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The Goodbye Gift That Taxman Didn't Forget - Taxability of Ex-gratia/ Severance/ VRS Amount received by Employee on Retirement, Termination or Cessation of Employment.

1. The controversy

1.1 One of the recurring issues in income-tax litigation is whether an amount received by an employee from his employer, at the time of retirement, voluntary retirement, resignation, termination, closure of unit or cessation of employment, can be brought to tax as "profits in lieu of salary" or whether the same is to be treated as capital receipt not chargeable to tax.

1.2 Be it a case of VRS, lay-off, closure of unit, forced exit, mutual cessation agreement, settlement with employer, early exit scheme or any other similar arrangement, the issue generally arises where an employee receives a lump sum amount described as ***ex-gratia, severance pay, settlement amount, voluntary retirement amount, early bird incentive, notice pay, group participation incentive or by any other similar nomenclature***. In many such cases, the employee takes a stand that the amount is received on account of loss of source of income and therefore, it is a capital receipt. However, the practical difficulty begins because the employer, while saying "thank you and goodbye", also deducts TDS and reflects the amount in Form 16, thereby leaving the employee in complete confusion as to whether the amount is really exempt/ capital in nature or whether it is to be offered as salary income. On the other hand, the Department generally proceeds on the basis that the amount is received from employer or former employer in connection with cessation of employment and therefore, the same is taxable either u/s. 17(3)(ii) as profits in lieu of salary.

1.3 The controversy has become more interesting because various judicial precedents have held that such ex-gratia or voluntary payment, where the employer was under no obligation to make such payment, is not compensation and therefore cannot be taxed as profits in lieu of salary. However, the deeper question is whether such reasoning completely answers the issue after considering the language of section 17(3)(iii), which specifically covers any amount received by an assessee from any person before joining employment or after cessation of employment.

1.4 In my respectful view, the issue is not as simple as saying that every such receipt is capital receipt merely because the employer has used the word "ex-gratia". The real enquiry must be into the exact provision invoked, the timing of receipt, the nature of employment cessation, the terms of scheme, the right of employee to receive the amount, and whether the amount is received before or after cessation of employment.

2. Relevant statutory provision – Section 17(3)

2.1 Section 17(3) defines "profits in lieu of salary" and the provision reads as under:

17(3): "profits in lieu of salary includes—

(i) the amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the termination of his employment or the modification of the terms and conditions relating thereto;

(ii) any payment (other than any payment referred to in clause (10) [, clause (10A)] [, clause (10B)], clause (11), [clause (12) [, clause (13)] or clause (13A)] of section 10), due to or received by an assessee from an employer or a former employer or from a provident or other fund [***], to the extent to which it does not consist of contributions by the assessee or [interest on such contributions or any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy.

Explanation.—For the purposes of this sub-clause, the expression "Keyman insurance policy" shall have the meaning assigned to it in clause (10D) of section 10;]

[(iii) any amount due to or received, whether in lump sum or otherwise, by any assessee from any person4"—

(A) before his joining any employment with that person; or

(B) after cessation of his employment with that person.]"

2.2 This statutory text is important because the first limb, namely section 17(3)(i), is based on "compensation" received at or in connection with termination or modification of employment terms. However, section 17(3)(iii) is worded differently and uses very wide language, namely "any amount due to or received" before joining employment or after cessation of employment. The text of s.17(3), including clause (iii), was specifically reproduced and argued in Dnyaneshwar Shinde *[ITA No. 1726/PUN/2025],* before ITAT Pune. Therefore, where the Department invokes only section 17(3)(i), the assessee may have a strong argument that the amount is not compensation because it is voluntary and ex-gratia. But where the Department invokes section 17(3)(iii), the enquiry becomes slightly different, because that clause does not use the word "compensation" in the same manner.

<u>3. Earlier judicial approach: Voluntary ex-gratia not treated as compensation</u>

3.1 The leading authority on this issue is the decision of Hon'ble Calcutta High Court in ***CIT v. Ajit Kumar Bose [1986] 26 Taxman 510 / [1987] 165 ITR 90 (Cal.)***. In that case, the assessee's employment was terminated by giving three months' notice. Apart from salary for notice period and leave dues, the employer paid an ex-gratia amount of Rs. 24,933. The Hon'ble High Court held that there was nothing to show that the assessee was entitled to continue in employment up to a particular age, or that the employer was under an obligation to make any payment other than salary for notice period. Therefore, in its true nature, the payment was voluntary and ex-gratia, and not compensation which implies some obligation to pay. Accordingly, it was held that the amount was not profits in lieu of salary within the meaning of section 17(3).

3.2 This decision has become the foundation for many later decisions. The principle emerging from this judgment is that where the payment is voluntary, not arising from any service rule, and not something which the employee could claim as a matter of right, such payment may not partake the character of compensation. The difficulty, however, is that the decision primarily dealt with the then controversy of compensation in connection with termination. It does not appear to have examined the later and specific consequence of a broadly worded clause such as section 17(3)(iii), which taxes any amount received after cessation of employment.

3.3 ***Mahadev Vasant Dhangekar – Important but debatable***

In ***Mahadev Vasant Dhangekar v. ACIT [2023] 149 taxmann.com 170 (Pune - Trib.)***, the assessee had taken voluntary retirement from Racold Thermo Pvt. Ltd. and had received Rs. 47.21 lakhs as ex-gratia. Out of this, Rs. 5 lakhs was claimed u/s. 10(10C) and the balance of Rs. 42.21 lakhs was claimed as capital receipt. The AO specifically taxed the amount u/s. 17(3)(iii) by treating it as additional compensation received from employer as profits in lieu of salary. The Tribunal noted that section 17(3)(iii), in normal course, would apply where an amount is received after cessation of employment. However, the Tribunal finally accepted the assessee's contention because the employer's letter stated that the payment was voluntary, made out of appreciation, and was not compensation. The Tribunal also noted that the Department had not doubted the genuineness of the employer's letter and had not conducted any enquiry to establish that the letter was non-genuine.

3.4 This decision is very important because it directly dealt with section 17(3)(iii). At the same time, with due respect, the debatable aspect is whether the mere description of payment as voluntary or not compensation can take the receipt outside section 17(3)(iii), when that clause uses the expression "any amount due to or received" after cessation of employment. In other words, the question is: ***If section 17(3)(iii) is not confined only to compensation, can the assessee still escape tax merely by showing that the receipt is voluntary and ex-gratia*?** This is where the controversy remains alive.

3.5 ***Avirook Sen – Out of court settlement and voluntary payment***

In ***ITO v. Avirook Sen [2024] 161 taxmann.com 462 (Delhi - Trib.)***, the assessee received a lump sum amount after termination of service pursuant to an out of court settlement with employer. The AO treated the amount as compensation and profits in lieu of salary u/s. 17(3)(i). The Tribunal held that the payment was voluntary in nature, without there being any obligation on part of employer to pay further amount in terms of any service rule, and therefore, it would not amount to compensation u/s. 17(3)(i). This decision again supports the assessee on the issue of voluntary ex-gratia not being compensation. However, it appears that the main discussion was in the context of section 17(3)(i), namely compensation.

Therefore, while the decision is useful for cases where the Department proceeds only on the basis that the payment is compensation, its application to section 17(3)(iii) may still be debated.

3.6 ***Ashok Raghunathrao Kulkarni – Pfizer line of cases***

In ***Ashok Raghunathrao Kulkarni v. ITO [2024] 165 taxmann.com 680 (Pune - Trib.)***, the assessee was an employee of Pfizer and had received ex-gratia/ severance pay, early bird incentive, group participation incentive, notice period payout, medical reimbursement, bonus, EL encashment and part salary, aggregating to Rs. 57.12 lakhs. The AO treated the amount as profits in lieu of salary u/s. 17(3). The Tribunal, after referring to *Ajit Kumar Bose, Mahadev Vasant Dhangekar and Avirook Sen*, held that ex-gratia compensation received by the assessee was voluntary in nature and there was no obligation on the part of employer to pay such amount in terms of service rules. Therefore, it would not amount to compensation in terms of section 17(3). The Tribunal also noted that in the cases of other employees, the Department itself had accepted similar compensation as capital receipt in reassessment proceedings and no action u/s. 263 had been initiated. This decision strengthens the assessee's case on facts, particularly in Pfizer cases, because it applies consistency and follows co-ordinate bench decisions. However, from a legal drafting perspective, one must still carefully see whether the Department's case is only under section 17(3)(i), or whether section 17(3)(iii) is independently invoked.

3.7 ***Dnyaneshwar Shinde – Section 17(3)(iii) was argued***

In **Dnyaneshwar Shinde v. ITO [ITA No. 1726/PUN/2025, dated 21.01.2026]**, the assessee had received various amounts from Pfizer pursuant to the financial scheme. The assessee's grounds included claim that ex-gratia, early bird incentive, notice pay, leave encashment and bonus were capital receipts in light of Ashok Raghunathrao Kulkarni. The assessee specifically argued that section 17(3) was not applicable and the order reproduces section 17(3)(iii), namely any amount received before joining employment or after cessation of employment. The assessee relied on Ajit Kumar Bose, Mahadev Vasant Dhangekar and Avirook Sen for the proposition that voluntary payment, not arising from obligation, cannot be termed as compensation. The Tribunal accepted the assessee's position by following the Pfizer line of cases and the principle that similar receipts of other employees had been accepted as capital in nature by the Department. This decision is relevant because it shows that section 17(3)(iii) was at least placed before the Tribunal. However, the real controversy, namely whether a voluntary amount received after cessation can still be taxed under the wide words of section 17(3)(iii), may still require deeper examination in an appropriate case.

4. Section 56(2)(xi) – A separate and wider provision from AY 2019-20

4.1 For AY 2019-20 onwards, the controversy does not remain confined only to section 17(3). Section 56(2)(xi), inserted w.e.f. 01.04.2019, *taxes any compensation or other payment due to or received by any person, by whatever name called, in connection with termination of employment or modification of terms and conditions relating thereto.* This provision is wider in one sense because it covers not only compensation but also "other payment". In Ram Dattatray Kaldate, the CIT(A)/NFAC had reasoned that section 56(2)(xi) was introduced to address taxation of amounts received in connection with termination of employment, and that the provision covers not only compensation but also other payments.

4.2 However, the Tribunal in the Pfizer cases examined the terms of the scheme and noted that clause 11(viii) of the scheme provided that employees opting for voluntary retirement would not be entitled to compensation or notice pay under the Industrial Disputes Act, 1947, because their cessation constituted "resignation" and did not constitute "retrenchment" or "termination of employment" by the company. On that basis, the Tribunal held that the case was one of voluntary retirement/ resignation and not termination by employer. In ***Paresh Vithal Padwalkar v. ITO [2026] 187 taxmann.com 638 (Pune - Trib.)***, the Tribunal followed the same reasoning and held that the amount received under Pfizer scheme was not taxable u/s. 56(2)(xi), since the employment was not terminated by Pfizer and the assessee had opted for voluntary retirement under the scheme.

4.3 Thus, for AY 2019-20 onwards, even if section 17(3) is avoided, one must separately deal with section 56(2)(xi), particularly where the receipt is in connection with termination or modification of employment terms. As the newly inserted provision does not necessarily require a direct employer-employee relationship at the time of receipt, because what matters is whether the compensation or any other payment is received in connection with termination of employment or modification of terms and conditions of employment. This becomes more pertinent in cases where the parent company (employer) is taken over by another entity and the employee is offered certain compensation/ other payment by the new company/ entity.

5. The important distinction – receipt before last working day vs. after cessation

5.1 In my respectful view, one of the most important aspects which requires careful consideration is the timing of receipt. Section 17(3)(iii)(B) applies to any amount due to or received by an assessee from any person ***after cessation of his employment*** with that person. Therefore, if the amount is actually due or received after cessation, the Department may have a stronger argument that clause (iii) applies, irrespective of whether the payment is described as voluntary, ex-gratia or not compensation.

5.2 However, if the amount is due and received before the last working day, or during the subsistence of employer-employee relationship, then an arguable case can be made that section 17(3)(iii)(B) is not attracted, because the receipt is not after cessation of employment. In such a case, the Department may still try to tax the amount under other provisions, but the specific trigger under section 17(3)(iii)(B) becomes debatable. This argument will depend heavily on documents, such as:

a. *date of scheme;*
b. *date of acceptance by employee;*
c. *date of approval by employer;*
d. *date of payment;*
e. *date of relieving;*
f. *date of resignation / VRS becoming effective;*
g. *full and final settlement letter;*
h. *Form 16;*
i. *TDS certificate;*
j. *board/ HR communication;*
k. *clause stating when employment actually ceased.*

5.3 Thus, in such cases, the most important factual enquiry is not only "what is the nomenclature of receipt", but also "when did the right to receive arise" and "when did employment actually cease".

6. Capital receipt argument – still available but not automatic

6.1 The capital receipt argument proceeds on the basis that compensation for loss of source of income is capital in nature. In ***Sudhakar Ratan Shanker Gautam [2024] 168 taxmann.com 369***, the Hon'ble Ahmedabad Tribunal held that severance compensation received on termination due to acquisition and redundancy was for loss of employment and not for past services, and therefore was capital receipt not chargeable to tax u/s. 17(3). The Tribunal also observed that capital receipts, especially in employment context, are generally not taxable unless specifically brought within the tax net. Similarly, in Kalyanasundaram Ranjithkumar, the Chennai Tribunal followed Ashok Raghunathrao Kulkarni *(Supra)* and held that full and final settlement received on closure of unit, being voluntary and without obligation under service rules, did not qualify as compensation u/s. 17(3).

6.2 These decisions certainly support the assessee. However, the expression "capital receipt" should not be used loosely in every case. If the amount is directly linked to past services, salary arrears, bonus, leave encashment, notice period salary, gratuity beyond exemption, or contractual entitlement, the taxability may be different. A lump sum received at exit may consist of multiple components, and each component may require separate treatment. For example, part salary for month of relieving, bonus for current year, leave encashment and gratuity may not automatically become capital merely because they are paid along with ex-gratia. This issue becomes particularly important where the employer gives a single full and final settlement statement with different components.

7. Suggested legal position

7.1 The correct legal position, in my respectful view, may be summarised as under:

a. Firstly, if the amount is received as salary, bonus, leave encashment, gratuity or any other contractual employment benefit, the normal charging provisions and specific exemption provisions must apply and such amounts would ordinarily be governed by the normal charging provisions and specific exemption provisions, as applicable.

b. Secondly, if the amount is received as voluntary ex-gratia, not arising from any service condition and not payable as a matter of right, the assessee can strongly rely upon Ajit Kumar Bose and subsequent Tribunal decisions to contend that it is not compensation u/s. 17(3)(i).

c. Thirdly, where section 17(3)(iii) is invoked, the assessee must not stop at saying that the payment is not compensation, because clause (iii) is wider and uses the expression "any amount". The assessee should additionally demonstrate that the amount was not received after cessation of employment, or that the receipt does not fall within the mischief intended by the clause on proper interpretation.

d. Fourthly, for AY 2019-20 onwards, section 56(2)(xi) has to be separately dealt with. The assessee may contend that voluntary retirement/ resignation under a scheme is not the same as termination by employer, especially where the scheme itself contains such a clause, as seen in Pfizer cases.

e. Fifthly, where the amount is received before the last working day and before cessation of employment takes effect, a possible argument can be raised that section 17(3)(iii)(B) is not attracted since as per the literal interpretation rules, only amounts received before joining employment or after cessation of employment are taxed in this sub-clause, though the Department may still examine taxability under other provisions depending on facts.

8. Practical drafting approach in litigation

8.1 In appeals involving such issue, the assessee should avoid taking a one-line stand that the entire amount is capital receipt. The better approach would be to first break up the amount component-wise and then deal with each item separately. A proper submission should cover:

(a) *nature of employment and terms of appointment;*
(b) *whether employee had right to continue up to retirement age;*
(c) *whether employer had obligation to pay the amount;*
(d) *whether amount was voluntary or contractual;*
(e) *whether it was compensation, incentive, salary or settlement;*
(f) *whether the receipt was before or after cessation;*
(g) *whether there was termination by employer or voluntary retirement / resignation by employee;*
(h) *whether s.10(10C), s.10(10AA), s.10(10B), s.17(3), s.56(2)(xi) or s.89 has been claimed / invoked;*

(i) *whether similar cases of co-employees have been accepted by Department;*

(j) *whether TDS deduction by employer is only a tax-compliance act and not conclusive of taxability.*

8.2 In almost all cases, TDS is deducted by employer out of abundant caution. Such deduction cannot by itself decide the nature of receipt. In Mahadev Vasant Dhangekar *(Supra)*, even though TDS was one of the reasons relied upon by the NFAC, the Tribunal still accepted the assessee's claim because the employer's letter was not doubted and no independent enquiry was conducted by the Department.

9. Concluding observations

9.1 The judicial trend at present is largely in favour of the assessee, especially where the payment is voluntary, ex-gratia, not arising from any service rule, and paid on account of closure, redundancy, VRS or loss of employment. The courts and tribunals have repeatedly held that such payment does not amount to compensation u/s. 17(3)(i), and in many cases, have treated it as capital receipt. However, the issue is still not free from debate. The reason is that section 17(3)(iii) uses wide language and covers any amount received after cessation of employment. Therefore, in a case where the amount is admittedly received after cessation, and the provision is properly invoked, the Department may still argue that the receipt is taxable as profits in lieu of salary even if it is not compensation in the narrow sense. At the same time, if the amount is received before the last working day, or if the right to receive arises before cessation of employment, the assessee may have a strong arguable case that section 17(3)(iii)(B) does not apply. Similarly, where the case is of voluntary retirement / resignation and not termination by employer, the assessee may resist section 56(2)(xi), particularly by relying on the Pfizer line of cases.

- ***Chinmayy Suhas Pathak, C.A.***

List of decisions relied upon:

1. *CIT v. Ajit Kumar Bose [1986] 26 Taxman 510 (Cal.) / [1987] 165 ITR 90 (Cal.) / [1986] 52 CTR 250 (Cal.)*
2. *Mahadev Vasant Dhangekar v. ACIT [2023] 149 taxmann.com 170 (Pune - Trib.) / [2023] 201 ITD 5 (Pune - Trib.)*
3. *ITO v. Avirook Sen [2024] 161 taxmann.com 462 (Delhi - Trib.)*
4. *Ashok Raghunathrao Kulkarni v. ITO [2024] 165 taxmann.com 680 (Pune - Trib.)*
5. *Sudhakar Ratan Shanker Gautam v. ITO [2024] 168 taxmann.com 369 (Ahmedabad - Trib.)*
6. *Kalyanasundaram Ranjithkumar v. ITO [2025] 178 taxmann.com 493 (Chennai - Trib.)*
7. *Dnyaneshwar Shinde v. ITO [ITA No. 1726/PUN/2025, dated 21.01.2026]*
8. *Paresh Vithal Padwalkar v. ITO [2026] 187 taxmann.com 638 (Pune - Trib.)*
9. *Ram Dattatray Kaldate v. ITO [2026] 187 taxmann.com 639 (Pune - Trib.)*
10. *Ajay B. Ghose v. DCIT, CPC [ITA No. 1720/Mum/2021, dated 15.11.2021]*
11. *Parvez Mukhtar Khan v. ITO [ITA No. 1111/PUN/2024, dated 27.09.2024]*
12. *Prasad Vijaykumar Kulkarni v. ITO [ITA No. 850/PUN/2024, dated 17.09.2024]*
13. *Atul Shashikant Garbhe v. ITO [ITA No. 863/PUN/2024, dated 17.09.2024]*
14. *Shrikant Anantrao Zori v. ITO [ITA No. 798/PUN/2024, dated 28.01.2025]*
15. *Parna Vasudevaiah v. ITO [ITA No. 456/PUN/2024, dated 22.05.2025]*
16. *Godavari Vijay Kulkarni v. ITO [ITA No. 1159/PUN/2023, dated 03.04.2025]*