

**Termination payments: removal of Foreign Service Relief (FSR) for UK residents
Response by the Chartered Institute of Taxation**

1 Introduction

- 1.1 The Chartered Institute of Taxation (CIOT) sets out below its response to the draft clause, Termination payments: foreign service, published on 13 September 2017 for inclusion in Finance Bill 2017 to 2018.
- 1.2 The draft legislation removes Foreign Service Relief (FSR) (except for seafarers) in respect of payments made on the termination of an individual's employment where the payment relates in full or in part to a period of non-UK residence and the individual is UK resident in the tax year the payment is received. A termination payment made during a tax year in which the individual is non-UK resident will remain eligible for FSR. The new legislation will take effect from 6 April 2018. The current exception for foreign service is contained in section 413, Income Tax (Earnings and Pensions) Act 2003 (ITEPA 03).
- 1.3 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 1.4 Our stated objectives for the tax system include:
- A legislative process which translates policy intentions into statute accurately and effectively, without unintended consequences.
 - Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
 - Greater certainty, so businesses and individuals can plan ahead with confidence.

2 Executive summary

- 2.1 We have previously¹ raised concerns about the interaction of the removal of FSR on termination awards and the rules normally applied to attribute general earnings between UK and non-UK duties.
- 2.2 We remain concerned that the net result of removing FSR without replacing it will be that a termination award made to an individual that has largely worked overseas but ends his/her employment in the UK will be taxed more heavily than a 'normal' bonus. We do not believe this will provide certainty or clarity, especially where a bonus is received at a time when an employment is being terminated.
- 2.3 Guidance will be needed to assist employers (and employees and HMRC) in determining whether a 'terminal bonus' is a bonus payment for past services, taxable as general earnings, or part of the termination award, taxable under section 401, ITEPA 03.
- 2.4 Guidance will also be needed to deal with:
- Foreign tax credits, where the termination award is liable to tax in both the UK and an overseas territory;
 - Employers' determination of a (former) employee's residence status at the time a termination award is paid;
 - Social security obligations in the UK (ie whether and when a liability to NICs arises); and
 - The tax treatment of termination payments straddling the 2017/18 and 2018/19 tax years.

3 Termination payments: foreign service

- 3.1 The draft legislation removes FSR on termination payments for UK residents. As a result an assignee returning to the UK and then having his/her contract terminated will be liable to UK tax on his/her termination payment even where almost all of the individual's period of service has been overseas. We remain of the view that this is inequitable.
- 3.2 For example, an individual works 19 tax years outside the UK when non-resident and 1 tax year at the end of the employment in the UK when UK resident. The employment is terminated and a £40,000 termination award under section 401, ITEPA 03 (payments and benefits on termination of employment) is received. Under the existing rules there would be full FSR. Under the new rules there will be no FSR with £10,000 taxable under section 401 after accounting for the £30,000 exemption.

3.3 Terminal bonuses

Compare this situation to that of an assignee returning to the UK and then receiving a bonus for past services. This would be taxable as earnings under section 62, ITEPA 03 and sourcing rules would mean that, using the above example, the bonus would be apportioned over the 20 years and as 19/20ths are attributable to non-UK duties, on a just and reasonable basis,

¹ 170206 Draft FB17 Clause 9 Termination payments - CIOT comments.pdf

only 5% or £2,000 would be taxable in the UK. In other words a materially lesser amount than will result following the abolition of FSR.

- 3.4 It seems to us that if termination payments do not follow the same sourcing rules as apply to general earnings, there is an incentive created to pay sums as bonuses rather than termination payments in some cases. We would therefore suggest the government reconsiders its approach to the taxation of termination payments where an individual has previously worked extensively outside the UK. Failing that we think that guidance, including examples, will be needed to help employers (and individuals) determine when a payment is (a) a bonus at the end of an employment and taxable as general earnings or (b) a termination award.

3.5 *Overseas tax credits*

In many cases an individual returns to the UK because his/her contract is being terminated. In the past FSR has meant that it is only the tax position in the overseas jurisdiction that requires consideration. In future, as in many cases the individual will be UK resident for the tax year the award is received, it is likely that the award will be liable to tax in both the UK and overseas territories, eg where an individual is caught by the OECD model.

- 3.6 Confirmation that an individual can claim a foreign tax credit in the UK for the overseas tax paid would be appreciated and we think this should be incorporated into HMRC's guidance.

3.7 *Statutory Residence Test (SRT)*

The draft legislation maintains FSR where an individual is non-UK resident for the tax year in which the employment terminates, with residence status being determined under the SRT. Generally, residence is determined at the end of the tax year, when all the facts are known by the individual. However, it is the employer, under the PAYE Regulations, that has to determine whether or not a termination award is liable to PAYE at the time payment is made.

- 3.8 Consequently, the employer will have to consider the (former) employee's residence status under SRT at the time of payment. And yet the employer is unlikely to have all the information to make that judgement. For example, the individual may be non-UK resident when his/her contract is terminated so that the employer quite reasonably considers the individual to be non-UK resident when the termination award is made and does not subject the payment to PAYE believing that FSR applies – but the individual could subsequently return to the UK and so maintain UK residence for that tax year under the SRT rules in which case the termination payment would no longer benefit from FSR.

- 3.9 Employers will require guidance on determining UK residence status at the time a termination award is paid, and what happens if they get it wrong. In the above example we suggest that provided the employer acted in good faith, based on their knowledge at the time of payment, then any tax due as a result of the employee's change of residence status should be the responsibility of the individual through his/her Self-Assessment return.

3.10 *National Insurance Contributions (NICs)*

Early clarification of the employer's social security obligations, eg where a termination payment is potentially liable to taxation both in the UK and the overseas territory the employee was working in, would be appreciated. For example, where EEA rules apply,

where there is a bilateral social security agreement, where there is a certificate of continuing liability in place or where none of these situations apply. This is particularly important in FSR type cases where a significant amount of service is rendered outside the UK. In addition, where an award is a section 62 bonus rather than a section 401 payment, the issue will be around Class 1 NIC (employee and employer) rather than Class 1A (employer only).

3.11 *Transitional rules*

We understand that the existing rules apply up to 5 April 2018 and that the new rules are to apply to terminations on or after 6 April 2018. Guidance and examples confirming the treatment of instalment payments that straddle the 2017/18 and 2018/19 tax years would be helpful. For example, we assume that for a termination in 2017/18 where part of the termination award is received in 2018/19 then this will fall to be taxed under the 'old' rules – and that for a termination in 2018/19 where part of the award is paid in 2017/18 then it will be taxed under the 'new' rules.

4 **Acknowledgement of submission**

- 4.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

5 **The Chartered Institute of Taxation**

- 5.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
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