TAXREP 58/15 (ICAEW REPRESENTATION 148/15)

15.10.15

TERMINATION PAYMENTS SIMPLIFICATION

ICAEW welcomes the opportunity to comment on the consultation document *Simplification of the tax and national insurance treatment of termination payments* published by HMRC on 24 July 2015.

This response of 15 October 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 20 August and 17 September 2015 we attended meetings with HMRC jointly with other professional bodies in which we were able to put forward some key comments and concerns and discuss aspects of the consultation document.

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ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 144,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

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MAJOR POINTS

Key point summary

1. Whilst we welcome attempts at simplification of the tax rules, we do not regard the proposed changes as the correct solution to the misunderstandings, as they would merely create a different set of rules to confuse taxpayers, not a simpler set. We see only one compelling case for change.

2. The only real difficulty our members see in practice is in the treatment of pay in lieu of notice (PILON), which HMRC invariably regards as earnings derived from the contract, while employers and employees see it as additional compensation for the loss of an employment. We do not believe that this difficulty justifies the wider changes proposed, and we would recommend that, if any change is to be made, it should address only this point. Since employees would expect to pay PAYE and NICs on any earnings while they worked their notice, we would not regard deeming all PILONs to be earnings for the purposes of both SSCBA 1992 and ITEPA 2003, in order to achieve simplicity and parity, as particularly unreasonable.

3. We accept that the different treatment for income tax and NICs can be confusing to some, but in essence it boils down again to the PILON question: NICs are currently only chargeable on earnings, not compensation. Employers and their advisers have no difficulty understanding that compensation is not subject to NICs. If ministers want to raise more revenue, we can see the logic of a deeming provision for NICs equivalent to s 401 ITEPA 2003, using the same exemption threshold as set by s 403, but HMRC has consistently stated that the aim of the changes is simplification, not revenue raising. If compensation is to be deemed to be earnings for both income tax and NICs, and the exercise is indeed to be revenue-neutral, we would expect the extra NI Fund revenue from the employee and employer contributions to mean that the exemption would be raised above £30,000 for both.

4. HMRC has few statistics about how much is paid below the £30,000 limit, as nothing is reported, so we question how the proposals could have been designed to be revenue-neutral.

5. The consultation document betrays in places a lack of understanding about why the current rules are as they are, and about employment law principles (eg, the distinction between unfair and wrongful dismissal). All the provisions were created for a reason, and ministers should not expect their reform to be problem-free if those reasons still appertain. Equally, some of the proposed reforms are unnecessary. For example, the document proposes a new anti-avoidance rule to prevent agreement in advance to payment of a lower wage for the duration of a contract, followed by a large termination payment with up to £30,000 tax-free. Such a termination payment would already be subject to tax and NICs as earnings, as it would be derived directly from the employment contract (the principle was examined by the Court of Appeal in 1950).

6. Most complicated termination payments involve calculating damages for loss of future earnings, share entitlements, pension rights and loss of status, plus possible psychological harm, caused by the employer's breach of contract. None of the payment could legitimately be regarded as a reward for working for the employer: in fact, it is damages for not being permitted to work, or worse, so it is not clear why anything not paid under a provision of the employment contract should be deemed to be earnings, unless the aim is to raise more revenue. A settlement package could be made up of numerous elements, and would not be simplified by the proposed reform introducing an extra need to gross up for NICs above the chosen threshold.

7. There is also in places a lack of clarity about what exactly is being proposed. For example, it is proposed to change the foreign service exemption to a 'source basis', but to give broadly the same outcome as would arise from taxing earnings. It is wholly unclear how the proposed sourcing would work and how it would be easier for employers to understand and implement.

It cannot be right that a termination payment in the UK in respect of a job that has not produced UK taxable and/or NICable earnings for many years might become taxable or NICable because it is paid by a UK employer to an employee who has returned to work for a short time in the UK before leaving the employment. The current rules work equitably and cause few problems to our members.

General comments

8. We understand that whilst most employees and employers are aware that termination payments are subject to a £30,000 exemption, many employers appear not to understand the correct tax and national insurance contributions (NIC) treatment of the different elements of payments made on the termination of employment, and HMRC has, often at the request of recipients, to ensure that the exemptions have been recognised for tax and NIC. There are various possible reasons for this.

9. First, it might be because HMRC's guidance is not sufficiently clear (although we believe the CWG2 guidance to be clear, there is scope for more extensive explanation on GOV.UK), especially for employers who might never before have made a payment on the termination of an employment and so not even be aware that conditions attach to the £30,000 tax exemption, let alone what the conditions are. For example, if the employee has died, does the £30,000 apply? We suggest that the guidance is reviewed and clarified as necessary, and we should be happy to help HMRC with this exercise. It may be something that HMRC can draw to the attention of employers in Employer Bulletins.

10. Secondly, some of the technicalities do not have simple answers and it can be necessary to dig deep to ascertain the facts. For example, a payment in lieu of notice (PILON): some employers and HMRC officers find it difficult to distinguish whether this is part of the employment contract (explicitly or implicitly) or whether it is effectively damages or compensation for not being given notice. Another example where confusion arises is where payments are made near to retirement: when does a payment on termination of employment turn into a payment from an employer's funded or unfunded retirement benefits scheme? Yet another difficult area is payments where there has been service overseas: are these within the scope of tax and/or NIC? Questions also arise over what code number to use, so where the payment is made before leaving then the normal code number is used but if after the employee's employment has terminated then the employer should apply 0T. Navigating the RTI system to report termination (and flexi-access pension) payments is a challenge introduced recently that the OTS proposals does not address.

11. Thirdly, there is the real possibility that some employers, because of HMRC's recent focus on penalties, do not apply the exemptions correctly and deduct tax and NIC where none is due. This is probably because the employer does not want to risk being liable to pay the tax and NIC if it is discovered later that tax and NIC have incorrectly not been accounted for. Or it could be because the employer does not bother because recipients are no longer, or will shortly not be, employees. Where employers have made mistakes in computing the tax and NIC and applying the exemptions, HMRC might be able to help those who are responsible for assessing which exemptions apply to and calculating tax and NIC on termination payments get it right in future by providing targeted guidance.

12. It has been suggested that the availability of any tax and /or NIC exemption should be linked to the amount payable as statutory redundancy (or an equivalent notional figure for those who are not entitled to statutory redundancy because of the status of their employer). We disagree with this suggestion in principle. While it links the exemption back to one of the reasons for the original provision (which, we understand, was to recognise that redundancy can lead to hardship), it fails to recognise the equivalent problems caused by job loss for those who are terminated for other reasons, such as competency or diminishing physical ability short of injury or disability, which do not fall within the ERA 1996 definition of redundancy. However, we consider that having bespoke exemption thresholds depending on individual circumstances would make calculating the tax and NIC very complex and would be retrograde compared to

the current position of having a single, easy-to-remember blanket threshold. We therefore suggest that there be one threshold, and that if it is decided to change the amount of the threshold from £30,000, then any new threshold should be expressed as a multiple of the Employment Rights Act weekly limit.

RESPONSES TO SPECIFIC QUESTIONS

Tax and NICs treatment of contractual and non-contractual payments

Q1 Do you agree that the distinction between contractual and non-contractual termination payments should be removed? Please provide reasons for your answer.

13. We believe that the distinction between whether a payment is contractual, whether explicitly or implicitly, or non-contractual needs to be retained because it is fundamental to determining whether a payment is taxable as employment income or not taxable because it is in reality a payment of damages.

14. However, we can see the logic of simplifying the main source of confusion, the treatment of PILONs.

Q2 Do you agree that removing the different tax and NICs treatment of different types of PILONs will help remove complexity for termination payments? Please provide reasons.

15. PILONs are the element of termination payments which pose the most problems for employers and potential for disputes, because it is necessary to consider whether any element is contractual or non-contractual. We therefore agree that treating all PILONs in the same way would remove complexity, even though treating non-contractual PILONS as taxable and subject to NIC would extend the definition of employment income. We would expect the quid pro quo to be an increase in the £30,000 exemption in any revenue-neutral reform package.

Alignment of income tax and NICs treatment of termination payments

Q3 Do you think that the income tax and NICs treatment of termination payments should be aligned? Please provide reasons.

16. We believe that the income tax and NIC treatments should be aligned as this will make it simpler for employers to administer payroll and employees to understand the basis of the tax and NIC paid.

17. We would expect the quid pro quo for the extra amount collected by HMRC from adding NIC liability on termination payments to be an increase in the £30,000 exemption in any revenue-neutral reform package.

Q4 Do you think that aligning the income tax and NICs treatment of termination payments will make termination payments easier to administer and easier to understand? Please provide reasons for your answer.

18. See answer to Q3.

Options for reform of the tax and NICs exemption / New exemption proposal

Q5 The government would like to explore what level the threshold for the termination payment tax and NICs exemption should be set and would welcome views. Please provide reasons for your answer.

19. We understand from HMRC that the average termination payment is around £11,000, although this was reportedly based on statistics collected without the benefit of employers' data on non-taxable payments below £30,000, so we would caution against basing any material decisions on the £11,000 figure. There was also no indication given as to the statistical distribution of the size of awards around that mean, so we do not know how many leavers receive a few £00s and how many receive £30,000. Logically the distribution ought to be skewed towards the lower values by large redundancy programmes, but the spread needs to be take into account. We suggest that the threshold be set at a figure sufficient to enable the widest number of people to benefit, because that will help them at a time when they are losing their jobs and face the prospect of hardship. Given that extra NICs will be collected, ministers should look at raising the £30,000 exemption. If that is politically unacceptable, then we would suggest that a logical figure might be based around average weekly earnings for a year, currently around £26,000.

Q6 Do you agree that a relief based on length of service and those who are being made redundant would be easier for employers to administer? Please provide your reasons.

20. No, because it would make the calculation even more complicated than it is now. For every employee for whom the tax and NIC on a termination payment is being calculated and exemptions applied the employer would have to ascertain the employee's length of service as defined, including perhaps service accrued with former employers, service with whom might have to be taken into account under TUPE rules. This approach would make agreeing a redundancy programme in consultation with representatives of a large number of at-risk employees almost impossible, and seriously complicate any calculations needed in order to compensate a former worker by paying enough to replace net pay for a certain period.

21. The length of the explanation in the consultation document and the perceived need for not only an anti-avoidance provision (paras 4.22-23 of CD) but also additional anti-avoidance provisions (paras 4.24 et seq) are also reasons enough for not adopting this approach.

Q7 Do you think that structuring the relief based on length of service and redundancy will be easier for employees to understand? Please provide reasons.

22. No, we think that this would make the calculation that employers have to carry out more complicated than it is already.

23. It would also mean that employees on the same pay scale who are made redundant at the same time for the same reason would receive different amounts, which is likely to create confusion and resentment amongst employees, and employers will have to spend time answering queries and objections from upset employees.

Q8 Are there any alternative ways that the income tax and NICs exemption could be structured that would better meet the government's stated aims as set out in at 3.5 of this document. Please provide details with your answer.

24. We believe that the same rules and the same exemptions applying to all employees with the same facts and circumstances rather than bespoke exemptions would be simplest for employers to apply and be perceived by employees as being the fairest outcome.

25. We suggest that there be one threshold, and that if it is decided to revise the current £30,000 threshold, then any new blanket threshold should be an annualised value of the Employment Rights Act 1996 current weekly limit on reckonable earnings for redundancy (currently £475 pw) or based on average or median annual earnings (currently around £500 pw). This suggests a standard threshold of £25,000 or £26,000.

Anti-avoidance provisions

Q9 Are there any alternative approaches that you can think of that will prevent this payments of salary being disguised as a termination payment? Please provide details with your answer.

26. Any employer which knowingly treats the taxable and NICable elements of termination payments as exempt is breaking the law. This is not something that can be remedied by an anti-avoidance rule. Effective policing by HMRC with a publicity campaign would help to discourage employers from not applying tax and NIC to taxable pay.

27. Any change to the rules will almost inevitably lead to changes in employer behaviour, but it is impossible to simplify the treatment of termination payment taxation without leaving any scope for such changed behaviour. Any vague targeted anti-avoidance rule based on what an HMRC officer's view of what an employer might have done as an alternative will inevitably be fraught with subjective judgements and will not amount to simplification.

Q10 Please can you provide details of the types of payments and people who receive termination payment who would be affected by the anti-avoidance provisions? Please also state which anti-avoidance provision you are referring to.

28. We consider that the proposal in paragraph 4.24 regarding fixed term contracts could unfairly impact those on fixed term contracts who are laid off before the end of the contract.

29. We suggest that the 12 month re-employment rule would still be needed, as would a simple rule to cover associated company risks, and perhaps a rule restricting the number of times the relief can be claimed in one year.

Exemptions which remove the liability to income tax

Exemptions for injury or disability

Q11 Do you think that the exemption for injury or disability should be maintained? Please provide reasons for your answer.

30. We think the injury/disability exemption should be kept as it is needed to help tide over unfortunate employees who may never be able to work again. It should also not be overlooked that an employee who has to stop working because of disability is likely to be entitled to state benefits of some kind, and any damages awarded against the employer are likely to reduce the burden on the state (with the corollary that increasing the tax and NIC liability by taxing the damages merely means that the state will spend more on social security benefits).

31. However, the exemption should only be for situations where the termination payment is made as a result of injury or accident at work. If the payment arises from a matter outside the employment then the general body of taxpayers should not have to forfeit the tax/NIC arising from a payment made in these circumstances.

Q12 Do you agree that by removing the requirement to differentiate between the different elements of payments made in connection with injury or disability will provide simplification? Please provide reasons for your answer.

32. Whilst on the face of it the smallest number of differences would make for simpler compliance, any new law would most likely introduce new uncertainties in place of the established body of

law which is explained in HMRC's manuals at EIM13610 et seq. It is far from clear that the benefit of any simplification might outweigh the cost of taxing damages.

Q13 Do you think that there should be a cap on the amount of tax and NICs relief that is provided where the payment is connected with injury or disability? If so please provide reasons and suggested amounts.

33. No. Damages replace future potential earnings and are generally calculated by reference to net pay, other than such elements as a 'Vento' addition for injury to feelings caused by discrimination. If part of the damages was made taxable, it would complicate rather than simplify matters.

Foreign service exemption

Q14 Do you think that the foreign service exemption should be removed? Please provide reasons for your answer.

34. No. The foreign service exemption (FSE) rules are in the legislation because there is otherwise no source on which to base a UK tax charge and no exclusion for non-residents or periods of non-residence. HMRC has yet to explain how it would propose to exclude all or part of a compensation from UK tax and NIC on a source basis. Bearing in mind that the proposal involves levying NICs on compensation, and the rules for tax and NICs on earnings from overseas duties are totally different, we do not see any change here as improving clarity or consistency of treatment. Employers who need to deal with former expatriates generally take advice, because they know that expatriate tax is generally complex, and we regard any alleged confusion caused by the FSE rule as illusory.

Other exemptions

Q15 Do you think any of the other exemptions should be maintained? If so which ones? Please provide reasons for your answer.

35. The existing exemptions were each created to meet a need. We do not regard any of those needs as having changed. For example, the Employment Rights Act 1996 created the idea of a compromise agreement and imposed an obligation on the employer to require the employee to take independent legal advice. The employer was then allowed, by concession and subject to restrictions, to pay the legal fees in addition to the £30,000 tax-free compensation. This was intended to ensure that the ex-employee could benefit from the £30,000 rule even if his legal fees were high. We do not see how this principle has, or should in future be, changed.

Q16 Do you agree that any payments that would usually be exempt from income tax and NICs should remain exempt (subject to the usual rules) when made as termination payments? Please provide reasons for your answer.

36. Yes, we agree. The exemptions do not confuse employers. The complexity comes from taxing elements that employers (usually justifiably) believe fall within the exemption, such as taxing payments on termination due to the death of the employee under the EFRBS rules, when s 406 appears to grant an exemption.

New exemptions

Compensatory amounts for unfair/wrongful dismissal

Q17 Do you think that there should be a financial cap, above which income tax (and possibly NICs) should be payable in cases of unfair or wrongful dismissal? Please provide reasons for your answer.

37. We believe that should not be a new exemption for payments made where there is unfair or wrongful dismissal as this would encourage vexatious disputes and litigation. If a case goes to the tribunal or court, the tribunal or court can adjust the amounts for tax if they think that it is appropriate. We see no reason why a separate cap might be needed where simplification is the objective of the whole exercise.

Q18 Do you think that that should be any differentiation in terms of a financial cap where payments have been settled by a tribunal or an arrangement between an employee and employer? Please provide reasons for your answer.

38. See answer to Q17. If despite our reservations, an exemption is introduced for unfair and wrongful dismissal, there should be no differential between cases settled by a tribunal or by arrangement because any differential would influence whether or not cases are taken to the tribunal. Compromise (now settlement) agreements were introduced to ease the burdens on tribunals and employers, but the outcomes were intended to be the same: a just and reasonable compensation award. The two routes to settlement should not be treated differently.

Compensatory amounts for loss of future earnings following discrimination

Q19 Do you think that there should be a financial cap, above which income tax (and possibly NICs) should be payable in cases of discrimination? Please provide reasons for your answer.

39. We believe that should not be a new exemption for payments made following discrimination as this would encourage vexatious disputes and litigation. If a case goes to the tribunal or court, the tribunal or court can adjust the amounts for tax if they think that it is appropriate.

40. Awards made for discrimination amount to personal damages, unrelated to any amount earned or to be earned. They should not be brought within the scope of ITEPA 2003 or SSCBA 1992. Employment law imposes no cap on damages for discrimination. It would be inconsistent and confusing for all concerned if, eg, 'Vento' additions were made taxable. To make matters simpler, HMRC staff should be instructed always to accept automatically the classification of elements of tribunal awards as set by the tribunal judges, and not to argue with employers that tax is due when settlement agreements outside the tribunal system include elements based broadly on the 'Vento' guidelines.

Q20 Do you think that there should be any differentiation in terms of a financial cap where payments have been settled by a tribunal or an arrangement between an employee and employer? Please provide reasons for your answer.

41. See answer to Q19. If despite our reservations, an exemption is introduced for discrimination, there should be no differential between cases settled by a tribunal or by arrangement because any differential would influence whether or not cases are taken to the tribunal and would be contrary to the objective of simplifying the system.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).