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Eligible termination payments – a guide for employers on redundancy of an employee



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- phone our information line on **13 10 20** between 8.00am and 6.00pm, Monday to Friday
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- obtain a fax by phoning **13 28 60**, or
- write to:

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PO Box 277
WORLD TRADE CENTRE VIC 8005**

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OUR COMMITMENT TO YOU

We are committed to providing you with advice and information you can rely on.

We make every effort to ensure that our advice and information is correct. If you follow advice in this publication and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we must still apply the law correctly. If that means you owe us money, we must ask you to pay it. However, we will not charge you a penalty or interest if you acted reasonably and in good faith.

If you make an honest mistake when you try to follow our advice and you owe us money as a result, we will not charge you a penalty. However, we will ask you to pay the money, and we may also charge you interest.

If correcting the mistake means we owe you money, we will pay it to you. We will also pay you any interest you are entitled to.

If you feel this publication does not fully cover your circumstances, please seek help from the Tax Office or a professional adviser.

The information in this publication is current at June 2006.

We regularly revise our publications to take account of any changes to the law, so make sure that you have the latest information. If you are unsure, you can check for a more recent version on our website at www.ato.gov.au or contact us.

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ABOUT THIS GUIDE

This guide helps employers decide if they are paying a redundancy payment called an 'approved early retirement scheme payment' or a 'bona fide redundancy payment'. If you are an employer it will help you calculate the tax-free amount of these payments and explain what amounts are eligible termination payments (ETPs). The guide also explains how to get approval to pay early retirement scheme payments.

➤ A checklist is included at the back of this publication to help you through the payment process.

A glossary of commonly used terms in this guide is available by visiting our website at www.ato.gov.au and click on the 'Definitions' link at bottom of the home page screen.

TAX BENEFITS FOR EMPLOYEES

Some payments you make as a result of an employee's termination are taxed at special rates. These are:

- approved early retirement scheme payments, and
- bona fide redundancy payments.

An approved early retirement scheme is when an employer offers an incentive for certain groups of employees to retire early or resign. To get the special tax rates, the Tax Office **must** approve the scheme.

A bona fide redundancy payment is made to an employee who is dismissed because the job they were doing has been made redundant.

Approved early retirement scheme payments and bona fide redundancy payments are tax-free up to the tax-free limit. The tax-free limit is a flat dollar amount plus an amount for each year of the employee's completed service, including annual and long service leave taken. The tax-free limit changes on 1 July each year.

The tax-free limit for the 2005–06 year is a flat dollar amount of \$6,491 plus \$3,246 for each completed year of service. The tax-free limit for the 2006–07 year is a flat dollar amount of \$6,783 plus \$3,392 for each completed year of service.

If the payment is more than the tax-free limit, the amount over the limit is an eligible termination payment (ETP). Special tax benefits also apply to the ETP part of the payment.

➤ You can use our ETP calculator, available on the Tax Office website, to complete the calculations required when paying ETPs.

You cannot use the calculator to work out the tax-free amount of a bona fide redundancy payment. The amount over the tax-free limit is an ETP and the calculator can only be used for this part of the payment.

Visit www.ato.gov.au/super and select 'Calculators' – 'Eligible termination payments' to access the calculator.

WHICH PAYMENTS CAN BE TAX-FREE UP TO THE LIMIT?

Any payments you make which are employer ETPs and meet the **conditions** for payments under an approved early retirement scheme or redundancy are tax-free up to the limit for that year.

Examples of payments that can meet the conditions are:

- payment in lieu of notice
- severance payment of a number of weeks' pay for every year of service, and
- a gratuity or golden handshake.

Payments that **are not employer ETPs** and are taxed differently include:

- payments for unused annual leave and leave loading, and
- payments for unused long service leave.

❗ You may also pay an employee a lump sum to compensate them for superannuation benefits they have lost because of redundancy. This payment does not meet the conditions for an approved early retirement scheme or bona fide redundancy tax-free payment. However, the payment is still an ETP and is taxed at a special rate.

➤ If you need more information about employer ETPs, there is a checklist of these payments in *Eligible termination payments – a practical guide for employers* (NAT 2698). This guide is available by contacting us using one of the methods in the 'More information' section at the front of this guide.

WHAT ARE THE CONDITIONS FOR PAYMENTS TO BE TAX-FREE UP TO THE LIMIT?

Before a payment is tax-free up to the limit, your employer ETP needs to meet all of these conditions.

- The payment is more than the amount you would have paid if the employee had voluntarily resigned or retired in other circumstances. See the examples on pages 5 and 6.
- Your employee's termination occurred before they turned 65 or before they previously agreed to retire.
- You have not made an agreement with another person to rehire your employee.
- If you are related to your employee in some way, the payment is not more than it would have been if you and your employee were not related (known in tax law as dealing with each other at 'arm's length').
- If it is an early retirement scheme payment, the Tax Office has approved the scheme.
- If the payment is a redundancy payment, it is made because the job the employee was doing has been made redundant.

PART 1

GETTING APPROVAL FOR YOUR EARLY RETIREMENT SCHEME

If you are rationalising or reorganising your business operations, you may want to offer employees incentives to retire early or resign. An early retirement scheme is a scheme that you put into place for this reason.

! For tax benefits to apply, we must approve your early retirement scheme before you make any payments.

WHAT ARE THE CONDITIONS FOR APPROVAL?

Your early retirement scheme will generally be approved when it meets these three conditions.

- A** Your scheme is available to broad groups of your employees.
- B** Your scheme is part of a plan to reorganise your business operations.
- C** You applied to the Tax Office for approval of your scheme before making any payments.

Condition A – your scheme is available to broad groups of your employees

Broad groups of your employees may include:

- all employees hired by your organisation
- all employees who have reached a particular age
- all employees with a particular occupational skill, or
- a class of employees approved by the Commissioner.

The number of employees affected is not necessarily relevant. You can offer early retirement to employees in only one location.

We may approve your scheme when the above conditions are met. You may reserve the right to reject additional applications. However, you do not have unlimited right of veto on acceptance of applications under the scheme. An unlimited right of veto would allow you to effectively choose which employees are to be made redundant and this would not be approved.

Condition B – part of a plan to reorganise your business operations

You must be able to show you are implementing the scheme to achieve a specific short-term objective. A specific objective may include:

- replacing employees with particular skills with employees who have different skills
- the closure, relocation or reduction in output of part of your business operations
- the introduction of new technology, processes, systems or productivity increases, or
- any other change to operations or work force approved by the Commissioner.

An early retirement scheme offered as part of normal business operations will not be approved (for example, an early retirement scheme available to everyone 55 years and over each year).

Condition C – approval before the scheme starts

You need our approval for your scheme before you start making payments.

Applying for approval

Your request should include information that shows your scheme meets the conditions for approval. There is no special form.

Your request should include these details:

- 1 the class of your employees that will be offered the scheme
- 2 the information you will be giving to employees
- 3 details of any reasons why you may reject applications for early retirement under the scheme
- 4 relevant industrial awards, agreements or workplace agreements
- 5 an outline of the purpose of the scheme
- 6 terms of the scheme
- 7 the period the scheme will remain open
- 8 payments to be made to your employees who accept an offer under the scheme, and
- 9 the normal retirement age for your employees.

Send your request to the Tax Office where your organisation lodges its tax return. Allow sufficient time (generally 28 days) for us to consider your request.

PART 2

WHEN IS A REDUNDANCY GENUINE (BONA FIDE)?

EXAMPLE 1: An approved early retirement scheme payment

Michael (aged 52) is offered early retirement under an approved early retirement scheme. He has worked for *Great Sounds* since 10 August 1982, with unbroken service other than taking annual leave and long service leave. Michael is offered \$90,000 in addition to other entitlements owed to him.

Michael accepts the offer and is paid \$90,000 on 1 September 2005.

The number of whole years of service was 23 years. (Remember that annual leave and long service leave taken are included in years of service.)

Michael's tax-free limit is \$6,491 plus (23 years x \$3,246) = \$81,149. The tax-free amount of the payment must be shown at label D on Michael's ordinary payment summary.

The balance of the payment (\$90,000 – \$81,149) \$8,851 is an ETP.

As Michael's eligible service period started before 1 July 1983, the ETP will have a pre-July 1983 component and a post-June 1983-untaxed element.

See the ETP procedures checklist on page 7.

There is a worksheet (NAT 12319) included at the back of this guide to help you calculate the tax-free amount of an approved early retirement scheme payment.

➤ *Eligible termination payments – a practical guide for employers* (NAT 2698) sets out the procedures you need to follow when paying an ETP. This guide is available by contacting us using one of the methods in the 'More information' section at the front of this guide. The guide includes worksheets and samples of forms that you may need to use.

A redundancy is genuine when you dismiss an employee because the job they were doing has been made redundant. You do not need approval from us to make this type of payment. When the payment is a bona fide redundancy, your employees will receive tax benefits.

WHAT IS THE MEANING OF 'DISMISSAL'?

For tax purposes, a dismissal is when the decision to terminate employment is yours and not the employee's. For example, a dismissal can occur when you offer a redundancy package to an employee to:

- minimise disruption to other employees, or
- comply with industrial relations law or a workplace agreement.

A dismissal may be a 'constructive dismissal' if you place an employee in a position where there is little choice but to resign.

Some examples of this are when you offer the employee:

- the choice between a package and another job which is different to the employee's qualifications and experience
- a reduction in their pay, or
- dismissal without the benefits of the package.

A redundancy is still considered genuine if you seek expressions of interest from employees before you decide which employee to dismiss. This is different to offering your employees early retirement under an approved early retirement scheme. In this case, it is your employee's decision to terminate employment when they accept your offer.

WHEN IS THE DISMISSAL A REDUNDANCY?

A dismissal is a redundancy when you dismiss an employee because the **job** they were doing is made redundant. The redundant job may be work of a particular kind, either generally or in a particular location.

The following situations are not bona fide redundancies:

- your dismissed employee has reached normal retirement age
- your employee left voluntarily
- another employee of similar age or skills replaced your employee soon after
- your employee was dismissed for disciplinary reasons, or
- your employee was dismissed for inefficiency.

EXAMPLE 2: A bona fide redundancy payment

Eric, aged 38, started working for *Zip Computers* on 15 August 1985 and was dismissed on 30 July 2005.

His job was made redundant when *Zip Computers* closed the division.

Eric's termination payment from *Zip Computers* was \$70,000 more than his other entitlements. There was no agreement to re-hire Eric and the redundancy is genuine.

The tax-free amount available to Eric was a fixed dollar amount of \$6,491 plus a set amount of \$3,246 for each of his 19 years of completed service.

The tax-free amount available to Eric is \$68,165 and is shown on label D on Eric's ordinary payment summary.

The amount over \$68,165 is an ETP. *Zip Computers* will need to work out the components of the ETP and follow the ETP payment procedures. See the ETP procedures checklist on page 7.

EXAMPLE 3: A bona fide redundancy payment

Nicole started work for *Able Security* on 10 July 1991. Her employment contract states that if she is dismissed or resigns for any reason she will be paid one month's severance pay of \$5,000. Nicole is dismissed on 30 August 2005 because her employer lost a contract to supply security services in Nicole's area. There is no agreement to re-hire Nicole at a later time. Nicole was aged 50 when she received a redundancy payment of \$12,000 including the amount of \$5,000 in her employment contract.

The amount of \$5,000 payable on normal resignation is not a bona fide redundancy payment because *Able Security* already had an obligation to make this payment. However it still qualifies for low tax rates as an ETP.

Able Security will need to follow the ETP procedures for paying the \$5,000 ETP. See the ETP procedures checklist on page 7.

This left \$7,000 for consideration for tax-free treatment as a bona fide redundancy payment.

The tax-free limit available to Nicole was $\$6,491 + (14 \text{ years} \times \$3,246) = \$51,935$. The amount of \$7,000 is tax-free, as it is within the tax-free limit. This is shown at label D on Nicole's ordinary payment summary.

➤ The worksheet (NAT 12319) included at the back of this guide will help you calculate the tax-free amount of a bona fide redundancy payment. You can photocopy this worksheet for future use. *Eligible termination payments – a practical guide for employers* (NAT 2698) sets out the procedures you need to follow when paying an ETP and contains samples of the forms you may need.

CAN MY EMPLOYEE ROLL OVER THE TAX-FREE PAYMENTS?

The amount up to the tax-free limit of an approved early retirement scheme payment or bona fide redundancy payment cannot be rolled over to an employee's superannuation fund or any other fund. The amount over the tax-free limit is an ETP and can be rolled over to an employee's superannuation fund or any other fund.

YOUR ETP PROCEDURES CHECKLIST

Step 1

Decide if the lump sum payment is:

- an approved early retirement scheme payment, or
- a bona fide redundancy payment.

Step 2

When the payment is an approved early retirement scheme or bona fide redundancy payment

- Decide how much of the payment is a tax-free amount (there is a worksheet to help you at the back of this guide).
- Use the current year's tax-free amounts.
- Do not include:
 - unpaid salary and wage payments
 - unused annual leave or leave loading or unused long service leave, and
 - other payments that are not ETPs.

➤ For more information, refer to *Eligible termination payments – a practical guide for employers* (NAT 2698). This guide is available by contacting us using one of the methods in the 'More information' section at the front of this guide.

Step 3

Pay the tax-free amount

Write the tax-free amount at label D on the ordinary payment summary you issue at the end of the tax year.

Step 4

When part of the payment is an ETP (over the tax-free limit)

Follow the steps in *Eligible termination payments – a practical guide for employers* (NAT 2698) to:

- calculate the ETP components (Part B in the guide)
- before paying the ETP, give your employee an opportunity to roll over the ETP by filling in an ETP pre-payment statement if the payment is more than \$5,000, unless your employee has already given you payment instructions
- pay the ETP as instructed by your employee, and
- report cash payments over \$5,000 to us for reasonable benefit limit purposes.



Employer ETP worksheet

For redundancy and approved early retirement scheme payments

Employee's name:

No.

Date employment commenced: / /

Step 1 Gross amount of the payment

\$

Step 2 Exclude amounts that are not ETPs

Refer to *Eligible termination payments – a practical guide for employers* (NAT 2698).

Normal salary and wages

\$

Unused annual leave

\$

Unused annual leave loading

\$

Unused long service leave

\$

Other payments

\$

Total amount excluded =

\$

\$

Step 1 less Step 2

Step 3 Amount available for tax free consideration

\$

Step 4 Calculate the employee's tax-free amount

Approved early retirement scheme payment or a bona fide redundancy payment

Get this year's tax-free limit amounts from the Tax Office and use the formula:

Flat \$ amount

\$

Set \$ amount for each whole year of completed service

\$

The formula for the amount of the tax-free limit is:

Flat \$ amount + (each whole year of completed service × the set \$ amount)

\$ + (years × \$)

Amount of the tax-free limit available =

\$

Step 5 Amount of the payment within the tax-free limit

write the lesser of Step 3 \$ or Step 4 \$

The lowest amount (up to the tax-free limit) is tax-free =

Write this amount at label D on the payment summary you issue to employees at the end of the tax year.

\$

Step 6 Amount of the payment over the tax-free limit

write the amount of the payment that is over Step 4

This amount is over the tax-free limit and is an ETP =

*Pay the ETP following the procedures in the guide, *Eligible termination payments – a practical guide for employers* (NAT 2698).*

\$