DechertOnPoint

March 2011 / Special Alert

A legal update from Dechert's Employment Law and International and Domestic Tax Groups

Changes to the Taxation of Termination Payments

HMRC published regulations to amend the Income Tax (Pay As You Earn) Regulations 2003 on 14 March 2011. These regulations will come into force on 6 April 2011 and will implement the changes to the taxation of post-termination payments that HMRC announced at the end of 2010 and that were summarised in "Changes to the Taxation of Post-Termination Payments", a *DechertOnPoint* published in January. This update explains the operation of the new rules and their practical impact on the timing of tax deductions in relation to termination payments.

The key points to note are as follows:

- From 6 April 2011, employers must deduct PAYE using the 0T code when making taxable termination payments to employees after they are issued with a form P45.
- Only the way payments are treated for PAYE purposes is changing—the actual tax treatment of termination payments is not being altered—for example, the £30,000 exemption for certain payments remains in place.
- This change will remove the cashflow advantage currently available for higher rate or additional rate employees in relation to termination payments. Termination payments are currently taxed only at the basic rate when paid with higher and additional rate income tax liabilities being payable through self assessment at a later date.
- This change also increases the risk that the PAYE deducted will be greater than the actual income tax liability. If this occurs, the employee will have to reclaim the overpaid tax through their self assessment tax return for the period.

Effect of the 0T Tax Code to Termination Payments

The 0T tax code (which does not allow for any personal allowance) must be applied on a non-cumulative (Week 1/Month 1) basis at the basic, higher and additional rates of income tax by reference to the monthly income tax bands.

The months used are tax, rather than calendar, months and so run from the 6th of the month to the 5th of the next. Therefore, if, for example, two payments are made in different calendar months but in the same tax month only one month's bands would be available to share between the two payments. However, if each payment is made in a different tax month then each payment will be subject to PAYE independently and will not take account of the earlier payments.

In terms of calculating the income tax to be deducted, the process is complicated by the fact that not only does the 0T tax code not allow for any personal allowance but that it also requires deduction of tax on a **non-cumulative** (Week 1/Month 1) basis at the basic, higher and additional rates of tax. Accordingly, the monthly equivalents of the limits for the rate bands for those paid monthly are applied. The monthly bands (and maximum PAYE deductions for the basic and higher rate bands) for 2011/12 are:

- £0 - £2,916.67 for the basic rate, so the maximum PAYE deduction is £583.33 (£2,916.67 x 20%);
- £2,916.68 - £12,500 for the higher rate, so the maximum PAYE deduction is £3,833.33 (£9583.33 x 40%); and
- over £12,500 for the additional rate, with the PAYE deduction being 50% of the payment above this threshold.

Examples

Some worked examples in relation to a taxable lump sum termination payment made after 6 April 2011 and after a P45 has been issued may assist in understanding how the new system will produce different results to the current regime and differing levels of tax deduction depending on the level and timing of payment.

- If the taxable element of the termination payment is £5,000, the PAYE to be deducted will be £1,416.66 comprising the following elements:
  - £583.33 will be withheld at the basic rate as 20% of the first £2,916.67 (i.e., 1/12 of the basic rate band excluding the 10% starting rate); and
  - £833.33 will be withheld at the higher rate as 40% of the remaining £2,083.33.
- If the taxable element of the termination payment is £30,000, the PAYE to be deducted will be £13,166.66 comprising the following elements:
  - £583.33 will be withheld at the basic rate as 20% of the first £2,916.67;
  - £3,833.33 will be withheld at the higher rate as 40% of the next £9,583.33 (i.e., 1/12 of the higher rate band); and
  - £8,750 will be withheld at the additional rate as 50% of the remaining £17,500.

An extreme example of how this can lead to an overpayment of tax is if the employee does not receive any other taxable income in the tax year in which the termination payment is received. In that situation, the actual income tax liability in example 1 would be nil, as the taxable element of the termination payment would fall entirely within the personal allowance of £7,475.

In the same situation, the actual income tax liability in example 2 would be £4,505, as £22,525 (the amount of payment not covered by the personal allowance of £7,475) will fall entirely within the basic rate band and will be taxable at 20%.

In both scenarios, the PAYE required to be deducted under the new rules is greater than the actual tax liability and the employee will have to reclaim the additional tax paid through their self assessment tax return for the period.

Possible Advantages of the New 0T Tax Code

Although, in most cases, the new procedure will increase the PAYE deducted from termination payments, there may be ways to take advantage of (or at least mitigate the effect of) the change in cash flow terms.

If a termination payment is made in a series of monthly instalments, then each payment will be assessed independently of the others. Each payment could therefore legitimately be brought (in part at least) within the monthly non-cumulative basic (or basic and higher) rate bands.

The key date is when the employee becomes contractually entitled to the amount and so merely delaying a payment of an amount to which the employee is already absolutely entitled (for example under an existing compromise agreement) will not improve the employee's tax position.

There may still be some cashflow advantage for some 50% taxpayers. They do not have a personal allowance in any case (as it is withdrawn as annual income increases over £100,000) and a pre-P45 payment is likely to be taxed entirely at the 50% rate (as their salary in that tax month will probably have used up their basic and higher rate allowance for the month). If the payment is made post-termination (i.e. following the P45) then they will be able to use the monthly basic and higher rate bands. They will not be liable for the additional tax until they settle their income tax for the year.

Other Applications of the New 0T Tax Code

The new 0T tax code will also apply to new employees who start work without producing a P45 and where an employer starts paying an occupational pension to an existing employee in addition to their salary. The new tax code will also apply to payments made to the personal representatives of deceased employees.

What Does It Mean?

Employers should ensure that their payroll and HR departments are aware of the new rules, to ensure the employer's PAYE obligations are met. Those structuring termination payments will need to consider whether payment before 6 April 2011 is possible or, if not, whether staggering the payment would be advantageous. Employees receiving termination payments after 6 April 2011 need to appreciate that they may be able to reclaim excess PAYE deducted from termination payments through self-assessment.

Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/employment and www.dechert.com/tax.

If you would like to receive any of our other *DechertOnPoints*, please click here.

Charles Wynn-Evans
London
+44 20 7184 7545
charles.wynn-evans@dechert.com

Daniel Hawthorne
London
+44 20 7184 7327
daniel.hawthorne@dechert.com