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By PwC Deutschland | 01 August 2021

Additional severance payment for earlier termination of employment also tax-privileged

The mutual termination of an employment is normally (also) in the interest of the employer. A severance payment made in return is therefore generally tax privileged. The Lower (regional) Tax Court of Hesse decided that this also applies in the event of an additional payment because of the (premature) termination of the employment relationship prior to the date as originally set in the termination agreement.

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Background

Pursuant to Section 24 (1) No.1a) Income Tax Act income from employment also includes compensation, which is paid "*as compensation for lost income or for expected loss of income*". According to its wording, the provision only applies to compensation for losses of income suffered or expected to be suffered; this does not include compensation paid for any other type of damage. A severance payment is not tax-exempt, but subject to the privileged taxation acc. to Sec. 34 Income Tax Act (so called "1/5 ruling") in the event of a payment within one year.

The case in dispute revolved around a termination and compensation contract signed by the appellant and her former employer on 23 June 2015 for reasons of health. In addition, the contract included a clause for an earlier termination of the employment relationship (so-called "*sprinter clause*"): To this effect, it was foreseen that the plaintiff may terminate the employment relationship prematurely at short notice. If the option was exercised an additional severance payment was due to be paid to the plaintiff. The plaintiff had exercised this right and received the additional payment. The tax office held that only the "main" severance payment resulting from the termination of the employment relationship was subject to the tax privilege, but not the amount received due to the exercise of the "option for earlier termination".

Decision of the Lower (regional) Tax Court

The Lower Tax Court ruled differently and upheld the claim.

The legal grounds for the additional severance payment - as well as the main severance payment, which was not in dispute - is the termination agreement concluded on 23 June 2015. Absent of this, there would be no justification for the employer to grant an extra right such as the early termination option and hence pay the employee an additional amount for the premature termination of the employment.

The exercise of the option does not change the termination agreement itself, but rather has its provenance in this very contract. The payment of the additional severance payment is the result of the termination of the employment relationship at the initiative of the employer. The option must as such be viewed in the overall context of and in conjunction with the termination agreement.

Source:

Lower Tax Court of Hesse, decision of 31 May 2021 (case ref. 10 K 1597/20); the judgement is final, an appeal was apparently not filed.

Keywords

compensation payment, employment termination, severance payment, tax privilege