Investing in a house the best way to save tax

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Investment in a house could be the best way to save tax. As prices of residential units have gone up in the range of Rs 50 lakh and over, tax experts say buying a second house for investment purpose will save even more tax than that over the first house you bought for personal use.

When you buy a house for personal use, you can take the deduction from your taxable income against the interest payment on your loan taken to buy the house up to Rs 1,50,000 only. Besides this, you can also avail the benefit of deduction against the repayment of principal amount under section
80C. However, under 80C, you can avail the deduction up to Rs 1,00,000 - but this is inclusive of all the investments like your contribution in EPF, PPF, tax savings mutual funds and school fees of your children among other things.

Therefore, normally, if your taxable income is more than Rs 5 lakh, most of the limit provided under section 80C is exhausted because of the compulsory savings scheme. Still, if you take repayment up to Rs 20,000 against principal under section 80C, your net tax savings every year will be Rs 52,350.

This is mainly because the benefit against interest payment is capped at Rs 1,50,000 even if you have taken a loan of Rs 50 lakh to buy a house at 8%, and your interest outgo in the first year will be Rs 3,96,181. The monthly installment on Rs 50 lakh loan at 8% for 20 years will be Rs 41,822. This works out to an annual payment of Rs 5,01,864. Out of this, Rs 3,96,181 will go against the interest payment in the first year and the rest Rs 1,05,683 will go against the principal repayment.

Despite, the interest payment of Rs 3,96,181 you will get the deduction benefit of Rs 1,50,000 only. So, the tax benefit under this will be Rs 46,350 - including the education cess - at the rate of 30.9%. Besides this, though you have repaid Rs 1,05,683 from the principal, you will get a deduction of Rs 20,000 as most of the quota of Rs 1,00,000 is used up by the investments in other instruments. So, the tax benefit against the principal repayment will be Rs 6,180, making your total benefit at Rs 52,350.

But, if you have invested the same amount to buy a house as an investment instrument, you can take the benefit against the interest payment for the entire amount. In this case, the benefit against the interest payment is not capped. But, there is a catch. The rental income of the house will be includedin your income.

But in India, annual rental income, most of the time, is in the range of 2% to 3% of the capital value. Even today, an apartment of Rs 50 lakh is easily available on rent for Rs 10,000 a month. At the same time, the repayment of principal amount will not be allowed for deduction from your taxable income under 80C.

But still, as the interest payment on loan is huge, the rental income does not offset a substantial benefit. Take for example a loan of Rs 50,00,000. In this case, the interest payment in the first year is Rs 3,96,181 and the rental income is Rs 1,20,000. But, only 70% of the rental income gets added to your income. You get a rebate of 30% on rental income against the maintenance of the house.

So in the first year, only Rs 84,000 will be included in your income as the house income. Now, as you spend Rs 3,96,181 as interest payment and Rs 84,000 you earned as house income, you will get a net deduction of Rs 3,12,181 because of your investment in the house. At the rate of 30.09%, you will save a tax of Rs 96,464.

Similarly, in the second year, the interest element in your EMI will come down to Rs 3,87,409 while your tax benefit will be Rs 92,456. In the calculation for the second year, the rental income was taken at Rs 10,500 - 5% more than that in the first year. Similarly, for the third, fourth and fifth year, as shown in the adjoining chart, the tax benefit remains substantially more than when the property is bought for personal use.

Because of the tax benefit, the effective interest rate on your loan will work out to be 6%, instead of 8% - the rate at which you have contracted the loan.
This benefit will become even bigger, if you are buying a house of larger amount. While the loan amount becomes bigger, the interest amount will become larger. In the case of buying the house for investment purpose, you can avail the benefit of deduction against the interest payment. But, in the case of personal use, it is capped at Rs 1,50,000.

However, the rental income may pose problem in the 10th year onwards. Around 10th year, the tax benefit under the investment scheme will be lower than that for the personal use. But, at the same time, after 10 years, the value of money will go down substantially and so the payment of high tax. It may not hurt you as much as it does today.