

Changes to the Taxation of Post-Termination Payments

From 6 April 2011, employers will be required to withhold income tax at rates of up to 50% when making post-termination payments to employees. Currently employers are only required to withhold income tax at the basic rate of 20%. This *DechertOnPoint* reports on the proposed change.

HMRC has announced plans to amend the Income Tax (Pay as You Earn) Regulations 2003 (the "PAYE Regulations"). These amendments will come into effect from 6 April 2011 and will require employers to use the OT code when deducting PAYE from payments made to employees after they leave their employment and are issued with a form P45. This will mean that post termination payments will no longer only have basic rate income tax deducted from them.

The Current Requirements

Under regulation 37 of the PAYE regulations, payments made by employers to former employees following the issue of Form P45 are subject to deduction only of income tax at the basic rate in force at the time of the payment. Employers currently use the BR code when making such payments. This leads to a cash flow benefit for employees who suffer only a basic rate deduction on, for example, termination payments at the time they are made and only have to account for higher or additional rate tax (at 40% and 50% respectively) through self assessment some time later.

Requirements from 6 April 2011

Employers will be required to operate code OT in respect of payments made to employees after issue of Form P45 rather than code BR. Consequently, income tax will be deducted at source from post-termination payments at the

basic and/or higher and/or additional rates of tax as appropriate.

The new rules will not affect the existing tax exemption applicable to termination payments. Broadly, when a termination payment is made to an employee, for example under a compromise agreement, the payment should only be subject to the deduction of income tax on its excess over £30,000 (s.403(1) Income Tax (Earnings and Pensions) Act 2003). This will be the case provided that the relevant employee's contract of employment does not contain a payment in lieu of notice ("PILON") clause, the payment is not consideration for the agreement of new restrictive covenants, is not a payment in consideration of retirement and the employer does not have a practice of paying in lieu of notice.

Other Changes

In the same announcement, HMRC also outlined its intention to change the PAYE tax codes that employers are authorised to use when:

- an employee starts work but does not provide a form P45; and
- an employer continues to make payments to an individual as an employee and then begins to pay a pension to the individual.

Currently when an employee starts work without completing a form P46, the employer is required to complete the form P46 as far as possible before submitting it to HMRC. A tax code may then be issued if necessary but in the meantime employers operate code BR on a cumulative basis. This can result in an underpayment arising at the end of the year and from 6 April 2011 employers will be required to operate code OT so that the employee is taxed at the basic and/or higher and/or additional rate as appropriate.

Similarly, employers will also be required to operate code OT when employees begin receiving occupational pension payments whilst still in employment with their existing employer. Currently employers continue using the same tax code against the employee's income until HMRC issues a new code. The same code is also used against the

pension payments but on a Week 1/Month 1 basis. As a result, employees may receive greater personal allowances than they should, which can again lead to an underpayment at the end of the tax year. From 6 April 2011 employers will be required to operate code OT against pension payments for those still working for the employer.

Further Details

The amendments to the PAYE Regulations have not yet been published. However, these changes will be included in the 2011 version of CWG2 "Employers Further Guide to PAYE and NICs" which will be published on HMRC's website in February 2011. Guidance regarding the uncompleted P46 will be included in the E13 "Day to day Payroll" helpbook which will also be published online in February 2011.

Practice group contacts

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