

Tax-free gratuity withdrawal limit to be Rs20 lakh

The tax exemption limit on gratuity is set to increase to Rs20 lakh

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Recently, the Ministry of Labour and representative of state governments, employees and employers agreed to increase the gratuity withdrawal limit to Rs20 lakh from the current ceiling of Rs10 lakh. The tax exemption limit on gratuity is also set to increase to Rs20 lakh. *Mint* had earlier reported that a labour ministry spokesperson had said on 23 February that all the stakeholders—states, Centre, trade unions and industry representatives—were in agreement over enhancing the gratuity ceiling from Rs10 lakh to Rs20 lakh. Once this gets implemented, employees will have access to a larger amount of tax-free gratuity. Here is how the math works:

Who gets gratuity

Gratuity is part of an employee's salary but it is not paid every month. It is paid to the employee either at the time when she leaves the job or at the time of retirement; provided she has completed at least 5 years of employment with the employer. In case of death of the employee, the amount is paid to the employee's family, irrespective of the employment period. Under Payment of Gratuity Act, 1972, any establishment (factory, mine, oilfield, plantation, port and railway company, or shop) having more than 10 employees at any point of time in the last 12 months, is required to provide gratuity to its employees.

Tax liability

Under the income-tax Act, gratuity is taxed under the head 'income from salaries'. The portion of salary received as gratuity can be exempt from tax under section 10(10) of the Income-tax Act, 1961, depending on various factors. But if gratuity is received by an employee of central, state or a local government agency, it is fully exempt when withdrawn on death or retirement.

Under the current regime, where the Payment of Gratuity Act is applicable, the least of the following received by the employee is exempt from tax:

—Rs 10 lakh,

—actual gratuity received,

—15 days' salary, based on the salary last drawn multiplied by the number of years in employment .

To calculate 15 days' salary, the last drawn salary is divided by 26 and the number is multiplied by 15. Here, salary includes basic salary and dearness allowance, if any.

Let us take the case of an employee who has worked for 25 years with an employer and her last-drawn salary was Rs1 lakh per month. Let us assume her total accumulated gratuity amount was Rs15 lakh. In this case, she can claim Rs10 lakh as tax-free gratuity.

This would be so because, Rs10 lakh (maximum allowed) is the least of the other two options: Rs15 lakh (gratuity receivable) and Rs14,42,307. The latter figure is arrived at by the following computation: $((1,00,000/26)*15)*25$.

The remaining Rs5 lakh (Rs15 lakh minus Rs10 lakh) can be given by employer as ex-gratia or performance bonus; this would be taxable.

However, after the limit is extended to Rs20 lakh, the least amount for this employee would no longer be Rs10 lakh, it would be Rs14.42 lakh, and instead of paying tax on Rs5 lakh, she would have to pay tax on Rs58,000 (Rs14.42 lakh minus her total gratuity entitlement).

Under the current rules, in cases where employers are not covered under the Payment of Gratuity Act, then minimum of the three—Rs10 lakh, actual gratuity received or half month's salary for each completed year of service—is exempt from tax. Salary is taken as average salary of 10 months immediately before the month in which the person retires. This may change once the Act is amended.