

Payments In Lieu Of Notice (Lecture P1091 – 12.01 minutes)

Introduction

Finance (No. 2) Act 2017 and Finance Act 2018 have made a number of changes to the termination payments regime such as:

- The abolition of foreign service relief for UK residents from 6 April 2018;
- The imposition of Class 1A NICs for employers on ex-gratia payments over £30,000 (this measure is deferred for 12 months and becomes effective from 6 April 2019);
- A new system for taxing payments in lieu of notice (PILONs).

These notes will cover the changes in the tax treatment of PILONs.

Payments During the Notice Period

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.

The tax treatment of PILONS until 5 April 2018

This is still relevant for those with clients who received a PILON in 2017/18 and need to know how this should be disclosed.

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.

The tax treatment of PILONS since 6 April 2018

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).

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.

Calculating PENP

PENP is calculated using the following formula:

$$\frac{BP \times D}{P} - T$$

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:

$$BP = \text{£}1,000$$

$$D = 18 \text{ August } 2018 - 9 \text{ September } 2018 \text{ (23 days)}$$

$$P = 7 \text{ days}$$

$$T = \text{Nil (i.e., none of the termination payment is otherwise taxed as earnings).}$$

The post-employment notice pay (PENP) is:

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

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 $\text{£}(5,000 - 3,286) = \text{£}1,714$ will be treated as an ex-gratia termination payment and will qualify for the $\text{£}30,000$ 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 $\text{£}72,000$ 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 $\text{£}60,000$ was paid to Julia on 8 September 2018.

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

$$BP = \text{£}6,000$$

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

$$T = \text{Nil}$$

The post-employment notice pay (PENP) is:

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

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

PAYE should be applied to the $\text{£}12,000$ but it is not currently subject to NICs. [such payments will be liable to Class 1A NICs from 6 April 2019.]

As this falls within the termination payments rules, the $\text{£}12,000$ 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 $\text{£}30,000$ (being PENP of $\text{£}18,000$ plus non-PENP of $\text{£}12,000$) is the same as would have been the case under the old rules. Julia received a non-contractual PILON of $\text{£}60,000$ that, under the pre-2018 regime, would have qualified for the $\text{£}30,000$ exemption leaving $\text{£}30,000$ taxable.

The PENP rules ensure that:

- Where the non-contractual PILON is less than $\text{£}30,000$, 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 $\text{£}30,000$ would have been subject to NICs.

Example 3

Julio works for Gamma Ltd. His annual salary is $\text{£}120,000$ paid monthly on the final working day of each month. He participates in an occupational pension salary sacrifice arrangement under which he sacrifices $\text{£}1,000$ per month in lieu of additional company pension contributions. His gross monthly pay is therefore $\text{£}9,000$.

His employment contract provides for a three-month notice period. Alternatively Gamma Ltd can terminate the contract by making a payment in lieu of notice equal to three months' basic salary.

On 1 September 2018 Julio is informed by Gamma Ltd that he is being made redundant and he must leave his job immediately without being required to work his notice period. He receives the following payment:

	£
Payment in lieu of notice (3 months' salary @ $\text{£}9,000$)	27,000
Statutory redundancy pay	10,000
Employer pension contributions (3 months @ $\text{£}1,000$)	3,000
Non-statutory redundancy payment	25,000
Total	65,000

First we divide the payment into PENP and non-PENP.

PENP can be calculated on a monthly basis (the conditions are satisfied).

BP = £10,000 (being the pre-salary sacrifice monthly pay for August 2018)

D = 3 months

T = £27,000 (being the contractual PILON)

The post-employment notice pay (PENP) is:

$$10,000 \times 3 \quad - \quad 27,000 \quad = \quad \text{£}3,000$$

The taxable amounts are therefore as follows:

	Taxable	
	£	£
PENP		3,000
Non-PENP:		
Contractual PILON		27,000
Employer pension contributions	Exempt	
Statutory redundancy	10,000	
Non-statutory redundancy £(25,000 – 3,000)	<u>22,000</u>	
Total	32,000	
Less: Exemption	<u>(30,000)</u>	
		<u>2,000</u>
Taxable income		<u>32,000</u>

Note:

Again we can see that the taxable amount is the same as would have been the case under the pre-April 2018 rules as the contractual PILON would have been taxable in full, the employer pension contribution was exempt and £5,000 of the redundancy payments (being the excess over £30,000) would be taxable. The difference now is that £3,000 of the redundancy payment is re-classified as PENP. This does however increase the overall liability as PENP is liable to Class 1 NIC whereas redundancy pay is not.

Other issues

Employers may wish to consider including a PILON clause within their standard contracts of employment as this allows them to terminate the employment contract without breach and without having to allow the employee to work out their notice period. Before April 2018 PILON clauses were omitted in order that a subsequent PILON would qualify for the £30,000 exemption. This has now gone.

It will also be interesting to see whether the new PENP rules will lead to employees trying to negotiate more generous termination packages in order to compensate them for the extra PAYE which will have to be withheld.

Contributed by Steve Sanders