

# TAX EDITORIAL

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<sup>th</sup>

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#### **Gist of Income Tax Provisions related to Salary**

It is that time of the year, when the employers are trying to finalize the deduction of tax from salary paid to employee and the employees on the other hand are trying to arrange for the proofs and making a last dash towards any other method for reduction of TDS. In the beginning of February, the final TDS calculations are made and the employer makes an account of TDS already deducted and the amount that has to be adjusted from the final salary payments.

With that at the outset, let us look at a few important salary provisions under the Income Tax Act (the "Act") and their impact on the salary and TDS calculations thereon;

#### **Income chargeable under the head salary:**

Basically any income received by an employee from the employer by virtue of the employer-employee relationship will be charged as salary in the hands of the employee. Further, the Act makes specific mention of the following situations, namely;

- a. where salary is received before it is due (advance salary),
- b. salary not received (outstanding salary), and
- c. salary received of previous years (arrears of salary)

All the above would be chargeable to tax under the head salary.

Here it may be pertinent to note that, any salary, bonus or remuneration received by a partner of a firm, from the firm shall not be regarded as income from salary. The same shall be charged as income from business or profession, in the hands of the recipient partner.

#### **Deductions from salary:**

The Act (currently) provides for two specific deductions from the salary income;

- a. entertainment allowance (only for government employees) of an amount equal to one-fifth of his salary or five thousand rupees, whichever is less
- b. tax on employment (profession tax)

#### **Salary includes:**

As per the provisions of the Act, salary specifically includes the following;

- i. wages
- ii. any annuity or pension
- iii. any gratuity

- iv. any fees, commissions, perquisites or profits in lieu of or in addition to any salary or wages
- v. any advance of salary
- vi. any payment received by an employee in respect of any period of leave not availed of by him

vii.

the annual accretion to the balance at the credit of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under rule 6 of Part A of the Fourth Schedule

viii. the aggregate of all sums that are comprised in the transferred balance as referred to in sub-rule (2) of rule 11 of Part A of the Fourth Schedule of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under sub-rule (4) thereof

ix.

the contribution made by the Central Government [or any other employer] in the previous year, to the account of an employee under a pension scheme referred to in section 80CCD

From the above definition it can be seen that any payment received by an employee by virtue of the employer-employee relationship shall be regarded as income from Salary, in the hands of the recipient.

### **Perquisites:**

Now let us shift our attention to the word “perquisites”. Perquisites would mean any benefit received by an employee from an employer either free of cost or at a concessional rate. Some common examples are rent free accommodation, ESOP’s, use of motor car, furniture, so on and so forth. We will look into a few commonly used perquisites more in detail now;

a. Rent free accommodation/ Concessional rent accommodation: Where the employer provides accommodation to the employee without any consideration (rent free), or at a concessional rate, the value of such accommodation or such concession in the matter of rent, will be deemed to be the value of perquisite received by the employee and added to the income from salary of the employee.

Now the question arises, how do we value the benefit received by the employee. The following table provides the valuation mechanism for such perquisite;

**Sr.**

**No.**

### **Particulars**

#### **Valuation Mechanism**

1 Unfurnished Accommodation

owned by the employer

Value of perquisite = (Specified rate X salary) –  
rent recovered from the employee

Specified rate is defined as;

a. 15% of salary in cities having population

> 25 lakhs

b. 10% of salary in cities having population

10lakhs > < 25 lakhs

c. 7 ½ % of salary in any other place

2 Unfurnished Accommodation

is leased or rented by the  
employer

Value of perquisite = (Actual Lease rent or 15%  
of salary, whichever is lower) – rent recovered  
from the employee

3 Furnished Accommodation

owned by the employer

Value of perquisite = valuation as per point 1 above as increased by the value of furniture, i.e. 10% of the cost of the furniture if it is owned by the employer or actual rent paid, if the furniture is leased

4 Furnished Accommodation is leased or rented by the employer

Value of perquisite = valuation as per point 2 above as increased by the value of furniture, i.e. 10% of the cost of the furniture if it is owned by the employer or actual rent paid, if the furniture is leased

For the purpose of this clause, salary includes the pay, allowances, bonus or commission payable monthly or otherwise, but does not include

- i. Dearness Allowance (unless it enters into computation for retirement benefits),
- ii. Employers contribution to Provident Fund
- iii. Value of perquisites
- iv. Allowances which are exempt from tax

b. The value of any benefit or amenity granted or provided free of cost at a concessional rate in the following cases;

- i. By a company to an employee who is a director
- ii. By a company to an employee who has substantial interest in the company
- iii. By any employer to an employee other than the above, whose income from salary, excluding non-monetary benefits, exceeds Rs. 50,000/-.

An example would be the provision of vehicle for personal use. It would be pertinent to note that in case the vehicle has been provided by the employer to the employee for journey from residence to office or other place of work, or from office or place of work to residence, it shall not be considered as perquisite.

c. Any sum paid by employer in respect of any obligation which would have been payable by the employee.

Eg. payment of salary to household staff, etc.

d. The value of any specified security or sweat equity shares allotted or transferred by the employer, either free of cost or at a concessional rate.

The value of perquisite = the fair value of the shares on the date the option is exercised by the employee – the amount actually paid or recovered from the employee in respect of the same.

e. Interest free loans or loans at concessional rate of interest: The value of benefit to the employee from Interest free loans or loans at concessional rate of interest, advanced by the employer (or any other person on his behalf) to the employee or any member of the household of such employee is considered as a perquisite. The value to be considered is the amount of interest charged by the State Bank of India as on the 1<sup>st</sup>

day of the relevant

previous year for loans advanced for the same purpose. The interest is to be calculated on the maximum outstanding monthly balance reduced by the amount of interest, if any, paid by such employee or the member of the household.

However, no amount will be considered as a perquisite if any of the following conditions have been satisfied;

- i.

The amount of loan advanced is less than Rs. 20,000/-, or  
ii.

The loan is advanced for medical treatment of specified diseases.

It is important to note here that, the exemption in case of loan advanced for the medical treatment of specified disease shall not be allowed on the amount reimbursed to the employee under medical insurance scheme.

f. The value of any other fringe benefit or amenity as may be prescribed.

### **Exemptions & Deductions**

We have considered what constitutes salary, what are perquisites and the valuation mechanism thereof. Now let us move on to certain exemptions available in regards to income from salary;

**1. House Rent Allowance (HRA):** House rent allowance, as the name suggests, is an allowance received by an employee towards the rent expenses incurred by him for his place of residence.

Under the Income Tax Act, 1961, HRA is exempt to the extent of **Least** of the following;

a. Actual HRA received

b. Actual rent paid less 10% of salary

c. 50% of salary in case the accommodation is situated in Mumbai, Delhi, Kolkata or Chennai and 40% of salary in case of any other city

Naturally, if the employee resides in a house owned by him, there won't be any rent expenditure and hence the exemption will be **NIL**. This particular exemption has raised many questions as regards the applicability in a few peculiar situations. Let us consider a few common situations and the applicability of HRA thereof;

a. Where the employee owns a house and resides in the same: As mentioned above, where no rent expenditure has been incurred, the exemption under this section will be **NIL**.

b. Where the employee owns a house in another city and pays rent for premises leased in the city of work: In this case, since the employee incurs expenditure towards rent the exemption will be calculated as mentioned above.

c. Where the employee owns a house which is under construction (in the same city) and pays rent for premises leased for residence: In this case again, the exemption should be allowed to the employee as expenditure has been incurred towards residential rent.

d. Where the employee owns a house which has been given out on rent, and he pays rent for another accommodation in the same city: The plain reading of the provisions would suggest that the exemption should be allowed since expenditure towards rent has been incurred.

**Note: The above examples are just indicative. The allowability of the exemption shall vary based on the actual facts of the case.**

**2. Gratuity:** The amount of gratuity received by an employee from his employer (present or past) on death, retirement or termination of employment shall be exempt from tax subject to the limits prescribed.

The amount of gratuity that is exempt from income tax is as under;

a. Actual amount of gratuity received

Or

b. If covered by Gratuity Act: 15 days (last drawn) salary for every completed year of service or part thereof in excess of 6 months (month to be considered of 26 days)

If not covered by Gratuity Act: Half months average salary for every completed year of service (average salary of last 10 months)

Or

c. Rs. 10,00,000/-

Whichever is **Least**

Hence from the above, the maximum amount which shall be exempt from tax will be Rs. 10,00,000/-.

**3. Commuted Pension:** Normally pension payments are periodic payments (monthly) received by the employees. In certain cases the employee may request the employer to pay a lump sum amount, which is called commuted pension. Commuted pension is exempt to the extent of  $\frac{1}{3}$

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of pension if gratuity is also received, or 50% of pension if

no gratuity is received. Conversely, any uncommuted pension received is taxable under the head Salary.

**4. Voluntary Retirement Scheme:** In case of approved voluntary retirement scheme, and subject to fulfillment of prescribed conditions, the exemption shall be the least of the following;

a. Actual amount received

b. Three months salary for each completed year of service

c. Last drawn salary multiplied by the balance months of service left before retirement

d. Rs. 5,00,000/-

**5. Leave Salary Encashment:** Leave salary encashment refers to situations wherein the employee encashes the leave standing to his credit, i.e. un-availed leave. The taxation of leave salary encashment is as follows;

a. Leave encashment during the term of service is taxable

b. Leave encashment at the time of retirement/ resignation is exempt to the extent of least of the following;

i.

Actual amount received

ii.

10 months average salary

iii.

Rs. 3,00,000/-

iv.

No. of months of leave to the credit of employee multiplied by his average salary

For the purpose of the above calculation, leave to the credit of the employee refers to the leave entitled as reduced by leave availed and leave encashed already.

**6. Travel Concession:** The value of travel concession or assistance received by an employee from the employer in respect of him proceeding on leave with his family, subject to such conditions as have been prescribed. (Rule 2B of the Income Tax Rules)

The above are some of the more important exemptions from the salary income, which we have dealt in detail.

Before we conclude, let us consider a few practical points that need to be taken care of;

1. The employee should provide the details and the proofs of investments on time to enable the employer to consider the tax saving investments and accordingly deduct tax.

2. The employee should disclose any other income, like bank interest, interest on fixed deposits, income from house property, salary from other employer, etc to enable the employer to consider the same.

3. In case of HRA, the proof of rent agreement & rent receipts should be provided on time.

4. The employer should take into consideration the interest paid and the principal repayment towards housing loan.

5. The employer should take utmost care in calculation of valuation of exemptions and prerequisites.

6. The employer shall take into consideration the conveyance allowance of Rs. 800/- per month and the medical reimbursement of expenses upto Rs. 15,000/-, while making the computation of salary.

7. The deduction of profession tax should be done as notified.

8. The payment of TDS deducted, the profession tax deducted, employer and employee contribution of provident fund should be paid on a timely manner to avoid late payment penal consequences.

There are certain provisions of salary, which have a different treatment for government employees. This article has been prepared keeping in mind the requirements of non-government and corporate employees.

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