EXPLANATORY MEMORANDUM TO

THE SOCIAL SECURITY (CONTRIBUTIONS) (AMENDMENT NO. 2) REGULATIONS 2018

2018 No. 257

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty (HMRC).

2. Purpose of the instrument

2.1 This instrument will apply a Class 1 National Insurance contribution (NICs) liability to all payments-in-lieu-of-notice (PILON) paid as part of a termination award. A termination award is money an individual can receive when their employment is terminated. A PILON can be paid to an individual who, instead of working their notice period before the employment ends, has their employment terminated with immediate effect. The payment is made in lieu of their entitlement to work that notice period. A Class 1 NICs liability is paid by both the employer and the employee and the amount due is based on the individual's level of earnings.

2.2 This instrument also ensures third parties aren't liable for Class 1 NICs where certain avoidance schemes have been used by others.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 None.

4. Legislative Context

<u>*Applying a Class 1 NICs liability to some aspects of termination awards*</u>

4.1 Section 5 of the Finance (No. 2) Act 2017 makes changes to the taxation of termination awards for income tax purposes. It inserts new sections 402A to 402E into Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003). The effect of these new clauses is that some payments that previously formed part of a termination award, and were therefore not taxable until a £30,000 threshold was exceeded are now treated as general earnings. They are therefore now taxable.

4.2 Sections 402B to 402E ITEPA 2003 set out calculations for working out which parts of the termination award should be treated as general earnings. In essence, all PILONs become taxable as earnings and will not benefit from the £30,000 tax-free threshold. A PILON is a payment made when an individual is asked to leave their job immediately, without working a notice period.

4.3 This instrument mirrors the tax position around PILONs and applies a Class 1 NICs liability to termination payments that fall within new section 402B ITEPA 2003. Payments falling within section 402B ITEPA 2003 will now be treated as earnings for Class 1 NICs purposes

Protecting third parties from liability to NICs under the loan charge

4.4 Part 7A ITEPA 2003 charges income tax on payments to employees where income is routed through someone other than the employer. Regulation 22B of the Social Security (Contributions) Regulations 2001 (SSCR 2001) treats employment income arising under Part 7A ITEPA 2003 as earnings for NICs purposes.

4.5 Section 6(4)(a) of the Social Security Contributions and Benefits Act 1992 (SSCBA 1992) places the liability for Class 1 primary and secondary NICs on the employee and employer (the 'secondary contributor') respectively. However, under paragraph 3 of Schedule 1 SSCBA 1992, the secondary contributor is liable in the first instance to pay both the primary and secondary contributions to HMRC. Under regulation 5(1) of, and paragraph 9 of Schedule 3 to, the Social Security (Categorisation of Earners) Regulations 1978, a secondary contributor can include a host employer, end client, UK agency or UK employer.

4.6 Schedule 11 to the Finance (No. 2) Act 2017 introduced a tax charge on defined loans received through a disguised remuneration tax avoidance scheme which are still outstanding at 5 April 2019. The outstanding amounts will count as employment income by virtue of Chapter 2 of Part 7 of ITEPA 2003 and be treated as earnings for NICs purposes by regulation 22B of SSCR 2001. An unintended consequence of this is that secondary contributors such as host employers, end clients, UK agencies and UK employers, who may not have been party to the avoidance, will be liable to pay Class 1 NICs on the amounts treated as earnings.

4.7 This instrument inserts new paragraph (3A) into regulation 22B SSCR 2001 in order to relieve secondary contributors who were not party to the avoidance of the liability for paying Class 1 NICs to HMRC under Schedule 11 to the Finance (No. 2) Act 2017.

4.8 The Secretary of State for Work and Pensions and the Northern Ireland Department for Communities have concurred to the making of the final tax of regulation 2 of this instrument.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

Applying a Class 1 NICs liability to some aspects of termination awards

7.1 At Budget 2016 the government announced that it would make changes to the taxation of termination payments. This included clarifying the scope of the exemption for termination payments to prevent manipulation, by making the tax and NICs consequences of all post-employment payments consistent.

7.2 Historically, the tax treatment of PILONs, where the employee leaves employment without a notice period being worked but receives a payment to compensate them for this, has been variable. Some PILONs have been taxed as earnings, some have been paid tax free.

7.3 When an individual is paid a PILON due to a contractual entitlement or because it is customary for their employer to pay a PILON then these payments are already regarded as being earnings and liable for Class 1 NICs. However, a non-contractual or non-customary PILON paid as compensation in lieu of a notice period is not regarded as earnings for Class 1 NICs purposes.

7.4 Finance (No. 2) Act 2017 introduced changes so that all PILONs are treated as general earnings for tax purposes. This measure aligns the tax and NICs treatment to ensure that those PILONs that do not already attract a Class 1 NICs liability, but which are now taxable as general earnings, will now also be treated as earnings for Class 1 NICs purposes.

7.5 Statutory Redundancy payments are not affected by this change.

Protecting third parties from liability to NICs under the loan charge

7.6 This instrument supports the government's announcement at Autumn Statement 2015 that it would take action to ensure those who have used disguised remuneration tax avoidance schemes pay their fair share of tax and NICs. Disguised remuneration schemes seek to avoid income tax and NICs. They normally do this by paying employment income via another party and in the way of loans.

7.7 At Budget 2016 the government announced a package of changes to tackle existing disguised remuneration avoidance schemes and prevent their future use. Schedule 11 to the Finance (No. 2) Act 2017 introduces a new loan charge with effect from April 2019 which will put beyond doubt that certain avoidance arrangements incur a liability to pay tax and NICs. The measure is expected to raise £2.5 billion by 2020/21.

7.8 However, current anti-avoidance legislation will interact with the new loan charge to create an unintended NICs liability.

7.9 The instrument ensures that parties who were not involved in certain avoidance arrangements do not have a liability to pay Class 1 NICs arising as a result of those avoidance arrangements. If the government does not legislate, those parties who were not involved in the avoidance arrangements will have a liability to pay the Class 1 NICs arising as a result of the arrangements.

Consolidation

7.10 There are no plans to consolidate the SSCR 2001.

8. Consultation outcome

Applying a Class 1 NICs liability to some aspects of termination awards

8.1 The government consulted in summer 2015 on a broad package of changes to termination payments. The government received 109 written responses, and HMRC and HM Treasury also held discussions with stakeholders in 2015.

8.2 Around two-thirds of respondents agreed that removing the different tax and NICs treatment of PILONs would remove complexity. Some thought the distinction should be removed on principle, as the system gave preferential treatment to those paid non-contractual PILONs, compared to those who served their notice period. Around a third of respondents did not want the distinction to be removed.

8.3 The consultation response is published on Gov.uk at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/552850/160719_Termination_payments_consultation_template_v_9_Aug_-_to_comms_team_-_corrected_12_Sept.pdf.

Protecting third parties from liability to NICs under the loan charge

8.4 The draft regulations for this measure were published in December 2017 for comment, but no comments were received.

9. Guidance

9.1 Guidance will be made available on Gov.uk after 6th April 2018.

10. Impact

Applying a Class 1 NICs liability to some aspects of termination awards

10.1 There will be minimal impacts on businesses, charities and voluntary bodies where they make termination awards as they familiarise themselves with the legislation and guidance.

10.2 There will be minimal impacts on the public sector where they make termination awards as they familiarise themselves with the legislation and guidance.

10.3 A Tax Information and Impact Note covering this measure and the wider package of changes to termination awards was published at https://www.gov.uk/government/publications/income-tax-and-national-insurance-contributions-treatment-of-termination-payments/income-tax-and-national-insurance-contributions-treatment-of-termination-payments. It remains an accurate summary of the impacts that apply to this measure.

Protecting third parties from liability to NICs under the loan charge

10.4 The impact on business, charities, and voluntary bodies is that those who are not involved in certain avoidance arrangements will not have a liability to pay the Class 1 NICs arising as a result of those arrangements.

10.5 The impact on the public sector is that public sector bodies who are not involved in certain avoidance arrangements will not have a liability to pay the Class 1 NICs arising as a result of those arrangements.

10.6 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

Applying a Class 1 NICs liability to some aspects of termination awards

11.1 The legislation will have a negligible impact on small businesses, as set out in paragraph 10.1.

Protecting third parties from liability to NICs under the loan charge

11.2 The legislation will have a negligible impact on small businesses, as set out in paragraph 10.4.

12. Monitoring & review

12.1 No review or monitoring is considered necessary.

13. Contact

Applying a Class 1 NICs liability to some aspects of termination awards

13.1 Emma Barker at HMRC – telephone: 03000 586 778 or email: emma.robinson3@hmrc.gsi.gov.uk can answer any queries regarding the instrument

Protecting third parties from liability to NICs under the loan charge

13.2 Ram Joshi at HMRC - telephone: 03000 575 587 or email: Ram.Joshi@hmrc.gsi.gov.uk can answer any queries regarding the instrument.