Global Mobility: Termination Payments for people who've worked overseas

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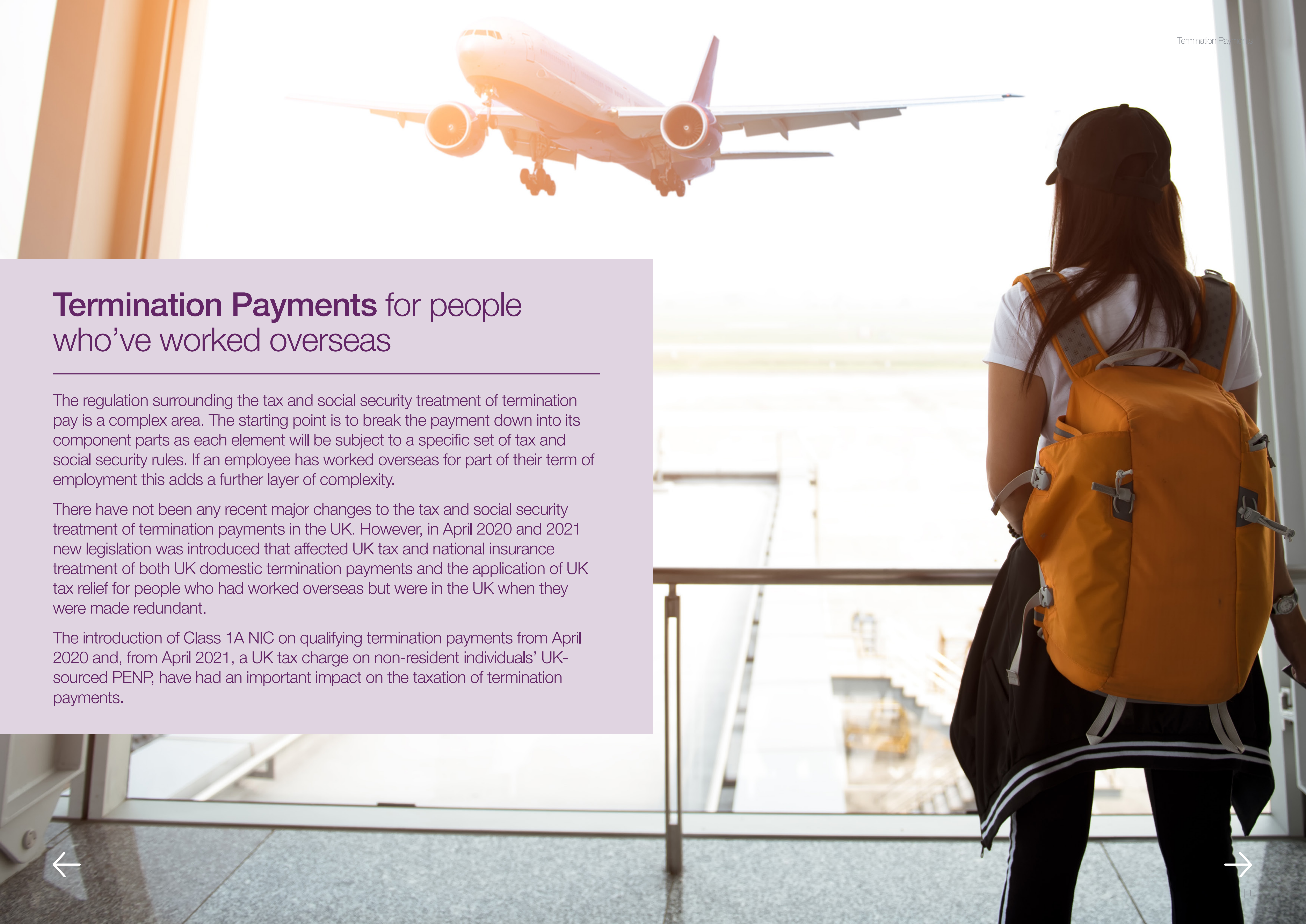

Termination Payments for people who've worked overseas

The regulation surrounding the tax and social security treatment of termination pay is a complex area. The starting point is to break the payment down into its component parts as each element will be subject to a specific set of tax and social security rules. If an employee has worked overseas for part of their term of employment this adds a further layer of complexity.

There have not been any recent major changes to the tax and social security treatment of termination payments in the UK. However, in April 2020 and 2021 new legislation was introduced that affected UK tax and national insurance treatment of both UK domestic termination payments and the application of UK tax relief for people who had worked overseas but were in the UK when they were made redundant.

The introduction of Class 1A NIC on qualifying termination payments from April 2020 and, from April 2021, a UK tax charge on non-resident individuals' UK-sourced PENP, have had an important impact on the taxation of termination payments.

Types of termination payments: a summary

In the event of being made redundant, in addition to the statutory payments that are required by law, employers will often make voluntary payments to an employee as compensation for loss of office.

Payments can fall into one of three main categories; statutory e.g. redundancy payments required under domestic law, contractual compensation as a reward for services, and voluntary non-contractual payments as a compensation for loss of office (also known as ex gratia payments).

In the UK, employees are entitled to statutory redundancy pay if they work for their employer for two years or more. The statutory payment consists of:

- half a week's pay for each full year the employee was under 22
- one week's pay for each full year the employee was 22 or older, but under 41
- one and half week's pay for each full year the employee was 41 or older.

The length of service is capped at 20 years.

Statutory redundancy pay under £30,000 is not taxable or liable to UK National Insurance.

Contractual Payments

Payments considered to be contractual are taxed as general earnings and are subject to PAYE and Class 1 NIC. These include garden leave, payment in lieu of notice (PILON), restrictive covenant (i.e. a payment made to an employee to give up certain rights) and post-employment notice pay (PENP).

Post-Employment Notice Pay

Regardless of whether the employment contract allows the employer to make a cash payment instead of giving the employee notice before ending the employment, HMRC deems the amount of basic pay an employee would have received had they worked for the full duration of their notice period to be taxable as normal . This is referred to as Post Employment Notice Pay (PENP).

PENP may consist of a number of different elements. Statutory redundancy pay is not included in PENP if less than £30,000.

From April 2021, non-residents will be charged tax and NI contributions on PENP to reflect how this would have been treated had the individual worked in the UK during their notice period.

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Non-contractual payments

Some payments are not contractual and/or may be made following an agreement reached between the employer and the employee upon termination of employment. Examples include enhanced redundancy, ex gratia payments and damages.

Non-contractual payments are subject to certain tax exemptions and reliefs with some payments being fully exempt from tax including:

- payments made on death, injury or disability of the employee,
- payments into a registered pension scheme
- payments relating to the provision of outplacement counselling or a retraining course, and
- legal costs in relation to a dispute on termination.

If the payment made does not qualify for a full exemption, any remaining £30,000 exemption can be used against non-contractual payments (after the statutory payments are considered) for UK tax purposes but not Class 1A National Insurance. It is worth mentioning that the charge of Class 1A NIC on qualifying termination payments was only introduced in 2020 and often catches employers out.

Amounts over £30,000 are fully taxable and also subject to Class 1 National Insurance.

Care should be taken if the employee is retiring after being made redundant. In such cases, HMRC will treat the payments as fully taxable with no £30,000 exemption.

Working abroad and its impact on termination pay

Foreign Service Relief

Foreign service relief (FSR) is a tax relief which applies to an employee who has worked abroad for some or all of their contract and who receives a non-contractual termination payment. FSR is applied to any residual amounts after the standard £30,000 deduction

Prior to April 2018, FSR could be claimed by employees who were UK resident or non-resident at the time of redundancy so long as they met the criteria for time spent working overseas. However it is now limited to UK non-residents which means that employees who are resident in the UK in the tax year that the termination payment is received are no longer able to claim any exemption for time worked overseas. This creates a potential issue for an employee who is resident in the UK at the time of being made redundant but who has spent most of their career working for the same company outside the UK. In this scenario, the employee may be taxable in the overseas jurisdiction on the majority of the redundancy payment but will also be taxable on 100% of the payment in the UK.

This often comes as a shock to both employers and employees as it seems unfair, particularly if the time spent in the UK during the period of employment is either very small or non-existent but the employee happens to be UK tax resident at the time the payment is made.

Tax treaties

If FST is not available then it may be possible to make use of a tax treaty between the UK and a second country. The treaty determines which country has primary or even sole taxing rights on the various elements of the payment. It is then possible to claim a foreign tax credit or exemption in one country.

When using the treaty it is important to consider both the nature of the payment and whether it is being made in respect of employment duties exercised in the UK or elsewhere

If the tax treaty does not contain a specific clause about the treatment of termination pay, then it is possible to use the OECD model treaty on which worldwide tax treaties are based. Generally HMRC consider its policies to be aligned with those of the OECD, whereby income received as a result of a redundancy is taxed in the same way that the original income the redundancy payment replaces would have been.

For example, payment in lieu of notice is taxed with reference to the notice period the employee would have worked, and to the country or countries where they would have been expected to have worked during that period had they not been made redundant.

This forward looking tax treatment is seen as a departure from HMRC's previous practice of allocating the payment made retrospectively over the final 12 months of employment.

It should be noted that not all countries who have treaties with the UK take the same view and this has led to issues when seeking to relieve double taxation.

Payroll considerations

Following the change in Foreign Service Relief, there has been an increased focus on payroll withholding when making termination payments to internationally mobile employees

One of the problems created by the change is the requirement to withhold UK tax through payroll. There is a risk of double withholding if another jurisdiction also considers some or all of the payment taxable.

In time the issue of double withholding may be resolved by way of a treaty claim but this still creates a cashflow issue, as the claim is made after the end of the tax year on the tax return. Before the change to the rules, the payment may simply have fallen out of charge to UK tax.

Termination payments subject to PAYE should be processed using an emergency tax code (0T Week 1/Month 1) if a P45 has already been issued when the payment is made unless a prior agreement has been reached with HMRC. If the termination package contains non-cash benefits that are not eligible for tax relief, the employer must file a report with HMRC by 6 July following the end of the tax year and provide the details to the employees.

Conclusion

Determining the correct UK tax treatment of a termination payment with international elements can be complex. We can help you navigate these. Our team can help both employers and employees navigate the complexities.

This guide provides an overview of UK redundancy tax and social security rules. We recommend specific professional advice is sought prior to agreeing any redundancy package.

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Leading Global Mobility Advisors

Global Mobility is a complex area but we can help simplify this, whether you already operate and deploy people internationally, or are looking to undertake employee mobility for the first time.

It is crucial that your business understands the options available to structure an international workforce – whether employing people locally or sending more senior individuals to work with the business in a different country for a period.

Our Global Mobility team focuses on client relationships to get the best results, helping them optimise service quality and cost efficiency. Whilst acknowledging the value of technology and its benefits, we also value getting to know our clients and their business, whatever their location.

Get in touch today to see how we can help...

Louise Fryer
Director & Head of Global Mobility
+44 (0)20 7516 2446
lfryer@pkf-l.com

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PKF Littlejohn LLP,
15 Westferry Circus,
Canary Wharf,
London E14 4HD

Tel: +44 (0)20 7516 2200
www.pkf-l.com