Winter Finance Bill: Termination payments and disguised remuneration

Employment Tax

01 December 2017

In September 2017 the government published draft clauses for the Finance Bill which will be published in December 2017, known as the Winter Finance Bill, along with accompanying explanatory notes, tax information and impact notes and other supporting documents. The CIOT commented on a number of these.

Termination payments: removal of the Foreign Service Relief (FSR) for UK residents

The government is proposing to remove Foreign Service Relief (FSR) with effect from 5 April 2018 (except for seafarers). The CIOT commented on the draft legislation proposed for the Winter Finance Bill, which will apply in respect of payments made on the termination of an individual's employment where the payment relates in full or in part to a period of non-UK residence, and the individual is UK resident in the tax year the payment is received.

The CIOT is concerned that if the termination payment rules do not follow the same sourcing rules as apply to general earnings, there will be an incentive created to pay sums as bonuses rather than termination payments in some cases.

The CIOT has previously raised concerns about the interaction of the removal of FSR on termination awards and the rules normally applied to attribute general earnings between UK and non-UK duties, and we remain concerned that the net result of removing FSR without replacing it will be that a termination award made to an individual that has largely worked overseas but ends his/her employment in the UK

will be taxed more heavily than a ‘normal’ bonus.

For example, an individual works 19 tax years outside the UK when non-resident and one tax year at the end of the employment in the UK when UK resident. The employment is terminated and a £40,000 termination award under Income Tax (Earnings and Pensions) Act 2003 (ITEPA) section 401 (payments and benefits on termination of employment) is received. Under the existing rules there would be full FSR. Under the new rules there will be no FSR with £10,000 taxable under section 401 after accounting for the £30,000 exemption.

Compare this situation to that of an assignee returning to the UK and then receiving a bonus for past services. This would be taxable as earnings under ITEPA section 62 and sourcing rules would mean that, using the above example, the bonus would be apportioned over the 20 years and as 19/20ths are attributable to non-UK duties, on a just and reasonable basis, only 5% or £2,000 would be taxable in the UK.

We have, therefore, suggested that the government reconsiders its approach to the taxation of termination payments where an individual has previously worked extensively outside the UK as, otherwise, if termination payments do not follow the same sourcing rules as apply to general earnings, there is an incentive created to pay sums as bonuses rather than termination payments in some cases.

The full CIOT response can be found on the CIOT website.

Employment income provided through third parties (disguised remuneration)

The CIOT has also commented on the draft legislation which would introduce a new ‘close company gateway’ (CCG) into the ‘disguised remuneration’ rules. The CIOT believes that, as drafted, the gateway could act as a general anti-avoidance rule for close companies and thus apply to transactions that are not employment tax avoidance.

The introduction of the proposed CCG has been deferred from 6 April 2017 to 6 April 2018. While the deferral is welcome the CIOT nevertheless remain concerned that the CCG is too widely drafted. The aim of the CCG is stated to be to target employment income avoidance by close company owners. However, for example, draft section 554AA (1)(c), which will be included in ITEPA if the legislation is

enacted, extends to, inter alia, income tax avoidance and is not restricted to employment income so, in our view, the ambit is much wider. Hence, we believe that the CCG could potentially apply to ordinary commercial transactions and other transactions that are not employment income tax avoidance.

The CIOT has, therefore, suggested that if employment income tax avoidance is the target of the CCG, an alternative and simpler approach would be to introduce a rebuttable presumption that the rewards, payments or loans are in connection with employment. It would then be for the individual concerned to demonstrate that this is not the case by setting out their evidence to this effect.

We have also raised concerns that the proposed new tax avoidance test at section 554AA is too widely drafted and in practice could act as a general anti-avoidance test for close companies. In addition, we have raised a number of concerns with the operation of the 'material interest' rules, especially where close company shares are settled on trust.

Lastly, an obligation on employees and former employees is being introduced to report additional information on loans on which a loan charge arises (or would have arisen) on 5 April 2019, to HMRC by 1 October 2019, unless a full and final settlement has been reached with HMRC before then (or the loans to participators regime takes priority over the disguised remuneration rules). While HMRC has said it will contact all individuals it is aware of to inform them of their obligation, how effective this will be remains to be seen.

The full CIOT response can be found on the CIOT website.