Do 'pilon' clauses provide enough protection when executives leave?

The introduction in April of the 50 per cent tax rate for those earning above £150,000 makes the tax-effective structuring of severance packages all the more important.

Pay in lieu of notice (pilon) clauses affect the tax treatment of termination payments. These clauses have their attractions. They give employers an explicit right to terminate employment with immediate effect and pay an employee instead, without breaching the contract. They can cover all or part of the notice period.

Without them, immediate dismissal without notice (unless the employee is in breach of contract) constitutes wrongful dismissal, even if the employer pays full compensation for the notice period. Employers can't rely on any post-termination restrictive covenants in an employee's contract in a case of wrongful dismissal.

Stopping bonuses

Contractual pilon clauses also help to exclude the possibility of damages claims relating to notice periods. Employees may stop accruing bonus or commission entitlements if their contract is terminated with immediate effect. Pilon clauses can reduce the cost of an executive's exit by providing that payment should consist only of salary for the notice period and not the benefits that would otherwise be due.

Lost tax breaks

There are downsides to pilon clauses. HM Revenue & Customs treats contractual pilon payments as fully taxable – the £30,000 exemption on termination payments applying under s403 Income Tax (Earnings and Pensions) Act 2003 does not apply. A pilon payment also attracts employers' national insurance contributions. Given that the after-tax value to an employee of a severance package can be significant, a sensitive termination negotiation may be made more difficult, or at least more expensive, if a pilon clause reduces the employer's flexibility to structure a package effectively.

Ex gratia payments

This problem may not arise if the employer is making the employee a significant payment that can use the tax exemption in full, in addition to compensation for the notice period. However, it can cause problems in less generous severance packages or where the employee has a long notice period so the tax exemption would ideally be applied to compensation for that entitlement. Also, immediate termination in line with a pilon clause leaves an employer relying only on any post-termination restrictions in an employee's contract. These must be narrower than an employee's usual obligations to its employer when employment is ongoing, or they may be challenged as unenforceable.

Pluses and minuses

Pilons can close down bonus and commission entitlements and bring option arrangements to an earlier end than would be the case if employment continued throughout the notice period. But employees and employers stand to lose tax exemption on a termination package.

Having well-drafted "garden leave" provisions may be a more effective way of protecting an employer's business interests. These keep the individual out of the market, without precluding the alternative of a negotiated severance package that takes advantage of the £30,000 tax exemption.

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