

Decoding the tax exempt status of encashed leaves

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Leave encashment received on retirement is exempt from tax. (Photo: istock)

Leave encashment received on retirement is exempt from tax. It is eligible only if it is received on retirement from employment, and not if encashed during the course of employment. Courts have held that such retirement need not necessarily be on retirement at superannuation, but would also cover cases of leaving an employment by resigning. For employees of the central or state governments, the entire leave encashment amount received is exempt, without limits or conditions. On the other hand, for all other employees, there are various conditions and limits that are applicable to be able to claim exemption.

For non-government employees, one condition is that leave entitlement for computing such exemption cannot exceed 30 days for each year of service. Besides, such leave encashment cannot exceed 10 months, and the exemption has to be computed on the basis of the average salary drawn within the 10 months, immediately preceding retirement. Besides, there is an overall cap on the amount of exemption, which is notified from time to time by the government.

Furthermore, if leave encashment was claimed earlier on retirement from any other employer, only the balance of the limit would be eligible on retirement.

leave encashment from ₹3 lakh to ₹25 lakh, effective 1 April. At first glance, this seems a great benefit given to non-government employees. But, is it really so?

The limit of ₹3 lakh was fixed way back in 2002, with effect from 1998. An important aspect is that the law provides that the limit has to be fixed by the central government having regard to the limit applicable to central government employees. The limit of ₹3 lakh was therefore based on the highest monthly salary of a central government employee of ₹30,000 (drawn by the cabinet secretary) in 1998. Given the monthly salary of the cabinet secretary at ₹2,92,500 in 2021, the exemption available to government employees from that year has been ₹29.25 lakh. Therefore, the limit given to non-government employees is still lower than what is being enjoyed by government employees.

That apart, this limit was not enhanced from time to time as government salaries increased, but only after a period of 25 years. Employees who retired during 1998 and March 2023 would have got exemption for a maximum of ₹3 lakh, as opposed to government employees who would have got a much larger exemption.

Besides, this limit was not voluntarily increased by the government due to its magnanimity or out of sympathy for non-government employees. The enhancement was necessitated on account of a writ petition filed by employees of public-sector banks and undertakings against the government before the Delhi High Court in 2019, claiming status of government employees, and seeking parity for leave encashment exemption with government employees. While the Delhi High Court rejected the contention that public sector bank employees were government employees, in its interim order of November 2019, the court found merit in the grievance that the limit had not been increased since 1998.

The court had observed that over the decades, the pay-scales admissible to government servants, and even employees of the public sector undertaking and nationalised banks, and all others, had been upwardly revised, keeping in view the financial growth in the country, as well as on account of rising inflation, and that the last drawn salaries had increased manifold since the last notification. It had therefore asked the government to file a counter-affidavit in that regard. This writ petition is still pending before the high court. The action of the government has come three years after the Delhi High Court observations.

It is unfortunate that every tax exemption comes with so many strings attached, that it often defeats the purpose of giving the exemption. Could the notification increasing the limit not have been issued every three or five years? Could the government not have been more magnanimous, given that it was responsible for not issuing any notification for 25 years? There are so many provisions requiring notification from time to time, that one wonders whether the purpose of all this is either to create more jobs in the government to handle such work, or to quietly reduce the value of the benefit being provided by not issuing a notification.

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