

24 November 2016

PAYMENTS ON TERMINATION OF EMPLOYMENT – A TAXING AFFAIR!

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On termination of employment, there are certain payments that must be made to employees by the employer. Some of these payments are required in terms of legislation while others may be required in terms of the employee's employment contract. Termination payments usually include:

- salary until last day of work;
- payment in lieu of notice if the employee is not required by the employer to work his/her notice period, as provided in the employment contract (and unless the employee's services are terminated *summarily* (without notice), typically in dismissals for gross misconduct);
- payment in respect of annual leave that has accrued to the employee but is untaken as at the date of termination; and
- pension or provident fund benefits in terms of fund rules.

Other termination payments may include, for example, a pro rata 13th cheque or bonus. This depends on whether it is company policy or practice for the employer to pay a pro-rated 13th cheque or bonus where an employee's services are terminated part way through the year.

In addition, on termination for operational requirements (retrenchment), the Basic Conditions of Employment Act 75 of 1997 requires that an employee be paid severance pay, an additional payment of a minimum of 1 week's remuneration for every completed year of service. "Remuneration" is defined in the BCEA to mean any payment in money or in kind, or both in money and in kind, made or owing to the employee in return for that person working for the employer. Accordingly, statutory severance pay is calculated on more than an employee's basic wage or salary.

On termination, many employers simply deduct income tax in the ordinary course from the lump sum payment due to the employee (made up of, *for example*, salary, notice pay and accrued leave pay and perhaps severance pay and/or a gratuity), remit the income tax to the South African Revenue Service ("SARS"), and pay the balance to the employee. This is actually in contravention of the Income Tax Act 58 of 1962 ("ITA") and may result in the employer facing an additional tax bill.

Paragraph 9(3)(a) of the Fourth Schedule to the ITA provides that the amount to be deducted or withheld in respect of employees' tax from any lump sum to which paragraph (d) or (e) of the definition of 'gross income' in the ITA applies, "shall" be ascertained by the employer from SARS before paying out the lump sum.

Paragraphs (d) and (e) of the definition of "gross income" in the ITA deal with payments to an employee on termination of employment, including voluntary termination, for purposes of taxation.

1. In terms of paragraph (d)(i), the following is included in an employee's "gross income" – "any amount ..., including any voluntary award, received or accrued (i) in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of any office or employment or of any appointment ... to any office or employment; ..."

2. In terms of paragraph (e), the following is also included in an employee's "gross income" - "a retirement fund lump sum benefit or retirement fund lump sum withdrawal benefit ...".

The effect of paragraphs (d) and (e) of the definition of gross income is that, with limited exceptions, all lump sum termination payments, including so-called "ex gratia" or gratuity payments made to an employee in consequence of an "agreed resignation" or "mutually agreed termination", are subject to income tax. Therefore, the normal procedure where a lump sum is to be paid to an employee on termination of her employment is that a tax directive must be obtained from SARS by the employer prior to paying the lump sum amount to the employee (in terms of the employer's statutory obligation), and the employer deducts income tax from the amount to be paid to the employee in accordance with the tax directive obtained.

Tax exemptions

One of the benefits to applying for an income tax directive from SARS is that certain benefits payable to employees on termination of employment are subject to a cumulative tax exemption and to more attractive tax rates. With effect from 1 March 2014:

- any "retirement fund lump sum benefit" and/or any "severance benefit" received by or accrued to an employee upon termination of employment will qualify for a once-off R500,000 tax exemption, while the amounts in excess of R500,000 will be taxed at lower rates than provided for in the normal SARS tables; and
- while a "retirement fund lump sum withdrawal benefit" also qualifies for an exemption and special tax rates, this is much less attractive with only the first R25,000 of a retirement fund lump sum withdrawal benefit qualifying for an exemption.

A "**retirement fund lump sum benefit**" generally refers to a retirement fund lump sum payable on retirement, while a "**retirement fund lump sum withdrawal benefit**" refers to a withdrawal benefit payable on termination of employment prior to retirement. It is much more beneficial for employees in the latter instance to have their withdrawal benefits transferred to another retirement fund or to a preservation fund (which transfer should not trigger any tax), rather than to take it in cash and be taxed on it.

A "**severance benefit**" is defined to mean "any amount (other than a lump sum benefit ...) received by or accrued to a person by way of a lump sum from or by arrangement with the person's employer ... in relation to that employer in respect of the relinquishment, termination, loss, repudiation, cancellation or variation of the person's ... employment ..., if-

- (a) such person has attained the age of 55 years; or
- (b) such relinquishment, termination, loss, repudiation, cancellation or variation is due to the person becoming permanently incapable of holding the person's office or employment due to sickness, accident, injury or incapacity through infirmity of mind or body; or
- (c) such termination or loss is due to-
 - (i) the person's employer having ceased to carry on or intending to cease carrying on the trade in respect of which the person was employed or appointed; or
 - (ii) the person having become redundant in consequence of a general reduction in personnel or a reduction in personnel of a particular class by the person's employer, ...".

The favourable tax treatment in respect of “*severance benefits*” thus only applies on termination of employment -

- in respect of a lump sum retirement fund withdrawal accrued from a retirement fund; or
- if the employee is 55 or older; or
- if the termination is due to incapacity; or
- if the termination is due to the employer ceasing to carry on trade, or the employee becoming redundant.

The following tax rates are now applicable to retirement fund lump sum benefits and severance benefits:

<i>Taxable income from retirement fund lump sum benefits and from severance benefits</i>	<i>Rate of tax</i>
R500,000 or less	0% of taxable income
R500,000 - R700,000	18% of taxable income above R500,000
R700,000 - R1,050,000	R36,000 + 27% of taxable income above R700,000
R1,050,000 +	R130,500 + 36% of taxable income above R1,050,000

It must be kept in mind that the above rates and thresholds apply over the person’s lifetime i.e. should an employee have received retirement fund lump sum withdrawal benefits and/or severance benefits previously, such amount(s) would have to be taken into account to determine whether the current payment will be exempt or will be subject to the 18%, 27% or 36% rates as set out in the table. *For example*, if the employee was previously retrenched, the amount in respect of which the employee previously received an exemption from income tax (up to the maximum of R500,000) must be deducted from the R500,000 allowed. If the employee previously received an exemption in respect of the full R500,000, no further exemption will be allowed, but the current payment will be subject to the beneficial tax rates set out in the table.

Can all payments to the employee on termination in the circumstances contemplated above be included in the lump sum severance benefit for purposes of applying the tax exemption, such as the employee’s pay in lieu of notice, accrued leave pay, severance pay and bonus?

The only amounts which are expressly excluded from the definition of a “severance benefit” are proceeds from insurance policies linked to employment. However, the SARS Guide for Employers expresses the following view in respect of accrued leave pay: *“Please note that leave pay is a payment in respect of services rendered and does not form part of a severance benefit. The normal bonus calculation should be used to calculate the tax.”* (SARS apparently uses a similar argument to argue that pro rata bonus payments also do not form part of the severance benefit.)

The counter-argument is that leave and bonus payments become payable as a result of the termination of employment, even though the entitlement is calculated with reference to past employment. This is so particularly in the case of leave pay, as employees often are not entitled to leave pay should they not use their leave. They would thus not have become entitled to leave pay should they have remained in employment. Leave and bonus payments are thus not paid in respect of “services rendered” and should thus not be excluded from the definition of a severance benefit. This is supported by the argument that retrenchment packages are generally also calculated based on length of service, but it is accepted that retrenchment packages form part of the severance benefit and are not paid in respect of “services rendered”.

retrenchment. If an employee is to qualify for the tax exemption as a result of her redundancy, such redundancy must be a genuine dismissal for operational requirements.

If it is simply a scheme devised for the purposes of reducing the income tax payable by the employee and so to ensure that she is able to “qualify” for the tax benefits, this “redundancy” arrangement will not qualify for the more beneficial tax table as it will either not be a severance benefit as defined, or SARS may apply anti-avoidance provisions to deny the taxpayer the benefit. Although the ultimate income tax liability is that of the employee, in terms of the Tax Administration Act 28 of 2011 read with the Fourth Schedule to the ITA, the employer will be personally liable for the tax which it failed to withhold, together with interest. SARS may further impose penalties of up to 210% on the employer and the conduct of the parties may well constitute tax evasion, which carries criminal penalties.

Failing the application of the tax exemption, any gratuity or other statutory or contractual payments paid to an employee on termination of employment, whether mutually agreed or not, will be subject to normal income tax in the ordinary course. In either event, prior to effecting payment of the lump sum termination payment to the employee, the employer first must obtain a tax directive from SARS and deduct the requisite income tax as directed, and then effect payment of the balance of the lump sum to the employee.

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