

**Simplification of the Tax and National Insurance Treatment of Termination Payments
HM Revenue & Customs (HMRC) and HM Treasury (HMT) consultation document
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Executive Summary

- 1.1 We welcome the opportunity to respond to the HMRC and HMT consultation document on simplification of the income tax and National Insurance contributions (NIC) treatment of termination payments.
- 1.2 This consultation attempts to continue the work of HMRC to implement proposals put forward in a report by the Office of Tax Simplification (OTS), following their review of employee benefits and expenses.¹ The consultation states that it aims to lead to reforms that will give employees certainty and simplify matters for employers. Unfortunately, we think the proposals are unlikely to deliver genuine simplification for employers and employees; we think the proposals will raise more revenue for the Government and are concerned that the changes are almost certainly going to disadvantage low income employees.
- 1.3 We make two observations at the outset. Firstly, the income tax and NIC treatment of termination payments should fully take account of employment law. When employers are considering termination payments and employees are trying to understand them, differences between employment law and tax law only create complexity. It is disappointing therefore that the consultation does not recognise the preference of the OTS for income tax relief to be available only when the employee qualifies for statutory redundancy (and

¹ *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014):
<https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

equivalent situations for those unable to qualify for redundancy). This would make it easier to understand when relief is available and would result in a common approach between employment and tax law.² Such an approach would need to take into account the various individuals currently unable to qualify for statutory redundancy, so that they are not placed at a disadvantage. In connection with this, we do not think there should be a need to have served for two years in order to be eligible for such an exemption; we also think that the exemption should be available to those on fixed term contracts where the contract is terminated early. Otherwise there is likely to be discrimination against those on low incomes.

- 1.4 Secondly, alignment of the income tax and NIC treatment of termination payments will eliminate some burdens for employers (although it is likely to increase the Class 1 NIC burden for both employers and employees), but unless and until there is complete alignment or integration of income tax and NIC, discrepancies, and therefore complexity, will remain. We refer for example to the fact that Class 1 NIC is calculated on a non-cumulative basis whereas income tax allowances and rates apply on a cumulative basis. The effect of alignment of income tax and NIC treatment of termination payments on low income individuals facing redundancy will depend to a large extent on the level and type of exemption introduced. Many low income individuals receive relatively low termination payments, which might well be covered by an exemption, meaning that the alignment of income tax and NIC treatment poses little problem. Any changes to the termination payments regime should not result in a less favourable outcome for low income individuals, particularly as the proposals are being brought forward under the banner of fairness and simplicity.
- 1.5 The current tax and NIC treatment of termination payments requires consideration of the nature of the constituent parts of the payment and also whether or not they are contractual. There are also a number of exemptions, reliefs and reductions potentially available. In order to simplify the system, it would appear therefore that fairly radical changes are needed including the removal of many of the existing exemptions, but there are justifications for retaining several of these, for example, the exemption for termination of employment due to disability or injury. We suggest there should be greater consideration of policy objectives and the likely winners and losers prior to taking any decisions on how to proceed.
- 1.6 We suggest that HMRC consider developing an online tool to give a binding answer on the tax and NIC treatment of a termination payment. This could perhaps apply only to cases where the total payment is less than a certain limit; it would also need to be subject to the employer answering all the questions correctly. This might help to free up HMRC resources to focus on more complex and higher value payments.

² Paragraphs 2.4, 2.14 and 2.22, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

- 1.7 We recommend that HMRC consider the impact that any changes to the current position will have on tax credits and universal credit. Currently, tax credits follow the income tax position in so far as only termination payments which are chargeable to tax are included as employment income in determining the value of a tax credits award. A move away from that general position may well adversely impact the value of tax credits awards for those low income workers losing their jobs, should their termination payments become taxable and therefore included as income in their tax credits assessments. We recommend that corresponding changes are accommodated in tax credits legislation to ensure the changes do not disadvantage claimants. For universal credit, termination payments are treated as capital and further support for low paid workers could be provided if there was a corresponding move to exclude non-taxable termination payments from the universal credit assessment altogether. Any changes that affect tax credits and universal credit will need to be communicated to claimants.
- 1.8 If changes are made to the existing regime, it will be necessary to provide guidance and educational resources for employers, particularly for the smaller employers that have fewer resources.

2 About Us

- 2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.
- 2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

- 3.1 We agree with the stated aims of the reform of termination payments, as set out at paragraph 3.5 of the consultation document. Simplicity, certainty, ease of administration and fairness are key principles for taxation generally. We also acknowledge that the policy

must be affordable for the Exchequer. We question however, whether the proposals will achieve the stated aims.

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

4.1 Yes, we agree that in the long-term, the distinction between contractual and non-contractual termination payments should be removed. This would allow employers to amalgamate all payments, regardless of their nature, and apply the same treatment. This would have the advantages of simplicity and certainty for the employer and employee, in terms of administration, understanding the tax liability and actual payment received. Given the need for any changes to be affordable for the Exchequer, we accept that (as recommended by the OTS), as a starting point, all payments made in connection with a termination of employment should be subject to income tax.³

4.2 Removing the distinction between contractual and non-contractual termination payments would also be fairer, in that eligibility for tax relief would not depend on the terms of the employment contract. The current rules favour those able to pay for professional tax advice and well-advised employers. Under the current rules, we understand that HMRC often require evidence of a 'critical assessment' in order to ensure that a particular payment is not treated as an 'autoPILON'. This favours well-advised businesses and larger employers. Removing the distinction between contractual and non-contractual termination payments would remove this additional administrative and cost burden.

5 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.

5.1 Yes. The OTS work showed that much of the complexity and uncertainty derives from confusion as to the operation of the £30,000 exemption, since it does not apply to all termination payments and requires assessment of the nature of the constituent parts of termination payments.⁴

³ Paragraph 2.4, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

⁴ Paragraphs 2.7 and 2.15, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

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

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.

- 6.1 We assume that the proposal would be to align income tax and NIC treatment, such that both employee and employer NIC would apply to a payment that is taxable. If this is the case, we think that the impact on the level of termination payments, particularly those payable to individuals on lower incomes, should be explored. Alignment of income tax and NIC treatment would in many cases mean a greater cost for employers, who would face a liability to employer NIC. This would come at a time when the employer might already be facing financial constraints, which are forcing them to make redundancies. This might mean they pay lower termination payments. The employee would lose out twice – both in terms of a lower gross termination payment and in terms of a lower net amount received, following the deduction of Class 1 primary NIC.
- 6.2 Paragraph 4.4 of the consultation document misrepresents the recommendations of the OTS in respect of the NIC treatment of termination payments. The OTS suggest that consultation should include a review of whether the NIC treatment should also be reformed, thus aligning the tax and NIC treatment. The OTS also raise several issues for consideration in this regard, to be further explored via consultation, such as the fact that income tax operates on a cumulative basis throughout the tax year, whereas NIC is concerned only with the particular pay period in question.⁵
- 6.3 Nevertheless, we think that subject to the outcome of further exploration, it would probably be helpful to align the income tax and NIC treatment of termination payments. It should be noted though that while differences continue to exist in income tax and NIC generally, such as in relation to the basis of assessment, some complexity will remain, particularly in terms of understanding their position for affected employees.
- 6.4 Alignment of income tax and NIC treatment would probably make administration simpler for employers, with less likelihood of error, which is particularly important for smaller employers, who may be less able to obtain specialist advice. In addition, it would probably be easier for employees to understand, if a payment is subject to both income tax and NIC, and the same level of exemption applies to both, where appropriate.
- 6.5 The effect of alignment of income tax and NIC treatment of termination payments on low income individuals facing redundancy will depend to a large extent on the level and type of exemption introduced. Many low income individuals receive relatively low termination

⁵ Paragraphs 2.77 and 2.78, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

payments, which might well be fully covered by an exemption, meaning that the alignment of income tax and NIC treatment would pose few problems for them or their employers.

7 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.

7.1 We do not have a specific recommendation as to the level for an exemption, but we have a few comments that we think should be borne in mind. Whatever limit is set, it should be reviewed regularly.⁶ A single threshold would be simplest to operate; provided it is set at a sensible level it would enable employers making average level termination payments to determine quickly and easily whether or not to apply income tax and NIC deductions. One option might be to set the limit at the level of the personal allowance (or a multiple thereof, such as 2X or 1.5X of the personal allowance) or at the level of the overall maximum statutory redundancy payment (capped at £14,250 post 6 April 2015) or a multiple thereof.

8 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.

8.1 The use of the definition of redundancy as used for employment law should introduce more certainty and clarity, provided employers are able to understand the correct employment law position.⁷ The tax relief would only be available to the extent that statutory redundancy is available, which helps to protect against abuse. We agree with the OTS' suggestion that the exemption should be linked to this regime.⁸ As the OTS noted, however, certain individuals cannot qualify for statutory redundancy rights.⁹ We think that if the exemption is linked to the definition of redundancy for employment law, the Government should examine how to structure the exemption to allow it to extend to such individuals, like civil servants.

8.2 We do not think it is appropriate to require the employee to have completed two years of service in order to qualify for the relief (para. 4.17 of the consultation). In relation to such a condition it would be necessary to explore whether an issue of indirect discrimination arises.

⁶ Recommendation 6. *Ensure limits and thresholds keep up with the cost of living*, p. 23 – *A Manifesto for Low Income Taxpayers* (2015) – The Low Incomes Tax Reform Group:

<http://www.litrg.org.uk/reports/2015/LITRGManifesto>

⁷ S. 139 Employment Rights Act 1996. Where the criteria are met, this triggers a right to statutory redundancy pay.

⁸ Paragraphs 2.4, 2.14 and 2.22, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

⁹ Paragraphs 2.52 and 2.53, *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

For example, such a condition may adversely affect low income earners, who may be more likely not to have completed two years of service. Such a condition might also discriminate against individuals employed under short, fixed-term contracts, which are a fairly common form of employment.

9 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.

9.1 Provided the relief is based on the employment law rules, we think it should be easier for employees to understand. There is a fairly simple message that HMRC can communicate, in that if an employee qualifies for redundancy (or the equivalent for those unable to qualify for statutory redundancy pay), they also qualify for income tax and NIC relief. We also refer to our comments at 8.1 and 8.2 above. In terms of understanding the value of the exemption, basing the value on the length of service (rather than simply having a single level of exemption that applies to all) introduces complexity.

10 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.

10.1 Another option might be to consider a simple regime for termination payments below a certain level, such as the maximum statutory redundancy payment; payments above that level could continue with the current regime. Although two regimes introduces a level of complexity, such a system might ensure simplification for many, and in particular those who are lower-paid.

10.2 Alternatively, a flat-rate exemption, at a lower level than the current exemption of £30,000, for all termination payments could be considered, regardless of their nature. Although, as stated in the consultation document, such a "blanket" exemption would require anti-avoidance provisions, it is likely to cover most termination payments made to low income individuals, simplifying the position for both them and their employers.

11 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.

11.1 No comment.

12 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.

12.1 At paragraph 4.26, an anti-avoidance provision is proposed that would lead to a termination payment becoming taxable and liable to NIC if the employee is re-engaged to do a similar job for the same company within a 12 month period. This could adversely affect low income individuals. For example,

John has worked for a supermarket chain for 10 years in a store located in town X, when the store is closed down and he is made redundant. He receives a termination payment, which is exempt from tax and NIC. Within the next 12 months, he manages to obtain a job with the same supermarket chain at another store in town Y, 10 miles away. It appears that the anti-avoidance provision proposed at paragraph 4.26 would result in John now having to pay tax and NIC on his termination payment, despite having to go through the normal recruitment process in order to win the new job.

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

13.1 Yes, since this reflects compensation or damages rather than being an element of remuneration. We note however, that there are problems with the current exemption in practice.¹⁰ We think it would therefore be advisable to review the exemption, ensure it is targeted correctly and clarify the guidance as appropriate.

14 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.

14.1 Yes. Given the intention to remove the requirement to differentiate between the different elements of termination payments elsewhere, for example with regards to contractual and non-contractual payments, we think it would be sensible and consistent to do the same for payments connected with injury or disability. This will be simpler for employers to administer and easier for employees to understand the payments they receive.

¹⁰ S. 406(b) ITEPA 2003. Paragraphs 2.62 ff., *Review of employee benefits and expenses: final report* – Office of Tax Simplification (July 2014): <https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-final-report>

15 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.

15.1 No; payments connected with injury or disability should be fully exempt.

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

16.1 In the interests of simplification, it would be logical to remove the foreign service exemption. There is a trade off with fairness, however. Provided the removal of the foreign service exemption is accompanied by the adoption of territorial limits for termination payments, then this would seem to balance the aims of simplicity and fairness.

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

17.1 We think it would be appropriate to retain several of the current exemptions. We recognise that this is likely to mean continued complexity in the termination payments regime. Nevertheless, the various exemptions aim to ensure fairness. Consequently, we think it is necessary to evaluate the policy objectives and aims of any reform more fully before taking any further steps.

17.2 We agree with the consultation that the exemptions for HM Forces payments and payments into a registered pension scheme should be maintained.¹¹

17.3 We think the exemption for outplacement counselling, plus associated travelling expenses, should be maintained.¹² Employees who are being made redundant find themselves in a stressful position, through no fault of their own. If their employer is able to assist by arranging outplacement counselling, this should not be taxable.

17.4 We think that other exemptions should likewise be maintained, for example the death exemption, the exemption for lump sums from tax-exempt retirement benefit schemes, the exemption for indemnity insurance, and the exemption in respect of certain legal costs.¹³ We note that it may be necessary to review or provide more certainty in respect of some of these exemptions, to ensure they are simple to understand and apply.

¹¹ Ss. 411 and 408 ITEPA 2003 respectively.

¹² S. 310 ITEPA 2003.

¹³ Ss. 406(a), 407, 409, 410 ITEPA 2003 and ESC A81.

18 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.

18.1 Yes. It would add complexity to apply income tax and/or NIC to any part of a termination payment that would normally be exempt if paid as part of salary. Nor would there appear to be any logical basis for doing so.¹⁴ It would be confusing for employers and employees alike.

19 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.

19.1 We note that if an employer dismisses an employee without giving the term of notice specified in the contract, the employee can make a claim for unfair or wrongful dismissal. Meanwhile, a PILON can be viewed as a payment of damages in respect of the employer's breach of contract. As a result, it seems that introducing a new exemption in respect of unfair or wrongful dismissal would create significant uncertainty, confusion and complexity – it would probably not be workable in practice.

19.2 If an exemption is introduced for cases of unfair or wrongful dismissal, however, we think there should be a financial cap. We would expect this to be set at a level such that those on low incomes, receiving relatively low payments, would still be exempt.

20 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.

20.1 Differentiation would introduce yet more uncertainty. Also, if the differentiation were favourable in respect of tribunals, this would encourage settlement by tribunal, which is more expensive and time-consuming. Given the Employment Tribunal charges fees, differentiation favouring tribunal settlements would place the employee, and particularly employees on low incomes, in a lose-lose position. If they choose to go to the Tribunal, they face fees; if they make an arrangement with their employer, they would potentially have to pay more tax and NIC.

¹⁴ Given termination payments would in effect be being treated as taxable and NICable salary.

21 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.

21.1 A financial cap would introduce complexity. Nevertheless, it would be reasonable for an exemption to be capped in cases of discrimination. We would expect this to be set at a level such that those on low incomes, receiving relatively low payments, would still be exempt.

22 Q20. 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.

22.1 We refer to our comments at paragraph 20.1 above, which are also relevant here.

LITRG
14 October 2015