Termination Payments – recent changes, but don’t forget Rule Number 1

Employment Tax | Tax voice



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Paul Tucker discusses discusses termination payments and a reminder of the changes that have occurred in the past three years

The tax treatment of termination packages is complex. There have been some significant changes over the past few years. In particular:

- From 6 April 2018
    - The introduction of the Post Employment Notice Payment (PENP) charge; and
    - The legislation in respect of injury to feelings
- From 6 April 2020
    - New National Insurance (NI) legislation

Rule Number 1

It is always important to remember the first rule. **The £30,000 tax exemption is not always due!**

Consider each element

Employers should always consider how is the termination package made up? It is likely that different parts will be subject to different tax and NI treatment. HM Revenue and Customs (HMRC) will look at each element and ask:

1. Is it earnings, including contractual Payments In Lieu Of Notice ("PILON") – under S62 ITEPA 2003?
2. Is it a payment for a restrictive covenant – under S225 ITEPA 2003?
3. Is it in respect of an Employer Financed Retirement Benefit Scheme – under S394 ITEPA 2003?

It is only any remaining amount that is potentially eligible for the exemptions under S401 ITEPA 2003 (most commonly, the £30,000 tax exemption).

The PENP challenge

Having decided how much is eligible for an exemption, it is then necessary to navigate the first major piece of new legislation to be introduced for many years. Is any of the payment taxable and liable to NI as Post Employment Notice Pay (PENP)?

Many articles have been written about PENP and the calculations are sometimes complex, but it is important to remember why the change was made. The simple answer is that the change, which arose as a result of an Office of Tax Simplification review, was to level the playing field in respect of notice periods. Historically, in broad terms, a non-contractual PILON used to be eligible for the tax exemption

(often using what many of you may fondly remember as the Gourley principle). A contractual PILON was always taxable and liable to NI.

In broad terms, if there is a contractual PILON the amount of the PENP will usually be zero, as the PILON will be taxable as earnings under S62 ITEPA 2003 (point 1 above). However, employers must always calculate the amount of the PENP as in some cases they will be different (for example in salary sacrifice cases).

Injury to feelings

There has always been a debate about the tax treatment of payments for injury to feelings. The key question to address is whether it is connected to the termination or not. HMRC confirm in their Employment Income Manual at paragraph 12965 that if the payment is solely attributable to discrimination occurring before the termination of employment they should accept that it is not connected with the termination and is outside the scope of S401 ITEPA 2003 (thus not taxable).

However, a number of taxpayers have claimed that the payment was potentially eligible for the complete tax exemption available under S406 ITEPA 2003 (for death and disability payments). New legislation was introduced from 6 April 2018 specifically excluding injury to feelings from the S406 ITEPA 2003 exemption.

Death or disability

Whilst on the subject of S406 ITEPA 2003, it is always important to consider the reason the employee is having their employment terminated. If it is as a result of death or disability then the payment may be eligible for the complete tax and NI exemption (rather than the £30,000 exemption). To be eligible for the disability exemption, in broad terms (as set out in the case of Hasted v Horner (67TC439) and summarised in HMRC's Employment Income Manual at paragraph EIM13630):

- There must be an identified medical condition that prevents the employee from carrying out the duties of their employment; and
- The payment must be made on account of that disability and nothing else.

The rules are potentially complex, but the amounts payable (and therefore the tax and Employers' NI) could be considerable. Employers sometimes only apply the £30,000 tax exemption when calculating the PAYE deductions, rather than risk making a mistake and facing a significant liability for failing to operate PAYE

correctly. They would then advise the employee to make a claim on their own personal tax return if they considered the exemption under S406 ITEPA 2003 was available.

Prior to the change in the NI rules from 6 April 2020, that was often a sensible approach, as there was no NI on payments taxable under S401 ITEPA 2003. However, from 6 April 2020 with the Class 1A Employers' NI charge on the excess over £30,000, see note below, it is worth considering carefully the exemption in more detail, as an overly cautious approach could result in not only the employee paying too much tax, but also the employer paying too much Class 1A NI.

In cases of doubt, HMRC do offer the opportunity to obtain clearance via their non-statutory clearance team.

Continuing benefits – reports to HMRC

If an employee is provided with continuing benefits, such as medical insurance for six months after leaving, these are likely to be eligible for the tax exemptions under S401 ITEPA 2003. The tax exemptions are given against cash amounts first and then non-cash benefits. However, care should be taken to ensure that benefits are attributed correctly (pre-termination contractual benefits and those that are part of the termination package). HMRC's Employment Income Manual at paragraph EIM12815 provides further detail.

If the package is taxable (as it exceeds the exemption) and is made up of a cash amount (eligible for the £30,000 tax exemption under S401 ITEPA 2003) and benefits, then a report must be made to HMRC by 6 July after the end of the year for which the benefit is provided. HMRC guidance at their Employment Income Manual Paragraph 13844 onwards gives more detail (including the content of the report and frequency).

The report is important, but not all employers are aware of it, as it ensures HMRC are aware of the taxable benefit. There is no P11D requirement for a continuing benefit provided on termination so without the report HMRC would simply have to rely on the employee reporting the benefit on their return. A copy of the report is typically also provided to the employee.

Class 1A National Insurance

This major change was introduced from 6 April 2020. Payments eligible for a tax exemption under S401 ITEPA 2003 will be liable to Class 1A Employer only NI on the excess over £30,000.

This increases the cost for employers in relation to any element of a package that is eligible for a termination payment exemption under S401 ITEPA 2003 (including continuing benefits) in relation to the excess over £30,000.

To further complicate matters in some cases the liability is collected in different ways:

1. Compensation payments and benefits as part of the termination are subject to Class 1A NI via payroll and the Real Time Information process.
2. Class 1A NI on continuing benefits is payable via the P11D(b) process.

HMRC's CWG5 – guide to Class 1A NI Contributions includes a section on termination payments and some useful examples.

The Class 1A liability and reporting requirements are probably best explained in an example.

Comprehensive example of Class 1A NI payment and reporting requirements

1. The facts

- Employee salary £75,000 per annum, paid monthly
- Six month notice period
- Employment terminated on 31 December 2020 after employee worked their notice
- The employment is not being terminated on the grounds of ill health.
- Termination package
    1. Compensation for loss of employment £75,000 paid 31 March 2021
    2. Gift of company car valued at £15,000 on 31 March 2021
    3. Medical insurance cost £1,000 per month for 10 months to 31 October 2021

2. The tax and NI treatment of the package

- Consider each element of the package
  The employer checks each element and none are taxable as either:

1. Earnings; or
2. A payment for a restrictive covenant; or
3. As part of an Employer Financed Retirement Benefit Scheme

The total package should therefore be taxable under S401 ITEPA 2003

- Is anything taxable and liable to Class 1 NI as PENP?
  The employee worked their notice so PENP is zero.
- What termination tax exemptions are due?
  The total package should be eligible for the £30,000 tax and Class 1A NI exemption.
- How will the £30,000 tax exemption be applied?
  The £30,000 exemption will be applied to the compensation payment of £75,000, leaving the following liable to tax and Class 1A NI:
  Compensation - £45,000 (£75,000 - £30,000)
  Value of car provided as part of package - £15,000
  Medical insurance for 10 months - £10,000 (1 January 2021 until 31 October 2021)
  Total taxable and liable to Class 1A NI = £70,000

3. Payments to HMRC and reporting requirements

- **2020/21**
  - Compensation payment:
    £30,000 – via payroll free of tax and any NI
    £45,000 – via the payroll subject to tax and liable to Class 1A NI
- £15,000 car as part of termination package:
  Tax
  Payable via Self Assessment.
  Employer required to report the benefit to HMRC by 6 July 2021 for tax purposes
  Copy of report given to employee
- Class 1A NI
  Payable via payroll.
- £3,000 medical insurance continuing benefit:

Tax

- Payable via Self Assessment.
- Employer required to report the benefit to HMRC by 6 July 2021 for tax purposes
- Copy of report given to employee
  Class 1A NI
  Payable via P11D(b) process.

- **2021/22**
  - £7,000 medical insurance continuing benefit:
    Tax
    Payable via Self Assessment.
    Employer required to report the benefit to HMRC by 6 July 2021 for tax purposes
    Copy of report given to employee

  Class 1A NI
  Payable via P11D(b) process.