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### Taxability of Retirement Benefits

Retirement benefits play a crucial role in providing financial security to employees in their post-retirement years. In India, employers provide various retirement benefits to employees. The most common retirement benefits offered by employers in India include the Employee Provident Fund (EPF) and the National Pension System (NPS), both of which are savings schemes that allow employees to accumulate a portion of their salary, along with a matching contribution from their employer. Additionally, employees are entitled to receive gratuity, a lump sum payment made as a token of appreciation for their service, and leave encashment on their retirement. If an employee is eligible for a pension, he may also receive the commuted pension. If an employee is voluntarily retired or retrenched, he may be entitled to voluntary retirement compensation or retrenchment compensation. The taxability of these retirement benefits under the Income-tax Act is as follows:

#### Gratuity

An employer is liable to pay gratuity to an employee who has completed 5 years of continuous services and his employment with the employer terminates due to retirement, resignation, or superannuation. However, in case of death or disablement of the employee, the employer is liable to pay the gratuity even if the employee does not complete 5 years of service. The taxability of gratuity shall be as under:

| <i>Particulars</i>                                                                                                                                                     | <i>Taxability</i>                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Gratuity received during service                                                                                                                                       | Fully Taxable                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Gratuity received at the time of retirement</b>                                                                                                                     |                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| Gratuity received by Government Employees (Other than employees of statutory corporations)                                                                             | Fully Exempt                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| Death -cum-Retirement gratuity received by other employees who are covered under Gratuity Act, 1972 (other than Government employees) (Subject to certain conditions). | Least of the following amount is exempt from tax:<br>1. $(\frac{*15}{26}) \times \text{Last drawn salary}^{**} \times \text{Completed year of service or part thereof in excess of 6 months.}$<br>2. Rs. 20,00,000<br>3. Gratuity actually received.<br>*7 days in case of an employee of a seasonal establishment.<br>** Salary = Last drawn salary including DA but excluding any bonus, commission, HRA, overtime, and any other allowance, benefits, or perquisite |
| Death -cum-Retirement gratuity received by other employees who are not covered under                                                                                   | Least of the following amount is exempt from tax:                                                                                                                                                                                                                                                                                                                                                                                                                      |

|                                                                                       |                                                                                                                                                                                                                                                                                                                                                          |
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| Gratuity Act, 1972 (other than Government employees) (Subject to certain conditions). | 1. Half month's Average Salary* X Completed years of service<br>2. Rs. 20,00,000<br>3. Gratuity actually received.<br>*Average salary = Average Salary of the last 10 months immediately preceding the month of retirement<br>** Salary = Basic Pay + Dearness Allowance (to the extent it forms part of retirement benefits)+ turnover-based commission |
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### Pension

Pension is a payment made by the employer after the retirement/death of the employee as a reward for past services. There are two kinds of pension:-

- (a) Commuted Pension - Commutation of pension means immediate payment of the lump-sum amount to an employee in lieu of surrender of a portion of the monthly pension.
- (b) Uncommuted Pension - When the pension is paid on a periodical basis, it is called an uncommuted Pension.

The tax treatment of pension shall be as under:

| <i>Particulars</i>                                                                                                               | <i>Taxability</i>                                                                                                                                                                                    |
|----------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Uncommuted Pension                                                                                                               | Fully Taxable. However, disability pension payable to disabled armed forces personnel shall be exempt from tax.                                                                                      |
| Family Pension                                                                                                                   | 33.33% of Family Pension subject to a maximum of Rs. 15,000 shall be exempt from tax. However, the family pension received by the family members of the armed forces shall be fully exempt from tax. |
| Commuted pension received by an employee of the Central Government, State Government, Local Authority, and Statutory Corporation | Fully Exempt                                                                                                                                                                                         |
| Commuted pension received by other employees who also receive gratuity                                                           | 1/3 of the full value of commuted pension will be exempt from tax                                                                                                                                    |
| Commuted pension received by other employees who do not receive any gratuity                                                     | 1/2 of the full value of commuted pension will be exempt from tax                                                                                                                                    |

### Leave Encashment Salary

Every entity provides leaves to the employees, which can be availed of by them in emergency situations or for vacations. If these leaves are not availed of by them, they may lapse or are encashed at the year-end or are carried forward to next year, as per the service rules of the employer. The accumulated leaves standing to the credit of an employee may be availed of by the employee during the tenure of employment or may be encashed at the time of retirement

or resignation. When leaves are surrendered in lieu of monetary consideration, it is known as 'leave encashment'. The taxability of leave encashment shall be as under:

| <i>Particulars</i>                                                                                                   | <i>Taxability</i>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
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| Received during the period of service                                                                                | Fully Taxable                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| Received on death of the employee                                                                                    | Fully Exempt                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| <b>Received on retirement, whether on superannuation or otherwise</b>                                                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| Encashment of unutilized earned leave at the time of retirement of Government employees                              | Fully Exempt                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| Encashment of unutilized earned leave at the time of retirement of other employees (not being a Government employee) | Least of the following shall be exempt from tax:<br>a) Amount actually received<br>b) Unutilized earned leave* X Average monthly salary<br>c) 10 months Average Salary**<br>d) Rs. 25,00,000<br>*While computing unutilized earned leave, earned leave entitlements cannot exceed 30 days for each year of service rendered to the current employer<br>**Average salary = Average Salary*** of the last 10 months immediately preceding the retirement<br>***Salary = Basic Pay + Dearness Allowance (to the extent it forms part of retirement benefits)+ turnover-based commission |

### **Voluntary Retirement Scheme**

Voluntary retirement is an early retirement option given by an employer to its employees to take retirement before the decided age of retirement. To ensure social security for the retiring employees, employers provide 'voluntary retirement compensation' to its employees. Such compensation is taxable in the hands of the employees as profit in lieu of salary. However, exemption under Section 10(10C) is allowed to the extent of lower of the following:

- (a) Compensation received; or
- (b) Rs. 500,000.

The exemption is allowed subject to the following conditions:-

- (a) The voluntary retirement compensation is paid by the specified category of employer.
- (b) The scheme should be drawn to result in an overall reduction in the existing strength of the employees.

- (c) The employee has completed 10 years of service or completed 40 years of age. (This condition is not applicable in the case of employees of a Public Sector Company).
- (d) The vacancy caused by the voluntary retirement is not re-filled by any other new hiring. Moreover, the retiring employee must not be employed in any other company or concern of the same management.
- (e) The employee has not availed of any tax exemption in respect of voluntary retirement compensation in the past.
- (f) The amount of compensation does not exceed 3 months' salary for each completed year of service or salary for the remaining period of employment left before such retirement. 'Salary' for this purpose shall be the total of last drawn basic salary, dearness allowance (if forms part of salary for computing retirement benefits), and commission paid to the employee.
- (g) The scheme should apply to all employees, including workers and executives of a concern excluding directors of a company or a co-operative society.
- (h) Employee should not claim relief under Section 89 in respect of such compensation.

### Retrenchment Compensation

Retrenchment Compensation received by a workman under the Industrial Dispute Act, 1947, or any other law for termination of his employment is exempt from tax up to Rs. 5,00,000. The taxability of retrenchment compensation is as follows:

| <i>Particulars</i>                                                                                                | <i>Taxability</i>                                                                                                                                                                                                        |
|-------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Payment of compensation under a Scheme approved by the Central Government                                         | Fully Exempt                                                                                                                                                                                                             |
| Payment of compensation on the closure of the undertaking due to the losses                                       | Lower of the following is exempt:<br>(a) Rs. 5,00,000.<br>(b) Retrenchment compensation actually received.<br>(c) Average wage * 15/26 * completed year of continuous service or any part thereof in excess of 6 months. |
| Payment of compensation on the closure of the undertaking for any other reason beyond the control of the employer | Lower of the following is exempt:<br>(a) Rs. 5,00,000.<br>(b) Retrenchment compensation actually received.<br>(c) Average wage of three months.                                                                          |

### Provident Fund

Employee's Provident Fund (EPF) is a retirement benefit scheme that's available to salaried employees. Contribution in EPF is made both by the employee and the employer. The contribution, earning, and withdrawals from the EPF account are exempt from tax except in certain circumstances.

Tax treatment in respect of contributions made to and payments from various provident funds are summarized in the table given below:

| <i>Treatment of</i>      | <i>Recognised Provident Fund (RPF)</i>                                                                                                                                                                                                                                                                                                                                       | <i>Statutory Provident Fund (SPF)</i>                                                                                                                                                                                                                                                                                           | <i>Unrecognised Provident Fund (UPF)</i>                                                                                                                                |
|--------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Employer's Contribution  | Contribution up to 12% of basic salary + DA is exempt from tax. However, it shall be taxable in the following two scenarios:<br>(a) Any contribution above 12%;<br>(b) Any contribution above Rs. 7,50,000 <sup>1</sup> .                                                                                                                                                    | -                                                                                                                                                                                                                                                                                                                               | Not Taxable                                                                                                                                                             |
| Employee's Contribution  | Eligible for deduction under Section 80C                                                                                                                                                                                                                                                                                                                                     | Eligible for deduction under Section 80C                                                                                                                                                                                                                                                                                        | Not eligible for deduction under Section 80C                                                                                                                            |
| Interest earned on PF    | Exempt from tax. However, it shall be taxable in the following two scenarios:<br>(a) Interest above the notified rate;<br>(b) Interest relating to the employee's contribution above Rs. 5 lakh, in case no contribution is made by employer;<br>(c) Interest relating to the employee's contribution above Rs. 2.5 lakh, in case employer has also contributed to the fund. | Exempt from tax. However, it shall be taxable in the following scenarios:<br>(a) Interest relating to the employee's contribution above Rs. 5 lakh, in case no contribution is made by employer;<br>(b) Interest relating to the employee's contribution above Rs. 2.5 lakh, in case employer has also contributed to the fund. | Not taxable at the time of accrual                                                                                                                                      |
| Withdrawal after 5 years | Exempt from tax                                                                                                                                                                                                                                                                                                                                                              | Exempt from tax                                                                                                                                                                                                                                                                                                                 | Aggregate of the following shall be taxable:<br>(a) Employer's contribution;<br>(b) Interest on employer's contribution; and<br>(c) Interest on employee's contribution |

<sup>1</sup> The excess contribution shall be taxable only if the aggregate amount of contribution made by the employer to the account of employee in a Recognised Provident Fund, National Pension Scheme and Superannuation Fund exceeds Rs. 7,50,000. In this situation, the excess amount so contributed is taxable as perquisite in the hands of employee.

|                           |                                                                               |        |                                                                                                                                                                         |
|---------------------------|-------------------------------------------------------------------------------|--------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Withdrawal before 5 years | Total income is computed as if the fund is not recognised from the beginning. | Exempt | Aggregate of the following shall be taxable:<br>(a) Employer's contribution;<br>(b) Interest on employer's contribution; and<br>(c) Interest on employee's contribution |
|---------------------------|-------------------------------------------------------------------------------|--------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

### National Pension System (NPS)

National Pension System (NPS) is a retirement savings scheme administered and regulated by Pension Fund Regulatory and Development Authority (PFRDA). Under the NPS, individual savings are pooled into a pension fund which is invested by PFRDA regulated professional fund managers as per the approved investment guidelines into the diversified portfolios comprising of government bonds, bills, corporate debentures and shares. These contributions would grow and accumulate over the years, depending on the returns earned on the investment made.

The tax treatment of the contribution made to the NPS, accumulation of return and the amount withdrawn from the NPS is as follows:

| <i>Particulars</i>                  | <i>Taxability</i>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|-------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Contribution to NPS</b>          |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                       |
| (a) Employees' contribution to NPS  | The deduction is allowed up to 10% of salary <i>plus</i> additional deduction of Rs. 50,000.                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| (b) Employers' contribution to NPS* | <p>The deduction is allowed up to:</p> <ul style="list-style-type: none"> <li>▪ 14% of salary in case of Central Government or State Government employees;</li> <li>▪ 10%* of salary in case of other employees.</li> </ul> <p>* 14% if the total income of employee is chargeable to tax under section 115BAC(1A), i.e., new tax regime</p> <p>Note: The benefit of additional deduction of upto Rs. 50,000 under section 80CCD(1B) is also available to sum deposited to the account of minor by parent or guardian (effective from AY 2026-27)</p> |



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Department of Revenue, Ministry of Finance, Government of India

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| (c) Any other person not being an employee                                         | The deduction is allowed up to 20% of gross total income <i>plus</i> additional deduction of Rs. 50,000.                                                                                                                                                                    |
| <b>Accumulation</b>                                                                |                                                                                                                                                                                                                                                                             |
| Yearly return on the corpus amount                                                 | Tax-free                                                                                                                                                                                                                                                                    |
| <b>Withdrawal</b>                                                                  |                                                                                                                                                                                                                                                                             |
| (a) Partial withdrawal                                                             | <p>In subscriber is an employee, exempt to the extent of 25% of the contribution made by the employee to the NPS.</p> <p>Note: Any partial withdrawal from NPS shall be exempt to the extent of 25% of amount of contributions made by the parent or guardian of minor.</p> |
| (b) Final withdrawal at the time of closure of account or opting out of the scheme | Exempt up to 60% of the total corpus available in the NPS account of the subscriber.                                                                                                                                                                                        |
| (c) Amount received by the nominee on death of subscriber                          | Fully exempt                                                                                                                                                                                                                                                                |
| <b>Pension Income</b>                                                              |                                                                                                                                                                                                                                                                             |
| Pension received out of NPS or annuity                                             | Fully Taxable                                                                                                                                                                                                                                                               |



## MCQs on Taxability of retirement benefits

**Q1. An employer is liable to pay gratuity to an employee who has completed \_\_\_\_\_ and his employment with the employer terminates due to retirement, resignation, or superannuation.**

- (a) 5 years of continuous service
- (b) 2 years of continuous service
- (c) 1 year of continuous service
- (d) 10 years of continuous service

**Correct answer – (a)**

*Explanation: An employer is liable to pay gratuity to an employee who has completed 5 years of continuous services and his employment with the employer terminates due to retirement, resignation, or superannuation.*

**Q2. Gratuity received by an employee during his service is \_\_\_\_\_.**

- (a) Fully taxable
- (b) Fully exempt
- (c) Exempt to the extent of Rs. 10 lakhs
- (d) Exempt to the extent of Rs. 20 lakhs

**Correct answer – (a)**

*Explanation: Gratuity received by an employee during his service is fully taxable.*

**Q3. When the pension is paid on a periodic basis, it is called \_\_\_\_\_.**

- (a) Commuted pension
- (b) Uncommuted pension

**Correct answer – (b)**

*Explanation: When the pension is paid on a periodical basis, it is called an uncommuted Pension.*

**Q4. Commuted pension received by an employee of the Local Authority is fully exempt.**

- (a) True
- (b) False

**Correct answer – (a)**

*Explanation: Commuted pension received by an employee of the Central Government, State Government, Local Authority, and Statutory Corporation is fully exempt.*

**Q5. Leave encashment received on the death of the employee is fully taxable.**

- (a) True
- (b) False

**Correct answer – (b)**

*Explanation: Leave encashment received on the death of the employee is fully exempt.*

**Q6. What is the maximum amount allowed as exempt under section 10(10C) in respect of voluntary retirement compensation?**

- (a) Compensation received

- (b) Rs. 5,00,000
- (c) Lower of (a) and (b)
- (d) Higher of (a) and (b)

Correct answer – (c)

*Explanation: Exemption under Section 10(10C) is allowed to the extent of lower of the following:*

- (a) Compensation received; or
- (b) Rs. 500,000.

**Q7. What is the maximum amount allowed as exempt in respect of retrenchment compensation received on the closure of undertaking due to the losses?**

- (a) Retrenchment compensation received
- (b) Rs. 5,00,000
- (c) Average wage \* 15/26 \* completed year of continuous service or any part thereof in excess of 6 months.
- (d) Lower of (a), (b), and (c)

**Correct answer – (d)**

*Explanation: Lower of the following is exempt where retrenchment compensation received by the employee on the closure of the undertaking due to the losses:*

- (a) Rs. 5,00,000.
- (b) Retrenchment compensation actually received.
- (c) Average wage \* 15/26 \* completed year of continuous service or any part thereof in excess of 6 months.

**Q8. Whether employee's contribution to the Unrecognised Provident Fund is allowed as a deduction under Section 80C?**

- (a) Yes
- (b) No

**Correct answer – (b)**

*Explanation: Employee's contribution to the Unrecognised Provident Fund (UPF) is not allowed as a deduction under Section 80C.*

**Q9. Pension received out of annuity is \_\_\_\_\_.**

- (a) Fully taxable
- (b) Fully exempt
- (c) Partially taxable and partially exempt

**Correct answer – (a)**

*Explanation: Pension received out of NPS or annuity is fully taxable.*