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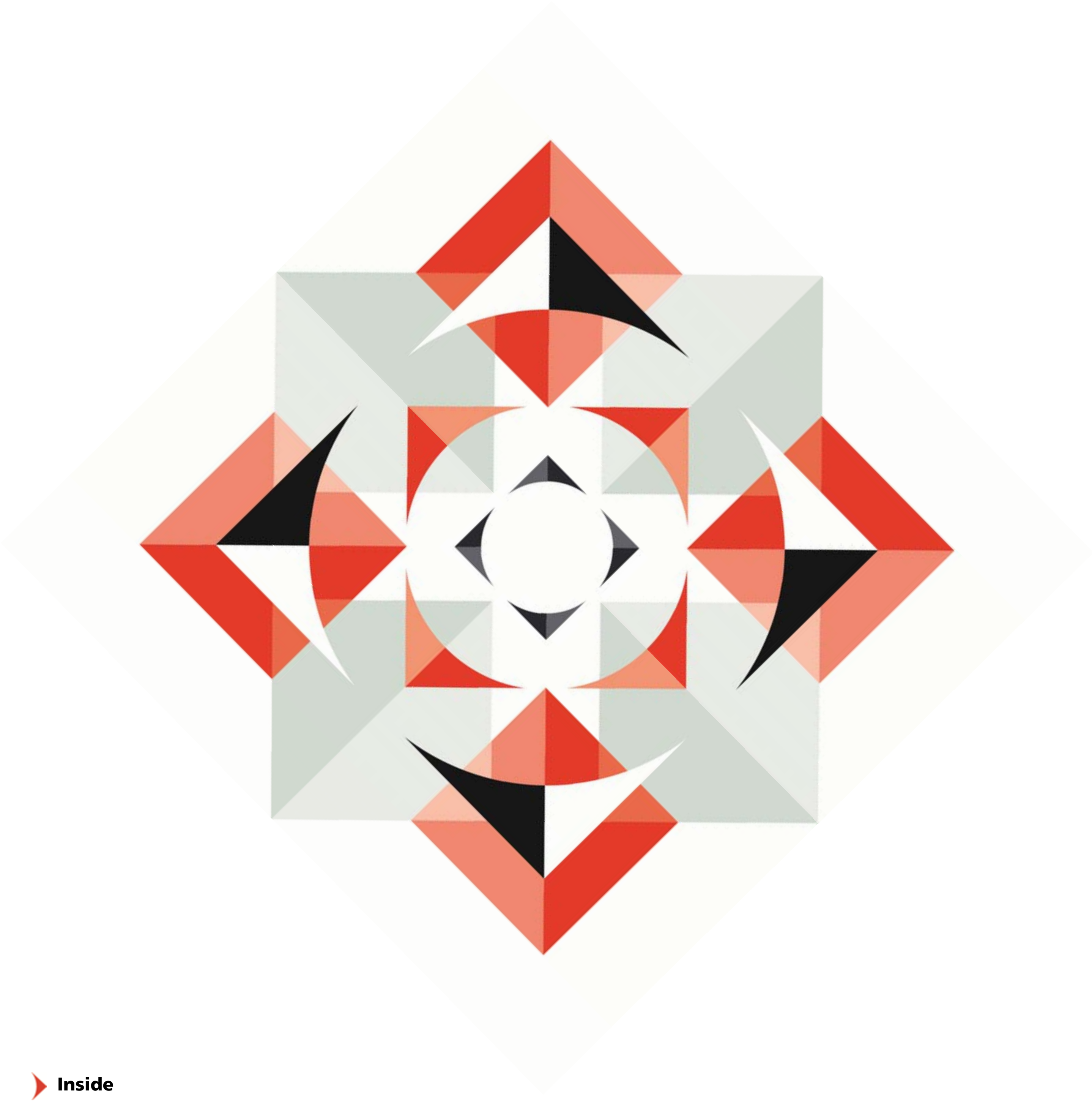
Taxation of payments in lieu of notice



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Introduction

From 6 April 2018 new rules took effect to ensure that all payments in lieu of notice (PILONs) are subject to income tax and NICs in full. The rules emerged from a Government consultation on the simplification of the tax treatment of termination payments which was first launched in 2012. Far from simplifying the taxation, the rules are complex and, in many cases, will increase the costs of both employers and employees.

This Inbrief explains the new rules on taxation of payments in lieu of notice and gives some practical examples. Please see our Inbrief "Frequently asked questions on termination payments" for information on some other common tax questions that can arise on termination of employment.

Tax position prior to 6 April 2018

If an employee's employment terminated before 6 April 2018, the tax treatment of a PILON depended primarily on whether the employer had the contractual right to terminate the employee's employment by paying a PILON rather than serving notice.

In broad terms, if the employment contract gave the employer the right to terminate the employee's employment by paying a PILON, the PILON was generally subject to income tax and NICs in full. The position was different in circumstances where the employment contract did not allow the employer to terminate the employment by paying a PILON but the employer still did so. In these situations, the PILON generally benefitted from the £30,000 income tax exemption for payments made as compensation for termination of employment and could be paid NIC free on the basis that it was damages for breach of contract.

There were exceptions. For example, even if there was no PILON clause in the contract, HMRC often argued that the PILON was subject to tax and NICs in full if the employer invariably paid PILONs to employees automatically without considering the employee's individual circumstances. Conversely, if there was a PILON clause, it may have been possible, in appropriate circumstances, to argue that the employment had not been terminated in accordance with the terms of the employment contract and therefore any amount the employee received was eligible for the tax and NICs exemption.

Tax position with effect from 6 April 2018

From 6 April 2018 all PILONs are subject to income tax and NICs in full, irrespective of the contractual position.

If on or after 6 April 2018 an employee's employment terminates and the employer pays a "**relevant termination award**" to that employee, the employer must calculate how much of the relevant termination award is "**post -employment notice pay**" ("**PENP**").

The PENP is subject to income tax and employee and employer NICs in full. The balance of the relevant termination award and any statutory redundancy payment ("**SRP**") is eligible for the £30,000 tax exemption and full NICs exemption. Note that for payments made on or after 6 April 2019, the employer NICs exemption will be limited to the first £30,000 but the employee NICs exemption will remain.

A relevant termination award is any payment or benefit which compensates the individual for the termination of their employment (i.e. those payments and benefits which prior to 6 April 2018 would have qualified for the £30,000 tax exemption), excluding any statutory redundancy pay.

What is PENP and how is it calculated?

PENP is, broadly, the basic salary the employee would have received during any unworked period of notice minus any contractual or deemed PILON.

PENP is calculated using the following formula:

$$((BP \times D)/P) – T$$

Where generally:

> BP = "**basic pay**" in the pay period which ends prior to the date on which notice is given, or, if no notice is given, the termination date ("**relevant pay period**").
>
> D = the number of calendar days in the "**post-employment notice period**" being the period beginning at the end of the date on which the employee's employment terminates and ending on the earliest date on which the employer could lawfully terminate the employee's employment by notice.
>
> P = the number of calendar days in the relevant pay period.
>
> T = contractual or deemed contractual PILON.

However, where: (i) the employee is paid monthly; (ii) under the employment contract the minimum notice is a number of whole months; and (iii) the unworked period of notice is a number of whole months:

> D = the number of whole months in the post-employment notice period
>
> P = 1.

In either case, if the formula results in a negative number, PENP is zero.

What is basic pay for these purposes?

Basic pay excludes benefits, bonuses, commission, some allowances (see below), share options/awards. However, if the employee participates in a salary sacrifice arrangement, pre-salary sacrifice salary must be used – in practice many employers use pre-salary sacrifice salary to calculate contractual PILONs in any event.

Basic pay will not necessarily be the same in every pay period. In some situations the employee may have received a one-off payment which increases their basic pay (for example, a payment for accrued holiday). In other situations the employee's basic pay may be reduced (for example, if the employee is off sick and only receiving sick pay).

Which allowances are excluded from basic pay?

HMRC guidance states that an allowance is "a supplementary payment received by an employee over and above their standard pay".

HMRC give the following examples of allowances which are excluded from basic pay:

> Allowances paid in recognition of particular circumstances, such as an additional responsibility allowance for temporarily undertaking duties not otherwise required under the employment contract;

> Allowances paid in recognition of particular working arrangements, such as a weekend working allowance for an employee working unsociable hours; and

> Allowances paid to reimburse an employee for out of pocket expenses, such as a travel allowance to cover an employee's transport costs whilst performing duties of the employment.

However, HMRC guidance also states that "any amount which is actually, or in reality reflects an amount which has been, consolidated into an employee's standard pay" must be included in basic pay. The guidance does not give any examples of these types of allowance but, by way of example, we consider that the following allowances should be included in basic pay:

> Car allowances;

> Allowances in lieu of pension contributions; and

> The balance of any flexible benefits fund.

What is the impact of the new rules on an employee's termination payment?

In some circumstances the PENP may be greater than the employee's PILON and in others it may be equal to or less than the employee's PILON.

Where the PENP is *greater* than the employee's PILON, this will have implications for the tax and/or NICs treatment of any relevant termination award:

> If the employee's relevant termination award (and any SRP) is less than £30,000, the amount to which the £30,000 tax exemption and NICs exemption applies is reduced.

> If the employee's relevant termination award (and any SRP) is more than £30,000, the amount to which the NICs exemption applies is reduced.

Where the PENP is *equal to or less* than the employee's PILON, the £30,000 tax exemption and NICs exemption will apply in accordance with the normal rules.

Practical examples

Example 1: 6 months' notice period; no PILON clause; no salary sacrifice; no cash allowances

On 31 October 2018, Jo is told that she is being made redundant. She has to leave her job immediately without working her notice. Her employment contract provides for 6 months' notice but there is no PILON clause. Jo is paid monthly and her monthly gross basic salary is £6,750 per month. Jo does not participate in a salary sacrifice arrangement and does not receive any cash allowances. Jo receives a termination payment of £50,000 including £4,000 statutory redundancy payment.

Jo's relevant termination award is £46,000 (£50,000 - £4,000).

Jo's PENP is £40,500 ((£6,750 x 6)/1)).

This means:

> PENP of £40,500 is subject to tax and NICs in full.

> Statutory redundancy payment of £4,000 benefits from the £30,000 exemption and is not subject to tax or NICs.

> The balance of the relevant termination award of £5,500 benefits from the £30,000 tax exemption and 100% NICs exemption.

Example 2: 3 month notice period; contractual PILON based on pre-salary sacrifice pay; no cash allowances

In December 2018, Adam is told that he is being made redundant. He has to leave his job immediately without working any of his notice. His employment contract provides for a 3 month notice period and there is a PILON clause. Adam is paid monthly and his monthly gross basic salary is £4,500 per month. Adam participates in a salary sacrifice arrangement and sacrifices £500 per amount so his pre-salary sacrifice salary is £5,000 per month. He does not have any cash allowances. Adam receives a termination payment of £20,000 including £4,000 statutory redundancy payment and a PILON of £15,000 (based on pre-salary sacrifice pay).

Adam's relevant termination award is £16,000 (£20,000 - £4,000).

Adam's PENP is £0 ((£5,000 x 3)/1 - £15,000).

This means:

> £15,000 PILON is subject to income tax and NICs in full.

> £4,000 statutory redundancy payment benefits from £30,000 exemption and 100% NICs exemption.

> Relevant termination award of £16,000 benefits from the £30,000 exemption and 100% NICs exemption.

Example 3: 5 week notice period; contractual PILON based on pre-salary sacrifice pay; no cash allowances

In December 2018, Jim is told that he is being made redundant. He has to leave his job immediately without working any of his notice. His employment contract provides for a 5 week notice period and there is a PILON clause. Jim is paid monthly and his monthly gross basic salary is £4,500 per month. Jim participates in a salary sacrifice arrangement and sacrifices £500 per month so his pre-salary sacrifice salary is £5,000 per month. He does not have any cash allowances. Jim receives a termination payment of £20,000 including £4,000 statutory redundancy payment and a PILON of £5,770 (£60,000/52 x 5). The relevant pay period is November which has 30 days.

Jim's relevant termination award is £16,000 (£20,000 - £4,000).

Jim's PENP is £64 ((£5,000 x 35)/30 - £5,770).

This means:

> £5,770 PILON is subject to income tax and NICs in full.

> £64 PENP is subject to income tax and NICs in full.

> £4,000 statutory redundancy payment benefits from £30,000 exemption and 100% NICs exemption.

> Balance of relevant termination award of £15,936 benefits from the £30,000 exemption and 100% NICs exemption.

If Jim's employment had terminated in September 2018, the relevant pay period would have been August which has 31 days so PENP would have been zero.

Example 4: 2 month notice period; contractual PILON based on pre-salary sacrifice pay; car allowances

In June 2018, Amy is told that she is being made redundant. She has to leave her job immediately without working any of her notice. Her employment contract provides for a 2 month notice period and there is a PILON clause. Amy is paid monthly and her monthly gross basic salary is £2,500 per month. Amy participates in a salary sacrifice arrangement and sacrifices £100 per amount so her pre-salary sacrifice salary is £2,600 per month. Amy also receives a £250 car allowance per month.

Amy receives a termination payment of £12,000 including £2,000 statutory redundancy payment and a PILON of £5,200

Amy's relevant termination award is £10,000 (£12,000 - £2,000).

Amy's PENP is £500 ((£2,850 x 2)/1 - £5,200).

This means:

> £5,200 PILON is subject to income tax and NICs in full.

> £500 PENP is subject to income tax and NICs in full.

> £2,000 statutory redundancy payment benefits from £30,000 exemption and 100% NICs exemption.

> Balance of relevant termination award of £9,500 benefits from the £30,000 exemption and 100% NICs exemption.

Example 5: 3 month notice; partly worked contractual PILON based on pre-salary sacrifice salary; no cash allowances

On 1 July 2018, Charlotte is given notice that she will be made redundant. Her employment contract has a 3 month notice period so her employment will end on 30 September. Charlotte is required to work 6 weeks' of her notice until 10 August. Charlotte is paid monthly and her monthly gross basic salary is £3,750 per month. Charlotte participates in a salary sacrifice arrangement and sacrifices £250 per month so Charlotte's pre-salary sacrifice salary is £4,000 per month. Charlotte does not have any routine allowances. Charlotte receives a termination payment of £16,000 including £4,000 statutory redundancy payment and a PILON (based on pre-salary sacrifice salary) of £6,710 (£4,000 + (£4,000 x 21/31). The relevant pay period is June which has 30 days.

Charlotte's relevant termination award is £12,000 (£16,000 - £4,000).

Charlotte's PENP is £90 ((£4,000 x 51)/30) - £6,710).

This means:

> PILON of £6,710 is subject to tax and NICs in full.

> PENP of £90 is subject to tax and NICs in full.

> Statutory redundancy payment of £4,000 benefits from £30,000 tax exemption and 100% NICs exemption.

> Balance of relevant termination award of £11,910 benefits from £30,000 tax exemption and 100% NICs exemption.

Example 6: 12 weeks' notice; no PILON clause; salary sacrifice arrangement but PILON is calculated on pre-salary sacrifice salary; no cash allowances

On 17 July 2018, Mary is told that she is being dismissed. She has to leave her job immediately without working her notice. Her employment contract has a 12 week notice period. Mary is paid monthly and her monthly gross basic salary is £3,750 per month. Mary participates in a salary sacrifice arrangement and sacrifices £250 per month so Mary's pre-salary sacrifice salary is £4,000 per month. Mary receives a termination payment of £24,000 including £4,000 statutory redundancy payment. The relevant pay period is June which has 30 days.

Mary's relevant termination award is £20,000 (£24,000 - £4,000).

Mary's PENP is £11,200 ((£4,000 x 84)/30)).

This means:

> PENP of £11,200 is subject to tax and NICs in full.

> Statutory redundancy payment of £4,000 benefits from the £30,000 tax exemption and 100% NICs exemption.

> The balance of the relevant termination award of £8,800 benefits from the £30,000 tax exemption and 100% NICs exemption.

Example 7: 6 months' notice; PILON clause; salary sacrifice; no notice period worked; no cash allowances

On 31 October 2018, David is told that he is being made redundant. He has to leave his employment immediately without working his notice. His employment contract provides for 6 months' notice and there is a PILON clause calculated by reference to basic salary. David is paid monthly and his monthly gross basic salary is £6,000 per month. David participates in a pension salary sacrifice arrangement under which he sacrifices £1,000 gross per month so his monthly pre-salary sacrifice pay is £7,000. David receives a termination payment of £50,000 including £5,000 statutory redundancy payment and a contractual PILON of £36,000 (based on £6,000 per month) plus £6,000 contribution into his pension.

David's relevant termination award is £45,000 (£50,000 - £5,000). The £6,000 pension contribution is ignored.

David's PENP is £6,000 ((£7,000 x 6)/1)) - £36,000.

This means:

> PILON of £36,000 is subject to tax and NICs in full.

> PENP of £6,000 is subject to tax and NICs in full.

> Statutory redundancy payment of £5,000 benefits from the £30,000 exemption and is not subject to tax or NICs.

> £25,000 of the relevant termination award benefits from the £30,000 tax exemption and 100% NICs exemption.

> £14,000 of the remainder of the relevant termination award is subject to income tax but not NICs.

> No tax or NICs are deducted from the pension contribution.

What are the implications of the new rules?

The new rules have the following implications:

> From 6 April 2018, there is no tax disadvantage in having a PILON clause for basic salary in the contract.

> If the employee works out their full notice or is put on garden leave for their full notice, the new rules do not apply.

> In those situations where the new rules apply, the employer will need to ensure any settlement agreement makes clear that the employer will deduct income tax and employee NICs from PENP.

> Employers will need to calculate the PENP for each employee whose employment is terminating, including those employees whose contracts of employment contain a PILON clause. Employees are likely to want to see this calculation before signing any settlement agreement.

> If the PILON is contractual, however, there are two limited scenarios where the PENP is likely to be zero. This depends on how the contractual PILON is calculated and will still need to be checked in every case.

Scenario 1

The PENP is likely to be zero if:

> There is a contractual PILON based on a number of whole months;

> There is no salary sacrifice arrangement in place (or PILON is calculated on the basis of pre-salary sacrifice salary);

> No standard cash allowances are paid (or PILON is calculated taking those allowances into account); and

> The unworked period of notice is in a number of whole months.

Scenario 2

The PENP is likely to be zero if:

> There is a contractual PILON based on a number of weeks;

> There is no salary sacrifice arrangement in place (or PILON is calculated on the basis of pre salary pre salary sacrifice salary);

> No standard cash allowances are paid (or PILON is calculated taking those allowances into account); and

> The relevant pay period has 31 days.

Unusual situations

There are a number of situations where it is uncertain how the new rules apply. In these situations employers should seek specific advice:

> It is unclear how the anti-avoidance provisions (which allow HMRC to ignore any arrangements which are designed to reduce PENP) apply where the employee asks for some or all of the relevant termination award to be paid into his or her pension. Pension contributions would normally fall outside the new rules but it is possible that HMRC would view a request for a pension contribution as an arrangement to reduce PENP and therefore seek tax and NICs on the relevant termination award as if the pension contribution had not been made.

> Where the employee has received no pay in the relevant pay period (because for example the employee had exhausted their entitlement to both company and statutory sick pay), it is likely that the new rules would not apply since BP would be zero.

> If an employee's employment is terminated summarily without notice or pay in lieu of notice, it is unclear whether it is necessary to apply the PENP calculation to any relevant termination award the employee receives. The more cautious approach is for employers to calculate PENP and apply tax and NICs to it.

> In some cases the period of notice that the employee has to give may be less than the period of notice that the employer has to give. However, the amount of PENP is calculated on the basis of the length of the *employer's* notice period. As a result, if the employee resigns and receives a relevant termination award, the PENP must be calculated based on the notice period that would have been required from the employer (rather than the shorter notice actually given by the employee).

For further information on this subject please contact:

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