ULIPS POST-BUDGET

Assess suitability, examine costs before investing

Investors prioritising liquidity and flexibility should stick to a term plan-MF combo

HIMALI PATEL

The Union Budget clarified the tax treatment of unit-linked insurance plans (Ulips) that do not qualify for tax exemption under Section 10(10D). Before investing in this market-linked insurance-cum-investment product, taxpayers must understand whether it is suitable for them or if they would be better off opting for a combination of a term plan and mutual funds.

Clarity on taxation

Under Section 10 (10D) of the Income-Tax (I-T) Act, the sum insured received from a life insurance policy is exempt from taxation, subject to two conditions. "This tax exemption is not available if the premium paid in any of the years during the policy term exceeds 10 per cent of the actual sum insured. This rule applies to policies issued on or after April 1, 2012. Furthermore, in the case of Ulips, the tax exemption under Section 10(10D) is not available if the premium payable during the term of the policy exceeds ₹2.5 lakh," says Rupali Singhania, partner, Areete Consultants LLP.

Before the budget, confusion prevailed regarding how a Ulip that does not meet Section 10(10D) conditions should be taxed. "While it was clear that such policies were not exempt from taxation, there was ambiguity regarding the head under which tax should be charged," says Suresh Surana, a Mumbai-based chartered accountant.

The confusion, according to Singhania, lay in whether the sum received should be taxed as 'capital gains' or as 'income from other sources'.

The budget has ushered in complete clarity in this regard. "If exemption under Section 10(10D) does not apply, then the sum received from a Ulip shall be chargeable to tax under the head 'capital gains'," says Surana.

Ulips, according to Singhania, will henceforth be treated on a par with equity-oriented mutual funds. "They will be taxed at the rate of 12.5 per cent after one year," she says.

KEY CHECKS TO RUN BEFORE BUYING A ULIP

- Assess premium allocation, fund management, and switching fees
- Choose right Ulip type
- Type 1 Ulip provides a death benefit equal to the sum assured or the fund value, whichever is higher
- Type 2 Ulip offers a death benefit equal to both the sum assured and the fund value but typically comes with a higher premium
- Consider the tax benefits and lock-in associated with Ulips before investing
- Evaluate the fund's historical performance and track record of its fund manager

More or less attractive?

This clarity will benefit high-income earners. "The rate at which they will have to pay tax on capital gains in Ulips will be lower than their slab rate," says Abhishek Kumar, a Securities and Exchange Board of India (Sebi)-registered investment adviser and founder, SahajMoney.com.

According to other experts, this clarification neither enhances nor diminishes the attractiveness of Ulips. "The tax treatment remains consistent. This clarification does not make Ulips more or less attractive; it simply removes ambiguity," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Switch without paying tax

One advantage of a Ulip is that investors can choose the underlying mix of products. "People who want to mix insurance with market-linked instruments can do so through Ulips. Policyholders can also change funds based on their preferences during the policy term," says Kumar.

The switches one makes between funds in a Ulip are not subject to tax. "This is unlike a mutual fund, where if you switch from one fund to another, there is a tax incidence," says Dhawan.

Ulips also offer a tax benefit to taxpayers under the old tax regime. "Such individuals can get a tax deduction of up to ₹1.5 lakh under Section 80C," says Dhawan. Ulips come with a lock-in of five years. This can be advantageous for investors who find it hard to stay invested in a market-linked instrument amid increased volatility.

Low flexibility, high costs

According to Dhawan, investors enjoy greater flexibility (for example, reduce coverage) when they segregate life insurance from investments. This aim gets defeated on investing in a Ulip. "The expenses could be a little higher than in a pure investment product," says Dhawan.

Kumar points out that Ulips have liquidity issues. Investors who realise that a Ulip they have purchased does not suit them cannot exit the product before five years.

"Many Ulips come with several charges such as policy administration charge, fund allocation charge, etc. These, in turn, reduce the overall returns of policyholders," says Kumar.

Are they suitable for you?

Investors who struggle with financial discipline and are prone to panic during market fluctuations may find Ulips beneficial, as they restrict premature withdrawals and encourage long-term investment.

"Investors who are more informed and value flexibility may benefit from keeping their insurance and investment separate, allowing for greater control over their financial planning," says Dhawan.

One also needs to understand the liquidity constraints of these products. "People who want to maintain liquidity should avoid Ulips," says Kumar. The same holds for investors who do not want the volatility of equities.

Points to keep in mind

Investors who decide to invest in a Ulip should be mindful of its costs. "Examine the charges you will pay over the policy's tenure," says Kumar. Assess the adequacy of life cover.

"The insurance coverage should be sufficient to provide a decent sum to dependants. Ulips typically offer coverage of around 10 times the premium amount, which may not be adequate," says Kumar.