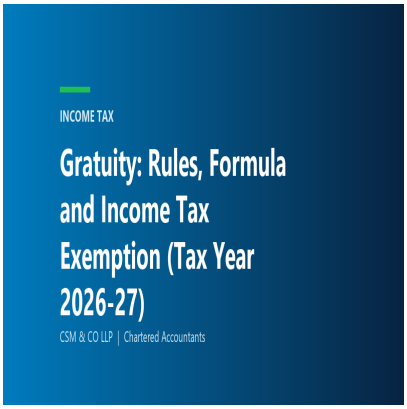

Gratuity: Rules, Formula and Income Tax Exemption (Tax Year 2026-27)

Description

Last updated: 02 October 2026 · Written and reviewed by CA Meet Dhrangadhariya, CSM & Co LLP

Quick summary

- Gratuity is payable on five years of continuous service (one year for fixed-term employees) at 15 days' wages for each completed year, worked out as last monthly wages ÷ 26 × 15 × years.
- The Code on Social Security, 2020 has been in force since 21/11/2025 and now governs gratuity; the ?20 lakh ceiling is a notified amount, so check it before you rely on it.
- Under the Income-tax Act, 2025 the exemption is in section 19(1): government employees get it in full, others get the least of the gratuity received, the notified limit (?20 lakh) and the statutory formula.
- The gratuity exemption is also available in the new tax regime.

Gratuity is a lump sum an employer pays for long service. Two questions come up every time: how much is payable, and how much of it escapes tax. This post answers both under the Code on Social Security, 2020 and the Income-tax Act, 2025.

Which law governs gratuity now

The Code on Social Security, 2020 repealed the Payment of Gratuity Act, 1972 (section 164(1)). The four labour codes were made effective from 21 November 2025 (PIB press release), and the Ministry of Labour has said gratuity under the Code applies from that date. Notifications made under the old Act, such as the ceiling, are deemed to continue under the corresponding provisions of the Code (section 164(2)(a)). Gratuity is now in sections 53 to 56 of the Code. Older articles that quote the 1972 Act describe the same scheme, but the section numbers have changed.

Eligibility and formula under section 53

- **Five years of continuous service** is needed on superannuation, retirement, resignation, death or disablement. The five years are not needed on death or disablement.
- **Fixed-term employees** are paid gratuity pro rata and do not need five years. The Ministry of Labour has clarified (FAQs of 16/03/2026) that a fixed-term employee is eligible after rendering **one year** of service under the contract. This covers employees engaged directly by the employer, not contract labour

supplied by a contractor.
- **Rate:** 15 days' wages for every completed year of service or part of a year in excess of six months, on the wages last drawn.
- **Monthly-rated employees:** the 15 days' wages are the monthly wages last drawn ÷ 26 × 15.
- **Ceiling:** the Central Government notifies the maximum (section 53(3)). The Ministry of Labour's FAQs say it is currently ?20 lakh.
- **Time to pay:** within 30 days from the date gratuity becomes payable, with simple interest for delay (section 56(3) and (4)). The employer must work out the amount and give written notice even if you have not applied.
- **Nomination:** if the employee dies, gratuity goes to the nominee or heirs.
- **Forfeiture:** wholly or partly, only for wilful damage to property, riotous or violent conduct, or an offence involving moral turpitude committed during employment.

Gratuity = Last drawn monthly wages ÷ 26 × 15 × completed years

Example: monthly wages ?40,000, service 8 years: 40,000 ÷ 26 × 15 × 8 = **?1,84,615**.

Under section 2(88) of the Code, "wages" are basic pay, dearness allowance and retaining allowance, and if the excluded allowances (house rent allowance, conveyance and others) are more than **half of total remuneration**, the excess is added back to wages. The Ministry of Labour's FAQs say performance incentives, ESOPs and reimbursements are not wages, and that gratuity and retrenchment compensation are left out of the 50% test. If your pay structure keeps basic pay low, the gratuity base may now be higher than under the old 1972 Act, from 21/11/2025. Ask your employer how the base is worked out.

Is gratuity taxable?

Gratuity is part of salary (section 16(c) of the Income-tax Act, 2025). Section 19(1) then allows these deductions from it, in the order of the Table:

Who receives it	Exempt amount
Death-cum-retirement gratuity under the Central Government pension rules or a similar government scheme (serial 3)	The entire amount
Retiring gratuity under the defence services pension code (serial 4)	The entire amount
Gratuity under the Payment of Gratuity Act, 1972, now the Code (serial 5)	The amount received, limited to the amount worked out under section 4(2) and (3) of that Act, which gives the 15/26 formula and the ?20 lakh ceiling
Any other gratuity on retirement, incapacity before retirement or termination (serial 6)	The least of the actual gratuity, the notified amount (?20 lakh) and half a month's salary for each completed year

"Salary" for these purposes is basic pay plus dearness allowance, if the terms of employment provide for it. All other allowances and perquisites are left out (section 19(2)(b)).

Employees covered by the gratuity law (serial 5)

The exempt amount is the least of three figures:

1. the gratuity actually received,
2. the formula amount: last drawn salary ÷ 26 × 15 × completed years (a part year of more than six months counts as a year), and
3. ?20 lakh.

Example: last drawn basic plus DA is ?1,00,000 a month, service is 19 years and 7 months, so 20 years are counted. Gratuity paid is ?15,00,000.

- Formula amount: 1,00,000 ÷ 26 × 15 × 20 = ?11,53,846
- Ceiling: ?20,00,000
- Received: ?15,00,000
- **Exempt: ?11,53,846. Taxable: ?3,46,154**, added to salary income.

Employees not covered (serial 6)

The exempt amount is the least of the gratuity received, ?20 lakh and **half a month's salary for each completed year of service**, where the salary is the average of the **ten months before the month of the event** (retirement, incapacity or termination). Only completed years count.

Example: average salary of the last ten months is ?90,000, service is 25 years and 2 months, gratuity received is ?14,00,000.

- Half month's salary: 90,000 × 1/2 × 25 = ?11,25,000
- **Exempt: ?11,25,000. Taxable: ?2,75,000.**

Gratuity from more than one employer

For serial 6, if you receive gratuity from more than one employer in a tax year, or received exempt gratuity in earlier years, the total exemption cannot exceed the notified limit reduced by what was already exempted (section 19(2)(a)). Keep a record of gratuity exempted in earlier jobs.

New tax regime

Of the section 19(1) Table, section 202(2) bars only serial number 1 (professional tax) in the new regime. The gratuity entries are not barred, so **the gratuity exemption is available in both regimes**.

Employer side

- Contributions to an **approved gratuity fund** created under an irrevocable trust are deductible (section 29(1)(c)).
- A provision for gratuity that **has become payable during the tax year** is deductible (section 29(1)(d)).
- Gratuity paid during the employee's lifetime is treated as salary (Schedule XI, Part B, paragraph 5). The income of an approved gratuity fund is itself exempt (Schedule VII).
- TDS on the taxable part is deducted with other salary under section 392.

Gratuity and pension compared

Point	Gratuity	Pension
Payment	One time, on leaving	Monthly, for life
Paid by	Employer	Employer, a pension fund or the government
Condition	Five years of continuous service (one for fixed-term)	As per the scheme
Tax	Exempt up to the limits above	Taxable as salary when received (commuted lump sum has separate rules)

Things to check before you rely on this

- The Income-tax Act, 2025 still names the Payment of Gratuity Act, 1972 in serial 5 and its section 4(2) and (3). Those sub-sections (15 days' wages and the ceiling) are now section 53(2) and (3) of the Code, and section 164(2)(a) of the Code carries the old notifications forward, so the exemption works as described. A future amendment of the Income-tax Act may update the wording.
- The ?20 lakh ceiling is a notified amount, not a number in the Act. The labour ceiling dates from 29/03/2018 and the income-tax limit from S.O. 1213(E) of 08/03/2019. The Ministry of Labour still calls ?20 lakh the current ceiling, and we found no newer notification. Check before you advise on a very large gratuity.

Frequently asked questions

Who is eligible for gratuity?

An employee who has completed continuous service of five years, on superannuation, retirement, resignation, death or disablement. Death and disablement do not need five years. A fixed-term employee is eligible after one year of service under the contract, with pro-rata gratuity.

What is the gratuity formula?

Last drawn monthly wages ÷ 26 × 15 × completed years of service. A part year of more than six months counts as a full year.

How much gratuity is tax free?

For a government employee, the whole amount. For an employee covered by the gratuity law, the least of the gratuity received, the amount worked out by the statutory formula and the notified ceiling (?20 lakh). For others, the least of the gratuity received, the notified ceiling and half a month's average salary for each completed year.

Is gratuity exempt in the new tax regime?

Yes. Section 202(2) bars section 19(1) serial number 1 (professional tax) in the new regime, but not the gratuity entries at serial numbers 3 to 6.

Is gratuity taxable at all?

Yes, to the extent it exceeds the exempt amount. It is part of salary (section 16), so the excess is taxed at your slab rate and TDS applies.

Can the employer forfeit gratuity?

Only in the cases the law allows: wilful damage to the employer's property, riotous or violent conduct, or an offence involving moral turpitude committed during employment. Forfeiture can be whole or partial.

Official sources

- Income Tax Department: Income-tax Act, 2025 (sections 16, 19, 29, 202; Schedule XI Part B)
- India Code: Code on Social Security, 2020 (sections 2(88), 53, 56, 164)
- Ministry of Labour and Employment: Additional FAQs on Labour Codes (16/03/2026)
- Ministry of Labour and Employment: FAQs on Labour Codes (30/12/2025)
- PIB: Four Labour Codes made effective from 21 November 2025

Related reading

- Dearness Allowance (DA): Meaning, Tax Treatment and the 60% Rate from January 2026
- How to Calculate Income From Salary: Step by Step With Example (Tax Year 2026-27)
- How to Save Tax on Salary from ?7 Lakh to ?1 Crore: Old vs New Regime (Tax Year 2026-27)

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Author
meetsoni