

# *Commissioner's Statement CS 17/02*

## **Tax treatment of backdated remedial payment of holiday pay**

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*The purpose of a Commissioner's Statement is to inform taxpayers of the Commissioner's position and the operational approach being adopted on a particular tax matter. A Commissioner's Statement is not a consultative document.*

### **Summary**

1. A backdated remedial payment of holiday pay is an employment-related remedial payment under the Income Tax (Employment-related Remedial Payments) Regulations 2017 (the regulations) and should be treated as an extra pay from 18 August 2017. This treatment also applies to a remedial payment made to a former employee.
2. The remedial payment is taxed at the current tax rates and deductions made from the remedial payment should be recorded in the Employer Monthly Schedule (EMS) at the time of payment. There is no requirement to adjust the EMS for the past periods to which the entitlements relate.
3. PAYE, as well as other deductions such as student loan repayment and KiwiSaver contributions, should be deducted at the time of payment.
4. Where a former employee cannot be found and the amount of remedial payment is not paid out for 6 years, that amount will be subject to the Unclaimed Money Act 1971.

### **Background**

5. It was identified recently that for a number of years some employers have been underpaying their employees' holiday pay entitlement. The Commissioner of Inland Revenue (the Commissioner) is aware that employers are undertaking an exercise to remedy this by calculating and repaying the shortfall to the affected employees and former employees in a lump sum payment.
6. This Statement provides guidance to employers on how the backdated remedial payments are to be treated for tax purposes. "Backdated" in this context means a payment that is being made because an earlier payment was insufficient. The backdated payment satisfies that shortfall. Such a payment will be referred to as a "remedial payment" in this Statement.
7. Please note that this Statement is concerned only with the **tax treatment** of the backdated remedial payment and not the calculation of the backdated holiday pay entitlement itself (or any matters of a contractual nature for instance).

## **Explanation**

### **Remedial payment treated as extra pay**

8. From 18 August 2017, an employment-related remedial payment is declared to be included in the definition of extra pay under the Income Tax Act 2007 (ITA) by the regulations.
9. An employment-related remedial payment is defined as a payment that, but for the regulations, would be a payment of salary or wages or an extra pay, or a combination of both, and is made to a person to satisfy all or part of a shortfall in 1 or more previous payments to the person in respect of the person's entitlements under the Holidays Act 2003 or an employment agreement, or both. This means an employment-related remedial payment covers more than just holiday pay. It covers a payment made to correct other types of entitlements under the Holidays Act (e.g. sick leave) and entitlements under an employment agreement (e.g. long service leave). The regulations do not apply to a payment that is made to satisfy a failure to pay any salary or wages at all (e.g. wages that are paid late).
10. Prior to the regulations coming into force, a backdated remedial payment of holiday pay entitlements was treated as salary or wages, or an extra pay, or a combination of both, depending on the circumstances which gave rise to the original payment of holiday pay. It is the Commissioner's view that, but for the regulations, the tax treatment of a backdated payment of holiday pay follows that of the original payment, had it been paid correctly. A backdated payment of holiday pay that would have been salary or wages should be treated as salary or wages at the time of the backdated payment. Similarly, a backdated payment of holiday pay is an extra pay if the original payment would have been an extra pay.
11. However, from 18 August 2017, as a backdated remedial payment of holiday pay entitlements made to an employee or a former employee falls within the definition of an employment-related remedial payment under the regulations, it is treated as an extra pay for tax purposes.

### **Current tax rates apply**

12. While the remedial payment is made up of holiday pay entitlements relating to previous tax years, the deficit amount is not calculated and paid until a current year. It is the Commissioner's view that the individuals who receive the remedial payment derive the payment as income when it is received, and are properly assessed for tax in the year of receipt. There is no ability under the ITA for a person to spread the payment back to the years to which the entitlements relate.
13. This means that the current tax rates are applicable when withholding PAYE from the remedial payments. There is no expectation that employers make adjustments to the Employer Monthly Schedules (EMS) for the previous tax years. The amount of the remedial payment and amount of PAYE withheld simply needs to be recorded in the EMS for the period in which the payments are made.
14. Please refer to the [Inland Revenue](#) website for more information on how to calculate PAYE for extra pays.

## **Deductions other than PAYE**

15. Where applicable, other deductions, such as student loan repayments and KiwiSaver contributions, should be made in the usual manner for current employees.

## **Remedial payment made to a former employee**

16. A backdated remedial payment of holiday pay made to a former employee also falls within the definition of employment-related remedial payment under the regulations and should be treated as an extra pay. The same methods of calculating PAYE are to be used.
17. When determining the correct extra pay withholding rate, an employer is required to annualise the PAYE income payments made to the employee in the 4-week period prior to the date of the extra pay payment (see section RD 17 of the ITA). It is the Commissioner's view that the PAYE income payments required to be annualised are those paid by the employer making the remedial payment. The employer making the remedial payment is not expected to ascertain the PAYE income payments that are made to the former employee by other employers (for example, the former employee's current employer).
18. A former employee who notifies the former employer of their tax code may choose the tax rate for the extra pay in the same manner as a current employee. The rate that the former employee chooses must not be lower than the applicable rate had the annualised value method been used.

### *Student loan repayment deductions*

19. If the former employee notifies the former employer of a student loan tax code, then student loan repayments should be deducted from the remedial payment.

### *KiwiSaver contributions*

20. The KiwiSaver Act 2006 applies to a remedial payment made to a former employee if they are a KiwiSaver member. Employee is defined in the KiwiSaver Act as a natural person who receives salary or wages (salary or wages in the KiwiSaver context includes extra pay). An employer, for the purposes of the KiwiSaver Act, is a person who pays or is liable to pay salary or wages to a person who is not a private domestic worker.
21. If the former employee has given the former employer a KiwiSaver deduction notice (either while they were in employment or at the time a remedial payment is made), then the contribution deduction rules are triggered and the employer must deduct KiwiSaver contribution from the former employee's remedial payment in accordance with the deduction notice. The employer is encouraged to ascertain the former employee's current KiwiSaver status as circumstances may have changed since they were in employment (e.g. the former employee may have been granted a contribution holiday).
22. As a general rule, if an employer is required to deduct KiwiSaver contribution from a payment of salary or wages, that employer is also required to pay compulsory employer contribution.

23. A remedial payment made to a former employee who is not a KiwiSaver member at the time of payment will not be considered "new employment" and will not trigger the automatic enrolment rules under the KiwiSaver Act.

*Deceased employees*

24. If the person eligible to receive a remedial payment is deceased, that remedial payment should be made to the executor or administrator of the deceased employee's estate and PAYE should be deducted at the time of payment.

*When former employee cannot be located*

25. The Commissioner foresees that there will be instances where a former employee (or their executor) cannot be located and a payment cannot be made. An employer's obligation to withhold and pay PAYE to the Commissioner arises at the time the PAYE income payment is paid, i.e. actual payment to the employee. Therefore, where no remedial payment is made, it is not necessary for the employer to deduct PAYE, even if the backdated entitlement has been calculated. If the former employee is subsequently located and payment is made then PAYE will need to be deducted at the time of payment.
26. It is the Commissioner's view that the remedial payment will eventually become unclaimed money and the Unclaimed Money Act 1971 applies if a former employee cannot be found and the remedial payment is not paid out for more than 6 years.

**Application**

27. This Statement applies to remedial payments made on or after 18 August 2017.
28. For employers who have, prior to 18 August 2017, treated the remedial payments made as either salary or wages, or an extra pay, the Commissioner will not be devoting resources to determine whether the payments were salary or wages, an extra pay or a combination. However, if employers have failed to deduct any PAYE at all from the remedial payments, they should contact Inland Revenue.



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