

## Gratuity and its implications.. In a Nutshell ..

### **What is Gratuity?**

In India gratuity is a type of **retirement** benefit. Gratuity is a Gratification paid by the employer to the employee based on the past service record of the employee, however, an employee should complete the minimum period of the rendering of service i.e. 5 years in a single organisation prescribed under the Payment of Gratuity Act. It is a payment made with the intention of helping an employee monetarily after his retirement. It was held by the Supreme Court of India in Indian Hume Pipe Co Ltd v Its Workmen, that the general principal underlying gratuity scheme is that by service over a long period the employee is entitled to claim a certain amount as retirement benefit.

The Payment of Gratuity Act was passed by Indian Parliament in 21st August 1972. The Act came in force on 16th September 1972.

### **Applications and extent**

The Act applies to the whole of India. But according to **section 1(2)**, in so far it relates to plantation or ports, it shall not be extended to State of Jammu and Kashmir. The Act applies to all factories, mines, oilfield, plantation, port and railway company. But in case of shops or establishments other than those stated before, it applies to those organisations with 10 or more persons are employed on any day of the preceding 12 months. Under **Section 1(3-A)**, if in case of any shop and establishment to which the Act applies the number of employee reduces below 10, it shall continue to be governed by the Act irrespective of the number of employee's. Thus no employer can escape liability under this Act by reducing the number of employee's. Under **Section 2(e)**, Nothing in this Act applies to Apprentices and Persons who hold civil posts under the Central Government or State Government and are subjected to any other Act or rule other than this Act.

## **Payment of gratuity: Eligibility and calculation**

Under [Section 4](#), payment of gratuity is mandatory. Gratuity shall be payable to an employee on termination of employment after he has rendered continuous service for not less than 5 years in a single organisation. The termination can be due to :

1. Superannuation.
2. Retirement or Resignation.
3. On Death or Disablement due to accident or disease.

As per [Section 4\(1\)](#), the completion of continuous service of 5 years is not required where termination of employment is due to death or disablement. In such case mandatory gratuity is payable.

Gratuity is paid at a rate of 15 days wages for every completed year of service or part thereof in excess of Six months. The wages here means wages last drawn by the employee. The "15 Days Wages" will be calculated by dividing the last drawn wages by 26 and multiplying the result with 15. But under [section 4\(3\)](#), the maximum gratuity that is payable is fixed at Rupees 20,00,000 [1].



## **How is Gratuity Calculated?**

### **Formula for Gratuity Calculation =**

$$[((\text{Basic Pay} + \text{D.A}) \times 15 \text{ days}) / 26] \times \text{No. of years of service}$$

First of all, under [section 10\(10\) of Income Tax Act](#), Gratuity is tax-free for Government Employees as well as employees of local authority i.e. the whole sum received by the Government Employees and local authority employees is exempt from tax irrespective of any threshold limit.

However, in the case of non-government employees, the gratuity is taxable above a certain threshold limit.

Let's see how gratuity is calculated and what the income tax benefits are-

As per the provisions of the Income Tax Act, lowest of the below three amount shall be tax-free as Gratuity covered under the Payment of Gratuity Act.

1. Actual Gratuity Received
2. Last Drawn Salary X 15/26 X Completed Years of Service where salary includes basic pay + dearness allowance and for the determination of completed years of service, if an employee serves more than 6 months in the last year of employment, it is considered as a full year of service.
3. Maximum Amount of Rs.20 lakhs as per the amended Gratuity Act

*Let's understand with an example*

| Particulars                              | Case Study 1   | Case Study 2   |
|--|--|--|
| <b>1. Completed year of service</b>      | <b>29 Years 7 months</b><br>(shall be considered as 30 years because more than months served in the last year of service)              | <b>25 Years</b>  |
| <b>2. Annual Income (Basic Pay + DA)</b> | <b>12,00,000 (1,00,000 per month)</b>  | <b>18,00,000 (1,50,000 per month)</b>  |
| <b>3. Actual Gratuity Received</b>       | <b>18,00,000 (Assumed)</b>   | <b>18,00,000 (Assumed)</b>   |
| <b>4. Calculation</b>                    | i) <b>18,00,000</b><br>ii) <b>1,00,000 * 15/26 * 30 = 17,30,770</b><br>iii) <b>20,00,000</b><br>(Whichever is lower shall be tax-free) | i) <b>18,00,000</b><br>ii) <b>1,50,000 * 15/26 * 25 = 21,63,462</b><br>iii) <b>20,00,000</b><br>(Whichever is lower shall be tax-free) |
| <b>5. Exempted Gratuity</b>              | <b>17,30,770</b>   | <b>18,00,000</b>   |

The Amendment in the Gratuity Act was much anticipated to bring the parity in the taxation of Gratuity between Government and Non-Government Employees. This move will surely benefit those employees who have just started their careers and stay in the organization for more than 5 years.