

Tax Treatment of Termination Payments: Changes From 6 April 2018

The UK government is changing the tax treatment of termination payments. This means it is going to get more expensive for those employers who are not currently taxing payments in lieu of notice (PILONs) and/or who make high-value compensation payments (i.e. on top of any PILON). Any employer negotiating an exit should consider the impact these changes will have on any termination payments that will be made on or after 6 April 2018.

Changes Taking Effect From 6 April 2018

- **All payments in lieu of notice will be treated as earnings and, therefore, subject to tax and employee's and employer's NICs.** This is irrespective of whether there is a PILON clause in the contract of employment.

The following example shows how these changes could reduce the amount of tax-free compensation that an employer can pay to an employee:

Ruth has a monthly basic salary of £5,000, a three-month notice period and no PILON clause in her contract of employment. Her employer decides to dismiss Ruth without notice and the parties agree on a termination payment of £30,000, i.e. the equivalent of six months' salary.

Under the current rules, the employer could pay the full £30,000 tax-free because there is no contractual PILON clause in Ruth's contract and so the whole sum would come within the £30,000 exemption.

Under the new rules, the employer would instead be required to work out Ruth's "post-employment notice pay" to determine the amount of the termination payment that is subject to tax and NICs. The new legislation contains the following formula for doing this:

$$\left(\frac{BP \times D}{P} \right) - T$$

BP = The employee's basic pay for the last pay period before the date on which notice is given. For the purposes of the calculation, basic pay excludes overtime, bonuses, commissions, allowances, benefits in kind, etc.

D = The number of days in the "post-employment notice period" (the period from the last day of employment to the earliest lawful termination date, i.e. when the notice period would have expired if given in full).

P = The number of days in the last pay period.

T = Amounts paid on termination (other than holiday pay and termination bonuses) that are already taxable as earnings (e.g. a contractual PILON).

Things are slightly simpler if, as in this scenario, the employee gets paid monthly and the notice period and the "post-employment notice period" are both expressed in months. In those circumstances, the new rules say that D = the length of the notice period in months and P = one. In all other cases, the reference to number of days does, unfortunately, mean that the exact figure will depend on the month in which notice is given. Quite why the rules could not have referred just to "basic pay for the unserved part of the notice period" is hard to understand! Otherwise, we are left with the proposition that the taxable part of a severance payment will be greatest for dismissals in March because the preceding pay period has the smallest number of days.

If we apply the formula, then Ruth's post-employment notice pay is £15,000 ($5,000 \times 3/1 = 15,000$). This amount will be treated as earnings (and thus fully taxable and NIC-able).

The remaining £15,000 is subject to the "normal" rules on termination payments (including the £30,000 exemption) and taxed (or not) accordingly. As the balance of the payment falls within the £30,000 exemption, it should all be free from income tax and NICs to the extent it represents a genuine termination payment. So Ruth is worse off under the new rules by, say, 42% of £15,000 because she has to pay tax and employee's NICs on the £15,000, which she could previously have had free of tax and NICs. The employer is also prejudiced because it now has to pay employer's NICs on the notice pay where before it did not. The only winner is the Treasury. The reality, of course, is that it will often be the employer which carries most or all of that extra cost. Many termination payments are negotiated by reference to the net benefit to the employee, so if I lose out because of any of these changes, I may simply up my demands of my (ex-)employer to compensate. After all, I still suffer the same net losses from my dismissal.

- **Foreign service relief (where tax on compensation is reduced to reflect overseas periods of employment) will be abolished.** Currently, foreign service relief allows termination payments for certain qualifying individuals to be completely exempt from income tax.

- **The exemption from tax for payments for injury and disability will not apply to injury to feelings, whether on or before termination of employment, except where the injury amounts to a psychiatric injury or other recognised medical condition.**

The government also proposes to introduce employer NICs on even non-contractual termination payments above £30,000. These changes were due to come into force on 6 April 2018, but they will now take effect from 6 April 2019 (which is at least some good news for employers). Employees will continue to benefit from an unlimited employee NICs exemption for payments associated with the termination of employment, even if they exceed £30,000.

If you would like to discuss the impact of these changes for your business, please speak to [Patrick Ford](#), or your usual contact in the Labour & Employment team.

Contacts

Patrick Ford

Partner, Tax Strategy and Benefits
T +44 161 830 5014
E patrick.ford@squirepb.com

Caroline Noblet

Partner, Labour and Employment
T +44 207 655 1473
E caroline.noblet@squirepb.com

David Whincup

Partner, Labour and Employment
T +44 207 655 1132
E david.whincup@squirepb.com

Matthew Lewis

Partner, Labour and Employment
T +44 113 284 7525
E matthew.lewis@squirepb.com

Alison Treliving

Partner, Labour and Employment
T +44 161 830 5327
E alison.treliving@squirepb.com

Charlie Frost

Partner, Labour and Employment
T +44 121 222 3224
E charlie.frost@squirepb.com