



## **TAX TREATMENT OF TERMINATION PAYMENTS**

When an employment contract is terminated, eligible employees will 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.

### **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 or automatic PILONS;
- Golden handshakes and payments under a change of control clause; and
- Consideration for entering into restrictive covenants.

#### *1.1 Contractual payment in lieu of notice (PILONS)*

PILONS allow the employer to terminate the employment immediately pursuant to contractual provisions and are fully taxable, even where the employee waives the right to notice.

In certain circumstances, where PILONS are paid as damages for loss of notice and not made on an automatic basis or pursuant to a discretionary right, they will be tax free up to £30,000. There will be no liability for NICs. Such payments are best referred to as "compensation (or damages) for loss of notice" in order to make clear that they represent damages or compensation, rather than a payment under a contractual PILON.

Often, 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 as part of the process of termination, and is not contractual, automatic or pursuant to a discretionary right, it will not result from the employment but form part of the agreed terms for its destruction. Accordingly, it will be a damages payment and fall within the £30,000 exception rule.

If, however, agreement is reached before termination is in prospect, HMRC regard the contract as varied so that the payment is taxed as a contractual PILON.

Where the employee claims constructive dismissal, it is arguable whether any payment constitutes damages for a breach of contract, which would only be taxable if over £30,000, or whether it is a payment under the PILON clause and therefore fully taxable. If the employee resigns and there is evidence of a fundamental breach of contract, the terms of the contract are no longer valid. Any payment will subsequently not be part of any PILON and the £30,000 exemption rule will apply.

### *1.2 Automatic PILONS*

Many employers have a custom of making PILON payments rather than making provisions in the contract of employment. Whether these payments will be fully taxable or not will depend on whether the payment of a PILON is an automatic part of the employment. If there is a genuine assessment procedure in the making of the payment and if it was individually negotiated or considered, then it should not attract the usual tax treatment as for contractual PILONS.

### *1.3 Discretionary PILONS*

An employer may incorporate a discretionary right into the contract of employment to make a PILON. Any subsequent payment following termination will need to be examined to establish whether it was a PILON which is fully taxable, or whether it constituted a payment for damages for breach of contract, in which case the £30,000 exemption rule would apply.

The HMRC has issued helpful guidelines to distinguish between discretionary PILONS and damages.

### *1.4 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 automatically or discretionary on termination, any PILON paid will 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.

### *1.5 Contractual redundancy payments as exception to the rule*

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.

## *2.2 Payments not connected to termination*

Payments where termination results from disability or discrimination claims not connected to termination will generally be 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. Reforms to the tax treatment of pension contributions were announced in the 2009 Budget for those earning more than £150,000 per tax year.

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.

## **3. Calculations**

If severance payments are made after termination and the issue of the P45, the employer must deduct tax at the basic rate, and the employee will have to account to HMRC for any further tax due. If the P45 has not been issued, the employer should operate PAYE in the normal way, by deducting tax according to the employee's tax code and include the figures on the P45.

In practical terms, where 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. If tax is due because the termination payment is taxable under section 401 and is above the £30,000 limit then how this is represented on the P45 depends on when the payment is made:

- If it is made on or before termination 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 lump sum payment;
- If the payment is made after termination then the employer should not issue a further P45, but rather should write to HMRC advising them of the amount and date of the lump sum, and the amount of basic rate tax deducted (and give the employee a copy of this letter)

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