Leave Encashment Exemption – Discriminatory Against Non-Government Employees?

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A. Law as it existed prior to recent notification

Leave encashment, received on retirement, whether on superannuation or otherwise, by an employee of a non-government sector was exempt under section 10(10AA)(ii) of the Income-tax Act (Act), subject to least of the following limits:

1. Leave salary actually received.
2. 10 month's salary based on average salary drawn during the last 10 months preceding retirement.
3. Cash equivalent of unavailed leave calculated on the basis of maximum 30 days leave for every year of completed service.
4. Amount specified by the Government i.e. INR 3 lakh.

B. Recent Notification

Central Board of Direct Taxes (CBDT) vide Notification No. 31/2023, dated 24 May 2023, has increased the limit as mentioned in A. 4. above from INR 3 lakh which was last notified in May 2002 to INR 25 lakhs now. Notification also says that it shall be deemed to have come into force with effect from 1st day of April, 2023.

C. Recent Notification - Whether appliable from AY 2023-24 or AY 2024-25?

It is cardinal principle of the tax law that the law to be applied is that in force in the assessment year unless otherwise provided expressly or by necessary implication[1]. And that would be so even if it is a conditional or a delegated legislation through a notification. The term 'with effect from 1 April' has always been interpreted as effective AY beginning 1 April of the year mentioned. Therefore, the increase in limit to INR 25 lakhs being applicable from AY 2023-24 seems to be a better view.

D. Law on leave encashment exemption – Whether discriminatory against non-government employees?

1. It bothers an ordinary mind as to what significant changes have happened between AY 2022-23 and AY 2023-24 so as to necessitate a sudden increase in exemption limit which is more than eight times of what was available last? There seems to be no plausible explanation except that someone sitting on legislating income-tax laws suddenly realized that exemption limit on leave encashment for non-government employees has not been revised for the last 21 years. Imagine the plight of those employees who have retired preceding this notification becoming effective and were eligible to a meagre exemption in comparison, and the frustration it reeks in this class of employees.

2. At this juncture, it is important to refer to the speech of the Finance Minister (FM) in India Budget 2023, wherein, while proposing such increase in maximum limit of leave encashment exemption, FM has said

that, and I quote – “the limit of ‘3 lakh for tax exemption on leave encashment on retirement of non-government salaried employees was last fixed in the year 2002, when the highest basic pay in the Government was ‘30,000 per month. In line with the increase in Government Salaries, I am proposing to increase this limit to ‘25 lakh.”

3. It is common knowledge that salaries of Government employees increase at periodic intervals. Basic Pay increases either on promotion or on implementation of Pay Commission Reports, and DA, which is also counted towards computation of leave encashment and is linked to inflation, increases based on office orders. Accordingly, Government employees have always been eligible for exemption on their leave encashment based on their higher/updated salaries.

4. This brings us to the question that whether it was mandatory on the part of Central Government to issue notification u/s 10(10AA)(ii) periodically, every time there was a change in leave encashment exemption of Government employees whether on account of any change in the limit or increase in their basic pay and DA?

5. The language in section 10(10AA)(ii) with respect to issuance of notification is as follows: “subject to such limit as the Central Government **may**, by notification in Official Gazette, specify in this behalf **having regard to** the limit applicable in this behalf to the employees of that Government”.

6. As we can see, the word used in the law is ‘may’ and not ‘shall’. However, it cannot be disputed that the use of the expression ‘may’ is not decisive. Having regard to the context, the expression ‘may’ used in a statute has varying significance. In some contexts, it is purely permissive, in others, it may confer a power and make it obligatory upon the person invested with the power to exercise it as laid down.[2]

7. Further, the words ‘having regard to’, ordinarily are understood as a guide and not a fetter.[3] They only oblige the authority on whom the power is conferred to consider as relevant data material to which it must have regard.[4] Therefore, when some statutory power is to be exercised ‘having regard to’ certain specific provisions, it only means that those matters must be taken into consideration. But as the words ‘having regard to’ have to be construed according to the context and subject matter, they may in a particular context have a compelling or mandatory effect.[5] Further, the words ‘having regard to’ certain enumerated matters do not mean ‘having regard only to’ those matters and, therefore, consideration of other relevant matters is not excluded.[6]

8. Therefore, the word ‘may’ can be interpreted as ‘shall’ in certain context and the word ‘with regard to’ shall have a compelling and obligatory effect in a particular context. In the context of leave encashment exemption to non-government employees, it is our considered view that both the words ‘may’ and ‘with regard to’ shall have mandatory application as no plausible reasons could be understood for not increasing this limit since 2002 given that the Government salaries and consequential leave encashment exemption for Government employees has increased many-folds since then. The only other explanation could be that Government, treated the law as only directory, and in all its wisdom, consciously decided every year that non-government employees as a class have to kept at a dis-advantage in comparison to Government employees with respect to leave encashment exemption. And relief, if any, to be granted, shall be granted purely on the whims and not based on any logical reasoning. Can this be termed as arbitrary and discriminatory application of law to non-government employees?

9. The question on discrimination was examined by Hon’ble Supreme Court in Shashikant Laxman Kale.[7] In this case, by a petition under article 32 of the Constitution, the petitioners challenged the constitutional validity of section 10(10C) of the Act, inserted by the Finance Act, 1987 with effect from 1-4-1987. This insertion, at that point in time, granted tax exemption to employee of a public sector company in respect of any payment received by him at the time of his voluntary retirement in accordance with an approved scheme etc. The petitioners contended that the denial of this benefit to an employee of a private sector company at the time of his voluntary retirement amounted to an invidious distinction between public sector employees and private sector employees in the matter of taxation and was arbitrary and unintelligible amounting to hostile discrimination.

10. After examining the issue in detail, Hon’ble Supreme Court held as under:

a) One has to look beyond the ostensible classification and to the purpose of the law to determine

reasonableness of the classification. By enacting section 10(10C), the proposal obviously was to extend the same benefit to the payment made under those approved schemes as was existing for compensation under approved schemes given by section 10(10B). A safe mode to relieve the public sector of its unproductive and surplus manpower is to induce those persons to seek voluntary retirement under a scheme providing some incentive or inducement for seeking voluntary retirement. The purpose of the legislation included reduction in the existing gap between the lower compensation package in public sector and the higher compensation package of the counterpart in private sector in addition to preventing misuse of the benefit in private sector which was not subject to the control of administration by the Government like that in the public sector.

b) It is clear that the Government or the public sector undertakings have been treated as a distinct class separate from those in the private sector and the fact that the profit earned in the former is for public benefit instead of private benefit, provides an intelligible differentia from the social point of view which is of prime importance for the national economy. Thus, there exists an intelligible differentia between the two categories which has a rational nexus with the main object of promoting the national economic policy or the public policy.

c) The argument of discrimination is based on initial equality between the two classes alleging bifurcation thereafter between those who stood integrated earlier as one class. This basic assumption being fallacious, the question of any hostile discrimination by granting the benefit only to a few in the same class denying the same to those left out does not arise. Further some other clauses in section 10 further show that the scheme of section 10 contemplates a distinction between employees based on the category of their employer.

d) Once the impugned provision contained in the newly inserted clause (10C) of section 10 is viewed in the above perspective keeping in mind the true object of the provision, there is no foundation for the argument that it is either discriminatory or arbitrary. This classification could not, therefore, be faulted. Consequently, the writ petition was dismissed.

11. Madras High Court (HC) also examined the question of discrimination in relation to section 10(10AA)[8] and, relying on SC decision in Shashikant Laxman Kale (supra), has held that “No doubt, a differentiation was made between the employees of the Central and State Governments, on the one hand, and the other employees, on the other hand, in sections 10(10) and 10(10AA). While full exemption is provided in the sections to retirement gratuity and encashment of earned leave by the Government employees, the exemption in the case of other employees has been restricted to a limit calculated in accordance with the provisions in the sections on the basis of the salary of those employees. But that would not by itself make the sections discriminatory or violative of article 14.”

12. The above decisions, both of the SC and Madras HC, can be distinguished. The SC decision was rendered in relation to an exemption which was available to employees of the public sector and was not available to employees of private sector, and hence the question of discrimination was raised. Madras HC decision was rendered in relation to an exemption which is subject to conditions in case of non-government employees but carried no conditions for Government employees.

On the contrary, section 10(10AA) under clause (i) provides exemption to Government employees, and under clause (ii), provides exemption to non-government employees. Whatever distinction the legislature wanted to maintain between these classes of employees, is already built into the law in those two clauses. The only further requirement u/s 10(10AA)(ii) was for the Central Government to periodically issue notifications to keep leave encashment exemption at par with those of Government employees. And therefore, given the history of the notifications issued under section 10(10AA)(ii), we can very well say that law has been implemented arbitrarily leading to discrimination against non-government employees.

Conclusion

Salaried employees generally, and employees in the private sector especially, have been at the forefront of paying taxes to the exchequer in comparison to other non-salaried individuals, the fact which has been recognized at the highest level in executive. Rather than being rewarded for this contribution, non-government employees have been penalised in this particular case on exemption of leave encashment

where maximum limit was not revised in the last 21 years.

It would be a fair question to ask the Government that whether the subject matter of increase in the limit of leave encashment exemption for non-government employees was discussed and disposed of, with reasons recorded in writing, every budget since 2002?

Further, it would be a fair question to ask Hon'ble Supreme Court of India that whether the obligation to issue notification under section 10(10AA)(ii) is mandatory and must be exercised by Central Government on every change in exemption for Government employees, whether on account of change in limit or change in basic pay & DA, and whether, non-issuance of such notification by Central Government is arbitrary and hostile discrimination towards non-government employees? Further, what should be the frequency of such changes / notifications in order not to defeat the objective of the law itself?

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[1] CIT v. Isthmian Steamship Lines [TS-5006-SC-1951-O]; Reliance Jute & Industries Ltd. [TS-2-SC-1979-O]

[2] Societe De Traction v. Kamani Engg. Co., AIR 1964 SC 358.

[3] State of Karnataka v. Ranganath Reddy, AIR 1978 SC 215.

[4] Saraswati Industrial Syndicate Ltd. v. UOI, [TS-5779-HC-1980(PUNJAB)-O].

[5] UOI v. Komalabai, AIR 1968 SC 377.

[6] CIT v. Gangadhar Banerjee & Co. (Pvt.) Ltd., AIR 1965 SC 1977.

[7] Shashikant Laxman Kale And Anr. v. UOI And Anr., [TS-5010-SC-1990-O].

[8] K. Gopalakrishnan v. CBDT, [TS-5306-HC-1993(MADRAS)-O].