IS HIGHER GRATUITY TO BE PAID RETROSPECTIVELY UNDER THE LABOUR CODES?

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Out of all the changes brought in by the Labour Codes, the ones pertaining to payment of gratuity have perhaps gained the most traction. This is probably because of the financial ramifications which the said changes are set to bring. The first big change comes by way of the components on which gratuity is to be calculated. Under the Payment of Gratuity Act, 1972 ("**Gratuity Act**", hereinafter), the definition of "wages" was such that it included all emoluments which are earned by an employee while on duty or on leave in accordance with the terms and conditions of his employment and which are paid or are payable to him in cash and included dearness allowance but did not include any bonus, commission, house rent allowance, overtime wages and any other allowance. The said definition was interpreted by the Supreme Court in its decision of ***Chairman-Cum- Managing Director Fertilizer Corporation of India Ltd. and Another v. Rajesh Chandra Shrivastava and Others***[1], by placing reliance upon the earlier judgment of ***Straw Board Manufacturing Co. Ltd. v. Its Workmen***[2], to hold that "wages" under the Gratuity Act will mean and include basic wages and Dearness Allowance and nothing else. Even though the Supreme Court in the judgment of ***TI Cycles of India, Ambattur v. MK Gurumani and Others***[3], has indeed held that "basic wages" under section 2(b) of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 is identical with the definition of "wages" under section 2(s) of the Payment of Gratuity Act, 1972, the same was confined to its context and did not lay down any law under Article 141 of the Constitution of India that the principle of "universally, necessarily and ordinarily payable", as laid down in ***Bridge and Roof Co. (India) Ltd. v. Union of India***[4], would be applicable upon the Gratuity Act.

Under Section 53 of the Code on Social Security, 2020 ("**CoSS**", hereinafter), gratuity very clearly will have to be paid as per the definition of "wages" as set out under Section 2(88) of the CoSS. The said definition is wide enough include allowances and other payments beyond basic pay and dearness allowance. This change, obviously, will increase costs for the companies as gratuity will now have to be calculated on a larger base. Recent reports suggest that companies have begun making provisions for payment of an increased amount of gratuity for the upcoming quarters. The Institute of Chartered Accountants of India had also issued clarifications on the accounting practices which are to be followed in view of increase in gratuity related costs.

The second big change is the mandate of payment of gratuity in respect of fixed term employees, which was not at all the case under the earlier regime, in which the five year rule was to be strictly followed. Some pertinent questions regarding payment of gratuity under the Labour Codes, however, still remain to be answered:

A. Do employers need to pay gratuity as per the new definition of "wages" to employees who have been working before 21st November, 2025?

Sub-section (2) of section 53 of the CoSS provides that the employer has to pay gratuity to an employee @15 days' wages for every completed year of service on the last drawn "wages" of the employee. What becomes clear from a bare reading of this provision is that gratuity is to be calculated as per the definition of "wages" under the CoSS. Sub-Section (1) of Section 53 further states that an employee would be entitled to gratuity only on the termination of his employment after he has rendered continuous service for not less than five years. The term "continuous service" has been defined under Section 54 of the CoSS. It would be necessary to reproduce Clause (A) of the said Section:

> "(A) an employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order treating the absence as break in service has been passed in accordance with the standing orders, rules or regulations governing the employees of the establishment), lay-off, strike or a lock-out or cessation of

work not due to any fault of the employee, ***whether such uninterrupted or interrupted service was rendered before or after the commencement of this Code***…."

From a bare reading of these provisions, two things become very clear. First, that gratuity under the CoSS is payable on the last drawn "wages" of an employee. Thus, gratuity is to be calculated on the "wages" (as defined under the CoSS) which the employee has received just before cessation of employment. Secondly, that the period of "continuous service" will take into account the service rendered by the employee even before the commencement of the CoSS. Also, The Ministry of Labour & Employment under its FAQs dated 16.03.2026 has affirmed that gratuity, from 21.11.2025, will have to be paid as per the new definition of "wages".

Therefore, for the employees who had joined an establishment before the enforcement of the CoSS, gratuity will have to be paid as per the definition of "wages" contained therein. It may also be stated that the savings clause under Section 161 of the CoSS will not come into play here as the rights which had accrued to employees before the commencement of the CoSS i.e. payment of gratuity on basic pay and dearness allowance, are not more beneficial to the employees.

B. As higher gratuity is to be paid to the employees already working for us, would that not mean that the liability would be retrospective in nature?

It would not be correct to state that the provisions pertaining to payment of gratuity as per the new definition of "wages" is retrospective application of law. The difference between prospective, retrospective and retroactive law was explained by the Supreme Court in ***Vineeta Sharma v. Rakesh Sharma and Others***[5], which is as follows:

Prospective statute: It operates from the date of its enactment conferring new rights.

Retrospective statute: It operates backward and takes away or impairs vested rights acquired under existing laws.

Retroactive statute: It does not operate retrospectively. It operates in the future. However, its operation is based upon the character or status that arose earlier. Characteristic or event which happened in the past or requisites which had been drawn from antecedent events.

The employees in question were already employed and thus a right has been granted in the present based on an event (employment) which had happened in the past. The application of the gratuity related provisions is retroactive and not retrospective in nature.

C. Payment of gratuity under the CoSS would be contingent upon the Rules as the Draft Central Rules provide that certain components would be excluded for the purposes of calculating gratuity. So, no gratuity is to be paid till the Rules are enforced?

Please note that unlike PF and ESI, payment of gratuity is not dependent upon any Scheme or Rules or Regulations. Gratuity has to be paid as per the substantive provisions of law, which are not dependent upon the rules. It has been held by the Hon'ble Supreme Court in ***Union of India and Others v. Alok Kumar***[6]***,*** that delegated legislation cannot operate to the prejudice of the substantive provisions of law.

The question of whether payment of gratuity as per the definition of "wages" under the Codes is dependent upon the Rules would not require much consideration. Even though the draft Rules framed by the Central Government have not been notified yet, a perusal of the same would be necessary. Chapter V of the draft Rules deals with gratuity. The only Rule which can serve as an impediment towards immediate payment of gratuity as per the definition of "wages" under the Codes is rule 34 of the draft Rules. The same lays down the manner in which the application for payment of gratuity is to be made by the employees and the manner in which the same is to be responded by the management. It also provides the manner in which the employee is to approach the competent authority for instituting gratuity claims against the employer.

The Rules do not hinder payment of gratuity as per the substantive provisions of the Code as *first*, the provisions under the draft Central Rules pertaining to the mode and manner of making the application and payment are *pari materia* to the ones specified under the Payment of Gratuity (Central) Rules, 1972. Section 164 of the Code provides that the Rules under the repealed laws will continue to remain in force till the time they are replaced by the new rules. As stated above, the matters provided for under the draft Central Rules pertaining to gratuity are procedural in nature and do not hinder substantive rights. It

has been held in countless judgments, such as that of ***Municipal Corporation of Delhi v. Narender Kumar Aggarwal***[7], that it is not necessary for the employee to make an application for the purpose of payment of gratuity and the employer is statutorily bound to do so on its own.

Second, the only hindrance to the substantive provisions of the Code which may be caused by the Rules is the manner in which the explanation to clause (a) to sub-rule (2) of Rule 34 is framed. It provides that any payment payable on "*an annual basis, that is linked to performance or productivity of an employee or of the establishment in which he is employed and is not part of the remuneration payable under the terms of employment"* and would be an exclusion. Such payments, however, will be considered for the 50% add back rule for the purposes of calculating gratuity.

Other payments such as "*reimbursement of medical expenses; stock option benefit or cash equivalent of stock award; crèche allowance; telephone and internet reimbursement; and value of meal vouchers*" will not be considered as "wages" for gratuity. They are not to be considered for the purposes of the 50% add back rule for the purposes of gratuity. Even the answer to the 3rd FAQ is in line with the draft Central Rules and states that performance based incentives, Employee Stock Option Plans (ESOPs), variable part of the component or reimbursement-based payments to the employee shall not be part of the wages.

While this does affect the substantive provision, it would still not mean that it would override the substantive provision. This is even more so because the said explanation reduces the liability of payment of gratuity by excluding certain payments from the ambit of the definition of "wages".

D. For the Fixed Term Employees, do we have to pay gratuity on a pro rata basis or only after completion of one year?

The draft Central rules under the CoSS specify that an employee on fixed term employment will be eligible for gratuity, if he renders service under the contract for a period of at least one year and for subsequent period in excess of six months and more, but less than one year, shall be rounded off to one additional year. The Draft Rules of the States do not seem contain such a rider. However, the bare text of the CoSS, under Section 53 states that gratuity for fixed term employees will have to be paid on a pro rata basis. No qualification period of one year is provided therein. The Industrial Relations Code further states that a fixed term employee would be eligible for gratuity if he renders service under the contract for a period of one year. Even though there is a conflict to some degree, it would be appropriate to read both the laws harmoniously. The pro rata payment related provisions should only kick in once the fixed term employee has rendered a service on year. This interpretation is further accentuated by the clarification given by the Central Government under its draft rules.

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1. *2022 SCC Online SC 417.*
2. *1977 (34) FLR 269 (SC).*
3. *(2001) 7 SCC 204.*
4. *1962 (2) LLJ 490 (SC).*
5. *(2020) 9 SCC 1 (SC).*
6. *2010 (125) FLR 1015 (SC).*
7. *2007 (115) FLR 1148 (Del. HC).*