BUDDLE FINDLAY

Redundancy compensation - Taxing issues

Peter Chemis, Hamish Kynaston, Sherridan Cook, Alastair Sherriff, Susan Rowe

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The tax implications of redundancies are not straightforward. In this article we summarise the impact of income tax (including the often overlooked redundancy tax credit), KiwiSaver, student loans, and leave entitlements on redundancy payments.

Redundancy compensation taxed in the usual way

Redundancy compensation is classed as taxable income. The employer must treat the redundancy compensation as an "extra pay" and deduct PAYE at the employee's marginal tax rate in the usual way. Redundancy compensation cannot be paid tax free; either as a special exemption (none exists) or as a compensation payment for hurt and humiliation under s.123(1)(c)(i) of the Employment Relations Act 2000.

A tax free payment should only be made in terms of s.123(1)(c)(i) where a genuine - although it may be disputed - personal grievance has been raised, and where the amount paid is within the range of what the employee might be awarded if he or she were successful in the Employment Relations Authority or Court. Otherwise Inland Revenue may deem part or all of the payment to be income and require the employer to pay PAYE, plus penalties and interest. Culturally, also, it is damaging for employers to pay money for hurt and humiliation when there isn't a proper basis for that.

Lump sum v payment over time

A common concern raised by employees is that a lump sum payment of compensation might be taxed at a higher rate than if the same amount had been earned by the employee working over time. Employees sometimes ask for the employer to gross-up the redundancy compensation so that they are left in the same position as if they had earned the amount as wages or salary paid over time.

This concern may be correct if the employee is earning $70,000 or less, in which case the redundancy payment might push them into a higher tax bracket. For example, an employee earning $55,000 who receives a redundancy payment of $20,000 will move into the next tax bracket and be taxed at the top marginal tax rate on the portion that is over $70,000 (ie $5,000). However, if the employee had received that amount spread over a period of time, they may not have moved into the next tax bracket, so may have paid less tax.

However, if an employee is earning over $70,000 and is therefore on the highest marginal tax rate of 38%, a lump sum is taxed at the same rate as if the same amount of money had been paid and therefore taxed over a period of time.

The situation becomes more complicated if a person is made redundant and then does not obtain employment for the remainder of the income year. This is because their annual income may be reduced to such an extent that they drop to a lower marginal tax rate. This could mean that the employee can claim a refund of income tax, although this would not generally be available until the following year.

Redundancy tax credit

The redundancy tax credit introduced in April 2008 provides some immediate tax relief for taxpayers receiving redundancy compensation. The effect of the tax credit is to allow an employee to apply for an early tax refund rather than waiting until the following year. The credit is payable at the rate of 6% for the first $60,000 of a genuine redundancy payment i.e. there is a maximum credit available of $3,600.

Certain conditions must be met, essentially that the employee must have received the redundancy payment for loss of employment rather than any other reason such as retirement or dismissal. The credit is available to all irrespective of income level, but any amount paid will be taken into account in calculating that employee's tax liability for the whole income year, so it is possible that the employee may have to repay some of this credit to Inland Revenue. This is more likely to happen if the employee is re-employed and then works for all or the majority of the income year.

For those employers who look to provide an added benefit to redundant employees in the form of an enhanced notice payment, it may be that a better outcome could be achieved by expressly making the payment as redundancy compensation.

An employee can claim the credit by completing a redundancy tax credit form (IR 524) and providing verification of the redundancy and the reason for the redundancy. Form IR 524 is available from the Inland Revenue website.

KiwiSaver and student loans

KiwiSaver contributions should not be automatically deducted from a redundancy compensation payment. The KiwiSaver Act 2006 specifically excludes redundancy payouts from the definition of salary or wages. Student loan payments should be automatically deducted however, because redundancy compensation is classed as taxable income.

Leave entitlements

Redundancy compensation is generally not taken into account when calculating an employee's outstanding holiday pay. This is because the obligation to pay is not triggered until termination of employment, so it does not amount to gross earnings or ordinary weekly pay under the Holidays Act.

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Auckland

188 Quay Street
Auckland 1010

PO Box 1433
Auckland 1140
New Zealand

P: +64 9 358 2555
F: +64 9 358 2055

Wellington

Aon Centre
1 Willis Street
Wellington 6011

PO Box 2694
Wellington 6140
New Zealand

P: +64 4 499 4242
F: +64 4 499 4141

Christchurch

83 Victoria Street
Christchurch 8013

PO Box 322
Christchurch 8140
New Zealand

P: +64 3 379 1747
F: +64 3 379 5659