RELEVANT TO ACCA QUALIFICATION PAPER F6 (IRL)

Studying Paper F6?
Performance objectives 19 and 20 are relevant to this exam

Taxation of termination payments

From 2011, termination payments will be examinable in Paper F6 (IRL). The scope of the topic will require students to be able to ascertain from a typical termination payment the part that will be treated as salary, the amount that is exempt, the taxable ex gratia amount, and the part of that ex gratia amount that will be tax free due to reliefs that are available. Students will not be required to calculate Top Slicing Relief (TSR) and neither will they be required to deal with termination payments where the office holder had carried out foreign service.

Introduction

When an employee's employment terminates, either as a consequence of dismissal, redundancy or retirement, it is common that the employer will pay a lump sum payment to the employee. These payments may be referred to as a 'golden boot' or a 'golden handshake'. The tax treatment of these payments is the same, and both can be referred to as termination payments.

Almost all payments made by an employer to an employee are taxable as emoluments under Schedule E, however, relief is available on all, or part of, a termination payment.

Elements of a termination payment

It is common for a termination payment to be made up of statutory and non statutory redundancy. The Redundancy Payments Acts 1967–2007 provides that an employee aged 16 or over is entitled to two-weeks' pay for every year of service plus one further weeks pay. There is an earnings limit of €600 per week in determining the amount of the statutory redundancy. The sum payable as statutory redundancy is exempt from income tax.

An employer may decide to pay an employee an amount in excess of the statutory lump sum, this non-statutory payment is taxable. The Revenue provides for some relief to be given to an employee on this tax free lump sum.

When employment ceases it is not uncommon for an employee to receive payments other than statutory and non statutory redundancy lump sum payments. It is important to determine whether these extra payments are taxable as normal salary or if they are to be treated as part of the redundancy package. The table on the next page shows common payments and their classification:

Payment type	*Classification*	*Extra notes*
Pay in lieu of notice	Ex gratia redundancy	As long as the employment contract provides that a required period of notice is necessary
Pension lump sum	Tax free, not income or redundancy, as long as the payment does not exceed one and a half times the individual's salary	A cap of €200,000 has been introduced as an additional condition for 2011
Holiday pay	Income	Treated as part of salary and assessed under Schedule E
Loans written off or assets transferred	Ex gratia redundancy	The market value at the date of the termination is used regardless of their original cost or value

Tax free ex gratia amount
Once the value of the ex gratia payment has been determined the next step is to calculate the amount of this payment that may be treated as tax free. There are three different methods which can be used to calculate the exempt amount, and the taxpayer will use the method that gives them the highest tax free sum. The exemption methods are referred to as:

- the Basic exemption
- the Increased exemption
- the Standard Capital Superannuation Benefit (SCSB).

The Basic exemption
This is available to all individuals that are made redundant and is calculated as: €10,160 plus €765 for each complete year of service.

Example 1
John was made redundant on 1 June 2010 having being employed for 14 years and 11 months. The basic exemption amount will be: €10,160 + (€765 X 14) = €20,870.

The Increased exemption
This is the Basic exemption plus €10,000. It is available to persons who have not previously availed of relief from taxation on ex gratia payments within the past 10 years. In addition the €10,000 is only available in full where the individual has not received, and will not receive, a pension

lump sum under an approved pension scheme relating to the employment.

Where an individual receives a pension lump sum as part of the termination payment, or will receive one at some time in the future, then the €10,000 will be reduced by this amount.

Example 2
Sam was made redundant on 1 October 2010, having worked in his employment for 13 years and five months. Sam is not a member of an approved pension scheme, therefore, his increased exemption will be:
€10,160 + (€765 X 13) + €10,000 =€30,105.

Example 3
As in Example 2, except in this example Sam receives a pension lump sum of €7,000.
€10,160 + (€765 x 13) + (€10,000 - €7,000) = €23,105.

Example 4
As in Example 2, but in this example Sam will receive a pension lump sum of €15,000.

As the pension lump sum exceeds the additional €10,000, this €10,000 will not be available, and so the increased exemption will not be available.

From a practise point of view students should be aware that an employer needs the prior approval of Revenue to use the figure calculated under this increased exemption method as the tax free amount.

The Standard Capital Superannuation Benefit
This method demands slightly more computation. The formula is:
(A x B/15) – C
Where:
A is the average annual emoluments of the individual over the past three years. Emoluments include salary and taxable benefits.
B is the number of years of complete service.
C is the amount of a lump sum payment under an approved superannuation scheme, that is paid now or receivable at some time in the future.

Example 5
Susan retired from her employment on 31 December 2010. She had worked in her employment for 18 years and three months. Her pay for the past three years was:

	Salary	*Benefit in kind valuation*
2010	€44,000	€7,000
2009	€41,000	€6,000
2008	€38,000	€5,000

She received a lump sum pension payment on retirement of €12,000.
Her tax free ex gratia payment will be:
A: €(44,000 + 41,000 + 38,000 + 7,000 + 6,000 + 5,000)/3= €47,000
B: 18
C: €12,000

(€47,000 x 18/15) – €12,000 = €44,400.

Students should note that in calculating the average annual salary for the past three years, the average will be calculated to the final date of employment and is not done by reference to tax years.

Example 6
John was made redundant on 31 August 2010. Details of his salary for past years are:

	Salary	*Benefit-in-kind*
	€	€
1 January to 31 August 2010	24,000	1,600
Year to 31 December 2009	34,000	2,400
Year to 31 December 2008	32,000	2,100
Year to 31 December 2007	28,000	2,000

Average annual salary for use in SCSB calculation is:	€
2010 (Eight months)	25,600
2009 (12 months)	36,400
2008 (12 months)	34,100
2007 (Four months) (€30,000 x 4/12)	<u>10,000</u>
Total income for three years to date of termination	106,100
Average income for the past three years	€35,367

A full case scenario, pulling together all the various elements of a typical termination payment follows.

Example 7
Kevin, aged 63, was employed by Expert Engineering Ltd for the past 21 years and seven months. On 31 May 2010 he was made redundant. He received the following payment on termination of his employment:

	€
Holiday pay	2,400
Pay in lieu of notice (notice is required in his employment contract)	3,200
Statutory redundancy	25,600
Ex gratia payment	67,200
Pension lump sum received	8,000

Kevin agreed to purchase his company car. The car cost €26,000 when purchased new five years ago, its market value on 31 May 2010 was €12,000, and his employer agreed to sell it to Kevin for €8,000. Kevin's annual average emoluments for the past three years were €40,000.

Step 1 Calculate the taxable amount of the ex gratia payment.

Payment	*Tax treatment*	*Taxable ex gratia payment*
		€
Holiday pay	Schedule E, treated as part of normal salary	
Pay in Lieu of notice	Taxable ex gratia payment	3,200
Statutory redundancy	Exempt from tax	
Non statutory redundancy payment	Taxable ex gratia payment	67,200
Motor car acquired at less than market value	As the price paid is less than the market value the difference is treated as taxable ex gratia payment	4,000
Pension lump sum	As this is less than one and a half times his salary this amount is exempt from income tax	

The lump sum that is taxable before any relief is given is, therefore, €74,400.

Step 2 Calculate the relief available on the taxable ex gratia payment using the alternate methods.

- The Basic exemption: €10,160 + (€765 x 21) = €26,225
- The Increased exemption: €10,160 + (€765 x 21) + (€10,000 - €8,000) = €28,225
- The SCSB: €40,000 x 21/15 – €8,000 = €48,000

The taxpayer will avail of the method that gives them the greatest exemption, therefore in this case Kevin would choose the SCSB figure of €48,000.

The taxable sum will be €26,400, which is €74,400 less €48,000. This sum will be taxed at the Kevin's marginal rate of tax and will also be liable to the income levy.

Top slicing relief will be available to the taxpayer, but this is currently not examinable at Paper F6 (IRL).

References

- Irish Taxation: Law and Practice, Dr Geraldine Doyle, 2010
- Irish Revenue, 2008
- Citizens Information Board, 2010