



TAX TREATMENT OF TERMINATION PAYMENTS

When an employment contract is terminated, some employees may be entitled to a payment on termination.

Both income tax and national insurance contributions (NICs) will have to be considered when a severance payment is made. The employer and former employee will want to be sure that the termination payment is legitimately structured to reduce the tax liability. They also want to be certain that no future tax liability or penalties for non-payment of tax and NICs will arise.

As different tax treatment will apply according to the type of payment, it is important to distinguish between termination payments which arise under a contract of employment and those which do not. Some payments will fall into the £30,000 exemption rule (where the first £30,000 can be paid tax free to the employee), whereas other payments will be fully taxable.

1. Payments under the contract of employment

As a general rule, any termination payments arising out of the contract of employment are fully taxable whether paid before or after termination. Such payments include:

- Salary (also during garden leave);
- Contractual bonus or commission;
- Contractual payment in lieu of notice (PILON);
- Customary PILONS;
- Golden handshakes and payments under a change of control clause; and
- Consideration for entering into restrictive covenants.

1.1 Express contractual payment in lieu of notice clause

A payment in lieu of notice (PILON) clause allows the employer to terminate the employment immediately by making a PILON payment pursuant to contractual provisions and such payments are fully taxable, even where the employee waives the right to notice.

1.2 Customary (implied) PILONS

Some employers have a custom of making PILON payments without having PILON provisions in the contract of employment. Whether such payments are fully taxable will depend on whether the payment of the PILON is an 'automatic response' in relation to the termination. If there is a genuine assessment procedure in respect of the payment and if it is individually negotiated or considered, then it should be possible to rely on the £30,000 exemption rule.

1.3 PILONS paid as damages for loss of notice

Where the contract of employment is silent as to whether or not a PILON will be made, and payments are not made customarily, any PILON paid should not be regarded as contractual but treated as payment of damages.

Such payments will attract the £30,000 exemption rule and are best referred to as “compensation (or damages) for loss of notice” to make it clear that they are not a contractual PILON.

Sometimes the employer and employee will agree to a PILON so that there is no breach of contract for lack of proper notice. Provided the payment is made pursuant to a negotiation process on termination, and is not contractual or automatic it should be regarded as a damages payment and fall within the £30,000 exemption rule.

If, however, an agreement to pay PILON is reached before termination is in prospect, HMRC regard the contract as varied and the payment will be taxed as a contractual PILON.

Where the employee claims constructive dismissal, it may be arguable whether any payment in lieu of notice constitutes damages for a breach of contract, or whether it is a payment pursuant to a PILON clause. If the employee resigns and there is evidence of a fundamental breach of contract, the terms of the contract are no longer valid. Arguably any subsequent payment could not be pursuant to the PILON clause and accordingly the £30,000 exemption rule would apply.

1.4 Contractual redundancy payments

Even though redundancy payments can be contractual, they will qualify for the £30,000 exemption rule as long as they are paid genuinely on account of redundancy.

2. Other termination payments

2.1 Non-contractual payments

These will be the result of termination and redundancy. They are generally tax-free for the first £30,000 and include:

- Damages for wrongful dismissal and payments on account of damages;
- Compensation for unfair dismissal or discrimination connected solely with the termination of employment;
- Payments of statutory and non-statutory redundancy;
- Ex-gratia payment up to £30,000; and
- Non-contractual benefits in kind provided on termination.

3. Payments not connected to termination

Compensation payments relating to discrimination claims which are not connected with termination can be paid tax-free without limit.

Employer-financed retirement benefit schemes and contributions to registered pension schemes may be tax-free up to the annual contribution limit.

Benefits such as legal fees as part of a compromise agreement made in connection with the termination, outplacement counselling and re-training will also not be taxable as long as they are paid directly to the service provider.

4. Calculations

If severance payments are made after termination and the issue of the P45, the employer must deduct tax applying the OT code, as if the employee had no personal allowances available.

If no tax is due on a termination payment because it falls below the £30,000 limit, then the payment should not be included in the P45 and it is not necessary to notify the HMRC.

However, if tax is due because the termination payment is taxable under section 401 and is above the £30,000 limit then the following applies:

- If the payment is made on or before termination (or before the P45 is issued) then the taxable amount should be included in the gross pay in the P45 and the employer should send a letter to HMRC advising it of the amount and date of the payment;
- If the payment is made after termination and the P45 has been issued, there will be no need to issue a further P45. Instead the employer should write to HMRC informing them of the amount and date of the taxable payment, and the amount of basic rate tax deducted (and give the employee a copy of this letter).

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