



Tax Alert
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Termination Payments...Transitional Traps for Employers

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A New Era for ETPs

The *Simplified Superannuation* measures effective from 1 July 2007 have brought with them some significant changes to the taxation treatment of termination payments payable to employees upon cessation of employment.

Payments previously taxed as *eligible termination payments* will now be treated as *employment termination payments*. Broadly, "employment termination payments" will only receive concessional taxation treatment where the amount of the payment is less than a \$140,000 cap (indexed annually). Any amounts paid in excess of this cap stand to be taxed at the top marginal rate. As a general proposition, this is a far less attractive tax outcome than the previous position for eligible termination payments made prior to 1 July 2007.

A significantly improved taxation outcome will be achieved where employees are entitled to transitional termination payments that arise from employment agreements and other arrangements entered into prior to **10 May 2006**. The identification of these transitional entitlements will be critical to the process of making severance payments under

the new regime. This will especially be the case where executives and senior employees have substantial entitlements and can be expected to be highly sensitive to taxation outcomes.

Employers who fail to take account of these measures do so at their own peril. A failure to identify and appropriately deal with a transitional termination payment may substantially compromise an employee's tax position, thereby creating potential exposure for the employer.

What are Employment Termination Payments?

Before considering the nature of transitional termination payments, it is worthwhile to briefly note the nature and taxation treatment of employment termination payments.

Under the new legislation, the policy makers have finally severed the link between payments made to employees upon termination and lump sum payments made by superannuation funds to their members. Only the former are treated as employment termination payments. An employer pays an "employment termination



payment" where they make a lump sum payment to an employee in consequence of termination of that person's employment. The definition of "employment" is extended (as was the case for ETPs) to the holding of an office. The circumstances in which such payments may arise can include dismissal, resignation, retirement and the death of the employee. Further, to qualify as an employment termination payment, the payment must be made within twelve months of termination of employment.

A number of other types of payments that may be payable upon termination of employment are expressly excluded from being employment termination payments. These include accrued annual leave and long service leave entitlements and the tax free component of a genuine redundancy (formerly bona fide redundancy) amongst others. These entitlements each have their own specific taxation treatment.

Taxation Treatment of Employment Termination Payments

Employees in receipt of employment termination payments (that are not transitional) in excess of the \$140,000 cap will be taxed at the top marginal rate of 45% plus medicare levy on the excess. Amounts below the \$140,000 cap will be subject to a tax rate of up to 15% plus medicare levy if the employee has attained preservation age in the year of the payment. If the employee has not attained preservation age, a tax rate of up to 30% plus medicare levy will apply. The term "preservation age" borrows from the existing definition in the superannuation legislation. Employees born before 1 July 1960 will have a preservation age of 55 increasing for later birth dates up to a preservation age of 60 for persons born after 30 June 1964.

Significantly, employment termination payments cannot be rolled over into superannuation. This fact, as well as the above taxation treatment, means that any substantial employment termination payment is now likely to be highly tax ineffective when compared to its pre 1 July 2007 treatment.

Identification of Transitional Termination Payments

To prevent the perceived risk of employers and employees bringing forward entitlements prior to the introduction of the *Simplified Superannuation* measures, the policy makers have attempted to substantially mirror the previous taxation treatment for entitlements that existed prior to budget night last year, namely, 10 May 2006. Such entitlements are known as *transitional termination payments*. However, in a sense these benefits are more than simply transitional in that they will remain a practical issue for employers and employees until at least 2012.

In order to qualify for a transitional termination payment, the following criteria must be satisfied:

- > the employee must receive a payment they are entitled to under a written contract, a law of the Commonwealth, a State, a Territory or another country, an instrument under such a law or a workplace agreement;
- > the entitlement must be provided for under that contract, law, instrument or agreement as in force just before **10 May 2006**;
- > the payment needs to be made before **1 July 2012**; and
- > the contract, law or agreement, as in force just

before 10 May 2006, must specify the amount of the payment or a way to work out the specific amount of the payment.

The legislation stipulates that the specific amount of an entitlement can be worked out by:

- > a method or formula for working out the amount; or
- > provision for the employee or another person to make a choice between the forms of payment, allowing the amounts to be worked out as a specific amount or in accordance with a formula.

The explanatory memorandum that accompanied the bill introducing these measures provides the following examples of transitional termination payments:

Duncan is to have his employment terminated shortly after 1 July 2007. If Duncan were entitled, as at 9 May 2006, to an amount of \$10,000 or an amount of 10,000 shares in the company, this would meet the transitional provision requirement of being a specified amount or providing for a way to work out the amount. If Duncan were able to choose between the shares or the cash, or was entitled to whichever had the greater value at termination, this would also meet the requirement. If Duncan were entitled to 10,000 shares only if they were at the time worth more than \$5 each, this would also satisfy the test.

If the payer has discretion as to whether the payment is made (but not the value of the payment) then such payments are also likely to satisfy the transitional provisions. For



instance, if Duncan was entitled to 10,000 shares of the company if, in the opinion of the board, he has raised the value of the company, or if he was entitled to \$10,000 or 10,000 shares at the board's discretion, these payments would qualify for the transitional arrangements. This is because the amount of the payment is still specified or able to be determined, despite the fact that the board holds the sole decision-making power about the payment.

If Duncan was entitled to an amount of money, or number of shares, at the complete discretion of the board, this would not meet the requirement of the transitional provisions. Similarly, if the board was to determine the value of the payment as an amount equal to 10% of the amount by which the board considers that Duncan has raised the value of the company, this would also fail to meet the requirements.

Whilst the above examples are reasonably straightforward, in practice the issue of whether a particular entitlement amounts to a transitional termination payment may not be easily resolved. Moreover, complications will also often arise as to whether the employee is in a better position to take their transitional termination payment or to compromise that payment and take a substantially different entitlement involving significantly more value.

Taxation Treatment of Transitional Termination Payments

We have noted above that any benefit qualifying as a transitional termination payment will be significantly more tax effective. For employees who have

attained preservation age, such payments will be taxed at up to 15% plus Medicare levy for amounts up to \$140,000, and 30% plus Medicare levy for amounts in excess of \$140,000 up to \$1M. Only amounts in excess of \$1M will be taxed at the top marginal rate. Where the employee has not attained preservation age, all payments up to \$1M will attract a tax rate of up to 30% plus Medicare levy. Again, payments in excess of this \$1M cap will be taxed at the top marginal rate. Thus, in both situations an employee can receive considerable severance payments before a 46.5% tax rate applies.

Significantly, unlike employment termination payments generally, transitional termination payments are able to be rolled over into superannuation. This is a major concession given the new taxation treatment of superannuation benefit payments. Since 1 July 2007, most benefits taken from complying superannuation funds for persons who are 60 years or over are able to be received tax free. Therefore, the rolling over of a transitional termination payment into a complying superannuation fund will have a significant tax advantage for employees upon retirement.

Some Traps and Practical Issues

Perhaps the most significant trap for employers will be to unknowingly compromise an employee's entitlement to a transitional termination payment. For instance, if an employer and employee agree to a re-write of the employee's employment contract, replacing their pre 10 May 2006 entitlements, the employee's entitlement to a transitional termination payment will be compromised. This may occur in the course of the employee's employment. Alternatively, it may

occur in the process of terminating an employee where a settlement deed or similar document is prepared which overrides the employee's existing entitlements - perhaps replacing them with what is perceived to be a more comprehensive severance package. It is clear that employers must now identify whether any entitlement to a transitional termination payments exists when reviewing employee contracts.

It may be in the employee's interest that a transitional termination payment is relinquished. For instance, the employer may be able to offer the employee a superior severance package (after tax) to what the employee would have been entitled to under a pre 10 May 2006 contract. The main focus here will be to ensure the employee is properly informed of their entitlements and understands the consequences of waiving any transitional entitlement. The position needs to be carefully evaluated.

It may be possible to supplement an employee's entitlement upon termination without the employee relinquishing the transitional termination payment. Whatever the situation, it is clear the employer needs to exercise a high degree of care to ensure substantially different taxation outcomes are taken into account in dealing with an employee's entitlements.

Other practical issues will be:

- > withholding the appropriate amount of tax from an employment termination payment for PAYG withholding purposes including a careful evaluation of an employee's claim that they are eligible for a transitional termination payment;
- > taking the necessary steps to allow employees to rollover any transitional termination



payments into superannuation (there is a new procedure in the legislation to facilitate this process);

- > ensuring that the various other components of the severance package are properly identified and subject to appropriate tax withholding (ie accrued leave entitlements).

If you would like more information about transitional termination payments or the tax issues associated with effecting termination of employment, please feel free to contact one of the members of our team.

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