



### EXEMPTION OF COMPENSATION FOR LOSS OF EMPLOYMENT

The Lagos State Internal Revenue Service (LIRS) is issuing this Public Notice to all employers, company owners or their representatives, employees and other members of the public.

#### Definition

Compensation for loss of employment could either be a termination benefit or terminal benefit. An employee will receive compensation for loss of employment when any of the following occurs:

- Where an employee is made redundant and gets a settlement, which may include the statutory redundancy lump sum, and a further sum negotiated by the employee or the trade union with the employer. This is termination benefit.
- When an employee retires and is paid a lump sum by his employer. This is a terminal benefit.
- Where an employee had a fixed-term contract and it is ended early, and the employee gets paid a lump sum in compensation. This is a termination benefit.

#### Legal basis

Paragraph 26 of Schedule 3 of Personal Income Tax Act (PITA) exempts from taxation any income earned as compensation for loss of employment. Section 6(a) subjects such compensation to tax under the Capital Gains Tax Act.

#### Compliance Requirements

The following principle should guide employers in determining how to tax terminal benefits and termination benefits

1. Tax relief will only be granted for PAYE if the amount paid was never pre-agreed before the disengagement process began. However, in such cases capital gain tax will be applicable on such sums as they are capital in nature and payable to LIRS.
2. Pre-agreed amounts are generated from employment and subject to PAYE.
3. Gratuity payments are tax deductible for PAYE purposes if they are paid under an approved pension scheme in line with Section 5 of the Pension Reform Act (PRA) 2014. If paid outside the PRA, the gratuity payments would be taxable if the conditions under Paragraph 18 of the 3rd Schedule is triggered, i.e.
  - The service period is not up to 10 years;
  - Any amount in excess of N100,000; and
  - Where the service period is not up to five years (or an aggregate of 63 consecutive months in the case of a service that is not continuous), the exemption allowed is N1,000 per annum for such period or aggregate period of employment. Any excess calculated does not qualify for the exemption.

Reporting Obligations: It is no longer acceptable to lump terminal benefits under the heading of compensation for loss of employment. Employers are required to show each pay component and the corresponding payments in their tax returns to enable the LIRS determine the correct tax treatment. Every employer is required to notify the LIRS of payments for compensation for loss of employment and who those amounts were paid to.

For further enquiries, please call **0700-CALL LIRS (0700 2255 5477)** or visit **www.lirs.gov.ng**

Thank You

Signed

**Ayodele Subair**

**Executive Chairman**

Lagos Internal Revenue Service

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### 1. TAX TREATMENT OF COMPENSATION FOR LOSS OF EMPLOYMENT

#### Definition

Compensation for loss of employment could either be a termination benefit or terminal benefit. Termination benefits are not subject to PIT but are subject to CGT, while terminal benefits are subject to PIT. An employee will receive compensation for loss of employment when any of the following occurs:

- Where an employee is made redundant and gets a settlement, which may include the statutory redundancy lump sum, and a further sum negotiated by the employee or the trade union with the employer; this is a termination benefit.
- Where an employee retires and paid a lump sum by his employer; this is a terminal benefit.
- Where an employee had a fixed-term contract and it is ended early, and the employee gets paid a lump sum in compensation or a penalty for early termination; this is a termination benefit.

Based on the above, exemption from Personal Income Tax (PIT) of compensation for loss of employment should be determined where:

- the disengagement is one that was not planned by the employer (premature disengagement) at the time of employing the staff; and
- the amount paid was never pre-agreed in the employment contract as accruing when services are being provided.

However, if the employee is dismissed without recourse, and an amount is paid to the staff which is referenced to salary but does not accrue to the staff from providing services, it will not be subject to tax under PAYE but CGT. To add credence to the above position, as an employee is legally entitled to provide employment services to earn the amount (based on mutual agreement), it cannot be considered to be compensation for loss of employment that is exempt from PIT.

#### Distinction between “termination benefits” and “terminal benefits”

Termination benefits are referred to as benefits accruable on premature termination of employment or contract. This is a redundancy lump sum and considered to be capital in nature as it may not be fully tied to compensation that is linked to employment. Terminal benefits such as gratuity and pension are based upon satisfactory completion of employment. This is a retirement or resignation lump sum payment. They are revenue in nature as they are clearly linked to performance of duties in the form of employment.

#### Legal basis

Schedule 3 paragraph 26 of PITA exempts from taxation any income earned as compensation for loss of employment. However, Section 6 (1) (a) of the Capital Gains Tax Act (CGTA) considers ".any capital sum derived by way of compensation for any loss of office or employment" as being capital in nature and subject to Capital Gains Tax (CGT).

#### Objective

There is uncertainty on what constitutes compensation for loss of employment as it is not defined in PITA or the CGTA. There are various pay components received by employees or contractors during termination of contracts. These could be gratuities, payments in lieu of notice, golden handshakes etc. As such, there is a need for the clarification on the taxation of various type of termination benefits.

The purpose of this explanatory note is to clarify what constitutes compensation for loss of employment which is exempted from PAYE in accordance with the PITA and what is exempted from PAYE but taxable under CGT in line with the CGTA.

#### Compliance Requirements

1. The exemption will only be granted for PAYE if the amount paid was never preagreed through an employment contract before the disengagement process began (such as golden handshakes, redundancy, severance pay). However, in such cases capital gain tax will be applicable on such sums as they are capital in nature and payable to LIRS. The employer will not be responsible for CGT as this is not part of the PAYE Scheme. The individual affected will be required to assess themselves for CGT separately.
2. Pre-agreed amounts embedded in the employment contracts (such as payment in lieu of notice, unfunded gratuity or gratuity that is not covered by a Pension Fund Administrator, etc.) are generated from employment and subject to PAYE. Amounts agreed as part of the termination process (and not more than 6 months from termination) are classified under compensation for loss of employment which is subject to Capital Gains Tax.



3. Capital Gains Tax: Compensation for loss of employment is liable to capital gain tax at 10% of the amount received. Every employer is required to notify the LIRS of payments for compensation for loss of employment to disengaged staff.
4. Gratuity payments are tax exempt if they are paid under an approved pension scheme in accordance with the provisions of section 5 of the Pension Reform Act (PRA) 2014. If paid outside the PRA, the gratuity payments would be taxable if the conditions under Paragraph 18 of the 3rd Schedule is triggered, i.e.
  - The service period is not up to 10 years;
  - Any amount in excess of N100,000; and
  - Where the service period is not up to five years (or an aggregate of 63 consecutive months in the case of a service that is not continuous), the exemption allowed is N1,000 per annum for such period or aggregate period of employment. Any excess calculated does not qualify for the exemption.
5. Consequently, payment in lieu of notice (PILON) is not considered as compensation for loss of employment which is exempt from Personal Income Tax (PIT) as PILON forms part of an employee's contract of service.

Reporting Obligations: Employers should make a distinction between terminal benefits and not lump it under the heading of compensation for loss of employment. Employers are required to show each pay component and the corresponding payments in their tax returns to enable the LIRS determine the correct tax treatment. As stated above, every employer is required to notify the LIRS of payments for compensation for loss of employment. These reports must be provided as an appendix to the annual returns of the company on an annual basis.