Taxation of termination payments

Employment Tax | Tax voice



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Susan Ball and *Paul Tucker* provide an update on the rules introduced in 2018

The new rules for the tax and Class 1 National Insurance contributions (NIC) treatment of termination payments took effect from 6 April 2018. Even with the benefit of HMRC guidance, the application of the new rules remains uncertain in many scenarios.

This article covers some frequently asked questions and builds on the article by Mark Groom published in 2017.

What is causing the uncertainty?

The income tax treatment of Payments In Lieu Of Notice (PILON) appears to be causing the majority of the on-going issues. Employers must consider the new rules if they make any payments or provide any benefits on termination of employment that aren't fully liable to tax and NIC. Employers need to become familiar with the new rules and calculations in relation to 'Relevant Termination Awards' (RTA) and 'Post-Employment Notice Pay (PENP).

What is an RTA?

RTA constitutes termination payments and benefits which meet all of the following criteria:

- the payments, or benefits fall within section 401(1)(a) ITEPA 2003 (i.e. they are received directly, or indirectly in consideration of or in consequence of, or otherwise in connection with the termination of a person's employment)
- the payments, or benefits are received on or after 6 April 2018
- the employment was ended on or after 6 April 2018
- the payments or benefits are not statutory redundancy payments, or approved contractual payments to the extent that they are exempt under section 309 ITEPA 2003 (see EIM13760)
- the payments or benefits are not chargeable to income tax by virtue of any provision other than in Chapter 3 of Part 6 ITEPA 2003 (see EIM13000).

These RTAs are split into two elements:

- PENP – these are taxable and liable to NIC
- RTAs subject to section 403 ITEPA 2003 – these are eligible for the termination related tax exemptions.

If an employer pays an employee in lieu of notice how is the tax and NIC calculated?

This is done through either a 'Contractual PILON', payments which are subject to tax and NIC as earnings, or through a 'Non-contractual PILON' which are RTAs. In order to work out the amount liable to tax and NIC, employers need to undertake the PENP calculation.

How is redundancy pay treated under the new rules?

Statutory redundancy pay is not an RTA and automatically qualifies for the £30,000 tax exemption.

Any amount of enhanced redundancy payment does count as an RTA and therefore does not automatically benefit from the £30,000 exemption.

What must be subject to tax and NIC as earnings?

The slice of the RTA that must be treated as earnings under the legislation is:

- the entire RTA if PENP is equal to or more than the RTA
- PENP, if it is less than the RTA but is not nil (If PENP is a negative amount, it is treated as nil).

When is a PENP calculation not required?

There are two situations when the PENP calculation is unnecessary:

- if all the lawful notice due is worked or the employee is placed on gardening leave and is paid in the normal way subject to PAYE tax and NIC
- if there is no termination payment other than items that are taxable and liable to NIC as earnings, such as a contractual PILON, holiday pay and bonus.

Additionally, if the termination date was on or before 5 April 2018 then the PENP rules do not apply.

What is PENP?

The PENP is calculated using the formula ((BP x D) /P) – T.

Where:

- BP = basic pay
- D = days in the notice period
- P = days in the pay period
- T = taxable amounts on termination other than holiday pay and bonuses.

It requires the employer to work out the number of days in the pay period. While there is no definition of ‘pay period’, it is taken to mean the period covered by the last payment of pay. More information is available on HMRC’s website.

How do I work out the days in the notice period?

For PENP, ‘D’ is the number of days in the post-employment notice period (broadly the unworked period of notice). Note that ‘D’ is calculated by reference to the notice that the employer must give (by contract or law). This may be different from the period of notice that the employee must give. Please see HMRC’s website for further information.

How do I work out the days in the pay period?

In the PENP formula, ‘P’ is the number of calendar days in the employee’s last pay period ending before the ‘trigger date’.

EIM13898 provides the definition of ‘trigger date’. This is where notice of termination of employment is given or received it is the date that notice is given by either party. Otherwise it is the last day of employment. Guidance is available on HMRC’s website .

What happens where an employee is paid on a monthly basis?

If their notice period is expressed in monthly terms, the termination date is the last day of the month and the employee has not worked any of their notice period then the calculation may be made using months, as in Example 1 below.

However, if the employee has worked part of their notice period then the calculation will need to be made in days.

Example 1 – PENP calculation

Facts

- employment terminated on 30 April 2018
- contractually entitled to three months’ notice, but no contractual entitlement to a PILON

- employee did not work their notice
- employee was paid £33,000 made up as follows:
    - £2,000 statutory redundancy pay
    - £7,000 enhanced redundancy pay
    - £9,000 PILON
    - £15,000 termination payment
- salary £36,000 per annum (£3,000 per month)

Computation

- RTA:
    - their RTA is £31,000 (£7,000 + £9,000 + £15,000)
    - the statutory redundancy pay of £2,000 is not part of the RTA calculation
- PENP:
    - PENP subject to tax and NIC is £9,000 calculated as follows
    - ((BP x D) /P) – T =((£3,000 x 3)/1) – 0 = £9,000
- Balance – eligible for termination related tax exemptions
    - the balance of £24,000 (£33,000 - £9,000) is eligible for the £30,000 tax exemption and the complete NIC exemption.

HMRC's website provides examples of how PENP is calculated here and here.

Do the PENP rules need to be applied where an employee is dismissed without notice and is offered a settlement agreement at a later date?

Yes. The fact that there is a gap between termination and agreeing settlement terms does not prevent the rules applying.

If a fixed term contract ends early, is there any notice period?

Yes. The notice period runs from the date of termination to when the contract would have ended.

What is the position if the employer and employee agree to shorten the employee's notice period so there are no unserved periods of notice?

When determining whether there are any unserved periods of notice, employers must use whichever is the greater of the contractual or statutory notice periods that

the employer is required to give. So varying the employee's notice period may have no impact on the application of the new rules. It is worth noting that there is an anti-avoidance purpose test in the new rules.

If an employer pays a contractual PILON, does it have to do a PENP calculation?

It will depend on whether the employer is also paying a RTA. If they are then the PENP calculation will be needed.

Do you need to include salary sacrifice as well as basic pay when calculating PENP?

Yes. Basic pay for the purposes of this legislation includes any salary sacrifice amounts. More information is available here.

Example 2a – no contractual PILON – salary sacrifice

Facts

- employment terminated on 30 April 2018
- contractually entitled to three months' notice, but no contractual entitlement to a PILON
- employee did not work their notice
- employee was paid £33,000 made up as follows:
    - £2,000 statutory redundancy pay
    - £7,000 enhanced redundancy pay
    - £9,000 PILON
    - £15,000 termination payment
- salary £36,000 per annum after a salary sacrifice of £6,000 (£3,500 per month pre-salary sacrifice)

Computation

- RTA
    - their RTA is £31,000 (£7,000 + £9,000 + £15,000)
    - the statutory redundancy pay of £2,000 is not part of the RTA calculation.
- PENP

    - PENP subject to tax and NIC is £10,500 calculated as follows:
    - ((BP x D) /P) – T =((£3,500 x 3)/1) – 0 = £10,500
- Balance – eligible for termination related tax exemptions
    - the balance of £22,500 (£33,000 - £10,500) is eligible for the £30,000 tax exemption and the complete NIC exemption. As a result of the salary sacrifice adjustment £1,500 more is taxable and liable to NIC than in Example 1.

Example 2b – contractual PILON – salary sacrifice

Facts

- employment terminated on 30 April 2018
- contractually entitled to three months' PILON
- employee did not work their notice
- employee was paid £33,000 made up as follows:
    - £2,000 statutory redundancy pay
    - £7,000 enhanced redundancy pay
    - £9,000 PILON
    - £15,000 termination payment
- salary £36,000 per annum after a salary sacrifice of £6,000 (£3,500 per month pre-salary sacrifice).

Computation

- Taxable under S62 ITEPA 2003

The contractual payment of £9,000 will be subject to tax and NIC under PAYE in the normal way and will not be part of the RTA calculation (although it will be reflected in the PENP calculation).

- RTA

Their RTA is £22,000 (£7,000 + £15,000). The statutory redundancy pay of £2,000 is not part of the RTA calculation.

- PENP

PENP subject to tax and NIC is £1,500 calculated as follows:

((BP x D) /P) – T =((£3,500 x 3)/1) – £9,000 = £1,500.

- Balance – eligible for termination related tax exemptions

The balance of £22,500 (£33,000 - £9,000 - £1,500) is eligible for the £30,000 tax exemption and the complete NIC exemption.

Example 2b demonstrates that even where there is a contractual PILON, the amount that is subject to tax and NIC may be higher for post 6 April 2018 terminations than pre 6 April 2018 terminations. However, the tax and NIC treatment of pay attributable to the unworked notice period will be the same irrespective of whether there is a contractual entitlement or not.

Basic pay includes allowances – does that mean car allowances?

It is possible that a car allowance should be included, but it will depend on the circumstances. For example, HMRC takes the view that an allowance is part of basic pay if it is an ‘amount that has been consolidated into an employee’s standard pay.’ For a car allowance, this might be part of basic pay where the employee receives it regardless of whether they need a car for work and no car alternative is offered.

Are payments made under a settlement agreement taxable?

It depends on the nature of the payments. Entering into a settlement agreement doesn’t change the tax and NIC positon.

Can payment be made over more than one tax year?

Yes. However, depending on the nature and size of payments this may mean you need to undertake PENP more than once. If a settlement agreement specifically sets dates for payment then the tax rates will be those at the time of the entitlement to the payment.

How does this impact on ill health terminations?

The RTA and PENP calculations still need to be considered. It is only the RTAs that are subject to S403 ITEPA 2003. You may need to consider any eligibility for the complete tax exemption available under S406(b) ITEPA 2003.

If we are unsure of the tax treatment can we ask HMRC?

Employers can seek clearance from HMRC where the payment relates to redundancy (SP 1/94).

In relation to other types of payment, from 1 April 2008, HMRC will give advance clearance on:

- areas of material uncertainty arising from new legislation passed in the last four Finance Acts
- legislation older than the last four Finance Acts where there is material uncertainty around the tax outcome of an issue of commercial significance for the business.

HMRC will also, as a matter of practice, give binding replies to questions relating to proposed terminations, in relation to certain statements of practice. (EIM12825 and EIM12827.)

Do I need to report the termination payment to HMRC?

When considering reports it is only necessary to consider the part of the package that is eligible for the £30,000 tax exemption:

- where there is a cash-only settlement and no tax is deducted because the amount does not exceed £30,000, and there was no PENP the employer does not need to report the payment to HMRC (section 5.2.5, Employer Further Guide to PAYE and NIC (CWG2)
- if the cash value exceeds £30,000, section 5.11.2 of the Employer Further Guide to PAYE and NICs (CWG2) sets out the reporting requirements under the PAYE system
- if the package includes benefits and exceeds £30,000 then the employer must submit a report to HMRC by 6 July following the tax year in which the termination takes place; consult the HMRC website for more information.

Where a package is made up of cash and benefits and exceeds £30,000, employees completing a tax return will need to make sure they understand the tax treatment of the payment and also correctly report it on their tax return.

Are there more changes to NIC coming in from April 2019?

No, the Government announced that it intended to subject all termination payments above the £30,000 threshold to Class 1A NIC (employer liability only). However, this reform has been postponed twice and will now take effect from April 2020.

Do the new rules impact on the tax and NIC treatment of pre 6 April 2018 terminations?

No. There may, however, be an opportunity for tax and NIC refunds if an employer has subjected non-contractual PILONs to tax and NIC incorrectly.

Example 3

An employee had their employment terminated on 31 December 2017. They did not work their notice and received a payment of £10,000, made up of £2,500 statutory redundancy pay and £7,500 PILON. The employer subjected the PILON to tax and NIC, even though the employee did not have a PILON clause in their contract and the amount was part of a negotiated settlement.

The employee should consider claiming a tax refund as the PILON should be covered by the £30,000 tax exemption and both the employer and employee should consider claiming a NIC refund.

Summary

It is clear from the text and examples above that this is an extremely complex area. If there is any confusion regarding the taxation of termination payments, then specialist advice should be sought.