NPS withdrawal made 100% tax free

The government has made the NPS more tax friendly by offering complete tax exemption to the 60% of the corpus that an investor can withdraw on maturity. When they retire, NPS investors have to use 40% of the corpus to buy an annuity and can withdraw the remaining 60% of the corpus. Till now, only 40% of this withdrawn amount was tax free, while the remaining 20% was taxed.

Last week, the Union Cabinet approved a proposal to enhance the tax exemption limit to 60%. "This is a very positive step and brings NPS at par with other retirement products. It will make the NPS more attractive and have a far reaching impact on the pension sector in India," says Hemant Contractor, chairman of the Pension Fund Regulatory and Development Authority (PFRDA).

Pension funds are delighted by the move. "Now that 60% of the corpus will be tax free on maturity, NPS will now be comparable with the Public Provident Fund and Employee Provident Fund and better than any other financial savings product," says Sumit Shukla, CEO of the HDFC Pension Fund. "Earlier, 20% of the corpus was taxable at maturity. That included the principal as well as the gain. Now, no part of the principal will get taxed on withdrawal," he adds.

In another major change, the mandatory contribution by the Central Government for employees covered under NPS has been enhanced from the existing 10% of salary to 14%. "The hike in the government's contribution will make NPS better than the defined pension under the old system where the pensioner got 50% of his last drawn salary," claims Shukla.

HDFC Pension Fund did a study and found that if the employee contributes 10% of his salary to NPS and the government pitches in with 14%, the corpus accumulated in 35 years will generate a pension equal to 64% of the last drawn salary. This assumes that the employee's income (and NPS contribution) will rise 7% every year, the corpus will earn 7% compounded returns and annuity rate will be 7%.

"Central government employees will also be allowed to choose their pension funds and decide the pattern of investment," Contractor said.

The Cabinet has also decided that investments by government employees in the Tier II funds of NPS will be eligible for tax deduction under Section 80C, provided there is a three-year lock-in period. This reduction in the lock-in period pits the ultra low-cost NPS against ELSS mutual funds in the battle for the tax-saving pie. Direct plans of ELSS funds charge up to 1.5% a year, while regular plans can cost 2.5%. "The expense ratios of NPS funds are 0.01%, which is a fraction of what ELSS funds charge," claims Shukla. The savings on costs will obviously add to the returns of the investors.

However, it is not clear how the gains from investments in NPS will be taxed when they are withdrawn. The government must make it clear whether the investments will get the same tax treatment as mutual funds. This is important because till now, the 20% of the Tier I NPS units withdrawn on maturity were fully taxed.

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