

## Employees' Tax on Termination

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Employees are entitled to certain payments upon termination of their employment. Some are payments to which they are entitled by law while others are payments to which employees may be entitled to in terms of their contracts of employment. These payments (depending on the circumstances of termination of employment) may include (i) severance payments in the event that the termination of employment is on account of retrenchment; or (ii) mutual termination payments, where employers and employees have reached agreement on the employee's termination of employment in return for which the employer undertakes to make payment of an agreed *ex gratia* (payment done from a sense of moral obligation) sum to the employee. With regard to the latter, these often take the form of so-called 'voluntary severance' payments.

Employers are often uncertain what employees' tax deductions are required to be made from such payments, and the processes that must be followed to determine the amounts to be deducted. The Income Tax Act, 58 of 1968 (ITA) provides that an employer, intending to make any lump sum payment to an employee upon termination of employment, is required first to ascertain from the South African Revenue Services (SARS) the amount of employees' tax to be deducted from the lump sum prior to making the payment. This is done by applying for a tax directive from SARS by completing the prescribed form, IRP3 (a).

Special tax rates, based on the retirement lump sum tax table, apply specifically to severance payments made to an employee. Currently, the first ZAR 500,000 is not subject to tax, the next ZAR 200,000 is taxed at 18%, the subsequent ZAR 350,000 is taxed at 27%, and all amounts above ZAR 1,050,000 are taxed at 36%. Leave pay and pro-rata bonuses that is paid at that time, does not form part of a severance benefit and is subject to normal employees' tax.

What circumstances need to exist before an employee may lawfully claim an entitlement to the tax benefit specified above? Clearly, from an employment law perspective, the benefit will apply to severance amounts paid to an employee on account of his retrenchment. We are often asked, however, whether other types of lump sum payments may qualify for the same benefit. The situation arises, for example, where the employer and the employee are negotiating a mutual termination of employment and one of the benefits sought by the employee during negotiations is that the payment be characterised as a 'severance' payment for purposes of the employees' tax deductions. The short answer is that employers are not permitted to misconstrue the nature of the payment in order to assist the employee in obtaining tax relief. To qualify for the severance tax rate, the employee's termination of employment must have been terminated because (i) the employer stops or is intending to stop operations; or (ii) the employer embarks on a retrenchment exercise in order to reduce its head-count; or (iii) the employee has become incapacitated due to sickness, accident or injury. Any lump sum payment made to an employee who has attained the age of 55 years at termination of employment (irrespective of the underlying reason for the payment) will also be subject to the tax deductions as set out in the retirement tax table. The tax benefit is, however, only available to employees once i.e. an employee who is retrenched and has received this benefit cannot claim it again in any subsequent retrenchment.

Related to the above, another question that we are often asked is whether a 'voluntary severance' payment will also qualify for the special tax rate. There is a view that a severance payment made pursuant to an agreement being reached between the employer and the employee does not qualify for the tax benefit because the benefit only contemplates a scenario where the employee is forced to leave because of the employer's operational requirements. Whilst each set of circumstances is different (and the facts surrounding the termination of employment will have a direct bearing), in our view, the tax benefit is available to employees who conclude voluntary severance agreements with their employers provided that such agreements are concluded after the employer has already made a decision, in principle, to implement retrenchments. If, during this process, an employee chooses to accept a voluntary severance and concludes a voluntary severance agreement with his employer, there is no reason, in our view that the severance payments made to the employee should not receive the same treatment as ordinary severance payments made pursuant to a compulsory retrenchment exercise.