



Employment Termination Payments

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Employment termination payment

- ▶ Section 82-130 of the ITAA 1997 defined employment termination payment:
 - (i) Payment of either money or property;
 - (ii) Received by a person (generally does not include superannuation paid to a fund);
 - (iii) There must be a relationship of employment;
 - (iv) The employee must be terminated – either actual or constructive dismissal, resignation or death;
 - (v) The payment must be received in “consequence of termination” of employment – there must be a causal link, but termination does not need to be the dominant reason;
 - (vi) The payment must generally be received within 12 months, but the payment can be received outside the 12-month period where:
 - (a) There is legal action over the person’s entitlement to payment and it commenced within 12 months of termination;
 - (b) The payment is made by a liquidator, receiver or trustee in bankruptcy who was appointed no later than 12 months after termination (Employment Termination Payments (12-month rule) Determination 2007).

Payments excluded from being ETP's

- ▶ Certain payments are **not** employment termination payments:
 - (i) Super benefits from a super fund;
 - (ii) Pension and annuity payments;
 - (iii) Unused annual leave payments;
 - (iv) Tax-free part of a genuine redundancy / early retirement scheme payment;
 - (v) An advance or loan on arm's length terms;
 - (vi) A payment that is not a deemed dividend;
 - (vii) A capital payment for personal injury in so far as it is reasonable having regard to the nature of the injury and its effect on an employee's ability to derive income;
 - (viii) A capital payment in respect of a legally enforceable restraint of trade;
 - (ix) An amount received in commutation of a pension and wholly applied to pay an SCC liability;
 - (x) An amount assessable under an employee share scheme.

Is there a relationship of employment?

- ▶ The person was an employee and not a contractor
- ▶ Substance over form – must consider the relationship of the parties as a practical matter (*Hollis V Vabu* (2001) 207 CLR 21 at 41):
 - (i) It is not simply about a label on a contract;
 - (ii) The circumstance surrounding the formation of a contract may be relevant;
 - (iii) Ultimately it is about what actually happens in practice.
- ▶ The “control” test is just one factor, being the **right**/ability of an employer to tell a persons not only what will be done, but **when and how** a task will be performed (*Hollis v Vabu Pty Ltd* (2001) 207 CLR 21 at 41)
 - (i) Given increasing specialisation and expertise there is less need for supervision- it is the right of a party to control rather than whether they actually use it (*Hollis v Vabu* endorsing Mason J in (1986) 160 CLR 16 at 29);
- ▶ Integration-organisation test – does the worker operate for their own account/run their own enterprise, or do they work for someone else?
 - (i) The High Court in *Hollis v Vabu* was of the view that the bicycle couriers did not operate independently running their own enterprise. Their skills were not highly specialised, they would be unable to work as free-lancers or generate goodwill and they were subject to substantial “control by Vabu.

Contractor v Employee - indicia

Contractor

- ▶ Running enterprise for own account – ability to generate goodwill;
- ▶ Ability to control how and when work is performed (not just what work is performed)
- ▶ Running enterprise for own account
- ▶ Payment to achieve a specified result
- ▶ The ability to delegate work
- ▶ Bearing the risk in carrying out work
- ▶ Provision of own tools and bearing own expenses

Employer / Employee

- ▶ Right to control **how and when** work is performed;
- ▶ Right to suspend/dismiss a person;
- ▶ Provision of annual leave / sick leave
- ▶ Directing use of company uniforms

The holder of an “office” is an employee

- ▶ Section 80-5 ITAA 1997 - a person who holds an “office” is also an employee;
- ▶ What constitutes an “office” depends on the context of the legislation, most likely connotes a position of defined authority in an organisation, although not necessarily a position of permanence (Full Fed Ct in *Grealy v FCT* 89 ATC 4192)
 - (i) The executor or a will who renounced probate and received a payment was found to have held an “office” (12 CTBR Case 12);
 - (ii) Managing partner of a grazing enterprise was found to have held an office (FCT v Sealy (1987) 78 A.L.R. 387)

ETP – there must be “Termination” of employment

- ▶ “Termination” means dismissal of constructive dismissal and voluntary resignation;
- ▶ “Termination” is also extended under section 80-10 of the ITAA 1997 to include cessation of employment due to “retirement” or “death”;
- ▶ **Major issue:** where someone retires or resigns and is then re-employed by the same company or an associated company, have they been “dismissed”?

It is a matter of fact and circumstance in each case:

- (i) *Hilton v FCT* 92 ATC 4534, Hill J rejected that it was necessary that someone relinquishing their employment show that they never intend to be reemployed by that organisation. However, he accepted that intention may play a part in determining whether that person’s “office” or employment actually ceased;
- (ii) A taxpayer was a director of a UK corporate group that had operations internationally. He was seconded to turn around the Australian business. Upon his “retirement” and transfer back, he sought to have his retiring allowance taxed as an ETP on the basis he had held an “office”. The AAT dismissed the ATO’s challenge (Icase U75 87 ATC 453);
- (iii) The Commissioner considers that an employee who ceases a particular job but resumes that job some distance away within a period not inconsistent with normal / seasonal conditions in that industry will not have been terminated (Taxation Ruling IT 200);
- (iv) The Commissioner accepts that there is a “termination” of employment where where employment ceases because a business is transferred to an associated company and the employee is reemployed with the new company,

ETP – the payment must be “in consequence of” termination

- ▶ The payment “follow from” or is a “result of” (in a causal sense) a termination of employment (*Reseck v FCT* (1975) 133 CLR 45 and *Le Grand v FCT* (2002) 195 ALR 194 Goldberg J);
- ▶ Termination need not be the “dominant cause” of the payment (*Reseck v FCT* (1975) 133 CLR 45 – a taxpayer employed by a construction company for around 2 years, terminated and given a weekend break and then re-employed for 6 months held to have been terminated in respect of first period of employment);
- ▶ TR 2003/13 the Commissioner considers that a substantial lapse of time between termination of employment and payment may mean that the payment was not received “in consequence of” termination of employment;
- ▶ *Advanced Prosthetic Centre Pty Ltd v Appliance & Limb Centre (International) Pty Ltd* [2002] NSWSC 515: the Supreme Court rejected that certain payments made to a husband and wife after they had left a prosthetics company were ETP's because legal action brought by the husband and wife for oppression against the majority shareholder muddied whether the payments they had received were actually “in consequence” of the termination of their employment.

ETP taxation - ETP cap amount

- ▶ **ETP cap amount:** The maximum ETP that an employee can received concessional; for **2016/2017 ETP cap = \$195,000;**
- ▶ The following payments are subject to the ETP cap amount:
 - (i) Genuine redundancy payments;
 - (ii) Early retirement scheme payments;
 - (iii) ETP's including an invalidity segment payments;
 - (iv) Payments in connection with a genuine dispute that principally relate to an action for:
 - a. Personal injury – either physical or mental, but not reputation (*McMahon v FCT* [1999] AATA 5);
 - b. Unfair dismissal (specific statutory cause of action);
 - c. Harassment or discrimination.

And exceed the sum that the employee could have expected on a voluntary termination of their employment

ETP taxation – whole of income cap

- ▶ All other ETP's are subject to the lower of the **“ETP cap”** and the **“whole of income”** cap amount **\$180,000 (not indexed)**;
- ▶ Other payments subject to the **“whole of income”** cap include;
 - (i) all “non-genuine” redundancy payments including payments in lieu of notice;
 - (ii) Golden handshakes;
 - (iii) Gratuities;
 - (iv) Unused sick leave;
 - (v) Unused rostered days off.
- ▶ ETP cap amount and whole of income cap amount can apply to parts of payment that were made for different reasons (e.g. payment partially for genuine redundancy and partially for gratuity);
- ▶ ETP cap amount and whole of income could also apply to different ETP's made in same income year

Summary - taxation of ETP's

Reason for ETP payment	Age payment received	Component subject to tax	Maximum tax rate
Genuine redundancy Early retirement Invalidity Unfair dismissal Discrimination	Under preservation age	Up to ETP cap	0% - 32%
	At or above preservation age	Up to ETP cap	0% - 17%
	All ages	Above ETP cap	Up to 49%
Non-genuine redundancy Golden handshake Gratuity In lieu of notice Unused sick leave Rostered days off	Under preservation age	Lower of ETP cap or whole of income cap	Up to 32%
	At or above preservation age	Lower of ETP cap or whole of income cap	Up to 17%
	All ages	Above relevant cap	Up to 49%

Preservation age

For a person born....	Preservation age
Before 1 July 1960	55
1 July 1960 – 30 June 1961	56
1 July 1961 – 30 June 1962	57
1 July 1962 – 30 June 1963	58
1 July 1963 – 30 June 1964	59
1 July 1964 – 30 June 1965	60

ATO Schedule 11 – Employer PAYG withholding

Reason for ETP payment	Age payment received	Component subject to tax	Maximum tax rate
Genuine redundancy Early retirement Invalidity Unfair dismissal Discrimination	Under preservation age	Up to ETP cap	32%
	At or above preservation age	Up to ETP cap	17%
	All ages	Above ETP cap	49%
Non-genuine redundancy Golden handshake Gratuity In lieu of notice Unused sick leave Rostered days off	Under preservation age	Lower of ETP cap or whole of income cap	32%
	At or above preservation age	Lower of ETP cap or whole of income cap	17%
	All ages	Above relevant cap	49%

Legal costs and employment disputes

- ▶ TR 2000/5 (para 2 and 4) – the ATO considers that legal costs to settle an employment dispute are deductible for both employee and employer;
- ▶ TR 2012/8 – where a settlement amount includes an amount for legal costs, the ATO considers this is not an ETP and is assessable as ordinary income

Documentation – settlement deeds

- ▶ The settlement deed should ideally specify the following:
 - (i) The type of redundancy and circumstances should be specified, particularly for a genuine redundancy
 - (ii) the various heads of damages and amounts received for each head (e.g. genuine redundancy, personal injury etc.);
 - (iii) A breakdown of any amount for legal costs;
- ▶ The taxpayer bears the onus of proof. The ATO will treat an undissected lump sum on the basis most favourable to it:
 - (i) e.g. capital payment for personal injury not dissection, the ATO will not accept it is a capital payment no subject to tax pursuant to s 118-37 ITAA 1997 if it is not properly apportioned (TR 95/35);
 - (ii) If there is an amount for costs, this should be properly defined to avoid a dispute with the ATO.
- ▶ If it is not possible to have payment dissected in the settlement deed, consider whether other independent evidence can be obtained of the nature of the payment (e.g. emails, correspondence with other side)
- ▶ The employee should obtain a payment summary from their employer

Genuine redundancy payment

- ▶ Where an employee's position is generally redundant, the payment they receive is concessional tax. The requirements are:
 - (i) The employee's position must be dismissed or constructively dismissed (they must not voluntarily resign – *Marriott v FCT* [2004] AATA 806 an employee effectively voluntarily resigned after an internal reorganisation was found not to have been dismissed);
 - (ii) There must be a causal link between the termination of employment and the payment;
 - (iii) Their position must have been made **genuinely redundant**;
 - (iv) The employee must be dismissed before they are 65 or the age at which their employment would have otherwise terminated (if less);
 - (v) There must be no arrangement between the employer and employee that the employee be employed after their dismissal;
 - (vi) The payment must be an arms length amount – there must be real bargaining; and
 - (vii) The payment must be apportioned if it includes a payment for personal injury or another payment specified in section 82-135 of the 1997 Act (apart from s 82-135(e))

Early retirement scheme

- ▶ Essentially, a scheme approved by written instrument from the Commissioner of Taxation for such class of employees as the Commissioner approves, and the scheme relates to a reorganisation / rationalisation of the employer;
- ▶ The written instrument must be issued before the scheme is implemented; and
- ▶ The same requirements above for genuine redundancy payments above apply

Concessional tax treatment of genuine redundancy payments

- ▶ **Tax-free amount:** (i) base amount for the income year +
(ii) service amount for the income year x years of service;
 - ▶ **Base amount 2016/2017:** \$9,936 (indexed for future income years);
 - ▶ **Service amount 2016/2017:** \$4,969 (indexed for future income years);
 - ▶ **Example:** (i) Margaret is 55 years of age
(ii) She had reached a senior position at Ford Motor Company;
(iii) She had worked for Ford for 20 years;
(iv) The company undertook a major reorganisation and Margaret's position was made redundant;
(v) Margaret took legal action against Ford as she felt her initial redundancy payment was too low;
(vi) The matter was settled and it was agreed in the deed of settlement that her redundancy was a genuine redundancy for tax purposes.
(vii) Margaret received a payout of \$180,000. The standard voluntary severance payment at Ford was \$30,000.
- Tax free amount** = $\$9,936 + 20 \times \$4,969 = \$109,316 - \$30,000 = \$79,316$
- Remainder:** \$70,684 subject to the ETP cap amount (limit \$195,000) and subject to tax at 17% = \$12,016

Invalidity segment payment

- ▶ An ETP includes an “invalidity segment” if:
 - (a) A payment is made to a person because they stop being gainfully employed as a result of their suffering from physical or mental health;
 - (b) The gainful employment stopped before the person’s last retirement day; and
 - (c) Two legally qualified medical practitioners certify that, because of a persons ill health, they will never be employed in the capacity for which they are reasonably qualified through education, experience of training
- ▶ Essentially, these payments must be compensation for loss of earnings and must not be capital in nature (otherwise they will be excluded from the definition of ETP);
- ▶ Often capital payments will come from an insurer so this may be a way to distinguish whether a payment is income or capital in nature; and
- ▶ A persons last retirement day is when their employment would have terminated on reaching a certain age or otherwise when they reach age 65.

Invalidity segment payment

- ▶ Section 82-150(2) of the ITAA 1997 states the invalidity segment is calculated as follows:

ETP amount x days to retirement / (employment days + days to retirement)

- ▶ Example: David commenced working with his employer on 12 February 2000. He is suffering from ill health and has 2 doctors certify that she is no longer fit to work. He ceases employment on 18 December 2015. David was 62 on 21 September 2015. He receives \$300,000 which in his case represented an arm's length termination payment. Assuming the statutory retirement age of 65 applies, the invalidity segment is calculated as:

$$\$300,000 \times (1008 / (2135 + 1008)) = \$96,214$$

- ▶ \$96,214 is tax-free;
- ▶ The remainder of the payment is subject to the ETP cap amount:
 - (i) \$195,000 - \$96,214 = \$98,786 taxed @ 17% = \$16,794;
 - (ii) Excess of \$105,000 taxed @49% = \$51,540
 - (iii) Total tax on \$300,000 = \$68,244

ETP by instalments – stagger payments

- ▶ Payments can be staggered over different income years of an individual;
- ▶ Be careful to ensure random timing of instalments and preferably different amounts;
- ▶ If payment is classified as an “annuity” or “pension” it will be excluded from the definition of ETP under section 82-135 ITAA 1997;
- ▶ Be careful not to trigger Part-IVA (e.g. payments obviously structure to obtain a tax advantage – e.g. one payment at the end of June and the other in early July).

Worked example – whole of income

Facts

- ▶ Michael is 55 and was the head coach of a high profile rugby team and had a contract that ran from 1 January 2013 to 31 December 2016;
- ▶ Management made Michael redundant and appointed a new head coach on 25 November 2014;
- ▶ Michael takes legal action on 30 November. The matter is ultimately settled in April 2016;
- ▶ Michael receives a total payment of \$400,000 specified in the deed to be \$300,000 and \$100,000 for racial discrimination.
- ▶ The payment is staggered so that \$250,000 is received in May 2016 (2015/2016 income year) and \$150,000 in July 2016 (2016/2017 income year)

Analysis

- ▶ Michael commenced legal action within 12 months of dismissal, therefore the payment qualifies as an ETP;
- ▶ The \$300,000 is subject to the “whole-of-income” cap. Up to \$180,000 may be subject to tax at 17% if he has not received other income during 2015/2016 income year;
- ▶ The \$100,000 is subject to the ETP cap of \$195,000. This will be subject tax at 17% = \$17,000
- ▶ \$250,000 will be subject to tax in Michael's 2015/2016 income year and \$150,000 subject to tax in his 2016/2017 income year.
- ▶ The ETP cap and “whole of income” cap apply to the entire payment regardless of the fact that it is staggered (section 82-65(4) ITAA 1997)

Annual leave – tax treatment

Payment type	Reason	Accrual dates	Withholding rates
Annual leave	Normal termination (e.g. voluntary resignation, employment terminated due to inefficiency, retirement)	Pre-18 August 1993	32%
		Post-17 August 1993	Marginal rates
	Termination because of genuine redundancy, invalidity or early retirement scheme		32%
Annual leave loading	Normal termination (egg voluntary resignation, employment terminated due to inefficiency, retirement)	Pre-18 August 1993	32%
		Post-17 August 1993	Marginal rates
	Termination because of genuine redundancy, invalidity or early retirement scheme		32%

Long service leave – tax treatment

Payment type	Reason	Accrual dates	Withholding rates
Long service leave	Normal termination (egg voluntary resignation, employment terminated due to inefficiency, retirement)	Pre-16 August 1978	5% of total at marginal rates
		16 August 1978 to 17 August 1993	32%
		Post-17 August 1993	Marginal rates
	Termination because of genuine redundancy, invalidity or early retirement scheme	Pre-16 August 1978	5% of total at marginal rates
		16 August 1978 to 17 August 1993	32%
		Post-17 August 1993	32%

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