

Frequently asked questions on termination payments



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Our FAQs Inbrief looks at some of the common tax questions that arise on termination of employment.

Do payments made on termination always qualify for the £30,000 exemption?

No. Just because a payment is made on termination of employment does not mean that it necessarily qualifies for the £30,000 exemption. The tax treatment depends on the reason for the payment.

Termination packages may consist of many elements, for example: accrued holiday pay, bonus, payment in lieu of notice (“PILON”), continued private medical insurance and compensation. You must determine the reason for each element separately.

Generally, the £30,000 exemption applies if the payment in question is compensation for termination of employment and is not otherwise subject to tax (“Termination Payment”). The £30,000 exemption does not apply if there is some other reason for the payment, such as a reward for employment service (earnings), a payment for a new restrictive covenant or a payment on or in anticipation of retirement. Such payments are subject to income tax and NICs in full. In addition, under statutory rules relating to PILONs, the £30,000 tax exemption and NICs exemption may be reduced if any part of the Termination Payment consists of post-employment notice pay (see below).

Occasionally a payment may be made which completely falls outside the scope of income tax and NICs (for example, compensation for injury to feelings due to alleged discriminatory acts prior to termination of the employment).

We do not have a PILON clause in our contracts of employment, can we therefore pay out PILONs gross (subject to the £30,000 exemption)?

No. Prior to 6 April 2018, some PILONs were not taxable as earnings and benefited from the £30,000 tax exemption (and were not subject to NICs).

This was because the tax treatment of PILONs 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 by paying a PILON (a “PILON” clause), the PILON was subject to income tax and NICs in full. In contrast, if the employment contract did not allow the employer to terminate the employment by paying a PILON but the employer did so, this “non contractual” PILON would generally have benefited from the income tax and NICs exemption.

Under the current rules, in addition to ensuring that any amount due under a contractual PILON clause is subject to income tax and NICs in full, the employer must calculate how much of the Termination Payment (excluding any statutory redundancy pay) is post-employment notice pay, (“PENP”). PENP is, broadly, the basic salary the employee would have received during any unworked period of notice, minus any contractual PILON. PENP is subject to tax and NICs in full.



PENP is calculated using the following formula:

$$((BP \times D)/P) - T$$

Where:

BP = "basic pay" (see below) in the pay period which ends prior to the earlier of (i) the date on which notice is given; or (ii) if no notice is given, the termination date ("relevant pay period").

D = the number of calendar days in the unworked period of notice.

P = the number of calendar days in the relevant pay period.

T = contractual PILON.

If the PENP is a negative number, PENP is treated as zero.

For employees who are paid monthly in 12 equal instalments, it may be possible to use a simplified formula as follows.

If the minimum notice period under the employment contract is expressed as a number of whole months and the unworked notice period is a number of whole months, D = the number of whole months in the unworked notice period and P = 1 whole month.

If the employee's unworked notice period is not a number of whole months, D = the number of calendar days in the unworked notice period and P = 30.42.

Basic pay excludes benefits, bonuses, commission, some allowances (see below), share options/ awards. If the employee participates in a salary sacrifice arrangement, pre-salary sacrifice salary must be used. HMRC guidance states that an "allowance" is a supplementary payment received by an employee over and above their standard pay. However, HMRC guidance makes it clear that any allowance "which ...actually, or in

reality, reflects an amount which has been, consolidated into an employee's standard pay" must be treated as basic pay. In other words, standard, routine allowances such as living allowances or allowances in lieu of pension contributions should be included in the calculation of basic pay. HMRC has indicated that car allowances should also be included in basic pay if the employee does not have the option to choose a company car instead of the allowance.

Is there NICs on Termination Payments?

Termination Payments are generally completely exempt from employee NICs even if the termination payment exceeds £30,000.

However, the amount of the Termination Payment which exceeds £30,000 will be subject to Class 1A employer NICs (as well as income tax). The Class 1A employer NICs (and the income tax) must be paid via the payroll.

It is worth noting that there is no NICs exemption for protective awards. Protective awards qualify for the £30,000 tax exemption but are subject to employee and employer NICs in full.

We are proposing to write off an employee's outstanding loans. Is this ok?

If the loan is written off, the amount written off will be treated as earnings on which income tax and NICs is due.

Where the Termination Payment is less than £30,000 it is better to increase the Termination Payment to enable the employee to repay the loan and therefore utilise the full exemption.

The employee is requesting that part of their Termination Payment is paid into their registered pension. Is there anything we should be aware of?

Advice should be sought where the employer is asked to pay the employee's PILON into a pension. Generally, if the employee is receiving a Termination Payment it will not be tax efficient for the employer to pay PILON into pension because of the PENP rules.

Where the employee asks for part of their Termination Payment to be paid into their registered pension as part of the termination arrangements, the pension scheme rules should be checked to ensure that such a contribution can be made. Assuming the pension scheme rules allow such a contribution, the employer can make the contribution without deducting PAYE income tax or accounting for employer NICs.

However, the employee should seek specialist advice on their personal circumstances, in particular the employee will need to consider the "Annual Allowance".

Contributions can be made by or on behalf of an employee with full tax relief if, the total amount of contributions do not exceed the relevant Annual Allowance for that tax year (For tax year 2024-25 the general Annual Allowance is £60,000, although there are exceptions - see further below for the exception which applies to high earners). In addition, subject to certain conditions, an employee may be able to carry forward any unused Annual Allowance from the previous three tax years (provided that they were at some point during those tax years a member of a registered pension scheme).



Individuals are subject to income tax under self-assessment at their marginal rate on contributions in excess of the Annual Allowance.

In tax year 2024-25 for those individuals with annual adjusted incomes of more than £260,000, the Annual Allowance is reduced by £1 for every £2 of income above £260,000 up to a maximum reduction of £50,000. This means that individuals with annual adjusted incomes of £360,000 or more will be entitled to an Annual Allowance of £10,000. In broad terms, annual adjusted income is taxable income from all sources and all pension savings less any pension contributions the individual has personally made. Individuals whose threshold income is £200,000 or less are not subject to the tapered Annual Allowance. Threshold income is taxable income from all sources and excludes employer pension contributions (other than those made under a salary sacrifice agreement entered into after 8 July 2015) and any pension contributions the individual has personally made. An individual affected by the taper may still be entitled to carry forward unused Annual Allowance from the three previous tax years, although the amount carried forward will be limited to the unused tapered Annual Allowance in respect of any tax year in which the taper applies.

Prior to 6 April 2023, if the value of an individual's accrued pension rights at retirement, exceeded the Lifetime Allowance (which for tax year 2022-23 was £1,073,100) the individual was subject to an additional, penal tax charge. The Lifetime Allowance was disappplied from 6 April 2023. It has been replaced by a Lump Sum Allowance (LSA) which caps the maximum tax free lump sum an individual may take from their pension

to the lower of 25% of the value of the fund or £268,275. Amounts taken above the LSA will be taxed at the individual's marginal rate.

The tax position for those individuals whose pension funds exceeded the Lifetime Allowance is complex and specialist advice should be sought before making any contributions into pension. In any event the position should be kept under review as Labour has pledged to reverse the abolition of the Lifetime Allowance if they win the next General Election.

In addition to the £30,000 exemption and making a contribution into the employee's registered pension are there any other tax exemptions which we may be able to use on termination of employment?

Potentially, depending on the circumstances. For example:

- a. The employer can pay the employee's legal costs tax free provided the costs are incurred exclusively in connection with the termination of employment and the payment is made either pursuant to a (i) court or tribunal order; or (ii) a settlement agreement which provides for the payment to be made by the employer directly to the former employee's solicitor.
- b. If the employee suffers from a recognised medical disability or injury which at the date the employee's employment terminates prevents the employee from carrying out their job, a payment made solely on account of that disability or injury is exempt from income tax.
- c. Compensation for personal injury.
- d. Compensation for injury to feelings suffered as a result of alleged discrimination prior to termination of the employment.

e. If the employee had a period of "foreign service" during his or her employment some or all of the Termination Payment may be exempt from income tax. A period will generally only qualify as foreign service if it relates to a period of non-UK residency and non-UK work. Employees cannot claim foreign service relief if they are tax resident in the UK in the tax year in which the employment terminates.

Specialist advice should be sought if you consider that any of the exemptions in (a) to (e) above may be relevant.

We are paying the employee's legal fees under a term in the compromise agreement. Can we recover the VAT?

No. You can only recover VAT on supplies made.

At what rate should employers deduct tax from taxable payments made after the P45 is issued?

The employer is obliged to deduct tax using the OT code on any payments (including share based payments) made after the P45 is issued which are subject to income tax (irrespective of whether those payments are earnings or Termination Payments which exceed the £30,000 exemption).



For tax year 2024-2025 the application of the OT code means that for employees in England and Northern Ireland tax is deducted as set out in the table below.

Taxable income	Tax rate
£0 to £3,141	20%
£3,141.01 - £10,428	40%
£10,428 +	45%

The Welsh and Scottish Governments are able to decide the rates of income tax paid by Welsh and Scottish taxpayers respectively. For tax year 2024-2025 the rates and bands for Welsh taxpayers are as set out in the table above. Different income tax rates apply in Scotland.

If the application of the OT code results in the employee paying too much (for example because the employee is not liable to tax at 40% and/or 45%) the employee will be able to claim a tax refund from HMRC. Conversely, if the application of the OT code results in the employee paying too little tax, the employee will pay the balance due under self-assessment.

How are NICs calculated on payments made after termination?

Where a payment which does not qualify for the £30,000 exemption and is therefore subject to employee and employers NICs (for example, retention bonuses) is made after the P45 is issued, NICs is calculated using the weekly earnings period.

The NICs rates and weekly thresholds for tax year 2024-25 are set out in the table below. NICs on final payments of salary is calculated using the employee's normal earnings period.

Earnings	Employee NICs rate	Employer NICs rate
£0 to £175	0%	0%
£175.01- £242	0%	13.8%
£242.01- £967	12%	13.8%
£967.01	2%	13.8%

Note there are special rules for directors. For individuals who were directors at the beginning of a tax year, NICs is calculated using an annual earnings period for the remainder of the tax year regardless of when that payment is made.

Should we report the termination payment to HMRC?

Employers are required to report PAYE payments to HMRC in "real time" - this is referred to as Real Time Information or RTI.

Under RTI, employers are required to provide details of payments made to employees and other payroll information to HMRC generally before or at the same time as the payments are made. This information must be submitted to HMRC online using a new report known as a Full Payment Submission ("FPS").

The PAYE processes relating to leavers, mean that employers are not required to report leavers separately to HMRC - the employee's date of

leaving is simply included on the FPS. The employer continues to issue Parts 1A and 2 of the P45 to the employee but does not need to send part 1 of the Form P45 to HMRC. If payments are made to the employee after the date of leaving, the employer is required to give the employee a letter showing the date of the payment, the gross amount and the PAYE/NICs deducted.

In addition, if the termination package includes non-cash benefits and exceeds £30,000, the employer should inform HMRC by 6 July following the end of the tax year in which the termination occurred. The report should be sent to the PT Operations North East England, HM Revenue & Customs, BX9 1BX.

For more information on this subject please contact:



Victoria Goode
Consultant Partner

+44 (0)20 7074 8317
victoria.goode@lewissilkin.com