Syllabus Outline and Weightages

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CHAPTER 1: BASICS OF INSURANCE

LEARNING OBJECTIVES:
After studying this chapter, you should know about:

- Need of Insurance
- Fundamental Principles of Insurance
- Concepts in Insurance
- Role of Insurance in personal finance
- Investing through Insurance
- Role of Insurance Advisor
- Regulations pertaining to Insurance

1.1 Some Simplistic/ Common Examples

These examples have been mentioned for the purpose of illustrating specific Insurance concepts. These examples will be referred later in the study material to understand and illustrate the concepts of Insurance.

Example 1 – Merchant Ships
Sometime in the 19^{th} century, every month merchants in London would send out ships filled with cloth to the distant ports in India and the ships would come laden back with spices and other exotic goods for sale in Europe. A round trip took approximately 30 days. Some ships would be lost at sea.

For the purpose of this example, it is assumed that 100 merchants sent one ship each month. The loss to the merchant in case a ship was lost was Rs. 10,00,000. On an average, 2 ships were lost at sea every month.

So, the total loss suffered by all merchants together was Rs. 20,00,000 (i.e. Rs. 10,00,000 multiplied by 2 ships that were lost). If all 100 merchants got together and paid Rs. 20,000 each into an Insurance fund, it would collect Rs. 20,00,000 (i.e. 100 merchants multiplied by Rs. 20,000 paid by each merchant).

This fund of Rs. 20,00,000 would be paid to the 2 merchants whose ships were lost at sea. So effectively each merchant would be assured that his loss of Rs. 10,00,000 would be covered if his ships were lost at sea by paying Rs. 20,000 each.

From this, come the following concepts:
Risk covered: Ship lost at sea
Sum assured: Rs. 10,00,000
Premium amount: Rs. 20,000
What could go wrong:

a) Not all the 100 merchants agree to pay the premium (i.e. Law of large numbers -- explained subsequently).

b) Some merchants do not want to "waste" their premiums in case their ship is not lost and want to get their premiums back in that case. (i.e. Investment cum Insurance policies -- explained subsequently).

Example 2 – King's employees

A king has 500 employees in his court. All employees will earn Rs. 2 lakhs per year for the next 10 years. All the employees will retire after 10 years. Each employee is the sole earning member of his family. The family is fully dependent on the employee's earnings. Ignoring interest calculations, the gross earnings of each employee is thus Rs. 20,00,000 (i.e. Rs. 2 lakhs multiplied by 10 years).

It is estimated that two of the employees are likely to die during the year. Thus, the loss of employee income during the year is Rs. 40,00,000 (i.e. Rs. 20,00,000 per employee multiplied by 2 employees). The king devises a simple scheme. He contributes an additional Rs. 8,000 per employee totalling to Rs. 40,00,000 (i.e. Rs. 8,000 multiplied by 500 employees) into a separate Insurance fund which would be paid to the family members of the employees who die during the year. Thus, by paying an additional amount of Rs. 8,000 per employee (4% of the annual salary of Rs. 2,00,000) the king is able to assure all his 500 employees that their families will be financially taken care of in case of their deaths.

From this come the following concepts:
Risk covered: Loss of Income due to death
Sum assured: Rs. 20,00,000
Premium amount: Rs. 8,000 per employee

1.2 Need for Insurance

These simplistic examples give a glimpse of why Insurance needs arise. Insurance is a basic form of risk management that provides protection against the loss of the economic benefits that can be enjoyed from assets. These assets may be physical assets, such as ships (in the merchant ship example) or buildings and machinery, or they may be human assets such as employees (in the King's employees' example).

In the above examples, assets are subject to the risk that their ability to generate benefits could be lost or reduced due to unforeseen or unexpected events. There is a financial or economic consequence to the risk, and insurance indemnifies or protects against these consequences. For example, the ability of King's employees (example 2) to generate income from occupation may be affected by illness, disabilities and death. The merchant ships (example 1) could be lost at sea due to storms, piracy, mutiny, leading to loss. The events themselves can only be minimised by taking precautions but not totally prevented. Thus, the consequences of the loss can either be borne by the person to whom the benefits accrue (risk retention) or they can be transferred to another (risk transfer).

Insurance enables risk transfer from the beneficiary (Insured) to the insurance company (Insurer), which undertakes to indemnify the insured for the financial loss suffered. In return, the insured pays a periodic fee, called premium, to the Insurer to receive this protection. To be insurable, the event being insured against, such as death, accident or fire must result in a financial loss that can be quantified and insured against. The premium payable will depend upon this expected loss and the probability of the event occurring during the period of contract.

For example, the premium payable on a health policy for an individual whose parents have a history of ill-health that are considered genetic, such as ailment of heart, cancer or diabetes, may be much higher than that for an individual coming from parents with no such history. This is because the probability that the insurance company will be required to pay medical expenses in the first case is much higher than what it is in the second case.

In the absence of insurance, the loss arising out of the event has to be borne by the person who would have otherwise enjoyed the benefit from the asset.

1.2.1 Requirements of an Insurable risk

There are certain requirements for a risk to be insurable.

a. Large number of exposure units

Large groups of similar, though not necessarily identical, units are subject to the same peril or group of perils. An insurance company is able to offer the protection against such perils, because it operates a common pool in which only a few is expected to suffer loss in any one year. The entire pool pays premium but the liability for the insurance company will be only to a few in a year. In the absence of a large number of people being exposed to the same risk, the premium payable would be much higher and it would be unviable for the insurer and the insured. If the pool of people likely to suffer the loss is large but the number of them who are willing to pay a premium for covering that loss is a fraction, then also the insurance premium would be larger for the people who are willing to pay the premium. In the merchant ships example, if only 40 of the merchants agree to pay the premium, it can increase to Rs. 50,000 per merchant (i.e. Rs. 20,00,000 loss divided by 40 merchants), as against Rs. 20,000 (if all 100 merchants participate). It is not sure of the risk of 2 ships being lost will be from these 40 merchants or the balance 60 merchants who did not participate in the Insurance pool.

b. Insurable Interest

Insurable interest implies that the individual seeking insurance will face financial loss in the event of loss or destruction of the subject matter of insurance. The loss should be monetary in nature and not merely emotional or related to feelings. The interest must be lawful. In the merchant ship example, the merchants have an insurable interest in the ship.

c. Accidental and unintentional

Loss must be accidental, unintentional and uncertain. The only exception is life insurance where the event being insured against, namely death, is certain. However, the time of death is uncertain, which makes it insurable. Loss should be fortuitous and outside the insured's control.

d. Determinable and measurable

Loss should be definite as to cause and amount. The cause must be known, such as death in the case of Life Insurance or fire in the case of property Insurance. It means that loss must be calculatable based on some definite evidence. For example, in case of health insurance, it is determinable with the help of medical bills.

e. No prospect of gain or profit

A further characteristic of the insurable risk is that it does not involve any prospect of gain or profit. In other words, it must be pure risk with only the possibility of full or partial loss. Speculative risk is not insurable. For example, investing in the stock market may result in loss, but it may also result in gain and as such this is a speculative risk and therefore not insurable.

The 'Principle of Indemnity' implies that insurance will restore the financial situation of the insured to where it was before the event that caused the loss or damage. The intent of insurance should not be to make a profit or gain. If it were possible to insure against not making a profit from selling goods in a shop, there would be very little incentive to try to sell the goods if the owner knew the insurance company would step in and pay up anyway.

f. Chance of loss must be calculable

Insurer must be able to calculate with some accuracy, average frequency and average severity of future losses.

g. Premium must be economically feasible

Premiums should not only be affordable but also far less than the value of the risk covered. Else, the option to retain risk will be more feasible than transfer risk through insurance.

1.3 Fundamental Principles of Insurance

Insurance is a unique form of a contract that enables the transfer of risk from one party (the insured) to another party (the insurer). Given the unique circumstances, there are two fundamental principles:

1.3.1 Utmost good faith (*Uberrimae Fidei*)

Since the insured is better informed about himself or herself than the insurer, there is an information asymmetry between the two parties.

The party that has less information i.e. insurer, therefore impose certain screening processes before entering into the contract. Medical test is a typical screening process. However, medical test has its limitations. It does not reveal all ailments or the family history. Therefore, the insurer agrees to enter into the insurance contract based on utmost good faith in the insured.

The obligation is on the insured to disclose all relevant information truthfully. Family history of medical conditions, medical history of the insured, habits regarding smoking and drinking, nature of the profession etc. have implications on risk perception. These need to be disclosed by the Insured before getting covered by the insurer. If this is not done, the Insured is said to have acted in breach of good faith.

At times, the insured does not reveal the relevant information. On that basis, the insurance policy may be issued. However, when a claim comes up, investigation by the insurer may throw up the facts about the information that were suppressed. Based on that, the insurer has the right to reject the claim entirely.

It is therefore in the interest of the insured to share all material information. What is material can be subjective. Anything that can influence the insurer's risk perception on the insured is material. When in doubt, it is safer for the insured to reveal the information, rather than suppress it.

An Insurance policy is a promise from the Insurance Company to pay on the happening of certain risk that causes loss. It is better to fully disclose everything and pay a higher premium to cover the additional risk factor and be sure that the policy will pay up when the risk occurs. In the absence of full disclosure, the Insurance Company may reject the claim. The lower premium paid would be a complete waste and more importantly the loss will not be reimbursed.

1.3.2 Insurable interest

The insurer will cover the risk only if the insured has an insurable interest in the subject matter of insurance. The test of insurable interest is that the insured should be better off if the risk does not materialise but will be adversely affected if the risk materialises.

For example, a business owner has an insurable interest on his inventory, but not in the inventory of a competitor. Family members i.e. direct dependents and relationships of blood and marriage have insurable interest in each other. In other blood relationships, such as aunts and uncles, cousins, nieces, and nephews, the insurable interest would not exist unless there is a proof of financial dependence. Lender has insurable interest in the borrower to the extent of the amount outstanding. Employers have insurable interest in their key employees.

1.4 Concepts in Insurance

a) Indemnity Insurance

Indemnity is defined as "a duty to make good any loss, damage, or liability incurred by another". An insurance contract is thus a classical contract for Indemnity. A good example would be health insurance that normally promises to make good the losses incurred due to hospitalisation expenses.

Thus, any indemnity policy will require a determination of actual loss suffered by the insured person before a pay-out of a claim is made under the indemnity policy.

b) Benefit Insurance

A defined benefit insurance plan is different from an Indemnity Insurance. In a defined benefit insurance plan a fixed sum of money, based on pre-estimated amount of loss, is paid on the happening of a covered event. A life Insurance policy is a good example of a defined benefit insurance as it pays a pre-fixed sum of money on the death of the insured person without really trying to ascertain the exact actual loss caused due to the death of the insured person.

A defined benefit plan is used in situations where it is certain that a loss has been incurred due to the happening of the covered event but:

- it is difficult to ascertain the exact actual loss caused - such as the example of life insurance where the exact loss of future income caused due to the untimely death of the insured person is difficult to ascertain. Another example could be a critical illness policy where again there is a loss of future income due to a critical illness but it is difficult to ascertain the exact loss caused due to this.
- the amount of loss is small and the cost of determining the "actual loss" might not be worth the actual amount of loss caused. An example is a fixed amount paid as daily hospital allowance in some health insurance policies. This amount is to reimburse the losses caused due to personal expenses of the attendant or travelling expenses from residence to hospital, or lost wages of the insured and/or attendant etc. which might be difficult to ascertain on an exact basis. Thus, if there is a fixed daily hospital allowance as a part of a health insurance policy then this portion is a defined benefit plan in contrast to the main policy, which is an indemnity policy that reimburses the actual loss caused due to the expenses paid to the hospital directly.

Table 1.1 highlights the difference between indemnity and benefit policies.

Table 1.1: Difference between Indemnity and Benefit Policies

Sr. No.	Type of Policy	Whether Indemnity or Defined Benefit	Remarks
1	Life Insurance Policy	Defined Benefit	Difficult to ascertain exact loss due to loss of earnings

2	Health Insurance policy for reimbursement of expenditure incurred in hospitalisation (popularly referred to as Mediclaim policies)	Indemnity	Bills are available to ascertain actual loss
3	Daily Hospital Cash benefit allowing a specified sum per day of hospitalisation	Defined Benefit	Losses not easily ascertainable or too small for individual ascertainment
4	Critical Illness Policy that pays a lump sum on occurrence of specified critical Illnesses	Defined Benefit	Difficult to ascertain exact loss due to loss of earnings
5	Property Insurance to pay for losses caused due to fire, earthquake, flood, etc.	Indemnity	Loss is ascertainable
6	Car Insurance	Indemnity	Loss is ascertainable

c) Subrogation

Subrogation means the insurance company steps into the shoes of the insured person after paying the claim and taking all actions that the insured person could have taken. An example could be loss incurred by the insured person due to the accident caused by another car that was at fault. In such cases, the insurance company pays the claim to the insured person; and then steps into the shoes of the insured person and pursues the claim with the “at fault” driver or her insurance company and recovers the loss from them.

Subrogation allows the insurance company a chance to reduce/ recover its losses and the insured person to get her claim from her own insurance company faster without waiting for completing the process to enforce her right against third parties.

A policy without Subrogation rights for the insurer would be more expensive for the insured person.

d) Contribution

When the insured person has more than one insurance policy covering the same risk, contribution is the right of one insurer to get a proportionate share of the claim payable to the insured person. The concept of contribution is applicable only to indemnity policies as the loss amount is ascertainable and the total claim amount cannot exceed the ascertained loss.

The following example will explain the concept of contribution. The insured took two policies of Rs. 5 lakhs each from Company A & Company B respectively to cover the risk of loss arising from floods. Floods occurred and the ascertained loss was Rs. 30,000/-. If

Company A is paying this, it may require Company B to chip in with the proportionate amount of Rs. 15,000/- (based on the share in the Sum Assured).

Contribution is also used in the context of Health Insurance policies (relating to reimbursement of hospitalisation expenses incurred). As per IRDAI regulations, in health insurance policies when the insured person has covered the risk with more than one company, it is the choice of the insured person to choose from which company to get her claim. Thus, the chosen insurer has no option to apply the contribution clause where the claim amount is less than the sum insured in the chosen policy. However, if the amount of claim exceeds the sum insured under the chosen policy, the insured person can choose another policy(ies) under which the claim can be made. In such cases, the claim is settled by the chosen insurers by applying the Contribution provisions.

e) Co-Pay

Co-Pay is the proportion of the claim amount that will be met by the insured person. It is used in the context of car insurance and health insurance. For example, if the insured person has agreed on a co-pay of 15% and the ascertained claim amount is Rs. 2,00,000, then the insured person will pay Rs. 30,000 (i.e. 15% of Rs. 2,00,000) and the insurer will pay only the balance amount of Rs. 1,70,000.

The concept of co-pay is to make the insured person sensitive to the claim amount as she will also be bearing a part of the eventual claim amount. Co-Pay also allows the insured person to lower the premium amount for the same degree of coverage. Higher the co-pay, lower will be the premium.

However, in practise, it is not very popular with insured persons as they have very little control over what the hospitals/ garages charge for their services.

f) Deductible

Deductible is that portion of the claim that is paid by the insured person after which the claim becomes admissible. For example, car insurance in India has a compulsory deductible of Rs. 1,000 for cars with an engine capacity of upto 1600 CC.

Suppose, a car insurance policy has a deductible of Rs. 1,000 and the claim amount is ascertained at Rs. 25,000. The amount that will be paid by the insurer will be Rs. 24,000 after deducting Rs. 1,000. The insured person can accept a larger deductible to reduce the premium. This is popular in car insurance as most insured persons are loath to make small claims, given the time and effort involved with making claims.

Similarly, in health insurance policies the concept of Deductible applies. The claim from these policies is payable only when the insured has paid the deductible amount either from his own funds or from any other health insurance policy. The company will be liable to pay the claim only if the claim exceeds the Deductible amount.

Health insurance deductibles are of 2 types:

1. Compulsory Deductible - The amount of deductible is either fixed by the insurance company, or expressed as a percentage of sum assured. For example, if compulsory deductible is Rs. 30,000 and the hospitalization bill is Rs. 80,000, then the company will pay Rs. 50,000 and the insures will borne the fixed deductible portion i.e. Rs. 30,000. The premium for health insurance policies are calculated after factoring in the deductible of the policy. Top-up and Super Top-up policies are designed with a fixed deductible amount and the premiums are generally lower than the basic health plan of same coverage amount.
2. Voluntary Deductible – The insured, based on his affordability or medical expenses, choose an amount which he/she would like to pay from his own pocket. In this case, the premium is based on the deductibles. If the insured choses a higher deductible, then the premiums of the health policy will be lower.

Difference between Deductible and Co-Pay

An example will help to explain this. Policy 1 has a deductible of Rs. 1,000 and Co-Pay of 10%. Policy 2 only has a deductible of Rs. 5,000 and no co-Pay. The ascertained claim amount is Rs. 40,000.

In this case, Policy 1 will pay Rs. 35,100, which is calculated as Rs. 40,000 less deductible of Rs. 1,000 equals Rs. 39,000 less Co-Pay Rs. 3,900 equals Rs. 35,100.

Policy 2 will pay Rs. 35,000, which is calculated as Rs. 40,000 less Deductible of Rs. 5,000 equals Rs. 35,000.

g) Other Concepts

Cashless claim payment

This is relevant for indemnity insurance and mostly used in the context of health insurance and car insurance. Under normal circumstances, the insured person first incurs the expenditure at the hospital/ garage and then files a claim for reimbursement with the insurer. This blocks the cashflow of the insured person. In many cases, the insured person may not have that amount of cash available to make the payment to the hospital/ garage. The uncertainty about the timeframe of the reimbursement process may also worry the insured person. Hence, an arrangement is made where the insurer approves the claim amount as soon as the bill is submitted to the insurer and the payment is made by the insurer directly to the hospital/ garage. Also, as the claim amount to be paid remains the same, whether the amount is paid directly to the hospital/ garage or reimbursed to the insured person, there is no impact on the premium.

If the insurer selected by the insured person has a cashless arrangement with the insured person's favoured garage/ hospital, then it is a big positive for the insured person in selecting the insurer.

However, a few words of caution on using this as a major reason for selecting an insurer for Health Insurance/ Car Insurance:

- Cashless claim payment is a one-on-one arrangement between the insurer and the Hospital/ Garage. The list of hospital/ garages approved by the insurer for cashless payment keeps changing and even though the favoured hospital/ garage of the insured person is on the approved list at the time of taking the insurance policy, it may no longer be on the list at the time of the claim.
- Where the claim occurs, (location) is not in the hands of the insured person and the treatment/ repair is required to be done at any convenient hospital/ garage, not necessarily the one favoured by the insured person.
- The cashless payment process has still not stabilised and leads to delays in releasing the patient/ car as the approval by the insurer takes time.
- Since the cashless process has not stabilised many hospitals/ garages will require a deposit from the insured person before releasing the patient/ car. This deposit is refunded once the hospital/ garage actually receives the claim from the Insurance company. This deposit process defeats the whole purpose of cashless claims. It is also administratively cumbersome to get the deposit refunded from the hospital/garage.
- There will be certain expenditures like pre-hospitalisation and post-hospitalisation expenses incurred in a health Insurance policy that requires submitting a re-imbursement claim in any case.

For all these reasons, if cashflow is not an issue, then this feature may be considered less important while making a choice of the insurer. Note: In recent times the Insurance regulator has laid a lot of emphasis on cashless settlements and the percentage of claims being settled in this manner is increasing. In any case it is happening across the board and hence is not a material parameter for selecting your health insurer/ car insurer.

Cashless payment on health insurance policies bought for employees and their family members by the Employer (generally referred to as Corporate policies)

Cashless payment on Corporate policies is a little different from cashless payments under policies bought by the Individuals directly from the insurance company. The main reason for this difference is that most Corporate policies allow hospitalisation expenditure incurred on pre-existing disease to be reimbursed. This contrasts with policies bought by the individuals directly from the Insurance companies where this may not be reimbursed for the first 3-4 years.

Most disputes on claim payments for individual policies are due to this pre-existing disease clause. Since that is not a factor for most Corporate policies, the cashless payment process works far more smoothly in the case of Corporate policies.

Corporates pay large premiums to the insurer for all the risks covered by them. That is one more reason why the cashless process works smoother for the corporate policies than it does for individual health policies.

Nominee and Legal Heirs

Under normal law, the Nominee holds any property in trust for the legal heirs of the person. In other words, if Mr. Rich nominates Mrs. Rich as his nominee in a bank fixed deposit of

Rs. 1 lakh then on his death the bank will pay over the amount of Rs. 1 lakh to Mrs. Rich in discharge of its liability to pay back the fixed deposit. However, Mrs. Rich holds the amount in trust for all the legal heirs of Mr. Rich. Further assume, Mr. Rich died without leaving a will and as per the personal law applicable to him the bank fixed deposit is to be equally divided among Mrs Rich and their two children. In such a case, Mrs. Rich holds the children's share in trust for them and she will be accountable to them for that money.

However, there are exceptions to the "Nominee is a trustee for the Legal Heirs" rule. The Insurance Act, 1938 was amended in February 2015 to introduce the concept of "Beneficial Nominee". Under this provision if the nominee of a Life Insurance Policy is "*the parent, or spouse, or his children, or his spouse and children, or any of them, the nominee or nominees shall be beneficially entitled to the amount payable by the Insurer to him or them*" (Section 39(7) of the Insurance Act, 1938).

For example, Mr. Rich had a Life Insurance policy of Rs. 1 lakh and the nominee was his spouse Mrs. Rich. Mr. Rich died without making a will. Mrs. Rich will be beneficially entitled to the claim amount of Rs. 1 lakh without being accountable to the legal heirs who may include the two children also.

Life Insurance contract not to be called-in question after 3 years on any grounds

Section 45 of the Insurance Act, 1938 provides that no life insurance policy can be called into question 3 years from the date of the policy. It means that 3 years after the policy is issued or risk commences or from a revival date (whichever is later) a death claim cannot be denied on any ground whatsoever. However, during the 3-year period the claim can be denied (repudiated) or the policy can be cancelled on grounds of fraud. In fact, any large death claim during the first 3 years will invariably result in a full-fledged investigation irrespective of the Life Insurance company involved.

Hence, it makes sense to follow the principle of *Uberrimae fide* (utmost good faith) and make full and complete disclosure of all relevant facts while taking an insurance policy.

Health Insurance Policies not contestable post moratorium period[1]

A moratorium period, which is 5 continuous years, is applied in health insurance policies. If insured has paid premiums during this moratorium period, without any breaks, then no health insurance claim shall be contestable, except for proven fraud and permanent exclusion as specified in the policy. In case of any enhancement in the basic sum insured of the first policy year, then 5 continuous years will be applicable from the date of enhancement of sum insured for the enhanced limit.

[1] Vide Ref No.: IRDAI/HLT/CIR/PRO/84/5/2024 dated May 29, 2024 on Master Circular on IRDAI (Insurance Products) Regulations 2024 - Health Insurance.

1.5 Role of Insurance in Personal Finance

Insurance removes the risks to the income of a household from situations such as loss of income, reduction in income or an unplanned and unexpected charge on income, which will upset the personal financial situation of the household. Consider the following situations:

- Siddesh died young leaving his dependent wife and kids without financial support.
- Manohar is an architect who suffered from a stroke and is now unable to practise his profession.
- Arushi is a Computer Aided Design professional who met with an accident in which she lost her eyes and thus is unable to continue with her profession.
- Sindhu's car met with an accident and requires a large sum for repairs.
- Mohit suffers from arthritis and has to spend a large sum each month on physiotherapy.
- Jayant's daughter is getting married in a few days. The house is full of gifts and valuables. There is a burglary in the house and the valuables are stolen.

In all the situations described above, there is either a loss or reduction of income or a large expense that has to be met out of available income. Income is at the base of all financial plans and any event that affects income of the individual will affect the achievement of the goals that the financial plan seeks to achieve.

Insurance can be used to protect the income so that the financial goals are not at risk. If Siddesh had a life insurance policy for a sum adequate to meet his family's financial needs and goals, then he would have protected them from the financial effects of his death. Similarly, a critical illness policy would have provided a corpus to Manohar to compensate for the lost income from his architectural practise. A personal accident disability insurance would have provided a corpus that could generate the income that Arushi lost due to her accident; and a motor insurance policy would have covered the cost of repairs to Sindhu's car and his income would not have been affected. There are insurance policies available to provide cover against most situations that can cause disruption to the income and affect the financial situation of the individual.

Prioritizing insurance needs and investment needs

Insurance comes before Investments. A simple analogy can explain this. In cricket, a batsman wears protective gear. An abdomen guard and leg pads will slow down the batsman's movement and the running between the wickets. Yet even the greatest batsman in the world will never play an innings without wearing the protective gear. That is because one hit could finish his cricket career.

Similarly paying an insurance premium to cover the risk of the financial plans getting derailed, is acceptable before any investments are made to realize the financial goals.

1.6 Investing through Insurance

Insurance is also seen as a way to save and invest. Some insurance policies include a saving component along with the risk protection. The premium collected will be higher, with one portion assigned for risk protection (insurance component) and the other for the saving component (investment component). The type of investment envisaged will determine the risk and return from the investment.

1.6.1 Should investments be done via insurance

Carrying the earlier cricket batting analogy further, the protective gear and the bat together can be bought as a single kit or separately. To win the match, both good protective gear and good bat are required. However, a combined kit consisting of the protective gear and bat should not be bought just because it is convenient or cheap, if either the protective gear or the bat is not as per the required quality.

Using the merchant ship example cited earlier, if the merchant desires that the premium be returned in case the ship comes back unharmed, the premium amount payable will go up astronomically. Assuming the rate of return on investments is 12% per annum (or 1% per month) the merchant will need to pay a premium of Rs. 20,20,000 (which is higher than the value of the ship itself) to be able to get the premium amount back. Here is how the math works out. The merchant pays a premium of Rs. 20,20,000 out of which the Insurance company allocates Rs. 20,000 to the insurance pool and the balance Rs. 20,00,000 is invested. The investment amount becomes Rs. 20,20,000 (original amount of Rs. 20,00,000 plus interest earned at 1% pm) after one month which is then returned to the merchant.

This is an extreme example to illustrate some of the pitfalls of combining investment and insurance together without doing a detailed analysis. As premiums rise astronomically in investment cum insurance policies that provide adequate insurance as well, the insured person who insists on getting her premium back typically compromises by reducing the amount of coverage, which effectively compromises the basic purpose of insurance.

1.6.2 Prioritizing insurance needs and investment needs

The primary job of any insurance company is to provide risk coverage not investment products. There are other entities that specialize in providing investment products. Risk coverage (Insurance) products can be bought only from Insurance companies. Investment products can be bought from entities that specialize in investment products.

Even if an insurance cum investment product is being considered, it can be evaluated as an insurance product that also has investment elements in it. The first thing is to decouple the insurance and investment elements of the instrument. Then, the adequacy of the risk coverage needs to be examined. If the risk coverage is not adequate, then the instrument does not meet its primary goal and should be eliminated. Only after this primary requirement is met, should the investment return be considered separately to see if it is suitable for the investor and meets her requirements; and also comparable with investment products with similar profiles.

1.7 Role of Insurance Adviser

1.7.1 Steps in Insurance Planning

An essential part of financial planning is insurance planning. Just like financial planning, insurance planning is also specific to the individual and their situation. The steps in insurance planning include identifying the protection needs and quantifying them, buying the type of insurance that suits the requirement and setting in place a review of insurance needs periodically.

a. Identify insurance need

Insurance is primarily a tool for protection from financial loss. Identifying insurance needs therefore requires identifying all those situations that can result in a loss of income or an unexpected charge on income. Insurance needs can be broadly categorized as:

- Income replacement needs in the event of risk to the earning ability of an asset, which includes the life of an individual as well as his earning ability as an asset generating income. Life insurance, critical illness and accidental disability insurance for the maintenance and replacement of plant and machinery and annuities are all examples of insurance products that meet this need.
- Income protection needs protect the available income from an unexpected charge. Health insurance and motor insurance are examples of insurance products that will take over such expenses if they occur, and thereby protect the income from a large and unplanned outflow.
- Asset protection needs include the need to protect assets created from theft or destruction. Household insurance is one such product.

The type of insurance required depends upon the age and stage in the life of the individual. Insurance implies a cost and buying insurance that is not required is a wasteful use of income.

A young individual without any dependents may probably need a personal accident disability insurance policy or a critical illness policy that will give him an income in the event of his being incapacitated in an accident or suffering from a critical illness, more than a life insurance policy. The life insurance policy will replace his income in the event of his death, but since he has no dependents, it may not be as relevant at this stage in his life. For an individual with dependents, the primary need is income replacement to support his family in the event of his death and therefore a life insurance policy that does this will be more relevant.

b. Estimate the insurance coverage

- **Estimate the amount of insurance required**

The purpose of insurance is to compensate the financial loss suffered from a specified event. It is not to profit or gain from it. The amount of insurance required must be calculated by giving due consideration to factors such as the future value of the costs being sought to be replaced, the period for which protection is required and the ability to bear the cost of insurance. Under-insurance implies the beneficiary, who is likely to suffer the loss, is retaining a portion of the risk with themselves. On the contrary, over-insurance imposes unnecessary costs in the form of higher premiums.

- **Estimate the tenure for which the insurance is required**

The purpose of any income replacement policy is to replace income that would otherwise have been generated. By definition, income replacement policy is required during the earning phase of the insured person's life and not after her retirement. In some cases the additional premium payable from the first year of coverage is pretty low even if the coverage term is extended. For example: For somebody aged 30 years they are able to get a 30 year (till age 60) term insurance policy for Rs. 13,800/- per year versus a 40 year (till age 70) term insurance policy for Rs. 16,200/- per year. It effectively means that the person is paying additional premium of Rs. 2,400/- per year to get an option to continue the policy beyond their earning years (assuming they retire at 60 years). The person may find it worthwhile to pay that price for the option to continue renewing the policy even after reaching the age of 60 years.

c. Identify the most suitable insurance product

Having decided on the insurance coverage, the next decision is the choice of product. Various types of insurance products are discussed in the next section.

d. Optimise the insurance premium

Within the same insurance product and coverage, there are choices that help the insured reduce the insurance premium.

For example, in motor insurance, it is common to ask for non-mandatory information relating to the insured that help in understanding the risk better. Insurance policy will be issued even if the additional information is not shared; but the insured can reduce the premium by sharing the information.

Another avenue for reducing premium in the case of non-life policies is in the choice of 'deductible'. The insured can agree that in the event of a claim, a certain amount (the deductible) will be borne by the insured. Thus, the insured is sharing the risk with the insurer. This is compensated through a lower insurance premium. Higher the deductible that the insured is prepared for, lower the insurance premium. The 'no claim' bonus can be used to reduce premiums in the following years.

Insurers may also offer discount on premiums to policyholders on E-Insurance policies, i.e. insurance policies issued in electronic forms that are exempt for issuance in physical form

e. Monitor the insurance coverage

Insurance is not a one-time activity. The exposure and coverage need to be monitored continuously. Where necessary, the policy coverage would need to be modified to mitigate additional risks. Reviewing insurance cover is advised whenever there is a big change in life, which alters the demands on your income. Marriage, children, buying a house and even a large raise, are situations that require a review of the adequacy of the insurance cover. Life insurance cover may even be reduced over time as goals are met and there are fewer goals to be provided for.

1.8 Regulations pertaining to Insurance

Some aspects of regulations pertaining to life insurance have been discussed earlier. Below is a glimpse of certain regulatory aspects pertaining to health insurance and ULIPs.

1.8.1 Health Insurance

- Standard terminology should be used in all Health Insurance policies to impart common understanding to the insured persons. Important terms such as pre-existing diseases, portability, co-payment, deductible etc. have been standardized.
- There is standardization of what can be excluded from coverage in a health insurance policy. The insurance company can have lesser exclusions than provided for but cannot exceed the exclusions provided in the prescribed regulations.
- Many illnesses, like mental illness, genetic disorders, congenital disease and others have been removed from exclusion list.
- Any health insurance policy (other than a group policy or a super top-up or a top-up policy) can be ported from one company to another company.
- Group health insurance policies can also be ported to individual policies within same company in first year of leaving the company, and to any other company from second year onwards.
- The insurance company must provide fair justifiable and transparent reason in writing for any rejection of health insurance coverage.
- A health insurance company cannot reject a claim if policy is continued for 5 years without any break by the policyholder.
- Telemedicine is now covered under health insurance.
- If there is any delay in claim settlement, insurance company is now liable to pay interest on claim amount.
- All general and health insurers are required to offer a standard individual health insurance product mandated by IRDAI with the following objectives:
    - Health Insurance policy to take care of basic health needs of insuring public.
    - To have a standard product with common policy wordings across the industry.
    - To facilitate seamless portability among insurers.
    - The standard product shall have the basic mandatory covers as specified in IRDAI Guidelines which shall be uniform across the market.
    - No add-ons or optional covers are allowed to be offered along with the standard product.

1.8.2 Unit Linked Insurance Products (ULIP)

- Insurers must provide the prospect/policyholder all relevant information about various charges for each policy year.
- Insurers must provide benefit illustrations giving two scenarios of interest – at 4% and at 8%.
- The prospect is required to sign on the illustration also while signing the proposal form.
- The lock-in period is 5 years to reflect the long-term, protection function of the policy.

- All regular premium/ limited premium ULIPs shall have uniform/ level paying premiums.
- Any additional payment shall be treated as single premium for the purpose of insurance cover charges on ULIPs should be evenly distributed during the lock-in period so that the expenses are not excessively front-ended.
- All limited premium paying term unit linked insurance products, other than single premium products, shall have premium paying term of at least 5 years.
- All unit linked products, other than pension and annuity products should have a mortality or health cover.
- The minimum cover to be offered has been specified for these segments.
- A cap on charges has been imposed from the 5th year onwards to smoothen the charge structure for the policyholder.
- Discontinuance charges are capped as a percentage of fund value and premium and also as an absolute value.
- The Grace Period for different modes of premium payment is clearly defined.
- No Surrender charges are applicable after 5 policy years.
- The partial withdrawals from ULIPs are allowed to a certain limit after 5 years of lock-in is over.
- A lapsed ULIPs can be revived within a period of 3 years from the date of lapsation.

1.8.3 Regulatory aspects for insurance intermediaries[2]

1. "Intermediary or insurance intermediary" includes insurance brokers, reinsurance brokers, insurance consultants, surveyors and loss assessors.
2. Insurance Brokers: Brokers represent the client and assist the client in matching their needs with multiple Insurance companies.
3. There are various types of Insurance Brokers:
    a. "Direct Broker" means an Insurance Broker who can charge a fee to his clients or earn a commission from the Insurance companies. Direct Insurance Brokers solicits and arranges insurance business for its clients with multiple insurers located in India and/or provides claims consultancy, Risk Management services or other similar services.
    b. Reinsurance is the practice whereby insurance companies transfer portions of their risk to other parties/Reinsurance firms by some form of agreement to reduce the likelihood of paying a large obligation resulting from a single insurance claim or similar risks. Reinsurance is done so as to spread the risk widely among as many parties as possible so that no single party is affected in case of a large claim. "Reinsurance Broker" means an insurance Broker who solicits and arranges reinsurance for its clients/Insurance companies with multiple insurers and/or reinsurers located in India and/or abroad; and/or provides claims consultancy, Risk Management services or other similar services.
    c. "Composite Broker" means an Insurance Broker who is both – Direct Broker as well as a reinsurance broker.

[2] Vide IRDAI (Insurance Brokers) Regulations, 2018, IRDAI (Appointment of Insurance Agents) Regulations, 2016 and IRDAI (Registration of Corporate Agents) Regulations, 2015.

d. "Insurance Agent" means an individual appointed by an insurer for the purpose of soliciting or procuring insurance business including business relating to the continuance, renewal or revival of policies of insurance.
e. “Composite Insurance Agent” means an individual who is appointed as an insurance agent by two or more insurers subject to the condition that he/she shall not act as insurance agent for more than one life insurer, one general insurer, one health insurer and one each of the mono-line insurers.[3]
f. Corporate Insurance agent - Corporate entities represent an insurance company and sell its policies. Usually, they are engaged in a particular business and sell insurance policies to their existing customers based on the situation. For example, a travel agent may offer you a travel insurance policy or a vehicle dealer a motor insurance policy.
g. Corporate Agent (composite) can work with a maximum of three life insurers, three general Insurance companies and three health Insurance companies.
h. When a bank becomes the corporate agent of an insurance company it is referred to as a bancassurance arrangement or partnership.

4. Insurance Web Aggregators are insurance intermediaries who maintain a website for providing online price comparison and information of products of different insurers and other related matters.

Table 1.2: Difference between Insurance Agent and Direct Insurance Broker

Parameters	**Direct Insurance Broker**	**Insurance Agent**	**Corporate Insurance Agent**
Who he Represents	The client	Insurance Company	Insurance Company(ies)
Can work with	Multiple Insurance Companies	More than one Insurance company in each line of business – Life, general and health; provided he dispassionately advices the policyholder on the products of all Insurers whom he is representing and the product best suited to the specific needs of the prospect	Corporate Agent (composite) can work with a maximum of three life insurers, three general insurance companies and three health Insurance companies

[3] Mono-line insurer means insurer, as defined under section 2(9) of Insurance Act, 1938, and carrying on one particular specialized line of business such as agriculture insurance, export credit guarantee business

Parameters	Direct Insurance Broker	Insurance Agent	Corporate Insurance Agent
Can Charge	Fees to the Client and get commission from the Insurance Company	Get commissions from the Insurance Company	Get commissions from the Insurance Company(ies)

1.8.4 Regulations for Insurance Intermediaries under IRDAI Regulations

In order to make insurance intermediaries such as agents and brokers more accountable and reduce instances of mis-selling, insurance agents have to ensure that they sell policies based on product suitability parameters such as risk appetite and financial goals of their clients.

Insurance agents will have to justify product suitability before selling it to clients. Suitability analysis has been optional for quite some time. As a result, most agents skip this section in the proposal form.

Insurance companies cannot issue an investment cum insurance policy until their agents ensure that the policy is sold after suitability analysis. Such suitability will have to be ascertained through a series of questions such as age, income, family status, life stage, financial and family goals, investment objectives, insurance portfolio already held and so on. Suitability is to be determined based on information collected at the time of sale. Such a determination should be based on prospect's risk profile, financial situation and investment objectives. However, agents can skip this requirement only if they get a written consent from policyholders saying that they have consciously chosen to bypass suitability module despite recommendation of their agents.

On benefit illustration, agents will have to clearly state what the policy is all about. Agents and insurance companies can give benefit illustration by taking 4% and 8% return into account. Also, agents are required to sign the benefit illustration form along with policyholder to ensure that they have not lured investors with attractive returns. In addition, agents will have to clearly state what is guaranteed and non-guaranteed benefits attached to a policy.

1.8.5 Do's and Don'ts under SEBI (Investment Advisers) Regulations, 2013

SEBI (Investment Advisers) Regulations (IA regulations) provide an exemption to an insurance agent or insurance broker registered with IRDAI who offers investment advice solely in insurance products. However, if the insurance agent or insurance broker also offers investment advice on non-insurance securities or investment products then such advice would be covered by IA regulations. In that case, while advising on insurance based security or Investment products also the IA cum insurance intermediary would need to keep the principle of risk profiling, suitability and fiduciary responsibility to the client in mind.

CHAPTER 2: LIFE INSURANCE PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Elements of Life Insurance Products
- Life Insurance Need Analysis
- Types of Life Insurance Products
- Insurance under Married Women's Property Act (MWPA)
- Criteria To Evaluate Various Life Insurance Products
- Global coverage for Different Life Insurance Products

2.1 Life Insurance Products

Life insurance products provide cover for the life of the insured.

Elements of Life Insurance Products

Life insurance products can be defined by the benefits that they provide to the insured. The insured would get the following benefits from life insurance products:

- **Death cover:** Where the benefit is paid only on the death of the insured within a specified period. If death does not occur, then no benefit will be paid.
- **Survival benefit:** Where the benefit is paid when the insured survives a specified period.

Term Insurance policies provide for only death benefit. Investment cum insurance policies will provide a combination of the above two features.

An insurance contract has the following several elements, the definitions of the key ones are as follows:

- **Insured:** This refers to the person whose life is being insured and can be individuals, minors or joint lives. If the life being insured is different from the person buying the insurance policy, such a buyer is called the proposer or policy holder and such person should have an insurable interest in the individual being covered.
- **Term of the contract:** This is the time period during which the insurance cover is available to the insured. In some cases, the insurance company may specify an upper age limit at which the term of the policy would end.
- **Sum assured:** This is the amount being insured. The IRDAI Regulations require all life insurance products with terms of more than 10 years to provide a minimum sum assured of 10 times the annual premium for individuals below 45 years of age and 7 times the annual premium if age is above 45 years. If the term is less than 10 years the minimum sum assured shall be 5 times the annual premium for all individuals. The insurance contract may also specify situations, if any, when the sum assured will change. For example, if a reducing term insurance policy taken to cover outstanding mortgage payments, the sum assured will decrease as the outstanding loan decreases.
- **Payment of sum assured:** The payment of sum assured will be on the occurrence of a specific event such as death of the life insured (death benefit) or expiry of the

term of the policy (survival benefit). The mode of payment of the sum assured, whether lump sum or as instalments is specified in the contract.

- **Premium payable:** This depends on the sum assured and the term of the policy. The mode of payment of premium, such as monthly, quarterly, half-yearly or annually are included in the contract. Some policies involve the payment of a single premium at the start. Non-payment of premium due on a policy within the grace period allowed makes the policy lapse. The policy can be revived/ reinstated during the timeframe provided by the insurance companies by paying the pending premiums along with penalty.
- **Bonus:** This is relevant only to investment cum insurance policies. Bonus is an amount that is added to the sum assured, announced periodically as a percentage of the sum assured. It is paid out along with the maturity value or on the occurrence of the insured event.
- **Guaranteed bonus:** This is relevant only to investment cum insurance policies. Guaranteed bonus is paid for the first few years of the policy period, say, five years and is paid as a percentage of the sum assured. It forms part of the benefits of the policy and is generally received at the end of the term.
- **Reversionary bonus:** This is relevant only to investment cum insurance policies. This is based on the performance of the insurance company and is declared for policy holders at the discretion of the insurer. Reversionary bonus is declared after the completion of the guaranteed bonus period and is applicable to those policies that are called participating policies. The premium for such policies is higher than those policies that are non-participating.
- **Policy lapse:** If the premium due on a policy is not paid, even within the applicable grace period, then the policy lapses and no claim is payable on a lapsed policy. However, in a traditional investment cum insurance policy that has been in force for at least 3 years (2 years if the term of the policy is less than 10 years), on which full premiums have been paid, may acquire a cash value or surrender value. This value is returned to the policy holder. The minimum surrender value will be 30% of all premiums paid and goes up to 90% in the last two years.
  For a single premium policy, the guaranteed surrender value will range from 70% of total premium paid if surrendered within the first three years to 90% in the last two years. For ULIPs, surrendering a policy before 5 years is possible even though there is a lock in of 5 years. There is a discontinuation charge levied which is maximum of Rs 6000. Post deducting this charge, the balance fund is transferred to a discontinuation policy fund.

  - Along with this, the insurers may also pay an amount based on the current value of the assets held against the policy. In case of unit- linked insurance plans, the policy has a lock-in of 5 years and the surrender value is paid only at the end of the lock-in period.

  - The other option in investment cum insurance policies when there is a lapse in premium is to make the policy paid-up. This means the sum assured is proportionately reduced to the same proportion that the number of premiums paid bears to total premiums due. For example, Surinder had taken a 25-year life insurance policy (investment cum insurance policy) with a sum assured of Rs. 10,00,000, premiums being paid in a half-yearly mode. After paying the premium for 5 years, Surinder is unable to continue paying the premiums. In the example the sum assured would be Rs. 10,00,000 only if premiums are paid for 25 years; on a half yearly basis, that would be 50 premium payments. Since only 10 premiums have been paid over a period of 5 years, the sum assured will be readjusted to Rs. 2,00,000 (i.e. Rs. 10,00,000*10/50).

- **Nomination**: It is the right of a policy holder to identify the person(s) entitled to receive the policy money, in the event of the policy becoming a claim by death. The nomination can be made at the time of taking the policy or subsequently at any time during the term of the policy, and can also be changed any number of times.

2.2 Life Insurance Needs Analysis

The amount of life insurance cover required depends on the economic value that can be attached to human life. This is called the Human Life Value (HLV). This is the value that insurance needs to compensate for, if there is a loss to life, or disability that results in a reduction in the ability to generate income. HLV is the present value of the expected income over the working life of the individual that is available for the dependents. There are different ways in which the HLV are calculated.

2.2.1 Estimate the life insurance coverage

Insurers have their techniques for estimating human life value. One simple approach is given in Table 2.1.

Table 2.1: Estimating Human Life Value

E15 =PV(E14,E11,-E8)

	A	B	C	D	E	F
7						
8				Current Annual income of insured (Rs)	₹ 10,00,000.00	
9				Proposed Retirement Age (years)	60	
10				Current Age (Years)	33	
11				Years to Retieremnt (Yrs)	27	60-33
12				Estimated Return on Investment	8%	
13				Expected inflation rate	6%	
14				Discounting rate	1.89%	((1+8%)/(1+6%))-1
15				Estimated Human Life Value	₹ 2,10,04,210.30	
16						

Note: The discounting rate shown in the table is only upto 2 decimals. The calculations are based on the formula given in the table, whose result goes into several more decimals.

The HLV calculations are relatively easy to calculate as it has only 2 basic assumptions – (i) by how much does the current income increase (the inflation rate of 6% in the above example) and (ii) what is the post-tax return on the sum assured (8% in the above example).

Question 1: If we do the same calculations but now assume that the income will increase by 8% every year the Human Life Value will go down. Is this statement True or False?

Answer: It is a False statement as the following calculations will show:

Discounting rate is 0 as (1+8%)/(1+8%)-1 = 0

That means the HLV becomes Rs. 2,70,00,000 where discounting rate is 0, Nper is 27 and PMT is 10,00,000. In other words, where the rate of increase in income is assumed same as the post-tax return on investment, the HLV will always be equal to the current income multiplied by the number of years left for retirement.

This is an easy thumb rule to remember. It is also the origin of the basic thumb rule that the HLV of younger people is higher (as both the number of years left for retirement are higher and the increase in income also tends to be higher).

Question 2: All other things being equal in the above example and the income actually going up as assumed – the HLV will fall as the person gets older. Is this statement True or False?

Answer: The statement is True because the discount rate will remain the same but the Nper will fall and hence the calculated PV will fall.

An alternative approach is called the needs-based approach. It assumes that the insurance proceeds will be used for the expenditure needs and meeting the liabilities of the insured, as calculated in Table 2.2. These needs and liabilities are first met out of the value of investments and other assets (other than personal assets such as residential house and personal jewellery that the insured person's family will not want to sell even if the insured person dies). The difference between these figures constitutes the insurance requirement. The current insurance requirement will be calculated after deducting the existing life insurance from this figure.

Table 2.2: Estimating Insurance based on Needs analysis

G37 =PV(G35,G29,G23)

	A	B–F	G	H
21				
22				
23	a	Current annual expense of the family (Rs)	₹ 10,00,000	(net of loan repayments,
24				insurance premia etc.)
25	b	Life Expectancy of beneficiary (years)	80	
27	c	Current age of beneficiary (years)	49	
29	d	Years to provide for (years)	31	b - c
31	e	Estimated Return on Investment	8%	
33	f	Expected annual inflation rate	6%	
35	g	Discounting rate	1.89%	{(1+e)÷(1+f)}-1
37	h	Estimated Insurance to cover expenses	₹ -233,09,243	based on PV formula in Excel
39	i	Loans outstanding	-₹ 20,00,000	(housing loan, car loan etc.)
41	j	Estimated Insurance Need	₹ -253,09,243	h+i
43	k	Coverage in insurance already taken	₹ 50,00,000	(on life of earning member
44				to cover the beneficiary)
45	l	New insurance required	₹ -203,09,243	j+k

Note: The discounting rate shown in the table is only upto 2 decimals. The calculations are based on the formula given in the table, whose result goes into several more decimals.

Example: Anil currently has a monthly income of Rs.1,50,000. He pays an insurance premium of Rs.25,000 per month and an EMI of Rs.32,000 on a loan of Rs.40 lakhs that he has taken for this house. His personal expenses are Rs.10,000. He wants to provide insurance protection for his wife who is currently 49 years old and is expected to live till 80. If the expected inflation is 6% and return on investment is 8%, what is the insurance cover he should take? His current insurance cover is for Rs.1 Cr and he has other investments amounting to Rs.50 lakhs. His house is worth about Rs.50 lakhs.

Income Replacement Method

The first step is to calculate the current value of the income required to be provided for Anil's wife. The next step will calculate the corpus required that will generate the income required. For this the applicable rate will be the rate adjusted for inflation and expected rate of return from the investment of the corpus. To this, the values of any other obligations or needs are added to come to the total funds required to meet the needs. The values of the existing investments are deducted to arrive at the corpus that needs to be created. This will be the insurance amount.

Steps for Calculation

1. Calculate the current value of the income required to be provided.
    a. Total income - (Portion of income used by Anil for personal needs+ EMI payments+ Insurance Premium)
    b. = Rs.1,50,000 - (Rs.10,000+Rs.32,000+Rs.25,000)
    c. = Rs.1,50,000 - Rs.67,000= Rs.83,000 per month
    d. =Rs.9,96,000 per annum
2. Calculate the applicable rate after adjusting for inflation and investment return
    a. Inflation rate =6%
    b. Investment rate= 8%
    c. Adjusted rate= ((1+8%)/(1+6%))-1= 1.89%

    (The result, based on the formula, goes into several more decimals. However, for the calculation, we consider the discounting rate upto 2 decimal places only.)
3. Use the PV function in excel to calculate the corpus
    a. Rate is the adjusted rate of 1.89%
    b. Nper is the number of years for which the income has to be provided. In this case it is 31 years (80 years – 49 years)
    c. PMT is the income that has to be provided, starting at Rs.9,96,000
    d. The value calculated is the corpus that will generate the income required when invested at a rate of 8%. This is Rs.2,36,43,984.
4. To this corpus value calculated, the loan outstanding of Rs.40,00,000 has to be added. The total sum required is Rs.2,76,43,984.
5. From the total amount required, the existing insurance cover of Rs.1,00,00,000 and Rs.50,00,000 of investments is deducted to arrive at the amount of insurance cover that will be required for Anil so that all the needs are met. This amount is Rs.1,26,43,984.

Need based approach -- Calculation of Insurance Need

		Formula
Current income to be replaced	Rs.9,96,000	Rs.83,000 x 12
Adjusted rate	1.89%	((1+8%)/(1+6%))-1
Period over which income has to be provided	31 years	(80 years- 49 years)
Corpus required	Rs. 2,36,43,984	PV(1.89%, 31,-996000,,1)*
Add loan outstanding of Rs.40 lakhs	Rs. 2,76,43,984	
Deduct insurance available of Rs.1 Cr and investments of Rs.50 lakhs	Rs. 1,26,43,984	
Additional insurance cover required	Rs. 1,26,43,984	

*The calculation considers payment at the beginning of each year. This is indicated in excel by putting in '1' in the PV function for the argument 'Type'.

Note: The amount of additional insurance taken along with the existing insurance cover and investment will be adequate to take care of the needs and the value of the corpus created will be drawn down completely by the end of the period.

Question: Other things remaining equal the needs-based calculation for Life insurance requirements will be lower where the insured has a higher amount of investments. Is this statement True or False?

Answer: This statement is true, as already mentioned in the example.

Therefore, from the above discussion it is clear that the insurance requirement calculated as per the HLV method will always be higher or equal to the insurance requirement calculated as per the needs-based approach, as overall expenditure cannot exceed income.

2.3 Types of Life Insurance Products

Life insurance policies can be categorized based on the benefit patterns. The payment of benefits from the policy, at death or on maturity, are used to differentiate the policies.

Term Insurance

Term insurance is a pure risk cover product. It pays a benefit only if the policy holder dies during the period for which one is insured. Term life insurance provides for life insurance coverage for a specified term of years for a specified premium. The premium buys protection in the event of death and nothing else. Term insurance premiums are typically low because it only covers the risk of death and there is no investment component in it. It offers the most affordable form of life insurance and is an ideal way to cover the Life Insurance needs because the entire protection needs of the Insured can be covered as the premiums are affordable.

The three key factors to be considered in term insurance are:

- Sum assured (protection or death benefit)
- Premium to be paid (cost to the insured), and
- Length of coverage (term)

Various insurance companies sell term insurance with many different combinations of these three parameters. The term can be for one or more years. The premium can remain the same every year (level premium) or increase as the insured gets older. A policy holder insures his life for a specified term. If he dies before that specified term is over, his estate or named beneficiaries receive a payout. If he survives the term nothing is payable.

The payouts under the term insurance policies has many variants. The insurance company can pay a lumpsum amount or a fixed regular monthly amount for a specific period say 10 years or both lumpsum and fixed monthly amount (for a specified period). The tenure of the policy too has been extended with some companies providing coverage up to 85 or 100 years. The premium for such "term" policies with extended coverage is much higher than those term policies that cover only the earning years.

- **Term insurance with return of premiums**

Several variants of term policies are available in the market such as a term policy with return of premium. In this variant, normally the premium is much higher than a regular term policy; and the difference is invested by the insurance company to provide for the return of premium at the end of the term. The inherent investment return on this policy can be calculated by using the 'Rate' formula in Excel:

The following real-life example of pure term plan and return of premium term plan from the same insurance company will illustrate this:

Need for Insurance or Sum Assured: Rs. 1,00,00,000

Policy tenure: 30 years

Policy premium if pure protection policy: Rs. 9416 per annum

Policy premium if premiums returned in the end: Rs. 17,473 per annum

Difference between the 2 premiums (Rs. 17,473 less 9,416) = Rs. 8057

Amount of Premium returned on maturity: Rs. 5,24,190 (i.e. 30 times the annual premium of Rs. 17,473)

Nper = 30

PV = 0

PMT = 8057 (17,743 less 9,416)

Future Value = - 5,24,190

Payment at the beginning of each period

Rate is = 4.61%

In this example, it means that the insured person is getting a return of 4.61% p.a. on the extra premium paid by him to choose the 'return of premiums' policy. This working can be done for any set of pure term plan and term plan with return of premiums from the same company.

Endowment

Endowment is an investment cum insurance plan with the same premium being paid every year. If the insured person survives the tenure of the plan, the insurance company returns the investment portion of the premium along with actual returns realised on them. This actual return is normally calculated and declared every year (called accrued bonus) but paid only at the end of the tenure. After the insurance period is over, a lump sum is paid out, equal to the sum assured plus any accrued bonus as above. Accrued bonus is a figure that is not pre-defined at the commencement of the policy but is generally calculated at the end of every year. If death occurs during the term of the policy, then the sum assured and any bonus accrued till death are paid out.

There are many products in the market that offer various options in terms of tenure, type of bonuses, payout options at various times (popularly called Money back policies) etc.

The inherent investment return on such policies are calculated by using the official illustration offered by the insurance company on the Investment cum Insurance plan. This official illustration obtained from the insurance company's website is the only official document that clearly lays down what are the probable returns on an Investment cum Insurance policy, and also lays down which portion is "guaranteed" and which portion is not guaranteed.

Again, we can use either the 'RATE' function in Excel (where the amounts received on survival are in a lumpsum) or the 'XIRR' function in Excel (where the amounts are received over a period) to work out the inherent investment return from the investment cum insurance policy.

A real-life example is given below:

Sum Insured: Rs. 1 crore

Tenure of coverage: 30 years

Policy premium if Endowment policy: Rs. 3,16,332 per annum

Policy premium if pure protection policy: Rs. 9416 per annum

The higher of the two amounts shown as payable after 30 years as per official illustration of the Insurance company: Rs. 2,14,00,000

Nper = 30

PV = 0

PMT = 3,06,916 (3,16,332-9416 i.e. the term plan premium)

Future Value = - 2,14,00,000

Payment at the beginning of each period

Rate is = 5%

In this example, it means that the insured person is getting a return of 5% p.a. on the extra premium paid by him to choose the endowment policy. This working can be done for any set of pure term plan and endowment plan from the same company.

The premium for a pure term plan (Rs. 9416) is very affordable as compared to Rs. 3,16,332 payable for the endowment plan for a similar amount of insurance coverage. Since the primary function of an insurance policy is protection, and if the premium is not affordable, an endowment plan can be ruled out of the consideration. The inherent investment return on such policies based on the official illustration is normally around 3-5% p.a. (it is 5% in the above example) and even that is not guaranteed. The actual return can be lower or higher than that shown in the official illustration.

Whole Life insurance

Whole Life insurance policies are investment cum insurance policies that provide life insurance cover for the entire life of the insured person or upto an upper age limit specified by the insurer, whichever is earlier, provided the premiums are paid as contracted. Premium amount is fixed through the entire period. There are variations to the whole life policy such as shorter premium payment periods and return of premium option. For a traditional whole life policy, the entire sum assured plus any bonuses will be paid on death of the policy holder. Whole Life Policies were originally designed primarily to pass on wealth to the next generation without payment of estate duty since life insurance payments on death were normally exempt from estate duty. With the abolition of estate duty, the whole life insurance policy is like any other investment cum insurance policy that needs to be evaluated based on adequacy of coverage and the inherent investment return.

Unit-Linked Insurance

In the case of both whole life and endowment policies, the insured has no say in deciding how the savings component in the policy will be managed. Unit-linked insurance policies allow the insured to decide on the kind of portfolio (mix of asset classes, such as debt and equity) that the insurer should maintain for the savings portion.

The risk cover charges are deducted from the regular premium paid by the insured during the period of insurance. The balance is invested as per the agreed asset allocation. The value of the investment portfolio (savings portion) will keep changing in line with the market. The insurer announces a Net Asset Value on a daily basis.

In the event of death of the insured, the sum assured (or net asset value or higher of both or total of both, depending on structure of the policy) is paid to the beneficiaries. If the insured survives the insurance period, then the net asset value is returned.

Single premium policies allow the insured to pay a one-time premium for the coverage. There are no indicated inherent investment returns in ULIPs and they are more transparent than their endowment or whole life counterparts.

Below is the Case study for comparison of using Term policy for protection plus mutual funds for investments as compared to a Unit Linked plan that provides same level of protection and invests for the same amount.

Case Study: Assumptions for Case study of Mr Jeevan

Age: 35 years
Life Insurance policy required: Rs. 100 lakhs
Tenure: 20 years
Term Life Premium: Rs. 1100/- per month

Investment amount per month: Rs. 25,000 pm
Investment period: 300 months (25years)
Tax benefit sought: No tax benefit is sought on the investment amount

Option 1: Pay term life premium of Rs. 1,100/- per month and invest Rs. 25,000 per month in a mutual fund scheme

Option 2: Invest Rs. 26,100/- per month in a Unit Linked Insurance plan of type II (which means on death before maturity the ULIP will pay the sum assured amount plus the fund value; on maturity the fund value is payable). Sum assured is Rs. 100 lakhs. Policy term is 25 years. Monthly premium is Rs. 26,100.

Based on the above set of assumptions the comparison works out as under:

Sr. No.	Particulars	Option 1 (Term Policy plus investment in Mutual Fund)	Option 2 (Unit Linked Insurance Plan Type 2)
1	Divisibility of Insurance contract from Investment contract – this is an important consideration since most of outgo is on account of investment.	Completely divisible as these are 2 separate contracts. A break can be taken in the investment portion without any cost implications. It can then be restarted when able. The insurance portion can also be discontinued if not needed at a future stage.	For the first 5 years, these 2 contracts are indivisible. During this 5-year period if the monthly premium is not paid (within allowed grace period) the entire contract moves into discontinued policy account and the insurance coverage stops. Even after 5 years, whilst investments can be discontinued insurance cannot be discontinued even if not needed.
2	Liquidity of investment	No lock in period. There can	The investment portion is

Sr. No.	Particulars	Option 1 (Term Policy plus investment in Mutual Fund)	Option 2 (Unit Linked Insurance Plan Type 2)
	portion	be an exit load on the investment portion if money is withdrawn within 12/18 months.	locked in till 5 years from inception date.
3	Risk in the Investment portion	Mutual funds are available for whatever risk profile is required.	Most Insurance companies will also have a variety of possible investment options that will meet with the risk profile of the client.
4	Movement between schemes of one provider to the schemes of another provider	This is easily possible though there could be exit load and capital gains tax cost implications.	This is not possible.
5	Movement between different schemes of the same provider	This is easily possible but could have exit load/capital gain tax implications.	This is possible with the added benefit that it has no tax implications and normally most providers provide a few shifts every year free of cost.
6	Transparency of information, rules around costs, creation/cancellation of units, availability of independent monitoring information in the public domain	The regulatory infrastructure has evolved over the years and is quite sophisticated. Large number of independent monitoring agencies ensure that performance of each schemes are widely monitored leading to a competitive environment. Maximum costs that can be debited are known. Units cannot be created disproportionately or cannot be cancelled for meeting any costs. This allows for proper comparison of returns for a scheme and inter-scheme comparison.	The reporting and regulatory infrastructure is still evolving making it relatively less transparent than mutual funds. Most costs such as mortality charges (for insurance), policy administration costs are debited by cancellation of units rather than embedded in the NAV itself making return comparison difficult. There is less competitive pressure on the funds of insurance companies from independent monitoring agencies. Also, creation of bonus units for loyal investors means that the newer contributors to the fund are subsidising the older investors. This again makes return comparison across schemes difficult.

Sr. No.	Particulars	Option 1 (Term Policy plus investment in Mutual Fund)	Option 2 (Unit Linked Insurance Plan Type 2)
7	Tax on maturity value	Capital gains tax is chargeable at maturity.	If the sum assured is at least 10 times the annual premium no tax is payable on the maturity value. In the given example, the maturity value will be exempt as the sum assured of Rs. 1 crore is higher than 10 times Rs. 3,13,200 (annual premium). As per the Finance Act 2021, the maturity proceeds of ULIPs having annual premium of more than Rs 2.5 lakh shall be treated as capital gains and taxed accordingly. This, however, is applicable only for the policies taken on or after 01.02.2021.

The parameters to evaluate any Investment cum Insurance policy remain that it should first serve its primary purpose, which is providing life cover. Thus, the big assumption in the above comparison remains that the insurance cover is required. Based on that, both options seem to be comparable in the above example, with the lack of flexibility and lower transparency of the ULIP being balanced somewhat by better tax treatment of its maturity value (for policies issued before February 1, 2021).

If however, the insurance is not required then the mortality charge (insurance premium part) of the ULIP becomes an additional cost. Large investments typically come from relatively older investors who may not need a large insurance cover based on a needs analysis calculation since they would have already accumulated sufficient assets to meet their goals. Additionally, they find it difficult to be eligible for the 10 times life insurance required based on their health parameters and even where they are able to get the required insurance amount it would come at a stiff cost.

In summary, a ULIP should be considered in place of a term policy plus mutual fund only where insurance cover is required in the first place.

Mortgage Insurance

This is a special kind of insurance policy, where the sum assured keeps going down with time. This is suitable when the insurance policy is taken to cover a housing loan, which will keep reducing with loan repayments.

If the insured seeks a policy for the entire amount borrowed, then there will be over-insurance viz. insurance amount will be greater than the loan outstanding after repayments. In theory, by reducing this over-insurance, the insured is able to reduce premium costs as compared to a term plan that covers the full amount of loan from the beginning till the end of the loan tenure.

This, though, is in theory only. In practise, reducing balance mortgage insurance is not much cheaper than level term insurance plan. Ironically, in many cases the mortgage insurance plan that is supposed to be cheaper than a level term plan is actually more expensive than a level term plan for the full value of the loan. In many cases, the sum assured is the lower of the outstanding home loan or the reducing sum assured as per the mortgage plan. Since home loans are prepaid in a majority of cases, the premium paid for the extra coverage that is not available because the home loan has been prepaid, goes waste. This is the reason these plans are not popular.

Insurance companies also offer various riders that the insured can benefit from, by paying an extra premium.

- Double sum assured rider, which provides twice the amount insured in case of death before the term of the policy.

- Critical illness rider, which provides a pre-specified sum on diagnosis of a life-threatening illness and survival for 30 days after such diagnosis. In some cases, the life insurance cover is reduced by the amount of money paid out under this rider. This is called the accelerated sum insured. It is cheaper than a rider that pays out the pre-specified sum independent of the death claim. Ironically, in most cases, the premium on a term insurance policy with an equal critical illness cover (on an accelerated sum insured basis) is cheaper than just a standalone critical illness policy from a general insurance company.

- Accident death benefit or disability rider, which enables the insured to receive a periodic payout if temporarily disabled, for a limited period of time or a specified sum on permanent disability caused due to accident.

- Waiver of premium rider, which is triggered if there is a disability or loss of income that makes it difficult to pay the premium.

- Guaranteed insurability option rider, which enables enhancing the insurance cover without further medical examination. This is very useful for young persons who expect to have increased income in the future but may also suffer from medical issues as they age.

- Income Benefit Rider is the rider that allows the policyholder’s nominee to get a specific amount of sum periodically as a fixed income in the event of the policyholder’s death during the duration of the plan instead of getting it as lumpsum on the death of the policy holder.

Group insurance is another option for cheaper insurance. For example, the insurance company may cover all employees of a company under a group insurance policy. The premium in that case turns out to be lower than for individual policy offering the same coverage. Further, the claim processing may be simpler, with the employer facilitating the process.

2.4 Facilities available under Life Insurance Policies

Loan against insurance policy

Pure protection policies do not acquire any surrender value and hence it is not possible to get a loan against them. Most insurance companies offer a loan against the surrender value of Investment cum Insurance policies. Banks and Non-Banking finance companies may also offer loans against the security of such Investment cum Insurance policies. Normally the interest rates charged by the insurance companies on the loans provided by them against the security of their own policies are lower than those charged by banks/ NBFCs. So, it makes sense to take the loan from banks/ NBFCs against security of life insurance policy only if a number of such policies are being combined to get a larger loan which is more convenient than taking separate loans from different insurance companies.

Taking loan from bank/ NBFC against the security of Investment cum Insurance policies is also a good way to rebuild credit score after it may have been damaged due to a past default.

Nomination and change of nomination

Nomination is the right of a policy holder to identify the person(s) entitled to receive the policy money, in the event of the policy becoming a claim by death. The nomination can be made at the time of taking the policy or subsequently at any time, and can also be changed any number of times.

Under normal law, the nominee holds any property in trust for the legal heirs of the person. However, the Insurance Act, 1938 has been amended in 2015 to provide that if the nominee is the spouse, parent or children or any combination of them, then such nominee(s) will inherit on a beneficial basis rather than as trustees. Refer to section 1.4 for example of nomination.

Policy assignment

- Assignment means transferring the interests in the policy.
- Assignment normally done for taking loan against the policy but can also be done for other reasons.
- An assignment cancels an existing nomination in the policy.
- However, if assignment is to the insurance company itself for loan taken from the insurance company then the nomination does not stand cancelled just affected to the extent of the insurance company's interest in the policy.

- Nomination gets reinstated after policy is re-assigned back to policy holder.
- Assignation has to be recognised by the insurance company by way of endorsement on the policy after receiving a written notice in this regard.

2.5 Insurance under Married Women's Property Act (MWPA)

The normal purpose of taking a life insurance policy is to make sure that the family members get a certain sum of money on the death of the income earner so that they have a financially secure future and the same standard of living can be maintained even after the death of the income earner.

In most cases, the spouse, children or parents are listed as nominees on the life insurance policy and on death of the policy holder the amount is paid to the nominee(s) as a beneficial owner – which means that they hold the money as owners and not as trustees for the legal heirs. However, the nominees can be changed at any time during the policy period. Also, if the creditors of the insured person may be able to lay claim to the proceeds of a life insurance policy even from such "beneficial nominees". All these risks can be avoided if a married man takes a life insurance policy and does the appropriate declaration of buying it under the Married Women's Property Act, 1874. When any life insurance policy is bought under the MWP Act, the nominees can only be the spouse or children or both (but not parents) of the insured person. When the life insurance policy is bought under the MWP Act the nominees named therein acquire all rights to the claims in the policy. The nominees cannot be changed after the policy has been bought. Even if the insured person divorces his wife, she continues to be the nominee in the policy. The insured person himself cannot lay any right to the amounts payable under the policy. If a MWP policy has any survival benefit (amounts payable even as the insured person is alive), the same will be paid to the nominees and not to the insured person. The declaration of the policy being bought under the MWP Act has to be made only at the time of buying the policy. The declaration can be made in respect of any life insurance policy, including term policies bought both online and offline.

With the amendment of the Insurance Act made in 2015 making nominees the beneficial nominees holding the money in their own right, some of the relevance of the MWP Act has been lost especially because of the rigidity around not being able to change the nominees. Policies under MWP Act are useful to ensure that the benefits of the insurance policy stay with the nominees despite any claim on the assets of the insured by his creditors.

2.6 Benefits, Limitation and Provisions when insurance taken from multiple companies

Life insurance premiums are telescopic which means that the premiums do not go up in the same proportion as the sum assured. A larger sum assured can be insured for a lower rate of premium per thousand of sum assured and hence it makes sense to buy policies from the same company.

Telescopic rates stop after a certain level, say Rs. 2 crores for a particular life insurance company. If the insured person is buying term insurance for Rs. 8 crores then it might be advisable to buy 4 policies of Rs. 2 crores each from the same company. This enables the insured to have the option to give up certain policies as the insurance needs come down in the future.

Insurance proposal form should list all existing insurance policies and any pending proposals for life insurance with any other insurance company. This enables the insurance company to take an informed view of the possible amount of risk cover being sought by the insured vis-à-vis the insured's financial standing and need for insurance. Any omission to provide these facts might be treated as omission to provide a material fact and may be grounds for repudiation of a claim or cancellation of the policy within the first 3 years after the policy is issued.

2.7 Criteria to evaluate various life insurance products

2.7.1 Online versus offline Term Plans

- It's a long-term commitment from both sides. The faith the insured person has in the brand of the Insurance Company that it will still be around when the claim arises.
- Availability of amount of risk cover for the sought tenure. In some cases, the insurers are not comfortable with large sum insured despite those being shown as available in their online or offline sales material.
- Premium payable after evaluation of the insured's health and financial profile. In some cases, the declared premiums are meant for super healthy individuals and additional premiums are charged even for minor deviations from the standard health profile for a given age.
- Availability of other riders such as accelerated sum insured for critical illnesses or permanent disability rider.
- Claim settlement ratio published by IRDAI (although if full disclosure has been made by the insured then it may not be a very important criteria).

2.7.2 Traditional life insurance policy or unit-linked plans

If investment cum insurance policy is to be opted for then:

a) In traditional policies the insured person cannot choose the type of investment that can be made by the insurance company. In that case the inherent investment return can be calculated based on the methodology described earlier by using the higher possible maturity value shown in the official illustration from the insurance company. The investment returns from a traditional life insurance policy is normally low. For such policies issued on or after April 1, 2023 where the insurance premium is higher than Rs. 5 lakhs, the maturity proceeds are taxable as "Income from other sources".
b) In Unit linked insurance plans (ULIPs) the insured person can choose from among the various types of funds offered by the insurance company, which will typically be a mix of fixed income instruments, equities or both. In ULIPs, the investment risk is borne by the insured person. The insured person can reduce (not eliminate) the risk by choosing the low risk funds offered by the insurance companies.

2.7.3 Investment linked insurance plans or pure term insurance

The primary job of any insurance company is to provide risk coverage and not investment products. There are other entities that specialize in providing investment products. Ideally, risk coverage (insurance) products should be bought from insurance companies and investment products from entities that specialize in investment products.

Even if insurance cum investment product is being considered, it can be evaluated as an insurance product that also has investment elements in it. The first thing is to de-couple the insurance and investment elements of the instrument. Then the adequacy of the risk coverage needs to be examined. If the risk coverage is not adequate, then the instrument does not meet its primary goal and should be eliminated. Only after this primary requirement is met, should the investment return be considered separately to see if it is suitable for the investor and meets her requirements and is also comparable with investment products with similar profile.

2.7.4 Online Insurance plans and offline Insurance Plans

Most Insurance companies now offer their plans online where clients can apply directly. In many cases, specific policies have been tailor made for online which are also cheaper than the offline counterparts. Many also offer instant policy issuance after payment of premium online.

Many Insurance Brokers and Insurance Web Aggregators offer online comparisons of various insurance policies. They have tie-up with the insurance companies to offer online premium payment and policy issuance services for convenience of the insureds.

2.8 Global coverage for different Life Insurance Products

Does a life insurance policy pay if the death occurs outside India?

Normally, defined benefit policies such as life insurance, critical illness policies, accidental death policies, etc will pay wherever the covered risk occurs. It is relatively easy to verify that the covered risk (death or critical illness or accident) has occurred and the circumstances surrounding the incident are ascertainable wherever in the world they happen.

Are resident Indians allowed to buy life insurance policies provided by Insurance companies, not registered in India?

Indian residents can use their Liberalised Remittance Scheme (LRS) entitlement of up to USD 2,50,000 per annum to buy life Insurance policies of foreign companies. These policies are denominated in foreign currency. Some insured persons use investment cum insurance policies, denominated in foreign currencies, to provide for their goals such as children’s education that may be denominated in foreign exchange.

However, these policies and the grievance redressal mechanism in case of refusal to pay claim amounts are governed by the regulations of the countries where they are issued. So, caution must be exercised in using this option.

Secondly, if insurance cum investment policy is being bought, it should be evaluated like any other investment cum insurance policy with protection needs being covered first. If that is sufficient only then the investment portion can be considered for risk profiling, suitability and comparing it with similar foreign exchange denominated investment instruments that are also available under the Liberalised Remittance Scheme.

CHAPTER 3: NON-LIFE INSURANCE PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Elements Of Non-Life Insurance Products
- Benefits/Limitations and Provisions When Insurance is Taken from Multiple Companies
- Criteria To Compare Various Insurance Products
- Global coverage for Different General Life Insurance Products

3.1 Non-Life Insurance

Non-Life insurance provides risk cover from loss or destruction of assets. It provides cover against unexpected large expenses that can be a drain on the available income of the individual.

3.1.1 Elements of Non-Life Insurance Products

- Sum insured is the amount specified in the policy that represents the insurer's maximum liability for claims made during the policy period. The minimum and maximum sum may be specified by the insurer.
- Term of the insurance is typically 1 year. In some cases, such as health/ two wheeler policies, the term may be two/three years.
- Premium payable is a function of the sum insured and the assessed risk. The risk is determined based on the type of insurance cover such as: age, gender and health history for medical cover; cubic capacity of the vehicle, place of registration and age of the vehicle for motor insurance etc. Premium is typically paid at the inception of the policy.
- Deductible is a term used to denote the portion of the claim that is met by the insured.
- Restore and Recharge are two benefits available in health insurance policies. In restoration benefit, the health insurance company restores the sum insured to 100% in case of either partial or full exhaustion of the sum insured amount (as the case may be). Alternatively, in recharge benefit, the sum insured is restored to 100% only when it gets reduced due to a claim.
- No claim bonus is the benefit of lower premiums enjoyed in subsequent years for each year of no claims being made. It can also be offered as an additional bonus cover, as another way of reflecting this benefit.

3.1.2 Types of Non-Life Insurance Products

a. Property Insurance

Property insurance provides protection against most risks to property such as fire, theft etc. Property insurance generally means insuring the structure and the contents of the building against natural and man-made disasters. Wilful destruction of property, loss/ damage due to normal wear and tear is generally not covered. Valuables such as jewellery and art and antiques typically require an add-on or separate insurance policy. These kinds of policies are normally taken along with a home loan, as the lender insists on such a policy to be taken by the borrower.

b. Health Insurance

Health insurance policies reimburse the medical expenses incurred for the policy holder and identified family members who are covered under the policy. This policy provides for reimbursement of hospitalization or domiciliary treatment expenses for illness or accidental injury up to the sum insured under the policy. The expenses that can be claimed, such as consultation fees, medicine and treatment costs, room costs, are specified in the policy and sub-limits may be fixed for each head. Claim is typically allowed only for "In-patient" (patients who are admitted in a hospital for treatment that requires at least overnight or 24 hours of stay in hospital) treatments and domiciliary treatments (patients can be treated at home when they are not in a condition to be moved to the hospital), according to the terms of the policy. Now many policies cover day care treatment for certain procedures which require hospitalisation but due to advancement of technology the insured may be released on the same day. Pre-existing illnesses may be excluded from cover for a fixed period when insurance is being taken for the first time or if it is being renewed after a lapse.

Health policies provide cashless facility too where the bills are directly settled with the hospital and the insured is not required to pay upfront, upto the sum approved for this facility. There is also the option to take a family floater policy that will cover multiple family members under the same policy upto the sum insured.

The premium payable on the policy is a function of the sum insured, age and medical history of the insured, among others. Premiums may be adjusted for continued health cover and record of no-claim. Portability of health policies are available under which the benefits of no-claim, bonus and time-bound exclusions for existing conditions can be transferred, if the insured chooses to switch the insurance company. To benefit from portability, the previous policy should have been maintained without a break.

c. Motor Insurance

Under this insurance, the company indemnifies the insured in the event of accident caused by, or arising out of the use of the motor vehicle, anywhere in India, against all sums, including claimant's cost and expenses, which the insured shall become legally liable to pay in respect of (i) death or bodily injury to any person, (ii) damage to the property other than property belonging to the insured or held in trust or custody or control of the insured. Though the insurance of motor vehicles against damage or theft is not compulsory but the insurance of third-party liability arising out of the use of motor vehicles in public places is compulsory. No motor vehicle can be used in a public place without such Third-party insurance.

Some lesser known facts about Car Insurance:

i. "No claim" bonus means a reduction in next year's car insurance premium for own damage when no claim has been made for a specific number of years and can go up to 50% of the premium amount where no claims have been made for 5 years. The "No Claim" bonus is available to the insured person and is not attached to the car. Thus, when an insured sells an existing car, the new owner will not be eligible for the no-claim bonus. The original owner can transfer the no claim bonus on the own damage premium to the new car he purchases.

ii. The own damage portion of the car insurance premium is not fixed and varies from insurance company to insurance company. An online comparison from an Insurance Broker or Insurance Web Aggregator can save substantial amounts on premium while buying a policy for a new car or renewing the policy on an old one.

iii. The new insurance company provides the "no claim" bonus if a policy is shifted at the time of renewal of the new policy.

d. Personal Accident Insurance

This type of policy provides that if the insured shall sustain any bodily injury resulting solely and directly from accident caused by external violent and visible means, then the company shall pay to the insured or his legal personal representative, as the case may be, the sum defined in the policy. Following types of disablement are covered under this policy:

- Permanent total disablement
- Permanent Partial disablement
- Temporary total disablement

The need for calculating permanent total disability due to accident, just like calculating life insurance need, is often over-looked and hence permanent disability cover due to accident is often inadequate.

e. Critical Illness Insurance

This policy provides for a lump sum benefit to be paid if the insured contracts certain specified diseases such as cancer, heart attack, stroke, kidney failure or multiple sclerosis etc. It differs from life insurance in that there is no payment on death. Reimbursement is usually subject to a minimum survival period of 30 days after diagnosis of the critical illness. The lump sum payment under the critical illness policy can be used in whatever way the claimant chooses, such as for generating income, or for repaying a mortgage, etc. Currently, these are available either with life insurance policies or as standalone policies.

Critical illness policies are mostly thought of as an additional coverage to receive a much smaller lump sum to spend on items that are not covered in health insurance plans. There is a lack of awareness about the importance of critical illness policy as an income replacement policy. The calculation for amount of critical illness coverage required has to be done like life insurance policy. Normally such large sum will not be available as a rider to a health insurance policy but only as a stand-alone critical illness policy or as an accelerated sum insured rider on a life Insurance policy.

f. Overseas Travel Insurance

Travel insurance provides medical, financial and other assistance in case of an emergency during international travel. The cover will typically be provided for medical help required, delay in baggage clearance, accident and any additional cover required. The cover will be in the form of reimbursement upto the maximum amount mentioned in the policy. Travel insurance may be mandatory for travel to some countries.

g. Liability Insurance

The purpose of liability insurance is to provide indemnity in respect of damages payable under law for personal injury to third parties or damage to their property. This legal liability may arise under common law on the basis of negligence or under statutory law on no fault basis i.e. when there is no negligence.

Most common example of liability insurance is professional indemnity plans taken by various professionals like Doctors, Lawyers or Investment Advisers. Liability insurance provides cover for legal expenses incurred in defending suits or payment of damages to third parties for which the insured is found liable. Liability insurance will not cover intentional damage or damages caused due to criminal activities.

h. Fidelity Insurance

A fidelity insurance policy covers losses sustained by the employer as a result of an act of forgery, fraud or dishonesty from an employee. The loss can be of money or goods, for the duration of the policy. The policy is usually taken where large sums of cash or other valuables are being handled by the employees.

i. Directors and Officers Liability Insurance

The Directors & Officers liability insurance policy insures members of the board of directors, the management and employee performing a supervisory or managerial role in a company against personal liability and defence costs incurred from claims alleging them to have committed a wrongful act in the line of their duties for the company.

Some specific exposures that make the policy necessary include vulnerability to shareholder and their claims, discrimination allegations, regulatory investigations, corporate governance requirements, compliance with legal statuses and other employment practice violations.

j. Keyman Insurance

Keyman insurance is a life insurance policy that a company purchases to cover itself in case of the loss of life of a key executive. The company is the beneficiary of the policy and pays the insurance policy premiums.

3.2 Benefits and Limitations of having multiple Insurance Policies

Multiple indemnity policies such as Health Insurance Policies make very little sense as the total claim amount cannot exceed the sum insured on all policies put together. Multiple policies also mean having to deal with multiple insurance companies at the time of claim settlement that brings added complications.

In health insurance the premium rate per additional lakh of coverage drops significantly as the coverage increases and becomes almost negligible after a certain amount of coverage. For example, the premium payable on a health insurance policy for Rs. 100 lakhs may be just a few single digit thousand rupees more expensive than a Rs. 50 lakhs health insurance policy.

Sometimes multiple health insurance policies are unavoidable as the employer may offer policies upto a certain amount and the employee may wish to cover a larger sum insured or to have an independent policy of their own. In such cases, the contribution clause is not applicable except where the sum insured of the policy chosen by the insured is lower than the claim amount.

The insured person needs to choose from which company to get her claim from, and normally she should choose the employer policy first. The chosen insurer has no option to apply the contribution clause if the claim amount is less than the sum insured in the chosen policy. However, if the amount of claim exceeds the sum insured under the chosen policy, the insured person can choose another policy(ies) under which the claim can be made. In such cases the claim is settled by the chosen insurers by applying the contribution provisions.

In many a times, the insured may choose to buy a base policy (say Rs. 5 lakhs) and a super top up policy (say Rs. 10 lakhs) with a deductible (say Rs. 5 lakhs). Using this strategy, the insured is able to get a total coverage of Rs. 15 lakhs at an economical premium (as the premium on the super top up policy is quite low). The total premium paid on base policy plus the super top up policy as above can be compared with the premium on single policy of Rs. 15 lakhs. Interestingly, the premium of the second option (single policy of Rs. 15 lakhs) is not much higher than the first option (base policy plus super top up policy with a deductible totalling to Rs. 15 lakhs). The small difference in the premium is due to the administrative simplicity of having to deal with a single insurance policy. However, super top up policies remain ideally suitable for employees seeking additional cover over and above that provided by their employer. In that case, the employee chooses the deductible as per the amount provided by the employer and the super top up policy only covers the claim if the amount is above that value. Many health insurance companies are selling a combination of Base Health Plan and Top up/ Super top up plan, bundled as a single policy to provide higher coverage at a lower premium.

If there are multiple defined benefit policies such as life insurance policies, critical illness policy, accidental death or disability policies, all of them will pay irrespective of how many such policies the insured person has.

Top up Policy V/s Super Top up Policy

The terms “Top up Policy” and “Super Top up Policy” are not legal terms. They are generally used to describe a Health Insurance Policy that pays for claims arising from hospitalisation expenses incurred over and above a pre-agreed threshold limit. The difference between the two types of plan is in how the threshold limit is applied. In a Top up plan the threshold limit is applied for every claim whereas in a super top up plan the threshold limit is applied on the total of all hospitalisation claims for the year.

The following example will illustrate the difference between how the threshold limit is applied:

In this example we assume:

Case 1: Base Health plan of Rs. 5 lakhs and a Top up health plan of Rs. 10 lakhs above a threshold (called deductible in many plans) of Rs. 5 lakhs.
Case 2: Base Health plan of Rs. 5 lakhs and a Super top up health plan of Rs. 10 lakhs above a threshold (called deductible in many plans) of Rs. 5 lakhs.

Here is how the threshold will apply in different situations:

Sr. No.	Particulars	Case 1 – Top up Plan	Case 2 – Super Top up plan
1.	If there is a single claim of Rs. 8 lakh	Rs. 5 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 3 lakhs will be paid from the Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Top up plan is Rs. 7 lakhs.	Rs. 5 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 3 lakhs will be paid from the Super Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Super Top up plan is Rs. 7 lakhs.
2.	If there are Multiple claims as follows:		
	First claim of Rs. 3 lakhs	Rs. 3 lakhs paid from Base plan. Limit left in base plan is Rs. 2 lakhs.	Rs. 3 lakhs paid from Base plan. Limit left in base plan is Rs. 2 lakhs. Aggregate threshold limit already applied is Rs. 3 lakhs and balance threshold limit to be applied is Rs. 2 lakhs for the purpose of the Super Top up plan.
	Second claim of Rs. 6 lakhs	Rs. 2 lakhs will be paid from the Base plan. No limit left in the Base plan. Rs. 1 lakhs will be paid from the Top up plan after the threshold of Rs. 5 lakhs is applied. Balance limit left in the Top up plan is Rs. 9 lakhs.	Rs. 2 lakhs will be paid from the Base plan. No limit left in the Base plan. Threshold limit of Rs. 3 lakhs has already been applied earlier. Rs. 4 lakhs will be paid from the Super Top up plan after the balance threshold of Rs. 2 lakhs is applied. Balance limit left in the Super Top up plan is Rs. 6 lakhs. Aggregate threshold limit already applied is Rs. 5 lakhs.
	Third claim of Rs. 2 lakhs	No Limit left in the Base plan. Claim amount of Rs. 2 lakhs is less than the threshold limit of Rs. 5 lakhs and nothing is	No limit left in the Base plan. Threshold limit of Rs. 5 lakhs has already been applied. Hence, Rs. 2 lakhs is payable from the

Sr. No.	Particulars	Case 1 – Top up Plan	Case 2 – Super Top up plan
		payable under the Top up plan. Limit left in the Top up plan is 9 lakhs.	Super Top up plan. Balance limit left in the Super Top up plan is Rs. 4 lakhs.
	Fourth claim of Rs. 4 lakhs	No Limit left in the Base plan. Claim amount of Rs. 4 lakhs is less than the threshold limit of Rs. 5 lakhs and nothing is payable under the Top up plan. Limit left in the Top up plan is 9 lakhs.	No limit left in the Base plan. Threshold limit of Rs. 5 lakhs has already been applied. Hence, Rs. 4 lakhs is payable from the Super Top up plan. Balance limit left in the Super Top up plan is Nil.
	On total claims of Rs. 15 lakhs	Rs. 5 lakhs paid on Base plan and Rs. 1 lakh paid on Top up plan – total Rs. 6 lakhs.	Rs. 5 lakhs paid on Base plan and Rs. 10 lakhs on Super top up plan. Total Rs. 15 lakhs.
3.	Administrative issues in dealing with separate insurance companies and separate Insurance policies	If the Base plan and the Top up plan are from different insurance companies then the insured need to deal with both of them in cases where the claim amount exceeds the threshold limit. Hence, it is always advisable to have the Base plan and the top up plan from the same insurance company as far as possible.	In the case of Super top up plans, apart from the point mentioned under Top up plan, there is an additional requirement. In the multiple claims example given above for the first claim of Rs. 3 lakhs the company that is handling the super top up policy also needs to be informed so that it can mark the threshold used levels even though no claim is payable by the company on the Super top up policy.

3.3 Comparison between Insurance Policies

3.3.1 Health Insurance Policy vs. Critical Illness Policy

Parameters	Health Insurance Policy	Critical Illness Policy
Type of policy	Indemnity Policy	Defined Benefit Policy
Primarily designed to cover	Reimburses actual expenditure incurred in hospitalization.	Provides a lump sum that can be used either to generate lost income or to meet any other purposes/ expenses, including meeting hospitalization expenditure.

Parameters	Health Insurance Policy	Critical Illness Policy
Claim paid	On incurring covered hospitalization expenditure.	On contracting pre-specified disease/ illness and surviving for 15-30 days.

3.3.2 Offline Insurance versus Online Insurance Policies

Most insurance policies can be bought online nowadays. All insurance companies offer online policies on their websites. In fact, many insurance companies charge lower premiums for policies bought online directly from their websites. There are also 'web only' policies offered by some insurance companies.

Many Insurance Web Aggregators or Insurance Brokers provide convenient online comparison of policies to enable informed choice by the insured person. Given the rapid uptake of buying policies online by the insured population, these web aggregators/ online insurance brokers have also become major sources of selling insurance policies for the insurance companies.

3.4 Global coverage for different General Insurance Products

Will a health insurance policy pay if hospitalisation expenses are incurred outside India?

Normally, defined benefit policies such as life insurance, critical illness policies, accidental death policies will pay wherever the covered risk occurs. It is relatively easy to verify that the covered risk (death or critical illness or accident) has occurred and the circumstances surrounding the incident are ascertainable wherever in the world they happen. Indemnity policies, such as health insurance policies, involve ascertaining the expenses/ losses incurred. The insurer already has the necessary systems to ascertain the expenses (loss) that are incurred in India but ascertaining losses in an unfamiliar location outside India is difficult. Hence, indemnity policies like health insurance (covering reimbursement of hospitalisation expenses incurred) normally provide coverage for expenses incurred in India only.

However, there are some exceptions too. Overseas travel policies are indemnity policies that are designed specifically for each country. The insurer designs such policies after making specific arrangements to ascertain expenses (losses) in each foreign country.

Are resident Indians allowed to buy general insurance policies provided by Insurance companies, not registered in India?

Indian residents can use their Liberalised Remittance Scheme entitlement of up to USD 2,50,000 per annum to buy insurance policies of foreign companies. In many cases where Indian students go overseas to study, it is usual for them to buy such policies from the foreign insurer recommended by the concerned university.

However, these policies and the grievance redressal mechanism in case of refusal to pay claim amounts, are governed by the regulations of the countries where they are issued. So, caution must be exercised in using this option.

For students going overseas, is it beneficial to buy a health appropriate policy from an Indian insurance company or should they buy from an insurance company of that country?

This will depend on the specific country and the University to which the student is going for studies.

Some Universities in US, UK, Europe, Australia/ NZ do not give an option of buying a separate insurance policy. Their cost includes the cost of compulsory insurance policy bought through them. Some require students to buy it from a designated insurer. Many will just lay down the conditions that the policy should cover for it to be treated as an eligible buy. However, some universities do not have any requirement of compulsorily buying health insurance. As treatment cost can be very high overseas and therefore, even in such cases, it is advisable to buy appropriate insurance.

Most Indian insurance companies are well aware of the requirements of major countries/ universities and have appropriate policies available to suit the requirements with various add-on policies.

Generally, universities allow prospective students to interact with their existing students in a bid to familiarise and ease the way for incoming students in matters such as subjects to choose, housing, food etc. Such forums help in understanding the requirements, costs, etc. in deciding upon insurance. Other things being equal, Indian policies tend to be cheaper than similar policies issued by foreign companies.

Module 7: Risk Management and Insurance Planning I Module-end Questions

1. Which of the following characteristics are required for a risk to be insurable?
   a. The risk does not involve any prospect of gain
   b. The loss incurred should be definite and quantifiable
   c. The loss must be accidental and uncertain
   d. **All the options given**

2. In a/an ___________ insurance plan, the exact losses incurred by an insured are not ascertainable or are difficult to ascertain.
   a. Indemnity
   b. **Defined benefit**

3. The lock-in period for unit-linked insurance policy is ___________ to reflect the long-term, protection function of the policy.
   a. 3 years
   b. **5 years**
   c. 7 years
   d. 10 years

4. When a bank becomes the corporate agent of an insurance company it is referred to as a _________.
   a. Direct Insurance Broker
   b. Re-insurance Broker
   c. **Bancassurance Arrangement**
   d. Insurance Agent

5. The insured would get which of the following benefits from investment cum insurance policies?
   a. Death cover
   b. Survival benefits
   c. **Both (a) and (b)**
   d. Either (a) or (b)

6. Which of the following products is a pure insurance product?
   a. ULIP
   b. Money back policy
   c. **Term insurance policy**
   d. Whole life policy

7. In which of the following situations will the insured not have insurance cover?
   a. **Surrendered policy**
   b. Paid-up policy
   c. Term policy
   d. Both (a) and (b)

8. The premium payable on a ULIP is higher for the same sum assured as a term policy because:

a. The period of cover is shorter
b. **A portion of the premium is used for investment**
c. The pool of insured is smaller
d. The risk is higher

9. The term of insurance in non-life insurance is typically __________.
    a. Decided by the insured
    b. Decided based on sum insured
    c. **One year**
    d. Flexible

10. A __________ policy covers losses sustained by the employer as a result of an act of forgery, fraud or dishonesty from an employee.
    a. Keyman Insurance
    b. **Fidelity Insurance**
    c. Liability Insurance

CHAPTER 4: RETIREMENT PLANNING BASICS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Need for Retirement Planning
- Difference between various financial goals and retirement
- Retirement planning
- Global coverage for Different General Life Insurance Products
- Estimating Retirement Corpus
- Employee benefits and superannuation benefits

4.1 Need for Retirement Planning

Retirement planning pose a critical role for an individual due to increase in life expectancy. Life expectancy is referred to the number of years an individual is expected to live and is dependent on various factors such as health condition, scientific advancements etc. With the increase in average life expectancy coupled with difficulty to estimate accurately, has led to the need for retirement planning to sustain expenses post-retirement.

For example, X, who is in his 20s, has a total working life of 40 years (assuming 60 years being the retirement age). If the life expectancy is 80 years, then X has to spend 20 years of post-retirement life, without any commitment to work. Thus, to sustain the expenses during his retired life, X needs to plan for his retirement.

Retirement planning is not only about money accumulation, but living a life of one's choice, post-retirement. That can happen only when retirement planning is started early in life. People generally make the mistake of waiting for too long to begin and thereby fall short of time for sufficient fund accumulation.

The biggest roadblock for retirement planning is accumulating enough money at retirement. At younger age/ during start of the working life, too many responsibilities, such as house, marriage, kids and their associated expenses keep the idea of retirement planning at the back burner. But these responsibilities are the reasons why retirement planning is important. Inflation, taxes, pension receivable by family, and many more factors have to be considered while planning for retirement.

Previously, retirement was looked at a period when a worker is unable to do anything. This can happen by a job loss or a layoff. As time progresses the definition of retirement has also changed and now retirement is defined as a period when there is no work involved. Everyone wants to enjoy their retirement years through travel, leisure, social activities, pursuing hobbies, or spending time with their children. Thus, the definition of retirement has undergone a drastic change where people now look more for relaxation or sometimes changeover of employment which can be financially remunerative too.

Retirement planning, like any other life process, has various phases or stages: (a) Preparation stage, (b) period of Initial Retirement/ Pre-retirement stage and (c) Final

Retirement. These phases are characterized with different aspects that any individual who is planning for his/her retirement has to understand. For instance, the preparation stage includes need for child education, buying house for living, adequate life and health insurance and recognizing the impact of ageing. Similarly, at the pre-retirement phase, the physical and psychological changes will happen and one gets familiarize with the retirement regulations and procedures. The final is the retirement phase where one should have completed all necessary arrangements and are in a good position to decide about their life.

However, things are not that simple as it looks. Our society is getting more complex in terms of both its structure and operational challenges. There are various issues connected with the society such as longer life expectancy, decreasing retirement benefits, multiple job changes, rising healthcare cost, etc. which have made retirement planning one of the most important and critical element of financial planning.

All this demands a careful planning for retirement regardless of what stage of life one is in. If retirement planning starts early, one will be able to take steps towards the retirement income he/she wants.

4.2 Financial Goals and Retirement

Generally, when people plan their financial goals, they often mix retirement goal with other financial goals. Goals such as children education, retirement, buying a house or a car, etc. are planned simultaneously. Though all of these goals are important for any individual, there is a difference in meeting retirement goal than any other goals.

Many goals can be met comfortably through loans, if one does not have enough assets accumulated. Based on earnings and work profile, financial institutions approach individuals with their best offers. Thus, for all these goals one has easy finance available. That is not the case with retirement, since no company gives loans for meeting retirement needs. Still, most people do not want to talk about it.

Goals like children education have a defined time horizon as they have to be achieved within a specified timeframe. For example, the goal of college education is generally at a horizon of 14 to 15 years from the day the child starts going to school. There is hardly an option to delay this goal by 4 to 5 years if enough funds are not available. However, when it comes to retirement often it is delayed for any adjustment towards any other life goals. Take the case above for children education. If adequate funds are not available either loan will be availed or the retirement kitty will be withdrawn, thus delaying retirement goal by few years. This delay in planning for retirement can be catastrophic as financial requirements increases manifold and sometimes difficult to achieve if one misses the early benefits.

4.3 Retirement Planning

The retirement goal has certain features that are unique to it. It is the goal with the longest accumulation and distribution periods and requires the largest corpus.[4] Though the income required to meet expenses in retirement can be defined with certainty only close to the time of transition to retirement, the accumulation of the corpus has to be done from the beginning of an individual's working years. There are many variables in estimating the goal and these variables are likely to change multiple times given the long periods associated with the goal. Therefore, it becomes important to put in place adequate rigour in determining the variables that affect the retirement goal and periodic monitoring to incorporate changes, if any, into the goal.

The process of determining the retirement goal is about defining the income that will be required to meet living expenses in the period when there is no income being earned from employment. Once this is done, then the planning process deals with how to accumulate the corpus required, and use this corpus to generate the income. The steps involved in retirement planning process are as follows:

a. **Determine expenses in retirement**: The first step in retirement planning process is to determine the expenses that have to be met in retirement. The expense in retirement is unlikely to be the same as prior to retirement. The categories of expense heads during the retirement phase includes housing (including utilities, maintenance cost, taxes), living expenses (food and personal upkeep), medical care, transportation, recreational expenses and insurance (life, health, disability) and taxes.
b. **Determine income requirement in retirement**: While determining the income requirements in retirement, one needs to consider a few factors such as maintaining their standard of living in retired life, the expenses to be incurred in retirement, the inflation rates etc.
c. **Time horizon**: Time plays an important role in retirement planning. The time periods that are central to calculating the retirement corpus are:

    i. **Years to retirement -** This is the period from the current point in time to the year of retirement. Another way to calculate it is as the period between current age and retirement age. With every passing year, this period will reduce as long as the year/ age of retirement have not changed. The 'years to retirement' is important to be able to determine the cost of expenses that have to be met in retirement. The effects of inflation on cost will depend on the years to retirement. Lower the number, lower will be the effect of inflation. This number is also important in the calculation of the periodic savings required to accumulate the corpus required to fund the expenses in retirement. Longer the period, greater will be the compounding effects, and lower will be the allocation from savings required for the retirement.

[4]The accumulation stage is the stage in which the saving and investment for the retirement corpus is made. The distribution stage of retirement is when the corpus created in the accumulation stage is employed to generate the income required to meet expenses in retirement.

ii. **Years in/during retirement:** The years in/during retirement are the number of years from the beginning of retirement to the end of life for which an income has to be secured. This period cannot be defined precisely. However, life expectancy can be broadly estimated based on factors such as average life expectancy in the country for the specific gender, health conditions, genetic factors, lifestyle habits and so on. The years for which funding has to be provided will determine the corpus required. Underestimating the years, or longevity risk, will mean that there may not be enough money to last the retirement years.

d. Determine the retirement corpus: The retirement corpus that will generate the income required in retirement is to be calculated. The variables considered in such calculation are:

i. The periodic income required
ii. The expected rate of inflation
iii. The rate of return expected to be generated by the corpus
iv. The period of retirement, i.e. the period for which income has to be provided by the corpus.

4.3.1 Impact of Inflation

Inflation is a general rise in prices of goods and services over a period of time. Over time, as the cost of goods and services increase, the value of one unit of money will go down and the same amount of money will not be able to purchase as much as it could have earlier i.e. last month or last year. Inflation eats away the purchasing power of money over time.

Inflation impacts retirement planning in two ways:

i. At the time of calculating the income required, the value of the current expenses has to be adjusted for inflation to arrive at the cost of the expense at the time of retirement. For instance, if consumer goods prices rise 6 percent a year over the next 30 years, items that cost Rs. 100 today would cost Rs. 179 in 10 years, Rs. 321 in 20 years and Rs. 574 in 30 years.

ii. This figure is true for the beginning of the retirement period. Over the retirement years, the income required to meet the same level of expenses would not be constant but would go up due to inflation. The corpus created to fund income during retirement will have to consider the escalation in cost of living during the period in which pension is drawn. The increase in expenses has to be considered while calculating the retirement corpus else there is a risk of the retirement being under-funded. If you're planning to live on Rs. 60,000 a month at the start of retirement, a 6 percent inflation rate means that in 10 years you would actually need Rs. 1,07,451 a month, and in 20 years you'd need Rs. 1,92,428 a month to cover the same expenses.

iii. While the standard rate of inflation may be appropriate to calculate the future cost of living expenses, other expenses, such as health costs and travel, typically increase at a higher rate.

4.3.2 The Expected Rate of Return

While estimating the corpus required to generate the retirement, it has to be kept in mind that this corpus will be invested to earn a return both at the time of accumulation and at the time of distribution, and this return will contribute towards the corpus that will be used to provide the income in retirement. The contribution that has to be made towards the retirement corpus from savings will be lower to the extent of the return generated. The size of the corpus that has to be in place at the start of retirement can be lower to the extent that these funds will generate a return through the retirement period. Higher the rate of return that the funds are expected to earn, lower will be the required corpus. However, a higher return will come with a higher risk. Investors may be willing to take higher risk in the accumulation period for higher return. But, in the distribution stage of retirement, the ability to take risk with the savings will reduce.

The rate of inflation and the expected rate of return on investments act in opposite directions on the amount of retirement corpus required. While the rate of inflation pushes up the expenses and therefore the amount of retirement savings required to fund the income in retirement, the return that the corpus invested will generate, will reduce the savings required. The real or effective rate of return that the investment will generate, will then be the expected return adjusted for inflation.

Inflation adjusted rate or real rate of return is the periodic rate of return on an investment after adjustment for inflation.

$$\text{Inflation - Adjusted Return} = \frac{(1+\text{Return})}{(1+\text{Inflation Rate})} - 1$$

4.4 Estimating Retirement Corpus

There are 2 methods through which the income in post-retirement years can be estimated.

- Replacement Ratio Method
- Expense Protection Method

4.4.1 Replacement Ratio Method

Here it is assumed that the standard of living remains same as just before one enters the retirement phase. This helps in defining the target much easily and more accurately. For example, if one is at 58 years of age and is earning Rs 150000 p.m. then the retirement should maintain this income. Thus, assumption of standard of living becomes an important factor in estimating the retirement income. If income is Rs 200000 and standard 80% replacement ratio is assumed for retirement then one will have to plan for Rs 160000 income in the first year of retirement. This income is then increased by inflation rate every year to maintain the purchasing power.

Replacement Income (Year 1) = Pre-retirement Income *0.80

Replacement Income (each subsequent years) = Pre-retirement Income * Annual rate of Inflation (added per year) * 0.80

Let us take an example for easy understanding.

Mr. Rajeev (age 50 years) earns Rs. 100000 per month now. He wants to retire at the age of 60 years with 50% of his income as post-retirement income.

Let us assume that his income goes up at 10% p.a.

At the time of his retirement, his Income will be Rs. 259374 per annum (i.e. Rs. 100000*1.1^10).

Then Replacement Income just after his retirement income will be 259374*.50 = Rs 129687.

His replacement income will increase by inflation every year to maintain the purchasing power. Here the inflation rate is assumed to be 7% p.a.

Replacement income in the second year of his retirement will be 129687*107/100 = 138765 and so on.

Reductions in Living Expense and Taxes

Many expenses tend to reduce at retirement stage, such as housing loan, children education, work related expenses etc. while few other expenses such as medical, travel etc. tend to increase. Some long-term savings requirements also cease to exist. Many a times, just after retirement, the income reduces, pushing one into a lower tax bracket, thereby eliminating a good amount of tax liabilities. All these factors, clubbed together, decrease the retirement income of an individual.

Limitations of the Income Replacement Ratio

The more number of years one has for retirement, the less accurate income replacement estimate is likely to be. Still, the earlier one starts calculating it and investing, the lower the interest rate one may need to achieve their wage replacement goal.

4.4.2 Expense Protection Method

This method defines retirement Income based on expenses in retirement. Many people using this method keep a detailed monthly budget. Tracking expenses enables them to have a reasonable understanding of what it will cost to retire.

Adjustments to budgets often must be made. For example, some expenses may increase over a period of time such as, medical expenses, travel, gifting, house maintenance etc. On the other hand some of the expenses tend to reduce like housing loan repayment, children education expenses, income tax etc. Once the estimation is done based on the probable expenses to be incurred, the retirement income required is estimated. The estimation is easier for individuals nearing their retirement.

Limitations of the Expense Protection Method

As with the income method, there is also a drawback to the expense method, particularly for those who are many years away from their retirement. With longer period to retire, expense estimation for future becomes difficult. In such cases, estimation of future retirement expenses is done with speculation and so needs to be reviewed periodically.

Let us take an example for easy understanding.

Mr. Ashish is earning a monthly income of Rs. 60000 of which 50% is household expenses. He is 40 years old and is planning to retire at the age of 60 years. He is expecting additional expenses of Rs. 15000 at his retirement. If we assume inflation at 6% then his expense at the time of retirement will be as below:

Particulars	**Amount (Rs.)**	**Calculation**
Current household expense	30000	50% of 60000
Additional expenses at retirement	15000	
Total retirement expense	45000	30000 + 15000
Years to retire	20	60 - 40
Inflation rate	6%	
Expenses at time of retirement	144321	45000*(1.06)^20

4.5 Superannuation Benefits to Employees

Superannuation is an organizational pension program created by a company for the benefit of its employees. It is also referred to as a company pension plan. Funds deposited in a superannuation account will grow, typically without any tax implications, until retirement or withdrawal.

Once an employer has a superannuation benefit in place for his employees, he has a liability to meet. In India, there is no legislation providing statutory superannuation (pension) benefits except to those employees covered under the Employees' Pension Scheme, 1995. The Government bodies, nationalized banks and a very few other organizations are, if they so decide, allowed to pay pension to their employees. All other establishments whether in public or private sector are required to arrange annuities through Life Insurance Corporation of India or any other IRDAI approved life insurance companies. Therefore, an employer can have any one of the following two arrangements:

(1) Payment by the employer; and
(2) Funding through a trust.

4.5.1 Payment by the employer

The employer arranges to pay superannuation benefits to its employees through the below mentioned methodologies:

(a) There are occasions when an employer decides to arrange for superannuation benefits for one or a few employees as reward for their dedicated services by paying a lump sum contribution out of the current revenue to buy an immediate annuity from a life insurance company.

(b) The employer has framed a superannuation scheme for his employees and has not created any fund for it and wishes to pay himself the pensionary benefits. It means that employer would, if otherwise allowed by law, pay out the superannuation payments to the retired employees as and when they are due out of the current revenue. Though this may look easy to follow, this is not a satisfactory method for many reasons.

First of all, the likelihood of payment of pension to the employees who have retired will depend upon the financial health of the employer and if the employer does not make enough profits in a year to pay the pension disbursements, the retired employees may not get their pension. This situation is more likely to happen as the pension payout liability will keep on increasing year after year as the number of pensioners receiving superannuation payments increase. The situation would be still worse if an employer goes bankrupt and winds up the establishment. Hence, this method is not allowed.

The Accounting Standard 15, brought out by the Institute of Chartered Accountants of India (ICAI), does not allow companies to provide for the retirement benefits at the time they become due. It insists that all the retirement benefits have to be provided for in the respective year of accrual. Also, Section 2 (11) of Insurance Act defines life insurance business in such a way as to include the payment of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged in or who have been engaged in any particular profession, trade or employment or of the dependents of such persons. This has made it obligatory for employers to arrange for payment of superannuation benefits only through a life insurance company registered with the Insurance Regulatory and Development Authority of India (IRDAI). The question arises as to what is required on the part of the employer during the period till the superannuation benefit of an employee becomes payable. The employer has to create a fund for paying the superannuation benefits to the employees and to set aside funds required for meeting the liability on an accrual basis every year.

4.5.2 Funding through a Superannuation Trust

The second method of administering a superannuation scheme is to do it through a Trust. The employer should create a Trust for funding the pension liability and appoint Trustees for the purpose. The Trust so created should be irrevocable and should be distinct from the employer. The employer should transfer the contributions for the superannuation benefit (both that of the employer and employees, if the scheme were to be contributory) to the Trust Fund.

4.5.3 Approved Superannuation Funds

When an employer introduces a superannuation benefit scheme for his employees and contributes funds for the scheme, it is natural that he would like to expense off the contributions that he makes against the profits made by him and pay tax on the reduced profits only. In other words, he would like his contributions to get tax exempt. For getting tax exemption for the contributions to the superannuation fund, established for the employees, the employer has to get the fund approved by the Commissioner of Income Tax. Once the fund is approved by the Commissioner of Income Tax, the employer can treat the contributions made to the fund, within the limits prescribed in the Income Tax Act, as business expense and deduct it from the profits made for Income Tax purposes.

The Income Tax Act (IT Act) defines approved superannuation fund as "a superannuation fund or any part of a superannuation fund which has been and continues to be approved by the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner in accordance with the rules contained in Part B of the Fourth Schedule". The rules contained in Part B of the Fourth Schedule of IT Act states that in order that a superannuation fund may receive and retain approval as defined under the IT Act:

- The fund shall be established under an irrevocable trust in connection with a trade or undertaking carried on in India and not less than 90% of the employees shall be employed in India.
- The fund should have for its sole purpose the provision of annuities for employees in the trade or undertaking on their retirement at or after a specified age or on their becoming incapacitated prior to such retirement, or for the widows, children or dependents of persons who are or have been such employees on the death of those persons.
- The employer should be a contributor to the fund.
- All annuities, pensions and other benefits shall be payable only in India.

Further, the Income Tax Act provides the following benefits to the approved superannuation fund, for both the employers and the employees:

- ***Section 10(13):*** Any payment from an approved superannuation fund, made on the death of a beneficiary; or to an employee in lieu of or in commutation of an annuity on his retirement at or after a specified age or on his becoming incapacitated prior to such retirement; or by way of refund of contributions on the death of a beneficiary, or by transfer to a pension scheme under 80CCD (NPS) shall not be included in computing the total income of a previous year of any person. This makes it clear that payments made out of an approved superannuation fund to the beneficiaries upon the death of the member and also the commuted value of the pension payable on retirement of the employee after ascertaining the age as well as payments made on the retirement of an employee due to becoming incapacitated are exempt from Income Tax.

- ***Section 10(25)(iii)***: Any income *r*eceived by the trustees on behalf of an approved superannuation fund shall not be included in computing the total income of the trust. This makes the funds of an approved superannuation fund to be accumulated in a tax-free environment.

- ***Section 36(iv)***: Any sum paid by the assessee as an employer by way of contribution towards an approved superannua*t*ion fund, subject to su*c*h limits as may be prescribed for the purpose of approving the superannuation fund and subject to such conditions that the Central Board of Direct Taxes (CBDT) may specify, will be allowed as dedu*c*tion in the computation of business income of the employer.

- ***c) Section 80 C*** : Any contributions made by an employee to an approved superannuation fund are eligible as deduction in computing the taxable income, subject to a ceiling as prescribed by Income Tax Act.

4.5.4 Trustees Responsibilities

The trustees of an approved Superannuation Trust Fund (also referred to as Superannuation Scheme) have many responsibilities in the administration of the funds, payment of benefits along with legal and tax responsibilities.

These are:

a. To have periodical meetings of the Trustees to review the performance of the Trust and to keep records of the minutes.
b. To keep in touch with the Company and inform the employer the decisions taken by the Trustees.
c. To collect the amount of contributions from the employer as per the rules of the scheme or get it calculated by an Actuary in case of a defined benefit scheme and then requests the employer to pay it.
d. To invest the Trust money as per the prescribed pattern of investment given in IT Rules.
e. To realize the interest earned on the investments and re-invest it as per the prescribed pattern.
f. To make or enter into an arrangement to ensure pension benefits to the employee/ beneficiary as per the options exercised.

g. To deduct tax at source from the annuity payments wherever applicable and remit them to IT Authorities or advise the life insurance company to deduct tax at source before releasing annuity payments as the case may be.
h. To prepare the annual accounts of the Trust, get them audited and submit to the IT authorities.

CHAPTER 5: RETIREMENT PRODUCTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Accumulation related products
- Portfolio created by an investment adviser
- Distribution related products

5.1 Accumulation related products

In accumulation stage, various products are available to an individual for generating his/her retirement corpus. Few of the accumulation related products are mandatory in nature while others are voluntary. Some of the accumulation related products are discussed below:

5.1.1 Employees Provident Fund

EPF (Employees' Provident Fund), also referred to as PF (Provident Fund), is a mandatory savings cum retirement scheme for employees of an eligible organisation. This fund is intended to be a retirement corpus. As per the EPF norm, the employees must contribute 12% of their basic pay plus dearness allowance every month. A matching amount is contributed by the employer as well. The amount deposited in EPF accounts earns interest on an annual basis. Employees can withdraw the entire sum accumulated in their EPF account at the time of their retirement. However, premature withdrawals can be made on meeting certain conditions.

Monthly Contribution

As mentioned above, both employer and employee have an equal contribution towards the employees' provident fund. The actual amount of EPF contribution is calculated based on the employee's basic salary and dearness allowance.

The employer deducts 12% of the employee's salary (basic + dearness allowance) directly every month for a contribution towards EPF. This entire contribution goes to the EPF account of the employee. Similarly, the employer also contributes 12% of the employee's salary towards EPF. But, the employer's contribution has the following categories:

Category	**Percentage of contribution**
Employees Provident Fund	3.67%
Employees' Pension Scheme (EPS)*	8.33%

Employee’s Deposit Linked Insurance Scheme (EDLIS)	0.5%
EPF Admin Charges	0.50%

*Subject to a ceiling of Rs 15000 monthly salary

However, the EPF contribution can be 10% in certain circumstances such as:

- If a company has less than 20 employees
- The company incurs losses that are more than its entire net worth
- If a company is associated with beedi, jute, brick, guar gum or coir industry

The contribution can also vary in case of women employees. As per the announcement in the Union Budget 2018-2019, new women employees can make an EPF contribution of 8% instead of 12%. This privilege is only for the first three years of employment. The primary reason for this revision was:

- To enable women for higher take-home pay
- To encourage companies to hire more women to bridge the gap

Even though a woman employee contributes 8% towards EPF, the employer has to maintain its EPF contribution at 12%. Well, an employee can also add more than 12% towards EPF. This is the Voluntary Provident Fund (VPF), discussed in subsequent section.

It is important to note that EPF will continue to be active as long as you are a salaried employee. If you switch jobs, it is paramount to update your EPF information with your new employer to continue their contribution.

Interest Rate

Interest rate is decided by the Central Board of Trustees (CBT) in concurrence with Ministry of Finance. The interest rate which is announced by EPFO stays valid for a financial year, i.e. starting from 1st April to 31st March. This interest is calculated every month and then transferred to the Employee Provident Fund accounts every year on 31st March. The interest earned on EPF is exempted from tax within certain limits. However, effective from April 1, 2021, if an employee's own contribution to the EPF account along with VPF exceeds Rs 2.5 lakh in a financial year, then the interest earned on excess contributions will be taxable in the hands of an employee.

If there are no contributions in the EPF account consecutively for 3 years, then the account becomes inactive or dormant. Even in such instances, the interest is paid on the EPF account until the employee retires. The interest earned on inactive accounts is taxable as per the employee’s tax slab rate. However, once the account is inoperative (i.e. no contributions received for 3 years after retirement; or permanent migration abroad; or in case of death), no interest will accrue. After 7 years of being inoperative, the money lying in such accounts is transferred to the Senior Citizen Welfare Fund by EPF, if no claim is received.[5] This can be claimed by EPF members or their nominees within 25 years by furnishing the required proofs and documents.

Subsequently, the employer's share contributed towards the Employee Pension Scheme (EPS) does not accrue interest. However, a member is eligible to receive his/her pension only after the age of 58.

Withdrawal

One may choose to withdraw EPF balance entirely or partially. EPF balance can be completely withdrawn in the following instances:

a. When an individual retires

b. When an individual remains unemployed for more than two months.

In case of unemployment for 2 months, EPFO allows withdrawal of 100% of the corpus. Currently, EPFO allows withdrawal of 75% of the corpus after 1 month of unemployment and the remaining 25% of the corpus can be withdrawn if unemployed for 2 months or more. In case the individual is employed after 1 month of being unemployed, the remaining 25% of the corpus is transferred to the new EPF account. However, the 2-month waiting period for complete withdrawal does not apply to women who quit their jobs for marriage.

Partial withdrawal of EPF balance can be done under certain circumstances and subject to certain prescribed conditions, as discussed in brief below:[6] (refer Table 5.1)

Table 5.1: EPF balance Withdrawal

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
1	Medical purposes	6 months basic salary and dearness allowance Or total employee's share plus interest Whichever is lower	No criteria	Medical treatment of self, spouse, children, or parents

[5] Senior Citizens' Welfare Fund (SCWF), established by the Central Government under the Finance Act, 2015, is to be utilised for such schemes for the promotion of the welfare of senior citizens.
[6] https://www.epfindia.gov.in/site_docs/PDFs/Downloads_PDFs/TypesOfAdvances_Form31.pdf

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
2	Marriage	Up to 50% of employee's share of contribution to EPF with interest	7 years	For the marriage of self, son/daughter, and brother/sister
3	Education	Up to 50% of employee's share of contribution to EPF with interest	7 years	Either for account holder's education or child's education (post matriculation)
4	Purchase of land or purchase/construction of a house	**For land** – Up to 24 months basic salary plus dearness allowance **For house** – Up to 36 months basic salary plus dearness allowance Or Total of employee and employer share with interest Or Total Cost Whichever is least.	5 years	i. The asset, i.e. land or the house should be in the name of the employee or jointly with the spouse. ii. It can be withdrawn just once for this purpose during the entire service. iii. The construction should begin within 6 months and must be completed within 12 months from the last withdrawn installment.
5	Home loan repayment	Least of below: Up to 36 months basic salary plus dearness allowance Or Total corpus consisting of	10 years	i. The property should be registered in the name of the employee or spouse or jointly with the spouse. ii. Withdrawal permitted subject to furnishing of requisite documents as stated by the EPFO relating to

Sl. No.	Particulars of reasons for withdrawal	Limit for withdrawal	No. of years of service required	Other conditions
		employer and employee's contribution with interest Or Total outstanding principal and interest on housing loan		the housing loan availed. iii. The accumulation in the member's PF account (or together with the spouse), including the interest, has to be more than Rs 20,000.
6	House renovation	Least of the below: Up to 12 months basic wages and dearness allowance Or Employees contribution with interest Or Total cost	5 years	i. The property should be registered in the name of the employee or spouse or jointly held with the spouse. ii. The facility can be availed twice: a. After 5 years of the completion of the house b. After the 10 years from withdrawal for renovation
7	Partial withdrawal before retirement	Up to 90% of accumulated balance with interest	Once the employee reaches 54 years and withdrawal should be within one year of retirement/superannuation, whichever is later	

Tax Implications

The contributions made by the employee to EPF are eligible for deduction under section 80C along with other investments/expenses mentioned in that section. The interest earned on the employee contributions is exempted from taxation only up to a specified limit. As per Finance Act 2021, the annual interest earned on employee contribution exceeding Rs. 2.50 lakhs per annum is taxable. This includes the contribution in Voluntary provident fund account. In other words, for annual contributions of more than Rs 2.5 lakh including Voluntary Provident fund account, the interest earned on these is taxable.

Employer Contribution

Employer's contribution towards EPF is also tax exempted up to a certain limit.

Now if the aggregate employer's contribution to EPF, National Pension System and Superannuation Fund exceeds Rs.7.5 lakh in the financial year, then the contribution and interest/ dividend thereon, in excess of the aforesaid amount, is treated as perquisite in the hands of the employee in the year of contribution. The employer has an obligation to consider such excess amount as perquisite in the hands of the employee and withhold taxes thereon.

Tax on Withdrawals

EPF balance withdrawal is considered to be tax-free. As per the rule, there are certain exceptions based on the number of years of employment.

A. *Before five years*

Suppose the employee has not completed a consecutive five years of service. In that case, the amount withdrawn is taxable in the hands of the employee in the year of receipt. The amount may remain tax-free in the following two exceptions.

- If the employment is terminated due to an employee's ill health or the employer has discontinued its business or any other reason for withdrawal, which is beyond the control of the employee. In such a scenario, the EPF amount withdrawn before five years of employment is considered to be tax-free in the hands of the employee.
- If the employee changes his employer in less than five years, then the employee can transfer his PF account balance of the existing employer to the new employer. In such case, the PF balance remains tax-free. Therefore, it is always suggestible to transfer the PF balance while changing jobs to avoid any taxation.

B. *After five years*

If the employee has completed a consecutive five years of service, in that case, the amount withdrawn is tax-free in the hands of the employee in the year of receipt.

c. Otherwise

- If the EPF withdrawal amount is less than Rs.50,000, before completion of 5 years of service, in such instances the individual has to pay tax on the EPF withdrawal amount if he falls in the taxable bracket (based on this tax slab rate).
- If the EPF withdrawal amount is more than Rs.50,000, before completion of 5 years of service, in such instances, tax is deducted at source (TDS). If PAN is furnished, then 10% TDS is charged. If PAN is not furnished, then TDS is applicable at the maximum marginal tax rate. However, if Form 15G/15H is submitted, as the case may be, TDS will not apply.

5.1.2 Voluntary Provident Fund

Persons covered under the Employee Provident Fund (EPF) can choose to contribute over and above the mandatory 12 percent of the basic and dearness allowance, to their EPF account under the Voluntary Provident Fund (VPF). There will be no employer contribution to match any contribution made by the employee under the VPF.

The contributions will be invested in the EPF account of the employee. Like the primary account, the investments will be predominantly in debt investments, particularly government securities.

Return

The return on the investment will be declared each year by the government.

Investment Limits

The subscriber can invest any percentage of the basic salary into the VPF, going up to 100% of basic salary and dearness allowance. The amount of investment can be decided by the subscriber and discontinued with prescribed notice.

Tenure and Withdrawals

The VPF is open-ended and subscribers can contribute till the time of retirement. Withdrawal of funds is possible according to the rules of EPF.

Taxation

All contributions, interest earned and withdrawals are exempt from tax upto a specified limit. If the aggregate employee contribution to EPF plus VPF is in excess of Rs 2.5 lakh in a financial year then the interest earned on the excess amount is taxable as interest income.

5.1.3 Public Provident Fund

Public Provident Fund (PPF) is a long-term saving product that can be used to accumulate funds for retirement and other goals. It can be opened with prescribed banks and post offices. It is a voluntary savings product.

Eligibility Criteria

- Only an Indian resident can open a PPF account
- NRIs are not eligible to open PPF accounts. Post September 30, 2024, existing account holders who attained NRI status will be able to contribute further but cannot extend the duration of their PPF accounts. These accounts, maintained by NRIs, will not earn any interest post September 30, 2024.
- Parents/guardians can also open PPF accounts for their minor children
- Opening of joint accounts and multiple accounts are not allowed

Key Features

Here are some of the primary features of Public Provident Fund:

- **Lock-in period:** A PPF account is a fixed-income, long term investment with a lock-in period of 15 years. Premature withdrawals are allowed after 5 years subject to certain conditions and limits. This tenure can be extended in blocks of 5 years at the end of the first 15 year lock-in period. However, post September 2024, NRIs donot have this extension privilege once their accounts mature.

- **Minimum and maximum investments:** Individuals need to make a minimum investment of Rs. 500 annually. A maximum investment of Rs. 1.5 lakh can be made in one year in PPF account. An individual can contribute not more than Rs. 1.50 lakh to his PPF account and the PPF account of the minor/s taken together.

- **Taxation:** PPF comes under the Exempt-Exempt-Exempt (EEE) category of tax policy which implies that the principal amount is allowed as a deduction under section 80C while the interest earned and the maturity amount are exempt from taxes.

- **Loan against PPF:** A PPF account holder can take a loan against the balance from the beginning of 3rd financial year till the end of the 6th financial year from the date of account opening. Loan against PPF balance is available upto a maximum of 25% of the total balance at the end of the 2nd financial year immediately preceding the year in which loan is applied.

Interest Rate

PPF is a floating rate investment. The interest rate on PPF accounts is notified by the Central Government every quarter. Effective from October 2024, minors' accounts will earn interest rate applicable for Post Office Savings Account (POSA) till they turn 18 (major), post which standard PPF rates will apply. Also if one has multiple PPF accounts then interest will be earned on the primary account till the deposit remains within the yearly limit; any excess deposit beyond the yearly limit will not earn any interest and will be returned back to the interest.

Withdrawals

PPF works under a mandatory lock-in period of 15 years. However, partial withdrawals from the account can be made after the completion of 5 financial years from the end of the financial year in which the account is opened. For example, if the account was opened on Feb 15, 2017, withdrawal can be made from the financial year 2023-24 onwards. Only one partial withdrawal is allowed per financial year. The maximum amount that can be withdrawn per financial year is the lower of the following:

- 50% of the account balance as at the end of the preceding year, or
- 50% of the account balance as at the end of the 4th year, immediately preceding the year of withdrawal application.

Form-2 should be submitted to withdraw a partial amount from the PPF account.

- Details such as account number, amount of money to be withdrawn, etc. are to be mentioned in the form.
- A declaration stating that no other amounts were withdrawn during the same financial year should also be submitted.
- In case, the account is in the name of the minor, additional declaration stating that the amount is required for the use of minor child who is still a minor and is alive.
- Passbook is also required to be submitted along with the form.

Extension of account tenure

PPF account matures after 15 years from the end of the financial year in which the account was opened. At the time of maturity, the account holder has the option to extend the tenure in the blocks of 5 years:

Extension of PPF with contribution: A subscriber can extend the life of the PPF account indefinitely in blocks of 5 years at a time. The subscriber has to submit a request to extend the account, with further contributions by submitting Form-4.

- The choice of extension with contribution has to be made within one year before the date of maturity, otherwise, the default choice of extension without further contribution applies.
- Once the account is extended with contributions, the maximum 60% of the balance as on the date of extension of the account can be withdrawn.
- This amount can be withdrawn in one go or can be spread over several years.
- A maximum of one withdrawal can be made in a year.

Extension of PPF without further contribution: If no choice is made, then the default choice, i.e. extension without further contribution applies.

- No separate form needs to be filled to choose this option.
- A maximum of one withdrawal is allowed per financial year and any amount up to the total balance in the account can be withdrawn.

Once the PPF account is renewed with/without contribution, the option cannot be switched, i.e. from with contribution to without contribution or vice versa. In case the amount is deposited in the account without choosing the correct option, no interest will be payable on such amount. Also, no deduction under the Income Tax Act will be available on such contributions.

Premature Closure

Individuals can choose to close their PPF account prematurely, instead of withdrawing from it, after completing of 5 financial years from the end of the year of account opening, subject to the following conditions:

1. to utilize accumulated savings for treatment of life threatening diseases, ailments or any other medical emergency of self, or spouse, or parents or children
2. To finance higher education of self, or dependent children
3. If there is a change in residency status of the account holder

Taxation

- Public Provident Fund falls under EEE (i.e. exempt-exempt-exempt) regime of taxation.
- Contribution to the account (up to Rs 1.5 lakh per annum) is eligible for deduction under section 80C of Income Tax Act, interest earned and maturity proceeds are also exempt from tax. However, the interest earned must be declared on the income tax return.

5.1.4 Gratuity

Gratuity is given by the employer to his/her employee for the services rendered by him/her during the period of employment. It is usually paid at the time of retirement but can be paid earlier, provided certain conditions are met.
A person is eligible to receive gratuity only if he has completed minimum 5 years of continuous service with an organisation. However, it can be paid before the completion of five years at the death of an employee or if he has become disabled due to an accident or disease.

There is no set percentage stipulated by law for the amount of gratuity an employee is supposed to receive - an employer can use a formula-based approach or even pay higher than that. The Gratuity payable depends on two factors: last drawn salary and number of years of service. To calculate how much gratuity is payable, the Payment of Gratuity Act, 1972 has divided non-government employees into two categories:

a. Employees covered under the Act

b. Employees not covered under the Act

An employee will be covered under the Act if the organisation employs at least 10 persons on a single day in the preceding 12 months. Once an organisation comes under the purview of the Gratuity Act, it will always remain covered even if the total number of employees falls below 10.

Calculation of Gratuity

<u>For employees covered under the Act</u>

There is a formula using which the amount of gratuity payable is calculated. The formula is based on 15 days of last drawn salary for each completed year of service or part thereof in excess of 6 months.

The formula is as follows:

(15 X last drawn salary X tenure of working) divided by 26

Here, the last drawn salary means basic salary, dearness allowance, and commission based on sales.

Suppose, A's last drawn basic pay is Rs 60,000 per month and he has worked with XYZ Ltd for 20 years and 7 months. In this case, using the formula above, gratuity is calculated as: (15 X 60,000 X 21)/26 = Rs. 7.26 lakh.

In the above case, we have taken 21 years as tenure of service because A has worked for more than 6 months in year. Had he worked for 20 years and 5 months, 20 years of service would have been taken into account while calculating the gratuity amount.

<u>For employees not covered under the Act</u>

There is no law that restricts an employer from paying gratuity to his employees, even if the organisation is not covered under the Act. The amount of gratuity payable to the employee is calculated based on half month's salary for each completed year. Here also salary is inclusive of basic pay, dearness allowance, and commission based on sales.

The formula is as follows:

(15 X last drawn salary X tenure of working) divided by 30

In the above mentioned example, if A's organisation was not covered under the Act, then his gratuity will be calculated as: (15 X 60,000 X 20) /30 = Rs 6 lakh.

Here the number of years of service is taken on the basis of each completed year. So, since A has worked with the company for 20 years and 7 months, his tenure will be taken as 20 and not 21.-

Gratuity to Central Government Employees
As per the government's pensioners' portal website, retirement gratuity is calculated as: one-fourth of a month's basic pay plus dearness allowance drawn before retirement for each completed six monthly period of a qualifying service. The retirement gratuity payable for qualifying service of 33 years or more is $16^1/_2$ times the basic pay plus dearness allowance, subject to a maximum of Rs 20 lakh.

In case of death of an employee, the gratuity is paid based on the length of service, where the maximum benefit is restricted to Rs 20 lakh. Summarized below are the entitlement of death gratuity rates as applicable for qualifying years of services: (refer Table 5.2)

Table 5.2: Gratuity rates applicable corresponding to qualifying service

Qualifying service	**Rate**
Less than one year	2 times of basic pay
One year or more but less than 5 years	6 times of basic pay

5 years or more but less than 11 years	12 times of basic pay
11 years or more but less than 20 years	20 times of basic pay
20 years or more	Half of the basic salary for each completed six-monthly period. However, it is subject to a maximum of 33 times of the basic salary.

Taxability

The taxability of gratuity depends on the recipient's job. In case of **Government employees**, there is no tax on the gratuity (fully exempt). In case of **Private sector employees**, the tax liability is as below:

- In case of private sector employees covered under the Payment of Gratuity Act, 1972, any gratuity received is tax exempt to the extent of least of the following:
    - Statutory limit of Rs. 20 Lakh (Maximum limit/ Government notified amount)
    - Last drawn salary * 15/26 * No. of completed years of service.
    - Gratuity Actual Received.
      [Salary includes Basic Pay plus Dearness allowance]

If the gratuity exceeds the limit mentioned above, then it becomes taxable.

- For private employees not covered under the Payment of Gratuity Act, 1972, any gratuity received is tax exempt to the extent of least of the following:
    - Statutory limit of Rs 20 Lakh.
    - Gratuity = Average salary x one half x No. of years of service.
    - Actual gratuity received.
      [Salary includes basic pay, dearness allowance and commission based on the percentage of turnover. The average salary is taken as the average of the salary of last 10 months immediately preceding the last working month.]

5.1.5 Superannuation Benefit

The existing mandatory retirement benefits are very often found to be insufficient to meet the income replacement required at retirement. Employers provide superannuation plans to augment the benefits available by contributing to a superannuation fund. The company has to appoint trustees to administer the scheme and get the scheme approved by the Commissioner of Income Tax.

A company can offer a group superannuation scheme in two ways:

- Through the constitution of a trust fund where fund managers are appointed by the trustees to manage the fund.
- Through investment in a superannuation scheme from a life insurance company.

On retirement, the employee is allowed to take one third of the accumulation in his account as commutation. Commutation refers to the exercise of the facility of taking a portion of the annuity corpus in a lumpsum. The balance in the corpus is used to purchase an annuity. Apart from LIC, all other life insurance companies allow its customers to purchase annuity from any annuity provider. (Refer to Chapter 4 for details)

Income Tax rules restrict the employer's contribution, whether to the PF or superannuation fund or a combination of both, to 27 percent of the employee's earnings. Payments received at the time of retirement are completely exempt from tax only in specified conditions. Aggregated with EPF and NPS, the contributions are treated as perquisite if they exceed Rs 7.5 lakhs in a financial year. However, payment received at the time of death, from an approved Superannuation Fund, remains exempted from tax.

5.1.6 National Pension System

National Pension System is a social security initiative by the Central Government. This pension scheme is open to employees from the public and private sectors, except those from the armed forces. NPS is also open to all Indian citizens on a voluntary basis. The scheme encourages people to invest in a pension account at regular intervals during the course of their employment. After retirement, the subscribers can take out a certain percentage of the corpus. As an NPS account holder, one will invest the remaining amount in an annuity of an approved annuity service provider and will receive monthly pension therefrom, post their retirement. NPS scheme holds immense value for anyone who works in the private sector and requires a regular pension after retirement. The scheme is portable across jobs and locations, with tax benefits under Section 80C and Section 80CCD of the Income Tax Act.

The NPS is a contributory pension system where the subscriber contributes to the fund over their working life and at retirement draws the corpus so created to buy annuity(ies) that will provide regular income in retirement.[7] There is no guaranteed return or principal protection in the NPS. Subscribers earn market returns on their contribution and the pension drawn will depend on the corpus that is available to buy the annuity(ies) on retirement.

Models under NPS

The National Pension System (NPS) platform offers different models to suit the different specifications of its users. These include:

- The Government Sector model for the Central (except armed forces) and State Government Employees, and also employees of Central Autonomous and State Autonomous Bodies. The individuals mandatorily subscribe to the NPS on becoming government employees.
- The All Citizens model as a voluntary contributory pension scheme available to

[7] Subscribers have the option of buying multiple annuities from a single Annuity Service Provider (ASP) at the time of their exit, provided their annuity corpus is more than Rs. 10 lakhs wherein Rs. 5 lakhs be utilized to buy each annuity scheme. The same is notified PFRDA Circular No.: PFRDA/2023/14/SUP-ASP/02 dated May 10, 2023 on Retirement Income Optimization through multiple Annuities.

all Indian citizens aged between 18-70 years of age.
- The Corporate model for companies/entities desirous of adopting the NPS platform to provide retirement benefit to its employees.

All the models broadly use the NPS architecture to provide the systems to aggregate the contributions of the subscribers, invest it to accumulate pension wealth and provide the pensions at retirement.

Types of NPS Account

The two primary account types under the NPS are Tier I and Tier II. The former is the default account, while the later is a voluntary addition. Table 5.3 below explains the two account types in detail:

Table 5.3: NPS Tier I account Vs NPS Tier II account

Particulars	NPS Tier-I Account	NPS Tier-II Account
Status	Default/ Mandatory	Voluntary
Withdrawals	Conditional and Restricted	Permitted/ Unrestricted
Tax deduction on contribution by employee/ self-employed person	Upto Rs 2 lakh p.a. i.e. Rs. 1,50,000 tax deduction under Section 80C and an additional Rs. 50,000 under Section 80CCD(1B).	Government employees – Deduction available under Sec 80C (i.e. maximum Rs. 1.5 lakh) Other employees - No exemptions
Tax deduction on contribution made to NPS account by Employer	Upto 14% of (Basic + DA) for central and state government employees and 14% for any other employer[8] (As per Budget 2024) (under Section 80CCD(2) of IT Act) Note: the contribution made by the employer is considered as a perquisite in the hands of the employee and is available for deduction under this Section.	Not applicable

[8] Vide The Finance Act, 2024 effective from April 1, 2025.

Particulars	NPS Tier-I Account	NPS Tier-II Account
Minimum NPS contribution	Each contribution to be of minimum Rs 500; subject to minimum yearly contribution of Rs. 1000.	Rs. 1000 at the time of activation Rs. 250 for subsequent contributions.
Maximum NPS contribution	No limit	No limit

The Tier-I account is mandatory for everyone who opts for NPS scheme. The Central Government employees have to mandatorily contribute 10% of their basic salary plus dearness allowance. For everyone else, the NPS is a voluntary investment option.

Choice of Investments

There are four asset classes across which contributions can be invested. These are: Equity, Corporate Debt, Government Bonds and Alternative Investments. These choices can be exercised through various pension fund managers allowed to manage the NPS funds. Further, each asset class has further defined investments as stipulated by the regulator, PFRDA. Table 5.4 lists the asset classes offered by Pension Fund Managers (PFMs) for investment.

Table 5.4: Asset classes offered by Pension Fund Managers (PFMs) for investment

Equity (E)	Invests predominantly in Equity market instruments.
Corporate Debt (C)	Invests in Bonds issued by Public Sector Undertakings (PSUs), Public Financial Institutions (PFIs), Infrastructure Companies and Money Market Instruments.
Government Securities (G)	Invests in Securities issued by Central Government, State Governments and Money Market Instruments.
Alternative Investments (A)	Invests in instruments such as Commercial Mortgaged Backed Securities (CMBS), Real Estate Investment Trust (REITS), Alternative Investment Funds (AIFs), Infrastructure Investment Trusts (InvITs) etc.

Mode of Investment

- **Active Choice**

In the NPS Active Choice, subscribers have the option to choose the ratio in which their contributions will be invested among various asset classes or the NPS funds that offer a defined combination. However, there are limitations even within this choice as the maximum permitted allocation to equities is restricted to 75%.[9] Each Pension fund manager has a bouquet of fund schemes that a subscriber can select from. (see Table 5.5)

Table 5.5: Permissible fund allocation under Active Choice

Active Investment Class	Equity (E)	Corporate (C)	Government (G)	Alternative Investments (A)[10]
Permissible allocation	Upto 75%	Upto 100%	Upto 100%	Upto 5%

- **Auto choice**

The NPS Auto Choice option adopts a life-cycle based approach -- starts with an equity-heavy portfolio during the subscriber's younger age and systematically reduces the equity exposure as the subscriber approaches retirement.

Under the auto choice, the investments are made in a life-cycle fund, with three life cycle funds (LC) to choose from. (refer Table 5.6)

1. **Moderate Life Cycle Fund**: It is the default option, which caps the equity exposure to maximum of 50%.
2. **Conservative Life Cycle Fund**: As the name suggests, it takes a conservative approach to investing with maximum equity allocation capped at 25%.
3. **Aggressive Life Cycle Fund:** In this option, maximum equity allocation can go up to 75%.

[9] PFRDA Circular No. PFRDA/2022/31/REG-PF/04 dated October 20, 2022 on maximum allocation limit allowable under Active Choice.

[10] This asset class is not available for investment of contribution made under Tier II account. Investment in this asset class is only available to the subscribers opting for Active choice investment option.

Table 5.6: Fund Allocation under Auto Choice

	Asset Class (%)								
	Moderate Life Cycle Fund			Aggressive Life Cycle Fund			Conservative Life Cycle Fund		
Age	**E**	**C**	**G**	**E**	**C**	**G**	**E**	**C**	**G**
Up to 35 years	50	30	20	75	10	15	25	45	30
40 years	40	25	35	55	15	30	20	35	45
45 years	30	20	50	35	20	45	15	25	60
50 years	20	15	65	20	20	60	10	15	75
55 years & Above	10	10	80	15	10	75	5	5	90

Returns/Interest

No scheme of NPS offer guaranteed returns or interest. The money of subscribers is invested as per the allocation selected.

Option to change the Scheme or Fund Manager

NPS provides its subscriber the options to change the pension scheme or the fund manager, once in a financial year, if the subscriber is not happy with the performance of the fund. This option is available for both Tier I and Tier II accounts.

All subscribers or employers under 'All Citizen Model' and 'Corporate Model' have the option to change the investment choice/ asset allocation (i.e. changing between Auto Choice and Active Choice or to change the allocation ratio among asset classes under Active Choice) four times in a financial year.[11]

Withdrawal and Exit Rules

<u>Partial withdrawals</u>

If the subscriber has been investing for at least 3 years, he/she may withdraw up to 25% of the contribution made by the subscriber and excluding any contribution made by the employer and any returns earned, for certain specified purposes, such as children's wedding or higher studies, building/buying a house or medical treatment of self/family etc.

[11] PFRDA Circular No.: PFRDA/2022/02/PDES/01 dated January 27, 2022 on Change of Pension Fund and Asset Allocation by NPS subscriber.

One can make a withdrawal for up to three times in the entire tenure. These restrictions are only imposed on Tier I accounts and not on Tier II accounts.

Exit and Withdrawal on retirement

A subscriber can exit from the NPS on reaching the age of 60 or superannuation or retirement according to the terms of employment by using a minimum of 40% of the corpus to buy an annuity from the approved annuity service providers which will provide the monthly pension. The balance (60% of the corpus) can be withdrawn as a lumpsum. However, the subscribers joining the NPS beyond the age of 60 years (but before attaining the age of 70 years) can exit after completion of 3 years from the date of joining NPS.

The subscriber can also opt for continuation of NPS account till the age of 75 years and can contribute too. If the subscriber after attaining the age of 60 years/ superannuation has not initiated exit request or has not exercised the option of continuation under NPS, then the subscriber shall be automatically continued under NPS till he/she attains the age of 75 years (as if he/she has exercised the option of continuation).

In case the accumulated corpus at the time of exit is equal to or less than Rs.5 lakhs, the subscriber will have the option to withdraw the entire corpus in lumpsum.

Exit and Withdrawal before retirement

In case of resignation or exit from the NPS before the age of 60 or before superannuation as prescribed in the employment terms, at least 80% of the corpus has to be utilized for purchasing an annuity and the balance is paid out to the subscriber as a lumpsum.

Subscribers joining the NPS beyond the age of 60 years can opt to exit before completion of 3 years from the date of joining NPS. In such case, the subscriber will be required to annuitize at least 80% of the corpus and the remaining corpus can be withdrawn in lumpsum.

In case the accumulated corpus at the time of exit is equal or less than Rs.2.5 lakh, the subscriber will have the option to withdraw the entire corpus in lumpsum.

In case of unfortunate death of the subscriber, the entire accumulated corpus will be paid to the nominee of the subscriber as lumpsum; or nominee can purchase annuity, if they so desire.

Deferment of Withdrawal

A subscriber of NPS has an option to defer their withdrawal if he/she is not in need of funds. Subscriber can defer: (a) receiving the lumpsum or (b) annuity purchase or (c) both till the age of 75 years.

Taxation implications

The NPS comes under Exempt, Exempt, partly Exempt – partly Taxable regime. This refers to the tax implications at the stage of making a subscription to the NPS, earning returns on the contribution and withdrawing the accumulated wealth (withdrawal is partly taxable).

- **The subscriber is allowed a deduction at the time of making the investment (First E)** - Contributions made by the subscriber in the individual pension account are exempt from tax under Sec 80CCD (1) up to a limit of Rs.1.5 lakhs. This limit covers the deductions available under section 80C, 80CCC and 80CCD (1). This deduction is limited to 20% of gross annual income for a non-salaried individual and 10% of basic and DA for salaried employees.

  Sec 80CCD(2) covers the employer's NPS contribution, which will not form a part of Section 80C. This benefit is not available for self-employed taxpayers. The maximum amount eligible for deduction will be the lowest of the below: (a) Actual NPS contribution by employer (b) 14% of Basic and DA for central government employees and 14% of Basic + DA for other employees (c) Gross total income.

  Further, one can claim any additional self contribution (up to Rs 50,000) under section 80CCD(1B) as an exclusive NPS tax benefit.

  The scheme, therefore, allows a tax deduction of up to Rs 2 lakh in total for contribution by the subscriber and upto the limits specified above in respect of contribution made by the employer.

- **There is no taxation when the income or return is earned on the contributions made (Second E)**.
- **At the stage of exit on maturity, there is no tax on a maximum of 60 percent withdrawn as lumpsum – section 10(12A) (partial E)**.The balance 40% has to be compulsorily used to buy an annuity from a life Insurance company. The annuity payable by the life Insurance company will be added to subscriber's income and will be taxable at the applicable rates in the year in which the annuity is due. The partial withdrawals are tax exempt under section 10(12B) of the Income Tax Act upto 25% of own contribution.

Contributions made to the Tier II account only by government employees will be eligible for deduction under the limits prescribed for section 80C.

5.1.7 NPS Vatsalya

NPS Vatsalya is a saving cum pension scheme introduced in Budget 2024 for minor citizens. Any parent can open this account in the name of their minor children (below 18 years) and operate it as a guardian. The account is subject to all regulations of NPS Tier 1 account managed by PFRDA. Once the minor turns 18 years of age, the account will be maintained by him/her like any other NPS account of an individual.

5.1.8 Atal Pension Yojna

Atal Pension Yojana (APY) is a pension scheme introduced by the Government of India in 2015–16. It was implemented with an objective to provide pension benefits to individuals in the unorganized sector. This scheme is regulated and controlled by the Pension Fund Regulatory and Development Authority (PFRDA).

It is an extension of the recognized National Pension System (NPS) and replaces the previously institutionalized Swavalamban Pension Yojana. All accounts that were opened in the first year of the scheme, i.e. in 2015, were eligible for co-contributions from the Indian government for 5 years.

Currently, any citizen of India within the age group of 18 - 40 years, who are not members of any statutory social security scheme and who are not income tax payers, can join APY for availing benefits guaranteed by Government of India under the scheme (effective from October 1, 2022).12 Therefore, APY focusses on all citizens in the unorganized sector only. Retirement Plans from Mutual Funds and Insurance companies.

Most insurance companies and mutual funds offer products specific to retirement. Insurance companies have pension plans and annuity products that cater to financial requirements for retirement years. The pension plans are deferred product where one needs to pay premium till a specified age which is deductible under section 80C and based on the corpus accumulated one can receive pension. There are various options offered by insurance companies to receive the pension. The rate of pension varies as per the option selected by the policy holder. These options include pension to policyholder for life long and to his/her spouse post death of the policyholder. The insurance companies offer both ULIPs and traditional pension plans.

Mutual funds too have retirement specific schemes. These are mainly hybrid products with a mix of equity and debt investments. Within one scheme, there are 3 to 4 variants with each variant offering different allocation to equity and debt. Some of the funds offer insurance cover up to a specified age of the investor. Retirement schemes from mutual funds typical have a lock-in period of at least 5 years or till the retirement age, whichever is earlier.

5.2 Portfolio created by an Investment Adviser

Before making any investment decision for their clients, an investment adviser has to manage the psychological stress the client may be going through. This can come in due to retrenchment or at retirement even if they are well prepared for it. An investment adviser has to understand their clients' personal needs and encourage them to set goals, plan their lifestyle and plan their finances.

[12] Vide Gazette Notification: F. No. 16/1/2015-PR dated August 10, 2022.

While creating a retirement portfolio for their clients, an investment adviser has to take into consideration the key factors such as liquidity, security, estimated returns, resistance to inflation, taxes and social security. Clients approaching retirement may have different investment philosophy based on experience they would have gone through. Some would tend to take a very conservative approach, not ready to invest in high risk investments. Contrary to this, some would have luxury of life and be ready to take high risk. As an adviser, one needs to listen to the concerns of the clients and explain the risk reward relationships while investing money for the long term.

The final creation of the portfolio will depend on the factors discussed above. The long-term portfolio can be invested in Equity, Debt, Gold or any other asset classes appropriate for the investor. How much to be invested in each asset class will be decide by the adviser based on clients' risk appetite. Benefits, such as EPF, NPS, Superannuation and Gratuity, form the core of the retirement portfolio of salaried employees and hence advised by the adviser for retirement portfolios.

5.3 Distribution Related Products

In the accumulation stage of retirement, the corpus required is created out of the savings and investments made over the working years. In the retirement years, this corpus is used to generate income to meet expenses. The products that are suitable in retirement (distribution stage) are those generating periodic income, where (i) the returns are adequate for the investors' needs and (ii) have a lower risk to income and principal invested. Protection of capital is important at this stage since the opportunity to add to the corpus after retirement is limited. The products used to generate income in the distribution stage are discussed below.

5.3.1 Annuity from insurance companies

An annuity, in general term, is a fixed stream of payment for life term or for a pre-defined period. An annuity contract is a life insurance policy in which the annuity provider (insurer) agrees to pay the purchaser of annuity (annuitant) a series of regular payments for a fixed period or over someone's lifetime. The main objective of annuity is to counter risk of longevity and, to some extent, inflation.

There are two basic types of annuities designed in any annuity product:

1. **Deferred Annuity**: It is an annuity under which periodic benefits are scheduled to begin after a specified period i.e. more than 12 months after the date on which annuity is purchased. The date on which annuity is scheduled to begin is often specified in the insurance contract. In general, deferred annuity is purchased during working years in anticipation of the need of retirement income in later years.
2. **Immediate Annuity**: It is an annuity under which annuity benefits are scheduled to begin on immediate period after the date on which annuity is purchased. In general, the annuity payments in these types of annuities begin within 12 months after its purchase.

Annuities can be purchased in 2 modes: (a) Single Premium and (b) Regular Periodic Premiums. Most immediate annuities are purchased as single premium annuities where a lump sum premium is paid. The benefits under this mode begin soon after the premium is paid. On the other hand, annuity purchased by paying premiums over a period can be level playing or flexible. In the level-playing mode, the premium remains same over a scheduled intervals such as monthly or annually until some predetermined future date. Contrary to this in variable premium payment, the amount of each premium payment can vary between a set of minimum and maximum amount.

Under any annuity product, the frequency of periodic annuity payments depends on the length of the annuity period. This annuity period is typically one month or annual though other options like quarterly or half yearly are also available.

The annuity paid will depend upon the annuity rate applicable at the time of purchase of annuity. The annuity rate is guaranteed for the entire period. The annuity rates are reviewed periodically with the approval of IRDAI.

Payout Options

There are various options though which the insurance company pays annuity to the annuitant. These options vary in the feature they provide and are chosen by the policyholder at vesting age i.e. the age at which the annuity is to be started.

a. **Lifetime without return of purchase price**: Here the annuity is paid for the lifetime and stops once the investor dies. The principal amount (i.e. purchase price) is retained by the company. The annuity amount is the highest in this option.
b. **Lifetime with return of purchase price**: Here the annuity is paid for lifetime to the investor and the purchase price is returned to the nominee after the investor's death. The annuity amount will be the lowest in this option.
c. **Annuity guaranteed for certain period**: Annuity is paid for a defined period, say 10 years or 20 years, irrespective of survival of policyholder. Beyond this, amount is paid only to the policyholder till he/she dies.
d. **Joint Annuity**: Here, the spouse too gets the annuity for lifetime after the death of the investor.

There are other options launched by the companies such as inflation adjusted and fixed increasing annuity.

Taxability of Annuities

Unlike life insurance policies, the annuities do not enjoy the tax exempted status. The money received by the annuitant are treated as the income and are taxed in the hands of the annuitant. The premium paid by the annuitant for the annuity contract or the annuity policy is eligible for tax benefit under Section 80C, within the overall limit prescribed by the Income Tax Act.

5.3.2 Systematic Withdrawal Plans from mutual funds

One of the tax efficient ways to generate a regular income is Systematic Withdrawal Plans (SWP) in mutual fund schemes. It is an option where an investment withdrawal plan is scheduled in a specified frequency. One can withdraw, either a fixed amount or only the capital gains, whichever options suits ones requirements. The money withdrawn through SWP can be either invested in another fund or used for own requirements.

Systematic withdrawal plan is specifically beneficial for generating regular income for meeting retirement needs. Retirees need a regular income source to meet their monthly expenses. With the help of SWP, the timing and frequency of withdrawals can be set-up based on their monthly requirements. This ensures the funds are available at the right time and thus, goals are not delayed due to any cash crunch.

Typically, mutual funds offer multiple withdrawal frequencies such as monthly, quarterly, half-yearly or annual. One can choose the desired SWP frequency based on the financial requirements. Through a fixed withdrawal option, one can redeem a specified amount from investments. Contrary to this, with an appreciation withdrawal option, one can withdraw only the appreciated amount.

It is important to note that an SWP is not equivalent as receiving monthly interest against a fixed deposit account in a bank. In a fixed deposit, the corpus value is not impacted when interest amount in withdrawn, while, in the case of a systematic withdrawal plan in mutual fund schemes, the value of the fund is reduced by the number of units withdrawn.

Example:

Mr. A has 8,000 units in his mutual fund scheme and he wishes to withdraw Rs 5,000 every month through a Systematic Withdrawal Plan.

Let us assume the Net Asset Value (NAV) of the scheme is Rs 10. The withdrawal of Rs 5,000 from this scheme will mean that 500 units are being sold (i.e. Rs. 5000/NAV of the scheme, which is Rs. 10). The remaining units in his mutual fund scheme post this withdrawal, will be 7,500 units (i.e. 8,000-500).

During the start of the next month if the NAV of the scheme increases to Rs 20, then the withdrawal of Rs 5,000 would mean selling of 250 units (i.e. Rs 5,000/NAV of the scheme, which is Rs 20). The mutual fund would be left with 7,250 units post this withdrawal (i.e.7,500-250).

So, with each withdrawal, the mutual fund will see a decline in its units. At higher NAVs, one may redeem fewer units to fulfill the cash requirements. Conversely, as the NAV falls, it would have the opposite effect, requiring the redemption of more units.

An essential aspect of benefiting from this plan and making the most of it is by planning the SWP, keeping in mind the needs and the end goal of the client. It can have a detrimental effect on the value of the fund if withdrawals are unplanned.

Taxation in SWP

Any redemption through SWP is subject to taxation. The rate of taxation depends on: (a) the type of funds from which SWP is scheduled and (b) holding period.

Post April 1, 2023, in case of SWP from debt funds, irrespective of the holding period, the capital gain portion of amount withdrawn will form as part of the income. It will then be taxed according to one's income tax slab.

In case of SWP from equity funds, if holding period is less than or equal to 12 months, the capital gain portion of the withdrawn amount will be taxed at the rate of 20%. On the other hand, if the holding period is more than 12 months, then the capital gains portion of the withdrawn amount will be taxed at 12.5%. However, an exemption of Rs 1.25 lakh p.a. is available on long-term capital gains earned from all equity investments combined together.[13]

5.3.3 Laddering of Bonds or Fixed Deposits

One of the effective strategies to create a good retirement income is laddering strategy. Here, instead of buying securities that is scheduled to become due during the same year one purchases bonds or fixed deposits (FDs) that are staggering at different dates i.e. maturing at different dates.

Laddering of Bonds

There are two primary goals a bond ladder can help investors achieve.

1. Managing interest Rate risk

Bonds are most impacted by interest rate movements. When investors invest most of their money in bonds maturing in the same year then there is a risk of locking at a single interest rate. The investors tend to lose money when interest rate rises after few years. The laddering bond is a strategy to reduce this risk since it works in both the interest rate scenarios. When interest rate rises then the investor can invest the maturing bond to benefit from it. Similarly, when interest rates are falling the investors have already bonds locking in at higher rates even though the matured bonds have to be invested at lower rates.

2. Manage cash flow

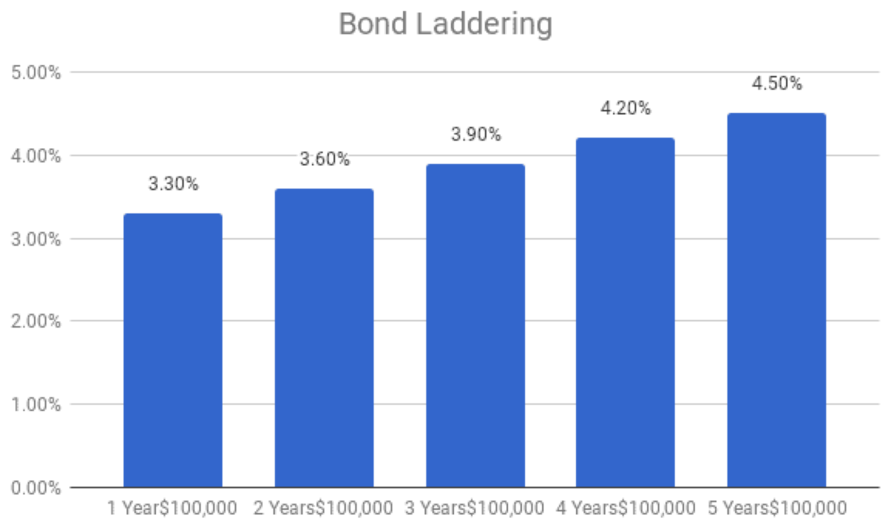
The laddering of bonds can also manage cash flows for retirement income needs. Many of the bonds have options of paying interest twice in a year. By structuring the maturity of the bond at different periods the interest payment at different months or years can help in generating cash flow in the form of regular income.

[13] The tax rates on short-term and long-term capital gains on sale of equity mutual funds are 20% and 12.5% respectively if units are redeemed on or after July 23, 2024.

With bond laddering, one invests in multiple bonds with different maturities—which is designed to give the predictable income one expects from the bonds and the flexibility to reinvest the principal.

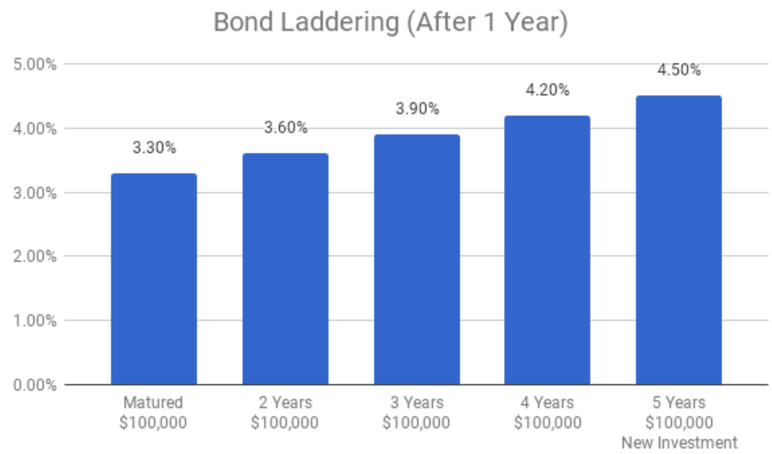
Example[14]

Let us assume, Mr. B has USD 500,000 to invest in fixed income. He divided the sum into 5 investments of USD 100,000 each and invested it in different bonds maturing in 1, 2, 3, 4 and 5 years respectively. The following graph shows the investments:



Starting today, every one year an investment of USD 100,000 will mature and will be available to Mr. B for reinvestment. When the first investment matures, he takes that money and reinvests it in the bond at the longest end of the ladder. The investment, which was two years away, is now one year away and the original investment that was 5 years away is now 4 years away. Mr. B has invested the sum, received from 1-year bond, with maturity of 5 years away. Thus, the ladder is kept intact as shown below:

[14] Source: https://financetrain.com/what-is-bond-laddering-strategy-for-investment/



Laddering of Fixed Deposits

We have understood from above how laddering strategy works with bonds. The same strategy can be applied on fixed deposits. Instead of buying a single FD instrument, one can buy different FD instruments with different maturities to invest.

For example, Mr. C wants to invest Rs. 10 lakh. Under the FD laddering technique, Mr. C can break his corpus in five equal parts, i.e. into five FDs of Rs. 2 lakh each but with different maturities. Meaning, Mr. C can invest Rs 2 lakh each in a 1-year, 2-year, 3-year, 4-year and 5-year FDs, and when these FDs mature, he reinvests the fund. Further assume, Mr. C has reinvested each FD in a new 5-year FD, So when your 1-year FD matures, it will be reinvested for five more years and will mature in the sixth year. The 2-year FD will mature in the seventh year, the 3-year FD will mature in the eighth year, and so on. Thus, by using this strategy Mr. C has created an investment loop through which he will have enough liquidity to meet his financial requirements every year.

Laddering of Fixed Deposits helps in 2 ways: (a) the investments are less impacted by interest rate fluctuations in long term; (b) keeps most of the funds secure and can be utilised separately in times of need. One can even choose different banks for different ladder thus diversifying the investment for better earnings.

5.3.4 Senior Citizens' Savings Scheme

Eligibility

In order to avail the Senior Citizens' Savings Scheme (SCSS), resident Indians have to meet the following key conditions:

- The scheme is available to any resident individual aged 60 years and above.
- Individuals who have attained 55 years or more but are less than sixty years are also eligible to apply for SCSS provided they have retired under applicable

superannuation or Voluntary Retirement Scheme (VRS). In such cases, the account should be opened within 1 month of the receipt of the retirement benefits.

- The scheme is also available for the retired personnel of the Defence Services (excluding Civilian Defence employees) on attaining the age of 50 years subject to fulfilment of other terms & conditions.
- Hindu Undivided Family, Non-Resident Indians (NRIs) and Person of Indian Origin (PIOs) are not entitled to open a Senior Citizens Savings Scheme account.
- The scheme can be held in individual capacity or jointly with the spouse. The age restrictions apply only to the first holder.

Deposit Limits

- Depositors are allowed to make a lump sum deposit with a minimum deposit of Rs.1000. Deposits greater than Rs.1000 have to be made in multiples of Rs.1000. The maximum SCSS limit deposit is Rs.30 lakhs.
- While deposits in the SCSS accounts can be made in cash, this is allowed only for amounts less than Rs. 1 lakh. If the deposit amount for Senior Citizens Savings Scheme exceeds Rs. 1 lakh, using a cheque/demand draft for making the deposit is mandatory.

Maturity

Deposits made into a Senior Citizens' Savings Scheme mature after 5 years, calculated from the date of account opening. However, the account holder does have the option of extending the account for an additional 3 years after it has matured. This extension option is available just once and the extension request has to be made within 1 year of maturity of the SCSS account.

Taxability

- Investments made in a Senior Citizens' Savings Scheme account qualify for income tax deduction benefit up to Rs. 1.5 lakh under Section 80C of the Income Tax Act, 1961.
- Interest on SCSS is fully taxable. In case the interest amount earned is more than Rs. 50,000 for a fiscal year, Tax Deducted at Source (TDS) is applicable to the interest earned.

Interest Rates

The rate of interest is reviewed quarterly by the Ministry of Finance and is subject to periodic change. The interest rate is fixed on the investment according to the rate fixed for that quarter. If the same is extending post-maturity, then the interest prevailing at that time will be applicable. Interest on SCSS account deposits is calculated and credited quarterly.

Premature Closure

Premature withdrawal of Senior Citizen's Savings Scheme is allowed but penalties are applicable in such cases based on the time elapsed between account opening and withdrawal. The penalties on premature exit from SCSS are as follows:

- 1.5% of SCSS deposit amount deducted as a penalty if an exit from the scheme occurs after completion of 1 year but before completion of 2 years from the date of account opening.
- 1% of SCSS deposit amount deducted as a penalty if an exit from the scheme occurs between 2 years to less than 5 years from the date of account opening.

Closure of Account before Maturity on Death

In the event of death of the primary account holder before actual maturity of the account, the account will be closed and all the maturity proceeds will be transferred to the legal heir/nominee. For deceased claims, the nominee or the legal heir will have to fill out a written application in prescribed format along with Death Certificate to facilitate the closure of the account.

5.3.5 Pradhan Mantri Vaya Vandana Yojana

The Government of India launched the Pradhan Mantri Vaya Vandana Yojana (PMVYY) in 2017 to provide pension benefits for citizens aged 60 years in the private sector. The scheme is operated by LIC of India. This is a 10-year scheme. The minimum pension is Rs.1000 per month and the maximum is Rs. 10,000 per month or Rs.1,20,000 per year. For the minimum monthly pension of Rs.1000/month the purchase price or investment required is Rs.1,50,000 and for the maximum monthly pension of Rs. 10,000 the investment required is Rs.15,00,000. The purchase price is marginally lower if the quarterly, half-yearly or annual mode of pension is chosen. The investment is returned on maturity. The ceiling on the maximum pension permitted under the scheme applies to the family comprising of the pensioner, spouse and dependents. 98 percent of the purchase price is returned if the policy is surrendered for specified needs such as critical healthcare requirements. After the completion of three policy years, loan to the extent of 75 percent of the purchase price can be availed at the prevailing interest rates.

Further, Government of India has introduced Pradhan Mantri Vaya Vandana Yojana (Modified-2020), with modified rate of pension under this plan and extended the period of sale of this plan for a further period of three years from Financial Year 2020-21 till 31st March, 2023. Post 31st March 2023, investments in PMVVY are not activated and so individuals are unable to avail the benefits of this scheme. As per the terms and conditions under this modified plan, guaranteed rates of pension for policies sold during a year will be reviewed and decided at the beginning of each year by the Ministry of Finance, Government of India which will be applicable for the entire duration of 10 years. LIC of India is solely authorised to operate this scheme.

Benefits (PMVVY Modified – 2020)

a. **Pension Payment**: On survival of the pensioner during the policy term of 10 years, pension in arrears (at the end of each period as per mode chosen) shall be payable.

b. **Death Benefit**: On death of the pensioner during the policy term of 10 years, the Purchase Price shall be refunded to the beneficiary.

c. **Maturity Benefit**: On survival of the pensioner to the end of the policy term of 10 years, Purchase Price along with final pension instalment shall be payable.

Mode of pension payment

The modes of pension payment are monthly, quarterly, half-yearly & yearly. The pension payment shall be through NEFT or Aadhaar Enabled Payment System (AEPS). The purchase of the policy under this Government subsidised scheme requires unique Aadhaar number validation. The first instalment of pension shall be paid after 1 year, 6 months, 3 months or 1 month from the date of purchase of the same depending on the mode of pension payment chosen.

Taxation

Income from pension is taxable as income in the hands of the annuitant.

5.3.6 Post Office MIS

Post Office Monthly Income Scheme (POMIS) is a government-sponsored savings scheme. It provides its investors monthly returns in the form of interest payments. It is offered by the Department of Post (DoP) or India Post. The scheme's interest rates are announced every quarter.

Eligibility

POMIS account can be opened by:

i. A single adult
ii. 2 or 3 adults jointly
iii. A guardian on behalf of minor/ person of unsound mind
iv. A minor above 10 years in his own name

Deposit

- Account can be opened with a minimum of Rs. 1000 and in multiples of Rs. 1000.
- A maximum of Rs. 9 lakh can be deposited in a single account and Rs. 15 lakh in a joint account.
- In a joint account, all the joint holders shall have equal share in investment.

- An individual may open and operate one or more than one account as a single account or a joint account under this Scheme, subject to the ceiling of maximum deposit limit.
- Deposits in all the accounts taken together for an individual shall not exceed Rs. 9 lakh in a single account and Rs. 15 lakh in a joint account.
- Limit for account opened on behalf of a minor as guardian shall be separate.

Interest

- Interest shall be payable on completion of a month from the date of opening and so on till maturity.
- If the interest payable every month is not claimed by the account holder such interest shall not earn any additional interest.
- In case any excess deposit made by the depositor, the excess deposit will be refunded back and only Post Office Savings Account interest will be applicable from the date of opening of account to the date of refund.
- Interest can be drawn through auto credit into savings account standing at same post office, or ECS. In case of MIS account at CBS Post offices, monthly interest can be credited into savings account standing at any CBS Post Offices.
- Interest is taxable in the hand of depositor.

Pre-mature closure of account

- No deposit shall be withdrawn before the expiry of 1 year from the date of deposit.
- If account is closed after 1 year and before 3 year from the date of account opening, a deduction equal to 2% from the principal will be deducted and remaining amount will be paid.
- If account closed after 3 year and before 5 year from the date of account opening, a deduction equal to 1% from the principal will be deducted and remaining amount will be paid.
- Account can be prematurely closed by submitting prescribed application form with pass book at concerned Post Office.

Maturity

- Account may be closed on expiry of 5 years from the date of opening by submitting prescribed application form with pass book at concerned Post Office.
- In case the account holder dies before the maturity, the account may be closed and amount will be refunded to nominee/legal heirs. Interest will be paid up to the preceding month, in which refund is made.

5.3.7 Reverse Mortgage

Rental income from real estate held provide a source of income that is adjusted for inflation. In periods of inflation, which pushes up costs, rental income also rises, thereby giving income that is adequate to meet expenses. The income also has the advantages of being periodic and known in advance, so that the investor can plan and use the income to meet their expenses. However, rental yield (i.e. rental income relative to the price of the property) in India is typically low, given the high property prices. If the property that was purchased at a lower price earlier is now generating good rental income, the yield may be comparable with other income generating investments. Real estate provides appreciation in value as well as inflation adjusted income. The drawback of real estate comes from the very low liquidity in the investment. If there is an emergency and funds are required immediately, it will be difficult to liquidate the investment fast, though it is possible to get a loan against the property.

For many households the self-occupied property constitutes a large investment. The self-occupied home can also become a source of income in the extreme situation if the income from the retirement corpus being insufficient to meet the needs in retirement. The Reverse Mortgage Scheme is offered by housing finance companies and banks.

The important features of Reverse Mortgage are summarized below:

a. In a mortgage, a lumpsum is borrowed against the security of the property and this is paid back over a period of time using Equated Monthly Instalments (EMIs). In reverse mortgage, a property owned by the individual is pledged with the financial institution against which a periodic income is paid to the property owner.
b. Eligibility Criteria:
    i. Indian citizen of 60 years or more,
    ii. Married couples will be eligible as joint borrowers for joint assistance. In such cases, the age criteria for the couple would be at the discretion of the Reverse Mortgage Loan (RML) lender, subject to at least one of them being above 60 years of age and the other not below 55 years of age.
    iii. Should be the owner of a residential property (house or flat) located in India, with clear title indicating the prospective borrower's ownership of the property.
    iv. The residential property should be free from any encumbrances.
    v. The residual life of the property should be at least 20 years. There is no minimum period of ownership of property required.
    vi. The prospective borrower(s) should use that residential property as permanent primary residence.
c. The amount of loan available under RML depends on the age of the borrower, appraised value of the house and the prevalent interest rates of the lending institution.
d. A reverse mortgage loan cannot be availed against commercial property.
e. The maximum monthly payments under RML have been capped at Rs.50,000. The maximum lump sum payment shall be restricted upto 50% (varies with lenders) of the total eligible amount of loan subject to a cap of Rs. 15 lakhs, to be used for medical treatment for self, spouse and dependants, if any. The balance loan amount would be eligible for periodic payments.

f. All receipts under RML shall be exempt from income tax under Section 10(43) of the Income-Tax Act, 1961.
g. The rate of interest and the nature of interest (fixed or floating) will be decided by the lender.
h. The maximum tenure of an RML will be 20 years.
i. The borrower can prepay the loan at any time without a penalty.
j. An RML will become due and payable only when the last surviving borrower dies or permanently moves out of the house. An RML will be settled by proceeds obtained from sale of the house property mortgaged. After the final settlement, the remaining amount (if any) will be given to the borrower or his/her heirs/beneficiary. However, the borrower or his/her heirs may repay the loan from other resources without allowing the property to be sold.
k. The borrower will remain the owner of the house property and need not service the loan during his/her lifetime as long as the property is used as primary residence. Periodic payments under RML will cease after the conclusion of the loan tenure. Interest will accrue until repayment.
l. The Reverse Mortgage Loan can be prepaid at anytime during the loan period. On clearance of all the dues, all the title deeds will be returned by the lender.
m. The borrower can opt for the frequency of EMI pay out (monthly, quarterly, and annual or lump sum payments) at any point, as per his discretion.
n. The Reverse Mortgage Loan Enabled Annuity (RMLEA) is an extension of the reverse mortgage scheme. The scheme ensures a lifetime pay-out to the senior citizens through an annuity bought from an insurance company using the reverse mortgage loan amount disbursed by the primary lending institutions.
    - The scheme will be available to senior citizens of India over 60 years of age who are the owners of the property. In case of married couples applying as joint borrowers, at least one of the borrowers should be above 60 years and the other 55 years.
    - The primary lending institutions (housing companies and scheduled commercial banks) will be the interface for the individual. They will assess the property for the eligible loan, disburse it and source a lifetime annuity with the loan amount from eligible insurance companies.
    - The operational guidelines of the National Housing Bank (NHB) define the loan to value (LTV) ratio to determine the quantum of loan.
    - The borrowing individual has to choose between a lifetime annuity without return of purchase price and a lifetime annuity with return of purchase price. The scheme also provides for an annuity cover for the spouse of the primary borrower.
    - The amount of annuity received will be a function of the loan value and type of annuity chosen. The borrower can decide on the periodicity of the annuity payment from the options provided such as monthly,

CHAPTER 6: MISCELLANEOUS ASPECTS OF RETIREMENT PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Advisor's role in retirement planning
- Calculations for retirement planning
- Criteria to evaluate various retirement benefit products
- Concept of Philanthropy

6.1 Advisor's role in Retirement Planning

Investment advisers can play an important role in planning for retirement of their clients. They understand their clients' financial goals and know when the client will need savings and on what they will be spending.

While creating a detailed financial plan, the adviser will have a clear understanding of the financial assets that are accumulated, as well as other resources such as pensions, Social Security, part-time work, home equity, etc. The adviser then put these pieces of a puzzle together in a way that will result in reliable monthly income once client is retired. This regular income planning requires an in-depth knowledge of taxes, employer benefits, and retirement plan rules. Such knowledge often requires years of experience and training to accumulate.

An investment adviser will be able to offer advice on:

- When to take employer benefits in a way that is best for them
- What pension distribution choices are right for their client needs
- If an annuity is a suitable investment for any of their client
- The amount of retirement income one could reasonably expect to have
- What withdrawal rate is appropriate when withdrawing money from a traditional portfolio
- How much of the money should be in guaranteed investments
- What types of taxable income investments will generate
- How can investments be restructured to reduce taxable income in retirement
- If client should pay off mortgage before or during retirement
- If a reverse mortgage is a good option for the client
- Whether client should keep their life insurance policies or not

An investment adviser will *not* make recommendations until they understand the client's expected time horizon, their level of experience with investments, their goals, and their tolerance for investment risk. They will also want to understand the need for guaranteed income and get a thorough understanding of all the current resources such as assets, liabilities, and current and future sources of income.

The adviser *will* want to know where all the client investments are so that the investment portfolio, as a whole, will make sense and can be optimized to produce a steady stream of retirement income.

6.2 Calculations for Retirement Planning

Higher disposable incomes and easy availability of finance have increased the lifestyle of Indians. People who are in mid 30s are earning handsomely and have a comfortable lifestyle today. Children going in good school, have own house to live in and have a respectable social life. However, many of these lifestyle assets are mortgaged with lenders and one is burdened with many EMIs. All these expenses bundled with high education cost leave very less for retirement savings.

Further, the presence of inflation, i.e. the rate at which prices of all essential items increase every year, impacts one's purchasing power in future. An item of Rs 100 today will cost Rs 107 next year if inflation rate is 7%. This means that the expenses increases by this rate every year and one will have to shell out much more than what is required today to meet their living. So if one is spending Rs 10000 p.m. today to meet their living, to sustain the current living standard he/she will require Rs 54724 p.m. after 25 years (expected inflation of 7%). Add to this, the risk of longevity i.e. the increase in the life expectancy, the retirement years can be really painful if not planned in advance.

Retirement corpus required
A person generally gets concerned when he/she sees the high amount of retirement corpus required for their golden years. Sometimes what they ask is beyond their means. But, one should take into consideration that retirement living is always based on ones existing lifestyle which he/she builds. Since inflation decreases the value of money (i.e. the purchasing power of money) the corpus requirement in future will always be higher for maintaining the same standard of living.

Estimating the future requirements is necessary to ensure appropriate planning for later years of life. Although, the expenses at retirement are generally lower than the current expenses, as one is free from loan liabilities and children's goals, the high cost of medication at higher age, however, should be considered while planning. One can estimate that expenses at retirement are roughly 50%-60% of one's existing expenses if there are not any liabilities.

To calculate the retirement corpus one have to consider the longevity of life. One may expect life till 75 years but may live beyond 80 years of age, which may add another 5-10 more years.

Given below is an estimation of retirement corpus for an individual who is at the age of 35 years and wishes to retire at the age of 60 years. Here, life expectancy is assumed till the age of 85 years.

	Scenario 1	Scenario 2	Scenario 3
Monthly Income (Rs) [GIVEN]	20000	30000	50000
Monthly Expense (Rs)	15000	25000	40000
Monthly expense for Retirement (say, 60%) (Rs)	9000	15000	24000
Inflation rate p.a.	7%	7%	7%
No. of Years to retire (60-35)	25	25	25
Monthly expense at retirement (Rs)	9000*(1.07)^25= 48847	15000*(1.07)^25= 81411	24000*(1.07)^25= 130258
Life expectancy post retirement (in years)	85	85	85
No. of Years post Retirement (85-60)	25	25	25
Post Retirement Inflation expected	6% p.a.	6% p.a.	6% p.a.
Return on the retirement corpus	8% p.a.	8% p.a.	8% p.a.
Retirement Corpus Required (Rs)#	**1.17 cr**	**1.95 cr**	**3.11 cr**

For calculating Retirement Corpus, Present Value Formula in excel is used.

Formula: =PV(rate, nper, pmt, [fv], [type])

The PV function uses the following arguments:

Argument	Meaning	Inputs as per the above Example
rate (required argument)	The interest rate per compounding period. A loan with a 12% annual interest rate and monthly required payments would have a monthly interest rate of 12%/12 or 1%. Therefore, the rate would be 1%.	Inflation adjusted return on the retirement corpus is {(1+8%)/(1+6%)-1} p.a. i.e. 1.89% p.a. This is equivalent to 1.89%/12 p.m. [This is same in all scenarios]
nper (required argument)	The number of payment periods. For example, a 3-year loan with monthly payments would have 36 periods. Therefore, nper would be 36 months.	Expected post retirement years is 25 years i.e. 300 months (25*12). [This is same in all scenarios]
pmt	The fixed payment per period.	As calculated in above table:

Argument	Meaning	Inputs as per the above Example
(required argument)		Scenario 1: - Rs. 48847 Scenario 2: - Rs. 814111 Scenario 3: - Rs. 130258 [Since these are cash outflows i.e. expenses, the amounts are prefixed with a ‘minus’ sign]
fv (optional argument)	An investment’s future value at the end of all payment periods (nper). If there is no input for fv, Excel will assume the input is 0.	This is left blank.
type (optional argument)	Type indicates when payments are issued. There are only two inputs, 0 and 1. If type is omitted or 0 is the input, payments are made at period end. If set to 1, payments are made at period beginning.	The payments are considered to be made at the end of each period. Thus, it is taken as 0 (i.e. left blank).

The above data clearly shows the impact of inflation and indicates the need of retirement planning at an early stage. Procrastination or delay in planning impact the savings required for reaching the estimated corpus.

The below table shows how the requirement for savings increases manifold when one delays the contribution towards retirement corpus. This can strain the finances in later years considering presence of other important goals and liabilities to meet.

	Scenario 1	**Scenario 2**	**Scenario 3**
Retirement Corpus required (Rs) [GIVEN]	1.18 crore	1.18 crore	1.18 crore
Age to start Investment (Yrs)	30	35	40
Time horizon of investing till retirement (Yrs)*	60-30 = 30	60-35 = 25	60-40 = 20
Returns Assumed (%)	12	12	12
Monthly Savings required to reach the Corpus (Rs)#	**3376**	**6280**	**11928**

*Retirement age is 60 years.

For calculating monthly savings required to reach the corpus, PMT function in excel has been used.

Formula: =PMT(rate, nper, pv, [fv], [type])

The PV function uses the following arguments:

Argument	Meaning	Inputs as per the above Example
Rate (required)	The constant interest rate per period. It can be supplied as a percentage or a decimal number. For example, if one makes annual payments on a loan at an annual interest rate of 10 percent, use 10% or 0.1 for rate. Similarly, if one makes monthly payments on the same loan, then use 10%/12 or 0.00833 for rate.	It is given as 12% p.a. i.e. 12%/12 per month. [This is same in all scenarios]
Nper (required)	The number of payments for the loan, i.e. the total number of periods over which the loan should be paid. For example, if one makes annual payments on a 5-year loan, input 5 for nper. Similarly, if one makes monthly payments on the same loan, then multiply the number of years by 12, and use (5*12) 60 for nper.	As calculated in above table: Scenario 1: 30 years i.e. 360 months Scenario 2: 25 years i.e. 300 months Scenario 3: 20 years i.e. 240 months
Pv	The present value, i.e. the total amount that all future payments are worth now. In case of a loan, it is simply the original amount borrowed.	This is left blank.
Fv	The future value, or the cash balance you wish to have after the last payment is made. If omitted, the future value of the loan is assumed to be zero (0).	The retirement corpus required at the time of retirement is given as Rs. 1.18 crore. [This is same in all scenarios]
Type (optional)	It specifies when the payments are due: 0 or omitted - payments are due at the end of each period. 1 - payments are due at the beginning of each period.	The payments are considered to be made at the end of each period. Thus, it is taken as 0 (i.e. left blank).

Benefits of stepping up Investment in the accumulation years

Accumulation years are filled with uncertainties. An emergency may arise which force to defer the contributions planned for retirement. There may be liabilities running which impact the savings ability. Any of such situations will be a deterrent to retirement goals, knowing that most retail investors rely on regular savings to accumulate for the future goals.

Most of the investments towards retirement are fixed contributions and with limited savings. There is a probability that these fixed contributions fall short because one has insufficient of funds during the initial years of accumulation phase. One of the strategies to avoid these situations is stepping up the investment in accumulation years.

In a stepping strategy, one steps up their contributions periodically with regular payments or with a lump sum amount. In a periodic step up strategy an individual starts with a fixed investment but steps up by a certain percentage every year. Such stepping up of contributions helps in maximizing the savings for retirement. It can be done through investments in EPF, NPS or mutual funds.

For example:
If one is eligible for any employer sponsored plans like EPF, they can contribute to the maximum amount. Similarly, if one is aged 50 years and above and wishes to boost savings, can consider investing through Voluntary Provident Fund. This will help in maximizing gains in retirement accumulation stage since returns are tax exempted in this avenue.

If one has opted for NPS then there is no limit to invest. Beyond employers contribution one can invest any amount through various means of SIP or lump sum contribution plans to step up their investments either way.

Lastly, mutual funds offer an option of step up Systematic Investment Plans (SIPs) where through an automated feature, the SIP contributions are increased after a specific period, for instance, Rs. 5000 in 2023, Rs. 5000+10% in 2024 and so on. This is done taking into consideration of the current income, prospective yearly increments and of course, financial goals. This lays down a set plan for the investor to reach the predetermined investment amount over a period of time. The main attraction about SIP is convenience. Investors can automate the payments on their salary day. Suppose, if the income increases by 10%, then the investor can step-up their investment amount by at least 5% to 7%. With every annual bonus, hike or increment, one can step-up their SIP, adding more contributions to their retirement corpus.

In all the methods illustrated above, stepping up the contributions helps in reaching the required retirement goals with the limited resources available.

Let’s understand this from an example: Mr. A has to accumulate a retirement corpus of Rs 2.0 crore in 20 years. Assuming a rate of return of 12% per annum on his contributions, he will need a monthly fixed savings of Rs. 20,217 to reach the desired goal (using PMT formula in excel).

Now if he steps up his monthly contributions by 7% annually then he can start with lower contributions initially and increase on yearly basis. This will help him to optimize his savings.

Not all are able to generate higher saving initially. Starting with lower amount, the requirement increases with time, and thus one looses on compounding benefit. Stepping up strategy helps in increasing the investment proportionally as income increases leading to compounding of one’s wealth.

Impact of pre-retirement Withdrawals on retirement corpus

The statistics on EPF shows that many investors do not reach the retirement age with a good accumulation. Most of the accumulation in EPF is withdrawn before retirement for many other needs like children's education, marriage, medical emergencies, and house purchase. Though this avenue provides liquidity to the investors, it is still used by many when not in need.

Any withdrawal from retirement funds well before reaching the retirement will have a detrimental impact. The accumulation for retirement years will fall short of reaching the corpus if funds are withdrawn much early. Further, not having enough funds for the retirement years will force to either work for more years (i.e. postpone retirement) or adopt strategies to reduce your lifestyle so that the money can last longer than one have expected.

Let's consider the retirement product – Employees' Provident Fund (EPF). It is a long term investment where returns are compounded, and provides tax deduction benefits. If one withdraws from his EPF account in pre-retirement stage, it will hurt his EPF accumulation for retirement years.

For example if Mr. E withdraws Rs 75000 from his EPF balance, where he has still 30 years to retirement, he will potentially lose Rs 8.66 lakh if his EPF balance earns 8.5% p.a. for this period.

The above example clearly spells out the impact on the retirement fund if withdrawn early in pre-retirement stage. Even if one has financial difficulties while opting for such an option he/she needs to think whether he/she can fill the gap later and contribute more to reach their retirement corpus as planned and calculated.

Benefits of transferring retirement corpus from one employer to another

Retirement benefit products are structured for long term accumulation. The magic of compounding makes them an excellent product only when it is continued for long term. But there are situations like switching jobs where people end up losing this benefit as they are unable to shift the previous employer corpus.

Let us consider an example on EPF. While switching jobs, one may open a new EPF account with the new employer. If done multiple times, it results in multiple EPF accounts. Apart from having operational issues, this has a cascading effect due to taxation of the older EPF balances if certain conditions are not met. Also, one ends up losing the compounding benefit on the older corpus which would have added to the retirement goal substantially.

However, with UAN in force the rules of transferring EPF from one employer to another has eased out.[15] Now an employee can transfer EPF account from old employer to new

[15] Universal Account Number (UAN) is a 12 digit unique number allotted to each employee contributing to the Employees Provident Fund (EPF). This number remains the same for each employee throughout their life irrespective of the number of times they have joined new organisations.

employer completely online. But, to make it effective the employee has to ensure the UAN is updated along with KYC and personal details.

Contrary to EPF, NPS has easier process of shifting corpus to new employer while switching jobs since one cannot have multiple NPS accounts. Once a Permanent Retirement Account Number (PRAN) is generated with an employer the same PRAN can be used to shift the corpus to new employer, if that is also a registered entity. If not, then the employee can still continue the PRAN under 'All Citizen Model'.

- ***Taxability Clause***

As already discussed in Chapter 5, taxability on withdrawals of EPF balance is based on the number of years of employment. If the employee changes his employer in less than 5 years and withdraws his old EPF balance, then the withdrawal becomes taxable. In such cases, the employee can transfer his PF account balance of the old employer to the new employer without incurring any tax incidence. Also, transferring of old PF balance to the new PF account will result in including the service period with old employer to compute the employee's total service period.

Under NPS, taxability on partial or full withdrawal is subject to various conditions (refer Chapter 5 for details).

- ***Compounding Effect***

The other benefit of transferring the retirement corpus to new employer is compounding impact. Though NPS can be shifted without any difficulty, EPF has more stringent clauses. Unlike EPF, NPS can be converted to 'All Citizen Account' and one can continue the product for retirement. This is not the case with EPF.

The corpus lying with old employer will earn interest till the age of 58 years. However, the taxability of such corpus will depend upon certain criteria. Considering EPF is a long-term product with compounding interest and tax-free returns (upto certain limits), it is more beneficial when one continues to earn on the accumulated corpus. However, if one withdraws the old corpus without transferring the same to the new employer account, he has to start all over again with the new employer where the contribution requirement has already increased by then. One may or may not generate required savings now since they have other goals to plan. By adding the older corpus you remain to the same path which you have planned earlier and reach your desired goal without any major impact on other financial goals.

Thus, while switching jobs, transferring the existing retirement corpus from one employer to another is more beneficial and rewarding for meeting the retirement goal.

6.3 Criteria to evaluate various retirement benefit products

People often make mistake in selecting appropriate products for their retirement, which they have to shun later on. This impacts the retirement corpus they want to create through that product. It is important that any retirement benefit products should be evaluated on various parameters, before investing, to check its suitability to meet the end objectives.

One of the best ways to evaluate any retirement benefit products is to consider life stages. In general, there are three life stages around retirement.

Pre-retirement

This is the phase where objective is to accumulate. One is 15 to 20 years away from retirement. Though there are other goals, which have to be met, with higher disposable income and no excess income requirement, the risk appetite is higher. While evaluating retirement benefit products, one should look at products which allow money to grow even though downside risk may be there. The longer horizon will allow managing this risk by riding through cycles of downside. Any income benefit product may not be a viable option for this phase.

A retirement benefit product at this phase should be evaluated on the following factors:

1. Cost: Cost is one of the major factors in any long-term product. More the cost less is the earning and so the accumulation. In some products, the total cost may not be clear.
2. Return: Since the focus is on accumulation and ample time is available, the product should be able to generate returns, which can beat inflation and grow money.
3. Risk: There will be risk factors associated with a product which may offer higher returns. Understanding of these risks is absolutely important to ensure it aligns with one's risk tolerance.
4. Tax Efficiency: The impact of taxation can be high in long term products. Different products are treated differently under Income Tax provisions. Products where taxation impact can be reduced are considerable products for retirement.

Employee benefits like EPF/ NPS are long term products and fit into the criterion for a retirement benefit product. There are other long term products like PPF and a few categories of Mutual Fund schemes which are considered for retirement planning. Before making a selection, these products should be evaluated on the above factors.

Retirement

The second stage is when one has retired. At this stage, the need will change as there will be a requirement of steady income along with growth of the accumulated corpus. There may not be any time horizon for this income requirement as the need is for the lifetime.

2 types of products will be required – one which can generate income and other which can grow the corpus. For income generating products, evaluation should be done based on 2 factors:

1. Inflation: The income generated need to beat inflation to sustain the longevity risk. How much income is generated for lifelong and how it beats inflation are important areas to evaluate in any product.

2. Capital Protection: Along with income generation, the protection of the capital is also required. Any product, which generates income but fluctuates the capital may not be a viable option for this objective.

The second basket in this phase is the growth. The corpus needs to grow so that it can sustain longer. Here, long term products should be the choice as the horizon for this basket will be 10 to 15 years. The evaluation factors will remain the same as of pre-retirement phase but products may change. Now EPF, NPS may not be viable and so one may have to rely on PPF, certain categories of mutual funds and others.

Post Retirement

The third phase of the retirement planning is later years of life i.e. beyond 75 years. Now the objective shifts completely to generate the income, as long horizon to grow the money is no more viable. The protection of capital is the primary factor along with low return with least risk. These become the evaluation criteria for selecting any product in this phase. Also, one objective which adds now is leaving money for heirs where liquidity might be the primary factor.

6.4 Concept of Philanthropy

Philanthropy has been the talk of the town globally. The urge to do for others is not only limited to rich and wealthy, now many small income earners wish to contribute to their society. The reasons are not unexplained. India is the second largest population in the world. Being such a large country, it has to deal with many issues. The disparity between poor and rich is increasing as we are progressing. The poverty is on higher side and poor are not able to get the required attention. Unless the realm of poverty and issues of disabled are addressed, it is difficult for a country to march towards a real progress. However, this cannot be achieved by government initiatives alone, unless as a country everyone contributes to the cause.

In our country, slowly but steady, individuals with any amount of income are willing to contribute for the noble causes. Within their capacity, they are coming forward to donate part of their income to ensure the needy are being taken care of. This also gives a satisfaction that one has contributed their share for better development of surroundings.

For Investment Advisers: Communicating with their clients about their values and passions in life is a meaningful way to strengthen client relationships. It can also be enjoyable, and a natural part of building clients' trust in the Investment Adviser.

Below are the steps an Investment Adviser may follow to discuss philanthropy with their clients:

- **Starting the conversation**

Speaking with someone about their values does not have to be a serious, awkward conversation. In fact, it can be quite interesting. It is also an important opportunity to learn more about clients and invite further, more meaningful interactions going forward. (see Box 6.1)

Box 6.1: Sample conversation between an Investment Adviser and a Client

The conversation might start by saying:

I'm pleased with what we've accomplished together in preparing you for retirement. We've met your financial objectives and I hope you feel secure about your financial plan.

Now is when we like to talk a bit about your personal and family values. If you're passionate about particular social or environmental causes, my team can help you address those values through a charitable giving plan. Is this something you'd be interested in talking more about?

Even if clients haven't given the topic much thought, advisers are at least opening the door to further discussion and providing them with advice and resources when they're ready.

- **Timing it right**

Choosing the right moment to introduce the topic of charitable giving can make the conversation flow easily. There are a number of situations that could naturally spark a conversation about Philanthropy, such as:

- A liquidity event, such as the sale of a business or an inheritance
- Whilst drafting or revisiting a will
- A life event, such as retirement, marriage or the birth of children or grandchildren
- During an annual client meeting

- **Following up**

Now that the Investment Adviser has raised the topic of charitable giving with his clients, it is up to the adviser to follow up.

While philanthropy is important to a lot of people in principle, it can easily fall to the bottom of a busy person's to-do list. If they have expressed genuine interest in developing a charitable giving strategy, the clients will expect the Investment Adviser to follow up with resources and next steps.

CHAPTER 7: CONCEPTS IN TAXATION

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Key concepts of Taxation
- Residential Status
- Five Heads of Income and Clubbing of Income
- Set off and carry forward of losses
- Exemptions, Deductions and Rebate
- Double Tax Avoidance Agreement
- Taxation Regime, Maximum Marginal Rate of Tax and Effective Rate of Tax

7.1 Framework

Income tax in India is governed by the provisions of the Income Tax Act, 1961 (the Act) and comes under the Ministry of Finance. The matters relating to administration of the Act are assigned to the Central Board of Direct Taxes (CBDT).

The Income tax Rules, 1962 are framed to carry out the purposes of the Act. In addition to this, the CBDT also issues Circulars and Notifications as and when required. It becomes very important to understand the income tax implications while trading or investing in securities market. Gains arising on sale of securities may have different tax treatments depending on various factors such as the type of security, holding period, whether the transaction was done in capacity of trader or investor etc.

7.2 Key concepts

7.2.1 Previous year v/s Assessment year

India follows Financial Year (FY) (i.e. April 1 to March 31) for calculation of income for various purposes – be it for preparation of annual accounts or calculation of income tax.

Any particular financial year for which one wants to calculate the tax liability is termed as ‘previous year’ for the purposes of Income Tax Act. For instance, if one needs to calculate his taxable income for FY 2021-22, the Previous Year (PY) here will be the period from April 1, 2021 to March 31, 2022.

The financial year following relevant previous year is called the ‘Assessment Year’ (AY). Hence, in the above example, assessment year will be AY 2022-23.

Section 2(9) of the Act defines 'assessment year' as a period of 12 months commencing on the 1st day of April every year. Section 3 of the Act defines 'Previous year' as the financial year immediately preceding the assessment year.

CHAPTER 14: BASICS OF ESTATE PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Estate planning and its constituents
- Elements of estate planning
- Applicable laws
- Mutation

14.1 Estate Planning

What happens when one dies – who inherit their assets and how? If one becomes ill and is unable to manage his/her estate, then who will take care for them? These are a few issues one faces while starting accumulating wealth. Estate planning deals with such and many other questions.

For some people the size of the assets grow manifold. The amount is substantial enough to leave it unplanned. So, there is a need to plan adequately how the assets will be utilized and then will be inherited by the legal heirs. Sometime the legal heirs are not capable enough to manage such large estate. Then one needs to plan with the right estate planning tools to protect the assets after their lifetime.

Though estate planning is an important element of anyone's life, still many people die without any estate planning i.e. not leaving behind a Will for forming trust for special situation. The law of the land then prevails and decides the distribution of the assets after the deceased.

Estate Planning can be defined as a process that deals with the accumulation, conservation and distribution of an estate. The overall purpose of estate planning is to develop a plan that will enhance and maintain the financial security of Individuals and their families.

Estate planning is a process that determines how an individual wants to distribute his/her estate, which includes the rights and interest in the property owned, when he/she dies. One very strong misconception that people hold is that estate planning is for wealthy. This is not true. Anyone, who holds a property and wishes that on his death the property should be transferred to specific heirs and in a specific manner, needs estate planning. The financial security for their family is the objective of estate planning.

Estate planning is not only about distributing assets. There are lot many issues due to which estate planning needs attention. Why estate planning is required by individuals, can be answered if they start addressing the following type of visions:

- ✓ How do you want your property to be distributed?

- ✓ Who should get how much share from your property?
- ✓ What happens if you get physically disabled or mentally incompetent? Who will manage your care?
- ✓ What happens to the liabilities? Who will repay them?
- ✓ Is the money enough to sustain your spouse for lifetime?
- ✓ How can you provide for charity you wish to do?

Answers to such questions will be derived from estate planning.

Is estate planning for everyone?

Yes, estate planning is for anyone. The misconception that people have is that estate planning is only for the rich. Life has many uncertainties and no one knows what is stored for them in the future. Having a proper estate plan is therefore important for dealing with uncertainties. Identifying a suitable guardian for minors is also important to manage estate if parents die early. Similarly, if an individual has high liabilities then the provision to repay, in case of early death, can be resolved through estate planning.

Following are some areas for which effective estate planning should be done:

a. Family with minor children
b. Individuals with high liabilities
c. Properties in multiple states
d. Owning a small business
e. Estate Taxes
f. Address uncertainty of permanent disability

Estate Planning Goals

The objectives of estate planning are manifold. A proper estate planning ensures distribution and preservation of one's legacy with minimal disputes. If one has not prepared its estate plan then there are more chances of unsatisfactory distribution by some legal heirs. Below are some reasons for having estate planning:

1. Preserving assets for loved ones.
2. Appointing a guardian for minors to be prepared for any eventuality.
3. Addressing concerns arising from an individual's disability. For example, in case an individual become incapacitated then estate planning will help to manage finances and make health care decisions.
4. Ensuring availability of funds to pay one's liabilities after death.
5. Giving loved ones specific assets.
6. Provisioning for protection and care of special needs children
7. Protection for financial security of minor children till they turn 18.
8. Streamlining an efficient method to collect and distribute assets.

Estate Planning & Succession Planning

Estate planning is misconceived to be equivalent to succession planning. These two are completely distinct with different objectives. A succession planning is planning for one's business which takes effect within one's lifetime. For long term continuity and success of one's business, it has to be transferred to the next generation when one decides to quit. Then one has to ask questions like:

- Is it viable for next generation?
- If so, do family members, who are not involved in the business, intent to join in future and what vision do they have for the business?
- How does their individual vision align with the vision of the business?
- Should the business be sold if no one is interested?
- If business is not sold then who will take over it and are they qualified enough?

Any estate plan is a personal estate plan, which involves one's personal assets. Every individual needs to have an estate plan whether there is succession plan for business or not. The succession of business plan may start late in life but estate plan needs to be prepared as one accumulates enough assets.

14.2 Constituents of Estate

An estate may have different meaning for different professionals; but for estate planning, the estate consists of all the properties an individual owns or controls. This estate can be indifferent ownership formats. It can be in sole name of an individual, in partnership with any family member such a spouse, in a joint worthy agreement or even through a trust. An estate includes any money or asset that would be generated on a person's death such as life insurance.

An estate can be under three categories:

1. **Gross Estate**: The gross estate comprises items that determine one's net worth. Real estate properties (house, land etc.), bank accounts, investments, businesses, retirement account such as NPS, life insurance etc.
2. **Residue Estate**: This is an individual's personal estate property. This includes car, jewellery, furniture, clothes, and any other item found at one's home. Any investment not mentioned in the will or allocated in the trust form part of the residue estate. Lastly, any outstanding payments at the time of death are also a part of residue estate.
3. **Estate Debt**: This includes all debt and obligations owed to others. Housing loan, car loan, credit card payments, business outstanding are part of estate debt. Tax liabilities of any form or any legal cases are also a part of estate debt.

For any individual the estate is complete with all the above items.

14.2.1 Consequences of dying Intestate

The Indian Succession Act, under section 30, states that "a person is deemed to die intestate in respect of all property of which he or she has not made a testamentary disposition which is capable of taking effect."

This means a person is said to have died intestate with respect to an asset that he has not disposed under a will, or the disposition under the will is not capable of taking effect either on account of invalid bequest or illegal bequest. Intestacy may either be total or partial.

There are consequences on distribution of properties when an individual dies intestate. When a person dies without a Will, then the property devolves upon the heirs as per the laws of inheritance applicable to him/her. The law of inheritance in case of Hindus, Buddhists, Jains and Sikhs is governed by the Hindu Succession Act, 1956; in case of Christians, Parsis and the Jews, the law of inheritance is mentioned in the Indian Succession Act, 1925. However, for Muslims the law of inheritance is not provided in any legislation. Their inheritance laws are based on the religious texts, where the inheritance laws are different for Shias and Sunnis.

Succession Certificate

When a person dies intestate (i.e. without making a Will), the legal heirs have to apply to the civil court for obtaining a succession certificate which shall be issued in accordance with the laws of succession applicable to the deceased.

14.3 Elements of Estate Planning

A good estate plan consists of many different components, including what happens to one's assets and who should act on their behalf if they are unable to. Many a times it is quite confusing for people to understand what their estate plan should include. At a bare minimum, there should be two main components in an estate plan: (i) a last will and testament and (ii) a living will. Based on one's situation, this or any other legal provisions can become part of the estate plan. Below are the different elements of estate planning:

1. **Will:** This is the document which specifies who will inherit one's assets and in what manner. A Will helps to ensure that the assets that an individual leaves behind for his/her loved ones are distributed as per his/her wishes. There is also an important element pertaining to Will when it comes to appointment of guardian for minors or children with special needs. The Will should state who will be the person and how the assets will be managed till the minors turn adults or how assets will be managed for lifetime in case of children/adults with special needs.

2. **Trust**: Trusts are legal arrangements that hold assets on behalf of a beneficiary or beneficiaries. There are different types of trusts that can be created. The

person who creates the trust can decide the terms of the trust to be formed. Trusts can also be created through the Will, this is known as testamentary trust. However, these trusts are subject to the rulings under the 'Will' which means they also go through the process of probate.

3. **Power of Attorney**: It is a legal arrangement where an individual designates someone to manage one's finances in case an individual becomes incapacitated or is not in a position to do so. Many NRIs use Power of Attorney (PoA) to designate someone in India to manage their assets—movable or immovable.

4. **Living Will**: A living Will is an advance directive written primarily for physicians. There may be life situations like one is terminally ill, seriously injured, in a coma, in the late stages of dementia or near the end of life. This document states the wishes of the people for these kinds of situations, when one is at the end of life care and unable to communicate their decisions.

5. **Nomination and Beneficiary Designations**: This is not really a component of an estate plan but is important for completing the estate plan. Appointing nominees are important for smooth transfer of one's financial assets after his/her demise. The rights of nominee are limited to holding the assets as a custodian till it is transferred to the right legal heirs. In some assets, such as life insurance policy, beneficial nominees can be appointed who will also be the legal recipient of the life insurance proceeds at death of the policyholder. Under the new Insurance act, Parents, Spouse and Children, if any one of them is the nominee in the policy, they will automatically become the Beneficial Nominee and hence can consume the monies too.

   The legal beneficiaries can change in situations like marriage; therefore, it is important to periodically review nominations and beneficiary designations, wherever applicable.

14.4 Applicable Laws

14.4.1 Indian Succession Act, 1925

The Indian Succession Act deals with testamentary and intestate succession. When a will is written, Testamentary succession is applicable. However, if there is no will then Intestate succession applies. In that case, the properties are distributed as per the religious laws. The laws applicable to various religions are discussed below:

Succession for Hindus
For Hindus, the Indian Succession Act, 1925 is applicable for testamentary succession. For intestate succession, the Hindu Succession Act, 1956, as amended in 2005, is applicable. This difference arises due to the presence of the separate laws related to Hindu Undivided Family (HUF).

Succession for Muslims
In case of Muslims, the Indian Succession Act, 1925 is not applicable in Testamentary or Intestate Successions. The succession is as per religion.

Succession for Jains, Sikhs and Buddhists
The laws related to succession for Jains, Sikhs and Buddhists are very much similar to laws related to Hindus. For testamentary succession among Jains, Sikhs and Buddhists, the Indian Succession Act, 1925 is applicable. However, for intestate succession, the Hindu Succession Act, 1956 as along with amendments in 2005, are applicable.

Succession for Christians
In case of Christians, for both testamentary succession and intestate succession, the Indian Succession Act, 1925 is applicable.

14.4.2 The Hindu Succession Act, 1956

The Hindu Succession Act, 1956 extends to whole of India. The succession of property of a Hindu, who dies intestate (after coming into force of this Act), is governed by the provisions of this Act. This implies that, if a Hindu died before the Act came into force, succession of his property is regulated by the then held Hindu Law. It is a well-established rule of Hindu law of succession that succession never remains in abeyance. The succession immediately pen up on the death of a Hindu and his property vests immediately, upon his death, to his heirs.

Law of Succession of Property of a Hindu Male

In the Hindu Succession Act, Sections 8 to 13 lay down the general rules for succession when a Hindu male dies intestate. These rules are to be read along with the Schedule that provides the list of Class-I and Class-II heirs. All these sections are discussed later in this section.

Types of Heirs[51]

The heirs of a Hindu male are broadly of four types—Class I Heirs, Class II Heirs, Agnates and Cognates.

Class I Heirs

Under the Hindu Succession Act, the legal heirs who fall under Class I heir are:

1. Son
2. Daughter
3. Widow
4. Mother
5. Son of a pre-deceased son
6. Daughter of a pre-deceased son
7. Son of pre-deceased daughter
8. Daughter of pre-deceased daughter
9. Widow of pre-deceased son

[51] Class I and Class II Heirs are listed in the Schedule of the Hindu Succession Act, 1956.

10. Son of pre-deceased son of a pre-deceased son
11. Daughter of pre-deceased son of pre-deceased son
12. Widow of pre-deceased son of pre-deceased son
13. Son of a pre-deceased daughter of a pre-deceased daughter
14. Daughter of a pre-deceased daughter of a pre-deceased daughter
15. Daughter of a pre-deceased son of a pre-deceased daughter
16. Daughter of a pre-deceased daughter of a pre-deceased son

It is to be noted that among the Class I heirs:

- Adopted children (son or daughters) are counted as heirs.
- The children born out of void or voidable marriage are entitled to succession by virtue of section 16 (3) of the Hindu Marriage Act.
- The widow is also entitled to property and if there are more than one widow then they will inherit jointly one share of the deceased.
- Father is not Class I Heir.

Class II Heirs

Under the Hindu Succession Act, the legal heirs who fall under Class II heir are:

I. Father
II. (1) Son's daughter's son, (2) son's daughter's daughter, (3) brother, (4) sister
III. (1) Daughter's son's son, (2) daughter's son's daughter, (3) daughter's daughter's son, (4) daughter's daughter's daughter
IV. (1) Brother's son, (2) sister's son, (3) brother's daughter, (4) sister's daughter
V. Father's father; father's mother
VI. Father's widow; brother's widow
VII. Father's brother; father's sister
VIII. Mother's father; mother's mother
IX. Mother's brother; mother's sister

[Note: References to a brother or sister do not include references to a brother or sister by uterine blood.]

Agnates

A person is said to be an agnate to another if the two are related by blood or adoption wholly through males.

Cognates

A person is said to be cognate to another if the two are related by blood or adoption but not wholly through males.

Below are a few definitions and interpretations of related terms used in the Act:

Full blood Relationship

Two persons are said to be of full blood relationship when they have descended from a common ancestor by the same wife. In other words, when both the parents are same then children are related by full blood.

Half-blood Relationship

Two persons are said to be related by half-blood when they have descended from a common ancestor but by different wives. In other words, when two persons have the same father but different mother then they are related to each other by half-blood relationship.

Uterine blood Relationship

Two persons are said to be related to each other by uterine blood when they are descendants from a common ancestress but by different husbands. In other words, when mother of two persons are same but the father is different then they are related to each other by uterine blood relationship. The schedule of the Act excludes uterine brothers and sisters from inheritance of class I or class II heirs.

Relationship by Adoption

Under the Hindu Succession Act, an adopted child is for all intentions and purposes like a neutral born child. Under this Act, an adopted child is treated as equivalent to relation of full blood.

Illegitimate Relationship

Any child who is born outside the lawful wedlock is considered to be illegitimate child of his parents. Under the Hindu Succession Act, illegitimate relationship with father is not recognized but it is recognized with the mother and through their mother, children are related to each other.

Section 8: General rules of succession in case of males:

The property of a male, dying intestate, devolve according to the following priority rules:

1. First, upon the primary heirs being the relatives specified in Class I of the schedule of the Act.
2. Secondly, if there is no heir in Class-I then upon the heirs being the relative specified in Class II of the schedule of the Act.
3. Thirdly, if there is no heir in any two classes then upon the agnates of the deceased.
4. Lastly, if there is no agnate then upon the cognates of the deceased.

Section 9: Order of Succession among heirs in the Schedule of the Act:

Among all the heirs, those in Class I shall take priority simultaneously and to the exclusion of all other heirs; those in the first entry in Class II shall be preferred to those in the second entry, those in the second entry shall be preferred to those in the third entry and so on in succession.

Section 10: Distribution of property among heirs in Class I of the Schedule of the Act:

The property of the intestate shall be divided among the heirs in Class I of the Schedule of the Act in accordance with the following rule:

Rule 1: the intestate's widow, or if there are more widows than one, all the widows together, shall take one share.

Rule 2: The surviving sons and daughters and the mother of the intestate shall each take one share.

Rule 3: The heirs in the branch of each pre-deceased son or each pre-deceased daughter of the intestate shall take between them 'one share'.[52]

Rule 4: The distribution of the share referred to in Rule 3:

1. Among the heirs in the branch of the pre-deceased son shall be so made that his widow (or widows together) and the surviving sons and daughters get equal proportions; and the branch of his pre-deceased sons gets the same portion.
2. Among the heirs in the branch of the pre-deceased daughter shall be so made that the surviving sons and daughters get equal portions.

Section 11: Distribution of property among heirs in Class II of the Schedule of the Act:

The property of an intestate shall be divided between the heirs specified in any one entry in class II of the schedule of the Act so that they share equally.

Section 12: Order of succession among agnates and cognates

The order of succession among agnates or cognates, as the case may be, shall be determined in accordance with the rules of preference as below:

Rule 1: Of the two heirs, the one who has fewer or no degrees of ascent is preferred.

Rule 2: Where the number of degrees of ascent is the same or none, that heir is preferred who has fewer or no degrees of descent.

Rule 3: Where neither heir is entitled to be preferred to the other, under Rule 1 or Rule 2, they take simultaneously.

Section 13: Computation of Degrees

- For the purpose of determining the order of succession among agnates or cognates, relationship shall be reckoned from the intestate to the heir in terms of degrees of ascent or degrees of descent or both as the case may be.
- Degrees of ascent or degrees of descent shall be computed inclusive of the intestate.
- Every generation constitutes a degree either ascending or descending.

Succession of Property of Hindu Female

The "Rau Committee on Hindu Law" which submitted its report in the year 1948 recommended that all properties held by a woman should be her absolute properties and also laid down certain rules of succession of her property. The Hindu code bill substantially incorporated these recommendations. The substantive provision lays down that any property acquired by a woman becomes her absolute property and devolves on her own heirs.

From acceptance of Rau Committee recommendations till the Hindu Succession Act, 1956 came into force, the law was short of granting a status to woman where she could acquire,

[52] Its equal share among all legal heirs so each heir takes one share

retain and dispose properties similar as Hindu Male. The Hindu Succession Act, 1956 and particularly section 14 brought substantial changes, this upon the aspect of a right of a Hindu Female over her property and thereby settling the conflict. **Section 14: Property of a Hindu Female to be her absolute property:**

Any property possessed by a Hindu Female shall be held by her as full owner thereof and not as a limited owner.

Section 15: General Rules of succession in case of Hindu Female:

The property of a Hindu female dying intestate shall devolve as follows:

a) First, upon the sons and daughters (including the children of any pre-deceased son or daughter) and the husband;
b) Secondly, upon the heirs of the husband;
c) Thirdly, upon the mother and father;
d) Fourthly, upon the heirs of the father; and
e) Lastly, upon the heirs of the mother.

14.4.3 Muslim Personal Law

The Law of Succession among Muslims is combination of four sources:

1. The Holy Quran
2. The Sunna - Practice of the Prophet
3. The Ijma - Consensus of the learned men of the community over the decision over a particular subject matter
4. The Qiya - Deductions based on analogy on what is right and just in accordance with good principles

There are 2 types of heirs recognized by Muslim law:

1. Sharers - are the ones who are entitled to a certain share of the deceased property.
2. Residuary – are the ones who take up the share in the property that are left after sharers have taken their part.

Succession of Muslim male having left behind certain properties

Sharers

There are 12 sharers in Muslims:

1. Husband
2. Wife
3. Daughter
4. Daughter of a son (or son's son and so on)
5. Father
6. Paternal Grandfather
7. Mother
8. Grandmother on male line
9. Full sister
10. Consanguine sister
11. Uterine sister

12. Uterine brother

There are various factors, which decide the share taken by each sharer. For instance, a wife takes 1/4th of share in a case where the couple is without lineal descendants, and a one-eighth share otherwise. A husband (in the case of succession to the wife's estate) takes a half share in a case where the couple is without lineal descendants, and a one-fourth share otherwise. A sole daughter takes a half share. Where the deceased has left behind more than one daughter, all daughters jointly take two-thirds.
If the deceased had left behind son(s) and daughter(s), then, the daughters cease to be sharers and become residuary instead, with the residue being so distributed to ensure that each son gets double of what each daughter gets.

Non-Testamentary and Testamentary succession under Muslim law:
Under the Indian legislative scheme, the rules that govern inheritance under the Muslim law depend on the kind of property involved. In cases of Non-testamentary succession, the Muslim Personal Law (Shariat) Application Act, 1937 is applicable. On the other hand, in case of a person who dies testate i.e. one who has created his wills before death, the inheritance is governed under the relevant Muslim Sharia Law as applicable to the Shias and the Sunnis.

In cases where the subject matter of property is an immovable property, situated in the state of West Bengal or comes within the jurisdiction of Madras or Bombay High Court, the Muslims shall be bound by the Indian Succession Act, 1925. This exception is only for the purposes of testamentary succession.

Birth Right
There is no concept of ancestor property rights by birth in the case of Muslim succession. The rights, a Muslim heir acquires upon death of his ancestors, are fixed and determined with certainty on that date; and do not fluctuate. If an heir lives even after the death of the ancestor, he becomes a legal heir and is therefore entitled to a share in the property. However, if the apparent heir does not survive his ancestor, then no such right of inheritance or share in the property shall exist.

Rule of Distribution for Inheritance
Under the Muslim law, distribution of property are done in either of the two ways – per capita or per strip distribution.

The per capita distribution method is majorly used in the Sunni law. According to this method, the estate left over by the ancestors gets equally distributed among the heirs. Therefore, the share of each person depends on the number of heirs.

The per strip distribution method is recognised in the Shia law. According to this method of property inheritance, the property gets distributed among the heirs according to the strip they belong to. Hence, the quantum of their inheritance also depends upon the branch and the number of persons that belong to the branch.

Distribution of Joint or ancestral Property

Unlike Hindu law, there is no provision of distinction between individual i.e. self-acquired or ancestral property. Every property that remains within the ownership of an individual can be inherited by his successors. Whenever a Muslim dies, all his property whether acquired by him during his lifetime or inherited from his ancestors, can be inherited by his legal heirs. Subsequently, on the death of every such legal heir, his inherited property plus the property acquired by him during his lifetime shall be transferred to his heirs.

Rights of females

Muslim law does not create any distinction between the rights of men and women. On the death of their ancestor, nothing can prevent both girl and boy child to become the legal heirs of inheritable property. However, the quantum of the share of a female heir is half of that of the male heirs.

Succession Rights of a Widow

Under Muslim law, no widow is excluded from the succession. A childless Muslim widow is entitled to one-fourth of the property of the deceased husband, after meeting his funeral and legal expenses and debts. However, a widow who has children or grandchildren is entitled to one-eighth of the deceased husband's property. If a Muslim man marries during an illness and subsequently dies of that medical condition without brief recovery or consummating the marriage, his widow has no right of inheritance. But if her ailing husband divorces her and afterwards, he dies from that illness, the widow's right to a share of inheritance continues until she remarries.

Succession Rights of a Child in the womb

Under Muslim Law, a child in the womb shall only be entitled to the share in property if he or she is born alive. In case if he is born dead then the share vested in him shall cease to exist and it shall be presumed that it never existed.

Escheat

When a deceased Muslim has no legal heir, under Muslim law, Government inherits his properties through the process of escheat.

Wasiyat

In Muslim law, a will is referred to as 'Wasiyat'. According to Muslim law any person who is major (15 years and above) and is of sound mind can make a will. Muslim law recognizes that person cannot dispose off more than one third of his net assets by will, while remaining two thirds should be made available for distribution among the heirs. Muslim law requires no formalities of creating a Will. A will can be made in writing, oral or even by gestures. A Muslim Will or any part thereof can be revoked by the testator at any time before his death. The revocation may be expressed (tearing or burning the Will) or implied (e.g. if testator transfers the same property by sale or gift subsequently to another).

14.4.4 Married Women's Property Act, 1874

Married Women's Property Act, 1874 was enacted to protect the properties of woman against the creditors. Under this Act, all the properties of a woman get insulated from all the other court attachments or any income tax department attachments that the husband has run up.

This Act applies to any woman who at the time of her marriage professed the Hindu, Muhammadan, Buddhist, Sikh or Jain religion, or whose husband, at the time of such marriage, professed any of those religions. The state government has powers to exempt from operations of all or any of the provisions of this Act, the members of any race, sect or tribe or part of a race, sect or tribe, to whom it may consider it impossible or inexpedient to apply such provisions.

Married women's earnings to be their separate property

The following shall be deemed to be the separate property of any married women and her receipts alone shall be good discharges for such wages, earnings and property:

(a) the wages and earnings of any married woman acquired or gained by her after the passing of this Act, in any employment, occupation or trade carried on by her and not by her husband
(b) any money or other property so acquired by her through the exercise of any literary, artistic or scientific skill
(c) all savings from and investments of such wages, earnings and property

Married woman may effect policy of insurance

Any married woman may effect a policy of insurance on her own behalf and independently of her husband; and the same and all benefit thereof, if expressed on the face of it to be so effected, shall ensure as her separate property, and the contract evidenced by such policy shall be as valid as if made with an unmarried woman.

Insurance by husband for benefit of wife

A policy of insurance effected by any married man on his own life, and expressed on the face of it to be for the benefit of his wife, or of his wife and children, or any of them, shall endure and be deemed to be a trust for the benefit of his wife, or of his wife and children, or any of them, according to the interest so expressed, and shall not, so long as any object of the trust remains, be subject to the control of the husband, or to his creditors, or form part of his estate.

When the sum secured by the policy becomes payable, it shall, unless special trustees are duly appointed to receive and hold the same, be paid to the Official Trustee of the State in which the office at which the insurance was effected is situated, and shall be received and held by him upon the trusts expressed in the policy, or such of them as are then existing.

Married women may take legal proceedings

A married woman may maintain a suit in her own name for the recovery of property of any description which, by force of the said Indian Succession Act, 1865, (10 of 1865) or of this Act, is her separate property; and she shall have, in her own name, the same remedies, both civil and criminal, against all persons, for the protection and security of such property, as if she were unmarried, and she shall be liable to such suits, processes and orders in respect of such property as she would be liable to if she were unmarried.

Wife Liability for post Nuptial Debts

If a married woman (whether married before or after the first day of January, 1866) possesses separate property, and if any person enters into a contract with her with reference to such property, or on the faith that her obligation arising out of such contract will be satisfied out of her separate property, such person shall be entitled to sue her, and, to the extent of her separate property to recover against her whatever he might have recovered in such suit had she been unmarried at the date of the contract and continued unmarried at the execution of the decree: Provided that nothing herein contained shall-

> (a) entitle such person to recover anything by attachment and sale or otherwise out of any property which has been transferred to a woman or for her benefit on condition that she shall have no power during her marriage to transfer or charge the same or her beneficial interest therein,
>
> (b) affect the liability of a husband for debts contracted by his wife's agency expressed or implied.

Husband not liable for wife's ante-nuptial debts

A husband married after the thirty-first day of December, 1865 shall not by reason only of such marriage be liable to the debts of his wife contracted before marriage, but the wife shall be liable to be sued for, and shall, to the extent of her separate property, be liable to satisfy such debts as if she had continued unmarried. Provided that nothing contained in this section shall invalidate any contract into which a husband may, before the passing of this Act, have entered in consideration of his wife's ante nuptial debts.

Extent of husband's liability for wife's breach of trust or devastation

Where a woman is a trustee, executrix or administratrix, either before or after marriage, her husband shall not, unless he acts or intermeddles in the trust or administration, be liable for any breach of trust committed by her, or for any misapplication, loss or damage to the estate of the deceased caused or made by her, or for any loss to such estate arising from her neglect to get in any part of the property of the deceased.

14.5 Mutation

Mutation is a process whereby a property is transferred from one person’s name to another. In practice, this is done by alteration or substituting a name of a person with another in revenue records showing the right of title to the property.

Mutation of property is a state matter and therefore is carried out as per the state specified laws. The records are then maintained to prove the rightful owner of the property. There is another objective to it. Since state or central government has to collect taxes on properties, the records of the revenue department have to show the rightful owner so that tax liabilities can be fixed.

The process of mutation is generally handled by the state governments. The land development authority provides necessary details and documentation. The present owner of the property is required to clear all the dues pertaining to it, post which the development authority cannot object to selling the property. It becomes an obligation for the authority to record the mutation and grant a no-objection certificate, or sanction the building plan. The development authority then sends notice to the present holder of the property on the event of changing the allotment. The mutation is not considered as evidence, but if there are co-owners of the property then value of the mutation will not allow one person to claim the property alone.

Though mutation, as shown above, can hold significant relevance, it is still not a proof to confer title of the property in the name of person in whose name property is mutated. The proceeding which happens in front of the revenue authorities are not considered as judicial proceedings. The title of any property should be the basis on which an owner acquires land and not mutation entries. The sole objective of Mutation is to collect revenue from the person in whose possession is the property.

14.6 Caselet

Mr. XYZ has died without leaving a Will. He was not married. He has 1 surviving brother and 2 surviving sisters. The family is Hindu.

Question 1*: Under the law who all qualify to inherit from the estate?*

a. *Surviving Brother*
b. *Surviving Sisters*
c. *All brother and sisters equally*
d. *None of the above*

Answer: (c) ***All brother and sisters equally***

Explanation:

Mr, XYZ has died without a Will, i.e. he has died Intestate. In such case, the distribution of assets of Mr. XYZ will be as per the Indian Succession Act 1925. Since Mr. XYZ is a Hindu, The Hindu Succession Act, 1956 will apply. There are none from Mr. XYZ's family who fall under Class I heir (refer to the list at section 14.4.2 of this chapter). Therefore, this case falls under Class II heirs of Hindu Succession Act.

Among the heirs specified in the Schedule, those in the first entry in Class II shall be preferred to those in the second entry; those in the second entry shall be preferred to those in the third entry, and so on in succession (refer to the list at section 14.4.2 of this chapter). Therefore, Mr. XYZ's brother and two sisters equally qualify to inherit his estate.

CHAPTER 15: TOOLS FOR ESTATE PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Tools for estate planning
- Concept of Will / Gifts / Nomination
- Probate process
- Family settlement
- Trust-characteristics and regulations
- Power of attorney

15.1 Tools for Estate Planning

Estate planning tools are classified as those that take effect during the life of a person and after death of a person. There are different tools of estate planning. Not all of them are applicable at same instance. Some tools are used within one's lifetime while some of the tools benefit the family post death.

a. Tools used post death of the individual

- Will
- Nomination

b. Tools used during the lifetime of the individual

- Family Settlement
- Trust
- Guardianship
- Joint Holding
- Gift
- Power of Attorney
- Mutation

15.2 Concept of Wills

15.2.1 Characteristics and content of will

"Will" is defined in Section 2(h) of the Indian Succession Act, 1925 to mean the "*legal declaration of the intention of the testator with respect to his property, which he desires to be carried into effect after his death*."

The person making the will is the testator, and his rights extend to what are legally his own.

The will comes into effect only after the death of the testator.

The person who is named in a will to receive a portion of the deceased person's estate is known as a Legatee. The person named in the will to administer the estate of the deceased person is termed as an Executor.

Anyone who has some asset accumulated can write a will, but often is neglected or delayed for later years of life. In absence of a will, the laws of inheritance come into action and the assets are distributed as per the law, which can be a cumbersome process and also against the wish of the person. Thus, there is a strong reason that one should write a Will.

Here are some of the strong reasons to write a will:

1. After testator's death, there will be no confusion among the family members and relatives as to how to dispose of the properties.
2. A will is a highly personal document. The testator is able to express his opinions and feelings about his relationship with the family members, relatives, friends and others.
3. The laws of inheritance do not consider any specific situation of any family like special needs, minor children, widow daughter, etc. Through the 'will' the testator can address these specific situations.
4. Through a 'will', a testator can take away rights of disobedient/ fraudulent person of family members.
5. The 'will' offers many tax advantages too in many situations.
6. By appointing executor, the testator has appointed a faithful personnel. In intestacy, the administrators have to provide an administration bond and securities for due administration of the estate.

The wills are made for disposing properties along with appointing executors, for creating trusts, and for appointing guardian of the children. There are certain formalities required by the statute to a valid 'Will'. If those formalities are not complied with, then the Will is not considered as valid.

A will takes into effect only after the death of the testator. During the lifetime, the testator can revoke the will anytime without any legal difficulty whatsoever. The Will can be changed by the testator as and when he likes. Till the execution, the Will remains a confidential document.

The Section 62 of the Indian Succession Act lays down that a Will is liable to be revoked or altered by the maker at any time during his lifetime when he is competent to dispose of the Will.

15.2.2 Types of will

There are different kinds of Will which are written by the testator to dispose their properties-

1. **Conditional or Contingent Will**: A will may be expressed to take effect only in the event of happening of some contingency or condition and if in case the contingency did not happen or the condition fails the will is not legally enforceable or probate. If the condition imposed is invalid or against law then the will is deemed to be invalid.
2. **Joint and Mutual Will**: A joint will is a will made by two or more persons. In Indian law, a joint will is a valid will. A joint will is recognized as two wills and is intended to take effect after the death of both the testators. Though it is termed as joint will, the disposition of properties happens as an individual will and even admitted to probate as an individual will.
   In a mutual will, the two testators confer upon each other reciprocal benefits. The testator has absolute benefits in each other's properties or life interest. This means the executants fulfil the role of both testator and legatee. But when the testator and legatee are different then the mutual will is not viable.
3. **Duplicate Will**: A duplicate will is a copy of the Will kept with the testator. But the will has to be duly signed and attested. The duplicate will generally lies with the executor or trustee**.** When the testator mutilates or destroys the part in his custody then both wills are considered to be revoked.
4. **Holograph Will**: A holograph Will is a will entirely in the handwriting of the testator. It is considered to be a good will if it is completely handwritten by the testator.
5. **Concurrent Will**: In general there should be only one Will left by the testator, but sometimes the testator may write two wills –one relating to his property in one country and other relating to his property in other country. Both these wills are treated as independent and one of the Wills can be graded probate. However, if there is any relations between the two then both wills are to be included in the probate.
6. **Sham Will**: If a document is deliberately executed with all due formalities purporting to be a Will, it will be anullity if it is proved that the testator did not have any intention of any testamentary operations but some collateral object. The reason for this is that the intention is the primary characteristic of validity of the Will. Such a Will is a sham one.
7. **Privileged and unprivileged Will**: Mostly the will has to be made in writing. But there are situations where this may not be possible. The best example is a soldier during his engagement in the actual warfare or airmen so engaged or a mariner at sea may pronounce his Will by word of mouth before 2 witnesses present at the same time. The will, so pronounced by such persons, is called privileged will. All other kinds of Wills, which are not privileged wills, are called unprivileged will.

15.2.3 Legal requirements and Testamentary capacity

According to section 59 of the Indian Succession Act, the essentials for making a will are:

- Testamentary capacity and sound mind
- Knowledge of contents

- Free from undue influence/ fraud/ coercion
- Voluntary act

Thus, the following persons are eligible to make a will:

1. A person of sound mind may dispose his properties by will with a condition that he/she is not a minor.
2. A married woman may make a will of the property which she could alienate by her own act during her lifetime.
3. Deaf or dumb or blind persons can also make a will if they are able to know what they are doing.
4. An ordinary insane person can also make a will during an interval in which he is of sound mind.

No person can make a will in a situation that he is not in a sound state of mind. This may arise due to intoxication or for illness or form any other cause that he does not know what he is doing.

Testamentary Capacity

A person is said to be in testamentary capacity only if he is in sound state of mind. When in sound state of mind, the testator should have sufficient capacity to comprehend perfectly the condition of properties, his relation to the persons who were or might have been object of his bequest and the scope and bearing of the provisions of his Will.

15.2.4 Registration of Wills

Registration of Will has been dealt under Section 17 of the Registration Act, 1908. The section does not mention compulsory registration of documents pertaining to will. Section 18 of the Act mentions that registration of Will is an optional process. Thus, the law does not provide any reference to compulsory registration and so a non–registered Will is considered to be a genuine will. However, there are many advantages of a registered will. These are:

1. The will cannot be tampered, destroyed or stolen.
2. Under the Registration Act, Section 57(2), the certified copy of a will can be given only to the testator or this agent. After testator's lifetime the certified copy can be given only at his/her death to the person applying for it through a written application. The death certificate of the testate has to be produced by the person.
3. The wills are kept in the safe custody at the registrar office.
4. With a registered will, the leasehold property can be edited in the name of the legal heirs.

How to get the Will Registered?

The will needs to be registered at the Registrar/Sub registrar office. All the witnesses of a will along with the testator have to attest the will in front of the Registrar/Sub-registrar.

After attestation, one copy is given to the testator and the others are kept in the safe custody of the Registrar.

There might be a situation when the testator is not able to travel to the Registrar office then the Registrar can be requested to visit testator's house or hospital. Following are exempted from attending Registrar's office:

1. A person by reason of bodily infirmity is unable to visit without the risk or serious inconvenience to appear at the registrar office
2. A person in jail under civil or criminal process
3. A Muslim *pardanashin* Woman

A will is registered on a plain paper and so there is no stamp duty payable. The Will can be registered within the lifetime or by legatee after the testator's death.

Even if the will is registered, all subsequent Wills or amendments need not be registered.

Specific Situations

There are specific circumstances when a will has to be registered with the Registrar/Sub-registrar office. The bequeath to charitable or religious institution by a non-Hindu is one such instance. The Will written by such persons and bequeath to the near ones shall be deposited with the Registrar/Sub-registrar of deeds and comments within 6 months of the execution of the will.

Any bequeath to a religious or charitable institute can take effecting only when certain conditions are met. These conditions are:

1. The Will has been executed.
2. The will has been deposited with the Registrar/Sub-registrar within 6 months of its execution.
3. The testator has to survive for a period of 12 months starting from the month in which the Will is executed. This means any bequeath made few days prior to testator death is not considered valid.

Important Considerations

Here are some important considerations for a person writing the will:

- The will should be kept in a safe custody with a banker or lawyer. Even the registrar can be considered for safekeeping of the Will. To do this, the testator personally or through his agent can submit the copy of the Will in a sealed envelope. Once the registrar receives the sealed copy and is satisfied, he/she can keep the copy in safe custody.
- This sealed copy can be opened either in presence of the testator or in the presence of any person applying for it at the testator's death. If the registrar is satisfied then the sealed cover is opened in presence of the applicant. All expenses in this process are borne by the applicant.

- The registrar holds the original copy till any competent court asks them to produce.

15.2.5 Modifying and Revoking a Will

Revocation of Will

A will by nature is revocable. A man's act or deed cannot make a Will irrevocable. Section 62 of the Indian Succession Act deals with revocation of will. As per the law, a will can be altered or revoked by the testator at any time when he is competent to dispose of his property through Will.

Section 57 of the Act specifically mentions that marriage shall not revoke any Will or codicil for Hindus. A Will is not deemed to be revoked in case of divorce of the maker of the will.

Modes of Revocation

There are four modes of revocation of a 'Will':

(i) Through a later Will or codicil duly executed;
(ii) Through written declaration of an intention to revoke the Will and duly executed as a Will;
(iii) By burning, tearing or otherwise destroying the Will by the testator or someone in his presence and by his direction, with the intention of revoking the Will
(iv) By a subsequent marriage

The mere loss of the Will does not lead to revocation but where the Will is destroyed by the testator or with his privity or approbation, the Will is deemed to have been revoked. Section 70 of the Indian Succession Act requires that a document declaring the intention of the testator to revoke the Will, should be executed in the same manner as a Will.

One of the important characteristics of a Will is that it is always revocable until the death of the testator. However, the testator should be in sound mind at the time of revocation. A mere expression of intention to revoke a Will at some future date is not valid. A sample of revocation is shown in Exhibit 15.1.

Exhibit 15.1: Sample Revocation

I, AB etc., hereby revoke all my Wills and codicils and particularly the Will made by one on __________ in the presence of ______ and ________ as attesting witnesses thereof. I declare it to be my intention to die intestate.

(Sd.) ________

(AB)

Witnesses:

1. ____________________

2. ____________________

15.2.6 Codicils

A Codicil is a supplementary document to a Will. Through a codicil, the testator can make minor alterations in his Will. As per section 2 (b) of the Indian Succession Act, "Codicil" means any instrument made in relation to a Will and explaining, altering or adding to its disposition and shall be formed to be part of the Will. The codicil has to be executed and attested just as the Will.

A codicil is not an independent document. When alterations are considerable then a fresh Will revoking the earlier Wills should be written. The codicil can be endorsed on the original Will or may be written as a separate document. Exhibit 15.2 provides a sample Codicil substituting a Trustee appointed under Will.

Exhibit 15.2: Sample Codicil Substituting a Trustee Appointed Under Will

I, AB etc., hereby declare this to be first codicil to my Will dated the ______ day of __________.

WHEREAS by my aforesaid Will I have appointed EF as one of the executors and trustees and given him a legacy of Rs. _______ if he acts;

AND, WHEREAS the said EF has died on ________________.

1. Now I hereby revoke the appointment of the said EF as one of the executors and trustees of my Will and appoint GH, etc., to be executor and trustee thereof in place of the said EF.

2. I bequeath to the said GH a legacy of Rs. _______ if he acts as such executor and trustee and I hereby revoke the legacy of Rs. ______ given to the said EF by the said Will.

3. I hereby declare that my said Will and all the provisions contained therein shall be construed and take effect in all respects as if the name of the said GH where substituted therein as an executor and trustee thereof for the name of EF.

4. In all other respects, I hereby confirm my said Will.

IN WITNESS WHEREOF I, the said AB have signed this codicil on the _______ day of ______ in presence of the witnesses hereunder who have attested the same in my presence.

(Sd.) __________

(AB)

Testator

Signed by the above-named testator as a codicil to his Will dated ______ in our presence at the same time and each of us has in the presence of the testator signed his name hereunder as an attesting

Witnesses:

1. ________________

2. ________________

15.2.7 Succession Certificate

Under Indian Succession Act, 1925 the succession certificate is defined as a document issued by a court to the legal heirs for establishing their authenticity and authorizing them to represent the deceased for the purpose of collecting debts, securities and other assets due or payable to them.

The succession certificate is required in absence of a Will to establish the legal character of heir who lays a claim on the property of the deceased. But a succession certificate does not determine the right, title and interest of a deceased person to any property. Hence mere issuance of succession certificate does not give right of succession to the property in which the legal heir has laid a claim.

Section 370 of the Indian Succession Act, states that when the deceased person has left a valid Will, his/her entire property as stated in the Will, vests with the executor and thus succession certificate cannot be granted.

The succession certificate is granted by the District Courts as stated in Section 371 of the Indian Succession Act. It is issued by the applicable laws of inheritance on an application filed by the beneficiaries in a court of relevant jurisdiction. The succession certificate is used to claim both movable and immovable properties of the deceased. The purpose of a succession certificate is limited in respect of debts and securities such as provident fund, insurance, deposits in banks, shares, or any other security of the central government or the state government to which the deceased was entitled.

A succession certificate may be used in situations where banks, financial and private institutions release funds to the nominee (where such nominee is not the legal beneficiary of the asset) and the nominee refuses to cooperate in distribution of the asset to the legal beneficiary. In case of immovable properties, the legal heirs claim on the ownership of title and possession. The transferring of title of a property is a systematic process which can be based on the factum of the Will or Law of Natural Successions where Class I legal heirs are the primary inheritors. Even a gift deed can be used to transfer the title of the property to any legal heir while the person is alive.

Difference between Legal Heir Certificate and Succession Certificate

The succession certificate is a different document than a legal heir certificate. A legal heir certificate is issued to identify the living heirs of a deceased person. A legal heirship certificate establishes the relationship of the heirs to the deceased for claims relating to pension, provident fund, gratuity or other service benefits of central and state government departments, specifically when the deceased has not selected a nominee. Banks and private companies also accept such certificates for allowing transfer of deposits, balances, investments, shares, etc. The succession certificate, on the other hand, establishes the authenticity of the heirs and gives them the authority to inherit debts, securities and other assets of the deceased. Table 15.1 summarizes the difference between Succession Certificate and Legal Heir Certificate.

Table 15.1: Succession Certificate Vs Legal Heir Certificate

Succession Certificate	**Legal Heir Certificate**
It is issued by Civil Court.	It is issued by Tehsildar of district.
It authorizes a valid and a rightful person to succeed over the deceased person.	It identifies and establishes living heirs of a deceased person.
Purpose is to gain authority to obtain the debts and securities of the deceased where a Will has not been drawn up.	Purpose is to stake a claim as a rightful heir to the estate of the deceased.
Succession Certificate acts as a valid proof under succession laws and the holder can become the beneficiary of the property of the deceased.	Legal Heir Certificate does not serve as conclusive and valid evidence under succession laws.
The right of a succession certificate holder is extensive in the sense that every payment made by the holder of the certificate on behalf of the deceased would be considered valid.	Legal Heir Certificate is limited to insurance claims and so on.
Only the certified legal heir can apply.	Spouse, parents of the deceased, son or a daughter can apply.

15.2.8 Role of the executor

Who is an Executor?

An executor is a person appointed by the testator of the Will. Section 2(c) of the Indian Succession Act defines executor to be a person to whom the execution of the last Will of the deceased person is, by the testator’s appointment, confided. An executor has been granted powers and duties to act as per the Will. The main role of an executor is to collate all assets of the deceased, pay off liabilities and distribute the legacy as per the wish in the Will.

Sec 222 of the Indian Succession Act states that the court grants probate only to executors appointed by the Will.

Functions of an Executor

The role of an executor is filled with huge responsibility since the executor manages the execution of the Will which can be as detailed as the testator would have written. If the 'Will' goes for probate, the executor is the person who has to oversee the entire process. It is the executor's responsibility to offer the Will for probate if situation arises. The court issues the probate certificate to the executor authorizing him to execute the Will as per the wish of the testator.

The other role of the executor involves working on the content of the Will. Since executor has the complete responsibility, he has to analyse the Will minutely. If there is a trust formation through the Will, then the trust deed will have to be analysed by the executor.

The first responsibility to shoulder is to pay off the funeral and burial expenses and obtain the death certificate, needed to manage the financial affairs. Once death certificate is obtained, the executor can proceed with the disbursal of assets as per the 'Will' content.

The executor also has to locate the assets as mentioned in the Will. This includes banking, investment, properties, and any other assets. The executor will have to ensure that all the assets can be located with their original papers and determine their present value to ascertain the exact value of the estate involved. For this, the executor may seek services of legal professionals. Post determining the total value of estate, the executor will have to pay off all the debts and liabilities along with taxes according to the provisions specified in the Will. Without paying off pending dues the estate cannot be distributed, as the lenders have the first right. If required some of the assets may be liquidated to pay off these dues. Once the dues are paid off, the estate can be disbursed to the legal heirs as per the provisions of the Will.

Further, another important role that can arise for the executor is to manage the assets of the minor child. Many a times, parents leave it to the executor to manage the assets of the child till he/she becomes major. Once the child becomes major all the assets are transferred to the child. In such cases, the role of executor is more than just execution of the Will. An important consideration to remember is that if the executor mismanages any of the assets he/she can be held liable for the same.

Who can be the Executor?

All persons capable of executing a Will can be executors. Family/ friends/ relatives or even a company can be appointed as executor of the Will. A beneficiary can also be named as an executor of the Will. In general, the testator appoints the executor while writing the Will. Where an executor is absent in a Will, the court can also appoint the administrator to look after the distribution of estate. However, an executor has the right of refusal before he/ she starts dealing with estate. But once the responsibility is accepted by the executor, he/she is legally bound to complete the task. The executor can be relieved only by a court order if he/she is not willing to act.

A minor too can be appointed as an executor. However, probate cannot be granted to a minor until he attains the age of majority. In such cases, the legal guardian of the minor can obtain letters of administration by submitting an application in the court of law. In a similar manner, the courts do not grant probate to person with unsound mind, hence mentally disabled person cannot be appointed as executor in the Will. Apart from this, a corporate (as defined under section 223 of The Indian Succession Act) can be appointed as an executor in the will.

Number of Executors

By law, there is no restriction on the number of executors, a testator may appoint in the Will.

What if no Executor is appointed?

If there is no executor appointed in the Will then the court grants Letters of Administration to the agent or attorney of the principal i.e. the testator.

Bequests in favour of Executor

Sec 141 of the Indian Succession Act states that an executor as legatee cannot claim the legacy unless he shows intention to act as an executor.

Administrator

There are many instances when executors may not be available in the Will. The court then appoints administrators for execution of the Will.

Here are circumstances when the courts will appoint administrators:

1. There is no executor appointed in the will.
2. The appointed executor is legally incapable or refuses to act.
3. The executor dies just after proving the will but has not completed the distribution of the estate.

15.3 Probate

Probate, as defined in section 2 (f) of the Indian Succession Act, means the copy of a will certified under the seal of a court or competent jurisdiction.

To put it simply, it is a legal process where a certificate from the court establishes the legal character of the person to whom the grant is made. It also establishes the validity of all intermediate acts of the executor appointed in the Will. The other alternative to probate is the letters of administration, which is generally issued by the court, in the following cases:

1. No executor has been appointed in the Will.
2. The executor appointed is legally incapable or refuses to act or has died before he has proved the Will.
3. The executor has died after proving the Will but before he has administered the entire estate of the deceased.

So, when either of the above three situations are not satisfied in a Will, the court will issue letters of administration of the estate to the legatee.

Why Probate is required?

A probate is mandatory in some cities. Currently if the Will or codicil has been made in any of the three Presidency towns i.e., Kolkata, and the municipal limits of metro cities of Chennai and Mumbai, or, if the immovable property is situated in any of these towns then probate is mandatory. Beyond these, probate is optional. Apart from this, there can be many situations when a probate may be required -

1. If executor or legatee has to establish any legal right over the assets of the deceased.
2. If there is no executor in the Will.
3. The deceased has multiple assets, some of which are present in the above mentioned states.
4. In general, the authorities of the state where the asset lies demand a registered Will and a probate to transfer the assets in the name of the legal heirs.

Who can take a Probate?

A probate is given only to the executor appointed in the Will. In case the executor is not there, then the letters of administration is given by the court with legal jurisdiction. Letters of Administration is issued to any person who would be entitled to the whole or any part of the estate of the deceased. But there are situations when there will be more than one person to claim the assets. In such cases, the court will decide whether to issue the letters of administration to any one person or more.

Probate is not a Succession Certificate

Often, when a person dies intestate or without a Will, a succession certificate is required for legal heirs to lay claim on the assets. This succession certificate is entirely different from the probate certificate and is obtained from a civil court. It is a certificate that validates the right of the legal heir. Contrary to this, a probate is an order issued by a court in favour of a Will, which upholds and certifies its genuineness. Thus, a Probate is issued when there is a Will, while a succession certificate is issued when there is no Will.

Process of Probate

The law prescribes a procedure for issuing the probate. To obtain a probate, the executor files an application in the appropriate court along with a copy of the Will. Where no executor is present, any competent person can file the application. The application, duly verified and signed by the executor or any competent person, should include the time of the testator's death, the existence of an executed Will, assets involved and the name of the executor along with other details. Further, at least one of the witnesses of the Will needs to verify the application. The applicable fee is attached with the application form on stamp paper on which court grants the probate.

Once the petition is received, the court issues notice to the legal heirs to file objections to grant of probate. Public is also notified through advertisement in a national newspaper. Once the next generation is invited for objections, the petitioner has to lay proof of death of the testator, valid execution of the Will and prove that it is actually the last will.

Probate Fees

The probate process involves a court fee. This fee is a fixed or percentage of the total value of assets going in for probate. Some states have a limit of the maximum fee charged by the court for probate. The rate varies across states as Wills are a state subject.

15.4 Gifts, Joint Holding and Nominations

15.4.1 Gifts

A gift is a transfer of movable or immovable property made voluntarily and without consideration. The person making the gift is called donor; the person receiving the gift is called the donee. Any person capable of making a contract can make a gift. A gift is usually an irrevocable transfer however, it can be revoked if the donee agrees to do so.

Gifts are taxable as income from other source, subject to exemptions provided under Income Tax Act. This includes gifts received from relatives such as spouse, siblings of self and spouse, parents, grandparents, children, grandchildren and other relationships as defined under Income Tax Act. Any gift received on the occasion of marriage or inherited under a will is exempt from tax.

Gifts are routinely used to transfer wealth from donor to donee; especially where the exemptions mentioned above would apply, thereby exempting the gift from tax in the hands of the donee. However, any income earned from the gift after such transfer will be subject to tax in the hands of the donee.

15.4.2 Joint Holding

It may be procedurally easy to enable specific family members, such as the spouse or children, easily access assets through the simple method of joint holding. Joint holding means the property is held by more than one person and can be accessed by such joint holders subject to the mode of operations. Bank accounts, property, demat accounts, shares, mutual funds and specific saving schemes can all be held jointly. The operation of a joint account can be done 'jointly', where all joint holders have to approve all transactions, or on 'either of survivor', or 'anyone or survivor' basis.

The specific procedural aspects for joint holding, with respect to how many joint holders are permitted, what kind of operational choices are available, and what type of transactions need all joint holders' assent, can vary across different types of assets. It is usually the case that the first holder would be the registered holder of the asset and entitled to receive information and benefits of holding the asset. The joint holders can, subject to terms of holding, access the asset after the death of the first holder. The procedures for accessing the asset are simpler in the case of a joint holding. However, it should be remembered that if there is a legal contest among the heirs, joint holders right to the asset can be superseded by laws of succession as they may apply.

15.4.3 Nomination

Nomination is the right conferred upon the holder of an investment product to appoint the person entitled to receive the monies in case of the death. A nomination is seen as a formal bequest authorized by the holder of the asset, though in the event of a dispute the nominee's position is reduced to being the trustee of the bequest, the final owners being decided according to the applicable laws of succession.

Only an individual can nominate. Non-individuals including corporate bodies, partnership firms, trusts, Karta's of Hindu Undivided Families (HUFs) and power of attorney holders, cannot nominate. Nomination can be done either at the time of making the investment or entering into an insurance contract or subsequently at any time. Nominations can be modified any number of times.

Nominee can be an individual, company or trust, depending on the terms of investment or asset. A minor can be a nominee, but a guardian will have to be named. Nominations to NRIs will be honoured subject to repatriation rules. Multiple nominees are allowed, with percentage of interest defined for each nominee.

Different rules for nomination apply for different types of assets

The purpose of nomination is simplification of payment process in the event of the death of the holder and not the equitable distribution of estate.

Payment to nominee is a valid discharge in case of all financial products. The onus of proving any rights to legacy of the investment so transmitted is on those that contest such transmission. A will supersedes a nomination, but the company or mutual fund can still make payment of proceeds to the nominees. The nominee is not a legatee or beneficiary under the Indian Succession Act. However, there are certain assets where the nominee has been granted the legal rights of the proceeds. Under the Insurance Act, 1938, beneficial nominees i.e. the immediate family members such as spouse, parents and children are entitled to the death benefit of the insurance and other legal heirs will not have a claim on the money. Similarly, under the EPF Act the subscriber can appoint only immediate family members such as spouse, parents and children as nominee in his/her Provident Fund account who inherit the proceeds upon death of the subscriber. In absence of any nomination, proceeds are distributed among legal heirs.

The nominee takes the amount subject to any claim or right of the owners/heirs or other persons. The nominee may only receive the proceeds, but title to the assets is not absolute. Various courts in India have upheld the rights of legal heirs over the nominee and so in most financial assets Succession Rule supersedes nominations. Exception to this will be financial assets, which have been created by a separate Act and where provisions have been provided in the Act itself for bequeath of the assets to specified legal heirs, post the demise of the investor.

Nomination is an effective method, absence of which leads to ballooning corpus of unclaimed assets. Considering this, changes in nominations are undertaken to bring out efficiency in claim processing on account of demise of investors. SEBI has introduced changes in nomination by increasing the number of nominees, allowed to be registered, upto 10.[53] Similarly banking laws are proposed to be amended to bring successive nomination in place meaning one can appoint alternate nominees if first nominee is not alive or unable to accept. This is called "One after another "arrangement.[54]

15.5 Family Settlement

A family settlement is an instrument used to achieve peace and harmony in the family when there is a dispute or rival claims to property that can lead to a long drawn out litigation. The dispute must be between members of the same family and a settlement entered must be between persons having title, claim or interest in the property. It must be entered into voluntarily and in good faith and with the purpose of accomplishing tranquility and accord in the family.

The advantages of a family settlement are:

- Family arrangements are not treated as transfer and hence capital gains tax will not arise.
- It is not treated as a gift.
- The clubbing provision will not be applicable.

[53] Vide SEBI Circular No.: SEBI/HO/OIAE/OIAE_IAD-3/P/ON/2025/01650 dated January 10, 2025 on Revise and Revamp Nomination Facilities in the Indian Securities Market.
[54] As per the Banking Laws (Amendment) Bill, 2024.

A family settlement agreement may be oral or in writing. It may be stamped and registered, if required.

15.5.1 Intra-family business and property transfer

An intra-family transfer is a transfer from one family member to another family member without the assets actually being sold. In other words, the assets are essentially 'given' to another member of the family so that there is a reduction in the taxes owed.

Transferring property among family members is quite common in India. Be it an estate planning goal or just for love and care, property transfer within family happens for multiple reasons. Though among family members property transfer can be highly useful, there may be tax implications that needs to be taken into consideration.

The property transfer may have some other issues to be resolved like that of mortgage. If any property is under mortgage, the liability is also carried to the new owner if the property is sold and transferred. Similarly other issues may arise in transferring a property, therefore due importance should be given to the strategies to be applied for the purpose.

15.5.2 Forms of property transfer

Here are common forms of property transfer among family members:

Joint ownership: The property may be held in a joint ownership where on death of one owner the share of his property is transferred to the second owner. This ownership structure is quite common within spouses. The tax implication does not arise during death but capital gains tax may be payable if ownership is transferred during one's lifetime.

Gifting: Gift among family members due to love or care is one of the common ways to transfer property among family members. Grandparents gifting immovable property to grandchildren or parents gifting to their children are common. This mode of property transfer does not have tax implications when it is within blood relatives. However, there is a stamp duty payable since it is an immovable property transfer which has to be mandatorily registered. The rate of stamp duty varies among the states as stamp duty is a state jurisdiction. Some states have a lower concessional rate of stamp duty on gift of residential property or agricultural land to close relatives such as spouse and children.

Will/Inheritance: Will is written for transferring property to the loved ones after an individual's lifetime. Will can be revoked by the testator during his/her lifetime. So the beneficiaries of the Will get the ownership rights in any property only after the death of the testator. If there is no written Will, property transfers will take place through the Laws of Inheritance.

There are no tax implications on the beneficiaries if a property is received through Will or Inheritance. The registration of the property on his/her name is also not required but change in the mutation has to be applied to the concerned local civil authorities. If the inheritor decides to sell the property, then capital gains taxation will be payable where the cost of acquisition to the previous owner will be considered as the cost of acquisition of the property.

15.5.3 Estate Planning for Family Business

Estate planning for family business is equally important. Many researches show that only 70% of family businesses survive generation. The rest either disappear or are sold by the second generations. But family businesses make substantial contributions towards workforce and the gross domestic product. To protect family-owned assets, estate planning and succession planning needs to be effective.

The succession of family business is one of the critical elements. Issues arise when the business have to be transferred to the next generation. An effective estate planning strategy can sustain a family business across generations.

Here are a few estate planning strategies for a family business to deploy:

Rise to the challenge

Ownership transfer is quite difficult considering the difference between ownership and management succession. Estate planning is more effective if the assets are transferred early to the next generation. However, what hold family business to make this decision is losing control on the business and too early to give reins to the children.

There are different ways through which this challenge can be addressed. A limited partnership can be set up; or bringing ESOP into practice; or transferring non-voting stock to heirs. Giving the members, who are not involved in the business, non-voting rights or other equity interest, that does not provide them any control, can be an effective solution to share wealth with them. Members who actively work in the business can take over the management.

Partial sale

The financial needs of older and younger generations can bring challenges to any family business. The younger generations will be more aggressive and their needs are immediate. Contrary to this, the cash flow requirements for the owner are recurring in nature. With effective estate planning, both these requirements can be fulfilled. The proceeds from a partial sale of the business can provide enough liquidity to the owner, while the younger generation can be funded through cash flow from the residual business.

Creation of a Trust

There can be another option of creating a trust. By transferring business interest to a trust a fixed income stream can be generated for many years and the business can also survive across generations or it can be transferred to the owner's beneficiaries after a defined term. The structure of trust can be created based on family needs and the objective. One of the major advantages is that the control remains with the families during the trust term.

15.5.4 Forms of Family Business Ownership

There are different types of ownership in family-owned businesses. Most family business adopts one of these models of ownership. Still some family business will have hybrid structures. All of these models have their implications and trade-offs. Choosing which business model to adopt is one of the important decisions for any family-owned business.

There are 5 basic ownership structures in family business:

1. Owner-Operator: This is the simplest model where the ownership remains with the founder i.e. control is with one person (or couple). This type of model can be quite successful across generations. For this model to work, the challenge families face is deciding on the successor who can be fair and work towards the long-term sustainability of the business.
2. Partnership: These models are quite unique as only the leaders in the business can own it and also derive financial benefit. However, these models run with lots of challenges especially when succession among family partners who has unequal second generations succession. For example, a large business is owned by four brothers in partnership. Their partnership was a success as they contributed equal and drawn equal benefits. But the issue broke out in the third generation when one brother had only a daughter who was not even considered as the partner in the business. The brother confronted this and eventually the business was sold since they did not reach to any consensus.
3. Distributed: This is the third type of business model and may be an answer to the challenges faced in partnership model. In this model, the ownership in the family business is passed down to all descendants whether or not they work in the company. This type of model is the most sought after model for family business. Parents usually want all their children to inherit equally and, besides, most assets are wrapped up in the company. In the above case, if the family business has been run through distribution model then all members of the third generation could have become owners. The changes in the compensation structures would have rewarded those who are contributing to the business.

   Even then this business model has challenges to face. When there are differences between the family members, those who are contributing would often disagree with those who are outside the business especially in areas like compensation and distribution.
4. Nested Model: This model is quite attractive in ownership especially where difference arises. In this model, various family branches agree to own some assets jointly and others separately. Thus, small family ownership groups are nested in a larger one. This larger business is the one that runs the business as a profit making operation and distributes dividends to the branches. The branches then use the money to create their business portfolios. Though everything looks perfect, this model can face challenges if the core business is underfunded to finance the outside investments.
5. Public: The last of the model for family business where a portion of shares is publicly traded but the business is privately owned. The business is largely run by

professional managers and the owners are involved in a limited manner, mainly in decision making. This model is considered when there is a need of outside capital infusion or owners do not want to get involved in day-to-day running of the business. The larger challenge that the model faces is keeping the control when owners are not involved in running the day-to-day business.

Therefore, there is no one model that fits for all family business. To the owner's discretion, they can move to and fro between any of these models based on their business requirements. Of course, moving to a different ownership model involves big changes in governance, legal structures, and family relationships.

15.5.5 Valuation of Family Business

Future of a family business depends on many factors. Valuing the business is one of the important elements, which can be a significant asset of owner's estate. In many a situations valuing the business would be necessary especially when it gets transitioned to the next generations.

Every business owner desires the future succession of business to next generations to be an equitable solution. However, equal does not necessary mean 50-50. There will be members who would like to run the business and members who would not have interest.

Valuation of business can be quite challenging. Following methods are used to value a family business:

1. Capitalizing of Earnings: The business is valued based on the amount of cash flow available to the owner or investors. The overall profitability as well as the current and future capital needs of the business are considered for valuation.
2. Projected Earnings: Also known as discounted cash flow method. The business is valued based on the anticipated earnings. Reviewing the company budget and forecast of future earnings is helpful in determining the value. However, taking a long-term view like 5 years plus can be more challenging in deriving accurate value.
3. Market Approach: This approach analyses what value the market is offering to similar businesses. Though it may not be an accurate measure, but it can keep the valuation within a range giving business owners a direction in the value they should look at for their business.
4. Net Asset Value: Family business held for decade might have built assets like real estate or machinery. These in itself can be more than the operating value of business. Thus, in valuing a business, net asset value can be an important factor.

There are other actors like insurances for protecting risk and provisions for mitigation of risk like cash crunch. When a business is analysed on all these factors a fair value is derived.

15.5.6 Transfer of business and inter-generation wealth transfer

Inter-generational wealth transfer presents significant challenges for both families and their professional advisers. It is absolutely essential for families to obtain the correct advice regarding wealth transfer, so that they can minimise their exposure to unwanted liabilities such as capital gains tax or stamp duties on transfer. Meanwhile, adviser firms need to understand the scale and implications of the inter-generational wealth transfer trend in order to succeed in the increasingly competitive wealth management industry.

One of the challenges faced in inter-generational wealth transfer is the long court battle leading to the benefits of transfer to the next generation. The other challenge is the sustainability of the wealth when it is transferred to the next generation. If the tools are not right then there is a higher probability that the wealth transferred to the next generation may not last long.

There is a need of highly tax efficient and low cost tools to ensure time bound transfer. For efficient wealth transfer a proper estate planning is required. The interest of the beneficiaries has to be considered and the means through which the assets will be transferred has to be implemented well. Listed below are tools, used for inter-generational wealth transfer:

Succession laws- The three major inheritance laws – namely, The Hindu Succession Act, 1956 (applicable to Hindus, Buddhists, Jains and Sikhs), Mohammedan Personal Laws (governing inheritance of Muslims) and Indian Succession Act, 1925 (applicable to Christian, Jews and Parsis) play an important role in many situations when wealth has to be transferred to next generation.

Will- A will or a testament is a simple document for transfer for inter-generational wealth. It is easy to write and can be revoked at any time during the lifetime. However, a will as a document is more liable to be challenged and so inter-generational wealth transfer can delay. Planning everything through the will may not be the right estate planning option for everyone. Many a time delays in wealth transfer can reduce the importance or value of the assets involved. The generation for which the wealth is planned may not reap the benefits.

Gift – A gift deed is a highly efficient way of transferring immovable assets from one generation to another. The benefit it derives from the fact that the transfer happens immediately and does not have to wait for years. Though both movable and immovable properties can be transferred, the utility is more with immovable properties. Since the transfer is immediate and needs to be registered, the probability of litigation is reduced. Another important benefit derived is the taxation. Within blood relatives there is no tax liability making it a highly tax efficient tool for inter-generational wealth transfer. However, there are some negatives too. Since gift deed for immovable properties have to be compulsorily registered, there is cost involved in the form of stamp duty. This can be substantial if the value of assets is high. Secondly, the gift deeds are irrevocable and so once executed, one cannot change any terms or claim it back. Still the limitations and the cost associated to it may not be much when you consider the benefits it offers for inter-generational wealth transfer.

Trust - Family trusts have been utilized by many wealthy families to set up a cost effective and sustainable framework for inter-generational wealth transfer. In this option, the wealth is transferred to the trustees for the benefit of the final beneficiaries. There can be different structures, how a family trust can be created. The benefit a trust structure provides is the long-term sustainability of wealth with the real benefits being passed on to generations.

There will be other tools to support inter-generational transfers but each one of them has to be analysed on many factors to see the actual benefits they offer. The long-term sustainability still remains a challenge and that is where the value system of the family plays an important role. Families should involve heirs in important decision making, especially for financials, so that they understand the importance of sustaining wealth for the future. They should be provided with financial and moral support to fulfil their dreams. They should be provided continuous learning so that they value the time and effort that goes in creating wealth.

15.5.7 Joint Tenancy and Tenancy-in-Common

Joint and Tenancy both are form of ownership in an estate. This ownership rests in when two or more persons show an interest in holding the estate. At the time of purchasing the ownership, the interest in land has to be given.

Joint Tenants

In this form of ownership, the joint tenants have a right of survivorship i.e. post demise of the owner the interest of the deceased joint tenant will pass on to the survivor. This is not an ownership where joint tenant can leave a Will to pass on the interest to the legal heirs. Only in situations where the owner is the sole survivor joint tenant, he/she can pass the interest by writing in the Will.

One of the major conditions in Joint Tenancy is that all the joint tenants have to acquire their interest in the property at the same time and from the same transaction. The interest must be identical in nature and each tenant enjoys the equal right to the whole or part of the property. No tenant will enjoy exclusive right to possess any part.

Tenants-in-Common

In this form of ownership, there is no right of survivorship i.e. when a tenant-in-common dies, his/her land passes in accordance of the Will or as per the succession Act if there is no Will.

The tenant-in-common has an undivided share and interest in the property. There is an equal right to possession of whole property but no tenant-in-common has a right to possess any part exclusively. The tenant-in-common has complete ownership to deal with his share of the property as he deems fit. The share of tenant-in-common can also be unequal but if no share is mentioned then it is deemed to be equal share in the property.

15.5.8 Asset Protection

Any individual or business can run a risk of creditors making a claim on their assets. Asset protection are set of strategies, techniques and laws that are used to protect assets of individuals and business from such risks. A debtor who owns significant personal assets may choose to use asset protection to shield his/her assets in case of a payment default.

There is no one fit formula for deriving the asset protection strategies. Based on one's requirement the strategy is prepared for keeping the asset protected from any claim. Below are some of the factors to determine the degree of asset protection required:

- Identity of the Debtor: The sharing of properties between debtor and their spouse is critical. The property rights for assets can be transferred to the safer individual before any lawsuit is filed against his/her spouse. For businesses, the guarantor, i.e. the individual who guarantees the repayment, is liable to asset seizure in the event of any lawsuit against the entity. Any clause that obliges the individual to repay an organization debt will be instrumental in creditors seizing personal assets.

- Identity of the Creditor: This is important for asset protection planning. If the creditor is a powerful organization such as government then they have more power in seizing assets as compared to private lenders. Having an aggressive creditor will require strong asset protection strategies.

- Nature of the Claim: What kind of claim can arise will determine the type of asset protection required. For example, dischargeable claims (claims that can be written off or "injuncted" by the court) can be used to protect personal assets in the event of bankruptcy and require a relatively lower degree of asset protection.

- Nature of the Asset: What types of assets are not included in creditor claim can be a factor to determine the level of asset protection required. For example, PPF accounts of individuals cannot be attached to any claim by creditors; life insurance protects home owners from home getting seized in case of any default etc.

Asset Protection Strategies

1. Using Corporations, Limited Liability Partnerships (LLPs): Entities such as private limited LLPs, are protected by the law whereas individual owners are not held liable for the entity or organizations' debt. Having these types of structures for running a business can protect individual's personal assets from seizure in case of a lawsuit. But still the individual can be held accountable for any fraudulent transfers which delay debt repayments.
2. Using Asset Protection Trusts (APTs): A trust is a strong tool for asset protection. Asset that are part of trust are not legally entitled to owners but they can be beneficiaries holding equitable interest in the trust. This way the assets are protected from creditors. Having said that the asset protection trust has its own drawbacks. The major is that these are irrevocable and the settlor has to give away the control on the assets.
3. Transferring Property Rights: An individual can transfer or gift the legal ownership of the property to spouse, relative or a trusted friend to ensure the creditors cannot lay a claim on it. But this also possesses high risk if there is a dispute within family members or friends who will own the assets after the transfer. Even then the debtor may be held accountable for delaying defaulting on payments if the transfer of asset is funded by fraudulent ways.

15.5.9 Creditor Protection Period

Before 2016, the protection for creditors from the defaulting companies was considered to be weak. Many companies took massive debts and vanished away. For creditors the only recourse was to approach a civil court. The fight in these courts, for recovery of dues and enforcement and security, often took years. There was always a need to enact a law, which can hear creditors' woes and expedite these cases.

There have been laws related to creditor right such as, Winding and liquidation under the Companies Act, the Sick Industrial Companies Act (SICA). However, there was no special tribunal for creditors' cases. The first such tribunal was set up under The Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993, where cases regarding bankruptcy are dealt with, avoiding lengthy court proceedings. But this was also not quite effective as liquidation may take more than 10 years. So, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 came in, allowing secured creditors to seize the assets of the defaulting firms. With emergence of credit bureaus like CIBIL under the Credit Information Companies (Regulation) Act (CICRA), the environment of information about debtors changed. More powers came in for creditors.

Finally, in 2016 Insolvency and Bankruptcy Code (IBC), was enacted which was a turnaround for creditors. With defined timelines set for the proceedings, the IBC is proving to be an effective solution for both creditors and debtors (companies and individuals). Here are how the proceedings under IBC are timelined:

1. The financial creditors can file an application before the adjudicating authority.
2. After furnishing the information, within 14 days the adjudicating authority has to ascertain the default.
3. If default has occurred, the application is admitted. If default has not occurred, the application is rejected.
4. Adjudicating authority has to communicate the admission of the application to the financial creditors within 7 days of the admission and after that corporate insolvency resolution process takes place.

15.6 Trust - Characteristics and Regulations

15.6.1 Indian Trust Act, 1882

The Indian Trust Act, 1882 is the governing law of the Trust in India and is quite an acceptable law even internationally. One of the great characteristics of a trust model is that it hides the real owner from any public glare and he can still operate it with ease. The trustees are the one who becomes the public face for all practical purposes and carries out the task assigned to him without any fanfare.

Generally, Trusts are formed to fulfil any one or more of the following objectives:

1. For discharge of the charitable and/or religious sentiments of the author or settlor of trust in a way that ensures public benefit.
2. For claiming exemption under section 10 or 11 of the Income Tax Act, as the case may be, in respect to income applied to charitable or religious cause.
3. For the welfare of the members of the family and/or other relatives, who are dependent on the settlor of the trust.
4. For regulating affairs of the provident fund, superannuation fund or gratuity fund or any other fund constituted by a person for the benefit of employees.

Definition

A trust is a confidence imposed by one person on another, and enforceable in a court of law. Section 3 of the Indian Trust Act, 1882 defines a trust as under:

"A trust is an obligation annexed to the ownership of the property and arising out of a confidence reposed in and accepted by the owner or declared and accepted by him for the benefit of another or for another and the owner."

- The person, who reposes or declares the confidence, is called the author of the trust.
- The person, who accepts the confidence, is called the trustee.
- The person for whose benefit the confidence is accepted, is called the beneficiary of the trust.
- The subject matter of the trust is called the trust property or trust money.
- The beneficiary interest is his right against the trustee as power of the trust property.
- The instrument, if any, by which the trust is declared, is called the instrument of the trust.

Essential Elements of the Trust

The following are the basic elements for forming a trust:

1. There must be an author or settlor of the trust, who sets aside certain properties for the benefit of the beneficiaries.
2. There must be a trustee. A trustee is a person who manages the property of the trust for the benefit of the beneficiaries as laid down in the trust deed. The settlor himself may become one of the trustees.
3. There must be a beneficiary or beneficiaries.
4. The trust property is the subject matter of the trust.
5. The object of the trust must be specific.

As per Section 6 of the Indian Trust Act, the trust is created when the author of the trust indicates with reasonable certainty by any words or acts:

a) An intention on his part to create a trust
b) The purpose of the trust
c) The beneficiary
d) The trust property
e) And (unless the trust is declared by will or the author of the trust himself to be the trustees) transfers the trust property to the trustee

Coverage of the Indian Trust Act

Private/family trusts are governed by the provisions of the Indian Trust Act, 1882. However, the principles on which the provisions of the trust act are based on, can be applied to public trust as well. There are certain general provisions of the Indian Trust Act such as remuneration by trustees once they have accepted the role of the trustee or prohibition to delegate their office to any other person etc. can apply to the public trust too.

There are charitable or religious trusts, which are generally governed by the religious laws. For example, the Hindu charitable trusts or religious trusts are mainly governed by the provisions of Indian law. Also, several states have passed their own legislation to govern public trust, like Bombay Public Trust Act, 1950.

Advantages of a Trust

The trust offers many advantages and it can form the core of any estate planning objectives. These are:

1. A trust can be formed for the welfare of the family members and relatives dependent on the settlor.
2. A trust can reduce the probabilities of litigations.
3. A trust can administer income so as to accommodate the settlor's wishes with respect to charitable distributions.
4. A trust can preserve wealth over a lifetime by providing a plan for accumulation and orderly distribution among heirs.
5. A trust is an effective tool to gift money to minor or to provide for the care of elderly parents. A trust is also used by people to protect their future during times of incapacity.
6. A trust is a strong tax planning tool, as growth on assets transferred to a trust belongs to the beneficiary/ies.
7. Lastly, a trust avoids probate on properties transferred to it ensuring it is passed directly to the beneficiaries.

Disadvantages of a Trust

These include:

1. The structure may be complex.
2. The Trust can be expensive to establish and maintain.
3. The high cost of transfer in case of immovable properties, with variation in the rate of stamp duty payable across states.
4. There is no control of settlor over the properties transferred to the trust or gifted.
5. The powers of trustees are restricted by the trust deed.

15.6.2 Classification of Trust

Public Trust

A public trust Is created for the benefit of general public or a particular section of public. These types of trusts are generally set up as a charitable or religious trust. Temples, schools, hospital etc. can be categorised under public trust. Here the appointed trustees are responsible for managing the trust assets and ensuring that they are utilized only for their set objectives.

Private Trust

A private trust is created for the benefit of specific individual or families. The objective of these type of trusts is to protect family assets such as wealth or property and along with it provide funds for education or care for family members. The trust deed mentions the beneficiaries of such trust and the appointed trustees manage the trust affairs.

Revocable Trust

A revocable trust allows the settlor to retain control over the trust assets and have the option to modify or terminate the trust during their lifetime. These types of trusts are considered as alternative to Will. They do not protect assets as they can be withdrawn anytime from the trust. Also, under this structure the assets are not considered as given away and so they are taxed in the hands of the settlor. The terms of the revocation are written down in the trust deed. These terms can be like revocation after a certain number of years; or at a specific event say, child attaining 25 years of age; etc.

Irrevocable Trust

Contrary to revocable trust, an irrevocable trust is one in which the terms of the trust cannot be amended or revised until the terms or purposes of the trust have been completed. Section 77 or 78 of the Indian Trust Act specifies clearly that a trust can be revoked only when the Trust Deed contains an express provision giving the author the power of revocation. Any situation opposite to this is irrevocable.

Simple Trust

In a simple trust, the property is vested in one person upon trust for the benefit of another, and the nature of the trust neither being nor prescribed by the settlor is left to the construction of the law. In these kinds of trusts, the trustees have no active duties to perform. However, the beneficiaries have the right to be put in actual possession of the property and the right to call upon the trustee to execute conveyances of the trust property.

Specific Trust

A specific trust is formed for the execution of some special purpose and the trustee is not a mere depository of the estate, but is required to exert himself in the execution of the settlors' intention.

Oral and written Trust

A trust may be declared either orally or through an instrument in writing. A trust can be declared orally only where movable properties have to be settled. Such trusts are created by transferring the possession of the property with a direction to be held under a trust. But if immovable properties are to be settled then a written trust deed is required. Even though oral trust can be created, it is always advisable to have a written trust deed since enforceability of law is much easier then.

Implied and Express Trust

An implied trust is created when the circumstances of the situation suggest that the trust was intended, even if there was no formal trust deed. For example, if a person leaves a money to a friend for a specific purpose an implied trust is created.

An express trust is created by a formal trust deed that outline the trust's terms and conditions. The deed identified the beneficiaries, the trustees and the trust assets. The trustees manage the trust assets and distribute income to the beneficiaries according to the term of the deed.

15.6.3 Characteristics of Trust

Discretionary Trust

A discretionary trust is a trust where the trustees have full discretion over the application of income and corpus of the trust to the benefit of the beneficiaries. A discretionary trust gives no right to the beneficiaries to any part of the income of the trust property, but vested in the trust a discretionary power to pay him, or apply for his benefit such part of the income as they think fit.

Section 164 (1) of the Income Tax Act also defines the discretionary private trust. As per the provision if the income of the private trust is not specifically receivable on behalf of or for the benefit of anyone person or where the individual shares of the persons on whose behalf of/ for whose benefit such income or such part thereof is receivable are not determinate or unknown is considered as discretionary trust. Such trusts are taxed at maximum marginal rate, subject to certain exceptions. Thus, such a trust that is popularly known as a "discretionary trust" is chargeable to income tax at the maximum marginal rate (MMR), i.e., 30%.

However, there are certain exceptions to the above rule of charging the income of a discretionary trust at the maximum marginal rate. These exceptions are:

- None of beneficiaries is beneficiary under any other trust or has any other income more than threshold limit or otherwise chargeable at rate more than MMR.
- Such trust is sole trust created under Will for support and maintenance of dependent relatives.

Determinate Trust

A determinate trust or a specific trust is one where beneficiary or beneficiaries are clearly specified in the trust deed along with their specific or ascertained share in the property and income of the trust. In this type of the trust, the trustees do not have any discretion over the distribution of the income of the trust. The trustees have to apply the distributions as per the specific ratio defined on the trust deed. Further, as upheld in various court judgements, a trust would be treated as determinate trust even if the trust deed only provides for manner of computation of beneficial interest of each beneficiary (e.g. equally among all living family members or a case where the beneficial interest in the trust would vary due to birth and demise of family members) and not state the exact beneficiary interest of each beneficiary in absolute terms.

Under the Income Tax Act, Explanation 1 to section 164 explains the meaning of the term indeterminate as:

"*(i) any income in respect of which the persons mentioned in clause (iii) and clause (iv) of sub-section (1) of section 160 are liable as representative assesse or any part thereof shall be deemed as being not specifically receivable on behalf or for the benefit of any one person unless the person on whose behalf or for whose benefit such income or such part thereof is receivable during the previous year is expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and is identifiable as such on the date of such order, instrument or deed ;*

(ii) the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is received shall be deemed to be indeterminate or unknown unless the individual shares of the persons on whose behalf or for whose benefit such income or such part thereof is receivable, are expressly stated in the order of the court or the instrument of trust or wakf deed, as the case may be, and are ascertainable as such on the date of such order, instrument or deed."

Under determinate trust structure, the tax is levied on the representative assesses in accordance with the provision of Section 161 (1) of The Income Tax Act. The section imposes the liability to pay tax on the trustees, in respect of any income that he receives or is entitled to receive on behalf or for the benefit of any beneficiary under a trust.

15.6.4 Types of a Family Trust

Public and Private Trust

A public trust is one that is constituted wholly or partially for the benefit of public at large. A public trust can be of two types—Public Charitable Trust and Public Religious Trust. Both these types of public trust are of permanent and indefinite character.

Contrary to public trust, in private trust, the beneficiaries are defined and ascertained individuals. A private trust will come into existence when the settlor (owner of the property) with an intention to transfer the property to certain individuals (beneficiaries) instead vest the property with other persons (trustees) who are made responsible for transferring the benefits for the property to the beneficiaries.

The private trusts are governed by Indian Trust Act, 1882, while, public trusts are governed by Indian Trust Act, 1882 and Act of the respective states.

The private trusts are also of 2 types –

1. Private Discretionary Trust, where trustees have discretion and beneficiaries income is not defined or determinate.
2. Private Specific Trust, where the share of the beneficiaries income is determined in the trust deed.

Public cum Private Trust

A public cum private trust is a trust where a part of the income is applied for public purpose and a part goes to private person or persons. Such trust in respect of the portion of income going to private person is assessable as private trust and not exempted from income tax.

A public cum private trust may become a fully public trust if the income of the private beneficiaries renounce their rights, which one is entitled to do under the provision of Section 58 of the Indian Trust Act.

15.6.5 Family Trust versus Will

Family Trusts and Will are useful estate planning tools used for different purposes and both can work together to prepare an effective estate plan. The following are the importance differences between them:

1. A Will goes into effect only when one dies while a trust is effective as soon as it is created.
2. Through the Will, the testator directs who will receive property at death and he appoints a legal representative to meet this objective. In contrast, a trust can be used to begin distribution of property at death, before death, or after death.
3. A Will covers property that is in one's name and when one dies. A trust, on other hand, covers properties that are transferred to the trust.
4. A Will may pass through probate which means the court overseas the administration of the Will and ensures the Will is valid and property gets distributed as desired by

the deceased. A trust does not pass through a probate, therefore, no court overseas the trust.

5. A Will can become a public record, while family trust remains private.
6. A Will allows naming a guardian for minors, while a trust can be used to plan for disability or for saving taxes.

15.6.6 Parties to Trust

There are three parties to a trust deed:

1. **Author or Settlor of the Trust**: The person who settles certain property upon trust for the benefit of the beneficiary is known as author or settlor of the trust. As per section 3 of the Indian Trust Act, 1882, the person who reposes or declares a confidence in another person (trustee) in some property for the benefits of beneficiary is called the "author" or "settlor" of the trust. In a living trust, the settlor retains the right to amend, alter or revoke the trust. In some circumstances, two or more people may decide to create a trust and are collectively referred to as settlors. Generally, both people must agree to amend, alter or revoke the trust.

2. **Trustee**: The person in charge of managing the trust, who can be the same person who created the trust, is called a *trustee*. As per Section 3 of the Indian Trust Act, a "trustee" is a person who accepts the confidence reposed by the author, which gives rise to an obligation annexed to the ownership of the property. The trustee is responsible for the management of the trust assets. The trustee has legal title of the trust assets and the power to buy, sell, borrow against or transfer the trust assets. The trust agreement sets forth the rights, duties and obligations of the trustee.

3. **Beneficiary**: He is a person for whose benefit the confidence is reposed by the settlor and accepted by the trustee. The beneficiary is entitled to receive the benefits of the income and principal of the trust. There are several categories of beneficiaries—the primary beneficiary (the persons who are first to receive the benefits of the trust assets) and the residual beneficiary (sometimes referred to as a secondary beneficiary who are entitled to receive the benefits of the trust assets after the primary beneficiaries). In a private trust, the beneficiary and author may be the same person.

15.6.7 Hybrid Trust

A hybrid trust has the features of both determinate and discretionary trust. In this type of trust, the trustee pays a certain amount of the trust property to the beneficiary as provisioned by the settlor in the trust document. On the remaining property of the trust, the trustee have discretion as to how this to be paid to the beneficiaries.

15.6.8 Cancellation and Revocation of a Private Trust

The Indian Trust Act does not provide for dissolving a private trust. However, a private trust can only become extinct or be revoked, which also means dissolution. A trust becomes extinct when its purpose has been fuilfilled or it has become unalwful or it has become impossible to carry on its purpose due to the destruction of trust property or lastly if it has been revoked.

Revocation of a trust is, in general, at the pleasure of the testator/settlor. But there are other situations where a trust can be revoked.

1. If the beneficiaries are competent to contract and they have a consent that the existing structure of the trust is not beneficial any more, then with their consent a trust can be revoked.
2. If the trust is specifically created by the settlor for payment of his/her debts to the creditors.
3. When a trust is created by a non-testamentary document or even verbally, then there can be power reserved to the settlor for revocation of the trust.

15.6.9 Trust structure for Tax efficiency

The structure of a trust decides how its income is going to be taxed. There are various exemptions available under the Income Tax Act, which helps in reducing the tax liability for the trust.

Public Trust

The taxation of the charitable trust is governed by Chapter III of the Income Tax Act, that includes Section 11, 12, 12A, 12AA, 12AB and 13. There are various exemptions given to Charitable and Religious Trust due to the services they render to the nation.

Private Trust

Private Trust plays a very important role in succession and estate planning for the families. There are special provisions under the Income Tax Act, which governs assessment and taxation of income of a private trust. These sections are 160,161,162, and 164 of the Income Tax Act, 1961. Income of a private trust are either taxed at the income tax slab rate or at maximum marginal tax rate, based on the structure of the trust.

Taxation of Revocable Trust

- In case where an income is transferred (whether revocable or not) to a person without transfer of the corresponding asset from which the income arises, the income so transferred would be taxable in the hands of the transferor only. (**Section 60**)
- Where an income arises as a result of revocable transfer of asset, such income is to be taxed in the hands of the transferor. **(Section 61)**

- However, provision of section 61 would not apply where the trust is not revocable during the lifetime of the beneficiary and where the transferor derives no direct or indirect benefit from such income. **(Section 62)**

Assessment of Business Income of Trust

Sec 161-1(A) deals with the business income of the trust. As per the provision, if any part of the income of a trust includes income from profit and gains of a business, then entire income of the trust including any profits or gains from business will be taxed at the maximum marginal rate with some exemptions available. However, there is an exemption provided to charge this income at income tax slab rate instead of maximum marginal rate if following conditions are met:

1. The profits and gains are receivable under a trust which is declared by any person by Will;
2. Such profits are exclusively for the benefit of any relative dependent on him for support and maintenance;[55] and
3. Such trust is the only trust so declared by the person through the Will.

Clubbing of Minor Income

Sec 64 deals with clubbing of income of a minor child with the parents. As per the provision, the income of a minor child (with some exceptions) is included in the parents or guardian's income and taxable as per their income tax slab rate. The same provision is applied in a private trust created for the minors.

Any income of a minor child suffering from disability specified under section 80U, shall not be clubbed with the parent or guardian income. By transferring some of the higher taxed assets to the minor trust the liability of his/her parent or guardian can be reduced.

Taxation of Discretionary Trust

Discretionary trust is chargeable to income tax at the maximum marginal rate (MMR), with some exemptions available.

Trust for Deity

A trust could also be made for the benefit of one's deity. The Supreme Court of India in CIT v. Sri Jagannath Jew [1977] 107 ITR 9 (SC) held that where the Testator gave away his estate to the deity and created an absolute debutter thereof and obligated the managers of the debutter with responsibility to discharge certain secular or secondary behests including benefit to family members, their residence and transportation, the Deity was the legal owner of the whole estate and was liable to be assessed as such.

[55] "Relative" as per Section 2(41) of Income Tax Act means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual.

Tax planning is a very important element for a family trust. To reduce the tax liability the structure of the trust and income to the beneficiary should be planned while drafting the trust deed.

15.6.10 Trust Structure to align strategic objectives of the Settlor

The settlor has a limited but fundamental role in creating a trust. A trust does not exist until the settlor expresses an intention for the trust to exist and transfers the settled sum to the trustee. If a settlor is not independent to the trust, serious tax consequences arise.

A settlor role is limited to creating the trust and setting the objectives. Once the settlor moves the property to the trust, he/she can absolve himself from any of the issues related to the property that he has transferred. For example, once the settlor has transferred an immovable property to the trust and has conveyed effectively the title of the property to the trust, then thereafter the trust will be responsible for all the benefits accrue from the possession of the property. The trust has to discharge responsibilities like paying taxes, distribution of income etc. as illustrated in the trust deed.

A settlor may have various objectives of creating a trust.

1. A settlor may set up a revocable trust in order to exercise control over the assets and distribution of income and capital gains from the trust.
2. A settlor may set up an irrevocable discretionary trust in order to safeguard the assets amongst the claim of the creditors of the stocks and/or the beneficiaries or multiple trusts to achieve various objectives.
3. Creating the legal framework for family assets.
4. Bypassing probate process.
5. Safeguarding interest of family members including maintenance of member with special needs/disabilities.
6. Continuation of a business avoiding family disputes.
7. Exploring offshore business opportunities.

15.6.11 Trust Perpetuities

The trust cannot be perpetual. The Indian law restricts the perpetuity period within which gifts in a trust must vest, or the period during which trust income can be accumulated. No transfer of property can operate to create an interest, which is to take effect after the lifetime of a person living at the date of such transfer, and the minority of some person who comes in existence at the expiration of that period, and to whom the interest created is to belong when he or she reaches 18 years of age.

However, the exception to this rule against perpetuity relates to transfers of property for the benefit of the public in advancement of religion, knowledge, commerce, health, safety or any other object beneficial to mankind.

Except for charitable bequests, a bequest in which the vesting of the property is to occur after the lifetime of one or more persons will not be valid. Further, subject to the exceptions prescribed under statute, the accumulation (either wholly or partly) of any income from property is not allowed for a period longer than the lifetime of the transferor or 18 years from the date of transfer (whichever is later). Similarly, if the Will directs that income arising from property can be accumulated (wholly or in part) during a period longer than 18 years from the death of the testator, this direction will (subject to exceptions) be void to the extent that the period during which the accumulation is directed exceeds this period, and at the end of the 18-year period, the property and the income will be disposed off.

15.6.12 Trust as a Pass-through entity

A pass-through entity is a medium through which any income or any transaction flows. The term "Pass Through" denotes the transparency in the end result of the transaction, the point of destination of the transaction being somewhere else and not getting obstructed in any manner by the conduct through which it flows. A trust structure completely fits into the definition of pass-through entity where the settlor and beneficiaries does not come under public glare.

Explanation of pass-through entity:

"A flow through entity (FTE) is a legal entity where income "flow through "to investors or owners, i.e., the income of the entity is treated as income of investors or owners. Flow through entities is also known as pass through entities".

A private trust does not have a separate legal identity, and is essentially a pass-through entity, which is created to transfer assets held by one person (Settlor) to another person (Trustee), who holds the assets in trust for the benefit of a specified set of individuals (Beneficiaries). Such type of trusts essentially helps in the consolidation of all key business and personal assets of the business families in a single vehicle.

In a private trust, the receipts by the trust/trustee on behalf of the beneficiary are not taxable. What is taxable is the income of the beneficiary. The liability to pay the tax is on the trustee but in a representative capacity. So under income tax provisions, the trust has been given the pass through status by the nature of tax liability.

15.6.13 Stamp Duty and Capital Gains Tax on asset transfer

Under Indian Stamp Act 1899 (Central Stamp Act), stamp duty is levied on the instrument of transfer. The power to levy stamp duty is divided between centre and state government. States have right to adopt the Central Stamp Act with or without modification.

The stamp duty on trust is dealt in Central Stamp Act (Schedule 1) and as illustrated below:

Article 58 deals with settlement under the trust structure. Under this article, stamp duty is levied on instrument of transfer i.e. the trust deed. Hence stamp duty is payable when the trust deed is registered. Since stamp duty is a state matter, the actual stamp duty is decided by the state Stamp Act. In general, the stamp duty is levied in the transfer deeds i.e. trust deed and so when there is distribution of assets to beneficiaries no stamp duty is applicable.

Whenever an immovable property is settled in the trust, the stamp duty is levied. However, this provision applies when the immovable property is transferred during the lifetime of the settlor through a registered document as per the Registration Act, 1908. Contrary to this, any settlement of property in the trust through Will does not attract stamp duty.

Stamp duty is one of the considerations while deciding when one should transfer the property to a trust. Transferring within the lifetime can lead to major cost if the value of the property is much higher than expected. But provision of the same property will ensure there is savings of the cost by the settlor. A settlor too enjoys no stamp duty while settling any property to the trust.

The other major consideration under transfer of asset is applicability of capital gains. In general course when there is a transfer of assets from one person to another person, it attracts capital gain tax liability. The trust being a pass-through entity enjoys the benefit of no capital gains in certain situations.

Sec 47 (iii) of the Income Tax Act exempts transferor from capital gain tax for any transfer of capital under an irrevocable trust. The same is not true when the trust is a revocable trust i.e. any transfer to the revocable trust is subject to capital gains tax. If the trust is testamentary, i.e. executed on death of the settlor, as part of the Will then the transfer is as per the Will and so is exempt from capital gains.

15.6.14 Offshore Trusts

Offshore trust has been an important estate planning tool for high net worth families. Exploiting offshore business opportunities, cross border movement of family members and acquisition of interest in other countries are some of the reasons where offshore trust-like structures are planned.

These are types of trusts that are formed outside India and under the laws of other countries. These have similar trust structures like others, with three or more participants viz the author, the trustees and the beneficiaries. Any of the three principal protagonists can be based out of different country.

India places no restrictions on offshore trust having non-resident as trustees or beneficiaries in the Indian trust. The residency of an offshore trust is determined by the trust law under which the trust comes into existence. However, this residency criterion is restricted to only the non-tax attributes of the trust.

In the case of revocable offshore trust, where the settlor has been granted powers to claim assets, any income derived by the trust is treated as settlor’s income and so taxable in his hands as if directly arisen to him. In case of irrevocable offshore trust, certain considerations have been given:

1. If all beneficiaries in the offshore trust are Indian residents then the trustee is taxed as a representative capacity.
2. If there are both resident and non-resident beneficiaries in an offshore trust then only the Indian beneficiary is taxed for the distribution they have received from an offshore trust and the trustee has no representative role in India.
3. If the offshore trust has any partial control in India then it can be taxed as association of persons.

Under the current laws, the Indian resident beneficiaries are required to report their interest in an offshore trust in the information return filed along with the income tax return.

15.6.15 Distributable Net Income

Distributable net income (DNI) of a trust is that portion of the income, which is allotted to the beneficiaries. The DNI identifies how much income has to be distributed between trust and the beneficiaries. This income receivable by beneficiaries then becomes the source of his/her income.

The distributable net income is considered as the income of the beneficiary and so the amount is taxed to the beneficiaries. A distribution is a payment made from a fund, an estate or income of trust, to a beneficiary. In India, there is no maximum cap on the income distributed to the beneficiaries. Therefore, the entire income, after deducting expenses, exemptions and fees, can be distributed to the beneficiaries.

Similar like individuals, a trust needs to file its income tax returns. The income generated by the trust are either taxed at entity level or at beneficiary level. The taxation depends on the structure of the trust – whether it's a determinate or discretionary.

One of the purposes of determining DNI is to avoid double taxation, especially in cases where it may be taxed at beneficiary level. The formula to calculate DNI is:

Distributable Net Income (DNI) = Taxable Income - Capital Gains + Tax Exemptions

If there is a capital loss, it is added to the above formula, replacing the capital gains.

In order to calculate the taxable income, one needs to add the interest income, dividends, and capital gains, and then subtract any fees and tax exemptions. Unlike the DNI calculation, capital gains are added in the taxable income formula, while capital losses are subtracted.

Example

Trust ABC reported a total income of Rs 1,00,000. A total of Rs 50,000 of this was interest income, while the remaining Rs 50,000 was from dividends. Fees charged by the trustees amounted to Rs 20,000, while the trust realized capital gains of Rs 20,000 and it got an exemption of Rs 20,000. Calculate the Distributable Net Income (DNI) of Trust ABC.

Using the above formula, the trust's taxable income is Rs 80,000 i.e.

Rs 50,000 (interest income) + Rs 50,000 (dividends) + Rs 20,000 (capital gains) –Rs 20,000 (fees) – Rs 20000 (Exemptions)

We can then use this taxable income figure to calculate the DNI, which would be Rs 80000

Rs 80,000 (taxable income) – Rs 20,000 (capital gains) + Rs 20000 (Exemption)

15.7 Guardianship

Guardianship is the legal process of establishing who will step-in should a person become unable to care for other person, he/she was earlier taking care for. This includes an elderly parent or other family member, or an adult who is unable to care for themselves. Once a legal guardian steps in, under whatever the circumstances are, he/she would assume all the responsibilities of care i.e. food, housing, education, medical and other basic needs.

A guardian’s responsibilities will depend on whether they are a Guardian of the Person or a Guardian of the Estate.

- A Guardian of the Person is responsible for custody and care of the person.
- A Guardian of the Estate is responsible for managing the financial affairs.

A legal guardian has many responsibilities, but in general they fill the role of a caretaker for the person who are under guardianship in the event the existing caretaker can no longer do so himself. This could be the case after he/she passed, or in the event he/she becomes either mentally or physically incapacitated. Guardians have fiduciary duties to act on behalf of those they are put in charge of such as making decisions regarding healthcare, legal matters, financial issues etc, and they must agree to always act in their best interest.

Types of Legal Guardianship

There are three major kinds of legal guardianship:

- Natural Guardian – A natural guardianship is one where no legal provision is required, as it falls by birth. Parents are termed as the natural guardians of their child until the child reaches the age of legal maturity i.e. 18 years.
- Guardian appointed by Court – Individuals (with no parents alive), who are incapacitated by birth, accident or any other eventuality and unable to take responsible decisions, need a guardian. The courts have the power to appoint a guardian who can take decisions on the individual’s behalf.

- Testamentary Guardian – When a guardian is appointed under the provisions of Will, it is termed as testamentary guardianship. This type of guardianship is mostly seen in case of minor children. The appointed guardian manages the child's affairs within the limits set in the Will.

The person applying for legal guardianship has to be a citizen of India of more than 18 years of age. In absence of parents or legal heirs, anyone concerned with the welfare of the special needs can apply for a legal guardianship.

A legal guardianship is primarily required to make financial and personal decisions on behalf of other individual. In case a person is more than 18 years of age and is incapacitated to take his/her own decisions, only a legal guardian is then allowed to make any financial decisions on his/her behalf. Some of the financial decisions that require legal guardian are:

1. Managing Bank Accounts- Opening a bank account, managing transactions in existing account etc.
2. Making any investments and managing the same. - Investments in financial securities such as mutual funds, shares, bonds, debentures etc.
3. Availing loans and/or concessions from governments for the disabled person.

15.8 Powers of Attorney

A Power of Attorney (POA) is an instrument by which a person may formally authorize another person to act on his behalf or as his agent on all matter or for a specific transaction or particular types of transactions. There are two parties to a POA – Donor and the Donee. Both the parties to the POA should have attained majority, be of sound mind and competent to contract.

A Power of Attorney is among the most important instrument used in Estate Planning. In India, it was widely used for transfer of properties through sale or succession of lease and other means. The power of attorney is also frequently used in the event of a principal's illness or disability, or when the principal can't be present to sign necessary legal documents for financial transactions. A power of attorney can be used by or on behalf of others.

Definition

A power of attorney is a legal document, which gives one person (the agent or the attorney-in-fact) the power to act for another person (Principal). To be applicable in the court of justice, the power or the authority has to be expressively or impliedly conferred to do that which without an authority it could have been done. The agent is also known as the Attorney and under Attorney-in-fact the person is given power of attorney specifically for an act or generally for series of acts to represent him in any business or act by virtue of that power of attorney.

Here are a few definitions of Power of Attorney, according to various sources:

Halsbury's Laws of England - A Power of Attorney is a formal instrument by which one person, the donor of the "power", confers on another, the donee, power to act on the behalf of the donor in the performance of specified act or classes of act or generally.

Osborn's Concise Law Dictionary, 7th Edition – A Power of Attorney means a formal instrument with which one person empowers another to represent him, or act in his stead, for certain purposes, usually in the form of a deed poll, and attested by two witnesses. The donor of the power is called principal or constituent; the donee is called attorney. The latter is not entitled to exercise such power for his/her benefits.

Section 1A of The Powers of Attorney Act, 1882 – Power of Attorney includes any instrument empowering a specified person to act for and in the name of the person executing it.

Section 2(21) of Indian Stamp Act, 1899 - Power of attorney includes any instrument (not chargeable with a fee under the law relating to court-fees for the time being in force) empowering a specified person to act for and in the name of the person executing it.

A power of attorney is usually in the form of deed, sometimes under a seal as necessary for certain purpose.

Parties to Power of Attorney

There are 2 parties to Power of Attorney:

1. Donor
2. Donee

In accordance with Section 183 of the Indian Contract Act 1872, any person, who is 18 years and above and is of sound mind can employ an agent. However, married women can execute Power of Attorney, even if they are minors.
As per Section184 of the Indian Contract Act, even a minor can be a donee. However, a lunatic person cannot be appointed as an Attorney, as he is not capable of exercising the Will of his principal.

15.8.1 Types of Power of Attorney

A power of attorney can be classified into three forms:

1. General Power of Attorney
2. Special Power of Attorney
3. Special Power of attorney for registration

General power of attorney

In this document, the authorization of power to the agent is broad. The agent entitled to act generally, or in more than one transaction.

Special power of attorney

Here the mandate authorization is narrow. The agent is restricted to act only for a specific/particular matter or transaction for the principal. The authority of the agent expires on the completion of the transaction.

Special power of attorney for Registration

A document of attorney, which authorizes the attorney to present a document for registration in case of a document executed by the principal but not registered by him is known as Special Power of Attorney for registration.

Important rules for construction of Power of Attorney are:

1. It should be construed.
2. The operative part of the deed is controlled by recitals.
3. The general words do not construe general powers but are limited to the purpose for which the authority is given.
4. The document should be construed so as to include all medium powers necessary for effective execution.
5. Where authority is to do particular act followed by general words, the general words are restricted to what is necessary for the performance of the particular acts.

15.8.2 Revocation of Power of Attorney

A principal has right to cancel power of attorney whenever he wants to do so. There are certain conditions laid down in Sec 201 of the Indian Contract Act, 1872 for revocation of power of attorney. These conditions are:

- When the principal revokes the authority to the agent.
- When either of the principal or the agent is declared insolvent by the competent court of authority.
- If the power of attorney holder renounces his powers.
- If the business for which power of attorney was granted gets completed.
- On the death of either principal/donor or agent/done.

Sec 202 of the Indian Contract Act states that if the agent, in a principal-agent relationship, has an interest in the agency then, the power of attorney cannot be revoked without the consent of the agent. Section 206 of the Indian Contract Act provides that a sufficient notice of any revocation or renunciation must be given to the principal or agent otherwise the damages, if any, result from such situations must be made good by them.

Person who can authenticate

Under section 85 of the Indian Evidence Act, the following persons are authorized to authenticate the power of attorney:

1. Notary Public
2. Any court, Judge or Magistrate
3. Indian Council or Vice-Consul
4. Representative of Central Government

Registration

A power of attorney does not require compulsory registration under section 17(1)b of the Registration Act. The rationale behind is that in POA, the donor by execution of the document only authorises the donee to act on his behalf. The POA itself does not create, declare, assign, limit or extinguish any right title or interest to or in immovable property. The execution of deed of power of attorney has been held valid in law and subject to provision of the act, is not compulsory registrable. A power of attorney is not compulsorily registrable unless it creates an interest in any immovable property i.e. charge in favour of donee.

Stamp Duty

Article 48 of the Indian Stamp Act specifies the stamp duty payable on documents. The power of attorney has to be stamped, either with engrossed stamp or by affixation or impressing a label on it by a proper officer. Stamp Duty being a state matter, the rate at which the stamp duty is payable is decided by the state where the POA has to be registered. Though the stamp duty is payable, the legal nature of POA is not defined by it but by the content.

15.8.3 Limits of Power of Attorney holder

There are limitations to the power the agent has in a POA.

1. The agent cannot make decision outside the terms of the legal document. In doing so he/she can be held liable for any fraud or negligence.
2. The agent cannot make changes in the document or hand over the control to someone else who has not been designated in the POA.
3. The agent loses the control once the principal dies.

Even though these limitations restrict the powers of the agent, there are a few situations where they may have unlimited controls. For example, when managing finances on behalf of principal, the agent can sell the properties for an undesirable price or can make poor investment decisions. The agent may not choose the medical facility or care which the principal would have preferred if the principal have fallen ill. Lastly, the agent can end the agreement at any time if s/he no longer wants the responsibility. This is the risk involved in POA and so the principal should decide whether to limit the POA to specific situations.

15.8.4 Power of Attorney executed abroad

Non-resident Indians (NRI), even by staying outside India can execute power of attorney for matters related to banking, property or any other matter which have to be done in India. They do not have to be present in India. POA can be made in favour of family member, relative or friend who resides in India permanently.

The power of attorney executed outside India has to be authenticated/ attested by the Indian Embassy, Consulate and notarized where it has been executed. Once the POA is authenticated, the person in whose favour POA has been executed has to be authenticated/ embossed before the concerned lawful authority by paying necessary charges.

The power of attorney executed before and authenticated by a foreign court, judge or magistrate will be considered as validly executed and authenticated. Power of attorney if executed out of India by a person will continue to operate even when the person returns to India at the time when the documents are presented for registration.

15.9 Caselets

Case 1: *Mr. PQR has died leaving behind a Will. He was a Hindu, unmarried and so did not have immediate family. He has 2 living brothers and sisters and 2 of his brothers and sisters are deceased. The deceased brothers and sisters have spouses and children. He has made a Will giving 1/5 share of his estate to one brother who is alive, and 1/5 share each to a nephew and niece of one his surviving sisters.*

Question 1: *Can any of his living brother /sister contest or spouse or children of deceased brother/sister contest the Will?*

- *Option 1: Brother*
- *Option 2 Sister*
- *Option 3 Spouse or children of deceased brother/sisters*
- *Option 4 All of the above*

Explanation:

On filing the **probate proceedings, the court will issue notices to all legal heirs for filing objections, if any. During this stage, the children and spouse of deceased brother/sister can also object to the grant of probate. If any of the legal heirs do not appear before the court then it will be presumed that such person has no objection to the grant of probate.**

There are specific grounds on which a Will can be challenged in the court of law. The court will see this and then will decide the acceptance of the objection. In general, a no objection can also be sought from the non-inheritors during the preparation of the Will.

During probate, also non-inheritors can give the no objection which will be more beneficial.

Question 2: *Who will be called when Mr. PQR's Will goes for a probate process?*

On filing the probate proceedings, the court will issue notices to all legal heirs for filing any objection if any. During this stage the children and spouse of deceased brothers can also be called for any objection to the grant of probate.

Case 2: Rajesh created a Trust for his parents who are senior citizens, both with equal beneficial interest. Father gets a fixed monthly pension of Rs. 40,000 while mother gets a net annual value of Rs. 3.80 lakh from her let-out property. The trust property has generated a net annual value of Rs. 5.40 lakh in FY 2024-25-.

Question: Find the tax payable (New Tax Regime) by the trustee as a representative assessee for AY 2025-2026 after taking into account cess @4%.

Options:

a) *58485*
b) *75000*
c) *24180*
d) *62343*

Solution:

Particulars	**Amount (Rs.)**
Net Annual Value of trust property in FY 2024-2025 to be shared equally by Rajesh's father and mother [A]	540,000
Income of Rajesh's Father	
Pension Income (Salary Income) [B = Rs. 40000 * 12]	480,000
Total Income [C = A/2 + B]	750,000
Standard deduction [D]	75,000
Assessable Taxable income [E = C – D]	675,000
Tax payable by Rajesh's Father (trustee) as a Representative Assessee	
So, trust income above pension of Rs. 4.8 lakh up to Rs. 6.75 lakh is to be taxed at 5% [F]	**9750**
Income of Rajesh's Mother	
Net Annual value of Rented Property [G]	380,000
Assessable Taxable income [H = A/2 + G]	650,000
Tax payable by Rajesh's Mother (trustee) as a Representative Assessee	

Particulars	Amount (Rs.)
So, trust income above Rs. 3.80 lakh up to Rs. 6.50 lakh is to be taxed at 5% [I]	**13,500**
Total Tax on Assessable Income of The Trust [J = F + I]	23,250
Cess @4% [K = 4% * J]	930
Total Tax payable by the trustee as representative assessee [L = J + K]	**24,180**

CHAPTER 16: BASICS OF BEHAVIOURAL FINANCE

LEARNING OBJECTIVES:

After reading this chapter the reader should know:

- Difference between Behavioural Finance versus Standard Finance
- How do individuals make decisions?
- Different types of biases
- Fusion Investing
- How Behavioural Finance explains Market Anomalies

16.1 Behavioural Finance versus Standard Finance

Behavioral Finance is the study of the way in which psychology influences the behavior of market participants, both at the individual and group level, and the subsequent effect on the financial markets. It is a part of Behavioural Economics, which deals with biases and cognitive errors affecting investors' investing behaviour. Behavioural Finance makes an attempt to explain the gaps and market anomalies, which are not explained by standard finance theories and frameworks.

Standard finance theories and models are based on certain assumptions. The key assumptions are:

- Investors are rational
- Investors are risk averse
- Investors are self-interested utility maximizers
- Investors update their belief, as new information comes in
- Investors have access to all available information

The real life behaviour demonstrated by investors is far from what is assumed in traditional finance models. Some of the examples we observe in daily life are:

- Instead of diversifying, investors hold concentrated portfolios.
- Instead of making a rationale choice of risk-return, investors show distinct greed and fear over the course of time.
- Instead of accepting randomness with winning investments, investor attribute it to their skills.
- Investors getting confused between a good company and a good stock.
- Investors preferring domestic companies (home bias) because they perceive the risk is low due to familiarity of the company.

In other words, the real life investors are very different from those in standard finance theory. Following table points out salient points about Standard and Behavioural Finance:

Standard Finance	Behavioural Finance
Economics at core.	Psychology at core.
Investors are rationale and process new information without any bias. Efficient market hypothesis describes random movement in prices.	Biases (decision making behaviour) guide investments. Every new information is seen with the same lens. Collective bias or herd mentality is responsible for sharp movements.
Decision making is rule driven and consistent under different scenarios.	Decision making is inconsistent given the experience, recency or loss aversion.
Risk-return trade-off is the foundation of investment.	Loss aversion is basis, which in turn makes an investor over-sensitive to losses.
Decision is rational based on detailed analysis.	Decision is ad-hoc based on thumb rules.

Nobel laureates Daniel Kahneman (2002) and Richard Thaler (2017) are credited for bringing the Behavioural Finance to the forefront and attempt to integrate it with Standard Finance.

16.2 How do individuals make decision?

As discussed above, the process of decision making, as envisaged under standard finance theories and the way investors make decision in reality, is different. Investors do not act like rational actors as suggested under standard finance theory. They show limits to rationality.

16.2.1 Bounded Rationality

Most investors have limited (i) time or (ii) information or (iii) ability to comprehend complex information at the time of decision making. Similarly, when selecting one of the many options requires meticulous analysis incorporating all the available information, people get confused. They settle with an option (possibly sub-optimal), which seems to be satisfactory and sufficient based on quick analysis governed by 'thumb rules'. In other words, instead of optimizing as suggested by theories in finance, investors "satisfice" (seemingly satisfactory and sufficient).

Bounded Rationality, therefore, is the cognitive limitation of mind where in absence of time or complete information, decision making favours satisficing solution (satisficing is combination of satisfactory and sufficient) instead of an optimal (or maximising) one. It is important to note here that bounded rationality is not irrational decision making, but rational decision making under certain boundary conditions.

Nobel laureate Herbert Simon (1978) is credited with the concept of Bounded Rationality. The steps involved in decision making according to Bounded Rationality are:

- Process only the information which is manageable (as against processing all information)
- Rule of thumb or quick approaches are applied while processing, and
- Select solution which is Satisfactory and Sufficient (Satisficing solution)

Bounded Rationality, therefore, falls between Rationality (decision making process where all available information is processed to arrive at the optimal solution) and intuition (experience).

16.2.2 Prospect Theory

Daniel Kahneman and Amos Tversky (1979) introduced Prospect Theory. It describes how individuals make choices in situations where they have to decide between alternatives that involve risk (e.g. financial decision) and how individuals evaluate potential losses and gains. Prospect theory considers how prospects are perceived based on their framing, how gains and losses are evaluated, and how uncertain outcomes are weighted.

There are two phases of making choices:

- an early phase in which prospects are framed
- a subsequent phase in which prospects are evaluated and chosen

The framing phase consists of using heuristics to do a preliminary analysis of the prospects. In the second phase, the edited prospects are evaluated and the prospect of highest perceived value is chosen.

To summarize, premises of Prospect Theory are:

- Choices are evaluated relative to a reference point (which is their well-being);
- People are risk-averse about gains (realizing it early) but risk seeking about losses (holding to them longer)
- Monetary losses hurt more than monetary gains

16.3 Categorization of Biases

Individuals as well as institutions process information based on their experiences and preferences, which in psychology are referred to as biases. Such intentional errors often lead to systematic favouring.

While people desire to follow rational decision making which involves evaluating all the options with all the information available, individual biases hold them from doing so. Rational decisions often get circumstantial. While it is impossible to be unbiased, maintaining discipline and checklists can help in mitigating them.

Broadly, investing biases fall into two main categories:

- Emotional biases – based on feeling or emotions
- Cognitive errors – based on faulty cognitive reasoning

16.3.1 Emotional Bias

At the time of decision making, individual’s feelings or emotions occur spontaneously which is a result of deep-rooted personal experiences. It is important to note that emotional bias does not mean making errors. On the contrary, it has an underlying of being protective and taking suitable and comfortable decision for oneself.

Following are some of the emotional biases:

Loss Aversion Bias: People prefer taking chances for avoiding losses. However, they do not like taking chances with certain gains. Losses are significantly more powerful than gains. Shefrin and Statman (1985) proposed Disposition Effect for holding “losers” too long and selling “winners” too early. They noted that "people dislike incurring losses much more than they enjoy making gains, and people are willing to gamble in the domain of losses." Consequently, "investors will hold onto stocks that have lost value and will be eager to sell stocks that have risen in value."

Stereo Typing Bias: Investors, while dealing with uncertainties, look for representative characteristics and base their decisions on the general perception about those characteristics. For example, belief that a high-profile manager is equals to a better managed company and that makes good investments, is a stereo type bias.

Overconfidence Bias: Overconfidence Bias is a bias in which people demonstrate unwarranted larger faith in their own intuitive reasoning, judgments and cognitive abilities. Most people rate themselves better than average in their skills, expertise, knowledge etc. With illusion of superior knowledge, overconfidence bias is intensified when combined with self-attribution bias, where people confuse brain with bull market. Overconfidence often results in underestimating the losses. This unwarranted confidence often leads to sub-optimal decisions in investments. Overconfidence leads to misguided conviction and often blurs the difference between skill and luck. Even the feedback loop in such cases further fuels the overconfidence bias and investor easily gets swayed away from risk-return trade off principles. Some of the observed behaviour of overconfidence biases is visible in portfolio concentration, sector or country bias, excessive trading, sticking with loss making stocks in sectors which investor believes to know more etc.

Endowment Bias: Endowment Bias is an emotional bias in which people value an asset more when they hold rights to it than when they do not. When the investor believes that the stock(s) she owns is more valuable than others and when the market will recognise, she would make superior returns. Endowment bias has two attributes: valuing ownership and loss aversion. It has been generally observed that inherited stocks are rarely sold even if they do not fit into the overall investment strategy.

Status Quo Bias: When an individual has second thoughts or want to avoid regrets in decision making, often left with taking no decision at all and maintaining status quo. Status Quo Bias is closely linked to Regret Aversion bias in which people tend to avoid making decisions that will result in-action out of fear that the decision will turn out poorly.

Regrets have two dimensions –

- actions that people take (Error of commission)
- actions that people could have taken (Error of omission)

Regret is more intense due to error of commission than omissions and hence people prefer the status quo. Sometimes complexity in understanding or execution also leads to status quo. A simple nudge, as explained by Richard Thaler, resulted into employees enrolling for pension plans, which otherwise had poor enrolment only due to status quo bias.

16.3.2 Cognitive Errors

Cognitive errors are statistical, information-processing or memory errors that cause a person to deviate from rational behaviour. Cognitive errors result from reasoning based on faulty thinking whereas emotional biases result from reasoning influenced by feelings. Depending on thumb rules instead of doing exact calculations, is an example of cognitive bias. People are less likely to make cognitive errors if they remain vigilant. Unlike emotional bias, cognitive biases can be considered as short-cut approach to decision making where one avoids going through the pains of analysing and evaluating options. Also at times, it can be factually incorrect.

Mental Accounting: Mental Accounting Bias is an information processing bias in which people treat one sum of money differently from another equal-sized sum, based on which mental account the money is kept. The concept of 'mental accounting' was developed by Richard Thaler in 1999.[56] People code, categorize and evaluate economic outcomes by grouping their assets into any number of non-fungible mental accounts.[57] When people keep mental accounts, they treat money less fungible than it really is, which often leads to sub optimal decisions. People link their spending to specific budgets. They are willing to take more risk with money that is perceived as windfall gain or lottery winnings. People end up spending their non-regular income extravagantly. This treatment of salary income differently from tax refunds and bonus amount etc., leads to irrational spending.
Thaler recommended that people should consider money as fungible and treat all money the same, regardless of its origin or use.

[56]According to the theory of mental accounting, people treat money differently, depending on factors such as the money's origin and intended use, rather than thinking of it in terms of the "bottom line" as in formal accounting (Thaler, 1999).
[57] Fungibility is the fact that all money is interchangeable and has no labels.

Investors think about their wealth as if it consists of various buckets e.g. retirement fund, children's education fund and marriage fund etc. It mentally helps them to keep a tab on it. This often results into selection of assets under each bucket, which could have been avoided by the investor on a broader level if they consider their overall investments together and work towards optimizing portfolio.

Framing: Framing Bias is an information-processing bias in which a person answers a question differently based on the way in which it is asked (framed). An investor's choices are influenced by how information or facts are presented. Different types of framing approaches have been identified, including risky choice framing (e.g. the risk of losing 10 out of 100 lives vs. the opportunity to save 90 out of 100 lives), attribute framing (e.g. beef that is 95% lean vs. 5% fat). As can be seen, the outcomes of both the choices in both the scenarios is the same, however people mostly opted for second options in both the scenarios.

Prospect theory describes how individuals make decision when they have to decide between choices that involve risk (e.g., financial decisions) and how individuals evaluate potential losses and gains. Prospect theory considers how prospects (alternatives) are perceived based on their framing, how gains and losses are evaluated, and how uncertain outcomes are weighted.

Investors have to rise above of this bias while filling risk tolerance questionnaire for the purpose of determining the risk appetite as that would influence the asset allocation choices greatly. Also at the time of evaluating the performance of the portfolio, decision making frames may lead to sub-optimal judgments.

Anchoring: Anchoring bias occurs when people rely on pre-existing information when they make decisions. Most of the investors anchor their investments around some initial information, which they so heavily rely upon. This makes all the subsequent information to be seen in light of the anchor information. For example, during negotiations, it is often observed that the first price mentioned becomes anchor price during the entire negotiations. Making a judgement about where the prices of the stock could be on the basis of its past performance, is another example of anchoring.

Choice paralysis: The availability of too many options for investment can lead to a situation of not wanting to evaluate and make the decision. Too much of information also leads to a similar outcome on taking action.

16.4 Fusion Investing

Fusion investing, integrate traditional and behavioural paradigms to create investment strategies. It attempts to combine fundamental analysis with behavioural finance. On one hand, fundamental style of investing suggests that stock price is the discounted value of future cash flows and. all company related information is fully reflected in the stock price.

On the other hand, we observe volatile stock prices in short-term, which show that short-term price is influenced by collective behaviour of investors or traders.

In the words of Benjamin Graham, the father of value investing style, “in the short run the market is a voting machine, and in the long run it is a weighing machine” tells the stark combination of biases. Fusion investing can be seen as integration of both the voting and the weighing machines. Fusion investing, therefore, combines value-growth phenomenon from fundamental investing and the momentum effect from behavioural finance.

Portfolio manager ought to understand that inefficiencies exist in market and Fusion Strategy is an attempt to exploit this inefficiency. Broad steps involved in identifying stocks, which comprise both value-growth and momentum are:

- **Step I:** Identify stocks (from the universe of stocks) which are showing promising on value terms i.e. Price Earnings (P/E), Price to Book Value (P/BV), Price to Sales (P/S).
- **Step II:** Filter from step I, stocks which are fundamentally strong i.e. profitability, leverage and efficiency parameters (e.g. Piotroski Score) on historical as well as based on earnings forecast. [58]
- **Step III:** From the stocks, which are filtered after step II, identify stocks, which are showing strong momentum i.e. price uptrend.

These stocks, which are left after step III shall qualify to be part of the portfolio. While, intuitively it seems to be a good strategy, market data is insufficient to conclusively prove the same. Moreover, momentum, which is captured through step III, is short-term phenomenon and would require rebalancing at a much shorter periodicity as compared to the value-growth parameters. This means transaction cost will play a critical role in determining overall return on the portfolio. Taxation policy also needs to be considered in such a rebalancing process.

16.5 Behavioural Finance explains Market Anomalies

Market anomaly, in simple terms, is departure of stock price from its expected value given its fundamentals. A market anomaly may be present if a change in the price of an asset or security cannot be explained by the current relevant information known in the market or to the release of new information into the market. Empirical research show that the actual returns deviate from the expected return as required by Capital Asset Pricing Model (CAPM) or other asset pricing models. These gaps are referred to as anomalies. Anomalies

58 The Piotroski Score is a discrete score between 0-9 that reflects nine criteria used to determine the strength of a firm's financial position. The Piotroski score is used to determine the best value stocks, with nine being the best and zero being the worst. The Piotroski score was named after Chicago Accounting Professor Joseph Piotroski, who devised the scale, according to specific aspects of company financial statements.

appear, disappear and reappear quite randomly. It is expected that such anomalies disappear as others would try to profitably exploit them. While some anomalies do disappear, there are others, which persist for much longer period.

Behavioural biases may cause investors to make systematic mistakes when they invest, and those mistakes create anomalies in the market. Biases like overconfidence make investors underestimate risks. Under self-attribution bias, Investors tend to take credit for successes and blame others for failures. They follow information that supports their beliefs and disregard conflicting information. These biases may cause investors to trade too often. Disposition effect where investors hold on to losers longer and sell winners faster explain momentum in prices.

16.6 Behavioural Finance explains Bubbles and Crashes

Charles Kindleberger in his book 'Manias, Panics and Crashes (1978)' describes **Bubbles** as a sharp rise in asset price in a continuous process with the initial rise generating expectations of further rises and attracting new buyers, generally speculators, interested in profit from trading rather than investing for long term. In his view, psychology is as important as finance and economics explaining such behaviour in the financial market.

When an asset is mispriced, rational arbitrageurs would exploit it to their advantage and soon such mispricing will disappear. However, arbitrageurs suffer from synchronisation problem (in order to attain a coordinated selling strategy) besides difference in individual incentives to time the market during bubble and crash phases. This leads to persistence of bubbles for a longer period.

Some of the notable examples of bubbles and crashes are: Dutch Tulip mania of 1630s, South Sea Bubble of 1729-30s and Tech bubble of 2000s. Kindleberger noted that even Isaac Newton tried to ride the South Sea Bubble in 1720. He got out of the market at GBP 7,000 after making a profit of GBP 3,500, but decided to re-enter it, thereby losing GBP 20,000 at the end. Frustrated with his experience, he concluded, "I can calculate the motions of heavenly bodies, but not the madness of people".

Historically, bubbles have often emerged during structural change in productivity e.g. Railway Boom, Electricity Boom, Technology Boom etc. Bubbles typically begin with a justifiable rise in asset price (due to new product, new idea, disruption etc.) given rise in productivity or prosperity. Such productivity or prosperity changes expectations about future. Early investors, in such themes, make very high returns, which start attracting new investors. Cheap borrowing costs fuel bubbles as more new buyers chase the asset. Bubble phase takes share prices to unrealistic levels and analysts come out with 'new age' theories to justify such prices. Some of the potential reasons for such bubbles are:

Liquidity: Liquidity chasing stocks lift stock prices. Cheaper borrowing and investing further fuels. Those who are sellers, invest in other assets, which create a vicious cycle of price rise. And each round raises price to next level.

Celebrity status: Celebrity status is self-fulfilling. Media promotes celebrity and its cult. Likewise, media promoted tech-boom. This resulted into disconnect between value and price (or say, earnings capability and value).

Momentum: Research suggests that investors extrapolate uptrend (or downtrend) with their positive (or negative) feedback on asset price. If this extrapolative expectation is widespread, it results in herd trading. Herd trading overcomes rational interventions (by rational investors who take contrary position knowing that asset is mispriced and needs to get corrected).

Illusion of Control: Familiarity, access to information, active involvement etc. give rise to the illusion of control over the stock price. This leads to believing that investor can forecast prices and will be able to sell before others, hence avoid losses.

Keith Redhead (2008) writes in the report that speculative bubbles are more likely to emerge where:

- Proportion of inexperienced traders is high;
- Uncertainty about true value is high;
- Investment promises small chance of profit but the amount of profit is very high;
- It is possible to finance purchases by borrowing money;
- Short selling is difficult (difficult to borrow shares for the purpose of selling them).

Crashes entail similar processes like bubbles, but in reverse order and everyone comes to sell at the same time. Negative news, change in opinion, liquidity crunch, return to fundamental pricing models etc. makes every investor or trader to liquidate their position before anyone else. Such jostling among investors/traders to get rid of stock leads to crashes.

CHAPTER 17: BEHAVIOURAL FINANCE IN PRACTICE

LEARNING OBJECTIVES:
After reading this chapter the reader should know:
- Role of emotions in goal setting
- Nudging the investor to behave better
- Role of investment adviser in management of client emotions

17.1 Role of emotions in goal setting

People react differently to stress and strain of modern life. Some people over-eat, some people over-exercise or oversleep and some people go on a shopping spree when they are emotionally charged.

This behaviour initially provides a good feeling leading to relief from stress and allowing the person to escape the immediate pressure. In moderation, such behaviour is good to take the sting out of the emotional stress. However, normally such behaviour will rarely stay moderate and will invariably lead to more stress in the future, as the economic impact of the behaviour kicks in.

An Adviser's role lies in understanding these impulses and providing ways to make sure that such behaviours are self-limiting.

- **Retail therapy - stress buster or escape mechanism?**

Retail therapy is referred to as a situation where a person goes on a shopping or buying binge in order to reduce the stress. This situation can be tackled by undertaking some specific steps. The first step would be to make the client conscious about the fact that this behaviour is induced by stress.

The second step is to have a specific budget for indulging in such behaviour. In extreme cases, a separate account may be opened by the client, where the budgeted amount is kept and money is spent only from there (either through debit card or withdrawing cash). The important thing is to have a self-imposed brake on the behaviour which comes from an in-built expense limit. This is one reason why using credit card is not a good thing for most people as credit cards induce impulsive spending.

- **Too many and too frequent transactions**

"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or grass grow. If you want excitement, take USD800 and go to Las Vegas... It is not easy to get rich in Las Vegas, at Churchill Downs, or at the local Merrill Lynch office." said Economic Nobel Laureate Paul Samuelson. Humans have an action bias or the need to do something whereas investing requires long term consistency and long years of patience. The action bias combined with other biases induces clients to have too frequent and too many transactions, which has the impact of turning an investment activity into a trading activity.

The only way to induce the client to curb such a tendency is to prime them in advance with the benefits of patience and long term investing.

- **Chasing past performance**

Some investors simply invest in last year's winners – whether it be asset classes or specific security within an asset class. When Gold goes up they invest in Gold and when equity markets rise they shift their investments to Equities. This behaviour, based on the performance in the immediate past, assumes that what did well last year will do so this year as well. Most asset classes have a cycle of growth and decline and there is an inevitable reversal to the mean. Investing based on past performance is like driving a car by looking in the rear view mirror. It is bound to crash at some point or the other.

A pre-decided asset allocation policy that has upper limits for each asset class makes sure that overexposure to a specific asset class is avoided. Similarly, a maximum exposure limit within a given asset class will do so for a specific security as well.

- **Home country bias**

Most investors prefer to invest in the securities available in their home countries due to familiarity with the markets, the companies involved as well as the regulatory environment. The benefits of diversification which come from investing into asset classes which do not move in tandem with the local securities is thus denied to them.

Apart from lack of familiarity and comfort, there are many other reasons for investors not investing in overseas securities or asset classes:

a) Lack of knowledge on opportunities outside their home country
b) Home country laws may prevent domestic investors from investing outside India
c) Lack of access and high cost of access where available
d) Compliances with the tax and other laws of the other country, which at times may be in conflict with the local laws
e) Lack of expert advice on such asset classes as the advisers themselves are not well versed with such asset classes

In the context of India, the Liberalised Remittance Scheme (LRS), wherein a resident of India can remit upto USD 250 thousand for investments outside India, has spurred the interests of Indian investors in foreign securities. Local mutual funds have also come out with many schemes that allow investors to conveniently invest in Indian mutual fund schemes that in turn invest in overseas securities across the globe. Global indexes such as S&P 500 and Nasdaq 100 are also available as Indian mutual fund schemes now.

The antidote for Home country Bias is for the advisor to get educated on the benefits and opportunities in global investing and, in turn, educate their clients about the same.

- **Buying insurance for tax saving**

At least 3 generations of Indians have grown up on a diet of buying insurance for tax saving alone. As a result, they end up buying the wrong kind of insurance and/or completely inadequate insurance.

The module on Insurance Planning makes it clear that appropriate and adequate insurance is the first step of any good financial plan. Tax saving through the insurance premium just reduces the cost of a good insurance plan. In an investment cum insurance product, it enhances the return from the plan, which in turn be compared with an equivalent tax saving investment. For example, the ultimate return from investing the same sum of money into buying a term policy plus investing in Public Provident Fund will invariably beat the ultimate return from buying an endowment life insurance product for the same amount of investment.

The only cure for this bias to buy insurance purely for the sake of tax saving is to highlight the need for adequate pure insurance products and the poor returns from investment cum insurance products as compared to equivalent investments combined with pure insurance plans.

- **Too much diversification or highly concentrated portfolio**

Many investors have so many securities in their portfolio that they find it impossible to manage their investments. Diversification does not come from buying many securities. It can come simply by buying an index representing that asset class. For example, if the investor buys 2 large cap funds, 4 mid-cap funds and 6 small cap funds for diversifying his risk, he can achieve similar diversification by simply buying a top 500 shares index fund.

Conversely, some investors will have their entire investment portfolio in a couple of specific securities or investment without adequate diversification across asset classes or securities within a specific asset class.

The Adviser has a vital role to play in finding the golden mean for an appropriately diversified investment portfolio for their clients, based on the clients' risk profile, available resources and time frame for goals.

- **The impact of framing on risk tolerance questions**

Different investors react differently to specific triggers. A specific client would prefer knowing what can be gained by following a specific investment pattern, whereas another client would like to know what is lost by not following it. In both cases, the Investment Adviser is justifying the recommended investment pattern but the framing is very important if the client has to be convinced. There are specific tools available that report on what kind of framing a client prefers. That diagnosis is to be reconfirmed through discussions with the client.

- **Overconfidence and dilution in risk management**

Human beings are prone to overestimate their talents and abilities. A simple example is surveying employees in a work place as to which percentile of relative performance they put themselves in. Most employees will put themselves anywhere around 60-75 percentile, with a rare individual claiming to be below the 50 percentile. The aggregate of these employee perceptions is an arithmetical impossibility. Thus, the truth is individuals consider themselves as better than they really are.

In the arena of investments, this manifests itself in terms of attributing skill to their bets that have come off which can lead to overconfidence on the part of the client. For example, the client made a small bet on an individual stock that became a 5X in 3 months' time. This may only partly be due to skill and mostly be luck. In any case, even if it is skill, it is doubtful if it is consistently repeatable.

Based on overconfidence arising from the bet that materialised, the client may be tempted to over-invest in an asset class or security and modify the existing asset allocation. In times like these, the Investment Adviser's influence can stand between the client and her big mistake.

17.2 Nudging the investor to behave better

Laying down advance ground rules that the client buys into allows the Investment Adviser to have built in nudges for the client to follow. For example, having ground rules on when to do asset re-balancing become an inbuilt nudge for profit booking when the asset prices go high and buying into an asset class when its prices are low.

17.3 Role of Investment Adviser in management of client emotions

The Investment Adviser plays a very important role in the management of client emotions. Most clients will go through a cycle of greed and fear. Over exuberance can goad the client into taking rash decisions or overarching fear can freeze the client. In both circumstances, the Investment Adviser plays a vital role in making sure that the client continues on the journey that has been planned in advance. The cool and calming influence of the Investment Adviser is a must as the client wrestles with the emotional upsurge caused by the market cycles.

Another area where the Investment Adviser plays an important role in managing client emotions is in prioritizing client goals where resources are not sufficient for meeting all goals. For example, assume a client has requirement for funding her daughter's higher education and her retirement. The client is emotional about making sure her daughter gets the best possible education even if it means compromising with her retirement, which may be some distance away, and hence is not that important for her immediately.

The Investment Adviser can point out the extent of compromise that is being done for a vital goal like retirement and also point out alternatives like partial education loan for the higher education which can then be paid by the daughter from her earnings after completion of the education course. This kind of objective role played by the Investment Adviser is crucial in assisting the clients to take the right decisions even as they are highly emotional.

Module 11: Behavioural Finance I Module-end Questions

1. Anchoring bias occurs when people rely on _________.
    a. **pre-existing information when they make decisions**
    b. collect all available information when they make decisions
    c. do not make use of any information when they make decisions
    d. make forecast about the future prospects

2. According to _____________, people treat money differently, depending on factors such as the money's origin and intended use.
    a. Capital market theory
    b. Modern portfolio theory
    c. Prospect theory
    d. **Mental accounting theory**

3. The following is the premise of Prospect Theory:
    a. Choices are evaluated relative to a reference point (which is their well-being);
    b. People are risk-averse about gains (realizing it early) but risk seeking about losses (holding to them longer)
    c. Monetary losses hurt more than monetary gains
    d. **All of the above**

4. Daniel Kahneman and Amos Tversky (1979) introduced the ___________.
    a. Capital market theory
    b. Modern portfolio theory
    c. **Prospect theory**
    d. Mental accounting theory

5. Behavioural finance differs from the standard model of finance because Behavioural finance:
    a. Precludes the impact of investor psychology.
    b. **Includes the impact of investor psychology.**
    c. Accepts the Efficient Markets Hypothesis.
    d. Rejects the idea of market anomalies.

MODULE 12: COMPREHENSIVE INVESTMENT ADVICE

CHAPTER 18: RISK PROFILING FOR INVESTORS

LEARNING OBJECTIVES:

After reading this chapter, the reader should know:

- Risk profiling for investors
- Risk profiling approach
- Parameters for risk profiling
- Role of risk profiling in asset allocation

18.1 Risk Profiling for Investors and Risk Profiling Approach

A simple example to understand how different people have different appetite for taking risk:

A person is offered a chance to play a game in which a coin will be tossed. The person pays Rs. 1,00,000 for one chance to play the game. The person can choose to call “heads” or “tails”. If the coin comes on the person’s choice he wins Rs. 2,10,000

As per statistical analysis of the above game,

If he guesses right – he stands to win Rs. 1,10,000 – (Prize amount of Rs. 2,10,000 less original stake of Rs. 1,00,000) – at 50% probability the expected win amount is Rs. 55,000

If he guesses wrong – he stands to lose the original stake amount of Rs.1,00,000 – at 50% probability the expected loss amount is Rs. 50,000

The total expected win amount is Rs. 5,000 (Rs. 55,000 expected win less Rs. 50,000 expected loss)

Though few people agree to play the game, most other people do not agree to play the game, simply because of the fear of losing Rs. 1,00,000 if they do not select the right choice. More people agree to play the game as the winning amount is increased to say Rs. 2,50,000 or Rs. 3,00,000 indicating that the net payoff amount needs to be much higher for some.

This indicates the innate willingness of a person to take a risk in order to get a payoff. Willingness to take risk has more to do with the individual's psychology than with their financial circumstances. Some clients will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues.

Whether the actual risk is taken or not is also affected by both, the resources that a person has (more the available resources, more are the chances that the risk will be taken) and the need to take the risk (more important the payoff is for the person, higher are the chances that the risk will actually be taken).

Some of the factors and their influence on risk appetite are given in Table 18.1.

Table 18.1Factors affecting risk appetite

Factor	Influence on Risk Appetite (assuming all other factors remaining the same)
Family Information	
Earning Members	Risk appetite increases as the number of earning member increases.
Dependent Members	Risk appetite decreases as the number of dependent member increases.
Life Expectancy	Risk appetite is higher when life expectancy is longer.
Personal Information	
Age	Lower the age, higher the risk that can be taken.
Employability	Well qualified and multi-skilled professionals can afford to take more risk.
Nature of Job	Those with steady jobs are better positioned to take risk.
Knowledge about markets	A person who is better informed about markets is in a better position to take market risks, than someone who is ignorant about them.
Psyche	Daring and adventurous people are better positioned mentally, to accept the downsides that come with risk.
Financial Information	
Capital base	Higher the capital base, better the ability to financially take the downsides that come with risk.
Regularity of Income	People earning regular income can take more risk than those with unpredictable income streams.

Clients' financial risk tolerance - attitudes, values, motivations, preferences and experiences, is measured with a risk profile. The risk profile questionnaire helps in understanding the risk tolerance levels of a client. Risk tolerance is the assumed level of risk that a client is willing to accept. Risk tolerance is typically measured using questionnaires that estimate the ability and willingness to take risks. The responses of investors are converted into a score that may classify them under categories that characterize their risk preferences.

18.2 Parameters for Risk Profiling

Some risk profiling tools are available on websites. These typically revolve around investors answering a few questions, based on which the risk appetite score gets generated.

Some of these risk profile surveys suffer from the investor trying to "guess" the right answer, when in fact there is no right answer. Risk profiling is a tool that can help the investor; it loses meaning if the investor is not truthful in his answers.

Some advanced risk profilers are built on the responses to different scenarios that are presented before the investor. Service providers can assess risk profile based on actual transaction record of their regular clients.

While such tools are useful pointers, it is important to understand the robustness of such tools before using them in the practical world. Some of the tools featured on websites have their limitations. The investment advisor needs to use them judiciously.

Consider the following 3 grade classification:

I. Conservative Investors

- Do not like to take risk with their investments, typically new to risky instruments.
- Prefer to keep their money in bank accounts or invest in safe income yielding instruments.
- May be willing to invest a small portion in risky assets if it is likely to be better for the longer term.

II. Moderate Investors

- May have some experience of investment, including investing in risky assets such as equities.
- Understand that they have to take investment risks in order to meet their long-term goals.
- Are likely to be willing to take risk with a part of their available assets.

III. Aggressive Investors

- Are experienced investors, who have used a range of investment products in the past, and who may take an active approach to managing their investments.
- Willing to take on investment risk and understand that this is crucial to generating long term return.
- Willing to take risk with a significant portion of their assets.

SEBI (Investment Advisers) Regulation 16 requires that the Investment Adviser (IA) has to ensure that client's risk profiling is done so as to ensure that the advice or recommended investment product is suitable for the client. For this purpose, the Investment Adviser is required to ensure that:

- It obtains relevant information such as age; investment objectives and time frames over which such objectives need to be achieved; resources available like income, existing investments, innate ability to take risks and details of loans.
- It has a process to assess a client's innate willingness and ability to take risks including the client's ability to incur and absorb losses. Such process needs to be objective and not geared towards giving undue weightage to certain factors and less weightage to other factors.
- Tools or questionnaires, if used for risk profiling, are fit for the purpose and any limitations of such tools are identified and mitigated to the extent possible.
- Any questionnaires used need to be fair, clear and not misleading; and should not be vague or use difficult/complex language; and should not contain leading questions.
- Risk profile of the client needs to be done before any investment advice is provided No Free trial can be offered without communicating such risk profile to the client and obtaining clients consent on such risk profile.
- Client information on which the risk profiling is based and the clients risk profile needs to be updated periodically. Whilst the periodicity can vary, a risk profile review is recommended on special events, such as change in family composition, change in income/expenses or change in assets/liabilities.

18.3 Role of Risk Profiling in Asset Allocation

18.3.1 Investor's risk profile with the asset allocation

'Don't put all your eggs in one basket' is an old proverb. It equally applies to investments. The discussions earlier in this workbook highlighted how the risk and return in various asset classes (equity, debt, gold, real estate and others) are driven by different factors. This implies that return from asset classes at any point in time will not be the same in direction or magnitude but will vary depending upon the impact of the prevalent economic conditions on their performance. For example, during the recessionary situation in 2007-09, equity markets in many countries fared poorly, but gold prices went up. Thus, an investor who had invested in both gold and equity earned better returns than an investor who invested in only equities. The distribution of an investor's portfolio between different asset classes is called asset allocation. An efficient asset allocation is one that includes asset classes that have low or negative correlation so that the returns from the investments do not rise and fall together. Being invested in multiple asset classes, allows the portfolio to benefit from the higher returns of the asset class that finds the prevalent economic conditions favourable to their performance, and reduce the risk of being invested only in an asset class that has performed poorly.

Some international researches suggest that asset allocation and investment policy can better explain portfolio performance, as compared to selection of securities within an asset class (stock selection).

Three types of asset allocations are often referred to viz. Strategic, Tactical and Dynamic Asset Allocation.

Strategic Asset Allocation is allocation aligned to the financial goals of the individual. It considers the returns required from the portfolio to achieve the goals, given the time horizon available for the corpus to be created and the risk profile of the individual.

Profiling the investor with regard to their ability to take risks, need for growth, income or capital protection, and investment horizon is done using questionnaires and other tools to determine the optimal allocation between growth-oriented and income-oriented assets.

Strategic asset allocation is a long term plan that is reviewed periodically for continued relevance to the individual's goals or situation. A change in these fundamentals may alone trigger a change in the allocation. The allocation to an asset class will not be increased on the basis of expected performance of the asset class. This implies that while the portfolio is protected from errors in asset performance forecast, at the same time the portfolio will not benefit from a higher exposure to an asset class that is performing well. The portfolio will be rebalanced periodically so that the allocations to various asset classes that may have changed over time due to their performance, is brought back to what was originally envisaged.

Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market. An investor who decides to go overweight on equities i.e. take higher exposure to equities, because of expectations of buoyancy in industry and share markets, is taking a tactical asset allocation call.

Tactical asset allocation is suitable only for seasoned investors operating with large investible surpluses. Even such investors might like to set a limit to the size of the portfolio on which they would take frequent tactical asset allocation calls. The major portion of the portfolio would be aligned to a strategic asset allocation.

Dynamic Asset Allocation uses pre-defined models to allocate assets among different asset classes. Triggers for re-allocation may be defined in terms of asset class valuations or portfolio performance. Dynamic asset allocation removes the subjective element from asset allocation decisions.

18.3.2 Model Portfolios and their application[59]

Since investors' requirements from their investments vary, a single portfolio cannot be suggested for all. Investment advisers often work with model portfolios – the asset allocation mix that is most appropriate for different investment objectives, return expectations, risk appetite levels and liquidity needs. The list of model portfolios, for example, might read something like this:

- **Young call centre / BPO employee with no dependents (with high risk profile):** 50% equities/ diversified equity schemes (preferably through SIP); 20% sector

[59] The asset allocations given here are for education purpose. Please take professional advice on the allocation that is most suitable to you or that is most suitable for clients while giving advice.

funds; 10% gold ETF, 10% diversified debt fund / fixed deposits, 10% short-term debt funds and liquid schemes / savings bank account / current account.

- **Young married single income family with two school going kids (with moderate risk profile):** 35% equities/ diversified equity schemes; 10% sector funds; 15% gold ETF, 30% diversified debt fund / fixed deposits, 10% liquid schemes and short-term debt funds / savings bank account / current account.
- **Single income family with grown up children who are yet to settle down (with conservative risk profile):** 35% equities/ diversified equity schemes; 15% gold ETF, 10% gilt fund, 20% diversified debt fund / fixed deposits, 20% short-term debt funds, liquid schemes / savings bank account / current account.
- **Couple in their seventies, with no immediate family support (with conservative to moderate risk profile):** 15% diversified equity index scheme; 5% gold ETF, 35% debt oriented hybrid fund/MIS/SCSS, 30% diversified debt fund / fixed deposits, 15% liquid schemes / savings bank account / current account.

As the reader would appreciate, these percentages are illustrative and highly subjective. The critical point is that the Investment Adviser should have a model portfolio for every distinct client profile. This can then be tweaked around based on specific investor information.

Thus, a couple in their seventies, with no immediate family support but very sound physically and mentally, and a large investible corpus might be advised the following portfolio, as compared with the previous model portfolio:

10% equities/ diversified equity scheme; 15% diversified equity index scheme; 10% gold ETF, 30% debt-oriented hybrid fund, 25% diversified debt fund/ fixed deposits, 10% liquid schemes/ savings bank account/ current account.

- **Portfolio Construction**

The risk tolerance level of the investor is considered while constructing an investment portfolio.

An individual creates a portfolio of investments to meet their various goals. The investments selected have to balance the required return with an appropriate level of risk. Assets and investments differ on their features of risk, return, liquidity and others.

An investor will have multiple, differing requirements from their portfolio depending upon the goals they are saving for. They may need growth for long-term goals, liquidity for immediate needs and regular pay-outs to meet recurring expenses. No one investment can meet all the requirements for growth, liquidity, regular income, capital protection and adequate return. The investor will have to create a portfolio of securities that has exposure to different assets, which will cater to these diverse needs.

Investment objectives and their suitable investments

- Growth and appreciation in value: Equity shares and equity funds, Real estate, Gold

- Regular income: Deposits, Debt instruments and debt funds, Real estate
- Liquidity: Cash, Bank deposits, Short-term mutual fund schemes
- Capital preservation: Cash, bank deposits, Ultra-short term funds

Consider the impact of the following investment decisions:

- Jayesh invests only in real estate. He has an urgent need for funds but finds that he is not able sell the real estate or take a loan quickly enough.
- Kamal leaves all his money in his savings bank account, which earns a very low interest. He finds that he is not able to accumulate enough money required to meet his future expenses.
- Latika invests all her money in equities. She finds that the value of her investment keeps fluctuating and she is not sure if she will have the required funds when she needs it.
- Harmeet has most of her money in gold jewellery. She finds that she is not able to generate any income from her investments to meet her regular monthly expenses.
- Gayatri has invested her money in bank fixed deposits. She is not able to manage her expenses from the interest she receives because the interest is fixed but her expenses keep on increasing.

The risk to the investors in the cases described above comes from the concentration of their portfolio in one category of investment. When equity markets go down, Latika will find that her entire investment portfolio has gone down in value. If the real estate markets crash, Jayesh's investment value will decline, as will Harmeet's investments when the price of gold falls. Instead, if they were holding some portion of the portfolio in different assets, a fall in one will be cushioned by a rise in another, since not all asset values rise or fall together. This process of dividing the portfolio among different asset classes so that the overall portfolio's return is protected from the effect of a fall in one or few assets is called asset allocation. Each asset comes with its own focus feature, such as growth, income generation or liquidity, and together the assets in the portfolio will cater to the different needs of the investor.

The asset allocation that is suitable for a person will depend upon their specific situation. For example, a person close to retirement will have a higher allocation to safer investments such as debt and lower allocation to equity. On the other hand, an individual in the high income period whose goals are far away will prefer to earn higher returns with assets such as equity rather than lower risk assets with lower returns. The suitable asset allocation is a function of the investment period available to the investor and their ability and willingness to take risk. Asset allocation leads to different asset categories being included in a portfolio. This brings diversification to the portfolio. Diversification means having a combination of investments in a portfolio in such a way that a fall in the value on one or few will be made up by other investments that are doing well. The benefit of diversification will be available to a portfolio only if the selection of investments is done with care so that they do not rise and fall together. Asset allocation and diversification reduces the risk of loss in a portfolio and stabilizes the returns that the portfolio generates.

- **Review and Rebalancing**

The investments made for the goals will require to be reviewed periodically. The review is necessary to answer the following questions:

- Are all the goals still relevant?
- Are the goals on target for achievement in the required time-frame?
- Are the investments performing as expected?
- Do the investments need to be changed if it is no longer suitable for the goal?

A periodic review will help identify problem areas and enable early corrective actions. For example, if an investment has not generated returns as expected, the goal may remain under-funded. The investor can take the call to save more for the goal or to divert funds from some other less important goal, if required. These decisions can be made at the right time only when a review throws up the problem.

Rebalancing the portfolio involves modifying the exposure to different asset classes in an investor's portfolio. Ideally, a portfolio should be rebalanced so that it is aligned to the risk and return requirements of the investor and reflects any change in their needs and situation, and not to benefit from short-term movements in asset prices. For example, Jayant has been saving for the education of his children for the last 8 years by investing in equity. The goal has to be met after 4 years now. Jayant would not want to leave the funds that have been accumulated in equity any more since there is a risk that the fluctuation in equity values will affect the amount that he has accumulated so far. Jayant would be ready to move the funds to less riskier investments at this stage.

Review of the portfolio of investments has to be done at pre-fixed intervals (ideally at least once a year) as part of the financial planning process.

CHAPTER 19: COMPARISON OF PRODUCTS ACROSS CATEGORIES

LEARNING OBJECTIVES:

After reading this chapter, the reader should know:

- Sources of performance data
- Portfolio performance and investment alternatives
- Alternatives among other products

19.1 Performance data for investment products

Performance data for various investment products is now widely available. In some cases, it is mandated by SEBI such as for Mutual Funds and Portfolio Management Services. There are many information aggregators who collect this mandatorily disclosed data and provide value added services for comparison across various schemes. This information is easily available on various websites. In many cases, it is free though some value added services may be on paid basis.

19.2 Attribute portfolio performance and Evaluation of investment alternatives

All investment instruments are compared across 3 broad parameters: Risk, Return and Liquidity. Given below are comparisons of some investment instruments.

19.2.1 Equity Linked Savings Scheme (ELSS) V/s Other Tax Saving Instruments

Sr. No.	**Parameter**	**Equity Linked Savings Scheme (ELSS)**	**National Pension System (NPS) - Tier 1**	**Fixed Income Tax Saving Instruments (e.g.: PPF and Tax saving bank FD)**
1	Description	Equity Linked Saving Scheme invests exclusively in Equities.	Mutual Fund like pension scheme, that allows varying degree of investments in equity (max 75% for selected subscribers), Government securities, Corporate bonds and Alternative Investments (max 5% for certain subscribers).	Public Provident Fund (PPF) is a government scheme and tax saving Bank Fixed Deposits (FD) are offered by all banks.
2	Risk of loss of Invested Capital	High, as the entire investment is in equities.	Moderate, as it does allow a high percentage of investment in equity and some investment in Alternative Investments.	PPF – Low, as it is a sovereign risk Tax saving Bank FD – moderately low, as it is like any other bank FD

Sr. No.	Parameter	Equity Linked Savings Scheme (ELSS)	National Pension System (NPS) - Tier 1	Fixed Income Tax Saving Instruments (e.g.: PPF and Tax saving bank FD)
			But it can be made low if so desired by choosing higher proportion of Government securities.	and the risk of loss is only if there are payment issues at the bank.
3	Returns	No guaranteed returns. Can be moderately high to high, depending on period of holding. The returns are market linked. Capital Gains taxed at 12.50%.	No guaranteed returns. Can be moderate to moderately high, depending on how much equity /Alternative Investment have been chosen/allowed. The returns are market linked. 60% of the corpus can be withdrawn tax free, after reaching the age of 60 years. The balance 40% has to be used to buy annuity product(s) from an Insurance company. The annuity(ies) received from the Insurance company is fully taxable.	PPF - Guaranteed returns with varying rate of returns dependent on G-sec rate. Returns can fluctuate for every quarter. Nil tax on the returns. Moderate post tax return. Maximum Rs. 1,50,000 contribution allowed each year. Tax saving Bank FD – Returns are fixed for the entire duration. Returns are taxable each year. Moderately low post tax returns.
4.	Liquidity	3 years lock in. Post that can be withdrawn at any time.	Lock in till the age of 60 years. However, partial withdrawals are allowed, subject to conditions. Premature withdrawal requires using 80% of the withdrawal amount for purchasing annuity from an Insurance Company.	PPF – lock in for 15 years from inception of the account. Partial withdrawal possible after 5 years. Tax Savings Bank FD – lock in for the entire tenure of the deposit.

19.2.2 Equity Mutual Funds V/s Portfolio Management Services V/s Alternative Investment Funds Category 3

Sr No	Parameter	Equity Mutual Funds	Portfolio Management Services	Alternative Investment Funds (AIF) Category 3
1	Nature of Investments	Pooled investment vehicle, where investments are in a	Investment in the individual investors' demat account.	Pooled investment vehicle that undertakes diverse or complex

Sr No	Parameter	Equity Mutual Funds	Portfolio Management Services	Alternative Investment Funds (AIF) Category 3
		pooled account with units allocated to each investor.		trading strategies including investment in listed or unlisted derivatives.
2	Risk	Common investment for all investors in a scheme.	Can be customized to meet the needs of an individual investor.	Complex strategies but common across all investors in a scheme.
3	Minimum Investments	Can be as low as Rs. 1,000/- in a scheme	Minimum investment size is Rs. 50 lakhs	Minimum investment size is Rs. 1 crore
4	Maximum percentage of scheme investment in a specific company/ group/ sector	Regulated by SEBI to ensure some amount of broad basing of investment.	Not regulated by SEBI. Can be and normally is a concentrated portfolio.	Regulated by SEBI to avoid portfolio concentration in a single investee company.
5	Fees payable by Investor	Maximum fee payable is regulated by SEBI and varies depending on the size of the fund.	Upfront charges not allowed. Operating expenses are capped at 0.50%. Fees can be as agreed between the investor and the PMS manager. It may be a fixed amount or a performance-based fee or a combination of both.	Not regulated by SEBI. Fees are charged as per the agreement between the AIF and its investors.
6	For whom it is meant	Retail Investor	High Net worth Investor	High Net worth Investor, looking for complex or leveraged investment strategies.
7	Redemption and costs of redemption	Redemption can be at any time in open-ended mutual funds, though an exit load can be levied based on a pre-declared rule.	The fund manager may have charges for redeeming the investments or for handing over the charge of the investments back to the investor.	Close-ended AIFs have lock in period and have poor liquidity.

19.2.3 Mutual Funds V/s Unit Linked Insurance Plans (ULIP)

Sr No	Parameter	Mutual Funds	Unit Linked Insurance Plan
1	Nature	Pooled investment scheme managed by Asset Management Companies.	Pooled investment scheme managed by Life Insurance Companies.
2	Purpose	Investments only	Insurance cum Investments
3	Charges	Maximum charges are regulated by SEBI.	Maximum charges are regulated by IRDAI. Insurance (mortality) and other charges are deducted from fund value making post expense return calculation difficult
4	Returns	Dependent on market	Dependent on market
5	Tax status on withdrawals	Taxable as per the tax laws (see details in Chapter 10 and Chapter 11 under Module 9)	Withdrawals/maturity is tax free, if sum assured is at least 10 times of annual premium. However, the Finance Act, 2021 has amended section 10(10D) of the Income Tax Act where no exemptions are allowed to any ULIP issued on or after February 1, 2021, if the amount of premium payable for any of the previous year during the term of the policy exceeds Rs. 2.5 lakh. For those who pay annual premiums below that, this would remain exempt.
6	Disclosure	Transparent daily/ periodic disclosures. Many independent media track disclosures and provide value added comparison services.	Lower disclosure standards and less availability of value added comparison services from independent media.
7	Liquidity	Open-ended mutual funds can be redeemed at any time but may be subject to exit load.	Compulsory contribution required for 5 years (except single premium plans). No redemption for at least 5 years. Discontinuation charges apply, if premiums cease before 5 years.

Sr No	Parameter	Mutual Funds	Unit Linked Insurance Plan
8	Suitable for	Any investor looking for investment options.	See section 2.3 of Chapter 2 under Module 7.

19.2.4 Actively managed Equity Mutual Funds V/s Index Funds

Sr No	Parameter	Actively Managed Mutual Funds	Index Funds
1	Nature & Purpose	The fund manager seeks to generate additional return (alpha) over the chosen benchmark by actively choosing securities from among the investment universe.	Replicate the returns from the chosen benchmark by investing in the securities in the benchmark in the same proportion.
2	Cost	Higher as the fund manager is actively involved in the decision-making.	Lower cost
3	Return	Attempt to get higher returns, net of the higher management cost.	Attempt is to track as closely as possible the benchmark return.

19.2.5 Direct Equity V/s Equity Funds

Sr No	Parameter	Direct Equity	Equity Funds
1	Nature	Investing in specific equity stocks.	Investing in specific equity fund scheme.
2	Level of attention/ expertise needed	Requires personal expertise or services of a PMS firm or a Registered Investment Advisor.	One can invest in mutual fund schemes of the type of desired investment, including index fund for that type of investment.
3	Risk	Concentrated risk on the invested security.	Risk is spread over many securities. There is diversification of risk.

19.2.6 Exchange Traded Funds (ETFs) V/s Index Funds

Sr No	Parameter	Exchange Traded Index Funds	Index Funds
1	Nature	These are index funds that are traded on the exchange like any other securities	These are available for buy/sell from the concerned Asset Management Company (AMC)

Sr No	Parameter	Exchange Traded Index Funds	Index Funds
2	Price	Is available on a minute to minute basis like any other security	Is the NAV that is available on end of day basis
3	Costs	Management costs are comparatively low. But there can be brokerage and demat and other charges involved in both buy and sell as well as the difference between the buy and sell quotes on the exchange. There are differences between the buying and selling price which adds to the cost when buying and reduces the final sale value.	Management costs may be nominally higher than exchange traded Index funds. But there are normally no other costs
4	Liquidity	Depends on the market and in fact, except for a couple of ETFs, liquidity is very poor on the Indian stock exchanges. There is a big difference between the NAV of the underlying securities and the quoted prices. Also, there is a relatively large difference between buy-sell quotes.	Available from the AMC on end of day basis

19.2.7 Physical Gold V/s Gold Funds V/s Gold ETFs V/s Sovereign Gold bonds

Sr No	Parameter	Physical Gold	Gold Funds	Gold ETF	Sovereign Gold Bonds
1	Buy as per prevailing price at the moment	Possible	NAV at the end of the day	Possible	Every issue is priced based on price prevailing on last 3 days
2	GST cost is incurred	Yes	Yes, as physical gold is bought by the fund and GST cost is incurred on purchase and added to the cost. However, it	Yes, as physical gold is bought by the fund and GST cost is incurred on purchase and added to the cost. However, it is	No

Sr No	Parameter	Physical Gold	Gold Funds	Gold ETF	Sovereign Gold Bonds
			is accounted as an asset and not loaded as cost.	accounted as an asset and not loaded as cost.	
3	Purity concerns	Very much there, though some of it has been removed due to hallmarking	Purity is ensured by the fund house	Purity is ensured by the fund house	No purity concerns as no physical gold is bought
4	Safety and storage costs	Yes	Yes, in-built into the Fund management charges	Yes, in-built into the Fund management charges	No such costs
5	Can it be exchanged with physical gold	Not applicable	Yes, at a nominal cost	Yes, at a nominal cost	Not available
6	Any Income	No	No	No	2.50% p.a. interest payable semi-annually
7	Taxability on sale	Taxable as capital gains	Taxable as capital gains	Taxable as capital gains	No tax if redeemed with RBI. Taxable as capital gains if sold in the market before maturity. Interest is taxable as per IT Act.
8	Liquidity	Can be sold in the market	Redeemed by the fund house at end of day NAV	Sellable on the exchange. Liquidity is decent, though all costs apply (brokerage, buy-sell differences etc.).	Redeemable on its anniversary dates after 5 years. Last redemption after 8 years. Can be sold in the stock market in the interim but liquidity is moderate.

19.2.8 Real Estate V/s REITs V/s INVITs

Sr No	Parameter	Real Estate	REITs	InvITs
1	Exposure	Large concentrated exposure to one or a couple of properties. Only large lump sum exposure is possible.	Like a real estate mutual fund, the exposure is spread over many properties. Involves professional expertise. Lower minimum exposure possible.	Like a mutual fund it invests in infrastructure projects. The exposure is again spread over many projects to reduce risk on one specific project. Like REITs, it makes possible lower minimum exposure.
2	Type of exposure	Depends on the type of asset chosen by the Investor but many times includes under construction properties where the risk is very high.	Primarily in real estate commercial properties that provide rental income apart from possibility of capital appreciation.	Primarily in infrastructure projects like roads, bridges, etc.
3	Management of properties	Needs to be managed by the Investor	Managed by the Investment manager	Managed by the Investment manager
4	Liquidity	Being lumpy investments, it is poor and time consuming.	REITs maybe listed on the stock exchange and have relatively better liquidity.	Invits may be listed on the stock exchange and have relatively better liquidity.

19.2.9 Debt Instruments V/s Debt Funds V/s Fixed Maturity Plan V/s Bank Fixed Deposit

Sr No	Parameter	Debt Instruments	Open-ended Debt Fund	Fixed Maturity Plan	Bank Fixed Deposit
1	Safety	Depends on the instrument chosen.	Depends on the type of assets in which the scheme can invest. But definitely diversification across many instruments provides relatively higher safety for the same level of rated instruments.	Depends on the type of assets in which the scheme can invest. But definitely diversification across many instruments provides relatively higher safety for the same level of rated instruments.	Safety is pretty high.
2	Post tax Returns	In proportion to risk taken.	Post tax returns can be better by investing in growth schemes and withdrawing needed amounts. This ensures that the withdrawal has a large element of capital.	Pre-defined, if held till maturity.	Pre-defined
3	Liquidity	Pre-redemption liquidity for debt instruments in India tends to be poor, where available, a large cost needs to be paid in the form of much lower price.	Redemption facility is available from the fund house though there can be exit loads in some cases.	Though listed on the stock exchanges, effectively there is very poor liquidity for FMPs.	Instant liquidity available from the bank though there can be clawback of interest paid and/or pre-mature redemption penalty.

19.2.10 Index Futures V/s Index Options V/s Index Funds

Sr No	Parameter	Index Futures	Index Options	Index Funds
1	Time Horizon	From a few days to a max of 3 months.	From a few days to a max of 3 months. However, long dated options are also available.	This can be for a very long tenure or for life time also, as it is an actual investment.
2	Cost	Basically, interest cost for the delayed purchase.	Apart from the interest cost for the delayed purchase there is a risk premium to be paid as implementing the option is at the discretion of the option buyer.	Actual market cost at the time of purchase plus management cost paid to the AMC regularly.
3	Risk	Same as buying an index fund.	Max risk for the option buyer Is equivalent to the option premium paid.	The risk of buying the securities underlying the fund.

19.2.11 Gold Futures V/s Gold Options V/s Gold ETFs

Sr No	Particulars	Gold Futures	Gold Options	Gold ETFs	Gold fund
1	Time Horizon	12 months	As per the contract launch calendar.	This can be for a very long tenure or for life time also, as it is an actual investment.	This can be for a very long tenure or for lifetime also, as it is an actual investment.
2	Cost	Basically, interest cost for the delayed purchase.	Apart from the interest cost for the delayed purchase there is a risk premium to be paid as implementing the option is at the discretion of the option buyer.	Actual market cost at the time of purchase plus holding cost paid in the form of management charges to the AMC.	Actual market cost at the time of purchase plus holding cost paid in the form of management charges to the AMC.

Sr No	Particulars	Gold Futures	Gold Options	Gold ETFs	Gold fund
3	Risk	Same as buying an index fund.	Max risk for the option buyer Is equivalent to the option premium paid.	The risk of buying the gold and fluctuations in its price underlying the fund.	The risk of buying the gold and fluctuations in its price underlying the fund.

19.2.12 Company Deposits V/s Debentures (if both are offered by the same company)

Sr No	Parameter	Company Deposits	Company Debentures
1	Risk	Company deposits are unsecured so even if from the same company the risk level is relatively higher.	Debentures will normally be secured so even if from the same company the risk level is relatively lower.
2	Return	Tends to be slightly higher than debentures from the same company for the same period.	Tends to be slightly lower than company deposits from the same company for the same period.
3	Liquidity	Redemption facility provided by the company though no interest can be paid if redeemed within a year.	Depends on the market where liquidity is always an issue.

19.3 Other Comparatives

19.3.1 Market linked V/s Non-market-linked Retirement accumulation Products

Sr No	Parameter	Market linked retirement accumulation products (NPS, ELSS, other mutual fund schemes)	Non-market-linked retirement accumulation products (PPF, etc.)
1	Risk	Will depend on the option chosen, but is linked to market returns. For example, risk for G-Sec option chosen under NPS is Low but under ELSS – which invests in equity exclusively is high.	Is low as far as return of principal portion is concerned.

Sr No	Parameter	Market linked retirement accumulation products (NPS, ELSS, other mutual fund schemes)	Non-market-linked retirement accumulation products (PPF, etc.)
2	Returns	Are linked to market and will vary upon the chosen option.	Tends to be moderate to low, given the low principal risk. Also, increasingly there are no long term fixed return products with even EPF declaring returns every year, PPF declaring returns every quarter etc.
3	Liquidity	By definition, tax advantaged retirement products tend to have lock in periods to ensure that the resources are actually available for the purpose for which they are meant – namely retirement.	Liquidity tends to be even poorer in these principal guaranteed products for the same reason as market-linked products.

We further look into a few comparative analyses of insurance products that are of importance to the investors.

19.3.2 Personal Accident Insurance V/s Life Insurance

Sr No	Parameter	Personal Accident Insurance	Life Insurance
1	Covers death due to:	Accident only.	Any cause including accident.
2	Disability coverage	Temporary or Permanent total or partial disability arising due to accident.	Does not cover disability.
3	Suitability	As additional cover, over and above the required life insurance cover, especially for permanent total disability arising from accident.	Is essential for income earners on whom other people are dependent.