



# K. A. PANDIT's VIEWPOINT on KARNATAKA GRATUITY INSURANCE RULES

The Government of Karnataka (GoK), on 10th January 2024, rolled out the Notification No. LD 397 LET 2023 outlining the rules on Compulsory Gratuity Insurance for the State (of Karnataka.) The notification requires establishments under the GoK to have compulsory insurance covering the employer's liability towards gratuity. The Notification is based on the powers conferred by sub-section (4) of Section 4A of the Payment of Gratuity Act, 1972 (Central Act No. 39 of 1972). Karnataka follows the Andra Pradesh Government who introduced similar rules in 2011.

## Payment of Gratuity Act, 1972 Reference - Section 4(A) summarized below:

Section 4A	Summary
<b>Sub Section 1</b> Mandatory Insurance Requirement	Employers, excluding those under central or state governments, must secure insurance for gratuity liabilities. Options include the Life Insurance Corporation of India or other specified insurers. Compliance dates, varying by region or enterprise, will be notified by the relevant Government.
<b>Sub-section 2</b> Exemptions for Approved Gratuity Fund	Authorities can exempt specific employers from compulsory insurance, applicable to those with existing authorized gratuity funds or those with 500 or more employees, establishing a fund, adhering to specified conditions.
<b>Sub-section 3</b> Registration Requirement	Employers must register establishments within the stipulated timeframe with the controlling authority, contingent on acquiring necessary insurance or establishing an approved gratuity fund meeting specified criteria.
<b>Sub-section 4</b> Government Rules	Authorities can establish regulations through notifications for effective enforcement, covering aspects like the structure of Boards of Trustees for approved gratuity funds and procedures in the recovery process overseen by the controlling authority.
<b>Sub-section 5</b> Liability for Non-payment	Employers failing to make required payments are immediately liable for gratuity amounts, including interest for delays.
<b>Sub-section 6</b> Penalties for Non-compliance	Non-compliance with payment obligations may result in fines, extending up to ten thousand rupees, with additional daily fines for continuing offenses, reaching up to one thousand rupees per day.

## Commentary to link to the GoK Rules:

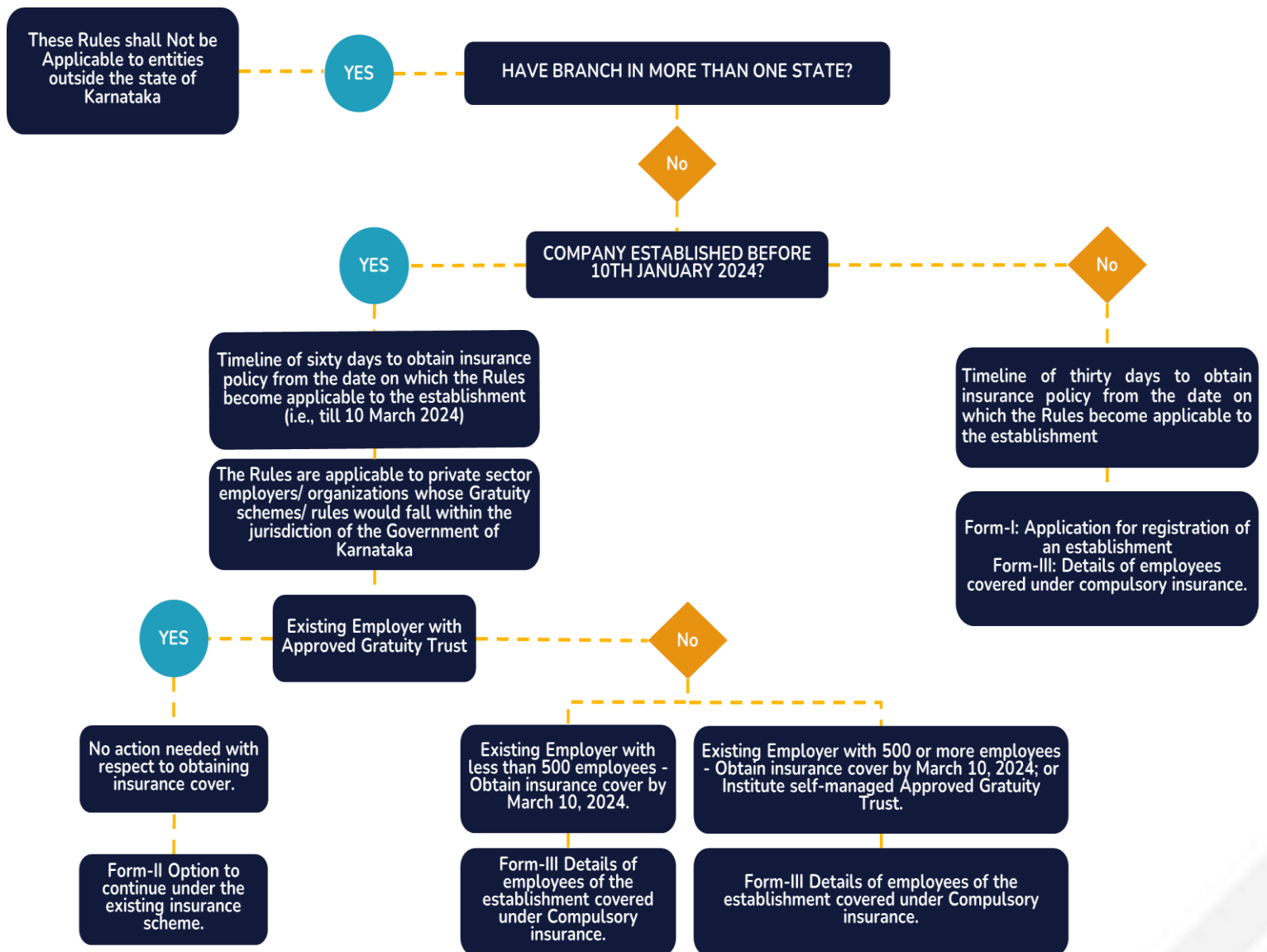
When we say Authorities, we mean the "Appropriate Government". This is defined in the Payment of Gratuity Act, 1972. The Payment of Gratuity Act refers to the Appropriate government as:

- i. in relation to an establishment
  - a. belonging to, or under the control of, the Central Government,
  - b. having branches in more than one State,
  - c. of a factory belonging to, or under the control of, the Central Government,
  - d. of a major port, mine, oilfield or railway company, the Central Government,
- ii. in any other case, the State Government.

This is important as it enables us to clarify which establishments have the Central Government as it's Appropriate Government and which establishments are covered by GoK as the Appropriate Government. The part in bold suggests therefore that only those establishments (registered legal entities) that only have operations in Karnataka are affected by the GoK Rules.

It is to be noted that the Central Government have not notified similar Rules yet. So will it just be a matter of time? Especially given Section 57 of the Code on Social Security, 2020 (yet to be notified) is a transposition of Clause 4A of the Payment of gratuity Act, 1972. Upon notification of the Code on Social Security, the GoK may need to re-notify these Rules.

**Based on the Rules stated in Payment of Gratuity Act 1972 regarding Compulsory Insurance, the Karnataka Gratuity Rules are summarized as follows:**





## Brief Explanation of the above diagram

- The Karnataka Gratuity Notification mandates that new employers must secure a valid insurance policy within 30 days of the rules becoming applicable to their establishment. Similarly, existing employers are required to obtain such a policy within 60 days of the rules' commencement. Employers with valid insurance policies are obligated to make premium payments to the insurance company and renew the policy in a timely manner, informing the Controlling Authority of the renewal within 15 days. Ensuring the punctual payment of premiums and policy renewals is the responsibility of every employer.
- In the event of gratuity payments, the Controlling Authority has the authority to recover the determined amount from the Life Insurance Corporation of India or any other insurance company with which the employer has obtained insurance, as specified in the rules.
- For registration purposes, employers must apply in Form-I to the Controlling Authority within 30 days of obtaining insurance, accompanied by a list of insured employees. Additionally, employers are required to update the Controlling Authority on any changes in insured employees or policies.
- Employers with existing approved gratuity funds have the option to continue the arrangement by applying in Form II, provided the fund covers the entire liability of all employees. Furthermore, employers establishing new approved gratuity funds for establishments with five hundred or more employees must register with the Gratuity Trust, with representatives from both the employer and employees.
- The Gratuity Trust, whether managed privately, by an insurance company, or jointly, must maintain a separate fund with contributory contributions from the employer and non-contributory for employees. The trust must adhere to relevant accounting standards and laws, and both the employer and the insurance company share joint responsibility for fulfilling their obligations under the Act. The employer is required to maintain the gratuity trust and fund as an irrevocable system.
- In conclusion, the notification emphasizes compliance with the Act, requiring employers to take all necessary measures to fulfill their obligations under its provisions. This comprehensive framework aims to ensure the timely and secure payment of gratuity to eligible employees in the state of Karnataka.



## Consultant's Viewpoints:

- There are many potential areas that need some clarification from the Rules. Here is a list of the key areas:
  - The definition of terms used like “insurance” for Gratuity liability or “towards gratuity payment” etc. need clarification from a few perspectives.
  - Currently, no insurance products exist that will fully insure the gratuity “liability” per say. The only insurance under current gratuity funding products is to insure a death in service gratuity benefit.
  - More precise guidance is needed to confirm the definition of “liability”. There can be many interpretations such as; full accrued gratuity benefit to date, or the liability accounted in the Company books per AS15 or INDAS19. If based on Accounting standards, then the GoK will need to ensure appropriateness and governance of the assumptions being used. An actuarial figure can easily be less than the full accrued benefit). Which does the GoK desire?
  - AS15 is mentioned in the GoK Rules in respect of the Trust using an actuarial figure. However, how does that relate to the insurance company calculating their funding requirement/”premium” and the AS15 valuation conducted by the Company for its books?
- The wording of the Rules suggests that any establishment with less than 500 employees (or currently not having an approved Gratuity Trust) would not be required to create a Trust? In order to get tax benefits for the contributions and earnings in the fund, the insurance policy should be part of the investment of an approved Trust. In turn this would mean that all establishments would need to make an approved Trust. This may be cumbersome for smaller establishments, especially ongoing compliances, education of Trustees, tax returns etc.. This needs to be clarified by GoK.
- Clause 4 in the Rules sets out how the GoK is authorised to recover the amount of the Gratuity payable to an employee, from the insurer. More detail is needed on how this would work. Can any master policy pay to the Appropriate Government? Will policies need to include the Government as a potential beneficiary?
- The level of funding and quantum of contributions needs careful consideration by a Company/Trust. Many business specific matters such as cashflow, demographics, tax status will influence the merits of how much to fund and when. Up to now companies have had this freedom to decide. If the Rules are suggesting an establishment has to be 100% funded (ie fund assets = gratuity liabilities) then it may be good for employees, but does it lock up vital capital for the business? An actuarially calculated liability may be more or less than the full accrued service benefit as on date.



## Questions

### 1. What exactly is Compulsory insurance for Gratuity?

Our understanding the requirement refers to Group Gratuity Products offered by many life insurance companies in India. There are clarifications needed (as mentioned earlier) that these Group products will meet the intention of the GoK.

### 2. Are there suitable products offered by insurers to meet this requirement?

As of today, there is no insurance product available that fully insures the entire gratuity liability. The current products are funding vehicles (along with some small component of insurance related to death in service gratuity). There are clarifications needed (as mentioned earlier) that these Group products will meet the intention of the GoK.

### 3. What is Gratuity Funding and how can I fund my gratuity?

Group Gratuity products offered by life insurance companies are the funding vehicles. Contributions are paid which then earn investment returns. Withdrawals from the funds would be made to pay the gratuity payments to employees. One needs to select the insurance company and engage with them on the process to initiate one of these policies.

### 4. What would be the initial contribution to a new company? (with no service)

There are many ways one could estimate the contribution a company could pay. However, we do not believe there is a mandatory minimum amount of contribution. Common practices to determine the contribution amount include; calculation by the insurance company or taking the estimated future period current service cost from an actuarial valuation (under accounting norms like AS15/INDAS19).

There are tax limits for initial contributions to 8.33% of wages. One should obtain some tax advice with respect to the tax treatment of any initial contribution, as well as regular contributions. There are provisions in the Income Tax Rules to allow instalments for the initial contributions.

### 5. How to approach gratuity Funding in case of the entity being previously unfunded?

See Q3 and Q4

### 6. Is a Gratuity Trust required?

The rules seem to imply that it is not compulsory to set up a Gratuity Trust. In fact, the option seems only to be mentioned for those establishments with more than 500 employees, or if an approved Trust already exists. It is our understanding that a tax approved Trust would be required for ALL companies if they want the tax benefits for contributions made to the gratuity fund, as well as the interest earnings within the fund. It would mean that the Group Gratuity policies should technically be in the name of the Trust and not the Company. Companies should obtain tax advice to confirm this.



### **7. Who's the Controlling Authority?**

The Controlling Authority is the Ministry of Labor (Karnataka)

### **8. Do I need to change anything if my company already has a Gratuity Trust?**

In the main, No. Form II in the Rules will need to be submitted. One aspect to check is to review the existing Trust Deed and ensure it complies with the guidelines set out in the Rules. Especially the responsibilities and composition of the Trustee Board. We foresee some challenges for smaller companies to meet the governance requirements of running a Trust. Especially training for new Trustees.

### **9. Are there restrictions in terms or investment into fund as well as exit from fund? (Income Tax)**

There are tax restrictions. For contributions to be tax deductible for the Company, they should be payable to a tax approved Trust. The maximum contribution treated as tax deductible is 8.33% of wages. Formal tax advice should be obtained before making contributions. Trust funds cannot normally be returned to the Company due to the tax benefits. Special tax advice would be required in case a Company wants to have the funds revert to them (e.g. if the company is closing)

### **10. What is funding valuation and how it is different from actuarial valuation?**

Both valuations use actuarial methods and techniques. A funding valuation is usually to determine the long-term financial health of the fund, along with contribution requirements. In India the term actuarial valuation has typically been used to refer to the accounting valuations e.g. AS15/INDAS19 that are for the purpose for financial reporting of the entity. The two can give the same answer but that is not necessary. Assumptions and methods may be different. Only the accounting actuarial valuation has a prescribed approach stated in the accounting standards.



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