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Why NPS is an exceptional product for retirement planning

Swapnil Pawar April 11, 2015

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Retirement planning is often under-addressed by individuals, especially professionals. This is evident from the over-reliance of most individuals on relatively moderate contributions towards provident funds and lack of suitable **long-term products** to address this need. The National Pension System (NPS), launched on January 1, 2004, aims to overcome these limitations by offering higher returns and tax benefits.

NPS subscribers get a unique Permanent Retirement Account Number that they can use anywhere in India. It provides access to two personal accounts: One, a tier-I savings account meant for retirement where subscribers must deposit Rs 6,000 a year and from which withdrawals cannot be made. Two, a tier-II account, which can be opened only when a subscriber has a tier-I account, and which allows withdrawals any time but does not offer any tax benefit.

NPS subscribers would get an opportunity to invest in government securities, equities or corporate debt as opposed to the Employees' Provident Fund (EPF), which invests only in safe but low-yielding government securities. The equity part of the allocation in NPS cannot exceed 50 per cent of the corpus. The equity exposure is decided on the basis of the investor's age. The allocation to equities is reduced every year by two per cent after the investor turns 35 till it becomes 10 per cent. The rebalancing can be done only once a year. Individuals can switch from one fund manager to another and from one **investment** to another. Returns in NPS are not guaranteed unlike returns from EPF and PPF. However, in general, over the time intervals implicit in retirement planning, the expected returns of the portfolio are well in line with the required returns for building a retirement nest-egg.

Finance Minister Arun Jaitley has made NPS more attractive in the 2015/16 Budget by allowing a deduction of Rs 50,000 under Section 80CCD (1B) over and above the existing limit of Rs 1,50,000 available under Section 80C of the Income Tax Act.

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NPS is one of the most inexpensive **retirement products** in the world. In comparison, a typical mutual fund is costlier owing to its higher expense ratio. Besides the fund management cost, there are some additional but small fixed costs for every transaction in the NPS account. NPS ensures that an individual is assured an annuity income in old age with the use of the restrictions it puts on withdrawals. If the withdrawal is done before the age of 60, it is mandatory for the individual to invest 80 per cent of the proceeds in an annuity plan. Even if the withdrawal is made after 60 years of age, 40 per cent of the proceeds have to be invested in an annuity plan whose resulting **pension** is taxed like income from any other pension plan.

Leaving aside the 40 per cent mandatory investment into annuity plans after 60 years of age, the remaining amount is taxable. In comparison, all other retirement products such as EPF and PPF are EEE (Exempt, Exempt, Exempt) in their tax treatment. NPS is EET (Exempt, Exempt, Taxed). On **retirement**, many investors would have a corpus running into lakhs of rupees and so they are likely to fall into the 30 per cent tax bracket. This has been one of the main reasons behind individuals and their advisors staying skeptical about NPS.

Tax treatment at exit aside, NPS is an exceptional product for **retirement planning** since it is low on costs and has tax benefits at present. It is also one of the most investor-friendly investment products in India. As is true of all retirement products, it is never too late to start saving for your retirement right away since it gives the money more time to grow.

(The author is CEO of Karvy Capital)

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