

Taxation of Termination Payments: Recent Developments

There are several changes being made to the taxation of termination payments; Donna Sharp, a director in KPMG's Employment Legal Services team and Mike Lavan, a director and employment tax specialist in KPMG's Employer Reward Services team, take a look.

Background

While the government aims to simplify the system, recent parliamentary debates and the announcement of the deferral of the National Insurance Contributions Bill have complicated matters.

In this article we look each of the slated changes to consider where they currently stand and outline what is left to do.

Recap

The changes to the taxation of termination payments have followed a winding road. It was back in 2015 when HMRC first issued its **consultation** on whether change was merited. But the issue had, in effect, been live since 2014 when the Office of Tax Simplification issued its **report** on employee expenses and benefits, which considered termination payments among other areas.

Legislative changes were first announced at Budget 2016. Draft legislation was published later that year. However, one of the key areas of contention regarding the draft legislation was the abolition of Foreign Service Relief in certain scenarios.

In response to stakeholder feedback, the government subsequently announced that the changes to FSR would be deferred for further consultation. The other termination payment reforms were included in the Finance Bill 2017-19, published on 8 September 2017 and due to receive Royal Assent in November 2017. On 2 November 2017 it was announced that the main NIC change, the imposition of an employer-only NIC charge on termination payments in excess of £30,000, would be deferred by a year.

Why are changes being made?

The 2015 consultation document listed the following as reasons for contemplating change:

- To provide certainty for employees and employers on the tax and NIC treatment of termination payments;
- To simplify the current rules;
- To ensure that rules are fair and not open to "abuse or manipulation"; and
- (less clearly stated but there nevertheless) to ensure that the Exchequer does not lose out.

It is debatable whether the changes achieve any simplification (certainly from an employer's perspective). That said, the Spring Budget 2017 (table 2.2) shows that the changes will yield £1.65 billion to the Exchequer over the next five years. No doubt, further yield is anticipated thereafter.

What are the changes?

Changes are being made in the following areas:

- Non-contractual pay in lieu of notice (PILON);
- Employer's NIC on payments above the £30,000 threshold;
- The exception for payments made in case of death, injury or disability; and,
- Foreign Service Relief

Non-contractual PILONS

Under current rules, if an employment contract contains a right to receive a PILON then the payment is regarded as being a payment of earnings and this is subject to tax and social security in full.

On the other hand, if the contract is silent on this point and a contractual right to a PILON cannot otherwise be inferred, then the payment may be exempt from Income Tax up to the £30,000 threshold and will not be subject to NIC at all. Finance Bill 2017-19, which is currently before Parliament, contains changes designed to remove this distinction between contractual and non-contractual PILONS, although the distinction will remain for other payments related to termination.

Broadly, the Finance Bill seeks to achieve this parity by calculating the amount of salary that the terminated employee would have received had they worked the balance of their notice period. This amount is called the post-employment notice pay (PENP) and the amount of the termination payment equal to the PENP is subjected to income tax and NIC (both employee and employer) in full, as general earnings.

The balance of the termination payment over and above the PENP is subject to the "normal" rules regarding termination payments (including the £30,000 exemption) and taxed accordingly.

Undoubtedly this will simplify the taxation of termination payments (and specifically PILONS) for HMRC. Currently if HMRC wishes to challenge the tax treatment of a payment, frequently they are required to undertake a resource-intensive fact-finding exercise where each case is different. Under the new rules, such challenges are likely to fall away and ease the burden on HMRC.

On the other hand, working out the PENP and the correct amount to subject to tax and NIC will create an additional burden for employers. The calculations require a high degree of specific information regarding the terminated employee's remuneration package and the contractual terms agreed between the parties. A standardised approach to how to structure termination payments is unlikely to be possible and each termination will need to be considered in the round and on its own merits. Existing termination payment policies and calculators used by employers will need to be revisited in light of the new rules.

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Employer's NIC on payments above the £30,000 threshold

Currently a non-contractual payment made in connection with the termination of an employment is not subject to NIC.

The original intention was for a NIC charge to be introduced for *employers only* from 6 April 2018. Thereafter NIC would have been due from the employer at 13.8 percent on payments that are also subject to income tax (i.e. amounts in excess of £30,000 threshold). Importantly, there was never any intention to impose an *employee* NIC liability on such payments.

On 2 November 2017, the Treasury announced the deferral of the measures, which is welcome in the context of termination payments, not least because the feedback we have been getting from both employers and payroll software providers alike is that this change has not been well communicated.

The confusion stems from the fact that the proposed employer's NIC charge on termination payments was initially intended to be a Class 1A charge. Normally Class 1A NIC is reported and paid after the tax year on employee benefits, via Form P11D(b). However, this proposed Class 1A charge on termination payments will not follow the normal rules; instead HMRC has indicated that it will seek to collect the NIC in real time via the real time information systems.

Not only does this complicate the reporting for employers but we understand that at the date of the announcement to defer the implementation, payroll software providers had still not been provided with the full specifications to implement the change.

It is to be hoped that the delay will allow further thought to be given to this change and ensure that any software changes can be implemented in good time for April 2019.

As regards the £30,000 threshold itself, the current Finance Bill also includes a power allowing the Treasury to vary the threshold in the future. It is worth recalling that the £30,000 threshold was set in 1988 and has not changed in the intervening years. Adjusting the threshold for inflation would yield a current threshold of circa £70,000 so it is interesting, or perhaps worrying, that the parliamentary debate over the inclusion of this power focused on whether the threshold would be *reduced*. However, the Treasury has reiterated the government's current intention not to reduce the threshold.

Exception for payments made in case of death, injury or disability

The legislation currently provides a full exception for payments or other benefits provided in connection with death, injury or disability. Although, the extent to which injured feelings fall within this exception has been a source of uncertainty for some under the current rules. To date we have had conflicting views and case law as to whether or not such payments are taxable.

This change is designed to make it clear that although "injury" includes psychiatric injury, it does not include injured feelings.

Interestingly, one of the amendments to the Finance Bill tabled by Labour sought to specifically include injured feelings, not exclude them. The amendment was unsuccessful however and injured feelings will be clearly excluded from relief in future.

Foreign service relief

The restriction on FSR is perhaps the change which has sparked most debate. As mentioned above, this was originally meant to be part of the current Finance Bill but, owing to stakeholder feedback, it was deferred in favour of further consultation.

That consultation commenced on 13 September 2017 with the release of draft legislation for inclusion in the next Finance Bill (the third Finance Bill of 2017, to be called Finance Bill 2017-18).

The draft legislation proposes to remove FSR in cases where the relevant employee is UK tax-resident in the tax year that their employment is terminated. However, this proposed change is not extended to seafarers for whom the position on FSR will essentially remain unchanged.

The intention is for this change to be implemented in April 2018 in addition to the other proposed changes on termination payments (but not the employer's NIC charge on payments over the £30,000 threshold which, as discussed above, is now being deferred).

Although we are still in the post-consultation stage and awaiting the government's response, there are certain points that employers may wish to consider if the changes proceed as proposed:

- Should any settlement be grossed up to deliver the same net amount in cases where FSR is no longer available?
- What will be the additional cost of any employer's NIC on settlements that previously would have benefited from FSR?
- What changes need to be implemented to internal procedures to ensure settlements that can no longer utilise FSR are identified and reported correctly?
- How should payments be reported when the employee's residence status cannot actually be determined until the end of the tax year?
- Should the timing of termination payments and compromise agreements be changed and how will they interact with an employee's tax residence position?

A separate point that has been raised in consultation is the extent to which the new rules on FSR invite employers to adopt a different approach, perhaps by paying bonuses for past service prior to any termination of employment. Such a bonus would arguably be taxable as earnings and the sourcing rules would mean that the bonus would be apportioned between UK and non-UK duties on a just and reasonable

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basis. In cases where full FSR would have been available under the current rules, this would result in a materially lower amount of tax than would result from paying a termination payment following the abolition of FSR.

From an employee's perspective, aside from a significantly increased UK tax liability, the material question arising from the proposed changes is around foreign tax credits. It is likely that if a UK tax charge does crystallise (e.g. as the employee becomes UK resident again before the termination) it will do so on a payment that will also suffer foreign tax (since almost by definition there will have been overseas duties). It remains unclear at the present time to what extent a foreign tax credit will be available against UK tax.

And from a practical point of view, even if such relief is available, most countries use a calendar year basis. Consequently, in many cases there will be an initial mismatch with the UK tax year and the foreign tax suffered will need to be estimated in the first instance. Only later, once the foreign tax is finalised, will a revised figure for the foreign tax be available to be submitted to HMRC. Rather than simplifying the tax position, restricting FSR in this way has the potential to complicate it considerably.

Next steps

There will be no further amendments to the current Finance Bill before Royal Assent is granted. The changes to non-contractual PILONs will therefore come into effect as described above.

Whether HMRC uses the one-year deferral to reshape the Class 1A employer's NIC charge on termination payments remains to be seen, although we urge them to do so.

A degree of uncertainty remains around the change to FSR but we should know more after the Autumn Budget on 22 November 2017. As always we will be posting our thoughts on any developments on **KPMG's Employers' Club** so do check in.

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