Termination payments

Employment Tax | Tax voice



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Eleanor Meredith brings us up to date on the complex changes and the administrative burdens

This article is intended as a summary of the reform of the termination payments law that is to apply from 6 April 2018. As such, it builds on Mark Groom's article published in the March 2017 edition of Employment Taxes Voice and uses many of the concepts introduced there.

Although the reform of the law has been subject to a lengthy consultation period, the lead time between confirmation of the final law and its application (at least for

income tax) is frustratingly short. The date originally suggested for the reforms to apply remains their operative date for income tax, despite outstanding concerns, especially in relation to the foreign service relief (FSR) law. It may be understandable that the Government is unwilling to defer law that will be revenue raising, but the timeframe feels tight and the degree of Parliamentary scrutiny applied inadequate.

It should also be noted that despite originally being badged as simplification, this reform of law is likely to complicate matters for employers, partly because of additional complexity in the law, and partly because of changes to the original timetable and proposals. The final changes are now being introduced with two effective dates, with the employer's NIC charge on qualifying termination payments in excess of £30,000 being deferred until 6 April 2019 because of a delay to the NIC Bill. While the extra time to allow for an update to payroll systems will no doubt be welcome, the change in timetable is likely to cause further confusion about when and how the reformed law is to apply.

Summary of changes

The final law enacted is similar in concept to the draft law considered in last year's article, in that employers will still need to consider what amounts have to be taxed as "post- employment notice pay" (PENP), although some improvements have been made to the definitions used.

The law relating to foreign service relief (FSR) has been finalised in F(No 2)B 2017 and will be enacted in March 2018. Although narrower in scope than at present, it can continue to apply to non-residents and to UK resident seafarers who meet certain criteria. Crucially, however, the updated law does not allow FSR to apply in a split year situation, other than for seafarers, as the individual will be UK tax resident all year. This is likely to lead to a significant number of claims to relief under a double tax treaty, most commonly where the individual comes to the UK in such a way as to become UK tax resident, after receiving a termination payment during an overseas part of the tax year.

There also appears to be a drafting error in the FA 2017 law relating to the PENP, as under one of the consequential amendments, any amounts taxed as PENP are treated as general earnings, without any corresponding change to remove these from the definition of specific employment income. So such payments will be both

general earnings and specific employment income, despite these terms being defined and used quite separately in ITEPA 2003. In practice, this may affect few taxpayers overall, but it is likely to matter to any individuals claiming UK tax relief for employer contributions to relevant non-UK pension schemes, as it will distort the fraction that is applied to determine how much of the pension contribution counts as pension input for the tax year concerned.

More detail on the updated F(No 2)A 2017 law

As noted above, the key concepts of relevant termination awards (RTA) and post-employment notice pay (PENP) have been retained.

A “relevant termination award” (RTA) is defined by s402C(2), essentially as a termination award which isn’t a statutory redundancy payment (or so much of an approved contractual payment limited to the amount that would be due if a redundancy payment had been payable). Once both RTA and PENP have been determined, the law applies so that where the PENP is greater than or equal to the total RTA, the whole RTA will be earnings under s402B; but if the PENP is less than the total RTA, only the PENP will be treated as earnings under s402B. The underlying aim of the law is to tax the payment that is calculated as earnings, rather than allowing it to benefit from the reliefs that have previously applied to all qualifying termination payments. As might be expected, though, the devil is in the detail of the formula and how it is likely to apply in practice.

PENP is calculated by s402D, using the formula:

$$\frac{(BP \times D)}{P} - T$$

Where

BP = basic pay in respect of the last pay period ending before the trigger date. If there is no pay period between the start of employment and the trigger date (see below), both BP and P are measured from the start of the employment to the trigger date

D = the number of days in the unworked notice period

P = the number of days in the last pay period, rather than 365 days which was the denominator in the previous iteration of the law

T = the total of the payments and benefits made in connection with the termination of employment that are taxable as general earnings, but excluding any accrued holiday pay or termination bonus.

There are a number of improvements compared to the previous version of the law but also a number of areas that remain a challenge.

The definition of basic pay now excludes any commission, overtime, bonus or allowance, and various other irregular payments, such as amounts paid as sick pay and share awards taxed as specific employment income; but it is not clear what is meant in all cases (how “allowance” is meant to be defined being one obvious example). In addition, the definition requires any amounts that have been salary sacrificed to be added back to arrive at basic pay. Although it will still be possible for employees to waive part of a termination package in return for an employer pension contribution, without this affecting the PENP calculation in any way, care is needed to ensure that any tax consequences are fully understood, especially in terms of the individual’s Annual Allowance capacity. (In contrast, note that if part of basic pay is waived, this will have to be added back when calculating BP in the PENP calculation).

A further improvement is made to the calculation by s402D(6), which provides that if the minimum contractual notice period, the last pay period and the post-employment notice period are all a whole number of months, the formula should be solved using whole numbers of months, taking P as 1 and D as the number of whole months in the post-employment notice period. This is considerably better than the previous draft law which, as it also applied based on the number of days, caused inadvertent and inappropriate variations in the calculation, depending on the date on which the termination of employment fell and which months formed part of the post-employment notice period.

Finally, in terms of amendments to the detail of the component elements, item “T” is much more tightly defined as anything that is taxed as general earnings in connection with the termination of the employment, other than either accrued holiday pay, or any form of terminal bonus. The previous version of the law allowed a deduction for any payments or benefits made in connection with the termination of the employment, regardless of how they were taxed, so that even payments such as

those for restrictive covenants that are taxed as specific employment income could have been deducted for the calculation from a payment in which they were not included. While this might have been a favourable outcome for the taxpayer it was effectively allowing relief for types of payments that did not necessarily bear any relation to the notice period. If the intention in deducting T is to avoid any particular item being taxed twice, the law as it is now drafted is far more equitable.

The law around the trigger date and earliest lawful termination date remains hugely complex, however. The trigger date will depend on whether or not notice has been given to terminate the contract and in some cases will determine the earliest lawful termination date. Further complexities can arise in establishing the earliest lawful employment date, especially in the case of fixed term employment contracts. Typically, we might expect a contract to be terminated by notice being given; as the trigger date will always be the date on which notice is given in this case, establishing the last pay period before the trigger date, the amount of pay and the pay period concerned will be straightforward in a lot of cases. Accordingly, no further analysis of the more complicated situations is considered here, but that does not mean they do not have the potential to cause real difficulties where they arise in practice.

Foreign service relief (FSR)

The draft law released as s10 Finance Bill (no 2) 2017 will not come into force until 6 April 2018, but is likely to be enacted early in 2018. The law itself is narrower in scope than was originally envisaged in that foreign service relief (FSR) is not simply abolished from 6 April 2018 but instead will apply much more narrowly than it now does, so that no UK tax residents, other than seafarers, may continue to benefit from it from 2018/19 onwards.

As now drafted, the changes in law are consistent with the restrictions placed on FSR for lump sums drawn from non-UK pensions that are paid to UK tax residents, applying from 6 April 2017, with one exception. In the overseas pensions provisions, where the pension lump sum is attributable to non-UK service prior to 6 April 2017, FSR may continue to apply to the extent that entitlement to the lump sum had accrued prior to that date. In other words, FSR for pension lump sums paid to a UK tax resident is withdrawn from 6 April 2017 only, whereas for termination payments it is withdrawn in its entirety from 6 April 2018 for all UK resident taxpayers, other than seafarers.

The law itself is quite simple and extends to only a little over two pages of draft law, more than half of which is devoted to new provisions applying to UK resident seafarers from 6 April 2018. The only other substantive change, apart from the revised scope that will limit the circumstances in which UK tax residents may benefit from FSR, is a really clear cut-off date. S10(5) is specific that this change in law can apply only to benefits and payments received after 13 September 2017 and where the employment is terminated on or after 6 April 2018.

This contrasts with the wider termination payments law, which can only apply to payments made or benefits provided on or after 6 April 2018, but which does not appear to be limited quite so categorically to situations where the employment ceased on or after 6 April 2018. However, HMRC has since confirmed its intention to only apply the new rules where the termination date and payment date are both after 6 April 2018, and guidance should be issued shortly confirming the approach to be taken.

One caveat to add to the above, is that the law we all think of as relating to termination payments can also apply, at least in theory, to payments made in connection with a change in the duties of a person's employment, or a change in the earnings from a person's employment, and in this case FSR can in principle continue to apply for UK tax residents. However, in practice, the Courts have consistently held, most famously in Hamblett v Godfrey, that such payments fall within the general earnings charge which takes priority over the law relating to termination payments. It is, therefore, difficult to envisage a situation where this is likely to apply.

For seafarers, two new clauses are added, s414B and s414C that cater for full and partial FSR respectively. Full FSR will apply where the seafarer's foreign earnings comprised:

(a) three-quarters or more of the whole period of service ending with the date of termination, or

(b) if the period of service exceeded 10 years, the whole of the last 10 years, or

(c) if the period of service exceeded 20 years, one-half or more of that period, including any 10 of the last 20 years.

Where conditions for full FSR are not met, relief may apply pro rata so that FSR applies to the proportion of service out of total service that qualifies for the seafarer's foreign earnings deduction. The definition of foreign service for s414B and s414C is narrower than that in s413 and s414, which allows taxpayers to combine tax years of non-residence with tax years qualifying for a full foreign earnings deduction. For s414B and 414C only tax years for which a full foreign earnings deduction applied are counted.

FSR – Split year issues

The most significant issue for non-seafarers is the absence of any split year provisions. This may seem quite sensible in the context of someone who is UK tax resident at the beginning of the tax year, but during that year has his UK employment terminated and takes up full time employment abroad. Even were he to move abroad before the employment formally ended and to receive the payment while in the overseas part of the tax year, it would seem reasonable for the UK to regard the payment as a UK termination payment. There is, accordingly, some rationale for denying FSR in these circumstances, although that situation might have been managed better by a targeted anti-avoidance rule.

It is less easy to see a justification for denying FSR in a situation where an individual comes to the UK, possibly for the first time ever, to work, having received a termination payment in his home country before moving to the UK. Under SRT, assuming such an individual has more than 45 days in the UK in the tax year concerned, it will be very easy for him to become UK tax resident, especially if he meets the test for full time working in the UK. In this case, even though the termination payment was received in the overseas part of a split year, and the underlying employment was nothing to do with the UK, the individual is denied FSR because he is misguided enough to establish UK tax residence during the same tax year.

This outcome feels particularly bizarre in the context of how any general earnings payment from such an employment would be treated. Assuming that the individual had no UK duties in the overseas part of the year, any general earnings payment, including a terminal bonus, would be wholly outside the scope of UK tax. Obviously the tax treatment of a payment is driven by its character, rather by what it is called, but one might imagine a certain amount of planning being done to avoid having a termination payment in this situation. However, this will only be possible, if the

individual knows prior to the termination of his employment that he is likely to be coming to the UK subsequently and needs to plan accordingly.

HMRC's response in consultation was largely that double tax treaties would resolve the potential double taxation issues. There may be circumstances where they do so, but this will not be universal, particularly if the individual was previously tax resident in a non-treaty country such as Brazil. Even where there is a treaty that has the potential to apply, the extent to which it will help will depend on how both the contracting states apply the treaty to the situation in hand. So far HMRC has yet to issue any commentary on the updated OECD Model commentary of July 2014 that indicated that most termination payments would fall within the employment income article. This is urgently needed, as is some further consideration of the sorts of positions employers are likely to face where individuals come to the UK to work, having had an employment terminated in the overseas part of the tax year.

Some employees, who have more of a connection to the UK, may realise the danger in becoming UK tax resident later in a tax year and choose to defer the date of their return until after the next 6 April. Equally, those who have not had much connection to the UK previously may not realise there is anything to declare on any termination payment received before their arrival, so may come to a more reasonable (if incorrect) answer by default and simply not report anything. However, clients who are professionally advised will find themselves in a difficult position, as their advisers will have to remind them of the reporting obligations. This is likely to be particularly tricky if there is no treaty position that might mitigate the effect of UK domestic law, so that affected individuals are left with a UK tax charge on a payment that was wholly unrelated to UK service.

Employer's NIC charge on termination payments in excess of £30,000

There has been much debate about whether the employer's NIC charge on qualifying termination payments would be a Class 1 employer only or Class 1A (which always is an employer only) charge. It was confirmed in the December 2017 edition of HMRC's Employer Bulletin that it will be a Class 1A charge and that it will be deferred until 6 April 2019.

It is assumed, although it is still not entirely clear, that this Class 1A charge will have to be returned to HMRC as part of the regular RTI submission for the month in which

the termination payment takes place. This is likely to necessitate substantive amendment to payroll software and systems that are currently designed to support annual submissions in respect of Class 1A NIC some three months after the end of the tax year. In the circumstances, despite the confusion the deferral is likely to create, it has to be welcomed as allowing some opportunity for all the revisions likely to be required.

Discussions with HMRC suggest that the law applying Class 1 NIC on any PENP that is reclassified as general earnings is still expected to apply from 6 April 2018, despite the deferral of the National Insurance Bill. It is assumed that the intention is to impose the charge by means of Statutory Instrument as no legislation has been released, at least at the time of writing.

Conclusions

It is disappointing that the outcome of the reform of this law is not just further cost for employers, but also additional complexity and an administrative burden. In a lot of cases, the improved PENP formula may allow employers who routinely tax PILON to continue to do just that without going through the PENP calculation, but care will be needed wherever any salary sacrifice is involved. For employers of internationally mobile executives the challenges are likely to be even more significant.