

Analysis

Tax on termination payments: the new law in practice

Speed read

Since April 2018, all payments in lieu of notice, whether contractual or not, are taxable earnings subject to income tax, PAYE and NICs. Relevant termination awards are split between amounts to be treated as taxable 'post-employment notice pay' (PENP); and amounts which can benefit from the £30,000 exemption. Whilst the change was said to be a simplification, the new PENP regime has introduced several areas of practical difficulties, such as when the anti-avoidance rule applies when parties agree a shorter notice period; the taxation on summary or constructive dismissal; when the employee gives shorter notice than the employer; and how to determine what is meant by 'basic pay', for instance when the employee receives low/no pay or unusually high pay in the period prior to termination.



Sam Whitaker

Shearman & Sterling

Sam Whitaker is Counsel in the Compensation, Governance and ERISA practice at Shearman & Sterling. Sam provides the full range of employment and benefits advice on transactions and stand-alone employment matters. Email: sam.whitaker@shearman.com; tel: 020 7655 5954.

In April 2018, the new regime relating to the tax treatment of certain payments made on termination of employment (in particular, payments in lieu of notice (PILONs)) came into effect. Although the new rules were introduced as part of a tax simplification drive, they have nonetheless given rise to several areas of uncertainty.

Background

In broad terms, the intention of the new law was to ensure that all PILONs (whether such provisions are contractual or not) are taxable earnings and subject to income tax, PAYE and NICs. Under the new regime, 'relevant termination awards' are effectively split between:

- amounts to be treated as taxable 'post-employment notice pay' (PENP); and
- amounts which can benefit from the usual £30,000 tax exemption for certain termination payments.

Relevant termination awards do not include payments and benefits which are chargeable to tax by other provisions in the ITEPA 2003 outside of Chapter 3; therefore, for example, contractual PILONs continue to be fully taxable as general earnings under ITEPA 2003 s 62. The formula for calculating the PENP differs depending, amongst other things, on whether the employee is paid monthly or not, but for a monthly-paid employee the simplified calculation is as follows:

$$\text{PENP} = \text{BP} \times \text{D} - \text{T}$$

where:

BP is the basic pay for the last pay period to end before the trigger date;

D is the number of months in the 'post-employment notice period'; and

T is any payment or benefit received in connection with the termination of the person's employment which is chargeable to tax as earnings (e.g. a contractual PILON).

So, for example, for an employee on a salary of £30,000 who is paid monthly and has a three month notice period (with no contractual PILON) the calculation would be:

$$\text{PENP} = \text{BP (i.e. £2,500)} \times \text{D (3)} - \text{T (i.e. nil)} = \text{£7,500}$$

Can the parties agree a shorter notice period?

The amount which is subject to the PENP calculation is determined by reference to the 'minimum notice' required to be given by the employer to terminate the employee's employment by notice. This is effectively the greater of the notice period required by statute (i.e. the Employment Rights Act 1996) or the employment contract. If, for example, an employee had a relatively long notice period (e.g. 12 months), would it be possible for the parties to agree on or shortly prior to termination that this was reduced to a notice period that was shorter but still above the statutory minimum (e.g. three months) and thereby reduce the amount subject to the PENP calculation? This would seem unlikely in practice.

To begin with, ITEPA 2003 s 402D(11) is effectively an anti-avoidance rule applying where the purpose of certain arrangements is to cause the PENP to be less than it would otherwise have been. Unless the change had been made for reasons unconnected with the termination (and preferably some time before termination), there is a real risk that the changes would be caught by those anti-avoidance provisions. In addition, there is also a risk that a payment made to an employee in consideration of the employee agreeing to changes to the employment terms would be caught as earnings referable to employment and therefore classified as general earnings within the scope of s 62.

Taxation on summary or constructive dismissals?

What is the tax position if an employee is dismissed summarily with no notice (e.g. for gross misconduct) or resigns claiming constructive dismissal and brings a claim against the employer for damages in respect of the notice period which is then settled? Or what if an employee resigns without giving notice and subsequently a settlement is reached under which the employee is paid a termination payment? How is the settlement payment in such cases treated?

At least on the face of the legislation, it would appear that the employer must apply the usual PENP calculation. Section 402D requires the employer to assess the length of the 'post-employment notice period' for the purposes of the PENP calculation. The post-employment notice period commences on the last day of employment and ends on the 'earliest lawful termination date', which is itself defined by reference to the minimum notice that must be given by the employer to terminate the employee's employment by notice in accordance with the relevant law and contractual terms. This would suggest that, even in relation to settlement payments made in situations of gross misconduct, constructive dismissal or resignation without notice, the employer must carry out a PENP calculation in respect of any settlement payment.

We understand that, in practice, HMRC has informally advised that if an employee is summarily dismissed the PENP would be nil. If, however, it was subsequently established by a tribunal that the employee was entitled to

a notice period (in respect of which no payment had been made), then any settlement amount should have the PENP calculation applied to it.

Employee's shorter notice period

It is odd that, under the legislation, the calculation of the PENP is based solely on the *employer's* notice period. This is because ITEPA 2003 s 402E(4) (the provision which determines the minimum notice period for the purposes of calculating the PENP) specifically refers to the 'minimum notice to be given *by the employer*' (our emphasis). It would seem that this is a deliberate choice by those drafting the legislation, not least because other provisions of s 402 do refer to notice which has been given by either the employer or the employee (e.g. s 402E(3)). This in practice leaves an odd position when the period of notice which an employee is required contractually to give is shorter than the notice required by the employer (or even perhaps a situation in which an employee is served with notice of termination by the employer for redundancy and the employee serves a counter-notice of termination, bringing the employment to an end at an earlier date (Employment Rights Act 1996 s 136(3)).

If the employee gives notice, but still receives a termination payment, the PENP will have to be calculated but based on the longer period of notice that would have applied to an employer notice, potentially meaning that part of the termination payment may then fall within the PENP and be fully taxable. This may leave the employee in a position where he/she is expecting to receive a payment which in practice is not labelled as a PILON but which nonetheless gets taxed under the PENP provisions.

One of the key purposes of the new PENP provisions was to give more certainty to employers about the tax treatment of PILONs. A basic concept of the new legislation was that, if notice was worked by the employee, the PENP would essentially be nil. However, the outcome of the PENP still applying to a termination payment where the employee's worked notice period is shorter than the employer's notice period arguably shows that the intention has not been entirely met by the legislation in practice.

Basic pay: low/no pay or unusually high amounts of pay

The concept of 'basic pay' feeds into the calculation of the PENP. In broad terms, this covers the employment income that the employee received in the 'last pay period' prior to the relevant trigger date (the legislation deems certain items not to be included as employment income for these purposes). However, what if the employee had been off sick prior to termination and was receiving either statutory sick pay (SSP), or indeed had exhausted SSP and was not receiving any pay at all? Is the PENP then calculated on the basis of that reduced or nil pay?

The legislation does not define what is meant by a 'last pay period' but examples given in its guidance (see HMRC's *Employment Income Manual* at EIM13888) strongly suggest that HMRC takes the view that this means the standard payroll period operated by the employer for that employee. If the employee was receiving SSP during that period, it might be argued that this should not be counted as employment income for the purposes of the PENP calculation, as arguably SSP would not fall within the definition of employment income set out at ITEPA 2003 s 7(2). However, HMRC's guidance at EIM76350 may indicate that it does not share this view:

'SSP is payable by the employer. SSP is not a social security benefit funded by the state. It is a mandatory provision under social security law. Broadly SSP is a measure of earnings replacement paid by employers to employees whilst they are unable to work through illness administered and mainly funded by employers. Section 151 of the Social Security Contributions and Benefits Act 1992 requires the employer to make the payments. This means that payments of SSP are charged to tax as employment income.'

This would suggest that if the employee is receiving SSP in the period prior to termination, that is counted as the employment income for the purposes of determining basic pay for PENP purposes; however, this remains uncertain.

The reality is that the complexity of the detail of the PENP regime has introduced a number of areas of new uncertainty

If the employee was receiving no pay at all prior to termination (e.g. because his/her entitlement to SSP (28 weeks) had been exhausted and there was no company-related sick pay scheme in place), there is even greater uncertainty as to whether 'basic pay' for that employee would effectively be nil (because nothing was paid in the relevant pay period) or whether the 'pay period' should, for such an employee, effectively be interpreted as meaning the last pay period during which some employment income was paid.

Basic pay and allowances

As noted above, s 402D(7) sets out what is meant by basic pay, but deems certain items to be disregarded for those purposes. Section 402D(7)(a)(i) provides that 'any amount received by way of overtime, bonus, commission, gratuity or allowance' shall be disregarded. ITEPA 2003 does not define what is meant by 'allowances'. HMRC has given its own guidance on what is meant by this term (EIM13884), which states:

'The term allowance is wide in scope. An allowance is an amount received by an employee as a supplementary payment over and above their standard pay. The period over which the allowance is paid, or the activity to which the allowance relates may, or may not be temporary in nature. Allowances could be paid:

- in recognition of particular circumstances, such as an additional responsibility allowance for temporarily undertaking duties not otherwise required under the employment contract;
- in recognition of particular working arrangements, such as weekend working allowance for an employee working unsociable hours; and
- 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.

'There are a variety of reasons why allowances are paid. The above list is not exhaustive.

'An allowance does not include any amount which is actually, or in reality reflects an amount that has been consolidated into an employee's standard pay.'

Although the above guidance gives some clarity on

what is included within the scope of allowances, it still leaves a lot of room for uncertainty. For example, one common type of allowance is a car allowance (often provided as an alternative to a company car). Some practitioners have taken the view that such allowances would fall within the definition of 'allowances' in s 402D(7)(i) if they are not guaranteed (e.g. if they are simply paid by reference to actual business miles incurred each month), whereas car allowances which are fixed guaranteed amounts paid to the employee each month in lieu of having a company car may effectively be 'consolidated into the employee's pay' and therefore fall outside the definition.

HMRC has indicated informally that if an employee is offered a choice between a company car and a car allowance, then such a car allowance might be an allowance for the purposes of s 402D(7)(i), whereas an allowance which was provided with no alternative, or as part of a salary sacrifice arrangement with no option to have a company car, might be an arrangement that did not count as an allowance for those purposes (although HMRC noted that each case would be very fact specific).

Action points

On one level, the new legislation has achieved its aim of simplification. At a very high level, it is probably true to

say that HR and payroll practitioners can say with more certainty that there is no longer a need to distinguish between contractual and non-contractual PILONs, as both types of PILON will now in principle be subject to income tax.

In that sense, the new legislation has created more certainty and simplified the regime. Nonetheless, the reality is that the complexity of the detail of the PENP regime has introduced a number of areas of new uncertainty, some of which have been explored above. Employers faced with such issues should consider:

- seeking bespoke tax advice on the relevant issue before committing to a particular course of action;
- seeking guidance or advance clearance from HMRC on the specific issue, if the circumstances of the termination allow for it; and/or
- if acting for the employer, including within the settlement agreement (if one is used) a comprehensive indemnity from the employee in respect of any additional income tax or (employee's) NICs that may be deemed due on the payments or benefits provided under the agreement. ■

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- ▶ Termination payments: what's changing from 2018/19 onwards (Alasdair Friend, 25.1.18)