

India Life Hewitt

**White Paper
on
Employer Pension Reform**

(Provident, Superannuation & Gratuity Funds)

EXECUTIVE SUMMARY

PROVIDENT FUND

- Transparent and Time bound procedure for employers to form exempt PF trusts.
(Current procedures are opaque and do not meet employer and employee objectives)
- Option for new companies to form exempt PF trusts
(The current “default” to the PF commissioner is stifling for companies that want exempt trusts and results in waste from duplication, multiple database setups, fund transfers, etc)
- Allow transfer of balances between exempt and excluded trusts.
(The current prohibition defeats the objective of ensuring accumulations and hinders labor mobility)
- Remove taxation on investment returns higher than Central Provident Fund Commissioner
(This removes all incentives for better fund management)
- Harmonize tax treatment for exempt/ un-exempt situations
(This will create the right incentives of avoiding withdrawals before five years and level the playing field)
- Allow investment optimization within prescribed pattern
(This will encourage better and more dynamic fund management)
- Operational and Infrastructure issues for compliance of exempt and un-exempt institutions
(This will allow streamlining of operations and higher compliance)

GRATUITY FUND

- Evolve regulatory framework; disclosure, filing, compliance, fiduciary responsibility, etc
(These funds are currently not regulated by any agency)
- Mandatory funding of gratuity liability
(Funding will ensure asset segregated plans and higher safety of employee benefits)

SUPERANNUATION FUND

- Evolve Regulatory Framework; disclosure, filings, compliance, fiduciary responsibility, etc
(Funds are currently not regulated by any agency)

COMMON ISSUES

- Re-look at cap on tax deductibility of contributions on defined benefit plans
(cap on contributions creates unhealthy incentives for under-funding)
- Simplify and Harmonize Income Tax Approvals/ Procedures
(Harmonize different centers and operational issues)
- Formation of multi-company trusts
(Reap economies of scale with participation of group companies in a single fund)

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BACKGROUND

In India the Occupational Pension Schemes available for the organized workforce are Provident Fund, Gratuity and Superannuation.

Provident Fund is over regulated but under supervised as provided in the Employees Provident Fund and Miscellaneous Provisions Act, 1952 (the PF Act) at least for those employees who are coverable under the PF Act. There are Provident Fund Schemes run by the employers for the benefit of employees who are excluded from the provisions of the PF Act. These Schemes run by typically called Excluded PF Trusts are only governed by the Income Tax Act, 1961.

Gratuity as a benefit is mandated under the Payment of Gratuity Act, 1972 (the Gratuity Act) and the employer is under a statutory obligation to pay gratuity to his employees under the stipulated conditions. However the modus of providing the benefit is largely unregulated except for the provisions in the Income Tax Act, 1961 (the IT Act)

Superannuation is a voluntary Occupational Pension Scheme adopted by many of the employers and is again governed only by the provisions of the I T Act.

In this note we make an attempt to present issues that needs to be addressed to ensure that there is reasonable amount of regulation leading to supervision, which shall allow the employers to provide the desired benefits to his employees. This we believe could be the first steps in the incremental efforts to reform the Pension Industry as such in India.

PART A – PROVIDENT FUND

A1. PROCESS OF EXEMPTION

The current process of obtaining exemption is very time and paper intensive and leads to inordinate delays before genuine exemption applications are processed and notified. This is particularly apparent in the case of new companies and established companies that are undergoing some kind of restructuring.

A1.1 OPTIONS FOR EXISTING UN-EXEMPT ESTABLISHMENTS

Current Scenario

Companies complying as un-exempt desiring exemption are now forced to go through a tedious process before their exempt status is notified. The following is the current sequence for obtaining Exemption

- Set up of the PF Trust
 - Recognition by the Commissioner of Income Tax
 - Application to the RPFC with
 - Proforma of application
 - Details of contractors
 - Consent Signatures of majority of employees
 - Comparison between the trust rules and PF Scheme
 - On filing of Application with RPFC, inspection of the Company for ensuring compliance status
 - RPFC recommendation to CPFC based on the report by the inspector
 - CPFC recommendation to appropriate government.
 - Notification by the Appropriate Government
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- The entire process takes more than a year and depending upon the appropriate government, often gets delayed beyond that period.
 - The power granted to RPFCs under Para 79 of the EPF Scheme 1952 to issue relaxation orders now stand withdrawn.
 - The delay causes avoidable friction between the Companies and the EPFO, with the applicants for exemption left to feel aggrieved at the whole situation.
 - The EPFO concern over the history of relaxed/exempt trusts and some abuses is valid and borne out by the facts
 - The remedy of the situation is to ensure that genuine cases are not clubbed with the companies that do not have good intentions or are not operating in good faith.
 - The key is to ensure that only the compliant and good corporate citizens are granted relaxation/exemption and on grant of such exemption the continuation of relaxation/exemption is strictly dependent upon the performance.

Suggestions:

- Specify clear guidelines (size of employees, base of calculation, profitability, etc) and simple documentation so multiple iterations and interpretations are minimized.
- The concept of economic size only after 200 employees merits review under the current scenario. The more appropriate variable is the size of the wage bill and there are a number of

companies with less than 200 employees but whose high wages ensure the viability of the trust.

- Re-instating the power of relaxation to RPFCs with a caveat that only if the RPFC is satisfied about the 100% compliance status.
- Delegation of power to notify exemption to the CPFCs or even RPFCs
- Prescribing an automatic approval or time-bound approvals for the process, e.g. within 60 days of complete application RPFC to forward the application to CPFC and within 60 days of application reaching CPFC, application to be approved etc.
- Making the decisions on exemption process both at the RPFC and CPFC level appealable to the PF Appellate tribunal. This will give a reasonable opportunity to the establishments against arbitrary decisions at RPFC levels.

A1.2 RESTRUCTURING SCENARIOS FOR EXISTING COMPANIES

Since the liberalization and globalization of the Indian economy in the early 1990s, the competitive environment for Indian industry has substantially changed. Companies are witnessing a great amount of churning by restructuring through mergers, acquisitions, de-mergers etc.

Though this started with multinational companies, indigenous industry is also going through this process to keep itself competitive. Furthermore, global mergers mean that restructuring happening across the world results in implementation issues by their Indian subsidiaries.

The current framework of PF law and its administrative machinery does not provide for such a dynamic environment and this leads to considerable confusion and inefficiencies for employers. The possible scenarios presented by such restructuring are:

A1.2 a) An exempt establishment merging with an un-exempt establishment

The view taken by some of the RPFCS is that the exemption is granted to an establishment. When an exempt establishment merges with an un-exempt establishment it loses its identity along with its exemption.

Such an interpretation would result in considerable inconvenience to the exempt establishment as well as to the EPFO.

- The trust would have to be disbanded and balances transferred to the EPFO;
 - Not an acceptable alternative to the employees who have enjoyed the exempt status
 - EPFO is burdened with employees whose PF affairs could continue to be handled by the final entity.

It would be ideal to allow the un-exempt establishment to participate into the exempt trust of the merged establishment.

A1.2 b) Merger of two exempt establishments

There is no clarity in such a scenario as to whether the merged establishment could make use of one single trust to cover all its employees.

In such scenarios, if the exempt trusts are allowed to merge,

- Would be able to provide better services to the Employees at a lesser cost and administrative hassles.
- Merged establishments could provide uniform benefits to their employees.
- This would also ensure easier regulation and monitoring by EPFO from one location.

A1.2 c) De-merger of Establishment with an exempt trust

De-merger of an establishment is often the result of hive of business divisions or factories by companies either through a scheme of restructuring approved by high court or through a sale of undertaking.

If such an establishment was an exempt establishment the employees forming part of the hived of unit or division end up losing their status as exempt employees as the EPFO insists that the resultant establishment shall start complying as an un-exempt establishment.

The resultant establishment is not given time to set up their own trusts and obtain exemption. Even if allowed, the process of exemption is long winding leading to considerable difficulties for establishments and employees.

A1.2d) Merger of Establishments located under different RPFC/APFC jurisdictions:

The merger of establishments located under different jurisdictions or different states. This often leads to RPFCs or Sub Offices of EPFO taking diametrically opposing views on the situations.

Suggestions on Restructuring Scenarios:

- Resultant Entity of any type of Restructuring shall be allowed to choose the compliance option.
- De-merged Establishments to be given time to set up their own PF Exempt Trusts till which time they may be permitted to comply as participants of the Exempt Trusts of parent establishments. Or in the alternative they may be allowed to contribute into their own trusts till they are granted exemption.
- On Merger of two exempt establishments, RPFCs may allow the merged establishment to merge the PF Exempt trusts at an administratively convenient location.
- On Merger of exempt and un-exempt establishments, RPFCs may allow participation of un-exempt employees to the exempt trusts.
- On Merger of un-exempt establishments, the merged establishment may be allowed to comply from single administratively convenient location for all the merged established.

A.2 OPTIONS FOR NEW COMPANIES

Current Scenario:

- New companies that cross the threshold of 20 employees are compulsorily required to comply as un-exempt by remitting their contributions to the EPFO.
- A number of new companies (IT, Multinationals, etc) that have large growth plans would like to provide retirement benefits including Provident Fund by setting up a private trust from day one. However, these companies are forced to comply as un-exempt for their application for exemption to be considered. This involves
 - Transfer of all the balances in the private trust to EPFO
 - Remittance of Contributions till grant of exemption to be remitted to EPFO
 - On obtaining exemption, transfer of balances of individual employees back to the Exempt Trust.
 - This exercise involves the EPFO allocating resources for an employer who, in any case, wants an exemption.

Suggestion:

- Companies will be obligated to apply for exemption under clearly laid guidelines within 30 days of their meeting any criteria of coverage under the PF Act. In the interim, they need not comply as un-exempt.
- They may be allowed from the date of coverage continued to remit their PF contributions to their own Provident Fund Trust, provided they apply for exemption along with their coverage application to EPFO.
- They may, however, be asked to remit their EPS and EDLI contributions and charges to the respective RPFCS.
- This ensures that the resources of EPFO are not wasted on an employer who is capable of administering the Provident Fund for the benefit of his employees.
- To safeguard against these companies folding up and leaving the employees in the lurch, EPFO may insist on a Bank Guarantee for a percentage of salary based on time bound approval of exemptions.

A.3 TRANSFER OF BALANCES TO EXCLUDED TRUSTS

Background

- A number of companies have set up provident fund trusts for the benefit of employees who are excluded employees as defined under the PF Scheme. (Only employees who are starting their career with a PF salary over and above Rs. 6,500/- per month)
- Alternatively, an employee drawing salary more than the said threshold should have withdrawn all his earlier Provident Fund balances from the RPFC or an exempt trust. This clause effectively defeats the purpose of providing for excluded employee concept beyond the prescribed threshold.
- This clause forces employers to cover an employee with a previous RPFC balance under the EPFO even though his salary may be few multiples of the excluded employee threshold.
- Employees tend to give wrong declarations about their prior status and participate in the Excluded Employees PF Trust by withdrawing their earlier balances.

Possible advantages of allowing transfer to excluded trusts

- Discouraging withdrawal of balance on movement from exempt to excluded trusts. This will ensure that the accumulation amount at retirement is not compromised.
- Higher portability for employees as they advance in their careers and move across and between industries and companies.

Suggestions

- Redefine the concept of excluded employees, by treating all employees as those drawing PF salary beyond the threshold limit of Rs.6, 500/- as excluded employees.
- Allow transfer of RPFC balances into the Excluded Provident Fund Trusts. EPFO may insist on a certain level of compliance by insisting on reporting requirements to be met by such trusts to safeguard the interest of the employees.

A.4 TAXATION ON INVESTMENT RETURNS

Background

- Income Tax Act, currently prescribes that if a Provident Fund Trust credits interest at more than 9.5% on the member balances, the amount exceeding 9.5% is to be deemed as an income in the hands of the member and shall be taxed.
- This rule forces the Trustees of even well managed PF trusts to declare minimum interest rates.
- This penalizes the well managed trusts who prudently invest the PF contributions and are able to earn better returns
- Administrative complexities in deducting the tax at source by the employers are also a major disincentive for rewarding the member with higher returns; Even if the members are willing to bear the tax burden

Possible advantages of removing the cap on returns by PF Trusts

- Would act as a major incentive for the employers to ensure that the PF trust for their employees are run professionally.
- Employees would also take better interest in the affairs of the Trust; otherwise they are always assured of a minimum return and therefore do not bother about Trust activities.

Suggestions

- Remove the cap on the tax-free rate of interest payable by the recognized PF trusts as prescribed under Rule 6 of Part A of Schedule VI of Income Tax Act, 1961.

A.5 HARMONIZE TAX TREATMENT IN EXEMPT/ UN-EXEMPT

Background

- The Provident Fund accumulations maintained with the Employees Provident Fund Organisation if withdrawn at the time of retirement or resignation is tax free irrespective the number of years of membership with the EPFO.
- Whereas if a Recognised Provident Fund Trust, which is exempted by the EPFO, settles an employee who has not rendered service with an employer for more than five years, the entire accumulated balance with the interest is taxed as salary.
- In addition to that whatever the Income Tax benefits enjoyed by such an employee towards contributions towards PF will be withdrawn.
- This rule based on the sub section 11 and 12 of Section 10 of the Income Tax Act, discriminates against the employees of establishments which run their own trusts based on exemption granted by EPFO.

Possible advantages of treating settlements of PF balances in Exempt/Unexempt scenarios at par

- Would remove a major irritant faced by employees resigning from the exempt establishments.
- Members of PF whether maintained with EPFO or by the Trust run by the establishment are beneficiaries of same legislation and therefore should be treated at par.

Suggestions

- Remove the disparity by amending the relevant sections and treat the employees whether members of EPFO or PF Trusts run by the employers at par.
- Cap on the tax-free rate of interest payable by the recognized PF trusts as prescribed under Rule 6 of Part A of Schedule VI of Income Tax Act, 1961.

A.6 INVESTMENTS – FLEXIBILITY WITHIN PRESCRIBED PATTERN

Background

- Trustees have to approach the RPFC for approval every time there is a need to sell the securities even in the case of genuine requirements such as VRS settlements.
- Trustees are not allowed to restructure the Investment Portfolio even within the mandated investment pattern.

Possible advantages of investment flexibility within prescribed

- Higher returns; Trustees could use the opportunities available in the market to optimize the returns to the trust.
- Employee settlements will happen faster and more efficiently
- Trusts could use scientific methods of asset and liability management to ensure that the objectives of risk and portfolio management are met

Suggestion:

- Trustees may be allowed to liquidate SDS and other investments for the purpose of contingencies such as VRS.
- The trustees may be allowed to restructure the investment Portfolio within the mandated investment pattern.
- RPFC to monitor the movements in the investment portfolio from the monthly returns being already filed by the Trusts (Annexure A) and in the event of any concern take up with the trustees immediately.

A.7 OPERATIONAL & INFRASTRUCTURE ISSUES

A7.1 E-INFRASTRUCTURE FOR FILINGS AND TRANSACTIONS

- We appreciate that the EPFO is moving towards an Electronic Infrastructure that would change the whole face of the organization.
- In its effort to reengineer its processes internally, it should provide for electronic infrastructure, which will take care of its interface with the employers.
- This could be achieved to a great extent by way of providing for electronic filing of returns and electronic remittance of contributions to the EPFO.

E – Filing

EPFO's Information Technology infrastructure could provide for:

- a) Filing of returns via Internet; an employer with a distinctive Identification number and password shall be able to access the EPFO database to file his monthly and yearly returns over the Internet.
- b) The IT infrastructure shall be able to generate acknowledgements in proof of filing of returns.
- c) The IT infrastructure shall also enable the employer to submit applications on behalf of its employees for various transactions such as settlements/loans etc.
- d) The employer shall be able to file the nomination and other details of its employees through electronic media.

E – Transactions by exempt trusts

- With the Information Technology Act recognizing electronic documents, it would be very effective to allow exempt trusts to operate based on documents transmitted electronically.
- Currently, exempt trusts are forced to maintain all their back up papers in hard copy format. These include nomination and declaration papers, loan applications, and settlement applications. This is despite a well-developed Information Technology infrastructure with in the exempted establishment.
- In the absence of hard copy of documents, the EPFO inspectors during the annual inspection dispute the veracity of many a transactions of the trust.
- We would therefore suggest that the exempted trusts should be allowed to operate based on the electronic documents.
 - This would facilitate easier administration of the trust.
 - The application processing is made easier in this process leading to efficient service to the employee.
- Infrastructure is already available with the exempted companies to provide for electronic workflow in applying for various benefits of the exempt trusts, approval of applications, processing of such applications and payment of various benefits to the employees.

A7.2 TRANSFER OF FUNDS TO EXEMPT TRUSTS

- The transfer of funds to Trusts on exemption/relaxation takes a lot of time. The employees and the establishment are put to lot of inconveniences.
- Till the time of transfer of all the amounts, the employees are forced to make applications to the trust and to RPFC for settlements, loans etc.
- It also strains the trusts return on investments as the trust operates on a lesser corpus. Delay is normally caused due to the time taken to reconcile the accounts of the individual employee balances of at the RPFC.

Suggestion:

- The first tranche in cash may be transferred immediately based on the updation accounts till date. (Based on the Annual Statements issued till the end of the previous financial year)
- On finalization of accounts till the date of exemption the balance may be paid to the Exempt Trust after making the adjustments for the cash and securities proportions (85:15).

PART B – GRATUITY FUND

B.1 EVOLVE REGULATORY FRAMEWORK

Background

- The Gratuity Act is currently enforced by the Labour Commissioners of the respective state governments.
- This could lead to differential regulations particularly if as per the current Section 4A, each of the states notify the clauses for exemption from insurance policy in their own way.
- Gratuity Act being in the realm of occupational pension laws needs to be administered differently than that of Labour Welfare legislations such as Factories Act, Payment of Wages Act etc.

Possible advantages of Centralized Administration of Gratuity Act

- The regulations for administering the Act will be uniform
- The entire Pension related laws could be administered by one single identified Pension Regulator.
- The Income Tax Provisions could be aligned with the requirements of the Pension Regulator rather than having to get all the state wise regulations in line.

Suggestion:

- Identify a Pension Regulator, which could be IRDA or restructured EPFO, with only a regulatory role.
- Identified Regulator would be responsible for the administration of all Pension Legislations supervision of all the players in the Pension industry, the administrators, employers etc.

B.2 MANDATORY FUNDING OF GRATUITY LIABILITY

Background

The Gratuity Act while mandating the gratuity as a benefit and defining eligibility norms, quantum of benefit etc, is silent on how the employer should fund the liability. It leaves the aspects of funding for the liability to the employer. Though from a corporate governance perspective, the Accounting Standards prescribed by Institute of Chartered Accountants of India requires the employer to value the liability actuarially and provide for the same in the books.

The Gratuity Act provides for Compulsory Insurance for the liability under the Act (Section 4A) and also for exemption from the requirement for Compulsory Insurance if the employer has set up Income Tax Approved Gratuity Fund. However the provision has not been made effective as the State Governments have not notified the date of application of the provision.

There is no incentive for the employers have the gratuity liability funded either through an insurance policy or by setting up an IT approved Gratuity Fund. In the event of unexpected closure of a business, the employer would not be able to meet the gratuity liability. Employees in such a situation would be put to hardship.

Possible advantages of mandatory funding of gratuity liability

- The liability is always funded and the employee is assured of the benefit at the time of termination of employment.

Suggestion

- The Section 4A shall be notified with immediate effect.
- It should be clearly laid out that the employer shall either obtain an insurance policy or set up a gratuity fund with the due approval of Income Tax authorities
- Actuarial valuation of Gratuity Liability shall be made compulsory for all the employers in the Gratuity Act itself.
- It should also be made mandatory that the contribution/premium is paid annually within a specified time limit.
- Such Contributions/premium shall be made an eligible expenditure in the year of contribution

PART C – SUPERANNUATION FUNDS

C.1 EVOLVE REGULATORY FRAMEWORK

Background

- Employees on a voluntary basis now provide the Superannuation benefits
- There is no legislation that regulates the Superannuation benefits, its structure, etc other than the Income Tax provisions.
- This has led to lax supervision of these funds

Possible advantages of covering superannuation in the Pension Regulation

- The superannuation trusts set up by employer, though voluntarily, will get regulated and the employee benefits as assured by the Employer at the time of commencement of employment would get the same at the time of retirement.

Suggestion

- Subject the Superannuation Trusts also as any other occupational pension to the Pension Regulator

PART D – COMMON ISSUES

D.1 REMOVE CAP ON TAX DEDUCTIBILITY OF CONTRIBUTION IN DEFINED BENEFIT PLANS

Background

- The Income Tax Rules caps the business deduction on contribution to Superannuation and Gratuity arbitrarily at 15% (including Provident Fund contribution of 12% shall not exceed 27%) of the Basic Salary and 8.33% of the Basic Salary respectively per annum.
- While Defined Contribution Superannuation could be restricted to 15% of the gross basic salary, the defined benefit contributions shall be allowed subject to the actuarial valuation.
- The contributions arrived at based on actuarial valuation shall be allowed as deductions.
- The current cap on the contributions could lead to asset liability mismatch if the employer decides to restrict the contributions to the cap.
- In respect of the initial contribution, it is allowed as a deduction over a period of five years.

Possible advantages of removing the cap on the business deduction on contribution

- The Trusts would be fully funded as it would employers to fully contribute based on the actuarial valuation
- It will encourage the employers to set up such trusts for the benefit of their employees.

Suggestion

- The cap on the business deduction on the contributions to Trusts shall be removed if it is based on the actuarial valuation.
- To avoid excessive contributions, there could be a cap on the defined benefit, for example, the gratuity benefit could be limited to the benefit defined under the Gratuity Act.
- Allow full deduction in the year of contribution itself.

D.2 SIMPLIFY & HARMONIZE IT APPROVAL/ PROCEDURES

Background

- The IV Schedule to the Income Tax Act read with rules 82 to 111 provide for the guidelines for setting up Superannuation/Gratuity Fund by an employer and obtaining Income Tax approval.
- The Commissionerates of Income Tax at different locations follow different procedures for granting approvals.
- The process at certain locations takes anywhere between three to six months
- Certain Locational IT officials insist that the Assessing Officers of the Employer has to clear the proposal for Superannuation or a Gratuity. This leads to considerable wastage of time.
- Till such approval is granted, the returns on the investments of the Fund are liable for deduction at source. The whole process of getting refund of such TDS is again time consuming resulting in considerable opportunity loss for the funds.

Possible advantages of simplifying the procedure for Income Tax Approval

- The Trusts could start functioning at the earliest, leading to minimum start time in the initial set up and efficient investment of funds from the inception.

Suggestion

- To begin with the Income Tax authorities could devise an approval procedure, which shall ensure approval or rejection within say 30 days of filing for approval or automatic approval if no reply is received within 30 days.
- By the time the Pension Regulator is in place, if a trust is approved or recognized by the Pension Regulatory, it shall automatically qualify for approval under the Income Tax Act and shall be eligible for all the tax benefits.

D.3 FORMATION OF MULTI-COMPANY TRUSTS

Background

- A number of businesses (Indian Groups, MNCs, etc) have multiple legal operating entities for strategic and business reasons. A number of these companies would prefer to provide Provident Fund and other retrial benefits to employees across the group in a single trust.
- Current provisions of the PF act allow participation into an exempt trust by 6 participating units. However, there is no clarity on the definition of a participating unit with different interpretations by different RPFs (factories, offices, legal entities, etc)
- Most established Industrial houses have one or more of the companies that operate exempt trusts. However due to the unclear position of EPFO on this, other group companies are currently not participating into such trusts.
- The Income Tax authorities refuse to grant approval for more than one legal entities to participated into Superannuation and Gratuity trusts

Possible Advantages of Multi-Company Trusts

- Reduced administrative complexity
- Total Cost Reduction
- Harmonization of benefits and trust rules
- Economies of scale and scope
- Employee friendliness in case of intra-group transfers
- Single window for compliance and higher ability for supervision

Suggestion

- A group of companies should be allowed to obtain exemption and operate a trust for all the member companies of the Group.
- If an exempted trust is already in existence, other members of the group as well as newly established member companies of the group should be allowed to participate automatically into such group companies.
- Income Tax Authorities should grant approvals for setting up Superannuation and Gratuity Trusts to cater to a group of companies.

