Changes to the Taxation of Termination Payments

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Termination payments are payments made to individuals as a result of their loss of employment. They are often made up of different components including statutory redundancy, compensation for loss of office, damages and payment in lieu of notice. The tax treatment of each element differs and therefore employers need to look at each element when calculating what tax is owed.

Currently, in the United Kingdom, the first £30,000 of a payment made as compensation of loss of office or employment can be made free of income tax and NICs (the "Threshold"). Sums which are paid in excess of the Threshold are subject to income tax only. The Threshold was set at £30,000 in 1988/89 and has not been raised since. Sums which are received for work done (e.g. bonus payments) or which an individual is contractually entitled to receive (e.g. payment in lieu of accrued but untaken holiday) are, generally, subject to income tax and NICs.

The Consultation

The Government, in July 2015, launched a consultation on the tax treatment of termination payments. The purpose of the consultation was to try to simplify the treatment of termination payments and make them fairer. The consultation paper made a number of proposals including reducing the £30,000 Threshold, removing the distinction between contractual and non-contractual termination payments, linking the Threshold to length of service and limiting the Threshold to certain sums such as bona-fide redundancy payments.

Response to Consultation

In the 2016 Budget it was announced that changes would be made with effect from April 2018. Earlier this month, the government issued draft legislation which is now subject to consultation until 5 October 2016. The key proposals are as follows:

(a) The Threshold is to remain at £30,000

There was concern, on publication of the consultation paper, that one of the aims of the exercise was to reduce the level of the Threshold either by cutting it or by linking the amount of the Threshold to an individual's length of service. It is therefore to be welcomed that the Threshold will remain at its current level.

The Government appears to have recognised that the tax free payment is extremely important for many individuals who have lost their jobs, no matter how long they have had been employed for.

Maintaining the Threshold is good news for employers as this is a useful way of being able to offer the employee a more generous settlement package when negotiating an exit.

(b) Employers to pay National Insurance Contributions above the Threshold

Employers will now have to pay employer NICs on any sums which are paid in excess of the Threshold. The current rate is 13.8% which could result in a significant additional cost for high value settlements. Employees will continue to be exempt from paying NICs. This change, while costly for employers, seems to reflect the Government's view that the Threshold should support employees who have lost their job and not provide employers with a tax break.

(c) Contractual and non-contractual payments in lieu of notice to be treated in same manner

Notice periods, and how they are taxed, is an area which has caused some confusion. Currently, if an employment contract has a payment in lieu of notice ("PILON") clause, then the amount received by the individual is subject to income tax and NICs. However, if an employee does not have a PILON clause, and the employer decides to breach the employee's contract of employment and pay a lump sum instead of the employee working their notice period, then this sum can be paid tax free up to the Threshold as damages for breach of contract.

The government is removing the distinction between the different treatment of PILONs resulting in all payments referable to contractual or statutory notice period being subject to tax and NICs. Therefore, any payment that covers an individual's contractual entitlement including the notice period, even if it is not worked, will be subject to tax and NICs.

If there is no express PILON, and the employer decides to breach the contract then there is an argument that any post termination restrictions would fall away. With this change, any tax advantage of not having a PILON falls away, therefore employers should review contracts to make sure they contain a PILON.

(d) Changes to other exemptions

Various exemptions apply to termination payments on top of the Threshold. If the exemptions are met then the individual does not need to pay income tax on sums received above the Threshold. Following the consultation, the exemptions will remain largely unchanged save that the personal injury exemption shall not apply to compensation for injury to feelings (unless a medical condition has arisen from the treatment) and the Foreign Service relief, which applied to employees who had worked outside of the UK for more than 75% of the last 20 years, will be abolished.

Conclusion

The changes will require employers to be more cautious in the future about striking deals with departing employees on the basis of the £30,000 tax "exemption", and they should therefore take appropriate advice on how best to structure any settlement package.

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