

Salary Package For Employees - Tax-Planning Measures

203 CTR (Art.) p.136 (Part V)

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Introduction

As is well-known, income-tax is deducted at source in respect of income from '*Salaries*'. As the income of salaried tax-payers is fixed, they are more susceptible to inflationary pressures. Therefore, there have been progressive attempts in the past, to grant relief to salaried tax-payers. In order to subserve the aforesaid objective, a number of exemptions and deductions in respect of various allowances and other receipts, have been provided in the Income-Tax Act, 1961(the Act), over a period of time.

Most of the employers make best use of the aforesaid provisions, in order to minimize the tax incidence in the case of their employees, so as to make their pay-package most attractive. In a given case, it is possible to so arrange the basic salary, allowances and perquisites, that the incidence of taxation is minimized. In other words, the pay-package of a salaried tax-payer can be planned in such a manner, within the four corners of law, that the income-tax payable in respect thereof is kept to the minimum.

Now-a-days flexi pay-package is very popular amongst the employees. As per the flexi pay-package, within the over-all consolidated amount of remuneration or cost to the employer fixed per month or per annum, the employee is allowed to choose the items of payment / benefit, which are most suitable to him. It may be stated here that in a flexi pay-package certain items like basic salary, dearness allowance, etc. are fixed, whereas the other items of payment / benefit are left to the choice of the employee.

At the outset, it may be stated that no hard and fast guidelines may be laid-down for the purpose of tax-planning in respect of the pay-package of a salaried tax-payer, so as to minimize the incidence of taxation in his case.

In order to formulate some broad guidelines for the aforesaid purpose, the relevant provisions of the Act and the Income-Tax Rules, 1962 (the Rules), will have to be examined. In addition, the relevant case-law will also have to be referred to. The same are examined / discussed hereinafter.

1. Charge on salary income – Section 15

Section 15 is the charging section in respect of income from '*Salaries*'. This section brings to charge the following categories of salary-

- (i) Any salary due in the previous year, whether paid or not
- (ii) Advance salary, and
- (iii) Arrears of salary

A combined reading of sections 15 and 16 will reveal the following basis for charging salary to tax.

- (a) Due basis
- (b) Payment basis, and
- (c) Allowance basis

Any salary due from an employer or former employer to an employee in the previous year, whether paid or not, is chargeable to tax. Clauses (b) and (c) of section 15 charge salary to tax when it is paid or allowed, viz. by way of advance salary or arrears of salary.

Under section 17(2), perquisites, when granted or allowed or provided to an employee by an employer, like rent-free accommodation, accommodation on concessional rent, etc., the value thereof, is to be included in salary and is chargeable to tax as such. Therefore, they are chargeable on '*Allowance basis*'.

2. Deductions from salaries – Section 16

Clause (i) of section 16 has been omitted with effect from 1.4.2006. Therefore, no standard deduction is allowable in respect of income from salaries, with effect from 1.4.2006, viz. assessment year (AY) 2006-07, onwards.

Entertainment allowance under section 16(ii), received by an employee is to be included in the income of the employee under the head '*Salaries*' and thereafter, a deduction therefrom, is permissible subject to the conditions and limits laid-down under section 16(ii) of the Act.

As per the provisions of section 16(iii), any sum paid by an employee on account of the tax on employment (i.e. Profession tax), which is levied by a State Government, is allowable as a deduction from the salary of the employee, provided it has been paid by him.

The employer may allow deduction for the Profession tax paid by the employee while computing the tax to be deducted at source from '*Salaries*'.

3. Perquisites – Section 17(2)

Section 17(2) of the Act, gives an inclusive definition of ‘*perquisites*’. This clause comprises six sub-clauses followed by two provisos, and they deal with the following perquisites.

- (i) Value of rent-free accommodation provided to the assessee by his employer. [Sub-clause (i)]
- (ii) Value of any concession in respect of rent respecting any accommodation provided to the assessee by his employer. [Sub-clause (ii)]
- (iii) Value of any benefit or amenity granted or provided free of cost or at concessional rate to employee-directors and specified employees, with some exceptions. [Sub-clause (iii)]
- (iv) Sums paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee. [Sub-clause (iv)]
- (v) Sums payable by the employer to effect an assurance on the life of the assessee-employee or to effect a contract for an annuity. [Sub-clause (v)]
- (vi) Value of any other fringe benefit or amenity as may be prescribed [Sub-clause (vi)]
- (vii) Under the first proviso to clause(2) of section 17, medical benefits are not treated as perquisite in certain specific situations.

As per sub-clause(vi) of section 17(2), ‘*Perquisites*’ also includes the value of any other fringe benefit or amenity, as may be prescribed.

The valuation of ‘*Perquisites*’ is to be made as per Rule 3 of the Income-Tax Rules, 1962.

Sub-Rules (1) to (6) deal with the valuation of perquisites as follows:-

- (a) Valuation of rent-free / concessional accommodation – Rule 3(1)
- (b) Valuation of provision of domestic servants – Rule 3(3)
- (c) Valuation of provision of gas / electricity / water – Rule 3(4)
- (d) Valuation of provision of free or concessional educational facilities – Rule 3(5)

Sub-rule (7) of Rule 3 enumerates the ‘*Fringe benefits*’ contemplated under section 17(2)(vi) of the Act, and the method of their valuation. These benefits are as follows:-

- (a) Provision of interest-free or concessional loan – Rule 3(7)(i)
- (b) Use of employer’s moveable assets – Rule 3(7)(vii), and
- (c) Transfer of employer’s moveable assets – Rule 3(7)(viii)

4. Specified employees

As per section 17(2)(iii), 'Perquisite' includes the value of any benefit or amenity granted or provided free of cost or at concessional rate in respect of certain employees. Such employees may be called as specified employees. The specified employees in this context are as follows:-

- (i) Director – employee
- (ii) An employee having 20 per cent or more of voting power in employer Company, and
- (iii) An employee who is drawing salary in excess of Rs.50,000 and does not fall in the aforesaid two categories.

For computing the limit of Rs.50,000, the following items are excluded / deducted:-

- (a) Non-monetary benefits
- (b) Deduction on account of Profession tax
- (c) Exempt entertainment allowance, and
- (d) Non-taxable allowance.

From the aforesaid discussion, it may be concluded that any benefit or amenity granted or provided free of cost or at concessional rate, to an employee with salary not exceeding Rs.50,000, will not be treated as perquisite in his hands.

5. Special allowance or benefit – Section 10(14)

Certain special allowances or benefits are exempt under section 10(14) of the Act. This is a very important provision. For the sake of ready reference section 10(14) is reproduced as follows:-

Incomes not included in total income.

10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included—

- (14)(i) any such special allowance or benefit, not being in the nature of a perquisite within the meaning of clause (2) of section 17, specifically granted to meet expenses wholly, necessarily and exclusively incurred in the performance of the duties of an office or employment of profit, as may be prescribed, to the extent to which such expenses are actually incurred for that purpose ;*

(ii) any such allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at the place where he ordinarily resides, or to compensate him for the increased cost of living, as may be prescribed and to the extent as may be prescribed.

Provided *that nothing in sub-clause (ii) shall apply to any allowance in the nature of personal allowance granted to the assessee to remunerate or compensate him for performing duties of a special nature relating to his office or employment unless such allowance is related to the place of his posting or residence.*

From the aforesaid provisions, it may be seen that under sub-clause (i) of section 10(14), any prescribed special allowance or benefit other than those in the nature of a perquisite, specifically granted to meet expenses wholly, necessarily and exclusively incurred in the performance of the duties of an office or employment of profit, is exempt to the extent to which such expenses are actually incurred for that purpose.

Certificate furnished by the employee in regard to expenditure is adequate evidence

For exemption in respect of any special allowance under section 10(14)(i), there is a condition that the exemption will be limited upto the extent to which such expenses are actually incurred.

In this regard a certificate furnished by the employee that he has fully spent the allowance granted to him in the performance of his duties, will be adequate evidence for the purposes of TDS under section 192 of the Act. It may also be stated here that section 192 does not vest any power in the employer to disbelieve the genuineness of the declarations filed by the employees for the purposes of TDS in respect of their income from salaries.

The allowances prescribed for this purpose (which are fully exempt) are listed in Rule 2BB(1) of the Income-Tax Rules, 1962. For the sake of ready reference Rule 2BB(1) is reproduced as follows:-

2BB.

(1) *For the purposes of sub-clause (i) of clause (14) of section 10, prescribed allowances, by whatever name called, shall be the following, namely :—*

- (a) *any allowance granted to meet the cost of travel on tour or on transfer;*
 - (b) *any allowance, whether, granted on tour or for the period of journey in connection with transfer, to meet the ordinary daily charges incurred by an employee on account of absence from his normal place of duty;*
 - (c) *any allowance granted to meet the expenditure incurred on conveyance in performance of duties of an office or employment of profit :*
- Provided** *that free conveyance is not provided by the employer;*
- (d) *any allowance granted to meet the expenditure incurred on a helper where such helper is engaged for the performance of the duties of an office or employment of profit;*
 - (e) *any allowance granted for encouraging the academic, research and training pursuits in educational and research institutions;*
 - (f) *any allowance granted to meet the expenditure incurred on the purchase or maintenance of uniform for wear during the performance of the duties of an office or employment of profit.*

Explanation: For the purpose of clause (a), “allowance granted to meet the cost of travel on transfer” includes any sum paid in connection with transfer, packing and transportation of personal effects on such transfer.

Besides, under sub-clause(ii) of section 10(14), any prescribed allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at the place where he ordinarily resides, or to compensate him for the increased cost of living, is exempt upto the prescribed extent laid down under Rule 2BB(2). For this purpose, a table has been provided under Rule 2BB(2). For our purpose, the following items are important.

- (a) As per item No. (5) of the aforesaid table, children educational allowance upto Rs.100 per month per child, upto a maximum of two children, is exempt.
- (b) As per item No.(6) of the aforesaid table, any allowance granted to an employee to meet the hostel expenditure of his children, upto Rs.300 per month per child, upto a maximum of two children, is exempt.

- (c) As per item No.(10) of the aforesaid table, transport allowance granted to an employee to meet his expenditure for the purpose of commuting between the place of his residence and the place of his duty, upto Rs. 800 per month, is exempt.

6. Important exemptions in respect of the salaried employees under Section 10 of the I.T. Act

There are a number of exemptions provided under sections 10(10) to 10(13A) in respect of salaried employees. The same may be briefly stated as follows:-

- (i) **Any death-cum-retirement gratuity** received by Central and State Government Servants in civil posts or in the defence services and employees of the local authority, which is exempt under section 10(10)(i).
- (ii) **Any gratuity received under the Payment of Gratuity Act, 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, which is exempt under section 10(10)(ii).
- (iii) **Any other gratuity** received by an employee from one or more employers on retirement or incapacitation or by his dependants on his death, not exceeding one half month's salary for each year of completed service etc., is exempt under section 10(10)(iii).
- (iv) **Any payment in commutation of pension** received by a servant of the Government, local authority or public corporation and any such payment received by an employee from a private employer to the extent it is exempt under section 10(10A).
- (v) Any payment received by a Central or State Government employee in **cash equivalent of the leave salary** in respect of the period of Earned leave at his credit at the time of his retirement is exempt under section 10(10AA)(i) and any payment of the aforesaid nature received by an employee other than an employee of the Central or State Governments, within certain limits, is exempt under section 10(10AA)(ii).
- (vi) **Any compensation received by a workman** under the Industrial Disputes Act or under any other Act, Rule, Order or Notification or under any Award at the time of retrenchment subject to certain conditions, is exempt under section 10 (10B)
- (vii) Any payment received by an employee of Public Sector Company at the time of his **voluntary retirement** in accordance with any scheme approved by the Central Government having regard to the economic viability of such Company, is exempt under section 10(10C).

- (viii) **Any payment from a Provident Fund** which the Provident Fund's Act, 1925, applies or any other Provident Fund set-up and notified by the Government is exempt under section 10(11).
- (ix) The accumulated balance due and becoming payable to an employee participating in a **Recognized Provident Fund**, to the extent provided on Rule 8 of Part A of the Fourth Schedule, is exempt under section 10(12).
- (x) Any payment received from an **Approved Superannuation Fund** to the extent it is exempt under section 10(13); and
- (xi) **Any special allowance** granted to an assessee by his employer to meet his **house rent** expense to the extent exempt under section 10(13A).

7. Perquisites in respect of which tax is paid or payable by the employees, are not liable to fringe benefit tax—S.115 WB(3)

As per section 115WB(3), for the purposes of Section 115WB(1), the privilege, service, facility or amenity, etc. does not include perquisites in respect of which tax is paid or payable by the employee.

The perquisites in respect of which tax is paid or payable by an employee may broadly fall in the following two categories:-

- (i) When tax on perquisite is actually paid or payable by an employee., e.g. rent-free accommodation, as per Section 17 (2)(i).
- (ii) When tax on perquisite is not payable in view of specific exemption under the Act, e.g. provision of medical facilities, transport allowance, etc.

It may be stated here that as regards the exempted perquisites, tax would have been payable by the employees in respect thereof, but for the specific exemptions provided under the Act.

8. Any special allowance or fixed allowance is not liable to fringe benefit tax (FBT)

Any special or fixed allowance cannot be treated as fringe benefit, because it cannot be termed as '*perquisites*'. The other reason for this proposition is that such allowance is part of the salary package and liable to tax in the hands of the employees.

It may be further stated in this context that if a special / fixed allowance is exempt under any of the provisions of the Act, then also it cannot be treated as fringe benefits. The examples of such allowances are as follows:-

- (i) Leave Travel Allowance – exempt under section 10(5) r.w. rule 2B.
- (ii) House Rent Allowance – exempt under section (13A) r.w. rule 2A
- (iii) Conveyance Allowance – exempt under section 10(14)(i) r.w. rule 2BB(1)
- (iv) Transport Allowance – exempt under section 10(14) (ii) r.w. rules 2BB(2)

In respect of Leave Travel Allowance, we may refer to the answer to question No.44 of Circular No.8/2005, dated 29.8.2005. As per the aforesaid answer, the value of any Leave Travel Allowance or Concession received by an employee normally falls within the meaning of ‘Salary’ as defined under section 17(1) of the Act. This benefit is taxable under the head ‘Salaries’, subject to the exemption under section 10(5) of the Act. Accordingly, it would not be liable to FBT.

The aforesaid logic will also apply to conveyance allowance which is subject to exemption under section 10(14)(i) of the Act. The same logic will also apply to all other such allowances.

9. It is, therefore, advisable to pay more special allowances to the employees, which are exempt in their hands

In view of the reasons stated in earlier para (7), it would be advisable to pay more special allowances to the employees, which are exempt in their hands under section 10 or 17(2). In this context, Rule 2BB(1) is very relevant. As per Rule 2BB(1)(c), any allowance granted to meet the expenditure incurred on conveyance in performance of duties of an office or employment of profit, is exempt from tax. In this regard, a certificate from the employee that he has fully spent the aforesaid allowance for the purpose of his duties, will be sufficient, as regards the employer and no tax will be required to be deducted at source in respect thereof.

It may be noted that any reimbursement of such expenses by the employer will fall within the purview of fringe benefit tax.

Therefore, a special allowance should be preferred to payment by way of reimbursement on the expenditure incurred by the employees.

As per section 115WB(2)(Q) r.w.s.115WC(1)(e) the value of fringe benefits in respect of expenditure on tour and travel, including foreign travel, will be five per cent of such expenditure.

It would, therefore, be advisable to bring more expenditure under tour and travel, including foreign travel and pay fringe benefit tax in respect thereof.

10. Deductions under section 80C, etc.

Section 80C provides that an assessee, being an individual or a Hindu Undivided Family, will be allowed a deduction from gross total income of an amount not exceeding Rs.1.00 lakh in respect of amount paid or deposited in the previous year in the specified savings listed in section 80C(2).

The deductions include payment of life insurance premia and contributions to provident fund, etc. Such payments also include contribution to certain pension funds, subscription towards units of mutual fund / UTI, payment of tuition fees for children, payment for repayment of loan in respect of purchase / construction of a residential house. The most important point to be noted here is that total deduction under sections 80C as well as 80CCC and 80CCD, should not exceed Rs.1.00 lakh.

11. Tax-planning measures

No hard and fast guidelines can be provided for the purpose of tax-planning, so as to reduce the incidence of taxation to the minimum. In the light of the discussion, in the preceding paragraphs, some broad guidelines by way of tax-planning measures, may be provided as follows:-

- (i) The basic salary may be taken at 35-40% of the total pay-package
- (ii) It should be ensured that dearness allowance forms part of salary as per the terms of employment.
- (iii) House rent allowance (HRA) paid by the employer, is exempt under section 10(13A), as per the limits prescribed by Rule 2A of the Income-Tax Rules, 1962. It is, therefore, advisable to pay house rent allowance to the employees in preference to providing rent-free accommodation to them.
- (iv) All these special allowances exempt under section 10(14) r.w.rule 2BB should be provided to the extent possible.

Some instances of these allowances are, as follows:-

- (a) Conveyance allowance
- (b) Transport allowance for commuting between the office and residence upto Rs.800 per month.
- (c) Uniform allowance, if the employer has uniform code in the organisation.
- (d) Helper allowance where such helper is engaged in the performance of official duties, and
- (e) Education allowance, etc.
- (v) Leave travel allowance may be provided as a part of pay-package.

(vi) Expenditure on medical treatment should also be made a part of pay-package. Such expenditure is exempt, vide proviso to section 17(2) after clause (vi) thereof.

It may be noted that medical reimbursement of actual expenditure upto Rs.15,000 per year, is also exempt in the hands of the employee.

(vii) If employee owns a house, which he has occupied for his own residence, such house may be taken by the employer on lease and thereafter, the same may be allotted to the employee as rent-free accommodation.

(viii) Maximum benefit must be availed of, in respect of the exemptions provided to salaried employees under section 10 of the Income-Tax Act. This issue has been discussed in the aforesaid para (6). Some instances of such exemptions are as follows:-

- (a) Gratuity : section 10(10)
- (b) Commutation of pension : section 10(10A)
- (c) Encashment of leave salary : section 10(10AA)
- (d) Recognised Provident Fund : section 10(12), and
- (e) Approved Superannuation Fund : section 10(13)

(ix) Maximum benefit must be availed of, in respect of deduction under section 80C, etc. This issue has been discussed in the aforesaid para (10).

(x) Motor-car for office and private use, along with driver, if necessary, may be provided to senior employees of the organization.

The expenditure on use of motor-car is not taxable in the hands of the employee. On the other hand, FBT is chargeable in respect of such expenditure in the hands of the employer and the rate of such FBT is only six per cent of such expenditure.

(xi) Computer or lap-top for office and private use may also be provided to the employee. This benefit is neither taxable in the hands of the employees, nor is it liable to FBT in the hands of the employer.

(xii) Free tea, coffee, snacks, refreshment, lunch / dinner in office or factory, may be provided to the employees. If feasible paid meal vouchers may also be provided to the employees in the absence of canteen or other such arrangement.

The expenditure on the aforesaid items is neither taxable in the hands of the employees, nor is it liable to FBT in the hands of the employer.

12. Conclusion

As already pointed out, no hard and fast parameters can be laid-down for the purpose of tax-planning in respect of income from 'Salaries'. Only broad guidelines may be provided in this regard and the same have been discussed in the preceding paragraphs.

In the light of the aforesaid reasons, the Human Resource Department (HRD) of an organization will have to try different permutations and combinations in respect of the pay-package of the employees of the organization, on the basis of their peculiar needs and circumstances.

The aforesaid broad guidelines may be used as tax-planning measures in respect of the pay-package of the employees of an organization.

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