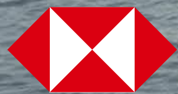
Tax and retirement planning

March 2020



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Why to plan your investments in advance?

- Amish is a professional in his 30s. He receives an email from his office's HR department reminding him that his tax-saving investment declaration for the financial year is due in the next few days.
- In a last-minute rush to declare investments, clueless Amish seeks his uncle's advise.
- Amish's uncle, who has been investing in traditional fixed income products for decades, recommends the same to him. Without a second thought, Amish invests in fixed income products and declares his investments.
- This example is representative of how a lot of professionals plan their taxes in India.

The most common mistake in tax planning

Amish planned his taxes in a disorganised manner – Investing lump sum for tax saving towards the end of the year

- *Tax planning should not be a last-minute job*
- *A tax saving plan at the start of the year will put investors in a better position to estimate cash flows and liabilities that will be due in coming months.*
- *Investors will also be able to allocate small sums of money periodically through the year when they start early.*

For illustration purpose only

It is recommended to consult financial advisor before taking any investment decisions

The don’ts in tax planning

- Apart from haphazard planning, investors like Amish commonly make the following mistakes:

Wrong practices	What should be done?
Not investing according to age and risk profile	The investor’s age and risk profile determine whether riskier investments are appropriate. As Amish is young, he would benefit from exposure to market-linked instruments such as equity linked savings scheme (ELSS), which require longer holding periods and have an advantageous compounding effect.
Investing solely to reduce taxes	While reducing the tax outgo is one of the aims of tax planning, investors should consider their overall financial planning objectives.
Not considering the lock-in period	All tax saving instruments come with a lock-in period. Investors for whom liquidity is a major constraint should be mindful of this criteria. Some tax saving avenues in Section 80C include a multi-year commitment to avail benefits.
Lack of understanding about Section 80C of the Income Tax Act	You can save up to Rs 1.50 lakh under Section 80C, but many investors may not be able to meet this limit resulting in higher tax outflows. Investor can use exemptions provided for life insurance or children's tuition fees apart from making investments.
Considering tax-inefficient avenues	Many individuals prefer investing in national savings certificate (NSC) and long-term bank fixed deposits (FDs), but they may not be optimum for saving tax. Investors can get one-time tax claim on the investment made, but the interest earned on it is taxable.

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What are my tax saving options?

- Mistakes can be avoided by increasing awareness. This is also the first step toward successful tax planning. Here are some tax saving options available under different sections of the Income Tax Act.

Section of IT Act	Particular	Tax exemption limit
Investment linked		
80C	Employee provident fund	Rs 1,50,000
	Life insurance premiums (ULIPs)	
	ELSS	
	National pension system (NPS)	
	FDs (5 years)	
	NSC	
	Sukanya Samriddhi Yojana	
	Senior Citizen Saving Scheme	
	Public provident fund (PPF)	
80 CCD (1B)	NPS	Rs 50,000 (over and above Rs 1.50 lakh under 80C)
Non-investment linked		
80D	Medical insurance	Rs 25,000
80E	Education loan interest	No limit
24B	Payment of interest on home loans	Rs 2,00,000

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A closer look at Section 80C instruments

- Popularity of traditional debt-based tax saving instruments – PPF, NSC and FD – notwithstanding, new age instruments which take equity exposure, such as ELSS, should not be ruled out if the risk profile permits.
- In our example, the latter would benefit Amish greatly.

	Equity-based		Debt-based		
Characteristics	ELSS	Insurance / ULIP	PPF	NSC	Tax Saving FDs
Returns	Linked to equity market returns	Market-linked based on investment chosen (equity / debt)	7.90%*, compounded annually	7.9%*, compounded annually	6.10%^
Lock-in period	Full amount can be withdrawn after three years from date of allotment	No surrender charges after five years	Lock-in period of 15 years; partial withdrawal permitted after six years	No withdrawal prior to maturity, but investments can be used as collateral to avail loans from banks	Premature exits permitted, subject to applicable charges
Tax treatment	10% tax after one year on long-term capital gains over Rs 1.0 lakh	All gains are tax-free	Tax exempt at contribution, accumulation and withdrawal	Interest income taxed at income tax slabs	Interest income taxed at income tax slabs

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*Rate notified for Q4, fiscal year 2019-20

^SBI term deposit rate for 5 year as at January 2020.

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Traditional instruments - pros

- The key attraction of traditional debt-based instruments is safety.
- Apart from tax deductions, investors can use debt instruments to meet their financial planning goals. As debt offers relatively stable returns, it is easier for investors to predict the end value of the corpus.
- Another advantage is that a change in interest rates only affects the interest component and not the invested amount. As a result, there is no risk of experiencing negative returns.

Illustration

Suppose Amish requires cash flow of Rs 1 lakh annually to meet his son's educational expenses five years from now. He can get it by investing Rs 75,000 annually in a five-year FD. This way he will be able to meet his objective and also save tax every year.

Period	Investment in 5-year FD	Tax savings assuming 30% tax slab	Period	Maturity value assuming interest rate of 6.10%*
Year 1	75000	22500	Year 6	100841
Year 2	75000	22500	Year 7	100841
Year 3	75000	22500	Year 8	100841
Year 4	75000	22500	Year 9	100841
Year 5	75000	22500	Year 10	100841

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*SBI fixed deposit rate for 5 year as at Jan 2020

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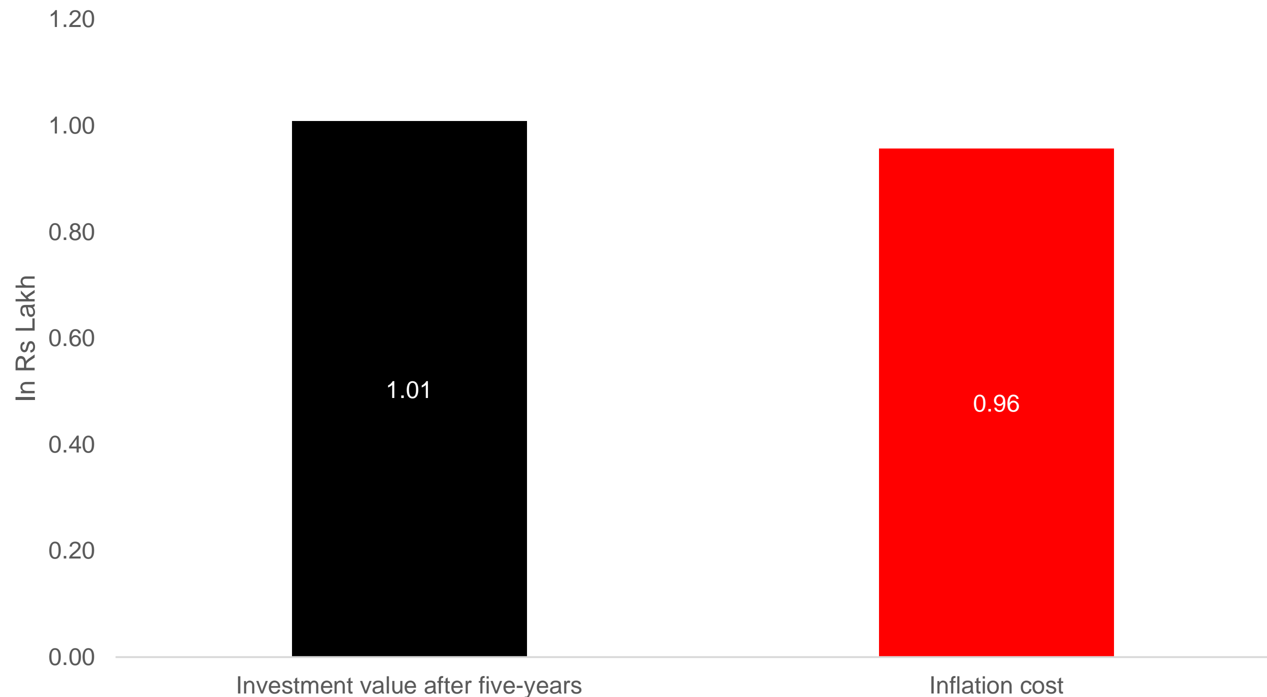
Traditional instruments - cons

- While fixed income investments give the benefit of capital protection and stable returns, they can be disappointing after factoring in inflation.
- This highlights the biggest drawback of traditional investments – their inability to act as return enhancers. Hence, there is a need to look at instruments, such as the ELSS, that take equity exposure.



*Assuming inflation of 5% (Five-year average inflation rate for period ended FY15-19 CPI)

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ELSS – combo to save tax and build wealth in the long term

- A tax saving scheme that predominantly invests in equity securities.
  - Professionally managed by fund managers with experience and research backing.
  - Diversified portfolio across sectors and market cap.
- Investors need to hold units for at least three years to claim tax rebate.
  - Longer investment horizon increases the probability of higher risk-adjusted returns for the investor.
- Withdrawals from ELSS are tax-free as the long-term capital gains tax on equity funds is nil and dividend income is tax-free.
- Flexibility to invest on a monthly basis through systematic investment plans (SIPs).
  - Minimum investments as low as Rs 500 per month.
  - Reduces market volatility and averages out the cost for investor.
- Investments are subject to market risk and, hence, investors must consider their age and risk appetite.

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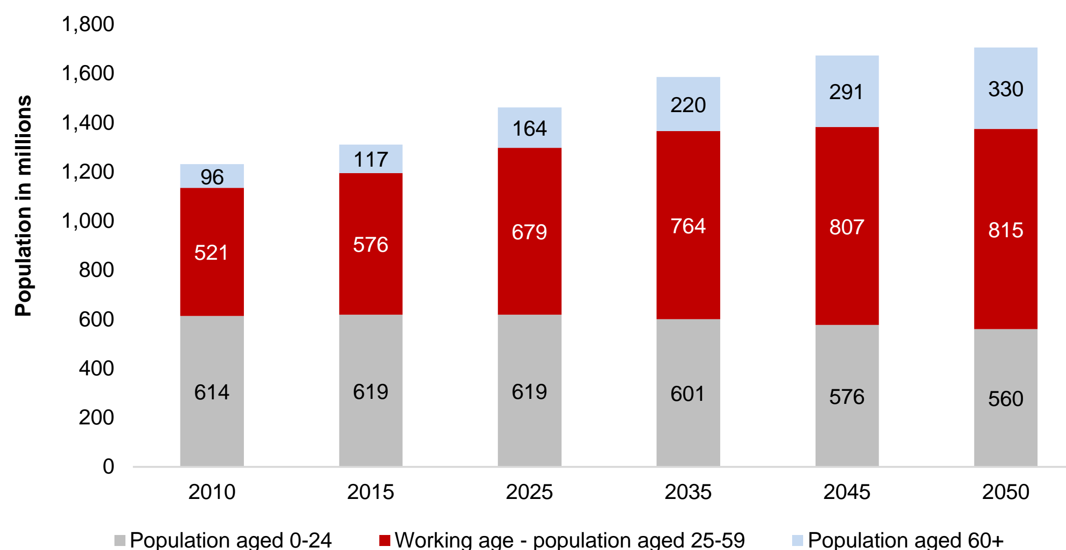
The case for ELSS in India

Equity aligns with the demographic advantage

- India has a demographic advantage over most major economies of the world.
- We have a relatively young population with average age less than 30 years. The country will continue to have a large young population in the foreseeable future.



- By basic thumb rule, a young investor has a higher risk profile i.e. ability to take higher risks and thus generate higher returns to his / her investments.
- In this case, ELSS funds with their mandate to invest in equity allows investors to use this demographic advantage to their benefit while also saving tax in the process.

Source: United Nations data

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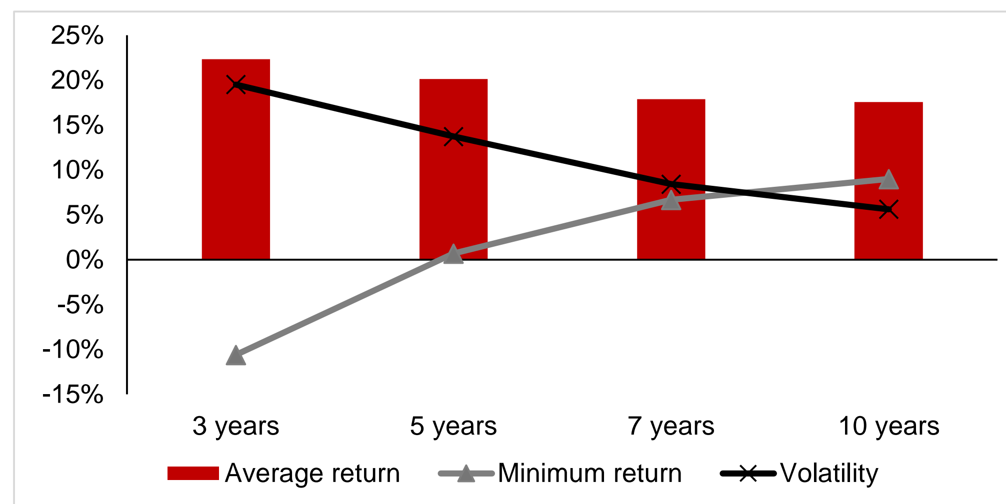
Return and risk characteristics

- ELSS is for investors who have an investment horizon of at least three years. As can be seen by the scheme's return and risk characteristics, investors who stay invested over longer holding periods are rewarded.
- Being an equity product, ELSS is volatile only in the short term. As seen in the graph, volatility decreases and minimum returns increase with increase in the investment horizon.
- Thus, young investors such as Amish, who have a longer time horizon and greater risk tolerance, stand to gain the most from ELSS.

Performance (%)*	3 years	5 years	7 years	10 years
ELSS funds *	12.03	8.32	13.17	11.36
Nifty 50	14.11	7.99	10.88	8.87
Nifty 500	12.22	7.82	11.03	8.59

Annualised returns as of December 31, 2019



Data as of December 31, 2019
Returns are annualised calculated on a daily rolling basis of CRISIL – AMFI ELSS Fund Performance Index since December 2003 till December 2019
Volatility represented by standard deviation

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* ELSS category represented by CRISIL ranked ELSS funds

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Mutual fund (ELSS) versus traditional instruments

- In terms of returns, ELSS' equity exposure helps it score over fixed income investments such as PPF in the long term.
- As tabled, Rs 75,000 each is assumed to have been invested in PPF and ELSS for 10 years ended March 31, 2019, with fresh investment at the start of each fiscal.
- While PPF grew to around Rs 12 lakh at ~8.5%, ELSS garnered Rs 20.58 lakh at 18%.

	PPF			ELSS		
	Beginning balance	Interest rate	Ending balance	Beginning balance	ELSS Funds	Ending balance
Fiscal year 2010	75000	8.50%	81375	75000	-38%	46500
Fiscal year 2011	156375	8.50%	169667	121500	94%	235710
Fiscal year 2012	244667	9.50%	267910	310710	9%	338673.9
Fiscal year 2013	342910	8.60%	372401	413673.9	-4%	397126.9
Fiscal year 2014	447401	8.80%	486772	472126.9	6%	500454.6
Fiscal year 2015	561772	8.70%	610646	575454.6	24%	713563.7
Fiscal year 2016	685646	8.70%	745297	788563.7	46%	1151303
Fiscal year 2017	820297	8.10%	886741	1226303	24%	1520616
Fiscal year 2018	961741	7.80%	1036757	1595616	11%	1771133
Fiscal year 2019	1111757	7.90%	1199586	1846133	12%	2058439

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Returns for ELSS schemes are based on average of CRISIL ranked ELSS funds. PPF returns are based on interest rate announced every year.

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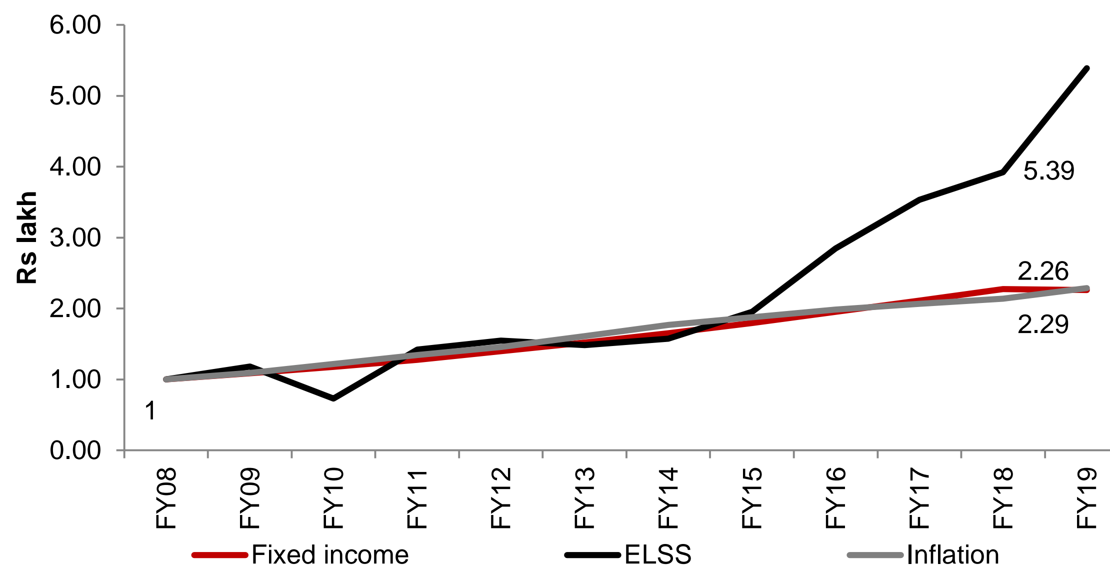
ELSS aims for higher inflation-adjusted returns

- The equity exposure helps ELSS generate higher inflation-adjusted returns than traditional instruments.
- If Rs 1 lakh each is invested in, say, traditional fixed income product (PPF) and ELSS at the end of fiscal 2010 for 10 years ended March 31 2019, the two investments would grow to Rs 2.26 lakh and Rs 5.39 lakh, respectively, compared to inflation (Rs 2.29 lakh).
- In terms of gross returns, ELSS generated 18.35% CAGR and the PPF 8.5% CAGR. On an inflation-adjusted basis, ELSS generated higher CAGR of 11.06% versus PPF's 1.2%.



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Performance of ELSS represented averaged CRISIL ranked ELSS funds , fixed income by PPF and inflation by CPI

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SIP through the year

- SIPs allow investors to park funds in ELSS, starting with Rs 500 per month, at regular intervals. They help investors benefit from rupee cost averaging and, thus, offset volatility in the equity market.
- SIPs also negate the need to time the market, as they rely on time spent in the market to generate returns (read: discipline). Thus, investors can invest in SIPs through the year.

ELSS Funds				
Period	SIP start date	Total amount invested(Rs)	Market value (Rs)	SIP returns (%)
3-Years SIP	02-Jan-2017	18000	19767	6.18
5-Years SIP	01-Jan-2015	30000	36699	8.00
7-Years SIP	01-Jan-2013	42000	62358	11.10
10-Years SIP	04-Jan-2010	60000	110493	11.74

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Data an of December 31, 2019

Performance of ELSS represented by CRISIL – AMFI ELSS Fund Performance Index

SIP returns are annualised

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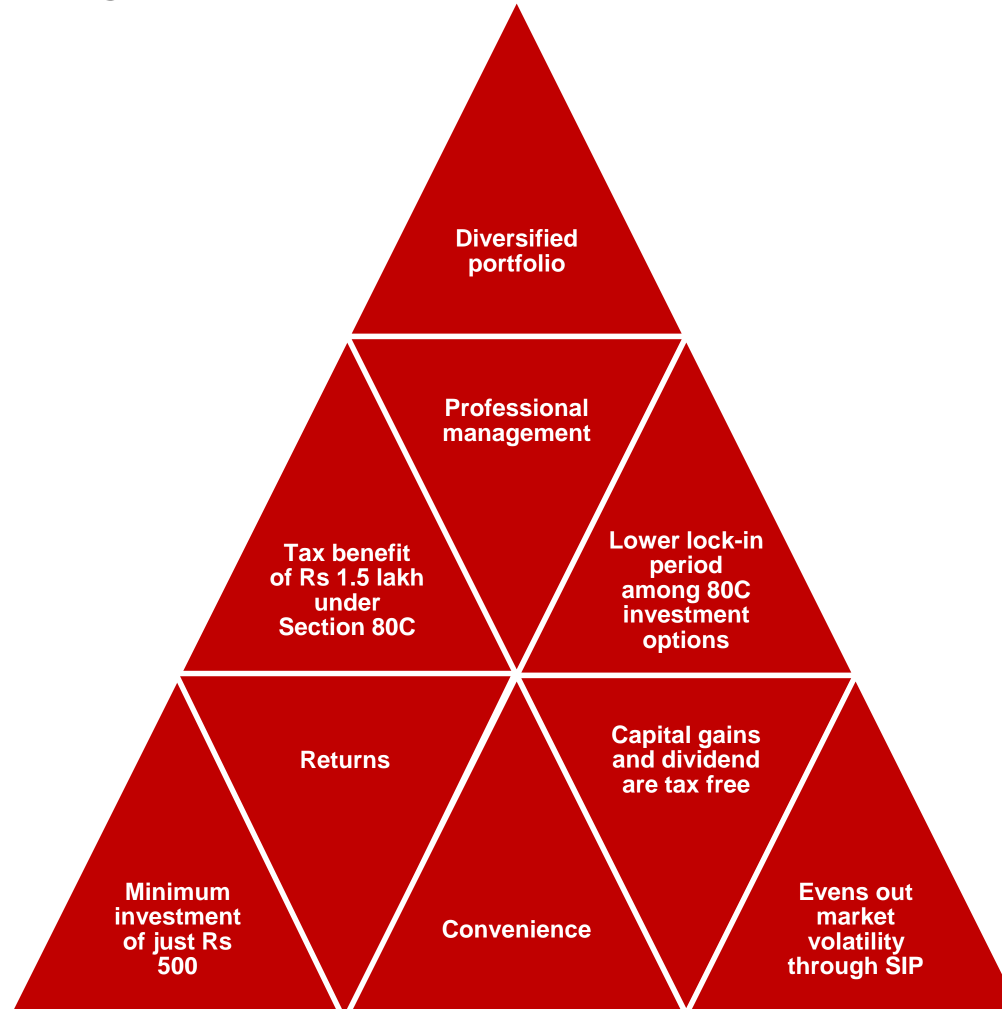
ELSS offers many benefits…



- A word of caution: Investors must remember that as returns are market-linked, they are prone to volatility. Hence, ELSS may not be suitable for very risk-averse investors. Also, investors must remain invested for at least three years to claim tax benefits.

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… Including building a retirement kitty

- In India, it is common for young investors to not take retirement planning seriously. This is because investors entering the workforce usually make the mistake of believing that there will be time to do so in the years ahead.
- What's more, many investors who plan for their retirement rely on fixed income investments for this purpose.
- As retirement planning is a long-term goal, it can effectively be met by investing in ELSS.
- If Amish wants to build a retirement kitty of Rs 4 crore at the retirement age of 60, he can achieve it by investing around Rs 6,000 on a monthly basis (assuming 15% CAGR*) in ELSS for the next 30 years.

* Based on 15-year annualized point to point returns as of December 31, 2019 of a weighted averaged fund performance index created for ELSS funds

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Times are changing and we can’t ignore retirement planning

Rising expenses of lifestyle

If we assume a yearly inflation rate of 6%, Rs 1 lakh in expenses today will increase to around Rs 5.74 lakh per year in 30 years. An investor’s retirement kitty will have to grow at a high enough rate to factor in the rise in living expenses.

Span of retirement

With improvement in health care delivery and higher economic growth, Indians are expected to live longer. According to WHO data, the expected life span of an average Indian is around 68 years at present and is expected to rise in the coming decades.

Nuclearisation of family

Indian households are becoming more nuclear; the average number** of people in a house has decreased to less than five from over five a decade ago. This means that most retirees are expected to fend from themselves rather than look at the traditional form of joint family system.

** According to Census 2011 data

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A ready reckoner on retirement planning

- Start early – No time is considered too soon to begin retirement planning. The sooner you start, the more time you give the funds to grow through compounding.
- Decide how big a retirement kitty you want – This amount varies among investors. At a bare minimum, the retirement kitty needs to be big enough to pay for essential living expenses, which could include expenditure for medical treatment. Additional funds can then be used for specific goals that the investor may have, such as donations to charitable causes and foreign vacations.
- Invest according to your risk profile – Determine the optimum mix of investments according to your risk profile that will help the retirement kitty grow optimally.
  - A young investor has greater risk-taking ability and a longer investment horizon. Accordingly, allocate more funds to equity, which acts as a return enhancer.
  - Middle-aged investors who have greater responsibilities and reduced risk tolerance should invest in a prudent mix of equities and fixed income instruments.
  - Investors nearing retirement, who can't tolerate heavy losses, must allocate most of their funds to safe fixed income investments.
- Monitor and rebalance – Allocation to risky assets should be gradually reduced as you grow older.

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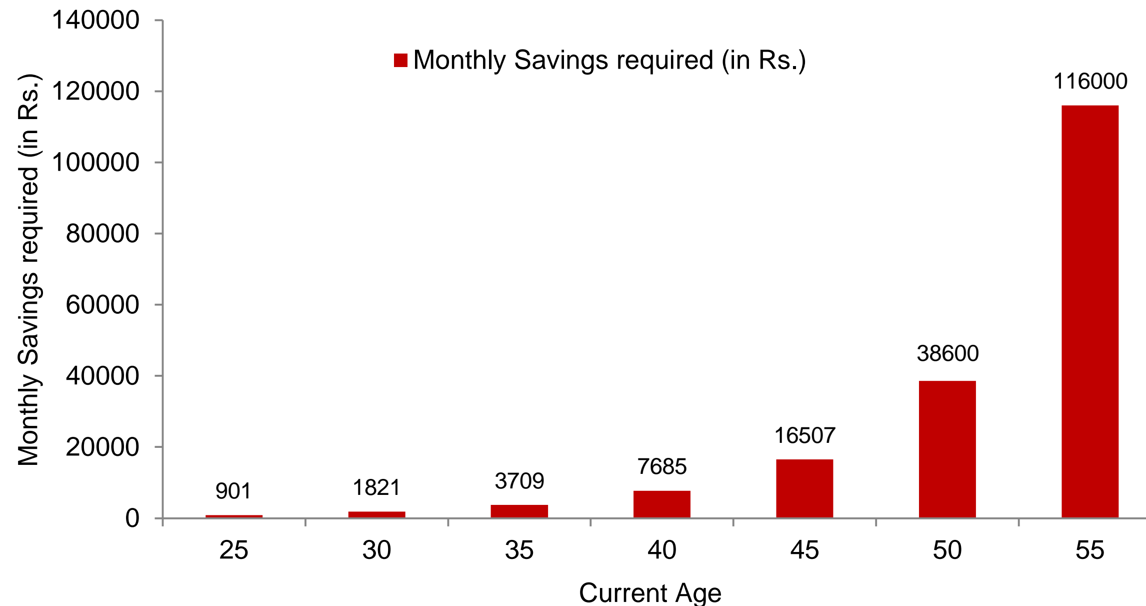
Start early to avoid a large financial burden later

- Amit and Isha, both professionals, wish to have a retirement kitty of Rs 1 crore when they retire at the age of 60.
- Amit is 45 years old and is 15 years away from retirement. Isha is 25 and has just begun her career. Assuming both can deploy their monthly savings in an investment scheme that provides 15%* growth per year, the table below shows how the required monthly savings increase the more you delay.
- As can be seen, Isha needs to save only Rs 672 per month compared with Amit's Rs 14,744.



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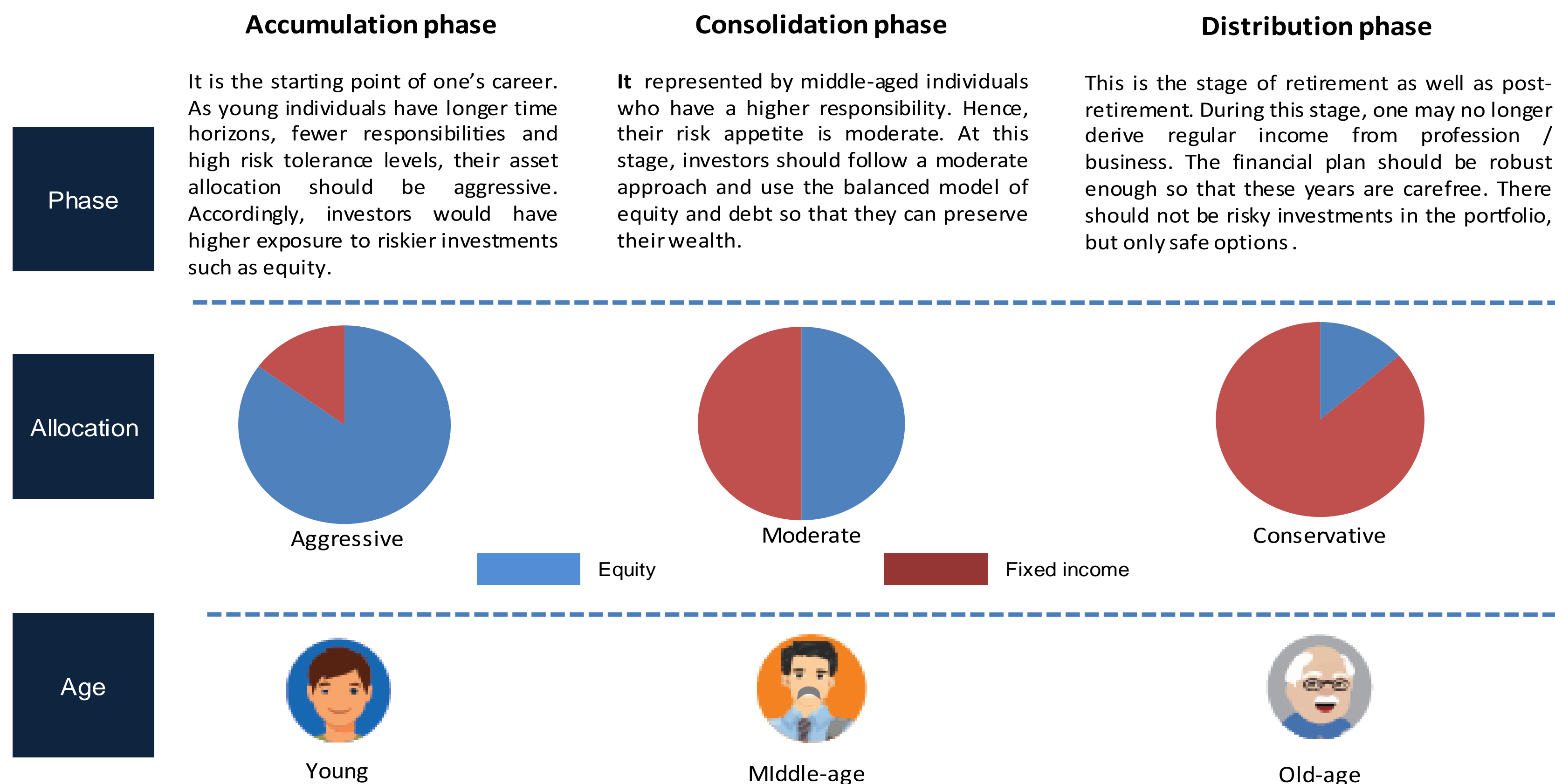
Follow a glide path

- To optimise the retirement planning process, investors must follow a glide path wherein allocation to equities is gradually reduced with the advancement of age. This maps the reduction in risk appetite accurately with the change in invested asset class.
- This is also known as lifecycle-based investment, wherein the retirement planning is split into three phases - accumulation, consolidation and distribution.



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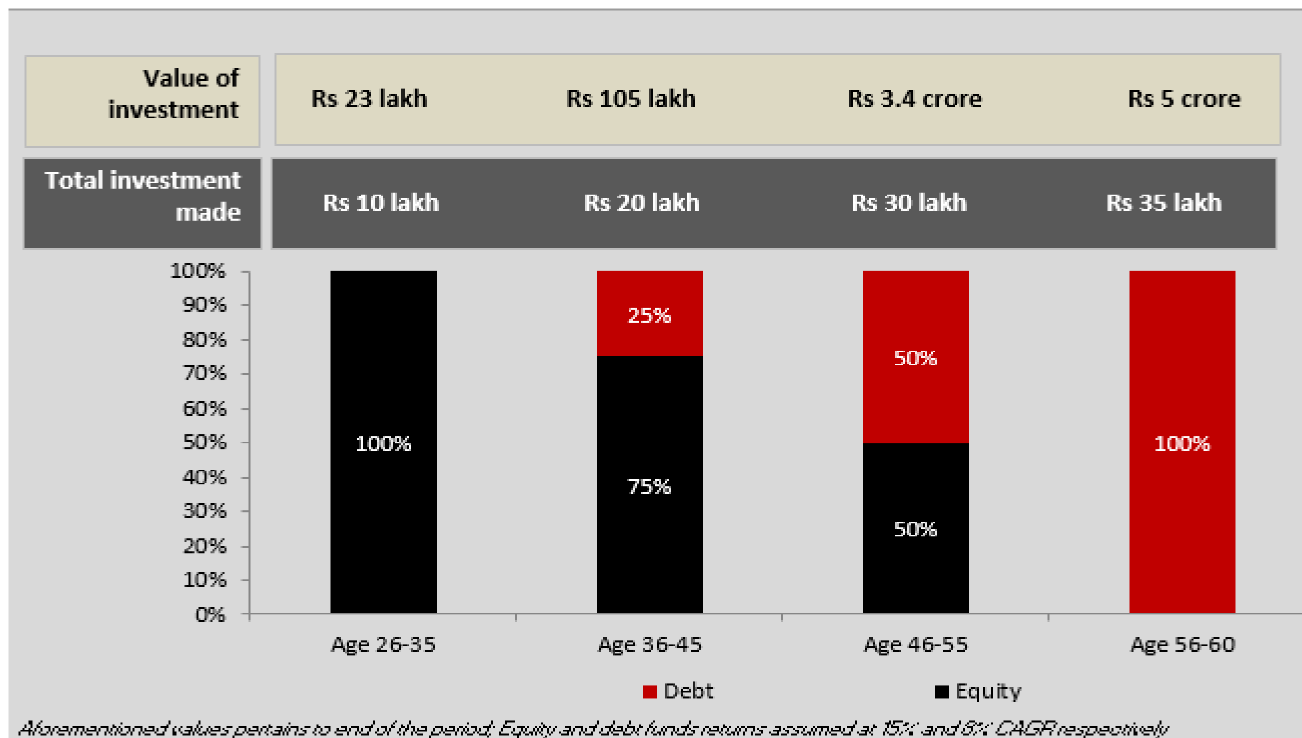
Change in asset allocation when following the glide path

- Illustration – Ravi, 25, wants to build a retirement corpus of Rs 5 crore till he turns 60. His financial advisor suggest to invest Rs 1 lakh annually and follow the glide path wherein his investment allocation should have higher allocation to equity funds in the beginning and reduced at various life stage by allocating more to a debt fund.
- Ravi planned to invest 100% in equity funds between ages 26 and 35; 75% equity and 25% debt funds between ages 36 and 45; 50% each in equity and debt funds between ages 46 and 55; and 100% in debt funds after 55-60.
- At the age of 60, Ravi would be able to achieve his retirement corpus of Rs 5 crore after which he would stay invested in fixed income and withdraw the required amount monthly to enjoy a stress-free retirement life.



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Equity fund returns are based on 15-year annualized point to point returns as of December 31, 2019 of a weighted averaged fund performance index created for ELSS funds

Fixed income fund returns are based on past one –year returns as of December 31, 2019 of a weighted average fund performance index created for short duration debt funds

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