Behavioral and Personal Finance

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Module – 02
Personal Finance
Lecture – 26
Taxes and Financial Planning

Hi, there. Welcome back to the second module of the course Behavioral and Personal Finance. How many times do you consider taxes as one of the important factors in making your financial decisions? Well, this session focuses on the income tax basics and how income tax rules or provisions can help us in making better financial decisions. This session starts with an example of how taxes or tax provisions in prevailing economy can contribute towards a better financial decision making for individuals and what are the factors that we should consider before we take a financial decision making in terms of tax considerations.

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CONCEPTS COVERED

- Income Tax Basics
- Taxes and Financial Planning

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Taxes and Financial Planning

Planning for taxes in your financial decisions

- Taxes are financial (and legal) obligations
- Knowledge of current tax laws and regulations that affect you
- Maintaining complete and appropriate tax records
- Making purchase and investment decisions (*to reduce your tax liabilities*)

Taxes on financial transactions

- Taxes on purchases: e.g., properties & real estate, luxurious goods, flight tickets
- Taxes on property: e.g., personal property tax, municipal taxes
- Taxes on wealth: e.g., wealth tax, taxes on assets (at time of death) on fair value
- Taxes on earnings: e.g., salaries, interest, dividends, other income

Tax bracket for individuals:

- Up to ₹2.5 lakh: Nil
- ₹2.5 lakh to ₹5 lakh: 5% + 4% cess
- ₹5 lakh+ to ₹10 lakh: ₹12,500 + 20% of Total Income *minus* ₹5 lakh + 4% cess
- Above ₹10 lakh: ₹1,12,500 + 30% of Total Income *minus* ₹10 lakh + 4% cess

So, taxes as we know are basically the financial and legal obligations for individuals. If you are making some economic transaction or the transactions that have economic value and you are contributing towards activities that an economy considers as part of the GDP, you are liable to pay taxes on it. Well, taxes can be of several types, broadly categorized into direct taxes and indirect taxes. The examples of indirect taxes are GST, which we as individuals do not pay directly to the government rather we subscribe some product or services or we buy some item for which we pay some price and the price includes taxes that are paid to the government by the seller.

Well, the second category of taxes is direct taxes, where people pay taxes directly to the government and income tax is one such tax where individuals are supposed to pay directly to the government authorities. So, that the tax records of individuals can be incorporated while making economic policies and other related decisions. When we are making tax payments or

making financial decisions that have certain relationship with tax payments, we should have knowledge of current tax regulations and prevailing rules and provisions related to taxes and how saving taxes could be an important factors for making better financial decision.

The first rule of understanding the tax provisions is to maintain a complete and accurate financial transactions and records thereof. Particularly when you are making a tax payment or you are trying to calculate the value of tax liability that you are supposed to pay to the government, you need to rely on a complete and accurate records of financial transactions that you have made during a particular period.

Typically, taxes are required to be paid annually, but if the volume of transaction is very high government encourage people to pay taxes on a quarterly basis. Now, unless you maintain an accurate and complete financial transactions record, you cannot establish how much tax liability you have. So, once you have the accurate transaction records, you can assess or determine what is your tax liability and how this can determine your cash flow, both inflows and outflows and help you make better financial planning.

The, for example, the provisions that are prevailing these days in current financial year related to the taxes could be seen as follows. So, for individuals who have an income up to 2.5 lakh rupee per annum, the tax liability for that individual is nil, but if the income is above 2.5 lakh, but below 5 lakh the tax liability is 5 percent of income tax and 4 percent of all cess. So, when the income crosses 5 lakh rupees that is 5 lakh 1 rupee onwards up to 10 lakh rupees the tax liability is considered to be 12500 and 20 percent of total income minus 5 lakh plus 4 percent of cess.

So, if suppose you have an income of 9 lakh, so, your tax liability would be 12 Point 12500 plus 20 percent of 9 lakh minus 5 lakh that is 4 lakh. So, that will be your tax liability on the remaining income, 20 percent of 4 lakh plus 4 percent of total tax due as cess. If your income crosses 10 lakh rupees, you are supposed to pay a base tax of 112500 and 30 percent of tax on total income minus 10 lakh and 4 percent of cess.

So, suppose your income is 15 lakh then your tax liability is to the tune of 112500 plus 30 percent of 15 lakh minus 10 lakh which is 5 lakh plus 4 percent of tax. So, these are the prevailing rules for taxes with respect to the individuals. Now, government has given some additional provisions for senior citizens and women as far as tax rules are concerned.

Since, this course does not cover tax taxes as the major component of the course, we will not discuss much details rather we will focus on how taxes can influence our financial planning and can help us make better financial decisions.

So, when we talk about financial decisions basically, we consider both purchasing and investment decision also, investment decisions are a function of savings decisions. So, taxes can help us make better savings decision that will subsequently lead to a better investment decision and all these decisions should be driving towards reducing or minimizing tax liabilities for the individual we are considering.

When you talk about taxes on different transactions of economic value, these transactions could be purchases in terms of consumables or the purchases of consumer items, purchases on properties and assets such as land and buildings, purchases of items which are of luxury and even flight ticket or any other similar services. These taxes are calculated on the gross value of properties or real estate or luxurious goods, flight ticket or bus ticket, even personal properties or the properties or the houses where we live in.

There are taxes on wealth, such as wealth taxes or taxes on assets at the time of death of an individual, which other kins are supposed to pay to the government. Similarly, taxes on earnings that is another category of taxes such as taxes on salaries, interest, dividend income and any other income that a person receives. So, these are four broader categories of taxes; taxes on purchases, taxes on property, taxes on wealth and taxes on earnings.

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Implications of Taxes on Returns

After-tax Savings Rate of Return

- Taxes influence our decisions
  - Investing our money in tax-saving avenues, e.g., tax-saver bonds, insurance policies, etc.
- Taxability of interest on your savings *reduces* your real rate of return.

How to find actual rate of return

- Determine your top tax bracket for the personal income taxes
- Subtract this rate, expressed as a decimal, from 1.0
- Multiply the results by the yield on your savings account
- This number, expressed as percentage, is your after-tax rate of return.

If you look further we understand that taxes are playing an important role in terms of making financial decisions. Essentially, the reason for taxes being so important is that taxes are basically reducing our net gain. For example, if we are saving some money in an investment avenue that does not get any advantage in terms of tax reduction, we are getting an income which is going to be considered as the total taxable income for us and then we have to pay taxes on the total taxable income.

Instead, if we are investing our money in tax saving instruments, such as tax saver bonds or tax saving insurance policies or any other such tax saving instrument, the income that we are getting will not be counted to the large extent or in some cases totally in the computation of total taxable income and that is why the total tax liability will be lesser. So, if we consider that we are getting an income and that income should be considered for taxes in our total income, we should follow a simple approach to understand the net value of that income as such. For

example, if you receive an interest on the deposits that you have made in your savings bank account and that savings bank account provides you an interest rate of certain percentage. First, you should determine the tax bracket that you are falling in.

We know that there are three tax brackets mostly, the income below 2.5 lakh, no tax, 2.5 lakh to 5 lakh and so on. So, if we consider our total taxable income and we can determine whether we fall in 10 percent tax bracket or 20 percent tax bracket or 30 percent tax bracket or so on, we will first determine the tax bracket that we fall in, because the interest income that you are getting from bank basically are charged against the tax bracket that you are falling at the top, which means if you are getting an interest income of 100 rupees from bank banks typically charged a flat 30 percent tax on that interest income.

It is your responsibility to later claim that you do not belong to 30 percent tax bracket rather you are in a bracket with lower tax rate. So, you should get a refund of the tax deducted by the bank.

So, first you determine your tax bracket then you use this tax bracket rate that is 30 percent for example, from the value of one let us say 1 minus 30 percent which is 0.3 and then multiply the remaining number the result by the yield on your savings account or the income that you have generated in terms of percentage and this number will be expressed as a percentage and can be considered as your after tax return.

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Implications of Taxes on Returns (cont.)

After-tax rate of return: an example

- Ms. DoGood maintains a bank account with SharkBank Ltd.
- She earns 6.5 percent rate on her savings bank account deposits.
- Due to her other incomes, she falls into 30% tax bracket.
- Advise her if she should re-compute her return.

How to find actual rate of return

- Determine your top tax bracket for the personal income taxes
- Subtract this rate, expressed as a decimal, from 1.0
- Multiply the results by the yield on your savings account
- This number, expressed as percentage, is your after-tax rate of return.

1. Ms DoGood is in 30% tax bracket.
2. 1.0 − 0.30 = 0.7
3. 0.7 × 0.065 = 0.0455
4. After-tax return = 4.55%

A simple example could be let us say, a case of Miss Do Good. So, Miss Do Good maintains a savings bank account with a bank, the bank offers her an interest rate of 6.5 percent per annum. So, she receives a 6 6.5 percent per annum rate of return on her savings bank account deposits.

And she also has some other sources of income that is why she falls in the top tax bracket which is 30 percent. So, if we want to advise her whether her return rate of return of 6.5 percent is actual or not we should follow the structure that we have just discussed. So, the structure says that first you determine the top tax bracket, then you subtract that percentage rate from one and multiply with your yield or the return that we have generated on your savings or investment and then this number when expressed as percentage can be considered as the after tax return.

So, in case of Miss Do Good if we try to understand the numbers that are given here, we know that she falls in 30 percent tax bracket. So, first step is Miss Do Good is in 30 percent tax bracket. So, the second step is we will deduct this 30 percent from 1. So, this is 1 minus 0.30 which gives us 0.7. The third step is, the step third, here is multiply this 0.7 with the return that she is getting the return that she is getting is 0.065, because the returns she is earning is 6.5 percent. So, this should be 0.065.

So, this is the third step and this value gives us a number which is 0.0455. So, this number when expressed as percentage is actually the after tax return. So, this is basically 4.55 percent. So, if a bank tells you that you are earning a 6.5 percent rate of return on your savings bank account actually, the return that you are getting is just 4.55 percent, because of the tax effect. This is how taxes can influence our net earning or net gain.

So, when we try to understand the implication of tax on our financial decision, we have to keep in mind several other factors. The factors that we should keep in mind or we should consider while making financial planning will be discussed now.

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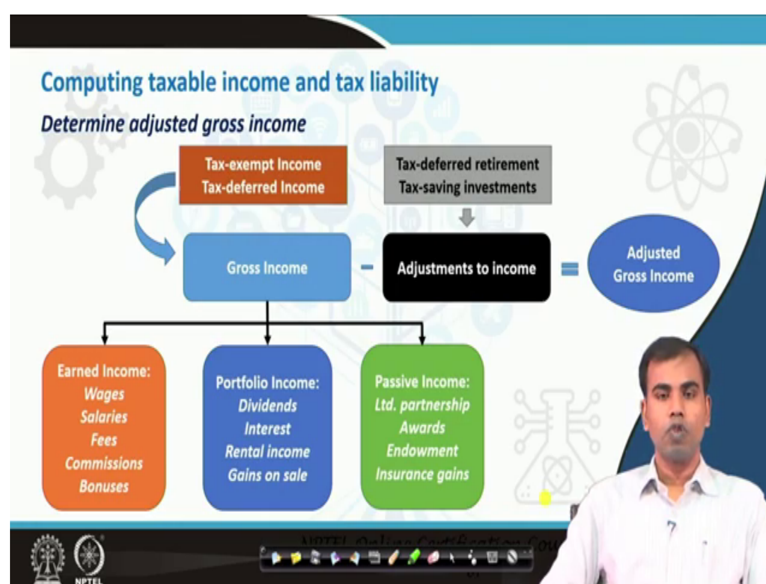

So, the step to understand the tax calculation purpose as discussed earlier, will be as follows. So, first we will start with the gross income and the gross income can be considered as all income that a person is receiving. The income such as salary income or any other income that a person is receiving will be included in calculation of gross income. So, if we know the gross income can be computed with the help of different type of income that the individual is receiving and these incomes can be earned income, portfolio income or investment income and passive income.

So, when we talk about earned income. It includes salaries, wages, fees for services provided, commission received and bonuses that are received by the individual. So, these factors are essentially comprising in earned income category. When we talk about portfolio income it includes dividends, interest on deposits, a rental income if the person has any property that property will be given on rent and the rent income will be considered as investment income or

portfolio income. Similarly, gain on sale of any asset. So, suppose a person has purchased a land few years ago and now, he has sold the piece of land for some money and that money is higher than the money that he has spent on purchasing that land. So, that will be considered as gain on sale of that land and it is investment income or portfolio income.

If you recall, portfolio is basically a combination of different assets including shares, bank deposits, property such as real estate, land, precious metals and any other asset which the person is holding. So, portfolio income or investment income will also be considered as part of the gross income then you have passive income. Passive income by definition are the income for which you are not putting much effort or you are not creating a lot of processes or decisions with respect to earning that income.

So, for example, if you are into a partnership business and you are you have just got into partnership passively which means you are not an active partner, but the profit that the business is generating is shared with you. So, that income from limited partnership will be considered as passive income. Suppose, you got an award or some lottery or something like some amount of money that you have won in a game show like Kaun Banega Crorepati, then that award money or the money that you have earned in lottery will be considered as passive income.

Similarly, an endowment fund income, where you had spent some money long time back and now it is paying you off in terms of income. So, this endowment income can also be considered as passive income and of course, insurance gains, such as you have claimed some insurance and that insurance gain has come to you as income that will be your passive income to be considered for calculation of gross income. Once, you have calculated the gross income, you need to do certain calculation further to understand what incomes are tax exempt income and what incomes are tax deferred income.

Now, by definition tax exempt income are those incomes where tax is not charged at all. For example, if you have earned some money or some income from your agriculture activity that income is to large extent not chargeable for tax. So, in an income where you do not have to pay any tax will be considered as tax exempt income and tax deferred income are incomes

where you have to pay taxes later. For example, if you are doing a job and your employer is contributing certain amount of money towards your pension fund or any other retirement investment, currently you are not entitled to pay taxes on those savings or those income rather when at the time of retirement or in future when you take away that money, then you have to pay certain tax on that income.

So, this kind of income is known as tax deferred income. These two types of income are considered to get the gross income calculated and once, you are ready with the gross in gross income you have to do certain adjustments with the gross income and these adjustments are basically, adjustment for the investments or decisions that you have taken to save taxes. For example, if you have invested some money in tax saving instrument such as post office deposits or maybe certain instrument where you have to get some tax advantage in terms of tax saving certificate of any bank or any government entity.

Similarly, government issued bonds are also carrying some tax exemption. So, you need to consider, if you have invested some money in these instruments where you get some tax deferment or tax saving, you make the adjustment for calculation of gross income and this will get you a net value of adjusted gross income.

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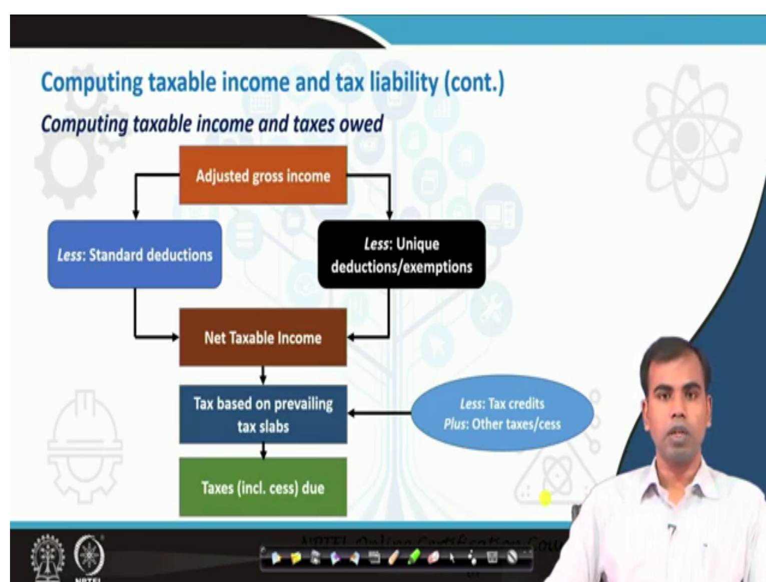

So, once you calculate the adjusted gross income, you need to do certain more calculation such as incorporating standard deductions as per the law of the land, such as the income tax department in India provides certain standard deductions in terms of a fixed amount of money is waved off for tax chargeability and that is known as standard deduction.

Similarly, there are some other deductions such as or deduction in terms of expenses on health or medical facilities of self or your family members, similarly deductions related to education expenses of your family members or kids or deductions related to the interest payment on your home loans or education loans. So, these are some unique deductions or exemptions which need to be incorporated into adjusted gross income this will lead you to net taxable income on which you will calculate the taxes based on the tax bracket or the tax rate for, you are supposed to pay.

Once, you calculate the tax rate or tax bracket for yourself, you need to see if you have any tax credit which means you have get some advantage in terms of some tax credit and any other taxes or cess has to be included as well to get the total value of tax payability. So, this will get you the total taxes including cess and other liabilities due to the government authorities. This is how we consider calculation of taxable income and taxes for financial planning purpose.

Now, this is a very generic approach to calculate the taxable income, because once you have some income be it from whatever sources you need to understand the tax implication in terms of the example that we have discussed earlier of Miss Do Good, where we showed that the income that you are receiving is not the exact income that you are going to get at the end of the day, because you have to pay certain amount of tax on it and when you are doing a financial planning the tax amount has to be incorporated beforehand to know the actual benefit or the real return that you are getting from that investment or the financial decision.

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Tax Planning for Personal Finance

Purchasing Decisions

- Place of residence and business/work
- Personal debts
- Job-related expenses
- Health-related expenses

Investment Decisions

- Investment in tax-exempt avenues
- Tax-deferred investments
- Short-term and long-term capital gains taxes

Now, when we talk about the implication of taxes on personal financial planning, we need to understand as elaborated earlier, that there are certain decisions which individuals take and these decisions should incorporate the implications of taxes as prevailing in that particular year or in future. So, that the decisions are most optimal for the individuals. Now, when you try to calculate tax implication on your financial decision basically, it is determined, it is determined by the level of income that you are earning which will basically determine your tax bracket and also some other factors.

The financial decisions such as purchasing decision or investment decisions, these decisions will have certain stronger tax implications. For example, if you are making a purchasing decision, let us say a purchase of car or purchase of home the factors that are going to determine your purchasing decisions are the place of residence or the business or work. For

example, if you are buying a house that is very close to your workplace is basically going to help you a lot in terms of saving money on transportation or commute cost.

So, when you try to make a personal decision particularly, in terms of personal financial decision with respect to purchasing of an asset then you keep these things in mind and this will save you some money which will ultimately save you some tax also. Some other factors such as personal debt, these are also important to understand, because if you have debt for example, education loan or home loan or any other type of loan, you are paying some fixed interest on these loans and these interest will be considered as certain exempt, certain amount of exemption from your total taxable income and this is how you save some money on tax part.

Similarly, if you are doing a job or a business there will expenses related to the job or the business will also be considered for tax exemption or deduction from the total taxable income. Health related expenses as are explained earlier for example, if you have incurred some amount of money on your own health care or health care of your dependent, this money will be considered as tax deductible income from your total taxable income and this will help you make a better purchasing decision.

Similarly, if there are investment decisions to be made, you know that investment decisions in tax exempt avenues such as national savings certificates or any other government bond which are tax exempt will help you save some taxes and determine your net return to be higher, because we understand that the net return as shown on paper or on the record is not going to be the exact amount of money or exact rate of return that we are going to receive, because of tax implications. So, if we are saving our money in tax exempt instruments, we are saving more money for ourselves and paying less taxes in the process.

Similarly, there are tax deferred instruments, where we can invest and save some money. for example, capital gain gains taxes are one tax one type of tax which are supposed to be paid when you are making some capital gain transactions. So, capital gain transactions are basically transactions involving capital goods; such as house property or cars or for that matter shares

which are to be purchased for long time, but if you are not holding it for long time and selling it within a year this is known as short term capital gain.

For example if you purchase a house and sell it within a year the profit that you have made in that transaction is to be considered for short term capital gains and if we have sold it for after many years, then this the gain that you have made out of this transaction will be considered as long term capital gain. So, these tax rates on short term capital gains or long term capital gains or any other such transactions will determine your investment decisions as well.

So, as a summary we understand that taxes play an important role and considering taxes as part of the financial planning process is very important to make better financial planning and personal finance decisions. That is it for now.

Thank you very much.