Termination Packages – Is a complete tax and NI exemption due?

Tax voice

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The tax treatment of termination packages is complex. Tax and National Insurance (NI) exemptions are often available in respect of some, or all, of the package. To determine both the tax treatment and whether these exemptions apply, employers need to decide “Why is the payment (or an element of the payment) being made?”. A payment in respect of an ill health severance may be eligible for a tax and NI exemption on the full amount of the payment under Section 406(1)(b) ITEPA 2003. A full exemption may also be available on the death of an employee in limited circumstances under Section 406(1)(a) ITEPA 2003, but in this article I am focusing purely on the ill health exemption.

Deciding if a tax exemption is available

The employer must decide whether tax and NI should be accounted for under PAYE, before they make any payment to an employee or former employee. With any termination package, a tax exemption (under Section 401 ITEPA 2003) will only be available in respect of any element of the package that is not:

- Earnings (Section 62 ITEPA 2003); or
- A payment for a restrictive covenant (Section 225 ITEPA 2003); or
- Taxable under the Employer-Financed Retirement Benefit Scheme legislation (Sections 393 to 400 ITEPA 2003); or
- Taxable notice pay (under Section 402 ITEPA 2003)

When will the ill health severance exemption be available?

HMRC confirm in their guidance at EIM13610 that a termination payment or benefit will be exempt from tax under Section 401 ITEPA 2003 (and therefore qualifies for the ill health exemption under Section 406(1)(b) ITEPA 2003 if it is paid wholly on account of:

- An injury to an officeholder or employee; or
- The disability of such a person.

They go on to confirm at EIM13620 (and also contained in Statement of Practice 10/1981) that “disability” means an incapacity to fulfil the duties of employment caused either by:

- A sudden affliction (such as a heart attack); or
- The culmination of a process of deterioration of physical or mental health caused by a chronic illness (such as chronic fatigue syndrome).

It does not mean the normal process of ageing. In practice, HMRC look at two tests from the tax case Hasted v Horner (67TC439). These are set out in detail at EIM13630:

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

In many cases the payment is funded by a Permanent Health Insurance (PHI) company. The payment is offered by the PHI company to commute their liability after they have been making payments to an employer in respect of an employee who has been off sick for some time where medical reports indicate the employee is not going to be capable of returning to their role. HMRC normally accept this as the typical scenario in which the ill-health severance exemption is available as set out in the Employment Income Manual EIM13635.

How does the tax exemption interact with NI?

Prior to 6 April 2020, there was no NI (employees’ or employers’) on any payment that was eligible, in whole or in part, for any tax exemption under Section 401 ITEPA 2003 (including the £30,000 exemption and the complete ill-health severance exemption). From 6 April 2020 a new Class 1A Employers’ NI liability was introduced in the NICs (Termination and Sporting Testimonials) Act 2019 in respect of the excess over the £30,000 tax exemption, (see also NIM13201 to NIM13205). However, if all of a payment is eligible for the exemption under Section 406(1)(b) ITEPA 2003 it will also be exempt from Class 1A NI.

What are the potential risks to employers and what actions can they take to reduce the risk?

Employers may be nervous about applying the exemption as:

- The rules are complex and often subjective;
- The amounts and the tax and NI involved are often significant.

If an employer incorrectly assumes the exemption applies then:

- HMRC will pursue them for any liability for the tax and NI which would have been due; and
- They will then need to consider how they may make any recovery from the former employee, via tax indemnities in any settlement agreements, which may not be easy.

An employer, who thinks the ill health exemption should be due, usually adopts one of the following approaches:

- They apply the exemption and will either rely on tax indemnities, or bear the tax cost if HMRC successfully challenge the exemption:
- They take a cautious approach and only apply £30,000 tax and NI exemption under Section 403 ITEPA 2003. They will then subject the employee to tax under PAYE on the excess and pay Class 1A NI on the excess. Under this approach, both the employer and employee could be making an overpayment to HMRC.
- They apply to HMRC for Non-Statutory Clearance under Statement of Practice 1/1994 (see EIM13790). If they adopt this approach they will need to include medical evidence in their submission to HMRC.

What should an employee do if their employer does not give the ill health severance exemption?

An employee may apply to HMRC for a tax refund if they consider they are due the full exemption under Section 406(1)(b) ITEPA 2003, but have not received it.

Summary

It is likely that many employers have historically adopted a cautious approach to ill health severance packages (or perhaps not been aware of the exemption). With the

introduction of Class 1A NI on termination packages in excess of £30,000 from 6 April 2020, the cost of not applying the exemption impacts both employee and employer.

Employers should:

- Consider the approach they take with future payments and whether to apply for HMRC clearance before making any payment; and
- Review any post 6 April 2020 payments to see if any Class 1A NI refunds are due.

Employees should:

- Not simply accept the approach taken by the employer if tax has been deducted; and
- If they consider the ill health exemption is due an appropriate claim should be made to HMRC for any tax they have suffered.

Even on a relatively small ill health severance payment of £100,000 a sizeable tax refund of £28,000 could be due for a 40% taxpayer along with a Class 1A NI refund for the employer of around £10,000 if the correct exemption has not been applied.

Finally, a practical point to advisers who complete personal tax returns. If you receive a P45 from your client always ask more questions, such as did you receive any payments when you left and why did you leave? The answer to your questions may result in a claim for an exemption, a potentially significant refund, and a very happy client.