EXPLAINED YOUR MONEY

How does provident fund interest rate cut impact your retirement corpus?

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TWO WEEKS after the Central Board of Trustees of the Employees' Provident Fund Organisation (EPFO) recommended a cut in interest rates from 8.5% to 8.1% for 2021-22, the Centre on Thursday announced it would hold the interest rates on small savings schemes. This came as a surprise — after the EPF rate cut, markets were expecting small savings rates to be reduced.

The post-tax return of 8.1% on EPF is the lowest rate in at least four decades. The EPFO, which has an active subscriber base of more than 6.7 crore and 6.9 lakh contributing establishments, will have an estimated surplus of Rs 450 crore after disbursing the interest. Keeping the rate at 8.5% would have resulted in a deficit of Rs 3,500 crore.

How do EPF rates compare with small savings instruments?

Even after the rate has been cut by 40 basis points and there has been no downward revision for small savings instruments, EPF, which enjoys 'EEE' benefit (at all three stages of investment, accumulation, and withdrawal) for contributions up to Rs 2.5 lakh per annum, offers the highest return to subscribers. Last year, the 2021-22 Budget proposed to tax the interest income on contributions exceeding Rs 2.5 lakh in a year. Against the interest offering of 8.1% on EPF, the highest interest offering among small schemes is 7.6% for investments in the Sukanya Samriddhi Scheme. The senior citizens' savings scheme offers 7.4%, and Public Provident Fund 7.1%.

How will the rate cut impact the corpus?

It will have a notable impact at the end of service. For example, an individual who has an EPF corpus of Rs 10 lakh at the end of March 2021, and who makes an annual contribution of Rs 1.2 lakh that grows at 5% every year on account of salary hikes, would have seen her corpus grow to Rs 1.32 crore at the end of 20 years at 8.5%. At 8.1%, however, this will grow to only Rs 1.25 crore — Rs 7 lakh less.

What has the government said on cutting the interest rate?

The cut in rates is a blow to a large section of the salaried class that mostly saves for retirement and other key life goals through EPF. At a time when CPI inflation has crossed 6%, most fixed income instruments, including fixed deposits, are generating negative post-tax real interest rates. EPF is among the few instruments that generates a positive post-tax real interest.

Labour and Employment Minister Bhupender Yadav, while announcing the interest rate, said: "EPFO's investments are not like commercial bonds; it's a commitment, assurance to workers. The Trust's money should be safe, secure, and offer optimum returns. This interest rate comes at a time when 10-year fixed deposit with the State Bank of India gives around 5.45% interest, while similar savings instruments like PPF offer interest rate in the range of 6.8-7.1%. Social security has to be kept in mind along with the global situation and market volatility. We cannot invest in instruments with high risk, so the interest rate was recommended at 8.10%..."

Over the years, the Finance Ministry has questioned the high rate retained by EPFO, and has nudged it to cut it to sub-8% levels. It had questioned the 2019-20 and 2018-19 interest rates of 8.65%, as also the EPFO's exposure to IL&FS and similar entities, which was deemed "risky".

How will the tax on EPF income work?

The Budget proposal became effective on April 1, 2021. The annual contribution to EPF and Gratuity — and also voluntary contributions to EPF — will be added. If the aggregate contribution exceeds Rs 2.5 lakh, the interest income on that will be taxed at the marginal tax rate. Importantly, only the contribution linked to the employee's component — not the employer's contribution — will be considered for taxation purposes.

So, for an individual in the higher tax bracket of 30%, the interest income on contributions above Rs 2.5 lakh will be taxed at the same marginal tax rate. This means, if an individual contributes Rs 3 lakh every year to PF (including voluntary PF contribution) then the interest on her contribution above Rs 2.5 lakh — that is, Rs 50,000 — will be taxed. So, the interest income of Rs 4,050 (8.1% on Rs 50,000) will be taxed at the marginal rate. If the individual falls in the highest tax bracket of 30%, she will have to pay tax of Rs 1,262.

For an individual contributing Rs 12 lakh in a year, the tax will be applicable on interest income on Rs 9.5 lakh (Rs 12 lakh minus Rs 2.5 lakh). Her tax liability would be Rs 23,985.

KEY NUMBERS

THE EPFO'S corpus for FY22 stood at Rs 9.4 lakh crore, up from Rs 8.29 lakh crore last fiscal. Its income from investments in 2021-22 was Rs 76,768 crore, compared to about Rs 70,457 crore in 2020-21.

REDEMPTION OF equity investment, carried out during February, resulted in realisation of capital gains of Rs 5,529.7 crore, which will be included in the income for 2021-22, as per Labour Ministry data. EPFO has also redeemed Non-Convertible Debentures of Air India in EPFO's portfolio, raising Rs 8,944.32 crore against the face value of Rs 7,772.50 crore.

HIGH WITHDRAWALS and lower contributions were seen in the aftermath of the pandemic. Until Dec 31, EPFO had settled 56.79 lakh claims worth Rs 14,310.21 crore provided under the advance facility.