Factors affecting Gratuity Benefits, Accounting & Taxation of Gratuity Benefits

Gratuity Benefits, Factors affecting Gratuity Benefits, Accounting requirement of Gratuity Benefits, Taxation benefits available to companies in pay as go option and Funding Option and Roll of a Gratuity Trust fund consultant in formation of an Approved Gratuity Trust.

This article is an attempt to give more clarity about Gratuity Benefits, Factors affecting Gratuity Benefits, Accounting requirement of Gratuity Benefits, Taxation benefits available to companies in pay as go option and Funding Option and Roll of a Gratuity Trust fund consultant in formation of an Approved Gratuity Trust.

1. Brief about Gratuity Benefit

Gratuity being an important retirement benefit to employees in the Indian context, is relevant for all organizations (i.e. MNC's, Schools and Other business entities) having more than 10 employees . Since an employee sacrifices prime time of his life for the development, prosperity and betterment of his employer, employer pays his employee gratuity as a graciousness or gift to him, when he no longer serves him. gratuity is a statutory obligation on the shoulders of the employer to make the payment of Gratuity to his employees as soon as it becomes payable **(Refer Sub Section (2) of Section 7 to the Act).**

2. Applicability

Compliance of this act is applicable to all organizations such as a factory, mine, oilfield, port, railways, plantation, shops, establishments or Educational institution having 10 or more employees on any day in the preceding 12 months.

3. Determination of Gratuity Amount

The amount of Gratuity payable to an employee on his exit from service, according to "The **Payment of Gratuity (Amendment) Act 2018** ", in force at present, is:-

(Wages of the employee at the time of exit) x (15/26) x (Number of Years of Service at the time of exit)

This is subject to a ceiling limit of 20,00,000/- effective from 29.03.2018.

4. Conditions for payment of Gratuity

Gratuity is payable to an employee on exit from service after he has rendered continuous service for not less than five years:

(a) On his superannuation

(b) On his resignation

(c) On his death or disablement due to injury or disease.

In the case of (c) vesting condition of 5 years does not apply.

5. Factors affecting Gratuity Benefits

Gratuity Benefits changes with the change in the following:-

(a) Past Service of Employee in the Company,

(b) Increase in wages of Employee in the Company,

(c) Change in Benefit Formula of the Gratuity Benefit due to the amendment in the Act,

(d) Change in Ceiling Limit on Gratuity Benefits due to the amendment in the Act,

(e) Change in Vesting Condition for eligibility of Gratuity Benefits due to the amendment in the Act,

6. The impact of the above Factors on Gratuity Benefits can be understood by the following Examples :

(a) Change Past Service of Employee in the Company.

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month and there is no change in basic salary, only his Past Service Change then Gratuity Payments for the next 5 years will be:-

On Completion of 1 Yr – (15/26)* 2,60,000*1 = 1,50,000/-

On Completion of 2 Yrs – (15/26)*2,60,000*2 = 3,00,000/-

On Completion of 3 Yrs – (15/26)*2,60,000*3 = 4,50,000/-

On Completion of 4 Yrs – (15/26)*2,60,000*4 = 6,00,000/-

On Completion of 5 Yrs – (15/26)*2,60,000*5 = 7,50,000/-

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

(b) Increase in wages of Employee in the Company.

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month and there is the change in wages @ 10%, then Gratuity Payments for the next 5 years will be :-

On Completion of 1 Yr – (15/26)* 2,86,000*1 = 1,65,000/-

On Completion of 2 Yrs – (15/26)*3,14,600*2 = 3,63,000/-

On Completion of 3 Yrs – (15/26)*3,46,060*3 = 5,98,950/-

On Completion of 4 Yrs – (15/26)*3,80,670*4 = 8,78,460/-

On Completion of 5 Yrs – (15/26)*4,18,730*5 = 12,00,788/-

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

(c) Change in Benefit Formula of the Gratuity Benefit due to the amendment in the Act.

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month, His increment in wages @ 10%, and due to change in the Gratuity Factor as 1/1 from 15/26 then Gratuity Payments for next 5 years will be :-

On Completion of 1 Yr – (1/1)*2,86,000*1 = 2,86,000/-

On Completion of 2 Yrs – (1/1)*3,14,600*2 = 6,29,200/-

On Completion of 3 Yrs – (1/1)*3,46,060*3 = 10,38,180/-

On Completion of 4 Yrs – (1/1)*3,80,670*4 = 15,22,660/-

On Completion of 5 Yrs – (1/1)*4,18,730 *5 = 20,93,660/-

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

(d) Change in Ceiling Limit on Gratuity Benefits due to the amendment in the Act.

Mr. A Joins the Company with a Basic Pay of Rs. 5,00,000/- per month, His increment in wages @ 10%, and due to changes in Ceiling Limit from 10 Lakhs to 20 Lakhs then Gratuity Payments for the next 5 years will be:-

Case 1 – When Ceiling Limit on Gratuity Payment is 10,00,000/-

On Completion of 1 Yr – (15/26)* 5,50,000*1 = 3,17,308/-

On Completion of 2 Yrs – (15/26)*6,05,000*2 = 6,98,077/-

On Completion of 3 Yrs – (15/26)*6,65,500*3 = 11,51,827/- Company liable to pay 10,00,000/-

On Completion of 4 Yrs – (15/26)*7,32,050*4 = 16,89,346/- Company liable to pay 10,00,000/-

On Completion of 5 Yrs – (15/26)*8,05,255*5 = 23,22,851/- Company liable to pay 10,00,000/-

Case 2 – When Ceiling Limit on Gratuity Payment is 20,00,000/-

On Completion of 1 Yr – (15/26)* 5,50,000*1 = 3,17,308/-

On Completion of 2 Yrs – (15/26)*6,05,000*2 = 6,98,077/-

On Completion of 3 Yrs – (15/26)*6,65,500*3 = 11,51,827/-

On Completion of 4 Yrs – (15/26)*7,32,050*4 = 16,89,346/-

On Completion of 5 Yrs – (15/26)*8,05,255*5 = 23,22,851/- Company liable to pay 20,00,000/-

Case 3 – When Ceiling Limit on Gratuity Payment is 30,00,000/-

On Completion of 1 Yr – (15/26)* 5,50,000*1 = 3,17,308/-

On Completion of 2 Yrs – (15/26)*6,05,000*2 = 6,98,077/-

On Completion of 3 Yrs – (15/26)*6,65,500*3 = 11,51,827/-

On Completion of 4 Yrs – (15/26)*7,32,050*4 = 16,89,346/-

On Completion of 5 Yrs – (15/26)*8,05,255*5 = 23,22,851/-

(e) Change in Vesting Condition for eligibility of Gratuity Benefits due to the amendment in the Act.

In the above examples for (a) to (d), If an employee leaves the company before completion of 5 years then "Nil" gratuity benefit is payable in the following events :

(a) on his superannuation, or

(b) on his retirement or resignation.

Case 1 – When Vesting Condition for eligibility is 3 years, Company will be liable to pay gratuity benefit on completion of 3 years in event of his superannuation, on his retirement or resignation.

Case 2 – When Vesting Condition for eligibility is 2 years, Company will be liable to pay gratuity benefit on completion of 2 years in event of his superannuation, on his retirement or resignation.

Case 3 – When Vesting Condition for eligibility is 1 year, Company will be liable to pay gratuity benefit on completion of 1 year in event of his superannuation, on his retirement or resignation.

7. Provisions for Employer under Payment of Gratuity Act 1972 (Amended)

Section 7 of the Act has kept obligation for payment of gratuity act on the shoulders of employer, few provisions of this section act are listed below:-

1. As soon as Gratuity becomes payable, it employers responsibility to determine the amount of gratuity and inform it to employee in writing **(Refer sub section 2 of Section 7 of the Act).**

2. The employer shall arrange to pay the amount of gratuity within 30 days from the date when it becomes mandatory. **(Refer Sub-section 3 of Section 7 of the Act).**

3. If the amount of gratuity is not paid within 30 days then amount of gratuity and simple interest will be paid by the employer to the employee for the duration when the payment is not made to the employee. **(Refer Sub-section 4 of Section 7 of the Act).**

4. Applicability of compulsory insurance for Gratuity by State Governments due amendment in the act. (State of Andhra Pradesh notified about the compulsory insurance for Gratuity under **Andhra Pradesh Compulsory Gratuity Insurance Rules, 2011** vide Lr.No.M1/8842/2010, dated: 04.12.2010 from the Commissioner of Labour, Andhra Pradesh and remains un-notified for rest of India). **Applicability of compulsory insurance for Gratuity can be notified by the other State Governments because compulsory insurance of gratuity secures the gratuity benefits of employee even in case of bankruptcy of the company.**

8. Options for Gratuity Benefits Management to Companies

From point No. 5, 6 & 7, we conclude that the Gratuity Liability of companies increase exponentially with the increase in wages of employee, service period of employee, regulatory changes as shown in point 6 and it is employers responsibility to pay the gratuity to employee to avoid the regulatory penalty for Non Payment of Gratuity within stipulated time as given in 7 (2) above. Employers generally have 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 **(Para 49 of AS 15 Revised 2005)** to Comply with the requirements of following Accounting Standards issued by the Institute of Chartered Accountants of India :-

a. AS 15 (Revised 2005)

b. IndAS 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.

<u>Taxation of Gratuity Payment under Pay as go options :-</u>

To understand this, 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.

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, Expected Tax Benefit calculation in case of “Pay as you Go Option” is as under :-

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/-.

2. 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.

9. Why Funding Option is preferred by Companies for Gratuity Benefits Management

Mostly companies prefer funding option for management Gratuity Benefits of the employees due to following reasons :-

1. For Tax Benefits :- Gratuity provision based on the Actuarial Valuation Report received from Actuary is required by the company for compliance of Para 133 of the **Companies Act 2013** for preparation of Financial Statement to comply with the requirement of Accounting Standard 15 (Revised 2005) but it is not allowed as a deduction under Section 40A(7) of Income Tax Act, 1961 (as amended time to time). The Section is produced below:-

“ (a) Subject to the provisions of clause (b), no deduction shall be allowed in respect of any provision (whether called as such or by any other name) made by the assessee for the payment of Gratuity to his employees on their retirement or on termination of their employment for any reason.

(b) Nothing in clause (a) shall apply in relation to any provision made by the assessee for the purpose of payment of a sum by way of any contribution towards an approved gratuity fund, or for the purpose of payment of any gratuity, that has become payable during the previous year.”

In case of funding there are 3 taxation benefits being available to companies :-

I. Initial Contribution based on actuarial report **(Refer Circular : No. 30(XLVII-18), dated 30-11-1964 for clarification for Rule 103 for Initial Contribution of Income Tax Rules 1962)** made by the Companies is treated as a annual expense for Income Tax Computation of the Company **(Refer Section 36(1)(v) of** Income Tax Act 1961. **Section 36(1)(v) of Income Tax Act, 1961 reads as under :-**

“any sum paid by the assessee as an employer by way of contribution towards an approved gratuity fund created by him for the exclusive benefit of his employees under an irrevocable trust”

II. Annual Contribution an amount equal to 8.33% of basic salaries can be paid into a gratuity fund as a tax-deductible expense.

III. Interest or investment income earned within the gratuity fund is also tax-free.

2. For Risk Management of Gratuity Benefits of Employees even in case of Financial Crisis:- Once companies forms an Approved Gratuity Trust and starts making contribution into the trust then their vulnerability to making the default for Gratuity Payment to employees as per the Section 7 of the Payment of Gratuity Act 1972 is taken over by the Irrevocable trust subject to fund available with them. Since the Approved Gratuity Trust are Irrevocable, so the money contributed by the companies will be **exclusively used for payment of Gratuity Benefits to the Employees** and fund money can not be used by the **company even in case of Bankruptcy.**

3. Liquidity management :- If Gratuity Benefits are unfunded, companies will need to pay off the gratuities to leaving employees as and when they leave. Therefore, the amount companies would pay Could vary greatly from year to year as the number of people leaving will be uncertain. This would be a particular concern for small or mid-size companies where the resignation of just a few senior employees, with high salary and service, could create a strain on their cashflow positions. On the other hand, if a scheme is ‘scientifically’ (or actuarially) funded, the fund will build up during the years when no major payouts are paid and then used when large payoffs are required to be paid.

4. Cashflow stability:- For new companies, the gratuity payments to employees would be few and low. However, gratuity payouts increase nearly exponentially as employees age and work longer. By having the liabilities funded, companies can replace the rapidly increasingly gratuity payouts with a relatively stable stream of contributions into the fund.

10. Steps Involved in Formation of Trust for Gratuity Fund

In this section my article we will discuss about the steps involved in Formation of Trust for Gratuity Fund. The different steps for Formation of Retirement Benefit Trust are as under :-

1. **Assessment of Gratuity Liability** – The process of formation of Gratuity Fund starts with assessment of gratuity liability on actuarial basis by taking as actuarial valuation certificate from An Actuary. Inputs for Actuarial Valuation is prepared by the HR Department of the Organization. It normally takes 2 to 3 days to complete this exercise.

2. Board Resolution for an Approved Gratuity Trust – Once the actuarial valuation certificate for accrued liability of gratuity is received from the Actuary. Management or Society of Organization with consultation of Gratuity Trust Fund Consultant can decide the Corpus of Investment into the Gratuity Fund of an Approved Gratuity Trust & A board resolution is passed by the Management of the Organization to form a Irrevocable Trust for Gratuity Fund.

3. Registration of Trust Deed – Indian Trusts Act, 1882 regulates and administers the private trusts in India, whereas the Public Trusts Direct the functioning of the public trusts except in the state of Maharashtra and Gujarat where public trusts are governed by Bombay Public Trust Act, 1950 :-

I. Trust Deed/Trust Rules is executed on a Non Judicial Stamp Paper.

II. Next Step is to Seek an appointment with the Sub Registrar office having jurisdiction based on the registered office of the Trust, and the Government Registration fee is to paid after that.

III. On appointment Date the Trust Deed is presented before the sub registrar where all trustees need to be present along with 2 witnesses.

IV. The registration process is undertaken by the office of the sub-registrar, and the registered deed can be collected after a week.

V. Once the Registered Deed is received then apply for PAN & TAN of the Trust and open a Bank Account in a Scheduled Bank as listed in for the Trust. It may take 30 Days.

VI. Once the Bank Account in a Scheduled Bank is opened then Organization Transfer the funds into Trust Bank Account.

4. Investment Decision – Once the Gratuity Fund is received from the organization into the Trust then the next step for the Trustees is to make decision for Investment of Gratuity Fund either by themselves or they can approach Insurance Company.

5. Application for Approval of Gratuity Trust – Once the Investment is done then organization needs to submit an application to their Zone Income Tax Commissioner for Approval of Gratuity Trust with a Copy of Trust Deed/Trust Rules, Investment details and other relevant documents.

For more details in the above matter you may contact me at tikaramchaudhary@gmail.com or call me at 9211637063.