

Lost your job or taking VRS? Here's how the severance payout will be taxed

Losing one's job can be traumatic. At a time when pruning of staff strength has become common among companies, what matters is how much the employee is paid as a parting gift and what are the tax implications for that amount.

Retrenchment compensation

The Industrial Disputes Act (IDA) states that if an employee who has put in more than a year's service is retrenched, he or she needs to be given a month's notice or salary in lieu. The employee is also eligible for retrenchment compensation amounting to 15 days' pay for every completed year of service. "These provisions apply to all employers, including the service sector," says labour law counsel Shihabudin Abdulkhader. It is a myth that only blue collar workers fall under the category of 'workmen' who are covered by retrenchment compensation provisions. "Workmen includes employees engaged in skilled, technical, operational, clerical or supervisory work and courts have taken a broad view of this term," adds Abdulkhader. The income tax (I-T) implications of retrenchment compensation differ from that of a VRS scheme. Additionally, certain conditions are to be met to enable the employee to obtain income tax benefits (see chart).

Relief for higher tax slab

When compensation is received, the employee could end up falling under a higher tax slab. Section 89 read with Rule 21A, provide for relief in such instances. It should be noted that Rule 21A (4) prescribes that only those cases will be covered where the terminated employee has been in employment for at least three years and the balance period of employment, as of the date of his or her termination, is also at least three years.

In order to claim relief under Section 89, the employee is required to fill Form 10E and submit to current employer, who is responsible for deducting tax at source. As computation of such relief is complex, Amarpal S. Chadha, Partner, People Advisory Services at EY explains with the following example: Mr A meets the conditions relating to tenure of service and the tenure prior to retirement as prescribed under Rule 21A (4). He receives a retrenchment compensation of Rs 5 lakh during the financial year 2016-17. The average rate of tax on his total income (including retrenchment compensation) is 29.5%. By applying this rate to Rs 5 lakh we get a sum of Rs 1,47,500. For computing tax relief, Rs 5 lakh will be spread equally over the last three years to examine the incremental tax liability in each of these years.

If we assume that the average rate of tax (total tax/ total income) for the last three financial years after including one-third notice period payout in each year is as follows (For 2015-16 @ 29.8%; for 2014-15 @ 26.9% and for 2013-14 @ 18.4%), the average tax rate thus works out to 25.03%. If this average tax rate is applied to Rs 5 lakh, the tax payable is Rs 1,25,150. The tax relief under Section 89 which will reduce Mr A's tax liability will be Rs 22,350 (Rs 1,47,500 - Rs 1,25,150). If Rule 21A (4) is not applicable, then the compensation or salary in arrears received would be covered by residuary Rule 21A (6), and the tax authorities may allow such relief as they deem fit. No defined formula has been prescribed in this context.

Non-disclosure or non-compete agreements

On retrenchment, key employees may be asked to enter into non-disclosure or non-compete agreements, for which more often than not, a handsome compensation is given. The former could prohibit the key employee from disclosing any trade secrets of the employer. On the other hand, the latter could have a gardening clause attached, prohibiting the employee from joining another company in the same industry for a certain period of time. "Typically, payouts which are in connection with the services rendered by the employee and the work relationship which the employee had with the employer, while in employment, would be taxable as salary income. However, a careful analysis of facts in each case is required before concluding on the nature of income," explains Chadha.

Know the tax implications after getting the pink slip

The payout:

Lump sum compensation

The amount is to be calculated by the employer as per the provisions of IDA

Tax impact

Under Section 10 (10B) of the I-T Act, the maximum exemption is Rs 5 lakh. Any excess received is taxable as salary income, subject to relief under Section 89.

The payout:

Compensation under VRS

Rule 2BA of I-T Rules mandate some conditions including amount payable

- (i) VRS must be offered to all employees and not select few
- (ii) To be eligible for tax benefit, employee must be at least 40 years old or completed 10 years of service
- (iii) Vacancies caused by VRS must not be filled up
- (iv) Employee opting for VRS must not be employed in a group company Amount must not exceed higher of: (i) A sum equal to 3 months salary for each completed year of service OR (ii) Salary at time of retirement multiplied by balance months of service left before the date of retirement

Tax impact

If the conditions in the Rules are met, under Section 10(10C) of the I-T Act, the maximum exemption is Rs 5 lakh. Any excess received is taxable as salary income.

THE PAYOUT	TAX IMPACT
LUMP SUM COMPENSATION	
<p>The amount is to be calculated by the employer as per the provisions of IDA</p>	<p>Under Section 10 (10B) of the I-T Act, the maximum exemption is ₹5 lakh. Any excess received is taxable as salary income, subject to relief under Section 89.</p>
COMPENSATION UNDER VRS	
<p>Rule 2BA of I-T Rules mandate some conditions including amount payable</p> <ul style="list-style-type: none"> (i) VRS must be offered to all employees and not select few (ii) To be eligible for tax benefit, employee must be at least 40 years old or completed 10 years of service (iii) Vacancies caused by VRS must not be filled up (iv) Employee opting for VRS must not be employed in a group company <p>Amount must not exceed higher of:</p> <ul style="list-style-type: none"> (i) A sum equal to 3 months salary for each completed year of service OR (ii) Salary at time of retirement multiplied by balance months of service left before the date of retirement 	<p>If the conditions in the Rules are met, under Section 10(10C) of the I-T Act, the maximum exemption is ₹5 lakh. Any excess received is taxable as salary income.</p> <p>Caveat: Exemption under this section is allowed only once in a lifetime. Further, no relief under Section 89 is available, if benefit under Section 10(10C) is claimed.</p>
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