

Chapter 15

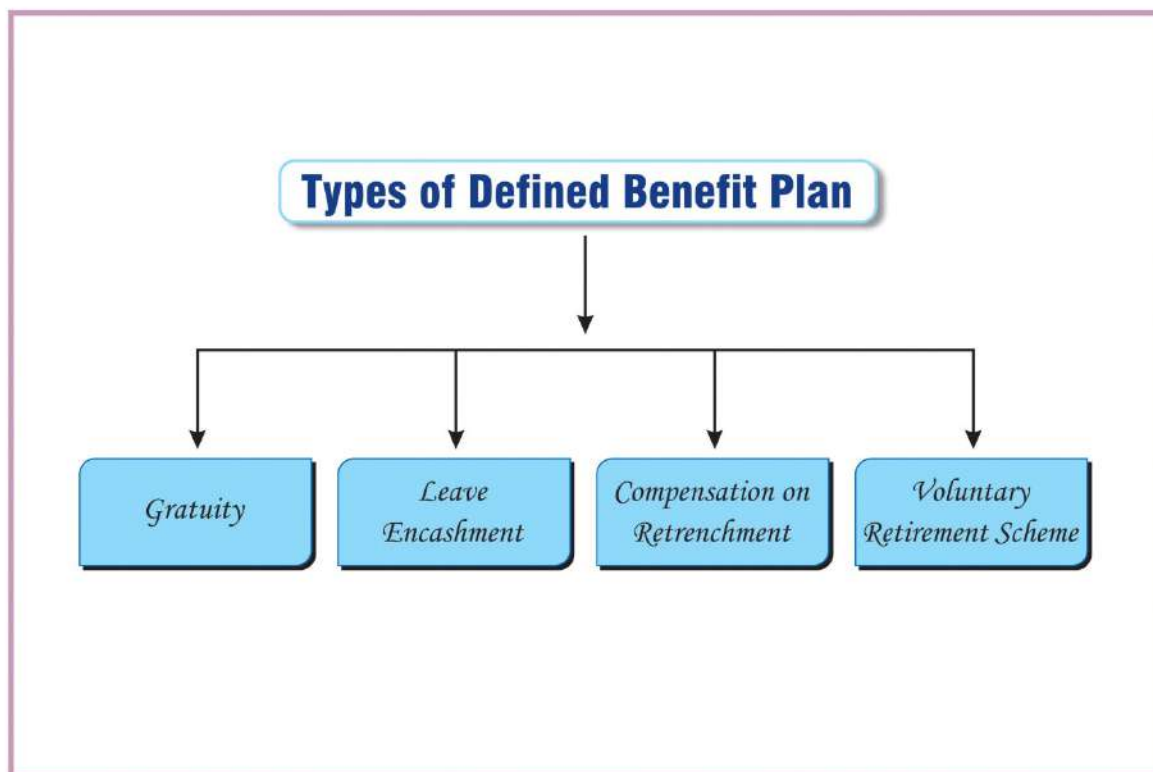
DEFINED BENEFIT PLANS

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Defined Benefit Plan reflects a traditional pension or fixed pension. A pension plan under which an employee receives a set monthly amount upon retirement, guaranteed for their life or the joint lives of the member and their spouse. As the name suggests is a plan that specifies the benefits each employee will receive at retirement or we can say that under a Defined Benefit plan, employees are guaranteed a fixed benefit upon retirement.



Types of Defined Benefit Plan

GRATUITY

As per the Oxford Dictionary, gratuity means “money given in recognition of services”. It is a gratuitous payment or a parting gift. It started as a symbol of goodwill, a voluntary gesture, or an acknowledgment of satisfaction on the part of a prosperous employer towards his employees when they part with him after rendering long and faithful service.

Historical Background of “The Payment of Gratuity Act, 1972”

In a landmark judgment, in the case of Indian Hume Pipe Co. Ltd. Vs. its workmen 1960 (Sec-251) the Supreme Court held that gratuity is a legitimate demand. Under this decision, gratuity came to be considered as a rightful benefit and no longer a gratuitous payment as in the past.

Passing of Legislation

The states of Kerala and West Bengal pioneered with legislative steps to make gratuity a legal payment to be made mandatory for all employers. Kerala brought its legislation in 1970 and West Bengal in 1971.

The Central Government got legislation passed by the Parliament in 1972 in this regard. Now gratuity is recognized as a statutory benefit under the 'Payment of Gratuity Act, 1972'.

With the enactment of the act, it is now compulsory for most of the cases, and hence, it is no more a gratuitous payment.

It can either be received by:

- a. The employee himself at the time of his retirement, or
- b. The legal heir in the event of the death of the employee

Scope and applicability of the Payment of Gratuity Act, 1972

Payment of Gratuity: [Section 4(1)]

Gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years:

- (a) On his superannuation, or
- (b) On his retirement or resignation, or
- (c) On his death or disablement due to accident or disease.

The completion of continuous service of five years shall not be necessary where the termination of the employment of any employee is due to death or disablement.

Provided further that in the case of death of the employee, gratuity payable to him shall be paid to his nominee or, if no nomination has been made, to his heirs, and where any such nominees or heirs is a minor, the share of such minor, shall be deposited with the controlling authority who shall invest the same for the benefit of such minor in such bank or other financial institution, as may be prescribed, until such minor attains majority.

Coverage [Section 1(2)]: It extends to the whole of India, Provided that in so far as it relates to plantations or ports, it shall not extend to the State of Jammu and Kashmir.

Application [Section 1(3)]

The Payment of Gratuity Act shall apply to:

- (a) Every factory, mine, oilfield, plantation, port, and Railway Company;
- (b) Every shop or establishment within the meaning of any law for the time being in force concerning shops and establishments in a State, in which ten or more persons are employed, or were employed, on any day of the preceding twelve months;
- (c) Such other establishments or class of establishments, in which ten or more employees are employed, or were employed, on any day of the preceding twelve months, as the Central Government may, by notification, specify in this behalf.

Once Covered Always Covered [Section 1(3A)]

A shop or establishment to which this Act has become applicable shall continue to be governed by this Act notwithstanding that the number of persons employed therein at any time after it has become so applicable falls below ten.

Retirement: "Retirement" means termination of the service of an employee otherwise than on superannuation.

Superannuation: "Superannuation" about an employee, means the attainment by the employee of

such age as is fixed in the contract or conditions of service as the age on the attainment of which the employee shall vacate the employment.

“Wages” [Section 2 (s)]: “Wages” means all emoluments which are earned by an employee while on duty or leave following the terms and conditions of his employment and which are paid or are payable to him in cash and includes dearness allowance but does not include any bonus, commission, house rent allowance, overtime wages, and any other allowance.

Continuous service [Section 2A (1)]

For this Act: (Section 2A clause(1)): An employee shall be said to be in continuous service for a period one year if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of:

- Sickness,
- Accident,
- Leave,
- Absence from duty without leave (not being absence in respect of which an order treating the absence as a break in service has been passed following the standing orders, rules or regulations governing the employees of the establishment),
- Lay-off,
- Strike or a lock-out or cessation of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or after the commencement of this Act.

Service of Seasonal Employee

An employee in a seasonal establishment shall be deemed to be in continuous service within the meaning of the Act, if for any period of one year or six months. He has worked for not less than 75 percent of the number of days in which the establishment was in operation during such a period.

Calculation of Gratuity: In the case of employees covered under the Payment of Gratuity Act, 1972

(i) Monthly Rated Employee or Full Time Employers

- 15 days wages (basic + D.A.) for each year of completed service (more than 6 months to be taken as one year)
- Wages-Terminal wage (Last drawn salary)
- To calculate per day wage monthly wage is divided by 26
- The maximum liability under the ‘Payment of gratuity act, 1972’ to be paid by the employer is Rs. 20,000,00. (Applicable from now onwards)

(ii) Piece Rated Employee

- Monthly wage = Last three-month average wage
- The calculation is the same as Monthly rated employee

(iii) Seasonal Employee

- 7 days wages for each season of service put in by him

Tax treatment of Gratuity

A. Government employees u/s 10(10)(i)

The scheme applies to:

- (i) The members of civil services of the union, or
- (ii) Holders of posts connected with defense or civil posts under the Union, or

- (iii) The members of the civil services of a state, or,
- (iv) Holders of civil posts under a state, or,
- (v) The employees of a local authority, or
- (vi) The members of all India services.

In the case of such employees, the entire amount of death-cum-retirement gratuity received is exempt from tax under section 10(10) (i). Nothing will, therefore, be taxable as the case may be on account of gratuity.

B. Non-government employees covered under ‘The Payment of Gratuity Act, 1972, u/s 10(10)(ii):

- As per The Payment of Gratuity Act, the minimum of the following amounts is exempted from tax in case of a monthly rated employee:
 - (i) 15 DAY’S salary (calculated as 26 working days in a month) based on last drawn salary for every completed year or part thereof exceeding six months
 - (ii) Rs. 20,00,000/-
 - (iii) Actual gratuity received.
- For seasonal employees instead of 15 days, it will be 7 days’ salary.
- For piece rated employee 15 DAY’S salary will be calculated as 26 working days in a month and computed on the average of the total wages received by him for 3 months immediately for every completed year.

C. In case of other employees, u/s 10(10)(iii): U/s 10(10) (iii) of the Payment of Gratuity act, 1972 for any gratuity received by an employee who is not covered by the Payment of Gratuity Act, 1972, the minimum of the following amounts is exempted:

1. Half months average salary based on the average salary of the last 10 months preceding the month in which the event occurs for every completed year.
2. Rs. 20, 00,000.
3. Actual gratuity received.

Salary = Basic salary+ Dearness allowance will be included, only to the extent, it is a part of salary for this purpose + Fixed % commission on turnover.

‘Average salary’ is to be calculated based on the average of the salary for the 10 months immediately preceding the month in which such event occurs.

In calculating the number of years of service only completed years is to be taken into account and part of the year whether more or less than 6 months, will be ignored.

Tax Treatment of Gratuity

Govt. & Local Authority Employees	Employees covered under the Gratuity Act	Any other Employee
Fully Ex-empt	Minimum of the following 3 limits is exempt	Minimum of the following limits is exempt
	<ol style="list-style-type: none"> 1. Actual Gratuity received, or 2. 15 days salary for every completed year, or part thereof exceeding 6 months, or 7 days salary for each season in case of an employee in a seasonal establishment 3. Rs. 20,00,000 (According to the 7th pay commission) 	<ol style="list-style-type: none"> 1. Actual gratuity received, or 2. ½ months average salary of each completed year of service 3. Rs. 20,00,000 (According to the 7th pay commission)
	Meaning of Salary	Meaning of Salary
	<ol style="list-style-type: none"> 1. Basic Salary plus Dearness Allowance 2. Last drawn salary. The average salary for the preceding 3 months in case of piece rates employees 3. No. of days in a month to be taken as 26 	<ol style="list-style-type: none"> 1. Basic salary plus DA to the extent the terms of employment so provide, Commission if the fixed percentage of turnover. 2. The average salary of last 10 months preceding the month in which event occurs 3. Only completed year of service is to be taken

LEAVE ENCASHMENT

Leave refers to the absence of an employee from his duty or work because of some unavoidable reasons and with due permission of the employer or the organization. Workers in every organization should be provided with a sufficient number of leaves so that they may refresh and revitalize themselves and contribute their best effort to the organization. Leave policy may vary from one company to another depending upon its work culture and organizational setup. The important features of a leave policy may be:

- The leaves may be computed on a yearly or monthly basis.
- The number and types of leave are fixed in advance for each organization. The total number of leaves may vary from 15 days to a month in a year. If the number of leaves for an employee exceeds the permitted number, then there is a deduction from the salary of the equivalent amount. The types of leave in a company may be:- casual leave; leave for academic work; medical leave; maternity leave emergency leave or study leave, etc.
- The unutilized leaves may lapse at the end of the year or maybe carried forward to the next year.
- The payment mode for each leave day may be full payment or half payment

As per the terms of the employment, and employees may become entitled to different types of leave such as:

- (i) Privileged Leave,
- (ii) Medical Leave,

(iii) Casual/Emergency Leave while they are in service.

Privileged leave can be accumulating during the service period. It is a non-statutory benefit to employees on exit from services.

Leave Salary

If the terms of the employment allow Privilege leave can be accumulated to avail a cash benefit by surrendering some of the leave accumulated while in service period or at the time of leaving this organization. Encashment of leave by surrendering leave standing to one's credit is known as "leave encashment".

If the employer has chosen to make payment of the leave salary benefit from his fund, an appropriate charge to the statement of Profit & Loss for the year is made through a provision for Accruing Liability. The amount of this accruing liability is to be calculated by an Actuary. The employer can also entrust this liability to an insurance company by purchasing a Group Insurance Policy to cover this employee benefit (but this can only be done if the leave encashment is done at the time of death or retirement).

Tax treatment of Leave Encashment

Encashment during the course employment: Leave encashment to an employee, while he continues to be in service with the same employer, is fully taxable. In this case, however, the assessee can claim relief under section 89(1) of the Income-tax act.

Encashment of Accumulated Leave at the Time of Retirement Section 10(10AA):

- (a) **Government Employees (Central and State Government Employees only):** Leave encashment of accumulated leave at the time of retirement, whether on superannuation or otherwise, received by a government employee, is fully exempt from tax.
- (b) **Other Employees:** Leave encashment of the accumulated leave at the time of superannuation or otherwise received by other employees (including employees of the local authority and public sector undertakings) is exempt to the extent of the minimum of the following:
 - (i). Leave encashment received;
 - (ii). 10 months' 'average salary';
 - (iii). The cash equivalent of un-availed leave calculated based on a maximum of 30 days leaves for every year of actual service rendered to the employer from whose service he has retired. The cash equivalent is to be calculated based on the average salary.
 - (iv). Rs. 3, 00,000/-

Note: Salary = Basic pay + Dearness allowance + Commissions based upon a fixed percentage of the turnover. Average salary = Average of the salary drawn by the employee for 10 months immediately preceding his retirement. Where an employee has taken leave encashment of one or more years from more than one employer, the total amount is exempted subject to the maximum ceiling of 3 lacs. Leave salary paid to legal heirs of a deceased employee is not liable to tax.



Example: Mr. Akash has worked with a company from 1/01/1980 to 31/12/2009. His last drawn salary was Rs. 85,000/- and his average salary for the last 10 months was Rs. 80,000. According to the service rules, he is entitled to 38 days' leave for each year of completed service. During his service, he has availed leave of 350 days during his employment and the employer paid him to leave encashment of Rs. 2, 50,000/- on the date of retirement.

Now to calculate his tax-free amount of leave encashment, we first have to find the balance un-availed leave to his credit. Leave that he was entitled to = 30 years of service x 30 days for each year = 900 days.

He availed a leave of 350 days.

So the balance days of leave left with him = $900 - 350 = 550$ days

The least of the following will be tax exempted leave encashment:

1. Actual amount received = Rs. 2,50,000/-
2. 10 months average salary = Rs. 80,000/- x 10 = Rs. 8,00,000/-
3. The cash equivalent of un-availed leave calculated based on a maximum of 30 days leaves for every year of actual service rendered to the employer from whose service he has retired.
550 days x (80,000/30) = Rs. 14,66,667/-
4. Rs. 3,00,000/-

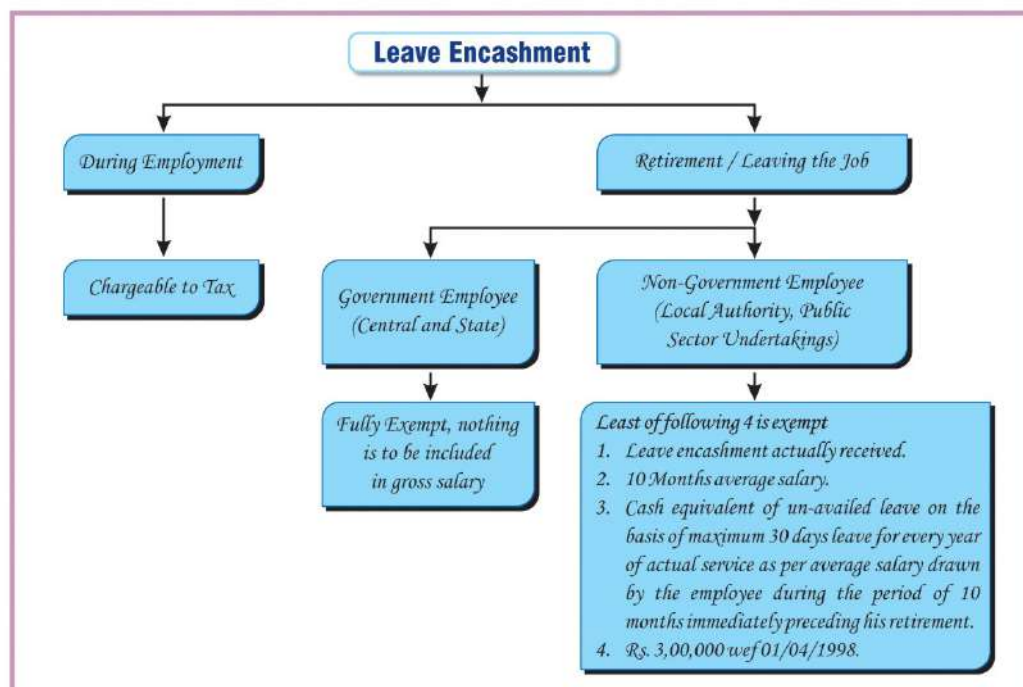
The tax-free amount of leave encashment is Rs. 2,50,000/-.

Note 1: For more than 30 days Income Tax Act considers 30 days for calculation of leave encashment

Note 2: For less than 30 days Income Tax Act considers the same days as per employer's terms

Tax Treatment of Leave Encashment at Various Stages

Nature of leave encashment	Status of employee	Whether it is taxable
During the continuation of service	Govt./Non-Govt.	Chargeable to tax
At the time of retirement / leaving job	Government	Fully exempt U/S 10 (10AA)(i)
At the time of retirement / leaving job	Non-Government	Fully or partly exempt from tax U/S 10(10AA)(ii)



Tax Treatment of Leave Encashment

COMPENSATION ON RETRENCHMENT

Retrenchment compensation is the payment received by an employee from an employer instead of being asked to exit a job or his service is being interrupted due to some management policy under the Industrial Dispute Act, 1947 or under:

- (a) Any other Act or rule or any order or notification issued thereunder; or
- (b) Any standing order; or
- (c) Any award, contract of service, or otherwise.

Conditions Precedent to Retrenchment of Workmen

Employer's Liability at the Time of Retrenchment

As per the section 25F of the industrial dispute act given below:

No workman employed in any industry who has been in continuous service for not less than one year under an employer shall be retrenched by that employer until

- (a) The workman has been given one month's notice in writing indicating the reasons for retrenchment and the period of notice has expired, or the workman has been paid instead of such notice, wages for the period of the notice;
- (b) The workman has been paid, at the time of retrenchment, compensation which shall be equivalent to fifteen days' average pay for every completed year of continuous service or any part thereof of over six months; and
- (c) Notice in the prescribed manner is served on the appropriate Government or such authority as may be specified by the appropriate Government by notification in the Official Gazette

The following are also deemed to be compensation received at the time of a workman's retrenchment:

- (1). The compensation received by a workman at the time of the closing down of the undertaking in which he is employed;
- (2). The compensation received by a workman, at the time of transfer of the ownership or management of the undertaking in which he is employed, if:
 - (a). The service of the workman has been interrupted by such transfer, or
 - (b). The terms and conditions of the service after such transfer are in any way less favorable than those applicable to him immediately before the transfer, or
 - (c). The new employer is under the terms of such transfer or otherwise, legally not liable to pay to the workman, in the event of his retrenchment, compensation on the basis that his service has been interrupted by the transfer.

Tax Treatment of Retrenchment Compensation

Any retrenchment compensation received on the above cases is exempt from the income tax u/s 10 (10B) to the extent of minimum/lower of the following limits:

- i. The actual amount received.
- ii. The amount calculated following provision of section 25F(b) of the Industrial Disputes Act, 1947, which is equal to 15 day's average pay for every completed year of service or part thereof more than 6 months.
- iii. The amount specified by the Central Government i.e. Rs. 5,00,000/-.

The compensation received more than the above limit is taxable and therefore part of Gross Salary, however eligible for relief u/s 89(1).

The “average pay” means the average of wages payable to a workman:

- (a) In the case of the monthly paid workman, in the three completed calendar months, or
- (b) In the case of the weekly paid workman, in the four completed weeks, or
- (c) In the case of the daily paid workman, in the twelve full working days preceding the date on which the average pay becomes payable.

Where such calculations cannot be made, the average pay shall be calculated as the average of the wage payable to a workman during the period he worked.

Wages for retrenchment compensation include:

- (a) Such allowance (including dearness allowance) as the workman is entitled to receive;
- (b) The value of any house accommodation or supply of light, water, medical attendance or other amenities;
- (c) Any traveling concession;

But does not include:

- (a). Any bonus;
- (b). Any contribution paid or payable by the employer to any pension fund under any law for the time being in force;
- (c). Any gratuity is payable on the termination of his service.



Example: Mr. Narottam Das was a monthly paid workman with a cloth manufacturer in Calcutta and was drawing a monthly payment for the last 12 months as follows:

Basic	: Rs. 8,500/-
Dearness allowance:	Rs. 1,500/-
The bonus of	Rs. 3,000/-
Traveling concession of	Rs. 1,200/-
Employers' contribution to pension fund:	Rs. 600/-

After working for 15 years, due to managerial disturbances, the company was shut down and retrenchment compensation of Rs. 1,25,000/- was paid to Narottam.

Calculate the tax-exempt amount of retrenchment compensation.

Solution: First let us calculate the salary to be considered for leave encashment. Salary = basic + DA + Any value of house accommodation or supply of water, electricity, etc + any traveling concession.

$$\text{Salary} = 8,500/- + 1,500/- + 1,200/-$$

$$\text{Salary} = 11,200/-$$

Least of the following is tax exempted:

1. Actual amount received = Rs. 1,25,000/-
2. 15 days average pay for every completed year of service and part thereof in excess of 6 months= $(11,200 / 30) \times 15 \text{ years} \times 15 \text{ days} = \text{Rs.}84,000$ (30 days month is considered)
3. Rs. 5,00,000/-

So, the tax-free amount will be Rs. 84,000/-

VOLUNTARY RETIREMENT SCHEME

A voluntary retirement scheme is an arrangement wherein an employer gives an option to his employees to voluntarily leave the organization in return for a compensation package offered by the employer.

The compensation received by the employee of the following organizations, on voluntary retirement, under the 'Golden handshake' scheme launched by GOI, is exempted u/s 10(10C):

- (i) A public sector company
- (ii) Any other company
- (iii) An authority established under a central, state or provisional act
- (iv) A local authority
- (v) A co-operative society
- (vi) A university established or incorporated by or under a central, state, or provisional Act and an institution declared to be a university under section 3 of the University Grant Commission Act, 1956
- (vii) An Indian Institute of technology within the meaning of clause (g) of section 3 of the Institute of technology Act, 1961
- (viii) Such institute of management as the central government may, by notification in the Official Gazette, specify in this behalf
- (ix) State government
- (x) Central government

The exemption shall be available under the Golden Hand Shake Scheme subject to the following conditions:

- (a) The employee must have completed 10 years of service or completed 40 years of age
- (b) It should apply to all employees, except the directors of a company or a co-operative society
- (c) The scheme should result in an overall reduction in the existing strength of the employees
- (d) The vacancy created by the scheme is not to be filled
- (e) The employee opting for the scheme shall not be employed in another company belonging to the same management

Maximum Tax Exemption Available

The amount of voluntary retirement of the employee should not exceed:

- (i) The amount received.
- (ii) The higher of the following amount:
 - a. The amount equivalent to three months' salary for each completed year of service, or
 - b. Monthly emoluments at the time of retirement multiplied by the balance months of service left at the time of his retirement.
- (iii) The amount notified by the government: Rs. 5,00,000.

The exemption is available to an employee only once and if it has been availed for an assessment year it shall not be allowed to him for any other assessment year

Salary = Basic pay + Dearness allowance + Commissions based upon a fixed percentage of the turnover



Example: Mr. Amit Bansal was employed with a company for the past 24 years. He opted for VRS 8 months before the actual retirement date. His last drawn salary details are as follows.

Basic	:	14,500/-
DA	:	2,500/-
Bonus	:	10,000/-
HRA	:	3,500/-
Overtime	:	2,500/-
Commission based on fixed percentage of turnover	:	3,500/-

The company gave him Rs. 14,76,000/- as VRS benefits.

Calculate the tax-free amount of VRS received by him.

Solution:

Minimum of the following is tax free:

The amount actually received = 14,76,000/-

The higher of the following two:

Three month salary for each completed year = $3 \times (14,500/- + 2,500/- + 3,500/-) \times 24 = 14,76,000/-$

Salary for the balance service left = $8 \times (14,500/- + 2,500/- + 3,500/-) = 1,64,000$ Higher amount is 14,76,000/-
5,00,000/-

So the tax free VRS amount received by him is least of the three = 5,00,000