Taxation of salaried individuals in India

Employment Tax Tax voice

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Ram Iyer provides an insight into taxation of salaried individuals

Having looked previously at the recently introduced GST law, an overview of India’s direct tax system, and the key features of the taxation of property, I now turn to certain aspects of the taxation of salaried individuals - in particular the more common payslip items of a professional employee.

Introduction

Salaries is one of the main heads of taxation in the Income Tax Act, 1961, as amended by annual Finance Acts. A salaried individual is subject to various aspects of the tax system, including withholding tax, exemptions and allowances, as explained below.

Common salary components

Employers are required to deduct TDS (Tax Deduction at Source, i.e. withholding tax) from the salary whenever it is paid. The TDS rates depend on the taxable salary, which is gross salary adjusted for perquisites, exemptions and allowances. In the table below is a specimen annual payslip of a salaried professional. The explanatory notes follow the table:

Specimen Annual Payslip of Salaried Professional
Gross Salary, including variable pay
Add Perquisites:
- Accommodation
- Car lease
Less Exemptions (exempt portion of salary):
- Conveyance allowance (office commuting expenses)
- Leave travel concession (holiday expenses)
Income Chargeable under the Head Salaries
Less Deductions (investment and other allowances):
- Employee contribution to provident fund
- Other allowances
Total Income
Tax Payable (income tax bands)
- On the first INR 250,000 (GBP 2,750) - Nil
- On the next INR 250,000 - 5%

Specimen Annual Payslip of Salaried Professional
- On the next INR 500,000 (GBP 5,500) - 20%
- On amount exceeding INR 1 million (GBP 11,000) - 30%
- Surcharge on Total Income that falls between INR 5 million and 10 million (GBP 55,000 to 110,000) - 10%
- Surcharge on Total Income exceeding INR 10 million (GBP 11,000) - 15%
- Health and Education Cess - 4% of the tax and surcharge as calculated above

Perquisites

Common perquisites include accommodation and car leases.

Company-owned accommodation is included as a taxable perquisite at rates that depend on the population size of the city. For example, an employee staying in an unfurnished company-owned apartment in Mumbai would see 15% of his salary added as a perquisite since Mumbai falls within cities with a population exceeding 2.5 million. If the accommodation is leased by the employer then the perquisite is valued at the lower of the above 15% and the actual rent paid by the employer.

As already highlighted in my previous article on the taxation of property, employees living in self-arranged rented accommodation can claim a house rent allowance (HRA) as a salary tax deduction, at the lower of:

1. the actual HRA received from the employer,
2. 50% of basic pay (i.e. pay excluding perks and allowances), and
3. actual rent paid less 10% of basic salary.

The 50% limit applies to Mumbai, Kolkata, Delhi and Chennai, whereas it is 40% otherwise.

So, if an employee in a big city receives 100 per month as the HRA (i) component of his salary, whilst his basic pay is 500 (50% of which is 250 (ii)), and the actual rental he pays his landlord is 120 (which, after deducting 10% of the 500 basic pay comes to 70) (iii), then he gets a tax deduction of 70, which is the lowest of (i) 100, (ii) 250, and (iii) 70.

Company car leases provide a good means of tax structuring. In a common example, under the tax rules, a company car lease of a car with a 1600 cc engine or lower would attract a perquisite value of INR 1,800 (GBP 20) per month. Thus, the rest of the lease rental becomes a tax-free perquisite in the employee’s hands.

Exemptions

Common exemptions include conveyance allowance, leave travel concession and reimbursement of medical expenses.

Where an employee commutes by means other than car, the rules allow a standard exemption of INR 1,600 (GBP 18) per month.

To encourage employees to take leave, the lower of the actual amount spent on domestic leave travel and the leave travel portion of the salary is allowed as an exemption. For example, under the detailed rules, a return plane fare for the employee, his spouse, children and dependent relatives is allowed twice in a pre-determined block of four years, based on the lowest fare for the shortest route charged by a national carrier. The current block of four years is from 1 April 2018 to 31 March 2021.

Allowances

It is mandatory for employers to deduct 12% of the employee’s basic pay as the employee’s contribution towards PF (Provident Fund), a post-employment benefit. In addition, employers are required to contribute a matching 12% as the employer’s share. Both these contributions are tax-free for the employee. PF is one of the most effective (albeit mandatory) tax-planning measures available to salaried employees.

As an incentive to promote long-term savings and investments, several other deductions are available. Common examples include voluntary contributions to the PPF (Public Provident Fund) and government-run pension schemes, life insurance and medical insurance premiums, long-term cash deposits with the Post Office and the principal portion of a home loan repayment. The maximum aggregate allowance for all of these items is approximately INR 200,000 (GBP 2,200) per annum.

In addition, home mortgage loan interest and interest on higher education loans are also allowed. The allowance on the mortgage interest is limited to the lower of the actual interest paid and INR 200,000 (GBP 2,200) per annum, with additional benefits for the first house purchase. There is no restriction on the amount of the higher education loan interest but it is allowed only for a maximum of eight years.

Exit

In addition to the allowances outlined above available during employment, there are some important allowances when an employee exits a company.

Many Indian companies have a leave encashment policy, through which they compensate in cash for any unutilized leave balance. A maximum of INR 300,000 (GBP 3,300) is allowed as the tax-free portion for such payments made on exit.

One of the most important exit compensations mandated by Indian laws is the payment of gratuity, a post-employment compensation. The law requires a minimum of 15 days' salary based on the most recent monthly basic pay to be paid to every exiting employee, for every completed year of service in that employment, if at least five years are served. For example, an employee leaves at the end of five years and his most recent monthly basic salary is 100. He will get at least 250 as a gratuity pay-out (i.e. 50% of monthly basic salary of 100 x 5 years of service). While there is no limit on how much gratuity an employer can pay, the tax-free portion is limited to INR 2 million (GBP 22,000).

The accumulated balance in the Provident Fund explained earlier is also available to an exiting employee. The accumulated principal and interest are both tax-free subject to at least five years of continuous service with one or more employers.

Tax Administration

To conclude, here are some basic tax administration points.

The employer is required to remit the withholding tax to the government every month.

An individual earning more than INR 250,000 (GBP 2,750) per annum, i.e. the current lower limit for taxable income, needs to file a tax return even if salary is the only source of income.