

# Clear waters

Employment Tax

OMB

Personal tax



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*Stephanie Symonds-Dye and Gareth Peyton* consider the tax treatment of payments on termination of employment

## Key Points

### What is the issue?

HMRC published draft legislation on 5 December 2016 outlining changes to the tax and National Insurance treatment of termination payments from 6 April 2018. This included the implementation of employers National Insurance on qualifying termination payments in excess of the £30,000 exemption, changes to the treatment of payments in respect of unworked periods and the abolition of foreign service relief for internationally mobile employees.

### What does it mean to me?

An additional 13.8% employer National Insurance charge on excess qualifying payments will mean a significant increase in the cost to the employer of terminating more highly paid or long serving employees. Employers will however have more certainty around the tax treatment of payments made in respect of unworked periods, meaning there will no longer be a requirement to review the contractual position of such payments.

## **What can I take away?**

The draft legislation makes some fundamental changes with effect from the start of the 2018/19 tax year, but it will not herald the dawn of a new era of clarity. The changes will in many cases create more cost for employers and employees, therefore it is more important than ever for employers to consider how they are structuring overall termination packages.

The tax treatment of payments on termination of employment has long been a topic of interest for employers, and it is often an area of taxation that employers get wrong. This for the most part is due to the status of the termination payment rules as the charge of last resort which means it is first necessary to determine whether a payment is from the employment or taxed under another part of the law. Only payments that are not from the employment and that are not taxed under another provision fall within the special tax rules for termination payments.

In the Technical section of November's edition of the *Tax Adviser* we heard from Joanne Walker about HMRC's plans to 'simplify' the tax and National Insurance treatment of termination payments. As expected, the Chancellor confirmed in the Autumn Statement that changes would be made with effect from 6 April 2018 and the draft law was released on 5 December 2016. Whether or not these draft changes represent a simplification is debatable.

## **Qualifying termination payments**

In order for a payment on termination of employment to be within the special charging rule at ITEPA 2003 s 403 the payment must not be taxable as earnings from the employment and must not be subject to income tax under any other provision.

If s 403 applies, the first £30,000 is tax free. If the total of all payments taxable under s 403 exceed the £30,000 threshold, the excess is normally subject to income tax at the employee's marginal rate and PAYE withholding must be operated. Currently, no National Insurance (employee or employer's) is due on payments taxable under s 403.

Some employers will get this wrong and assume the £30,000 exemption applies to all termination payments without first considering whether any other taxing provision applies in priority. It is important for employers to ensure the total termination package is reviewed in its constituent parts, as each part of the termination package may attract a different tax or National Insurance treatment and the conclusion that s 403 applies should be arrived at via a process of elimination through which other income tax charges are ruled out. Payments to which an employee could be said to have a contractual entitlement from the employment will normally be taxed as earnings, but this rule leaves considerable scope for uncertainty.

## **Changes to come in 2018**

The draft law confirms that from 6 April 2018 termination payments taxable under s 403 will be subject to Class 1A employer National Insurance to the same extent they are charged to income tax (so generally employer National Insurance will apply to the amount in excess of £30,000). This change removes the main benefit of having payments over £30,000 taxable under s 403. There will continue to be a National Insurance benefit for the employee, but in the majority of cases this is likely to only represent a 2% saving.

The additional 13.8% employer charge will mean a significant increase in the cost to the employer of terminating the employment of more highly paid or long-serving members of staff. Furthermore, it will create an additional administrative burden on the employer to ensure Class 1A National Insurance is paid on the appropriate amount at the appropriate time. At present, Class 1A National Insurance is payable by 22 July following the end of the tax year but the government has suggested that it will expect this new Class 1A National Insurance to be paid in 'real time' with the Class 1 National Insurance for the period in which the termination payment is paid. This is unusual. Employers should check that their payroll will be capable of operating employer only National Insurance on such payments.

## Payments in lieu of notice

Payments for unworked notice periods have typically required more consideration when determining the appropriate tax and National Insurance treatment.

Under the draft law, from 6 April 2018 payments in lieu of notice will be taxable as earnings, and subject to income tax in full and Class 1 (employee and employer) National Insurance, regardless of whether they are contractual or not. The question of whether the payment comes from the employment or is instead compensation for the loss of employment will no longer be relevant. Instead the law will prescribe a method for treating payments on termination that would otherwise be taxable under s 403 as being earnings, to the extent the employee has not received amounts at least equal to basic pay for their contractual notice period.

Although this may disappoint some individuals who under the current rules might have benefited from a tax or National Insurance saving, this change removes the anomaly of different treatments for what are ostensibly the same types of payment to different employees in varying circumstances.

During the consultation on these changes HMRC suggested irregular items of income (such as bonuses and commission) should be considered when calculating the new deemed payment in lieu of notice. From a practical perspective this would be difficult for most employers to calculate and administer as a detailed review of each employee's current and future earnings position would likely be required. It could also become extremely subjective thereby defeating one of the stated aims of the law changes.

It came as a relief to most when HMRC confirmed the element of termination payments that are to be treated as payment in lieu of notice (and taxed as earnings) would be calculated by reference to basic pay only. This means irregular items of income will not factor into the calculation, so if employers wish to include in the calculation of a payment on termination an amount to reflect the lost opportunity to earn irregular sums, there will still be scope for such payments to qualify under s 403 for the £30,000 exemption. More than ever it will be important for employers to consider how they are structuring their overall termination packages. It will be worthwhile establishing at an early stage what the basic pay for any unworked notice period will be.

# Foreign Service Relief

If an individual has lived or worked overseas during their employment, payments taxable under s 403 can benefit from either partial relief or complete exemption under the provisions at ITEPA 2003 ss 413 and 414. These provisions are well established for internationally mobile workers, and offer an equitable allocation of taxing rights to the UK for payments on termination of employment that are not obviously sourced to any particular period given they are not earned. This helps to avoid or mitigate double taxation issues.

It is somewhat surprising therefore that the draft law abolishes foreign service relief on termination payments from 6 April 2018 with no grandfathering. Only an extremely limited exemption will remain for employees who have never lived or worked in the UK during the employment. The fact that this exemption is needed at all highlights the lack of any clear territorial limit to the scope of charges under s 403. Logic might suggest that a payment from an overseas employer to a non-UK resident employee who has not worked in the UK during the tax year should not be within the scope of UK tax unless it is sourced to another period. Payments on termination that are taxable under s 403 are not typically going to be sourced to any particular period given they are not earned income. So the question arises as to precisely what the limits are on the territorial scope of s 403 in the absence of any specific provision in the law. The new exemption might suggest that only employees who have never lived or worked in the UK are outside the scope, but in reality it is unlikely HMRC could enforce a UK charge under s 403 in respect of an employee who has not lived or worked in the UK in the tax year of termination and who is employed by an entity with no UK presence.

If the changes mean that the ability to claim relief from UK tax on termination payments for foreign service will no longer be available under domestic law, then instead individuals will have to rely on double taxation agreements or unilateral UK credits to mitigate double taxation. For most individuals, avoiding double taxation will be a challenge without the support of an expatriate tax advisor.

Strong representations have been made to HMRC in respect of these international aspects of the termination payment changes. Perhaps this will lead to changes so that the final law can provide greater clarity and fairness for internationally mobile employees.

## Summary

Termination payments have for some time now proven to be a hotbed of uncertainty due to the way the various charging rules interact and the difficulty in categorising the components that make up the termination package. The draft law makes some fundamental changes with effect from the start of the 2018/19 tax year, but as currently drafted it would not herald the dawn of a new era of clarity. The changes will in many cases create more cost for employers and employees. A cynic might question the real motive behind the changes, but given 18 months ago the consultation mooted a substantial reduction in the £30,000 exemption perhaps the overall package of changes isn't too unreasonable. That is unless you are an internationally mobile employee.