

**Tax Incentives for Savings
Adjusting for changes in work-life**

Deloitte Tax Policy Paper 1

August 2018

For Private circulation only

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Foreword by Deloitte

Tax policy in India and internationally is rapidly evolving with the tax landscape closely following suit. The OECD / G20 BEPS initiative was an impetus for change around the world. Coverage of this initiative expanded to the 116 countries in the Inclusive Framework that led to the adoption of Anti-Tax Avoidance Directives (ATADs) I and II in the EU and influenced the US Tax Reform and tax policy changes around the world. India recently witnessed the roll out of the GST and the setting up of a task force for Direct Tax Code. Many of the changes will take effect over the next couple of years. Deloitte has been very supportive of the changing tax landscape and its emphasis on transparency both globally and locally. We have contributed to global and domestic initiatives by responding to

requests for submissions and in engaging with OECD and local government tax officials. We continue to keep our clients informed of these developments and have developed technology tools to assist them in analysing the impact and complying with the changes. The working paper on "Tax Incentives for Savings - Adjusting for changes in work life", is one in a series that will present researched ideas for the consideration of policy makers. It recognises the evolving demographics for India, the changing pattern of employment and the growing public objective to build a pensioned society.

We hope readers will find the analysis presented by this working paper and its recommendations to be useful.

Executive Summary

Employment trends indicate that during their working life, individuals will increasingly have multiple jobs interspersed with periods of self-employment and voluntary or involuntary separation from the job market. Life expectancy beyond working life is also on the rise in India. So the goal of public policy should be to promote tax-sheltered savings instruments that are flexibly tailored to the new working life and to take care of life after retirement.

The major financial instruments available in India for such long-term savings are the Employees Provident Fund (EPF) for employees in the non-government, formal sector. For government employees, it is the National Pension Scheme (NPS) Tier I Account. Both schemes envisage contributions from employer and employee and have significant tax incentives attached to them. However, these schemes (and the associated tax incentives) do not fully address the savings needs of individuals who are self-employed or who may be temporarily out of the workforce.

The National Pension Scheme (NPS) Tier II account run by the Pension Fund Regulatory and Development Authority (PFRDA) under a statutory law along with its attendant ecosystem of a single identifier and cross-country service providers, could be an ideal instrument for long-term savings for all individuals specially those who may not be part of the organized workforce. We suggest a Tax Exempt Exempt (TEE) mode with modified withdrawal norms for a revamped NPS Modified Tier II Account which would help address the savings profile of the workforce of the 21st century.







Background

One of the key issues for tax policy is the use of direct tax incentives for promoting long-term savings by individuals for working life exigencies and retirement. This issue is of special concern as the composition and demography of the workforce¹ and the nature of work contracts² is witnessing rapid changes globally. How should tax be used to shape the savings behaviour of the individual through his working life so that there is appropriate level of saving to support him through periods of working life when not employed and in retired life? One of the major concerns for India is its young workforce and the ability of the economy to generate enough formal jobs to employ this workforce. Life-long

employment with the same employer is also losing relevance as the nature of jobs and job security are changing. Individuals may increasingly expect to move between periods of employment (with different employers), self-employment and non-employment, with corresponding variations in their income. Increasing female participation in the organised workforce is crucial for increasing the growth and efficiency of the economy; therefore it is a public policy imperative to promote her long term savings for the period where she may choose to be outside the workforce for reasons such as to bring up a family. There is also a rapid increase in retirees who will need to sustain their post-retirement savings

Box 1: India old-age dependency Ratio

Year	Ratio
1965	7.0
1975	7.6
1985	7.9
1995	8.3
2005	9.1
2015	10

¹ Asia-Pacific Human Development Report, Shaping the Future: How Changing Demographics Can Power Human Development, United Nations Development Programme (2016) reports India's working-age population as 0.86 billion in 2015. In Future of work and skills (a paper presented at the 2nd Meeting of the G20 Employment Working Group, February 2017), the OECD forecast that the working-age population in India will swell by 33% by 2050

² Good Work: The Taylor Review of Modern Working Practices (July 2017) has proposed the term 'dependent contractor' to characterize individuals working as zero-hours or casual contractors in the sharing/ app based economy, who are "not an employee, but neither are they genuinely self-employed".



over a longer period as life expectancy is increasing³. The old-age dependency ratio (i.e. the ratio of population aged 65+ years per 100 population 20-64 years) has increased substantially [Box 1]⁴. It will be increasingly difficult for children to look after and support parents over their extended life expectancy.

The government has recently released for consultation the draft 'Labour Code on Social Security, 2018' which envisages progressive universalization of social security to the entire workforce. While the concept of universal social security or universal basic income support is widely debated, it is unlikely that the Indian economy will be able to find resources for this in the near future, especially for income-tax paying individuals who comprise less than 5 per cent of the population. Promoting long-term savings by taxpayers to support them through variations in employment and income during their working life, and separately, to provide a steady stream of pension

income in their post-retirement life is vital for public policy. We therefore, need to address specific savings behaviour which promotes (a) savings for working life exigencies and (b) savings for retirement. Globally, the primary mode of savings for major working life exigencies and for retirement are insurance schemes and pension funds with contributions by both the employer and the employee.

There is unanimity in views that tax incentives can be gainfully employed to promote savings in such funds.

The income-tax incentives for these funds can apply at the different stages of contribution, accretion and withdrawal from the fund:

- The income of the fund (as an entity) can be exempted from income tax
- The contribution made by the employer to the employee's account in the fund can be allowed as a deduction for computing income-tax liability

- The contribution made by the employer to the employees account can be excluded from the employees income for computing the employees' income-tax liability
- The contribution made by the employee can be deducted from the employee's income while computing the employee's income-tax liability
- The annual accretion to the employee's account in the fund can be excluded from the employee's income for computing the employee's income-tax liability
- The withdrawal by the employee of his accumulated corpus from the fund on retirement (or on a specified work-life exigency) can be excluded from the employee's income for computing income-tax liability

The extent of the tax incentive at all the above stages can be total or partial.

³ World Bank - Life expectancy in India is 69 years in 2016 as against 41 years in 1960 (<https://data.worldbank.org/indicator/SP.DYN.LE00.IN?locations=IN>) World Population Prospects, Key findings & advance tables 2017 Revision, United Nations - Life expectancy in India is projected to be 74.2 years in 2045-2050

⁴ World Population Prospects 2017, United Nation - DESA / Population Division



Employees Provident Fund (EPF)

In India, the primary mode of compulsory saving in the non-government formal sector is the **Employees' Provident Fund Scheme (EPFS)**. This is the main scheme under the Employees' Provident Fund and Miscellaneous Act, 1952 (EPF Act). The other schemes operated under the EPF Act are the Employees' Pension Scheme (EPS) and the Employees' Deposit Linked Insurance Scheme (EDLIS). The funds are invested by a Board of Trustees as per norms laid down by the government and the schemes are administered by the Employees' Provident Fund Organisation (EPFO). The EPF Act and the schemes, in general, cover every

business establishment employing 20 or more persons (and also specific establishments employing less number of employees if notified by the government). Only those employees of such business establishments are mandatorily covered under the EPF Act threshold, whose salary is up to INR 15,000 per month. However, a 'non-eligible employee' can also become a member of the EPF (with the permission of the EPFO) if he and his employer agree. Many business establishments choose to go in for automatic enrolment of all employees under the EPF irrespective of the salary threshold.

Under the current rules of the EPF scheme, an employer is obliged to deposit a certain contribution towards the scheme with an equal contribution being made by the employee. Currently, for most establishments, the contribution paid by the employer is 12% of defined Pay [Box 2].

**Box 2: PF contribution rates on Pay⁵**

Particulars	Name of the Fund	Members enrolled before September 1, 2014	Members enrolled on or after September 1, 2014
Contribution rates for Domestic employees			
Employee contribution	Provident Fund	12% of Pay (a)	12% of Pay
Employer contribution	Pension Fund	8.33% of INR 15,000 (b)	NIL ⁶
	Provident Fund	Balance [i.e. 12% - (8.33% of INR 15,000)] (a) - (b)	12% of Pay
Government	Pension Fund	1.16% of INR 15,000	NIL ⁶
Contribution rates for International workers			
Employee contribution	Provident Fund	12% of Pay (a)	12% of Pay
Employer contribution	Pension Fund	8.33% of Pay (b)	NIL ⁶
	Provident Fund	3.67% of Pay (a) - (b)	12% of Pay

⁵ The term Pay covers basic wages, dearness allowance (DA), retaining allowance and cash value of food concession.

⁶ In case monthly pay exceeds INR 15,000

Out of the employer's contribution, a small amount⁷ is deposited in the EPS. The remaining portion of employer and employee contribution is retained in the provident fund, the EPFS. There is an equal contribution of 12% payable by the employee [Box 2]. The employee can also voluntarily pay a higher contribution (above the statutory rate of 12% of basic pay) to the EPF. This is called contribution towards the Voluntary Provident Fund (VPF) and the employer does not have to match such voluntary contribution. On retirement or on specified exigencies even prior to retirement (like losing one's job)⁸, the employee gets a lump sum accumulated amount including self and employer's contribution (with accrued

interest on both) from the EPFS. Besides the lump sum amount, the employee is also eligible for a pension from the EPS on retirement if contribution has been made for at least 10 years; if not, withdrawal of contributions as per specified rates are permitted. The tax incentives relating to EPF are: statutory contributions by the employer are not included in the employee's salary income; the employee's contribution is allowed (under section 80C of the Act which includes other savings instruments up to a total limit of INR 1,50,000) as a deduction from income; the annual income accruing in the fund is not taxed, and withdrawal of corpus at the time of retirement subject to specified conditions, is also not taxed [Box 3].

Box 3: Tax implications related to EPF

Particulars	Component	Tax implications
Contribution stage	Employee contribution	• Deduction available up to INR 150,000 under section 80C
	Employer contribution	• Not taxable up to 12% of salary (excess is taxable) • Allowed as a business expense, while computing income under the Act
	Interest on accumulated balance	• Not taxable up to notified rate (excess of the notified rate is taxable)
Withdrawal of PF accumulated balance - Exempt		• Withdrawal is exempt if specified conditions ⁹ are complied with
Withdrawal of PF accumulated balance - Taxable	Employee contribution	• Taxable ¹⁰
	Employer contribution	• Taxable
	Interest on Employee contribution	• Taxable
	Interest on Employer contribution	• Taxable

⁷ Employer's maximum contribution towards EPS is 8.33% on INR 15,000 (which is the statutory wage ceiling as per the Employees' Provident Funds Scheme, 1952) i.e. INR 1,250

⁸ Para 69 of the Employees' Provident Fund Scheme, 1952

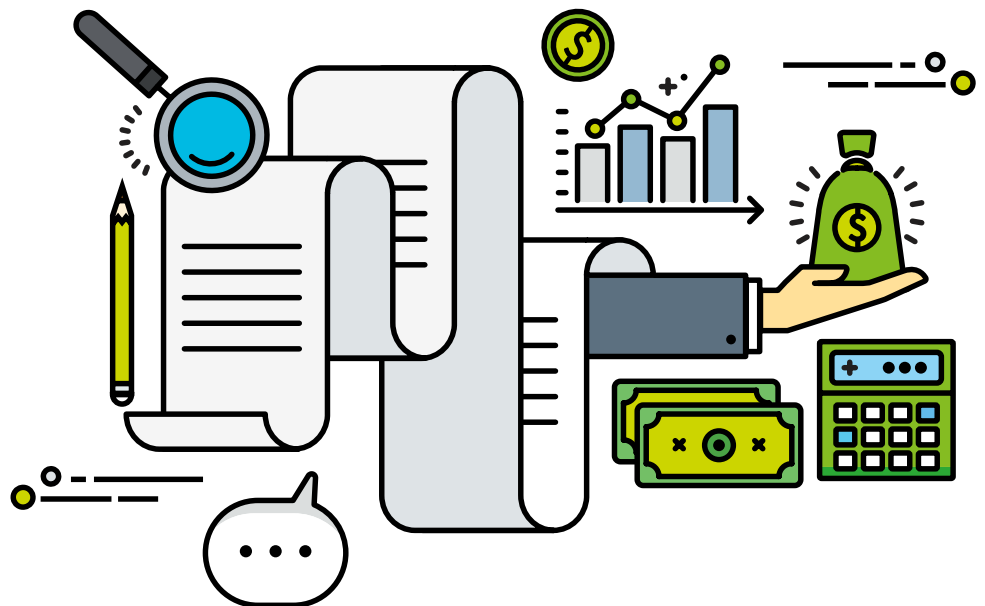
⁹ As per Rule 8 Part A of the Fourth Schedule to the Act, the total accumulated balance withdrawn is exempt if:

- The employee has rendered continuous service for a period of five years or more, or
- The service has been terminated by reason of the employee's ill-health or other cause beyond the control of the employee before the period of five years, or
- On the cessation of the employment, the employee finds another job and the accumulated PF balance is transferred to his individual PF account maintained by the new employer, or
- If the entire balance standing to the credit of the employee is transferred to his account under a pension scheme referred to in section 80CCD and notified by the Central Government

¹⁰ To the extent the contribution was claimed as deduction under section 80C in the relevant year

The generous tax incentives along with the 'sovereign' nature of the interest¹¹ which accrues from year to year in the EPFS, makes it an attractive source of long-term savings for all employees and especially for employees who have a higher level of income which is taxable under the Income-tax Act, 1961 (Act). However, the EPFS faces certain structural challenges - the scheme is

not available to the self-employed, the individual does not have a say in the financial instruments in which his corpus is invested, and there is no flexibility to make catch-up contributions for periods of unemployment or when leaving the workforce.



¹¹ The interest rate is recommended by the EPFO's Central Board of Trustees (CBT) subject to approval by the Central Government. It was 8.55% for FY 2017-18.



Other Funds

Employers in the non-government sector can also sponsor separate **Approved Superannuation Funds** (ASAF) to provide pensions to employees when they leave the organisation. The employer can create and manage an ASAF with the approval of the income-tax authorities¹². The tax benefits associated with an ASAF are contributions by the employer not included (up to a threshold of INR 1,50,000) in the employee's income;

employee's contribution is allowed (under section 80C of the Act which includes other savings instruments up to a total limit of INR 1,50,000) as a deduction from his income; the income accruing in the fund is not taxed and there is also no tax¹³ on withdrawal by the employee if it is by way of commutation of an annuity on retirement.

¹² Rule 2 Part B of the Fourth Schedule of the Act

¹³ As per section 10(13) of the Act, any payment made from an approved superannuation fund will not be included in the total income –

- 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 contribution on the death of a beneficiary; or
- By way of refund of contributions to an employee on his leaving the service in connection with which the fund is established otherwise than by retirement at or after a specified age or on his becoming incapacitated prior to such retirement, to the extent to which such payment does not exceed the contributions made prior to the commencement of this Act and any interest thereon; or
- By way of transfer to the account of the employee under a pension scheme referred to in section 80CCD and notified by the Central Government



The government-run **Public Provident Fund (PPF)**, is also available as a long-term savings instrument to all individuals. Individuals can contribute up to a threshold amount (ranging from INR 500 to INR 1,50,000 per annum), and the annual interest in the account is declared by the government. Withdrawals are allowed after a tenure of 15 years with some partial withdrawals allowed after 7 years. The tax incentive associated

with PPF are: contributions by the individual are deductible for computing taxable income (under section 80C of the Act, along with contributions to other designated savings, up to an overall threshold of INR 1,50,000); the annual interest income accruing in the account is not taxed and the proceeds received on maturity are also tax free.





National Pension Scheme (NPS)

Regarding pensions for employees in the government sector, there has been a transition since January 2004. Employees joining government before 2004, are eligible for a defined benefit pension on retirement which is linked to a percentage of the last salary drawn along with continuous upward inflation adjustments besides income from their contributions to a General Provident Fund (GPF). However, for employees joining on January 2004 and after, this has been replaced by a pension to be paid out

of defined corpus through contributions to the **National Pension Scheme** (NPS).

The NPS mandates matching contributions from the employee and the employer into the employee's Tier I account for which the employee is given a unique identity number i.e. Permanent Retirement Account Number (PRAN). The defined corpus is made up of compulsory contributions by the employee during working life, with a matching contribution by the government and the income



earned on these contributions through investment made by the NPS in debt and equity instruments¹⁴. Thus, NPS is a defined contribution scheme under which the final corpus available to a contributor depends on the total contributions made (by the contributor and the employer) and the investment returns on these contributions. The NPS is now also open to non-government employees and to self-employed individuals as it is administered under three models- Government Sector Model which is compulsory for government employees, an All Citizens Model and a Corporate Model which are optional. The All Citizens Model is open to self-employed individuals and does not require a matching employer contribution. Thus, for non-government employees, NPS is a voluntary scheme in which the

contributions can be made as employee contribution only, employer contribution only or both employee and employer contribution.

The tax incentives relating to NPS Tier I account are: statutory contributions by the employer are not included in the employee's income; employee's contribution, clubbed with certain other savings is allowed as a deduction from his taxable income up to a specified limit; income accruing in the fund is not taxed; and there is no tax on withdrawal of the corpus by the employee, on retirement (up to a threshold of 40 per cent of the corpus). On retirement, the employee also has to invest at least 40 per cent of the corpus in pension annuities. [Box 4]

¹⁴ Investments under NPS are made in three separate types of mutual funds i.e. those that invest in Equity (E) or Corporate bonds (C) or Government securities (G). A subscriber can choose 'Active choice' the proportion in which the contributions to the account are to be invested in these asset classes; however, allocation in Equity cannot be more than 50%. If a subscriber opts for 'Auto choice', the contributions to the account are invested by following a life-cycle matrix based on the age of the subscriber.

Box 4: Tax implications relating to NPS

Particulars		Tax implications
Contribution stage	Employee	<ul style="list-style-type: none"> Contribution up to 10% of salary (Basic + DA) is tax deductible under section 80CCD(1), subject to a ceiling of INR 1,50,000 under section 80CCE of the Act Additional deduction for investment up to INR 50,000 provided under section 80CCD(1B) over and above the ceiling of INR 1,50,000 Tax benefit on employer contribution to employees' NPS account i.e. contribution up to 10% of salary (Basic + DA) can be deducted under section 80CCD(2) - no cap on amount; this deduction is over and above ceiling limit of INR 1,50,000 under section 80C and INR 50,000 under section 80CCD(1B)
	Employer	<ul style="list-style-type: none"> Deductible as business expense under section 36(1)(iva) - Contribution up to 10% of the salary (Basic + DA) to employee's NPS account
Withdrawal of NPS accumulated balance	Upon attainment of 60 years of age	<ul style="list-style-type: none"> At least 40% of the accumulated pension wealth of the subscriber needs to be utilized for purchase of annuity providing for monthly pension to the subscriber and balance paid as lump sum In case the total accumulated corpus is less than INR 2,00,000, the subscriber may opt for 100% lump sum withdrawal The subscriber also has an option to contribute and also, defer the lump sum withdrawal till the age of 70 years
	At any time before attaining the age of 60 years	<ul style="list-style-type: none"> Subscriber may exit from NPS only if he has completed 10 years in NPS At least 80 percent of the accumulated pension wealth of the subscriber needs to be utilized for purchase of annuity providing for monthly pension to the subscriber and balance paid as lump sum In case the total accumulated corpus is less than INR 1,00,000, the subscriber may opt for 100% lump sum withdrawal
	Death	<ul style="list-style-type: none"> Option available to nominee to receive 100% of the NPS pension wealth in lump sum
	Tax benefits	<ul style="list-style-type: none"> Withdrawal on closure of account to the extent it does not exceed 40% of the total amount payable Partial withdrawal made by an employee from the NPS Trust is exempt under section 10(12B), to the extent the withdrawal does not exceed 25% of the total contribution made

The NPS is available to non-government employees and their employers (for making matching contributions) as well as the self-employed. The PFRDA has also laid down a process¹⁵ to enable employees to shift their EPF balances to

the NPS and to start contributing to the NPS. A comparison of the withdrawal provisions allowed under the EPF with what is allowed under the NPS would show that those under the EPF are more liberal.

¹⁵ Circular PFRDA/2017/11/PD/3 dated 6 March 2017. However, EPFO guidelines for the process are awaited.





Recent Developments

With the stated aim of promoting a pensioned society and bringing greater parity in the tax treatment of different types of pension plans, the government proposed to amend the tax provisions under the Act, through the Finance Bill, 2016. It proposed to exempt from tax, the withdrawal of an employee's accumulated balance in the NPS Tier I account up to 40 per cent of the accumulated corpus (which up to then had been fully taxable). At the same time, it proposed to limit the full tax exemption on the withdrawal of an employee's accumulated balance in the EPF account to a limit of up to 40 per cent of the accumulated corpus. It also proposed to include employer's contribution to an employee's account in the EPF in excess INR 1,50,000 as a perquisite to

be included in the taxable income of the employee¹⁶. Further, the government issued a notification to amend the EPF rules to allow the withdrawal of the remaining 3.67 per cent of the employer's contribution and accumulated interest only on retirement (or at the age of 58 years)¹⁷. The tax proposals (except for the one allowing exemption for withdrawals from NPS) and the notification on EPS withdrawal were rescinded owing to push back from stakeholders such as workers' unions, with the government stating that it would do a comprehensive review of the proposals. The government later introduced a separate tax incentive window in 2016 for voluntary pension savings¹⁸ (of up to INR 50,000) for individuals, if deposited in an individual's NPS Tier I account.

The need for a tax-incentivised national pension scheme is undisputed. The building blocks for such a scheme are already in place as the National Pension Scheme (NPS) which is governed under a statute and is overseen by a statutory pension regulator (the Pension Fund Regulatory Development Authority - PFRDA¹⁹), is now in place. A universal identifier (PRAN) for contribution into funds under the NPS is also in place so that an individual's contribution over his or her working life can be tracked. Currently, the major tax difference between the two schemes is the non-taxable full corpus (excluding the contributions relating to the EPS) withdrawal allowed from the EPF as against non-taxable 40 per cent of corpus withdrawal under the NPS. The

¹⁶ Explanatory Memorandum to Finance Bill 2016 (www.indiabudget.gov.in)

¹⁷ Press Information Bureau, Notification dated 21 April, 2016

¹⁸ Section 80CCD(1B) introduced w.e.f. 1.4.2016

¹⁹ PFRDA was made a statutory regulator under the Pension Fund Regulatory and Development Authority Act, 2013 w.e.f 1 February, 2014



government's attempt to bring the taxation and the withdrawal provisions of EPF and NPS at par, has not been successful given the historical legacy of the EPFO²⁰, the government-approved interest rate which applies to EPFO contributions²¹ and stakeholder pushback to restricting EPFO taxation and withdrawal norms. There is a significant difference between private sector and government sector employees, e.g. in security of tenure, the variability in the salary structure and in salary taxation such as difference in the valuation of perquisites (housing and provision of vehicle) for tax purposes. The structure of the NPS (a pure pension scheme with the contributor given some flexibility in choice of investment strategy with the annual income accrual on investment depending on performance of the equity and debt markets) is different from that of the EPF (a provident fund plus a

pension scheme with a defined interest income decided by the government). Besides, depending on the annual income which an individual can earn in his working life cycle, there would be significant variation in the ability to access tax incentives for contributions to these pension schemes, as the tax incentive may operate fully or partially given the level of tax liability on income in a particular year. Therefore, attempts to achieve 'parity' in the taxation of these schemes will remain a somewhat ad-hoc exercise. There is also the historical legacy of litigation on earlier decisions regarding benefits available to contributions made to the EPS²². The EPFO has also embarked on a number of technology driven initiatives to assist contributors in their interface with the organisation. However, structurally, given the rigid contribution rules, the fact that the employee coverage includes a

substantial majority of individuals whose incomes are below the taxable limit or may be in the lowest tax bracket and that it was meant primarily to provide a minimum level of social security protection to low income employees, the EPF is not the ideal vehicle for a tax incentive driven plan for long term savings which can cater to individuals with diverse working life profiles. The long-term savings legislation, structure and governance as evidenced in the Employees' Provident Funds & Miscellaneous Act of 1952 was not envisaged to deal with such variations in working life circumstances. The EPF currently remains positioned more as a source of savings which can be utilised to tide over periods of unemployment or self-employment during working life with only a small component as pension for retired life.

²⁰ EPFO is a statutory body formed by the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 to assist the Central Board of Trustees, and is under the administrative control of Ministry of Labour and Employment, Government of India

²¹ 8.55% for the year 2017-18

²² There was an ongoing dispute regarding the amount which an EPF subscriber is allowed to contribute to the EPS. Refer Supreme Court in SLP No. 33032-33033/2015 (R.C. Gupta and others vs. Regional P.F. Commissioner and others) ruled in favour of employees' right to raise their contributions to the pension fund without imposing any cut-off date for eligibility.



Current tax incentives for promoting savings

Given the current status, historical legacy and revenue considerations outlined above, what could be a possible overall structure of tax incentive for long-term savings to promote a pensioned society? We could discuss this from two aspects.

First, a review of the tax treatment relating to existing provident and pension funds at various stages of contribution, accumulation and withdrawal. Second, its impact on the ability and flexibility of an individual to save for a long-term corpus (and to access it for exigencies and for retired life) during a working life which has periods of employment, self-

employment and unemployment. Based on this review, we can explore whether we can create any other savings vehicle which meets the needs of the workforce in a rapidly evolving work environment.

Over the years, the tax legislation has listed a number of savings instruments as well as expenses (provident funds, equity, bank deposits, mutual funds, life insurance etc.) up to a specified threshold which will allow the taxpayer to reduce their income-tax liability [Box 5].



Box 5: Instruments and eligible expenditures covered under section 80C of the Act²³

Saving Instruments	Eligible expenditure
Contract for deferred annuity	Life Insurance Premiums
Deferred Annuity deduction from salary	Unit-linked Insurance Plans
Employees' Provident Fund (PF) and Voluntary Provident Fund (VPF)	Annuity plan for Life Insurance
Public Provident Fund (PPF)	Tuition fees
Approved superannuation fund	Home Loan Principal Repayment
Sukanya Samriddhi Account	
National Savings Certificate	
Unit Linked Insurance Plan of LIC Mutual Fund	
Equity Linked Saving Scheme	
Notified pension fund	
Deposit scheme for housing	
Subscription to specified shares/ debentures	
Notified mutual funds	
Five-year Bank Fixed Deposit	
NABARD Bonds	
Senior Citizen Savings Scheme 2004	
Five-year Post Office Time Deposit (POTD) Scheme	
NPS Tier I	

²³ Section 80C, 80CCB, 80CCC, 80CCD(1) of the Act currently up to a threshold of INR 1,50,000 and INR 2,00,000

Box 6: Other deductions available to individuals under Chapter VI-A of the Act**Saving Instruments**

Health insurance premia and medical expenditure ²⁴
Maintenance (including medical treatment) of handicapped dependent ²⁴
Treatment of specified illness ²⁴
Interest on loan taken for higher education
Interest on loan taken for residential house property
Donations to approved institutions
Rent paid by employees not having HRA
Contributions made to a political party by companies and individuals, respectively
Saving account interest
Interest on deposits in case of senior citizens
Person with disability

Besides this, there are other expenditures e.g. for medical expenses which are allowed as deduction under the Act [Box 6]. These provisions have been critiqued for being omnibus in nature,

for promoting one form of saving over another and for clubbing savings and expenditure incentives under the same provisions [Box 5, 6].



²⁴These deductions are subject to individual monetary limits specified in the relevant sections of the Act



Proposals for a more flexible long-term savings regime

A separate deduction threshold for provident and pension funds:

Currently, the contribution made by the employee to EPF or NPS Tier I or recognised provident fund or to an ASAF is allowed as a deduction from the employee's income, up to a monetary threshold, for computing his income-tax liability. However, the current threshold for such a deduction (of INR 1,50,000) is an omnibus one which includes other

savings instruments also [Box 5]. A separate additional deduction (up to INR 50,000) is allowed but only for employee contributions to the NPS Tier I. This can be rationalised to allow for a separate deduction of up to INR 2,00,000 for contributions to these provident, pension and superannuation funds which would be available to all taxpayers.



A more flexible savings instrument in the Taxed, Exempt, Exempt (TEE) mode for all taxpayers:

As pointed out, working life for most individuals will likely witness much greater variations in terms of periods of employment, self-employment and unemployment. There is a need for a more flexible long-term savings

instrument besides the ones currently available. As an example, in the US several other kinds of tax-incentivised options are allowed for long-term savings for retired life through holding accounts [Individual Retirement Accounts (IRAs) and Roth IRAs [Box 7] and retirement savings plans such as (401K) (for employees) Roth 401K (for all

citizens), 403(b) plans (for tax exempt organisations), SIMPLE IRA and solo 401K plans (for small businesses), SEP IRA plans (for self-employed individuals)]. India's income-tax statute should also allow for more flexible savings structures to accommodate the savings needs of the evolving workforce.

Box 7: USA: Salient features of Roth IRA

Contributions	Not tax deductible at the time these are made
Income accruing on the contributions	Not taxed
Withdrawals from the Roth IRA	<p>Tax-free where:</p> <ul style="list-style-type: none"> • withdrawal is of the amount of original contribution, regardless of age; • one attains the age of 59.5 years or older and has held the Roth for 5 years or longer; • one is under 59.5 years of age and has held the Roth for 5 years or longer, but is withdrawing because of disability, inheritance, etc. <p>Where the Roth IRA is held for less than 5 years, withdrawals are also subject to a 10% early withdrawal penalty (with certain exceptions, eg. For medical, healthcare, disability, etc.).</p> <ul style="list-style-type: none"> • There is no mandatory distribution age • Roth IRAs are exempt from creditor claims

The primary challenge to possibly providing a universal, flexible, tax-incentivised long-term savings option in the income-tax statute was the absence of a sound regulatory, institutional and technology framework. This has been addressed by the setting up of the PFRDA. An NPS Trust was set up by PFRDA (settlor of Trust) in 2008 with the execution of the NPS Trust Deed for taking care of the assets and funds under the NPS in the interest of the beneficiaries (subscribers). PFRDA has appointed central record keeping agencies, pension Fund Managers, Trustee Bank, annuity service providers to provide services to subscribers. It has also put in place intermediary pension funds for receiving contributions, accumulating them and making payments to subscribers as specified. A pension fund also acts as a bridge between the various intermediaries under NPS architecture and PFRDA, in order to protect the interests of the subscribers by providing information and data as required. PFRDA has also appointed a Trustee Bank for NPS in 2013 which is responsible for the day-to-day flow of funds and banking facilities. The Trustee Bank receives NPS funds from all nodal offices and transfers them to the pension funds/ annuity service providers/other intermediaries as required. The NPS has also appointed institutions for providing custodial and depository participant services for the pension schemes regulated by it. Point of Presence (PoPs) have been appointed nationwide as the first point of interaction between the subscriber and the NPS architecture. PoPs perform functions relating to registration of subscribers, undertaking KYC verification, receiving contributions and instructions and transmitting them in the NPS architecture. The PFRDA was itself made a statutory regulator from February, 2014 under the PFRDA Act, 2013. The NPS currently has an NPS Tier I account which can be started by any individual and which also has the option for the employer to make a matching

contribution. The NPS Tier I account, while being mandatory for government employees, will continue to be optional for others and will need to coexist with the EPF for the foreseeable future.

The setting up of the PFRDA as a statutory body under the PFRDA Act and its roll out of the entire NPS architecture (besides its rollout of PRAN as a unique Aadhaar-linked identifier for every individual contributor) now allows for the introduction of a more flexible long-term savings instrument which is universally available to all individuals throughout their working lives. As detailed earlier, the NPS Tier I account is currently mandatory for government employees who joined the government after January 1 2014, with the government and the employee making matching contributions. Employers in the non-government sector can also optionally join under the Corporate Model. Any individual can also open a Tier I account in the NPS and make his own contribution under the All Citizens Model even without any employer contributions.

The NPS allows any person with a Tier I account to also start a Tier II account. Contributions to the Tier II account are kept separate from the Tier I account. Amounts are freely withdrawable from a Tier II account at the option of the subscriber. However, contributions to NPS Tier II account do not qualify for any tax deduction under the Act and any withdrawal from the Tier II account is taxed in the hands of the subscriber²⁵. The withdrawal characteristics and tax treatment of the NPS Tier II account can be modified to provide a flexible long-term savings instrument to all taxpayers which would meet the requirements of all kinds of employment stages. The Tier II account can be modified (labelled as '**NPS Modified Tier II Account**' in this write-up). The NPS Modified Tier II Account would have the following features:

²⁵ Tier-II contributions kept in a separate account that will be withdrawable at the option of the Government servant. Government will not make any contribution to Tier-II account. NPS Tier II account does not qualify for tax rebate under the Act.





- Contributions to the account will not get any tax deduction or benefit
- Annual income accrued and accumulated in the account will not be taxed
- The subscriber would be able to withdraw his principal contributions (but not the income which has accrued in the account) without any taxation
- The subscriber would be able to withdraw his entire accumulated balance without any taxation if he is 60 years or older and he has had the account for 5 years or more
- Besides this, for specific life emergencies and exigencies such as disablement etc. the subscriber would also be able to withdraw his entire accumulated balance without any taxation even if he is less than 60 years old, subject to his having held the account for at least 5 years.

For any other kind of withdrawal from the NPS Modified Tier II Account, the amount withdrawn would be subject to a withholding of 10 per cent (to be allowed as credit against final tax liability) and the income element embedded in the withdrawal would be includible in the taxable income of the individual. Thus, though there would be no bar on withdrawals, there would be tax consequences on some kinds of early withdrawals. The account described above will have characteristics akin to that of a Roth IRA account. [Box 7 gives salient features of a Roth IRA account].

An NPS Modified Tier II Account with the characteristics and tax treatment outlined above will allow an individual to contribute any small or large sum depending upon his income in that year and will also give him more flexibility of tax free withdrawal than the Tier I account [Box 8]. It will be available to all individuals as long as they have opened a Tier I account under the NPS.

Box 8: Proposed 'NPS Modified Tier II Account'

Nature of Contribution	Non-Government Sector	Government Sector	Self-employed
Voluntary contribution by the Individual	Available	Available	Available
Employers contribution	Not Applicable	Not Applicable	Not Applicable
Tax incentives			
Contribution by the Individual	Not allowed as a deduction from taxable income		
Annual income accruing in the account	Not taxed		
Withdrawal of accumulated balance	Not taxed		
Nature of Income	Market return from investments in debt and equity		

Specifically, a self-employed individual will have the option to contribute to either the more tax-advantaged Tier I account (which consequently has less flexibility of withdrawal) or to the less tax advantaged Tier II account (with more flexibility of withdrawal) or to apportion his contribution between

both, depending upon his economic circumstances. An employed individual would also have the option to contribute to the NPS Modified Tier II Account besides his contribution to the Tier I account. Box 9 gives the long term retirement accounts/plans which would be available to an individual who during

his working life is employed with the government, the private sector or is self-employed. The full range of provident and pension funds with contribution and taxation proposals is outlined in the Appendix.

Box 9: Pension options with the suggested 'NPS Modified Tier II Account'

Particulars	Government Sector	Private Sector	Self-employed
EPF	X	✓	X
NPS Tier I	✓ (mandatory)	✓ (optional)	✓ (optional)
'NPS Modified Tier II Account'	✓	✓	✓
PPF	✓	✓	✓

Suggestions

To recap, the recommendations regarding tax incentives for long-term savings for meeting the flexible employment structure through a working life, over the coming decades are:

- A separate tax deduction for contributions to EPF, recognised provident funds, NPS Tier-I and ASAF
- An 'NPS Modified Tier II Account' in the TEE mode available to all taxpayers with the following contribution rules and tax treatment:
 - Contributions to the account will not get any tax deduction or benefit
 - Annual income accrued and accumulated in the account will not be taxed
 - The subscriber can withdraw his principal contributions (but not the income which has accrued in the account) without any taxation
 - The subscriber can withdraw his entire accumulated balance without any taxation if he is 60 years or older and he has had the account for 5 years or longer
 - Besides this, for specific life emergencies and exigencies such as disablement etc. the subscriber can also withdraw his entire accumulated balance without any taxation even if he is less than 60 years old, subject to his having held the account for at least 5 years.

The EPF, NPS Tier I and the 'NPS Modified Tier II Account' (with attendant income-tax incentives) would help cater to individual savings, keeping in mind the different employment situations an individual taxpayer might encounter in his working life. This would help in the public policy goal of promoting long-term savings by individuals in a changing work-life environment.

Appendix

Note: The savings options available to individuals along with their characteristics and tax treatment would be as per the Boxes below.

Savings Instrument	Nature of Contribution	Employment status of Individual		
		Non-government Sector	Government Sector	Self-employed
Employees Provident Fund (EPF)	Employers contribution with matching employee contribution	Available	Not Available	Not Available
Voluntary Provident Fund (VPF) as part of EPF	Additional contribution only by the individual employee to his EPF account	Available	Not Available	Not Available
NPS Tier I	Employers contribution	Available (referred to as the 'Corporate Model')	Available (referred to as the 'Government Sector Model')	Not Available (referred to as the 'All Citizens Model')
	Employees/ Individual's contribution	Available	Available	Available
	Additional, voluntary self-contribution by employee/ individual	Available	Available	Available
Approved Superannuation Fund (ASAF)	Voluntary Pension scheme offered by Employer	Available if employer offers such scheme	Not Available	Not Available
Public Provident Fund	Voluntary contribution by individual	Available	Available	Available
NPS Modified Tier II (Proposed)	Voluntary contribution by the Individual	Available (Proposed)	Available (Proposed)	Available (Proposed)

The tax incentives linked and returns linked to these schemes would be as follows:

Savings Instrument	Tax Incentives				Nature of Income
	Employers Contribution	Employees Contribution ²⁶	Annual accruals	Withdrawals	
Employees Provident Fund (EPF)	Not included in income of the individual employee up to 12% of the salary	Allowed as a deduction from taxable income	Not taxed	Not taxed after continuous service of 5 years and other specified circumstances	Annual Interest as notified by government
NPS Tier I	Not taxed as income of the individual employee to the extent it does not exceed 10% of salary	Allowed as a deduction from taxable income	Not taxed	Not taxed up to a specified threshold	Market return from investments in debt and equity
NPS Tier I (voluntary contributions)	Not Applicable	Allowed as a deduction from taxable income	Not taxed	Not taxed up to a threshold	Market return from investments in debt and equity
Approved Superannuation Fund (ASAF)	Not taxed up to a threshold	Allowed as a deduction from taxable income	Not taxed	Not taxed if converted into pension annuities and other specified circumstances	Market return from investments in debt and equity
Public Provident Fund	Not Applicable	Allowed as a deduction from taxable income	Not taxed	Not taxed	Interest as declared by government
NPS Modified Tier II (Proposed)	Not Applicable (Proposed)	Not allowed as a deduction from taxable income (Proposed)	Not taxed (Proposed)	Not taxed (Proposed)	Market return from investments in debt and equity (Proposed)

²⁶ Upto prescribed limits

Acknowledgement

We thank the following subject matter experts for their contributions and inputs:

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Sanjay Kumar

Gokul Chaudhri

Saraswathi Kasturirangan

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