

# GMS Flash Alert

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## United Kingdom - New Consultation Document on Taxation of Termination Payments

The U.K. tax authority, HM Revenue & Customs (HMRC), has published a consultation on the taxation of termination payments. Changes to the existing legislation will be introduced from 6 April 2018, removing certain exemptions and reliefs that currently exist, although the £30,000 tax-free threshold will remain.

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### WHY THIS MATTERS

The changes are said by HMRC to simplify the taxation of termination payments in order to reflect the government's view that the rules "should provide certainty for employees and employers" and "should be simple." However, we think the reality is that these proposals may make life more complicated rather than provide for simplification and that an opportunity for true simplification has been missed. Please see our further comments on page 3 below.

In addition, the changes are likely to increase the cost for both employees and employers when an employment contract is terminated. This will apply, in particular, to globally mobile employees where additional cross-border complexities are almost certain to arise as a result of the abolition of Foreign Service Relief.

It is important that employers are aware of what is proposed and plan ahead for the introduction of these new rules.

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### Background

In the summer of 2015, HMRC issued a consultation on the taxation of termination payments. Changes were subsequently announced in Budget 2016 (see GMS [Flash Alert 2016-040](#), 17 March 2016) with a promise of a further consultation over the summer. That consultation has now been published<sup>1</sup>.

In determining the taxation of payments made when an employment is terminated, the U.K has always made a distinction between a payment received further to an entitlement under an employment contract and an *ex gratia* (i.e., voluntary) payment made on a termination. It has been a feature of the legislation that payments in the second category may benefit from tax and social security exemptions.

## Principal Changes Proposed

HMRC has now confirmed in the published consultation that changes to the existing legislation will be introduced from 6 April 2018, removing certain exemptions and reliefs that currently exist, although the £30,000 tax-free threshold will remain.

## Overview of the Changes

Following responses to the original consultation, HMRC has made some changes to its original proposals. The main changes are summarized below:

### Taxation of Payments in Lieu of Notice (PILON)

Most employment contracts will contain provisions regarding the period of notice that either the employer or employee is required to give before the contract comes to an end. Some contracts will also stipulate various entitlements to payments if the employee is not required to work during his/her notice period when the employer terminates the contract.

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. If the contract is silent on this point and a contractual right to a PILON cannot otherwise be inferred, then the payment can attract tax relief and is not subject to social security.

From 6 April 2018, the distinction between contractual and non-contractual PILONs will be removed, although the distinction will remain for other payments related to termination. But the proposals in the published consultation go further than this and in broad terms (and with exceptions) they will require that any payments, bonus or benefits, that an individual "could reasonably be expected to receive" had he or she worked during the notice period will be fully subject to tax and social security regardless of what actually happens.

### National Insurance Contributions (NIC)

Social security payments in the U.K. are levied by way of National Insurance Contributions (NIC). Currently a non-contractual payment made on termination of an employment contract is exempt from NIC.

From 6 April 2018 this exemption will be removed and NIC will be due at 13.8 percent from the **employer** on payments that are also subject to income tax. However, the exemption from **employee** NIC will remain.

### Tax-free Threshold

Currently, the first £30,000 of a non-contractual termination payment is exempt from income tax. This threshold dates back to 1988 and has not increased to take account of inflation.

The proposals made in the summer of 2015 had indicated that the U.K. government wanted to remove the £30,000 exemption and replace it with a potentially lower tax-free threshold, possibly linked to years of service. But this would have been linked to a wider availability of the exemption by doing away with the distinction between contractual and non-contractual payments.

HMRC has now confirmed in the published consultation that the £30,000 tax-free threshold will remain, and it will not be increased to take account of inflation since 1988.

## Existing Exemptions

Currently there are several exemptions that may apply to take a non-contractual termination payment out of income tax where the payment is above the £30,000 threshold. The exemption that is of most interest to employers of globally mobile employees (and the employees themselves) is the exemption which applies where the employee has had a period of non-U.K. service. This is known as Foreign Service Relief (FSR).

The removal of FSR was one of the points included in the earlier consultation and HMRC confirms, in the published consultation, that the government believes that FSR “has become outdated and unnecessary.” From 6 April 2018, FSR will be removed and any non-contractual payment will be subject to tax and NIC to the extent that the £30,000 threshold is exceeded.

The consultation response also makes clear that the exemption for termination payments made in cases of injury or disability should not apply in cases of injured feelings. The injury or disability must be of “a physical or psychological nature that is sufficient to cause the employee to be unable to perform his or her job properly” and the legislation will be amended accordingly.

## Next Steps

This second consultation document includes draft legislation which is intended to bring the proposed changes into effect. A series of questions have been tabled by HMRC aimed at making clear that the legislation will be effective in implementing the intended changes.

Responses to the consultation have been requested by 5 October 2016.

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## KPMG NOTE

The government has expressed its belief that the tax and NIC rules on termination payments will simplify this area of taxation and provide more certainty for employees and employers. It is also stated in the published consultation that “the complexity that the Office of Tax Simplification (OTS) highlighted in their report<sup>2</sup> should be taken into consideration.”

However, KPMG LLP (U.K.) thinks it unfortunate that the draft legislation runs to some seven pages and that, even then, HMRC has said that “some detail...has not been included at this stage.”<sup>3</sup> This would seem to run counter to the government’s objective to simplify the rules and it will be interesting to see whether the OTS offers any comment in this regard.

Furthermore, these changes will bring increased NIC costs to employers with all payments above the £30,000 threshold being subject to employers NIC. Employees will also face increased costs with PILONs and other payments and benefits which would have been received during an employee’s notice period being made fully subject to tax and social security whether or not the employee works during his or her notice.

The fact that the £30,000 threshold has been maintained is a welcome move, but it is disappointing that the threshold remains the same as it was when introduced in 1988.

For employers with globally mobile employees, the removal of FSR will not necessarily mean that the whole payment is subject to tax in the United Kingdom. In particular, where the host location also has the right to tax this income and double taxation treaties exist, the terms of the treaty and any OECD guidance will have to be analyzed in order to determine which country has the primary right to tax the payment and how any potential double taxation relief is managed. That said, where taxing rights fall to the U.K., this is likely to be an increased cost given that FSR will no longer apply under the U.K.’s rules. Further updates in this area will be provided as the consultation proceeds.

## FOOTNOTES:

- 1 See HM Revenue & Customs and HM Treasury, "Simplification of the tax and National Insurance treatment of termination payments: government response and consultation on draft legislation," Consultation document (10 August 2016): [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/545135/Simplification\\_of\\_the\\_tax\\_and\\_National\\_Insurance\\_treatment\\_of\\_termination\\_payments-government\\_response\\_and\\_consultation\\_on\\_draft\\_legislation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/545135/Simplification_of_the_tax_and_National_Insurance_treatment_of_termination_payments-government_response_and_consultation_on_draft_legislation.pdf)
- 2 See Office of Tax Simplification, "Review of employee benefits and expenses: final report," (July 2014): [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/339496/OTS\\_review\\_of\\_employee\\_benefits\\_and\\_expenses\\_final\\_report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/339496/OTS_review_of_employee_benefits_and_expenses_final_report.pdf).
- 3 From the consultation document (p. 20, point 3). See footnote 1.

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