

TAXATION OF TERMINATION PAYMENTS

Key changes from 6 April 2018

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Key developments

- £30,000 tax-free threshold retained
- New concept of "post-employment notice pay" introduced which will be taxable and will not benefit from £30,000 tax-free threshold
- Employer's class 1 National Insurance payable on all taxable payments made in connection with the termination of employment, including payments above the £30,000 tax-free threshold (now delayed until 6 April 2019)
- Foreign service relief on termination payments abolished for employees who are UK tax resident in the year of termination
- Payments for injury to feelings connected with termination will be fully taxable
- HMRC to release guidance on the new rules – still outstanding

1 The current £30,000 tax-free threshold will be retained

The Government originally proposed in its Consultation Paper on the simplification of the tax and National Insurance (**NI**) treatment of termination payments back in July 2015 that the £30,000 threshold for payments (and other benefits) received in connection with the termination of employment (sections 401 and 403 Income Tax (Earnings and Pensions) Act 2003 (**ITEPA 2003**)) should be replaced with an exemption linked to the employee's length of service. However, following feedback on the Consultation Paper it decided that the existing £30,000 tax-free threshold should be retained.

2 A new concept of "post-employment notice pay" will be introduced

Whilst the £30,000 tax-free threshold has been retained, the types of payments that fall within the threshold have changed. New section 402D ITEPA 2003 introduces a concept of "post-employment notice pay" (**PENP**). In essence, PENP is the basic pay equivalent for any unworked notice period calculated using a specified formula.

Where an individual is not employed for the full notice period, any "relevant termination award" (i.e. disregarding any redundancy payment – see section 11 below) made post-termination will be taxed as general earnings (and therefore subject to income tax and Class 1 employer's and employee's NI) in so far as it is equal to (or less than) the PENP.

It is irrelevant whether or not the payment was made under a payment-in-lieu of notice clause in the individual's contract of employment. This means that non-contractual payments in lieu of notice which previously could have fallen within the £30,000 tax-free threshold will no longer do so.

HMRC has confirmed that the new PENP regime applies where the date of termination of employment is on or after 6 April 2018. It does not apply to termination payments made on or after that date where the employment is terminated before 6 April 2018 (see section 18 below).

The PENP calculation is set out below (although you should also see section 13 below for a revised calculation which must be used in cases where the employee is paid monthly, the notice period is expressed in months and the unworked notice period is a whole number of months).

The PENP calculation:

$$\frac{BP \times D}{P} \text{ minus } T$$

Where:

BP = employee's basic pay in respect of the last pay period of the employee before the "trigger date"

P = the number of days in that pay period

D = the number of days in the post-employment notice period

T = other taxable payments (that are not holiday pay or a bonus payment)

It is worth noting that where an individual is paid a payment-in-lieu of notice (**PILON**) under the terms of his employment contract (which remains taxable in full under section 62 ITEPA 2003) and no other payment is made, there is no requirement to calculate the PENP (as there will be no "relevant termination award"). However, HMRC has confirmed that where a contractual PILON is paid along with a "relevant termination award", the PENP must be calculated and, in some circumstances, this may be higher than the amount taxed under the PILON (see section 8 below for more details).

3 What falls within the definition of basic pay?

Calculating basic pay

For the purposes of calculating the PENP, basic pay is defined as all pay excluding:

- overtime payments
- commission
- bonus
- gratuity or allowance
- benefits in kind
- any termination-related bonus payment
- income relating to securities and securities options.

However, it includes "*any amount the employee has given up the right to receive but would have fallen within the definition of basic pay had the employee not done so*" which means that any salary which was given up under a salary sacrifice arrangement will be taken into account for the purposes of calculating basic pay.

4 What is the "pay period"?

This is not defined in the legislation and is therefore expected to be given its general meaning being the period for which the employee is regularly paid (for example, weekly or monthly).

5 When is the "trigger date" for the purposes of calculating PENP?

Where notice is given by either the employer or the employee, the trigger date will be the day the notice is given. If no notice is given or received, it will be the last day of employment.

It is therefore now essential for tax as well as employment law purposes that where notice is given or received, evidence is retained of such notice being given in order to satisfy any subsequent tax investigation or HMRC PAYE audit.

6 How do you calculate the post-employment notice period?

The post-employment notice period is the period beginning on the last day of employment and ending on the earliest lawful termination date. The earliest lawful termination date is the last day of the period which is equal in length to the minimum notice and begins on the trigger date.

For example, if an employee who has a 90 day notice period resigns on 1 January 2019 (the trigger date) and leaves employment on 31 January, her earliest lawful termination date would be 31 March 2019 and, as her last day of employment was 31 January, the post-employment notice period will be 59 days.

If the earliest lawful termination day is, or precedes, the last day of the employment, the number of days in the post-employment notice period will be zero (i.e. the employee will have been employed throughout the notice period). In these circumstances, the PENP calculation will also be zero.

7 What payments fall within "T- other taxable payments" in the formula?

Amounts which are received in connection with the termination and are taxable as general earnings under section 62 ITEPA but which are not either (i) accrued holiday pay for a period before the employment ends nor (ii) a bonus payable for the termination of the employment, are deducted from the PENP calculation. There is no further definition of a "termination bonus" in the legislation and it is hoped that the awaited HMRC guidance will give further explanation and examples of this in practice.

Payment made under a contractual PILON would fall within this category (see section 8 below). However, a payment for entering into a restrictive undertaking or covenant would not fall within "T" as it is separately taxable under section 225 ITEPA 2003. For the same reason, it would also not form part of a "relevant termination award".

8 What happens where there is a contractual PILON?

Where a PILON is paid under the terms of the contract, "T" in the formula will include the amount paid under that PILON. In most cases once the contractual PILON amount has been deducted, the PENP amount will be zero (as "T" will be equal to, or greater than, BP x D/P). However, in some cases, particularly where there is an element of salary sacrifice such that "BP" in the formula is greater than the amount actually paid under the contractual PILON, the amount given by BP x D/P will be greater than the contractual PILON payment deducted as "T". In these cases, the PENP amount must be deducted from any relevant termination award (see Example 4 below).

Where an individual is only paid a PILON under the terms of his employment contract (which remains taxable in full under section 62 ITEPA 2003) and no other payment is made, there is no requirement to calculate the PENP as there will be no "relevant termination award".

9 Some worked examples

Example 1: No notice period worked

Employee A earns £34,000 a year basic pay which is equivalent to £2,833.33 per month. She is paid monthly and her last pay period was November which has 30 days. Her notice period is 90 days. Her employment is terminated and she works none of her notice period. She is paid £20,000 on termination of her employment. She is not redundant.

PENP is calculated as follows:

$$\frac{\pounds 2,833.33 \text{ (basic pay for last pay period)} \times 90 \text{ (number of days in post-employment notice period)}}{30 \text{ (number of days in the last pay period before the trigger date)}} = \pounds 8,500$$

The PENP is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £11,500 potentially benefiting from the £30,000 tax-free threshold.

Example 2: Notice period worked in part

Employee B earns £42,000 a year basic pay which is equivalent to £3,500 per month. He is paid monthly and his last pay period was November which has 30 days. His notice period is 90 days. His employment is terminated and he works 48 days of his notice period. He is paid £20,000 on termination of his employment. He is not redundant.

PENP is calculated as follows:

$$\frac{\pounds 3,500 \text{ (basic pay for last pay period)} \times 42 \text{ (number of days in post-employment notice period)}}{30 \text{ (number of days in the last pay period before the trigger date)}} = \pounds 4,900$$

The PENP is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £15,100 potentially benefiting from the £30,000 tax-free threshold.

Example 3: Notice period worked in part – salary sacrifice

Employee C earns £65,000 a year. However, she has previously sacrificed £5,000 of her salary in exchange for increased pension contributions and, therefore, her basic pay (for the purposes of the PENP formula) is £70,000 a year which is equivalent to £5,833.33 per month. She is paid monthly and her last pay period was October which has 31 days. Her notice period is 90 days. Her employment is terminated and she works 30 days of her notice period. She is paid £15,000 on termination of her employment. She is not redundant.

PENP is calculated as follows:

$$\frac{£5,833.33 \text{ (basic pay for the last pay period)} \times 60 \text{ (number of days in post-employment notice period)}}{31 \text{ (number of days in the last pay period before the trigger date)}} = £11,290$$

The PENP is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £3,710 potentially benefiting from the £30,000 tax-free threshold.

Example 4: Contractual PILON

Employee D earns £84,000 a year. However, he has previously sacrificed £8,000 of his salary in exchange for increased pension contributions and, therefore, his basic pay (for the purposes of the PENP formula) is £92,000 a year which is equivalent to £7,666.66 per month. He is paid monthly and his last pay period was January which has 31 days. His notice period is 90 days. His employment is terminated and he is paid £21,000 under the terms of his contractual PILON (this is "T" for the purposes of the formula). He is paid an additional £6,000 on termination of his employment. He is not redundant.

PENP is calculated as follows:

$$\frac{£7,666.66 \text{ (basic pay for the last pay period)} \times 90 \text{ (number of days in post-employment notice period)}}{31 \text{ (number of days in the last pay period before the trigger date)}} \text{ minus } £21,000 = £1,258$$

The PENP is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £4,742 potentially benefiting from the £30,000 tax-free threshold.

10 Compensation for unfair dismissal

Compensation for unfair dismissal, whether awarded by an Employment Tribunal or under a settlement agreement, will be taxable to the extent that it represents PENP.

11 Redundancy payments

A new section 402C ITEPA 2003 provides that any (i) statutory redundancy payment, or (ii) "approved contractual payment" equal to or less than the amount which would have been due if a redundancy payment had been payable, will not be taken into account when calculating the relevant termination award and therefore such amounts will still potentially fall within the £30,000 tax-free threshold.

An "approved contractual payment" is one made to a person on the termination of that person's employment under an agreement in respect of which an order is in force under Section 157 ERA 1996 (i.e. under a collective agreement with a trade union).

It should be noted that where an enhanced contractual redundancy payment is made, only an amount equal to the statutory redundancy payment can be disregarded for the purposes of calculating the relevant termination award.

Example 5: Notice period worked in part - redundancy

Employee E earns £26,000 a year basic pay which is equivalent to £2,166.66 per month. He is paid monthly and his last pay period was January which has 31 days. His notice period is 90 days. His employment is terminated and he works 50 days of his notice period. He is paid £17,000 on termination of his employment of which £14,670 is statutory redundancy pay. His relevant termination award is therefore £2,330 (£17,000 - £14,670).

PENP is calculated as follows:

$$\frac{£2,166.66 \text{ (basic pay for last pay period)} \times 40 \text{ (number of days in post-employment notice period)}}{31 \text{ (number of days in the last pay period before the trigger date)}} = £2,795.69$$

The relevant termination award is less than the PENP and therefore £2,330 is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £14,670 statutory redundancy payment benefiting from the £30,000 tax-free threshold.

12 National Insurance Contributions

PENP is subject to both income tax and Class 1 (employer's and employee's) NI.

In addition, from 6 April 2019 termination payments in excess of the £30,000 tax-free threshold will also be subject to employer's Class 1A NI. This may result in a significant extra cost to the employer which will need to be factored into the overall costs of a termination and, in many cases, is likely to reduce the amount of any discretionary payment made to a departing employee. The implementation of these provisions has been delayed until 6 April 2019 due to a lack of Parliamentary time.

Example 6: Payment in excess of tax-free threshold

Employee F earns £120,000 a year basic pay which is equivalent to £10,000 per month. She is paid monthly and her last pay period was July which has 31 days. Her notice period is 90 days. Her employment is terminated and she works none of her notice period. She is paid £75,000 on termination of her employment. She is not redundant.

PENP is calculated as follows:

$$\frac{£10,000 \text{ (basic pay for last pay period)} \times 90 \text{ days (number of days in post-employment notice period)}}{31 \text{ days (number of days in the last pay period before the trigger date)}} = £29,032$$

The PENP is taxed as general earnings (income tax and employer's and employee's NI) with the remaining £45,968 (£75,000 minus £29,032) being taxed as follows:

£30,000 no income tax or NI

£15,968 subject to income tax and, if termination is on or after 6 April 2019, employer's NI (but not employee's NI)

By way of contrast, under the old regime, provided broadly that there is no PILON clause in the contract of employment and the payment of a PILON is not an automatic response by the employer, the first £30,000 would generally be paid free from income tax and NI with the additional £45,000 being subject to income tax but not NI. Given the current employer's NI rate of 13.8%, the additional cost to the employer of providing the package set out in Example 6 above to a departing employee under the new regime would be £4,006 (£29,032 X 13.8%) if termination is between 6 April 2018 and 5 April 2019 and £6,210 ((£29,032 X 13.8%) + (£15,968 X 13.8%)) if termination is on or after 6 April 2019.

13 There is a simplified PENP calculation in some case where employees are paid monthly

Where:

- the employee's pay period is a month; and
- the minimum notice is given by contractual terms and is expressed to be a whole number of months; and
- no notice is worked or some notice is worked and the post-employment notice period is a whole number of months,

the revised calculation for PENP set out below MUST be used.

The simplified "whole month" PENP calculation:

$$\frac{BP \times D}{P} \text{ minus } T$$

Where:

BP = employee's basic pay in respect of the last pay period of the employee before the "trigger date"

P = 1

D = the post-employment notice period expressed in months

T = other taxable payments (that are not holiday pay or a bonus payment)

Example 7: The "whole month" PENP calculation

Employee G earns £50,000 a year basic pay which is equivalent to £4,166.67 per month. He is paid monthly. His notice period is 3 months. His employment is terminated and he works exactly 1 month of his notice period. He is paid £10,000 on termination of his employment. He is not redundant.

PENP is calculated as follows:

$$\frac{\pounds 4,166.67 \text{ (basic pay for the last pay period)} \times 2 \text{ (post-employment notice period expressed in months)}}{1} = \pounds 8,333.34$$

The PENP is taxed as general earnings (subject to income tax and employer's and employee's NI) with the remaining £1,666.66 potentially benefiting from the £30,000 tax-free threshold.

14 What happens where the employment is terminated in circumstances where the employer is able to legally terminate the employment contract without giving notice?

It is not uncommon in cases where an employer is able to legally terminate an employment contract without giving notice (e.g. following gross misconduct) that a subsequent compensation payment is made to the employee – often to settle a claim where the departing employee contends that there has been a procedural irregularity.

The legislation refers to the post-employment notice period (for the purposes of calculating the length of the notice period not worked) ending on the "*earliest lawful termination date*" which might suggest that, where the employer is able to legally terminate the employment contract without notice, the length of the notice period not worked will be nil and therefore the PENP calculation will be zero. However, the legislation goes on to define the "*earliest lawful termination date*" as being "*the last day of the period which is equal in length to the minimum notice...*". Minimum notice is, in turn, defined as "*the minimum notice to be given by the employer to terminate the employee's employment **by notice**...*"

Therefore, even where, under the terms of the employment contract (or under general contract law), the employer can legally terminate the contract without giving notice, any subsequent payment made to the employee will be subject to income tax and NI to the extent that it is equal to or less than the PENP (calculated using the minimum notice that would have been required to terminate the employment by notice).

15 What if there is no notice period set out in the employment contract or there is no written contract of employment?

The period of statutory minimum notice required to be given by employers to their employees under section 86 Employment Rights Act 1996 (**ERA 1996**) is:

- no minimum in the first month of employment;
- one week after continuous service between one month and two years;
- one week for each complete year of continuous service for service between two years and twelve years; and
- 12 weeks after 12 or more years' continuous service.

The period of statutory minimum notice to be given by employees is one week, after continuous service of one month or more.

Under the new tax legislation, "minimum notice" is defined as being the minimum notice required to be given by the **employer** to terminate the employee's employment by notice in accordance with "*the law and contractual terms effective*". Therefore, where there is no notice period set out in the employment contract or there is no written contract of employment, the "minimum notice" will be between one week and 12 weeks depending on the length of the employee's continuous service (unless a court otherwise deems a longer notice period should be implied into the contract).

16 Fixed or limited term contracts

The PENP provisions outlined above may also apply where a termination payment is made to an employee who is employed under a "fixed or limited term contract" (i.e. a contract which is not intended to be permanent and which is subject to a "limiting event" being the expiry of a fixed term, the performance of a specific task, or the occurrence of a specific event).

Where the contract ends because the limiting event has occurred, any termination payment will not be PENP. However, if a termination payment is made where the contract is ended early, then the PENP provisions will apply. In these circumstances, the PENP will be the actual notice period set out in the contract or, if there is no provision for termination by notice, it will be the period between the last date of employment and the date on which the limiting event occurs. Where it is not possible to ascertain the date on which the limiting event occurs (because, for example, the limiting event was the completion of a specific task which will not now be completed), the PENP will be calculated in accordance with the minimum notice periods under section 86 ERA 1996 (as set out above).

17 Anti-avoidance provisions

The new legislation includes anti-avoidance provisions that catch any arrangement where the purpose, or one of the purposes, of the arrangement is the avoidance of tax by causing the PENP to be less than it would have been were it not for the arrangement. In these circumstances, the arrangement is to be ignored.

This would catch, for example, an agreement between the employer and departing employee to shorten the length of a contractual notice period in order to reduce the amount of the termination payment that would otherwise have been classified as PENP.

18 When will the new provisions apply?

The new provisions appear to apply to termination payments made on or after 6 April 2018, notwithstanding that the relevant termination date may have occurred prior to 6 April 2018. This would certainly be in keeping with the way in which tax legislation usually applies, with the relevant tax provisions being those in force on the date on which payment is made. However, HMRC has stated that its view is that the new provisions will only apply where the termination date is on or after 6 April 2018 and that this will be set out in the relevant guidance once it is published.

19 Looking forward – should all employment contracts now include PILONs?

The advantage of including a discretionary PILON clause in the employment contract is that the employer can legally bring the employment to an immediate end by making a payment under the PILON clause. This ensures that the employer can rely on any post-termination restrictions imposed on the employee under the contract as the employer will not be in breach of contract. Previously, the disadvantage of including a PILON clause in the employment contract was that any PILON was taxable as earnings under section 62 ITEPA 2003.

The new PENP regime means that there is now no tax advantage to be gained from excluding a PILON clause from the employment contract and, going forward, we would therefore expect employment contracts to include a PILON clause in order to give the employer greater flexibility around the timing of any termination.

20 Internationally mobile employees may lose foreign-service exemption for termination payments

From 6 April 2018, employees who are UK resident in the tax year in which their employment is terminated (determined using the existing Statutory Residency Test) will no longer be eligible for foreign-service tax relief in respect of any part of any termination payment paid to them. This will affect employees who have worked overseas during their employment and who, under current legislation, would expect to benefit from a full or partial exemption (depending on the length and timing of the overseas service) from income tax in respect of any termination payment which falls within section 401 ITEPA. This represents a relaxation from the changes initially proposed under which foreign service tax relief was to be abolished for all employees who were subject to UK tax at any point during the relevant employment regardless of whether or not they were UK resident in the tax year in which the employment is terminated.

Employees with foreign service who are subject to UK tax on a termination payment because they are UK tax resident in the tax year of termination, and who are also subject to tax on their termination payment in another jurisdiction, may be entitled to relief under the relevant Double Tax Treaty.

As with other termination payments, there may be an additional employer's NI cost from 6 April 2019 if the payment is above the £30,000 tax-free threshold.

There is a very limited exemption for seafarers who are UK resident in the tax year in which their employment terminates to continue to benefit from the foreign-service exemption in some circumstances.

21 Payments in the case of death, injury or disability

The existing provisions in section 406 ITEPA which exempt from tax payments made in connection with the termination of employment due to death, or payments on account of injury to, or disability of, an employee will continue. However, a new sub-paragraph will be introduced to clarify that "injury" includes psychiatric injury (or other recognised medical condition) but does not include injured feelings.

This change makes it clear that payments for injury to feelings connected to an employee's termination will be taxable in full. However, payments for injury to feelings that arise outside of a termination of an employee's employment can continue to be paid tax-free.

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