New taxation provisions will definitely affect the popularity of Ulips

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Many taxpayers may now prefer to keep insurance and investments separately

This year's Union budget has proposed to remove the exemption on new unit-linked insurance plans (Ulips) with a high premium. The objective is to remove the tax arbitrage that existed, where income from an equity oriented mutual fund was taxable, and income from a Ulip where the return was entirely tax-free. How do the new provisions work, and what are the issues?

Under the amended provisions, if a Ulip is issued on or after 1 February 2021, and the premium for any year is more than ₹2.5 lakh, the income from that policy would not be exempt. Such a policy would be regarded as a capital asset, and the returns on the policy would be taxable as capital gains. If it is an equity oriented Ulip (monthly average of 65% of assets is in equities), long-term capital gains from the policy would be taxable at the rate of 10% without indexation of cost, while short-term capital gains would be subject to tax at 15%. The sale, surrender or redemption of an equity oriented Ulip issued on or after 1 February 2021 would be subject to a 0.001% securities transaction tax, irrespective of the amount of premium. The amount received under Ulip on death would continue to be exempt.

Since taxability would arise if the annual premium exceeds ₹2.5 lakh, can one acquire multiple Ulips with premium less than ₹2.5 lakh each? Such splitting up may not help, as the law provides that the aggregate amount of annual premium of such Ulips issued on or after 1 February 2021 is to be considered. Is the amount of annual premium to be considered per insurance company, or in aggregate per taxpayer? The language of the provisions indicates that the aggregate of all companies is to be considered, and not just the premium per insurance company.

How are the taxable capital gains to be computed? The law provides that the manner of computation of such gains shall be prescribed in the income tax rules. This will probably be announced once the law is passed and is notified.

What would be the position of Ulips issued prior to 1 February 2021 or Ulips with an annual premium of less than ₹2.5 lakh? The income from such Ulips would continue to be exempt in the same manner as other life insurance policies, subject to the annual premium for any year not exceeding 10% of the sum assured.

In case the premium for any year exceeds 10% of the sum assured, the returns would be taxable. There is a view that even in such cases, the gains would be taxable as

capital gains, since a Ulip is in substance a capital asset of the taxpayer, even though the definition does not specifically so provide. Of course, in such cases, the long-term capital gains would be taxable at 20% with indexation of cost, and not at the concessional rate of 10%.

What is the position of Ulips other than equity oriented ones? The amended provision for withdrawal of exemption does not draw a distinction between an equity oriented Ulip and other Ulips. The income from all Ulips issued on or after 1 February 2021 is taxable, if the annual premium exceeds ₹2.5 lakh. The income from such Ulips (other than equity oriented ones) will be taxable as capital gains as well, but the rate of long-term capital gains tax would be the normal rate of 20%, while that for short-term would be the slab rate of tax.

Whether indexation of cost would be available or not would be known only after the new rules for computation of capital gains in such cases are announced.

What would be the period of holding for Ulips to qualify as long-term capital assets? It would be 12 months for equity oriented Ulips, and 36 months for other Ulips.

How is this period to be computed—from the date of inception of the policy, or separately for each annual instalment of premium? It would obviously be considered from the date of inception of the policy. However, whether each premium instalment is to be considered as cost of acquisition or cost of improvement is a question that may be addressed by the proposed rules.

Of course, this does not make any difference where indexation of cost is not available, but only affects cases where indexation is available, since indexation for cost of acquisition is available from the year of acquisition, while indexation of cost of improvement is available from the year of improvement.

All in all, these new taxation provisions would definitely impact the popularity of Ulips, since many taxpayers may now prefer to keep insurance and investments separate, having only a pure term insurance policy, and investing in units of mutual funds, instead of in Ulips.

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