

Termination payments (Lecture B1359 – 16.27 minutes)

Specific legislation exists for termination payments because they do not fall to be treated as earnings under the general definition explained above. To put it simply, a termination payment does not arise 'from' the employment, it arises 'from' the termination. Without specific legislation, such payments would be tax-free.

The legislation covers all payments and benefits arising from the termination. It subjects these to a charge to tax to the extent that they exceed £30,000. However, the situation is more complex than this. The termination payment provisions are a 'back-stop', that is that they are only considered once a payment is not taxed under any provision.

It is important to consider all of the different elements which make up a termination package. This is normally included within a compromise agreement.

Redundancy payments are always treated as termination payments. You need to make sure that it is really redundancy.

'An employee who is dismissed shall be taken to be dismissed by reason of redundancy if the dismissal is wholly or mainly attributable to –

(a) the fact that his employer has ceased or intends to cease –

(i) to carry on the business for the purposes of which the employee was employed by him, or

(ii) to carry on that business in the place where the employee was so employed, or

(b) the fact that the requirements of that business –

(i) for employees to carry out work of a particular kind, or

(ii) for employees to carry out work of a particular kind in the place where the employee was employed by the employer,

have ceased or diminished or are expected to cease or diminish.'

Once redundancy has been established an employee is entitled to statutory redundancy once they have at least two years' service with the amount to be paid per year of service dependent on their age whilst working. Service of more than 20 years is ignored and there is a maximum weekly pay to be applied. Non-statutory redundancy can be paid above this and it is normal to obtain HMRC clearance on any amounts to be paid so that you can be sure it is redundancy.

The first thing we need to consider is whether they are taxable as earnings. Is there a contractual right to receive this payment? If so, it is likely to be earnings. Expectation of payments on termination can cause problems as HMRC have been known to argue that these become quasi-contractual. This is not an area which they have been particularly successful in arguing before the FTT or beyond.

Secondly, does it fall to be taxed under a specific heading? The most common would be a payment which can be treated as a payment under an unapproved retirement benefit scheme. Alternatively, a payment under a restrictive covenant would be taxable as earnings.

A payment is a receipt from an unapproved retirement benefit scheme if it is paid on or in anticipation of retirement, other than retirement due to ill-health or disability. You do not have to be actually retiring and HMRC can argue this point very aggressively.

EIM15300 contains examples of situations where HMRC consider that retirement has occurred.

Payments in relation to things like employment-related securities would follow the tax treatment for those. Payments to pensions can be exempt, even if paid on termination.

The tax treatment of termination payments was changed considerably in 2018. This was particularly targeted at the tax treatment of payments in lieu of notice (PILONs) but some other changes were also made.

Most employees have a notice period. This is the amount of notice an employee must give their employer before leaving their job. It is also the amount of notice an employer needs to give an employee before the termination of their contract.

The legal minimum period of notice that an employer is required to give an employee is generally one week for each complete year worked, up to a maximum of 12 weeks. However, notice periods are normally specified in the employment contract and can exceed the statutory notice period. As a general rule, the more indispensable the employee, the longer the notice period.

If an employment is terminated (other than for reasons of gross misconduct), the employee normally has a legal right to work and is entitled to receive wages for the duration of the notice period.

When notice of the termination of employment is given, the employer has a number of choices:

- It can honour the notice period by allowing the employee to work for the notice period and terminate the contract at the end of that period. In this case the employee will receive wages, all of which would be taxable.
- It can honour the notice period by paying wages but not require the employee to work (the so-called "garden leave"). Employers may do this to protect their client base (for example if the employee is leaving to work for a competitor) or if the employer feels that the employee's continued presence is likely to be disruptive or unhelpful. Amounts paid during a period of garden leave are fully taxable.
- It can terminate the employment within the notice period. This will typically be accompanied by a termination payment which at least in part represents pay which the employee would have been entitled to had the notice period been honoured. Such payments are called PILONs.

The latter has been something of a moving target since the case of *EMI v Coldicott* in 1999 when HMRC successfully argued that a PILON should be treated as earnings from the employment as the contract reserved the right for the company to make a PILON. Non-contractual PILONs on the other hand were not earnings and instead fell within the rules for termination payments thereby qualifying for the generous reliefs that those provisions bring. This never sat comfortably in Whitehall and

things have now changed. The only real surprise is that it has taken the Government the best part of two decades to get around to it.

Until 5 April 2018, PILONs were either:

- Taxed in full if the employment contract gave the employer the right to make a PILON (which some contracts did to preserve the integrity of other elements of the contract such as non-disclosure agreements or restrictive covenant clauses); or
- Treated in the same way as an ex-gratia termination payment if the contract did not give the employer the right to make a PILON. In this case the making of the PILON was a breach of the contract and the subsequent compensation payment was treated as damages, thereby triggering eligibility for the £30,000 exemption. Non-contractual PILONs of less than £30,000 therefore escaped tax.

In cases within a), PAYE and NIC should have been applied to the full payment. I use the word “should” deliberately here as history is littered with cases where payments should have been put through payroll and haven’t. If PAYE has not been applied correctly, thought should be given to treating the payment as having been made net of PAYE leaving HMRC to seek the tax from the employer.

In cases within b), PAYE should have been applied to the excess over £30,000. There is no NIC liability.

Since 6 April 2018, whenever a termination payment (other than a statutory redundancy payment) is made before the expiration of the contractual notice period, the payment needs to be divided into:

- Post-Employment Notice Pay (PENP); and
- Amounts which are not PENP.

PENP is taxable and subject to Class 1 NICs (employer and employee). It is treated as part of the earnings.

The amount of the payment that is not PENP is taxed under the rules for termination payments.

These new rules only apply to payments received on or after 6 April 2018 in circumstances where the employment ended on or after 6 April 2018. PILONs made after 6 April 2018 in respect of an employment that ended before 6 April 2018 will be taxed under the old rules.

It should also be noted that termination payments in excess of £30,000 became liable to Class 1A NICs with effect from 6 April 2019.

Calculating PENP

PENP is calculated using the following formula: $(BP \times D)/P$ less T

where:

BP = the employee’s basic pay for the pay period immediately before the date on which notice is given. Basic pay excludes taxable benefits and “extra-ordinary” payments such as bonuses, commissions, overtime payments and share-option gains. If the employee participates in a salary sacrifice arrangement (for example by giving up salary for employer pension contributions), pre-salary sacrifice pay must be used.

D = the number of days in the “post-employment notice period” being the period from midnight on the last day of employment through to the ‘earliest lawful termination date’ (this being the date when the minimum notice period would have expired if given in full).

P = the number of days in the pay period immediately preceding the period in which the termination payment was made; and

T = amounts included as PENP that are already taxable as earnings (excluding holiday pay and termination bonuses). Deducting amounts already classed as earnings prevents a double charge. Amounts deducted would typically be payments such as contractual PILONs.

The intention of the formula is to produce a number that is equal to the basic salary the employee would have earned had they remained in employment for the whole of their notice period.

In essence, the slice of the termination payment that correlates with a PILON will now be taxable, irrespective of whether there is a PILON clause in the employment contract.

Example 1

Julian worked for Alpha Ltd. His basic salary was £52,000 per annum, paid weekly. Julian’s employment contract specified a 4-week notice period. The contract did not contain a PILON clause.

Alpha Ltd gave notice of termination to Julian on Monday 13 August 2018. It was agreed that he would work for 5-days to clear his work on hand. He left the employment on Friday 17 August 2018 receiving a termination payment of £5,000.

Alpha Ltd is required to work out the amount of PENP within the termination payment.

If we apply the formula to Julian’s payment:

BP = £1,000

D = 18 August 2018 – 9 September 2018 (23 days)

P = 7 days

T = Nil (i.e., none of the termination payment is otherwise taxed as earnings).

The post-employment notice pay (PENP) is:

$$\frac{1,000 \times 23}{7} \quad - \quad \text{Nil} \quad = \quad £3,286$$

This amount will be treated as earnings and is fully taxable. This should be put through payroll with PAYE and Class 1 NIC applied.

The remaining payment of £1,714 (5,000 – 3,286) will be treated as an ex-gratia termination payment and will qualify for the £30,000 exemption. None of this will therefore be taxable or NICable.

This new regime reflects HMRC’s historical opinion that all PILONs should be taxable on the grounds that, had the employee worked and earned his wages as usual until the end of his notice period, that pay would be fully taxable. PENP is the way of ensuring this now happens.

Monthly basis calculations

HMRC Guidance at EIM13886 confirms that a monthly basis can be used where:

- The pay period is exactly a calendar month;
- The notice period is expressed in calendar months; and
- The unexpired period of notice is a period of whole calendar months.

'P' in the formula is then taken to be 1 (and thereby ignored) and 'D' is calculated in months rather than days.

Example 2

Julia worked for Beta Ltd. Her basic salary is £72,000 per annum, paid monthly. Julia's employment contract specified a three-month notice period. Julia resigned on 1 September 2018 and was immediately dismissed without notice. A termination payment of £60,000 was paid to Julia on 8 September 2018.

If we apply PENP the formula to Julia's payment (working in whole months):

$$BP = £6,000$$

$$D = 3 \text{ months}$$

$$T = \text{Nil}$$

The post-employment notice pay (PENP) is:

$$6,000 \times 3 \quad - \quad \text{Nil} \quad \quad \quad £18,000$$

The remaining payment of £42,000 (60,000 – 18,000) is treated as an ex-gratia termination payment. After deducting the £30,000 exemption, £12,000 of this will be taxable.

PAYE should be applied to the £12,000 but it is not currently subject to NICs.

As this falls within the termination payments rules, the £12,000 will be treated as the "top-slice" of income and should be taxed after savings income and dividends. [This will make a difference in cases where taxable non-savings income does not exceed the basic rate threshold.]

What you will notice here is that the taxable amount of £30,000 (being PENP of £18,000 plus non-PENP of £12,000) is the same as would have been the case under the old rules. Julia received a non-contractual PILON of £60,000 that, under the pre-2018 regime, would have qualified for the £30,000 exemption leaving £30,000 taxable.

The PENP rules ensure that:

- Where the non-contractual PILON is less than £30,000, some part of it – ie, the bit correlating with a PILON – is taxable (this wouldn't previously have been the case);
- The PENP element is earnings and is subject to Class 1 NICs. Under the old rules, none of the taxable amount of £30,000 would have been subject to NICs.

Overseas aspects

Problems can arise when you have termination payments being made.

Prior to 2018, there was foreign service relief available where an individual had their employment terminated in the UK but had spent significant time working outside the UK. This does not apply now and so you have to look to relief being provided by Double Tax Treaties.

Contributed by Ros Martin