

Labour codes: Gratuity, leave encashment get a boost, maternity payout doesn't

Shipra Singh

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The four new labour codes—the Code on Wages, the Industrial Relations Code, the Code on Social Security, and the Occupational Safety, Health, and Working Conditions Code—aim to bring greater uniformity and clarity to salary structures.

However, the codes, notified on 21 November, also mean a mixed bag of outcomes for employees. While some statutory benefits, such as gratuity and leave encashment, are expected to increase, strengthening long-term financial security, certain allowances, including maternity benefit payouts, may shrink.

Under the new codes, the definition of 'wages' has been standardized to include basic pay, dearness allowance (DA), and all other allowances unless specifically exempted. More importantly, at least 50% of an employee's total cost-to-company (CTC), including these components, must be used to calculate social security benefits.

A company doesn't need to increase basic pay to 50% of CTC to comply with the new definition of wages, according to Preeti Chandrashekhar, an independent employee benefit consultant and actuary. "The labour codes have introduced deemed wages for the calculation of social security provisions."

The Code on Social Security also identifies exclusions such as house rent allowance, bonus, conveyance allowance and commissions, which will not be counted as 'wages' for social security calculations.

The new wage definition mainly impacts the calculation of gratuity and leave encashment. This is how you can expect payouts towards different social benefits to change.

Calculation of gratuity

While the Payment of Gratuity Act, 1972 (PG Act), has been repealed, the provisions from this law have been replicated in the Code on Social Security without any change, except in the definition of 'wages', said Atul Gupta, partner labour and employment practice, law firm Trilegal. "So, the formula to calculate gratuity and tax rules on it is the same," he added.

The formula to calculate gratuity is: last drawn wages x (15/26) x number of years of service.

Akhil Chandna, partner, global people solutions leader, business consulting firm Grant Thornton Bharat, explained that last drawn wages refer to the wages as defined in the new labour codes, and 26 is the average number of working days in a month used to calculate 15 days of salary. "For the number of years of service, completed years of service are rounded off to the nearest integer."

Let's understand with an example. You leave a company after six years, with your CTC comprising basic pay of ₹3 lakh and special allowance of ₹7 lakh. Earlier, with only the basic pay of ₹3 lakh (₹25,000), you would get $(25,000 \times (15/26) \times 6)$ or ₹86,538 as gratuity.

Now, both basic and special allowance (₹50,000 per month) will be considered, considerably increasing the gratuity payout to $(75,000 \times (15/26) \times 6)$ or ₹2.7 lakh.

Moreover, for employees receiving a higher gratuity amount than the statutory minimum, the tax-free portion of the payout will also increase.

There is a common misunderstanding that the entire gratuity amount up to the ₹20 lakh cap set by the government is automatically tax-free. Your tax-exempt gratuity amount is the lowest of a) the eligible gratuity calculated using the statutory formula b) actual gratuity paid to you, and c) ₹20 lakh. So, where the employer pays more gratuity than the eligible amount as part of its employee benefit policies, the excess amount over and above the eligible gratuity is not tax-free.

"The exemption is limited to the gratuity computed according to the statutory formula, subject to the overall cap of ₹20 lakh. Any gratuity paid in excess, whether due to CTC structuring, employer policy or any other reason, would be treated as ex-gratia and fully taxed at slab rates," said Sandeep Jhunjhunwala, partner, professional services firm Nangia & Co. LLP.

In the above example, if a gratuity of ₹50,000 was also part of the fixed components in the CTC. Over six years, it adds up to ₹3 lakh. So, out of the ₹3 lakh, ₹2.7 lakh will be tax exempt, whereas the remaining ₹30,000 will be taxed at slab rates.

If the same employee had received gratuity before 21 November, only ₹86,538 would have been tax-exempt, and the remaining ₹2.13 lakh would have been taxable. This means employees receiving gratuity after 21 November on a retrospective basis will benefit from both a higher payout and a larger tax-free portion.

It should be noted that paying gratuity over ₹20 lakh is upto the discretion of the employer.

Higher leave encashment

Leave encashment allows an employee to receive monetary compensation in exchange for their unused, accrued paid leave days. Under the new labour codes, a uniform limit on the number of leaves that may be carried forward and encashed is introduced.

"A worker earns one day of leave for every 20 days of work, as long as they have worked at least 180 days in a year. They can now carry forward up to 30 days of unused leave and anything above this must now be paid out every year," said Jhunjhunwala.

This brings in uniformity as compared to the current framework, where states prescribe varying thresholds and, in many cases, allow encashment only upon separation, said Vaibhav Bhardwaj, partner at corporate law firm Khaitan & Co.

Leave encashment is usually calculated based on the employee's last drawn wages. In line with the changed wage definition, the wage used for calculating leave encashment will increase for many workers.

For example, if someone earlier had a wage base of ₹20,000 per month and encashed 10 days of extra leave, they would have received around ₹6,667. After their wage structure is updated to meet the new rules, if the wage base rises to ₹30,000, the next 10 days of leave will fetch about ₹10,000. This means workers will get a higher amount both during annual encashment and when they leave the company.

Bhardwaj pointed out that these rules apply only to 'workers', that is people doing manual, technical, operational, clerical or sales-related jobs, and even journalists below a set wage level. "Employees performing purely managerial or administrative functions or employed in supervisory capacity drawing monthly wages exceeding ₹18,000 do not qualify as 'worker'," he said.

Maternity benefits

As an unintended consequence, the new wages definition could impact maternity benefit payout. As per the law, maternity payout is calculated on the 'average daily wage', and the wider list of exclusions, such as HRA, LTA, bonus, and certain other allowances, could reduce the net payout. Under the earlier Maternity Benefit Act (MBA), fewer components were excluded, resulting in a higher wage base for calculation, Jhunjhunwala pointed out. "HRA, LTA, and Special Allowance were not part of specified exclusions under MBA 1961. With these excluded, the wage base and consequently, the maternity benefit amount compared to the earlier regime may decrease," he said.

Despite technically being valid, experts believe it may not happen in practice. Tarun Garg, director, consulting firm Deloitte India, said there could be some legal debate over the interpretation of wages, but such arguments are unlikely to hold because the law clearly aims to preserve existing maternity protections.

"There's a section from the erstwhile Employees Provident Funds and Miscellaneous Provisions Act that says that employers cannot restructure the compensation structure to reduce their own liability. This section has a wider implication under the Code on Social Security, including the maternity benefit payout as well. Reducing benefits would go against the intent of the law," he said.

Jhunjhunwala added that the impact is subject to the final rules to be released by the Centre and the state governments. Given the spirit of the code and also the calculations of statutory benefits that's on at least 50%, it remains to be seen if the benefits would indeed go down.

Provident fund contributions

Provident fund contributions will not change for most employees under the new labour codes. Garg explained though the Code on Social Security links PF contributions to the new definition of wages, the government has not yet notified the relevant section, which means the existing EPF Act remains operational.

The current salary ceiling of ₹15,000 remains in force. Even employees with a basic salary above this limit will continue contributing 12% of their basic pay, according to Puneet Gupta, partner, people advisory services-tax, consulting firm EY India.

For example, if someone earns a basic salary of ₹25,000, both the employer and employee will still contribute ₹3,000 each. "Any change can occur only if the government issues new rules, and for now the only potential impact is on employees earning below ₹15,000, where PF must be calculated on wages beyond basic pay, as clarified by the Supreme Court in the Vivekananda Vidyamandir ruling," said Garg.

The actual impact, however, on your in-hand salary—and PF, leave encashment, and maternity benefits—will be clear once the government notifies new rules to clarify ambiguities.