

Taxation of termination payments

Latest Update

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The law and practice relating to the taxation of termination benefits.

Overview of Topic

1. The taxation of termination benefits is a complex area and it is understood that the Office of Tax Simplification is looking at ways of simplifying the tax treatment.
2. Frequently on termination an individual will receive a number of different benefits and payments and each of these needs to be considered separately.
3. Although there is specific legislation dealing with termination benefits it is not always the case that the benefit will be taxed in accordance with these provisions.

Key Acts

[Income Tax \(Earnings and Pensions\) Act 2003](#) (ITEPA)

Key Subordinate Legislation

None.

Key Quasi-legislation

None.

Key European Union Legislation

None.

Key Cases

[EMI Group Electronics Ltd v Coldicott \(Inspector of Taxes\) \[2000\] 1 W.L.R. 540](#)

[Goldberg v Revenue and Customs Commissioners \[2010\] UKFTT 346 \(TC\)](#)

[Oti-Obihara v Revenue and Customs Commissioners \[2010\] UKFTT 568 \(TC\)](#)

[Walker v Adams \(Inspector of Taxes\) \[2003\] S.T.C. \(S.C.D.\) 269](#)

Key Texts

[HMRC Employment Income Manual](#) (EIM)

[Employer Further Guide to PAYE and NICs](#)

Discussion of Detail

Introduction: Order of priority

1. Termination benefits are specifically dealt with in [ss.401 - 416 of ITEPA](#) (the **Termination Sections**). However, if a particular benefit is also covered under another section (e.g. under [s.62 of ITEPA](#) as general earnings) then that other section will prevail.
2. Accordingly, when considering the tax treatment of a termination benefit the first question to ask is whether it is taxable as general earnings or under some other specific provision. If the benefit is something that is specifically provided for in the contract of employment then it will almost certainly be taxable as general earnings under [s.62 of ITEPA](#).
3. If a benefit is not otherwise taxed and does fall within the Termination Sections then the first £30,000 of such benefits should be able to be paid tax-free (i.e. free of both income tax and national insurance contributions). See [EIM13500 - EIM13530](#).

PILON payments

1. An employment contract will set out the period of notice an employer or employee is required to give in order to end the employment relationship. In many employment contracts

the employer will have the right to make a payment in lieu of notice (PILON). This can be particularly important if the circumstances of the termination are such that the employer would not want the employee to actually serve their notice but the employer does not want to breach the contract. Avoiding a breach of contract should enable the employer to continue to rely on any restrictive covenants set out in the employment contract.

2. Where an employment contract contains a PILON clause and the employer makes a payment pursuant to that PILON clause then the payment will be taxable as general earnings under s.62 of ITEPA which means that it will be subject to deduction of both income tax and national insurance contributions. The fact that it would also fall within the Termination Sections is irrelevant and it therefore cannot benefit from the £30,000 tax-free threshold.
3. If the employment contract contains a PILON clause but an employer is asserting that a payment made is damages and not pursuant to the clause then it can be expected that HMRC would look at the position very closely (applying [EMI Group Electronics Ltd v Coldicott \(Inspector of Taxes\) \[1999\] STC 803](#) HMRC's starting point is that it is taxable). This will particularly be the case if the amount of the payment is the same as that which would have been received under the PILON clause.
4. Even if an employment contract does not contain a PILON clause HMRC is likely to argue that the payment is contractual if it can be shown that the making of a PILON payment is an automatic response to a termination (i.e. all employees receive a PILON when their employment terminates). It is therefore helpful in reducing the risk of HMRC challenge if it can be shown that each situation is considered on its own merits and good practice would involve retaining documentary evidence of such consideration.
5. If there is no PILON clause and it cannot be shown that it is an automatic response to termination then prima facie the payment will be within the Termination Sections as a payment of damages and the £30,000 tax-free threshold is in point. It is useful to consider the First Tier Tribunal decision of [Goldberg v Revenue and Customs Commissioners \[2010\] UKFTT 346 \(TC\)](#) in relation to PILONs and damages.
6. However, particular care must be taken if the payment is to an individual who retires or is nearing retirement. [Sections 393](#) and [394](#) of ITEPA specifically tax payments that are classified as being made under an employer-financed retirement benefits scheme. Where these sections apply the Termination Sections again become irrelevant. The scope of an employer-financed retirement benefits scheme is very wide and it is certainly not necessary to have a scheme in a formal sense. Where these sections potentially apply they should be reviewed closely. See [EIM12975 - EIM12979](#).

Ex-gratia payments

1. Where a payment is made on termination of employment and it is not either contractual or a payment of damages then it is generally referred to as an ex-gratia payment.
2. An ex-gratia payment will be captured by the Termination Sections and therefore can benefit from the £30,000 tax-free threshold. It is important to stress that an individual only has one £30,000 tax-free threshold in relation to an employment. Accordingly, if the individual receives a number of payments or benefits that could potentially benefit then the payments or benefits are aggregated when considering the ultimate tax liability.

3. As noted above in relation to PILON payments particular care needs to be taken if the payment being made is to someone who is retiring or nearing retirement.

Redundancy

1. Redundancy payments are within the scope of the Termination Sections. This is the case whether the payment is statutory, contractual, or non-contractual.
2. In addition to the concern in relation to an individual that retires or is nearing retirement a redundancy payment or part of a redundancy payment may be treated as earnings if it is conditional on the employee staying on to a particular date. See [EIM13750 - EIM13842](#).

Compensation for discrimination

1. A payment for discrimination that is unconnected with the termination should be able to be paid tax-free unless it relates to compensation for financial loss (in which case it will be taxable under the Termination Sections). The treatment of discrimination payments was considered in [Oti-Obihara v Revenue and Customs Commissioners \[2010\] UKFTT 568 \(TC\)](#) and [Walker v Adams \(Inspector of Taxes\) \[2003\] S.T.C. \(S.C.D.\) 269](#).
2. Where a significant sum is allocated for injury to feelings it can be expected that HMRC will subject the arrangement to considerable scrutiny.

Restrictive covenants

1. Payments for restrictive covenants are separately taxed under [ss.225](#) and [226](#) of ITEPA.
2. Although it may be argued that the restrictive covenants in the employment contract survive the termination in circumstances where there is a compromise agreement it is standard practice for the covenants to be repeated or perhaps even amplified within the compromise agreement.
3. As restrictive covenants are taxed separately it is important to allocate separate consideration within the compromise agreement for such covenants. This should reduce the risk that HMRC will argue that all payments within the agreement are attributable to the restricted covenants and therefore taxable. See [EIM03601 - EIM03626](#).

Writing-off loans

1. [Section 188 of ITEPA](#) separately taxes amounts of employment related loans that are written off. Accordingly, the Termination Sections will not apply and the amount of the write-off cannot fall within the £30,000 exemption.
2. Where it is proposed that a loan be written off as part of the termination it is generally advisable for the employer to make, or increase, an ex-gratia payment in the amount of the

loan. As part of the compromise agreement the individual would then agree to apply the relevant amount of the ex-gratia payment to repaying the loan.

3. Making the ex-gratia payment is then within the Termination Sections and even if the £30,000 tax-free threshold has been utilised and therefore taxable it will not be subject to national insurance contributions.

Non-cash benefits

1. In many termination situations there will simply be a cash payment or payments. However, if an individual had a company car or access to a laptop or mobile phone they may be entitled to utilise these post termination or even keep them. The way in which these non-cash benefits are taxed in large part mirrors the analysis for cash payments. Accordingly, if the individual had a contractual entitlement to the benefit it will be taxed in the usual way.
2. Conversely if there is no such payment they will fall within the Termination Sections. This means that they can fall within the £30,000 tax-free threshold.
3. One added area of complexity if non-cash benefits are involved is the need to value the benefit. Valuation will be based on an amount equal to the cash equivalent of the benefit. See [EIM13250 - EIM13330](#).
4. An individual may have the right to exercise options or be awarded shares at some point prior to termination or shortly thereafter. The tax treatment will depend on the rules of the scheme and the type of scheme and it will also be necessary to carefully work through the provisions of [Pt 7 of ITEPA](#).

Exemptions - Death or disability

1. [Section 406 of ITEPA](#) provides an exemption from the Termination Sections where a payment or benefit is provided in connection with the termination of employment by the death of an employee or on account of injury to, or disability of, an employee.
2. Particular care needs to be taken if relying on [s.406 of ITEPA](#) as the payment or benefit may be taxed under [ss.393](#) and [394](#) of ITEPA (these sections exclude a payment on death of an employee but only where the death was as the result of an accident during service). As noted above under the order of priority if a payment is taxed under a specific provision then the fact that it is dealt with under the Termination Sections is irrelevant. See [EIM13600 - EIM13650](#).

Exemptions - Foreign service

1. If an individual has spent time working overseas in relation to the employment that is being terminated then it may be possible to claim complete exemption (under [s.413 of ITEPA](#)) or partial exemption (under [s.414 of ITEPA](#)).
2. In circumstances where partial exemption is being claimed it is advisable to agree the

calculations with HMRC in advance of making the payment. See [EIM13970 - EIM13985](#).

Exemptions - Legal costs

1. [Section 413A of ITEPA](#) provides a specific exemption in relation to legal costs. In order to come within the exemption it is important that the employer meets the legal costs directly.
2. The payment must be either in response to an order of a court or tribunal or pursuant to a compromise agreement.
3. In negotiations with a departing employee if the full £30,000 tax-free threshold has already been utilised then one possibility to improve the tax position is for any proposed ex-gratia payment to be reduced with an increased contribution to legal costs. See [EIM13740](#).

Exemptions - Outplacement costs

1. [Section 310 of ITEPA](#) provides a specific exemption for certain outplacement and counselling costs. There are requirements as to the length of time someone must have been employed and who the outplacements services should generally be available to. See [EIM13745](#).
2. If the specific requirements are not satisfied then the payment will be dealt with in the usual way under the Termination Sections.

Reporting to HMRC

1. In deciding if it is necessary to specifically report a termination package to HMRC it will be necessary to consider the quantum of the payment(s) and whether any non-cash benefits are included.
2. Where payments within the Termination Sections exceed £30,000 but no non-cash benefits are included it is simply a matter of accounting for the tax due through payroll and no specific written report is required (usual PAYE reporting will apply).
3. If there are non-cash benefits but these together with any cash payments under the Termination Sections do not exceed £30,000 then again there is no need to send a separate report to HMRC.
4. However, if there are non-cash benefits and the package of cash and benefits within the Termination Sections exceeds the £30,000 tax-free threshold it is necessary to provide a report to HMRC detailing the cash payment and non-cash benefits and the tax deducted in relation to those payments and benefits. See [EIM13844 - EIM13872](#).

Analysis

KEY AREAS OF COMPLEXITY OR UNCERTAINTY

Planning considerations - Advance clearance

1. Where a termination of employment results in a compromise agreement such agreement will typically include a tax indemnity from the former employee to the employer. This is intended to give the employer the ability to recover any under-deducted tax from the employee if HMRC subsequently takes the view that insufficient tax has been accounted for.
2. Although having the indemnity is helpful it may be better if there is uncertainty over the treatment of a particular payment or benefit to seek advance clearance from HMRC. This should eliminate the risk of HMRC applying a penalty for a failure to deduct correctly.

Planning considerations - Employee challenge

1. If there is a risk that a payment is likely to be regarded as contractual then an employer may well seek to deduct income tax and national insurance contributions from the payment to protect its position with HMRC. In such circumstances if the individual disagrees with the proposed treatment it is always open to them to seek to challenge the treatment through their self-assessment return.

Planning considerations - Amount of deductions

1. The exact amount of income tax and national insurance contributions to be deducted will depend on whether the payments and benefits are provided prior to or after the issue of the individual's P45 (the P45 is the document issued by the employer detailing the income received and tax deducted during the current income year relating to that employment).
2. If the payments and benefits are made after the issue of the P45 then tax needs to be accounted for under tax code 0T. Details of the appropriate treatment are set out in HMRC's Employer Further Guide to PAYE and NICs.

Planning considerations - Splitting payments

1. Where an individual is unlikely to have significant income in the following tax year one planning possibility is to delay some of the payment until the following tax year to enable the individual to make full use of the allowances and bands within that year.
2. Whether this achieves the desired result depends on being able to establish that the individual has no entitlement to the relevant payment until the subsequent tax year.

Planning considerations - Timing

1. If an agreement in relation to the terms of a termination is reached significantly in advance

of termination then there is a risk that HMRC will argue that it amounts to a variation of the employment contract with the result that the payments and benefits are treated as contractual.

2. In such circumstances it will be important have clear documentary evidence to show that what is agreed is part of a termination process and not something reached before termination is in prospect.

LATEST DEVELOPMENTS

None.

POSSIBLE FUTURE DEVELOPMENTS

1. Depending on the review of the Office of Tax Simplification there may be revisions to the legislation.

HUMAN RIGHTS

None.

EUROPEAN UNION ASPECTS

None.

Further Reading

None.