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Malaysia: Public Ruling on Gratuity

Overview

Public Ruling (PR) No. 9/2016 on Gratuity (dated 23 November 2016) was issued by the Malaysian Inland Revenue Board (MIRB) to supersede PR No. 8/2013 (dated 25 June 2013).
URL: http://www.ctim.org.my/download.asp?cat=14&file=DFEGL_T4n67v6B%20-%20ceL_FDEG%20(FIDJEG).2qs

The PR explains:

- The method used to characterize lump-sum payments received by employees as gratuities upon the termination of their employment; and
- The tax treatment of gratuities.

The salient points addressed in this PR include:

- Lump-sum payments given to employees upon termination of employment may be attributable to the following elements; hence, the purpose of the lump-sum payment must be established in order to determine the tax treatment for such payment in relation to the recipient:

    - Loss of employment (i.e., compensation); and
    - Past services of the employee (i.e., gratuity).
- **Gratuity versus compensation:** A lump-sum payment is generally regarded as a gratuity when it is made to an employee upon his or her resignation or retirement and is attributable to past services of the employee. The particular circumstances of each case should determine whether the termination benefit is indeed a gratuity payment or compensation for loss of employment. The characteristics and nature of the termination payment prevail over the form and labeling of the payment.
- **Tax treatment of gratuity:** Gratuity is to be included as employment income under Section 13(1)(a) of the Income Tax Act of 1967 (ITA) and will be taxed in the year of receipt pursuant to Section 25(1) of the ITA. Gratuity received upon retirement qualifies for full exemption under paragraph 25 of Schedule 6 of the ITA if certain conditions are met (e.g., retirement due to ill health, upon reaching compulsory age of retirement, etc.). Starting in the year of assessment 2016, a partial exemption of RM1,000 for each completed year of service may be accorded to an employee if the conditions under paragraph 25D of Schedule 6 of the ITA are met (i.e., retirement from employment under any written law or termination of a contract of employment regardless of the age and period of service of the individual).
- **Gratuity received while still in service:** If an employer opts to pay a gratuity to an employee upon reaching age 55, and no further gratuity is payable when the employee reaches the compulsory retirement age of 60, the gratuity payment is to be taxed as part of the employee's remuneration in the year of receipt under Section 13(1)(a) of the ITA.
- **Gratuity credited to the Employee Provident Fund Account (EPF) account of the employee:** If (pursuant to certain collective agreements between employer and employee) the gratuity is credited to an employee's EPF account (either as a compulsory or optional payment) when a resignation takes place prior to retirement, the gratuity is taxed in the year of receipt pursuant to Section S25(1) of the ITA.
- **Death gratuities:** Lump sums received upon an employee's death or consolidated compensation paid for death or injuries of an employee are exempt from tax under paragraph 16 of Schedule 6 of the ITA.
- **Retirement gratuities:** All retirement benefits, including gratuities and pensions, are taxable unless specifically exempted under the ITA or an Exemption Order.

The examples in the PR have also been amended and updated to reflect the changes to the law.

Deloitte's view

This PR has been issued to replace an existing PR and sets out the circumstances and tax treatment for gratuities, including the elements that determine whether a lump-sum payment is considered a gratuity or compensation, as well as the tax treatment of gratuities related to an employee's past service, EPF, death, or retirement benefits.

Examples have been provided to illustrate the various scenarios and implications of lump-sum payments received by employees upon termination of their employment.

The PR provides more clarity and guidance to both employers and employees, particularly in view of the rise in the number of employees being terminated/retrenched amid a softening job market.

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Global Reward Updates:
United Kingdom: Implications of withholding errors on equity income

Background

While many companies have clear processes in place to operate withholding when a tax charge arises relating to their share plans, occasionally errors may be made and PAYE withholding is not applied when it should be.

In these circumstances an additional charge to tax known as a “section 222 charge”, may arise for UK employees. This charge can significantly increase the cost implications of such failures.

HMRC have recently released further guidance concerning this charge, and the circumstances in which it may apply.

The s.222 Charge

The aim of s.222 ITEPA 2003 is to ensure that an employee receiving equity (or other “notional”) income is no better or worse off than one simply receiving a cash payment, where PAYE and social security apply. The original intention of the legislation was to prevent abusive schemes designed to avoid income tax. However it can be applied to situations in which an employee does not make good their income tax and social security on an equity-related taxable event.

In summary, a s.222 Charge may apply where a withholding obligation arises which is not “made good” by the employee within 90 days of the end of the tax year in which the relevant taxable event takes place (whether or not the employer actually pays the tax due via PAYE). The amount not “made good” by the employee to the employer is treated as additional earnings liable to PAYE and NIC, and reportable through the annual summary of benefits, P11D. In settlement situations, companies often choose to bear this tax and NIC cost rather than pass it on to employees, which can significantly increase the costs to the employer.

HMRC’s new guidance

The updated guidance provides commentary on key cases, namely the Chilcott case (Court of Appeal) and the Benedict Manning case (First Tier Tribunal). The conclusion from these cases is that whilst the application of s.222 should not concern the “fairness” of the charge, the application is not an automatic process. HMRC should consider all the relevant facts in a reasonable manner and conclude on whether or not the requirements of s.222 are or are not met.

Whilst the wording of s.222 is clear and unambiguous, the Courts urge HMRC to consider the unique facts of each case and whether applying a s.222 Charge would fall within the intention of the legislation.

Use of indemnities

Many share plans include a requirement for the employee to fund income tax and social security payable on their awards; an indemnity clause.

The Benedict Manning case (found in favour of the taxpayer) highlighted the importance of the inclusion of an indemnity agreement which created a contractual liability on the part of the employee to reimburse the employer the PAYE and NIC due. The Court determined that this (along with the true intention to apply it) was sufficient to determine that s.222 should not apply.

The inclusion of such an indemnity within the terms of equity awards is therefore key, however the guidance emphasises that the inclusion of the indemnity is by itself, not enough to fall out of the charge. The intention that it would be applied in the relevant circumstances should be demonstrated. Again this highlights that the facts of each unique case should be considered on their own merit.

Action

The inclusion of an appropriate indemnity agreement within equity award documents is key to potentially minimising the charge should it ever become relevant. It must also be demonstrated that the intentions of the relevant parties was always to apply the indemnity. In many cases this will be clear from other equity transactions for example because the employer has a clear “sell to cover” process in place. If an employee actively accepts their award, this also supports the intention that the employee agrees to pay the PAYE and NIC.

Companies should ensure that new and existing equity arrangements include appropriate wording and that the relevant individuals are made aware of their obligations under PAYE where equity (or other “notional”) payments are received.

Companies in the process of discussions with HMRC on past payroll failures should consider the following:

- Whether an appropriate indemnity exists in any form (this may extend beyond award documents);
- How and why the PAYE failure arose; and
- Whether any other mitigating factors arise.

Deloitte has significant experience of supporting such discussions with HMRC and could support you in this process.

As mentioned above, although the s.222 tax liability is strictly an employee liability, it is not uncommon to see employers covering the tax cost on an employee or ex-employee’s behalf where this has arisen through a company process failure. This means that any mitigation of the charge may reduce the cost to the employer.

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