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Gratuity amendment

Effective from May 24, 2010, the Indian government, through the Ministry of Labour & Employment, increased the gratuity limit under the Payment of Gratuity Act, 1972 ("Gratuity Act") to Rs. 10,00,000 from the earlier limit of Rs. 3,50,000. The increase, which was brought by way of the Payment of Gratuity (Amendment) Act, 2010 ("Amendment Act"), has brought cheers to the large employee community in India. The amendment seems to emanate from the deliberations between the government officials and the state labour authorities on this subject, which discussions have been ongoing for some time.

Background

The Gratuity Act applies to every factory, mine, oilfield, plantation, port and railway companies and to every shop or establishment that had at least 10 employees on any day of the preceding 12 months. Once the Gratuity Act becomes applicable to a shop or establishment, such shop or establishment shall continue to be governed by the Gratuity Act even if the number of employees falls below 10.

To the extent the Gratuity Act applies to an employer, the employer is required to pay gratuity to each employee upon termination of such employee's employment on his superannuation, retirement, resignation, death or disablement, in the event such employee rendered continuous service for at least 5 years (such employment period does not apply for termination of employment due to death or disablement). Gratuity is to be paid at the rate of 15 days' wages for every completed year of service or part thereof in excess of 6 months.

In order to limit the employer's liability, the gratuity amount was, prior to the Amendment Act, capped at Rs. 3,50,000, which amount was increased from Rs. 1,00,000 in the year 1998. However, government employees were already eligible to receiving gratuity up to Rs. 10,00,000 based on the recommendations of the Sixth Pay Commission.

As per the Income Tax Act, 1961 ("ITA"), any gratuity received under the Gratuity Act, to the extent it does not exceed the amount calculated in accordance with the Gratuity Act, is tax free as it is not regarded as part of the total income. Following the Amendment Act, a notification was issued by the Central Board of Direct Taxes specifying Rs. 10,00,000 as the revised gratuity limit in relation to employees who retire or become incapacitated prior to retirement or on termination of employment or on death.

As per the applicable Indian accounting standards (AS-15 issued in 1995 titled "Accounting for retirement benefits in the financial statements of employers"), gratuity can be paid by the employer through a trust fund created for the purpose or alternatively arrangements can be negotiated with an insurance company such as the Life Insurance Corporation of India or any other prescribed insurer, so that the annual contributions towards gratuity, calculated actuarially, can be made each year.

Implications

1. The Amendment Act is a step in the right direction as it bridges the inequalities between the government employees and those working for private employers.
2. The existing gratuity limit of Rs. 3,50,000 was fairly low especially in recent times where India is witnessing escalating salaries. Several employees, especially those receiving higher salaries, failed to substantially benefit from Gratuity Act in view of the lower limit of gratuity. Also, Gratuity Act needed to keep pace with the steady

increase in the eligibility limits under some of the other labour laws including the Payment of Bonus Act, 1965 and the Employees' State Insurance Act, 1948.

3. From a retention standpoint, HR managers will be very pleased as the increased gratuity limit is likely to incentivise junior and mid level employees to stay with their current employer longer to reap greater benefits. If they leave and join a new employer, they may not be eligible to receive gratuity unless they complete 5 years of continuous service.

4. On the flip side, the Amendment Act would significantly increase the obligations of the private sector employer towards gratuity. Employers would need to obtain a new actuarial valuation report based on the enhanced gratuity limit and pay higher premium to insurance companies with whom they are maintaining gratuity policies.

5. The Amendment Act may not have entirely pleased some of the beneficiaries as they were seeking to scrap the gratuity limit altogether. They may look at this development only as an interim arrangement and may continue pursuing their efforts to request the regulators to consider abolishing the limit.

6. While some of the leading organisations already follow the retention strategy of calculation of the gratuity amount which is arrived at based on the prescribed formula but without being constrained to the statutory limit, most of the other organisations continue to limit their gratuity exposure as per the Gratuity Act. These organisations, predominantly small to mid-size, may need to rework their financials to reflect their higher gratuity obligation.

7. In view of the current scenario where hiring conditions have significantly revived in several sectors, senior level employees who are eligible to receiving gratuity and have reached the new gratuity ceiling, may prefer to cash in on the higher limit by considering alternative employment opportunities. Considering that the last change to the gratuity limit (prior to the change brought about by the Amendment Act) took place 12 years prior to the Amendment Act, a further increase from the new ceiling of Rs. 10,00,000 is unlikely to be expected for the next several years.

8. For several reasons, certain organisations have been adopting the mechanism of engaging consultants or retainers rather than employees, for certain non-core functions. A few others have also been engaging staffing services companies to fulfill their employment needs. As a result of the substantial increase to the gratuity obligation of the employer, these organizations will prefer or may be further incentivised to continue with such arrangements.

The increased gratuity limit is considered as a big bonanza for the employee community. The government continues to live up to its promise to provide enhanced social security benefits to its citizens. HC

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