Gratuity- Taxation benefits available to company in Pay as go Option & Funding Option

*This article is in continuation to my earlier article **'Requirement of Accounting and Funding Arrangement for Gratuity Benefits'** in this article we will understand about **'Taxation benefits available to company in Pay as go Option & Funding Option'***

Gratuity is a statutory right of employee whoever completes 5 years in the same organization and is a terminal. It means, Gratuity amount is determined only on the monthly terminal wages of the employee on his exit from the Company after completion of 5 years of Service. The cost is to be borne by the Company and not by an employee. hence, unlike other fringe benefits (i.e. Medical Insurance, Term Insurance & Accidental Insurance) it can not be part of CTC.

Gratuity Liability increase exponentially with the increase in wages of employee and service period of the employee. Also, it is employers responsibility to pay the gratuity to the employee in any case. Companies have generally 2 options for discharging the Gratuity Liability: –

***1.* Pay as go options –** *In this option, the Companies makes provision of Gratuity Liability by taking an Actuarial Valuation Report/Certificate from **Actuary** to Comply with the requirements of following Accounting Standards issued by the Regulators :-*

a. AS 15 (Revised 2005)

b. Ind AS 19

c. IAS 19 (Revised 2011)-IFRS- In Indian context, Companies falls in following three categories based on the basis of compliance criteria mentioned in Accounting Standards :-

(i) SME – In this case, company needs to disclose details as required for Clause (l) of Para 120 of AS 15 (Revised 2005)

(ii) Non – SME – In this case, company needs to disclose details as required for Para 120 of AS 15 (Revised 2005)

(iii) Companies with Net-worth more 250 cr. – In this case, companies and their subsidiaries has to give disclosure of in compliance of IndAS 19 with comparative numbers of previous 2 years.

2. Funding Option–In this option, Management of Company make decision based on the Gratuity Liability Computed and Certified by An Actuary to creates an **Irrevocable Trust. There are 2 major benefits to the company by creating** an **Irrevocable Trust:-**

(i) Contribution into Approved Trust is allowed as deductible Expense : – *Provision of Gratuity Liability shown in the Balance Sheet is not allowed as deduction whilst computing net Income for Income Tax ((Refer Section 47A (7) of Income Tax Act*

1961) whereas Initial and Annual Ordinary Contribution made by company into an Approved Gratuity Trust (Subject to condition specified in Income Tax Rules 103 & 104) is ***allowed as deductible expense*** *under* ***Section 36 (1) (v).***

(ii) Interest received from Investment of an Approved Gratuity Trust is also exempted as Income Tax :- *Interest received from Investment of an Approved Trust is also exempted as Income under* ***Section 10 (25) (iv)*** *of the Income Tax Act, 1961.*

To understand ***Taxation benefits of Accounting/Fund Arrangement for Gratuity Benefits*** *, let us take an Example,*

Mr. A Joins the Organization with a Basic Pay of Rs. 26,000/- per month and monthly CTC of 50,000/-. Assuming that expected increase in basic salary is assumed to be 10% p.a.

Now Gratuity Payments for next 5 years will be :-

On Completion of 1 Yr – (15/26) 28,600*1 = 16,500/-*
*On Completion of 2 Yrs – (15/26)*31,460*2 = 36,300/-*
*On Completion of 3 Yrs – (15/26)*34,606*3 = 59,895/-*
*On Completion of 4 Yrs – (15/26)*38,067*4 = 87,847/-*
*On Completion of 5 Yrs – (15/26)*41,873*5 = 1,20,788/-*

Now for making the payment of gratuity, Company has 2 options :

(i) Pay as you go option *– Where company makes a provision of Gratuity in the Balance Sheet on the accrual basis taking an actuarial report on BS date from an Actuary and as and when Mr. A leaves the organization, company pay gratuity from their resources and get the tax benefit for the gratuity paid.*

Expected Tax Benefit calculation in case of "Pay as you Go Option" :-

For Provision of 1st Yr – NIL
For Provision of 2nd Yr – NIL
For Provision of 3rd Yr – NIL
For Provision of 4th Yr – NIL
For Payment on 5th Yr – 1,20,788/-

*In this case company****, Mr. A will leave the company then company will get the tax benefit of Rs. 1,20,788/-.***

(ii) Funding Option *– In this option, Company decides to setup an Approved Gratuity Trust . The Investment of Company is either "Self Managed " or " Managed by Insurance Company". Company contribute the annual contribution in this Gratuity Trust and get the Tax Benefits. In this case, when Mr. A will leave the company, gratuity will be to Mr. A from the Gratuity Trust.*

Expected Tax Benefit calculation in case of "Funding Option" under Section 36(1)(v) of the IT Act 1961 for Annual Contribution which is 8.33% of Annual Basic Salary of Employee.

*For Contribution of 1st Yr – 28,600*12*0.833 = 28,589/-*
*For Contribution of 2nd Yr – 31,460*12*0.833 = 31,447/-*
*For Contribution of 3rd Yr – 34,606*12*0.833 = 34,592/-*
*For Contribution of 4th Yr – 38,067*12*0.833 = 38,051/-*
*For Contribution of 5th Yr – 38,067*12*0.833 = 41,857/-*

In this case, Mr. A will get gratuity of Rs. 1,20,788/- from the Gratuity Trust and employer will get approximate Tax Benefits of Rs.1,74,536/- for annual contribution made by him in previous 5 years.

To get more clarity on the above example, let us take some more questions about the possibilities/event that may happen on or after completion of 5 years and their impact on the Company in case of "Funding Option" :-

Question 1. If employee died during 1st to 4th year before completion of 5th year, then what would be the benefit for Company and employee's Nominee ?

Answer 1. If employees died after 1 yr, 2nd, 3rd and 4th year but before completion of 5th year, then the company will get tax benefits for the following contributions:-

*For Contribution of 1st Yr – 28,600*12*0.833 = 28,589/-*
*For Contribution of 2nd Yr – 31,460*12*0.833 = 31,447/-*
*For Contribution of 3rd Yr – 34,606*12*0.833 = 34,592/-*
*For Contribution of 4th Yr – 38,067*12*0.833 = 38,051/-*

The company will get the Tax for the contribution made by him before the date of death of the employee as stated above and employee's nominee will get following Gratuity Payments from the Trust along with a future service gratuity subject to certain limits as defined by the Insurance Company whilst taking Group Gratuity Scheme from the Insurance Company.

Question 2. If the employee resigns during 1st to 4th year and before completion of 5th year, then what would be the benefit for Company and employee?

Answer 2. If employees resign during 1st to 4th year and before completion of 5th year, then the company will get tax benefits for the following contributions:-

*For Contribution of 1st Yr – 28,600*12*0.833 = 28,589/-*
*For Contribution of 2nd Yr – 31,460*12*0.833 = 31,447/-*
*For Contribution of 3rd Yr – 34,606*12*0.833 = 34,592/-*
*For Contribution of 4th Yr – 38,067*12*0.833 = 38,051/-*
*For Contribution of 5th Yr – 38,067*12*0.833 = 41,857/-*

and the employee will not get following Gratuity Payment from the Trust. The amount contributed by the company and interest accrued will be used by the trust for future payments of Gratuity to other employees of the company.

Question 3. If the employee resigns/retires after completion of 5th year, then what would be the benefit for Company and employee?

Answer 3. If employees resigns/retires during after completion of 5th year, then the company will get tax benefits for the following contributions:-

*For Contribution of 1st Yr – 28,600*12*0.833 = 28,589/-*
*For Contribution of 2nd Yr – 31,460*12*0.833 = 31,447/-*
*For Contribution of 3rd Yr – 34,606*12*0.833 = 34,592/-*
*For Contribution of 4th Yr – 38,067*12*0.833 = 38,051/-*
*For Contribution of 5th Yr – 38,067*12*0.833 = 41,857/-*
Total Contribution in 5 years………………………= Rs.1,74,536/-

and the employee will get Rs. 1,20,788/- as Gratuity Payment from the Trust. Since the company has contributed an amount in the trust is more then what is payable after 5th year so the surplus amount and interest accrued on the contributions of will be used by the trust for payment to the other employees.

For more details or consultation on the above matter, you may contact me at 9211637063 or email me your queries at tikaramchaudhary@gmail.com