

SALARY - TAX-TREATMENT OF GRATUITIES

202 CTR (Art.) p.23 (Part-I)

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The word 'Gratuity', has not been defined in the Income-Tax Act, 1961(the Act). In the absence of any definition of 'Gratuity' in the Act, its meaning as provided in the dictionaries has to be referred to. The word 'Gratuity' has been variously defined in the Advanced Law Lexicon by P.R. Aiyar. The aforesaid definition is to be found on page 2038 of Book – 2, 3rd Edition,2005, of the Advanced Law Lexicon by Shri P.R. Aiyar. In the context of the Income-Tax Act, the following definitions may be referred to-

- (i) 'Gratuity' imports an idea of a gift or a present generally in return for some favours or services, a sort of retiral benefit – *Remington Rand of India Vs. Workmen [1968] 1 LLJ 542*
- (ii) 'Gratuity' is a reward for good, efficient and faithful service rendered for a considerable period. A workman gains experience during his tenure of employment.
- (iii) 'Gratuity' is a kind of retirement benefit like the provident fund or pension gratuity paid to workmen, is intended to help them after retirement whether the retirement is the result of the rules of superannuation or of physical disability. *Indian Hume Pipe Co. Ltd. V. Workmen, AIR 1960 SC 251.(Service law).*
- (iv) The 'gratuity', like pension, is retirement benefit for long and continuous services as a provision for long and continuous services as a provision for old age. It is earned as a matter of right on fulfilling the conditions subject to which it is earned. It is not a gratuitous payment depending upon the discretion or sweet will or fancy of the employer. Like pension, it can also be recovered through civil suit. *Sudhir Chandra Sarkar V. Tata Iron and Steel Co. Ltd., AIR 1984 SC 1064. (Labour and Services)*

In addition to the aforesaid definition, the payment of gratuity has been statutorily provided, vide 'The Payment of Gratuity Act, 1972'.

Thus, over a period of time payment of gratuity has become an enforceable right in the hands of the employees. It is for this reason that gratuity has been included in the definition of 'Salary', under the Income-Tax Act, 1961.

The word 'Salary' has been inclusively defined under Section 17(1) of the Act. As per Section 17(1)(iv), 'Salary' includes any fees, commissions, perquisites or profits in lieu of or in addition to any salary or wages. Further the term 'Profits in lieu of salary,' under Section 17(3)(ii) of the Act,

includes any payment other than any payment referred to in clauses (10), (10A), (10B), etc., of Section 10, due to or received by an assessee from an employer or a former employer, etc. In this context, it may also be stated that under the provisions of clause (10) of Section 10, exemption is provided in respect of gratuity received by an employee, within certain limits prescribed therein.

Besides, the provisions of Section 89 providing relief from income-tax and Section 192 relating to deduction of tax at source from salary, are also relevant in this context.

All the aforesaid provisions as well as relevant Circulars and legal precedents relating to the taxation of gratuity are discussed as follows-

I. Exemption in respect of ‘Gratuities’ – Section 10(10)

Under the provisions of Section 10(10) of the Act, any death-cum-retirement gratuity received by a Government employee or employees of a local authority or any gratuity received under the Payment of Gratuity Act, 1972 and all other gratuities are entitled to certain exemptions as prescribed therein. For the sake of ready reference, the provisions of Section 10(10) are reproduced as follows-

Section(10) (10)

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- (i) *any death-cum-retirement gratuity received under the revised Pension Rules of the Central Government or, as the case may be, the Central Civil Services (Pension) Rules, 1972, or under any similar scheme applicable to the members of the civil services of the Union or holders of posts connected with defence or of civil posts under the Union (such members or holders being persons not governed by the said Rules) or to the members of the all-India services or to the members of the civil services of a State or holders of civil posts under a State or to the employees of a local authority or any payment of retiring gratuity received under the Pension Code or Regulations applicable to the members of the defence services;*
 - (ii) *any gratuity received under the Payment of Gratuity Act, 1972 (39 of 1972), to the extent it does not exceed an amount calculated in accordance with the provisions of sub-sections (2) and (3) of section 4 of that Act;*
 - (iii) *any other gratuity received by an employee on his retirement or on his becoming incapacitated prior to such retirement or on termination of his employment, or any gratuity received by his widow, children or dependants on his death, to the extent it does not, in either case, exceed one-half month's salary for each year of completed service, calculated on the basis of the average salary for the ten months immediately preceding the month in which any such event occurs, subject to such limit as the Central Government may, by notification in the Official Gazette,*

specify in this behalf having regard to the limit applicable in this behalf to the employees of that Government:

***Provided** that where any gratuities referred to in this clause are received by an employee from more than one employer in the same previous year, the aggregate amount exempt from income-tax under this clause shall not exceed the limit so specified:*

***Provided further** that where any such gratuity or gratuities was or were received in any one or more earlier previous years also and the whole or any part of the amount of such gratuity or gratuities was not included in the total income of the assessee of such previous year or years, the amount exempt from income-tax under this clause shall not exceed the limit so specified] as reduced by the amount or, as the case may be, the aggregate amount not included in the total income of any such previous year or years.*

Explanation.—In this clause, and in clause (10AA), “salary” shall have the meaning assigned to it in clause (h) of rule 2 of Part A of the Fourth Schedule;

From the aforesaid provisions, it may be seen that broadly speaking clause (10) of Section 10, exempts from tax-

- (a) All gratuity received by Government servants and employees of a local authority;
- (b) All gratuity received under the terms of Payment of Gratuity Act, 1972; and
- (c) All other gratuity received by other employees, if it does not exceed an amount calculated at half a month’s salary for each year of service or an amount not exceeding the specified limit, whichever is less.

As per Explanation to Section 10 (10); in clause(10) and in clause (10AA), salary shall have the meaning assigned to it in clause (h) of Rule 2 of Part A of the Fourth Schedule to the Income-Tax Act. As per clause (h) of Rule 2 of Part A of the Fourth Schedule, ‘Salary’ includes dearness allowance, if the terms of employment so provide, but excludes all other allowances and perquisites.

The exemption in respect of gratuity under Section 10(10), is provided to three classes of employees as follows-

1. In the case of a Government employee – Section 10(10)(i)

Any death-cum-retirement gratuity received by an employee of the Central Government, State Government or local authority, is wholly exempt from income-tax under Section 10(10)(i) of the Act.

It may be clarified here that employees of statutory corporation are not covered under Section 10(10)(i).

2. In the case of an employee covered by the Payment of Gratuity Act, 1972 – Section 10(10)(ii)

All gratuity received by an employee in terms of the Payment of Gratuity Act, is exempt from income-tax to the extent, it does not exceed an amount calculated in accordance with the provisions of sub-sections (2) and (3) of Section 4 of that Act. The aforesaid provisions of the payment of Gratuity Act read as follows-

Payment of gratuity

4. (1)

- (2) *For every completed year of service or part thereof in excess of six months, the employer shall pay gratuity to an employee at the rate of fifteen days' wages based on the rate of wages last drawn by the employee concerned:*

Provided *that in the case of a piece-rated employee, daily wages shall be computed on the average of the total wages received by him for a period of three months immediately preceding the termination of his employment, and, for this purpose, the wages paid for any overtime work shall not be taken into account:*

Provided further *that in the case of an employee who is employed in a seasonal establishment and who is not so employed throughout the year, the employer shall pay the gratuity at the rate of seven days' wages for each season.*

Explanation - In the case of a monthly rated employee, the fifteen days' wages shall be calculated by dividing the monthly rate of wages last drawn by him by twenty-six and multiplying the quotient by fifteen.

- (3) *The amount of gratuity payable to an employee shall not exceed three lakhs and fifty thousand rupees.*

From the aforesaid provisions, it may be seen that any gratuity received by an employee covered by the Payment of Gratuity Act, 1972, is exempt from income-tax to the extent of-

- (i) 15 days' salary (7 days in the case of employees of seasonal establishments) based on the last salary drawn for every completed year of service or part thereof in excess of 6 months;
 - (ii) Rs.3,50,000 (Rs.1,00,000 upto September 23, 1997), or
 - (iii) gratuity actually received,
- whichever is the least.

The gratuity received in excess of the aforesaid limits is taxable in the hands of the assessee/employee. However, the assessee / employee may claim relief under Section 89 of the Act in respect of the excess amount of gratuity received.

'Salary' for the purpose of the aforesaid limits, means 'Salary' last drawn by the employee and includes dearness allowance but does not include any bonus, commission, house rent allowance, overtime wages or any other allowance.

Salary of 15 days' is calculated by dividing the salary last drawn, by 26, being the number of working days in a month and multiplying it by 15.

3. In the case of any other employee – Section 10(10)(iii)

Any other gratuity not covered under sub-clauses (i) and (ii) of Section 10(10) of the Act, are covered under sub-clause (iii) of Section 10(10) of the Act.

As per Section 10(10)(iii), any gratuity received by an employee on retirement, death, termination, resignation or on his becoming incapacitated prior to retirement, is exempt from income-tax to the extent of the least of the following-

- (i) Rs.3,50,000;
- (ii) Half month's salary for each completed year of service; or
- (iii) Gratuity actually received.

While calculating the completed years, any fraction of the year will be ignored.

Average monthly salary is calculated on the basis of the salary of ten months immediately preceding the month in which the person retires, etc.

'Salary' for this purpose, means basic salary and it includes dearness allowance, if the terms of employment so provide but excludes all other allowances and perquisites.

In this context, the following points are also relevant-

- (i) As per CBDTs (Central Board of Direct Taxes), letter F.No.194/6/73 – I.T.(A-I), dated 19.6.1993, the expression '*Termination ofemployment*' used in Section 10(10), covers the case of any employee whose service comes to an end on account of his **resignation**.
- (ii) The maximum amount of exempted gratuity payable to an employee under sub-clause (iii) of Section 10(10) has been fixed by the Central Government at Rs.3,50,000 from 24.9.1997 and onwards, vide Notification No.10772, dated 20.1.1999.

4. Other conditions – provisos to Section 10(10)

- (i) As per first proviso to Section 10(10), if an employee receives gratuities from more than one employer in the same previous year / financial year, the aggregate amount exempt from income-tax under Section 10(10) shall not exceed the limit of Rs.3,50,000.
- (ii) As per second proviso to Section 10(10), where any such gratuity or gratuities was or were received in any one or more earlier previous year (s) / financial year (s) also and the whole or any part of the amount of such gratuity or gratuities was not included in the total income of the employee, the amount exempt shall not exceed the limit of Rs.3,50,000 as reduced by the amount or the aggregate amount of gratuity not included in the total income of any such previous year(s) / financial year (s).

II. Relief under Section 89

Section 89 grants relief in respect of salary, being a profit in lieu of salary under Section 17(3) of the Act. It is relevant to note in this context that any payment of gratuity other than payment referred to in Section 10(10), will form part of salary under Section 17(3)(ii) of the Act.

For the computation of relief under Section 89, Rule 21A of the I.T. Rules, 1962, prescribes the mode of computation of such relief.

Rule 21A(1), *inter-alia*, covers a case where there is payment of gratuity in respect of the past services of the assessee / employee extending over a period of not less than five years in accordance with the provisions of Rule 21A (3) of the I.T. Rules, 1962.

It covers only that portion of gratuity which remains after leaving out the portion exempt under Section 10(10) of the Act, because this portion will be included in the total income.

The computation of relief under Section 89 may be summarized as follows-

1. Under Section 89, a relief can be claimed, if gratuity is received in excess of the limits specified under Section 10(10) of the Act.
2. However, no relief is admissible if taxable gratuity is in respect of services rendered for less than five years.
3. Cases in which the relief is admissible may be divided into two categories, namely, (a) where the gratuity is payable in respect of past service of 15 years or more, and (b) where such period is 5 years or more but less than 15 years.
4. Relief in a case belonging to the first category i.e. in 3(a) is worked out as under:
 - (i) Compute the average rate of tax on the total income, including the gratuity in the year of receipt.
 - (ii) Find out the tax on gratuity at the average rate of tax computed in (i) above.
 - (iii) Compute the average rate of tax by adding one-third of the gratuity to the other income of each of the three preceding years.
 - (iv) Find out the average of the three-average rates computed in the manner specified in (iii) above and compute the tax on gratuity at that rate.
 - (v) The difference between the tax on the gratuity computed in (ii) and that in (iv), will be the relief admissible under Section 89.
5. In cases covered under the second category, the relief is computed on the similar lines as above, with the only difference that instead of average of the average rates of the preceding three years, the average of the rates of the preceding two years is computed by adding one-half of the gratuity to the other income of each of preceding two years.

III. Deduction of tax at source from salaries – Section 192

Section 192 of the Act deals with deduction of tax at source from Salaries.. The income of the employee in respect of salary for the financial year, in which he resigns, etc., shall be computed as per the provisions of Sections 15, 17 and 10(10), as discussed in the earlier paras.

The income of the employee who resigns from service will thus, be computed as required under the provisions of Section 192 and tax in respect of such income from salary, so computed, shall be

worked out after taking into consideration the relief under Section 89, if any. It is this amount of tax which would be deductible from the income in respect of salary of such employee.

Clarification in respect of relief under Section 89 for TDS purposes

As per Section 89 of the Income-Tax Act, for relief thereunder, the Assessing Officer shall, on an application made to him, in this behalf, grant such relief, as may be prescribed.

Thus, it appears that relief under Section 89 may not be taken into account by the tax-deductor while deducting tax at source from salary under Section 192 of the Act.

However, as per para 3.5 of Circular No.9 of 2005, dated 30.11.2005, issued by the CBDT, relief under Section 89, may be granted by the tax-deductor also. The aforesaid para 3.5 is reproduced as follows-

Relief When Salary Paid in Arrear or Advance:

3.5 Under sub-section (2A) of section 192 where the assessee, being a Government servant or an employee in a company, co-operative society, local authority, university, institution, association or body is entitled to the relief under Sub-section (1) of Section 89, he may furnish to the person responsible for making the payment referred to in Para (3.1), such particulars in Form No. 10E duly verified by him, and thereupon the person responsible as aforesaid shall compute the relief on the basis of such particulars and take the same into account in making the deduction under Para(3.1) above.

Explanation :-For this purpose "University means a University established or incorporated by or under a Central, State or Provincial Act, and includes an institution declared under section 3 of the University Grants Commission Act, 1956(3 of 1956), to be University for the purposes of the Act.

From the aforesaid para 3.5 of the CBDT's Circular, it is clear that even the tax-deductor or the employer, may grant relief under Section 89 of the Act, after the employee, in question, furnishes the relevant particulars, as specified in Form No.10E. It may also be stated here that Form No.10E includes payment of gratuity, for relief under Section 89, read with Rule 21A of the I.T. Rules, 1962.

IV. Conclusion

In the light of the aforesaid discussion, it may be concluded that in order to arrive at that part of gratuity which is liable to be included in the salary for the purposes of taxation under the I.T. Act, the following steps may be taken-

- (i) First, find out the amount of gratuity which is exempt under section 10(10) of the Act.
- (ii) In respect of the gratuity amount in excess of the exemption available under Section 10(10), the relief under Section 89 r.w. Rule 21A of the I.T. Rules, 1962, may be worked out.

After the aforesaid steps, as regards the employer, the salary of the employee should be calculated for the financial year in which he retires or resigns from service, etc., as per the aforesaid guidelines and then tax should be deducted at source as per the provisions of Section 192 of the Act.

As regards the employee, he should compute that part of gratuity, which is liable to tax and disclose the same in his return of income. The employee may, also work out the relief entitled to him under Section 89 of the Act and work out the amount of tax payable by him, accordingly.

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