

Taxing times for termination payments

Charles Wynn-Evans reports on the forthcoming changes to the taxation of termination payments to employees



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The changes to the tax treatment of payments made to employees on the termination of their employment coming into effect in April 2018 could increase the costs to employers of termination packages and produce traps for the unwary. Employers and their advisers will need to become familiar with the complexities and practical operation of the revised tax legislation.

Payments in lieu of notice

Whether an employer can apply the £30,000 exemption from income tax available under s403(1) of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) to the element of a severance package which relates to the individual's notice period has historically been a vexed question. The issue can have a material commercial impact on the negotiation of an agreed severance package and the overall cost of the arrangement for the employer.

Where an individual's employment is terminated immediately by way of a payment in lieu of notice (PILON) in line with a clause in the employment contract, the situation has been clear. This is a demonstrably contractual payment, so it cannot fall within the £30,000 exemption and cannot be paid tax free. That said, it has been argued that, even where the employee's contract contains a PILON clause, a payment can still fall within the £30,000 exemption if the employment has not been terminated in accordance with the terms of the employment contract. To add to the potential for confusion and uncertainty, HM Revenue

and Customs (HMRC) has taken the position that 'auto-PILONs' should be taxable – where it is customary for the employer to make a PILON to departing employees even though there is no contractual PILON clause.

Other termination payments may benefit from the £30,000 tax exemption. For example, a bonus payment will constitute taxable earnings and a payment as consideration for new restrictive covenants will be taxable under ss225 and 226 of ITEPA.

For terminations of employment on or after 6 April 2018 where the relevant termination payment is also made after that date, in effect the basic salary element of all PILONs, whether or not made pursuant to a contractual PILON provision, will be treated as 'earnings'. This element will therefore be subject to income tax and Class 1 National Insurance Contributions (NICs). Whether the employee's contract of employment contains a PILON clause will no longer make any difference to the tax position.

Structure of the revised legislation

Although the intention behind the government's reforms was to simplify the legislation, the revised rules have ended up being far from simple. The starting point is the concept of a 'termination award', which is in essence a payment made in connection with the termination of an employee's employment. More precisely, s401(1) of ITEPA states that the relevant provisions apply to:

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... payments and other benefits which are received directly or indirectly in consideration or in consequence of, or otherwise in connection with –

- (a) the termination of a person's employment...

Section 402C of ITEPA states that the new provisions governing the taxation of notice-related payments apply to a 'relevant termination award'. This is a termination award that is neither a statutory redundancy payment nor 'approved contractual pay' under redundancy arrangements specifically approved by HMRC. (The definitions for these purposes of redundancy pay and approved contractual pay, which will both remain within the scope of the £30,000 exemption, are set out in s309(5) of ITEPA).

The PENP

Whether and to what extent the new tax provisions will apply will depend on the degree to which the employee is deemed to receive, as

part of a relevant termination award, a 'post-employment notice payment' (PENP). An employee's PENP is calculated in accordance with the applicable statutory formula set out below, which ensures that the basic pay which would otherwise have been due during the notice

benefits (not just salary), compensation for loss of benefits, as opposed to salary relating to the notice period, will presumably still potentially fall within the £30,000 tax exemption.

If the PENP is greater than or equal to the total of the employee's relevant termination award, then

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period, had the employee worked it, will now be taxable. This will be the case whether or not the notice element of a severance package is identified separately in the severance agreement. In the absence of a contractual clause providing for a PILON payment to include compensation for lost

the entire relevant termination award is treated as taxable earnings (s402C(3) of ITEPA). If the PENP is greater than nil but is less than the employee's relevant termination award, the part of the termination award that is equal to the PENP is taxable as earnings (s402C(4) of ITEPA).

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Terms used in calculating the PENP

The terms used in the statutory formula determining the employee's PENP are defined in s402D and E of ITEPA as follows:

Basic pay

This is employment income disregarding overtime, bonuses, commissions, gratuities, allowances, termination awards, benefits in kind and amounts treated as earnings (such as share-based earnings as defined in s421B ITEPA). Section 402D(7)(b) provides that basic pay for these purposes includes any amount sacrificed by way of a salary sacrifice arrangement but which would otherwise have fallen within the concept of basic pay. Payments made to a registered pension scheme are not taxable by virtue of s408, so should not count for the purposes of assessing the income tax payable on a relevant termination award.

Trigger date

This is the day on which notice of termination of employment is given (whether this is the notice required under the employee's contract or the statutory minimum notice). If such notice is not given (because employment terminates immediately), the trigger date is the last day of employment.

Post-employment notice period

This period begins at the end of the last day of the employee's employment and ends on the date when employment could first lawfully have been terminated, ie when contractual or, if longer, statutory minimum notice would have expired.

Employees not paid monthly

For employees who are not paid monthly or whose notice period or unworked notice period is not expressed in months, the statutory formula determining the PENP will, under s402D(3) ITEPA, be:

$$((BP \times D)/P) - T$$

where:

- BP is the employee's basic pay during the last pay period to end before the trigger date;

- D is the number of days in the post-employment notice period;
- P is the number of days in that pay period; and
- T is the total of any payments or benefits received in connection with the termination which are (in effect) already taxable under another taxation provision and which do not constitute either a bonus payable for termination of employment or payment for untaken holiday entitlement. This formulation seeks to ensure that such payments are not taxed twice and appears to cover a contractual PILON payment which was already taxable in any event.

Employees paid monthly

If the employee is paid monthly, the notice period is expressed in months and the employment is either terminated immediately or the unworked notice period is a whole number of months, then the formula is simplified (s402D(6) ITEPA). P is deemed to be 1 and the applicable formula is therefore:

$$BP \times D - T$$

where:

- BP is the basic pay for the last pay period to end before notice is given;
- D is the number of months' notice which are not worked; and
- T is as set out above.

Examples

Example one

Nigel is paid monthly and his gross salary is £60,000 per year. His basic pay for the last pay period is therefore £5,000 (£60,000 ÷ 12 months). His notice period is six months, of which he works three months. The number of months in the post-employment notice period is therefore the remaining three unworked months. He receives a severance payment of £35,000, £5,000 of which is a statutory redundancy payment. As the statutory redundancy payment is tax free, his 'relevant termination award' is £30,000. The taxable amount payable in respect of that award is therefore:

$$BP (£5,000) \times D (3) - T (0) = £15,000$$

£15,000 of the termination award is therefore taxable as earnings, whereas the statutory redundancy payment of £5,000 and the balance of the relevant termination award of £15,000 is capable of being paid tax free within the £30,000 exemption.

Example two

Theresa is paid weekly and her basic pay is £1,000 per week. She has a 12-week notice period, of which she works six weeks. The unworked notice period is therefore six weeks or 42 days. Her termination award is £12,000. The taxable amount is therefore:

$$(BP (£1,000) \times D (42) = £42,000)/P (7) - T (0) = £6,000$$

£6,000 of the £12,000 termination award is therefore taxable as earnings and the balance (£6,000) is capable of being paid tax free within the £30,000 exemption.

Example three

Donald earns £15,000 per month and is employed on three months' notice. His contract contains a 'salary only' PILON clause. He makes a salary sacrifice of £1,000 per month, which means his basic pay for the purposes of the PENP rules is increased to £16,000 per month. He is paid three months' salary in lieu of notice (£45,000), which is in any event taxable as a contractual PILON.

$$\text{The PENP is } (BP (£16,000) \times D (3)) - T (£45,000) = £3,000.$$

Additional tax is therefore payable above and beyond the taxable payment in lieu of notice because of the salary sacrifice element.

Salary sacrifice arrangements

Under the new rules, if a salary sacrifice arrangement is in place and the employee departs without serving out the full notice period, this may have adverse tax implications. Had the employee worked the full notice period, the salary sacrifice arrangements would have continued as normal and typically been tax free. However, if employment terminates before the end of the notice period with a PILON being made, the amount of salary which would otherwise have been sacrificed during the unworked notice period will count as basic pay and be taxable and subject to NICs.

Other provisions

There are specific provisions which apply to payments relating to the balance of a fixed-term contract (s402E(8-10) ITEPA). There are also anti-avoidance provisions providing that, if the employer puts arrangements in place to render the PENP lower than it otherwise would be, the PENP is deemed to be the amount it should have been (s402D(11) and (12) of ITEPA).

Timing of payments

It is understood from HMRC’s Employer Bulletin (February 2018 Issue 70) that the new rules will apply to:

... payments or benefits received on or after 6 April 2018 in circumstances where the employment is also ended on or after 2018.

When making terminations around the time of the change, it will therefore be important to be precise about the dates when employment is terminated and termination payments are to be made in order to ensure certainty about which tax treatment should apply.

Varying the £30,000 exemption

The changes to the tax legislation include giving HM Treasury the ability to introduce regulations to vary the £30,000 threshold (s404B ITEPA). It will be interesting to see if, when and how the government uses this power in due course.

Injury to feelings awards

Compensation for injury to feelings paid on termination of employment will fall outside the income tax exemption for injury payments unless

the employee has a psychiatric or other recognised medical condition. From 6 April 2018, pursuant to s5(7) of the Finance (No 2) Act 2017, s406 of ITEPA will provide as follows:

Exception for death or disability payments and benefits

- (1) This Chapter does not apply to a payment or other benefit provided –
 - (a) in connection with the termination of employment by the death of an employee, or
 - (b) on account of injury to, or disability of, an employee.
- (2) Although ‘injury’ in subsection (1) includes psychiatric injury, it does not include injured feelings.

Future NIC changes

While the legislation has not yet been finalised, it is anticipated that, from 6 April 2019, employer – but not employee – NICs will be payable on the excess of a termination award over £30,000. Employers should keep an eye out for the details of these proposed changes when they are confirmed.

Will contractual PILONS now be more advisable?

Historically, whether to include express PILON provisions in employees’ contracts of employment has been a matter for debate and commercial judgement, often dependent on the employee’s seniority. On the one hand, including a PILON clause could make settlements more expensive, for more junior employees in particular, since

the £30,000 tax exemption could not be applied to the notice element. On the other hand, including a PILON clause would enable the employer to terminate the individual’s employment immediately and without breach of contract which would preserve, without the employee’s agreement being necessary, the application of post-termination restrictive covenants. These would otherwise fall away if the employer breached the contract due to not serving notice, even if it paid the employee full compensation in respect of the termination of employment.

In future, however, the tax treatment of the basic salary element of any severance payment referable to an employee’s notice period will be the same whether or not there is a PILON clause in the contract of employment. This means that there will now be less of a tax disadvantage in including PILON provisions in employees’ contracts. Indeed, given that such provisions can, when carefully drafted, confine the employer’s notice liability to basic salary only, they may end up being seen as less problematic than they currently are.

What now?

HMRC is expected to publish guidance on the precise operation of the new rules in due course in its Employment Income Manual. Employers and their advisers should familiarise themselves with this guidance when it becomes available. They will also need to consider updating their internal processes and record-keeping to apply the proper tax treatment under the new rules, as well as continuing to take care to avoid miscategorising payments as tax free. ■

Foreign service relief abolished

Currently, ‘foreign service relief’ applies if a UK-resident employee has spent:

- more than three quarters of their employment abroad;
- at least the previous ten years abroad; or
- ten of the last 20 years working abroad.

This relief exempts a termination payment from income tax in full or, if the relevant criteria are not met fully, on a proportionate basis (ss413 and 414 ITEPA). With effect from 6 April 2018, clause 10 of the Finance Bill 2018 proposes that foreign service relief will no longer be available. Only employees who are not resident in the UK in the tax year when the termination occurs may be eligible for foreign service relief. However, new exemptions will apply for UK-resident seafarers.