FAQ

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FUNDING OF POST-EMPLOYMENT DEFINED BENEFIT PLANS

01

What does 'funding' mean in the context of post-employment defined benefits?

Simply stated, funding means the setting aside of money in advance and in a specific trust created for the purpose of paying the post-employment benefits when they become due.

02

Should the post-employment defined benefit pension liability be funded?

Funding – short for funding in advance of the benefits becoming due – would create some security for the employee's benefits (especially in case the employer's financial fortunes weaken).

In India, contributions made to recognized funds for employee benefits, such as gratuity and superannuation, are tax-deductible (as per Section 36(1) (iv) of Income-tax Act) and investment income of the fund is tax-exempt as well (under Section 10(25) (iii) of Income-Tax Act) subject to some conditions.

Thus, funding by a profit-making company will reduce its immediate tax outgo and potentially accrue income in a tax-exempt fund.

03

Which 'Post-employment defined benefit pension benefits' are prevalent in India?

The most prevalent post-employment defined benefit plan is an end of service gratuity, which is payable to all eligible employees under the Payment of Gratuity Act, 1972 (now subsumed in the Social Security Code, 2020). Gratuity is a last-salary based lump sum pay-out normally payable on exit from services, subject to an employee completing the vesting period and is obligatory for every shop or establishment in which ten or more employees are employed, or were employed, on any day of the preceding twelve months.

A defined benefit last salary- and often inflation-linked pension is also offered by some employers, however this practice is rare in the private sector.

Some employers manage the provident fund – a defined contribution plan, where the employer has no obligation beyond the contributions – by forming a separate trust with in-house responsibilities. In such a case, the employer is ordinarily required to at least match the end of year interest rate offered by the government administered Employees' Provident Fund Organization. Such 'guarantee of the interest rate' is classified as a post-employment defined benefit.

Another example is a post-retirement medical benefit scheme wherein the employer covers healthcare costs of retirees and former employees (often up to a limit with/ without a portion of healthcare cost being borne by the beneficiary).

This is not an exhaustive list. Other variants of post-employment defined benefit plans could exist.

04 *Which 'Other long-term benefits' are prevalent in India?*

Being tax-efficient (i.e., employee does not pay tax on receipt however subject to conditions), the privilege leave benefit is the most popular among 'Other long-term benefits.' If sick leave can be carried forward beyond one year, it also requires a valuation for compliance with the accounting standards on employee benefits.

- Apart from these leave-related benefits, other long-term benefits include: jubilee or other long-service benefits,
- Long-term disability benefits,
- Profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related service,
- Deferred compensation paid twelve months or more after the end of the period in which it is earned.

05

Should all long-term employee benefit liabilities e.g., Gratuity, Privilege Leave, Sick Leave, Long-term incentives, etc. be funded?

Funding is not obligatory in India. It is undertaken primarily for reasons of tax breaks and securing the employees' interests. For an employer, contributions to 'approved' plans (e.g., approved gratuity fund, approved superannuation fund and approved provident fund) alone qualify as tax-deductible expenses, subject to certain conditions.

06

Which types of employee benefit plans can be 'approved' under the Income Tax Act?

A gratuity fund, superannuation fund and provident fund can be approved under the Schedule IV to the Income Tax Act, 1961.

07

What are the tax benefits to such 'approved' plans to employers?

Apart from an employer's contribution to an approved fund qualifying for tax-deductibility (subject to certain conditions), an 'approved' fund's income is wholly exempt from income tax.

08

What are the pre-requisites for an employer's funding of an approved plan?

A careful understanding of the tax implications and a prior approval of the plan by the jurisdictional Commissioner of Income Tax is necessary before deciding whether to fund an employee benefit liability and to what extent.

09

What are the implications of funding an employee benefit plan that is not 'approved'?

The contributions to a fund/ plan that is not approved under the Income Tax Act would not qualify as tax-deductible for the employer. Further, the income earned by such fund/ plan would be taxable. It is hence fit for an employer to contribute only to approved funds of gratuity, superannuation and provident fund.

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What are the employer's obligations after funding a defined benefit plan?

The employer's obligations would still be to cover any benefits not paid by the fund. This would arise if the fund does not have sufficient assets to cover the benefits outgo.

Employers are also required to achieve tax and regulatory compliance for the approved funds.

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What are the investment options after funding?

After funding, the approved fund can either manage funds in-house i.e., self-managed funds following investment regulations laid out under the Income Tax Act, 1961 read with the Income Tax Rules, 1962 or entrust a life insurance company with the funds. However, only approved gratuity and superannuation funds have the option of investing assets with a life insurance company. Approved provident funds cannot invest with a life insurance company, but are required to manage the funds in-house.

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How can assets of an approved post-employment benefit plan be utilized?

Broadly the following investment options can be utilized.
a. *Insurer managed funds*
These are deposit administration services provided by life insurance companies. They can be either cash accumulation plans [e.g., returns are provided at the insurer's discretion and represent a debt-like investment] or unit-linked plans [i.e., the client can select to invest contributions by buying units in funds, e.g., an equity fund, bond fund or a balanced fund, with exposure to the underlying investment].

b. *Self-managed funds*
These are funds managed by the employer in-house with investment decisions being taken by the trustees of the plan. The investment pattern must comply with Rule 67 sub-rule (2) of Income-Tax Rules as mentioned below:

Asset class	Proportion to be invested
Government securities & related investments such as: • Government securities • Securities whose principal & interest is guaranteed by the Central Government or a State Government (max 10%) • Units of mutual funds that are dedicated to invest in government securities & regulated by SEBI (max 5%)	45% - 50%
Debt instruments such as: • Listed debt securities of bodies corporate with minimum residual maturity of 3 years • Defined commercial bank debt, Rupee bonds & term deposits. • Units of debt mutual funds regulated by SEBI (max 5%) • Some infrastructure bonds	35% - 45%
Short-term debt instruments such as: • Money market instruments • Term deposits • Liquid mutual funds	0% - 5%
Equities such as: • Shares of bodies corporate listed on BSE or NSE with a market cap of at least Rs 5,000 Crores. • Derivatives on such shares listed on BSE or NSE • Units of equity mutual funds regulated by SEBI & investing at least 65% in shares of bodies corporate listed on BSE or NSE (max 5%) • ETFs/ Index tracking funds regulated by SEBI replicating BSE SENSEX or NIFTY50. • Exchange traded derivatives regulated by SEBI for disinvestment of shareholding of Government of India. • Exchange traded derivatives regulated by SEBI for the purpose of hedging. • Derivative exposure is limited to 5% of this category.	5% - 15%
Asset-backed, Trust structure & Miscellaneous investments such as: • Commercial mortgage-based securities • Units of REITs • Units of infrastructure investment trusts • Asset-based securities	0% - 5%

Source: https://financialservices.gov.in/sites/default/files/Investment%20Pattern_0.pdf

c. *A combination of the above*
Some of the assets could be self-managed while the rest are invested with an insurer.

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Which areas of investment policy are of high significance for defined benefit plans?

Often the trustees may find comfort in finding assets that match the liability by term, currency and nature. This can be achieved by matching the asset's duration with that of the liability in order to hedge the interest rate risk. Trustees may seek higher risks from investing in real assets (e.g., equity) that meet with the underlying nature of the liabilities (e.g., inflation linked liabilities). It is likely that the investment policy is guided by regulation e.g., if the employer follows the IFRS-adapted Ind AS reporting, then a higher forbearance to the volatility of asset returns is acceptable.

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If a funding valuation were undertaken, how would the liability/ obligation of the defined benefit plan return as compared with an accounting valuation?

An accounting valuation uses assumptions that comply with accounting standards. Typically, this would mean using best estimate assumptions.

A funding valuation uses the same assumptions on salary escalation and withdrawal rates, but instead of the discount rate defined in the accounting standards which is based on the bond yields irrespective of the plan's asset composition, it uses the investment rate of return of the assets of the plan. The return on assets could be higher than bond yields if there is exposure to real assets viz. equity. In such a case, the funding valuation's discount rate would be based on the expected return on assets which is higher than the corresponding bond yields. The liability determined from a funding valuation could therefore be lower than the accounting valuation. Thus, the liability will be different between a funding valuation and an accounting valuation because of the different discount rates applicable. In India, a funding valuation is not mandatory.

Often, the accounting valuation informs the funding policy.

Accounting Standards usually prescribe the type of actuarial method to be applied. The most prevalent methodology applied is the Projected Unit Credit ("PUC") Method. Alternative methods of funding can be devised to ensure that the burden of financing past service liability, relating to current employees at the time of introduction of scheme benefits, is spread over a period.

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If the plan is in high surplus (i.e., assets are much higher than liabilities) is it possible for the employer to withdraw the assets from the plan?

Because of the irrevocable nature of the approved trust, no funds can be reclaimed by the employer except to discharge the liabilities.

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What is the implication of an asset ceiling for an employer?

If a plan is in high surplus and an asset ceiling is employed, some assets are derecognised. As a result, the net assets are reduced. Depending on the accounting standard employed for financial reporting, a charge to the Profit and Loss Account or the Statement of Other Comprehensive Income would ensue.

Employers should aim to fund such that assets belonging to an employer-sponsored irrevocable trust do not significantly exceed liabilities of a post-employment defined benefit plan, especially because a) the assets can be derecognised in an accounting valuation, and b) the assets held by an employee benefits trust cannot be returned to the employer.