Employment – Taxation of Termination Payments

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Termination Payments on or after 6th April 2018

There is a generous tax exemption available which allows up to £30,000 to be paid to an employee tax free as part of a severance payment on termination of their employment. However, new legislation has changed the tax treatment of payments in lieu of notice (PILON) which now makes PILONs fully taxable and subject to both employee and employer National Insurance Contributions (NICs) regardless of whether there is a PILON clause in the contract of employment.

Therefore, there is no longer a major tax advantage in not including a PILON clause in an employment contract.

The new rules

The new rules essentially split termination payments into two parts:

- The first is post-employment notice pay (PENP). PENP is the amount of basic pay an employee would have earned had the employee worked his or her notice period in full. If there is a contractual PILON, the payment will be treated as earnings. So, where an employer makes a PILON pursuant to a discretionary contract, the payment will be taxable as earnings.
- The second is the remaining balance of the termination payment. The balance of the payment is tax free up to £30,000. Any excess over £30,000 will be subject to income tax.

If the PENP is **equal or greater** than the entire termination award, then the £30,000 exemption does not apply, and the entire amount is fully taxable.

If the PENP is **less than** the entire termination award, only the post-employment notice pay is treated as taxable earnings and will still benefit from the first £30,000 being exempt from income tax. The remainder will be taxed as employment income.

Examples of Payments which can fall within the £30,000 exemption:

Statutory redundancy payments are always within the £30,000 exemption.

The following payments are examples that **can** fall within the £30,000 exemption to the extent they are not caught by PENP:

- Enhanced redundancy payments, whether due under contract or discretionary, so long as they are genuinely paid in respect of redundancy and not in relation to past or future service.
- Ex gratia payments.
- Damages for wrongful dismissal and payments on account of damages.
- Compensation for unfair dismissal or other breach of statutory rights.
- Non-contractual benefits in kind provided on termination.

How to calculate PENP

The calculation of PENP differs depending on a number of factors.

The basic formula for an employee who is paid monthly, whose contractual notice period is expressed in months and whose employment is terminated with immediate effect or whose unworked periods of notice is a whole number of months is: BP x D – T, where:

- BP is basic pay for the last pay period to end before the day notice is given (assuming notice is given).
- D is the number of months 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.

- T is amounts (other than holiday pay and termination bonuses) that are paid on termination but are taxable as earnings.

This is a complex and grey area and there are detailed requirements. It should also be remembered that in addition to the tax considerations outlined above there are legal requirements connected with termination of employment. An employer should therefore ensure they take advice on both the tax and the employment law aspects of this complex issue.