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NOT QUITE THERE YET

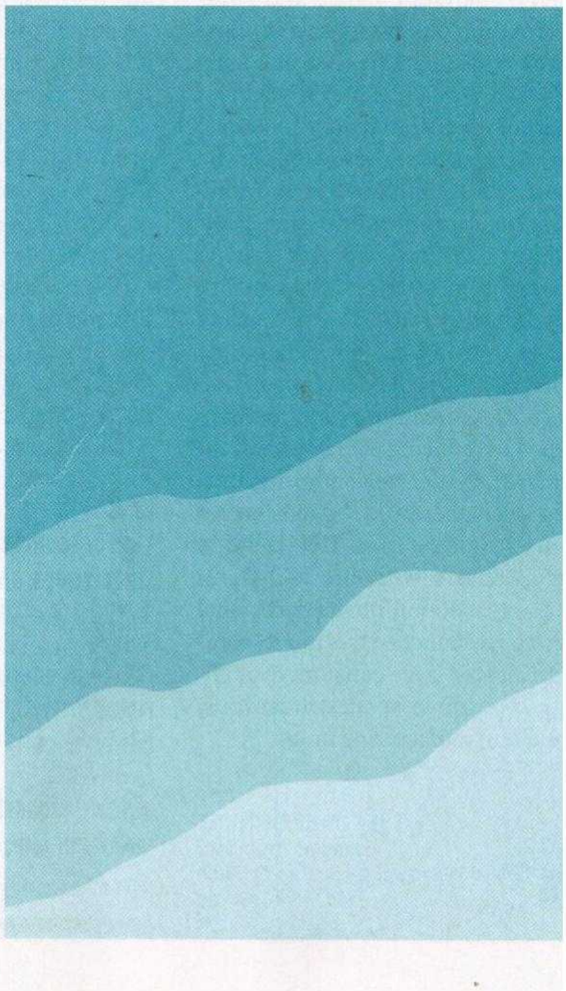
Additional tax benefits make NPS a desirable product, but the tax on maturity is a big minus

By Sunil Dhawan

LATELY, THERE has been a renewed interest in the National Pension System (NPS). The reason being the additional tax benefit announced on the product in Budget 2015. Since the announcement, NPS has recorded a significant growth in its investment inflows. That said, it's still a long way from being a must-have in a retirement portfolio.

For the uninitiated, NPS is a retirement-focused product regulated by the statutory body, the Pension Fund Regulatory and Development Authority (PFRDA). It is a defined contribution-based pension system, which means that the contribution is fixed but the benefit is not. What the investor gets as pension on retirement depends on how his money is invested. The return basically depends on the performance of underlying assets. What makes it stand out amongst other investment alternatives are its low-cost, easy accessibility and the option to build a corpus through market-linked asset classes. But is NPS the best retirement plan for your twilight years? Let's see where it stands today and what is needed to make it a pull product.

Bank fixed deposits are pull-products as investors flock to invest in them because of assured returns and safety. Mutual funds, although have no-assured returns, are slowly moving into the pull-products category, mainly because of their low-cost, return potential and ease of investing. NPS is not quite there yet. Though its cost is one of the lowest and returns potential is similar to mutual funds, distributors of investment products generally avoid pitching NPS to clients. It's because the commission rate on NPS is exceptionally low. And since the budget of 2015, NPS has



largely become a bait to attract potential investors before they are diverted to other products.

Structure

Anyone between the age of 18 years and 60 years can invest in NPS after fulfilling the KYC requirements; the minimum investment is Rs 6,000 a year. On opening an NPS account, the investor gets a Permanent Retirement Account Number (PRAN) that captures all the data including personal details as well as all transactions.

Holders of NPS can only invest in it till they turn 60. After that, contributions are stopped and the investor is allowed to withdraw up to 60 per cent of the corpus while annuity starts on the balance 40 per cent from any of the seven designated annuity providers.

The returns in NPS are linked to market performance and there are two ways to manage funds — active and auto. Under 'active', there are three fund options: E, C, and G. In E, a maximum of 50 per cent of the portfolio is invested in equities; In C, it's primarily into fixed income instruments other than government securities; and in G, primarily into government securities. Those not comfortable deciding the investment pattern can always opt for 'auto'.

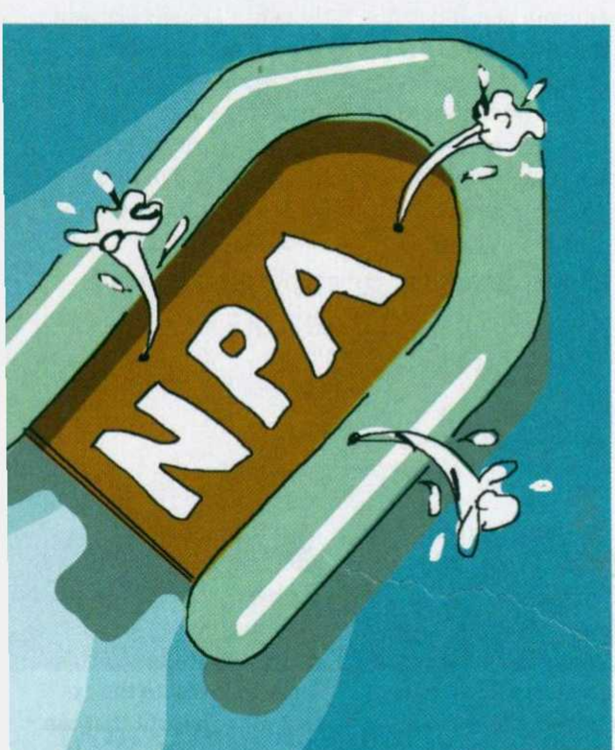
Under auto, funds invested automatically begin with a maximum equity exposure of 50 per cent till the age of 35 years and then tapers off to 10 per cent by age 55. The fund management cost in NPS is 0.01 per cent. The lower the cost, the lesser it eats into the corpus during the accumulation phase. Says Sumit Shukla, CEO of HDFC Pension Management Company, "In terms of charges, NPS is the cheapest product in the world and has a huge impact on any long-term investment."

NPS And Tax Gains

Tax payers, after exhausting their section 80C limit of Rs 1.5 lakh a year, can now look at NPS to save for their retirement and in the process save additional tax. An additional deduction of up to Rs 50,000 is made available for NPS from the financial year 2015-16. For someone in the highest income slab, paying 30 per cent tax rate, it's an additional savings of about Rs 15,000 a year.

In the 2015 Budget, the finance minister increased the deduction limit under section 80CCD for contribution to NPS from Rs 1 lakh to Rs 1.5 lakh. However, the total deduction under sections 80C, 80CCC and 80CCD (1) cannot exceed Rs 1.5 lakh. Suresh Surana, founder of consulting firm RSM Astute, says, "Please note that the said limit of Rs 1.5 lakh also covers section 80C which means that if the employee has paid life insurance premium or principal repayment of housing loan up to that limit, then his contribution to NPS will not fetch extra deduction under section 80CCD (1), although under new section 80CCD (1B), the employee can claim deductions up to Rs 50,000."

The tax benefit on NPS is available under different sections. Surana, has a concise explanation for each: "Under section 80CCD (1) of the Income-tax Act, 1961, if an individual, employed by any other employer other



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PEER PERFORMANCE

A comparative look at the returns given by different NPS funds over the years

Returns (%)

Pension Funds	1-year	2-year	3-year	Since inception
SBI	17.98	19.2	20.87	10.15
LIC	17.99	NA	NA	20.98
UTI	19.29	20.8	21.03	12.67
ICICI	18.37	21.07	21.89	13.21
RELIANCE	18.14	20.45	20.92	12.01
KOTAK	16.21	18.97	20.82	11.46
HDFC	18.5	NA	NA	26.14
Benchmark	17.99	19.99	21.07	NA

AS ON 29 MAY 2015; TIER I SCHEME RETURNS FOR MORE THAN A YEAR ARE ANNUALISED; NA IS NOT AVAILABLE

than the government, contributes to NPS, deductions up to 10 per cent of his salary is allowed. Further, under section 80CCD (1B), an employee can claim additional deductions up to Rs 50,000 by contributing towards NPS. Over and above, under Section 80CCD (2), an employee can also get deductions on account of his employer's contribution towards his NPS account up to a limit of 10 per cent of his salary."

Tax Disadvantage

The NPS currently has an exempt-exempt-tax (EET) structure. This means that 60 per cent of the corpus that is available for withdrawal is fully taxable and even the annuity is taxable under the present tax laws. The strict tax structure causes NPS to lose its edge over other competitive products such as equity mutual funds, public provident fund (PPF) and even life insurance as proceeds from these are tax-free over long period. Shukla agrees, "Additional tax benefits offered are creating a pull, but the tax on maturity of full amount under EET (Exempt, Exempt, Tax) continues to keep a large number of subscribers at bay. The Ministry of Finance will

have to bring parity between EPF/PPF/Life Insurance or MF as far as the tax on maturity is concerned."

The Way Out

To save for retirement, one should aggressively make use of equity-related products. The maximum one can invest in equities in NPS is, however, capped at 50 per cent of contribution. Therefore, it is best to create a retirement corpus with a mix of equity mutual funds and NPS. Investing in pension-Ulip is not advisable because of its inherent features that are restrictive in nature. Diversify across three to five consistently performing large-cap and mid-cap

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Founder & CEO, International Money Matters

mutual funds and also put in a portion earmarked for retirement into NPS.

For those who are financially disciplined and are comfortable in managing asset classes independently, saving through mutual funds should help. Also, for someone who has not exhausted the section 80C limit, investing in NPS can be put on hold. There are other retirement-focused mutual fund schemes, such as the Reliance retirement fund, which too come with tax benefits. Lovaii Navlakhi, founder and chief executive, International Money Matters, a Bangalore-based Securities & Exchange Board of India-registered financial planning and investment advisory, says, "This is not the best product to invest in for your entire retirement corpus. It makes sense to invest to the extent of tax benefit that can be availed. Otherwise, if one has the discipline of managing one's own asset allocation, investing in plain vanilla equity and debt products may generate superior returns."

EARLY START

A sizeable retirement corpus can be built if one starts contributing to NPS from the mid-30s

Monthly contribution	4,000	8,000
Total corpus at age 60	53,51,562	1,07,03,123
Withdrawable amount (60%)	32,10,937	64,21,873
Available for annuity (40%)	21,40,625	42,81,250
Monthly pension	10,704	21,407

THE NOS. ARE BASED ON CONTRIBUTION FOR 25 YRS TILL AGE 60 AND ASSUMED GROWTH RATE OF 10 PER CENT TILL AGE 60 AND ANNUITY RATE OF 6 PER CENT; FIGURES IN RS

Still Evolving

In an effort to make NPS more investor friendly, PFRDA has been bringing multiple changes in the NPS with regard to its investment guidelines and features. Recently, PFRDA allowed partial withdrawals from NPS, if the funds are needed for children education, marriage, buying of house or a medical emergency. Going forward, the NPS may witness radical changes if the recently submitted Bajpai committee report is put to practice. The underlying theme of the report is that "the investment philosophy pertaining to the entire pension sector needs to evolve from directed investment regime to the prudent investor regime." According to Shukla, "Prudent Investment Regime means the PFMs (pension fund managers) will be given freedom to manage the portfolios by adopting their own investment philosophies with strategies based on their investment experience and fund management expertise. We feel this will bring more maturity and responsibility in the decision making process at the PFM's end and generate higher returns for investors."

Conclusion

NPS has not become a pull-product yet, primarily because of the tax disadvantage. Many are of the opinion that the government may remove this distortion in future to give a level playing field to all retirement-focused products. Until then, investing in NPS will help in additional tax savings and giving a disciplined approach to saving for one's twilight years. BW

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For more on national pension system, visit www.businessworld.in

INVEST SMARTLY

The National Pension System seeks to encourage people to save for their retirement through tax sops. Here is what you should do make the most of the scheme:

1. **Exhaust section 80C limit of Rs 1.5 lakh a year and then consider investing in NPS for additional tax benefit of up to Rs 50,000**
2. **Choose fund option E (equity) to maximise the potential of equities over long term**
3. **Keep contributing at least Rs 50,000 a year into a tier I account**
4. **Put additional savings into a tier II account which does not give any tax benefit**
5. **Use the online facility to contribute, manage funds through ECS**
6. **Get Internet access to your account for efficient use**