income being earned from employment. Once this is done, then the planning process deals with how to accumulate the corpus required, and use this corpus to generate the income. The steps involved in retirement planning process are as follows:

a. **Determine expenses in retirement**: The first step in retirement planning process is to determine the expenses that have to be met in retirement. The expense in retirement is unlikely to be the same as prior to retirement. The categories of expense heads during the retirement phase includes housing (including utilities, maintenance cost, taxes), living expenses (food and personal upkeep), medical care, transportation, recreational expenses and insurance (life, health, disability) and taxes.
b. **Determine income requirement in retirement**: While determining the income requirements in retirement, one needs to consider a few factors such as maintaining their standard of living in retired life, the expenses to be incurred in retirement, the inflation rates etc.
c. **Time horizon**: Time plays an important role in retirement planning. The time periods that are central to calculating the retirement corpus are:

    i. **Years to retirement -** This is the period from the current point in time to the year of retirement. Another way to calculate it is as the period between current age and retirement age. With every passing year, this period will reduce as long as the year/ age of retirement have not changed. The 'years to retirement' is important to be able to determine the cost of expenses that have to be met in retirement. The effects of inflation on cost will depend on the years to retirement. Lower the number, lower will be the effect of inflation. This number is also important in the calculation of the periodic savings required to accumulate the corpus required to fund the expenses in retirement. Longer the period, greater will be the compounding effects, and lower will be the allocation from savings required for the retirement.

[4]The accumulation stage is the stage in which the saving and investment for the retirement corpus is made. The distribution stage of retirement is when the corpus created in the accumulation stage is employed to generate the income required to meet expenses in retirement.

ii. **Years in/during retirement:** The years in/during retirement are the number of years from the beginning of retirement to the end of life for which an income has to be secured. This period cannot be defined precisely. However, life expectancy can be broadly estimated based on factors such as average life expectancy in the country for the specific gender, health conditions, genetic factors, lifestyle habits and so on. The years for which funding has to be provided will determine the corpus required. Underestimating the years, or longevity risk, will mean that there may not be enough money to last the retirement years.

d. Determine the retirement corpus: The retirement corpus that will generate the income required in retirement is to be calculated. The variables considered in such calculation are:

i. The periodic income required
ii. The expected rate of inflation
iii. The rate of return expected to be generated by the corpus
iv. The period of retirement, i.e. the period for which income has to be provided by the corpus.

4.3.1 Impact of Inflation

Inflation is a general rise in prices of goods and services over a period of time. Over time, as the cost of goods and services increase, the value of one unit of money will go down and the same amount of money will not be able to purchase as much as it could have earlier i.e. last month or last year. Inflation eats away the purchasing power of money over time.

Inflation impacts retirement planning in two ways:

i. At the time of calculating the income required, the value of the current expenses has to be adjusted for inflation to arrive at the cost of the expense at the time of retirement. For instance, if consumer goods prices rise 6 percent a year over the next 30 years, items that cost Rs. 100 today would cost Rs. 179 in 10 years, Rs. 321 in 20 years and Rs. 574 in 30 years.

ii. This figure is true for the beginning of the retirement period. Over the retirement years, the income required to meet the same level of expenses would not be constant but would go up due to inflation. The corpus created to fund income during retirement will have to consider the escalation in cost of living during the period in which pension is drawn. The increase in expenses has to be considered while calculating the retirement corpus else there is a risk of the retirement being under-funded. If you're planning to live on Rs. 60,000 a month at the start of retirement, a 6 percent inflation rate means that in 10 years you would actually need Rs. 1,07,451 a month, and in 20 years you'd need Rs. 1,92,428 a month to cover the same expenses.

iii. While the standard rate of inflation may be appropriate to calculate the future

cost of living expenses, other expenses, such as health costs and travel, typically increase at a higher rate.

4.3.2 The Expected Rate of Return

While estimating the corpus required to generate the retirement, it has to be kept in mind that this corpus will be invested to earn a return both at the time of accumulation and at the time of distribution, and this return will contribute towards the corpus that will be used to provide the income in retirement. The contribution that has to be made towards the retirement corpus from savings will be lower to the extent of the return generated. The size of the corpus that has to be in place at the start of retirement can be lower to the extent that these funds will generate a return through the retirement period. Higher the rate of return that the funds are expected to earn, lower will be the required corpus. However, a higher return will come with a higher risk. Investors may be willing to take higher risk in the accumulation period for higher return. But, in the distribution stage of retirement, the ability to take risk with the savings will reduce.

The rate of inflation and the expected rate of return on investments act in opposite directions on the amount of retirement corpus required. While the rate of inflation pushes up the expenses and therefore the amount of retirement savings required to fund the income in retirement, the return that the corpus invested will generate, will reduce the savings required. The real or effective rate of return that the investment will generate, will then be the expected return adjusted for inflation.

Inflation adjusted rate or real rate of return is the periodic rate of return on an investment after adjustment for inflation.

$$\text{Inflation - Adjusted Return} = \frac{(1+\text{Return})}{(1+\text{Inflation Rate})} - 1$$

4.4 Estimating Retirement Corpus

There are 2 methods through which the income in post-retirement years can be estimated.

- Replacement Ratio Method
- Expense Protection Method

4.4.1 Replacement Ratio Method

Here it is assumed that the standard of living remains same as just before one enters the retirement phase. This helps in defining the target much easily and more accurately. For example, if one is at 58 years of age and is earning Rs 150000 p.m. then the retirement should maintain this income. Thus, assumption of standard of living becomes an important factor in estimating the retirement income. If income is Rs 200000 and standard 80% replacement ratio is assumed for retirement then one will have to plan for Rs 160000

income in the first year of retirement. This income is then increased by inflation rate every year to maintain the purchasing power.

Replacement Income (Year 1) = Pre-retirement Income *0.80

Replacement Income (each subsequent years) = Pre-retirement Income * Annual rate of Inflation (added per year) * 0.80

Let us take an example for easy understanding.

Mr. Rajeev (age 50 years) earns Rs. 100000 per month now. He wants to retire at the age of 60 years with 50% of his income as post-retirement income.

Let us assume that his income goes up at 10% p.a.

At the time of his retirement, his Income will be Rs. 259374 per annum (i.e. Rs. 100000*1.1^10).

Then Replacement Income just after his retirement income will be 259374*.50 = Rs 129687.

His replacement income will increase by inflation every year to maintain the purchasing power. Here the inflation rate is assumed to be 7% p.a.

Replacement income in the second year of his retirement will be 129687*107/100 = 138765 and so on.

Reductions in Living Expense and Taxes

Many expenses tend to reduce at retirement stage, such as housing loan, children education, work related expenses etc. while few other expenses such as medical, travel etc. tend to increase. Some long-term savings requirements also cease to exist. Many a times, just after retirement, the income reduces, pushing one into a lower tax bracket, thereby eliminating a good amount of tax liabilities. All these factors, clubbed together, decrease the retirement income of an individual.

Limitations of the Income Replacement Ratio

The more number of years one has for retirement, the less accurate income replacement estimate is likely to be. Still, the earlier one starts calculating it and investing, the lower the interest rate one may need to achieve their wage replacement goal.

4.4.2 Expense Protection Method

This method defines retirement Income based on expenses in retirement. Many people using this method keep a detailed monthly budget. Tracking expenses enables them to have a reasonable understanding of what it will cost to retire.

Adjustments to budgets often must be made. For example, some expenses may increase over a period of time such as, medical expenses, travel, gifting, house maintenance etc. On the other hand some of the expenses tend to reduce like housing loan repayment, children education expenses, income tax etc. Once the estimation is done based on the probable expenses to be incurred, the retirement income required is estimated. The estimation is easier for individuals nearing their retirement.

Limitations of the Expense Protection Method

As with the income method, there is also a drawback to the expense method, particularly for those who are many years away from their retirement. With longer period to retire, expense estimation for future becomes difficult. In such cases, estimation of future retirement expenses is done with speculation and so needs to be reviewed periodically.

Let us take an example for easy understanding.

Mr. Ashish is earning a monthly income of Rs. 60000 of which 50% is household expenses. He is 40 years old and is planning to retire at the age of 60 years. He is expecting additional expenses of Rs. 15000 at his retirement. If we assume inflation at 6% then his expense at the time of retirement will be as below:

Particulars	**Amount (Rs.)**	**Calculation**
Current household expense	30000	50% of 60000
Additional expenses at retirement	15000	
Total retirement expense	45000	30000 + 15000
Years to retire	20	60 - 40
Inflation rate	6%	
Expenses at time of retirement	144321	45000*(1.06)^20

4.5 Superannuation Benefits to Employees

Superannuation is an organizational pension program created by a company for the benefit of its employees. It is also referred to as a company pension plan. Funds deposited in a superannuation account will grow, typically without any tax implications, until retirement or withdrawal.

Once an employer has a superannuation benefit in place for his employees, he has a liability to meet. In India, there is no legislation providing statutory superannuation (pension) benefits except to those employees covered under the Employees' Pension Scheme, 1995. The Government bodies, nationalized banks and a very few other organizations are, if they so decide, allowed to pay pension to their employees. All other establishments whether in public or private sector are required to arrange annuities through Life Insurance Corporation of India or any other IRDAI approved life insurance companies. Therefore, an employer can have any one of the following two arrangements:

(1) Payment by the employer; and
(2) Funding through a trust.

4.5.1 Payment by the employer

The employer arranges to pay superannuation benefits to its employees through the below mentioned methodologies:

(a) There are occasions when an employer decides to arrange for superannuation benefits for one or a few employees as reward for their dedicated services by paying a lump sum contribution out of the current revenue to buy an immediate annuity from a life insurance company.

(b) The employer has framed a superannuation scheme for his employees and has not created any fund for it and wishes to pay himself the pensionary benefits. It means that employer would, if otherwise allowed by law, pay out the superannuation payments to the retired employees as and when they are due out of the current revenue. Though this may look easy to follow, this is not a satisfactory method for many reasons.

First of all, the likelihood of payment of pension to the employees who have retired will depend upon the financial health of the employer and if the employer does not make enough profits in a year to pay the pension disbursements, the retired employees may not get their pension. This situation is more likely to happen as the pension payout liability will keep on increasing year after year as the number of pensioners receiving superannuation payments increase. The situation would be still worse if an employer goes bankrupt and winds up the establishment. Hence, this method is not allowed.

The Accounting Standard 15, brought out by the Institute of Chartered Accountants of India (ICAI), does not allow companies to provide for the retirement benefits at the time they become due. It insists that all the retirement benefits have to be provided for in the respective year of accrual. Also, Section 2 (11) of Insurance Act defines life insurance business in such a way as to include the payment of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged in or who have been engaged in any particular profession, trade or employment or of the dependents of such persons. This has made it obligatory for employers to arrange for payment of superannuation benefits only through a life insurance company registered with the Insurance Regulatory and Development Authority of India (IRDAI). The question

arises as to what is required on the part of the employer during the period till the superannuation benefit of an employee becomes payable. The employer has to create a fund for paying the superannuation benefits to the employees and to set aside funds required for meeting the liability on an accrual basis every year.

4.5.2 Funding through a Superannuation Trust

The second method of administering a superannuation scheme is to do it through a Trust. The employer should create a Trust for funding the pension liability and appoint Trustees for the purpose. The Trust so created should be irrevocable and should be distinct from the employer. The employer should transfer the contributions for the superannuation benefit (both that of the employer and employees, if the scheme were to be contributory) to the Trust Fund.

4.5.3 Approved Superannuation Funds

When an employer introduces a superannuation benefit scheme for his employees and contributes funds for the scheme, it is natural that he would like to expense off the contributions that he makes against the profits made by him and pay tax on the reduced profits only. In other words, he would like his contributions to get tax exempt. For getting tax exemption for the contributions to the superannuation fund, established for the employees, the employer has to get the fund approved by the Commissioner of Income Tax. Once the fund is approved by the Commissioner of Income Tax, the employer can treat the contributions made to the fund, within the limits prescribed in the Income Tax Act, as business expense and deduct it from the profits made for Income Tax purposes.

The Income Tax Act (IT Act) defines approved superannuation fund as "a superannuation fund or any part of a superannuation fund which has been and continues to be approved by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in accordance with the rules contained in Part B of the Fourth Schedule". The rules contained in Part B of the Fourth Schedule of IT Act states that in order that a superannuation fund may receive and retain approval as defined under the IT Act:

- The fund shall be established under an irrevocable trust in connection with a trade or undertaking carried on in India and not less than 90% of the employees shall be employed in India.
- The fund should have for its sole purpose the provision of annuities for employees in the trade or undertaking on their retirement at or after a specified age or on their becoming incapacitated prior to such retirement, or for the widows, children or dependents of persons who are or have been such employees on the death of those persons.
- The employer should be a contributor to the fund.
- All annuities, pensions and other benefits shall be payable only in India.

Further, the Income Tax Act provides the following benefits to the approved superannuation fund, for both the employers and the employees:

- ***Section 10(13):*** Any payment from an approved superannuation fund, made on the death of a beneficiary; or to an employee in lieu of or in commutation

of an annuity on his retirement at or after a specified age or on his becoming incapacitated prior to such retirement; or by way of refund of contributions on the death of a beneficiary, or by transfer to a pension scheme under 80CCD (NPS) shall not be included in computing the total income of a previous year of any person. This makes it clear that payments made out of an approved superannuation fund to the beneficiaries upon the death of the member and also the commuted value of the pension payable on retirement of the employee after ascertaining the age as well as payments made on the retirement of an employee due to becoming incapacitated are exempt from Income Tax.

- ***Section 10(25)(iii)***: Any income *r*eceived by the trustees on behalf of an approved superannuation fund shall not be included in computing the total income of the trust. This makes the funds of an approved superannuation fund to be accumulated in a tax-free environment.

- ***Section 36(iv)***: Any sum paid by the assessee as an employer by way of contribution towards an approved superannuation fund, subject to such limits as may be prescribed for the purpose of approving the superannuation fund and subject to such conditions that the Central Board of Direct Taxes (CBDT) may specify, will be allowed as deduction in the computation of business income of the employer.

- ***c) Section 80 C*** : Any contributions made by an employee to an approved superannuation fund are eligible as deduction in computing the taxable income, subject to a ceiling as prescribed by Income Tax Act.

4.5.4 Trustees Responsibilities

The trustees of an approved Superannuation Trust Fund (also referred to as Superannuation Scheme) have many responsibilities in the administration of the funds, payment of benefits along with legal and tax responsibilities.

These are:

a. To have periodical meetings of the Trustees to review the performance of the Trust and to keep records of the minutes.
b. To keep in touch with the Company and inform the employer the decisions taken by the Trustees.
c. To collect the amount of contributions from the employer as per the rules of the scheme or get it calculated by an Actuary in case of a defined benefit scheme and then requests the employer to pay it.
d. To invest the Trust money as per the prescribed pattern of investment given in IT Rules.
e. To realize the interest earned on the investments and re-invest it as per the prescribed pattern.
f. To make or enter into an arrangement to ensure pension benefits to the employee/ beneficiary as per the options exercised.

g. To deduct tax at source from the annuity payments wherever applicable and remit them to IT Authorities or advise the life insurance company to deduct tax at source before releasing annuity payments as the case may be.
h. To prepare the annual accounts of the Trust, get them audited and submit to the IT authorities.

CHAPTER 5: RETIREMENT PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Accumulation related products
- Portfolio created by an investment adviser
- Distribution related products

5.1 Accumulation related products

In accumulation stage, various products are available to an individual for generating his/her retirement corpus. Few of the accumulation related products are mandatory in nature while others are voluntary. Some of the accumulation related products are discussed below:

5.1.1 Employees Provident Fund

EPF (Employees' Provident Fund), also referred to as PF (Provident Fund), is a mandatory savings cum retirement scheme for employees of an eligible organisation. This fund is intended to be a retirement corpus. As per the EPF norm, the employees must contribute 12% of their basic pay plus dearness allowance every month. A matching amount is contributed by the employer as well. The amount deposited in EPF accounts earns interest on an annual basis. Employees can withdraw the entire sum accumulated in their EPF account at the time of their retirement. However, premature withdrawals can be made on meeting certain conditions.

Monthly Contribution

As mentioned above, both employer and employee have an equal contribution towards the employees' provident fund. The actual amount of EPF contribution is calculated based on the employee's basic salary and dearness allowance.

The employer deducts 12% of the employee's salary (basic + dearness allowance) directly every month for a contribution towards EPF. This entire contribution goes to the EPF account of the employee. Similarly, the employer also contributes 12% of the employee's salary towards EPF. But, the employer's contribution has the following categories:

Category	Percentage of contribution
Employees Provident Fund	3.67%
Employees' Pension Scheme (EPS)*	8.33%

Employee's Deposit Linked Insurance Scheme (EDLIS)	0.5%
EPF Admin Charges	0.50%

*Subject to a ceiling of Rs 15000 monthly salary

However, the EPF contribution can be 10% in certain circumstances such as:

- If a company has less than 20 employees
- The company incurs losses that are more than its entire net worth
- If a company is associated with beedi, jute, brick, guar gum or coir industry

The contribution can also vary in case of women employees. As per the announcement in the Union Budget 2018-2019, new women employees can make an EPF contribution of 8% instead of 12%. This privilege is only for the first three years of employment. The primary reason for this revision was:

- To enable women for higher take-home pay
- To encourage companies to hire more women to bridge the gap

Even though a woman employee contributes 8% towards EPF, the employer has to maintain its EPF contribution at 12%. Well, an employee can also add more than 12% towards EPF. This is the Voluntary Provident Fund (VPF), discussed in subsequent section.

It is important to note that EPF will continue to be active as long as you are a salaried employee. If you switch jobs, it is paramount to update your EPF information with your new employer to continue their contribution.

Interest Rate

Interest rate is decided by the Central Board of Trustees (CBT) in concurrence with Ministry of Finance. The interest rate which is announced by EPFO stays valid for a financial year, i.e. starting from 1st April to 31st March. This interest is calculated every month and then transferred to the Employee Provident Fund accounts every year on 31st March. The interest earned on EPF is exempted from tax within certain limits. However, effective from April 1, 2021, if an employee's own contribution to the EPF account along with VPF exceeds Rs 2.5 lakh in a financial year, then the interest earned on excess contributions will be taxable in the hands of an employee.

If there are no contributions in the EPF account consecutively for 3 years, then the account becomes inactive or dormant. Even in such instances, the interest is paid on the EPF account until the employee retires. The interest earned on inactive accounts is taxable as per the employee's tax slab rate. However, once the account is inoperative (i.e. no contributions received for 3 years after retirement; or permanent migration abroad; or in case of death), no interest will accrue. After 7 years of being inoperative, the money lying in such accounts is transferred to the Senior Citizen Welfare Fund by EPF, if no claim is

received.[5] This can be claimed by EPF members or their nominees within 25 years by furnishing the required proofs and documents.

Subsequently, the employer's share contributed towards the Employee Pension Scheme (EPS) does not accrue interest. However, a member is eligible to receive his/her pension only after the age of 58.

Withdrawal

One may choose to withdraw EPF balance entirely or partially. EPF balance can be completely withdrawn in the following instances:

a. When an individual retires

b. When an individual remains unemployed for more than two months.

In case of unemployment for 2 months, EPFO allows withdrawal of 100% of the corpus. Currently, EPFO allows withdrawal of 75% of the corpus after 1 month of unemployment and the remaining 25% of the corpus can be withdrawn if unemployed for 2 months or more. In case the individual is employed after 1 month of being unemployed, the remaining 25% of the corpus is transferred to the new EPF account. However, the 2-month waiting period for complete withdrawal does not apply to women who quit their jobs for marriage.

Partial withdrawal of EPF balance can be done under certain circumstances and subject to certain prescribed conditions, as discussed in brief below:[6] (refer Table 5.1)

Table 5.1: EPF balance Withdrawal

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
1	Medical purposes	6 months basic salary and dearness allowance Or total employee's share plus interest Whichever is lower	No criteria	Medical treatment of self, spouse, children, or parents

[5] Senior Citizens' Welfare Fund (SCWF), established by the Central Government under the Finance Act, 2015, is to be utilised for such schemes for the promotion of the welfare of senior citizens.

[6]https://www.epfindia.gov.in/site_docs/PDFs/Downloads_PDFs/TypesOfAdvances_Form31.pdf

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
2	Marriage	Up to 50% of employee's share of contribution to EPF with interest	7 years	For the marriage of self, son/daughter, and brother/sister
3	Education	Up to 50% of employee's share of contribution to EPF with interest	7 years	Either for account holder's education or child's education (post matriculation)
4	Purchase of land or purchase/construction of a house	**For land** – Up to 24 months basic salary plus dearness allowance **For house** – Up to 36 months basic salary plus dearness allowance Or Total of employee and employer share with interest Or Total Cost Whichever is least.	5 years	i. The asset, i.e. land or the house should be in the name of the employee or jointly with the spouse. ii. It can be withdrawn just once for this purpose during the entire service. iii. The construction should begin within 6 months and must be completed within 12 months from the last withdrawn installment.
5	Home loan repayment	Least of below: Up to 36 months basic salary plus dearness allowance Or Total corpus consisting of	10 years	i. The property should be registered in the name of the employee or spouse or jointly with the spouse. ii. Withdrawal permitted subject to furnishing of requisite documents as stated by the EPFO relating to

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
		employer and employee's contribution with interest Or Total outstanding principal and interest on housing loan		the housing loan availed. iii. The accumulation in the member's PF account (or together with the spouse), including the interest, has to be more than Rs 20,000.
6	House renovation	Least of the below: Up to 12 months basic wages and dearness allowance Or Employees contribution with interest Or Total cost	5 years	i. The property should be registered in the name of the employee or spouse or jointly held with the spouse. ii. The facility can be availed twice: a. After 5 years of the completion of the house b. After the 10 years from withdrawal for renovation
7	Partial withdrawal before retirement	Up to 90% of accumulated balance with interest	Once the employee reaches 54 years and withdrawal should be within one year of retirement/superannuation, whichever is later	

Tax Implications

The contributions made by the employee to EPF are eligible for deduction under section 80C along with other investments/expenses mentioned in that section. The interest earned on the employee contributions is exempted from taxation only up to a specified limit. As per Finance Act 2021, the annual interest earned on employee contribution exceeding Rs. 2.50 lakhs per annum is taxable. This includes the contribution in Voluntary provident fund account. In other words, for annual contributions of more than Rs 2.5 lakh including Voluntary Provident fund account, the interest earned on these is taxable.

Employer Contribution

Employer's contribution towards EPF is also tax exempted up to a certain limit.

Now if the aggregate employer's contribution to EPF, National Pension System and Superannuation Fund exceeds Rs.7.5 lakh in the financial year, then the contribution and interest/ dividend thereon, in excess of the aforesaid amount, is treated as perquisite in the hands of the employee in the year of contribution. The employer has an obligation to consider such excess amount as perquisite in the hands of the employee and withhold taxes thereon.

Tax on Withdrawals

EPF balance withdrawal is considered to be tax-free. As per the rule, there are certain exceptions based on the number of years of employment.

A. *Before five years*

Suppose the employee has not completed a consecutive five years of service. In that case, the amount withdrawn is taxable in the hands of the employee in the year of receipt. The amount may remain tax-free in the following two exceptions.

- If the employment is terminated due to an employee's ill health or the employer has discontinued its business or any other reason for withdrawal, which is beyond the control of the employee. In such a scenario, the EPF amount withdrawn before five years of employment is considered to be tax-free in the hands of the employee.
- If the employee changes his employer in less than five years, then the employee can transfer his PF account balance of the existing employer to the new employer. In such case, the PF balance remains tax-free. Therefore, it is always suggestible to transfer the PF balance while changing jobs to avoid any taxation.

B. *After five years*

If the employee has completed a consecutive five years of service, in that case, the amount withdrawn is tax-free in the hands of the employee in the year of receipt.

c. Otherwise

- If the EPF withdrawal amount is less than Rs.50,000, before completion of 5 years of service, in such instances the individual has to pay tax on the EPF withdrawal amount if he falls in the taxable bracket (based on this tax slab rate).
- If the EPF withdrawal amount is more than Rs.50,000, before completion of 5 years of service, in such instances, tax is deducted at source (TDS). If PAN is furnished, then 10% TDS is charged. If PAN is not furnished, then TDS is applicable at the maximum marginal tax rate. However, if Form 15G/15H is submitted, as the case may be, TDS will not apply.

5.1.2 Voluntary Provident Fund

Persons covered under the Employee Provident Fund (EPF) can choose to contribute over and above the mandatory 12 percent of the basic and dearness allowance, to their EPF account under the Voluntary Provident Fund (VPF). There will be no employer contribution to match any contribution made by the employee under the VPF.

The contributions will be invested in the EPF account of the employee. Like the primary account, the investments will be predominantly in debt investments, particularly government securities.

Return

The return on the investment will be declared each year by the government.

Investment Limits

The subscriber can invest any percentage of the basic salary into the VPF, going up to 100% of basic salary and dearness allowance. The amount of investment can be decided by the subscriber and discontinued with prescribed notice.

Tenure and Withdrawals

The VPF is open-ended and subscribers can contribute till the time of retirement. Withdrawal of funds is possible according to the rules of EPF.

Taxation

All contributions, interest earned and withdrawals are exempt from tax upto a specified limit. If the aggregate employee contribution to EPF plus VPF is in excess of Rs 2.5 lakh in a financial year then the interest earned on the excess amount is taxable as interest income.

5.1.3 Public Provident Fund

Public Provident Fund (PPF) is a long-term saving product that can be used to accumulate funds for retirement and other goals. It can be opened with prescribed banks and post offices. It is a voluntary savings product.

Eligibility Criteria

- Only an Indian resident can open a PPF account
- NRIs are not eligible to open PPF accounts. Post September 30, 2024, existing account holders who attained NRI status will be able to contribute further but cannot extend the duration of their PPF accounts. These accounts, maintained by NRIs, will not earn any interest post September 30, 2024.
- Parents/guardians can also open PPF accounts for their minor children
- Opening of joint accounts and multiple accounts are not allowed

Key Features

Here are some of the primary features of Public Provident Fund:

- **Lock-in period:** A PPF account is a fixed-income, long term investment with a lock-in period of 15 years. Premature withdrawals are allowed after 5 years subject to certain conditions and limits. This tenure can be extended in blocks of 5 years at the end of the first 15 year lock-in period. However, post September 2024, NRIs donot have this extension privilege once their accounts mature.

- **Minimum and maximum investments:** Individuals need to make a minimum investment of Rs. 500 annually. A maximum investment of Rs. 1.5 lakh can be made in one year in PPF account. An individual can contribute not more than Rs. 1.50 lakh to his PPF account and the PPF account of the minor/s taken together.

- **Taxation:** PPF comes under the Exempt-Exempt-Exempt (EEE) category of tax policy which implies that the principal amount is allowed as a deduction under section 80C while the interest earned and the maturity amount are exempt from taxes.

- **Loan against PPF:** A PPF account holder can take a loan against the balance from the beginning of 3rd financial year till the end of the 6th financial year from the date of account opening. Loan against PPF balance is available upto a maximum of 25% of the total balance at the end of the 2nd financial year immediately preceding the year in which loan is applied.

Interest Rate

PPF is a floating rate investment. The interest rate on PPF accounts is notified by the Central Government every quarter. Effective from October 2024, minors' accounts will earn interest rate applicable for Post Office Savings Account (POSA) till they turn 18 (major), post which standard PPF rates will apply. Also if one has multiple PPF accounts then interest will be earned on the primary account till the deposit remains within the yearly limit; any excess deposit beyond the yearly limit will not earn any interest and will be returned back to the interest.

Withdrawals

PPF works under a mandatory lock-in period of 15 years. However, partial withdrawals from the account can be made after the completion of 5 financial years from the end of the

financial year in which the account is opened. For example, if the account was opened on Feb 15, 2017, withdrawal can be made from the financial year 2023-24 onwards. Only one partial withdrawal is allowed per financial year. The maximum amount that can be withdrawn per financial year is the lower of the following:

- 50% of the account balance as at the end of the preceding year, or
- 50% of the account balance as at the end of the 4th year, immediately preceding the year of withdrawal application.

Form-2 should be submitted to withdraw a partial amount from the PPF account.

- Details such as account number, amount of money to be withdrawn, etc. are to be mentioned in the form.
- A declaration stating that no other amounts were withdrawn during the same financial year should also be submitted.
- In case, the account is in the name of the minor, additional declaration stating that the amount is required for the use of minor child who is still a minor and is alive.
- Passbook is also required to be submitted along with the form.

Extension of account tenure

PPF account matures after 15 years from the end of the financial year in which the account was opened. At the time of maturity, the account holder has the option to extend the tenure in the blocks of 5 years:

Extension of PPF with contribution: A subscriber can extend the life of the PPF account indefinitely in blocks of 5 years at a time. The subscriber has to submit a request to extend the account, with further contributions by submitting Form-4.

- The choice of extension with contribution has to be made within one year before the date of maturity, otherwise, the default choice of extension without further contribution applies.
- Once the account is extended with contributions, the maximum 60% of the balance as on the date of extension of the account can be withdrawn.
- This amount can be withdrawn in one go or can be spread over several years.
- A maximum of one withdrawal can be made in a year.

Extension of PPF without further contribution: If no choice is made, then the default choice, i.e. extension without further contribution applies.

- No separate form needs to be filled to choose this option.
- A maximum of one withdrawal is allowed per financial year and any amount up to the total balance in the account can be withdrawn.

Once the PPF account is renewed with/without contribution, the option cannot be switched, i.e. from with contribution to without contribution or vice versa. In case the amount is deposited in the account without choosing the correct option, no interest will be payable on such amount. Also, no deduction under the Income Tax Act will be available on such contributions.

Premature Closure

Individuals can choose to close their PPF account prematurely, instead of withdrawing from it, after completing of 5 financial years from the end of the year of account opening, subject to the following conditions:

1. to utilize accumulated savings for treatment of life threatening diseases, ailments or any other medical emergency of self, or spouse, or parents or children
2. To finance higher education of self, or dependent children
3. If there is a change in residency status of the account holder

Taxation

- Public Provident Fund falls under EEE (i.e. exempt-exempt-exempt) regime of taxation.
- Contribution to the account (up to Rs 1.5 lakh per annum) is eligible for deduction under section 80C of Income Tax Act, interest earned and maturity proceeds are also exempt from tax. However, the interest earned must be declared on the income tax return.

5.1.4 Gratuity

Gratuity is given by the employer to his/her employee for the services rendered by him/her during the period of employment. It is usually paid at the time of retirement but can be paid earlier, provided certain conditions are met.
A person is eligible to receive gratuity only if he has completed minimum 5 years of continuous service with an organisation. However, it can be paid before the completion of five years at the death of an employee or if he has become disabled due to an accident or disease.

There is no set percentage stipulated by law for the amount of gratuity an employee is supposed to receive - an employer can use a formula-based approach or even pay higher than that. The Gratuity payable depends on two factors: last drawn salary and number of years of service. To calculate how much gratuity is payable, the Payment of Gratuity Act, 1972 has divided non-government employees into two categories:

a. Employees covered under the Act

b. Employees not covered under the Act

An employee will be covered under the Act if the organisation employs at least 10 persons on a single day in the preceding 12 months. Once an organisation comes under the purview of the Gratuity Act, it will always remain covered even if the total number of employees falls below 10.

Calculation of Gratuity

<u>For employees covered under the Act</u>

There is a formula using which the amount of gratuity payable is calculated. The formula is based on 15 days of last drawn salary for each completed year of service or part thereof in excess of 6 months.

The formula is as follows:

(15 X last drawn salary X tenure of working) divided by 26

Here, the last drawn salary means basic salary, dearness allowance, and commission based on sales.

Suppose, A's last drawn basic pay is Rs 60,000 per month and he has worked with XYZ Ltd for 20 years and 7 months. In this case, using the formula above, gratuity is calculated as: (15 X 60,000 X 21)/26 = Rs. 7.26 lakh.

In the above case, we have taken 21 years as tenure of service because A has worked for more than 6 months in year. Had he worked for 20 years and 5 months, 20 years of service would have been taken into account while calculating the gratuity amount.

For employees not covered under the Act

There is no law that restricts an employer from paying gratuity to his employees, even if the organisation is not covered under the Act. The amount of gratuity payable to the employee is calculated based on half month's salary for each completed year. Here also salary is inclusive of basic pay, dearness allowance, and commission based on sales.

The formula is as follows:

(15 X last drawn salary X tenure of working) divided by 30

In the above mentioned example, if A's organisation was not covered under the Act, then his gratuity will be calculated as: (15 X 60,000 X 20) /30 = Rs 6 lakh.

Here the number of years of service is taken on the basis of each completed year. So, since A has worked with the company for 20 years and 7 months, his tenure will be taken as 20 and not 21.-

Gratuity to Central Government Employees
As per the government's pensioners' portal website, retirement gratuity is calculated as: one-fourth of a month's basic pay plus dearness allowance drawn before retirement for each completed six monthly period of a qualifying service. The retirement gratuity payable for qualifying service of 33 years or more is $16^1/_2$ times the basic pay plus dearness allowance, subject to a maximum of Rs 20 lakh.

In case of death of an employee, the gratuity is paid based on the length of service, where the maximum benefit is restricted to Rs 20 lakh. Summarized below are the entitlement of death gratuity rates as applicable for qualifying years of services: (refer Table 5.2)

Table 5.2: Gratuity rates applicable corresponding to qualifying service

Qualifying service	**Rate**
Less than one year	2 times of basic pay
One year or more but less than 5 years	6 times of basic pay

5 years or more but less than 11 years	12 times of basic pay
11 years or more but less than 20 years	20 times of basic pay
20 years or more	Half of the basic salary for each completed six-monthly period. However, it is subject to a maximum of 33 times of the basic salary.

Taxability

The taxability of gratuity depends on the recipient's job. In case of **Government employees**, there is no tax on the gratuity (fully exempt). In case of **Private sector employees**, the tax liability is as below:

- In case of private sector employees covered under the Payment of Gratuity Act, 1972, any gratuity received is tax exempt to the extent of least of the following:
  - Statutory limit of Rs. 20 Lakh (Maximum limit/ Government notified amount)
  - Last drawn salary * 15/26 * No. of completed years of service.
  - Gratuity Actual Received.
    [Salary includes Basic Pay plus Dearness allowance]

If the gratuity exceeds the limit mentioned above, then it becomes taxable.

- For private employees not covered under the Payment of Gratuity Act, 1972, any gratuity received is tax exempt to the extent of least of the following:
  - Statutory limit of Rs 20 Lakh.
  - Gratuity = Average salary x one half x No. of years of service.
  - Actual gratuity received.
    [Salary includes basic pay, dearness allowance and commission based on the percentage of turnover. The average salary is taken as the average of the salary of last 10 months immediately preceding the last working month.]

5.1.5 Superannuation Benefit

The existing mandatory retirement benefits are very often found to be insufficient to meet the income replacement required at retirement. Employers provide superannuation plans to augment the benefits available by contributing to a superannuation fund. The company has to appoint trustees to administer the scheme and get the scheme approved by the Commissioner of Income Tax.

A company can offer a group superannuation scheme in two ways:

- Through the constitution of a trust fund where fund managers are appointed by the trustees to manage the fund.
- Through investment in a superannuation scheme from a life insurance company.

On retirement, the employee is allowed to take one third of the accumulation in his account as commutation. Commutation refers to the exercise of the facility of taking a portion of the annuity corpus in a lumpsum. The balance in the corpus is used to purchase an annuity. Apart from LIC, all other life insurance companies allow its customers to purchase annuity from any annuity provider. (Refer to Chapter 4 for

details)

Income Tax rules restrict the employer's contribution, whether to the PF or superannuation fund or a combination of both, to 27 percent of the employee's earnings. Payments received at the time of retirement are completely exempt from tax only in specified conditions. Aggregated with EPF and NPS, the contributions are treated as perquisite if they exceed Rs 7.5 lakhs in a financial year. However, payment received at the time of death, from an approved Superannuation Fund, remains exempted from tax.

5.1.6 National Pension System

National Pension System is a social security initiative by the Central Government. This pension scheme is open to employees from the public and private sectors, except those from the armed forces. NPS is also open to all Indian citizens on a voluntary basis. The scheme encourages people to invest in a pension account at regular intervals during the course of their employment. After retirement, the subscribers can take out a certain percentage of the corpus. As an NPS account holder, one will invest the remaining amount in an annuity of an approved annuity service provider and will receive monthly pension therefrom, post their retirement. NPS scheme holds immense value for anyone who works in the private sector and requires a regular pension after retirement. The scheme is portable across jobs and locations, with tax benefits under Section 80C and Section 80CCD of the Income Tax Act.

The NPS is a contributory pension system where the subscriber contributes to the fund over their working life and at retirement draws the corpus so created to buy annuity(ies) that will provide regular income in retirement.[7] There is no guaranteed return or principal protection in the NPS. Subscribers earn market returns on their contribution and the pension drawn will depend on the corpus that is available to buy the annuity(ies) on retirement.

Models under NPS

The National Pension System (NPS) platform offers different models to suit the different specifications of its users. These include:

- The Government Sector model for the Central (except armed forces) and State Government Employees, and also employees of Central Autonomous and State Autonomous Bodies. The individuals mandatorily subscribe to the NPS on becoming government employees.
- The All Citizens model as a voluntary contributory pension scheme available to

[7] Subscribers have the option of buying multiple annuities from a single Annuity Service Provider (ASP) at the time of their exit, provided their annuity corpus is more than Rs. 10 lakhs wherein Rs. 5 lakhs be utilized to buy each annuity scheme. The same is notified PFRDA Circular No.: PFRDA/2023/14/SUP-ASP/02 dated May 10, 2023 on Retirement Income Optimization through multiple Annuities.

all Indian citizens aged between 18-70 years of age.

- The Corporate model for companies/entities desirous of adopting the NPS platform to provide retirement benefit to its employees.

All the models broadly use the NPS architecture to provide the systems to aggregate the contributions of the subscribers, invest it to accumulate pension wealth and provide the pensions at retirement.

Types of NPS Account

The two primary account types under the NPS are Tier I and Tier II. The former is the default account, while the later is a voluntary addition. Table 5.3 below explains the two account types in detail:

Table 5.3: NPS Tier I account Vs NPS Tier II account

Particulars	NPS Tier-I Account	NPS Tier-II Account
Status	Default/ Mandatory	Voluntary
Withdrawals	Conditional and Restricted	Permitted/ Unrestricted
Tax deduction on contribution by employee/ self-employed person	Upto Rs 2 lakh p.a. i.e. Rs. 1,50,000 tax deduction under Section 80C and an additional Rs. 50,000 under Section 80CCD(1B).	Government employees – Deduction available under Sec 80C (i.e. maximum Rs. 1.5 lakh) Other employees - No exemptions
Tax deduction on contribution made to NPS account by Employer	Upto 14% of (Basic + DA) for central and state government employees and 14% for any other employer[8] (As per Budget 2024) (under Section 80CCD(2) of IT Act) Note: the contribution made by the employer is considered as a perquisite in the hands of the employee and is available for deduction under this Section.	Not applicable

[8] Vide The Finance Act, 2024 effective from April 1, 2025.

Particulars	NPS Tier-I Account	NPS Tier-II Account
Minimum NPS contribution	Each contribution to be of minimum Rs 500; subject to minimum yearly contribution of Rs. 1000.	Rs. 1000 at the time of activation Rs. 250 for subsequent contributions.
Maximum NPS contribution	No limit	No limit

The Tier-I account is mandatory for everyone who opts for NPS scheme. The Central Government employees have to mandatorily contribute 10% of their basic salary plus dearness allowance. For everyone else, the NPS is a voluntary investment option.

Choice of Investments

There are four asset classes across which contributions can be invested. These are: Equity, Corporate Debt, Government Bonds and Alternative Investments. These choices can be exercised through various pension fund managers allowed to manage the NPS funds. Further, each asset class has further defined investments as stipulated by the regulator, PFRDA. Table 5.4 lists the asset classes offered by Pension Fund Managers (PFMs) for investment.

Table 5.4: Asset classes offered by Pension Fund Managers (PFMs) for investment

Equity (E)	Invests predominantly in Equity market instruments.
Corporate Debt (C)	Invests in Bonds issued by Public Sector Undertakings (PSUs), Public Financial Institutions (PFIs), Infrastructure Companies and Money Market Instruments.
Government Securities (G)	Invests in Securities issued by Central Government, State Governments and Money Market Instruments.
Alternative Investments (A)	Invests in instruments such as Commercial Mortgaged Backed Securities (CMBS), Real Estate Investment Trust (REITS), Alternative Investment Funds (AIFs), Infrastructure Investment Trusts (InvITs) etc.

Mode of Investment

- **Active Choice**

In the NPS Active Choice, subscribers have the option to choose the ratio in which their contributions will be invested among various asset classes or the NPS funds that offer a defined combination. However, there are limitations even within this choice as the maximum permitted allocation to equities is restricted to 75%.[9] Each Pension fund manager has a bouquet of fund schemes that a subscriber can select from. (see Table 5.5)

Table 5.5: Permissible fund allocation under Active Choice

Active Investment Class	Equity (E)	Corporate (C)	Government (G)	Alternative Investments (A)[10]
Permissible allocation	Upto 75%	Upto 100%	Upto 100%	Upto 5%

- **Auto choice**

The NPS Auto Choice option adopts a life-cycle based approach -- starts with an equity-heavy portfolio during the subscriber's younger age and systematically reduces the equity exposure as the subscriber approaches retirement.

Under the auto choice, the investments are made in a life-cycle fund, with three life cycle funds (LC) to choose from. (refer Table 5.6)

1. **Moderate Life Cycle Fund**: It is the default option, which caps the equity exposure to maximum of 50%.
2. **Conservative Life Cycle Fund**: As the name suggests, it takes a conservative approach to investing with maximum equity allocation capped at 25%.
3. **Aggressive Life Cycle Fund:** In this option, maximum equity allocation can go up to 75%.

[9] PFRDA Circular No. PFRDA/2022/31/REG-PF/04 dated October 20, 2022 on maximum allocation limit allowable under Active Choice.

[10] This asset class is not available for investment of contribution made under Tier II account. Investment in this asset class is only available to the subscribers opting for Active choice investment option.

Table 5.6: Fund Allocation under Auto Choice

	Asset Class (%)								
	Moderate Life Cycle Fund			Aggressive Life Cycle Fund			Conservative Life Cycle Fund		
Age	**E**	**C**	**G**	**E**	**C**	**G**	**E**	**C**	**G**
Up to 35 years	50	30	20	75	10	15	25	45	30
40 years	40	25	35	55	15	30	20	35	45
45 years	30	20	50	35	20	45	15	25	60
50 years	20	15	65	20	20	60	10	15	75
55 years & Above	10	10	80	15	10	75	5	5	90

Returns/Interest

No scheme of NPS offer guaranteed returns or interest. The money of subscribers is invested as per the allocation selected.

Option to change the Scheme or Fund Manager

NPS provides its subscriber the options to change the pension scheme or the fund manager, once in a financial year, if the subscriber is not happy with the performance of the fund. This option is available for both Tier I and Tier II accounts.
All subscribers or employers under 'All Citizen Model' and 'Corporate Model' have the option to change the investment choice/ asset allocation (i.e. changing between Auto Choice and Active Choice or to change the allocation ratio among asset classes under Active Choice) four times in a financial year.[11]

Withdrawal and Exit Rules

Partial withdrawals

If the subscriber has been investing for at least 3 years, he/she may withdraw up to 25% of the contribution made by the subscriber and excluding any contribution made by the employer and any returns earned, for certain specified purposes, such as children's wedding or higher studies, building/buying a house or medical treatment of self/family etc.

[11] PFRDA Circular No.: PFRDA/2022/02/PDES/01 dated January 27, 2022 on Change of Pension Fund and Asset Allocation by NPS subscriber.

One can make a withdrawal for up to three times in the entire tenure. These restrictions are only imposed on Tier I accounts and not on Tier II accounts.

Exit and Withdrawal on retirement

A subscriber can exit from the NPS on reaching the age of 60 or superannuation or retirement according to the terms of employment by using a minimum of 40% of the corpus to buy an annuity from the approved annuity service providers which will provide the monthly pension. The balance (60% of the corpus) can be withdrawn as a lumpsum. However, the subscribers joining the NPS beyond the age of 60 years (but before attaining the age of 70 years) can exit after completion of 3 years from the date of joining NPS.

The subscriber can also opt for continuation of NPS account till the age of 75 years and can contribute too. If the subscriber after attaining the age of 60 years/ superannuation has not initiated exit request or has not exercised the option of continuation under NPS, then the subscriber shall be automatically continued under NPS till he/she attains the age of 75 years (as if he/she has exercised the option of continuation).

In case the accumulated corpus at the time of exit is equal to or less than Rs.5 lakhs, the subscriber will have the option to withdraw the entire corpus in lumpsum.

Exit and Withdrawal before retirement

In case of resignation or exit from the NPS before the age of 60 or before superannuation as prescribed in the employment terms, at least 80% of the corpus has to be utilized for purchasing an annuity and the balance is paid out to the subscriber as a lumpsum.

Subscribers joining the NPS beyond the age of 60 years can opt to exit before completion of 3 years from the date of joining NPS. In such case, the subscriber will be required to annuitize at least 80% of the corpus and the remaining corpus can be withdrawn in lumpsum.

In case the accumulated corpus at the time of exit is equal or less than Rs.2.5 lakh, the subscriber will have the option to withdraw the entire corpus in lumpsum.

In case of unfortunate death of the subscriber, the entire accumulated corpus will be paid to the nominee of the subscriber as lumpsum; or nominee can purchase annuity, if they so desire.

Deferment of Withdrawal

A subscriber of NPS has an option to defer their withdrawal if he/she is not in need of funds. Subscriber can defer: (a) receiving the lumpsum or (b) annuity purchase or (c) both till the age of 75 years.

Taxation implications

The NPS comes under Exempt, Exempt, partly Exempt – partly Taxable regime. This refers to the tax implications at the stage of making a subscription to the NPS, earning returns on the contribution and withdrawing the accumulated wealth (withdrawal is partly taxable).

- **The subscriber is allowed a deduction at the time of making the investment (First E)** - Contributions made by the subscriber in the individual pension account are exempt from tax under Sec 80CCD (1) up to a limit of Rs.1.5 lakhs. This limit covers the deductions available under section 80C, 80CCC and 80CCD (1). This deduction is limited to 20% of gross annual income for a non-salaried individual and 10% of basic and DA for salaried employees.

  Sec 80CCD(2) covers the employer's NPS contribution, which will not form a part of Section 80C. This benefit is not available for self-employed taxpayers. The maximum amount eligible for deduction will be the lowest of the below: (a) Actual NPS contribution by employer (b) 14% of Basic and DA for central government employees and 14% of Basic + DA for other employees (c) Gross total income.

  Further, one can claim any additional self contribution (up to Rs 50,000) under section 80CCD(1B) as an exclusive NPS tax benefit.

  The scheme, therefore, allows a tax deduction of up to Rs 2 lakh in total for contribution by the subscriber and upto the limits specified above in respect of contribution made by the employer.

- **There is no taxation when the income or return is earned on the contributions made (Second E)**.
- **At the stage of exit on maturity, there is no tax on a maximum of 60 percent withdrawn as lumpsum – section 10(12A) (partial E)**.The balance 40% has to be compulsorily used to buy an annuity from a life Insurance company. The annuity payable by the life Insurance company will be added to subscriber's income and will be taxable at the applicable rates in the year in which the annuity is due. The partial withdrawals are tax exempt under section 10(12B) of the Income Tax Act upto 25% of own contribution.

Contributions made to the Tier II account only by government employees will be eligible for deduction under the limits prescribed for section 80C.

5.1.7 NPS Vatsalya

NPS Vatsalya is a saving cum pension scheme introduced in Budget 2024 for minor citizens. Any parent can open this account in the name of their minor children (below 18 years) and operate it as a guardian. The account is subject to all regulations of NPS Tier 1 account managed by PFRDA. Once the minor turns 18 years of age, the account will be maintained by him/her like any other NPS account of an individual.

5.1.8 Atal Pension Yojna

Atal Pension Yojana (APY) is a pension scheme introduced by the Government of India in 2015–16. It was implemented with an objective to provide pension benefits to individuals in the unorganized sector. This scheme is regulated and controlled by the Pension Fund Regulatory and Development Authority (PFRDA).

It is an extension of the recognized National Pension System (NPS) and replaces the previously institutionalized Swavalamban Pension Yojana. All accounts that were opened in the first year of the scheme, i.e. in 2015, were eligible for co-contributions from the Indian government for 5 years.

Currently, any citizen of India within the age group of 18 - 40 years, who are not members of any statutory social security scheme and who are not income tax payers, can join APY for availing benefits guaranteed by Government of India under the scheme (effective from October 1, 2022).[12] Therefore, APY focusses on all citizens in the unorganized sector only. Retirement Plans from Mutual Funds and Insurance companies.

Most insurance companies and mutual funds offer products specific to retirement. Insurance companies have pension plans and annuity products that cater to financial requirements for retirement years. The pension plans are deferred product where one needs to pay premium till a specified age which is deductible under section 80C and based on the corpus accumulated one can receive pension. There are various options offered by insurance companies to receive the pension. The rate of pension varies as per the option selected by the policy holder. These options include pension to policyholder for life long and to his/her spouse post death of the policyholder. The insurance companies offer both ULIPs and traditional pension plans.

Mutual funds too have retirement specific schemes. These are mainly hybrid products with a mix of equity and debt investments. Within one scheme, there are 3 to 4 variants with each variant offering different allocation to equity and debt. Some of the funds offer insurance cover up to a specified age of the investor. Retirement schemes from mutual funds typical have a lock-in period of at least 5 years or till the retirement age, whichever is earlier.

5.2 Portfolio created by an Investment Adviser

Before making any investment decision for their clients, an investment adviser has to manage the psychological stress the client may be going through. This can come in due to retrenchment or at retirement even if they are well prepared for it. An investment adviser has to understand their clients' personal needs and encourage them to set goals, plan their lifestyle and plan their finances.

[12] Vide Gazette Notification: F. No. 16/1/2015-PR dated August 10, 2022.

While creating a retirement portfolio for their clients, an investment adviser has to take into consideration the key factors such as liquidity, security, estimated returns, resistance to inflation, taxes and social security. Clients approaching retirement may have different investment philosophy based on experience they would have gone through. Some would tend to take a very conservative approach, not ready to invest in high risk investments. Contrary to this, some would have luxury of life and be ready to take high risk. As an adviser, one needs to listen to the concerns of the clients and explain the risk reward relationships while investing money for the long term.

The final creation of the portfolio will depend on the factors discussed above. The long-term portfolio can be invested in Equity, Debt, Gold or any other asset classes appropriate for the investor. How much to be invested in each asset class will be decide by the adviser based on clients' risk appetite. Benefits, such as EPF, NPS, Superannuation and Gratuity, form the core of the retirement portfolio of salaried employees and hence advised by the adviser for retirement portfolios.

5.3 Distribution Related Products

In the accumulation stage of retirement, the corpus required is created out of the savings and investments made over the working years. In the retirement years, this corpus is used to generate income to meet expenses. The products that are suitable in retirement (distribution stage) are those generating periodic income, where (i) the returns are adequate for the investors' needs and (ii) have a lower risk to income and principal invested. Protection of capital is important at this stage since the opportunity to add to the corpus after retirement is limited. The products used to generate income in the distribution stage are discussed below.

5.3.1 Annuity from insurance companies

An annuity, in general term, is a fixed stream of payment for life term or for a pre-defined period. An annuity contract is a life insurance policy in which the annuity provider (insurer) agrees to pay the purchaser of annuity (annuitant) a series of regular payments for a fixed period or over someone's lifetime. The main objective of annuity is to counter risk of longevity and, to some extent, inflation.

There are two basic types of annuities designed in any annuity product:

1. **Deferred Annuity**: It is an annuity under which periodic benefits are scheduled to begin after a specified period i.e. more than 12 months after the date on which annuity is purchased. The date on which annuity is scheduled to begin is often specified in the insurance contract. In general, deferred annuity is purchased during working years in anticipation of the need of retirement income in later years.
2. **Immediate Annuity**: It is an annuity under which annuity benefits are scheduled to begin on immediate period after the date on which annuity is purchased. In general, the annuity payments in these types of annuities begin within 12 months after its purchase.

Annuities can be purchased in 2 modes: (a) Single Premium and (b) Regular Periodic Premiums. Most immediate annuities are purchased as single premium annuities where a lump sum premium is paid. The benefits under this mode begin soon after the premium is paid. On the other hand, annuity purchased by paying premiums over a period can be level playing or flexible. In the level-playing mode, the premium remains same over a scheduled intervals such as monthly or annually until some predetermined future date. Contrary to this in variable premium payment, the amount of each premium payment can vary between a set of minimum and maximum amount.

Under any annuity product, the frequency of periodic annuity payments depends on the length of the annuity period. This annuity period is typically one month or annual though other options like quarterly or half yearly are also available.

The annuity paid will depend upon the annuity rate applicable at the time of purchase of annuity. The annuity rate is guaranteed for the entire period. The annuity rates are reviewed periodically with the approval of IRDAI.

Payout Options

There are various options though which the insurance company pays annuity to the annuitant. These options vary in the feature they provide and are chosen by the policyholder at vesting age i.e. the age at which the annuity is to be started.

a. **Lifetime without return of purchase price**: Here the annuity is paid for the lifetime and stops once the investor dies. The principal amount (i.e. purchase price) is retained by the company. The annuity amount is the highest in this option.
b. **Lifetime with return of purchase price**: Here the annuity is paid for lifetime to the investor and the purchase price is returned to the nominee after the investor's death. The annuity amount will be the lowest in this option.
c. **Annuity guaranteed for certain period**: Annuity is paid for a defined period, say 10 years or 20 years, irrespective of survival of policyholder. Beyond this, amount is paid only to the policyholder till he/she dies.
d. **Joint Annuity**: Here, the spouse too gets the annuity for lifetime after the death of the investor.

There are other options launched by the companies such as inflation adjusted and fixed increasing annuity.

Taxability of Annuities

Unlike life insurance policies, the annuities do not enjoy the tax exempted status. The money received by the annuitant are treated as the income and are taxed in the hands of the annuitant. The premium paid by the annuitant for the annuity contract or the annuity policy is eligible for tax benefit under Section 80C, within the overall limit prescribed by the Income Tax Act.

5.3.2 Systematic Withdrawal Plans from mutual funds

One of the tax efficient ways to generate a regular income is Systematic Withdrawal Plans (SWP) in mutual fund schemes. It is an option where an investment withdrawal plan is scheduled in a specified frequency. One can withdraw, either a fixed amount or only the capital gains, whichever options suits ones requirements. The money withdrawn through SWP can be either invested in another fund or used for own requirements.

Systematic withdrawal plan is specifically beneficial for generating regular income for meeting retirement needs. Retirees need a regular income source to meet their monthly expenses. With the help of SWP, the timing and frequency of withdrawals can be set-up based on their monthly requirements. This ensures the funds are available at the right time and thus, goals are not delayed due to any cash crunch.

Typically, mutual funds offer multiple withdrawal frequencies such as monthly, quarterly, half-yearly or annual. One can choose the desired SWP frequency based on the financial requirements. Through a fixed withdrawal option, one can redeem a specified amount from investments. Contrary to this, with an appreciation withdrawal option, one can withdraw only the appreciated amount.

It is important to note that an SWP is not equivalent as receiving monthly interest against a fixed deposit account in a bank. In a fixed deposit, the corpus value is not impacted when interest amount in withdrawn, while, in the case of a systematic withdrawal plan in mutual fund schemes, the value of the fund is reduced by the number of units withdrawn.

Example:

Mr. A has 8,000 units in his mutual fund scheme and he wishes to withdraw Rs 5,000 every month through a Systematic Withdrawal Plan.

Let us assume the Net Asset Value (NAV) of the scheme is Rs 10. The withdrawal of Rs 5,000 from this scheme will mean that 500 units are being sold (i.e. Rs. 5000/NAV of the scheme, which is Rs. 10). The remaining units in his mutual fund scheme post this withdrawal, will be 7,500 units (i.e. 8,000-500).

During the start of the next month if the NAV of the scheme increases to Rs 20, then the withdrawal of Rs 5,000 would mean selling of 250 units (i.e. Rs 5,000/NAV of the scheme, which is Rs 20). The mutual fund would be left with 7,250 units post this withdrawal (i.e.7,500-250).

So, with each withdrawal, the mutual fund will see a decline in its units. At higher NAVs, one may redeem fewer units to fulfill the cash requirements. Conversely, as the NAV falls, it would have the opposite effect, requiring the redemption of more units.

An essential aspect of benefiting from this plan and making the most of it is by planning the SWP, keeping in mind the needs and the end goal of the client. It can have a detrimental effect on the value of the fund if withdrawals are unplanned.

Taxation in SWP

Any redemption through SWP is subject to taxation. The rate of taxation depends on: (a) the type of funds from which SWP is scheduled and (b) holding period.

Post April 1, 2023, in case of SWP from debt funds, irrespective of the holding period, the capital gain portion of amount withdrawn will form as part of the income. It will then be taxed according to one's income tax slab.

In case of SWP from equity funds, if holding period is less than or equal to 12 months, the capital gain portion of the withdrawn amount will be taxed at the rate of 20%. On the other hand, if the holding period is more than 12 months, then the capital gains portion of the withdrawn amount will be taxed at 12.5%. However, an exemption of Rs 1.25 lakh p.a. is available on long-term capital gains earned from all equity investments combined together.[13]

5.3.3 Laddering of Bonds or Fixed Deposits

One of the effective strategies to create a good retirement income is laddering strategy. Here, instead of buying securities that is scheduled to become due during the same year one purchases bonds or fixed deposits (FDs) that are staggering at different dates i.e. maturing at different dates.

Laddering of Bonds

There are two primary goals a bond ladder can help investors achieve.

1. Managing interest Rate risk

Bonds are most impacted by interest rate movements. When investors invest most of their money in bonds maturing in the same year then there is a risk of locking at a single interest rate. The investors tend to lose money when interest rate rises after few years. The laddering bond is a strategy to reduce this risk since it works in both the interest rate scenarios. When interest rate rises then the investor can invest the maturing bond to benefit from it. Similarly, when interest rates are falling the investors have already bonds locking in at higher rates even though the matured bonds have to be invested at lower rates.

2. Manage cash flow

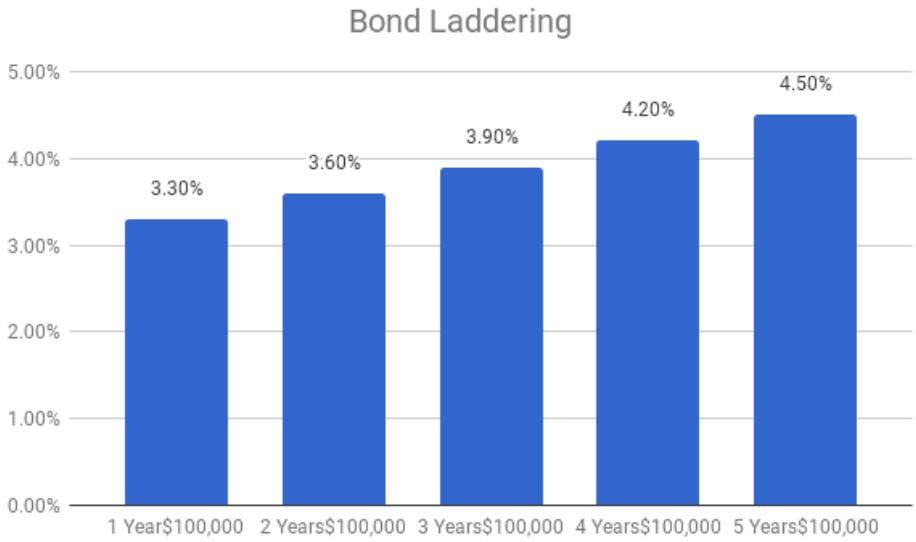
The laddering of bonds can also manage cash flows for retirement income needs. Many of the bonds have options of paying interest twice in a year. By structuring the maturity of the bond at different periods the interest payment at different months or years can help in generating cash flow in the form of regular income.

[13] The tax rates on short-term and long-term capital gains on sale of equity mutual funds are 20% and 12.5% respectively if units are redeemed on or after July 23, 2024.

With bond laddering, one invests in multiple bonds with different maturities—which is designed to give the predictable income one expects from the bonds and the flexibility to reinvest the principal.

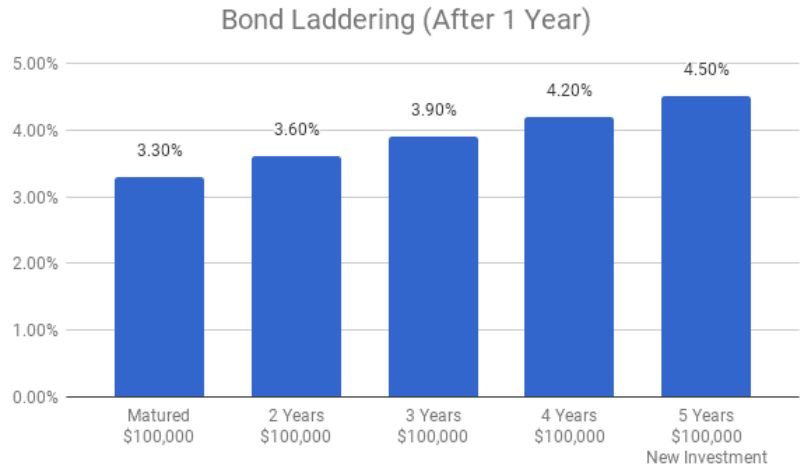
Example[14]

Let us assume, Mr. B has USD 500,000 to invest in fixed income. He divided the sum into 5 investments of USD 100,000 each and invested it in different bonds maturing in 1, 2, 3, 4 and 5 years respectively. The following graph shows the investments:



Starting today, every one year an investment of USD 100,000 will mature and will be available to Mr. B for reinvestment. When the first investment matures, he takes that money and reinvests it in the bond at the longest end of the ladder. The investment, which was two years away, is now one year away and the original investment that was 5 years away is now 4 years away. Mr. B has invested the sum, received from 1-year bond, with maturity of 5 years away. Thus, the ladder is kept intact as shown below:

[14] Source: https://financetrain.com/what-is-bond-laddering-strategy-for-investment/



Laddering of Fixed Deposits

We have understood from above how laddering strategy works with bonds. The same strategy can be applied on fixed deposits. Instead of buying a single FD instrument, one can buy different FD instruments with different maturities to invest.

For example, Mr. C wants to invest Rs. 10 lakh. Under the FD laddering technique, Mr. C can break his corpus in five equal parts, i.e. into five FDs of Rs. 2 lakh each but with different maturities. Meaning, Mr. C can invest Rs 2 lakh each in a 1-year, 2-year, 3-year, 4-year and 5-year FDs, and when these FDs mature, he reinvests the fund. Further assume, Mr. C has reinvested each FD in a new 5-year FD, So when your 1-year FD matures, it will be reinvested for five more years and will mature in the sixth year. The 2-year FD will mature in the seventh year, the 3-year FD will mature in the eighth year, and so on. Thus, by using this strategy Mr. C has created an investment loop through which he will have enough liquidity to meet his financial requirements every year.

Laddering of Fixed Deposits helps in 2 ways: (a) the investments are less impacted by interest rate fluctuations in long term; (b) keeps most of the funds secure and can be utilised separately in times of need. One can even choose different banks for different ladder thus diversifying the investment for better earnings.

5.3.4 Senior Citizens' Savings Scheme

Eligibility

In order to avail the Senior Citizens' Savings Scheme (SCSS), resident Indians have to meet the following key conditions:

- The scheme is available to any resident individual aged 60 years and above.
- Individuals who have attained 55 years or more but are less than sixty years are also eligible to apply for SCSS provided they have retired under applicable

superannuation or Voluntary Retirement Scheme (VRS). In such cases, the account should be opened within 1 month of the receipt of the retirement benefits.

- The scheme is also available for the retired personnel of the Defence Services (excluding Civilian Defence employees) on attaining the age of 50 years subject to fulfilment of other terms & conditions.
- Hindu Undivided Family, Non-Resident Indians (NRIs) and Person of Indian Origin (PIOs) are not entitled to open a Senior Citizens Savings Scheme account.
- The scheme can be held in individual capacity or jointly with the spouse. The age restrictions apply only to the first holder.

Deposit Limits

- Depositors are allowed to make a lump sum deposit with a minimum deposit of Rs.1000. Deposits greater than Rs.1000 have to be made in multiples of Rs.1000. The maximum SCSS limit deposit is Rs.30 lakhs.
- While deposits in the SCSS accounts can be made in cash, this is allowed only for amounts less than Rs. 1 lakh. If the deposit amount for Senior Citizens Savings Scheme exceeds Rs. 1 lakh, using a cheque/demand draft for making the deposit is mandatory.

Maturity

Deposits made into a Senior Citizens' Savings Scheme mature after 5 years, calculated from the date of account opening. However, the account holder does have the option of extending the account for an additional 3 years after it has matured. This extension option is available just once and the extension request has to be made within 1 year of maturity of the SCSS account.

Taxability

- Investments made in a Senior Citizens' Savings Scheme account qualify for income tax deduction benefit up to Rs. 1.5 lakh under Section 80C of the Income Tax Act, 1961.
- Interest on SCSS is fully taxable. In case the interest amount earned is more than Rs. 50,000 for a fiscal year, Tax Deducted at Source (TDS) is applicable to the interest earned.

Interest Rates

The rate of interest is reviewed quarterly by the Ministry of Finance and is subject to periodic change. The interest rate is fixed on the investment according to the rate fixed for that quarter. If the same is extending post-maturity, then the interest prevailing at that time will be applicable. Interest on SCSS account deposits is calculated and credited quarterly.

Premature Closure

Premature withdrawal of Senior Citizen's Savings Scheme is allowed but penalties are applicable in such cases based on the time elapsed between account opening and withdrawal. The penalties on premature exit from SCSS are as follows:

- 1.5% of SCSS deposit amount deducted as a penalty if an exit from the scheme occurs after completion of 1 year but before completion of 2 years from the date of account opening.
- 1% of SCSS deposit amount deducted as a penalty if an exit from the scheme occurs between 2 years to less than 5 years from the date of account opening.

Closure of Account before Maturity on Death

In the event of death of the primary account holder before actual maturity of the account, the account will be closed and all the maturity proceeds will be transferred to the legal heir/nominee. For deceased claims, the nominee or the legal heir will have to fill out a written application in prescribed format along with Death Certificate to facilitate the closure of the account.

5.3.5 Pradhan Mantri Vaya Vandana Yojana

The Government of India launched the Pradhan Mantri Vaya Vandana Yojana (PMVYY) in 2017 to provide pension benefits for citizens aged 60 years in the private sector. The scheme is operated by LIC of India. This is a 10-year scheme. The minimum pension is Rs.1000 per month and the maximum is Rs. 10,000 per month or Rs.1,20,000 per year. For the minimum monthly pension of Rs.1000/month the purchase price or investment required is Rs.1,50,000 and for the maximum monthly pension of Rs. 10,000 the investment required is Rs.15,00,000. The purchase price is marginally lower if the quarterly, half-yearly or annual mode of pension is chosen. The investment is returned on maturity. The ceiling on the maximum pension permitted under the scheme applies to the family comprising of the pensioner, spouse and dependents. 98 percent of the purchase price is returned if the policy is surrendered for specified needs such as critical healthcare requirements. After the completion of three policy years, loan to the extent of 75 percent of the purchase price can be availed at the prevailing interest rates.

Further, Government of India has introduced Pradhan Mantri Vaya Vandana Yojana (Modified-2020), with modified rate of pension under this plan and extended the period of sale of this plan for a further period of three years from Financial Year 2020-21 till 31st March, 2023. Post 31st March 2023, investments in PMVVY are not activated and so individuals are unable to avail the benefits of this scheme. As per the terms and conditions under this modified plan, guaranteed rates of pension for policies sold during a year will be reviewed and decided at the beginning of each year by the Ministry of Finance, Government of India which will be applicable for the entire duration of 10 years. LIC of India is solely authorised to operate this scheme.

Benefits (PMVVY Modified – 2020)

a. **Pension Payment**: On survival of the pensioner during the policy term of 10 years, pension in arrears (at the end of each period as per mode chosen) shall be payable.

b. **Death Benefit**: On death of the pensioner during the policy term of 10 years, the Purchase Price shall be refunded to the beneficiary.

c. **Maturity Benefit**: On survival of the pensioner to the end of the policy term of 10 years, Purchase Price along with final pension instalment shall be payable.

Mode of pension payment

The modes of pension payment are monthly, quarterly, half-yearly & yearly. The pension payment shall be through NEFT or Aadhaar Enabled Payment System (AEPS). The purchase of the policy under this Government subsidised scheme requires unique Aadhaar number validation. The first instalment of pension shall be paid after 1 year, 6 months, 3 months or 1 month from the date of purchase of the same depending on the mode of pension payment chosen.

Taxation

Income from pension is taxable as income in the hands of the annuitant.

5.3.6 Post Office MIS

Post Office Monthly Income Scheme (POMIS) is a government-sponsored savings scheme. It provides its investors monthly returns in the form of interest payments. It is offered by the Department of Post (DoP) or India Post. The scheme's interest rates are announced every quarter.

Eligibility

POMIS account can be opened by:

i. A single adult
ii. 2 or 3 adults jointly
iii. A guardian on behalf of minor/ person of unsound mind
iv. A minor above 10 years in his own name

Deposit

- Account can be opened with a minimum of Rs. 1000 and in multiples of Rs. 1000.
- A maximum of Rs. 9 lakh can be deposited in a single account and Rs. 15 lakh in a joint account.
- In a joint account, all the joint holders shall have equal share in investment.

- An individual may open and operate one or more than one account as a single account or a joint account under this Scheme, subject to the ceiling of maximum deposit limit.
- Deposits in all the accounts taken together for an individual shall not exceed Rs. 9 lakh in a single account and Rs. 15 lakh in a joint account.
- Limit for account opened on behalf of a minor as guardian shall be separate.

Interest

- Interest shall be payable on completion of a month from the date of opening and so on till maturity.
- If the interest payable every month is not claimed by the account holder such interest shall not earn any additional interest.
- In case any excess deposit made by the depositor, the excess deposit will be refunded back and only Post Office Savings Account interest will be applicable from the date of opening of account to the date of refund.
- Interest can be drawn through auto credit into savings account standing at same post office, or ECS. In case of MIS account at CBS Post offices, monthly interest can be credited into savings account standing at any CBS Post Offices.
- Interest is taxable in the hand of depositor.

Pre-mature closure of account

- No deposit shall be withdrawn before the expiry of 1 year from the date of deposit.
- If account is closed after 1 year and before 3 year from the date of account opening, a deduction equal to 2% from the principal will be deducted and remaining amount will be paid.
- If account closed after 3 year and before 5 year from the date of account opening, a deduction equal to 1% from the principal will be deducted and remaining amount will be paid.
- Account can be prematurely closed by submitting prescribed application form with pass book at concerned Post Office.

Maturity

- Account may be closed on expiry of 5 years from the date of opening by submitting prescribed application form with pass book at concerned Post Office.
- In case the account holder dies before the maturity, the account may be closed and amount will be refunded to nominee/legal heirs. Interest will be paid up to the preceding month, in which refund is made.

5.3.7 Reverse Mortgage

Rental income from real estate held provide a source of income that is adjusted for inflation. In periods of inflation, which pushes up costs, rental income also rises, thereby giving income that is adequate to meet expenses. The income also has the advantages of being periodic and known in advance, so that the investor can plan and use the income to meet their expenses. However, rental yield (i.e. rental income relative to the price of

the property) in India is typically low, given the high property prices. If the property that was purchased at a lower price earlier is now generating good rental income, the yield may be comparable with other income generating investments. Real estate provides appreciation in value as well as inflation adjusted income. The drawback of real estate comes from the very low liquidity in the investment. If there is an emergency and funds are required immediately, it will be difficult to liquidate the investment fast, though it is possible to get a loan against the property.

For many households the self-occupied property constitutes a large investment. The self-occupied home can also become a source of income in the extreme situation if the income from the retirement corpus being insufficient to meet the needs in retirement. The Reverse Mortgage Scheme is offered by housing finance companies and banks.

The important features of Reverse Mortgage are summarized below:

a. In a mortgage, a lumpsum is borrowed against the security of the property and this is paid back over a period of time using Equated Monthly Instalments (EMIs). In reverse mortgage, a property owned by the individual is pledged with the financial institution against which a periodic income is paid to the property owner.
b. Eligibility Criteria:
    i. Indian citizen of 60 years or more,
    ii. Married couples will be eligible as joint borrowers for joint assistance. In such cases, the age criteria for the couple would be at the discretion of the Reverse Mortgage Loan (RML) lender, subject to at least one of them being above 60 years of age and the other not below 55 years of age.
    iii. Should be the owner of a residential property (house or flat) located in India, with clear title indicating the prospective borrower's ownership of the property.
    iv. The residential property should be free from any encumbrances.
    v. The residual life of the property should be at least 20 years. There is no minimum period of ownership of property required.
    vi. The prospective borrower(s) should use that residential property as permanent primary residence.
c. The amount of loan available under RML depends on the age of the borrower, appraised value of the house and the prevalent interest rates of the lending institution.
d. A reverse mortgage loan cannot be availed against commercial property.
e. The maximum monthly payments under RML have been capped at Rs.50,000. The maximum lump sum payment shall be restricted upto 50% (varies with lenders) of the total eligible amount of loan subject to a cap of Rs. 15 lakhs, to be used for medical treatment for self, spouse and dependants, if any. The balance loan amount would be eligible for periodic payments.

f. All receipts under RML shall be exempt from income tax under Section 10(43) of the Income-Tax Act, 1961.
g. The rate of interest and the nature of interest (fixed or floating) will be decided by the lender.
h. The maximum tenure of an RML will be 20 years.
i. The borrower can prepay the loan at any time without a penalty.
j. An RML will become due and payable only when the last surviving borrower dies or permanently moves out of the house. An RML will be settled by proceeds obtained from sale of the house property mortgaged. After the final settlement, the remaining amount (if any) will be given to the borrower or his/her heirs/beneficiary. However, the borrower or his/her heirs may repay the loan from other resources without allowing the property to be sold.
k. The borrower will remain the owner of the house property and need not service the loan during his/her lifetime as long as the property is used as primary residence. Periodic payments under RML will cease after the conclusion of the loan tenure. Interest will accrue until repayment.
l. The Reverse Mortgage Loan can be prepaid at anytime during the loan period. On clearance of all the dues, all the title deeds will be returned by the lender.
m. The borrower can opt for the frequency of EMI pay out (monthly, quarterly, and annual or lump sum payments) at any point, as per his discretion.
n. The Reverse Mortgage Loan Enabled Annuity (RMLEA) is an extension of the reverse mortgage scheme. The scheme ensures a lifetime pay-out to the senior citizens through an annuity bought from an insurance company using the reverse mortgage loan amount disbursed by the primary lending institutions.
    - The scheme will be available to senior citizens of India over 60 years of age who are the owners of the property. In case of married couples applying as joint borrowers, at least one of the borrowers should be above 60 years and the other 55 years.
    - The primary lending institutions (housing companies and scheduled commercial banks) will be the interface for the individual. They will assess the property for the eligible loan, disburse it and source a lifetime annuity with the loan amount from eligible insurance companies.
    - The operational guidelines of the National Housing Bank (NHB) define the loan to value (LTV) ratio to determine the quantum of loan.
    - The borrowing individual has to choose between a lifetime annuity without return of purchase price and a lifetime annuity with return of purchase price. The scheme also provides for an annuity cover for the spouse of the primary borrower.
    - The amount of annuity received will be a function of the loan value and type of annuity chosen. The borrower can decide on the periodicity of the annuity payment from the options provided such as monthly,

quarterly or annual.

- The annuity received is exempt from tax in the hands of the borrower.

CHAPTER 6: MISCELLANEOUS ASPECTS OF RETIREMENT PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Advisor's role in retirement planning
- Calculations for retirement planning
- Criteria to evaluate various retirement benefit products
- Concept of Philanthropy

6.1 Advisor's role in Retirement Planning

Investment advisers can play an important role in planning for retirement of their clients. They understand their clients' financial goals and know when the client will need savings and on what they will be spending.

While creating a detailed financial plan, the adviser will have a clear understanding of the financial assets that are accumulated, as well as other resources such as pensions, Social Security, part-time work, home equity, etc. The adviser then put these pieces of a puzzle together in a way that will result in reliable monthly income once client is retired. This regular income planning requires an in-depth knowledge of taxes, employer benefits, and retirement plan rules. Such knowledge often requires years of experience and training to accumulate.

An investment adviser will be able to offer advice on:

- When to take employer benefits in a way that is best for them
- What pension distribution choices are right for their client needs
- If an annuity is a suitable investment for any of their client
- The amount of retirement income one could reasonably expect to have
- What withdrawal rate is appropriate when withdrawing money from a traditional portfolio
- How much of the money should be in guaranteed investments
- What types of taxable income investments will generate
- How can investments be restructured to reduce taxable income in retirement
- If client should pay off mortgage before or during retirement
- If a reverse mortgage is a good option for the client
- Whether client should keep their life insurance policies or not

An investment adviser will *not* make recommendations until they understand the client's expected time horizon, their level of experience with investments, their goals, and their tolerance for investment risk. They will also want to understand the need for guaranteed income and get a thorough understanding of all the current resources such as assets, liabilities, and current and future sources of income.

The adviser *will* want to know where all the client investments are so that the investment portfolio, as a whole, will make sense and can be optimized to produce a steady stream of retirement income.

6.2 Calculations for Retirement Planning

Higher disposable incomes and easy availability of finance have increased the lifestyle of Indians. People who are in mid 30s are earning handsomely and have a comfortable lifestyle today. Children going in good school, have own house to live in and have a respectable social life. However, many of these lifestyle assets are mortgaged with lenders and one is burdened with many EMIs. All these expenses bundled with high education cost leave very less for retirement savings.

Further, the presence of inflation, i.e. the rate at which prices of all essential items increase every year, impacts one's purchasing power in future. An item of Rs 100 today will cost Rs 107 next year if inflation rate is 7%. This means that the expenses increases by this rate every year and one will have to shell out much more than what is required today to meet their living. So if one is spending Rs 10000 p.m. today to meet their living, to sustain the current living standard he/she will require Rs 54724 p.m. after 25 years (expected inflation of 7%). Add to this, the risk of longevity i.e. the increase in the life expectancy, the retirement years can be really painful if not planned in advance.

Retirement corpus required

A person generally gets concerned when he/she sees the high amount of retirement corpus required for their golden years. Sometimes what they ask is beyond their means. But, one should take into consideration that retirement living is always based on ones existing lifestyle which he/she builds. Since inflation decreases the value of money (i.e. the purchasing power of money) the corpus requirement in future will always be higher for maintaining the same standard of living.

Estimating the future requirements is necessary to ensure appropriate planning for later years of life. Although, the expenses at retirement are generally lower than the current expenses, as one is free from loan liabilities and children's goals, the high cost of medication at higher age, however, should be considered while planning. One can estimate that expenses at retirement are roughly 50%-60% of one's existing expenses if there are not any liabilities.

To calculate the retirement corpus one have to consider the longevity of life. One may expect life till 75 years but may live beyond 80 years of age, which may add another 5-10 more years.

Given below is an estimation of retirement corpus for an individual who is at the age of 35 years and wishes to retire at the age of 60 years. Here, life expectancy is assumed till the age of 85 years.

	Scenario 1	Scenario 2	Scenario 3
Monthly Income (Rs) [GIVEN]	20000	30000	50000
Monthly Expense (Rs)	15000	25000	40000
Monthly expense for Retirement (say, 60%) (Rs)	9000	15000	24000
Inflation rate p.a.	7%	7%	7%
No. of Years to retire (60-35)	25	25	25
Monthly expense at retirement (Rs)	9000*(1.07)^25= 48847	15000*(1.07)^25= 81411	24000*(1.07)^25= 130258
Life expectancy post retirement (in years)	85	85	85
No. of Years post Retirement (85-60)	25	25	25
Post Retirement Inflation expected	6% p.a.	6% p.a.	6% p.a.
Return on the retirement corpus	8% p.a.	8% p.a.	8% p.a.
Retirement Corpus Required (Rs)#	**1.17 cr**	**1.95 cr**	**3.11 cr**

For calculating Retirement Corpus, Present Value Formula in excel is used.

Formula: =PV(rate, nper, pmt, [fv], [type])

The PV function uses the following arguments:

Argument	**Meaning**	**Inputs as per the above Example**
rate (required argument)	The interest rate per compounding period. A loan with a 12% annual interest rate and monthly required payments would have a monthly interest rate of 12%/12 or 1%. Therefore, the rate would be 1%.	Inflation adjusted return on the retirement corpus is {(1+8%)/(1+6%)-1} p.a. i.e. 1.89% p.a. This is equivalent to 1.89%/12 p.m. [This is same in all scenarios]
nper (required argument)	The number of payment periods. For example, a 3-year loan with monthly payments would have 36 periods. Therefore, nper would be 36 months.	Expected post retirement years is 25 years i.e. 300 months (25*12). [This is same in all scenarios]
pmt	The fixed payment per period.	As calculated in above table:

Argument	Meaning	Inputs as per the above Example
(required argument)		Scenario 1: - Rs. 48847 Scenario 2: - Rs. 814111 Scenario 3: - Rs. 130258 [Since these are cash outflows i.e. expenses, the amounts are prefixed with a 'minus' sign]
fv (optional argument)	An investment's future value at the end of all payment periods (nper). If there is no input for fv, Excel will assume the input is 0.	This is left blank.
type (optional argument)	Type indicates when payments are issued. There are only two inputs, 0 and 1. If type is omitted or 0 is the input, payments are made at period end. If set to 1, payments are made at period beginning.	The payments are considered to be made at the end of each period. Thus, it is taken as 0 (i.e. left blank).

The above data clearly shows the impact of inflation and indicates the need of retirement planning at an early stage. Procrastination or delay in planning impact the savings required for reaching the estimated corpus.

The below table shows how the requirement for savings increases manifold when one delays the contribution towards retirement corpus. This can strain the finances in later years considering presence of other important goals and liabilities to meet.

	Scenario 1	**Scenario 2**	**Scenario 3**
Retirement Corpus required (Rs) [GIVEN]	1.18 crore	1.18 crore	1.18 crore
Age to start Investment (Yrs)	30	35	40
Time horizon of investing till retirement (Yrs)*	60-30 = 30	60-35 = 25	60-40 = 20
Returns Assumed (%)	12	12	12
Monthly Savings required to reach the Corpus (Rs)#	**3376**	**6280**	**11928**

*Retirement age is 60 years.

For calculating monthly savings required to reach the corpus, PMT function in excel has been used.

Formula: =PMT(rate, nper, pv, [fv], [type])

The PV function uses the following arguments:

Argument	Meaning	Inputs as per the above Example
Rate (required)	The constant interest rate per period. It can be supplied as a percentage or a decimal number. For example, if one makes annual payments on a loan at an annual interest rate of 10 percent, use 10% or 0.1 for rate. Similarly, if one makes monthly payments on the same loan, then use 10%/12 or 0.00833 for rate.	It is given as 12% p.a. i.e. 12%/12 per month. [This is same in all scenarios]
Nper (required)	The number of payments for the loan, i.e. the total number of periods over which the loan should be paid. For example, if one makes annual payments on a 5-year loan, input 5 for nper. Similarly, if one makes monthly payments on the same loan, then multiply the number of years by 12, and use (5*12) 60 for nper.	As calculated in above table: Scenario 1: 30 years i.e. 360 months Scenario 2: 25 years i.e. 300 months Scenario 3: 20 years i.e. 240 months
Pv	The present value, i.e. the total amount that all future payments are worth now. In case of a loan, it is simply the original amount borrowed.	This is left blank.
Fv	The future value, or the cash balance you wish to have after the last payment is made. If omitted, the future value of the loan is assumed to be zero (0).	The retirement corpus required at the time of retirement is given as Rs. 1.18 crore. [This is same in all scenarios]
Type (optional)	It specifies when the payments are due: 0 or omitted - payments are due at the end of each period. 1 - payments are due at the beginning of each period.	The payments are considered to be made at the end of each period. Thus, it is taken as 0 (i.e. left blank).

Benefits of stepping up Investment in the accumulation years

Accumulation years are filled with uncertainties. An emergency may arise which force to defer the contributions planned for retirement. There may be liabilities running which impact the savings ability. Any of such situations will be a deterrent to retirement goals, knowing that most retail investors rely on regular savings to accumulate for the future goals.

Most of the investments towards retirement are fixed contributions and with limited savings. There is a probability that these fixed contributions fall short because one has insufficient of funds during the initial years of accumulation phase. One of the strategies to avoid these situations is stepping up the investment in accumulation years.

In a stepping strategy, one steps up their contributions periodically with regular payments or with a lump sum amount. In a periodic step up strategy an individual starts with a fixed investment but steps up by a certain percentage every year. Such stepping up of contributions helps in maximizing the savings for retirement. It can be done through investments in EPF, NPS or mutual funds.

For example:
If one is eligible for any employer sponsored plans like EPF, they can contribute to the maximum amount. Similarly, if one is aged 50 years and above and wishes to boost savings, can consider investing through Voluntary Provident Fund. This will help in maximizing gains in retirement accumulation stage since returns are tax exempted in this avenue.

If one has opted for NPS then there is no limit to invest. Beyond employers contribution one can invest any amount through various means of SIP or lump sum contribution plans to step up their investments either way.

Lastly, mutual funds offer an option of step up Systematic Investment Plans (SIPs) where through an automated feature, the SIP contributions are increased after a specific period, for instance, Rs. 5000 in 2023, Rs. 5000+10% in 2024 and so on. This is done taking into consideration of the current income, prospective yearly increments and of course, financial goals. This lays down a set plan for the investor to reach the predetermined investment amount over a period of time. The main attraction about SIP is convenience. Investors can automate the payments on their salary day. Suppose, if the income increases by 10%, then the investor can step-up their investment amount by at least 5% to 7%. With every annual bonus, hike or increment, one can step-up their SIP, adding more contributions to their retirement corpus.

In all the methods illustrated above, stepping up the contributions helps in reaching the required retirement goals with the limited resources available.

Let’s understand this from an example: Mr. A has to accumulate a retirement corpus of Rs 2.0 crore in 20 years. Assuming a rate of return of 12% per annum on his contributions, he will need a monthly fixed savings of Rs. 20,217 to reach the desired goal (using PMT formula in excel).

Now if he steps up his monthly contributions by 7% annually then he can start with lower contributions initially and increase on yearly basis. This will help him to optimize his savings.

Not all are able to generate higher saving initially. Starting with lower amount, the requirement increases with time, and thus one looses on compounding benefit. Stepping up strategy helps in increasing the investment proportionally as income increases leading to compounding of one’s wealth.

Impact of pre-retirement Withdrawals on retirement corpus

The statistics on EPF shows that many investors do not reach the retirement age with a good accumulation. Most of the accumulation in EPF is withdrawn before retirement for many other needs like children's education, marriage, medical emergencies, and house purchase. Though this avenue provides liquidity to the investors, it is still used by many when not in need.

Any withdrawal from retirement funds well before reaching the retirement will have a detrimental impact. The accumulation for retirement years will fall short of reaching the corpus if funds are withdrawn much early. Further, not having enough funds for the retirement years will force to either work for more years (i.e. postpone retirement) or adopt strategies to reduce your lifestyle so that the money can last longer than one have expected.

Let's consider the retirement product – Employees' Provident Fund (EPF). It is a long term investment where returns are compounded, and provides tax deduction benefits. If one withdraws from his EPF account in pre-retirement stage, it will hurt his EPF accumulation for retirement years.

For example if Mr. E withdraws Rs 75000 from his EPF balance, where he has still 30 years to retirement, he will potentially lose Rs 8.66 lakh if his EPF balance earns 8.5% p.a. for this period.

The above example clearly spells out the impact on the retirement fund if withdrawn early in pre-retirement stage. Even if one has financial difficulties while opting for such an option he/she needs to think whether he/she can fill the gap later and contribute more to reach their retirement corpus as planned and calculated.

Benefits of transferring retirement corpus from one employer to another

Retirement benefit products are structured for long term accumulation. The magic of compounding makes them an excellent product only when it is continued for long term. But there are situations like switching jobs where people end up losing this benefit as they are unable to shift the previous employer corpus.

Let us consider an example on EPF. While switching jobs, one may open a new EPF account with the new employer. If done multiple times, it results in multiple EPF accounts. Apart from having operational issues, this has a cascading effect due to taxation of the older EPF balances if certain conditions are not met. Also, one ends up losing the compounding benefit on the older corpus which would have added to the retirement goal substantially.

However, with UAN in force the rules of transferring EPF from one employer to another has eased out.[15] Now an employee can transfer EPF account from old employer to new

[15] Universal Account Number (UAN) is a 12 digit unique number allotted to each employee contributing to the Employees Provident Fund (EPF). This number remains the same for each employee throughout their life irrespective of the number of times they have joined new organisations.

employer completely online. But, to make it effective the employee has to ensure the UAN is updated along with KYC and personal details.

Contrary to EPF, NPS has easier process of shifting corpus to new employer while switching jobs since one cannot have multiple NPS accounts. Once a Permanent Retirement Account Number (PRAN) is generated with an employer the same PRAN can be used to shift the corpus to new employer, if that is also a registered entity. If not, then the employee can still continue the PRAN under 'All Citizen Model'.

- ***Taxability Clause***

As already discussed in Chapter 5, taxability on withdrawals of EPF balance is based on the number of years of employment. If the employee changes his employer in less than 5 years and withdraws his old EPF balance, then the withdrawal becomes taxable. In such cases, the employee can transfer his PF account balance of the old employer to the new employer without incurring any tax incidence. Also, transferring of old PF balance to the new PF account will result in including the service period with old employer to compute the employee's total service period.

Under NPS, taxability on partial or full withdrawal is subject to various conditions (refer Chapter 5 for details).

- ***Compounding Effect***

The other benefit of transferring the retirement corpus to new employer is compounding impact. Though NPS can be shifted without any difficulty, EPF has more stringent clauses. Unlike EPF, NPS can be converted to 'All Citizen Account' and one can continue the product for retirement. This is not the case with EPF.

The corpus lying with old employer will earn interest till the age of 58 years. However, the taxability of such corpus will depend upon certain criteria. Considering EPF is a long-term product with compounding interest and tax-free returns (upto certain limits), it is more beneficial when one continues to earn on the accumulated corpus. However, if one withdraws the old corpus without transferring the same to the new employer account, he has to start all over again with the new employer where the contribution requirement has already increased by then. One may or may not generate required savings now since they have other goals to plan. By adding the older corpus you remain to the same path which you have planned earlier and reach your desired goal without any major impact on other financial goals.

Thus, while switching jobs, transferring the existing retirement corpus from one employer to another is more beneficial and rewarding for meeting the retirement goal.

6.3 Criteria to evaluate various retirement benefit products

People often make mistake in selecting appropriate products for their retirement, which they have to shun later on. This impacts the retirement corpus they want to create through that product. It is important that any retirement benefit products should be evaluated on various parameters, before investing, to check its suitability to meet the end objectives.

One of the best ways to evaluate any retirement benefit products is to consider life stages. In general, there are three life stages around retirement.

Pre-retirement

This is the phase where objective is to accumulate. One is 15 to 20 years away from retirement. Though there are other goals, which have to be met, with higher disposable income and no excess income requirement, the risk appetite is higher. While evaluating retirement benefit products, one should look at products which allow money to grow even though downside risk may be there. The longer horizon will allow managing this risk by riding through cycles of downside. Any income benefit product may not be a viable option for this phase.

A retirement benefit product at this phase should be evaluated on the following factors:

1. Cost: Cost is one of the major factors in any long-term product. More the cost less is the earning and so the accumulation. In some products, the total cost may not be clear.
2. Return: Since the focus is on accumulation and ample time is available, the product should be able to generate returns, which can beat inflation and grow money.
3. Risk: There will be risk factors associated with a product which may offer higher returns. Understanding of these risks is absolutely important to ensure it aligns with one's risk tolerance.
4. Tax Efficiency: The impact of taxation can be high in long term products. Different products are treated differently under Income Tax provisions. Products where taxation impact can be reduced are considerable products for retirement.

Employee benefits like EPF/ NPS are long term products and fit into the criterion for a retirement benefit product. There are other long term products like PPF and a few categories of Mutual Fund schemes which are considered for retirement planning. Before making a selection, these products should be evaluated on the above factors.

Retirement

The second stage is when one has retired. At this stage, the need will change as there will be a requirement of steady income along with growth of the accumulated corpus. There may not be any time horizon for this income requirement as the need is for the lifetime.

2 types of products will be required – one which can generate income and other which can grow the corpus. For income generating products, evaluation should be done based on 2 factors:

1. Inflation: The income generated need to beat inflation to sustain the longevity risk. How much income is generated for lifelong and how it beats inflation are important areas to evaluate in any product.

2. Capital Protection: Along with income generation, the protection of the capital is also required. Any product, which generates income but fluctuates the capital may not be a viable option for this objective.

The second basket in this phase is the growth. The corpus needs to grow so that it can sustain longer. Here, long term products should be the choice as the horizon for this basket will be 10 to 15 years. The evaluation factors will remain the same as of pre-retirement phase but products may change. Now EPF, NPS may not be viable and so one may have to rely on PPF, certain categories of mutual funds and others.

Post Retirement

The third phase of the retirement planning is later years of life i.e. beyond 75 years. Now the objective shifts completely to generate the income, as long horizon to grow the money is no more viable. The protection of capital is the primary factor along with low return with least risk. These become the evaluation criteria for selecting any product in this phase. Also, one objective which adds now is leaving money for heirs where liquidity might be the primary factor.

6.4 Concept of Philanthropy

Philanthropy has been the talk of the town globally. The urge to do for others is not only limited to rich and wealthy, now many small income earners wish to contribute to their society. The reasons are not unexplained. India is the second largest population in the world. Being such a large country, it has to deal with many issues. The disparity between poor and rich is increasing as we are progressing. The poverty is on higher side and poor are not able to get the required attention. Unless the realm of poverty and issues of disabled are addressed, it is difficult for a country to march towards a real progress. However, this cannot be achieved by government initiatives alone, unless as a country everyone contributes to the cause.

In our country, slowly but steady, individuals with any amount of income are willing to contribute for the noble causes. Within their capacity, they are coming forward to donate part of their income to ensure the needy are being taken care of. This also gives a satisfaction that one has contributed their share for better development of surroundings.

For Investment Advisers: Communicating with their clients about their values and passions in life is a meaningful way to strengthen client relationships. It can also be enjoyable, and a natural part of building clients' trust in the Investment Adviser.

Below are the steps an Investment Adviser may follow to discuss philanthropy with their clients:

- **Starting the conversation**

Speaking with someone about their values does not have to be a serious, awkward conversation. In fact, it can be quite interesting. It is also an important opportunity to learn

more about clients and invite further, more meaningful interactions going forward. (see Box 6.1)

Box 6.1: Sample conversation between an Investment Adviser and a Client

The conversation might start by saying:

I'm pleased with what we've accomplished together in preparing you for retirement. We've met your financial objectives and I hope you feel secure about your financial plan.

Now is when we like to talk a bit about your personal and family values. If you're passionate about particular social or environmental causes, my team can help you address those values through a charitable giving plan. Is this something you'd be interested in talking more about?

Even if clients haven't given the topic much thought, advisers are at least opening the door to further discussion and providing them with advice and resources when they're ready.

- **Timing it right**

Choosing the right moment to introduce the topic of charitable giving can make the conversation flow easily. There are a number of situations that could naturally spark a conversation about Philanthropy, such as:

- A liquidity event, such as the sale of a business or an inheritance
- Whilst drafting or revisiting a will
- A life event, such as retirement, marriage or the birth of children or grandchildren
- During an annual client meeting

- **Following up**

Now that the Investment Adviser has raised the topic of charitable giving with his clients, it is up to the adviser to follow up.

While philanthropy is important to a lot of people in principle, it can easily fall to the bottom of a busy person's to-do list. If they have expressed genuine interest in developing a charitable giving strategy, the clients will expect the Investment Adviser to follow up with resources and next steps.

Module 8: Retirement Planning I Module-end Questions

1. Growth-oriented investments are suitable for which stage of retirement savings?
    a. Accumulation stage
    b. Distribution stage
    c. Income stage
    d. Investment stage

2. Inflation does which of the following to retirement planning?
    a. Reduces the periodic savings required
    b. Reduces the nominal return generated by an investment
    c. Increases the retirement corpus required
    d. Increases the value of the corpus created

3. The retirement corpus may require review:
    a. Every year
    b. Every time there is a significant change in financial situation
    c. Closer to the distribution period
    d. Not at all

4. Which of the following is a solution to manage inadequacy of retirement corpus closer to retirement?
    a. Invest in riskier assets
    b. Postpone retirement
    c. Reduce periodic savings
    d. Increase corpus target

5. How is gratuity amount paid to employees?
    a. As an annuity
    b. In a lump sum
    c. 1/3rd is commuted and the rest used to purchase an annuity
    d. It is credited to the EPFO account each year

6. What is the maximum tenure of the Reverse Mortgage Scheme?
    a. 30 years
    b. 25 years
    c. 20 years
    d. For the life of the borrower

7. Life expectancy directly affects which of the following features of the retirement goal?
    a. Period in retirement
    b. Monthly expenses in retirement

c. Remaining working years
d. Returns earned on the retirement corpus

8. In which of the following models of the NPS is the contribution always solely by the subscriber?
   a. Government model
   b. State government model
   c. Corporate model
   d. All citizens model

9. A subscriber to the NPS receives the pension for income in retirement from _____.
   a. An Annuity purchased on retirement
   b. The Corporate employer
   c. PFRDA
   d. The Government

10. Senior Citizens' Savings Scheme is available for the retired personnel of the Defence Services (excluding Civilian Defence employees) on attaining the age of 50 years, subject to fulfilment of other terms & conditions. State whether True or False.
   a. TRUE
   b. FALSE

MODULE 9: TAXATION[16]

Chapter 7: Concepts in Taxation
Chapter 8: Capital Gains
Chapter 9: Income from Other sources
Chapter 10: Taxation of Debt Products
Chapter 11: Taxation of Equity Products
Chapter 12: Taxation of Other Products
Chapter 13: Tax provisions for special cases

[16] This module has been prepared based on law as prevailing after the passing of July 2024 budget and as applicable for income occurring on or after July 23, 2024 for financial year 2024-25. Wherever required the provisions of the Finance Bill 2025 have been indicated separately.

CHAPTER 7: CONCEPTS IN TAXATION

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Key concepts of Taxation
- Residential Status
- Five Heads of Income and Clubbing of Income
- Set off and carry forward of losses
- Exemptions, Deductions and Rebate
- Double Tax Avoidance Agreement
- Taxation Regime, Maximum Marginal Rate of Tax and Effective Rate of Tax

7.1 Framework

Income tax in India is governed by the provisions of the Income Tax Act, 1961 (the Act) and comes under the Ministry of Finance. The matters relating to administration of the Act are assigned to the Central Board of Direct Taxes (CBDT).

The Income tax Rules, 1962 are framed to carry out the purposes of the Act. In addition to this, the CBDT also issues Circulars and Notifications as and when required. It becomes very important to understand the income tax implications while trading or investing in securities market. Gains arising on sale of securities may have different tax treatments depending on various factors such as the type of security, holding period, whether the transaction was done in capacity of trader or investor etc.

7.2 Key concepts

7.2.1 Previous year v/s Assessment year

India follows Financial Year (FY) (i.e. April 1 to March 31) for calculation of income for various purposes – be it for preparation of annual accounts or calculation of income tax.

Any particular financial year for which one wants to calculate the tax liability is termed as ‘previous year’ for the purposes of Income Tax Act. For instance, if one needs to calculate his taxable income for FY 2021-22, the Previous Year (PY) here will be the period from April 1, 2021 to March 31, 2022.

The financial year following relevant previous year is called the ‘Assessment Year’ (AY). Hence, in the above example, assessment year will be AY 2022-23.

Section 2(9) of the Act defines 'assessment year' as a period of 12 months commencing on the 1st day of April every year. Section 3 of the Act defines 'Previous year' as the financial year immediately preceding the assessment year.

7.2.2 Person

Section 2(31) of the Act defines person to include the following:

a) Individual
b) Hindu undivided family (HUF)
c) Company
d) Partnership firm including Limited Liability Partnership (LLP)
e) Association of Person (AOP) or Body of Individual (BOI), whether incorporated or not
f) Local authority
g) Artificial juridical person, not falling within any of the above categories.

Persons referred in (e), (f) and (g) above, shall be deemed as a person even if it is not formed or established or incorporated with the object of deriving income, profits or gains.

7.2.3 Assessee

Section 2(7) of the Income Tax Act defines the term assessee as the person who is liable for payment of taxes or any other sum of money under the Act. It also includes the person in respect of whom any proceeding has been initiated under this Act. Such proceedings may be in respect of income, loss or refund.

7.3 Income

Section 2(24) of the Income Tax Act provides an inclusive definition of income. It means, while any sum of money mentioned in the section 2(24) will be considered as income, any other sum which is not covered in this section can also be taxed if it is in the nature of income.

There are many clauses in the above mentioned section 2(24). The more relevant are:

- Profits and gains from business or profession
- Dividend
- Capital gains
- Gifts received from a non-relative which is covered by section 56
- Any movable or immovable property received at below the market price as per the provisions of section 56
- Certain perquisites arising out of employment

7.4 Residential status[17]

Residential Status of an Individual versus Citizenship:

In common parlance citizenship and residential status are often seen as one and the same concept. However, both of them are very different from each other. Also, residential status under Income Tax Act and that under FEMA needs to be seen separately.

[17]https://www.incometaxindia.gov.in/Tutorials/9.%20Non-resident.pdf

For instance, an individual may be a citizen of any other country but still can be a resident of India under the Income Tax Act. Again, basis the criteria given in FEMA, he may qualify as resident or a non-resident under FEMA. In this course, we will restrict our scope to residential status under the Income Tax Act.

In case of individuals, particularly non-residents, one needs to take all the three aspects i.e. citizenship, residential status under Income Tax Act and that under FEMA, before making investment decisions.

Below table summarises the broad differences in residential status of an individual under the Income Tax Act and under FEMA and its impact:

In India only	**FEMA**	**Income Tax Act**
When is the status to be determined	From day to day at the time of making an investment/remittance	Every financial Year
Based on	Number of days stayed in India in the preceding financial year but can be changed by the displayed intention at the current moment	- Stay in India during the concerned financial year as well as prior financial years - The number of days and tests can be different for Indian Citizens and/or PIOs
What does it Impact	Where and what he can invest in and remittances that he can make from India and bank accounts that he can open	Tax to be paid and tax deducted at source

Hence forth whenever we refer to a person as resident in India we would be referring to the residential status for income tax purposes only.

7.4.1 Residential Status of an individual under the Income Tax Act

Residential status for Income Tax Act has to be determined as per the provisions of section 6 of the Act. Income-tax liability of an assessee is calculated on basis of his *'Total Income'*. What is to be included in total income of assessee is greatly influenced by his residential status in India. *For example*, a person resident in India (irrespective of their citizenship) is liable to pay tax in India on his worldwide income. On the other hand, a person, who is a non-resident in India (may be a citizen of India) during the year, is liable to pay tax only on his Indian income. Total Income of an assessee can be computed only after determining his residential status as per provisions of section 6.

Hitherto, the residential status of an Individual was determined on the basis of his period of stay in India. However, with effect from Financial Year 2020-21, the residential status of

an Individual is determined on basis of his citizenship, period of stay in India and total income from Indian sources.[18]

An individual can be categorized into following residential status during the previous year:

a) Resident and ordinarily resident in India
b) Resident but not ordinarily resident in India
c) Non-Resident in India

An additional test has been introduced for Indian citizens under '**deemed resident**' category under *clause (1A)* of Section 6 with effect from Financial Year 2020-21. As per Section 6(1A) an Indian citizen is deemed as resident in India irrespective of his stay in India if his total income, excluding income from foreign sources, [hereinafter referred to as 'Indian Income'] exceeds Rs. 15 lakh during the previous year and he is not liable to tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature. Here, 'income from foreign sources' means income which accrues or arises outside India (except income derived from a business controlled in or a profession set up in India) and which is not deemed to accrue or arise in India. A deemed resident is always treated as Resident but Not-Ordinarily Resident.

7.4.2 Residential status of an Individual

The residential status of an Individual is categorised as follows:

Resident in India

Part 1: For Indian Citizens the following conditions to be considered for determining residential status:

An Indian Citizen is treated as resident in India:

(a) If he stays in India for 182 days or more during the relevant previous year; **or**

(b) If, being outside India, who comes on a visit to India during the previous year and his Indian Income is upto Rs. 15 lakhs and has been in India for 182 days or more or who leaves India during the previous year for the purpose of employment; or

(c) who leaves India during the previous year as a member of the crew of an Indian Ship and has been in India for 182 days or more and has been in India for 365 days or more in 4 preceding years;

(d) If, being outside India, who comes on a visit to India during the previous year and his Indian Income is exceeding Rs. 15 lakhs and has been in India for 120 days or more and has been in India for 365 days or more in 4 preceding years;

[18]The Finance Act, 2020 substituted the provisions for determination of residential status with effect from Financial Year 2020-21 (Assessment Year 2021-22).

(e) If not visiting India or leaving India and not covered by (a) above, been in India in a particular financial year for 60 days and has been in India in the four years preceding that year for a period amounting to 365 days or more;

(f) In case he is not covered by either of the 5 clauses above and Total income (excluding income from foreign sources) exceeds Rs. 15 lakhs and he is not liable to pay tax in any other country or territory by reason of his domicile or residence or any other criteria of similar nature

Part 2: Foreign nationals being a Person of Indian origin (defined as such if he or either of his parents or any of his grandparents were born in undivided India) will be treated as a resident in India:

(a) If he stays in India for 182 days or more during the relevant previous year; **or**

(b) If, being outside India, who comes on a visit to India during the previous year and his Indian Income is upto Rs. 15 lakhs and has been in India for 182 days or more and has been in India for 365 days or more in 4 preceding years; or

(c) If, being outside India, who comes on a visit to India during the previous year and his Indian Income is exceeding Rs. 15 lakhs and has been in India for 120 days or more and has been in India for 365 days or more in 4 preceding years;

(d) If not visiting India and not covered by (a) above has been in a particular financial year for 60 days and has been in the four years preceding that year for a period amounting to 365 days or more

Part 3: All other foreign nationals (other than persons of Indian origin) will be treated as a resident in India:

(a) If he stays in India for 182 days or more during the relevant previous year; **or**

(b) If he has been in India for 60 days or more (but less than 182 days) during the relevant previous year and for 365 days or more in 4 years preceding the previous year.

Resident but Not Ordinarily Resident

A resident individual will be treated as Not Ordinarily Resident (NOR) in India if he satisfies any one condition specified below:

a) He has been a non-resident in India for at least 9 out of 10 years immediately preceding the relevant previous year; or
b) He has been in India for 729 days or less during the period of 7 years immediately preceding the previous year; or
c) He has become a resident by virtue of clause (f) discussed in Part 1 under Resident in India section above.

If he does not satisfy any of the above-mentioned conditions, he is treated as Resident and Ordinarily Resident (ROR) in India.

Tax effect: Tax effect of being a resident and ordinarily resident, resident but not ordinarily resident or a non-resident is explained under Section 7.4.5 of this chapter.

7.4.3 Residential Status of HUF

The residential status of a HUF depends upon its place of control and management and residential status of its Karta.

Resident in India

An HUF is said to be resident in India in any previous year in every case except where during the year the control and management of its affairs are situated wholly outside India. If principal decision-makers of the HUF take even a single decision in India, the HUF will be considered a resident as 'part of its control and management' will be deemed to be situated in India.

Non-Resident

A HUF is deemed as a non-resident in India if during the previous year, the control and management of its affairs are situated wholly outside India.

Resident and Not-Ordinarily Resident

A resident HUF is further categorised into Not-Ordinarily Resident in India if any one of the following conditions is satisfied:

1. Manager of HUF has been a non-resident in India for at least 9 years out of 10 years preceding the previous year; or
2. Manager of HUF has been in India for 729 days or less during the period of 7 years preceding the previous year.

If neither of the above conditions is satisfied, the resident HUF will be treated as resident and ordinarily resident.

7.5 Scope of Income

Scope of total income according to the residential status of an assessee shall be as under:

Resident and Ordinary Resident

A resident assessee (Individual and HUF) shall be liable to pay tax in India on the following incomes:

a) Income received or is deemed to be received by him in India in the previous year by or on his behalf;
b) Income that accrues or arises or is deemed to accrue or arise to him in India during such year; and
c) Income accrues or arises to him outside India during such year.

In other words, its worldwide income will be taxable in India.

Resident and not Ordinary Resident

A resident but not ordinarily resident assessee (individual and HUF) shall be liable to pay tax in India on the following incomes:

a) Income received or deemed to be received in India in the previous year by or on his behalf;
b) Income accrues or arises or is deemed to accrue or arise to him in India during such year; and
c) Income accrues or arises to him outside India during such year if it is derived from a business controlled from India or from a profession set up in India.

In other words, only Indian income will be taxable in India.

Non-Resident

In case of a non-resident assessee, following incomes shall be taxable in India:

a) Income received or is deemed to be received in India in the previous year by or on his behalf; and
b) Income accrues or arises or is deemed to accrue or arise to such person in India during such year.

In other words, only Indian income will be taxable in India. Table 7.1 summarizes the Taxation of Income based on residential status of an assessee.

Table 7.1: Taxation of income based on residential status

Nature of income	Resident and ordinarily resident	Resident but not ordinarily resident	Non-resident
Income received or is deemed to be received in India	Taxable	Taxable	Taxable
Income accrues or arises or is deemed to accrue or arise to him in India	Taxable	Taxable	Taxable
Income accrues or arises outside India if it is derived from a business controlled from India or from a profession set up in India	Taxable	Taxable	Not-taxable
Any other Income that accrues or arises outside India (including income from a business controlled from outside India or from a profession set up outside India)	Taxable	Not-taxable	Not-taxable

Let us understand the residential status concept with a few examples:

Example 1: Mr. C, being an Indian Citizen, was working in London for some years. He returned to India in FY 2024-25. The details of his stay are given below:

Sr. No	Financial Year (i.e. April 01 to Mar 31)	Physical stay in India (no. of days)
1.	2024-25	298
2.	2023-24	264
3.	2022-23	70
4.	2021-22	70
5.	2020-21	50
6.	2019-20	50
7.	2018-19	34
8.	2017-18	40
9.	2016-17	60
10.	2015-16	52
11.	2014-15	40

Determine his residential status for FY 2024-25.

Answer:
Mr. C's stay in FY 2024-25 is more than 182 days. Hence, he is a resident. Now to check whether he is a not-ordinarily resident, he needs to satisfy any one of the following conditions:
Stayed 729 days or less in last seven years **or**

Being a non-resident in 9 out of 10 preceding years.

Mr C has spent 578 days in the 7 years preceding the financial year and hence satisfies the first condition. Mr. C is also a non-resident in nine out of ten preceding financial years. Hence, he is a resident but not ordinarily resident in India for FY 2024-25.

Example 2: Mr. A is a resident and ordinarily resident in India during the Financial Year 2024-25. He has a bank account in USA. There is an interest income on the balance lying in the offshore bank account. Will this account be taxable in India?

Answer:
Yes. Since, Mr. A is a resident and ordinarily resident, he will be liable to tax on his worldwide income in India.

(a) Will your answer be different if Mr. A was resident but not ordinarily resident in India in FY 2024-25?

Answer:
In that case, the interest income from USA bank account will not be taxed in India.

Example 3: Mr. Vilayati (a foreign national who is a person of Indian origin) who was overseas for 20 years and was non-resident in all these years, comes to India for employment on 1st April, 2024. After he came to India he will continue to stay in India for the entire year (s). He has been spending around 30 days in India in each of these years. He has bonds in that foreign country on which he earns interest in that foreign country.

(a) What is his residential status for FY 2024 -25, FY 2025-26 and FY 2026-27?

Answer:
Mr. Vilayati has stayed for more than 182 days in FY 2024-25. Hence, he is a resident. Now to check whether he is a "not-ordinarily resident", he needs to satisfy any one of the following conditions:

- Stayed 729 days or less in last seven years **or**
- Being a non-resident in 9 out of 10 preceding years.

Mr. Vilayati is a non-resident in nine out of ten preceding financial years. He has also spent less than 730 days during the preceding 7 years. Hence, he is a resident but not ordinarily resident in India for FY 2024-25 since he is required to satisfy only one of these conditions to be regarded as Not ordinarily resident.

The same position would continue for FY 2025-26. Hence, he would be resident but not ordinarily resident for FY 2025-26 as well.

Now, in FY 2026-27 his stay in India will be more than 182 days. As regards, the secondary tests, he will not be satisfying the condition of being non-resident in 9 out 10 preceding years since he is a resident in both FY 2024-25 and 2025-26. He has also spent more than 730 days in the preceding 7 financial years. He does not satisfy either of the 2 conditions laid down. Hence, he will be a resident and ordinarily resident for FY 2026-27.

(b) Is interest on bond taxable in India for FY 2024-25, FY 2025-26 and FY 2026-27?

Answer:
He is Resident but not ordinarily resident for FY 2024-25 and FY 2025-26, during which years the bond Interest is not taxable in India. From FY 2026-27, it will become taxable in India.

Example 4: Mr. Gora is a non-Indian Origin citizen of UK. He has been working in a permanent job in India since 2005. He has an appropriate work visa and has not travelled outside India since that time.

(a) Mr. Gora will become an Indian Citizen automatically after 10 years of staying in India. State whether True or False. Provide reason for the answer.

Answer:

False: Citizenship never comes automatically, no matter how many years one stays in a country.

(b) He is a "resident and ordinarily resident" in Financial Year 2024-25 for the purposes of Indian Income Tax Act, 1961. State whether True or False. Provide reason for the answer.

Answer:

True: As he stayed for more than 182 days for many years now.

(c) Mr Gora has rental income in UK. As a foreigner he will not pay any taxes on such Income in India. State whether True or False. Provide reason for your answer.

Answer:

False: As Resident and ordinarily resident (Tax) pays tax on their global income in India.

7.6 Five Heads of Income

In the Income Tax Act, income is classified under five heads of income, namely, salary, house property, business or profession, capital gain and other sources. Total income is an aggregate of income computed under these heads.

7.6.1 Income from Salary

Income Tax Act, 1961 defines the term 'Salary' under Section 17(1) to include wages, annuity, pension, gratuity, any fees, commission, advance of salary, perquisite or profits in lieu of salary, salary advance, leave encashment, employers' contribution to provident fund in excess of 12% of salary and contribution to pension scheme, contribution to Agniveer corpus, etc. The employers' contribution to NPS upto 14% of salary is deductible under section 80CCD (2) and Governments contribution to Agniveer corpus is deductible under section 80CCH even under the new Tax regime.

Certain important concepts under salary:

- Taxability of an income under this head pre-requisites existence of employee and employer relationship. In the absence of the employer-employee relationship, the income shall be assessable either as business income or income from other sources. It is pertinent to note that any benefit, whether monetary or otherwise derived by an employee in connection with his employment will be taxed under this head.
- The income under this head shall be taxable on due basis or receipt basis, whichever is *earlier*. Salary due from an employer to an employee shall be chargeable to tax even if it is not paid during the year. However, taxation of Employee Stock Options Plans (ESOPs) is an exception to this principle. Taxation of ESOPs is discussed in detail in Chapter 12.

Applicable deductions and exemptions on income from salary:

		Old Tax regime	New tax regime
12.	Standard deduction	Rs. 50,000	Rs. 75,000
13.	National Pension Scheme	Entire employer's contribution will be taxed as salary	Entire employer's contribution made will be taxed as salary
		Employee's contribution to NPS – section 80CCD(1B) – available upto Rs. 50,000	Not available
		Deduction u/s 80CCD (2) – upto 10% of the salary for private sector employees 14% for Government employees	Deduction u/s 80CCD(2) – upto 14% of the salary for private sector employees 14% for Government employees
14.	Employee's Provident Fund	Employer's contribution above 12% of salary is taxable Employees' contribution: section 80C	Employer's contribution above 12% of salary is taxable Section 80C is not available
15.	Superannuation	Where employer's contribution to all these three funds exceed Rs. 7,50,000 in aggregate, the excess will be taxed as salary income	
16.	Employee's Provident Fund		
17.	National Pension Scheme		

18.	Gratuity	**The computation of exempted amount of gratuity under section 10(10) for both the regimes is same:**
		• In the case of a government employee – any death-cum-retirement gratuity received by a Central Government / State government / local authority employee is fully exempt from tax (section 10 (10)
		• In case of employee covered under the Payment of Gratuity Act – Gratuity received is exempt to the extent of the least of the following –
		  ○ 15days' salary based on salary last drawn for every completed year of service or
		  ○ Rs. 20,00,000 or
		  ○ Gratuity actually received
		• In any other case not covered by the above, gratuity received on retirement, incapacitation, death, termination, resignation is exempt to the extent of the least of the following:
		  ○ Half month's salary for each completed year of service	

		○ Rs. 20,00,000 ○ Gratuity actually received	
19.	House Rent allowance	Exemption of house rent allowance is available to the extent of the least of the following: • House rent allowance received • Excess of rent paid over 10% of the salary • 50% of salary – (where the residential house is situated in Bombay, Calcutta, Delhi or Madras) or 40% of salary – in any other case	Not allowed under new regime
20.	Leave Travel Allowance	Allowed	Not allowed

There are many other allowances and perquisites which are taxable. The taxable value of the same is to be arrived at, based on the calculation formula given in the Income Tax Act and the Rules.

Example 1:

For instance, Mr. A is private sector employee with basic salary of Rs. 1 crore. His employer makes the following contributions:

Employer's contribution to:

EPF: 12,00,000

NPS: 14,00,000

Total contribution = Rs. 26,00,000

Employee's contribution to:

EPF is Rs. 12,00,000 for the year

NPS is Rs. 50,000 for the year

	Old Tax regime (Rs.)	**New tax regime (Rs.)**
Salary	1,00,00,000	1,00,00,000
Add: Employer's contribution to NPS [s. 17(1) (viii)]	14,00,000	14,00,000
Add: Employer's contribution to EPF	Nil	Nil

(since employer's contribution is upto 12% of salary, the taxable amount is Nil – section 17(1)(vi)		
Add: Aggregate of employer's contribution to superannuation fund, EPF and NPS to the extent to which it exceeds Rs. 750,000 [section 17(2)(vii)] (Rs. 26,00,000 – Rs. 7,50,000)	18,50,000	18,50,000
Gross salary	**1,32,50,000**	**1,32,50,000**
Less: Standard deduction	(50,000)	(75,000)
Net Salary (A)	**1,32,00,000**	**1,31,75,000**
Less: Employee's contribution to EPF u/s 80C	(1,50,000)	Nil
Less: Employee's contribution to NPS (section 80CCB(1B))	(50,000)	Nil
Less: Employer's contribution to NPS (10% of salary for old regime, 14% of salary for new regime) (section 80CCD(2))	(10,00,000)	(14,00,000)
Total deduction (B)	**(12,00,000)**	**(14,00,000)**
Taxable income (A-B)	**1,20,00,000**	**1,17,75,000**

Effectively the employer's contribution to NPS has been fully taxed since it has been added back two times while calculating salary (once as salary and another time as perquisite) and deduction has been allowed only once.

Example 2:

Mr. B is a private sector employee with basic salary of Rs. 15,00,000. His employer makes the following contributions:

Employer's contribution to:

EPF: 21,600

NPS: 210,000

Total contribution = Rs. 390,000

Employee's contribution to EPF is Rs. 21,600 for the year

Employee contributes to NPS Rs. 50,000 and to PPF Rs. 150,000

	Old Tax regime (Rs.)	**New tax regime (Rs.)**
Salary	15,00,000	15,00,000
Add: Employer's contribution to EPF (since employer's contribution is upto 12% of salary, the taxable amount is Nil – section 17(1)(vi)	Nil	Nil
Add: Employer's contribution to NPS [s. 17(1) (viii)]	2,10,000	2,10,000

Add: Aggregate of employer's contribution to superannuation fund, EPF and NPS to the extent to which it exceeds Rs. 750,000 [section 17(2)(vii)] (since aggregate of contribution is within the limit of Rs. 7,50,000, there will be no addition)	Nil	Nil
Gross salary	**17,10,000**	**17,10,000**
Less: Standard deduction	(50,000)	(75,000)
Taxable Salary (A)	**16,60,000**	**16,35,000**
Less: Employee's contribution to EPF u/s 80C and contribution to PPF	(1,50,000)	Nil
Less: Employee's contribution to NPS (section 80CCB(1B))	(50,000)	Nil
Less: Employer's contribution to NPS (10% of salary for old regime, 14% of salary for new regime) (section 80CCD(2))	(1,50,000)	(2,10,000)
Total deduction (B)	**(3,50,000)**	**(2,10,000)**
Taxable income (A-B)	**13,10,000**	**14,25,000**

Computation of Salary Income

The salary income shall be computed in the following manner:

Particulars	*Amount*
Basic Salary	xxx
Add: Additions	
a) Allowances (to the extent of taxable amount) (will depend on new tax regime or old tax regime)	xxx
	xxx
b) Perquisites	xxx
c) Profit in Lieu of Salary	xxx
d) Retirement benefits (to the extent of taxable amount)	xxx
e) Pension	
Less: Deductions	(xxx)
a) Entertainment Allowance	(xxx)
b) Employment Tax	(xxx)
c) Standard Deduction	
Income chargeable under the head Salary	**Xxx**

7.6.2 Income from House Property

Income is taxable under the head 'house property' if it arises from a property consisting of any building or lands appurtenant thereto. For the computation of income under this head, a house property is classified into three categories of (a) self-occupied, (b) let-out, and (c) deemed let-out house property.

The rental income from immovable property is taxable under the head 'Income from house property' if the following conditions are satisfied:

Building or land appurtenant thereto

Income is taxable under this head if it arises from a property which consists of any building or lands appurtenant thereto. Though the word 'property' has a wide meaning, but for chargeability of income under this head, the property must consist of any building or land appurtenant thereto.

Example, if any income is derived from a vacant land then such income shall not be chargeable to tax under the head 'Income from house property' as the property does not consist of any building. Such rental income is chargeable to tax under the head 'profits and gains from business or profession' or 'Income from other sources'.

Under construction property is not a building and any income pertaining to it cannot be taxed under this head, but has to be taxed as Income from business or profession or income from other sources.

Ownership of property

Income from a building and land appurtenant thereto is chargeable to tax under the head 'house property' only in the hands of an owner. If a person, deriving rental income from a property, is not the owner of such property, then the income so derived shall be chargeable to tax either as business income or income from other sources but not as income from house property.

To become an owner of a property, a person must hold the legal title of the property in his name. He should be able to exercise the rights of the owner, not on behalf of the owner but in his own right. However, in a certain situation, despite not holding the legal ownership of a property, a person is considered as deemed owner of the property, and income from such property is chargeable to tax in his hands.

The most common example of such a case is where the building (and land appurtenant thereto) is owned by a cooperative housing Society and the member has a right to reside and enjoy the benefits of a specific unit in the building including the right to transfer that right of enjoyment.

Use of property

The annual value of the property is chargeable to tax under this head if the owner does not utilize the property to carry on his business or profession. Even if an assessee is engaged in the business of letting out of residential property, the rental income earned from such business is taxable as income from house property.

Computation of income from house property

For the computation of income from house property, a house property has to be classified into the following categories: (a) Self-occupied; (b) Let out and (c) Deemed let-out.

An assessee can at his option select any two houses (which are not actually let out) as self-occupied properties for tax purposes. Once this selection is done, any other house property will be considered as 'deemed let-out', if it is not actually let out

For instance, Mr. P owns four house properties – say house A, house B, house C and house D. He stays in house A, house B is let out. House C and D are not let out. In such scenario, House B will be treated as let out and rental income from the same will be taxed. Out of house A, C and D, he can select any two houses as 'self-occupied' house. Say he selects house A and D as self-occupied, then, house C will be considered as deemed let-out. Reasonable rent expected from house C will have to be offered to tax. In a situation where the tax payer has to make a choice of which two non let-out properties to choose as "self-occupied" it will be in their interest to choose those self-occupied properties where the reasonable rent is the highest. Another way to choose these properties could also depend on the interest payable on a loan taken to acquire the said property.

Broadly, the income from such house property is computed in the following manner:

Particulars	*Let-out*	*Self-occupied*	*Deemed Let-out*
Annual Value of the property (A)	xxx	-	xxx
Less: (-) Municipal taxes (B)	(xxx)	-	(xxx)
Net Annual Value [C = A – B]	**xxx**	**-**	**xxx**
Share in Net Annual Value [D = C * share in property]	**xxx**	**-**	**xxx**
Less: Standard Deduction (E) {30% of D above}	(xxx)	-	(xxx)
Less: Share of Interest on home loan (F)	(xxx)	(xxx)*	(xxx)
Income from house property [G = D – E – F]	**Xxx*** **	**Xxx** **	**Xxx*** **

* Limited to Rs. 2,00,000 under old tax regime. No deduction is allowed in the new tax regime. ** It will always be a loss equivalent to the amount of interest allowed as a deduction in the old tax regime. will always be Nil in the new tax regime.
*** If this results in a loss then upto Rs. 2 lakhs can be adjusted against other other heads of income under the Old tax regime. Under the New Tax regime, the set off of Rs. 2,00,000 against other heads of Income is not allowed.

Annual value:

- The annual value in case of a property treated as a self-occupied house property will be Nil
- Where the property is actually let out, the annual value is the reasonable expected rent receivable from the property or the rent actually received whichever is higher.
- Where the property is considered as deemed let-out, the annual value will be reasonable expected rent.
- Annual value in case of deemed let out property or let out property is calculated after deduction of Municipal taxes actually paid by the owner.
- Interest on home loan can be claimed as deduction as mentioned in subsequent paragraph. This deduction is not available in respect of self-occupied property under the new tax regime.

- Consequently, under the old tax regime the income from self-occupied property will be negative as the annual value will be nil minus the interest payable on the loan taken to acquire such property subject to a maximum of Rs. 2,00,000. This negative value equal to the loan interest is widely thought of as a deduction from income. It is actually a calculation of negative "Income from House Property" that is allowed to be set-off against salary or business income or any other income. This deduction for self-occupied property is not available under the new tax regime and hence the calculation of Income from house property for self-occupied properties will always be Nil under the New tax regime

Deductions allowed from annual value:

1. **Municipal taxes:** As already mentioned earlier, any taxes levied by the local authority are allowed as deduction for let-out properties and for deemed let-out properties provided they are actually paid by the owner of the property.
2. **Net annual value:** It is defined as Annual Value minus Municipal Taxes to the extent allowed.
3. **Standard deduction (section 24(a)):** A standard deduction upto 30% of the net annual value is available.
4. **Interest on borrowed capital (section 24(b)):** Interest on capital borrowed for the purpose of purchase, construction, repair, renewal or reconstruction of house property will be allowed as deduction. In respect of self-occupied property – it is limited to Rs. 2,00,000 under the old tax regime and is not available under the new tax regime.

    - In case of let out or deemed let out properties, there is no maximum limit on allowability subject to set-off and carry forward provisions relating to the same.
    - Interest on self-occupied property is subject to following limits under the old tax regime
        - Where the self-occupied property is acquired or constructed on or after April 1, 1999 and the construction or acquisition is completed within 5 years of taking loan, the interest on such loan will be allowed to the maximum of Rs. 200,000. In such case, the assessee needs to furnish a certificate from the lender specifying the amount of interest payable.
        - However, for the tax payer, If the under-construction period exceeds five financial years (as happens many times), the interest allowed as deduction under the old tax regime on the self-occupied property will be allowed only upto Rs. 30,000 even after the construction is completed

    Interest during construction period: Interest during construction period refers to the interest paid on capital borrowed for the period prior to the financial year in which the property was acquired / purchased. Such pre-construction period interest is allowed in 5 equal instalments starting from the year when the property is acquired / constructed

Deemed owner

In certain situations, an assessee will be treated as owner of the property even when the property may not be in his / her name. Certain important ones are listed below:

- An individual who transfers the property to his or her spouse otherwise than for adequate consideration and which is not in connection with an agreement to live apart, will be treated as deemed owner of the said property for the purpose of this calculation of income from house property.
- The above provisions of deemed owner will also apply where the individual transfers the property to his / her minor child.

Example 1:
Facts: Mr. A is a salaried employee and owns a house property which is taken on loan as follows:

	Amount (Rs.)
Taxable salary income	15,00,000
Interest on Home loan for self-occupied property	5,00,000
EPF/Life Insurance/School Fees for Children	1,80,000

Determine his taxable income.

Answer:

Particulars	**Old tax regime Amt (Rs.)**	**New tax regime Amt (Rs.)**
Income from salary	15,00,000	15,00,000
Income from House Property:		
Self-occupied Property		
Annual Value (taken as NIL)	NIL	
Less:		
Standard Deduction @ 30% of Annual Value	-	
Interest payable on Home Loan is Rs. 5,00,000		-
Maximum deduction (interest on loan taken for self-occupied property is not allowed under new tax regime)	(2,00,000)	Nil
Gross Total Income	13,00,000	
Less: Deduction under section 80C (Rs. 180,000, subject to maximum of Rs. 150,000)	(1,50,000)	
Taxable Income	**11,50,000**	**15,00,000**

Example 2:
Mr. A is a salaried employee owning a house which he has given on rent. His income details are as follows:

	Amount (Rs.)
Taxable salary income	Rs.15,00,000
Rental from the property	Rs.2,20,000
Interest on Home loan for the rented property	Rs.5,00,000
EPF/Life Insurance/School Fees for Children	Rs.1,80,000

Determine his taxable income and amount to be carried forward.

Answer:
Taxable Income

Particulars	Taxable Income		
	Amt (Rs.)	Old tax regime Amt (Rs.)	New tax regime Amt (Rs.)
Income from salary (A)		15,00,000	15,00,000
Income from House Property:			
Rented Property			
Annual Value		2,20,000	2,20,000
Less:			
Standard Deduction @ 30% of Annual Value		66,000	66,000
Interest payable on Home Loan	5,00,000	(5,00,000)	(5,00,000)
No restriction on deduction of interest on let out property			
Income from house property		(3,46,000)	(3,46,000)
Maximum loss allowed to be set off during the current year against other head of income (B)		(2,00,000)	0*
Gross Total Income (A-B)		13,00,000	15,00,000
Less: Deduction under section 80C restricted to Rs. 1,50,000		1,50,000	Nil
Maximum Allowed			
Taxable Income		**11,50,000**	**15,00,000**
Balance loss from house property carried forward* (3,46,000 - 2,00,000 = 1,46,000)	1,46,000		

* Interest on house properties: Carry forward of the loss of the same amount (i.e. Rs. 1,46,000 in this example) is allowed under old regime and new regime as well. However, carried forward loss under the head house property can be set off only against income from house property in subsequent years under the new tax regime. The concept of carry forward of losses is explained in later section of this chapter.

7.6.3 Profit and Gains from Business or Profession

When an assessee carries on any business or profession, the income arising from such business or profession shall be calculated and taxed under the head 'Profit and Gains from Business or Profession'.

Meaning of business

Income Tax Act provides an inclusive definition of a business under Section 2(13) that "Business includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture."

However, the term business does not necessarily mean trade or manufacture only. The word 'business' has a comprehensive meaning and may be used in many different connotations. Business connotes some real, substantial and systematic or organised course of activity or conduct with a set purpose. It means an activity carried on continuously and systematically by a person by the application of his labour and skill to earn an income.

Computation of business income

As a general rule, all revenue receipts arising in the course of business shall be taxable under the head profits and gains from business or profession. Section 28 of the Income Tax Act provides an inclusive list of all receipts or income which is chargeable to tax under this head. The business profits shall be computed according to the method of accounting regularly employed by the assessee. Thus, if assessee follows the cash system of accounting, profits shall be computed on a receipts basis, while in the mercantile system, it should be computed on an accrual basis.

Income Tax Act allows certain types of assessees to compute income from business or profession on a presumptive basis. However, a person earning income in nature of commission or brokerage cannot opt for such a presumptive taxation scheme.

The business income under the normal provision shall be computed in the following manner:

Particular	*Amount*
Revenue receipts	xxx
Capital receipts which are specifically covered	xxx
Less:	
1. Revenue Expenditures	xxx
2. Capital Expenditures which are specifically allowed as a deduction	xxx
3. Depreciation	xxx
4. Expenditures allowed on payment basis	xxx
5. Expenditures allowed on fulfilment of certain conditions	xxx
Taxable Income from business or profession	**xxx**

The business income under the presumptive scheme shall be computed in the following manner:

Particulars	*Amount*
Total turnover or gross receipts of business or profession	xxx
Presumptive income as a percentage of turnover or receipts or otherwise	xxx
Less:	
Expenditures which are specifically allowed as a deduction	xxx
Presumptive Income from business or profession	**xxx**

Speculative and Non-speculative business income

While computing the income under the head 'profits and gains from business or profession', a business transaction has to be classified into 'speculative' and 'non-speculative'. As per Section 43(5) of the Act, a transaction of purchase or sale of any commodity (including stock and shares) is considered as a 'speculative transaction' if it is periodically or ultimately settled otherwise than through the actual delivery. However, where a transaction is entered into to safeguard against losses (i.e., hedging transaction) or a transaction in derivatives (including commodity derivatives) is also not considered as a speculative transaction.

Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, such business is treated as speculative business. The provisions for computation of profit and tax rates are the same in case of a speculative and non-speculative business except treatment of losses. If any loss is suffered from speculative business, it cannot be set off or adjusted against any profit from the non-speculative business. Further, such losses can be carried forward for 4 years only in contrast to 8 years allowed for non-speculative business losses.

7.6.4 Income from Capital Gains

Any profit or gain arising from the transfer of a capital asset is taxable under the head 'capital gains' in the previous year in which such transfer takes place. Determination of income taxable under the head capital gains depends upon various factors such as period of holding, cost of acquisition, full value of consideration, nature of asset etc. The nature of capital gain, that is, short-term or long-term, is determined on the basis of period of holding of the capital asset. (refer *Chapter 8* for detailed discussion*)*
However, every transfer of a capital asset does not give rise to taxable capital gain because some transactions are either not treated as 'transfer' under Section 47 or they are excluded from the meaning of a capital asset (i.e., rural agricultural land), or they enjoy exemption under Sections 54 to 54GB.

The short-term and long-term capital gain arising from transfer of a capital asset is computed in the following manner:

Computation of short-term capital gain	
Full value of consideration	xxx
Less:	

a) Expenditure incurred wholly and exclusively in connection with the transfer	(xxx)
b) Cost of acquisition	(xxx)
c) Cost of improvement	(xxx)
d) Capital gain taxable under Section 45(4) which is attributable to capital asset remaining with the firm, AOP or BOI after reconstitution	(xxx)
e)	
f) Exemption under Sections 54B, 54D, 54G and 54GA	(xxx)
Short-term capital gain or loss	**Xxx**
Computation of long-term capital gain	
Full value of consideration	Xxx
Less:	
a) Expenditure incurred wholly and exclusively in connection with transfer	(xxx)
b) Cost of acquisition	
c) Cost of improvement	(xxx)
d) Capital gain taxable under Section 45(4) which is attributable to capital asset remaining with the firm, AOP or BOI after reconstitution	(xxx)
e) Exemption under Sections 54 to 54GB	(xxx)
Long-term capital gain or loss	**Xxx**

7.6.5 Income from Other Sources

Where a particular income cannot be categorised under any of the four heads of income, it will be taxed under this head, provided the said income is otherwise not exempt from tax. However, certain income are always taxable under the head 'income from other sources'. Thus, income taxable under this head is an aggregate of certain incomes which are specifically taxed under this head and other incomes which are not chargeable under any other head, hence, chargeable under this head. *(refer Chapter 9 for detail discussion)*

Income taxable under the head 'income from other sources' shall be computed in the following manner:

Nature of Income	*Amount*
1. Dividend Income	xxx
2. Winning from lotteries, etc.	xxx
3. Winning from online games (in the nature of lotteries, etc.)	xxx
4. Interest on securities	xxx
5. Rental income of machinery, plant or furniture	xxx
6. Composite rental income from letting out of plant, machinery, furniture and building	xxx
7. Sum received under Keyman insurance policy	xxx
8. Interest on compensation or enhanced compensation	xxx
9. Advance money received in the course of negotiations for the transfer of a capital asset	xxx
10. Gifts to the extent taxable	xxx
11. Compensation on termination of employment or modification of terms of employment	xxx
12. Any money, immovable property or movable property received without consideration or at a consideration less than the prescribed stamp duty value/fair market value	xxx

13. Sum received under a life insurance policy (other than ULIP and keyman insurance policy) in excess of the aggregate premium paid during the policy term	xxx
14. Specified sum received (other than interest/dividend from SPV and rental income from REITs) by a unitholder from a business trust	xxx xxx
15. Any other income not taxable under any other head	xxx
Less: Attributable expenses (to the extent allowable)	(xxx)
Income from other sources	**xxx**

7.7 Clubbing of Income

A taxpayer is generally taxed in respect of his own income. However, the Income Tax Act deviates from this general provision in some cases and clubs income of other persons in taxpayer' income. The clubbing provisions have been enacted to counteract a generally prevalent and growing tendency on the part of the taxpayers to dispose of their property or income in favour of other persons in such manner that their tax-liability may either be avoided or reduced.

The income will first be computed in the hands of recipient under the relevant head after allowing all exemptions and deductions permissible under that head of income. Then the resultant income shall be clubbed in the hands of the transferor or beneficiary as per the provisions of section 60 to 64 of the Income Tax Act. The income computed under the relevant head in the hands of the recipient will be included in the total income of the transferor or beneficiary under the same head of Income. Thus, the clubbed income shall be retained under the same head in which it is earned. If the net result of the computation of income in the hands of the recipient is a loss, it shall also be clubbed.[19]

The provisions relating to clubbing of income are contained in Sections 60 to 64 of the Income Tax Act. These provisions are as follows:

a) Income from assets transferred to another person [Sections 60 to 63]
b) Income of another person to be included in the taxpayer's income [Section 64]

7.7.1 Income from assets transferred to another person

Transfer of Income without transferring the Asset [Section 60]

If any person transfers the income from any asset without transferring the asset, such income is included in the total income of the transferor.

Example: E holds 100, 10% redeemable debentures in Z Ltd. E assigns right to receive interest from 50 debentures in favour of his nephew 'N' and gifts 50 Debentures to his son 'P'. Since, E has transferred only the right to receive the income in favour of 'N' while as the income-producing asset remains his property. Therefore, interest income in respect of 50 Debentures shall be clubbed with the income of E as per provisions of Section 60. However, the interest earned from remaining 50 Debentures shall not be clubbed with the income of E as he has transferred both—the asset as well as the income from the asset.

[19]Circular No. 104, dated 19-02-1973

Section 60 has no application in this case. If son is a minor child, such income shall be clubbed with income of E as per provisions of Section 64.

7.7.2 Income of another person to be included in taxpayer's income [Section 64]

Income Tax Act contains provisions for clubbing of income of other person with the income of taxpayer. These situations arise when a minor child earns some income or when taxpayer transfers his asset to his spouse, son's wife, etc.

The clubbing provisions have been introduced to stop taxpayers from diverting a part of their income to the relatives in order to reduce tax burden. In order to prevent such tax avoidance, clubbing provisions have been incorporated, subject to certain exceptions, in respect of the income of the following persons:

a) Income of Spouse
b) Income of Son's Wife
c) Minor's Income
d) Income of any person or Association of persons
e) Income from property gifted to HUF

Example: Mr. A gifted Rs. 30,00,000 to his wife. Mrs. A earned interest income of Rs. 150,000 on the same. This interest is to be clubbed in the total income of Mr. A thereby offering it in his return of income. The tax rate on the same will be as per the income tax slabs of Mr. A and not his wife.

7.8 Set off and Carry forward of Losses

7.8.1 Loss under the head Capital Gains

Capital losses can be of two types – Short-term Capital Loss and Long-term Capital Loss. Though both the losses are computed under the same head of income, yet distinct provisions have been prescribed for set-off of these losses. Both the losses are computed and disclosed separately in the Income-tax Returns.

Intra-head Adjustment (within the head Capital Gains)

As a general rule, if there are several sources of income, falling under any head of income, the loss from one source of income may be set-off against the income from another source, falling under the same head of income.

However, long-term capital loss can be set-off only against long-term capital gains. It cannot be set-off against short-term capital gains, though both of them fall under the same head 'Capital Gains'. However, short-term capital loss can be set-off against any capital gain, whether short-term or long-term.

Inter-head Adjustment (against other heads of Income)

As a general rule, if after intra-head adjustment the net result under a head of income is a loss, the same can be set-off against the income from other heads in the same previous

year. However, a capital loss, whether short-term or long-term, cannot be set-off against income taxable under any other head.

Carry forward of losses

If capital loss could not be set-off against the eligible capital gains because of the inadequacy of income during the current year, it can be carried forward and set-off against the relevant capital gains of the subsequent year. The short term and long-term capital loss, which could not be set-off during the year, shall be carried forward separately. In subsequent years, the short-term capital loss can be set-off against the short term or long-term capital gain but the brought forward long-term capital loss shall be set-off only against long term capital gains.

The losses can be carried forward for 8 Assessment Years immediately following the year for which the loss was first computed.

The losses can be carried forward only if the return of income is filed on or before the due date of filing original return under section 139(1). However, the assessee can apply to the Assessing Officer or the CBDT for condonation of delay in filing of return of income. (see Table 7.2)

Table 7.2: Loss under the head Capital Gains

Type of Loss	How to Set-off the loss?	Adjustment Against	Time Limit
Long-term Capital Loss	Intra-head Adjustment of loss	Long-term Capital Gains	Same Year
Long-term Capital Loss	Inter-head Adjustment of loss	Not Allowed	-
Long-term Capital Loss	Carried Forward Losses	Long-term Capital Gains	Within 8 Years
Short-term Capital Loss	Intra-head Adjustment of loss	Any capital gains, whether short term or long term	Same Year
Short-term Capital Loss	Inter-head Adjustment of loss	Not Allowed	-
Short-term Capital Loss	Carried Forward Losses	Any capital gain, whether short term or long term	Within 8 Years

7.8.2 Loss under the head profits and gains from business or profession

Income Tax Act provides distinct provisions for set-off and carry forward of speculative loss and non-speculative loss. Loss from speculative transactions can be set-off only against profit from speculative transactions. Whereas, the normal business loss can be set-off from any income other than salary and income from gambling activities.

If the loss couldn't be set-off in the current year due to inadequacy of profit under other heads of income, same shall be carried forward for set-off in the subsequent year. Speculative loss and non-speculative loss can be carried forward for 4 years and 8 years respectively. In subsequent years, the speculative loss can be set-off only against speculative profit. Whereas, the normal business loss can be set-off against non-speculative as well as speculative income. (see Table 7.3). While computing business loss,

unabsorbed depreciation will be treated as a separate item and will be allowed to be carried forward for any number of years and can be set-off against any income except salary.

7.8.3 Losses under the head 'income from house property'

Loss from one house property can be set off against income from another house property during the same year.

Where the house property loss cannot be set off under the same head during the year, it can be set off against incomes under other heads but set off is restricted to Rs. 2 lakhs for any financial year in the old tax regime. The set off against the other heads of income is not allowed under the New Tax regime but is deemed to have been allowed. Please refer to the section on house property for practical examples on the same.

The unadjusted loss can be carried forward till next 8 years and can be set off only against income from house property in the subsequent year.

7.8.4 Loss under the head other sources

The loss under the head other sources can be set-off against any income under any head except income from gambling activities. However, if loss under the head other sources cannot be set-off in the current year due to inadequacy of income under other heads then the same shall not be allowed to be carried forward to subsequent years. Table 7.4 lays out a comprehensive summary of set-offs and carry forward of losses.

Table 7.4: Set-off and Carry Forward of Losses

Sr. No	Type of loss	Set off in the same financial year	Maximum period upto which unadjusted loss can be carried forward	Set off in subsequent previous year allowed against
1.	House Property	Old Tax regime - Any income under any head of Income (set off restricted to Rs. 200,000) New Tax regime - This set off is not available if the assessee opts for new tax regime u/s 115BAC but is deemed to have been set off	8 years	Income from House Property
2.	Business or Profession (other than speculation/specified	Any income under any head except salaries	8 years	Business income only

Sr. No	Type of loss	Set off in the same financial year	Maximum period upto which unadjusted loss can be carried forward	Set off in subsequent previous year allowed against
	business or depreciation)			
3.	Speculation Loss	Speculation Profit Only	4 years	Speculation Profit Only
4.	Short-term Capital Loss	Any Capital Gain	8 years	Any Capital Gains
5.	Long-term Capital Loss	Long-term Capital Gain	8 years	Long-term Capital Gains
6.	Other Sources	Any income under any head of income (except income from gambling activities)	Cannot be carried forward	Unutilized loss not allowed for carry forward

7.9 Exempt incomes

Under Chapter III of the Income Tax Act, there are certain incomes which are exempt and are not to be included in computing the total income of the assessee. Chapter III of the Act covers section 10 to section 13B. (Refer annexure 2 for the partial list of exempt income)

7.10 Deductions under Chapter VI-A

In computing the total income, certain deductions are allowed from the gross total income. These deductions are allowed to encourage saving habits in individuals and pursue institutions to take part in social activities. These deductions are prescribed in Chapter-VIA of the Income Tax Act. (see Table 7.5)

Table 7.5: Deductions under Chapter VI-A of the Income Tax Act, 1961

Section	Nature of payment/income	Available to	Permissible deduction	Whether available in new regime
80C	Deduction for investments in insurance policies, repayment of principal portion of housing loan, contribution to certain small saving schemes, taxpayer contribution to pension funds, or fixed deposits.	Individual and HUF	Rs. 1,50,000*	No
80CCD(1)	Employee's or self-employed individual's contribution towards NPS	Individual	10% of salary in case of an employee	No

			otherwise 20% of gross total income	
80CCD(1B)	Contribution towards NPS by any individual	Individual	Rs. 50,000	No
80CCD(2)	Employer's contribution towards NPS	Individual	• Central or State Government employees: 14% of salary • Others: 10% of Salary	Yes 14% of Salary
80CCH	Contribution to Agniveer Corpus	Individual	100%	Contribution by Central Government allowed
80D	1. Medical Insurance 2. Contribution to Central Government Health Scheme (CGHS) 3. Preventive Health Check-up 4. Medical Expenditure	Individual and HUF	• Rs. 75,000 [where individual (incl. his family) is less than 60 years of age and his parents are senior citizen)] • Rs. 1,00,000 [where both individual (incl. his any member of family) and his parents are senior citizens]	No
80DD	Expenditure on medical treatment or pays an insurance premium for the benefit, of a family member suffering from disability.	Individual and HUF	Rs. 75,000 (Rs.1,25,000 in case of severe disability)	No
80DDB	Medical treatment of specified diseases	Individual and HUF	Rs. 40,000 (Rs. 1,00,000 for senior citizen)	No
80E	Interest on education loan for the higher education	Individual	Amount paid as interest on loan without limit	No
80EEB	Interest on loan to purchase an electric vehicle	Individual	Rs. 1,50,000	No

80G	Donations to specified institution or funds	All assessees	50%/100% of the net qualifying amount	No
80GG	Rent paid	Individual not receiving HRA	Rent paid in excess of 10% of total income or Rs. 5,000 per month or 25% of total income whichever is less	No
80QQB	Royalty (authors)	Individual-Author	Rs. 3,00,000	No
80RRB	Royalty (patents)	Individual	Rs. 3,00,000	No
80TTA	Interest on deposits in saving account	Individual and HUF	Rs. 10,000	No
80TTB	Interest on deposits with bank/ post office/co-operative societies	Senior citizen	Rs. 50,000	No
80U	Medical disability	Individual	Rs. 75,000 (Rs.1,25,000 in case of severe disability)	No

*Note 1: As per section 80CCE, the aggregate amount of deduction under section 80C, 80CCC and 80CCD(1) shall not, in any case, exceed Rs. 1,50,000.

7.11 Rebate under section 87A

Section 87A of the Income Tax Act provides a tax rebate of up to Rs. 12,500 to a **resident individual** whose total income during the previous year does not exceed Rs. 5,00,000. However, from Assessment Year 2024-25 onwards, if a resident individual opts for the new tax regime under Section 115BAC and his total income is up to Rs. 7,00,000, he can claim a higher amount of tax rebate of up to Rs. 25,000. It is proposed to further increase to a maximum of Rs. 60,000 by the Finance Bill 2025. If the total income just exceeds Rs. 7,00,000, marginal relief is allowed to the extent of the increase in tax payable by the total income exceeding Rs. 700000. This amount is proposed to be increased to Rs. 12,00,000.

Effectively, for incomes upto Rs. 7,28,000 the tax payable will be the amount by which the income exceeds Rs. 7 lakhs. Proposed in the Finance Bill 2025, it will be that for incomes upto Rs. 12,71,250 the tax payable will not exceed the amount by which the taxable income exceeds Rs. 12,00,000/-

The rebate under Section 87A is not available from tax payable as per section 112A in respect of long-term capital gains arising from the transfer of equity shares, units of equity-oriented mutual funds, certain ULIPs or units of business trust which are chargeable to STT and tax on the accumulated balance of a recognised provident fund as referred under Section 111.

7.12 Gross Total Income

Section 80B(5) of the Income Tax Act provides that 'Gross Total Income' means the total income computed in accordance with the provisions of the Income Tax Act before making any deduction under Chapter VI-A. (refer Table 7.1) Gross total income of an assessee is computed in the following steps:

Step 1: Calculate income under five heads of income

In the Income Tax Act, the income is computed in the following five heads of income:

a) Salary
b) House Property
c) Profits and gains from business or profession
d) Capital Gain
e) Income from Other Sources

Step 2: Club income of other persons

A taxpayer is generally taxed in respect of his own income. However, in respect of certain income, the Income Tax Act deviates from this general provision and clubs income of other persons in taxpayer's income. Hence, an assessee has to add the income of another person with his own income if clubbing provisions apply in his case.

Step 3: Set-off the losses of the current year or earlier years

If the assessee has incurred losses under any head of income then he is allowed to make the following adjustments subject to relevant provisions relating to set-off and carry forward of losses:

a) Intra-head adjustment, i.e., set-off of losses from one source of income against income from another source taxable under the same head of income as described earlier.
b) Inter-head adjustment, i.e., set-off of losses from one head of income against income taxable under another head of income as described earlier.

If losses cannot be set-off in the same year due to inadequacy of eligible income, then such losses are carried forward to the next assessment year as described earlier.

7.13 Total Income

An assessee is allowed to claim various deductions from the 'Gross Total Income' on account of investments and savings made by him. The balance income remaining after claiming the deductions is called 'Total Income', which shall be the base for calculation of tax liability.

7.14 Computation of Tax Payable

7.14.1 Non-corporate Assessee

For calculation of tax in respect of income of the non-corporate assessees, the tax shall be calculated as per the applicable tax rates and special tax rates. (refer Annexure 1 for tax rates) Assessee being an Individual, HUF has an option to compute tax at the concessional tax rates prescribed under Section 115BAC, as the case may be, subject to fulfilment of certain conditions.

The tax so computed on total income is further increased by surcharge (if applicable) and Health & Education Cess and reduced by the amount of AMT credit, relief under section 89 or foreign tax credit to arrive at net tax liability. The net tax payable by the assessee shall be increased by the amount of interest and late filing fees (if any). Thereafter, the taxes already paid by the taxpayer in the form of Advance Tax, TDS, TCS or Self-assessment tax shall be deducted from the aggregate tax liability to compute the amount of tax payable by or refundable to taxpayer.

7.15 Double Tax Avoidance Agreement

Different countries may have a different mechanism for levy of tax on the income of a person. Generally, countries follow the principle of residence-based taxation or source-based taxation for levy of income-tax. The principle of 'Residence based Taxation' gives primary taxing rights to the country of residence of the assessee whereby worldwide income of an assessee is taxed in the country in which he is a resident. The 'Source-based Taxation' rule confers right to tax to a particular income to the country where the source of the said income is located. To elaborate, the source, a country seeks to tax the income within its territory even when such income belongs to a person who is not the resident of such a country. India follows the dual approach whereby on one hand, a person resident in India is liable to pay tax in India on his total worldwide income. On the other hand, a person, who is non-resident in India during the year, is liable to pay tax only on his Indian income.

Because of these taxation principles, it might be possible that same income of a person is charged to tax in two different countries, i.e., residence country as well as source country which gives rise to double taxation of income.

For example, Mr. A, resident of India, has a house property in the US which is being let-out for Rs. 1,00,000 per month. Mr. A does not have any other income in India as well as in the US.

In this case, as Mr. A is resident of India, he shall be liable to pay tax in India on his world-wide income. Thus, rental income shall be charged to tax in India even though the source of income, i.e., the property is located in the US. Similarly, the US may also impose a tax on such income if it applies the concept of source-based taxation. Thus, the same income may be taxed in both the countries resulting in double taxation of income.

To avoid double taxation of income, countries enters into Double Taxation Avoidance Agreement (DTAA).

DTAA is basically an agreement which is entered into between two or more countries to avoid double taxation of income. With DTAA, countries can avoid double taxation by allocating the taxing rights or by giving credit for taxes paid in the source state by the residence state.

In most cases DTAAs provide relief from double taxation by the residence country giving right to claim credit for taxes paid to the source country.

Example 1: Mr. IS (Indian Student) is an Indian Citizen, 24 years of age, leaves India in December of 2024 for France to study a 2-year MBA course. He is a resident and ordinarily resident for FY 2024-25. He has never been outside India before. After his studies, he intends to work in France as long as he can in case he gets appropriate work Visa. Mr. IS earns money in France during the financial year 2024-25 doing odd jobs. He will be paying taxes on income in France. Will he have to again pay tax on such income in India?

Answer: Mr. IS is a resident and ordinarily resident in India for FY 2024-25. Hence, his global income will be taxable in India. His income earned in France will be taxed in India but he will also be entitled to credit of taxes paid in France, since India is his country of residence.

Example 2: Mr. Vilayati who is in overseas, say UK for 20 years and was non-Resident (Tax) in all these years, comes to India for employment on 1st April, 2024. He has bonds in that foreign country on which he earns interest in that foreign country. As discussed earlier, he will be resident and ordinarily resident in the FY 2026-27. Hence interest on bonds in UK will be taxed in India as well. Since, the interest income arises in UK, UK has the primary right to tax the interest income as it is the source country. The residence country i.e. India, will tax the interest income but will also allow credit of taxes paid in UK while computing total taxes payable in India.

7.16 Taxation Regime

EEE, EET and ETE are three basic terms which are commonly used in reference to the tax-saving investments. Where 'E' denotes Exempt and 'T' denotes Taxable. Investment is generally made with an intention to grow the capital which involves 3 stages:

Stage 1: When a person invests in any security.

Stage 2: When such investment yields interest or returns.

Stage 3: When a person transfers the security or withdraws the amount of principal *plus* interest.

So, if an investment provides tax benefit at all three stages, it will fall under the category of 'EEE' where the first exempt means that the investment qualifies for a deduction; the second exempt means that the return/interest on investment shall be exempt from tax; the third exempt means that no tax shall be levied at the time of transfer or at the time of withdrawal of principal or interest.

Similarly, if an investment provides tax benefit at the time of deposit and withdrawal but return on such investment is chargeable to tax then it will fall under the category of "ETE". Whereas, if an investment is chargeable to tax only at the time of transfer or withdrawal, then it will fall under the category of "EET". With the new tax regime disallowing most deductions many erstwhile EEE investments have turned into TEE investments.

The examples of EEE, EET and ETE investment are as follows:

Category	Investment
EEE	Public Provident Fund*
EET	Equity Linked Saving Schemes (ELSS)*
ETE	Tax saving Bank Fixed deposit for 5 years or more; Senior Citizen Savings Scheme*

* The first leg of E is not available under the new tax regime

7.17 Maximum Marginal Rate of Tax

Section 2(29C) of the Income Tax Act defines 'maximum marginal rate' as the rate of Income-tax (including surcharge and health & education cess) applicable in relation to the highest slab of income in the case of an individual, Association of Person or Body of Individual, as the case may be, as specified in the Finance Act of the relevant year. Thus, the Maximum Marginal Rate (MMR) shall be as under:

Particulars	***Rate (in %)***
Highest slab rate applicable in case of Individual	30
Add: Surcharge [(B) = (A) * 37%]	11.1
Add: Health & Education cess [(C) = {(A)+(B)} * 4%]	1.644
Maximum Marginal Rate (MMR)	**42.744**

7.18 Effective Rate of Tax

The term 'effective tax rate' is not defined under the Income Tax Act. In general, effective tax rate means a rate inclusive of surcharge and health & education cess which is leviable on the income of an assessee. The effective tax rate can be computed with the help of the following formulae:

Effective tax rate = Applicable tax rate × (1 + Rate of Surcharge) × (1 + Rate of Health & Education Cess)

Example: Effective tax rate in case of a partnership firm having income in excess of Rs. 1 crore would be 34.944% [i.e. 30% x (1 + 12%) x (1 + 4%)]

In case of an individual, who is liable to pay tax as per slabs, the effective tax rate shall be total income-tax as a percentage of total taxable income.

Example: Effective tax rate in case of an individual having an income of Rs. 20 lakhs and income tax payable of Rs. 4,29,000 would be 21.45% [Rs. 4,29,000/Rs. 20,00,000].

CHAPTER 8: CAPITAL GAINS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Basic concepts of Capital Gains
- Capital Asset and types of Capital Assets
- Transfer
- Computation of Capital gains from transfer

8.1 Basic Concepts

Any income arising from **transfer** of a **capital asset** is chargeable to tax under the head **'capital gains'**.

The important constituents under this head are – capital asset, transfer, sale consideration, cost of acquisition and the date of purchase and transfer.

8.2 Capital asset

Meaning of Capital Asset

As per Section 2(14) of the Income Tax Act, capital asset means:

a. Property of any kind, held by an assessee, whether or not connected with his business or profession;
b. Any securities held by a Foreign Institutional Investor (FII) which has invested in such securities in accordance with the SEBI Regulations.[20]
c. Any unit linked insurance policy (ULIP) to which exemption under section 10(10D) does not apply on account of the applicability of the fourth and fifth proviso thereof hereinafter referred to as 'high premium ULIP').[21]

Specific inclusions

All kind of properties, whether movable, immovable, tangible or intangible including rights of management or control of an Indian company is a capital asset. A capital asset could also include business undertaking, partner's share in a firm, a route permit, a leasehold right, right to get conveyance executed, right to subscribe shares of a company, goodwill, license to manufacture, gold, jewellery, securities, etc.

Exclusions

The following assets have been excluded from the definition of capital assets.

[20] The concept of Foreign Institutional Investor (FII) has been substituted by Foreign Portfolio Investor (FPI) by SEBI (Foreign Portfolio Investors) Regulations, 2014 which has also been substituted by the SEBI (Foreign Portfolio Investors) Regulations, 2019.

[21] Inserted by the Finance Act 2021 with effect from Assessment year 2021-22

- **Stock-in-trade** - Any stock-in-trade, consumable stores or raw material held for the purpose of business or profession have been excluded from the purview of capital asset.

- **Personal Effects** - Movable property held for personal use of the assessee or any member of his family, dependent on him, is not treated as capital asset. Example, wearing apparel, furniture, car, scooter, TV, refrigerator, musical instruments, gun, revolver, generator, etc., are personal effects, thus, they are not treated as capital assets.

  An article is considered as personal effects if it is intended for personal or household use by the assessee and not merely because these articles are capable of being put to personal or household use. All personal effects need not be used daily. So long as they are meant for personal use, they are considered as personal effects.

  However, the following assets, even if are meant for personal use, shall not be considered as personal effects and any gain arising from their sale shall be charged to tax:

  i. Jewellery (including ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals whether or not worked or sewn into any wearing apparel)
  ii. Precious or semi-precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel
  iii. Archaeological collections
  iv. Drawings
  v. Paintings
  vi. Sculptures
  vii. Any work of art

- **Agricultural land in India** - Any agricultural land situated in any rural area in India is not a capital asset. Thus, the following agricultural lands shall be considered as capital assets:

  a) Agricultural land situated in an urban area in India or within the prescribed limits from municipalities;
  b) Agricultural land situated in any foreign country.

- **Bonds** - Following Bonds have been excluded from the purview of capital asset:

  i. 6.5% Gold Bonds, 1977
  ii. 7% Gold Bonds, 1980
  iii. National Defense Gold Bonds, 1980
  iv. Special Bearer Bonds, 1991
  v. Gold Deposit Bonds issued under Gold Deposit Scheme, 1999
  vi. Deposit certificates issued under the Gold Monetization Scheme, 2015

Depending on the period of holding, an asset can be classified as long term capital asset or short-term capital asset.

8.3 Types of Capital Asset

For the purpose of computing capital gain, capital assets are classified into short-term capital assets or long-term capital assets. This distinction is important as incidence of tax is higher on short-term capital gains as compared to the long-term capital gains. The distinction between a long-term and short-term capital asset is based on the period for which an asset is held by the owner before transfer.

Short-term vs. Long Term Capital Asset

The Finance Act, 2024 w.e.f. 23rd July, 2024 has significantly amended provisions relating to capital gains taxation including period of holding and rates of taxation which will be discussed in the subsequent paragraphs. These provisions will be applicable for transfer of capital assets after 23rd July, 2024. For transfer of capital asset before the said date, the erstwhile provisions shall apply. For the purposes of this content we have assumed transaction on or after July 23, 2024.

Transfer of capital asset after 23rd July, 2024:

In general, a capital asset is deemed as 'short-term' if it is held by an assessee for a period of not more than 24 months, immediately preceding the date of its transfer. Similarly, a capital asset is considered as 'long-term' if it is held by an assessee for a period of more than 24 months, immediately preceding the date of its transfer.

Exception 1: Period of holding 12 months:

Following capital assets are treated as short-term capital asset if they are held for not more than 12 months immediately preceding the date of transfer:

a. Listed Shares of a company (equity shares or preference shares)
b. Listed securities (Debentures, Bonds, Derivatives, Government securities, units etc.)
c. Units of UTI (Listed or Unlisted)
d. Units of Equity Oriented Fund (Listed or Unlisted)
e. Zero Coupon Bonds (Listed or Unlisted)
f. High Premium Equity Oriented ULIP

Exception 2: No criteria of period of holding

- A depreciable asset is always treated as a short-term capital asset irrespective of period of holding.
- Further, irrespective of the period of holding, the capital gains arising from the transfer, redemption or maturity of Market Linked Debentures (MLDs) or unit of Specified Mutual Funds (SMFs) acquired on or after 1st April, 2023 shall be taxable as short-term capital gains.

- Also, in view of the amendment brought by the Finance Act, 2024 where an unlisted bond or unlisted debenture is transferred, redeemed or matures after 23rd July, 2024, the gains on the same shall be taxable as short-term capital gains under section 50AA.

Table 8.1 summarizes the required holding period of various capital assets to be termed as long-term capital assets.

Table 8.1: Overview of holding periods of capital assets in respect of transfer made on or after July 23, 2024

Nature of Security	***Holding should be more than the following period to be treated as long term capital asset***	
	Listed	*Unlisted*
Equity shares	12 months	24 months
Units of Equity Oriented Funds	12 months	12 months
Units of REIT / InvIT	12 months	24 months
Other Units (other than schemes investing 65% or more in debt or money market instruments directly or indirectly)	12 months	24 months
Schemes investing 65% or more in debt or money market instruments directly or indirectly (Specified Mutual Fund (SMF) – type 1)	Always short term	Always short term
Schemes investing 35% or less directly in listed domestic equity in India and bought on or after April 1, 2023 and **sold before April 1, 2025 – and not part of above (SMF – type 2)**	Always short term	Always short term
Schemes investing 35% or less directly in listed domestic equity in India and bought on or after April 1, 2023 and **sold on or after April 1, 2025 – and not part of above**	12 months	24 months
Market linked debentures	Always short term	Always short term
Preference Shares	12 months	24 months
Debentures	12 months	Always short term
Government Securities in the form of bonds or debentures	12 months	Always short term
Zero coupon bonds	12 months	Always short term
Other Bonds	12 months	Always short term

Immovable property (Land and building both)	24 months
High Premium Equity Oriented ULIP	12 months
Any other asset (e.g. physical gold etc.)	24 months
Note: Gains arising from transfer of Market linked debentures (MLDs), specified mutual funds (SMFs) and depreciable assets, unlisted debentures or bonds are always treated as short-term capital gains, irrespective of the period of holding.	

8.3.1 Calculating Period of Holding

The period of holding of a capital asset is calculated from the date of its purchase or acquisition till the date of its transfer. However, in certain cases, the period of holding of a capital asset is determined in accordance with special provisions which are enumerated in the following table: (Table 8.2)

Table 8.2: Special provisions for calculating period of holding of capital assets

Type of Security	Period of Holding
Listed Shares sold through broker	Date of broker's note to be considered as date of purchase and sale provided it is followed up by delivery of shares and transfer of deed.
Listed shares transferred directly between parties (not through stock exchange)	Period of holding to be counted from date of purchase to date of contract of sale as declared by the parties, provided it is followed by actual delivery of shares and transfer deed.
Securities held in Demat form	Period of holding is determined as per First-in-First-out (FIFO) method, i.e., the securities that first entered into the Demat account is deemed to be the first sold out.
Bonus shares	Period of holding is reckoned from date of allotment of bonus shares.
Sweat Equity shares or ESOPs	Period of holding is reckoned from date of allotment of Sweat equity shares or shares issued on exercise of ESOPs.
Conversion of preference shares into equity shares	The period for which the preference shares were held by the assessee is also included in the period of holding of equity shares.
Conversion of bonds/ debentures/ debenture - stock/ deposit certificates into shares or debentures of that company	The period of holding of the original asset shall also be taken into consideration while determining the period of holding of converted assets.
Right Shares	Period of holding is counted from date of allotment of right shares.
Renouncement of right to subscribe to shares or any other security of a company	Period of holding is reckoned from the date of offer made by the company to the date of renouncement.
Shares of an amalgamated company	Period of holding of the original shares, held in the amalgamating company, is also included in computing the period of holding of the shares in the amalgamated company.

Type of Security	Period of Holding
Shares of a resulting company in case of demerger	Period of holding is counted from the date of holding of the shares in the demerged company and not from the date of allotment of the shares in the resulting company.
Acquisition by operation of law in the circumstances specified in Section 49(1) *[See Note 1]*	Period of holding of the last previous owner who acquired the asset by way of purchase is also included to determine the period of holding by the assessee.
Units of business trust allotted on account of transfer of shares of special purpose vehicle (SPV)	The period for which the shares of SPV were held is also included in counting the period of holding of the units of business trust.
Consolidation scheme of mutual fund	The period for which units were held under consolidating scheme shall also be included.
Consolidation plan of mutual fund	The period for which units were held under consolidating plan shall also be included.
Segregation of portfolio of mutual fund	The period for which original units were held in main portfolio shall also be included.
Gold converted into an Electronic Gold Receipt (EGR) and vice-versa	The period for which the Gold was held before converting into EGR shall be included for computing the period of holding of the EGR and vice-versa.

Note 1: some of the Circumstances specified in section 49(1) are as follows:

(a) Distribution of assets on total or partial partition of an HUF;
(b) Under a gift or will;
(c) By way of succession, inheritance or devolution;
(d) Transfer to a revocable or irrevocable trust;

8.4 Transfer of Capital Asset

In general sense, the expression 'transfer' of property connotes the passing of a property or rights in a property from one person to another. The meaning of transfer has been defined under Section 2(47) of the Income Tax Act. It includes various means by which the property may be passed from one person to another which would get covered under the definition of 'transfer'. Following are some of the examples of transfer of asset:

Sale of asset: The word 'sale' construes a transaction voluntarily entered into between two persons, commonly known as the buyer and seller, by which the buyer acquires property of the seller for an agreed consideration, commonly known as 'price'.

Exchange of asset: Under Section 118 of the Transfer of Property Act, 1882, 'exchange' is defined to mean when two persons mutually transfer the ownership of one thing for the ownership of another thing, neither thing nor both things being money only.

Receipt of shares of a company in exchange of shares of another company at the time of business reconstruction which are not otherwise excluded from the definition of transfer will be covered in the definition of exchange of asset.

Relinquishment of asset: The word 'relinquishment' has not been defined in the Act. A relinquishment is said to have taken place when the owner withdraws himself from the property and abandons his/her rights thereto.

For example, Mr A and Mr B entered into a partnership and contributed some assets. After 2 years, Mr A retired from such a firm and relinquished his rights and interest in such property in favour of Mr B. In this case, such relinquishment of rights would amount to transfer and chargeable to tax under the head capital gains.

Extinguishment of rights: The word 'extinguishment' has also not been defined in the Act. It refers to the case where rights of a person in a capital asset have extinguished and not the extinguishment of the capital asset as such. If the asset has irretrievably lost, it cannot be said that the assessee suffered loss under the head 'capital gains'. The extinction or loss of the asset does not fall within the import of the expression 'extinguishment of the right'.

Maturity or redemption of zero-coupon bonds: Redemption or maturity of zero-coupon bond, issued by any infrastructure capital company or infrastructure capital fund will be treated as transfer.

8.4.1 Transactions not regarded as transfer

The Income Tax Act has listed certain transactions, which are not regarded as transfers for the purpose of capital gains. Consequently, no capital gain may arise from such transfers. Some of these transactions are listed in Section 46 and 47 of the Income Tax Act, which have been enumerated below.

(i) Distribution of capital asset on the total and partial partition of a Hindu undivided family;

(ii) **Any transfer of a capital asset under a gift or will or irrevocable trust**

Any transfer of a capital asset under a gift or will or an irrevocable trust is excluded from the ambit of transfer, except shares, debentures or warrants allotted by a company directly or indirectly to its employees under any Employees' Stock Option Plan or Scheme of the company offered to such employees in accordance with prescribed guidelines.

(iii) **Transfer among non-residents**

Transfer of following securities by a non-resident to another non-resident is not charged to capital gains:

i. Transfer of bonds or GDRs of an Indian company or public sector company as referred under Section 115AC by a non-resident to another non-resident outside India;

ii. Transfer of Rupee Denominated Bond of an Indian company by one non-resident to another non-resident outside India;
iii. Transfer of bonds, GDR, Rupee Denominated Bond, derivatives, foreign currency-denominated bond, unit of a Mutual Fund, unit of a business trust, foreign currency-denominated equity shares of a company, unit of Alternative Investment Fund or Bullion Depository Receipt with underlying bullion by a non-resident on a recognised stock exchange located in any International Financial Services Centre provided the consideration is paid or payable in foreign currency; or
iv. Transfer of Government Security, carrying periodic payment of interest, outside India through an intermediary dealing in settlement of securities by a non-resident to another non-resident.

(iv) **Redemption of Sovereign Gold Bonds**

Redemption of Sovereign Gold Bond issued by the Reserve Bank of India under the Sovereign Gold Bond Scheme, by an individual will not be regarded as transfer.

(v) **Conversion of securities**

The following conversion of securities shall not be deemed as transfer of securities:
i. Conversion of bonds, debentures, debenture-stock or deposit certificate of a company into shares or debentures of that company;
ii. Conversion of Foreign Currency Exchange Bonds (FCEB), issued to non-residents by Indian companies, into shares of any company; and
iii. Conversion of preferences shares into equity shares of that company.

(vi) **Consolidation of mutual fund**

To promote consolidation of different similar scheme of transfer of mutual fund, Income Tax Act provides that consolidation of units shall not be treated as transfer.

(vii) **Lending of securities**

Under Securities Lending Scheme of SEBI, a person can lend his securities to a borrower through approved intermediary for a specified period with the condition that the borrower would return equivalent securities of the same type or class at the end of the specified period along with interest. The CBDT has clarified that any lending of scrips or security is not treated as transfer even if lender does not receive back same distinctive numbers of scrip or security certificate.[22] Hence, such transaction shall not be subject to capital gains tax.

(viii) **Rollover of fixed maturity plans**

Fixed Maturity Plans (FMP) are closed ended funds having a fixed maturity date wherein the duration of investment is decided upfront. The funds collected by FMPs

[22]Circular No. 751, dated February 10, 1997

are invested by the Asset Management Companies (AMCs) in securities having similar maturity period. To enable the FMPs to qualify as a long-term capital asset, some AMCs administering mutual funds offer extension of the duration of the FMPs to a date beyond 24 months from the date of the original investment by providing to the investor an option of roll-over of FMPs. The CBDT has clarified that the rollover of FMPs in accordance with the SEBI regulation will not amount to transfer as the scheme remains the same.[23] This was prevalent when listed debt mutual funds enjoyed treatment as long-term capital asset on completion of a certain period. In respect of schemes that invest 65% or more in debt or money market instruments, the gains are always treated as short term now due to the provisions of section 50AA. Hence this exemption is no longer relevant.

(ix) **Distribution in case of liquidation**

Any distribution of assets in kind by a company to its shareholders at the time of liquidation is not treated as transfer of asset by the Company. However, in this case, the shareholders are liable to pay tax on any capital gains arising there from in accordance with Section 46.

(x) **Conversion of Gold into Electronic Gold Receipt or vice versa**

Conversion of Gold into Electronic Gold Receipt (EGR) issued by a vault manager, or conversion of EGR into Gold**,** is not treated as transfer for the purpose of computing capital gain.[24]

Electronic Gold Receipt (EGR) is an electronic receipt which is issued based on the deposit of underlying physical gold in accordance with the regulations made by SEBI. EGR is covered under the definition of securities.[25]

Vault Manager means any person who stores and safe-keeps gold deposited by the depositor, for the purpose of trading in EGR and providing services incidental thereto.[26]

8.5 Computation of Capital Gains from Transfers

Any profit or gain arising from transfer of a capital asset is taxable on accrual basis during the previous year in which such transfer takes place. The mechanism for computation of capital gain from transfer of a short-term capital asset is different from the one applicable in case of long-term capital asset. In case of a long-term capital asset the indexation benefit is no longer available except as a parallel calculation to determine capital gains tax liability in respect of long-term capital gains arising from sale of land and building bought before July 23, 2024.

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[23]Circular No. 6/2015, dated April 9, 2015

[24] Inserted by the Finance Act, 2023 with effect from assessment year 2024-25.

[25] Regulation 2(1)(h) of the SEBI (Vault Managers) Regulations, 2021 read with Notification No. S.O. 5401(E), dated 24.12.2021 issued in exercise of the powers conferred by Section 2(h)(iia) of section 2 of the Securities Contracts (Regulation) Act, 1956.

[26] Regulation 2(1)(l) and 2(1)(m) of SEBI (Vault Managers) Regulations, 2021.

1. *In case of short-term capital gains*

Particulars	*Rs.*
Full value of consideration	xxx
Less:	
a) Expenditure incurred wholly and exclusively in connection with transfer	(xxx)
b) Cost of acquisition	(xxx)
c) Cost of improvement	(xxx)
Short-term capital gain or loss	**Xxx**

2. *In case of long-term capital gains*

Particulars	*Rs.*
Full value of consideration	xxx
Less:	
a) Expenditure incurred wholly and exclusively in connection with transfer	(xxx)
b) Cost of acquisition	(xxx)
c) Cost of improvement	(xxx)
Long-term capital gain or loss	**xxx**

For computation of capital gains, an assessee has to compute various figures which have been explained below.

1. *Full value of consideration*

The Act has not defined the term 'full value of consideration'. Therefore, it has to be understood in commercial sense according to the prevalent usage. It is the amount of consideration received or receivable by the owner of asset in lieu of transfer of such assets. Such consideration may be received in cash or in kind. If it is received in kind, then fair market value of such assets is taken as full value of consideration.

However, in the cases explained below, the full value of consideration shall be calculated in contrast to the general principle enumerated above. (see Table 8.3)

Table 8.3: Calculation of full value of consideration in special cases

Nature of security	Full value of consideration
Conversion of capital asset into stock-in-trade	Fair market value of capital asset on the date of conversion.
Transfer of securities allotted under ESOPs as gift or under irrevocable trust	Market value of such securities on the date of transfer.
Redemption of rupee denominated bonds by non-resident	An amount equal to the value of appreciation of rupee against a foreign currency from the date of issue to the date of redemption shall be excluded for the purpose of computing the full value of consideration.
Unquoted shares transferred for less than its fair market value	Fair market value of such shares on the date of transfer.
Consideration Where the transfer is not ascertainable	Fair market value of asset on date of transfer.

2. *Expenditure incurred in connection with transfer*

Any expenditure, incurred wholly and exclusively, in connection with transfer of a capital asset is allowed as a deduction in computing capital gain. Thus, the brokerage or commission, stamp duty, registration fee, travelling expenses and legal expenses, etc., incurred in connection with transfer are allowed to be deducted in computing capital gain. However, no deduction is allowed in respect of any sum paid on account of Securities Transaction Tax (STT), Commodities Transaction Tax (CTT) while calculating the capital gains from sale of securities.

Whether Fees payable to Investment adviser is allowed as a deduction? – Most likely not allowed unless it is directly related to the specific asset and can be directly connected with the transfer (such as stamp duty or brokerage payable for the transfer).

3. *Cost of acquisition*

As a general principle, cost of acquisition of an asset is the value for which it was acquired by the assessee. It includes all expenses which are incurred by the assessee in acquiring the capital asset. However, in the following circumstances, the cost of acquisition of a capital asset shall be different from its actual cost (see Table 8.4):

Table 8.4: Calculation of cost of acquisition

Situation	Cost of Acquisition
Shares acquired by way of purchase on or after 01-04-2001	Price actually paid for acquisition (subject to certain exceptions, i.e., price as on January 31, 2018 in accordance with Section 112A, etc.)
Shares acquired on or before 31-03-2001	Price actually paid for the acquisition or Fair Market Value as on 01-04-2001, whichever is *higher*
Equity shares, units of equity oriented mutual fund or units of business trust (being long-term capital asset) chargeable to STT acquired on or before 31-01-2018 and sold after 01-04-2018	Higher of following: a) Actual cost of acquisition b) Fair Market value as on 31-01-2018 or full value of consideration, whichever is *lower*
Right Shares	Price actually paid for acquisition.
Renouncement of right	*Nil*
Bonus share	If bonus shares issued on or before 31-03-2001: Fair Market value of share as on 01-04-2001 If bonus shares issued on or after 01-04-2001: *Nil*
Sweat Equity Shares or shares allotted under ESOP	Fair Market Value of shares on the date of exercise of option which has been considered for perquisite valuation u/s 17(2)(vi).
Units of business trust allotted in consideration of transfer of shares of special purpose vehicle (SPV)	Cost of acquisition of shares of SPV.
Securities held in Demat form	Security that first entered into the Demat account is deemed to be the first sold out, and, accordingly, cost of acquisition is computed.

Situation	Cost of Acquisition
Conversion of bonds/ debentures/ debenture-stock/ deposit certificates into shares or debentures of that company	Cost of converted shares or debentures is taken at the price paid for the acquisition of original bonds, debentures or debenture certificate.
Shares of a company acquired on redemption of Global Depository Receipts (GDRs) by non-resident	Price of such share prevailing on any recognized stock exchange on the date on which a request for redemption of GDRs was made.
Conversion of preference shares to equity shares	Cost of acquisition of preference shares shall be deemed to be the cost of acquisition of equity shares.
Stock or share becoming property of the assessee on consolidation, conversion etc.	Cost of acquisition of the shares or stock from which such asset is derived.
Consolidation of mutual fund scheme or plan	Cost of acquisition of units held in consolidating scheme or plan.
Conversion of Gold into Electronic Gold Receipt (EGR)	Cost of acquisition of gold shall be considered as the cost of acquisition of such EGR.
Conversion of EGR into Gold	Cost of acquisition of EGR shall be considered as the cost of acquisition of such gold.
Segregation of portfolio of mutual fund	Amount which bears, to the cost of acquisition of a unit held by the assessee in the total portfolio, the same proportion as the net asset value of the asset transferred to the segregated portfolio bears to the net asset value of the total portfolio immediately before the segregation of portfolios. Further, the cost of the acquisition of the original units held by the unit holder in the main portfolio shall be deemed to have been reduced by the cost of acquisition of units in the segregated portfolio.
Allotment of shares of amalgamated company in lieu of shares held in amalgamating company	Price paid for acquisition of shares in amalgamating company.
Shares acquired in resulting company in case of demerger	The cost of acquisition of shares held by the assessee in demerged company in proportion to the net book value of assets transferred in demerger bear to the net worth of the demerged company, immediately before the specified date of demerger.
Shares remained in demerged company after demerger	Cost of acquisition of the shares held by the shareholders in the demerged company is reduced by the cost of acquisition of shares, acquired from resulting company.
Cost of acquisition by operation of law i.e. on Partition of HUF, under a gift or will, by succession, inheritance or devolution, Transfer of property by a member to HUF	Cost of acquisition of previous owner. However, if such cost cannot be determined cost of acquisition will be the fair market value of such asset on the date on which such asset was acquired by previous owner.
Stock-in-trade converted into capital asset	Fair market value of stock on date of conversion.

4. Indexed cost of acquisition

As mentioned in previous paragraphs, the Finance Act, 2024 has made significant changes to capital gains chapter. Where a transfer of long-term capital has taken place before 23rd July, 2024, the benefit of indexation will be available on all asset class baring certain exceptions.

For any transfer of long-term capital asset on or after 23rd July, 2024, indexation benefit will not be available except for land or building or both acquired before 23rd July, 2024.

For this limited purpose, the concept of indexation is explained below:

Imagine a situation, where Mr. A has acquired a house in Mumbai out of inheritance from his father. His father had purchased the house for a sum of say Rs. 50,00,000 in the F.Y. 2002-03. The market value of that house, in present time has jumped manifold. It is now somewhere around Rs. 3.5 crore. Does this mean, the capital gain on sale of the house is Rs. 3 crore? Naturally, one would tend to think that appreciation in the price of house is due to several factors one of which is the inflation in the economy.

In order to nullify the effect of inflation while calculating capital gains, the Income Tax Act provides a facility to the tax payer in the form of Indexation. A Cost Inflation Index (CII) is notified by the Central Board of Direct Taxes (CBDT) every year.

The Indexed Cost of acquisition shall be calculated in a two-step process. The first step is to calculate the cost of acquisition of capital asset. In the second step, such cost of acquisition is multiplied by the CII of the year in which capital asset is transferred and divided by CII of the year in which asset is first held by the assessee or CII of 2001-02, whichever is later. (refer Annexure 3 for notified CII)

Indexed Cost of Acquisition	=	Cost of Acquisition	x	CII of the year in which asset is transferred / CII of the year in which asset is first held by assessee or CII of 2001-02, whichever is later

Applying this formula to our above illustration, the indexed cost of acquisition will be as follows:

$$\text{Rs. } 50,00,000 \times \frac{\text{CII of 2020-21}}{\text{CII of 2002-03}}$$

$$\text{i.e. } 50,00,000 \times \frac{301}{105} = \text{Rs. } 1,43,33,333$$

5. Cost of improvement

'Cost of Improvement' means all expenditure of a capital nature incurred on or after 01-04-2001 in making any addition or alterations to the capital asset either by the assessee or

the previous owner. Therefore, all capital expenditure incurred on or after 01-04-2001 shall be deducted while calculating the capital gains. In case capital asset is acquired by the assessee before 01-04-2001, any cost of improvement incurred prior to 01-04-2001, shall be ignored.

The cost of improvement in relation to a capital asset being goodwill of a business or a right to manufacture, produce or process any article or thing or right to carry on any business or profession shall be taken to be nil. Further, in relation to the Market Linked Debentures (MLDs) or Specified Mutual Funds (SMFs), the cost of improvement is not allowed to be deducted, notwithstanding whether it has been incurred by the assessee himself or by the previous owner.

However, cost of improvement shall not include such expenditure, which is deductible in computing the income chargeable under the head 'Income from House Property', 'Profits and Gains from Business or Profession', or 'Income from Other Sources'.

6. Indexed cost of improvement

The Indexed Cost of improvement shall be calculated in the same manner in which indexed cost of acquisition is computed.

8.5.1 Conversion of capital gain earned in foreign currency into Indian rupees

If any income accrues or arises to a resident or non-resident person in foreign currency, it shall be converted into Indian Rupees. The conversion shall be done as per the conversion rate as prevalent on the relevant dates.

For any other shares or debentures, the computation is as follows:

Where a non-resident assessee (except FII) acquires shares or debentures of an Indian company in foreign currency, the capital gain arising from the transfer of such shares or debentures shall be first computed in foreign currency, initially utilised in purchase of the securities, then it shall be converted into Indian currency. This provision of computation of capital gain shall be applicable in respect of capital gain accruing or arising from sale of every re-investment thereafter in shares or debentures of an Indian company. Also, the benefit of foreign currency conversion in the computation of capital gains will not be available to unlisted securities or shares of a closely held company transferred by a non-resident (except for non-residents choosing to be governed by special provisions of chapter XII-A)

Different provisions have been prescribed by Rule 115A for conversion of cost of acquisition, expenditure in connection with transfer and the capital gains and this provision shall apply to every re-investment of sale consideration into shares or debenture of an Indian company.

These provisions are explained below:

1. Sales Consideration

The sales consideration shall be converted at the average rate of foreign currency as on the date of transfer. Average rate is computed by dividing the aggregate of Telegraphic Transfer (TT) buying and selling rate as adopted by the State Bank of India (SBI).

2. Cost of Acquisition

The cost of acquisition shall be converted into foreign currency at the average rate of foreign currency as on the date of acquisition of share or debenture. Average rate is computed by dividing the aggregate of TT buying and selling rate as adopted by the SBI. In this case, the benefit of indexation shall not be available.

3. Expenditure in connection with transfer

The expenditure incurred wholly and exclusively in connection with transfer of the capital asset shall be converted at the average rate of foreign currency as on the date of transfer. Average rate is computed by dividing the aggregate of Telegraphic Transfer (TT) buying and selling rate as adopted by the State Bank of India (SBI).

4. Capital Gains

The resultant capital gains computed in foreign currency shall be re-converted into INR at TT buying rate of such currency on the date of transfer of the capital asset.

- *In case of other Capital Gains*

The capital gains arising to a resident or non-resident person in foreign currency shall be converted into Indian Rupees at the telegraphic transfer buying rate of such currency as it existed on the last day of the month immediately preceding the month in which the capital asset is transferred.

Example, if on May 15, 2022 an Indian resident transfers a plot of land situated in Dubai, the capital gains arising there from shall be converted into Indian Rupee at the rate of exchange as it existed on April 30, 2022

8.5.2 Tax rates on capital gains

As mentioned earlier, the Finance Act, 2024 has brought about significant changes to capital gains taxation chapter. Along with changes in the provisions of period of holding, there are amendments made in tax rates of short term and long-term capital gains.

The new provisions will be applicable for transfers on or after 23rd July, 2024.

Short term capital gains:

- Short term capital gains covered under section 111A of the IT Act will be taxed at the rate of 20%. Section 111A is applicable when there is transfer of equity shares, units of equity oriented mutual funds, equity oriented High Premium ULIPS or units of business trust, and such transaction is chargeable to Securities Transaction Tax (STT).

- All other short term capital gains will be taxed at applicable slab rates of the assessee.

Long term capital gains:

- Long term capital gains will be taxed at the rate of 12.5% in respect of all categories of assets.

- In case of transfer of listed equity shares, units of the equity-oriented fund, equity oriented high premium ULIPs or units of business trust where such transaction has suffered STT, long term capital gains exceeding Rs. 1,25,000 will be taxed at the rate of 12.5%.

- Long term capital gains in respect of immovable property held as long term capital asset:
    - In case of immovable property, one needs to check if the property was acquired before 23rd July, 2024. If such property is transferred also before 23rd July, 2024 itself, old provisions will apply i.e. it will be eligible for indexation and long-term capital gains will be taxed at the rate of 20%.

    - If such property is acquired before 23rd July, 2024 but transferred after this date, a parallel calculation has to be done taking indexation into account and if the tax payable (@20%) under that method is lower than 12.50% payable on the capital gains calculated without indexation then the calculation based on indexation will apply. Effectively, any loss calculated due to indexation will no longer be allowed.

    - Where such property is acquired after 23rd July, 2024, and transferred on any date which makes it long term capital asset, any long-term capital gains arising on such transfer will be chargeable to tax at the rate of 12.5% without any indexation benefit.

8.5.3 Exemption for capital gains

The Income Tax Act allows exemption from capital gains tax if the amount of capital gains or consideration, as the case may be, is further invested in specified new assets. These exemptions are available subject to certain key conditions. A summary of these provisions is given below: (see Table 8.5)

Table 8.5: Exemption for Capital Gains

Section	Type of Assessee	Type of original capital asset	Nature of original capital asset	Nature of new capital asset	Time-limit allowed for investment	Capital Gain Account Scheme (CAGS)	Amount of exemption
Section 54	Individual and HUF	Long-term Capital Asset	Residential House Property	Amount of capital gains to be re-invested in - . One Residential House in India If capital gains do not exceed INR 2 crore, new capital asset can be 2 houses instead of 1	*To Buy:* 1 Year before and 2 Years from the date of transfer *To Construct:* 3 Years from the date of transfer	Applicable	Lower of the following: - Rs. 10 crores - Aggregate of amount invested in new house property and deposited in capital gain account scheme
Section 54B	Individual and HUF	Short-term or Long-term	Agriculture land, used for agriculture for 2 years	Amount of capital gains to be re-invested in - Agriculture land	2 Years from the date of transfer	Applicable	Aggregate of amount invested in new agricultural land and deposited in capital gain account scheme
Section 54D	Any Assessee	Short-term or Long-term	Land or Building forming part of Industrial Undertaking used in business for 2 years, acquired by way of compulsory acquisition	Amount of capital gains to be re-invested in - Land or Building to shift or set up a new Industrial Undertaking	*To Buy or construct:* 3 Years from the date of compulsory acquisition	Applicable	Aggregate of amount invested in new land or building and deposited in capital gain account scheme
Section 54EC	Any Assessee	Long-term Capital Asset	Land or Building	Amount of capital gains to	6 months from the date of transfer	Not Applicable	Lower of the following:

Section	Type of Assessee	Type of original capital asset	Nature of original capital asset	Nature of new capital asset	Time-limit allowed for investment	Capital Gain Account Scheme (CAGS)	Amount of exemption
				be re-invested in - Bonds of NHAI or REC			- Rs. 50,00,000 - Amount invested in specified bonds
Section 54EE	Any Assessee	Long-term Capital Asset	Any Capital Asset	Units of notified Fund (no Notification has been issued yet)	6 months from the date of transfer	Not Applicable	Lower of the following: - Rs. 50,00,000 - Amount invested in notified funds
Section 54F	Individual and HUF	Long-term Capital Asset	Any Capital Asset other than residential house	Amount of net consideration to be re-invested in - One Residential House in India, subject to prescribed conditions	*To Buy:* 1 Year before and 2 Years from the date of transfer *To Construct:* 3 Years from the date of transfer	Applicable	Exemption is computed as per following formula: Eligible Investment * Long-term capital gain/Net sale consideration Note: The amount of eligible investment cannot exceed Rs. 10 crores.
Section 54G	Any Assessee	Short-term or Long-term	Specified assets of Industrial Undertaking in urban area	Amount of capital gains to be re-invested in - Assets of Industrial Undertaking in non-urban area	1 Year before and 3 Years from the date of transfer	Applicable	Aggregate of amount invested in new asset or transfer of establishment and deposited in capital gain account scheme

Section	Type of Assessee	Type of original capital asset	Nature of original capital asset	Nature of new capital asset	Time-limit allowed for investment	Capital Gain Account Scheme (CAGS)	Amount of exemption
Section 54GA	Any Assessee	Short-term or Long-term	Specified assets of Industrial Undertaking in urban area	Amount of capital gains to be re-invested in - Specified assets of Industrial Undertaking in SEZ	1 Year before and 3 Years from the date of transfer	Applicable	Aggregate of amount invested in new asset or transfer of establishment and deposited in capital gain account scheme
Section 54GB	Individual and HUF	Long-term Capital Asset	Residential Property, i.e., house or plot of land	Amount of net consideration to be re-invested in- Equity shares of eligible company or eligible start-up	*To Buy shares:* Before the due date for furnishing of return *To Buy new assets by the company:* Within 1 year from the date of subscription of shares	Applicable	Exemption is computed as per following formula: Investment in new asset by eligible company * Capital gain/Net sale consideration
Section 115F	Non-Resident Indian	Long-term Capital Asset	Shares of an Indian company, Debentures/Deposits of Indian Public Company or Government Securities purchased in foreign currency	Shares of an Indian company, Debentures/Deposits of Indian Public Company or Government Securities	6 months from the date of transfer	Not Applicable	Exemption is computed as per following formula: Investment in new asset * Capital gain/Net sale consideration

Note: As per Section 54H, if the transfer of original asset with respect to Section 54, 54B, 54D, 54EC and 54F occurs by way of compulsory acquisition and the consideration is not received on date of transfer, the timelines provided above shall be considered from the date of receipt of the consideration.

Example: Mr. A purchased a house on 14th April, 2011 for Rs. 1 crore. He sold the said house in December 2024 for Rs. 3 crore. He now intends to purchase a new house for Rs. 1.5

crore. The Cost Inflation Index for financial year 2011-12 was 184 and Cost Inflation Index for FY 2024-25 was 363. Compute his capital gains liability:

	Old provisions (Rs.)	**New provisions (Rs.)**
Sale consideration	3,00,00,000	3,00,00,000
Less: Cost of acquisition (for new provisions)		(1,00,00,000)
Less: Indexed cost of acquisition (for old provisions) (1,00,00,000 x 363 / 184)	(1,97,28,260)	
Long term capital gains	**1,02,71,740**	**2,00,00,000**
Exemption under section 54	(1,50,00,000)	(1,50,00,000)
Capital gains after exemption u/s 54	Nil	50,00,000
Tax payable @ 20% on indexed cost under old provisions	Nil	
Tax payable @ 12.5%		6,25,000

In this case, the lower of the tax payable under the old provisions and new provisions will be the final tax liability i.e. Nil in this example.

CHAPTER 9: INCOME FROM OTHER SOURCES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Introduction to Income from Other Sources
- Dividend Income
- Interest on securities
- Gift of securities

9.1 Introduction

Any income, which is not exempt from tax and has to be included in the total income, shall be chargeable to tax under the head 'Income from other sources', if it is not chargeable to income-tax under other four heads of income, i.e. Salaries, Income from House Property, Profits and Gains from business or profession and Capital gains. However, there are certain incomes that are always taxable under the head 'income from other sources'.

Income taxable under the head 'income from other sources' shall be computed in the following manner:

Nature of Income	*Amount*
1. Dividend Income (including buy back proceeds received by shareholder from company on buy back of shares)	xxx
2. Winning from lotteries, etc.	xxx
3. Winning from online games (in the nature of lotteries, etc.)	xxx
4. Interest on securities**	
5. Rental income of machinery, plant or furniture**	xxx
6. Composite rental income from letting out of plant, machinery, furniture and building**	xxx
7. Sum received under Keyman insurance policy++	xxx
8. Interest on compensation or enhanced compensation	xxx
9. Advance money received in the course of negotiations for transfer of a capital asset which has been forfeited and negotiation do not result in transfer of such capital asset	xxx
10. Deemed Income in certain cases	xxx
11. Compensation on termination of employment or modification of terms of employment	xxx xxx
12. Sum received under a life insurance policy (other than ULIP and keyman insurance policy) in excess of the aggregate premium paid during the policy term	xxx
13. Specified sum received (other than interest/dividend from SPV and rental income from REITs) by a unitholder from a business trust	xxx
14. Any other income not taxable under any other head	xxx
Less: Attributable expenses	(xxx)
Income from other sources	**xxx**

** If such income is not chargeable to income-tax under the head "Profits and gains of business or profession".

++ If such income is not chargeable to income-tax under the head "Profits and gains of business or profession" or under the head "Salaries".

Income arising from securities which are always chargeable to tax under the head other sources are as follows:

a) Dividend income from securities;
b) Interest income from securities held as an investment;
c) Advance money received in the course of negotiations for transfer of a capital asset which has been forfeited and negotiation do not result in transfer of such capital asset;
d) Deemed Income in certain cases specified under section 56(2); and
e) Specified sum received by a unitholder from a business trust.

9.2 Dividend Income

Meaning of Dividend

Dividend usually refers to the distribution of profits by a company to its shareholders. However, certain receipts are also deemed as a dividend. The deemed dividend, as defined in Section 2(22) of the Income Tax Act, includes the following:

a) Distribution of accumulated profits to shareholders entailing release of the company's assets;
b) Distribution of debentures, debenture-stock, or deposit certificates to shareholders out of the accumulated profits of the company and issue of bonus shares to preference shareholders out of accumulated profits;
c) Distribution to shareholders of the company on its liquidation out of accumulated profits;
d) Distribution to shareholders out of accumulated profits on the reduction of its capital by the company;
e) Loan or advance by a closely held company to its shareholder out of accumulated profits; and
f) Payment made by company on buy back of its own shares from a shareholder in accordance to relevant provisions of Companies Act, 2013.

Scheme of Taxation

Upto Assessment Year 2020-21, domestic companies and mutual funds were liable to pay Dividend Distribution Tax (DDT) on dividend. Therefore, shareholders or unit-holders were exempt from paying tax on the dividend income (subject to certain conditions). After abolition of DDT by the Finance Act, 2020 with effect from Assessment Year 2021-22, if a company, mutual fund, business trust or any other fund distributes dividend to its shareholders or unit-holders then such dividend income is taxable in the hands of such shareholder or unit-holders under the head 'income from other sources' and will be taxable

at applicable slab rate of the shareholder subject to residential status of the shareholders and quantum of income. In case of a non-resident shareholder, the provisions of Double Taxation Avoidance Agreements (DTAAs) and Multilateral Instrument (MLI) shall also come into play.

With effect from 1st October 2024, buy back proceeds received by shareholder shall be taxed as dividend under the head 'income from other sources'. No deduction for expenses shall be available from such dividend while determining the income from other sources. The cost of acquisition of shares which are bought back by the company will be treated as capital loss in the hands of the shareholder and will be eligible for set-off as per the applicable provisions.

Applicability of TDS provision

The tax is required to be deducted from dividend in accordance with Section 194 or Section 194K of the Act, as the case may be.

9.3 Interest on Securities

The income in the nature of interest on securities is taxable in the hands of the assessee under the head 'income from other sources'. This income is taxable as other sources if it is not in the nature of business income.

Meaning of 'interest on securities'

As per Section 2(28B) of the Income Tax Act, 'interest on securities' means:

a) Interest on any security of the central government or a state government;
b) Interest on debentures/other securities for money, issued by or on behalf of a local authority or a company or a corporation established by a central or state or provincial Act.

Meaning of 'securities'

As the word 'security' is not defined under the Income Tax Act. Therefore, the reference can be taken from Section 2(h) of the Securities Contracts (Regulation) Act, 1956. Thus, the interest on securities can arise from the following securities:

a) Bonds;
b) Debentures or debenture stock;
c) Security receipt;
d) Government securities;
e) Pooled investment vehicle.

Basis of charge

In view of Section 145 of the Income Tax Act, income in the nature of interest on securities shall be computed in accordance with the method of accounting regularly employed by the assessee. Two methods of accounting are allowed to be followed under the Income Tax Act, *namely*, the mercantile system and cash system. If assessee follows mercantile system of accounting, interest on securities is taxable on accrual basis. If he follows the cash system of accounting, it is taxable on receipt basis.

Interest exempt from tax

Section 10 of the Income Tax Act provides exemption to certain interest incomes. (refer *Annexure 2)*

*9.1-1.**Computation of taxable income***

The taxable income in the nature of interest on securities shall be computed in the following manner:

Particulars	*Amount*
Gross interest from securities	xxx
Less: Permissible deductions	
a) Collection charges	(xxx)
b) Interest on borrowings obtained to purchase securities	(xxx)
c) Any other revenue expenditure laid out or expended wholly and exclusively for the purpose of earning such income	(xxx)
Taxable income from securities	**xxx**

Taxability of income

If securities are held as stock-in-trade, any profit arising from the sale of securities is chargeable to tax under the head profits and gains from business or profession. If securities are held as an investment, any profit arising from the sale of such securities is chargeable to tax under the head capital gains.

Conversion of income from securities earned in foreign currency into Indian rupees

If any income from securities, earned in foreign currency, is taxable in India it shall be converted into Indian Rupees at SBI telegraphic transfer buying rate that existed on the last day of the month immediately preceding the month in which income is due. In case the income payable in foreign currency is subject to TDS, as per the provision of the Income Tax Act, the date of conversion will be date on which tax is required to be deducted.

Rate of tax

The interest shall be chargeable as per tax rates applicable to the assessee. However, in case of non-residents, certain interest incomes are taxable at concessional rates. (refer to Special tax rates section under Annexure 1)

9.4 Gift of Securities

Where any person receives a movable property from any person without consideration or for inadequate consideration, then the tax shall be chargeable in the hands of the recipient as income from other sources. However, no tax shall be charged if the aggregate amount of difference between the fair market value of properties received during the year and the amount of consideration paid in respect thereof, if any, does not exceed Rs. 50,000. The movable property, for this provision, shall include shares and securities.

9.4.1 Computation of income

Where shares and securities are received from any person without consideration, the whole of the aggregate fair market value of such properties received during the year shall be chargeable to tax if the aggregate fair market value thereof exceeds Rs. 50,000

Where shares and securities are received for inadequate consideration, the difference between the fair market value and consideration shall be chargeable to tax if the aggregate amount of difference between the fair market value of properties received during the year and consideration paid in respect thereof exceeds Rs. 50,000.

9.4.2 Computation of fair market value

The fair market value of share and securities is computed as per Rule 11UA of the Income Tax Rules, 1962. Rule 11UA prescribes the different method for computing the fair market value of quoted and unquoted shares and securities.

9.4.3 Cases when income is not chargeable to tax

Where shares and securities are received without consideration or for inadequate consideration, no tax shall be charged in the following cases:

Due to specified event

Income shall not arise under this provision if any sum of money or any property is received:

a) on the occasion of the marriage of the individual;
b) under a will or by way of inheritance;
c) in contemplation of death of the payer or donor;

Due to status of donor/payer

Income shall not arise under this provision if any sum of money or any property is received:

a) from any specified relative;

b) from any local authority;
c) from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in section 10(23C);
d) from any trust or institution registered under section 12A/12AA/12AB;
e) from an individual by a trust created or established solely for the benefit of relative of such individual.

In case of HUF, every member of HUF will be treated as relative. However, in case of an individual, the following persons are treated as a relative for the purpose of this provision:

Husband/Wife	
Son/Daughter (Including Stepchild and Adopted child)	Daughter-in-Law/Son-in-Law
Father/Mother Step-father/mother	Mother-In-Law Father-In-Law
Brother (and his wife)/ Sister (and her husband) Half-brother/Sister	Brother-in-Law (and his wife) Sister-in-law (and her husband)
Grandfather Grandmother	Spouse's Grandfather Spouse's Grandmother
Grandson (and his wife) Granddaughter (and her husband)	Great Grandson (and his wife) Great Granddaughter (and her husband)
Great Grandfather Great Grandmother	Spouse's Great Grandfather Spouse's Great Grandmother
Father's Brother (Chacha – Tau) (and his wife) Father's Sister (Bua) (and her husband)	Mother's Brother (Mama) (and his wife) Mother's Sister (Mausi) (and her husband)
The following persons are not deemed as 'relatives' for this provision: a) Step-brother/sister b) Nephew/Niece c) Cousins	

Due to transactions not regarded as transfer

Income shall not arise under this provision if any sum of money or any property is received under the following transactions not regarded as transfer under Section 47:

a) Any distribution of capital assets on total or partial partition of a HUF. [Section 47(i)]

CHAPTER 10: TAXATION OF DEBT PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Sources of income from debt products
- Types of Debt products
- Types of Mutual funds
- Tax liability of NRIs

Debt instruments are used by many entities to raise funds from the market. Debt instruments are similar to giving a loan to the issuing entity by the investor. The person holding the debt instrument of an entity would not hold any voting power or dividend claim. However, he is entitled to receive interest and redemption value at the time of maturity from the entity.

10.1 Sources of Income from Debt Products

Periodic income earned from debt instruments is classified as interest income. Whereas, the gain or loss arising from transfer or redemption of debt instruments is classified as capital gains and taxed as such.

10.1.1 Interest income

The income in the nature of interest on securities is taxable in the hands of the assessee under the head 'income from other sources' if the same is not taxable under the head business income.

As per Section 145 of the Income-tax Act, income chargeable to tax under the head 'income from other sources' or business income shall be computed in accordance with the method of accounting regularly employed by the assessee. Two methods of accounting are allowed under the Income-tax Act, *namely*, the mercantile system and cash system, whichever is regularly employed by the assessee. If the assessee regularly follows mercantile system of accounting, interest on securities is taxable on an accrual basis. If he regularly follows the cash system of accounting, it is taxable on a receipt basis.

Section 10 of the Income-tax Act provides exemption from certain interest income and, accordingly, no tax is charged thereon.

10.1.2 Capital gains

Gain or loss arising from transfer or redemption of any security including debt securities is chargeable to tax under the head capital gain if same is held by the assessee as a capital asset, that is, as an investment. Securities held by the foreign portfolio investors (FPIs) are always treated as a capital asset. Therefore, income arising from transfer or redemption of securities by FPIs shall always be taxed under the head capital gain. Tax on capital gain depends upon many factors such as nature of security, the period of holding, residential status of the assessee, etc.

10.2 Types of Debt Products

10.2.1 Coupon Bonds

Bonds are generally issued and redeemed at face value and carry interest which is paid to the investor over the tenure of the Bond. Thus, the principal features of a bond are maturity (i.e., tenure), coupon (i.e., interest), and principal (i.e., face value). In many cases, the name of the bond itself conveys the key features of a bond. Example, 7.4% CG Bond 2027 refers to a Central Government Bond maturing in the year 2027 and paying a coupon of 7.40%.

Coupon Bonds are the bonds which carry coupon rate and, thus, lender is entitled to periodic interest payments on such bonds.

The market value of a bond is determined by computing the present value of all future cash flows. Interest rate at which present value of future cash flows is determined is known as 'Yield-to-maturity'.

Tax on interest arising from bonds

Interest arising from bonds is taxable under the head other sources and generally taxable at a normal rate as applicable in case of an assessee. The assessee is allowed to deduct all expenditures laid out or expended wholly and exclusively to earn such interest income and the amount of commission or remuneration paid to a banker or any other person to realise such interest.

However, there are some cases where interest arising from bonds is chargeable to tax at concessional rate and no deduction (including deduction under sections 80C to 80U) is allowed from such interest income. (refer Annexure 1)

Example 1: Mr. A, a person resident in India, purchased 1,000 bonds of an Indian Company at Rs. 100 each on 01-01-2024. The face value, coupon rate and date of maturity of such bonds are as follows:

Face Value	Rs. 100 each
Coupon Rate	7.50% per annum
Date of Maturity	31-12-2029

The interest on bonds is paid half-yearly on June 30 and Dec 31 every year. Compute the amount of interest income chargeable to tax in the hands of Mr. A for the financial year 2024-25.

Answer: As per Section 145 of the Income Tax Act, income in the nature of interest on securities shall be computed in accordance with the method of accounting regularly employed by the assessee *namely*, the mercantile system and cash system.

The amount of interest on bonds chargeable to tax in the hands of Mr. A for financial Year 2024-25 shall be follows:

Particulars	Interest received	Interest chargeable to tax if Mr. A follows		Taxability arises in the financial year
		Mercantile System	Cash System	
Interest for the period Jan, 2024 to March, 2024 (received on June 30, 2024)	-	1,875	-	2023-24
Interest for the period April, 2024 to June, 2024 (received on June 30, 2024)	3,750	1,875	3,750	2024-25
Interest for the period July, 2024 to December, 2024 (received on December 31, 2024)	3,750	3,750	3,750	2024-25
Interest for the period Jan, 2025 to March, 2025 (received on June 30, 2025)	-	1,875	-	2024-25
Interest for the period April, 2025 to June, 2025 (received on June 30, 2025)	3,750	1,875	3,750	2025-26

Tax on long-term capital gain arising to a resident person from transfer or redemption of bonds

Where a person earns any profit or gains from transfer or redemption of bonds held as capital assets, it shall be chargeable to tax under the head capital gain. Taxability of capital gain arising from the transfer of bonds depends upon the nature of the bond, period of holding thereof and the status of assessee.

The period of holding in case of coupon bonds can be explained with the help of following table (see Table 10.1):

Table 10.1: Holding period of Coupon Bonds and tax rates thereon:

	Holding period to qualify as long term capital asset	Rate of tax
Listed bonds or debentures	12 months	Long term capital gains: 12.5% (without indexation benefit) Short term capital gains: applicable rates
Unlisted bonds or unlisted debentures or Market linked debentures	Not applicable	Irrespective of the period of holding, gains arising on transfer will be considered as short-term capital gains and will be taxed at applicable rates

The long-term capital gain in case of transfer of listed bonds shall be computed as under:

Particulars	*Rs.*
Full value of consideration (in case of transfer) or Redeemable Value (in case of redemption)	xxx
Less: a) Cost of acquisition	(xxx)
b) Expenditure incurred wholly and exclusively in connection with transfer	(xxx)
c)Exemption under Sections 54EE to 54F	(xxx)
Long-term capital gain or loss	**Xxx**

Example 2*:* Mr. A purchased 400 listed bonds of ABC Ltd. at Rs. 1,200 each on 01-01-2016. The face value of the bond is Rs. 1,000. It carries a coupon rate of 7% per annum. The interest on bonds is paid half-yearly on June 30 and December 31 every year. The bonds are redeemable on 31-12-2026. However, Mr. A sold such bonds on 31-07-2024 at Rs. 2,000 each. Compute the amount of interest and capital gain chargeable to tax in the hands of Mr. A for the financial year 2024-25. Assume that Mr. A follows the mercantile system of accounting.

Answer*:*

1. Computation of interest on bonds chargeable to tax for the financial year 2024-25

Particulars	*Amount*
Half yearly interest received on June 30, 2024 (400 * Rs. 1,000 * 7% * 6/12)	14,000
Interest accrued for the month of April 2024 to June 2024	7,000
Interest chargeable to tax for financial year 2024-25	**7,000**

2. Computation of capital gain chargeable to tax for financial year 2024-25

Computation of capital gain	
Period of holding (from 01-01-2016 to 31-07-2024)	8 years and 7 months
Nature of capital gain (held for more than 12 months)	Long-term capital gain
Full value of consideration (400 bonds * Rs. 2,000)	800,000
Less: Cost of acquisition (400 Bonds * Rs. 1,200)	(480,000)
Long-term capital gain	3,20,000
Tax rate on capital gain	12.50%

Example 3*:* Suppose in the above Example 2, the bonds are unlisted.

Answer*:*

The capital gains arising from unlisted bonds are always taxed as short-term capital gains irrespective of holding period. Hence the capital gains of Rs. 3,20,000 will be taxed at normal slab rates applicable to the tax payer.

Tax on long-term capital gain arising to a non-resident person from transfer or redemption of bonds

Tax on long-term capital gain arising to a non-resident person from transfer or redemption of listed bonds is always taxable at the rate of 12.50% and no benefit of indexation is allowed. The calculation of long-term capital gains as per foreign currency fluctuation is allowed in certain cases while computing the capital gain.

The relevant provisions of the Income Tax Act for taxability of long-term capital gain arising to a non-resident from the transfer of bonds are summarized in the following table (see Table 10.3):

Table 10.3: Long term Capital Gains Tax to NRIs

Section	Assessee	Particulars	Tax Rate
Section 115E	Non-resident Indian	Long-term capital gains arising from the transfer of Government securities or listed debentures of an Indian Public Company purchased in foreign currency	12.50% (without indexation and foreign exchange fluctuation benefit)
Section 112(1)(c)(iii)	Non-resident	Long-term capital gain arising from any unlisted security other than a bond or a debenture	12.50% (without indexation and foreign exchange fluctuation benefit)

Tax on short-term capital gain from bonds

Short-term capital gain arising from the transfer of bonds is generally taxable at normal rates as applicable in case of an assessee. Any capital gains arising on unlisted bonds or debentures or market linked Debentures (even if listed) shall always be taxed as short-term capital gains irrespective of holding period.

***Example 4**:* Mr. A acquired 9% Listed Bond having face value of Rs. 10,000 on April 1, 2024, for Rs. 10,500. Such bond provides for quarterly payment of interest. After receiving interest for first 2 quarters, that is, quarter ending on June 30, 2024 and September 30, 2024, he transferred such bond on November 1, 2024 for Rs. 13,000 inclusive of interest accrued till the date of transfer.

Compute the amount of interest and capital gain chargeable to tax in hands of Mr. A

***Answer**:*

Computation of interest income	
Particulars	*Amount*
Interest received for the quarter ending on 30-06-2024 (Rs. 10,000 * 9% * 1/4) [A]	225
Interest received for the quarter ending on 30-09-2024 (Rs. 10,000 * 9% * 1/4) [B]	225
Interest accrued till 31-10-2024 (Rs. 10,000 * 9% * 1/12) [C]	75
Total taxable interest income	**525**

Computation of capital gains	
Period of holding (from 01-04-2024 to 31-10-2024)	7 Months
Nature of capital gain (period of holding of less than 12 months)	Short term capital gain
Sales consideration [D]	13,000
Interest accrued but not received before the date of sale [E = C]	75
Adjusted sales consideration [F = D – C]	12,925
Less: Cost of Acquisition [G]	10,500
Short term capital gain [H = F - G]	2,425
Tax rate on capital gain	Applicable tax rate

10.2.2 Government Securities

A Government Security (G-Sec) is a tradable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Securities which are issued for short term (i.e., with a maturity of less than 1 year) are usually called as treasury bills or cash management bills. Whereas, long term securities i.e., Government securities with a maturity of 1 year or more, are called Government bonds or dated securities. In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called as State Development Loans (SDLs).

G-Secs are considered as the safest investment instrument as they carry the Sovereign's commitment for payment of interest and repayment of principal. They carry practically no risk of default and, therefore, they are also called as risk-free gilt-edged securities. Investors have the option to hold G-Secs in a dematerialized account with a depository (NSDL/CDSL). This facilitates the trading of G-Secs on the stock exchanges. Thus, G-Secs can be sold easily in the secondary market to meet cash requirements.

Types of Government Securities

G-Secs are available in a wide range of maturities ranging from less than 91 days to as long as 40 years to suit the duration of varied liability structure of various institutions. Depending upon the maturity period, G-Secs are classified into the following types:

a) Cash Management Bills

Cash Management Bills (CMBs) are issued for a very short period usually less than 91 days. These are highly flexible bills and are issued as per the cash requirements of the Government. CMBs are issued at a discounted price to its investors and are redeemed at the face value.

b) Treasury Bills

Treasury Bills (T-Bills) are the short-term debt instruments which are issued at a discounted price by the Government of India. These bills are issued in 3 tenors, namely, 91 days or 182 days or 364 days. The maturity period of T-Bills doesn't exceed 1 year.

These bills do not offer any interest to its investors. The return on a T-Bill is the difference between the issue price and the redemption value being the face value.

c) Dated Government Securities (Dated G-Secs)

Dated G-Secs are the type of bonds issued by the RBI on behalf of the government which carry a fixed or floating coupon (interest rate) which is paid on the face value, on a half-yearly basis. Generally, the tenor of dated securities ranges from 5 years to 40 years.

d) State Development Loans

State Governments also raise loans from the market which are called as State Development Loans (SDLs). Like Dated G-secs, interest on SDLs is serviced at half-yearly intervals and the principal is repaid on the maturity date.

Taxability of Cash Management Bills and T-bills

Cash Management Bills and Treasury Bills (T-Bills) are issued for a maturity period of less than 1 year, and they do not offer any interest to the investor. The income of a person investing in such instruments is the difference between the issue price and the face value. Profit arising on redemption or transfer of these bills shall be considered as a short-term capital gain which shall be chargeable to tax at the rates applicable in case of an assessee.

Taxability of Dated G-Secs and SDLs

Dated Government securities (Dated G-Secs) and State Development Loans (SDLs) are issued in the form of bonds by Central Government and State Governments, respectively. The taxability of these securities shall be the same as in case of listed bonds, discussed earlier.

No tax is required to be deducted under section 193 from the payment of interest to a resident person in respect of securities of Central Government or State Government except in case of 8% Savings (Taxable) Bonds, 2003 and 7.75% Savings (Taxable) Bonds, 2018. Further, tax on interest paid in respect of 8% Savings (Taxable) Bonds, 2003 and 7.75% Savings (Taxable) Bonds, 2018 is required to be deducted by the payer only when the amount of interest paid during the year exceeds Rs. 10,000.

Example 9: XYZ Bank invested Rs. 50 lakh in Dated G-Secs on 01-01-2015. The bonds are not listed on any recognized stock exchange in India. The details regarding face value, issue price, coupon rate, date of maturity and number of bonds issued are as follows:

Face Value	Rs. 100 each
Issue price	Rs. 125 each
No. of Bonds issued	40,000
Coupon Rate	7.50% per annum
Date of Maturity	31-12-2027

The interest on bonds is paid half-yearly on June 30 and December 31 every year. The Bank transferred such bonds on 01-01-2025 at Rs. 150 each. Compute the amount of interest income and capital gain chargeable to tax in the hands of XYZ Bank for the financial year 2024-25.

***Answer**:*

1. Computation of interest on Dated G-Secs chargeable to tax for the financial year 2024-25

Particulars	*Amount*
Interest accrued for the month of April, 2024 to Dec, 2024 (40,000 * Rs. 100 * 7.50%* 9/12)	225,000
Interest chargeable to tax for financial year 2024--25	**225,000**

2. Computation of capital gain chargeable to tax for the financial year 2024-25

Computation of capital gain	
Period of holding (from 01-01-2015 to 31-12-2024)	10Years
Nature of capital gain	Always short term irrespective of holding period
Full Value of Consideration (40,000 bonds * Rs. 150 each)	60,00,000
Less: Cost of Acquisition (40,000 Bonds * Rs. 125)	50,00,000
Short term capital gains	10,00,000
Tax rate on capital gain	Applicable tax rate

10.2.3 Tax Free Bonds

As the name suggests, the tax-free bonds are the bonds which provide tax-free income. The interest paid on these bonds is tax-free in the hand of the investor. Section 10 of the Income Tax Act provides various exemptions for the income earned from bonds issued by various organizations.

However, the capital gains arising on transfer or redemption of tax-free bonds shall be chargeable to tax. The taxability of such capital gains is same as in the case of Coupon bonds.

Example 10: Mr. X is issued 5,000 tax free bonds of NABARD at the rate of Rs. 120 each in Year 00. The bonds are listed on recognized stock exchange in India and carrying the interest rate of 5% per annum. The bonds are redeemable in Year 02 at the rate of Rs. 150 each. Discuss the tax implications.

***Answer**:*

The tax implications in the hands of Mr. X shall be as follows:

1. Interest on bonds

Interest on tax free bonds is exempt under section 10 of the Income Tax Act. Thus, no tax shall be payable by Mr. X on interest income.

2. Capital gain arising on redemption of bonds

Capital gain arising on redemption of bonds shall be computed as follows:

Particulars	*Rs.*
Full value of consideration (Rs. 150 * 5000)	750,000
Less:	
Cost of acquisition (Rs. 120 * 5000)	(600,000)
Long-term capital gain	**1,50,000**
Tax rate	**12.50%***
***Note:** As bonds are listed on a stock exchange and the period of holding is more than 12 months, the resultant long term capital gain shall be chargeable to tax at the rate of 12.50%.*	

10.3 Mutual Funds

Mutual Funds are the funds which collect money from the investor and invest the same in the capital market. Mutual Funds invest in a variety of instruments such as equity, debt, bonds, etc.

10.3.1 Types of Mutual Funds

Mutual funds are classified into the following categories based on their investment portfolios:

a) Equity Oriented Funds

These funds invest majorly in shares of companies. They allow investors to participate in the equity market. Though categorised as high risk, these schemes also have a high return potential in the long run.

b) Debt Oriented Funds

These funds invest in debt securities, or interest-bearing instruments like government securities, bonds, debentures, etc. These funds provide low return but considered as safe for investment as compared to equity funds.

c) Money Market Funds or Liquid Funds

These funds invest in liquid instruments such as Treasury Bills and Commercial Papers, etc. having high liquidity. These funds are suitable for conservative investors who want to invest their surplus funds over a short-term for a reasonable return.

d) Balanced or Hybrid Funds

These funds invest in all kinds of assets, that is, equity, debt and money market instruments. Some funds invest their major portion into the equity and the lesser in the debts whereas some opt for the other way around based on their needs for return and risk appetite.

e) Gold fund or Silver fund: Invests in gold or silver.

f) International securities fund: Invests in International securities
g) Fund of Funds: Invest in other funds including all the funds mentioned from (a) to (f) above

Each of the fund types can be listed on the exchange and are referred as exchange traded funds (ETFs). In the case of ETFs, the buyers have to buy or sell the units on the stock exchange. For other mutual funds the investor has to buy or redeem through the Asset Management Company.

10.3.2 Tax on income from mutual funds

Mutual Funds offer investors two main sources of earnings: Capital Gains and Dividends (called as Income Distribution and Capital Withdrawal or IDCW option). The taxation of dividend incomes, from different types of mutual funds, are governed by common provisions under the Income Tax Act. However, the taxation of capital gains resulting from the transfer or redemption of mutual fund units depends on the type of fund.

Until Financial Year 2022-23, mutual funds were categorized into two types for taxation purposes: 1) Equity-oriented Mutual Funds and 2) Other Funds. However, with effect from Financial Year 2023-24 and subsequent amendments, mutual funds are now classified into four types for taxation purposes:

1) Equity-oriented Mutual Funds
2) Specified Mutual Funds (that invest 65% or more of the proceeds in debt or money market instruments, directly or indirectly, and are bought after April 1, 2023)
3) Specified Mutual Funds (mutual funds other than mentioned in 2 above, which invested less than 35% of the proceeds in equity shares of Indian companies directly and were bought after April 1, 2023 but sold before April 1, 2025) These typically include: debt-oriented hybrid mutual funds not covered by point 2 above, gold or silver funds, international securities funds or fund of funds bought and sold during the relevant period.
4) All Other Mutual Funds

In this chapter, we will focus on explaining the taxation provisions related to serial numbers 2, 3 and 4.

10.3.3 Tax on dividend from Mutual Funds

Dividend received by a resident unit-holder from a mutual fund shall be taxable in his hands as per applicable tax rates. An investor is allowed to claim a deduction of interest expenditure incurred to earn that dividend income to the extent of 20% of the total dividend income. No further deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person to realise such dividend.

Where the dividend is received by a non-resident person, the dividend shall be taxable at 20% (subject to the provisions of the DTAA). However, in such cases, the assessee shall not

be allowed to deduct any expenditure from such income. Further, deduction under Chapter VIA (i.e., section 80C to 80U) shall not be allowed from such income even under the old tax regime.

***Example 11**:* Mr. A (resident in India) invested Rs. 50 lakhs in debt oriented mutual funds. He received dividend of Rs. 500,000 in respect of such units. He paid interest of Rs. 150,000 on the amount borrowed for making investment in mutual funds. Determine the taxability of dividend in the hands of Mr. A. Also comment whether the taxability will remain same if Mr. A is a non-resident in India?

***Answer**:*

The amount of dividend income taxable in the hands of Mr. A shall be as follows:

Particulars	*Amount (in Rs.)*
Amount received as dividend [A]	500,000
Expenses incurred for realising dividend [B]	150,000
Maximum amount which can be claimed as expenses [C = A * 20%]	100,000
Taxable dividend income [D = A - C]	400,000

Since Mr. A is resident in India, dividend income will be taxable in his hands at the normal tax rates. However, if he is non-resident in India then he would not be allowed to claim deduction for expenses and entire dividend income of Rs. 500,000 shall be taxable at the rate of 20% (subject to the provisions of DTAA).

10.3.4 Tax on capital gain from Specified Mutual Funds (being a mutual fund that invests 65% or more of the proceeds in debt or money market instruments directly or indirectly and are bought after April 1, 2023)

The specified mutual fund (SMF) is a mutual fund where at least 65% of the total proceeds are invested in debt or money market instruments either directly or indirectly through another fund and has been bought after April 1, 2023. The taxation of capital gain from such SMF is governed by the provision of Section 50AA.[27]

Section 50AA applies prospectively to such SMFs acquired on or after 01-04-2023. This means the SMFs acquired on or before 31-03-2023 will be subject to taxation as per the normal provisions as applicable in the case of any other mutual fund (outlined in section 4.3.6 below). Section 50AA will not apply to such specified mutual funds acquired on or before 31-03-2023.

In general, a capital asset is bifurcated into a short-term and a long-term capital asset based on the period of holding to compute the capital gain arising from its transfer or redemption. However, as per Section 50AA, the capital gains arising from the transfer, redemption or

[27] Inserted by the Finance Act, 2023 with effect from Assessment Year 2024-25 and amended by the Finance no 2 Act, 2024 with effect from Assessment Year 2026-27.

maturity of such SMFs shall be taxable as short-term capital gains irrespective of the period of holding.

The short-term capital gains from SMFs shall be computed in the following manner:

Particulars	*Rs.*
Full value of consideration	xxx
Less:	
(a) Cost of acquisition of units	(xxx)
(b) Expenditure incurred wholly and exclusively in connection with the transfer or redemption or maturity of SMFs	(xxx)
Short-term capital gain or loss	**xxx**

The short-term capital gain so computed shall be taxable at normal tax rates as applicable in the case of the assessee.

4.3.5 Tax on capital gain from Specified Mutual Funds (being any mutual fund other than mentioned in 4.3.4 above, which had invested less than 35% of the proceeds in equity shares of Indian companies directly and were bought on or after April 1, 2023, but sold before April 1, 2025)

These typically include: debt-oriented hybrid mutual funds, gold or silver funds, international securities funds or fund of funds bought and sold during the relevant period.

This is a very limited edition Specified Mutual Fund (SMF) that is applicable only during the relevant period as mentioned in the heading of this section. The taxation of capital gain from this limited edition Specified Mutual Fund is governed by the provisions of Section 50AA[28] and is same as 4.3.4, i.e. all gains are taxed as short-term capital gains at applicable rates.

10.3.5 Tax on capital gains from Other Mutual Funds

Long-term capital gain from Other Mutual Fund

The difference, between the value at which an investor purchased the units of a mutual fund scheme and the value at which these units are sold or redeemed, shall be taxable under the head capital gains.

Units of a such mutual funds which are listed are treated as a long-term capital asset if they are held for more than 12 months immediately preceding the date of transfer. Where the mutual fund is unlisted, the period of holding needs to be 24 months to qualify as long term capital asset.

Long-term capital gain arising from the transfer of such funds is chargeable to tax at the rate of 12.50%.

[28] Inserted by the Finance Act, 2023 with effect from Assessment Year 2024-25 and amended by the Finance no 2 Act, 2024 with effect from assessment year 2026-27.

Short-term capital gain from Other Mutual Fund

Short-term capital gains arising from the sale of units of such mutual funds is chargeable to tax as per the rate applicable in case of an assessee.

Example 12: Mr. A acquired 1,000 units of a debt-oriented mutual fund at Rs. 150 per unit on 01-01-2017. He sold such units on 15-03-2025 at Rs. 300 per unit. Compute the amount of capital gain chargeable to tax in hands of Mr. A.

Answer:

Computation of capital gain	
Period of holding (from 01-01-2017 to 14-03-2025)	8+ Years
Nature of capital gain (period of holding is more than 24 months)	Long-term capital gain
Full Value of Consideration (1,000 units * Rs. 300)	300,000
Less: Cost of Acquisition	(1,50,000)
Long-term capital gain	**1,50,000**
Tax rate on capital gain	**12.50%**

10.4 Taxation of Non-residents

Non-residents are generally exposed to double taxation due to tax liability in two or more countries. Consider a case of Mr. A who is non-resident in India and resident of USA. He derives interest income of Rs. 10,00,000 from debentures held in India. Under normal provisions of the Indian Income Tax Act, 1961, his interest income will be taxed as per his slab rates. Since he is a resident of USA, he will be taxed again in USA. This can put him in adverse position affecting his returns on investment.

In order to avoid this, the countries all over the world, including India, have entered into Double Taxation Avoidance Agreements (DTAAs) with other countries. Accordingly, where a non-resident is eligible for DTAA benefits, he will be taxed at a rate mentioned in the relevant DTAA or the Income Tax Act, whichever is more beneficial to him.

In the given example, as per Article 11 of the India-USA DTAA, interest income in the hands of Mr. A will be taxed at a concessional rate of 15%. Also, Mr. A will be eligible for tax credit in USA to the extent of Indian taxes paid.

The income tax rates in case of various incomes may be different for non-residents. For instance, dividends on shares are taxed at normal slab rates for resident individuals. In case of non-residents, the tax rate on dividends from shares is 20% (plus applicable surcharge and cess).

For instance, in the above example, consider that Mr. A also has dividend income of Rs. 220,000 from shares of Indian companies. The tax rate as per the Indian Income Tax Act is 20%. The tax rate as per the India-USA DTAA is 25%. Since the rate as per the Income Tax Act is lower, Mr. A can opt for tax rate under Income Tax Act i.e. 20%.
Now, if Mr. A is a tax resident of UK rather than USA - In that case, the India-UK DTAA provides a rate of 10%. Here, Mr. A can opt for rate as per the said DTAA.

In order to claim any relief under the DTAAs, the non-resident will be required to obtain Tax Residency Certificate (TRC) of the country of its residence. In addition to TRC, the non-resident payee also needs to furnish Form 10F which is a self-declaration giving prescribed details.

In case of Non-resident individuals who are Indian citizens or Persons of Indian Origin, they also have an option to avail the provisions of chapter XII-A of the Income Tax Act which provide concessional rate of tax.

The relevant provisions of Chapter XII-A are given below:

- Available to Indian Citizens or Persons of Indian Origin who are non-resident under the Indian Income Tax Act. For the purposes of this chapter, an individual shall be considered as Person of Indian origin if he, or either of his parents or any of his grand- parents, was born in undivided India.
- Investments should be made in convertible foreign exchange while being non-resident.
- Eligible Investments:
    - Shares in an Indian Company
    - Debentures and Deposits in an Indian company which is not a private company under the Companies Act
    - Certain Government securities
- No indexation benefit is available.
- Tax on Investment income is capped at 20% (plus applicable surcharge and cess) and long-term capital gains is at 12.50% (plus applicable surcharge and cess).
- Where the assessee, while he is a non-resident Indian, transfers the above-mentioned assets and re-invests the whole or part of the net consideration within a period of six months in the above-mentioned assets, the long-term capital gains arising out of the same can be claimed as exempt as follows:
    - Where entire net consideration is re-invested, the whole of the long-term capital gains is exempt
    - Where a part of the net consideration is re-invested, the proportionate amount of long-term capital gains will be exempted
- In case the new asset so purchased, is transferred within three years from the date of acquisition, the capital gains which were claimed exempted earlier, will be taxed in the year when the new asset is so transferred.
- The assessee can opt to be taxed at 20% on investment income related to Debentures & deposits in non-private companies and government securities even after he becomes a resident in India. He can exercise such option in the return of income.
- As long as he remains non-resident, he can choose not to be governed by the provisions of this chapter.

Finance Act 2021 brought in amendments to address the mismatch in taxation of income from notified overseas retirement fund:

Earlier, non-residents, who later on settle down in India, used to face a typical issue of double taxation in case of their overseas retirement funds. Earlier the withdrawal from such funds was taxed on receipt basis in such foreign countries, while on accrual basis in

India. In order to address this mismatch and remove this genuine hardship, section 89A to the Act was inserted to provide that the income of a specified person from specified account shall be taxed in the manner and in the year as prescribed by the Central Government. Section 89A defined the expression - specified person, as a person resident in India who opened a specified account in a notified country while being non-resident in India and resident in that country. Specified account is defined as an account maintained in a notified country which is maintained for retirement benefits and the income from such account is not taxable on accrual basis and is taxed by such country at the time of withdrawal or redemption. The countries notified so far are: United States of America, Canada and United Kingdom. For Indian residents, the income from the specified retirement accounts in these countries will be taxed at the time of withdrawal of funds from those retirement accounts and not on accrual basis.

10.5 Taxation of Market Linked Debentures

Market Linked Debentures (MLDs) are financial instruments regulated in India by various laws and regulations.[29] These debentures differ from traditional fixed-income investments as their returns are not fixed, instead linked to the performance of an underlying market index or security. The movement of the underlying asset determines the returns on MLDs. MLDs can be of two types: 1) Principal Protected MLDs and 2) Principal Non-Protected MLDs.

Principal Protected MLDs guarantee the return of the investor's principal amount at maturity, regardless of the underlying asset's performance. Whereas, Principal Non-Protected MLDs do not guarantee the return of the principal amount at maturity. The coupon rates vary based on the performance of the underlying asset.

The key features of MLDs are as follows:

(a) Computation of Coupon Rate: The returns on MLDs are variable and depend on the performance of the underlying index or security. If the underlying asset performs well, the MLDs will provide a higher return at maturity, but if it performs poorly, the returns may be lower or result in a loss of principal.

(b) Issuers and Investors: MLDs can be issued by companies with a minimum net worth of Rs. 100 crores. Investors, typically high-net-worth individuals (HNIs) or ultra HNIs, can invest in MLDs.

(c) Tenure and Repayment: The maximum tenure for MLDs is generally between 12 to 36 months. Unlike traditional debentures that provide periodic interest payments, MLDs offer returns only upon maturity, comprising the principal sum plus earned interest.

10.5.1 Tax on income from MLDs

Upto Financial Year 2022-23, income from market-linked debentures was taxable similarly to regular debentures or coupon bonds. However, with effect from the Financial Year 2023-

[29] SEBI (Issue and Listing of Non-Convertible Securities) Regulations, 2021, SEBI Circular No. SEBI/HO/DDHS/P/CIR/2021/613, dated 10-08-2021, Section 71 of the Companies Act, 2013 and Income-tax Act, 1961

24, a new section 50AA is inserted under the Income Tax Act, which governs the taxability of income arising from MLDs held as capital assets.

Section 50AA defines MLD as a security which has an underlying principle component in the form of debt security and where the returns are linked to the market returns on other underlying securities or indices and includes any security classified or regulated as an MLD by SEBI.

MLDs transferred, redeemed or matured on or after 01-04-2023 shall be subject to taxation under Section 50AA, even if such MLDs were issued or acquired before that date.

In general, a capital asset is bifurcated into a short-term and a long-term capital asset based on the period of holding to compute the capital gain arising from its transfer or redemption. However, as per Section 50AA, the capital gains arising from the transfer, redemption or maturity of MLDs shall be taxable as short-term capital gains irrespective of the period of holding.

The short-term capital gains from MLDs shall be computed in the following manner:

Particulars	*Rs.*
Full value of consideration	xxx
Less:	
(c) Cost of acquisition of MLDs	(xxx)
(d) Expenditure incurred wholly and exclusively in connection with the transfer, redemption, or maturity of MLDs	(xxx)
Short-term capital gain or loss	xxx

The short-term capital gain so computed shall be taxable at normal tax rates as applicable in the case of the assessee.

10.6 Benefits not allowed from capital gain arising from Market Linked Debentures (MLDs) or the 2 types of Specified Mutual Funds (SMFs) (mentioned in 4.3.4 and 4.3.5) under Section 50AA

No benefit of period of holding

In general, a capital asset is bifurcated into a short-term and a long-term capital asset based on the period of holding to compute capital gain. However, irrespective of the period of holding, the capital gains arising from the transfer, redemption or maturity of MLDs or SMFs shall be taxable as short-term capital gains.

No deduction for the cost of improvement

In relation to the MLDs or SMFs, the cost of improvement shall be taken to be nil, notwithstanding whether it has been incurred by the assessee himself or by the previous owner.

10.7 Summary of Taxation of Debt Products

[Sale assumed to be after July 23, 2024]

Product	***Period of holding to qualify for long-term capital asset (in months)***	***Tax on short-term capital gain***			***Tax on long-term capital gain***	
		In case of resident	*In case of non-resident*		*In case of resident*	*In case of non-resident*
Sovereign Gold Bond (Listed) *[Note 1]*	12	Normal tax rate	Normal tax rate		12.50%	12.50
Any other Bond (Listed)	12	Normal tax rate	Normal tax rate		12.50%	12.50%
Any other Bond (Unlisted)	Not applicable	Normal tax rate	Normal tax rate		-	-
Treasury Bills (T-Bills)	-	Normal tax rate	Normal tax rate		-	-
Dated Government Securities (Dated G-Secs) (Listed)	12	Normal tax rate	Normal tax rate		12.5%	12.5%
Dated Government Securities (Dated G-Secs) (Unlisted)	NA	Normal tax rate	Normal tax rate			
Municipal Debt Securities (listed)	12	Normal tax rate	Normal tax rate		12.50%	12.50%
Debentures (Listed)	12	Normal tax rate	Normal tax rate		12.50%	12.50%
Debentures (Unlisted)	-	Normal tax rate	Normal tax rate		Normal Tax rate	Normal Tax rate
Market Linked Debentures (MLDs)	-	Normal tax rate	Normal tax rate		Normal tax rate	Normal tax rate
Specified Mutual Funds (SMFs) Type 1 *[Note 2 and 3]*	-	Normal tax rate	Normal tax rate		Normal tax rate	Normal tax rate
Specified Mutual Funds (SMFs) Type 2 *[Note 2 and 3]*	-	Normal tax rate	Normal tax rate		Normal tax rate	Normal tax rate
Other Mutual Funds *[Note 2]*	24 / 12	Normal tax rate	Normal tax rate		12.50%	12.50%

Note 1: Capital gain arising to an Individual on redemption of Sovereign Gold Bond shall not be chargeable to tax under section 47 of the Income-tax Act. The rates mentioned are only for capital gains arising from sale other than on redemption.

Note 2: A resident shareholder is allowed deduction of interest expenditure incurred to earn dividend income from specified or debt-oriented mutual funds to the extent of 20% of total dividend income. No further deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person for the purpose of realising such dividend. However, a non-resident person, shall not be allowed to deduct any expenditure from dividend income. Further, deduction under Chapter-VIA (i.e., section 80C to 80U) shall not be allowed from such income.

Note 3: Specified Mutual Funds (Type 1) are those which invest more than 65% in debt and money market instrument. Specified Mutual Funds (Type 2) are those that have invested less than 35% in equity shares, purchased after April 1, 2023 and sold before April 01, 2025.

CHAPTER 11: TAXATION OF EQUITY PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Tax treatment for Listed and Unlisted Equity Shares
- Taxation of Preference Shares/Share Warrants
- Taxation of Equity Oriented Mutual Funds
- Tax treatment for Derivatives
- Bonus Stripping

The equity market, often called a stock market or share market, is a place where shares of companies or entities are traded. The market allows sellers and buyers to deal with equity shares and other securities on the same platform. Equity share represents the ownership of a person in the company. Equity investments are generally considered as risky as compared to debt instruments. There are many types of equity-related products available in the market, but they are not the same. Tax rules applicable to these products also differ. Taxes can reduce the overall returns that an investor gets from a product. Thus, it is important to understand the taxability of equity products before making an investment therein.

11.1 Sources of Income

An equity investment generally refers to the buying and holding of shares by an investor in anticipation of the return of income. Two types of income are earned from investment in the equity products - Capital gains and Dividend Income. Capital Gains arise when a capital asset is sold at a price higher than its cost of acquisition. The dividend is the sum paid by the company out of its profits to shareholders which, in turn, reduce the retained profits of the company.

Taxability of both types of incomes has been discussed in detail in the forthcoming paragraphs of this chapter.

11.1.1 Dividend Income

Dividend usually refers to the distribution of profits by a company to its shareholders. The dividend is paid by a company out of its profits. Thus, a share of profit received by a shareholder out of the profits of the company, proportionate to his shareholding, is termed as 'Dividend'.

Dividend declared at an annual general meeting is deemed to be the income of the previous year of the shareholder in which it is declared. The date of receipt by the assessee is not material. The interim dividend is deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to the shareholder. In other words, it is chargeable to tax on receipt basis.

The tax treatment of the dividend in the hands of shareholders depends on whether the dividend is received from a foreign company or a domestic company.

Tax on dividend

After the abolition of dividend distribution tax by the Finance Act, 2020 with effect from Financial Year 2020-21, if a company, mutual fund, business trust or any other fund distributes dividend to its shareholders or unit-holders then such dividend income is taxable in the hands of such shareholder or unit-holders. The taxability of dividend and tax rate thereon shall depend upon the residential status of the shareholders and quantum of income. In case of a non-resident shareholder, the provisions of Double Taxation Avoidance Agreements (DTAAs) and Multilateral Instrument (MLI) shall also come into play.

11.1.2 Capital Gains

Any profit or gain arising from the sale of a 'capital asset' is chargeable to tax as a capital gain.

Income from Capital Gains is computed as under:

Particulars	*Amount*
Full Value of Consideration	xxx
Less:	
a) Expenses incurred wholly and exclusively in connection with transfer	(xxx)
b) Cost of Acquisition/	(xxx)
c) Cost of Improvement/	(xxx)
Less:	
Exemption under Sections 54 to 54GB to the extent of the net result of above calculation	(xxx)
Short-term or Long-term Capital Gains	**xxx**

The capital gains from the sale of equity shares can be either long-term capital gains or short-term capital gains depending upon the period of holding of capital assets. This distinction is important as the incidence of tax is higher on short-term capital gains as compared to the long-term capital gains. Generally, the period of holding of a capital asset is calculated from the date of its purchase or acquisition till the date of its transfer.

Rate of tax on capital gains differs according to the nature of capital gain. Long-term capital gains are taxable at concessional rates of 12.50%. Short-term capital gains are generally added to total taxable income and are chargeable to tax as per tax rate applicable according to the status of the assessee. However, in a few cases, short-term capital gains are also taxable at concessional rate of 20%

In this chapter, we will discuss the tax treatment of capital gains arising from the following equity products:

i. Listed Equity Shares
ii. Unlisted Equity Shares
iii. Preference shares
iv. Share warrants
v. Equity Oriented Mutual Funds
vi. Equity Derivatives

11.2 Listed Equity Shares

Equity shares represent ownership of a person in a company. Any company offering its shares to the public for subscription is required to be listed on the stock exchange and has to comply with the conditions as provided in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (commonly known as SEBI (ICDR), Regulations).

Listing of securities with stock exchange is a matter of great importance for companies and investors because this provides the liquidity to the securities in the market. The two major stock exchanges of India in which shares of a company can be listed are Bombay Stock Exchange (BSE) and National Stock Exchange (NSE).

11.2.1 Charges & Taxes

Various taxes and charges are payable to purchase and sell equity shares through stock exchanges, which have been explained below.

Brokerage

Brokerage is charged by the share broker who maintains the share trading account of the investor. The amount of brokerage depends upon the broker and nature of the order placed.

Security Transaction Tax (STT)

The securities transaction tax is a tax levied on sale/purchase of securities (other than debt securities or debt mutual fund). Every recognised stock exchange or trustee of a mutual fund or lead merchant banker (in case of IPO) is required to collect the STT from purchaser or seller of the securities, as the case may be, and, subsequently remitt the same to the Central Government. STT collected during a calendar month is required to be paid to the Central Government by 7th day of the month immediately following the said calendar month.

Stamp Duty

Stamp duty is levied for transferring shares and securities from one person to another. Stamp duty is levied by States, thus, the rate of duty varies from state to state. However, with effect from April 1, 2020, stamp duty are levied at unified rates across India in respect of listed securities. The same rate applies even in case of off-market transactions.

Exchange Charges

This charge is levied by the stock exchanges of India. Transaction charges are levied on both sides of the trading and are same for both intraday and delivery.

SEBI Turnover Charges

Securities Exchange Board of India (SEBI) is the security market regulator, which forms rules and regulations for the stock exchanges. Turnover charge of Rs. 10 per crore is levied by SEBI for regulating the markets. This charge is levied on both sides of transaction, i.e., while buying and selling.

Depository Participant (DP) Charges

NSDL (National Securities Depository Limited) and CDSL (Central Depository Services Limited) are two stock depositories in India. The depositaries hold shares and securities in electronic form on behalf of the shareholder and facilitate exchange thereof between buyer and seller. When a person buys shares, such shares are credited in DEMAT account of that person and when he sells such shares to someone else, they are debited from his DEMAT account. Depositories levy a charge plus GST (irrespective of quantity) for this facility on the day the securities are debited from DEMAT Account.

The depository participants form the bridge between the investors and the depository as investors cannot directly approach the depository. Therefore, the depository charges fee from the depository participant and who in turn, charge the investors.

Goods and Services Tax (GST)

It is levied on the amount of brokerage, exchange transaction charges and clearing charges. At present, the GST is charged at the rate of 18% on the amount of brokerage, transaction and clearing charges.

11.2.2 Tax on dividend

Dividend received by a resident shareholder is taxable in his hands at the applicable rates. A resident shareholder is allowed a deduction of interest expenditure incurred to earn that dividend income to the extent of 20% of total dividend income. No further deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person for the purpose of realising such dividend.

Where the dividend is received by a non-resident person or foreign company (including foreign portfolio investors (FPIs) and Non-resident Indian Citizens), the dividend shall be taxable in their hands at special rates, subject to provisions of DTAA. However, no expenditure shall be allowed to be deducted from such income. Further, deduction under Chapter-VIA, *that is*, Sections 80C to 80U, shall not be allowed from such income.

As per DTAA, dividend income is generally chargeable to tax in the source country as well as the country of residence of the assessee and, consequently, country of residence provides a credit of taxes paid by the assessee in the source country. Thus, the dividend

income shall be taxable in India as per provisions of the Act or as per relevant DTAA, whichever is more beneficial.

As per most of the DTAAs India has entered into with foreign countries, the dividend is taxable in the source country in the hands of the beneficial owner of shares at the rate ranging from 5% to 15% of the gross amount of the dividends.

11.2.3 Some important aspects

Period of holding

The tax treatment of gains or losses arising from the sale of listed equity shares depends upon whether the gains are long-term or short-term. Shares which are listed on the recognised stock exchange in India are treated as a short-term capital asset if they are held for not more than 12 months immediately preceding the date of transfer. In other cases, they are treated as long term capital assets.

Securities held in Physical Form

If listed shares or securities are sold through brokers, the date of the broker's note is treated as date of transfer, provided the contract is followed up by delivery. Thus, the period of holding should be counted from the date of purchase to the date of the broker's note.

In case the transaction takes place directly between the parties and not through the stock exchange, the date of the contract of sale as declared by the parties is treated as the date of transfer, provided it is followed by the actual delivery of shares and the transfer deeds.[30]

Securities held in Demat Form

As per Section 45(2A) the period of holding of securities held in Demat Form shall be determined as per First-In-First-Out (FIFO) Method.[31] It implies that the securities that first entered into the Demat account are deemed to be the first to be sold out. In other words, the securities acquired last will be taken to be remaining with the assessee while securities acquired first will be treated as sold. For determining the period of holding, the contract note or Broker's note shall be considered provided such transactions are followed by delivery of shares and transfer deeds.

In the depository system, the investor can open and hold multiple accounts. In such a case, where an investor has more than one security account, FIFO method will be applied account-wise. This is because where a particular account of an investor is debited for sale of securities, the securities lying in his other account cannot be construed to have been sold as they continue to remain in that account.

[30]Circular No. 704, dated 28.04.1995
[31]Circular No. 768, Dated June 24, 1998

If in an existing account of Demat stock, the old physical stock is dematerialized and entered at a later date, under the FIFO method, the basis for determining the movement out of the account is the date of entry into the account.

***Example 1**:*

Date of credit in Demat account	*Date of purchase*	*Particulars*	*Quantity*
1-6-2020	25-05-2020	Purchased directly in Demat Form	2,000
5-6-2020	01-11-2005	Shares certificates Dematerialized	5,000
10-6-2020	10-6-2020	Purchased directly in Demat form	4,000
15-6-2020	01-05-2001	Shares certificates Dematerialized	3,000

If 2,500 shares are sold from this account, then the cost of acquisition of first 2,000 shares shall be calculated from 25-5-2020, whereas the balance 500 shares will be treated as having been acquired on November 1, 2005, at the relevant cost. This is the effect of the FIFO method.

11.2.4 Tax on long-term capital gains as per section 112A

Earlier the long-term capital gains arising from the sale of listed equity shares were exempt under section 10(38) of the Income Tax Act. In Finance Act, 2018, the long-term capital gains arising from the sale of listed equity shares were made taxable. Such long-term capital gain is chargeable to tax at different rates depending upon the year of acquisition and the payment of STT.

Rate of tax

As per the Finance Act 2024, where the total income of the assessee includes long-term capital gain arising from transfer of listed equity shares, no tax shall be charged on such long-term capital gain if the aggregate amount of such gain during the year is upto Rs. 1,25,000. If the amount of capital gain exceeds Rs. 1,25,000 then the excess amount shall be chargeable to tax at concessional rate of 12.50% (plus applicable surcharge and cess) under section 112A of the Income Tax Act. However, this section applies only when securities transaction tax is paid at the time of acquisition and at the time of transfer of equity shares except in the following cases:

Exception 1: Transaction undertaken on a stock exchange located in IFSC

The condition of payment of STT shall not be applicable if the transfer is undertaken on a recognised stock exchange located in an International Financial Services Centre (IFSC). This concession is available only when the consideration for such transaction is received or receivable in foreign currency.

Exception 2: If STT is not paid at the time of acquisition

The benefit of the concessional tax rate is available in case of transfer of equity shares if STT is chargeable both at the time of transfer and at the time of acquisition of shares. The CBDT[32] has relaxed this condition of payment of STT at the time of acquisition in the following scenarios:

a) Shares are acquired before 1-10-2004;
b) The acquisition has been approved by the Supreme Court, High Court, NCLT, SEBI or RBI;
c) The acquisition by any non-resident is in accordance with FDI guidelines issued by the Government of India;
d) The acquisition is done by an Investment Fund or Venture Capital Fund or a Qualified Institutional Buyer;
e) The acquisition is done through a preferential issue to which SEBI (Issue of Capital and Disclosure Requirements) Regulations does not apply;
f) The acquisition is done through an issue of share by a company;
g) The acquisition of shares is made by the scheduled banks, reconstruction or securitisation companies or public financial institutions during their ordinary course of business;
h) The acquisition is done under the ESOP or ESPS scheme framed under SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999
i) The acquisition of shares is made as per SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 2011;
j) The acquisition is made from the Government; and
k) The acquisition is made by mode of transfer referred to in Section 47 or Section 50B or Section 45(3) or Section 45(4) of the Income Tax Act, if the previous owner or transferor of such shares has acquired shares by any of the modes given in this list.

Cost of acquisition of shares acquired on or before 31-01-2018

The Finance Act 2018 grand-fathered the investments made on or before 31-01-2018 as the long-term capital gains arising from the sale of equity shares chargeable to STT were previously exempt from tax. The concept of grandfathering under this provision works as per the following mechanism.

If equity shares were acquired on or before 31-01-2018, the cost of acquisition of such shares or units shall be higher of the following:

a) The actual cost of acquisition of equity shares; or
b) *Lower* of the fair market value of such asset as on 31-01-2018 or full value of the consideration received as a result of the transfer of equity shares.

In case of listed equity shares, the highest price of share quoted on a recognized stock exchange as on 31-01-2018 is taken as the fair market value. If there is no trading in such share on such exchange on 31-01-2018, the highest price of such share on a date

[32]Notification No. 60/2018, dated 01-10-2018

immediately preceding 31-01-2018 when such share was traded shall be the fair market value.

However, the fair market value of the following equity shares will be the cost of acquisition indexed by the cost inflation index of financial year 2017-18 and divided by the cost inflation index of the year in which the shares were acquired or the FY 2001-02. whichever is *later*:

(a) Shares are not listed on recognised stock exchange on 31-01-2018 but listed on such exchange on the date of transfer; or
(b) Shares listed on a recognised stock exchange on the date of transfer and which became the property of the assessee in consideration of share which is not listed on such exchange as on 31-01-2018 by way of transaction not regarded as transfer under Section 47.

In general, cost of acquisition of the bonus shares are taken to be *nil*, however, if bonus shares are complying with the conditions prescribed in section 112A, the cost of acquisition shall be computed in the manner described above.

Let's understand how to compute long-term capital gains with the help of the following examples.

Scenario 1: An equity share is acquired on 01-01-2017 at Rs. 100, its fair market value is Rs. 200 on 31-01-2018 and it is sold on 01-01-2025at Rs. 250.

As the actual cost of acquisition is less than the fair market value as on 31-01-2018, the fair market value of Rs. 200 will be taken as the cost of acquisition and the long-term capital gain will be Rs. 50 (Rs. 250 - Rs. 200).

Scenario 2: An equity share is acquired on 01-01-2017 at Rs. 100, its fair market value is Rs. 200 on 31-01-2018 and it is sold on 01-01-2025 at Rs. 150.

In this case, the actual cost of acquisition is less than the fair market value as on 31-01-2018. However, the sale value is also less than the fair market value as on 31-01-2018. Accordingly, the sale value of Rs. 150 will be taken as the cost of acquisition and the long-term capital gain will be *nil* (Rs. 150 - Rs. 150). In other words, grandfathering cannot result in a long-term capital gain turning into a long-term capital loss, just because the sale price is lower than the fair market value as on 31-01-2018, but higher than the original cost of acquisition.

Scenario 3: An equity share is acquired on 01-01-2017 at Rs. 100, its fair market value is Rs. 50 on 31-01-2018 and it is sold on 01-01-2025 at Rs. 150.

In this case, the fair market value as on 31-01-2018 is less than the actual cost of acquisition, and therefore, the actual cost of Rs. 100 will be taken as the actual cost of acquisition and the long-term capital gain will be Rs. 50 (Rs. 150 - Rs. 100).

Scenario 4: An equity share is acquired on 01-01-2017 at Rs. 100, its fair market value is Rs. 200 on 31-01-2018 and it is sold on 01-01-2025 at Rs. 50.

In this case, the actual cost of acquisition is less than the fair market value as on 31-01-2018. The sale value is less than the fair market value as on 31-01-2018 and also the actual cost of acquisition. Therefore, the actual cost of Rs. 100 will be taken as the cost of acquisition in this case. Hence, the long-term capital loss will be Rs. 50 (Rs. 50 - Rs. 100) in this case.

Cost of acquisition of shares acquired on or after 01-02-2018

The cost of acquisition of equity shares, which are acquired on or after 01-02-2018, shall be computed as per general principles of Section 55, i.e., the actual cost for which it is acquired by the assessee.

11.2.5 Tax on long-term capital gain as per section 112

Long-term capital gains arising from the sale of equity shares that are not covered under section 112A (listed Equity shares) are taxable at the same rate of 12.50% under section 112. Long term capital gains on Listed equity shares satisfying the conditions mentioned in section 112A (primarily that securities transaction tax has been paid both on acquisition and sale or transaction is undertaken in foreign currency on a recognized stock exchange located in an IFSC) pay the same rate of tax @12.50% but with the first Rs. 1.25 lakh not being charged in that case.

11.2.6 Tax on short-term capital gains as per section 111A

Short-term capital gains arising from the sale of listed equity shares satisfying the conditions mentioned there (primarily that securities transaction tax has been paid both on acquisition and sale or transaction is undertaken in foreign currency on a recognized stock exchange located in an International Financial Services Centre) is chargeable to tax at concessional rate of 20% if the transaction is chargeable to Securities transaction tax or transaction is undertaken in foreign currency on a recognized stock exchange located in an International Financial Services Centre.

However, no deduction under Sections 80C to 80U shall be allowed from short-term capital gains covered under section 111A.

11.2.7 Tax on normal short-term capital gain

Short-term capital gain arising from the sale of equity shares is chargeable to tax at normal rates as applicable in case of an assessee if it is not taxable at the concessional rate of 20% under section 111A. This case arises if conditions specified under Section 111A aren't satisfied.

Tax treatment of Listed Equity Shares is enumerated in the below table (see Table 11.1):

Table 11.1: Capital Gains Tax on Listed Equities

Nature	***Rate of Tax (If STT is paid)***	***Rate of Tax (If STT is not paid)***	
Long Term	12.50% with the first Rs. 1.25 lakhs not being taxed		12.50%
Short Term	20%		As per applicable rate of tax

Rate of surcharge on the capital gains arising from the transfer of listed equity shares by an Individual, HUF, is enumerated in the below table.

Total Income	*Capital gains covered under Section 112, 112A and 111A*	*Other Income*
Up to Rs 50 lakhs	Nil	Nil
Rs 50 lakhs – Rs 1 crore	10%	10%
Rs 1 crore – Rs 2 crore	15%	15%
Rs 2 crore – Rs 5 crore	15%	25%
Above Rs 5 crore	15%	25% if opts for new tax regime of Section 115BAC otherwise 37%

Example 3: Mr. X (resident in India) made investment in equity shares of the following listed companies:

Company	*No. of shares*	*Date of Purchase*	*Purchase cost (Per share)*
ABC Ltd.	1,000	01-06-2023	Rs. 105
XYZ Ltd.	1,500	01-10-2023	Rs. 120

During the Financial Year 2024-25, he sold the shares as follows:

Company	*No. of shares*	*Date of sale*	*Selling price (Per share)*
ABC Ltd.	1,000	24-07-2024	Rs. 107
XYZ Ltd.	1,000	01-08-2024	Rs. 135

Answer:

The computation of capital gain from sale of shares by Mr. X during the financial year 2024-25 shall be as follows:

Particulars	*ABC Ltd.*	*XYZ Ltd.*

Date of Purchase	01-06-2023	01-10-2023
Date of sale	24-07-2024	01-08-2024
Period of holding	13 + Months	10 Months
Nature of Capital Gain	Long term capital gains	Short term capital gains
Full Value of Consideration [A]	Rs. 107,000 (1,000 shares * Rs. 107)	Rs. 135,000 (1,000 shares * Rs. 135)
Cost of Acquisition [B]	Rs. 105,000 (1,000 shares * Rs. 105)	Rs. 120,000 (1,000 shares * Rs. 120)
Amount of capital gain [A-B]	Rs. 2,000	Rs. 15,000
Tax rate	12.50% under Section 112A (on capital gains in excess of Rs. 1.25 lakhs). So, if these are the only long-term capital gains chargeable under section 112A then there will be no long-term capital gains tax payable.	20% under Section 111A

11.3 Tax Treatment of Unlisted Equity Shares

Unlisted shares or unquoted shares are the shares which are not listed on any recognised Stock Exchange in India. The tax treatment of gains or losses arising from the sale of unlisted equity shares depends upon whether the gains are long term or short term. Unlisted shares of a company are treated as short-term capital asset if they are held for not more than 24 months immediately preceding the date of transfer; whereas, if the shares are held for more than 24 months then long-term capital gain arises.

11.3.1 Tax on dividend from unlisted shares

The taxability of dividend income arising from unlisted equity shares shall be same as in case of listed equity shares.

11.3.2 Tax on long-term capital gains from unlisted shares

Long-term capital gains arising from the sale of unlisted equity shares shall be taxable at the rate of 12.50% *plus* surcharge and health & education cess

Where unlisted equity shares are offered for sale under an initial public offer (IPO), gain arising therefrom shall be chargeable to tax in accordance with the provisions contained under Section 112A.

11.3.3 Tax on short-term capital gains from unlisted shares

Short-term capital gain arising from the transfer of unlisted shares shall be taxable at the normal rate as applicable in case of an assessee.

Example 4*:* If in Example 3, shares of ABC Ltd. and XYZ Ltd. are not listed on a stock exchange. Will there be any difference in tax implications in the hands of Mr. X?

Answer:
Unlisted shares are treated as long-term capital asset if they are sold after holding for a period of more than 24 months. Whereas, capital gain arising from transfer of listed shares is treated as long-term capital gain if they are sold after holding for more than 12 months.

As shares of ABC Ltd. and XYZ Ltd. were sold within 24 months, the resultant capital gain shall be taxable as short-term capital gains. Further, as the shares are not listed on a stock exchange, the short-term capital gain shall be taxable at normal slab rate.

11.4 Tax Treatment of Preference Shares

Preference shares are those shares which carry certain special or priority rights. The preference share-holders get a right of fixed dividend, whose payment takes priority over ordinary dividends. Capital raised by the issue of preference shares is called preference share capital.

Preference share capital, with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right to:

a) Payment of dividend, either as a fixed amount or at a fixed rate, and
b) Repayment in the case of a winding-up or repayment of capital specified in the memorandum or articles of the company.

11.4.1 Tax on dividend from preference share

The taxability of dividend income arising from preference shares shall be same as in case of equity shares.

11.4.2 Tax on long-term and short-term capital gain from preference share

	Holding period to qualify as long term capital asset	**Rate of tax**
Listed shares	12 months	Long term capital gains: 12.50% Short term capital gains: applicable rates
Unlisted shares	24 months	Long term capital gains: 12.50% Short term capital gains: applicable rates

Example 5: Mr. X (resident in India) acquired 1,000 preference shares of ABC Ltd. at Rs. 105 each on 01-07-2018. The shares are listed on a stock exchange. He transferred such shares on 25-07-2024 at Rs. 120 per share. Compute the amount of capital gain chargeable to tax in hands of Mr. X.

Answer:

As the preference shares are listed on a stock exchange and transferred by Mr. X after holding for more than 12 months, the gain arising from transfer shall be treated as long-term capital gain and will be taxed at 12.50%.

The computation of capital gain shall be as follows:

Particulars	*Calculation*
Full Value of Consideration [A]	Rs. 1,20,000 (1,000 shares * Rs. 120)
Cost of Acquisition [B]	Rs. 1,05,000 (1,000 shares * Rs. 105)
Indexed Cost of Acquisition [B]	-
Capital gain/loss [A-B]	Rs. 15,000
Tax rate	12.50%
Tax	Rs. 1,875

11.5 Tax Treatment of Shares Warrants

Share warrant is an option issued by the company which gives the warrant holder a right to subscribe to equity shares at a pre-determined price on or after a pre-determined time period.

Stock warrant is issued with a "strike price" and an expiration date. The strike price is the price at which the warrant becomes exercisable, that is, the price at which warrant holder is entitled to subscribe for equity shares of the company. As per Regulation 13 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR), the warrant holder is required to pay at least 25% of the strike price upfront. The tenure of share warrants shall not exceed 18 months from the date of their allotment in the IPO or Right Issue or FPO, as the case may be.

In case the warrant holder does not exercise the option to take equity shares against any of the warrants held by the warrant holder, within 3 months from the date of payment of full consideration, such consideration made in respect of such warrants shall be forfeited by the issuer.

In case of share warrants, the following transactions are possible:

a) Conversion of share warrants into shares
b) Transfer of share warrants to another person
c) Forfeiture of the share warrant

11.5.1 Tax on conversion of share warrants into shares

The conversion of share warrants into shares shall be treated as a transfer of share warrants. The resultant capital gains arising from such transfer will always be treated as short-term capital gains if the share warrant is listed and has been converted within 12 months. If the conversion is done after 12 months it will be treated as long-term capital gains. The short-term capital gains shall be excess of the full value of consideration arising from such conversion over the strike price of share warrant. In view of Section 50D of the

Income Tax Act, the full value of consideration is the fair market value of shares on the date of conversion of warrants into shares.

The short-term capital gains shall be taxable as per applicable tax rates. The long-term capital gains will also be calculated in the same way but will be taxed at 12.50%.

11.5.2 Tax on transfer of share warrants

The transfer of share warrants to another person shall be treated as a transfer of a capital asset. The resultant capital gains arising from such transfer will always be treated as short-term capital gains if the share warrants are listed and are transferred within 12 months. They will be treated as long term if the transfer is done after 12 months. The short-term capital gains shall be excess of the full value of consideration arising from such transfer over the upfront payment or price paid for share warrant. The full value of consideration is the sum received from the buyer of the warrant.

The short-term capital gains shall be taxable as per applicable tax rates. Long term capital gains from listed share warrants will also be calculated in the same manner except that it will be taxed at 12.50%.

Forfeiture of premium paid for share warrants

In case a warrant holder does not exercise the option to take equity shares against any of the warrants held by the warrant holder, within 3 months from the date of payment of consideration, such consideration made in respect of such warrants shall be forfeited by the issuer. The loss arising from such forfeiture of the premium will have no tax treatment and it will be ignored for calculation of taxable income.

Example 7: ABC Ltd. issued 1,00,000 warrants of Rs. 200 each aggregating to Rs. 2 crores to Mr. X on 29-12-2023. Share warrants are exercisable into equal number of equity shares of face value of Rs. 10 each. The warrants are listed on the stock exchange. The company received a sum of Rs. 50 lakh from Mr. X towards 25% subscription against the said warrants on the same date.

What shall be the tax implications in the hands of Mr. X in the following scenarios?

(1) Mr. X exercised warrants and paid the entire consideration of Rs. 2 crore to ABC Ltd. on 29-03-2025. On the same day, the company allotted 1,00,000 equity shares of face value of Rs. 10 each to Mr. X at a premium of Rs. 190 per share. The fair market value of the share on date of allotment was Rs. 250 share.
(2) Mr. X transferred share warrants to Mr. Y on 15-08-2024 for Rs. 75 per warrant.

Answer:

The tax implications in the hands of Mr. X shall be as follows:

Scenario 1: Tax on conversion of share warrants into shares

The conversion of share warrants into shares shall be treated as a transfer of share warrants. The resultant capital gains arising from such transfer will be deemed as long-term capital gains. As the period of holding exceeds 12 months. The computation of long-term capital gain arising on conversion of share warrants into shares shall be as follows:

Particulars	*Amount*
Period of Holding	***15 months***
Full value of consideration (FMV of shares on the date of allotment)	Rs. 2,50,00,000 (100,000 shares* Rs. 250)
Less: Cost of Acquisition (strike price of share warrants)	Rs. 2,00,00,000 (100,000 warrants * Rs. 200)
Long-term capital gain	50,00,000
Tax rate	12.50%

Scenario 2: Tax on transfer of share warrants

The transfer of share warrants to another person shall be treated as a transfer of a capital asset. The resultant capital gains arising from such transfer will be short term as the warrants have been held for less than 12 months. The computation of short-term capital gain arising on transfer of share warrants shall be computed as follows:

Particulars	*Amount*
Period of Holding	*7 -8 months*
Full Value of Consideration (sale price of share warrants)	Rs. 75,00,000 (100,000 warrants * Rs. 75)
Less: Cost of Acquisition (i.e., upfront payment made for share warrants)	50,00,000
Short-term capital gain	25,00,000
Tax rate	Normal Slab Rate

11.6 Tax Treatment of Mutual Funds

Mutual funds are the funds which collect money from the investor and invest the same in the capital market for their benefit. Mutual funds invest in a variety of instruments such as equity, debt, bonds, etc. Investments of a mutual fund are managed by the Asset Management Company through fund managers.

All the mutual funds are registered with the SEBI and they function within the provisions of strict regulation created to protect the interests of the investor.

Before understanding, taxation aspects of Mutual Funds, it is important to understand a few terms which are used in the Mutual Fund industry.

Equity Oriented Funds

'Equity Oriented Fund' means a fund set up under a scheme of a mutual fund specified under clause (23D) of section 10 or under a scheme of an insurance company comprising

unit-linked insurance policies to which exemption under clause 10(10D) does not apply on account of the applicability of *fourth and fifth proviso* (i.e., high premium ULIP) and:

a) In a case where the fund invests in the units of another fund which is traded on a recognised stock exchange, at least 90% of the total proceeds of such fund is invested in the units of such other fund and such other fund also invests at least 90% of its total proceeds in equity shares of domestic companies listed on a recognised stock exchange; and
b) In any other case, a minimum of 65% of the total proceeds of such fund is invested in the equity shares of domestic companies listed on a recognised stock exchange.

The percentage referred above shall be computed with reference to the annual average of the monthly averages of the opening and closing figures. Additionally, in case of high premium ULIPs, the requirement of investing in equity products needs to be fulfilled throughout the term of the policy.

Fund of Funds

Fund of Funds (FoF), as the name suggests, is a mutual fund scheme that invests in other schemes of mutual funds. These funds create a portfolio of other mutual funds. The portfolio is designed to suit investors across risk profiles and financial goals. The diversification of funds helps in reducing the risks to a certain extent.

Equity Linked Savings Scheme

Equity Linked Saving Scheme (ELSS) is a category of mutual funds that encourage long-term equity investments. Through the ELSS, the Government sought to improve equity participation by allowing tax-deductible investment in equity-based mutual funds. ELSS helps the investors to save Income-tax, that's why they are also known as tax-saving funds. The Income Tax Act allows a deduction under section 80C to the extent of Rs. 1.5 lakh in respect of investment made in ELSS, if the assesee opts for the old tax regime.

ELSS funds invest a large percentage of their portfolio in the equity shares. They have a compulsory lock-in period of 3 years, which is the shortest amongst all tax-saving instruments.

Systematic Investment Plan

Systematic Investment Plan (SIP) is a mutual fund tool and is one of the easiest ways through which any common man can enter the stock market. It is an investment strategy wherein an investor needs to invest some amount of money in a particular mutual fund at every stipulated time period, say, once a month or once a quarter. To understand the concept of SIP, one can compare it with recurring deposit with the bank where one puts in a small amount every month.

Systematic Withdrawal Plan

Systematic Withdrawal Plan (SWP) is used to redeem the investment from a mutual fund scheme in a phased manner. SWP is the opposite of SIP. SWP pays investors a specific amount of payout at a pre-determined time intervals, like monthly, quarterly, half-yearly or annually. Mutual Fund SWPs' provide the assurance of paying a fixed amount. Choosing the SWP helps investors customize their cash flow as per need. The capital gain arising on the withdrawals is taxable.

Systematic Transfer Plan

Systematic Transfer Plan (STP) allows the investor to transfer amount from one scheme to another scheme of the same mutual fund house. An STP transfers a fixed amount of money from one mutual fund to another. STPs can only transfer money between two mutual fund schemes of the same Asset Management Company (AMC).

11.6.1 Taxation of Mutual Funds

Mutual Funds offer investors two main sources of earnings: Capital Gains and Dividends. The taxation of dividend income from different types of mutual funds is governed by common provisions under the Income Tax Act. However, the taxation of capital gains resulting from the transfer or redemption of mutual fund units depends on the type of fund.

Until Financial Year 2023-24, mutual funds were categorized into two types, for taxation purposes: 1) Equity-oriented Mutual Funds and 2) Other Funds. However, with effect from Financial Year 2023-24 and amendments made thereafter, mutual funds are now classified into four types, for taxation purposes: 1) Equity-oriented Mutual Funds, 2) Specified Mutual Funds (Type 1) [schemes that invest 65% or greater directly or indirectly in money market or debt market products and which are bought on or after April 1, 2023] 3) Specified Mutual Funds (Type 2) [not being those referred to in (2) earlier; which invested less than 35% directly in domestic equity and were bought on or after April 1, 2023 but sold/redeemed before April 1, 2025] , and 4) Other Mutual Funds.

In this chapter, we will focus on explaining the taxation provisions related to Equity-oriented Mutual Funds only.

- ***Tax on dividend from equity-oriented mutual funds***

Dividends received by a resident unit-holder from a mutual fund shall be taxable in his hands as per applicable tax rates. An investor is allowed to claim a deduction of interest expenditure incurred to earn that dividend income to the extent of 20% of the total dividend income. No further deduction shall be allowed for any other expenses including commission or remuneration paid to a banker or any other person to realise such dividend.

Where dividend is received by a non-resident person or foreign company, it shall be taxable in their hands at a special rate of 20% (10% if received from IFSC unit) *plus* surcharge & cess, subject to provisions of DTAA.

- ***Tax on long-term capital gains from equity-oriented mutual funds covered under section 112A***

Capital gain refers to the difference between the value at which an investor purchased the units of a mutual fund scheme and the value at which these units are sold or redeemed. Units of Equity Oriented Fund are treated as a long-term capital asset if they are held for more than 12 months immediately preceding the date of transfer.

Tax on long-term capital gain arising from the transfer of equity-oriented mutual funds depends on payment of securities transaction tax (STT) at the time of transfer. If STT is paid at the time of transfer then no tax shall be payable if the amount of capital gain earned during the year does not exceed Rs. 1,25,000. Where the amount of capital gain exceeds Rs. 1,25,000 then the excess amount shall be chargeable to tax at concessional rate of 12.50%. The condition of payment of STT at the time of transfer shall not be applicable if the transaction of sale of units is undertaken on a recognised stock exchange located in an International Financial Services Centre (IFSC) and the consideration for such transfer is received or receivable in foreign currency.

Cost of acquisition of units of equity oriented mutual funds acquired on or before 31-01-2018

The Finance Act 2018 grandfathered the investments made on or before 31-01-2018 as the long-term capital gains arising from the sale of units of listed equity oriented mutual funds were previously exempt from tax. The concept of grandfathering under this provision works as per the following mechanism.

If units of equity oriented mutual funds were acquired on or before 31-01-2018, the cost of acquisition of such units shall be higher of the following:

(a) The actual cost of acquisition of units of equity oriented mutual funds; or
(b) *Lower* of the fair market value of such asset as on 31-01-2018 or full value of the consideration received as a result of the transfer of units of equity oriented mutual funds.

The highest price of units quoted on a recognized stock exchange as on 31-01-2018 is taken as the fair market value. If there is no trading in such units on such exchange on 31-01-2018, the highest price of such units on a date immediately preceding 31-01-2018, when such units were traded, shall be its fair market value. In case such unit is not listed on a recognised stock exchange as on 31-01-2018, the net asset value of such unit as on the said date shall be treated as its fair market value.

Example 8: Mr. A (resident in India) acquired 5,000 listed units of an equity oriented mutual fund on 01-05-2017 for Rs. 200 per unit. He sold the units on 01-08-2024 for Rs. 300 per unit through the recognised exchange and paid STT on such transaction. The FMV of the units as on 31-01-2018 was Rs. 225 per unit. Compute the amount of income arising to Mr. A from transfer of units of equity oriented mutual funds and tax thereon.

Answer*:*

Particulars	*Amount*
Period of holding (from 01-05-2017 to 31-07-2024)	87 Months
Nature of capital gain (period of holding is more than 12 months)	Long term capital gain
Sale price (5,000 * Rs. 300 per unit)	Rs.15,00,000
Cost of acquisition [Note 1]	Rs. 11,25,000
Long term capital gain	Rs. 3,75,000
Tax rate†	12.50%
† The amount of capital gain in excess of Rs. 125,000 shall be chargeable to tax at concessional rate of 12.50% as per section 112A.	

Note 1: As the units were acquired by Mr. A on or before 31-01-2018, the cost of acquisition of such units shall be *higher* of the following:

(a) The actual cost of acquisition of units of equity oriented mutual funds, *that is*, Rs. 10,00,000 (5,000 units * Rs. 200); or
(b) *Lower* of the FMV of such asset as on 31-01-2018, *that is*, Rs. 11,25,000 (5,000 units * Rs. 225) or full value of the consideration received as a result of the transfer of units of equity oriented mutual funds, *that is*, Rs. 15,00,000 (5,000 units * Rs. 300)

Thus, the cost of units shall be Rs. 11,25,000.

Cost of acquisition of units of equity oriented mutual funds acquired on or after 01-02-2018

The cost of acquisition of units of equity oriented mutual funds, which are acquired on or after 01-02-2018, shall be computed as per general principles of Section 55, *that is*, the actual cost for which it is acquired by the assessee.

- ***Tax on long-term capital gains from equity-oriented mutual funds not covered under section 112A***

If STT is not paid at the time of transfer of equity-oriented mutual funds then tax shall also be charged at the rate of 12.50%. Further, capital gain shall be computed after taking the benefit of indexation.

- ***Tax on short-term capital gain from equity-oriented mutual fund***

Short-term capital gains arising from the sale of units of equity-oriented mutual funds are taxable at the rate of 20% if securities transaction tax is paid at the time of sale of such securities. However, the condition of payment of STT at the time of transfer shall not be applicable if the transfer is undertaken on a recognised stock exchange located in an International Financial Services Centre (IFSC) and the consideration for such transfer is received or receivable in foreign currency. Further, no deductions under chapter-VIA (i.e. deduction under Section 80C to 80U) shall be allowed from such income.

In case STT is not paid at the time transfer of equity-oriented mutual funds then short-term capital gain shall be chargeable to tax at normal rates as applicable in case of an assessee.

Example 9: Mr. X (resident in India) purchased 10,000 units of equity oriented mutual funds at the rate of Rs. 250 each per unit on 01-04-2021 through a recognised stock exchange. He had taken loan of Rs. 20,00,000 to purchase such units. He paid Rs. 1,60,000 as interest on such loan during the year. He received dividend of Rs. 50 per unit on 15-08-2024. Thereafter, he sold the units for Rs. 280 per unit on 01-09-2024 through a recognised stock exchange and paid STT on such transaction. Discuss the tax implications in the hands of Mr. X.

Answer:

Computation of dividend income	
Particulars	*Amount*
Number of units [A]	10,000
Dividend declared per unit [B]	Rs. 50
Total dividend received [C=A * B]	Rs. 500,000
Interest paid to earn dividend [D]	Rs. 160,000
Maximum deduction allowable [E = C * 20%]	Rs. 100,000
Income taxable as dividend income [C - E]	Rs. 400,000
Tax rate	Normal slab rate
Computation of capital gains	
Particulars	*Amount*
Period of holding (from 01-04-2021 to 31-08-2024)	41 Months
Nature of gains (period of holding is more than 12 months)	Long term capital gain
Sale price (10,000 units * Rs. 280)	Rs. 28,00,000
Less: Cost of acquisition (10,000 units * Rs. 250)	Rs. 25,00,000
Long term capital gain	Rs. 3,00,000
Tax rate on capital gain†	12.50%
†As STT has been paid at the time transfer of units, capital gain shall be chargeable to tax at the rate of 12.50% under section 112A of the Income Tax Act, 1961. The tax shall be charged on the amount of capital gain exceeding Rs. 125,000.	

11.7 Tax Treatment of Derivatives

Derivatives are the financial product whose value is derived from an underlying asset. The value of the derivative would replicate the value of the said asset. An equity derivative is a class of derivatives whose value is derived from one or more underlying equity securities. Trading in derivatives, popularly known as Future and Options (F&O), is quite popular among investors who invest in the stock market.

In the case of derivatives, the transactions are ultimately settled without the actual delivery of underlying security or index. These derivative transactions are not treated as speculative if transactions are carried in a recognised stock exchange through a stock-broker or such other intermediary registered with SEBI. Further, the contract note issued by such broker or intermediary to the client should indicate the unique client identity number and PAN of the client and should be time-stamped.

11.7.1 Types of Derivative Contracts

Commonly used derivatives are Futures, Options, Forwards and Swaps. These are briefly defined below:

Futures Contract

A 'futures contract' is a contract for buying or selling underlying security or index or commodity, on a future date, at a price specified today, and entered into through a formal mechanism on an exchange. The terms of the contract are specified by the exchange. Futures Contract or 'futures' are standardized and traded on a futures exchange thus counterparty risk if any is taken care of by the exchange mechanism. Underlying assets can be a commodity, stock, currencies, etc.

Options Contract

An 'option' is a contract that gives the right, but not an obligation, to buy or sell the underlying security or index on or before a specified date, at a stated price. An option contract gives the right, but not an obligation to do something in future. The buyer of the option contract is required to pay an upfront fee called option premium. There are two types of options:

(a) **Call option** which gives the right but not an obligation to buy an asset by a certain date for a certain price;
(b) **Put option** gives the right but not an obligation to sell an asset by a certain date for a certain price.

Forward Contracts

It is a contract between two parties, wherein settlement takes place on a specified date in future at an agreed price. Each contract is customized and unique in terms of contract size, expiry and asset type and quality. Thus, forward contracts are known as OTC (Over-the-counter) between parties without the exchange mechanism.

Swaps

These are private agreements between parties to exchange cash flows in the future according to a pre-arranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

a) ***Interest rate swaps*:** It entails swapping only in the interest related cash flows between parties in the same currency like floating rate with a fixed rate of interest;
b) ***Currency swaps:*** These entail swapping both principal and interest between the parties, with the cash flow in two different currencies.

Currency Derivatives

Currency derivatives are exchange-based futures and options contracts that allow hedging against currency movements. Currency derivatives are a contract between the seller and buyer, whose value is to be derived from the underlying asset, *that is*, the currency value.

In India, one can use such derivative contracts to hedge against currencies like Dollar, Euro, U.K. Pound and Yen. Corporates, especially those with significant exposure to imports or exports, use these contracts to hedge against their exposure to a certain currency.

Interest Rate Derivative

Interest Rate Derivative is a financial derivative contract whose value is derived from one or more benchmark interest rates, price, interest rate instruments, or interest rate indexes.

Interest rate derivatives (IRDs) contracts can be traded either on:

a) Recognized Stock Exchanges; or
b) Over-the-Counter. It refers to all transactions done outside of recognized stock exchanges and shall include transactions on Electronic Trading Platforms (ETP).

Commodity Derivative

Commodity derivative is a contract to buy or sell a commodity at a preset price for delivery on a future date. Almost all commodity contracts, barring a few (like crude oil and natural gas), result in compulsory delivery.

The Finance Act, 2020 had amended the definition of “taxable commodities transaction” as a transaction of sale of commodity derivatives or sale of commodity derivatives based on prices or indices of prices of commodity derivatives or option on commodity derivatives or option in goods in respect of commodities, other than agricultural commodities traded in recognised stock exchanges. The intention behind introducing CTT was to bring parity between the derivative trading in the securities market and the commodity market.

Trading in derivatives including commodity derivatives is regulated by the Securities Contract (Regulation) Act, 1956 (SCRA). Apart from numerous regional exchanges, India has five national commodity exchanges namely, Multi Commodity Exchange (MCX), National Commodity and Derivatives Exchange (NCDEX), Indian Commodity Exchange (ICEX), National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).

11.7.2 Nature of Derivative Income

The gains or losses arising from trading in F&O are taxable under the head 'Profits and Gains from Business or Profession' (PGBP) or income from other sources depending upon the fact whether the assessee is into the business of derivative trading, frequency of the transactions etc. Where the activity is offered to tax as business income by the assessee, the following wjll be applicable:

The Income Tax Act classifies the business income into 'speculative' and 'non-speculative'. Though Income arising from speculative transactions are taxable under the head PGBP, yet

they are treated differently and rigorously from non-speculative business income. Any loss arising from speculative transaction could be set-off only from speculative income.

A transaction is deemed as speculative if it is periodically or ultimately settled otherwise than through actual delivery or transfer. However, Section 43(5) has specifically excluded certain derivative transactions from the meaning of speculative transaction as these instruments are used for hedging of underlying assets. Thus, income or loss from dealing in F&O shall be deemed as normal business income (non-speculative business) even though delivery may not be effected in such transactions. Consequently, any loss arising from F&O can be set-off against any normal business income. The business income of an assessee is charged to tax at normal rates as applicable in case of an assessee.

11.7.3 Computation of Turnover

The Income Tax Act does not contain any provision or guidance for computation of turnover in F&O trading. However, the Guidance Note on Tax Audit issued by the ICAI prescribes the method of determining turnover which shall be as under:

a) The total of favourable and unfavourable differences is taken as turnover.
b) Premium received on sale of options is also to be included in turnover.
c) In respect of any reverse trades, the difference thereon should also form part of the turnover.

The computation of turnover is a very important factor as the applicability of tax audit is determined on the basis of turnover. Also, if the taxpayer is opting for the presumptive taxation scheme under section 44AD (subject to total turnover not exceeding Rs. 2 crores or 3 crores, as the case may be), he can declare the profit at the rate of 6% of such turnover in case of receipts in cheque or any digital modes or 8% of turnover in case of cash receipts.

11.7.4 Scheme of Taxation

The income from F&O trading can be offered to tax under the normal scheme of taxation or the presumptive scheme of taxation under Section 44AD (subject to total turnover not exceeding Rs. 2 crores or 3 crores, as the case may be). Under the presumptive scheme, the investor can choose to declare the profits at the rate of 6% of turnover as the payment is always received through banking channels. The presumptive income computed as per the prescribed rate is the final income and no further expenses will be allowed or disallowed. Also, the person opting for this scheme is not required to maintain the books of accounts prescribed under section 44AA and get them audited. Further, he can pay 100% of the advance tax in a single instalment up to 15th March of the relevant financial year.

11.7.5 Set-off and Carry Forward of Losses

The losses from the trading of F&O if treated as a normal business loss, it can be set-off against the income from the other heads. However, the business loss cannot be set-off against the income from salary.

The unabsorbed loss can be carried forward up to 8 Assessment years. It can be set-off only against the business income in the subsequent years. It is important to note that the assessee is entitled to carry forward the business loss provided the return of income is filed on or before the due date. If such return is not filed within the prescribed due date, the right to carry forward and set-off is lost.

Example 10: Mr. X, a resident investor, purchased 1 call option of X Ltd. at a premium of Rs. 35 per share on 01-08-2024. The details of the call option are as follows:

Lot size per option	1,000 shares
Exercise price	Rs. 450 per share
Date of expiry	24-08-2024

Determine the taxability in following situation:
Situation 1: It exercised the call option to buy shares of X Ltd. on 15-08-2024 and such shares were subsequently sold for Rs. 550 each on 30-11-2024.
Situation 2: It transferred such option for Rs. 30 per share on 10-08-2024.
Situation 3: It transferred such option for Rs. 37 per share on 10-08-2024
Situation 4: It does not transfer or exercise the call option and, therefore, contract was settled by stock exchange on expiry, *that is*, 24-08-2024 when premium for this option was prevailing at Rs. 10 per share.

Answer*:*
The taxability in aforesaid situations shall be as follows:

As Mr. X is trading in shares and derivatives, any income arising therefrom shall be taxable as normal business income. The computation of business income shall be follows:
Situation 1: Option exercised

Computation of business income on transfer of shares	
Particulars	*Amount*
Period of holding (from 15-08-2024 to 29-11-2024)	3.5 Months but does not matter as business income is being computed
Sale price [1,000 * Rs. 550] [A]	Rs. 550,000
Cost of Acquisition (Exercise price + Premium paid for call option) [1,000 * (450 + 35)] [B]	Rs. 485,000
Business Income [C = A - B]	Rs. 65,000
Tax rate on business income [D]	Applicable tax rate

Situation 2: Option transferred at loss

Computation of business income on transfer of option	
Particulars	*Amount*
Period of holding (from 01-08-2024 to 09-08-2024)	Less than 1 month but does not matter as business income is being calculated
Sale price (1,000 * Rs. 30) [A]	Rs. 30,000
Cost of Acquisition (1,000 * Rs. 35) [B]	Rs. 35,000
Business Income loss [C = A - B]	(Rs. 5,000)

Situation 3: Option transferred at gain

Computation of business income on transfer of option	
Particulars	*Amount*
Period of holding (from 01-08-2024 to 10-08-2024)	Less than 1 month but does not matter as business income is being calculated
Nature of capital asset	Short-term capital asset
Sale price (1,000 * Rs. 37) [A]	Rs. 37,000
Cost of Acquisition (1,000 * Rs. 35) [B]	Rs. 35,000
Business Gain [C = A - B]	Rs. 2,000
Tax rate [D]	Applicable rate

Situation 4: Option expired

Computation of business income on settlement of option on expiry	
Period of holding (from 01-08-2024 to 24-08-2024)	Less than 1 month but does not matter as business income is being calculated
Sale price (1,000 * Rs. 10) [A]	Rs. 10,000
Cost of Acquisition (1,000 * Rs. 35) [B]	Rs. 35,000
Business Income [C = A - B]	(Rs. 25,000)

***Example 11**:* Mr. A (resident in India) is engaged in the trading of shares and derivatives. He purchased 5 call option of Z Ltd. at a premium of Rs. 22 per share on 01-08-2024. The details of the call option are as follows:

Lot size per option	1,000 shares
Exercise price	Rs. 200 per share
Date of expiry	27-08-2024

Determine the taxability in the hands of Mr. A if he exercised 2 call options on 14-08-2024 to buy 2,000 shares of Z Ltd. at exercise price. He subsequently sold such shares for Rs. 250 each on 30-10-2024. The remaining 3 call options were sold at a premium of Rs. 27 per share.

***Answer**:*

As Mr. A is trading in shares and derivatives, any income arising therefrom shall be taxable as normal business income. The computation of business income shall be follows:

Computation of business income or loss	
Particulars	*Amount*
Sale price of shares (2,000 * Rs. 250) [A]	Rs. 500,000
Sale price of option (3,000 * Rs. 27) [B]	Rs. 81,000
Total Sale consideration [C = A + B]	**Rs. 581,000**
Cost of acquisition of shares (2,000 * Rs. 200) [D]	Rs. 400,000
Cost of acquisition of option (5,000 * Rs. 22) [E]	Rs. 1,10,000
Total purchase cost [F = D + E]	**Rs. 510,000**
Business Income [G = C - F]	**Rs. 71,000**

11.8 Bonus Stripping

Similar to dividend stripping, 'Bonus Stripping' is a practice where a person buys securities or units just before the record date to get bonus securities or units on basis of such holding and sells the original units after the record date at a price lower than the price at which securities or units were purchased and incurring a short-term capital loss.

To curb this practices, section 94(8) was inserted under Income Tax Act. The section provides that where any person acquires any securities or units within a period of 3 months, before the record date, and is allotted bonus securities or units on such date, then any loss arising on transfer of original securities or units shall be ignored to compute his income chargeable to tax, if he transfers such securities or units within a period of 9 months after the record date while continuing to hold all or any of the bonus securities or units.

Further, the amount of loss so ignored shall be deemed to be the cost of purchase or acquisition of bonus securities or units held by him on the date of transfer of original units.

Example 12*:* Mr. Ravi purchased 1,000 units of an listed equity at Rs. 106 per unit as on 01-07-2023. Thereafter, the company declared allotment of bonus shares of 1:1 on 01-09-2023, *that is*, the person holding 1 share gets 1 bonus share. After getting the bonus share, Mr. Ravi sold the original 1,000 shares on 01-04-2024 at a price of Rs. 95 per share.

Answer*:*

In the given example, Mr. Ravi had acquired the shares of the company within 3 months before the record date of allotment of bonus shares and sold the same within 9 months after the record date while continuing to hold the bonus shares. Thus, any loss arising on transfer of original shares shall be ignored to compute his income chargeable to tax and the amount of loss so ignored shall be deemed to be the cost of purchase or acquisition of bonus shares held by him.

The loss arising on transfer of original shares shall be Rs. 11,000 [1,000 shares * (Rs. 106 – Rs. 95)] which shall be ignored. Consequently, the cost of acquisition of 1,000 bonus shares so allotted shall be deemed to be Rs. 11,000, and, accordingly, per share cost shall be Rs. 11.

11.9 Benefits not allowed from Capital Gains

Income Tax Act provides for concessional tax rates in respect of long-term capital gain and certain short-term capital gains. Long-term capital gain is generally chargeable to tax at concessional rate of 12.50%.

Short-term capital gain is generally chargeable to tax at normal rates. However, the short-term capital gain arising from the transfer of specified securities, being equity shares, units of equity-oriented mutual fund, high premium ULIPs and units of REITs or InvITs is chargeable to tax at concessional rate of 20% (subject to payment of securities transaction tax).

As Income Tax Act provides for concessional tax rates in respect of long-term capital gain as well as short-term capital gain from transfer of specified securities, certain benefits are not allowed while computing such capital gains.

11.9.1 Benefits not allowed from long-term capital gain chargeable to tax at the rate of 12.50%

No deduction shall be available under Sections 80C to 80U from the long-term capital gains taxable at the rate of 12.50% under Section 112.

Following benefits shall not be allowed from the long-term capital gains taxable at the rate of 12.50% under Section 112A, 115AC, 115ACA, 115AB, 115AD and 115E:

No computation in foreign currency

Mode of computation of capital gain in foreign currency as available in the case of a non-resident while computing capital gains arising from the transfer of a capital asset, being shares in, or debentures of, an Indian company, purchased in foreign currency shall not be allowed when the long-term capital gain is chargeable to tax at concessional rate of 12.50%.

No deduction under Section 80C to 80U

No deduction shall be available under Sections 80C to 80U from the long-term capital gains taxable at the rate of 12.50%.

No Section 87A rebate from long-term capital gain covered under section 112A

Rebate under Section 87A is not available from income-tax payable on long-term capital gain covered under 112A, i.e., the long-term capital gain arising from transfer of specified securities, being equity shares, units of equity-oriented mutual fund, high premium ULIPs and units of REITs or InvITs. However, the rebate shall be allowed from the tax payable on the total income as reduced by tax payable on such capital gains.

11.9.2 Benefits not allowed from short-term capital gain chargeable to tax at the rate of 20% under section 111A

No deduction shall be available under Sections 80C to 80U from the short-term capital gains chargeable to tax at concessional rate of 15%.

11.10 Adjustment of Exemption Limit from Capital Gains

Total income of a resident being inter-alia individual or a resident HUF is not chargeable to tax up to maximum exemption limit. Thus, if total income of a resident individual or HUF, as reduced by the amount of long-term capital gains referred to in Section 112 and 112A or short-term capital gains covered under section 111A, is less than maximum exemption limit, the amount of such capital gains shall be reduced by that amount that would enable the individual or HUF to fully claim the maximum exemption limit.

Example, if total income of a resident individual (excluding long-term capital gains) is Rs. 1,85,000 and long-term capital gain from the sale of unlisted shares is Rs. 2,50,000, the tax under this provision shall be computed on Rs. 1,85,000. Maximum exemption limit in case of a resident individual is Rs. 2,50,000 (under old tax regime) and total income falls short of this limit by Rs. 65,000. The amount of long-term capital gain shall be reduced by Rs. 65,000 and the remaining amount, i.e., Rs. 1,85,000 (Rs. 2,50,000 less Rs. 65,000) shall be charged to tax.

11.11 Summary of Taxation of Equity Products and Other Capital Assets

Sr. No	For Resident in India Individual taxpayers	STCG On sale on or after 23 Jul 2024	Holding Period for classification as Long Term in respect of Sale on or after 23 Jul 2024	LTCG[Note1] on sale on or after 23 Jul 2024 but before 1 Apr 2025	LTCG[Note1] on sale on or after 1 Apr 2025
	Listed Securities:		**In Months**		
1	Listed Equity Shares [Note2]	20%	> 12	12.50%	Same
2	Equity MF / ETF (> 65% investment in listed domestic equity) [Note2]	20%	> 12	12.50%	Same
3	Hybrid MF Schemes/ ETFs (< 65% but > 35% investment in listed domestic equity)	Slab rate	> 12	12.50%	Same
4	Other MF Schemes/ ETFs (< 35% investment in domestic equity) bought before 01-04-2023	Slab rate	> 12	12.50%	Same
5	Other MF Schemes/ ETFs/ Gold ETFs (< 35% investment in domestic equity) bough >= April 1, 2023:	Slab rate	Always Short Term if sold before 01-04-2025 else > 12 Months	Slab rate	12.50%
6	Debt Funds and ETF (invests > 65% directly or indirectly in debt or money market) bought >= April 1, 2023	Slab rate	Always short term	Not Applicable	Not Applicable
7	MF/ ETFs located overseas (Nasdaq ETF etc)	Slab rate	Always short term if bought >= 01-04-2023 & Sold before 01-04-2025 or else 24 Months	12.50%	Same
8	Listed Bonds / Debentures Including Sovereign Gold Bonds (SGBs) [Note3]	Slab rate	> 12	12.50%	Same
9	Listed Market Linked Debentures		Always to be taxed at Slab rates irrespective of period of holding		
10	Any other Listed Securities	Slab rate	> 12	12.50%	Same
11	Listed Zero coupon Bond	Slab rate	> 12	12.50%	Same

Sr. No	For Resident in India Individual taxpayers	STCG On sale on or after 23 Jul 2024	Holding Period for classification as Long Term in respect of Sale on or after 23 Jul 2024	LTCG[Note1] on sale on or after 23 Jul 2024 but before 1 Apr 2025	LTCG[Note1] on sale on or after 1 Apr 2025
12	Listed REITs/ Invits [Note2]	20%	> 12	12.50%	Same
	Mutual Funds (unlisted) & Other Unlisted Assets:				
1	Equity MF/ ULIP Fund investing > 65% directly in domestic equity [Note2]	20%	> 12	12.50%	Same
2	ULIP Funds investing > 90% in domestic equity through ETFs [Note2]	20%	> 12	12.50%	Same
3	Hybrid MF investing < 65% but > 35% directly in domestic equity	Slab rate	> 24	12.50%	Same
4	MF Schemes investing > 90% in domestic equity through ETFs [Note2]	20%	Always Short Term if purchased on >= 01-04-2023 and sold before 01-04-2025 or else > 12 Months	12.50%	Same
5	Other MF/ Gold MF bought before April 1, 2023	Slab rate	> 24	12.50%	Same
6	Other MF/Gold MF bought >= April 1, 2023	Slab rate	Always short term if sold before 01-04-2025 else > 24 Months	Slab rate	12.50%
7	Debt funds/ Money market funds bought >= April 1, 2023	Slab rate	Always short term	Slab rate	Same
8	Holding in Foreign MF including foreign index funds	Slab rate	Always taxed as short term If bought >= 01-04-2023 & Sold < 01-04-2025 or else > 24 Months	12.50%	Same
9	Shares not listed on Indian stock exchanges	Slab rate	> 24	12.50%	Same
10	Unlisted Bonds/ Debentures/ SGB (not incl. MLDs)	Slab rate	Always short term	Not Applicable	Not Applicable
11	REITs/ InvITs not listed on Indian stock exchanges [Note2]	Slab rate	> 24	12.50%	Same
12	Other unlisted securities/ Other ULIPs	Slab rate	> 24	12.50%	Same

Sr. No	For Resident in India Individual taxpayers	STCG On sale on or after 23 Jul 2024	Holding Period for classification as Long Term in respect of Sale on or after 23 Jul 2024	LTCG[Note1] on sale on or after 23 Jul 2024 but before 1 Apr 2025	LTCG[Note1] on sale on or after 1 Apr 2025
13	Immovable property (being land or building or both) bought after July 23, 2024	Slab rate	> 24	12.5% or 20% after indexation whichever is lower (the second option is availble only for property bought before July 23, 2024)	Same
14	Large Value ULIP bought after on or after February 1, 2021 (aggregate premium exceeding Rs. 2.50 lakhs) If investment in an "equity-oriented fund" [Note2]	20%	12	12.50%	Same
15	Large Value ULIP bought after on or after February 1, 2021 (aggregate premium exceeding Rs. 2.50 lakhs) If investment is not in a "equity oriented fund" (Note debt oriented fund in a ULIP are not covered by section 50AA) [Note2]	slab rates	24	12.50%	Same
16	Any Other capital assets (silver, art, etc.)	Slab rate	> 24	12.50%	Same

Note 1: In view of the amendment brought by the Finance Act, 2024, the benefit of indexation is now not available on any asset (except immovable property in certain cases).
Note 2: Tax on long-term capital gain arising from transfer of equity shares, units of equity oriented mutual fund, high premium ULIPs or units of REITs/ InvITs, chargeable to STT, shall not be levied if the aggregate amount of long-term capital gain earned during the year from transfer of said capital assets does not exceed Rs. 1,25,000.
Note 3: This does not apply to redemption of SGB with RBI as the redemption is not treated as a transfer under section 47 and hence no capital gains are required to be calculated in respect of such redemption.
Note 4: Income from derivatives is considered as business income or income from other sources.

CHAPTER 12: TAXATION OF OTHER PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Tax aspects of:
  - Employee Stock Option Plans (ESOPs)
  - Sovereign Gold Bonds
  - Annuities (NPS Tier 1 & Tier 2) / ETFs
  - AIFs / REITs / InvITs
  - Life Insurance Products
  - Reverse Mortgage Loans

12.1 Taxation of Employees Stock Option Plan

Employee Stock Option Plans (ESOPs) are given to retain brilliant employees and to acknowledge their proven contribution to the company. Whenever ESOPs are issued, employees get the right to purchase a certain number of securities of the employer-company at a discounted price (i.e., less than the market price of such shares). It allows employees to have a stake in the company, which ensures higher loyalty and motivation for the employees to work. The option provided under this scheme confers a right but not an obligation on the employee.

Such an option to purchase shares can be exercised only after the vesting period. Such vesting period is the time period an employee must wait to get the right to buy those specified number of shares. Upon vesting of options, employees can exercise the options to acquire shares by paying the pre-determined exercise price.

Generally, employers offer ESOPs as an award to employees to retain top talent. Thus, it serves a twin-fold purpose both for the company and the employees. It acts as a motivation tool for the employees. After owning a stake in the company, they feel responsible for the performance of the company. It helps the employer to retain the top talent and assure the right level of performance in work.

ESOPs are quite popular amongst start-ups which cannot afford to pay huge salaries to employees in their initial phase and, accordingly, such start-ups offer ESOPs instead of monetary benefits to the top employees. ESOPs have been a significant component of the compensation for the employees of start-ups, as it allows the founders and start-ups to employ highly talented employees at a relatively low salary amount with the balance being made up *via* ESOPs.

12.1.1 Terms of ESOP

The employer-company does not charge anything at the time of offering ESOPs to employees. Such an option given to the employee can be exercised after a certain lock-in period, which is generally more than one year.

The right to exercise ESOP may get vested in the employee on the future date. The dates on which the employee becomes entitled to exercise the right to acquire the shares is called "vesting date".

Example 1, On April 1, Year 0, XYZ India Private Limited grants ESOP to its employee Mr. A to purchase 1,000 shares at a pre-determined price of Rs 100 per share. Date of vesting of ESOP is April 1, Year 4. Thus, Mr. A can exercise the right to exercise shares on or after April 1, Year 4. Incase of ESOPs, employees are given an option to exercise such option, and it is not compulsory for them to exercise such ESOP.

The employee is given a time period during which he has to exercise the option failing which the vested rights may lapse. The date on which the employees exercise this option to buy the shares is known as 'exercise date'.

12.1.2 Tax implications of ESOPs

The taxation of ESOPs is split into two components:

At the time of allotment of shares

The definition of salary also includes perquisites provided by the employer to employees. The value of any share allotted to an employee, either free of cost or at a concessional rate would be treated as perquisite.

The first tax instance shall arise at the time of allotment of shares. When an employee exercises the option, the difference between the Fair Market Value (FMV) of the shares on the date the option is exercised and the amount paid by the employee for such share, is taxable as perquisite in the year of allotment. Here, it is to be noted that though the tax is levied at the time of allotment of shares, the FMV of the shares on the date of allotment of the shares is not relevant for the calculation of perquisite value. In other words, FMV of shares at the time of exercising of option is considered for calculation of perquisite and not the FMV of shares at the time of allotment of shares. We can consider the following step-by-step treatment to determine the value of perquisite arising from ESOP:

Step 1: Determine the Fair Market Value of shares on the date on which the employee exercises the option. FMV has to be determined as per Rule 3 of the Income tax Rules. It may be noted that the FMV of shares on the date of vesting shall not be considered.

Step 2: Determine the pre-determined value of shares paid or to be paid by the employee to the employer at the time of exercising of option.

Step 3: Value of perquisite = (Step 1 – Step 2) * Number of shares exercised by the employee

Example 2, ABC India Private Limited has issued ESOP to Mr. B during the financial year 2024-25. Calculate the value of perquisite based on the following data:

Particulars	***Amount***
Date of granting of ESOP	01-04-2021
Vesting Period	01-04-2021 to 31-03-2024
Date of Exercise of ESOP	10-05-2024
Fair Market Value as on March 31, 2024	6,000
Fair Market Value as on May 10, 2024	6,500
Number of ESOP exercised	100
Pre-determined price to be paid by the employee to the employer	500
Value of perquisite [(Rs. 6,500 – Rs. 500) * 100]	**Rs 600,000**

At the time of sale of shares

The second tax implication shall arise when the employees sell shares allotted under ESOP. The resultant gains shall be taxable under the head capital gains. Taxability of capital gains shall depend on the type of share and the period of holding of such share.

The period of holding of shares shall be the period commencing from the date of allotment of shares, and not from the date of exercising of option, ending on the date employees sell the shares. Further, the fair market value of shares on the date of exercising the option shall be taken as the cost of acquisition of such shares to compute the capital gain.

Example 4, Mr John exercised the ESOP on 01-04-2024, and the shares are allotted to him on 01-05-2024. He sold such shares on 01-08-2024. The period of holding of such shares shall be counted from 01-05-2024 (and not from 01-04-2024) till 31-07-2024. However, for computing the cost of acquisition, the fair market value of shares as on 01-04-2024, being the date of exercising of ESOP, shall be considered.

The capital gains from transfer of shares allotted under the ESOPs shall be computed as per normal capital gains provisions explained earlier. A summary of these provisions is given below:

a) *Equity shares chargeable to STT (long-term capital assets):* Where shares allotted under ESOPs are equity shares, and the employees sell them after holding for more than 12 months and paid STT on same, the resultant long-term capital gains shall be taxable under Section 112A. The period of holding of such shares shall be counted from the date of allotment of shares to employees under ESOP. The long-term capital gains, to the extent it exceeds Rs. 1,25,000 shall be taxable at the concessional rate of 12.50% plus surcharge and cess. If shares are listed on a recognized stock exchange but STT is not paid at the time of transfer of such share (i.e., Over-the-Counter sale) the resultant

long-term capital gains shall be taxable Section 112(1), that is, at 12.50% but the initial exemption of Rs. 1,25,000 will not be available.

b) *Equity shares chargeable to STT (short-term capital assets):* Any short-term capital gains arising from the sale of equity shares allotted under ESOP on which STT has been paid shall be taxable at the rate of 20% *plus* surcharge and cess under Section 111A.

c) *Unlisted equity shares not chargeable to STT (long-term capital assets):* Where equity shares, which are not chargeable to STT, are sold by employees after holding it for a period of more than 24 months, the resultant long-term capital gains will be taxable at the rate of 12.50% *plus* surcharge and cess under Section 112. Period of holding of such shares shall be counted from the date of allotment of shares to employees under ESOP.

d) *Equity shares not chargeable to STT (short-term capital assets):* Any short-term capital gains arising from the sale of equity shares, which are not chargeable to STT, shall be taxable as per the Income-tax slab rate applicable to the taxpayer.

12.1.3 Deferment of tax on perquisite value of ESOPs in case of Start-ups

ESOPs are a significant component in the compensation of the employees of start-ups as it allows start-ups to employ highly talented employees at a relatively low salary amount with the balance being paid *via* ESOPs. The taxability of ESOPs arises in the hands of the employee at two stages. Firstly, when shares are allotted to employee on exercising his right to apply for the shares under ESOPs and, secondly, when such shares are sold by the employee.

At the time of allotment of shares, the difference between the fair market value of shares on the date of exercising the option and the amount actually paid by the employee for such shares is taxable as perquisite under section 17(2)(vi) of the Income Tax Act and chargeable to tax under the head 'Salary'. Consequently, the employer is required to include the amount of perquisite in the salary of the employee and deduct tax thereon under section 192 in the year in which shares are allotted.

As employees do not get any immediate benefit from the shares allotted under the ESOPs, the deduction of tax thereon in the year of allotment itself was very burdensome for them as it reduces the cash flow in their hand. To reduce the burden of taxes, the Finance Act, 2020 amended Section 192 (TDS on salary), Section 140A (self-assessment tax), Section 191 (direct payment of tax by the employee) and Section 156 (notice of demand) so to defer the deduction and payment of tax on income in the nature of perquisites arising from ESOPs for eligible start-ups as referred to in section 80-IAC.

Meaning of an eligible start-up

Only an eligible start-up as referred to in Section 80-IAC and its employees would get the benefit of deferment of TDS and tax payment on perquisite arising from ESOPs. As per section 80-IAC, an eligible start-up can only be a company or limited liability partnership (LLP) engaged in innovation, development or improvement of products or processes or

services or a scalable business model with a high potential of employment generation or wealth creation. Further, it has to satisfy the following conditions:

1. It must be incorporated on or after 01-04-2016 but before 1-04-2024[33];
2. Total turnover shall not exceed Rs. 100 crores in the previous year for which deduction under section 80-IAC is claimed; [34] and
3. It must hold a certificate of eligible business from the Inter-Ministerial Board of Certification.

12.2 Sovereign Gold Bonds

Sovereign Gold Bonds (SGBs) are government securities, which are denominated in grams of gold. They are substitutes for holding physical gold. Investors have to pay the issue price in cash, and the bonds will be redeemed in cash on maturity. Reserve Bank of India issues the bond on behalf of the Government of India. The quantity of gold for which the investor pays is protected, as investor receives the market price of gold on redemption.

The SGB offers a superior alternative to holding gold in physical form. The risks and costs of storage are eliminated. Investors are assured of the market value of gold at the time of maturity and periodical interest. SGB is free from issues like making charges and purity in the case of gold in jewellery form. The bonds are held in the books of the RBI or in Demat form, eliminating the risk of loss of scrip, etc.

The Sovereign Gold Bonds may be held by a Trust, HUFs, Charitable Institution, University or by a person resident in India, being an individual, in his capacity as such individual, or on behalf of minor child, or jointly with any other individual.[35] An individual investor whose residential status subsequently changes from resident to non-resident may continue to hold SGB till the original term of redemption/maturity.

Rate of interest of SGBs

The bonds bear interest at the rate of 2.50 per cent (fixed rate) per annum on the nominal value of the bond. Interest will be credited half-yearly to the bank account of the investor, and the last interest will be payable on maturity along with the principal.

Limit of investment

The Bonds are issued in denominations of one gram of gold and multiples thereof. The minimum investment in the Bond shall be one gram with a maximum limit of subscription of 4 kg for individuals, 4 kg for Hindu Undivided Family (HUF) and 20 kg for trusts and similar entities notified by the government from time to time per fiscal year (April – March).

In case of joint holding, the limit applies to the first applicant only. The annual ceiling will include bonds subscribed under different tranches during initial issuance by Government

[33] The Finance Act, 2023 has extended the outer date from 01-04-2023 to 01-04-2024.
[34]The turnover limit has been increased from Rs. 25 crore to Rs. 100 crore by the Finance Act, 2020
[35]Sovereign Gold Bond Scheme 2023-24 notified *vide* Notification No. G.S.R. 438(E), dated 1-06-2023

and those purchased from the secondary market. The limit on investment will not include the holdings as collateral by banks and other Financial Institutions.

Maturity

The gold bonds will mature on the expiration of 8 years from the date of issue of the bonds. On maturity, the Gold Bonds shall be redeemed in Indian Rupees, and the redemption price shall be based on the simple average of the closing price of gold of 999 purity of previous three working days from the date of repayment, published by the India Bullion and Jewellers Association Limited. Both interest and redemption proceeds will be credited to the bank account furnished by the customer at the time of buying the bond. The RBI / depository shall inform the investor one month in advance, about the date of maturity of the Bond.

Premature redemption

Though the tenor of the bond is 8 years, early encashment/redemption of the Bond is allowed after the fifth year from the date of issue of bond. Such repayments will be made on next interest payment date. The bond will be tradable on Exchanges if held in Demat form. It can also be transferred to any other eligible investor.

Collateral for loans

These securities are eligible to be used as collateral for loans from banks, financial Institutions and Non-Banking Financial Companies (NBFC). The Loan to Value ratio will be the same as applicable to conventional gold loan prescribed by the RBI from time to time. Granting loan against SGBs would be subject to the decision of the bank/financing agency, and cannot be inferred as a matter of right.

12.2.1 Tax implications on SGBs

Interest income

The interest received on the sovereign gold bond shall be chargeable to tax under the head 'Income from other sources' and taxed as per the tax rates applicable in case of an assessee.

However, any payment of interest on SGBs would not attract any TDS as they are Government Securities. Thus, investors would receive the full amount of interest on SGBs in their bank accounts. Currently, SGBs pay an interest of 2.5% per annum on the nominal value of the bond and interest is credited half-yearly to the bank account of the investor.

Capital gain on redemption

SGBs have a tenor of 8 years. The redemption of the SGBs would normally be treated as transfer, thus, be charged to capital gains tax. However, Section 47 of the Income Tax Act provides that redemption by an individual does not amount to 'transfer' and thus no capital gains arise on such redemption by an individual investor.

However, investors can go for pre-mature redemption of SGBs after the fifth year from the date of issue. Any capital gains arising to an investor other than Individual on redemption of SGBs (whether on maturity or pre-mature redemption) shall be taxable as a long-term capital gain if held for more than 12 months. As SGBs are listed on stock exchanges in India, the investor has to pay tax at the rate of 12.50%. If the non-individual has held the SGB for less than 12 months on the date of redemption then they will need to pay tax at normal slab rates.

For SGB sold or transferred other than through redemption, capital gains will be taxed at the rate of 12.50% (if held for more than 12 months) and at slab rates if held for less.

Example 6, Mr X purchased SGBs for Rs 5 lakhs. He received Rs. 6 lakhs on their redemption. The capital gain arising on such redemption shall not be charged to tax in the hands of Mr X as he is an Individual and redemption is not treated as transfer. However, if the capital gain is arising to a trust then it shall be charged to tax at the rate of 12.50% if the trust has held it for more than 12 months on the date of such redemption else on slab rates.

It is to be noted that if a person buys SGBs from the secondary market and not from the primary issue, the taxability on redemption would remain the same.

Capital gain on transfer

Sovereign Gold Bonds are listed on stock exchanges in India. Thus, a person can transfer the SGBs in the secondary market. The profit or loss arising on transfer of SGBs shall be chargeable to tax under the head capital gain. If the SGBs are transferred after holding for more than 12 months, the resultant gains shall be taxable as a long-term capital gain; whereas, if the SGBs are transferred within 12 months then the gains shall be treated as a short-term capital gain.

Short-term capital gain arising on transfer of SGBs is charged to tax at normal tax rates as applicable in case of an assessee. Long-term capital gain is charged to tax at the rate of 12.50% plus surcharge and cess.

The taxability shall remain same in case of off-market transactions. Further, it is to be noted that even an individual shall be liable to pay tax on capital gains arising on transfer of SGBs as exemption has been provided only in case of redemption and not on transfer of SGBs.

Example 7*:* Mr. X purchased 100 SGBs at its nominal value of Rs. 425,000 on 28-04-2019. The SGBs carry interest rate of 2.5% per annum on the nominal value of bond. The interest is payable at half yearly intervals on 28th October and 28th April every year. The bonds are redeemable on 28-04-2027 with the option for early redemption after 5th year from the date of issue of bonds.

What shall be the tax implications in the hands of Mr. X in following scenarios?

1. He holds SGBs till maturity;
2. He transfers SGBs in the secondary market on 01-08-2024for Rs. 7,50,000;
3. He transfers SGBs in the secondary market on 29-10-2024 for Rs. 7,92,000.

Answer:

Situation 1: SGBs held till maturity

As per section 47 of the Income Tax Act, the redemption of SGBs by an Individual is not treated as transfer. Thus, no capital gain shall arise in such a case. However, the interest received or receivable on SGBs is chargeable to tax in the hands of the investor at the applicable rates. Thus, Mr. X shall be liable to pay tax on the interest amount. For instance, for the financial year 2020-21, the interest amount taxable in the hands of Mr. X shall be Rs. 10,625 (425,000 * 2.5%).

Situation 2: SGBs transferred in the secondary market on 01-08-2024

Mr. X transferred SGBs for Rs. 750,000 on 01-08-2024 before the due date of payment of half yearly interest on 28-10-2024. The sales consideration shall include the amount of interest accrued to him from the last coupon date to the date of transfer of SGBs, *that is*, from 29-04-2024 to 01-08-2024. As interest is taxable under the head "Income from other sources', the amount of interest accrued shall be reduced from the amount of consideration to compute the capital gain arising on transfer of SGBs.

The amount of interest accrued to Mr. X before the date of transfer of SGBs shall be Rs. 2,765 (Rs. 425,000 * 2.5% * 95/365 days). The resultant value shall be the sale price of SGBs, *that is*, Rs. 7,47,235 (Rs. 7,50,000 – Rs. 2,765). The capital gain shall be computed as follows:

Computation of capital gain on transfer of SGBs	
Period of holding (from 28-04-2019 to 01-08-2024)	More than 12 months
Nature of capital gain	Long-term capital gain
Sale price	Rs. 7,47,235
Less: Cost of acquisition	Rs. 4,25,000
Long term capital gain	Rs. 3,22,235
Tax on capital gain	Tax @12.50%

Situation 3: SGBs transferred in the secondary market on 29-10-2024

The amount of interest taxable in hands of Mr. X in the financial year 2024-25 shall be Rs. 6,142 (Rs. 425,000 * 2.5% * 211/365 days).

A) As SGBs were transferred next day after the due date of payment of half yearly interest, no interest shall accrue to Mr. X from last coupon date to date of transfer of SGBs. Thus, interest amount shall not be reduced from consideration received on transfer of SGBs. Further, as Mr. X has transferred SGBs after holding for a period of more than 12 months, the nature of capital gain shall be long-term capital gain.

Computation of capital gain	
Particulars	*Amount*
Sale price [A]	7,92,000

Cost of Acquisition [B]	425,000
Long term capital gain [D = A - C]	3,67,000
Tax rate on capital gain [E]	12.50%

12.3 National Pension System

As discussed in earlier module, Retirement planning requires disciplined saving, vigilant investment to build a sufficient retirement corpus and its judicious drawdown in the post-retirement phase. This can be achieved by joining a pension/retirement plan at an early stage so that when a person retires from active work life, he gets a regular stream of income in the form of pension or annuity for his life.

National Pension System (NPS) is a defined contribution retirement savings scheme designed to enable the subscribers to make optimum decisions regarding their future through systematic savings during their working life. It is administered and regulated by Pension Fund Regulatory and Development Authority (PFRDA). NPS seeks to inculcate the habit of savings for retirement amongst the citizens. It is an attempt towards finding a sustainable solution to the problem of providing adequate retirement income to every citizen of India.

Under the NPS, individual savings are pooled into a pension fund which is invested by PFRDA regulated professional fund managers as per the approved investment guidelines into the diversified portfolios comprising of government bonds, bills, corporate debentures and shares. These contributions would grow and accumulate over the years, depending on the returns earned on the investment made.

At the time of normal exit from NPS, the subscribers may use the accumulated pension wealth under the scheme to purchase a life annuity from a PFRDA empanelled life insurance company apart from withdrawing a part of the accumulated pension wealth as lump-sum, if they choose so.

Features of NPS

NPS offers a range of investment options and choice of Pension Fund Manager (PFMs) for planning the growth of investments in a reasonable manner. Individuals can switch from one investment option to another or from one fund manager to another subject to certain regulatory restrictions.

When anyone opens an account with NPS, he gets Permanent Retirement Account Number (PRAN), which is a unique number and it remains with the subscriber throughout his lifetime.

NPS provides two types of accounts to the subscribers - Tier I and Tier II. Tier I is a mandatory retirement account, whereas Tier II is a voluntary saving account associated with PRAN of the subscriber. Tier II offers greater flexibility in terms of withdrawal, unlike Tier I account, the subscriber can withdraw from Tier II account at any point of time.

12.3.1 Tax treatment of contribution to NPS

Employee's contribution to NPS

When contribution to NPS is made by the employee himself, the deduction shall be allowed under Section 80CCD(1) which shall be lower of the amount contributed by the employee to NPS or 10% of salary. This deduction is subject to the overall limit of Rs. 1,50,000 available for other modes of investments such as Life Insurance premium, ELSS, Employee contribution to EPF, Public Provident Fund etc. An additional deduction of Rs. 50,000 over and above this limit is allowed under Section 80CCD(1B) to an employee for the amount deposited by him to his NPS account. Both these deductions are available only if the assessee has chosen the Old tax regime.

For this purpose, 'salary' includes dearness allowance (if terms of employment so provide) but excludes all other allowances and perquisites.

Employer contribution to NPS

When contribution to the NPS is made by the employer, such contribution is taxable in the hands of the employee and included in his salary income. However, deduction shall be allowed under Section 80CCD(2) to the employee for such contribution which shall be lower of the amount contributed by the employer to NPS, or 14% of salary in case of Central or State Government employee or 10% (for old tax regime) or 14% (in case of New tax regime) of salary in case of any other employee.

'Salary' for the purpose of contribution by the employer and employee shall mean basic salary and dearness allowance (if terms of employment so provide). All other allowance or perquisites will not be part of salary for the purpose of calculation.

Contribution to Tier II account by Central Govt. employees

Any contribution made by Central Govt. employees to the tier II NPS shall be allowed as tax deduction under Section 80C. However, such contribution to NPS shall be made for a fixed period of at least 3 years. The maximum amount of deduction allowed under this section shall be Rs 1,50,000.

Contribution to NPS by a self-employed person

When contribution to the NPS is made by a self-employed individual, the deduction shall be allowed under Section 80CCD which shall be *lower* of the amount contributed by him to NPS or 20% of his gross income. This is within the overall limit of Rs. 1,50,000 permissible for various investments such as PPF, ELSS or expenses such as Life Insurance premium, that is allowed under the old tax regime. An additional deduction of Rs. 50,000 over and above this limit is allowed under Section 80CCD(1B) to such individual for the amount deposited by him to his NPS account under the old tax regime.

Threshold limit for deduction in respect of contribution to NPS

The total deduction under Section 80C, 80CCC and 80CCD(1) shall be limited to Rs. 1,50,000. This limit of Rs. 1,50,000 is not applicable in respect of:

1. The contribution made by the employer to NPS account of the employee; and
2. Additional deduction of Rs. 50,000 for the contribution made by an individual (employee or self-employed) to his NPS account.

Thus, the total deduction to be allowed to an individual in respect of contribution to NPS can go up to Rs. 2,00,000. The additional deduction of Rs. 50,000 is above this limit of Rs. 1,50,000. In other words, an assessee can choose to take a tax deduction in respect of contribution to NPS within the limit of Rs. 1,50,000 or as an additional deduction.

Example 8, An employee repays a housing loan of Rs. 170,000 during the year and contributes Rs. 65,000 in his NPS account. Repayment of housing loan to a bank or housing finance company is eligible for deduction under Section 80C. Since the limit of Rs. 150,000 is exhausted by such repayment, the employee can choose to take the benefit of the additional deduction for the contribution to NPS. Thus, the total deduction shall be Rs. 2,00,000 (Rs. 1,50,000 under Section 80C for housing loan repayment and Rs. 50,000 for contribution to NPS under Section 80CCD(1B)).

Example 9, Basic salary of Mr. Gopal is Rs 50,000 per month. He is entitled to dearness allowance of 40% of basic salary (Rs. 20,000 per month) and 50% thereof forms part of retirement benefits. He and his employer (non-govt.) both contribute 15% of basic salary as a contribution to NPS. Mr. Gopal is already claiming a deduction of Rs 150,000 under Section 80C.

The contribution made by the employer to NPS would be treated as part of the salary of Mr. Gopal. Thus, employer's contribution of Rs. 90,000 (Rs. 600,000 * 15%) would be included in the salary of Mr. Gopal. The deduction available under Section 80CCD shall be computed in following two steps:

Step 1: Computation of salary

Particulars	*Amount*
Basic Salary [Rs. 50,000 * 12 months]	600,000
Dearness allowance [Rs. 20,000 * 12 months * 50% (forming part of retirement benefits]	120,000
Salary for computation of deduction under Section 80CCD	**720,000**

Step 2 Computation of deduction under new tax regime

Particulars	*Amount*
Deduction for employee's contribution [Note 1] [A]	Not available under new tax regime
Deduction for the employer's Contribution *(a)* Contribution by employer *(b)* Deduction allowable under Section 80CCD(2) [Note 2][B]	 90,000 90,000
Deduction under Section 80CCD [A + B]	**90,000**

Note 1: No deduction is available for this under the new tax regime *Note 2:* Deduction for the employer's contribution to the NPS shall be limited to 14% of the salary, that is, Rs. 7,20,000 * 14%. = Rs. 1,00,800, subject to a maximum of actual contribution which is Rs. 90,000.

Step 2: Computation of deduction under old tax regime

Particulars	*Amount*
Deduction for employee's contribution *(a)* Contribution by employee *(b)* Deduction allowable under Section 80CCD(1B) [Note 1] [A]	 90,000 50,000
Deduction for the employer's Contribution *(c)* Contribution by employer *(d)* Deduction allowable under Section 80CCD(2) [Note 2][B]	 90,000 72,000
Deduction under Section 80CCD [A + B]	**1,22,000**
Note 1: Maximum deduction of Rs. 150,000 is allowed under Section 80C, 80CCC and 80CCD(1), which has already been exhausted for deduction under Section 80C. Thus, no deduction can be claimed under Section 80CCD(1). However, deduction of up to Rs. 50,000 can be claimed under Section 80CCD(1B). *Note 2:* Deduction for the employer's contribution to the NPS shall be limited to 10% of the salary, that is, Rs. 7,20,000 * 10%. The deduction for employer's contribution would be in addition to deduction available for Rs. 150,000.	

Step 3 – Calculating Taxable Income

Sr No	Description	Calculation	Old Tax regime (Rs.)	New Tax regime (Rs.)
1	Basic (A)	6,00,000		
2	Dearness Allowance – (part of retirement calculation) (B)	1,20,000		
3	Dearness Allowance – not part of retirement calculation (C)	1,20,000		
4	Employer's Contribution to NPS (D)	90,000		
5	12.3.2 Gross Salary Less: Standard deduction **Net Salary (E)**	12.3.3 9,30,000	12.3.4 9,30,000 (50,000) **8,80,000**	12.3.5 9,30,000 (75,000) **8,55,000**
6	12.3.6 **Deduction under section 80C (F)**	12.3.7	12.3.8 **1,50,000**	12.3.9 **Nil**
7	12.3.10 **Employee contribution to NPS – deduction under 80CCD (1) (G)**	12.3.11	12.3.12 **Nil as limit already consumed by section 80C**	12.3.13 **Nil**
8	12.3.14 **Employee contribution to NPS – deduction under 80CCD (1B) (H)**	12.3.15	12.3.16 **50,000**	12.3.17 **Nil**

9	12.3.18 **Employer Contribution under section 80CCD (2) (I)**	12.3.19	12.3.20 **72,000**	12.3.21 **90,000**
10	12.3.22 Total deductions [(F+G+H+I) = J]	12.3.23	12.3.24 2,72,000	12.3.25 90,000
11	12.3.26 Taxable Income [E minus J = K]	12.3.27	12.3.28 6,08,000	12.3.29 7,65,000

The Finance Act, 2020 introduced a cap on maximum contribution an employer can make towards recognized provident fund (PF), National pension scheme (NPS) and Superannuation fund (hereinafter collectively referred to as 'employee welfare schemes'). The contribution to employee welfare schemes in excess of Rs. 750,000 shall be taxed as perquisite in the hands of the employees.

Employers' contribution to NPS is taxed as salary in any case. Thus, there is a double add back of employers' contribution to NPS (in excess of Rs. 7.50 lakhs) with only a single deduction.

An example is given below to understand this better:

Example 10:

Mr X has a basic salary of Rs. 50,00,000

His employer contributes 12% of his basic (Rs. 6 lakhs) to Mr X's EPF account. Mr X also contributes Rs. 6 lakhs as his contribution to EPF. Additionally, the employer contributes 14% of his Basic (Rs. 7,00,000) to his NPS account. Mr X contributes Rs. 50,000 to his NPS account.

Here is his calculation of Taxable Income under both the taxation regimes:

Sr No	Description	Calculation	Old Tax regime (Rs.)	New Tax regime (Rs.)
1	Basic (A)	50,00,000		
2	12% employers' contribution (6,00,000) to EPF is exempt (B)	Nil		
3	14% employers' contribution to NPS is added back as salary (C)	7,00,000		
4	Employers' contribution to EPF and NPS in excess of 7,50,000 is added as a perk (6,00,000+C)- 7,50,000	5,50,000		
5	**Gross Salary**	62,50,000	**62,50,000**	**62,50,000**
	Less: Standard deduction		(50,000)	(75,000)
	Net Salary (E)		**62,00,000**	**61,75,000**

6	Deduction under section 80C – employee EPF contribution (F) maximum of Rs. 1,50,000		1,50,000	Nil
7	Employee contribution to NPS – deduction under 80CCD (1) (G)		Nil, as limit already consumed by section 80C	Nil
8	Employee contribution to NPS – deduction under 80CCD (1B) (H) additional Rs. 50,000		50,000	Nil
9	Employer Contribution under section 80CCD (2) (I)		5,00,000 (max 10% of Basic)	7,00,000 (Max 14% of Basic)
10	Total deductions [(F+G+H+I) = J]		7,00,000	7,00,000
11	Taxable Income [E minus J]		**55,00,000**	**54,75,000**

Effectively the employers' contribution to NPS has been fully taxed since it has been added back 2 times while calculating salary (once as salary and another time as perk) and deduction has been allowed only once.

12.3.2 Tax treatment of sum received from NPS

In case of withdrawal on closure of account or opting out of NPS

Any payment from the National Pension System Trust to an assessee on closure of his account or on his opting out of the pension scheme is exempt from tax to the extent of 60% of the total corpus. As per the NPS scheme, a person can withdraw up to 60% of the total corpus. The exemption limit under the Income Tax Act has been set in symmetry with the NPS. Thus, the total amount withdrawn by an assessee at the time of closure of NPS account or opting out of the scheme shall be completely tax-free.

In case of partial withdrawal from NPS

Any amount withdrawn from NPS before the closure of account or opting out of the scheme shall be exempt only in case of employees to the extent of 25% of employee's contribution to NPS. Further, the amount should be withdrawn in accordance with the terms and conditions specified under the Pension Fund Regulatory and Development Authority (PFRDA) Act, 2013.

As per PFRDA (Exits and Withdrawals under the National Pension System) (First Amendment) Regulations 2017, the subscribers can withdraw after 3 years from the date of joining the system and a maximum of three times during the entire tenure of subscription under NPS.

In case amount is received by the nominee on death of subscriber

Where the amount standing to the credit of an assessee in NPS is received by his nominee on the death of the subscriber, it shall be fully exempt from tax.

In case pension received out of NPS

When a pension is received out of fund contributed to NPS, it will be chargeable to tax in the hands of the recipient.

In case amount withdrawn from NPS utilized for purchasing an annuity plan

Where the amount withdrawn or received out of NPS is utilized for purchasing an annuity plan of LIC or some other insurer in the same previous year then the annuity income received shall be taxable in the hands of the recipient.

In case of withdrawal from Tier II account

The investment made in Tier II Account is considered just like as an investment in an open-ended mutual fund. Thus, any profit or loss arising on account of withdrawal of amount from Tier II Account shall be taxable under the head of capital gain.

Summary of Taxability of NPS

Particulars	***Taxability***
Contribution to NPS	
Employees' contribution to NPS	The deduction is allowed up to 10% of salary *plus* additional deduction of Rs. 50,000.
Employers' contribution to NPS*	The deduction is allowed up to: ▪ 14% of salary in case of Central or State Government employees; ▪ 10% of salary in case of other employees (under old tax regime) and 14% of salary (under new tax regime)
Any other person not being an employee	The deduction is allowed up to 20% of gross total income *plus* additional deduction of Rs. 50,000.
Accumulation	Tax Free
Withdrawal	
Partial withdrawal	If subscriber is an employee, exempt to the extent of 25% of the contribution made by the employee to the NPS.
Final withdrawal at the time of closure of account or opting out of the scheme	Exempt up to 60% of the total corpus available in the NPS account of the subscriber.
Amount received by a nominee on death of the subscriber	The whole of the amount received by the nominee shall be exempt in the hands of the receiver.
In case of withdrawal from Tier II account	Profit or loss from investment in Tier II account shall be taxable under the head "Capital Gains".
In case the amount withdrawn from NPS utilised for purchasing an annuity plan	No tax shall be charged on such amount withdrawn if it is utilized for purchasing the annuity plan of LIC or some other insurer.

Pension Income	
Pension received out of fund contributed to NPS	Pension received from the fund will be taxable in the hands of the receiver

12.4 Real Estate Investment Trust

Real Estate Investment Trusts (REITs) were first introduced in the United States in 1960-61 through the Cigar Excise Tax Extension Act. It gave an opportunity to the investors to invest in large-scale, diversified portfolios of income-producing real estate. Since then, more than 30 countries have introduced REIT regimes. The concept of REIT was introduced in India in 2014 by SEBI. REITs are registered with the SEBI under SEBI (REITs) Regulations, 2014.

REITs invest in the majority of real estate property types, which includes offices, apartment buildings, warehouses, retail centres, medical facilities, data centres, cell towers, infrastructure and hotels. Most REITs focus on a particular property type, but some hold multiple types of properties in their portfolios. For example, Office REITs are those that own and manage office real estate and rent the space in those properties and Industrial REITs own and manage industrial facilities and rent space in those properties. Similarly, Retail REITs include REITs that focus on large malls, outlet centres, grocery anchored shopping centres etc. Residential REITs include REITs that specialize in apartment buildings, student housing, manufactured homes and single-family homes. Timberland REITs own and manage various types of timberland real estate. Timberland REITs specialize in harvesting and selling timber.

REITs allow investors to invest in portfolios of real estate assets the same way they invest in shares or a mutual fund or exchange-traded fund (ETF).

Structure of REITs

The structure of REITs is similar to that of a mutual fund wherein sponsor (generally real estate developers) sets up the REITs to collect money from the general public for investing on their behalf in income-generating real estate properties. The investment is made in real estate properties either by REITs directly or through Special Purpose Vehicle (SPV) in which it holds the controlling interest. SPVs is a separate entity which can be a company which is floated to hold and develop real estate properties.

Unit-holder

Unit-holder means any person who owns units of the REIT.

However, assets falling under the preview of “Infrastructure” shall not be considered as Real Estate property except following:

a) hotels, hospitals and convention centres forming part of composite real estate projects, whether rent generating or income-generating;
b) common infrastructure for composite real estate projects, industrial parks and SEZ.

12.4.1 Taxation of REITs

REITs are structured as a hybrid pass-through entity. Thus, certain types of income are exempt at REITs level and taxable at the level of unit-holders.

REITs may have the following types of income:

a) Rental income from real estate property;
b) Capital gains from the transfer of real estate property;
c) Dividend received from SPV;
d) Interest received from SPV; and
e) Any other income

The pass-through status is provided only in respect of income covered under point (a), (c) and (d) above. Thus, if REIT distributes any rental, dividend or interest income to its unit-holder then tax shall be charged at the level of unit-holder and not in the hands of the REIT. Further, any income distributed by REIT to its unit-holders shall be deemed to be of the same nature and in the same proportion in the hands of the unit-holder had it been received by, or accrued to, the REIT. Taxability of various income earned by REITs are explained as under:

Rental Income

Rental income earned by the REITs from the investment made in properties shall be tax-free by virtue of Section 10(23FCA) of the Income Tax Act. Thus, such rental income shall be exempt at the REITs level. Rental income distributed by REITs to its unit-holders shall be taxed in the hands of unit holders.

Interest Income

REITs may also invest in real estate *via* Special Purpose Vehicle (SPV). Any interest income that REITs earned from SPV is exempt in the hands of REITs under Section 10(23FC). However, when such interest income is further distributed to the unit-holders, it is taxable in the hands of the unit-holders.

Any other interest income earned by REITs (other than from SPV) is not exempt at the level of REITs. Consequently, such interest income is taxable in the hands of REITs and when such income is further distributed, it is exempt from tax under Section 10(23FD) in the hands of unit-holders. However, if such interest income is not chargeable to tax in the hands of the REIT, it shall be taxable in the hands of the unit holder under the head "other sources" as per Section 56(2)(xii).[36]

[36] Inserted by the Finance Act, 2023 with effect from Assessment Year 2024-25. Earlier, sum received from business trust (other than interest/dividend from SPV or rental income from REIT) was exempt in the hands of unit holder even if the sum so distributed is not chargeable to tax in hands of business trust.

Dividend Income

Dividend received by REITs from SPV is exempt from tax under Section 10(23FC). If dividend received from SPV is further distributed by REITs to the unit-holders, it shall be taxable in the hands of the unit-holders, being a pass-through income. However, if the dividend is received from SPV who has not opted for concessional tax regime of section 115BAA then such dividend shall be exempt in the hands of the unit holders as well under section 10(23FD).

Any other dividend income earned by REITs (other than from SPV) is not exempt at the level of REITs. Consequently, such dividend income is taxable in the hands of REITs and when such income is further distributed, it is exempt from tax under Section 10(23FD) in the hands of unit-holders. But, if such dividend income is not chargeable to tax in the hands of the REITs, it shall be taxable in the hands of the unit holder under the head "other sources" as per Section 56(2)(xii).

Capital Gains

Income Tax Act provides pass-through status to REITs only for rental income and interest/dividend received from SPV whereby tax is charged at the level of unit-holders. All other incomes are chargeable to tax at the level of REIT itself. Thus, any capital gain arising on transfer of real estate properties (including securities) by REIT shall be charged to tax in its own hands and not in the hands of the unit-holders.

Other income

All other incomes of REITs are chargeable to tax in the hands of REITs itself at a maximum marginal rate under Section 115UA. However, if the income is not chargeable to tax in the hands of the REIT and it is subsequently distributed to the unit holders, it shall be taxable in the hands of the unit holder under the head "other sources" as per Section 56(2)(xii).

12.4.2 Taxation of unit-holder of REITs

The income of a unit-holder in a REIT can be categorized into the following three categories:

(a) Pass-through Income: This includes sums distributed by the REIT to unit-holders for which pass-through status is accorded. In this case, the tax liability on the income is directly passed on to the unit-holders, and the REIT itself is not taxed on such distributed sums.
(b) Non-Pass-through Income: This category covers sums distributed by the REIT to unit-holders, but in this case, no pass-through status is accorded. As a result, the REIT is subject to taxation on such distributed sums at its own applicable tax rate, and the unit-holders are exempt from paying tax on this income. It is essential to note that if the sum distributed by the REIT to its unit-holder is not chargeable to tax at the level

of the REIT itself, it becomes taxable in the hands of the unit-holder as per Section 56(2)(xii).[37]

(c) Capital Gains from Unit Redemption or Transfer: The third category pertains to any income arising from the redemption or transfer of units of the REIT.

12.4.3 Taxation of capital gain from redemption or transfer of units of REITs

Redemption of units of REIT

Sum received on redemption of units of REIT shall be taxable under the head other sources in accordance with the provision of Section 56(2)(xii).

Transfer of units of REIT

Income arising from the transfer of units of REIT shall be taxable in the hands of the unit-holder under the head capital gain. Where units of listed REITs are held for 12 months or less or 24 months or less in the case of unlisted REITs short-term capital gains will arise. However, if the holding period is more than 12 or 24 months for listed REITs and Unlisted REITs respectively, the gains arising from the transfer of such units shall be in the nature of long-term capital gains.

The tax on short-term or long-term capital gain shall depend upon the payment of security transaction tax (STT) at the time of transfer of units of business trust.

If STT has been paid on the transfer of units of REIT, short-term capital gains shall be taxable at the rate of 20% *plus* surcharge and cess under Section 111A

Whereas long-term capital gains in excess of Rs 1,25,000 would be taxable at the rate of 12.50% *plus* surcharge and cess under Section 112A.

The investments made on or before 31-01-2018 were grandfathered as the long-term capital gains arising from the sale of units of business trust were previously exempt from tax. The grandfathering works as per the following mechanism.

If units of business trust were acquired on or before 31-01-2018, the cost of acquisition of such units shall be higher of the following:

a) The actual cost of acquisition of units of business trust; or
b) *Lower* of the fair market value of such asset as on 31-01-2018 or full value of the consideration received as a result of the transfer of units of business trust.

[37] Amendment made by the Finance Act, 2023 with effect from Assessment Year 2024-25. Earlier, sum distributed by the business trust (other than sum distributed under pass through status) was exempt in the hands of unit holder even if the sum so distributed is not chargeable to tax in the hands of business trust.

The highest price of units quoted on a recognized stock exchange as on 31-01-2018 is taken as the fair market value. If there is no trading in such units on such exchange on 31-01-2018, the highest price of such units on a date immediately preceding 31-01-2018 when such units were traded shall be the fair market value.

If units of business trust are not listed on a recognised stock exchange as on the 31-01-2018, the net asset value of such unit as on the said date is considered as cost of acquisition.

If STT has not been paid on the transfer of units of REIT, Short-term capital gains shall be taxable as per the tax rates applicable in case of unit-holder. Long-term capital gains shall be taxable at the rate of 12.50% under Section 112 of the Act in case of a resident.

12.4.4 Applicability of TDS

REIT to unit-holder

When REIT distributes the rental income or interest/dividend received from SPV to its unit-holders, the income so distributed is chargeable to tax in the hands of the unit-holders. Thus, to collect taxes from unit-holders at the time of distribution of such income by REITs, the Govt. has introduced TDS provisions. The REITs are required to deduct tax under section 194LBA while distributing the said incomes to the unit-holders. The tax shall be deducted at the following rates:

Nature of distributed income	***Residential status of the unit-holder***	
	Resident	*Non-resident**
Rental income	10%	Foreign company: 35% Any other non-resident person: 30%
Dividend income received from SPV[38]	10%	10%
Interest income received from SPV	10%	5%
****If the provisions of DTAA are more beneficial the tax shall be deducted as per DTAA.***		

12.4.5 Reporting of income by REITs to its unit-holders

When REITs distributes any income to its unit-holders, including the income taxable under Section 56(2)(xii), it shall be required to furnish a statement to the unit-holders (Form No. 64B) as well as to the income-tax department (Form No. 64A) giving the details of the nature of the income paid during the previous year to unit-holders.

12.5 Infrastructure Investment Trust

Infrastructure Investment Trusts (InvITs) invest in infrastructure projects that include roads, bridges, ports, airports, metros, electricity generation, transmission or distribution, telecommunication services, telecommunication towers, special economic zones, etc.

[38]No tax shall be deducted if the dividend is received from SPV which has not opted for concessional tax regime of section 115BAA.

InvITs are registered with SEBI under SEBI (InvITs) Regulations, 2014. The structure of InvITs is very much similar to that of a REITs. Further, the tax implications are also same for both InvITs and REITs, except pass-through status relating to rental income.

The rental income of REITs is chargeable to tax in the hands of the unit-holders as pass-through status has been provided to REITs in respect of such income. But, in case of InvITs, rental income is chargeable to tax in its own hands and not in the hands of its unit-holders.

Summary of Taxability of REITs and InvITs

Nature of sum received	**Taxability in the hands of**		
	REIT	**InvIT**	**Unit holders**
Interest from SPV	Exempt [Section 10(23FC)(a)]	Exempt [Section 10(23FC)(a)]	Taxable
Dividend from SPV (SPV has exercised option under Section 115BAA)	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FC)(b)]	Taxable [Income from business/other sources]
Dividend from SPV (SPV has not exercised option under Section 115BAA)	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FC)(b)]	Exempt [Section 10(23FD)]
Rental income from property owned by trust	Exempt [Section 10(23FCA)]	Taxable [Income from business]	Taxable (if received from REIT)
Other sum or income (if taxable in hands of business trust)	Taxable [Income from business/capital gain/ other sources]	Taxable [Income from business/capital gain/ other sources]	Exempt [Section 10(23FD)]
Other sum or income (if not taxable in the hands of business trust)	Not taxable	Not taxable	Taxable [Income from other sources under section 56(2)(xii)]

Tax on capital gain arising to unit holder from redemption or transfer of units of REITs/InVITs		
Nature of Income	*Tax Rates*	
	Resident	*Non-Resident*
Redemption of units of business trust	Normal tax rate [Income from other sources under Section 56(2)(xii)]	
Short-term capital gains from transfer of units of business trust (other than redemption)	*(a)* 20% under Section 111A (in the case of listed units) *(b)* Applicable rate (in case of unlisted units)	
Long-term capital gains from the transfer of units of business trust (other than redemption)	*(a)* 12.50% under Section 112A above Rs. 1,25,000 (listed units) *(b)* 12.50% under Section 112 (unlisted units)	*(a)* 12.50% under Section 112A above Rs. 1,25,000 (listed units) *(b)* 12.50% under Section 112 (unlisted units)

12.6 Alternative Investment Funds

Alternative Investment Fund (AIF) means any fund established or incorporated in India, as a privately pooled investment vehicle, to collect funds from sophisticated investors, whether Indian or foreign, for investing in accordance with a defined investment policy for the benefit of its investors. However, it does not include mutual funds, collective investment fund or any other fund for which there are separate regulations of SEBI.

AIF can be set up as a trust, company, limited liability partnership and any other body corporate and it is mandatory to obtain registration from SEBI as per SEBI (Alternative Investment Funds) Regulations, 2012 or under the International Financial Services Centres Authority Act, 2019.[39] SEBI grants registration to AIFs on the basis of their operational strategies, objectives and fund structure and, for this purpose, they are categorized into various categories. The AIF categories have already been discussed in Investment Adviser Level 1 workbook.

12.6.1 Taxation of Category-I and Category-II AIFs

Taxation of Category-I and Category-II AIFs is governed by Section 115UB of the Income Tax Act which provides pass-through status to such funds wherein income arising to such funds is exempted from tax, while investors are liable to pay tax on such income as if the investors have directly made the investments. However, this pass-through status is not given in respect of 'business income' of the AIF. Thus, business income is chargeable to tax in the hands of AIF itself.

Any income arising in the hands of the Investment fund shall be bifurcated into the following two categories:

a) Business income; and
b) Any other income.

Taxability of Business Income

Income in the nature of business income shall be taxed in the hands of the Investment Fund under the head 'Profits and gains from business or profession' and it shall be exempt in the hands of the unit-holders under Section 10(23FBB).

If Investment fund is a company or a firm, such business income will be taxable at the rates applicable to the company or firm. However, in any other case, where AIF is registered as a trust or any other body corporate, such income shall be taxed at maximum marginal rates.

Taxability of Other Income

Any other income shall be taxable in the hands of the unit-holder and it shall be exempt in the hands of the Investment Fund under Section 10(23FBA).

[39] Amended by the Finance Act 2021, with effect from assessment year 2022-2023

The income arising to the unit-holder, out of the investment made in the Investment Fund, shall be chargeable to tax in the same manner as if it were the income accruing or arising to them, had the investments (made by the Investment Fund) been made by them directly.

The income paid or credited by the investment fund to the unit-holder shall be deemed to be of the same nature and in the same proportion in the hands of the unit-holder as if it had been received by, or had accrued or arisen to, the investment fund.

Further, the income accruing or arising to, or received by, the AIF, during a previous year, if not paid or credited to the investor thereof, shall be deemed to have been credited to the account of the investors on the last day of the previous year in the same proportion in which investors would have been entitled to receive the income had it been paid in the previous year.

Set-off and carry forward of losses

Any losses arising in the hands of the investment fund under the head 'Profits and gains arising from business or profession' shall be allowed to carry forward and not to be passed to its unit-holders.

Up to Assessment Year 2019-20, AIFs were allowed to pass the income to the unit-holders but not losses. Thus, if the net result of the computation of total income of the AIF is a loss then the same was not allocated amongst the unit-holders. Thus, they were deprived of setting off such loss against their income. The Finance (No. 2) Act, 2019 amended the provisions of section 115UB to allow pass-through of losses as well. Thus, from Assessment Year 2020-21, non-business losses of AIF is allowed to be allocated amongst unit holders except where such loss is in respect of a unit, which has not been held by the unit-holder for a period of at least 12 months.

Any losses, other than the business losses, accumulated at the level of investment fund as on 31-03-2019, shall be deemed to be the loss of the unit-holder who held the units as on that date. In other words, the accumulated losses shall be deemed to be the losses of the unit-holders who held the units as on 31-03-2019 even if the period of holding of such unit is less than 12 months.

Such losses shall be allowed to be carried forward by such unit-holders for the remaining period calculated from the year in which the loss had occurred for the first time taking that year as the first year. He shall be allowed to set off and carry forward the losses in accordance with the provisions of Chapter-VI. Such losses which are passed to the unit-holders shall not be allowed to the investment fund for set off and carry forward.

Applicability of TDS Provisions

As other income (not being a business income) is taxable in the hands of the unit-holder, the CBDT has notified that no tax shall be deducted from the payment of such income to the investment fund.[40]

[40]Notification No. 51/2015/SO 1703(E), dated 25-6-2015

For example, if an investment fund receives any rental income or interest income from a bank, the payer shall not deduct tax from such payment.

In case the income arising in the hands of investment fund is taxable in the hands of the unit-holder, the investment fund shall deduct tax under Section 194LBB from the payment at the rate of 10% in case of resident unitholders and at rates in force in case of foreign unitholders. If the unit-holder is a non-resident (not being a company) or a foreign company, no tax shall be deductible in respect of any income which is not chargeable to tax.

Reporting of income by AIF

When AIF distributes any income to its unit-holders, it shall be required to furnish a statement to the unit-holders as well as to the income-tax department giving the details of the nature of the income paid during the previous year to unit-holders.

The statement shall be required to be furnished to the unit-holders in Form No. 64C by the 30th June of the financial year following the previous year during which the income is paid or credited.

The statement shall be required to be furnished to the Income-tax department in Form No. 64D by the 30th November of the financial year following the previous year during which the income is distributed.

Example 14: Category-I AIF, registered as a trust, has derived following income during the year:

Nature of income	*Amount (in lakhs)*
Income under the head profit and gains from business and profession	20
Income under the head capital gains	15
Income from other sources	5

Mr. X holds 30% units of the AIF. During the year, the AIF has credited the entire income to the accounts of its investors except for income in the nature of other sources. Determine the taxability both in the hands of AIF and Mr. X.

Taxability in the hands of AIF

Income Tax Act provides the pass-through status to the Category-I AIF. The income arising to the AIF is exempt from tax as investors are liable to pay tax on such income as if they have directly made the investments. However, this pass-through status is not given in respect of 'business income' of the AIF. Thus, business income of Rs. 20 lakh shall be chargeable to tax in the hands of AIF itself. As the AIF is registered as a trust, the business income shall be chargeable to tax at maximum marginal rate (MMR).

Taxability in the hands of Mr. X

Nature of income	*Amount (in lakhs)*
Income credited by the AIF:	

- Income under the head PGBP†	-
- Income under the head capital gains	4.5
Income deemed to be credited:	
- Income from other sources	1.5
Total income	**6**
† Income received by unit holder from AIF in the nature of income from business or profession shall be exempt under section 10(23FBB).	

12.6.2 Taxation of Category-III AIFs

Pass-through status has been accorded only to Category-I and Category-II AIF and not Category-III AIF. Thus, as AIFs can be formed as a trust, company, limited liability partnership and any other body corporate, the taxation system in the case of Category-III AIF shall be the same as in case of a normal trust, company, LLP or any other body corporate.

In case such Category III AIF fulfils the conditions for being a specified fund as referred under Section 10(4D), it shall be entitled to various exemptions, concessions and allowances.

12.7 Exchange Traded Funds (ETFs)

Exchange-Traded Funds (ETFs) are like Mutual Funds that track an index (i.e., NIFTY/SENSEX), or a commodity (Gold/Silver) or a basket of assets like an index fund. However, unlike regular Mutual Funds, ETFs are listed on exchange and trade like a stock, thus experiencing price changes throughout the day as it is bought and sold.

12.7.1 Gold ETFs

Gold exchange-traded fund scheme (Gold ETF) is defined under SEBI (Mutual Funds) Regulations, 1996 to mean mutual fund scheme that invests primarily in gold or gold related instruments. The taxation and exemption rules for them are the same as for physical gold or other than equity oriented mutual funds.

Any profit arising from the sale of Gold ETFs, after holding it for a period of more than 12months, is considered as long-term capital gain. Such capital gains are taxable at the rate of 12.50% *plus* surcharge and cess after taking benefit of Indexation. Further, where Gold ETFs are held for 12 months or less, any profit on sale of such ETFs is taxable at normal rate as applicable in case of the investor.

For Gold ETFs that were bought after April 1, 2023 and sold before April 1, 2025 the capital gains will always be treated as short term capital gains and will be taxed at Slab rates. This rule does not apply if the Gold ETF has been bought before April 1, 2023 or is sold on or after April1, 2025.

Example 15, Mr. A (resident in India) acquired 10,000 units of Gold ETF at Rs. 30 per unit on 01-03-2018. He sold such units on 25-03-2025 at Rs. 50 per unit. Compute the amount of capital gain chargeable to tax in hands of Mr. A.

Answer:

Computation of capital gain	
Particulars	*Amount*
Period of holding (from 01-03-2018 to 24-03-2025)	84+ Months
Nature of capital gain (held for more than 36 months)	Long term capital gain
Full Value of Consideration (10,000 units * Rs. 50)	500,000
Less: Cost of Acquisition	(-) 3,00,000
Long-term capital gain	**2,00,000**
Tax rate on capital gain	**12.50%**

12.7.2 Equity Index ETFs

Index fund scheme (Index ETF) is defined under Regulation 2(mn) of SEBI (Mutual Funds) Regulations, 1996 to mean a mutual fund scheme that invests in securities in the same proportion as an index of securities. Tax treatment of index ETFs that track equity indexes would be same as in the case of listed equity oriented mutual funds. Any profit arising from index ETF would be long-term if it is held for more than 12 months. Such long-term capital gains above Rs 1.25 lakh would be taxable at the rate of 12.50% *plus* surcharge and cess under Section 112A. However, short-term capital gains on index ETFs would be taxable at the rate of 15% under Section 111A.

Example 16, Mr. A (resident in India) acquired 5,000 units of an Nifty 50 Equity Index ETF on 01-05-2019 at Rs. 200 per unit. He sold the units on 01-08-2024 at Rs. 300 per unit through the recognised exchange and paid STT on such transaction. Compute the amount of capital gain chargeable to tax in hands of Mr. A.

Answer:

Particulars	*Amount*
Period of holding (from 01-05-2019 to 31-07-2024)	12+ Months
Nature of capital gain (holding period is more than 12 months)	Long term capital gain
Sale price (5,000 units * Rs. 300)	Rs. 15,00,000
Cost of acquisition (5,000 units * Rs. 200)	Rs. 10,00,000
Long term capital gain	Rs. 5,00,000
Tax rate of capital gain†	12.50%
† As the amount of capital gain exceeds Rs. 125,000, the excess amount shall be chargeable to tax at concessional rate of 12.50% as per section 112A.	

12.8 Tax aspects of Life Insurance Products

Any sum received from life insurance policy including bonus is exempt from tax.

However, it may be taxed if any of the following situations exist:

a) any sum received under a Keyman insurance policy

b) any sum received under sub-section (3) of section 80DD (i.e. where any amount is paid under the scheme of Life Insurance Corporation for maintenance of dependent and the dependent predeceases the assessee, the amount received by the assessee on death of dependent).

c) Where the insurance policy is issued on or after the 1st day of April, 2003 but on or before the 31st day of March, 2012 if the premium payable for any of the years during the term of the policy exceeds twenty per cent of the actual capital sum assured; or

d) Where the insurance policy is issued on or after the 1st day of April, 2012 if the premium payable for any of the years during the term of the policy exceeds ten per cent of the actual capital sum assured.

Any amount received on death of the person is not taxable and the conditions mentioned under point (c) and (d) above are not applicable.

The above tax treatment is applicable to all types of life insurance policies – be it traditional insurance policies, or unit linked insurance policy or pension plan.

Premiums payable are also allowed as deduction under section 80C. The total deduction allowed under section 80C (along with section 80CCC and 80CCD) is Rs. 150,000.

Certain important points to remember in this regard are:

i). In case of an individual, deduction is available for policy issued in the name of individual himself or spouse or children.

ii). In case of a HUF, deduction is available for policy issued in the name of any of the member thereof.

iii). Deduction is restricted to 20% of sum assured for policies issued on or before 31.03.2012 and 10% for policies issued on or after 01.04.2012. In case of policy taken on or after 1-4-2013 in the name of any person suffering from disability or severe disability referred to in section 80U or suffering from disease or ailment as given in section 80DDB, the limit will be 15% of capital sum assured

iv). The various policies need to be held for a minimum period as follows. Where the policies are terminated before this minimum period, any deduction allowed in earlier years will be taxed as income of the year in which such policy got terminated.

Nature of policy	Minimum Holding Period
ULIP of UTI or LIC	5 years
Life Insurance Policy	2 years

Following are salient features in respect of High value ULIPs vide amendments made by Finance Act:

1) Applies only in respect of ULIP policies issued on or after 1 February 2021 (affected policies) and does not impact earlier policies
2) Determination of High Value premium only for affected policies
3) Premiums of all affected policies to be added up together
4) To the extent the premium of the affected policies does not exceed Rs. 2,50,000 – old provisions will continue to apply
5) Long term period for equity-oriented funds from high premium ULIPs (defined in the same manner as an equity oriented mutual fund but with a requirement to maintain the 65% or 90% character of listed domestic equity throughout the tenure of the policy) will be 1 year.
6) Equity oriented funds within high premium ULIPs will be taxed at concessional rate of 12.50% for long term capital gains.
7) Short term capital gains (if any) on equity-oriented fund in a high premium ULIP will be taxed at the special rate of 20%.
8) Any gains on non-equity-oriented fund in a high premium ULIP would be taxed in accordance with normal capital gains taxation – normal rates for short term and 12.50% for long term.

However, where any sum is received on death of a person, the same will not be taxed and will remain exempt under section 10(10D).

Consequential amendment made in Finance (No 2) Act, 2004 to make security transaction tax applicable on maturity or partial withdrawal with respect to unit linked insurance policy issued by insurance company on or after the 1st February, 2021 [to which exemption under clause (10D) of section 10 of the Act does not apply on account of the applicability of the fourth and fifth proviso]. This amendment is effective from 1st February, 2021.

With the insertion of above amendments, it is quite clear that policies covered by virtue of above amendments will be treated as capital asset. However, for other policies where the conditions of section 10(10D) (i.e. 20% / 10% of sum assured, as the case may be) are not satisfied, it remains an open issue still as to whether maturity proceeds of such policies will be treated as capital gains or income from other sources.

Taxation of Endowment Policies:

Endowment policies are the type of life insurance policies for a particular term. Where the policy holder survives the term, he is paid lumpsum (sum assured plus bonus, as may be applicable) on the maturity of the policy. In the event of his death, his nominee receives death benefit.

Maturity proceeds received on endowment policies taken after 1st April, 2012 will be exempt under section 10(10D) of the premium payable for any of the year does not exceed 10% of the sum assured.

For policies taken on or after 1st April, 2023, if the premium or the aggregate of the premium payable during the term of the policy exceeds Rs. 500,000, then the maturity proceeds are taxable as income from other sources even if the sum assured is 10 times or more of the premium amount.

Example, Mr. X has taken an endowment policy of say Rs. 60 lakhs on 1st April 2024. The premium payable on the same is Rs. 6 lakhs every year. Here the condition of premium not exceeding 10% is being satisfied. However, since premium payable is more than Rs. 5 lakhs, the maturity proceeds including any bonus received will be taxable under income from other sources after deducting the aggregate amounts of premium paid (which has not been claimed as deduction in any preceding years).

12.9 Tax aspects of Reverse Mortgage

Reverse mortgage is a facility given to senior citizens whereby they can mortgage their house property and borrow funds. They can continue to stay and occupy the said property. This helps them to unlock the value of their immovable property.

These schemes had certain tax issues around it. It was highly debatable as to whether mortgaging a property will amount to 'transfer' under the Income Tax Act. Hence, clause (xvi) was inserted in section 47 of the Income Tax Act so as to specifically exclude a reverse mortgage transaction from the ambit of the term 'transfer' if such transaction is under a scheme made and notified by the Central Government. Also, section 10(43) exempts from tax any amount received as loan either in lumpsum or in instalment under reverse mortgage transaction scheme referred to in section 47(xvi).

12.10 Taxation of other Derivative Products

The taxation aspects of all derivative products have been discussed in detail in Section 11.7 under Chapter 11.

CHAPTER 13: TAX PROVISIONS FOR SPECIAL CASES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Tax applicability on:
  - Bonus issues / Rights issues / Buyback of shares
  - Split / Consolidation / Mergers / Acquisitions of securities
  - Stock Lending and Borrowing
  - Conversion of Bonds or Preference shares in equity shares
  - Segregated portfolios in mutual funds
  - Winding up of mutual fund schemes

13.1 Taxation of Bonus Shares

Meaning of Bonus shares

Bonus shares are the additional shares issued by a company to the existing shareholders on the basis of shares already owned by them. Bonus shares are issued to the shareholders without any additional cost. These shares are issued so as to give the shareholders an incentive and increase the equity base of the company.

The tax treatment of bonus issue depends upon whether the shares are held as stock-in-trade or as a capital asset. If they are held as capital assets, any profit or gain arising from the transfer of such shares are taxable as capital gains. If shares are held as stock-in-trade, the gain or loss arising therefrom is taxable under the head profits and gains from business and profession.

13.1.1 Taxation under the head capital gains

No tax implication arises either in the hands of the company or in the hands of the shareholders at the time of allotment of bonus shares. Gains will be calculated only at the time of transfer of shares by the shareholder. If the bonus shares are held as a capital asset, the profit arising from its transfer shall be taxable under the head capital gains. To calculate the capital gains, one should consider the following provisions.

Period of holding

The bonus shares may be classified either as long-term capital asset or short-term capital asset on the basis of the period of holding of such shares. The period of holding of bonus shares shall be reckoned from the date of allotment of such shares. If the bonus share is listed on the stock exchange in India, it will be treated as a short-term capital asset if it is held for not more than 12 months immediately preceding the date of transfer, otherwise,

they are treated as long-term capital assets. However, in case these shares are not listed on a recognised stock exchange, such a period of 12 months shall be increased to 24 months.

Cost of acquisition

If bonus shares are allotted to shareholder without any payment on the basis of holding of original shares, the cost of such bonus shares will be ***nil*** in the hand of the original shareholder. However, if bonus shares are issued to the assessee prior to 01-04-2001, the cost of acquisition is taken at fair market value as on 01-04-2001, at the option of the assessee, is considered as cost of acquisition.

Where bonus shares are long-term capital assets and they fulfil the conditions prescribed under section 112A, then the cost of acquisition shall be higher of the following:

a) The actual cost of acquisition of bonus shares (which is *nil*); or
b) *Lower* of the fair market value of such shares as on 31-01-2018 or full value of the consideration received as a result of the transfer of such shares.

As the actual cost of acquisition of a bonus share is *nil*, the deemed cost of acquisition of such share shall be lower of its FMV as on 31-01-2018 and full value of the consideration received as a result of the transfer of such shares.

Sale consideration

The sale consideration arising from the transfer of bonus shares shall be the amount received or receivable by the person transferring the shares. However, where bonus shares are unquoted shares and the consideration received by the shareholder from the transfer of such shares is less than the fair market value, such FMV shall be treated as sale consideration.

Computation of capital gains

The capital gains shall be computed in the following manner:

Particulars	*Amount*
Sale Consideration	xxx
Less:	
- Cost of acquisition of shares	(xxx)
- Cost of improvement	(xxx)
- Expenditure in connection with the transfer	(xxx)
- Exemption under Sections 54 to 54GB, if any	(xxx)
Short-term Capital Gains/Long-term Capital Gains	**xxx**

Applicable tax rates

a) Tax on short term capital gains: Short-term capital gains arising from the transfer of equity shares (if STT is paid at the time of transfer) are taxable under Section 111A at

the rate of 20%. In other cases, gains are added to the total taxable income and are chargeable to tax as per the tax rate applicable according to the status of the assessee.

b) *Tax on long term capital gains:* Long-term capital gains, arising from the transfer of equity shares (if STT is paid at the time of transfer), is chargeable to tax under Section 112A at the rate of 12.50% for capital gains exceeding Rs. 1,25,000. If STT is not paid at the time of transfer of listed equity shares, the long-term capital gains shall be taxable at the rate of 12.50% as the case may be under section 112.

13.1.2 Taxable under the head profits and gains from business or profession (PGBP)

If the bonus shares are held as stock in trade, gains arising at the time of transfer of such bonus shares shall be taxable under the head PGBP. As per ICDS-VIII, the shares held as stock-in-trade shall be initially recorded in the books at their cost of acquisition. As the cost of acquisition of bonus shares is *nil*, the value of shares held as stock-in-trade shall not be enhanced.

Gains or loss from the sale of bonus shares held as stock in trade shall be calculated as follows:

Particulars	*Amount*
Sale consideration	xxx
Less:	
- Cost of acquisition	(xxx)
- Expenditure relating to such sale	(xxx)
Business Income or loss	**xxx**

The gains arising in the manner explained above shall be assessable under head 'Profits and gains from business or profession' at the rates of tax as applicable in case of the assessee.

Example 1, Mr. A purchased 10,000 shares of X ltd (a listed co.) at Rs. 105 per share on 01-04-2020. Thereafter, the company announced bonus shares in the ratio of 1:2, *that is*, one bonus share for every two shares. The bonus shares were issued on 01-09-2023. Mr. A sold all 15,000 shares at Rs. 120 each on 01-08-2024. Compute the tax liability in his hands.

The capital gains shall be computed for the original shares (10,000 shares) and bonus shares (5,000) separately.

(a) Computation of capital gains from transfer of 10,000 original shares

No. of shares [A]	10,000
Cost per share [B]	Rs. 105
Total purchase value [C= A*B]	Rs. 10,50,000
Date of purchase	01-04-2020
Date of transfer	01-08-2024
Period of holding	52 months
Selling price per share [D]	Rs. 120
Total sale consideration [E=A*D]	Rs. 12,00,000
Long-term capital gains from sale of shares	Rs. 150,000

Tax Rate	12.50% on capital gain exceeding Rs. 125,000 under Section 112A

(b) Computation of capital gains from transfer of 5,000 bonus shares

No. of shares [A]	5,000
Total purchase value [B]	*Nil*
Date of purchase	01-09-2023
Date of transfer	01-08-2024
Holding period	11 months
Selling price per share [C]	Rs. 120
Total sale consideration [D = A * C]	Rs. 600,000
Short-term capital gains [E = D – B]	Rs. 6,00,000
Tax rate	20% under Section 111A

13.2 Taxation on Share Split or Consolidation of Shares

Meaning of Stock split

The process of dividing the outstanding shares into further smaller shares is known as a stock split. A stock split or stock divide increases the number of shares in a company. If a company declares a stock split, the number of shares of that company increases, but the market cap remains the same.

Meaning of Consolidation of shares

The share consolidation is a process conducted by the company with the intention to reduce its number of shares without reducing the share capital. The shares of the company are merged to reduce the number of shares and thereby increasing the market value of the shares. Consolidation of shares would lead to a decrease in the number of shares whilst an increase in the market price per share.

13.2.1 Taxation under the head capital gains

Section 45 provides that any profit or gain arising from transfer of a capital asset is taxable during the previous year in which such transfer takes place. Section 2(47) provides an inclusive definition of the term “Transfer”. However, splitting or consolidation of shares is not covered within the definition of transfer. Further, Section 55 provides that the cost of acquisition of such shares shall be determined with reference to the cost of acquisition of the shares or stock from which such asset is derived. Thus, it can be interpreted that no tax will be levied at the time of splitting or consolidation of shares though there is no specific exemption provided for this purpose under section 47. Tax implications will arise only at the time of sale of such converted shares. In such cases, the tax shall be computed as follows:

Cost of acquisition of shares after consolidation

In the case of consolidation of shares, the cost of acquisition shall be the total amount paid to acquire the original shares apportioned between the consolidated shares. Let’s understand this with the help of an example.

Example 2, Mr A acquired 2,000 shares of XYZ Ltd. at its face value of Rs. 100 per share. Subsequently, the company announces to consolidate 2 shares of face value Rs. 100 per share into one share having face value of Rs. 200. After the consolidation, Mr A will hold 1,000 shares of XYZ Ltd. of the face value of Rs. 200 each. Cost of acquisition of such consolidated shares shall be Rs. 200 per share (Rs. 200,000/1,000).

Cost of acquisition of shares after the split

Amount paid originally by the investor for acquiring the shares shall be divided proportionately to the split shares for the purpose of determining the cost of acquisition of the shares.

Example 3, Mr A purchased 1,000 shares of XYZ Ltd. having face value Rs. 100 for Rs. 150 per share. Subsequently, the company announces to split its one share of Rs. 100 into two shares of face value of Rs. 50 each. Now, after splitting up Mr A will hold 2,000 shares having face value Rs. 50 each. Cost of acquisition of such shares shall be Rs. 75 per share (Rs. 150,000/2000 shares).

Period of holding

Consolidation or splitting of shares does not amount to transfer and its cost is to be computed with reference to the cost of acquisition of the shares or stock from which such asset is derived, based on said principle it can be interpreted that the period of holding with respect to the split/consolidated shares shall be calculated from the date of acquisition of the original shares though no specific provision has been made in this regard.

13.2.2 Taxation under the head PGBP

If the shares are held as stock in trade, gains will be calculated only at the time of sale /transfer of such split up or consolidated shares. As per ICDS-VIII (Securities), the shares held as stock-in-trade shall be recorded in the books at their cost of acquisition.

Example 4, Mr. Rishabh purchased 10,000 shares of a company at Rs. 400 per share. These shares were held by him as stock-in-trade. Subsequently, the company announces to split the shares from one share having face value of Rs. 100 each into two shares of Rs. 50 each. He sold all shares (20,000 shares) at Rs. 207 each. Compute his business income.

Answer:
After splitting, the cost of acquisition of a share shall be the amount originally paid by the investor for acquiring the shares as divided by the number of shares in hand after split-up. Thus, the cost of acquisition shall be Rs. 200 per share (Rs. 40 lakh/20,000 shares).

As the shares are held as stock-in-trade and sold for Rs. 207 per share, the amount of business income chargeable to tax in the hands of Mr. Rishabh shall be Rs. 140,000 [20,000 shares * (Rs. 207 – Rs. 200)].

13.3 Taxation of Buyback of Shares

Meaning of buy-back of shares

'Buy-back' of shares mean the purchase by a company of its own shares in accordance with the provisions of any law for the time being in force relating to companies.

With effect from 1st October 2024, buyback proceeds received by shareholder shall be taxed as dividend under the head 'income from other sources'. No deduction for expenses or the cost of acquisition of such shares shall be available from such dividend while determining the income from other sources. The cost of acquisition of shares which are brought back by the company will be treated as capital loss (long-term or short-term, depending upon the period of holding of the shares bought back) in the hands of the shareholder and will be eligible for set off as per the applicable provisions.

Domestic company liable to pay tax[41]

As per section 115QA, if a domestic company purchases its own shares under a buyback scheme, such company shall be liable to pay tax on such distributed income. On the other hand, the consideration so received by the shareholders under the scheme shall be exempt from tax under Section 10(34A).

"Distributed income" means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares.

Only domestic company shall be liable to pay tax on the amount of distributed income paid to the shareholders at the time of buy-back of shares (listed or unlisted). However, if a foreign company pays consideration to buy-back shares from its Indian shareholders, the shareholders shall be liable to pay tax on the amount of capital gains arising from such transfer. The capital gains, in such a case, shall be computed in accordance with Section 46A.

The domestic company shall be liable to pay tax at the rate of 20% (*plus* 12% surcharge and 4% cess) of the distributed profit. The effective tax rate shall be 23.296%. The tax payable by the domestic company under this provision is an additional tax liability which shall be payable irrespective of the fact that the regular income-tax is payable or not payable by the company on its total income.

Payment of Tax

[41] SEBI (Buy-Back of Securities) Regulations 2018 and Section 68 of the Companies Act, 2013.

The tax on the distributed income shall be paid by the company to the credit of the central government through challan No. ITNS 280 within 14 days from the date of payment of such consideration.

The above tax shall be the final payment of tax in respect of the income on buy-back of shares and no credit thereof can be claimed either by the company or by any other person in respect of the tax paid. Further, no deduction under any other provision of the Act is allowed to the company or shareholder in respect of income distributed or the tax paid thereon.

13.3.1 Consequences of Default

If the tax on distributed income is not paid within the specified time-limit, the company shall be liable to pay interest at the rate of 1% per month (or part of the month) for the period beginning immediately after the last date on which tax was payable and ending with the date of actual payment. Also, the principal officer of the company and the company shall be deemed to be an assessee-in-default for the amount of tax payable.

Example 5, Mr. X subscribed 10,000 shares of ABC Ltd. (a domestic company) at the rate of Rs. 100 per share. The issuer co. announced to buy-back the shares at Rs. 125 per share. Discuss the liability in the hands of the company and Mr. X.

Answer:

(a) Taxability in the hands of Mr. X

No income shall be assessable in the hands of Mr. X as income arising in the hands of the shareholder due to buy-back of shares is exempt under section 10(34A).

(b) Taxability in the hands of the company

If a domestic company purchases its own shares under a buy-back scheme, such company shall be liable to pay tax on distributed income. The computation of tax shall be as follows:

Particulars	*Amount*
Number of shares bought back [A]	10,000
Issue price [B]	Rs. 100 per share
Buy-back price [C]	Rs. 125 per share
Distributed Income [D=C-B]	Rs. 25 per share
Total amount assessable as distributed income [E = D * A]	Rs. 250,000
Tax payable by the company [E * 23.296%]	Rs. 58,240

13.4 Taxation of Rights Issues

Meaning of Right Issue

A rights issue is a way of raising additional capital, wherein, instead of going to the public, the company gives its existing shareholders the right to subscribe to newly issued shares in proportion to their existing holdings.

13.4.1 Taxability at the time of renunciation of right

In general, the existing shareholders are given a right to acquire shares of the company at a price, which in most practical instances, is lower than the actual market price. There is an option with the shareholder either to purchase the shares at a given price or renounce his right in favor of some other investor and collect a fee from him for this purpose.

Any right available to a shareholder to subscribe to shares or any other security of a company is treated as 'capital asset' under Income Tax Act. Capital gains will arise in the hands of the shareholder who renounces his right in favour of any other person. Gains and tax thereon shall be calculated in accordance with the following provisions.

Cost of acquisition

The cost of acquisition of the rights so renounced shall be *nil*.

Period of holding

If such capital asset is renounced in favor of any other person, the period of holding of such capital asset shall be reckoned from the date of offer made by the company to the date of renouncement. Such right is deemed as 'short-term' if it is held by an assessee for a period of not more than 12 months (if the rights are listed) and 24 months (if the rights are not listed), immediately preceding the date of its transfer. In all practical aspect, the rights will be held for a short period which is likely to be less than even 12 months and hence always likely to be a short-term capital asset.

Sale consideration

The sale consideration shall be the amount received or receivable by the person renouncing the right.

Computation of capital gains

Particulars	*Amount*
Sale Consideration	xxx
Less:	
- Cost of acquisition	(xxx)
- Expenditure in connection with transfer	(xxx)
Short-term capital gains	**xxx**

Applicable tax rates

Such gains are generally in the nature of short-term capital gains, which shall be added to total taxable income and are chargeable to tax as per tax rate applicable according to the status of the assessee. Even if the rights are listed, it is not a listed equity share and hence not covered by section 111A.

13.4.2 Taxability at the time of sale of shares

Shares held as capital assets

Capital gains shall arise in the hands of the shareholder at the time of sale of such shares. Such gains shall be computed as under:

Particulars	*Amount*
Sale Consideration	xxx
Less:	
- Cost of acquisition of shares	(xxx)
- Cost of improvement of shares	(xxx)
- Expenditure in connection with the transfer	(xxx)
Short-term Capital Gains/Long-term Capital Gains	**xxx**

Cost of acquisition of the right shares is the price paid by the shareholder for their acquisition. If assessee buys shares on basis of rights entitlements of an original shareholder, the cost of acquisition of the rights shares so acquired shall be aggregate of the amount paid by him to renouncer (original shareholder) and the amount paid by him to the company for acquiring such rights shares.

The period of holding is reckoned from the date of allotment of such right share or security. Following periods shall be considered while determining whether the same shall be regarded as long term or short-term capital asset.

Type of shares and period of holding	*Nature of asset*
Unquoted shares held for not more than 24 months	Short term capital asset
Unquoted shares held for more than 24 months	Long term capital asset
Quoted shares held for not more than 12 months	Short term capital asset
Quoted shares held for more than 12 months	Long term capital asset

Sale of shares held as stock in trade

The profits arising from the transfer of right shares held as stock-in-trade, or from the renunciation of the right (obtained on basis of original shares held as stock-in-trade), shall be taxable as business income. Such business income shall be computed as per general provisions. The cost of acquisition of the rights so renounced shall be deemed to be *nil*.

Example 7, Mr. Paul purchased 1,000 shares of ABC Ltd. on 01-04-2024 at Rs. 500 each. On 01-08-2024 the company announced the right issue in the ratio of 2:1 giving the existing shareholders a right to purchase the shares at Rs. 250 each. Ascertain the taxability in the following cases:

(a) Mr. Paul renounced his right in favour of Mr. X for Rs. 200 per share on 01-09-2024.
(b) Mr. Paul exercised his right and the company allotted him 500 right shares as on 01-12-2024. On the date of allotment of right shares, the fair market value of the shares was Rs. 510. He thereafter sold the shares at Rs. 520 on 25-01-2025. The shares of the company are listed on stock exchange. Thus, STT was charged at the time of transfer.

(a) Computation of income and tax thereon in case rights are renounced

If Mr. Paul has renounced his right to subscribe for shares in favour of any other person. The capital gain arising from transfer of such right will be computed as follows:

Computation of capital gain on renouncement of right	
Particulars	*Amount*
Period of holding (from 01-08-2024 to 31-08-2024)	1 month
Nature of capital gain	Short-term capital gain
Full value of consideration (500 shares * Rs. 200)	Rs. 100,000
Less: Cost of acquisition	*Nil*
Short-term capital gain	Rs. 1,00,000
Tax rate on capital gain	Normal tax rates applicable to Mr. Paul

(b) Computation of income and tax thereon in case rights are exercised and shares are subsequently transferred

Computation of capital gain on transfer of right shares	
Particulars	*Amount*
Period of holding (from 01-12-2024 to 24-01-2025)	Less than 2 months
Nature of capital gain (held for less than 12 months)	Short-term capital gain
Sale Price (500 shares * Rs. 520 each)	Rs. 2,60,000
Less: Cost of Acquisition (500 shares * Rs. 250)	Rs. 1,25,000
Short-term capital gain	Rs. 1,35,000
Tax rate on capital gain	20%[†]
[†]As Mr. Paul has paid STT at the time of transfer of shares, capital gain shall be chargeable to tax at the rate of 20% under Section 111A of the Income Tax Act.	

13.5 Taxation in case of Mergers & Acquisitions

Meaning of Merger

The term merger and acquisition is not specifically defined under the Income Tax Act. In general sense, merger is the voluntary fusion of two companies either by closing the existing companies and making a new one or by one company absorbing the other company. Quite often term amalgamation is interchangeably used with mergers.

Under the Income Tax Act, amalgamation is defined as the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:

a) All the property of the amalgamating co(s).(transferor co.) immediately before the amalgamation becomes the property of the amalgamated co.(transferee co.) by virtue of the amalgamation;
b) All the liabilities of the amalgamating co. immediately before the amalgamation become the liabilities of the amalgamated co. by virtue of the amalgamation;
c) Shareholders holding not less than 75% in value of the shares in the amalgamating co. (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated co. or its subsidiary) become shareholders of the amalgamated co. by virtue of the amalgamation.

The amalgamation should be otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first-mentioned company.

13.5.1 Taxability at the time of allocation of shares

In case such shares are held as capital asset, there will be no tax implication in the hands of the shareholder at the time of allotment of shares of the amalgamated company in lieu of shares held as capital asset in the amalgamating company, as such transactions are not regarded as 'transfer' as per section 47(vii).

However, where such shares are held as stock-in-trade, income arising at the time of such exchange shall be taxable under the head profit and gains from business or profession.

13.5.2 Taxability at the time of transfer of shares

If the shares acquired in the amalgamated company are held as capital asset, the profits from its transfer shall be taxable under the head capital gains. On the other hands, if such shares are held as stock-in-trade, the profit or losses arising from the transfer shall be taxable under the head profits and gains from business or profession.

Shares held as capital assets

The capital gains from transfer of shares acquired in the amalgamated company shall be computed as per general provisions. The cost of acquisition of the shares acquired in the amalgamated company shall be the amount paid by the shareholder at the time of acquisition of original shares of the amalgamating company. The period of holding is reckoned from the date of acquisition of original shares in the amalgamating company

For other provisions relating to computation of sale consideration and the rate of tax, refer relevant paragraphs of the chapter - Taxation of equity products.

Shares held as stock-in-trade

The gains or loss from transfer of shares acquired in the amalgamated company shall be computed as per general provisions. Fair value of securities acquired under the scheme of

amalgamation, i.e., shares of amalgamated company, shall be treated as actual cost of such securities while determining such income.

Example 8, Mr. X purchased 10,000 shares of A Ltd. on 01-04-2023 for Rs. 58 each for investment purpose. With effect from on 01-08-2024, A Ltd. amalgamated with B Ltd. to form a new company AB Ltd. Mr. X was allotted 8,000 shares in the new amalgamated company. He sold the shares of the amalgamated company for Rs. 100 per share on 01-09-2024. The shares of AB Ltd. are listed on recognized stock exchange and STT was charged at the time of transfer. Compute his income and tax thereon.

Computation of capital gain on transfer of shares	
Particulars	*Amount*
Period of holding (from 01-04-2023 to 31-08-2024)	17 Months
Nature of capital gain (held for more than 12 months)	Long term capital gain
Sale Price (8,000 shares * Rs. 100 each)	Rs. 800,000
Less: Cost of acquisition of shares in the amalgamating co. (10,000 shares * Rs. 58)	Rs. 580,000
Long-term capital gain	Rs. 220,000
Tax rate on capital gain	12.50%
†As Mr. X has paid STT at the time of transfer of units, capital gain shall be chargeable to tax at the rate of 12.50% under section 112A of the Income Tax Act on the gains that exceed Rs. 1,25,000. It is irrespective of the fact that STT is paid at the time of acquisition or not as CBDT vide Notification No. SO 5054(E), dated 1-10-2018, has exempted the condition of payment of STT at the time of acquisition in respect of listed shares acquired by any mode of transfer referred under Section 47.	

13.6 Taxation in case of Stock Lending and Borrowing

Meaning of Stock Lending and Borrowing

Stock Lending and Borrowing (SLB) is a system wherein a person can lend his securities to a borrower through approved intermediary for a specified period with the condition that the borrower would return equivalent securities of the same type or class at the end of the specified period along with all the corporate benefits which have accrued on securities (e.g. dividend) during the period of borrowing. It is a temporary lending of securities executed by a lender to a borrower, for a stipulated duration, for a certain fee. The lending and borrowing of securities is regulated by the SEBI through Securities Lending Scheme, 1997.

The framework for Securities Lending and Borrowing (SLB) was specified by SEBI.[42] As per the circular, all market participants (including retail or institutional) in the Indian securities market are permitted to lend and borrow securities through an Authorized Intermediary (AI). Clearing Corporation of NSE and BSE are approved as an Intermediary for this purpose.

The SLB takes place on an automated, screen based, order-matching platform provided by the AIs which shall be independent of the other trading platforms. Further, only the securities traded in F&O segment and liquid index ETFs are eligible for lending & borrowing

[42]SEBI Circular No.: MRD/DoP/SE/Dep/Cir-14/2007 dated December 20, 2007 as amended from time to time.

under the scheme.[43] The SLB contracts can be of different tenures ranging from 1 day to 12 months. But, usually they are entered for 1 month and lender or borrower is allowed to rollover the contract but total duration of the contract after taking into account rollovers shall not exceed 12 months from the date of the original contract.

The process of lending and borrowing of securities is as follows:

1) Lender and borrowers place an order with intermediary mentioning the stock, quantity to lend or borrow, time period, and lending fees. Thereafter, order matching takes place similar to trading on an exchange.
2) The lender is required to deposit 25% of the lending price (i.e., total value of stock) as margin. If the lender lends securities on the date of transaction itself, no margin is required to be deposited.
3) Borrower is required to deposit 100% of the lending price, lending fee, value at risk margins and extreme loss margins on an upfront basis and, thereafter, daily mark to market margin (MTM) is collected.
4) At the end of contract, lender gets back the stock and borrower margin is released. If borrower fails to return the securities, the AIs shall have the right to liquidate the collateral deposited with it, in order to purchase from the market, the equivalent securities of the same class and type for the purpose of returning the equivalent securities to the lender.

Benefit of SLB to borrower and lender

The benefit of SLB for lender is that it provides incremental return on an idle portfolio. A person holding shares of a company with an intent to hold them for long-term may earn additional return in form of lending fees by lending such shares to borrower for short-term. This can be a meaningful income enhancer for mutual fund holdings that are meant to be held for the long-term.

Whereas, a borrower can borrow securities to cover his short-positions, avoid settlement failure or for arbitrage or hedging strategies.

Example, if futures of a stock is trading at a discount, then a borrower can take advantage of SLB by selling borrowed stock at spot price and buying stock futures.

13.6.1 Taxability in hands of lenders

Lenders can earn additional income from the idle portfolio held as they receive a certain fee to lend the stock, depending upon the demand and time value.

Any lending of scrips or security is not treated as exchange even if lender does not receive back same distinctive numbers of scrip or security certificate. The transaction of lending of shares or any other security under the securities lending scheme would not result in 'transfer' for the purpose of invoking the provisions relating to capital gains under the

[43]SEBI Circular CIR/MR/DP/30/2012dated November22, 2012.

Income Tax Act pursuant to section 47(xv) of the Act. The department has also clarified that transactions done in the SLB segment will not be treated as transfer.[44]

However, the fee earned from lending business shall be taxable under the head 'profits and gains from business or profession' or 'Income from other sources'.

13.6.2 Taxability in hands of borrowers

The borrower purchases the stocks with the objective of selling them. Hence, any gains or losses arising to the borrower from the sale of such shares shall be taxable under the head capital gains or PGBP, as the case may be. The fee paid by the borrowers may be claimed as deduction while computing the income under capital gains or PGBP.

Example 9, In December 2024, Mr. A lends 10,000 shares of XYZ Ltd. for one month. He receives the lending fee of Rs. 200,000 (Rs. 20/share * 10,000 shares). As per terms of the contract, Mr. A gets back his shares on first Thursday of the month of Jan 2025. He paid transaction charges of Rs. 2,000 for lending of securities. Compute the amount of income chargeable to tax in hands of Mr. A.

Answer: The fee earned from lending of securities shall be taxable under the head 'profits and gains from business or profession' if the assessee is in the business thereof otherwise income shall be taxable under the head other sources. The assessee can claim the deduction of the expenses incurred to earn such income.

Thus, in the given example, the amount of income taxable in the hands of Mr. A shall be Rs. 1,98,000 (Rs. 2,00,000 – Rs. 2,000).

Example 10, Mr. B borrowed 10,000 shares of Reliance Ltd. on 01-08-2024 at a lending fee of Rs. 5 per share. On the said date, the share of Reliance Ltd. was trading at stock market at Rs. 1,600 per share. Mr. B short-sells 1 lot of 10,000 shares at Rs. 1,600 in anticipation of decrease in the share price. In order to hedge his position and avoid settlement risk, he bought call option of Reliance Ltd. (1 lot of 10,000 shares) with an exercise price of Rs. 1,600 at a premium of Rs. 30 per share.

The expiry of the derivatives contracts (i.e., futures and options) of the month of August 2024 was 30-08-2024 and Mr. B has to return the shares to the lender on the first Thursday of the September, 2024, i.e., 05-09-2024.

Compute the amount of income or loss arising to Mr. B in following situations:

(a) If on the date of expiry (30-08-2024) the share price of Reliance Ltd. came down to Rs. 1,500 as anticipated by Mr. B. He squared off his short position at Rs. 1,500. Further, the call option that he purchased for the purpose of hedging was transferred at Rs. 10 per share.

(b) If on the date of expiry (30-08-2024) the share price of Reliance Ltd. increased to Rs. 1,700. As Mr. B did not anticipate the increase in share price, he exercised the call

[44]Circular No. 2/2008, dated 22-02-2008

option to take delivery of 10,000 shares to return them to the lender. The shares so borrowed by him were used to settle the short-position he made in Reliance Futures.

Answer:

(a) Situation 1: Share price of Reliance Ltd. reduced to Rs. 1,500

The income or loss arising to Mr. B shall be computed as follows:

Particulars	*Amount*
Futures	
- Profit of Rs. 100 per share arising after squaring off the short-position made at Rs. 1,600 per share [10,000 shares * (Rs. 1600 – Rs. 1500)]	10,00,000
Call Option	
- Loss of Rs. 20 per share arising on transfer of call option at Rs. 10 per share [10,000 shares * (Rs. 30 – Rs. 10)]	(-) 200,000
Lending Fees of Rs. 5 per share paid to borrow 10,000 shares	(-) 50,000
Net Profit	**7,50,000**
Tax rate	**Normal slab rate**

(b) Situation 2: Share price of Reliance Ltd. increased to Rs. 1,700

The income or loss arising to Mr. B shall be computed as follows:

Particulars	*Amount*
Call option premium (10,000 shares * Rs. 30 per share)	300,000
Lending Fees (10,000 shares * Rs. 5 per share)	50,000
Total Loss	**3,50,000**

13.7 Taxation in case of conversion of Preference Shares into Equity Shares

As per Section 2(47) of the Income Tax Act, 'transfer' includes exchange of assets. When two persons mutually transfer the ownership of one thing for the ownership of another, and none of them is a money, this transaction is treated as 'exchange'. Any conversion of an asset into other asset is an 'exchange'. It falls within the definition of transfer, and, consequently, the capital gain tax shall be charged on such transfer.

However, the Income Tax Act has specifically excluded certain types of transactions from the scope and meaning of the word 'transfer' in relation to a capital asset. Consequently, no capital gain shall arise on such transactions. These transactions are specified in Section 47 of the Act. The transaction of conversion of preference shares into equity shares has been excluded from the scope of transfer.

Section 47(xb) provides that any conversion of preference shares of a company into equity shares of that company would not amount to 'transfer'. However, when a person subsequently sells equity shares, the cost of acquisition thereof shall be same as that of the preference share. Further, the period of holding of equity shares shall be reckoned from the date of acquisition of the preference shares.

Example 11, Mr. X acquired 20,000 preference shares of ABC Ltd. on 01-01-2010 at Rs. 10 each. The preference shares are converted into equity share on 01-01-2023 at a convertible ratio of 2:1 (1 equity share for every 2 preference shares). As a result, Mr. X is allotted 10,000 equity shares of ABC Ltd. The fair market value of the equity share on the date of conversion is Rs. 25 per share. Mr. X sold the shares on 25-08-2024 for Rs. 35 per share. Securities Transaction Tax (STT) was paid at the time of transfer of shares. What shall be the tax implications in the hands of Mr. X in this case?

Answer: The tax implications in the hands of Mr. X shall be as follows:

(a) Tax implication in case of conversion of preference shares into equity shares of the company on 01-01-2023

As per Section 47(xb) of the Income Tax Act, conversion of preference shares of a company into equity shares of that company is not treated as transfer. Thus, no capital gain shall arise on conversion of preference shares into equity shares.

(b) Tax implication on transfer of equity shares on 25-08-2024

The cost of acquisition of the equity shares of ABC Ltd., acquired on conversion of the preference shares, shall be the same as that of those preference shares. Further, the period of holding of equity shares shall be reckoned from the date of acquisition of the preference shares.

The capital gain arising on transfer of equity shares shall be computed in the financial year 2024-25 in the following manner:

Computation of capital gain on transfer of equity shares	
Particulars	*Amount*
Period of holding (from 01-01-2010 to 24-08-2024)	14+ Years
Nature of capital gain (Period of holding is more than 12 months)	Long-term capital gain
Full value of consideration (10,000 equity shares * Rs. 35) [A]	350,000
Less: Cost of acquisition (20,000 preference shares * Rs. 10) [B]	200,000
Long-term capital gain [C = A - B]	150,000
Tax rate on capital gain in excess of Rs. 125,000	12.50%†
†As STT has been paid at the time transfer of shares and acquisition is made by mode of transfer referred to in Section 47, long-term capital gain in excess of Rs. 125,000 shall be chargeable to tax at the rate of 12.50% under Section 112A of the Income Tax Act.	

13.8 Taxation in case of Segregated Portfolios of Mutual Funds

The SEBI has permitted creation of segregated portfolio of debt and money market instruments by Mutual Fund schemes.[45] As per the SEBI circular, all the existing unit holders in the affected scheme as on the day of the credit event shall be allotted equal number of units in the segregated portfolio as held in the main portfolio. However, the SEBI has permitted the creation of a segregated portfolio of unrated debt or money market instruments by mutual fund schemes of an issuer that does not have any outstanding rated

[45]Circular SEBI/HO/IMD/DF2/CIR/P/2018/160, dated 28-12-2018

debt or money market instruments, subject to the conditions specified in the circular.[46] On segregation, the unit holders come to hold the same number of units in two schemes - the main scheme and the segregated scheme.

Taxability of income arising from transfer of units of segregated portfolio shall be similar as in case of normal mutual funds. However, period of holding and cost of acquisition of these units shall be computed as follows.

Period of holding

In the case of a capital asset, being units in a segregated portfolio, the period for which the original units were held in the main portfolio is also included in the period of holding of the units acquired in the segregated portfolio.

Example 14, Mr. X acquired units in the main portfolio on 01-06-2021. He was allotted units in the segregated portfolio on 01-04-2022. The period of holding of the units in the segregated portfolio shall be reckoned from 01-06-2021.

Cost of acquisition

Where a mutual fund segregates the portfolios, the cost of acquisition of units in the segregated portfolio shall be computed as follows:

Cost of acquisition of units in segregated portfolio	=	*Cost of acquisition of units in the total portfolio*	*X*	*Net asset value of the asset transferred to the segregated portfolio* / *Net asset value of the total portfolio immediately before the segregation of portfolios*

Further, cost of acquisition of these units shall be reduced from the cost of acquisition of units held in main portfolio.

Example 15, Mr. X acquired 1,000 units of a mutual fund on 01-04-2021 at Rs. 15 per unit. The mutual fund segregated the portfolio on 01-06-2022 and allotted 1,000 units of segregated portfolio to Mr. X whose net asset value (NAV) is Rs. 2 per unit. The NAV of the total portfolio on 31-05-2022 was Rs. 12 per unit. Compute the cost of acquisition of units of main portfolio and segregated portfolio after segregation of the portfolios.

Answer: The cost of acquisition of units in the segregated portfolio shall be computed as follows:

Cost of acquisition of units in segregated portfolio	=	*Cost of acquisition of units in the total portfolio*	*X*	*NAV of the asset transferred to the segregated portfolio [Rs. 2 per unit]*

[46] Circular SEBI/HO/IMD/DF2/CIR/P/2019/127, dated 07-11-2019

	*[1,000 units * Rs. 15 per units]*	*NAV of the total portfolio immediately before segregation of portfolios [Rs. 12 per unit]*

Thus, the cost of acquisition of units in segregated portfolio shall be Rs. 2,500 and cost per unit shall be Rs. 2.5 per unit (Rs. 2,500/1000 units).

The cost of acquisition of units in main portfolio shall be Rs. 12,500 [i.e., Original cost of acquisition (Rs. 15,000) *minus* Cost of acquisition of units in segregated portfolio (Rs. 2,500)].

13.9 Taxation in case of Consolidation of Mutual Fund schemes or plans

Any transfer of units held by a unit-holder in the consolidating scheme of a mutual fund in consideration of allotment of units in the consolidated scheme of the mutual fund shall not be treated as transfer. The exemption is available provided the consolidation is of two or more schemes of equity-oriented fund or two or more schemes of a fund other than equity-oriented fund.

Similarly, any transfer of units held by a unit holder in the consolidating plan of a mutual fund scheme in consideration of allotment of units in the consolidated plan of that scheme shall not be treated as transfer.

Where such units are further transferred, the taxability will be similar as in case of normal mutual funds. However, period of holding and cost of acquisition of these units shall be computed as follows.

Period of holding

Where units of a mutual fund become the property of the assessee in the consolidation scheme of a mutual fund, the period for which the units were held under consolidating scheme is also included in the period of holding of units acquired.
Where units of consolidated plan become the property of the assessee in consolidation of the plans within the scheme of a mutual fund, the period for which the unit or units were held under consolidating plan within the scheme is also included in the period of holding of units acquired.

Cost of acquisition

Where units in a consolidated scheme of mutual fund became the property of the assessee in consideration of transfer of units, held by him in the consolidating scheme of a mutual fund, the cost of acquisition of such units is deemed to be the cost of acquisition of the units held by him in consolidating scheme of the mutual fund.

Similarly, where units in a consolidated plan of mutual fund became the property of the assessee in consideration of any transfer of units, held by him in the consolidating plan of

the same mutual fund, the cost of acquisition of such units is deemed to be the cost of acquisition of the units held by him in consolidating plan of the mutual fund.

13.10 Taxation in case of winding up of Mutual Funds

As per SEBI (Mutual Funds) Regulations, 1996, a close-ended scheme shall be wound up on the expiry of duration fixed in the scheme on the redemption of the units unless it is rolled over for a further period.

In any other case, a scheme of a mutual fund may be wound up, after repaying the amount due to the unit holders:

(a) on the happening of any event which, in the opinion of the trustees, requires the scheme to be wound up; or

(b) if seventy-five per cent of the unit holders of a scheme pass a resolution that the scheme be wound up; or

(c) if the Board so directs in the interest of the unitholders.

Where a scheme is to be wound up as above, the trustees shall give notice disclosing the circumstances leading to the winding up of the scheme: (a) to the Board; and (b) in two daily newspapers having circulation all over India, a vernacular newspaper circulating at the place where the mutual fund is formed.

On and from the date of the publication of, the trustee or the asset management company as the case may be, shall—

(a) cease to carry on any business activities in respect of the scheme so wound up;

(b) cease to create or cancel units in the scheme;

(c) cease to issue or redeem units in the scheme.

Procedure and manner of winding up

(1) The trustee shall call a meeting of the unitholders to approve by simple majority and authorize the trustees or any other person to take steps for winding up of the scheme

(2)(a) The trustee or the person authorised shall dispose of the assets of the scheme concerned in the best interest of the unitholders of that scheme.

(2)(b) The proceeds of sale realised under clause (a), shall be first utilised towards discharge of such liabilities as are due and payable under the scheme and after making appropriate provision for meeting the expenses connected with such winding up, the balance shall be paid to the unitholders in proportion to their respective interest in the assets of the scheme as on the date when the decision for winding up was taken.

(3) On the completion of the winding up, the trustee shall forward to the SEBI and the unitholders a report on the winding up.

Winding up of the scheme

After the receipt of the report, if the SEBI is satisfied that all measures for winding up of the scheme have been complied with, the scheme shall cease to exist.

Delisting of units

The units of a mutual fund scheme shall be delisted from a recognised stock exchange in accordance with the guidelines as may be specified by the SEBI.

Hence, generally, the mutual fund schemes are first 'shut' (term used in common parlance) by giving notice in the newspapers. Once this notice is given, the trustees / AMC cannot carry on any business or create or redeem any units.

Thereafter, pursuant to voting done by the unit holders, the decision on winding up is finalized. Subsequently, the trustees would dispose of all the assets and pay off all liabilities. The balance amount is used to pay to unit holders in proportion of their units held.

When the amount received on winding of the mutual funds, it will be treated like normal redemption amount.

Annexure 1: Tax Rates for Financial Year 2024-25

1. Individual or HUF

1.1. Normal tax rates as applicable in case of Individual/ HUF

Net income range	***Resident Super Senior Citizen***	***Resident Senior Citizen***	***Any other Individual/HUF***
Up to Rs. 2,50,000	*Nil*	*Nil*	*Nil*
Rs. 2,50,001- Rs. 3,00,000	*Nil*	*Nil*	*5%*
Rs. 3,00,001- Rs. 5,00,000	*Nil*	*5%*	*5%*
Rs. 5,00,001- Rs. 10,00,000	20%	20%	20%
Above Rs. 10,00,000	30%	30%	30%

1.2. Alternative tax rates applicable to Individual/HUF under section 115BAC (New Tax regime)

Net Income Range	***Financial Year 2024-25***
Upto Rs. 3,00,000	-
Rs. 3,00,001 to Rs. 7,00,000	5%
Rs. 7,00,001 to Rs. 10,00,000	10%
Rs. 10,00,001 to Rs. 12,00,000	15%
Rs. 12,00,001 to Rs. 15,00,000	20%
Above Rs. 15,00,000	30%

1.3. Surcharge on tax whether computed as per the normal tax rates or new tax regime under section 115BAC

Nature of Income	***Range of Total Income***				
	Up to Rs. 50 lakh	***More than Rs. 50 lakh but up to Rs. 1 crore***	***More than Rs. 1 crore but up to Rs. 2 crore***	***More than Rs. 2 crore but up to Rs. 5 crore***	***More than Rs. 5 crore***
Short-term capital gain covered under Section 111A or under Section 115AD	*Nil*	10%	15%	15%	15%
Long-term capital gain covered under Sections 112, 112A and 115AD	*Nil*	10%	15%	15%	15%
Dividend income (not being dividend income chargeable to tax at a special rate under sections	*Nil*	10%	15%	15%	15%

115A, 115AB, 115AC, 115ACA)					
Unexplained income chargeable to tax under Section 115BBE	25%	25%	25%	25%	25%
Any other income	*Nil*	10%	15%	25%	37%*

* From the financial year 2023-24, the surcharge rates on other income for assessee opting to pay tax under the new tax regime of Section 115BAC shall not exceed 25%. Thus, the income exceeding Rs. 5 crores shall be subject to the surcharge rate of 25% if the assessee opts for the new tax regime of Section 115BAC.

1.4. Health and education cess

The amount of income tax and the applicable surcharge, shall be further increased by health and education cess calculated at the rate of 4% of such income tax and surcharge.

2. Special tax rates

Income-tax Act prescribes the following special tax rates in respect of certain income:

2.1. In case of capital gains

Section	***Assessee***	***Particulars***	***Tax Rate***
Section 111A	Any Person	Short-term capital gains arising from transfer of equity shares or units of equity-oriented mutual fund or units of business trust if the transfer of such capital asset is chargeable to Securities Transaction Tax (STT)	20%
Section 112	Any person	Long-term capital gains arising from transfer of listed securities (other than a unit) or zero-coupon bonds	12.50%
	Non-resident.	Long-term capital gains arising from the transfer of unlisted shares or shares of closely held companies without giving effect to benefit of indexation and currency translation.	12.50%
	Any Person	Any other long-term capital gains	12.50%
Section 112A	Any Person	Long-term capital gains, in excess of Rs. 1.25 lakhs, arising from transfer of equity shares, units of equity-oriented mutual fund or units of business	12.50%

		trust if the transfer of such capital asset is chargeable to Securities Transaction Tax (STT)	
Section 115E	Non-Resident Indian	Long-term capital gains arising from transfer of specified asset purchased in foreign currency	12.5%
Section 115BBH	Any Person	Income from transfer of any Virtual Digital Asset (VDA)	30%

2.2. In case of interest income

Section	***Assessee***	***Particulars***	***Tax Rate***
Section 115A	Non-resident or Foreign Co.	Interest received from Government or an Indian concern on monies borrowed or debt incurred by such Government or Indian concern in foreign currency	20%
	Non-resident or Foreign Co.	Interest on rupee-denominated bonds of an Indian Co. or Government Securities or municipal debt securities as referred to in Section 194LD	5%
	Non-resident or Foreign Co.	Interest income distributed by business trust to its unitholders as referred to in Section 194LBA.	5%
Section 115AC	Non-resident	Interest on bonds of an Indian Company or Public Sector Company (PSU) purchased in foreign currency	10%

2.3. In case of dividend income

Section	***Assessee***	***Particulars***	***Tax Rate***
Section 115A	Non-resident or foreign co.	Dividend income	10% if dividend is received from a unit in an IFSC otherwise 20%

In case of other income from securities

Section	***Assessee***	***Particulars***	***Tax Rate***
Section 115A	Non-resident or Foreign Co.	Income received in respect of units of specified Mutual Funds or UTI purchased in foreign currency	20%
Section 115E	Non-resident Indian	Income from the specified asset purchased in foreign currency	20%

2.4. In case of other incomes

Section	***Assessee***	***Particulars***	***Tax Rate***
Section 115BBE	Any person	Undisclosed income as referred to in Sections 68, 69, 69A, 69B, 69C and 69D	60%
Section 115BBH	Any Person	Income from transfer of any Virtual Digital Asset (VDA)	30%
Section 115BBJ	Any Person	Income by way of winning from Online Games	30%

(A) Income exempts under the head 'Salary'

Section	*Nature of Income*	*Whether available in New Tax regime*
Section 10(5)	Leave Travel Concession	No
Section 10(7)	Allowance/perquisites to Government employee for rendering service outside India	Yes
Section 10(10)	Gratuity	Yes
Section 10(10A)	Pension	Yes
Section 10(10AA)	Leave Salary	Yes
Section 10(10B)	Retrenchment Compensation	Yes
Section 10(10C)	Voluntary Retirement Compensation	Yes
Section 10(10CC)	Tax on non-monetary perquisites paid by the employer	Yes
Section 10(12)	Amount received from recognized Provident Fund subject to prescribed limit	Yes
Section 10(12C)[47]	Amount received from Agniveer Corpus Fund	Yes
Section 10(13)	Payment from an approved superannuation fund	Yes
Section 10(13A)	House Rent Allowance	No
Section 10(14)	Office Duty Allowances and Personal Allowances	Not allowed except as prescribed
Section 10(18)	Pension to gallantry award winner	Yes
Section 10(19)	Family pension received by the family members of armed forces	Yes

[47] Inserted by the Finance Act, 2023 with effect from Assessment Year 2023-24

(B) Income exempt under the head 'Capital Gains'

Section	*Nature of Income*
Section 10(10D)	Any sum received under a life insurance policy except certain excessive and high premium life insurance policies (including ULIPs) or high premium endowment policies
Section 10(37)	Capital gains on compulsory acquisition of urban agricultural land

(C) Income exempt under the head 'Income from other sources'

Section	*Nature of Income*
Section 10(4)(i)	Interest on notified securities and bonds
Section 10(4)(ii)	Interest on NRE account
Section 10(11)	Amount received from public provident fund subject to prescribed limit
Section 10(11A)	Amount received from Sukanya Samriddhi Account
Section 10(12A)	Payment from the National Pension Scheme
Section 10(12B)	Partial withdrawal from NPS
Section 10(15)	Interest on specified securities as prescribed

(D) Income exempt of certain specified assessees

Section	*Nature of Income*
Section 10(2)	Amount received by member of HUF
Section 10(4G)[48]	Income of a non-resident arising from portfolio of securities or financial products or funds, managed through IFSC or from the specified activity carried out by the specified person[49]
Section 10(23FC)]	Income of a Business Trust
Section 10(23FCA)	Certain income of a business trust, being a real estate investment trust

(E) Income exempt in the nature of distributed Income

Section	*Nature of Income*
Section 10(4E)	Income distributed by an IFSC banking unit to a non-resident in respect of offshore derivative instruments[50].
Section 10(23FBB)	Income referred to in section 115UB of a unit holder of an investment fund
Section 10(23FBC)	Income received by a unit holder of Category III AIF
Section 10(23FD)	Certain distributed Income of a Unit Holder from the Business Trust
Section 10(35A)	Income of an investor received from a securitisation trust

[48] Inserted by the Finance Act, 2022 with effect from Assessment Year 2023-24

[49] Amendment made by the Finance Act, 2023 with effect from assessment year 2024-25.

[50] Amendment made by the Finance Act, 2023 with effect from assessment year 2024-25.

After the abolition of dividend distribution tax, no exemption is available under Section 10(34) and Section 10(35) for the dividend distributed by a company or a mutual fund, as the case may be.

(F) Others

Section	*Nature of Income*
Section 10(1)	Agriculture Income
Section 10(16)	Educational scholarship
Section 10(17)	Daily allowance to a Member of Parliament or State Legislature
Section 10(17A)	Awards and Rewards
Section 10(43)	Loan in the case of reverse mortgage

Annexure 3: Cost Inflation Index

Cost Inflation Index (CII) is the inflation rate used to bring the cost of goods in line with the increased prices in the market. Under Income-tax Act, it is used to compute the indexed cost of acquisition and indexed cost of improvement of a long-term capital asset. CII for every year is notified through an official gazette each year.

Financial Year	***CII***
2001-02	100
2002-03	105
2003-04	109
2004-05	113
2005-06	117
2006-07	122
2007-08	129
2008-09	137
2009-10	148
2010-11	167
2011-12	184
2012-13	200
2013-14	220
2014-15	240
2015-16	254
2016-17	264
2017-18	272
2018-19	280
2019-20	289
2020-21	301
2021-22	317
2022-23	331
2023-24	348

Module 9: Taxation I Module-end Questions

1. Short term capital loss can be set off against which income?
    a. **Long-term or Short-term capital gains**
    b. Short term capital gains
    c. Long term capital gains
    d. Any Income

2. Who cannot invest in Sovereign Gold Bonds?
    a. **A Company**
    b. An individual on behalf of a minor individual
    c. A Charitable Institute
    d. A Private Trust

3. Maximum deduction available to a self-employed person for the investment made in NPS is _____.
    a. **Rs. 2,00,000**
    b. Rs. 1,50,000
    c. Rs. 50,000
    d. No limit

4. Which of the following statements is False?
    a. **Gains arising from currency derivatives is always regarded as capital gains**
    b. Derivative transactions will always lead to non-speculative business transaction
    c. Transaction in securities with actual delivery always deemed as non-speculative transaction

5. Which income is exempt in the hands of REIT?
    a. **Rental income from investment made by REIT in properties**
    b. Interest income from loan given to employees
    c. Dividend income from investment made in companies other than SPV
    d. Capital gains from transfer of shares in SPV

MODULE 10: ESTATE PLANNING

Chapter 14: Basics of Estate Planning

Chapter 15: Tools for estate planning

CHAPTER 14: BASICS OF ESTATE PLANNING

LEARNING OBJECTIVES:
After studying this chapter, you should know about:

- Estate planning and its constituents
- Elements of estate planning
- Applicable laws
- Mutation

14.1 Estate Planning

What happens when one dies – who inherit their assets and how? If one becomes ill and is unable to manage his/her estate, then who will take care for them? These are a few issues one faces while starting accumulating wealth. Estate planning deals with such and many other questions.

For some people the size of the assets grow manifold. The amount is substantial enough to leave it unplanned. So, there is a need to plan adequately how the assets will be utilized and then will be inherited by the legal heirs. Sometime the legal heirs are not capable enough to manage such large estate. Then one needs to plan with the right estate planning tools to protect the assets after their lifetime.

Though estate planning is an important element of anyone's life, still many people die without any estate planning i.e. not leaving behind a Will for forming trust for special situation. The law of the land then prevails and decides the distribution of the assets after the deceased.

Estate Planning can be defined as a process that deals with the accumulation, conservation and distribution of an estate. The overall purpose of estate planning is to develop a plan that will enhance and maintain the financial security of Individuals and their families.

Estate planning is a process that determines how an individual wants to distribute his/her estate, which includes the rights and interest in the property owned, when he/she dies. One very strong misconception that people hold is that estate planning is for wealthy. This is not true. Anyone, who holds a property and wishes that on his death the property should be transferred to specific heirs and in a specific manner, needs estate planning. The financial security for their family is the objective of estate planning.

Estate planning is not only about distributing assets. There are lot many issues due to which estate planning needs attention. Why estate planning is required by individuals, can be answered if they start addressing the following type of visions:

- ✓ How do you want your property to be distributed?

- ✓ Who should get how much share from your property?
- ✓ What happens if you get physically disabled or mentally incompetent? Who will manage your care?
- ✓ What happens to the liabilities? Who will repay them?
- ✓ Is the money enough to sustain your spouse for lifetime?
- ✓ How can you provide for charity you wish to do?

Answers to such questions will be derived from estate planning.

Is estate planning for everyone?

Yes, estate planning is for anyone. The misconception that people have is that estate planning is only for the rich. Life has many uncertainties and no one knows what is stored for them in the future. Having a proper estate plan is therefore important for dealing with uncertainties. Identifying a suitable guardian for minors is also important to manage estate if parents die early. Similarly, if an individual has high liabilities then the provision to repay, in case of early death, can be resolved through estate planning.

Following are some areas for which effective estate planning should be done:

a. Family with minor children
b. Individuals with high liabilities
c. Properties in multiple states
d. Owning a small business
e. Estate Taxes
f. Address uncertainty of permanent disability

Estate Planning Goals

The objectives of estate planning are manifold. A proper estate planning ensures distribution and preservation of one's legacy with minimal disputes. If one has not prepared its estate plan then there are more chances of unsatisfactory distribution by some legal heirs. Below are some reasons for having estate planning:

1. Preserving assets for loved ones.
2. Appointing a guardian for minors to be prepared for any eventuality.
3. Addressing concerns arising from an individual's disability. For example, in case an individual become incapacitated then estate planning will help to manage finances and make health care decisions.
4. Ensuring availability of funds to pay one's liabilities after death.
5. Giving loved ones specific assets.
6. Provisioning for protection and care of special needs children
7. Protection for financial security of minor children till they turn 18.
8. Streamlining an efficient method to collect and distribute assets.

Estate Planning & Succession Planning

Estate planning is misconceived to be equivalent to succession planning. These two are completely distinct with different objectives. A succession planning is planning for one's business which takes effect within one's lifetime. For long term continuity and success of one's business, it has to be transferred to the next generation when one decides to quit. Then one has to ask questions like:

- Is it viable for next generation?
- If so, do family members, who are not involved in the business, intent to join in future and what vision do they have for the business?
- How does their individual vision align with the vision of the business?
- Should the business be sold if no one is interested?
- If business is not sold then who will take over it and are they qualified enough?

Any estate plan is a personal estate plan, which involves one's personal assets. Every individual needs to have an estate plan whether there is succession plan for business or not. The succession of business plan may start late in life but estate plan needs to be prepared as one accumulates enough assets.

14.2 Constituents of Estate

An estate may have different meaning for different professionals; but for estate planning, the estate consists of all the properties an individual owns or controls. This estate can be indifferent ownership formats. It can be in sole name of an individual, in partnership with any family member such a spouse, in a joint worthy agreement or even through a trust. An estate includes any money or asset that would be generated on a person's death such as life insurance.

An estate can be under three categories:

1. **Gross Estate**: The gross estate comprises items that determine one's net worth. Real estate properties (house, land etc.), bank accounts, investments, businesses, retirement account such as NPS, life insurance etc.
2. **Residue Estate**: This is an individual's personal estate property. This includes car, jewellery, furniture, clothes, and any other item found at one's home. Any investment not mentioned in the will or allocated in the trust form part of the residue estate. Lastly, any outstanding payments at the time of death are also a part of residue estate.
3. **Estate Debt**: This includes all debt and obligations owed to others. Housing loan, car loan, credit card payments, business outstanding are part of estate debt. Tax liabilities of any form or any legal cases are also a part of estate debt.

For any individual the estate is complete with all the above items.

14.2.1 Consequences of dying Intestate

The Indian Succession Act, under section 30, states that "a person is deemed to die intestate in respect of all property of which he or she has not made a testamentary disposition which is capable of taking effect."

This means a person is said to have died intestate with respect to an asset that he has not disposed under a will, or the disposition under the will is not capable of taking effect either on account of invalid bequest or illegal bequest. Intestacy may either be total or partial.

There are consequences on distribution of properties when an individual dies intestate. When a person dies without a Will, then the property devolves upon the heirs as per the laws of inheritance applicable to him/her. The law of inheritance in case of Hindus, Buddhists, Jains and Sikhs is governed by the Hindu Succession Act, 1956; in case of Christians, Parsis and the Jews, the law of inheritance is mentioned in the Indian Succession Act, 1925. However, for Muslims the law of inheritance is not provided in any legislation. Their inheritance laws are based on the religious texts, where the inheritance laws are different for Shias and Sunnis.

Succession Certificate

When a person dies intestate (i.e. without making a Will), the legal heirs have to apply to the civil court for obtaining a succession certificate which shall be issued in accordance with the laws of succession applicable to the deceased.

14.3 Elements of Estate Planning

A good estate plan consists of many different components, including what happens to one's assets and who should act on their behalf if they are unable to. Many a times it is quite confusing for people to understand what their estate plan should include. At a bare minimum, there should be two main components in an estate plan: (i) a last will and testament and (ii) a living will. Based on one's situation, this or any other legal provisions can become part of the estate plan. Below are the different elements of estate planning:

1. **Will:** This is the document which specifies who will inherit one's assets and in what manner. A Will helps to ensure that the assets that an individual leaves behind for his/her loved ones are distributed as per his/her wishes. There is also an important element pertaining to Will when it comes to appointment of guardian for minors or children with special needs. The Will should state who will be the person and how the assets will be managed till the minors turn adults or how assets will be managed for lifetime in case of children/adults with special needs.

2. **Trust**: Trusts are legal arrangements that hold assets on behalf of a beneficiary or beneficiaries. There are different types of trusts that can be created. The

person who creates the trust can decide the terms of the trust to be formed. Trusts can also be created through the Will, this is known as testamentary trust. However, these trusts are subject to the rulings under the 'Will' which means they also go through the process of probate.

3. **Power of Attorney**: It is a legal arrangement where an individual designates someone to manage one's finances in case an individual becomes incapacitated or is not in a position to do so. Many NRIs use Power of Attorney (PoA) to designate someone in India to manage their assets—movable or immovable.

4. **Living Will**: A living Will is an advance directive written primarily for physicians. There may be life situations like one is terminally ill, seriously injured, in a coma, in the late stages of dementia or near the end of life. This document states the wishes of the people for these kinds of situations, when one is at the end of life care and unable to communicate their decisions.

5. **Nomination and Beneficiary Designations**: This is not really a component of an estate plan but is important for completing the estate plan. Appointing nominees are important for smooth transfer of one's financial assets after his/her demise. The rights of nominee are limited to holding the assets as a custodian till it is transferred to the right legal heirs. In some assets, such as life insurance policy, beneficial nominees can be appointed who will also be the legal recipient of the life insurance proceeds at death of the policyholder. Under the new Insurance act, Parents, Spouse and Children, if any one of them is the nominee in the policy, they will automatically become the Beneficial Nominee and hence can consume the monies too.

   The legal beneficiaries can change in situations like marriage; therefore, it is important to periodically review nominations and beneficiary designations, wherever applicable.

14.4 Applicable Laws

14.4.1 Indian Succession Act, 1925

The Indian Succession Act deals with testamentary and intestate succession. When a will is written, Testamentary succession is applicable. However, if there is no will then Intestate succession applies. In that case, the properties are distributed as per the religious laws.
The laws applicable to various religions are discussed below:

Succession for Hindus
For Hindus, the Indian Succession Act, 1925 is applicable for testamentary succession. For intestate succession, the Hindu Succession Act, 1956, as amended in 2005, is applicable. This difference arises due to the presence of the separate laws related to Hindu Undivided Family (HUF).

Succession for Muslims
In case of Muslims, the Indian Succession Act, 1925 is not applicable in Testamentary or Intestate Successions. The succession is as per religion.

Succession for Jains, Sikhs and Buddhists
The laws related to succession for Jains, Sikhs and Buddhists are very much similar to laws related to Hindus. For testamentary succession among Jains, Sikhs and Buddhists, the Indian Succession Act, 1925 is applicable. However, for intestate succession, the Hindu Succession Act, 1956 as along with amendments in 2005, are applicable.

Succession for Christians
In case of Christians, for both testamentary succession and intestate succession, the Indian Succession Act, 1925 is applicable.

14.4.2 The Hindu Succession Act, 1956

The Hindu Succession Act, 1956 extends to whole of India. The succession of property of a Hindu, who dies intestate (after coming into force of this Act), is governed by the provisions of this Act. This implies that, if a Hindu died before the Act came into force, succession of his property is regulated by the then held Hindu Law. It is a well-established rule of Hindu law of succession that succession never remains in abeyance. The succession immediately pen up on the death of a Hindu and his property vests immediately, upon his death, to his heirs.

Law of Succession of Property of a Hindu Male

In the Hindu Succession Act, Sections 8 to 13 lay down the general rules for succession when a Hindu male dies intestate. These rules are to be read along with the Schedule that provides the list of Class-I and Class-II heirs. All these sections are discussed later in this section.

Types of Heirs[51]

The heirs of a Hindu male are broadly of four types—Class I Heirs, Class II Heirs, Agnates and Cognates.

Class I Heirs

Under the Hindu Succession Act, the legal heirs who fall under Class I heir are:

1. Son
2. Daughter
3. Widow
4. Mother
5. Son of a pre-deceased son
6. Daughter of a pre-deceased son
7. Son of pre-deceased daughter
8. Daughter of pre-deceased daughter
9. Widow of pre-deceased son

[51] Class I and Class II Heirs are listed in the Schedule of the Hindu Succession Act, 1956.

10. Son of pre-deceased son of a pre-deceased son
11. Daughter of pre-deceased son of pre-deceased son
12. Widow of pre-deceased son of pre-deceased son
13. Son of a pre-deceased daughter of a pre-deceased daughter
14. Daughter of a pre-deceased daughter of a pre-deceased daughter
15. Daughter of a pre-deceased son of a pre-deceased daughter
16. Daughter of a pre-deceased daughter of a pre-deceased son

It is to be noted that among the Class I heirs:

- Adopted children (son or daughters) are counted as heirs.
- The children born out of void or voidable marriage are entitled to succession by virtue of section 16 (3) of the Hindu Marriage Act.
- The widow is also entitled to property and if there are more than one widow then they will inherit jointly one share of the deceased.
- Father is not Class I Heir.

Class II Heirs

Under the Hindu Succession Act, the legal heirs who fall under Class II heir are:

I. Father
II. (1) Son's daughter's son, (2) son's daughter's daughter, (3) brother, (4) sister
III. (1) Daughter's son's son, (2) daughter's son's daughter, (3) daughter's daughter's son, (4) daughter's daughter's daughter
IV. (1) Brother's son, (2) sister's son, (3) brother's daughter, (4) sister's daughter
V. Father's father; father's mother
VI. Father's widow; brother's widow
VII. Father's brother; father's sister
VIII. Mother's father; mother's mother
IX. Mother's brother; mother's sister

[Note: References to a brother or sister do not include references to a brother or sister by uterine blood.]

Agnates

A person is said to be an agnate to another if the two are related by blood or adoption wholly through males.

Cognates

A person is said to be cognate to another if the two are related by blood or adoption but not wholly through males.

Below are a few definitions and interpretations of related terms used in the Act:

Full blood Relationship

Two persons are said to be of full blood relationship when they have descended from a common ancestor by the same wife. In other words, when both the parents are same then children are related by full blood.

Half-blood Relationship

Two persons are said to be related by half-blood when they have descended from a common ancestor but by different wives. In other words, when two persons have the same father but different mother then they are related to each other by half-blood relationship.

Uterine blood Relationship

Two persons are said to be related to each other by uterine blood when they are descendants from a common ancestress but by different husbands. In other words, when mother of two persons are same but the father is different then they are related to each other by uterine blood relationship. The schedule of the Act excludes uterine brothers and sisters from inheritance of class I or class II heirs.

Relationship by Adoption

Under the Hindu Succession Act, an adopted child is for all intentions and purposes like a neutral born child. Under this Act, an adopted child is treated as equivalent to relation of full blood.

Illegitimate Relationship

Any child who is born outside the lawful wedlock is considered to be illegitimate child of his parents. Under the Hindu Succession Act, illegitimate relationship with father is not recognized but it is recognized with the mother and through their mother, children are related to each other.

Section 8: General rules of succession in case of males:

The property of a male, dying intestate, devolve according to the following priority rules:

1. First, upon the primary heirs being the relatives specified in Class I of the schedule of the Act.
2. Secondly, if there is no heir in Class-I then upon the heirs being the relative specified in Class II of the schedule of the Act.
3. Thirdly, if there is no heir in any two classes then upon the agnates of the deceased.
4. Lastly, if there is no agnate then upon the cognates of the deceased.

Section 9: Order of Succession among heirs in the Schedule of the Act:

Among all the heirs, those in Class I shall take priority simultaneously and to the exclusion of all other heirs; those in the first entry in Class II shall be preferred to those in the second entry, those in the second entry shall be preferred to those in the third entry and so on in succession.

Section 10: Distribution of property among heirs in Class I of the Schedule of the Act:

The property of the intestate shall be divided among the heirs in Class I of the Schedule of the Act in accordance with the following rule:

Rule 1: the intestate's widow, or if there are more widows than one, all the widows together, shall take one share.

Rule 2: The surviving sons and daughters and the mother of the intestate shall each take one share.

Rule 3: The heirs in the branch of each pre-deceased son or each pre-deceased daughter of the intestate shall take between them 'one share'.[52]

Rule 4: The distribution of the share referred to in Rule 3:

1. Among the heirs in the branch of the pre-deceased son shall be so made that his widow (or widows together) and the surviving sons and daughters get equal proportions; and the branch of his pre-deceased sons gets the same portion.
2. Among the heirs in the branch of the pre-deceased daughter shall be so made that the surviving sons and daughters get equal portions.

Section 11: Distribution of property among heirs in Class II of the Schedule of the Act:

The property of an intestate shall be divided between the heirs specified in any one entry in class II of the schedule of the Act so that they share equally.

Section 12: Order of succession among agnates and cognates

The order of succession among agnates or cognates, as the case may be, shall be determined in accordance with the rules of preference as below:

Rule 1: Of the two heirs, the one who has fewer or no degrees of ascent is preferred.

Rule 2: Where the number of degrees of ascent is the same or none, that heir is preferred who has fewer or no degrees of descent.

Rule 3: Where neither heir is entitled to be preferred to the other, under Rule 1 or Rule 2, they take simultaneously.

Section 13: Computation of Degrees

- For the purpose of determining the order of succession among agnates or cognates, relationship shall be reckoned from the intestate to the heir in terms of degrees of ascent or degrees of descent or both as the case may be.
- Degrees of ascent or degrees of descent shall be computed inclusive of the intestate.
- Every generation constitutes a degree either ascending or descending.

Succession of Property of Hindu Female

The "Rau Committee on Hindu Law" which submitted its report in the year 1948 recommended that all properties held by a woman should be her absolute properties and also laid down certain rules of succession of her property. The Hindu code bill substantially incorporated these recommendations. The substantive provision lays down that any property acquired by a woman becomes her absolute property and devolves on her own heirs.

From acceptance of Rau Committee recommendations till the Hindu Succession Act, 1956 came into force, the law was short of granting a status to woman where she could acquire,

[52] Its equal share among all legal heirs so each heir takes one share

retain and dispose properties similar as Hindu Male. The Hindu Succession Act, 1956 and particularly section 14 brought substantial changes, this upon the aspect of a right of a Hindu Female over her property and thereby settling the conflict. **Section 14: Property of a Hindu Female to be her absolute property:**

Any property possessed by a Hindu Female shall be held by her as full owner thereof and not as a limited owner.

Section 15: General Rules of succession in case of Hindu Female:

The property of a Hindu female dying intestate shall devolve as follows:

a) First, upon the sons and daughters (including the children of any pre-deceased son or daughter) and the husband;
b) Secondly, upon the heirs of the husband;
c) Thirdly, upon the mother and father;
d) Fourthly, upon the heirs of the father; and
e) Lastly, upon the heirs of the mother.

14.4.3 Muslim Personal Law

The Law of Succession among Muslims is combination of four sources:

1. The Holy Quran
2. The Sunna - Practice of the Prophet
3. The Ijma - Consensus of the learned men of the community over the decision over a particular subject matter
4. The Qiya - Deductions based on analogy on what is right and just in accordance with good principles

There are 2 types of heirs recognized by Muslim law:

1. Sharers - are the ones who are entitled to a certain share of the deceased property.
2. Residuary – are the ones who take up the share in the property that are left after sharers have taken their part.

Succession of Muslim male having left behind certain properties

Sharers

There are 12 sharers in Muslims:

1. Husband
2. Wife
3. Daughter
4. Daughter of a son (or son's son and so on)
5. Father
6. Paternal Grandfather
7. Mother
8. Grandmother on male line
9. Full sister
10. Consanguine sister
11. Uterine sister

12. Uterine brother

There are various factors, which decide the share taken by each sharer. For instance, a wife takes 1/4th of share in a case where the couple is without lineal descendants, and a one-eighth share otherwise. A husband (in the case of succession to the wife's estate) takes a half share in a case where the couple is without lineal descendants, and a one-fourth share otherwise. A sole daughter takes a half share. Where the deceased has left behind more than one daughter, all daughters jointly take two-thirds.
If the deceased had left behind son(s) and daughter(s), then, the daughters cease to be sharers and become residuary instead, with the residue being so distributed to ensure that each son gets double of what each daughter gets.

Non-Testamentary and Testamentary succession under Muslim law:
Under the Indian legislative scheme, the rules that govern inheritance under the Muslim law depend on the kind of property involved. In cases of Non-testamentary succession, the Muslim Personal Law (Shariat) Application Act, 1937 is applicable. On the other hand, in case of a person who dies testate i.e. one who has created his wills before death, the inheritance is governed under the relevant Muslim Sharia Law as applicable to the Shias and the Sunnis.

In cases where the subject matter of property is an immovable property, situated in the state of West Bengal or comes within the jurisdiction of Madras or Bombay High Court, the Muslims shall be bound by the Indian Succession Act, 1925. This exception is only for the purposes of testamentary succession.

Birth Right
There is no concept of ancestor property rights by birth in the case of Muslim succession. The rights, a Muslim heir acquires upon death of his ancestors, are fixed and determined with certainty on that date; and do not fluctuate. If an heir lives even after the death of the ancestor, he becomes a legal heir and is therefore entitled to a share in the property. However, if the apparent heir does not survive his ancestor, then no such right of inheritance or share in the property shall exist.

Rule of Distribution for Inheritance
Under the Muslim law, distribution of property are done in either of the two ways – per capita or per strip distribution.

The per capita distribution method is majorly used in the Sunni law. According to this method, the estate left over by the ancestors gets equally distributed among the heirs. Therefore, the share of each person depends on the number of heirs.

The per strip distribution method is recognised in the Shia law. According to this method of property inheritance, the property gets distributed among the heirs according to the strip they belong to. Hence, the quantum of their inheritance also depends upon the branch and the number of persons that belong to the branch.

Distribution of Joint or ancestral Property

Unlike Hindu law, there is no provision of distinction between individual i.e. self-acquired or ancestral property. Every property that remains within the ownership of an individual can be inherited by his successors. Whenever a Muslim dies, all his property whether acquired by him during his lifetime or inherited from his ancestors, can be inherited by his legal heirs. Subsequently, on the death of every such legal heir, his inherited property plus the property acquired by him during his lifetime shall be transferred to his heirs.

Rights of females

Muslim law does not create any distinction between the rights of men and women. On the death of their ancestor, nothing can prevent both girl and boy child to become the legal heirs of inheritable property. However, the quantum of the share of a female heir is half of that of the male heirs.

Succession Rights of a Widow

Under Muslim law, no widow is excluded from the succession. A childless Muslim widow is entitled to one-fourth of the property of the deceased husband, after meeting his funeral and legal expenses and debts. However, a widow who has children or grandchildren is entitled to one-eighth of the deceased husband's property. If a Muslim man marries during an illness and subsequently dies of that medical condition without brief recovery or consummating the marriage, his widow has no right of inheritance. But if her ailing husband divorces her and afterwards, he dies from that illness, the widow's right to a share of inheritance continues until she remarries.

Succession Rights of a Child in the womb

Under Muslim Law, a child in the womb shall only be entitled to the share in property if he or she is born alive. In case if he is born dead then the share vested in him shall cease to exist and it shall be presumed that it never existed.

Escheat

When a deceased Muslim has no legal heir, under Muslim law, Government inherits his properties through the process of escheat.

Wasiyat

In Muslim law, a will is referred to as 'Wasiyat'. According to Muslim law any person who is major (15 years and above) and is of sound mind can make a will. Muslim law recognizes that person cannot dispose off more than one third of his net assets by will, while remaining two thirds should be made available for distribution among the heirs. Muslim law requires no formalities of creating a Will. A will can be made in writing, oral or even by gestures. A Muslim Will or any part thereof can be revoked by the testator at any time before his death. The revocation may be expressed (tearing or burning the Will) or implied (e.g. if testator transfers the same property by sale or gift subsequently to another).

14.4.4 Married Women's Property Act, 1874

Married Women's Property Act, 1874 was enacted to protect the properties of woman against the creditors. Under this Act, all the properties of a woman get insulated from all the other court attachments or any income tax department attachments that the husband has run up.

This Act applies to any woman who at the time of her marriage professed the Hindu, Muhammadan, Buddhist, Sikh or Jain religion, or whose husband, at the time of such marriage, professed any of those religions. The state government has powers to exempt from operations of all or any of the provisions of this Act, the members of any race, sect or tribe or part of a race, sect or tribe, to whom it may consider it impossible or inexpedient to apply such provisions.

Married women's earnings to be their separate property

The following shall be deemed to be the separate property of any married women and her receipts alone shall be good discharges for such wages, earnings and property:

(a) the wages and earnings of any married woman acquired or gained by her after the passing of this Act, in any employment, occupation or trade carried on by her and not by her husband
(b) any money or other property so acquired by her through the exercise of any literary, artistic or scientific skill
(c) all savings from and investments of such wages, earnings and property

Married woman may effect policy of insurance

Any married woman may effect a policy of insurance on her own behalf and independently of her husband; and the same and all benefit thereof, if expressed on the face of it to be so effected, shall ensure as her separate property, and the contract evidenced by such policy shall be as valid as if made with an unmarried woman.

Insurance by husband for benefit of wife

A policy of insurance effected by any married man on his own life, and expressed on the face of it to be for the benefit of his wife, or of his wife and children, or any of them, shall endure and be deemed to be a trust for the benefit of his wife, or of his wife and children, or any of them, according to the interest so expressed, and shall not, so long as any object of the trust remains, be subject to the control of the husband, or to his creditors, or form part of his estate.

When the sum secured by the policy becomes payable, it shall, unless special trustees are duly appointed to receive and hold the same, be paid to the Official Trustee of the State in which the office at which the insurance was effected is situated, and shall be received and held by him upon the trusts expressed in the policy, or such of them as are then existing.

Married women may take legal proceedings

A married woman may maintain a suit in her own name for the recovery of property of any description which, by force of the said Indian Succession Act, 1865, (10 of 1865) or of this Act, is her separate property; and she shall have, in her own name, the same remedies, both civil and criminal, against all persons, for the protection and security of such property, as if she were unmarried, and she shall be liable to such suits, processes and orders in respect of such property as she would be liable to if she were unmarried.

Wife Liability for post Nuptial Debts

If a married woman (whether married before or after the first day of January, 1866) possesses separate property, and if any person enters into a contract with her with reference to such property, or on the faith that her obligation arising out of such contract will be satisfied out of her separate property, such person shall be entitled to sue her, and, to the extent of her separate property to recover against her whatever he might have recovered in such suit had she been unmarried at the date of the contract and continued unmarried at the execution of the decree: Provided that nothing herein contained shall-

(a) entitle such person to recover anything by attachment and sale or otherwise out of any property which has been transferred to a woman or for her benefit on condition that she shall have no power during her marriage to transfer or charge the same or her beneficial interest therein,

(b) affect the liability of a husband for debts contracted by his wife's agency expressed or implied.

Husband not liable for wife's ante-nuptial debts

A husband married after the thirty-first day of December, 1865 shall not by reason only of such marriage be liable to the debts of his wife contracted before marriage, but the wife shall be liable to be sued for, and shall, to the extent of her separate property, be liable to satisfy such debts as if she had continued unmarried. Provided that nothing contained in this section shall invalidate any contract into which a husband may, before the passing of this Act, have entered in consideration of his wife's ante nuptial debts.

Extent of husband's liability for wife's breach of trust or devastation

Where a woman is a trustee, executrix or administratrix, either before or after marriage, her husband shall not, unless he acts or intermeddles in the trust or administration, be liable for any breach of trust committed by her, or for any misapplication, loss or damage to the estate of the deceased caused or made by her, or for any loss to such estate arising from her neglect to get in any part of the property of the deceased.

14.5 Mutation

Mutation is a process whereby a property is transferred from one person's name to another. In practice, this is done by alteration or substituting a name of a person with another in revenue records showing the right of title to the property.

Mutation of property is a state matter and therefore is carried out as per the state specified laws. The records are then maintained to prove the rightful owner of the property. There is another objective to it. Since state or central government has to collect taxes on properties, the records of the revenue department have to show the rightful owner so that tax liabilities can be fixed.

The process of mutation is generally handled by the state governments. The land development authority provides necessary details and documentation. The present owner of the property is required to clear all the dues pertaining to it, post which the development authority cannot object to selling the property. It becomes an obligation for the authority to record the mutation and grant a no-objection certificate, or sanction the building plan. The development authority then sends notice to the present holder of the property on the event of changing the allotment. The mutation is not considered as evidence, but if there are co-owners of the property then value of the mutation will not allow one person to claim the property alone.

Though mutation, as shown above, can hold significant relevance, it is still not a proof to confer title of the property in the name of person in whose name property is mutated. The proceeding which happens in front of the revenue authorities are not considered as judicial proceedings. The title of any property should be the basis on which an owner acquires land and not mutation entries. The sole objective of Mutation is to collect revenue from the person in whose possession is the property.

14.6 Caselet

Mr. XYZ has died without leaving a Will. He was not married. He has 1 surviving brother and 2 surviving sisters. The family is Hindu.

Question 1*: Under the law who all qualify to inherit from the estate?*

a. *Surviving Brother*
b. *Surviving Sisters*
c. *All brother and sisters equally*
d. *None of the above*

Answer: (c) *All brother and sisters equally*

Explanation:

Mr, XYZ has died without a Will, i.e. he has died Intestate. In such case, the distribution of assets of Mr. XYZ will be as per the Indian Succession Act 1925. Since Mr. XYZ is a Hindu, The Hindu Succession Act, 1956 will apply. There are none from Mr. XYZ's family who fall under Class I heir (refer to the list at section 14.4.2 of this chapter). Therefore, this case falls under Class II heirs of Hindu Succession Act.

Among the heirs specified in the Schedule, those in the first entry in Class II shall be preferred to those in the second entry; those in the second entry shall be preferred to those in the third entry, and so on in succession (refer to the list at section 14.4.2 of this chapter). Therefore, Mr. XYZ's brother and two sisters equally qualify to inherit his estate.

CHAPTER 15: TOOLS FOR ESTATE PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Tools for estate planning
- Concept of Will / Gifts / Nomination
- Probate process
- Family settlement
- Trust-characteristics and regulations
- Power of attorney

15.1 Tools for Estate Planning

Estate planning tools are classified as those that take effect during the life of a person and after death of a person. There are different tools of estate planning. Not all of them are applicable at same instance. Some tools are used within one's lifetime while some of the tools benefit the family post death.

a. Tools used post death of the individual

- Will
- Nomination

b. Tools used during the lifetime of the individual

- Family Settlement
- Trust
- Guardianship
- Joint Holding
- Gift
- Power of Attorney
- Mutation

15.2 Concept of Wills

15.2.1 Characteristics and content of will

"Will" is defined in Section 2(h) of the Indian Succession Act, 1925 to mean the "*legal declaration of the intention of the testator with respect to his property, which he desires to be carried into effect after his death*."

The person making the will is the testator, and his rights extend to what are legally his own.

The will comes into effect only after the death of the testator.

The person who is named in a will to receive a portion of the deceased person's estate is known as a Legatee. The person named in the will to administer the estate of the deceased person is termed as an Executor.

Anyone who has some asset accumulated can write a will, but often is neglected or delayed for later years of life. In absence of a will, the laws of inheritance come into action and the assets are distributed as per the law, which can be a cumbersome process and also against the wish of the person. Thus, there is a strong reason that one should write a Will.

Here are some of the strong reasons to write a will:

1. After testator's death, there will be no confusion among the family members and relatives as to how to dispose of the properties.
2. A will is a highly personal document. The testator is able to express his opinions and feelings about his relationship with the family members, relatives, friends and others.
3. The laws of inheritance do not consider any specific situation of any family like special needs, minor children, widow daughter, etc. Through the 'will' the testator can address these specific situations.
4. Through a 'will', a testator can take away rights of disobedient/ fraudulent person of family members.
5. The 'will' offers many tax advantages too in many situations.
6. By appointing executor, the testator has appointed a faithful personnel. In intestacy, the administrators have to provide an administration bond and securities for due administration of the estate.

The wills are made for disposing properties along with appointing executors, for creating trusts, and for appointing guardian of the children. There are certain formalities required by the statute to a valid 'Will'. If those formalities are not complied with, then the Will is not considered as valid.

A will takes into effect only after the death of the testator. During the lifetime, the testator can revoke the will anytime without any legal difficulty whatsoever. The Will can be changed by the testator as and when he likes. Till the execution, the Will remains a confidential document.

The Section 62 of the Indian Succession Act lays down that a Will is liable to be revoked or altered by the maker at any time during his lifetime when he is competent to dispose of the Will.

15.2.2 Types of will

There are different kinds of Will which are written by the testator to dispose their properties-

1. **Conditional or Contingent Will**: A will may be expressed to take effect only in the event of happening of some contingency or condition and if in case the contingency did not happen or the condition fails the will is not legally enforceable or probate. If the condition imposed is invalid or against law then the will is deemed to be invalid.
2. **Joint and Mutual Will**: A joint will is a will made by two or more persons. In Indian law, a joint will is a valid will. A joint will is recognized as two wills and is intended to take effect after the death of both the testators. Though it is termed as joint will, the disposition of properties happens as an individual will and even admitted to probate as an individual will.
   In a mutual will, the two testators confer upon each other reciprocal benefits. The testator has absolute benefits in each other's properties or life interest. This means the executants fulfil the role of both testator and legatee. But when the testator and legatee are different then the mutual will is not viable.
3. **Duplicate Will**: A duplicate will is a copy of the Will kept with the testator. But the will has to be duly signed and attested. The duplicate will generally lies with the executor or trustee**.** When the testator mutilates or destroys the part in his custody then both wills are considered to be revoked.
4. **Holograph Will**: A holograph Will is a will entirely in the handwriting of the testator. It is considered to be a good will if it is completely handwritten by the testator.
5. **Concurrent Will**: In general there should be only one Will left by the testator, but sometimes the testator may write two wills –one relating to his property in one country and other relating to his property in other country. Both these wills are treated as independent and one of the Wills can be graded probate. However, if there is any relations between the two then both wills are to be included in the probate.
6. **Sham Will**: If a document is deliberately executed with all due formalities purporting to be a Will, it will be anullity if it is proved that the testator did not have any intention of any testamentary operations but some collateral object. The reason for this is that the intention is the primary characteristic of validity of the Will. Such a Will is a sham one.
7. **Privileged and unprivileged Will**: Mostly the will has to be made in writing. But there are situations where this may not be possible. The best example is a soldier during his engagement in the actual warfare or airmen so engaged or a mariner at sea may pronounce his Will by word of mouth before 2 witnesses present at the same time. The will, so pronounced by such persons, is called privileged will. All other kinds of Wills, which are not privileged wills, are called unprivileged will.

15.2.3 Legal requirements and Testamentary capacity

According to section 59 of the Indian Succession Act, the essentials for making a will are:

- Testamentary capacity and sound mind
- Knowledge of contents

- Free from undue influence/ fraud/ coercion
- Voluntary act

Thus, the following persons are eligible to make a will:

1. A person of sound mind may dispose his properties by will with a condition that he/she is not a minor.
2. A married woman may make a will of the property which she could alienate by her own act during her lifetime.
3. Deaf or dumb or blind persons can also make a will if they are able to know what they are doing.
4. An ordinary insane person can also make a will during an interval in which he is of sound mind.

No person can make a will in a situation that he is not in a sound state of mind. This may arise due to intoxication or for illness or form any other cause that he does not know what he is doing.

Testamentary Capacity

A person is said to be in testamentary capacity only if he is in sound state of mind. When in sound state of mind, the testator should have sufficient capacity to comprehend perfectly the condition of properties, his relation to the persons who were or might have been object of his bequest and the scope and bearing of the provisions of his Will.

15.2.4 Registration of Wills

Registration of Will has been dealt under Section 17 of the Registration Act, 1908. The section does not mention compulsory registration of documents pertaining to will. Section 18 of the Act mentions that registration of Will is an optional process. Thus, the law does not provide any reference to compulsory registration and so a non–registered Will is considered to be a genuine will. However, there are many advantages of a registered will. These are:

1. The will cannot be tampered, destroyed or stolen.
2. Under the Registration Act, Section 57(2), the certified copy of a will can be given only to the testator or this agent. After testator's lifetime the certified copy can be given only at his/her death to the person applying for it through a written application. The death certificate of the testate has to be produced by the person.
3. The wills are kept in the safe custody at the registrar office.
4. With a registered will, the leasehold property can be edited in the name of the legal heirs.

How to get the Will Registered?

The will needs to be registered at the Registrar/Sub registrar office. All the witnesses of a will along with the testator have to attest the will in front of the Registrar/Sub-registrar.

After attestation, one copy is given to the testator and the others are kept in the safe custody of the Registrar.

There might be a situation when the testator is not able to travel to the Registrar office then the Registrar can be requested to visit testator's house or hospital. Following are exempted from attending Registrar's office:

1. A person by reason of bodily infirmity is unable to visit without the risk or serious inconvenience to appear at the registrar office
2. A person in jail under civil or criminal process
3. A Muslim *pardanashin* Woman

A will is registered on a plain paper and so there is no stamp duty payable. The Will can be registered within the lifetime or by legatee after the testator's death.

Even if the will is registered, all subsequent Wills or amendments need not be registered.

Specific Situations

There are specific circumstances when a will has to be registered with the Registrar/Sub-registrar office. The bequeath to charitable or religious institution by a non-Hindu is one such instance. The Will written by such persons and bequeath to the near ones shall be deposited with the Registrar/Sub-registrar of deeds and comments within 6 months of the execution of the will.

Any bequeath to a religious or charitable institute can take effecting only when certain conditions are met. These conditions are:

1. The Will has been executed.
2. The will has been deposited with the Registrar/Sub-registrar within 6 months of its execution.
3. The testator has to survive for a period of 12 months starting from the month in which the Will is executed. This means any bequeath made few days prior to testator death is not considered valid.

Important Considerations

Here are some important considerations for a person writing the will:

- The will should be kept in a safe custody with a banker or lawyer. Even the registrar can be considered for safekeeping of the Will. To do this, the testator personally or through his agent can submit the copy of the Will in a sealed envelope. Once the registrar receives the sealed copy and is satisfied, he/she can keep the copy in safe custody.
- This sealed copy can be opened either in presence of the testator or in the presence of any person applying for it at the testator's death. If the registrar is satisfied then the sealed cover is opened in presence of the applicant. All expenses in this process are borne by the applicant.

- The registrar holds the original copy till any competent court asks them to produce.

15.2.5 Modifying and Revoking a Will

Revocation of Will

A will by nature is revocable. A man's act or deed cannot make a Will irrevocable. Section 62 of the Indian Succession Act deals with revocation of will. As per the law, a will can be altered or revoked by the testator at any time when he is competent to dispose of his property through Will.

Section 57 of the Act specifically mentions that marriage shall not revoke any Will or codicil for Hindus. A Will is not deemed to be revoked in case of divorce of the maker of the will.

Modes of Revocation

There are four modes of revocation of a 'Will':

(i) Through a later Will or codicil duly executed;
(ii) Through written declaration of an intention to revoke the Will and duly executed as a Will;
(iii) By burning, tearing or otherwise destroying the Will by the testator or someone in his presence and by his direction, with the intention of revoking the Will
(iv) By a subsequent marriage

The mere loss of the Will does not lead to revocation but where the Will is destroyed by the testator or with his privity or approbation, the Will is deemed to have been revoked. Section 70 of the Indian Succession Act requires that a document declaring the intention of the testator to revoke the Will, should be executed in the same manner as a Will.

One of the important characteristics of a Will is that it is always revocable until the death of the testator. However, the testator should be in sound mind at the time of revocation. A mere expression of intention to revoke a Will at some future date is not valid. A sample of revocation is shown in Exhibit 15.1.

Exhibit 15.1: Sample Revocation

I, AB etc., hereby revoke all my Wills and codicils and particularly the Will made by one on _____ in the presence of _____ and _____ as attesting witnesses thereof. I declare it to be my intention to die intestate.

(Sd.) _____

(AB)

Witnesses:

1. _____

2. _____

15.2.6 Codicils

A Codicil is a supplementary document to a Will. Through a codicil, the testator can make minor alterations in his Will. As per section 2 (b) of the Indian Succession Act, "Codicil" means any instrument made in relation to a Will and explaining, altering or adding to its disposition and shall be formed to be part of the Will. The codicil has to be executed and attested just as the Will.

A codicil is not an independent document. When alterations are considerable then a fresh Will revoking the earlier Wills should be written. The codicil can be endorsed on the original Will or may be written as a separate document. Exhibit 15.2 provides a sample Codicil substituting a Trustee appointed under Will.

Exhibit 15.2: Sample Codicil Substituting a Trustee Appointed Under Will

I, AB etc., hereby declare this to be first codicil to my Will dated the _____ day of _____.

WHEREAS by my aforesaid Will I have appointed EF as one of the executors and trustees and given him a legacy of Rs. _____ if he acts;

AND, WHEREAS the said EF has died on _____.

1. Now I hereby revoke the appointment of the said EF as one of the executors and trustees of my Will and appoint GH, etc., to be executor and trustee thereof in place of the said EF.

2. I bequeath to the said GH a legacy of Rs. _____ if he acts as such executor and trustee and I hereby revoke the legacy of Rs. _____ given to the said EF by the said Will.

3. I hereby declare that my said Will and all the provisions contained therein shall be construed and take effect in all respects as if the name of the said GH where substituted therein as an executor and trustee thereof for the name of EF.

4. In all other respects, I hereby confirm my said Will.

IN WITNESS WHEREOF I, the said AB have signed this codicil on the _____ day of _____ in presence of the witnesses hereunder who have attested the same in my presence.

(Sd.) _____

(AB)

Testator Signed by the above-named testator as a codicil to his Will dated _____ in our presence at the same time and each of us has in the presence of the testator signed his name hereunder as an attesting Witnesses: 1. _____ 2. _____

15.2.7 Succession Certificate

Under Indian Succession Act, 1925 the succession certificate is defined as a document issued by a court to the legal heirs for establishing their authenticity and authorizing them to represent the deceased for the purpose of collecting debts, securities and other assets due or payable to them.

The succession certificate is required in absence of a Will to establish the legal character of heir who lays a claim on the property of the deceased. But a succession certificate does not determine the right, title and interest of a deceased person to any property. Hence mere issuance of succession certificate does not give right of succession to the property in which the legal heir has laid a claim.

Section 370 of the Indian Succession Act, states that when the deceased person has left a valid Will, his/her entire property as stated in the Will, vests with the executor and thus succession certificate cannot be granted.

The succession certificate is granted by the District Courts as stated in Section 371 of the Indian Succession Act. It is issued by the applicable laws of inheritance on an application filed by the beneficiaries in a court of relevant jurisdiction. The succession certificate is used to claim both movable and immovable properties of the deceased. The purpose of a succession certificate is limited in respect of debts and securities such as provident fund, insurance, deposits in banks, shares, or any other security of the central government or the state government to which the deceased was entitled.

A succession certificate may be used in situations where banks, financial and private institutions release funds to the nominee (where such nominee is not the legal beneficiary of the asset) and the nominee refuses to cooperate in distribution of the asset to the legal beneficiary. In case of immovable properties, the legal heirs claim on the ownership of title and possession. The transferring of title of a property is a systematic process which can be based on the factum of the Will or Law of Natural Successions where Class I legal heirs are

the primary inheritors. Even a gift deed can be used to transfer the title of the property to any legal heir while the person is alive.

Difference between Legal Heir Certificate and Succession Certificate

The succession certificate is a different document than a legal heir certificate. A legal heir certificate is issued to identify the living heirs of a deceased person. A legal heirship certificate establishes the relationship of the heirs to the deceased for claims relating to pension, provident fund, gratuity or other service benefits of central and state government departments, specifically when the deceased has not selected a nominee. Banks and private companies also accept such certificates for allowing transfer of deposits, balances, investments, shares, etc. The succession certificate, on the other hand, establishes the authenticity of the heirs and gives them the authority to inherit debts, securities and other assets of the deceased. Table 15.1 summarizes the difference between Succession Certificate and Legal Heir Certificate.

Table 15.1: Succession Certificate Vs Legal Heir Certificate

Succession Certificate	**Legal Heir Certificate**
It is issued by Civil Court.	It is issued by Tehsildar of district.
It authorizes a valid and a rightful person to succeed over the deceased person.	It identifies and establishes living heirs of a deceased person.
Purpose is to gain authority to obtain the debts and securities of the deceased where a Will has not been drawn up.	Purpose is to stake a claim as a rightful heir to the estate of the deceased.
Succession Certificate acts as a valid proof under succession laws and the holder can become the beneficiary of the property of the deceased.	Legal Heir Certificate does not serve as conclusive and valid evidence under succession laws.
The right of a succession certificate holder is extensive in the sense that every payment made by the holder of the certificate on behalf of the deceased would be considered valid.	Legal Heir Certificate is limited to insurance claims and so on.
Only the certified legal heir can apply.	Spouse, parents of the deceased, son or a daughter can apply.

15.2.8 Role of the executor

Who is an Executor?

An executor is a person appointed by the testator of the Will. Section 2(c) of the Indian Succession Act defines executor to be a person to whom the execution of the last Will of the deceased person is, by the testator's appointment, confided. An executor has been granted powers and duties to act as per the Will. The main role of an executor is to collate all assets of the deceased, pay off liabilities and distribute the legacy as per the wish in the Will.

Sec 222 of the Indian Succession Act states that the court grants probate only to executors appointed by the Will.

Functions of an Executor

The role of an executor is filled with huge responsibility since the executor manages the execution of the Will which can be as detailed as the testator would have written. If the 'Will' goes for probate, the executor is the person who has to oversee the entire process. It is the executor's responsibility to offer the Will for probate if situation arises. The court issues the probate certificate to the executor authorizing him to execute the Will as per the wish of the testator.

The other role of the executor involves working on the content of the Will. Since executor has the complete responsibility, he has to analyse the Will minutely. If there is a trust formation through the Will, then the trust deed will have to be analysed by the executor.

The first responsibility to shoulder is to pay off the funeral and burial expenses and obtain the death certificate, needed to manage the financial affairs. Once death certificate is obtained, the executor can proceed with the disbursal of assets as per the 'Will' content.

The executor also has to locate the assets as mentioned in the Will. This includes banking, investment, properties, and any other assets. The executor will have to ensure that all the assets can be located with their original papers and determine their present value to ascertain the exact value of the estate involved. For this, the executor may seek services of legal professionals. Post determining the total value of estate, the executor will have to pay off all the debts and liabilities along with taxes according to the provisions specified in the Will. Without paying off pending dues the estate cannot be distributed, as the lenders have the first right. If required some of the assets may be liquidated to pay off these dues. Once the dues are paid off, the estate can be disbursed to the legal heirs as per the provisions of the Will.
Further, another important role that can arise for the executor is to manage the assets of the minor child. Many a times, parents leave it to the executor to manage the assets of the child till he/she becomes major. Once the child becomes major all the assets are transferred to the child. In such cases, the role of executor is more than just execution of the Will. An important consideration to remember is that if the executor mismanages any of the assets he/she can be held liable for the same.

Who can be the Executor?
All persons capable of executing a Will can be executors. Family/ friends/ relatives or even a company can be appointed as executor of the Will. A beneficiary can also be named as

an executor of the Will. In general, the testator appoints the executor while writing the Will. Where an executor is absent in a Will, the court can also appoint the administrator to look after the distribution of estate. However, an executor has the right of refusal before he/ she starts dealing with estate. But once the responsibility is accepted by the executor, he/she is legally bound to complete the task. The executor can be relieved only by a court order if he/she is not willing to act.

A minor too can be appointed as an executor. However, probate cannot be granted to a minor until he attains the age of majority. In such cases, the legal guardian of the minor can obtain letters of administration by submitting an application in the court of law. In a similar manner, the courts do not grant probate to person with unsound mind, hence mentally disabled person cannot be appointed as executor in the Will. Apart from this, a corporate (as defined under section 223 of The Indian Succession Act) can be appointed as an executor in the will.

Number of Executors

By law, there is no restriction on the number of executors, a testator may appoint in the Will.

What if no Executor is appointed?

If there is no executor appointed in the Will then the court grants Letters of Administration to the agent or attorney of the principal i.e. the testator.

Bequests in favour of Executor

Sec 141 of the Indian Succession Act states that an executor as legatee cannot claim the legacy unless he shows intention to act as an executor.

Administrator

There are many instances when executors may not be available in the Will. The court then appoints administrators for execution of the Will.

Here are circumstances when the courts will appoint administrators:

1. There is no executor appointed in the will.
2. The appointed executor is legally incapable or refuses to act.
3. The executor dies just after proving the will but has not completed the distribution of the estate.

15.3 Probate

Probate, as defined in section 2 (f) of the Indian Succession Act, means the copy of a will certified under the seal of a court or competent jurisdiction.

To put it simply, it is a legal process where a certificate from the court establishes the legal character of the person to whom the grant is made. It also establishes the validity of all

intermediate acts of the executor appointed in the Will. The other alternative to probate is the letters of administration, which is generally issued by the court, in the following cases:

1. No executor has been appointed in the Will.
2. The executor appointed is legally incapable or refuses to act or has died before he has proved the Will.
3. The executor has died after proving the Will but before he has administered the entire estate of the deceased.

So, when either of the above three situations are not satisfied in a Will, the court will issue letters of administration of the estate to the legatee.

Why Probate is required?

A probate is mandatory in some cities. Currently if the Will or codicil has been made in any of the three Presidency towns i.e., Kolkata, and the municipal limits of metro cities of Chennai and Mumbai, or, if the immovable property is situated in any of these towns then probate is mandatory. Beyond these, probate is optional. Apart from this, there can be many situations when a probate may be required -

1. If executor or legatee has to establish any legal right over the assets of the deceased.
2. If there is no executor in the Will.
3. The deceased has multiple assets, some of which are present in the above mentioned states.
4. In general, the authorities of the state where the asset lies demand a registered Will and a probate to transfer the assets in the name of the legal heirs.

Who can take a Probate?

A probate is given only to the executor appointed in the Will. In case the executor is not there, then the letters of administration is given by the court with legal jurisdiction. Letters of Administration is issued to any person who would be entitled to the whole or any part of the estate of the deceased. But there are situations when there will be more than one person to claim the assets. In such cases, the court will decide whether to issue the letters of administration to any one person or more.

Probate is not a Succession Certificate

Often, when a person dies intestate or without a Will, a succession certificate is required for legal heirs to lay claim on the assets. This succession certificate is entirely different from the probate certificate and is obtained from a civil court. It is a certificate that validates the right of the legal heir. Contrary to this, a probate is an order issued by a court in favour of a Will, which upholds and certifies its genuineness. Thus, a Probate is issued when there is a Will, while a succession certificate is issued when there is no Will.

Process of Probate

The law prescribes a procedure for issuing the probate. To obtain a probate, the executor files an application in the appropriate court along with a copy of the Will. Where no executor is present, any competent person can file the application. The application, duly verified and signed by the executor or any competent person, should include the time of the testator's death, the existence of an executed Will, assets involved and the name of the executor along with other details. Further, at least one of the witnesses of the Will needs to verify the application. The applicable fee is attached with the application form on stamp paper on which court grants the probate.

Once the petition is received, the court issues notice to the legal heirs to file objections to grant of probate. Public is also notified through advertisement in a national newspaper. Once the next generation is invited for objections, the petitioner has to lay proof of death of the testator, valid execution of the Will and prove that it is actually the last will.

Probate Fees

The probate process involves a court fee. This fee is a fixed or percentage of the total value of assets going in for probate. Some states have a limit of the maximum fee charged by the court for probate. The rate varies across states as Wills are a state subject.

15.4 Gifts, Joint Holding and Nominations

15.4.1 Gifts

A gift is a transfer of movable or immovable property made voluntarily and without consideration. The person making the gift is called donor; the person receiving the gift is called the donee. Any person capable of making a contract can make a gift. A gift is usually an irrevocable transfer however, it can be revoked if the donee agrees to do so.

Gifts are taxable as income from other source, subject to exemptions provided under Income Tax Act. This includes gifts received from relatives such as spouse, siblings of self and spouse, parents, grandparents, children, grandchildren and other relationships as defined under Income Tax Act. Any gift received on the occasion of marriage or inherited under a will is exempt from tax.

Gifts are routinely used to transfer wealth from donor to donee; especially where the exemptions mentioned above would apply, thereby exempting the gift from tax in the hands of the donee. However, any income earned from the gift after such transfer will be subject to tax in the hands of the donee.

15.4.2 Joint Holding

It may be procedurally easy to enable specific family members, such as the spouse or children, easily access assets through the simple method of joint holding. Joint holding means the property is held by more than one person and can be accessed by such joint holders subject to the mode of operations. Bank accounts, property, demat accounts, shares, mutual funds and specific saving schemes can all be held jointly. The operation of

a joint account can be done 'jointly', where all joint holders have to approve all transactions, or on 'either of survivor', or 'anyone or survivor' basis.

The specific procedural aspects for joint holding, with respect to how many joint holders are permitted, what kind of operational choices are available, and what type of transactions need all joint holders' assent, can vary across different types of assets. It is usually the case that the first holder would be the registered holder of the asset and entitled to receive information and benefits of holding the asset. The joint holders can, subject to terms of holding, access the asset after the death of the first holder. The procedures for accessing the asset are simpler in the case of a joint holding. However, it should be remembered that if there is a legal contest among the heirs, joint holders right to the asset can be superseded by laws of succession as they may apply.

15.4.3 Nomination

Nomination is the right conferred upon the holder of an investment product to appoint the person entitled to receive the monies in case of the death. A nomination is seen as a formal bequest authorized by the holder of the asset, though in the event of a dispute the nominee's position is reduced to being the trustee of the bequest, the final owners being decided according to the applicable laws of succession.

Only an individual can nominate. Non-individuals including corporate bodies, partnership firms, trusts, Karta's of Hindu Undivided Families (HUFs) and power of attorney holders, cannot nominate. Nomination can be done either at the time of making the investment or entering into an insurance contract or subsequently at any time. Nominations can be modified any number of times.

Nominee can be an individual, company or trust, depending on the terms of investment or asset. A minor can be a nominee, but a guardian will have to be named. Nominations to NRIs will be honoured subject to repatriation rules. Multiple nominees are allowed, with percentage of interest defined for each nominee.

Different rules for nomination apply for different types of assets

The purpose of nomination is simplification of payment process in the event of the death of the holder and not the equitable distribution of estate.

Payment to nominee is a valid discharge in case of all financial products. The onus of proving any rights to legacy of the investment so transmitted is on those that contest such transmission. A will supersedes a nomination, but the company or mutual fund can still make payment of proceeds to the nominees. The nominee is not a legatee or beneficiary

under the Indian Succession Act. However, there are certain assets where the nominee has been granted the legal rights of the proceeds. Under the Insurance Act, 1938, beneficial nominees i.e. the immediate family members such as spouse, parents and children are entitled to the death benefit of the insurance and other legal heirs will not have a claim on the money. Similarly, under the EPF Act the subscriber can appoint only immediate family members such as spouse, parents and children as nominee in his/her Provident Fund account who inherit the proceeds upon death of the subscriber. In absence of any nomination, proceeds are distributed among legal heirs.

The nominee takes the amount subject to any claim or right of the owners/heirs or other persons. The nominee may only receive the proceeds, but title to the assets is not absolute. Various courts in India have upheld the rights of legal heirs over the nominee and so in most financial assets Succession Rule supersedes nominations. Exception to this will be financial assets, which have been created by a separate Act and where provisions have been provided in the Act itself for bequeath of the assets to specified legal heirs, post the demise of the investor.

Nomination is an effective method, absence of which leads to ballooning corpus of unclaimed assets. Considering this, changes in nominations are undertaken to bring out efficiency in claim processing on account of demise of investors. SEBI has introduced changes in nomination by increasing the number of nominees, allowed to be registered, upto 10.[53] Similarly banking laws are proposed to be amended to bring successive nomination in place meaning one can appoint alternate nominees if first nominee is not alive or unable to accept. This is called “One after another “arrangement.[54]

15.5 Family Settlement

A family settlement is an instrument used to achieve peace and harmony in the family when there is a dispute or rival claims to property that can lead to a long drawn out litigation. The dispute must be between members of the same family and a settlement entered must be between persons having title, claim or interest in the property. It must be entered into voluntarily and in good faith and with the purpose of accomplishing tranquility and accord in the family.

The advantages of a family settlement are:

- Family arrangements are not treated as transfer and hence capital gains tax will not arise.
- It is not treated as a gift.
- The clubbing provision will not be applicable.

[53] Vide SEBI Circular No.: SEBI/HO/OIAE/OIAE_IAD-3/P/ON/2025/01650 dated January 10, 2025 on Revise and Revamp Nomination Facilities in the Indian Securities Market.
[54] As per the Banking Laws (Amendment) Bill, 2024.

A family settlement agreement may be oral or in writing. It may be stamped and registered, if required.

15.5.1 Intra-family business and property transfer

An intra-family transfer is a transfer from one family member to another family member without the assets actually being sold. In other words, the assets are essentially 'given' to another member of the family so that there is a reduction in the taxes owed.

Transferring property among family members is quite common in India. Be it an estate planning goal or just for love and care, property transfer within family happens for multiple reasons. Though among family members property transfer can be highly useful, there may be tax implications that needs to be taken into consideration.

The property transfer may have some other issues to be resolved like that of mortgage. If any property is under mortgage, the liability is also carried to the new owner if the property is sold and transferred. Similarly other issues may arise in transferring a property, therefore due importance should be given to the strategies to be applied for the purpose.

15.5.2 Forms of property transfer

Here are common forms of property transfer among family members:

Joint ownership: The property may be held in a joint ownership where on death of one owner the share of his property is transferred to the second owner. This ownership structure is quite common within spouses. The tax implication does not arise during death but capital gains tax may be payable if ownership is transferred during one's lifetime.

Gifting: Gift among family members due to love or care is one of the common ways to transfer property among family members. Grandparents gifting immovable property to grandchildren or parents gifting to their children are common. This mode of property transfer does not have tax implications when it is within blood relatives. However, there is a stamp duty payable since it is an immovable property transfer which has to be mandatorily registered. The rate of stamp duty varies among the states as stamp duty is a state jurisdiction. Some states have a lower concessional rate of stamp duty on gift of residential property or agricultural land to close relatives such as spouse and children.

Will/Inheritance: Will is written for transferring property to the loved ones after an individual's lifetime. Will can be revoked by the testator during his/her lifetime. So the beneficiaries of the Will get the ownership rights in any property only after the death of the testator. If there is no written Will, property transfers will take place through the Laws of Inheritance.

There are no tax implications on the beneficiaries if a property is received through Will or Inheritance. The registration of the property on his/her name is also not required but change in the mutation has to be applied to the concerned local civil authorities. If the inheritor decides to sell the property, then capital gains taxation will be payable where the cost of acquisition to the previous owner will be considered as the cost of acquisition of the property.

15.5.3 Estate Planning for Family Business

Estate planning for family business is equally important. Many researches show that only 70% of family businesses survive generation. The rest either disappear or are sold by the second generations. But family businesses make substantial contributions towards workforce and the gross domestic product. To protect family-owned assets, estate planning and succession planning needs to be effective.

The succession of family business is one of the critical elements. Issues arise when the business have to be transferred to the next generation. An effective estate planning strategy can sustain a family business across generations.

Here are a few estate planning strategies for a family business to deploy:

Rise to the challenge

Ownership transfer is quite difficult considering the difference between ownership and management succession. Estate planning is more effective if the assets are transferred early to the next generation. However, what hold family business to make this decision is losing control on the business and too early to give reins to the children.

There are different ways through which this challenge can be addressed. A limited partnership can be set up; or bringing ESOP into practice; or transferring non-voting stock to heirs. Giving the members, who are not involved in the business, non-voting rights or other equity interest, that does not provide them any control, can be an effective solution to share wealth with them. Members who actively work in the business can take over the management.

Partial sale

The financial needs of older and younger generations can bring challenges to any family business. The younger generations will be more aggressive and their needs are immediate. Contrary to this, the cash flow requirements for the owner are recurring in nature. With effective estate planning, both these requirements can be fulfilled. The proceeds from a partial sale of the business can provide enough liquidity to the owner, while the younger generation can be funded through cash flow from the residual business.

Creation of a Trust

There can be another option of creating a trust. By transferring business interest to a trust a fixed income stream can be generated for many years and the business can also survive across generations or it can be transferred to the owner's beneficiaries after a defined term. The structure of trust can be created based on family needs and the objective. One of the major advantages is that the control remains with the families during the trust term.

15.5.4 Forms of Family Business Ownership

There are different types of ownership in family-owned businesses. Most family business adopts one of these models of ownership. Still some family business will have hybrid structures. All of these models have their implications and trade-offs. Choosing which business model to adopt is one of the important decisions for any family-owned business.

There are 5 basic ownership structures in family business:

1. Owner-Operator: This is the simplest model where the ownership remains with the founder i.e. control is with one person (or couple). This type of model can be quite successful across generations. For this model to work, the challenge families face is deciding on the successor who can be fair and work towards the long-term sustainability of the business.
2. Partnership: These models are quite unique as only the leaders in the business can own it and also derive financial benefit. However, these models run with lots of challenges especially when succession among family partners who has unequal second generations succession. For example, a large business is owned by four brothers in partnership. Their partnership was a success as they contributed equal and drawn equal benefits. But the issue broke out in the third generation when one brother had only a daughter who was not even considered as the partner in the business. The brother confronted this and eventually the business was sold since they did not reach to any consensus.
3. Distributed: This is the third type of business model and may be an answer to the challenges faced in partnership model. In this model, the ownership in the family business is passed down to all descendants whether or not they work in the company. This type of model is the most sought after model for family business. Parents usually want all their children to inherit equally and, besides, most assets are wrapped up in the company. In the above case, if the family business has been run through distribution model then all members of the third generation could have become owners. The changes in the compensation structures would have rewarded those who are contributing to the business.
   Even then this business model has challenges to face. When there are differences between the family members, those who are contributing would often disagree with those who are outside the business especially in areas like compensation and distribution.
4. Nested Model: This model is quite attractive in ownership especially where difference arises. In this model, various family branches agree to own some assets jointly and others separately. Thus, small family ownership groups are nested in a larger one. This larger business is the one that runs the business as a profit making operation and distributes dividends to the branches. The branches then use the money to create their business portfolios. Though everything looks perfect, this model can face challenges if the core business is underfunded to finance the outside investments.
5. Public: The last of the model for family business where a portion of shares is publicly traded but the business is privately owned. The business is largely run by

professional managers and the owners are involved in a limited manner, mainly in decision making. This model is considered when there is a need of outside capital infusion or owners do not want to get involved in day-to-day running of the business. The larger challenge that the model faces is keeping the control when owners are not involved in running the day-to-day business.

Therefore, there is no one model that fits for all family business. To the owner's discretion, they can move to and fro between any of these models based on their business requirements. Of course, moving to a different ownership model involves big changes in governance, legal structures, and family relationships.

15.5.5 Valuation of Family Business

Future of a family business depends on many factors. Valuing the business is one of the important elements, which can be a significant asset of owner's estate. In many a situations valuing the business would be necessary especially when it gets transitioned to the next generations.

Every business owner desires the future succession of business to next generations to be an equitable solution. However, equal does not necessary mean 50-50. There will be members who would like to run the business and members who would not have interest.

Valuation of business can be quite challenging. Following methods are used to value a family business:

1. Capitalizing of Earnings: The business is valued based on the amount of cash flow available to the owner or investors. The overall profitability as well as the current and future capital needs of the business are considered for valuation.
2. Projected Earnings: Also known as discounted cash flow method. The business is valued based on the anticipated earnings. Reviewing the company budget and forecast of future earnings is helpful in determining the value. However, taking a long-term view like 5 years plus can be more challenging in deriving accurate value.
3. Market Approach: This approach analyses what value the market is offering to similar businesses. Though it may not be an accurate measure, but it can keep the valuation within a range giving business owners a direction in the value they should look at for their business.
4. Net Asset Value: Family business held for decade might have built assets like real estate or machinery. These in itself can be more than the operating value of business. Thus, in valuing a business, net asset value can be an important factor.

There are other actors like insurances for protecting risk and provisions for mitigation of risk like cash crunch. When a business is analysed on all these factors a fair value is derived.

15.5.6 Transfer of business and inter-generation wealth transfer

Inter-generational wealth transfer presents significant challenges for both families and their professional advisers. It is absolutely essential for families to obtain the correct advice regarding wealth transfer, so that they can minimise their exposure to unwanted liabilities such as capital gains tax or stamp duties on transfer. Meanwhile, adviser firms need to understand the scale and implications of the inter-generational wealth transfer trend in order to succeed in the increasingly competitive wealth management industry.

One of the challenges faced in inter-generational wealth transfer is the long court battle leading to the benefits of transfer to the next generation. The other challenge is the sustainability of the wealth when it is transferred to the next generation. If the tools are not right then there is a higher probability that the wealth transferred to the next generation may not last long.

There is a need of highly tax efficient and low cost tools to ensure time bound transfer. For efficient wealth transfer a proper estate planning is required. The interest of the beneficiaries has to be considered and the means through which the assets will be transferred has to be implemented well. Listed below are tools, used for inter-generational wealth transfer:

Succession laws- The three major inheritance laws – namely, The Hindu Succession Act, 1956 (applicable to Hindus, Buddhists, Jains and Sikhs), Mohammedan Personal Laws (governing inheritance of Muslims) and Indian Succession Act, 1925 (applicable to Christian, Jews and Parsis) play an important role in many situations when wealth has to be transferred to next generation.

Will- A will or a testament is a simple document for transfer for inter-generational wealth. It is easy to write and can be revoked at any time during the lifetime. However, a will as a document is more liable to be challenged and so inter-generational wealth transfer can delay. Planning everything through the will may not be the right estate planning option for everyone. Many a time delays in wealth transfer can reduce the importance or value of the assets involved. The generation for which the wealth is planned may not reap the benefits.

Gift – A gift deed is a highly efficient way of transferring immovable assets from one generation to another. The benefit it derives from the fact that the transfer happens immediately and does not have to wait for years. Though both movable and immovable properties can be transferred, the utility is more with immovable properties. Since the transfer is immediate and needs to be registered, the probability of litigation is reduced. Another important benefit derived is the taxation. Within blood relatives there is no tax liability making it a highly tax efficient tool for inter-generational wealth transfer. However, there are some negatives too. Since gift deed for immovable properties have to be compulsorily registered, there is cost involved in the form of stamp duty. This can be substantial if the value of assets is high. Secondly, the gift deeds are irrevocable and so once executed, one cannot change any terms or claim it back. Still the limitations and the cost associated to it may not be much when you consider the benefits it offers for inter-generational wealth transfer.

Trust - Family trusts have been utilized by many wealthy families to set up a cost effective and sustainable framework for inter-generational wealth transfer. In this option, the wealth is transferred to the trustees for the benefit of the final beneficiaries. There can be different structures, how a family trust can be created. The benefit a trust structure provides is the long-term sustainability of wealth with the real benefits being passed on to generations.

There will be other tools to support inter-generational transfers but each one of them has to be analysed on many factors to see the actual benefits they offer. The long-term sustainability still remains a challenge and that is where the value system of the family plays an important role. Families should involve heirs in important decision making, especially for financials, so that they understand the importance of sustaining wealth for the future. They should be provided with financial and moral support to fulfil their dreams. They should be provided continuous learning so that they value the time and effort that goes in creating wealth.

15.5.7 Joint Tenancy and Tenancy-in-Common

Joint and Tenancy both are form of ownership in an estate. This ownership rests in when two or more persons show an interest in holding the estate. At the time of purchasing the ownership, the interest in land has to be given.

Joint Tenants

In this form of ownership, the joint tenants have a right of survivorship i.e. post demise of the owner the interest of the deceased joint tenant will pass on to the survivor. This is not an ownership where joint tenant can leave a Will to pass on the interest to the legal heirs. Only in situations where the owner is the sole survivor joint tenant, he/she can pass the interest by writing in the Will.

One of the major conditions in Joint Tenancy is that all the joint tenants have to acquire their interest in the property at the same time and from the same transaction. The interest must be identical in nature and each tenant enjoys the equal right to the whole or part of the property. No tenant will enjoy exclusive right to possess any part.

Tenants-in-Common

In this form of ownership, there is no right of survivorship i.e. when a tenant-in-common dies, his/her land passes in accordance of the Will or as per the succession Act if there is no Will.

The tenant-in-common has an undivided share and interest in the property. There is an equal right to possession of whole property but no tenant-in-common has a right to possess any part exclusively. The tenant-in-common has complete ownership to deal with his share of the property as he deems fit. The share of tenant-in-common can also be unequal but if no share is mentioned then it is deemed to be equal share in the property.

15.5.8 Asset Protection

Any individual or business can run a risk of creditors making a claim on their assets. Asset protection are set of strategies, techniques and laws that are used to protect assets of individuals and business from such risks. A debtor who owns significant personal assets may choose to use asset protection to shield his/her assets in case of a payment default.

There is no one fit formula for deriving the asset protection strategies. Based on one's requirement the strategy is prepared for keeping the asset protected from any claim. Below are some of the factors to determine the degree of asset protection required:

- Identity of the Debtor: The sharing of properties between debtor and their spouse is critical. The property rights for assets can be transferred to the safer individual

before any lawsuit is filed against his/her spouse. For businesses, the guarantor, i.e. the individual who guarantees the repayment, is liable to asset seizure in the event of any lawsuit against the entity. Any clause that obliges the individual to repay an organization debt will be instrumental in creditors seizing personal assets.

- Identity of the Creditor: This is important for asset protection planning. If the creditor is a powerful organization such as government then they have more power in seizing assets as compared to private lenders. Having an aggressive creditor will require strong asset protection strategies.

- Nature of the Claim: What kind of claim can arise will determine the type of asset protection required. For example, dischargeable claims (claims that can be written off or "injuncted" by the court) can be used to protect personal assets in the event of bankruptcy and require a relatively lower degree of asset protection.

- Nature of the Asset: What types of assets are not included in creditor claim can be a factor to determine the level of asset protection required. For example, PPF accounts of individuals cannot be attached to any claim by creditors; life insurance protects home owners from home getting seized in case of any default etc.

Asset Protection Strategies

1. Using Corporations, Limited Liability Partnerships (LLPs): Entities such as private limited LLPs, are protected by the law whereas individual owners are not held liable for the entity or organizations' debt. Having these types of structures for running a business can protect individual's personal assets from seizure in case of a lawsuit. But still the individual can be held accountable for any fraudulent transfers which delay debt repayments.
2. Using Asset Protection Trusts (APTs): A trust is a strong tool for asset protection. Asset that are part of trust are not legally entitled to owners but they can be beneficiaries holding equitable interest in the trust. This way the assets are protected from creditors. Having said that the asset protection trust has its own drawbacks. The major is that these are irrevocable and the settlor has to give away the control on the assets.
3. Transferring Property Rights: An individual can transfer or gift the legal ownership of the property to spouse, relative or a trusted friend to ensure the creditors cannot lay a claim on it. But this also possesses high risk if there is a dispute within family members or friends who will own the assets after the transfer. Even then the debtor may be held accountable for delaying defaulting on payments if the transfer of asset is funded by fraudulent ways.

15.5.9 Creditor Protection Period

Before 2016, the protection for creditors from the defaulting companies was considered to be weak. Many companies took massive debts and vanished away. For creditors the only recourse was to approach a civil court. The fight in these courts, for recovery of dues and enforcement and security, often took years. There was always a need to enact a law, which can hear creditors' woes and expedite these cases.

There have been laws related to creditor right such as, Winding and liquidation under the Companies Act, the Sick Industrial Companies Act (SICA). However, there was no special tribunal for creditors' cases. The first such tribunal was set up under The Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993, where cases regarding bankruptcy are dealt with, avoiding lengthy court proceedings. But this was also not quite effective as liquidation may take more than 10 years. So, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 came in, allowing secured creditors to seize the assets of the defaulting firms. With emergence of credit bureaus like CIBIL under the Credit Information Companies (Regulation) Act (CICRA), the environment of information about debtors changed. More powers came in for creditors.

Finally, in 2016 Insolvency and Bankruptcy Code (IBC), was enacted which was a turnaround for creditors. With defined timelines set for the proceedings, the IBC is proving to be an effective solution for both creditors and debtors (companies and individuals). Here are how the proceedings under IBC are timelined:

1. The financial creditors can file an application before the adjudicating authority.
2. After furnishing the information, within 14 days the adjudicating authority has to ascertain the default.
3. If default has occurred, the application is admitted. If default has not occurred, the application is rejected.
4. Adjudicating authority has to communicate the admission of the application to the financial creditors within 7 days of the admission and after that corporate insolvency resolution process takes place.

15.6 Trust - Characteristics and Regulations

15.6.1 Indian Trust Act, 1882

The Indian Trust Act, 1882 is the governing law of the Trust in India and is quite an acceptable law even internationally. One of the great characteristics of a trust model is that it hides the real owner from any public glare and he can still operate it with ease. The trustees are the one who becomes the public face for all practical purposes and carries out the task assigned to him without any fanfare.

Generally, Trusts are formed to fulfil any one or more of the following objectives:

1. For discharge of the charitable and/or religious sentiments of the author or settlor of trust in a way that ensures public benefit.
2. For claiming exemption under section 10 or 11 of the Income Tax Act, as the case may be, in respect to income applied to charitable or religious cause.
3. For the welfare of the members of the family and/or other relatives, who are dependent on the settlor of the trust.
4. For regulating affairs of the provident fund, superannuation fund or gratuity fund or any other fund constituted by a person for the benefit of employees.

Definition

A trust is a confidence imposed by one person on another, and enforceable in a court of law. Section 3 of the Indian Trust Act, 1882 defines a trust as under:

"A trust is an obligation annexed to the ownership of the property and arising out of a confidence reposed in and accepted by the owner or declared and accepted by him for the benefit of another or for another and the owner."

- The person, who reposes or declares the confidence, is called the author of the trust.
- The person, who accepts the confidence, is called the trustee.
- The person for whose benefit the confidence is accepted, is called the beneficiary of the trust.
- The subject matter of the trust is called the trust property or trust money.
- The beneficiary interest is his right against the trustee as power of the trust property.
- The instrument, if any, by which the trust is declared, is called the instrument of the trust.

Essential Elements of the Trust

The following are the basic elements for forming a trust:

1. There must be an author or settlor of the trust, who sets aside certain properties for the benefit of the beneficiaries.
2. There must be a trustee. A trustee is a person who manages the property of the trust for the benefit of the beneficiaries as laid down in the trust deed. The settlor himself may become one of the trustees.
3. There must be a beneficiary or beneficiaries.
4. The trust property is the subject matter of the trust.
5. The object of the trust must be specific.

As per Section 6 of the Indian Trust Act, the trust is created when the author of the trust indicates with reasonable certainty by any words or acts:

a) An intention on his part to create a trust
b) The purpose of the trust
c) The beneficiary
d) The trust property
e) And (unless the trust is declared by will or the author of the trust himself to be the trustees) transfers the trust property to the trustee

Coverage of the Indian Trust Act

Private/family trusts are governed by the provisions of the Indian Trust Act, 1882. However, the principles on which the provisions of the trust act are based on, can be applied to public

trust as well. There are certain general provisions of the Indian Trust Act such as remuneration by trustees once they have accepted the role of the trustee or prohibition to delegate their office to any other person etc. can apply to the public trust too.

There are charitable or religious trusts, which are generally governed by the religious laws. For example, the Hindu charitable trusts or religious trusts are mainly governed by the provisions of Indian law. Also, several states have passed their own legislation to govern public trust, like Bombay Public Trust Act, 1950.

Advantages of a Trust

The trust offers many advantages and it can form the core of any estate planning objectives. These are:

1. A trust can be formed for the welfare of the family members and relatives dependent on the settlor.
2. A trust can reduce the probabilities of litigations.
3. A trust can administer income so as to accommodate the settlor's wishes with respect to charitable distributions.
4. A trust can preserve wealth over a lifetime by providing a plan for accumulation and orderly distribution among heirs.
5. A trust is an effective tool to gift money to minor or to provide for the care of elderly parents. A trust is also used by people to protect their future during times of incapacity.
6. A trust is a strong tax planning tool, as growth on assets transferred to a trust belongs to the beneficiary/ies.
7. Lastly, a trust avoids probate on properties transferred to it ensuring it is passed directly to the beneficiaries.

Disadvantages of a Trust

These include:

1. The structure may be complex.
2. The Trust can be expensive to establish and maintain.
3. The high cost of transfer in case of immovable properties, with variation in the rate of stamp duty payable across states.
4. There is no control of settlor over the properties transferred to the trust or gifted.
5. The powers of trustees are restricted by the trust deed.

15.6.2 Classification of Trust

Public Trust

A public trust Is created for the benefit of general public or a particular section of public. These types of trusts are generally set up as a charitable or religious trust. Temples, schools,

hospital etc. can be categorised under public trust. Here the appointed trustees are responsible for managing the trust assets and ensuring that they are utilized only for their set objectives.

Private Trust

A private trust is created for the benefit of specific individual or families. The objective of these type of trusts is to protect family assets such as wealth or property and along with it provide funds for education or care for family members. The trust deed mentions the beneficiaries of such trust and the appointed trustees manage the trust affairs.

Revocable Trust

A revocable trust allows the settlor to retain control over the trust assets and have the option to modify or terminate the trust during their lifetime. These types of trusts are considered as alternative to Will. They do not protect assets as they can be withdrawn anytime from the trust. Also, under this structure the assets are not considered as given away and so they are taxed in the hands of the settlor. The terms of the revocation are written down in the trust deed. These terms can be like revocation after a certain number of years; or at a specific event say, child attaining 25 years of age; etc.

Irrevocable Trust

Contrary to revocable trust, an irrevocable trust is one in which the terms of the trust cannot be amended or revised until the terms or purposes of the trust have been completed. Section 77 or 78 of the Indian Trust Act specifies clearly that a trust can be revoked only when the Trust Deed contains an express provision giving the author the power of revocation. Any situation opposite to this is irrevocable.

Simple Trust

In a simple trust, the property is vested in one person upon trust for the benefit of another, and the nature of the trust neither being nor prescribed by the settlor is left to the construction of the law. In these kinds of trusts, the trustees have no active duties to perform. However, the beneficiaries have the right to be put in actual possession of the property and the right to call upon the trustee to execute conveyances of the trust property.

Specific Trust

A specific trust is formed for the execution of some special purpose and the trustee is not a mere depository of the estate, but is required to exert himself in the execution of the settlors' intention.

Oral and written Trust

A trust may be declared either orally or through an instrument in writing. A trust can be declared orally only where movable properties have to be settled. Such trusts are created by transferring the possession of the property with a direction to be held under a trust. But if immovable properties are to be settled then a written trust deed is required. Even though oral trust can be created, it is always advisable to have a written trust deed since enforceability of law is much easier then.

Implied and Express Trust

An implied trust is created when the circumstances of the situation suggest that the trust was intended, even if there was no formal trust deed. For example, if a person leaves a money to a friend for a specific purpose an implied trust is created.

An express trust is created by a formal trust deed that outline the trust's terms and conditions. The deed identified the beneficiaries, the trustees and the trust assets. The trustees manage the trust assets and distribute income to the beneficiaries according to the term of the deed.

15.6.3 Characteristics of Trust

Discretionary Trust

A discretionary trust is a trust where the trustees have full discretion over the application of income and corpus of the trust to the benefit of the beneficiaries. A discretionary trust gives no right to the beneficiaries to any part of the income of the trust property, but vested in the trust a discretionary power to pay him, or apply for his benefit such part of the income as they think fit.

Section 164 (1) of the Income Tax Act also defines the discretionary private trust. As per the provision if the income of the private trust is not specifically receivable on behalf of or for the benefit of anyone person or where the individual shares of the persons on whose behalf of/ for whose benefit such income or such part thereof is receivable are not determinate or unknown is considered as discretionary trust. Such trusts are taxed at maximum marginal rate, subject to certain exceptions. Thus, such a trust that is popularly known as a "discretionary trust" is chargeable to income tax at the maximum marginal rate (MMR), i.e., 30%.

However, there are certain exceptions to the above rule of charging the income of a discretionary trust at the maximum marginal rate. These exceptions are:

- None of beneficiaries is beneficiary under any other trust or has any other income more than threshold limit or otherwise chargeable at rate more than MMR.
- Such trust is sole trust created under Will for support and maintenance of dependent relatives.

Determinate Trust

A determinate trust or a specific trust is one where beneficiary or beneficiaries are clearly specified in the trust deed along with their specific or ascertained share in the property and income of the trust. In this type of the trust, the trustees do not have any discretion over the distribution of the income of the trust. The trustees have to apply the distributions as per the specific ratio defined on the trust deed. Further, as upheld in various court judgements, a trust would be treated as determinate trust even if the trust deed only provides for manner of computation of beneficial interest of each beneficiary (e.g. equally among all living family members or a case where the beneficial interest in the trust would vary due to birth and demise of family members) and not state the exact beneficiary interest of each beneficiary in absolute terms.

Under the Income Tax Act, Explanation 1 to section 164 explains the meaning of the term indeterminate as:

"*(i) any income in respect of which the persons mentioned in clause (iii) and clause (iv) of sub-section (1) of section 160 are liable as representative assesse or any part thereof shall be deemed as being not specifically receivable on behalf or for the benefit of any one person unless the person on whose behalf or for whose benefit such income or such part thereof is receivable during the previous year is expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and is identifiable as such on the date of such order, instrument or deed ;*

(ii) the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is received shall be deemed to be indeterminate or unknown unless the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is receivable, are expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and are ascertainable as such on the date of such order, instrument or deed."

Under determinate trust structure, the tax is levied on the representative assesses in accordance with the provision of Section 161 (1) of The Income Tax Act. The section imposes the liability to pay tax on the trustees, in respect of any income that he receives or is entitled to receive on behalf or for the benefit of any beneficiary under a trust.

15.6.4 Types of a Family Trust

Public and Private Trust

A public trust is one that is constituted wholly or partially for the benefit of public at large. A public trust can be of two types—Public Charitable Trust and Public Religious Trust. Both these types of public trust are of permanent and indefinite character.

Contrary to public trust, in private trust, the beneficiaries are defined and ascertained individuals. A private trust will come into existence when the settlor (owner of the property) with an intention to transfer the property to certain individuals (beneficiaries) instead vest the property with other persons (trustees) who are made responsible for transferring the benefits for the property to the beneficiaries.

The private trusts are governed by Indian Trust Act, 1882, while, public trusts are governed by Indian Trust Act, 1882 and Act of the respective states.

The private trusts are also of 2 types –

1. Private Discretionary Trust, where trustees have discretion and beneficiaries income is not defined or determinate.
2. Private Specific Trust, where the share of the beneficiaries income is determined in the trust deed.

Public cum Private Trust

A public cum private trust is a trust where a part of the income is applied for public purpose and a part goes to private person or persons. Such trust in respect of the portion of income going to private person is assessable as private trust and not exempted from income tax.

A public cum private trust may become a fully public trust if the income of the private beneficiaries renounce their rights, which one is entitled to do under the provision of Section 58 of the Indian Trust Act.

15.6.5 Family Trust versus Will

Family Trusts and Will are useful estate planning tools used for different purposes and both can work together to prepare an effective estate plan. The following are the importance differences between them:

1. A Will goes into effect only when one dies while a trust is effective as soon as it is created.
2. Through the Will, the testator directs who will receive property at death and he appoints a legal representative to meet this objective. In contrast, a trust can be used to begin distribution of property at death, before death, or after death.
3. A Will covers property that is in one's name and when one dies. A trust, on other hand, covers properties that are transferred to the trust.
4. A Will may pass through probate which means the court overseas the administration of the Will and ensures the Will is valid and property gets distributed as desired by

the deceased. A trust does not pass through a probate, therefore, no court overseas the trust.

5. A Will can become a public record, while family trust remains private.
6. A Will allows naming a guardian for minors, while a trust can be used to plan for disability or for saving taxes.

15.6.6 Parties to Trust

There are three parties to a trust deed:

1. **Author or Settlor of the Trust**: The person who settles certain property upon trust for the benefit of the beneficiary is known as author or settlor of the trust. As per section 3 of the Indian Trust Act, 1882, the person who reposes or declares a confidence in another person (trustee) in some property for the benefits of beneficiary is called the "author" or "settlor" of the trust. In a living trust, the settlor retains the right to amend, alter or revoke the trust. In some circumstances, two or more people may decide to create a trust and are collectively referred to as settlors. Generally, both people must agree to amend, alter or revoke the trust.

2. **Trustee**: The person in charge of managing the trust, who can be the same person who created the trust, is called a *trustee*. As per Section 3 of the Indian Trust Act, a "trustee" is a person who accepts the confidence reposed by the author, which gives rise to an obligation annexed to the ownership of the property. The trustee is responsible for the management of the trust assets. The trustee has legal title of the trust assets and the power to buy, sell, borrow against or transfer the trust assets. The trust agreement sets forth the rights, duties and obligations of the trustee.

3. **Beneficiary**: He is a person for whose benefit the confidence is reposed by the settlor and accepted by the trustee. The beneficiary is entitled to receive the benefits of the income and principal of the trust. There are several categories of beneficiaries—the primary beneficiary (the persons who are first to receive the benefits of the trust assets) and the residual beneficiary (sometimes referred to as a secondary beneficiary who are entitled to receive the benefits of the trust assets after the primary beneficiaries). In a private trust, the beneficiary and author may be the same person.

15.6.7 Hybrid Trust

A hybrid trust has the features of both determinate and discretionary trust. In this type of trust, the trustee pays a certain amount of the trust property to the beneficiary as provisioned by the settlor in the trust document. On the remaining property of the trust, the trustee have discretion as to how this to be paid to the beneficiaries.

15.6.8 Cancellation and Revocation of a Private Trust

The Indian Trust Act does not provide for dissolving a private trust. However, a private trust can only become extinct or be revoked, which also means dissolution. A trust becomes extinct when its purpose has been fuilfilled or it has become unalwful or it has become impossible to carry on its purpose due to the destruction of trust property or lastly if it has been revoked.

Revocation of a trust is, in general, at the pleasure of the testator/settlor. But there are other situations where a trust can be revoked.

1. If the beneficiaries are competent to contract and they have a consent that the existing structure of the trust is not beneficial any more, then with their consent a trust can be revoked.
2. If the trust is specifically created by the settlor for payment of his/her debts to the creditors.
3. When a trust is created by a non-testamentary document or even verbally, then there can be power reserved to the settlor for revocation of the trust.

15.6.9 Trust structure for Tax efficiency

The structure of a trust decides how its income is going to be taxed. There are various exemptions available under the Income Tax Act, which helps in reducing the tax liability for the trust.

Public Trust

The taxation of the charitable trust is governed by Chapter III of the Income Tax Act, that includes Section 11, 12, 12A, 12AA, 12AB and 13. There are various exemptions given to Charitable and Religious Trust due to the services they render to the nation.

Private Trust

Private Trust plays a very important role in succession and estate planning for the families. There are special provisions under the Income Tax Act, which governs assessment and taxation of income of a private trust. These sections are 160,161,162, and 164 of the Income Tax Act, 1961. Income of a private trust are either taxed at the income tax slab rate or at maximum marginal tax rate, based on the structure of the trust.

Taxation of Revocable Trust

- In case where an income is transferred (whether revocable or not) to a person without transfer of the corresponding asset from which the income arises, the income so transferred would be taxable in the hands of the transferor only. (**Section 60**)
- Where an income arises as a result of revocable transfer of asset, such income is to be taxed in the hands of the transferor. **(Section 61)**

- However, provision of section 61 would not apply where the trust is not revocable during the lifetime of the beneficiary and where the transferor derives no direct or indirect benefit from such income. **(Section 62)**

Assessment of Business Income of Trust

Sec 161-1(A) deals with the business income of the trust. As per the provision, if any part of the income of a trust includes income from profit and gains of a business, then entire income of the trust including any profits or gains from business will be taxed at the maximum marginal rate with some exemptions available. However, there is an exemption provided to charge this income at income tax slab rate instead of maximum marginal rate if following conditions are met:

1. The profits and gains are receivable under a trust which is declared by any person by Will;
2. Such profits are exclusively for the benefit of any relative dependent on him for support and maintenance;[55] and
3. Such trust is the only trust so declared by the person through the Will.

Clubbing of Minor Income

Sec 64 deals with clubbing of income of a minor child with the parents. As per the provision, the income of a minor child (with some exceptions) is included in the parents or guardian's income and taxable as per their income tax slab rate. The same provision is applied in a private trust created for the minors.

Any income of a minor child suffering from disability specified under section 80U, shall not be clubbed with the parent or guardian income. By transferring some of the higher taxed assets to the minor trust the liability of his/her parent or guardian can be reduced.

Taxation of Discretionary Trust

Discretionary trust is chargeable to income tax at the maximum marginal rate (MMR), with some exemptions available.

Trust for Deity

A trust could also be made for the benefit of one's deity. The Supreme Court of India in CIT v. Sri Jagannath Jew [1977] 107 ITR 9 (SC) held that where the Testator gave away his estate to the deity and created an absolute debutter thereof and obligated the managers of the debutter with responsibility to discharge certain secular or secondary behests including benefit to family members, their residence and transportation, the Deity was the legal owner of the whole estate and was liable to be assessed as such.

[55] "Relative" as per Section 2(41) of Income Tax Act means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual.

Tax planning is a very important element for a family trust. To reduce the tax liability the structure of the trust and income to the beneficiary should be planned while drafting the trust deed.

15.6.10 Trust Structure to align strategic objectives of the Settlor

The settlor has a limited but fundamental role in creating a trust. A trust does not exist until the settlor expresses an intention for the trust to exist and transfers the settled sum to the trustee. If a settlor is not independent to the trust, serious tax consequences arise.

A settlor role is limited to creating the trust and setting the objectives. Once the settlor moves the property to the trust, he/she can absolve himself from any of the issues related to the property that he has transferred. For example, once the settlor has transferred an immovable property to the trust and has conveyed effectively the title of the property to the trust, then thereafter the trust will be responsible for all the benefits accrue from the possession of the property. The trust has to discharge responsibilities like paying taxes, distribution of income etc. as illustrated in the trust deed.

A settlor may have various objectives of creating a trust.

1. A settlor may set up a revocable trust in order to exercise control over the assets and distribution of income and capital gains from the trust.
2. A settlor may set up an irrevocable discretionary trust in order to safeguard the assets amongst the claim of the creditors of the stocks and/or the beneficiaries or multiple trusts to achieve various objectives.
3. Creating the legal framework for family assets.
4. Bypassing probate process.
5. Safeguarding interest of family members including maintenance of member with special needs/disabilities.
6. Continuation of a business avoiding family disputes.
7. Exploring offshore business opportunities.

15.6.11 Trust Perpetuities

The trust cannot be perpetual. The Indian law restricts the perpetuity period within which gifts in a trust must vest, or the period during which trust income can be accumulated. No transfer of property can operate to create an interest, which is to take effect after the lifetime of a person living at the date of such transfer, and the minority of some person who comes in existence at the expiration of that period, and to whom the interest created is to belong when he or she reaches 18 years of age.

However, the exception to this rule against perpetuity relates to transfers of property for the benefit of the public in advancement of religion, knowledge, commerce, health, safety or any other object beneficial to mankind.

Except for charitable bequests, a bequest in which the vesting of the property is to occur after the lifetime of one or more persons will not be valid. Further, subject to the exceptions prescribed under statute, the accumulation (either wholly or partly) of any income from property is not allowed for a period longer than the lifetime of the transferor or 18 years from the date of transfer (whichever is later). Similarly, if the Will directs that income arising from property can be accumulated (wholly or in part) during a period longer than 18 years from the death of the testator, this direction will (subject to exceptions) be void to the extent that the period during which the accumulation is directed exceeds this period, and at the end of the 18-year period, the property and the income will be disposed off.

15.6.12 Trust as a Pass-through entity

A pass-through entity is a medium through which any income or any transaction flows. The term "Pass Through" denotes the transparency in the end result of the transaction, the point of destination of the transaction being somewhere else and not getting obstructed in any manner by the conduct through which it flows. A trust structure completely fits into the definition of pass-through entity where the settlor and beneficiaries does not come under public glare.

Explanation of pass-through entity:

"A flow through entity (FTE) is a legal entity where income "flow through "to investors or owners, i.e., the income of the entity is treated as income of investors or owners. Flow through entities is also known as pass through entities".

A private trust does not have a separate legal identity, and is essentially a pass-through entity, which is created to transfer assets held by one person (Settlor) to another person (Trustee), who holds the assets in trust for the benefit of a specified set of individuals (Beneficiaries). Such type of trusts essentially helps in the consolidation of all key business and personal assets of the business families in a single vehicle.

In a private trust, the receipts by the trust/trustee on behalf of the beneficiary are not taxable. What is taxable is the income of the beneficiary. The liability to pay the tax is on the trustee but in a representative capacity. So under income tax provisions, the trust has been given the pass through status by the nature of tax liability.

15.6.13 Stamp Duty and Capital Gains Tax on asset transfer

Under Indian Stamp Act 1899 (Central Stamp Act), stamp duty is levied on the instrument of transfer. The power to levy stamp duty is divided between centre and state government. States have right to adopt the Central Stamp Act with or without modification.

The stamp duty on trust is dealt in Central Stamp Act (Schedule 1) and as illustrated below:

Article 58 deals with settlement under the trust structure. Under this article, stamp duty is levied on instrument of transfer i.e. the trust deed. Hence stamp duty is payable when the trust deed is registered. Since stamp duty is a state matter, the actual stamp duty is decided by the state Stamp Act. In general, the stamp duty is levied in the transfer deeds i.e. trust deed and so when there is distribution of assets to beneficiaries no stamp duty is applicable.

Whenever an immovable property is settled in the trust, the stamp duty is levied. However, this provision applies when the immovable property is transferred during the lifetime of the settlor through a registered document as per the Registration Act, 1908. Contrary to this, any settlement of property in the trust through Will does not attract stamp duty.

Stamp duty is one of the considerations while deciding when one should transfer the property to a trust. Transferring within the lifetime can lead to major cost if the value of the property is much higher than expected. But provision of the same property will ensure there is savings of the cost by the settlor. A settlor too enjoys no stamp duty while settling any property to the trust.

The other major consideration under transfer of asset is applicability of capital gains. In general course when there is a transfer of assets from one person to another person, it attracts capital gain tax liability. The trust being a pass-through entity enjoys the benefit of no capital gains in certain situations.

Sec 47 (iii) of the Income Tax Act exempts transferor from capital gain tax for any transfer of capital under an irrevocable trust. The same is not true when the trust is a revocable trust i.e. any transfer to the revocable trust is subject to capital gains tax. If the trust is testamentary, i.e. executed on death of the settlor, as part of the Will then the transfer is as per the Will and so is exempt from capital gains.

15.6.14 Offshore Trusts

Offshore trust has been an important estate planning tool for high net worth families. Exploiting offshore business opportunities, cross border movement of family members and acquisition of interest in other countries are some of the reasons where offshore trust-like structures are planned.

These are types of trusts that are formed outside India and under the laws of other countries. These have similar trust structures like others, with three or more participants viz the author, the trustees and the beneficiaries. Any of the three principal protagonists can be based out of different country.

India places no restrictions on offshore trust having non-resident as trustees or beneficiaries in the Indian trust. The residency of an offshore trust is determined by the trust law under which the trust comes into existence. However, this residency criterion is restricted to only the non-tax attributes of the trust.

In the case of revocable offshore trust, where the settlor has been granted powers to claim assets, any income derived by the trust is treated as settlor's income and so taxable in his

hands as if directly arisen to him. In case of irrevocable offshore trust, certain considerations have been given:

1. If all beneficiaries in the offshore trust are Indian residents then the trustee is taxed as a representative capacity.
2. If there are both resident and non-resident beneficiaries in an offshore trust then only the Indian beneficiary is taxed for the distribution they have received from an offshore trust and the trustee has no representative role in India.
3. If the offshore trust has any partial control in India then it can be taxed as association of persons.

Under the current laws, the Indian resident beneficiaries are required to report their interest in an offshore trust in the information return filed along with the income tax return.

15.6.15 Distributable Net Income

Distributable net income (DNI) of a trust is that portion of the income, which is allotted to the beneficiaries. The DNI identifies how much income has to be distributed between trust and the beneficiaries. This income receivable by beneficiaries then becomes the source of his/her income.

The distributable net income is considered as the income of the beneficiary and so the amount is taxed to the beneficiaries. A distribution is a payment made from a fund, an estate or income of trust, to a beneficiary. In India, there is no maximum cap on the income distributed to the beneficiaries. Therefore, the entire income, after deducting expenses, exemptions and fees, can be distributed to the beneficiaries.

Similar like individuals, a trust needs to file its income tax returns. The income generated by the trust are either taxed at entity level or at beneficiary level. The taxation depends on the structure of the trust – whether it's a determinate or discretionary.

One of the purposes of determining DNI is to avoid double taxation, especially in cases where it may be taxed at beneficiary level. The formula to calculate DNI is:

Distributable Net Income (DNI) = Taxable Income - Capital Gains + Tax Exemptions

If there is a capital loss, it is added to the above formula, replacing the capital gains.

In order to calculate the taxable income, one needs to add the interest income, dividends, and capital gains, and then subtract any fees and tax exemptions. Unlike the DNI calculation, capital gains are added in the taxable income formula, while capital losses are subtracted.

Example

Trust ABC reported a total income of Rs 1,00,000. A total of Rs 50,000 of this was interest income, while the remaining Rs 50,000 was from dividends. Fees charged by the trustees amounted to Rs 20,000, while the trust realized capital gains of Rs 20,000 and it got an exemption of Rs 20,000. Calculate the Distributable Net Income (DNI) of Trust ABC.

Using the above formula, the trust's taxable income is Rs 80,000 i.e.

Rs 50,000 (interest income) + Rs 50,000 (dividends) + Rs 20,000 (capital gains) –Rs 20,000 (fees) – Rs 20000 (Exemptions)

We can then use this taxable income figure to calculate the DNI, which would be Rs 80000

Rs 80,000 (taxable income) – Rs 20,000 (capital gains) + Rs 20000 (Exemption)

15.7 Guardianship

Guardianship is the legal process of establishing who will step-in should a person become unable to care for other person, he/she was earlier taking care for. This includes an elderly parent or other family member, or an adult who is unable to care for themselves. Once a legal guardian steps in, under whatever the circumstances are, he/she would assume all the responsibilities of care i.e. food, housing, education, medical and other basic needs.

A guardian's responsibilities will depend on whether they are a Guardian of the Person or a Guardian of the Estate.

- A Guardian of the Person is responsible for custody and care of the person.
- A Guardian of the Estate is responsible for managing the financial affairs.

A legal guardian has many responsibilities, but in general they fill the role of a caretaker for the person who are under guardianship in the event the existing caretaker can no longer do so himself. This could be the case after he/she passed, or in the event he/she becomes either mentally or physically incapacitated. Guardians have fiduciary duties to act on behalf of those they are put in charge of such as making decisions regarding healthcare, legal matters, financial issues etc, and they must agree to always act in their best interest.

Types of Legal Guardianship

There are three major kinds of legal guardianship:

- Natural Guardian – A natural guardianship is one where no legal provision is required, as it falls by birth. Parents are termed as the natural guardians of their child until the child reaches the age of legal maturity i.e. 18 years.
- Guardian appointed by Court – Individuals (with no parents alive), who are incapacitated by birth, accident or any other eventuality and unable to take responsible decisions, need a guardian. The courts have the power to appoint a guardian who can take decisions on the individual's behalf.

- Testamentary Guardian – When a guardian is appointed under the provisions of Will, it is termed as testamentary guardianship. This type of guardianship is mostly seen in case of minor children. The appointed guardian manages the child's affairs within the limits set in the Will.

The person applying for legal guardianship has to be a citizen of India of more than 18 years of age. In absence of parents or legal heirs, anyone concerned with the welfare of the special needs can apply for a legal guardianship.

A legal guardianship is primarily required to make financial and personal decisions on behalf of other individual. In case a person is more than 18 years of age and is incapacitated to take his/her own decisions, only a legal guardian is then allowed to make any financial decisions on his/her behalf. Some of the financial decisions that require legal guardian are:

1. Managing Bank Accounts- Opening a bank account, managing transactions in existing account etc.
2. Making any investments and managing the same. - Investments in financial securities such as mutual funds, shares, bonds, debentures etc.
3. Availing loans and/or concessions from governments for the disabled person.

15.8 Powers of Attorney

A Power of Attorney (POA) is an instrument by which a person may formally authorize another person to act on his behalf or as his agent on all matter or for a specific transaction or particular types of transactions. There are two parties to a POA – Donor and the Donee. Both the parties to the POA should have attained majority, be of sound mind and competent to contract.

A Power of Attorney is among the most important instrument used in Estate Planning. In India, it was widely used for transfer of properties through sale or succession of lease and other means. The power of attorney is also frequently used in the event of a principal's illness or disability, or when the principal can't be present to sign necessary legal documents for financial transactions. A power of attorney can be used by or on behalf of others.

Definition

A power of attorney is a legal document, which gives one person (the agent or the attorney-in-fact) the power to act for another person (Principal). To be applicable in the court of justice, the power or the authority has to be expressively or impliedly conferred to do that which without an authority it could have been done. The agent is also known as the Attorney and under Attorney-in-fact the person is given power of attorney specifically for an act or generally for series of acts to represent him in any business or act by virtue of that power of attorney.

Here are a few definitions of Power of Attorney, according to various sources:

Halsbury's Laws of England - A Power of Attorney is a formal instrument by which one person, the donor of the "power", confers on another, the donee, power to act on the behalf of the donor in the performance of specified act or classes of act or generally.

Osborn's Concise Law Dictionary, 7th Edition – A Power of Attorney means a formal instrument with which one person empowers another to represent him, or act in his stead, for certain purposes, usually in the form of a deed poll, and attested by two witnesses. The donor of the power is called principal or constituent; the donee is called attorney. The latter is not entitled to exercise such power for his/her benefits.

Section 1A of The Powers of Attorney Act, 1882 – Power of Attorney includes any instrument empowering a specified person to act for and in the name of the person executing it.

Section 2(21) of Indian Stamp Act, 1899 - Power of attorney includes any instrument (not chargeable with a fee under the law relating to court-fees for the time being in force) empowering a specified person to act for and in the name of the person executing it.

A power of attorney is usually in the form of deed, sometimes under a seal as necessary for certain purpose.

Parties to Power of Attorney

There are 2 parties to Power of Attorney:

1. Donor
2. Donee

In accordance with Section 183 of the Indian Contract Act 1872, any person, who is 18 years and above and is of sound mind can employ an agent. However, married women can execute Power of Attorney, even if they are minors.

As per Section184 of the Indian Contract Act, even a minor can be a donee. However, a lunatic person cannot be appointed as an Attorney, as he is not capable of exercising the Will of his principal.

15.8.1 Types of Power of Attorney

A power of attorney can be classified into three forms:

1. General Power of Attorney
2. Special Power of Attorney
3. Special Power of attorney for registration

General power of attorney

In this document, the authorization of power to the agent is broad. The agent entitled to act generally, or in more than one transaction.

Special power of attorney

Here the mandate authorization is narrow. The agent is restricted to act only for a specific/particular matter or transaction for the principal. The authority of the agent expires on the completion of the transaction.

Special power of attorney for Registration

A document of attorney, which authorizes the attorney to present a document for registration in case of a document executed by the principal but not registered by him is known as Special Power of Attorney for registration.

Important rules for construction of Power of Attorney are:

1. It should be construed.
2. The operative part of the deed is controlled by recitals.
3. The general words do not construe general powers but are limited to the purpose for which the authority is given.
4. The document should be construed so as to include all medium powers necessary for effective execution.
5. Where authority is to do particular act followed by general words, the general words are restricted to what is necessary for the performance of the particular acts.

15.8.2 Revocation of Power of Attorney

A principal has right to cancel power of attorney whenever he wants to do so. There are certain conditions laid down in Sec 201 of the Indian Contract Act, 1872 for revocation of power of attorney. These conditions are:

- When the principal revokes the authority to the agent.
- When either of the principal or the agent is declared insolvent by the competent court of authority.
- If the power of attorney holder renounces his powers.
- If the business for which power of attorney was granted gets completed.
- On the death of either principal/donor or agent/done.

Sec 202 of the Indian Contract Act states that if the agent, in a principal-agent relationship, has an interest in the agency then, the power of attorney cannot be revoked without the consent of the agent. Section 206 of the Indian Contract Act provides that a sufficient notice of any revocation or renunciation must be given to the principal or agent otherwise the damages, if any, result from such situations must be made good by them**.**

Person who can authenticate

Under section 85 of the Indian Evidence Act, the following persons are authorized to authenticate the power of attorney:

1. Notary Public
2. Any court, Judge or Magistrate
3. Indian Council or Vice-Consul
4. Representative of Central Government

Registration

A power of attorney does not require compulsory registration under section 17(1)b of the Registration Act. The rationale behind is that in POA, the donor by execution of the document only authorises the donee to act on his behalf. The POA itself does not create, declare, assign, limit or extinguish any right title or interest to or in immovable property. The execution of deed of power of attorney has been held valid in law and subject to provision of the act, is not compulsory registrable. A power of attorney is not compulsorily registrable unless it creates an interest in any immovable property i.e. charge in favour of donee.

Stamp Duty

Article 48 of the Indian Stamp Act specifies the stamp duty payable on documents. The power of attorney has to be stamped, either with engrossed stamp or by affixation or impressing a label on it by a proper officer. Stamp Duty being a state matter, the rate at which the stamp duty is payable is decided by the state where the POA has to be registered. Though the stamp duty is payable, the legal nature of POA is not defined by it but by the content.

15.8.3 Limits of Power of Attorney holder

There are limitations to the power the agent has in a POA.

1. The agent cannot make decision outside the terms of the legal document. In doing so he/she can be held liable for any fraud or negligence.
2. The agent cannot make changes in the document or hand over the control to someone else who has not been designated in the POA.
3. The agent loses the control once the principal dies.

Even though these limitations restrict the powers of the agent, there are a few situations where they may have unlimited controls. For example, when managing finances on behalf of principal, the agent can sell the properties for an undesirable price or can make poor investment decisions. The agent may not choose the medical facility or care which the principal would have preferred if the principal have fallen ill. Lastly, the agent can end the agreement at any time if s/he no longer wants the responsibility. This is the risk involved in POA and so the principal should decide whether to limit the POA to specific situations.

15.8.4 Power of Attorney executed abroad

Non-resident Indians (NRI), even by staying outside India can execute power of attorney for matters related to banking, property or any other matter which have to be done in India. They do not have to be present in India. POA can be made in favour of family member, relative or friend who resides in India permanently.

The power of attorney executed outside India has to be authenticated/ attested by the Indian Embassy, Consulate and notarized where it has been executed. Once the POA is authenticated, the person in whose favour POA has been executed has to be authenticated/ embossed before the concerned lawful authority by paying necessary charges.

The power of attorney executed before and authenticated by a foreign court, judge or magistrate will be considered as validly executed and authenticated. Power of attorney if executed out of India by a person will continue to operate even when the person returns to India at the time when the documents are presented for registration.

15.9 Caselets

Case 1: *Mr. PQR has died leaving behind a Will. He was a Hindu, unmarried and so did not have immediate family. He has 2 living brothers and sisters and 2 of his brothers and sisters are deceased. The deceased brothers and sisters have spouses and children. He has made a Will giving 1/5 share of his estate to one brother who is alive, and 1/5 share each to a nephew and niece of one his surviving sisters.*

Question 1: *Can any of his living brother /sister contest or spouse or children of deceased brother/sister contest the Will?*

- *Option 1: Brother*
- *Option 2 Sister*
- *Option 3 Spouse or children of deceased brother/sisters*
- *Option 4 All of the above*

Explanation:

On filing the **probate proceedings, the court will issue notices to all legal heirs for filing objections, if any. During this stage, the children and spouse of deceased brother/sister can also object to the grant of probate. If any of the legal heirs do not appear before the court then it will be presumed that such person has no objection to the grant of probate.**

There are specific grounds on which a Will can be challenged in the court of law. The court will see this and then will decide the acceptance of the objection. In general, a no objection can also be sought from the non-inheritors during the preparation of the Will.

During probate, also non-inheritors can give the no objection which will be more beneficial.

Question 2: *Who will be called when Mr. PQR's Will goes for a probate process?*

On filing the probate proceedings, the court will issue notices to all legal heirs for filing any objection if any. During this stage the children and spouse of deceased brothers can also be called for any objection to the grant of probate.

Case 2: Rajesh created a Trust for his parents who are senior citizens, both with equal beneficial interest. Father gets a fixed monthly pension of Rs. 40,000 while mother gets a net annual value of Rs. 3.80 lakh from her let-out property. The trust property has generated a net annual value of Rs. 5.40 lakh in FY 2024-25-.

Question: Find the tax payable (New Tax Regime) by the trustee as a representative assessee for AY 2025-2026 after taking into account cess @4%.

Options:

a) *58485*
b) *75000*
c) *24180*
d) *62343*

Solution:

Particulars	**Amount (Rs.)**
Net Annual Value of trust property in FY 2024-2025 to be shared equally by Rajesh's father and mother [A]	540,000
Income of Rajesh's Father	
Pension Income (Salary Income) [B = Rs. 40000 * 12]	480,000
Total Income [C = A/2 + B]	750,000
Standard deduction [D]	75,000
Assessable Taxable income [E = C – D]	675,000
Tax payable by Rajesh's Father (trustee) as a Representative Assessee	
So, trust income above pension of Rs. 4.8 lakh up to Rs. 6.75 lakh is to be taxed at 5% [F]	**9750**
Income of Rajesh's Mother	
Net Annual value of Rented Property [G]	380,000
Assessable Taxable income [H = A/2 + G]	650,000
Tax payable by Rajesh's Mother (trustee) as a Representative Assessee	

Particulars	Amount (Rs.)
So, trust income above Rs. 3.80 lakh up to Rs. 6.50 lakh is to be taxed at 5% [I]	**13,500**
Total Tax on Assessable Income of The Trust [J = F + I]	23,250
Cess @4% [K = 4% * J]	930
Total Tax payable by the trustee as representative assessee [L = J + K]	**24,180**

Module 10: Estate Planning I Module-end Questions

1. A house property is transferred to the daughter-in-law by father-in-law, and the same is let-out. The rent received is taxable in the hands of _____.
    a. Son
    b. Daughter-in-law
    c. Mother-in-law
    d. Father-in-law

2. What do you mean by "Dying Intestate"?
    a. A person is deemed to die intestate in respect of property of which he or she has not made a testamentary disposition capable of taking effect
    b. The descendant does not leave behind a Valid Will
    c. Both (a) and (b)
    d. None of the above

3. If the two persons are related by blood or adoption, wholly through females then what is said for one person to another:
    a. Cognate
    b. Agnate
    c. Urine Blood Relations
    d. None of the above

4. Who amongst the following is not a Class I heir according to the Hindu Succession Act?
    a. Father
    b. Mother
    c. Son of a Predeceased Daughter
    d. None of the above

5. Who can be the beneficiaries in life insurance bought under Married Woman Property act 1874?
    a. The wife alone
    b. The child/children alone (both natural and adopted)
    c. Wife and children together or any of them
    d. All of the above

6. Which is the most basic legal instrument of all estate plans?
    a. Will
    b. Power of Attorney
    c. Trust Deed
    d. None of the above
7. A person who prepares the Will is called a/an _____.

a. **Testator**
b. Deceased
c. Executor

8. A will can be revoked or altered by the testator any number of times. The instrument through which a Will can be altered is known as:
    a. Trust deed
    b. Probate
    c. **Codicil**
    d. Any one of the above

9. What is a Probate?
    a. **It's an Execution of Will under court order**
    b. It's a special type of trust
    c. It's a process of registration of Will
    d. None of the above

10. How many parties are required to form a trust?
    a. Two
    b. **Three**
    c. Four
    d. No Limits

MODULE 11: BEHAVIOURAL FINANCE

Chapter 16: Basics of Behavioural Finance
Chapter 17: Behavioural Finance in Practice

CHAPTER 16: BASICS OF BEHAVIOURAL FINANCE

LEARNING OBJECTIVES:

After reading this chapter the reader should know:

- Difference between Behavioural Finance versus Standard Finance
- How do individuals make decisions?
- Different types of biases
- Fusion Investing
- How Behavioural Finance explains Market Anomalies

16.1 Behavioural Finance versus Standard Finance

Behavioral Finance is the study of the way in which psychology influences the behavior of market participants, both at the individual and group level, and the subsequent effect on the financial markets. It is a part of Behavioural Economics, which deals with biases and cognitive errors affecting investors' investing behaviour. Behavioural Finance makes an attempt to explain the gaps and market anomalies, which are not explained by standard finance theories and frameworks.

Standard finance theories and models are based on certain assumptions. The key assumptions are:

- Investors are rational
- Investors are risk averse
- Investors are self-interested utility maximizers
- Investors update their belief, as new information comes in
- Investors have access to all available information

The real life behaviour demonstrated by investors is far from what is assumed in traditional finance models. Some of the examples we observe in daily life are:

- Instead of diversifying, investors hold concentrated portfolios.
- Instead of making a rationale choice of risk-return, investors show distinct greed and fear over the course of time.
- Instead of accepting randomness with winning investments, investor attribute it to their skills.
- Investors getting confused between a good company and a good stock.
- Investors preferring domestic companies (home bias) because they perceive the risk is low due to familiarity of the company.

In other words, the real life investors are very different from those in standard finance theory. Following table points out salient points about Standard and Behavioural Finance:

Standard Finance	Behavioural Finance
Economics at core.	Psychology at core.
Investors are rationale and process new information without any bias. Efficient market hypothesis describes random movement in prices.	Biases (decision making behaviour) guide investments. Every new information is seen with the same lens. Collective bias or herd mentality is responsible for sharp movements.
Decision making is rule driven and consistent under different scenarios.	Decision making is inconsistent given the experience, recency or loss aversion.
Risk-return trade-off is the foundation of investment.	Loss aversion is basis, which in turn makes an investor over-sensitive to losses.
Decision is rational based on detailed analysis.	Decision is ad-hoc based on thumb rules.

Nobel laureates Daniel Kahneman (2002) and Richard Thaler (2017) are credited for bringing the Behavioural Finance to the forefront and attempt to integrate it with Standard Finance.

16.2 How do individuals make decision?

As discussed above, the process of decision making, as envisaged under standard finance theories and the way investors make decision in reality, is different. Investors do not act like rational actors as suggested under standard finance theory. They show limits to rationality.

16.2.1 Bounded Rationality

Most investors have limited (i) time or (ii) information or (iii) ability to comprehend complex information at the time of decision making. Similarly, when selecting one of the many options requires meticulous analysis incorporating all the available information, people get confused. They settle with an option (possibly sub-optimal), which seems to be satisfactory and sufficient based on quick analysis governed by 'thumb rules'. In other words, instead of optimizing as suggested by theories in finance, investors "satisfice" (seemingly satisfactory and sufficient).

Bounded Rationality, therefore, is the cognitive limitation of mind where in absence of time or complete information, decision making favours satisficing solution (satisficing is combination of satisfactory and sufficient) instead of an optimal (or maximising) one. It is important to note here that bounded rationality is not irrational decision making, but rational decision making under certain boundary conditions.

Nobel laureate Herbert Simon (1978) is credited with the concept of Bounded Rationality. The steps involved in decision making according to Bounded Rationality are:

- Process only the information which is manageable (as against processing all information)
- Rule of thumb or quick approaches are applied while processing, and
- Select solution which is Satisfactory and Sufficient (Satisficing solution)

Bounded Rationality, therefore, falls between Rationality (decision making process where all available information is processed to arrive at the optimal solution) and intuition (experience).

16.2.2 Prospect Theory

Daniel Kahneman and Amos Tversky (1979) introduced Prospect Theory. It describes how individuals make choices in situations where they have to decide between alternatives that involve risk (e.g. financial decision) and how individuals evaluate potential losses and gains. Prospect theory considers how prospects are perceived based on their framing, how gains and losses are evaluated, and how uncertain outcomes are weighted.

There are two phases of making choices:

- an early phase in which prospects are framed
- a subsequent phase in which prospects are evaluated and chosen

The framing phase consists of using heuristics to do a preliminary analysis of the prospects. In the second phase, the edited prospects are evaluated and the prospect of highest perceived value is chosen.

To summarize, premises of Prospect Theory are:

- Choices are evaluated relative to a reference point (which is their well-being);
- People are risk-averse about gains (realizing it early) but risk seeking about losses (holding to them longer)
- Monetary losses hurt more than monetary gains

16.3 Categorization of Biases

Individuals as well as institutions process information based on their experiences and preferences, which in psychology are referred to as biases. Such intentional errors often lead to systematic favouring.

While people desire to follow rational decision making which involves evaluating all the options with all the information available, individual biases hold them from doing so. Rational decisions often get circumstantial. While it is impossible to be unbiased, maintaining discipline and checklists can help in mitigating them.

Broadly, investing biases fall into two main categories:

- Emotional biases – based on feeling or emotions
- Cognitive errors – based on faulty cognitive reasoning

16.3.1 Emotional Bias

At the time of decision making, individual's feelings or emotions occur spontaneously which is a result of deep-rooted personal experiences. It is important to note that emotional bias does not mean making errors. On the contrary, it has an underlying of being protective and taking suitable and comfortable decision for oneself.

Following are some of the emotional biases:

Loss Aversion Bias: People prefer taking chances for avoiding losses. However, they do not like taking chances with certain gains. Losses are significantly more powerful than gains. Shefrin and Statman (1985) proposed Disposition Effect for holding "losers" too long and selling "winners" too early. They noted that "people dislike incurring losses much more than they enjoy making gains, and people are willing to gamble in the domain of losses." Consequently, "investors will hold onto stocks that have lost value and will be eager to sell stocks that have risen in value."

Stereo Typing Bias: Investors, while dealing with uncertainties, look for representative characteristics and base their decisions on the general perception about those characteristics. For example, belief that a high-profile manager is equals to a better managed company and that makes good investments, is a stereo type bias.

Overconfidence Bias: Overconfidence Bias is a bias in which people demonstrate unwarranted larger faith in their own intuitive reasoning, judgments and cognitive abilities. Most people rate themselves better than average in their skills, expertise, knowledge etc. With illusion of superior knowledge, overconfidence bias is intensified when combined with self-attribution bias, where people confuse brain with bull market. Overconfidence often results in underestimating the losses. This unwarranted confidence often leads to sub-optimal decisions in investments. Overconfidence leads to misguided conviction and often blurs the difference between skill and luck. Even the feedback loop in such cases further fuels the overconfidence bias and investor easily gets swayed away from risk-return trade off principles. Some of the observed behaviour of overconfidence biases is visible in portfolio concentration, sector or country bias, excessive trading, sticking with loss making stocks in sectors which investor believes to know more etc.

Endowment Bias: Endowment Bias is an emotional bias in which people value an asset more when they hold rights to it than when they do not. When the investor believes that the stock(s) she owns is more valuable than others and when the market will recognise, she would make superior returns. Endowment bias has two attributes: valuing ownership and loss aversion. It has been generally observed that inherited stocks are rarely sold even if they do not fit into the overall investment strategy.

Status Quo Bias: When an individual has second thoughts or want to avoid regrets in decision making, often left with taking no decision at all and maintaining status quo. Status Quo Bias is closely linked to Regret Aversion bias in which people tend to avoid making decisions that will result in-action out of fear that the decision will turn out poorly.

Regrets have two dimensions –

- actions that people take (Error of commission)
- actions that people could have taken (Error of omission)

Regret is more intense due to error of commission than omissions and hence people prefer the status quo. Sometimes complexity in understanding or execution also leads to status quo. A simple nudge, as explained by Richard Thaler, resulted into employees enrolling for pension plans, which otherwise had poor enrolment only due to status quo bias.

16.3.2 Cognitive Errors

Cognitive errors are statistical, information-processing or memory errors that cause a person to deviate from rational behaviour. Cognitive errors result from reasoning based on faulty thinking whereas emotional biases result from reasoning influenced by feelings. Depending on thumb rules instead of doing exact calculations, is an example of cognitive bias. People are less likely to make cognitive errors if they remain vigilant. Unlike emotional bias, cognitive biases can be considered as short-cut approach to decision making where one avoids going through the pains of analysing and evaluating options. Also at times, it can be factually incorrect.

Mental Accounting: Mental Accounting Bias is an information processing bias in which people treat one sum of money differently from another equal-sized sum, based on which mental account the money is kept. The concept of 'mental accounting' was developed by Richard Thaler in 1999.[56] People code, categorize and evaluate economic outcomes by grouping their assets into any number of non-fungible mental accounts.[57] When people keep mental accounts, they treat money less fungible than it really is, which often leads to sub optimal decisions. People link their spending to specific budgets. They are willing to take more risk with money that is perceived as windfall gain or lottery winnings. People end up spending their non-regular income extravagantly. This treatment of salary income differently from tax refunds and bonus amount etc., leads to irrational spending.
Thaler recommended that people should consider money as fungible and treat all money the same, regardless of its origin or use.

[56]According to the theory of mental accounting, people treat money differently, depending on factors such as the money's origin and intended use, rather than thinking of it in terms of the "bottom line" as in formal accounting (Thaler, 1999).
[57] Fungibility is the fact that all money is interchangeable and has no labels.

Investors think about their wealth as if it consists of various buckets e.g. retirement fund, children's education fund and marriage fund etc. It mentally helps them to keep a tab on it. This often results into selection of assets under each bucket, which could have been avoided by the investor on a broader level if they consider their overall investments together and work towards optimizing portfolio.

Framing: Framing Bias is an information-processing bias in which a person answers a question differently based on the way in which it is asked (framed). An investor's choices are influenced by how information or facts are presented. Different types of framing approaches have been identified, including risky choice framing (e.g. the risk of losing 10 out of 100 lives vs. the opportunity to save 90 out of 100 lives), attribute framing (e.g. beef that is 95% lean vs. 5% fat). As can be seen, the outcomes of both the choices in both the scenarios is the same, however people mostly opted for second options in both the scenarios.

Prospect theory describes how individuals make decision when they have to decide between choices that involve risk (e.g., financial decisions) and how individuals evaluate potential losses and gains. Prospect theory considers how prospects (alternatives) are perceived based on their framing, how gains and losses are evaluated, and how uncertain outcomes are weighted.

Investors have to rise above of this bias while filling risk tolerance questionnaire for the purpose of determining the risk appetite as that would influence the asset allocation choices greatly. Also at the time of evaluating the performance of the portfolio, decision making frames may lead to sub-optimal judgments.

Anchoring: Anchoring bias occurs when people rely on pre-existing information when they make decisions. Most of the investors anchor their investments around some initial information, which they so heavily rely upon. This makes all the subsequent information to be seen in light of the anchor information. For example, during negotiations, it is often observed that the first price mentioned becomes anchor price during the entire negotiations. Making a judgement about where the prices of the stock could be on the basis of its past performance, is another example of anchoring.

Choice paralysis: The availability of too many options for investment can lead to a situation of not wanting to evaluate and make the decision. Too much of information also leads to a similar outcome on taking action.

16.4 Fusion Investing

Fusion investing, integrate traditional and behavioural paradigms to create investment strategies. It attempts to combine fundamental analysis with behavioural finance. On one hand, fundamental style of investing suggests that stock price is the discounted value of future cash flows and. all company related information is fully reflected in the stock price.

On the other hand, we observe volatile stock prices in short-term, which show that short-term price is influenced by collective behaviour of investors or traders.

In the words of Benjamin Graham, the father of value investing style, "in the short run the market is a voting machine, and in the long run it is a weighing machine" tells the stark combination of biases. Fusion investing can be seen as integration of both the voting and the weighing machines. Fusion investing, therefore, combines value-growth phenomenon from fundamental investing and the momentum effect from behavioural finance.

Portfolio manager ought to understand that inefficiencies exist in market and Fusion Strategy is an attempt to exploit this inefficiency. Broad steps involved in identifying stocks, which comprise both value-growth and momentum are:

- **Step I:** Identify stocks (from the universe of stocks) which are showing promising on value terms i.e. Price Earnings (P/E), Price to Book Value (P/BV), Price to Sales (P/S).
- **Step II:** Filter from step I, stocks which are fundamentally strong i.e. profitability, leverage and efficiency parameters (e.g. Piotroski Score) on historical as well as based on earnings forecast. [58]
- **Step III:** From the stocks, which are filtered after step II, identify stocks, which are showing strong momentum i.e. price uptrend.

These stocks, which are left after step III shall qualify to be part of the portfolio. While, intuitively it seems to be a good strategy, market data is insufficient to conclusively prove the same. Moreover, momentum, which is captured through step III, is short-term phenomenon and would require rebalancing at a much shorter periodicity as compared to the value-growth parameters. This means transaction cost will play a critical role in determining overall return on the portfolio. Taxation policy also needs to be considered in such a rebalancing process.

16.5 Behavioural Finance explains Market Anomalies

Market anomaly, in simple terms, is departure of stock price from its expected value given its fundamentals. A market anomaly may be present if a change in the price of an asset or security cannot be explained by the current relevant information known in the market or to the release of new information into the market. Empirical research show that the actual returns deviate from the expected return as required by Capital Asset Pricing Model (CAPM) or other asset pricing models. These gaps are referred to as anomalies. Anomalies

58 The Piotroski Score is a discrete score between 0-9 that reflects nine criteria used to determine the strength of a firm's financial position. The Piotroski score is used to determine the best value stocks, with nine being the best and zero being the worst. The Piotroski score was named after Chicago Accounting Professor Joseph Piotroski, who devised the scale, according to specific aspects of company financial statements.

appear, disappear and reappear quite randomly. It is expected that such anomalies disappear as others would try to profitably exploit them. While some anomalies do disappear, there are others, which persist for much longer period.

Behavioural biases may cause investors to make systematic mistakes when they invest, and those mistakes create anomalies in the market. Biases like overconfidence make investors underestimate risks. Under self-attribution bias, Investors tend to take credit for successes and blame others for failures. They follow information that supports their beliefs and disregard conflicting information. These biases may cause investors to trade too often. Disposition effect where investors hold on to losers longer and sell winners faster explain momentum in prices.

16.6 Behavioural Finance explains Bubbles and Crashes

Charles Kindleberger in his book 'Manias, Panics and Crashes (1978)' describes **Bubbles** as a sharp rise in asset price in a continuous process with the initial rise generating expectations of further rises and attracting new buyers, generally speculators, interested in profit from trading rather than investing for long term. In his view, psychology is as important as finance and economics explaining such behaviour in the financial market.

When an asset is mispriced, rational arbitrageurs would exploit it to their advantage and soon such mispricing will disappear. However, arbitrageurs suffer from synchronisation problem (in order to attain a coordinated selling strategy) besides difference in individual incentives to time the market during bubble and crash phases. This leads to persistence of bubbles for a longer period.

Some of the notable examples of bubbles and crashes are: Dutch Tulip mania of 1630s, South Sea Bubble of 1729-30s and Tech bubble of 2000s. Kindleberger noted that even Isaac Newton tried to ride the South Sea Bubble in 1720. He got out of the market at GBP 7,000 after making a profit of GBP 3,500, but decided to re-enter it, thereby losing GBP 20,000 at the end. Frustrated with his experience, he concluded, "I can calculate the motions of heavenly bodies, but not the madness of people".

Historically, bubbles have often emerged during structural change in productivity e.g. Railway Boom, Electricity Boom, Technology Boom etc. Bubbles typically begin with a justifiable rise in asset price (due to new product, new idea, disruption etc.) given rise in productivity or prosperity. Such productivity or prosperity changes expectations about future. Early investors, in such themes, make very high returns, which start attracting new investors. Cheap borrowing costs fuel bubbles as more new buyers chase the asset. Bubble phase takes share prices to unrealistic levels and analysts come out with 'new age' theories to justify such prices. Some of the potential reasons for such bubbles are:

Liquidity: Liquidity chasing stocks lift stock prices. Cheaper borrowing and investing further fuels. Those who are sellers, invest in other assets, which create a vicious cycle of price rise. And each round raises price to next level.

Celebrity status: Celebrity status is self-fulfilling. Media promotes celebrity and its cult. Likewise, media promoted tech-boom. This resulted into disconnect between value and price (or say, earnings capability and value).

Momentum: Research suggests that investors extrapolate uptrend (or downtrend) with their positive (or negative) feedback on asset price. If this extrapolative expectation is widespread, it results in herd trading. Herd trading overcomes rational interventions (by rational investors who take contrary position knowing that asset is mispriced and needs to get corrected).

Illusion of Control: Familiarity, access to information, active involvement etc. give rise to the illusion of control over the stock price. This leads to believing that investor can forecast prices and will be able to sell before others, hence avoid losses.

Keith Redhead (2008) writes in the report that speculative bubbles are more likely to emerge where:

- Proportion of inexperienced traders is high;
- Uncertainty about true value is high;
- Investment promises small chance of profit but the amount of profit is very high;
- It is possible to finance purchases by borrowing money;
- Short selling is difficult (difficult to borrow shares for the purpose of selling them).

Crashes entail similar processes like bubbles, but in reverse order and everyone comes to sell at the same time. Negative news, change in opinion, liquidity crunch, return to fundamental pricing models etc. makes every investor or trader to liquidate their position before anyone else. Such jostling among investors/traders to get rid of stock leads to crashes.

CHAPTER 17: BEHAVIOURAL FINANCE IN PRACTICE

LEARNING OBJECTIVES:
After reading this chapter the reader should know:

- Role of emotions in goal setting
- Nudging the investor to behave better
- Role of investment adviser in management of client emotions

17.1 Role of emotions in goal setting

People react differently to stress and strain of modern life. Some people over-eat, some people over-exercise or oversleep and some people go on a shopping spree when they are emotionally charged.

This behaviour initially provides a good feeling leading to relief from stress and allowing the person to escape the immediate pressure. In moderation, such behaviour is good to take the sting out of the emotional stress. However, normally such behaviour will rarely stay moderate and will invariably lead to more stress in the future, as the economic impact of the behaviour kicks in.

An Adviser's role lies in understanding these impulses and providing ways to make sure that such behaviours are self-limiting.

- **Retail therapy - stress buster or escape mechanism?**

Retail therapy is referred to as a situation where a person goes on a shopping or buying binge in order to reduce the stress. This situation can be tackled by undertaking some specific steps. The first step would be to make the client conscious about the fact that this behaviour is induced by stress.

The second step is to have a specific budget for indulging in such behaviour. In extreme cases, a separate account may be opened by the client, where the budgeted amount is kept and money is spent only from there (either through debit card or withdrawing cash). The important thing is to have a self-imposed brake on the behaviour which comes from an in-built expense limit. This is one reason why using credit card is not a good thing for most people as credit cards induce impulsive spending.

- **Too many and too frequent transactions**

"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or grass grow. If you want excitement, take USD800 and go to Las Vegas... It is not

easy to get rich in Las Vegas, at Churchill Downs, or at the local Merrill Lynch office." said Economic Nobel Laureate Paul Samuelson. Humans have an action bias or the need to do something whereas investing requires long term consistency and long years of patience. The action bias combined with other biases induces clients to have too frequent and too many transactions, which has the impact of turning an investment activity into a trading activity.

The only way to induce the client to curb such a tendency is to prime them in advance with the benefits of patience and long term investing.

- **Chasing past performance**

Some investors simply invest in last year's winners – whether it be asset classes or specific security within an asset class. When Gold goes up they invest in Gold and when equity markets rise they shift their investments to Equities. This behaviour, based on the performance in the immediate past, assumes that what did well last year will do so this year as well. Most asset classes have a cycle of growth and decline and there is an inevitable reversal to the mean. Investing based on past performance is like driving a car by looking in the rear view mirror. It is bound to crash at some point or the other.

A pre-decided asset allocation policy that has upper limits for each asset class makes sure that overexposure to a specific asset class is avoided. Similarly, a maximum exposure limit within a given asset class will do so for a specific security as well.

- **Home country bias**

Most investors prefer to invest in the securities available in their home countries due to familiarity with the markets, the companies involved as well as the regulatory environment. The benefits of diversification which come from investing into asset classes which do not move in tandem with the local securities is thus denied to them.

Apart from lack of familiarity and comfort, there are many other reasons for investors not investing in overseas securities or asset classes:

a) Lack of knowledge on opportunities outside their home country
b) Home country laws may prevent domestic investors from investing outside India
c) Lack of access and high cost of access where available
d) Compliances with the tax and other laws of the other country, which at times may be in conflict with the local laws
e) Lack of expert advice on such asset classes as the advisers themselves are not well versed with such asset classes

In the context of India, the Liberalised Remittance Scheme (LRS), wherein a resident of India can remit upto USD 250 thousand for investments outside India, has spurred the interests

of Indian investors in foreign securities. Local mutual funds have also come out with many schemes that allow investors to conveniently invest in Indian mutual fund schemes that in turn invest in overseas securities across the globe. Global indexes such as S&P 500 and Nasdaq 100 are also available as Indian mutual fund schemes now.

The antidote for Home country Bias is for the advisor to get educated on the benefits and opportunities in global investing and, in turn, educate their clients about the same.

- **Buying insurance for tax saving**

At least 3 generations of Indians have grown up on a diet of buying insurance for tax saving alone. As a result, they end up buying the wrong kind of insurance and/or completely inadequate insurance.

The module on Insurance Planning makes it clear that appropriate and adequate insurance is the first step of any good financial plan. Tax saving through the insurance premium just reduces the cost of a good insurance plan. In an investment cum insurance product, it enhances the return from the plan, which in turn be compared with an equivalent tax saving investment. For example, the ultimate return from investing the same sum of money into buying a term policy plus investing in Public Provident Fund will invariably beat the ultimate return from buying an endowment life insurance product for the same amount of investment.

The only cure for this bias to buy insurance purely for the sake of tax saving is to highlight the need for adequate pure insurance products and the poor returns from investment cum insurance products as compared to equivalent investments combined with pure insurance plans.

- **Too much diversification or highly concentrated portfolio**

Many investors have so many securities in their portfolio that they find it impossible to manage their investments. Diversification does not come from buying many securities. It can come simply by buying an index representing that asset class. For example, if the investor buys 2 large cap funds, 4 mid-cap funds and 6 small cap funds for diversifying his risk, he can achieve similar diversification by simply buying a top 500 shares index fund.

Conversely, some investors will have their entire investment portfolio in a couple of specific securities or investment without adequate diversification across asset classes or securities within a specific asset class.

The Adviser has a vital role to play in finding the golden mean for an appropriately diversified investment portfolio for their clients, based on the clients' risk profile, available resources and time frame for goals.

- **The impact of framing on risk tolerance questions**

Different investors react differently to specific triggers. A specific client would prefer knowing what can be gained by following a specific investment pattern, whereas another client would like to know what is lost by not following it. In both cases, the Investment Adviser is justifying the recommended investment pattern but the framing is very important if the client has to be convinced. There are specific tools available that report on what kind of framing a client prefers. That diagnosis is to be reconfirmed through discussions with the client.

- **Overconfidence and dilution in risk management**

Human beings are prone to overestimate their talents and abilities. A simple example is surveying employees in a work place as to which percentile of relative performance they put themselves in. Most employees will put themselves anywhere around 60-75 percentile, with a rare individual claiming to be below the 50 percentile. The aggregate of these employee perceptions is an arithmetical impossibility. Thus, the truth is individuals consider themselves as better than they really are.

In the arena of investments, this manifests itself in terms of attributing skill to their bets that have come off which can lead to overconfidence on the part of the client. For example, the client made a small bet on an individual stock that became a 5X in 3 months' time. This may only partly be due to skill and mostly be luck. In any case, even if it is skill, it is doubtful if it is consistently repeatable.

Based on overconfidence arising from the bet that materialised, the client may be tempted to over-invest in an asset class or security and modify the existing asset allocation. In times like these, the Investment Adviser's influence can stand between the client and her big mistake.

17.2 Nudging the investor to behave better

Laying down advance ground rules that the client buys into allows the Investment Adviser to have built in nudges for the client to follow. For example, having ground rules on when to do asset re-balancing become an inbuilt nudge for profit booking when the asset prices go high and buying into an asset class when its prices are low.

17.3 Role of Investment Adviser in management of client emotions

The Investment Adviser plays a very important role in the management of client emotions. Most clients will go through a cycle of greed and fear. Over exuberance can goad the client

into taking rash decisions or overarching fear can freeze the client. In both circumstances, the Investment Adviser plays a vital role in making sure that the client continues on the journey that has been planned in advance. The cool and calming influence of the Investment Adviser is a must as the client wrestles with the emotional upsurge caused by the market cycles.

Another area where the Investment Adviser plays an important role in managing client emotions is in prioritizing client goals where resources are not sufficient for meeting all goals. For example, assume a client has requirement for funding her daughter's higher education and her retirement. The client is emotional about making sure her daughter gets the best possible education even if it means compromising with her retirement, which may be some distance away, and hence is not that important for her immediately.

The Investment Adviser can point out the extent of compromise that is being done for a vital goal like retirement and also point out alternatives like partial education loan for the higher education which can then be paid by the daughter from her earnings after completion of the education course. This kind of objective role played by the Investment Adviser is crucial in assisting the clients to take the right decisions even as they are highly emotional.

Module 11: Behavioural Finance I Module-end Questions

1. Anchoring bias occurs when people rely on _____.
    a. pre-existing information when they make decisions
    b. collect all available information when they make decisions
    c. do not make use of any information when they make decisions
    d. make forecast about the future prospects

2. According to _____, people treat money differently, depending on factors such as the money's origin and intended use.
    a. Capital market theory
    b. Modern portfolio theory
    c. Prospect theory
    d. Mental accounting theory

3. The following is the premise of Prospect Theory:
    a. Choices are evaluated relative to a reference point (which is their well-being);
    b. People are risk-averse about gains (realizing it early) but risk seeking about losses (holding to them longer)
    c. Monetary losses hurt more than monetary gains
    d. All of the above

4. Daniel Kahneman and Amos Tversky (1979) introduced the _____.
    a. Capital market theory
    b. Modern portfolio theory
    c. Prospect theory
    d. Mental accounting theory

5. Behavioural finance differs from the standard model of finance because Behavioural finance:
    a. Precludes the impact of investor psychology.
    b. Includes the impact of investor psychology.
    c. Accepts the Efficient Markets Hypothesis.
    d. Rejects the idea of market anomalies.

MODULE 12: COMPREHENSIVE INVESTMENT ADVICE

Chapter 18: Risk Profiling for Investors
Chapter 19: Comparison of products across categories
Chapter 20: Case Studies

CHAPTER 18: RISK PROFILING FOR INVESTORS

LEARNING OBJECTIVES:
After reading this chapter, the reader should know:

- Risk profiling for investors
- Risk profiling approach
- Parameters for risk profiling
- Role of risk profiling in asset allocation

18.1 Risk Profiling for Investors and Risk Profiling Approach

A simple example to understand how different people have different appetite for taking risk:

A person is offered a chance to play a game in which a coin will be tossed. The person pays Rs. 1,00,000 for one chance to play the game. The person can choose to call "heads" or "tails". If the coin comes on the person's choice he wins Rs. 2,10,000

As per statistical analysis of the above game,

If he guesses right – he stands to win Rs. 1,10,000 – (Prize amount of Rs. 2,10,000 less original stake of Rs. 1,00,000) – at 50% probability the expected win amount is Rs. 55,000

If he guesses wrong – he stands to lose the original stake amount of Rs.1,00,000 – at 50% probability the expected loss amount is Rs. 50,000

The total expected win amount is Rs. 5,000 (Rs. 55,000 expected win less Rs. 50,000 expected loss)

Though few people agree to play the game, most other people do not agree to play the game, simply because of the fear of losing Rs. 1,00,000 if they do not select the right choice. More people agree to play the game as the winning amount is increased to say Rs. 2,50,000 or Rs. 3,00,000 indicating that the net payoff amount needs to be much higher for some.

This indicates the innate willingness of a person to take a risk in order to get a payoff. Willingness to take risk has more to do with the individual's psychology than with their financial circumstances. Some clients will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues.

Whether the actual risk is taken or not is also affected by both, the resources that a person has (more the available resources, more are the chances that the risk will be taken) and the

need to take the risk (more important the payoff is for the person, higher are the chances that the risk will actually be taken).

Some of the factors and their influence on risk appetite are given in Table 18.1.

Table 18.1Factors affecting risk appetite

Factor	Influence on Risk Appetite (assuming all other factors remaining the same)
Family Information	
Earning Members	Risk appetite increases as the number of earning member increases.
Dependent Members	Risk appetite decreases as the number of dependent member increases.
Life Expectancy	Risk appetite is higher when life expectancy is longer.
Personal Information	
Age	Lower the age, higher the risk that can be taken.
Employability	Well qualified and multi-skilled professionals can afford to take more risk.
Nature of Job	Those with steady jobs are better positioned to take risk.
Knowledge about markets	A person who is better informed about markets is in a better position to take market risks, than someone who is ignorant about them.
Psyche	Daring and adventurous people are better positioned mentally, to accept the downsides that come with risk.
Financial Information	
Capital base	Higher the capital base, better the ability to financially take the downsides that come with risk.
Regularity of Income	People earning regular income can take more risk than those with unpredictable income streams.

Clients' financial risk tolerance - attitudes, values, motivations, preferences and experiences, is measured with a risk profile. The risk profile questionnaire helps in understanding the risk tolerance levels of a client. Risk tolerance is the assumed level of

risk that a client is willing to accept. Risk tolerance is typically measured using questionnaires that estimate the ability and willingness to take risks. The responses of investors are converted into a score that may classify them under categories that characterize their risk preferences.

18.2 Parameters for Risk Profiling

Some risk profiling tools are available on websites. These typically revolve around investors answering a few questions, based on which the risk appetite score gets generated.

Some of these risk profile surveys suffer from the investor trying to "guess" the right answer, when in fact there is no right answer. Risk profiling is a tool that can help the investor; it loses meaning if the investor is not truthful in his answers.

Some advanced risk profilers are built on the responses to different scenarios that are presented before the investor. Service providers can assess risk profile based on actual transaction record of their regular clients.

While such tools are useful pointers, it is important to understand the robustness of such tools before using them in the practical world. Some of the tools featured on websites have their limitations. The investment advisor needs to use them judiciously.

Consider the following 3 grade classification:

I. Conservative Investors

- Do not like to take risk with their investments, typically new to risky instruments.
- Prefer to keep their money in bank accounts or invest in safe income yielding instruments.
- May be willing to invest a small portion in risky assets if it is likely to be better for the longer term.

II. Moderate Investors

- May have some experience of investment, including investing in risky assets such as equities.
- Understand that they have to take investment risks in order to meet their long-term goals.
- Are likely to be willing to take risk with a part of their available assets.

III. Aggressive Investors

- Are experienced investors, who have used a range of investment products in the past, and who may take an active approach to managing their investments.
- Willing to take on investment risk and understand that this is crucial to generating long term return.
- Willing to take risk with a significant portion of their assets.

SEBI (Investment Advisers) Regulation 16 requires that the Investment Adviser (IA) has to ensure that client's risk profiling is done so as to ensure that the advice or recommended

investment product is suitable for the client. For this purpose, the Investment Adviser is required to ensure that:

- It obtains relevant information such as age; investment objectives and time frames over which such objectives need to be achieved; resources available like income, existing investments, innate ability to take risks and details of loans.
- It has a process to assess a client's innate willingness and ability to take risks including the client's ability to incur and absorb losses. Such process needs to be objective and not geared towards giving undue weightage to certain factors and less weightage to other factors.
- Tools or questionnaires, if used for risk profiling, are fit for the purpose and any limitations of such tools are identified and mitigated to the extent possible.
- Any questionnaires used need to be fair, clear and not misleading; and should not be vague or use difficult/complex language; and should not contain leading questions.
- Risk profile of the client needs to be done before any investment advice is provided No Free trial can be offered without communicating such risk profile to the client and obtaining clients consent on such risk profile.
- Client information on which the risk profiling is based and the clients risk profile needs to be updated periodically. Whilst the periodicity can vary, a risk profile review is recommended on special events, such as change in family composition, change in income/expenses or change in assets/liabilities.

18.3 Role of Risk Profiling in Asset Allocation

18.3.1 Investor's risk profile with the asset allocation

'Don't put all your eggs in one basket' is an old proverb. It equally applies to investments. The discussions earlier in this workbook highlighted how the risk and return in various asset classes (equity, debt, gold, real estate and others) are driven by different factors. This implies that return from asset classes at any point in time will not be the same in direction or magnitude but will vary depending upon the impact of the prevalent economic conditions on their performance. For example, during the recessionary situation in 2007-09, equity markets in many countries fared poorly, but gold prices went up. Thus, an investor who had invested in both gold and equity earned better returns than an investor who invested in only equities. The distribution of an investor's portfolio between different asset classes is called asset allocation. An efficient asset allocation is one that includes asset classes that have low or negative correlation so that the returns from the investments do not rise and fall together. Being invested in multiple asset classes, allows the portfolio to benefit from the higher returns of the asset class that finds the prevalent economic conditions favourable to their performance, and reduce the risk of being invested only in an asset class that has performed poorly.

Some international researches suggest that asset allocation and investment policy can better explain portfolio performance, as compared to selection of securities within an asset class (stock selection).

Three types of asset allocations are often referred to viz. Strategic, Tactical and Dynamic Asset Allocation.

Strategic Asset Allocation is allocation aligned to the financial goals of the individual. It considers the returns required from the portfolio to achieve the goals, given the time horizon available for the corpus to be created and the risk profile of the individual.

Profiling the investor with regard to their ability to take risks, need for growth, income or capital protection, and investment horizon is done using questionnaires and other tools to determine the optimal allocation between growth-oriented and income-oriented assets.

Strategic asset allocation is a long term plan that is reviewed periodically for continued relevance to the individual's goals or situation. A change in these fundamentals may alone trigger a change in the allocation. The allocation to an asset class will not be increased on the basis of expected performance of the asset class. This implies that while the portfolio is protected from errors in asset performance forecast, at the same time the portfolio will not benefit from a higher exposure to an asset class that is performing well. The portfolio will be rebalanced periodically so that the allocations to various asset classes that may have changed over time due to their performance, is brought back to what was originally envisaged.

Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market. An investor who decides to go overweight on equities i.e. take higher exposure to equities, because of expectations of buoyancy in industry and share markets, is taking a tactical asset allocation call.

Tactical asset allocation is suitable only for seasoned investors operating with large investible surpluses. Even such investors might like to set a limit to the size of the portfolio on which they would take frequent tactical asset allocation calls. The major portion of the portfolio would be aligned to a strategic asset allocation.

Dynamic Asset Allocation uses pre-defined models to allocate assets among different asset classes. Triggers for re-allocation may be defined in terms of asset class valuations or portfolio performance. Dynamic asset allocation removes the subjective element from asset allocation decisions.

18.3.2 Model Portfolios and their application[59]

Since investors' requirements from their investments vary, a single portfolio cannot be suggested for all. Investment advisers often work with model portfolios – the asset allocation mix that is most appropriate for different investment objectives, return expectations, risk appetite levels and liquidity needs. The list of model portfolios, for example, might read something like this:

- **Young call centre / BPO employee with no dependents (with high risk profile):** 50% equities/ diversified equity schemes (preferably through SIP); 20% sector

[59] The asset allocations given here are for education purpose. Please take professional advice on the allocation that is most suitable to you or that is most suitable for clients while giving advice.

funds; 10% gold ETF, 10% diversified debt fund / fixed deposits, 10% short-term debt funds and liquid schemes / savings bank account / current account.

- **Young married single income family with two school going kids (with moderate risk profile):** 35% equities/ diversified equity schemes; 10% sector funds; 15% gold ETF, 30% diversified debt fund / fixed deposits, 10% liquid schemes and short-term debt funds / savings bank account / current account.
- **Single income family with grown up children who are yet to settle down (with conservative risk profile):** 35% equities/ diversified equity schemes; 15% gold ETF, 10% gilt fund, 20% diversified debt fund / fixed deposits, 20% short-term debt funds, liquid schemes / savings bank account / current account.
- **Couple in their seventies, with no immediate family support (with conservative to moderate risk profile):** 15% diversified equity index scheme; 5% gold ETF, 35% debt oriented hybrid fund/MIS/SCSS, 30% diversified debt fund / fixed deposits, 15% liquid schemes / savings bank account / current account.

As the reader would appreciate, these percentages are illustrative and highly subjective. The critical point is that the Investment Adviser should have a model portfolio for every distinct client profile. This can then be tweaked around based on specific investor information.

Thus, a couple in their seventies, with no immediate family support but very sound physically and mentally, and a large investible corpus might be advised the following portfolio, as compared with the previous model portfolio:

10% equities/ diversified equity scheme; 15% diversified equity index scheme; 10% gold ETF, 30% debt-oriented hybrid fund, 25% diversified debt fund/ fixed deposits, 10% liquid schemes/ savings bank account/ current account.

- **Portfolio Construction**

The risk tolerance level of the investor is considered while constructing an investment portfolio.

An individual creates a portfolio of investments to meet their various goals. The investments selected have to balance the required return with an appropriate level of risk. Assets and investments differ on their features of risk, return, liquidity and others.

An investor will have multiple, differing requirements from their portfolio depending upon the goals they are saving for. They may need growth for long-term goals, liquidity for immediate needs and regular pay-outs to meet recurring expenses. No one investment can meet all the requirements for growth, liquidity, regular income, capital protection and adequate return. The investor will have to create a portfolio of securities that has exposure to different assets, which will cater to these diverse needs.

Investment objectives and their suitable investments

- Growth and appreciation in value: Equity shares and equity funds, Real estate, Gold

- Regular income: Deposits, Debt instruments and debt funds, Real estate
- Liquidity: Cash, Bank deposits, Short-term mutual fund schemes
- Capital preservation: Cash, bank deposits, Ultra-short term funds

Consider the impact of the following investment decisions:

- Jayesh invests only in real estate. He has an urgent need for funds but finds that he is not able sell the real estate or take a loan quickly enough.
- Kamal leaves all his money in his savings bank account, which earns a very low interest. He finds that he is not able to accumulate enough money required to meet his future expenses.
- Latika invests all her money in equities. She finds that the value of her investment keeps fluctuating and she is not sure if she will have the required funds when she needs it.
- Harmeet has most of her money in gold jewellery. She finds that she is not able to generate any income from her investments to meet her regular monthly expenses.
- Gayatri has invested her money in bank fixed deposits. She is not able to manage her expenses from the interest she receives because the interest is fixed but her expenses keep on increasing.

The risk to the investors in the cases described above comes from the concentration of their portfolio in one category of investment. When equity markets go down, Latika will find that her entire investment portfolio has gone down in value. If the real estate markets crash, Jayesh's investment value will decline, as will Harmeet's investments when the price of gold falls. Instead, if they were holding some portion of the portfolio in different assets, a fall in one will be cushioned by a rise in another, since not all asset values rise or fall together. This process of dividing the portfolio among different asset classes so that the overall portfolio's return is protected from the effect of a fall in one or few assets is called asset allocation. Each asset comes with its own focus feature, such as growth, income generation or liquidity, and together the assets in the portfolio will cater to the different needs of the investor.

The asset allocation that is suitable for a person will depend upon their specific situation. For example, a person close to retirement will have a higher allocation to safer investments such as debt and lower allocation to equity. On the other hand, an individual in the high income period whose goals are far away will prefer to earn higher returns with assets such as equity rather than lower risk assets with lower returns. The suitable asset allocation is a function of the investment period available to the investor and their ability and willingness to take risk. Asset allocation leads to different asset categories being included in a portfolio. This brings diversification to the portfolio. Diversification means having a combination of investments in a portfolio in such a way that a fall in the value on one or few will be made up by other investments that are doing well. The benefit of diversification will be available to a portfolio only if the selection of investments is done with care so that they do not rise and fall together. Asset allocation and diversification reduces the risk of loss in a portfolio and stabilizes the returns that the portfolio generates.

- **Review and Rebalancing**

The investments made for the goals will require to be reviewed periodically. The review is necessary to answer the following questions:

- Are all the goals still relevant?
- Are the goals on target for achievement in the required time-frame?
- Are the investments performing as expected?
- Do the investments need to be changed if it is no longer suitable for the goal?

A periodic review will help identify problem areas and enable early corrective actions. For example, if an investment has not generated returns as expected, the goal may remain under-funded. The investor can take the call to save more for the goal or to divert funds from some other less important goal, if required. These decisions can be made at the right time only when a review throws up the problem.

Rebalancing the portfolio involves modifying the exposure to different asset classes in an investor's portfolio. Ideally, a portfolio should be rebalanced so that it is aligned to the risk and return requirements of the investor and reflects any change in their needs and situation, and not to benefit from short-term movements in asset prices. For example, Jayant has been saving for the education of his children for the last 8 years by investing in equity. The goal has to be met after 4 years now. Jayant would not want to leave the funds that have been accumulated in equity any more since there is a risk that the fluctuation in equity values will affect the amount that he has accumulated so far. Jayant would be ready to move the funds to less riskier investments at this stage.

Review of the portfolio of investments has to be done at pre-fixed intervals (ideally at least once a year) as part of the financial planning process.

CHAPTER 19: COMPARISON OF PRODUCTS ACROSS CATEGORIES

LEARNING OBJECTIVES:

After reading this chapter, the reader should know:

- Sources of performance data
- Portfolio performance and investment alternatives
- Alternatives among other products

19.1 Performance data for investment products

Performance data for various investment products is now widely available. In some cases, it is mandated by SEBI such as for Mutual Funds and Portfolio Management Services. There are many information aggregators who collect this mandatorily disclosed data and provide value added services for comparison across various schemes. This information is easily available on various websites. In many cases, it is free though some value added services may be on paid basis.

19.2 Attribute portfolio performance and Evaluation of investment alternatives

All investment instruments are compared across 3 broad parameters: Risk, Return and Liquidity. Given below are comparisons of some investment instruments.

19.2.1 Equity Linked Savings Scheme (ELSS) V/s Other Tax Saving Instruments

Sr. No.	Parameter	Equity Linked Savings Scheme (ELSS)	National Pension System (NPS) - Tier 1	Fixed Income Tax Saving Instruments (e.g.: PPF and Tax saving bank FD)
1	Description	Equity Linked Saving Scheme invests exclusively in Equities.	Mutual Fund like pension scheme, that allows varying degree of investments in equity (max 75% for selected subscribers), Government securities, Corporate bonds and Alternative Investments (max 5% for certain subscribers).	Public Provident Fund (PPF) is a government scheme and tax saving Bank Fixed Deposits (FD) are offered by all banks.
2	Risk of loss of Invested Capital	High, as the entire investment is in equities.	Moderate, as it does allow a high percentage of investment in equity and some investment in Alternative Investments.	PPF – Low, as it is a sovereign risk Tax saving Bank FD – moderately low, as it is like any other bank FD

Sr. No.	Parameter	Equity Linked Savings Scheme (ELSS)	National Pension System (NPS) - Tier 1	Fixed Income Tax Saving Instruments (e.g.: PPF and Tax saving bank FD)
			But it can be made low if so desired by choosing higher proportion of Government securities.	and the risk of loss is only if there are payment issues at the bank.
3	Returns	No guaranteed returns. Can be moderately high to high, depending on period of holding. The returns are market linked. Capital Gains taxed at 12.50%.	No guaranteed returns. Can be moderate to moderately high, depending on how much equity /Alternative Investment have been chosen/allowed. The returns are market linked. 60% of the corpus can be withdrawn tax free, after reaching the age of 60 years. The balance 40% has to be used to buy annuity product(s) from an Insurance company. The annuity(ies) received from the Insurance company is fully taxable.	PPF - Guaranteed returns with varying rate of returns dependent on G-sec rate. Returns can fluctuate for every quarter. Nil tax on the returns. Moderate post tax return. Maximum Rs. 1,50,000 contribution allowed each year. Tax saving Bank FD – Returns are fixed for the entire duration. Returns are taxable each year. Moderately low post tax returns.
4.	Liquidity	3 years lock in. Post that can be withdrawn at any time.	Lock in till the age of 60 years. However, partial withdrawals are allowed, subject to conditions. Premature withdrawal requires using 80% of the withdrawal amount for purchasing annuity from an Insurance Company.	PPF – lock in for 15 years from inception of the account. Partial withdrawal possible after 5 years. Tax Savings Bank FD – lock in for the entire tenure of the deposit.

19.2.2 Equity Mutual Funds V/s Portfolio Management Services V/s Alternative Investment Funds Category 3

Sr No	Parameter	Equity Mutual Funds	Portfolio Management Services	Alternative Investment Funds (AIF) Category 3
1	Nature of Investments	Pooled investment vehicle, where investments are in a	Investment in the individual investors' demat account.	Pooled investment vehicle that undertakes diverse or complex

Sr No	Parameter	Equity Mutual Funds	Portfolio Management Services	Alternative Investment Funds (AIF) Category 3
		pooled account with units allocated to each investor.		trading strategies including investment in listed or unlisted derivatives.
2	Risk	Common investment for all investors in a scheme.	Can be customized to meet the needs of an individual investor.	Complex strategies but common across all investors in a scheme.
3	Minimum Investments	Can be as low as Rs. 1,000/- in a scheme	Minimum investment size is Rs. 50 lakhs	Minimum investment size is Rs. 1 crore
4	Maximum percentage of scheme investment in a specific company/ group/ sector	Regulated by SEBI to ensure some amount of broad basing of investment.	Not regulated by SEBI. Can be and normally is a concentrated portfolio.	Regulated by SEBI to avoid portfolio concentration in a single investee company.
5	Fees payable by Investor	Maximum fee payable is regulated by SEBI and varies depending on the size of the fund.	Upfront charges not allowed. Operating expenses are capped at 0.50%. Fees can be as agreed between the investor and the PMS manager. It may be a fixed amount or a performance-based fee or a combination of both.	Not regulated by SEBI. Fees are charged as per the agreement between the AIF and its investors.
6	For whom it is meant	Retail Investor	High Net worth Investor	High Net worth Investor, looking for complex or leveraged investment strategies.
7	Redemption and costs of redemption	Redemption can be at any time in open-ended mutual funds, though an exit load can be levied based on a pre-declared rule.	The fund manager may have charges for redeeming the investments or for handing over the charge of the investments back to the investor.	Close-ended AIFs have lock in period and have poor liquidity.

19.2.3 Mutual Funds V/s Unit Linked Insurance Plans (ULIP)

Sr No	Parameter	Mutual Funds	Unit Linked Insurance Plan
1	Nature	Pooled investment scheme managed by Asset Management Companies.	Pooled investment scheme managed by Life Insurance Companies.
2	Purpose	Investments only	Insurance cum Investments
3	Charges	Maximum charges are regulated by SEBI.	Maximum charges are regulated by IRDAI. Insurance (mortality) and other charges are deducted from fund value making post expense return calculation difficult
4	Returns	Dependent on market	Dependent on market
5	Tax status on withdrawals	Taxable as per the tax laws (see details in Chapter 10 and Chapter 11 under Module 9)	Withdrawals/maturity is tax free, if sum assured is at least 10 times of annual premium. However, the Finance Act, 2021 has amended section 10(10D) of the Income Tax Act where no exemptions are allowed to any ULIP issued on or after February 1, 2021, if the amount of premium payable for any of the previous year during the term of the policy exceeds Rs. 2.5 lakh. For those who pay annual premiums below that, this would remain exempt.
6	Disclosure	Transparent daily/ periodic disclosures. Many independent media track disclosures and provide value added comparison services.	Lower disclosure standards and less availability of value added comparison services from independent media.
7	Liquidity	Open-ended mutual funds can be redeemed at any time but may be subject to exit load.	Compulsory contribution required for 5 years (except single premium plans). No redemption for at least 5 years. Discontinuation charges apply, if premiums cease before 5 years.

Sr No	Parameter	Mutual Funds	Unit Linked Insurance Plan
8	Suitable for	Any investor looking for investment options.	See section 2.3 of Chapter 2 under Module 7.

19.2.4 Actively managed Equity Mutual Funds V/s Index Funds

Sr No	Parameter	Actively Managed Mutual Funds	Index Funds
1	Nature & Purpose	The fund manager seeks to generate additional return (alpha) over the chosen benchmark by actively choosing securities from among the investment universe.	Replicate the returns from the chosen benchmark by investing in the securities in the benchmark in the same proportion.
2	Cost	Higher as the fund manager is actively involved in the decision-making.	Lower cost
3	Return	Attempt to get higher returns, net of the higher management cost.	Attempt is to track as closely as possible the benchmark return.

19.2.5 Direct Equity V/s Equity Funds

Sr No	Parameter	Direct Equity	Equity Funds
1	Nature	Investing in specific equity stocks.	Investing in specific equity fund scheme.
2	Level of attention/ expertise needed	Requires personal expertise or services of a PMS firm or a Registered Investment Advisor.	One can invest in mutual fund schemes of the type of desired investment, including index fund for that type of investment.
3	Risk	Concentrated risk on the invested security.	Risk is spread over many securities. There is diversification of risk.

19.2.6 Exchange Traded Funds (ETFs) V/s Index Funds

Sr No	Parameter	Exchange Traded Index Funds	Index Funds
1	Nature	These are index funds that are traded on the exchange like any other securities	These are available for buy/sell from the concerned Asset Management Company (AMC)

Sr No	Parameter	Exchange Traded Index Funds	Index Funds
2	Price	Is available on a minute to minute basis like any other security	Is the NAV that is available on end of day basis
3	Costs	Management costs are comparatively low. But there can be brokerage and demat and other charges involved in both buy and sell as well as the difference between the buy and sell quotes on the exchange. There are differences between the buying and selling price which adds to the cost when buying and reduces the final sale value.	Management costs may be nominally higher than exchange traded Index funds. But there are normally no other costs
4	Liquidity	Depends on the market and in fact, except for a couple of ETFs, liquidity is very poor on the Indian stock exchanges. There is a big difference between the NAV of the underlying securities and the quoted prices. Also, there is a relatively large difference between buy-sell quotes.	Available from the AMC on end of day basis

19.2.7 Physical Gold V/s Gold Funds V/s Gold ETFs V/s Sovereign Gold bonds

Sr No	Parameter	Physical Gold	Gold Funds	Gold ETF	Sovereign Gold Bonds
1	Buy as per prevailing price at the moment	Possible	NAV at the end of the day	Possible	Every issue is priced based on price prevailing on last 3 days
2	GST cost is incurred	Yes	Yes, as physical gold is bought by the fund and GST cost is incurred on purchase and added to the cost. However, it	Yes, as physical gold is bought by the fund and GST cost is incurred on purchase and added to the cost. However, it is	No

Sr No	Parameter	Physical Gold	Gold Funds	Gold ETF	Sovereign Gold Bonds
			is accounted as an asset and not loaded as cost.	accounted as an asset and not loaded as cost.	
3	Purity concerns	Very much there, though some of it has been removed due to hallmarking	Purity is ensured by the fund house	Purity is ensured by the fund house	No purity concerns as no physical gold is bought
4	Safety and storage costs	Yes	Yes, in-built into the Fund management charges	Yes, in-built into the Fund management charges	No such costs
5	Can it be exchanged with physical gold	Not applicable	Yes, at a nominal cost	Yes, at a nominal cost	Not available
6	Any Income	No	No	No	2.50% p.a. interest payable semi-annually
7	Taxability on sale	Taxable as capital gains	Taxable as capital gains	Taxable as capital gains	No tax if redeemed with RBI. Taxable as capital gains if sold in the market before maturity. Interest is taxable as per IT Act.
8	Liquidity	Can be sold in the market	Redeemed by the fund house at end of day NAV	Sellable on the exchange. Liquidity is decent, though all costs apply (brokerage, buy-sell differences etc.).	Redeemable on its anniversary dates after 5 years. Last redemption after 8 years. Can be sold in the stock market in the interim but liquidity is moderate.

19.2.8 Real Estate V/s REITs V/s INVITs

Sr No	Parameter	Real Estate	REITs	InvITs
1	Exposure	Large concentrated exposure to one or a couple of properties. Only large lump sum exposure is possible.	Like a real estate mutual fund, the exposure is spread over many properties. Involves professional expertise. Lower minimum exposure possible.	Like a mutual fund it invests in infrastructure projects. The exposure is again spread over many projects to reduce risk on one specific project. Like REITs, it makes possible lower minimum exposure.
2	Type of exposure	Depends on the type of asset chosen by the Investor but many times includes under construction properties where the risk is very high.	Primarily in real estate commercial properties that provide rental income apart from possibility of capital appreciation.	Primarily in infrastructure projects like roads, bridges, etc.
3	Management of properties	Needs to be managed by the Investor	Managed by the Investment manager	Managed by the Investment manager
4	Liquidity	Being lumpy investments, it is poor and time consuming.	REITs maybe listed on the stock exchange and have relatively better liquidity.	Invits may be listed on the stock exchange and have relatively better liquidity.

19.2.9 Debt Instruments V/s Debt Funds V/s Fixed Maturity Plan V/s Bank Fixed Deposit

Sr No	Parameter	Debt Instruments	Open-ended Debt Fund	Fixed Maturity Plan	Bank Fixed Deposit
1	Safety	Depends on the instrument chosen.	Depends on the type of assets in which the scheme can invest. But definitely diversification across many instruments provides relatively higher safety for the same level of rated instruments.	Depends on the type of assets in which the scheme can invest. But definitely diversification across many instruments provides relatively higher safety for the same level of rated instruments.	Safety is pretty high.
2	Post tax Returns	In proportion to risk taken.	Post tax returns can be better by investing in growth schemes and withdrawing needed amounts. This ensures that the withdrawal has a large element of capital.	Pre-defined, if held till maturity.	Pre-defined
3	Liquidity	Pre-redemption liquidity for debt instruments in India tends to be poor, where available, a large cost needs to be paid in the form of much lower price.	Redemption facility is available from the fund house though there can be exit loads in some cases.	Though listed on the stock exchanges, effectively there is very poor liquidity for FMPs.	Instant liquidity available from the bank though there can be clawback of interest paid and/or pre-mature redemption penalty.

19.2.10 Index Futures V/s Index Options V/s Index Funds

Sr No	Parameter	Index Futures	Index Options	Index Funds
1	Time Horizon	From a few days to a max of 3 months.	From a few days to a max of 3 months. However, long dated options are also available.	This can be for a very long tenure or for life time also, as it is an actual investment.
2	Cost	Basically, interest cost for the delayed purchase.	Apart from the interest cost for the delayed purchase there is a risk premium to be paid as implementing the option is at the discretion of the option buyer.	Actual market cost at the time of purchase plus management cost paid to the AMC regularly.
3	Risk	Same as buying an index fund.	Max risk for the option buyer Is equivalent to the option premium paid.	The risk of buying the securities underlying the fund.

19.2.11 Gold Futures V/s Gold Options V/s Gold ETFs

Sr No	Particulars	Gold Futures	Gold Options	Gold ETFs	Gold fund
1	Time Horizon	12 months	As per the contract launch calendar.	This can be for a very long tenure or for life time also, as it is an actual investment.	This can be for a very long tenure or for lifetime also, as it is an actual investment.
2	Cost	Basically, interest cost for the delayed purchase.	Apart from the interest cost for the delayed purchase there is a risk premium to be paid as implementing the option is at the discretion of the option buyer.	Actual market cost at the time of purchase plus holding cost paid in the form of management charges to the AMC.	Actual market cost at the time of purchase plus holding cost paid in the form of management charges to the AMC.

Sr No	Particulars	Gold Futures	Gold Options	Gold ETFs	Gold fund
3	Risk	Same as buying an index fund.	Max risk for the option buyer Is equivalent to the option premium paid.	The risk of buying the gold and fluctuations in its price underlying the fund.	The risk of buying the gold and fluctuations in its price underlying the fund.

19.2.12 Company Deposits V/s Debentures (if both are offered by the same company)

Sr No	Parameter	Company Deposits	Company Debentures
1	Risk	Company deposits are unsecured so even if from the same company the risk level is relatively higher.	Debentures will normally be secured so even if from the same company the risk level is relatively lower.
2	Return	Tends to be slightly higher than debentures from the same company for the same period.	Tends to be slightly lower than company deposits from the same company for the same period.
3	Liquidity	Redemption facility provided by the company though no interest can be paid if redeemed within a year.	Depends on the market where liquidity is always an issue.

19.3 Other Comparatives

19.3.1 Market linked V/s Non-market-linked Retirement accumulation Products

Sr No	Parameter	Market linked retirement accumulation products (NPS, ELSS, other mutual fund schemes)	Non-market-linked retirement accumulation products (PPF, etc.)
1	Risk	Will depend on the option chosen, but is linked to market returns. For example, risk for G-Sec option chosen under NPS is Low but under ELSS – which invests in equity exclusively is high.	Is low as far as return of principal portion is concerned.

Sr No	Parameter	Market linked retirement accumulation products (NPS, ELSS, other mutual fund schemes)	Non-market-linked retirement accumulation products (PPF, etc.)
2	Returns	Are linked to market and will vary upon the chosen option.	Tends to be moderate to low, given the low principal risk. Also, increasingly there are no long term fixed return products with even EPF declaring returns every year, PPF declaring returns every quarter etc.
3	Liquidity	By definition, tax advantaged retirement products tend to have lock in periods to ensure that the resources are actually available for the purpose for which they are meant – namely retirement.	Liquidity tends to be even poorer in these principal guaranteed products for the same reason as market-linked products.

We further look into a few comparative analyses of insurance products that are of importance to the investors.

19.3.2 Personal Accident Insurance V/s Life Insurance

Sr No	Parameter	Personal Accident Insurance	Life Insurance
1	Covers death due to:	Accident only.	Any cause including accident.
2	Disability coverage	Temporary or Permanent total or partial disability arising due to accident.	Does not cover disability.
3	Suitability	As additional cover, over and above the required life insurance cover, especially for permanent total disability arising from accident.	Is essential for income earners on whom other people are dependent.

CHAPTER 20: CASE STUDIES

LEARNING OBJECTIVES:

After reading this chapter, the reader should know:

- Practical aspects of providing financial advice through case studies
- Comprehensive financial planning solutions for the household

The cases in comprehensive financial advice will address different topics covered in the Workbook. Examinees are advised to make themselves comfortable with the kind of MS Excel working illustrated in the cases that follow.

20.1 Case 1

Mr. Z, aged 52 years, is working in a leading company. His net savings are Rs. 50,000 p.m. Based on salary growth and other factors, he expects this to rise by 20% p.a. till his retirement at age 60. This does not include monthly contributions of Rs. 9,000 (Rs.4000 own contribution; Rs.5000 employer contribution) to various funds towards retirement corpus. These are expected to grow by 20% p.a. till retirement. The retirement corpus by the end of the year will be Rs. 12 lakhs, entirely in debt, which will yield 8 % p.a. on average. Besides his own residential house and the retirement corpus, his savings and investments will amount to Rs.50 lakhs by the end of the year, 30% of which will be in equity. He has a practice of investing, at the end of each year, his disposable savings into debt and equity in the ratio of 80:20. In the long run, he expects equity to yield 15% and debt to yield 8.5%. At the end of age 55, he expects an outflow of funds amounting to Rs. 5 lakhs, which he hopes to meet out of annual savings.

He expects inflation of 10% and post-retirement investment return on his portfolio at 11%. His current expenses are Rs. 40,000 per month.

Assume zero date as the end of age 52. Calculations are to be done on annual basis. Ignore taxation and interest income on savings and contributions during the year.

1) On retirement, how much will Mr. Z have in his retirement corpus?

a. Rs. 46,65,905
b. Rs. 50,65,910
c. Rs. 44,81,442
d. Rs. 48,65,914

2) At the end of Age 55, what percentage of Mr. Z's portfolio will be in debt (excluding retirement corpus)?

a. 69.49%
b. 68.29%

c. 66.99%
d. 71.79%

3) If he re-invests the entire retirement corpus in debt, what percentage of Mr. Z's portfolio will be in debt when he retires?

a. 72.76%
b. 70.51%
c. 74.21%
d. 76.29%

4) What is the corpus requirement to ensure that he is able to sustain the same standard of living for 15 years after retirement?

a. Rs. 14,496,632
b. Rs. 13,861,919
c. Rs. 15,239,389
d. Rs. 15,254,894

<u>Calculations are shown in the following table</u>:

1. Total Retirement Corpus Calculation

Years to Retirement	**8**	**7**	**6**	**5**	**4**	**3**	**2**	**1**	**0**
Age of Mr. Z	52	53	54	55	56	57	58	59	60
Yearly Retirement Contribution@		129600	155520	186624	223949	268739	322486	386984	464380
Corpus (at age 52)	1200000								
Rate p.a.	8%								
Future Value (at age 60)*	2221116	222112	246791	274212	304680	338533	376148	417942	464380
Total Corpus at Retirement (Summation of all future values)									**4865914**

@[Rs. 9000 p.m. with Growth @ 20% p.a.]
*[=FV(8%,Year to Retirement,,-Contribution towards retirement corpus)]

2. Calculation

Age of Mr. Z	52	53	54	55	56	57	58	59	60
Net Savings		720000	864000	1036800	1244160	1492992	1791590	2149908	2579890
Outflow (at age 55)				-500000					
Net Savings available to invest		720000	864000	536800	1244160	1492992	1791590	2149908	2579890
Equity Investment	20%	144000	172800	107360	248832	298598	358318	429982	515978
Debt Investment	80%	576000	691200	429440	995328	1194394	1433272	1719927	2063912

Debt Portfolio

Age of Mr. Z	52	53	54	55	56	57	58	59	60
Opening Balance		3500000	4373500	5436448	6327986	7861192	9723787	11983581	14722113
Interest	8.50%	297500	371748	462098	537879	668201	826522	1018604	1251380
Additions		576000	691200	429440	995328	1194394	1433272	1719927	2063912
Closing Balance		4373500	5436448	6327986	7861192	9723787	11983581	14722113	18037404

Equity Portfolio

Age of Mr. Z	52	53	54	55	56	57	58	59	60
Opening Balance		1500000	1869000	2322150	2777833	3443339	4258439	5255523	6473833
Interest	15%	225000	280350	348323	416675	516501	638766	788328	971075
Additions		144000	172800	107360	248832	298598	358318	429982	515978
Closing Balance		1869000	2322150	2777833	3443339	4258439	5255523	6473833	7960886

Debt and Equity Allocation

Age of Mr. Z	52	53	54	55	56	57	58	59	60
% Allocation to Debt		70.06	70.07	**69.49**	69.54	69.54	69.51	69.46	69.38
% Allocation to Equity		29.94	29.93	**30.51**	30.46	30.46	30.49	30.54	30.62

3. Calculation

Particulars	Amount (Rs.)
Total Corpus at Retirement (A)	4865914
Total Debt Portfolio at Retirement (B)	18037404
Total Equity Portfolio at Retirement (C)	7960886
% allocation to Debt [(A+B)/(A+B+C)]*100	**74.21**

4. Calculation

Particulars	Amount (Rs.)	Calculation
Living expenses (at the age of 52)	480000	Expenses @ Rs.40,000 per month
Year to retire (at the age of 60)	8	60-52 = 8
Inflation (given)	10%	
Living expense (at retirement)	1028922.629	=FV(10%,8,,-480000)
No. of years in retirement	15	
Expected return on investment (given)	11%	
Inflation adjusted return	0.91%	=((1+11%)/(1+10%))-1
Retirement corpus required	**14496632.11**	=PV(0.91%,15,-1028922.63,,1) 1 denotes payment at the beginning of the period

20.2 Case 2

Mr. Y, aged 40, has the following goals ahead of him. (1) Son's post-graduate education: Due in Year 5. Current cost Rs.15,00,000 p.a. to be incurred at the end of each year for 2 years. Likely Inflation 15% p.a. (2) Daughter's marriage: Scheduled in end of Year 7. Current cost Rs.1,00,00,000. Inflation is assumed to be at 10% p.a. Mr. Y has provided a corpus of Rs.2,00,00,000 towards these two needs. The corpus is invested in a mix of debt and equity yielding 8% p.a. Ignore taxation.

1) How much money will need to be set apart from the corpus at the end of Year 5, to finance the son's post-graduate education? Assume the amount set apart will earn 6% interest.

a. Rs. 59,34,184
b. Rs. 62,90,235
c. Rs. 64,12,209
d. Rs. 60,35,259

2) What is the likely outflow on account of daughter's marriage in the year it is planned?

a. Rs. 1,94,87,171
b. Rs. 1,77,15,610
c. Rs. 2,14,35,888
d. Rs. 2,05,10,865

3) How much will be left in the corpus after both goals are fulfilled (assume that he does not set apart money in the 6% corpus mentioned in Q1)?

a. Rs. 81,24,932
b. Rs. 69,65,820
c. Rs. 75,23,085
d. Rs. 66,42,292

4) How would you describe the investment policy Mr. Y is using for the corpus?

a. A little conservative
b. A little aggressive
c. Very aggressive
d. Very conservative

<u>Calculations as shown in the following tables</u>:

Goal 1: Fund the son's two-year post-graduation education due in 5 years

Current cost of medical education for son	1500000 per annum	
Period after which has to be met	Years 5 and 6	
Expected inflation	15%	

Future Cost of Education

For year 1 (After 5 years)	3017035.781	**FV(15%,5,,-1500000)**
For year 2 (After 6 years)	3469591.148	**FV(15%,6,,-1500000)**

Funding the Goal

Funds required after 5 years to meet the cost of education of year 1.....**(a)**	3017035.78	
Funds required after 5 years to meet the cost of education of year 2.....**(b)**	3273199.20	**PV(6%,1,,-3469591)**
		(Rs.3273199 invested for one year @ 6% grows to the amount required for year 2, Rs.3469591)
Total amount of money required in year 5 to fund the cost of education for year 1, year 2...**(a)+(b)**	**6290235**	

Goal 2: Fund the daughter's marriage at the end of 7 years

Current cost of marriage	Rs.100,00,000	
Number of years after which the expense has to be met	7 years	
Expected inflation	10%	
Future Cost of the Goal	**19487171**	**FV(10%,7,,-10000000)**

Balance in corpus after funding goals

	Age------->	41	42	43	44	45	46	47
Opening Balance		20000000	21600000	23328000	25194240	27209779.2	26369525.8	25009496.67
Returns	8%	1600000	1728000	1866240	2015539.2	2176782.34	2109562.06	2000759.733
Outflow						-3017036	-3469591.15	-19487171
Closing Balance		21600000	23328000	25194240	27209779.2	26369525.8	25009496.7	**7523085.4**

20.3 Case 3

Mr. and Mrs. Gupta are both Indian Citizens (both 45 years old) who were working with multinational companies in the United States of America for the last 20 years. They have given up their jobs and have returned to India to pursue their own venture in India funded by a Venture Fund based in the Silicon Valley.

They had a house in the USA which they have given out on rent. They have substantial investments in their retirement investment accounts that are made on a tax deferred basis, meaning that investments were made from pre-tax income and the contribution and the income accrued on it is taxed at the time of withdrawal. Both have taken substantial life insurance policies, on their own, in the USA which will payout the sum insured of USD 1 million each if any of them dies in the next 15 years. Their employer paid for a health Insurance policy in the USA that continues to be valid till the end of the year but will cease thereafter unless they choose to renew it on their own.

They have certain questions regarding their re-location and seek your opinion:

1) **After they become resident in India as per Indian tax laws they will have to pay tax in India on their rental Income from the US property. Is this statement TRUE?**

   a) **Yes, they will have to pay tax in India on the rental income from the US property but will get credit for the tax paid in USA.**
   b) No, they will not have to pay any tax in India on the rental income from the US property.
   c) Yes, they will have to pay tax in India on the rental income from the US property without getting any credit for the tax paid in the US on such rental income.

2) **The income accrued on the deferred tax retirement account will be taxed only in the year when such money is withdrawn. Which of the following statements is TRUE?**

   a) **If the deferred tax retirement account is notified under section 89A of the Income Tax Act then tax in India will also be paid in the year of withdrawal and credit will be available for the tax paid in the US.**
   b) No tax is payable in India on the income accrued on the deferred tax retirement account in the US.
   c) Tax is payable in India in the year in which the Income accrues on the deferred tax retirement account and credit will be given for the tax payable in the US on such Income in the same year.

3) Both of them will need to buy Life Insurance policies in India for covering the risk of death. Which of the following is TRUE?

a) They will need to buy fresh life Insurance policies in India as, after becoming persons resident in India, they will not be allowed to remit the premiums for keeping the existing Life Insurance policies live.
b) They will need to buy fresh life Insurance policies in India as the Indian law does not allow persons resident in India to buy or maintain a policy of life insurance outside India.
c) They need not buy fresh life Insurance policy in India and can either pay the premiums for the existing Life Insurance policy from their rental income in US or remit it from India.

4) Their health Insurance policies cover hospitalization expenses across the world, including India. They can renew the policy on their own at the end of the year. Which of the following is TRUE?

a) It would be advisable to continue the existing health insurance policies. It is not necessary to buy any fresh health Insurance in India and incur additional expenditure as the existing policies already cover hospitalization costs in India.
b) It would be advisable to continue the existing health insurance policies and also buy an additional fresh health Insurance in India to create a no claim history on a health Insurance policy in India, even if there is an additional cost involved in buying such a policy.
c) They should give up their health Insurance policies in the US as it is expensive and buy a fresh health Insurance policy in India as it is quite economical.

20.4 Case 4

Mr. Smart (60) has just retired from service. He is entitled to a pension of Rs. 4,80,000/- p.a. received yearly in advance. The pension adjusts partially with inflation to the extent of 50%. Mr. Smart's wife (Mrs. Smart-58) is entitled to the pension for her lifetime in case of the demise of Mr. Smart before her. Nobody else is dependent on the couple. The couple stays in their own home. Mr. Smart received Rs. 40 lakhs (after tax) as retirement dues. Their current living expenses are equal to the pension amount. Mr. Smart's employer will continue to provide a family floater Mediclaim policy for both their lifetime that is considered adequate for their needs. Inflation is to be assumed at 6% p.a. Life expectancy is assumed to be 87 years for Mr. Smart and 85 years for Mrs. Smart.

The couple wants to make provision for expenses on social occasions that arise & leisure travel expenditure to the tune of Rs. 1,00,000 p.a. (inflation 6% p.a.) apart from compensating for the inflation adjustment shortfall in the pension income. Assume the expenditure arises at the beginning of each year.

The couple seek your advice.

1) **If discounted @ 5% p.a. and assuming that the adjustment is fully required at the beginning of the year, the inflation adjustment required is _____.**

   a) **80,18,710**
   b) 76,36,867
   c) 1,91,39,462

2) **The amount required for compensating the difference required for inflation adjustment based on a discounting rate of 5% is higher than the corpus of Rs. 40 lakhs available with them. This means that:**

   a) The couple cannot meet their expenses requirement for the next 27 years, if the corpus earns 5% p.a.
   b) **The couple can meet the expense requirements provided the corpus of Rs. 40 lakhs earns @9.90% p.a.**
   c) The couple can meet the expense requirements provided the corpus of Rs. 40 lakhs earns @9.22% p.a.
   d) The couple can easily meet the expense requirements for the next 27 years with the Corpus amount of Rs. 40,00,000.

3) **The fixed income options available to the couple to earn highest rate of interest from government schemes would be:**

   a) **Senior Citizen Savings Scheme upto a maximum investment of Rs. 30 lakhs.**

b) Fixed deposit schemes available from Public sector banks for senior citizens without any limit.

Answer hint:

- For sub-question no. 3 - SCSS is the government scheme –and PSU fixed deposit schemes are the respective PSU banks.
- For sub-questions 1 and 2 – Calculations are shown in the following tables.

f_x =-NPV(R1,O3:O29)-O2

I	J	K	L	M	N	O	Q	R
	(a)	Age	Exp	Others	Pension	shortfall	80,18,710	5.0000%
	1	60	4,80,000	1,00,000	4,80,000	-1,00,000		
	2	61	5,08,800	1,06,000	4,94,400	-1,20,400		
	3	62	5,39,328	1,12,360	5,09,232	-1,42,456		
	4	63	5,71,688	1,19,102	5,24,509	-1,66,280		
	5	64	6,05,989	1,26,248	5,40,244	-1,91,992		
	6	65	6,42,348	1,33,823	5,56,452	-2,19,719		
	7	66	6,80,889	1,41,852	5,73,145	-2,49,596		
	8	67	7,21,743	1,50,363	5,90,339	-2,81,766		
	9	68	7,65,047	1,59,385	6,08,050	-3,16,382		
	10	69	8,10,950	1,68,948	6,26,291	-3,53,607		
	11	70	8,59,607	1,79,085	6,45,080	-3,93,612		
	12	71	9,11,183	1,89,830	6,64,432	-4,36,581		
	13	72	9,65,854	2,01,220	6,84,365	-4,82,709		
	14	73	10,23,806	2,13,293	7,04,896	-5,32,202		
	15	74	10,85,234	2,26,090	7,26,043	-5,85,281		
	16	75	11,50,348	2,39,656	7,47,824	-6,42,179		
	17	76	12,19,369	2,54,035	7,70,259	-7,03,145		
	18	77	12,92,531	2,69,277	7,93,367	-7,68,441		
	19	78	13,70,083	2,85,434	8,17,168	-8,38,349		
	20	79	14,52,288	3,02,560	8,41,683	-9,13,165		
	21	80	15,39,425	3,20,714	8,66,933	-9,93,205		
	22	81	16,31,791	3,39,956	8,92,941	-10,78,805		
	23	82	17,29,698	3,60,354	9,19,730	-11,70,322		
	24	83	18,33,480	3,81,975	9,47,322	-12,68,133		
	25	84	19,43,489	4,04,893	9,75,741	-13,72,641		
	26	85	20,60,098	4,29,187	10,05,013	-14,84,272		
	27	86	21,83,704	4,54,938	10,35,164	-16,03,478		
	28	87	23,14,726	4,82,235	10,66,219	-17,30,742		

B1 =-NPV(AC1,Z3:Z29)-Z2

T	U	V	W	X	Y	Z	AB	AC
(b)		Age	Exp	Others	Pension	shortfall	40,00,320	9.9000%
	1	60	4,80,000	1,00,000	4,80,000	-1,00,000		
	2	61	5,08,800	1,06,000	4,94,400	-1,20,400		
	3	62	5,39,328	1,12,360	5,09,232	-1,42,456		
	4	63	5,71,688	1,19,102	5,24,509	-1,66,280		
	5	64	6,05,989	1,26,248	5,40,244	-1,91,992		
	6	65	6,42,348	1,33,823	5,56,452	-2,19,719		
	7	66	6,80,889	1,41,852	5,73,145	-2,49,596		
	8	67	7,21,743	1,50,363	5,90,339	-2,81,766		
	9	68	7,65,047	1,59,385	6,08,050	-3,16,382		
	10	69	8,10,950	1,68,948	6,26,291	-3,53,607		
	11	70	8,59,607	1,79,085	6,45,080	-3,93,612		
	12	71	9,11,183	1,89,830	6,64,432	-4,36,581		
	13	72	9,65,854	2,01,220	6,84,365	-4,82,709		
	14	73	10,23,806	2,13,293	7,04,896	-5,32,202		
	15	74	10,85,234	2,26,090	7,26,043	-5,85,281		
	16	75	11,50,348	2,39,656	7,47,824	-6,42,179		
	17	76	12,19,369	2,54,035	7,70,259	-7,03,145		
	18	77	12,92,531	2,69,277	7,93,367	-7,68,441		
	19	78	13,70,083	2,85,434	8,17,168	-8,38,349		
	20	79	14,52,288	3,02,560	8,41,683	-9,13,165		
	21	80	15,39,425	3,20,714	8,66,933	-9,93,205		
	22	81	16,31,791	3,39,956	8,92,941	-10,78,805		
	23	82	17,29,698	3,60,354	9,19,730	-11,70,322		
	24	83	18,33,480	3,81,975	9,47,322	-12,68,133		
	25	84	19,43,489	4,04,893	9,75,741	-13,72,641		
	26	85	20,60,098	4,29,187	10,05,013	-14,84,272		
	27	86	21,83,704	4,54,938	10,35,164	-16,03,478		
	28	87	23,14,726	4,82,235	10,66,219	-17,30,742		

Module 12: Comprehensive Investment Advice I Module-end Questions

1. EMI for a loan can be worked out using the _____ function in MS Excel.
    a. PV
    b. NPV
    c. EMI
    d. PMT

2. Which of the following depends on the market?
    a. Strategic asset allocation
    b. Tactical asset allocation
    c. Investor risk profile
    d. None of the above

3. Read the following caselet and answer the questions that follow:
   Ms. T invests Rs 60,000 in a 10% yielding asset, using leverage of 1.4 times. Borrowing was at 9% p.a.

    A. How much own funds did Ms. T invest?
        i. Rs 35,000
        ii. Rs 25,000
        iii. Rs 42,857
        iv. Rs 17,143

    B. How much interest did Ms. T need to pay?
        i. Rs 2,250
        ii. Rs 5,400
        iii. Rs 3,150
        iv. Rs 3,500

    C. What was Ms. T's net return?
        i. Rs 6,000
        ii. Rs 2,850
        iii. Rs 3,750
        iv. Rs 2,500

    D. What was Ms. T's return on equity?
        i. 1%
        ii. 10.4%
        iii. 10.9%
        iv. 11.4%

4. Read the following caselet and answer the questions that follow:
   Mr. C is a 45 years single earning member of his family with a good income. He is saving for different financial goals, some of which are due for funding now. He has a home loan and a car loan that he is servicing.

A. How would you best categorize Mr. C's risk profile based only on his circumstances ?

   i. Conservative
   ii. Moderate
   iii. Liquidity seeker
   iv. Aggressive

B. What are the assets that will be most suitable for Mr. C given his situation?

   i. Primarily growth with some income-oriented assets
   ii. Primarily liquid assets
   iii. Primarily growth assets
   iv. Combination of liquid and income-oriented assets

C. Mr C. has to park the funds from fixed deposits that have matured for a short period till it will be used for his daughter's education. What will you suggest as a suitable investment option?

   i. Large-cap equity, to capture growth but with lower risk
   ii. Current account, to enable liquidity
   iii. Alternative investments, to increase the corpus
   iv. Short-term fixed deposit, to ensure liquidity and some returns

Question 1:
Adil wants to ensure that his spouse will be able to take care of household expenses that currently amount to Rs.25,000 per month, even in the event of his death. He wants to make this provision for 30 years. Apart from household expenses, he wants to leave a corpus of Rs.10 lakhs for his child's requirements. He also has an outstanding home loan of Rs.30 lakhs. He has a life insurance of Rs.50 lakhs. How much additional life insurance should he take to meet these requirements. Take inflation at 6% and investment returns at 8%.

a. Rs.44 lakhs
b. Rs.58 lakhs
c. Rs.69 lakhs
d. Rs.81 lakhs

Answer: (b) Rs.58 lakhs

Solution:

Monthly expense	Rs.25,000
Annual expense (Rs.25000*12)	Rs.3,00,000
Period for which income should be provided	30 years
Inflation adjusted return [(1+8%)/(1+6%)-1]	1.89%
Corpus required to provide income for expenses (A) [Hint: Use PV function in Excel i.e. PV(Rate,Nper,Pmt). =PV(1.89%,30,-300000)]	Rs.68,24,711.97
Loan outstanding (B)	Rs.30,00,000
Child's corpus (C)	Rs.10,00,000
Total (A+B+C=D)	Rs.1,08,24,711.97
Existing life insurance (E)	Rs.50,00,000
Additional Life insurance required (D-E=F)	**Rs.58,24,711.97**

Question 2:
Bose is evaluating an insurance cum investment plan on which he will pay an annual premium of Rs.6,000 for a sum assured of Rs.1 lakh. The term of the policy is 20 years and the maturity value is Rs.2,00,000. A term plan of similar tenor and maturity costs Rs.150 per Rs.1 lakh sum insured. What is the return that Bose will earn on the investment portion of the insurance policy?

a. 1.7%
b. 3.6%
c. 5.3%
d. 6.1%

Answer: (c) 5.3%

Solution:

Portion of premium which will go to investment (Rs.6000 – Rs.150)	Rs.5,850
Term	20 years
Maturity value	Rs.2,00,000
Return on Investment portion of the insurance policy **[Hint: Use RATE function in Excel i.e. RATE(Nper,PMT,,FV). =RATE(20,-5850,,200000)]**	**5.3%**

Question 3:

Charu earns a monthly income of Rs.50,000, which she uses to meet expenses and save for her goals. She wants to ensure that she is adequately insured so that her family will continue to have the income she would have earned through her working life. Charu is 35 years old and expects to work till the age of 60. She sees inflation at a level of 6% and long term investment returns at 10%. She currently has an insurance cover of Rs.40 lakhs. How much additional life insurance should he take to meet these requirements?

a. Rs.72 lakhs
b. Rs.64 lakhs
c. Rs.47 lakhs
d. Rs.56 lakhs

Answer: (d) Rs.56 lakhs

Solution:

Current Annual Income (Rs.50000*12)	Rs.6,00,000
Rate at which income will grow each year (i.e. Inflation rate)	6%
Years of employment left	25 years
Return expected on investments	10%
Inflation adjusted returns [(1+10%)/(1+6%)-1]	3.77%
Corpus required (A) [Hint: Use PV function in Excel i.e. PV(Rate,Nper,Pmt). =PV(3.77%,25,-600000)]	Rs.96,01,652.38
Insurance cover available (B)	Rs.40,00,000
Insurance cover required (A-B)	**Rs.56,01,652.38**

Question 4:

Dhruv has base health policy of Rs.3 lakhs and a Top-up policy of Rs.10 lakhs with Rs.5 lakh deductible. He has to meet medical expenditure of Rs.4 lakhs. How much of the expense will he have to bear out of his pocket?

a. Rs.3 Lakhs
b. Rs.2 lakhs
c. Rs.1 lakh

d. NIL

Answer: (c) Rs.1 lakh

Solution:

Medical expense	Rs.4 lakhs
Of which base policy will take care of	Rs.3 lakhs
Top-up has a deductible of Rs.5 lakhs. So contribution from top-up	NIL
Portion of expense to be borne by Dhruv	**Rs.1 lakh**

Question 5:
Esther has base health policy of Rs.3 lakhs and a Top-up policy of Rs.10 lakhs with Rs.5 lakh deductible. She has to meet multiple medical expenditures of Rs.2 lakh, Rs.3 lakhs, and Rs.4 lakhs during the year. How much of the expense will she have to bear out of her pocket?

a. Rs.6 lakhs
b. Rs.3 lakhs
c. Rs.1 lakh
d. NIL

Answer: (a) Rs.6 lakhs

Solution:

Medical Expense	**Base** (Rs.3 lakhs)	**Top-up** (Rs.10 lakhs with Rs.5 lakh deductible)	**Out of pocket Expense**
Rs.2 lakhs	Rs.2 lakhs		
Rs.3 lakhs	Rs.1 lakh (As Rs.1 lakh remaining in the base policy.)	Top-up cannot be used as deductible of Rs.5 lakhs has not been met.	Rs.2 lakhs
Rs.4 lakhs	NIL (As Rs.3 lakhs of base policy has already been used.)	Top-up cannot be used as deductible of Rs.5 lakhs has not been met.	Rs.4 lakhs
		Total (out of pocket expense)	**Rs.6 lakhs**

Question 6:
Fahad has base health policy of Rs.3 lakhs and a Super Top-up policy of Rs.10 lakhs with Rs.3 lakhs deductible. He has to meet multiple medical expenditures of Rs.2 lakh, Rs.3 lakhs, and Rs.4 lakhs during the year. How much of the expense will he have to bear out of his pocket?

a. Rs.6 lakhs
b. Rs.3 lakhs
c. Rs.1 lakhs
d. NIL

Answer: (d) NIL

Solution:

Medical Expense	**Base** (Rs.3 lakhs)	**Super Top-up** (Rs.10 lakhs with Rs.3 lakhs deductible)	**Out of pocket Expense**
Rs.2 lakhs	Rs.2 lakhs		
Rs.3 lakhs	Rs.1 lakh (As Rs.1 lakh remaining in the base policy.)	Rs.2 lakhs (Super Top-up becomes active as deductible of Rs.3 lakhs has been met by the base policy over the two medical incidence.)	
Rs.4 lakhs		Rs.4 (Super Top-up becomes active as deductible of Rs.3 lakhs has been met by the base policy over the first two medical incidence.)	
		Total (out of pocket expense)	**NIL**

Question 7:

Giri has suffered damage to his insured property and wants to make a claim of Rs.50,000. The policy has a co-pay of 5% and deductible of Rs.10,000. How much will the insurance company reimburse?

a. Rs.38,000
b. Rs.50,000
c. Rs.37,500
d. Rs.40,000

Answer: (a) Rs.38,000

Solution:

Claim Amount (A)	Rs.50,000
Deductible (B)	Rs.10,000
Co-pay @5% (C) [5% of (50000-10000)]	Rs.2,000
Reimbursement (A-B-C)	**Rs.38,000**

Question 8:

Harish is 40 years old and intends to retire at the age of 55. He is saving for retirement and the corpus will have a balance of Rs.15 lakhs at the end of the current year. The monthly contributions that Harish and his employer makes towards the retirement corpus amounts to Rs.10,000 pm. This is expected to go up 10% each year. The retirement corpus is invested in debt and is expected to earn a return of 8% pa. What will be the balance that Harish will have in the retirement corpus when he retires?

a. Rs.86 lakhs
b. Rs.1 crore
c. Rs.1.14 crores
d. Rs.1.32 crores

Answer: (c) Rs.1.14 crores

Solution:

Annual contribution to retirement corpus (Rs.10000*12)	Rs.1,20,000
Annual growth rate in contribution	10%
Balance in the retirement corpus at end of current year	Rs.15,00,000
Yield earned by corpus	8%

Age	**Contribution* (Rs.)**	**Returns earned# (Rs.)**	**Balance@ (Rs.)**
40	120000		1500000
41	132000	120000	1752000
42	145200	140160	2037360
43	159720	162988.8	2360068.8
44	175692	188805.504	2724566.3
45	193261.2	217965.3043	3135792.81
46	212587.32	250863.4247	3599243.55
47	233846.052	287939.4842	4121029.09
48	257230.6572	329682.3271	4707942.07
49	282953.7229	376635.3659	5367531.16
50	311249.0952	429402.493	6108182.75
51	342374.0047	488654.62	6939211.38
52	376611.4052	555136.91	7870959.69
53	414272.5457	629676.7752	8914909.01
54	455699.8003	713192.7209	10083801.5
55	501269.7803	806704.1226	**11391775.4**

* Contribution for each year is calculated as previous year's contribution + 10% growth.
# Returns are calculated at 8% on the closing balance and are reflected in the following year's balance.
@ Balance is calculated as summation of Last year's Closing Balance, Current year's Contribution and Returns earned.

Question 9:

Jaspreet is 40 years old and currently requires Rs.50,000 pm to meet living expenses. He wants to retire at the age of 60 and expects his expenses to be at the same level, adjusted for inflation. He wants to know what is the corpus required to provide the retirement income required. He expects to fund 25 years in retirement. He sees inflation at 8% and investment returns in retirement at 9%.

a. Rs.1.5 crores
b. Rs.6.2 crores
c. Rs.4.8 crores
d. Rs.3.5 crores

Answer: (b) Rs.6.2 crores

Solution:

Current Annual Expenses (Rs.50000*12)	Rs.6,00,000
Rate of Inflation	8%
Period to retirement (60-40)	20 years
Future value of living expenses at retirement (This is the amount required to meet annual living expenses at the start of retirement at 60 years) [Hint: Use FV function in Excel i.e. FV(Rate,Nper,,PV). =FV(8%,20,,-600000)]	Rs.27,96,574.29
Number of years in retirement to provide for	25 years
Investment return expected from corpus in retirement	9%
Inflation adjusted return [((1+9%)/(1+8%))-1]	0.93%
Corpus required to generate retirement income **[Hint: Use PV function in Excel i.e. PV(Rate,Nper,Pmt). =PV(0.93%,25,-2796574.29)]**	**Rs.6,21,56,919.33**

Question 10:

L is in her late 60s and has a comfortable pension and assets to take care of her retirement years. She has made a Will and got it registered to make sure that her children will have access to her money, whenever they need it. She has bequeathed her house to her son since he does not own a house yet and her financial investments in mutual funds to her daughter. She finds that she is able to save some part of her pension and wants to create a corpus for the college education of her grandchild who is five years old.

1. **Which of the following funds would be best suited for L to create a corpus for her grandchild's education?**

    a. A target maturity debt fund, that will give L visibility on the likely returns.
    b. A short-term debt fund, since L is in her late 60s and cannot take too much risk.
    c. A large and mid-cap fund, since there is a long period before the goal has to be funded.
    d. An Arbitrage fund, that will provide downside protection for an important goal.

    *[**Hint**: Since the goal has a long term to funding, L can take equity exposure irrespective of her age.]*

2. **L's son wants to take a loan with the house as security and giving L's Will to prove his future ownership of the property. Is this a valid position?**

    a. Yes, since L has got her Will registered.
    b. No, unless the other Class 1 heirs to L's property give their no-objection in writing.
    c. Yes, since the son is a Class 1 heir under the provisions of the inheritance laws.
    d. No, since the provisions of the Will apply only on L's demise.

*[**Hint**: Will comes into effect only on death and can be changed by her before her death.]*

3. **L's daughter has an immediate need for money to meet an emergency. Which of the following will enable her to access the money L has intended for her to have?**

    a. A copy of a registered will is adequate to get the financial investments redeemed.
    b. L has to make her daughter a joint holder to enable her to redeem the investments immediately.
    c. L can make a gift to her daughter of the required sum of money.
    d. None of the options

*[**Hint**: A Will will come into effect only on L's death. As the primary holder of the mutual fund, L has to redeem the mutual fund investment. This can be gifted to her daughter for her immediate use and it is also tax free.]*

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