

DEDUCTION IN RESPECT OF LEAVE ENCASHMENT ON RESIGNATION

**[Whether and to what extent payment for leave encashment on resignation
is entitled to exemption U/S 10 (10AA) of the Income-Tax Act]**

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The controversy as to whether the payment received by an employee by way of leave encashment at the time of his resignation from service, is entitled to exemption U/S 10 (10AA) of the Income-Tax Act 1961 (the Act), still continues, though the Hon'ble High Courts of Bombay and Madras have held that the benefit of S.10(10AA) of the Act is available even in case of resignation.

The Income-Tax Department continues to hold the view that since the words “whether on superannuation or otherwise” qualify retirement, unless it is a case of retirement from service on attaining a particular age or on some other reason, a case of resignation will not be covered thereunder. In other words, the Revenue has been taking a stand that the benefit of S.10(10AA) of the Act is available only in cases where the amount is received by the assessee / the employee at the time of his retirement, which does not include retirement on resignation.

Therefore, in order to answer the aforesaid query, the foremost issue for consideration will be whether the term ‘retirement’ includes ‘resignation’ for the purposes of exemption U/S 10 (10AA) of the Act. The other issue for consideration would be the extent to which the quantum of payment of leave encashment is exempt under the aforesaid S.10(10AA) of the Act. Both the aforesaid issues are dealt with, as follows:

1. Whether the term ‘retirement’ includes ‘resignation’ in S.10(10AA)

Clause (10AA) of S.10 of the Act, exempts from tax any payment received by an employee as the cash equivalent of the leave salary in respect of the period of earned leave to his credit at the time of his retirement, whether on superannuation or otherwise, subject however, to the limits laid down therein. Prior to the incorporation of this clause, any amount received by an employee on retirement from service by way of cash equivalent of unutilized earned leave (EL) was charged to income-tax under the head ‘Salaries’. With a view to avoiding hardship to retiring employees, this clause was inserted w.e.f. 1.4.1978. On a plain reading of clause (10AA) of S.10, it is clear that exemption is available under the said clause, only to the retiring employees in respect of the amount received by them by way of encashment of unutilized EL standing to their credit at the time of retirement. This clause is not applicable to any such payment received by an employee while in service. The benefit of this clause is available to an employee only on his retirement, **whether on superannuation or otherwise.**

The benefit of S.10 (10AA) has been held to be available even in a case of voluntary retirement on resignation, as per the judgement in the case of **CIT Vs. R.J. Shahney, 159 ITR p.160 (Mad.)** The relevant part of the aforesaid judgement on p.161 of the Report is reproduced, as follows:

“The retirement may be of various kinds. It may be on superannuation or it may be voluntary. If there is any voluntary retirement from service, we are satisfied that the provisions of S.10(10AA) would apply”.

The Hon’ble Bombay High Court in the case of **CIT Vs. D.P. Malhotra, 229 ITR p.394 (Bom.)**; has dealt with the aforesaid issue in an elaborate manner. In this case, the assessee was an employee of the Shipping Corporation of India Ltd. During the previous year relevant to the assessment year (AY) 1982-83, the assessee resigned from his service w.e.f. July 29, 1981. In the assessment of his income under the Income-Tax Act, 1961 for the aforesaid AY, the assessee claimed deduction U/S 10 (10AA) of the Act in respect of the amount received by him from his former employer by way of cash equivalent of unutilized earned leave. This claim of the assessee was rejected by the ITO as he was of the opinion that the assessee having resigned from the employment, the amount received by him by way of leave encashment was not exempt U/S 10 (10AA) of the Act. On appeal against the order of the ITO, the CIT(A) accepted the claim of the assessee and directed the ITO to grant deduction of the amount received by the assessee by way of cash equivalent of the unutilized earned leave to the extent permissible U/S 10(10AA) of the Act. The order of the CIT (A) was affirmed by the ITAT. Against the order of the ITAT, the I.T. Department filed a reference before the Bombay High Court.

The Hon’ble Bombay High Court dealt with the issue in an elaborate manner and came to the conclusion that the term ‘retirement’ includes ‘resignation’ for the purposes of S.10 (10AA) of the Act. In order to correctly understand the import of the aforesaid judgement, relevant parts of the judgement on pp. 398 and 399 of the Report are reproduced, as follows:

“On a plain reading of clause (10AA) of section 10, it is clear that exemption is available under the said clause only to retiring employees in respect of the amounts received by them by way of encashment of unutilized earned leave standing to their credit at the time of retirement. This clause is not applicable to any such payment received by an employee while in service. The benefit of this clause is available to an employee only on his retirement, whether on superannuation or otherwise. How or why the retirement took place is irrelevant for that purpose – what is significant is ‘retirement’.” (On p. 398) ; and

“Thus, both ‘retirement’ and ‘resignation’ result in the conclusion of the service career. In fact resignation from service is also one of the modes of retirement from service. Resignation is a voluntary act of the employee to retire from service. Once an employee resigns, his service stands terminated from the date on which his letter of resignation is accepted by the appropriate authority, unless there is any law or statutory rule governing the conditions of service to the contrary. In other words, on acceptance of resignation, the employee stands retired from service. The word “retirement” has not been used in clause (10AA) in the restricted sense to mean ‘retirement on superannuation’. On the other hand, it is clear from the language of clause (10AA) itself that it has been used in the widest possible terms to mean and include all cases of retirement, whether on superannuation or otherwise. What is relevant is ‘retirement’ – how it took place is immaterial for the purpose of this clause. It is, therefore, clear that if on retirement, even on resignation by the employee, an employee gets by way of leave encashment any amount, clause (10AA) would apply and the assessee will be entitled to the benefit of the said clause to the extent mentioned therein.” (On pp. 398 & 399).

For reaching the aforesaid conclusion, the Hon'ble High Court has also looked into the various meanings of the word 'retire' and according to the Hon'ble High Court, one of the meanings of the word 'retire' is 'resign'.

Besides, if we look at the two Provisos to S.10(10AA) of the Act, the language of these Provisos contemplates payment(s) by way of leave encashment from more than one employer in one or more than one previous year. As per the first Proviso, where the cash equivalent of unutilized earned leave is received by an employee from two or more employers in the same year, the maximum amount exempt from tax will not exceed the limit specified U/S 10 (10AA). Further, in cases where an employee, who has received any cash equivalent of unutilized earned leave in any year from his former employer or employers, receives cash equivalent of unutilized earned leave from his present employer in a later year, the ceiling limit specified in S.10 (10AA) will be reduced by the amount of cash equivalent of unutilized earned leave which has been exempted in any earlier year or years. It is, thus, clear from both the aforesaid Provisos to S.10 (10AA) that this section contemplates payments by way of leave encashment from two or more employers in two or more than two previous years. **This clearly implies that the term 'retirement' includes 'resignation', for the purposes of S.10(10AA) of the Act.**

In this context, one may also refer to the judgement of the Apex Court in the case of **State Bank of India Vs. A.N. Gupta, (1997) 8 SCC 60**. It was held in this case that it cannot be said that an employee retire only on superannuation and there is no other circumstance under which an employee can retire. Retirement on superannuation is not the only mode of retirement known to service jurisprudence. There can be other types of retirements like pre-mature retirement, either compulsory or voluntary.

In view of the aforesaid reasons, it is clear that the benefit of S.10(10AA) of the Act is available in respect of cash equivalent of leave salary received by an employee, on resignation from service.

2. Other conditions / limits

There are various other conditions / limits in respect of the exemption regarding the encashment of leave salary under S.10(10AA) of the I.T. Act. The same are listed, as follows:

- (i) As per Explanation to S.10(10AA), the entitlement to EL of an employee shall not exceed 30 days for every year of actual service rendered by him as an employee of an employer from whose service he has retired.
- (ii) The amount of encashment of EL, will not exceed salary for a period of 10 months, calculated on the basis of average salary drawn by the employee during the period of 10 months immediately preceding the retirement / resignation.
- iii) Vide Notification No. 10749 [F.No. 200/23/98-I.T.(A-I)] dated 27.11.1998, the maximum limit of exemption in respect of encashment of leave salary would be Rs. 2,40,000/-, in relation to employees who retire / resign after 1.7.1997.

- (iv) In case where such payments are received by an employee from more than one employer, in the same previous year, the aggregate amount exempt from income-tax under S.10(10AA) shall not exceed the limit specified therein, and
- (v) Where any such payment or payments was or were received in any one or more earlier previous year also and the whole or any part of the whole or any part of the amount of such payment or payments was or were not included in the total income of the employee of such previous year or years, **the amount exempt from income-tax U/S 10(10AA) shall not exceed the limits so specified as reduced by the amount or the aggregate amount, not included in the total income of such previous year or previous years.** In other words, if the benefit of exemption U/S 10(10AA) has already been availed of by the employee in the past, then the same will also be considered while working out the exemption U/S 10(10AA) of the Act. To put it more simply, it may be stated that the aforesaid limits laid down U/S 10(10AA) are applicable to an employee for his total career whether under one employer or under more than one employer, during his whole life time.

3. Whether tax is to be deducted at source from the encashment of leave salary

As per S.17 (1)(va) of the Act, salary includes any payment received by an employee in respect of any kind of leave not availed of by him. Thus, the amount of encashment of leave salary is taxable as part of salary. However, the amount of encashment of leave salary entitled to exemption U/S 10(10AA) will not be included in the salary.

Thus, if the amount of leave encashment is fully exempt U/S 10(10AA), then no tax would be required to be deducted at source in respect thereof. However, if the amount of leave encashment is partly exempt U/S 10(10AA) then the amount not so exempt would be added to the income from salaries and tax would be deducted in respect thereof accordingly.

4. Conclusion

In the light of the aforesaid reasons, it may be concluded that the benefit of S.10(10AA) is available even in case of resignation from service by an employee.

The amount of leave encashment entitled to exemption U/S 10(10AA) has to be calculated in the light of various conditions and limits laid down thereunder.

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