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Taxation of payments in lieu of notice

Inside

Introduction

In April 2018 new rules took effect to ensure that all payments in lieu of notice (PILONs) are subject to income tax and NICs in full. Although the rules emerged from a Government consultation on the simplification of the tax treatment of termination payments, the rules are complex and in many cases increase the costs of both employers and employees. The rules require employers to calculate the employee's post employment notice pay (PENP) – broadly the basic salary that the employee would have received during any unworked period of notice minus any contractual or deemed PILON – and to operate PAYE and NICs on the PENP in full.

This Inbrief explains the rules and gives some practical examples. It also reflects some recent changes in HMRC practice in this area including a welcome concession relating to the calculation of the PENP where the period of unworked notice is not in a number of whole months.

Tax position prior to 6 April 2018

If an employee's employment terminated before 6 April 2018, the tax treatment of a PILON 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 gavethe employer the right to terminate the employee's employment by paying a PILON, the PILON was generally subject to income tax and NICs in full. The position was different in circumstances where the employment contract did not allow the employer to terminate the employment by paying a PILON but the employer still did so. In these situations, the PILON generally benefitted from the £30,000 income tax exemption for payments made as compensation for termination of employment and could be paid NIC free on the basis that it was damages for breach of contract.

There were exceptions. For example, even if there was no PILON clause in the contract, HMRC often argued that the PILON was subject to tax and NICs in full if the employer invariably paid PILONs to employees automatically without considering the employee's individual circumstances. Conversely, if there was a PILON clause, it may have been possible, in appropriate circumstances, to argue that the employment had not been terminated in accordance with the terms of the employment contract and therefore any amount the employee received was eligible for the tax and NICs exemption.

Tax position with effect from 6 April 2018

From 6 April 2018 all PILONs are subject to income tax and NICs in full, irrespective of the contractual position.

If on or after 6 April 2018 an employee's employment terminates and the employer pays a "relevant termination award" to that employee, the employer must calculate how much of the relevant termination award is "post-employment notice pay" ("PENP").

The PENP is subject to income tax and employee and employer NICs in full. The balance of the relevant termination award and any statutory redundancy payment ("PENP") is eligible for the £30,000 tax exemption and full NICs exemption. Note that for payments made on or after 6 April 2020, the employer NICs exemption will be limited to the first £30,000 but the employee NICs exemption will remain.

A relevant termination award is any payment or benefit which compensates the individual for the termination of their employment (i.e. those payments and benefits which prior to 6 April 2018 would have qualified for the £30,000 tax exemption), excluding any statutory redundancy pay.

What is PENP and how is it calculated?

PENP is, broadly, the basic salary the employee would have received during any unworked period of notice minus any contractual or deemed PILON.

PENP is calculated using the following formula:

((BP x D)/P) – T

Where generally:

> BP = "basic pay" in the pay period which ends prior to the date on which notice is given, or, if no notice is given, the termination date ("relevant pay period").
>
> D = the number of calendar days in the "post-employment notice period" being the period beginning at the end of the date on which the employee's employment terminates and ending on the earliest date on which the employer could lawfully terminate the employee's employment by notice.
>
> P = the number of calendar days in the relevant pay period, or by HMRC concession where it is to the employee's advantage1 P = 30.42 provided that (i) the relevant pay period is a month; (ii) the employee's salary is paid by 12 equal monthly instalments; and (iii) the post employment notice period is not a number of whole months.
>
> T = contractual or deemed contractual

However, where: (i) the employee is paid monthly in twelve equal instalments; (ii) under the employment contract the minimum notice is a number of whole months; and (iii) the unworked period of notice is a number of whole months:

> D = the number of whole months in the post-employment notice period
>
> P = 1.

In either case, if the formula results in a negative number, PENP is zero.

What is basic pay for these purposes?

Basic pay excludes benefits, bonuses, commission, some allowances (see below), share options/ awards. However, if the employee participates in a salary sacrifice arrangement, pre-salary sacrifice salary must be used – in practice many employers use pre-salary sacrifice salary to calculate contractual PILONs in any event.

Basic pay will not necessarily be the same in every pay period. In some situations the employee may have received a one-off payment which increases their basic pay (for example, a payment for accrued holiday). In other situations the employee's basic pay may be reduced (for example, if the employee is off sick and only receiving sick pay).

Which allowances are excluded from basic pay?

HMRC guidance states that an allowance is "a supplementary payment received by an employee over and above their standard pay".

HMRC give the following examples of allowances which are excluded from basic pay:

> Allowances paid in recognition of particular circumstances, such as an additional responsibility allowance for temporarily undertaking duties not otherwise required under the employment contract;

> Allowances paid in recognition of particular working arrangements, such as a weekend working allowance for an employee working unsociable hours; and

> Allowances paid 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.

However, HMRC guidance also states that any amount which has in reality, been consolidated into an employee's standard pay must be included in basic pay.

For example, if an employer ceases to provide a benefit but compensates employees by playing an allowance, that amount should be included in basic pay. This would include for example, allowances paid in lieu of pension contributions.

Whether a car allowance constitutes basic pay depends on the circumstances. HMRC guidance states that generally if an employee is provided with a choice between a company car and a car allowance, it is likely that the allowance should be excluded from basic pay. In no names correspondence, however, HMRC suggested that if the employee were asked to make the choice several years ago, over time the allowance may have actually been consolidated into basic pay. Employers may want to seek specific guidance on the point.

What is the impact of the new rules on an employee's termination payment?

In some circumstances the PENP may be greater than the employee's PILON and in others it may be equal to or less than the employee's PILON.

Where the PENP is *greater* than the employee's PILON, this will have implications for the tax and/or NICs treatment of any relevant termination award:

> If the employee's relevant termination award (and any SRP) is less than £30,000, the amount to which the £30,000 tax exemption and NICs exemption applies is reduced.

> If the employee's relevant termination award (and any SRP) is more than £30,000, the amount to which the NICs exemption applies is reduced.

Where the PENP is *equal to or less* than employee's PILON, the £30,000 tax exemption and NICs exemption will apply in accordance with the normal rules.

Practical examples

Example 1: 6 months' notice period; no PILON clause; no salary sacriﬁce; no cash allowances

On 31 October, Jo is told that she is being made redundant. She has to leave her job immediately without working her notice. Her employment contract provides for 6 months' notice but there is no PILON clause. Jo is paid monthly and her monthly gross basic salary is £6,750 per month. Jo does not participate in a salary sacrifice arrangement and does not receive any cash allowances. Jo receives a termination payment of £50,000 including £4,000 statutory redundancy payment.

Jo's relevant termination award is £46,000 (£50,000 - £4,000).

Jo's PENP is £40,500 ((£6,750 x 6)/1)).

This means:

- PENP of £40,500 is subject to tax and NICs in full.
- Statutory redundancy payment of £4,000 benefits from the £30,000 exemption and is not subject to tax or NICs.
- The balance of the relevant termination award of £5,500 benefits from the £30,000 tax exemption and 100% NICs exemption.

Example 2: 3 month notice period; contractual PILON based on pre-salary sacrifice pay; no cash allowances

In December, Adam is told that he is being made redundant. He has to leave his job immediately without working any of his notice.

His employment contract provides for a 3 month notice period and there is a PILON clause. Adam is paid monthly and his monthly gross basic salary is £4,500 per month. Adam participates in a salary sacrifice arrangement and sacrifices £500 per month so his pre-salary sacrifice salary is £5,000 per month. He does not have any cash allowances. Adam receives a termination payment of £20,000 including £4,000 statutory redundancy payment and a PILON of £15,000 (based on pre-salary sacrifice pay).

Adam's relevant termination award is £16,000 (£20,000 - £4,000).

Adam's PENP is £0 ((£5,000 x 3)/1 - £15,000).

This means:

- £15,000 PILON is subject to income tax and NICs in full.
- £4,000 statutory redundancy payment benefits from £30,000 exemption and 100% NICs exemption.
- Relevant termination award of £16,000 benefits from the £30,000 exemption and 100% NICs exemption.

Example 3: 5 week notice period; contractual PILON based on pre-salary sacrifice pay; no cash allowances

In December, Jim is told that he is being made redundant. He has to leave his job immediately without working any of his notice. His employment contract provides for a 5 week notice period and there is a PILON clause. Jim is paid monthly and his monthly gross basic salary is £4,500 per month. Jim participates in a salary sacrifice arrangement and sacrifices £500 per month so his pre-salary sacrifice salary is £5,000 per month. He does not have any cash allowances. Jim receives a termination payment of £20,000 including £4,000 statutory redundancy payment. Jim also receives a PILON of £5,770 (£60,000/52 x 5). The relevant pay period is November which has 30 days.

Under the legislation, Jim's PENP is £64 ((£5,000 x 35)/30 - £5,770). However, by HMRC concession on the basis that (i) the relevant pay period is a month; (ii) Jim's salary is paid by 12 equal monthly instalments; and (iii) the post employment notice period is not a number of whole months, the figure of 30.42 can be substituted for the figure of 30 meaning that Jim's PENP is zero. The whole of Jim's termination payment of £20,000 therefore benefits from the £30,000 exemption and 100% NICs exemption.

Example 4: 2 month notice period; contractual PILON based on pre-salary sacrifice pay; car allowances

In June, Amy is told that she is being made redundant. She has to leave her job immediately without working any of her notice.

Her employment contract provides for a 2 month notice period and there is a PILON clause. Amy is paid monthly and her monthly gross basic salary is £2,500 per month. Amy participates in a salary sacrifice arrangement and sacrifices £100 per month so her pre-salary sacrifice salary is £2,600 per month. Amy also receives a £250 car allowance per month. Amy receives a termination payment of £12,000 including £2,000 statutory redundancy payment and a PILON of £5,200

Amy's relevant termination award is £10,000 (£12,000 - £2,000).

Amy's PENP is £500 ((£2,850 x 2)/1 - £5,200).

This means:

- £5,200 PILON is subject to income tax and NICs in full.
- £500 PENP is subject to income tax and NICs in full.
- £2,000 statutory redundancy payment benefits from £30,000 exemption and 100% NICs exemption.
- Balance of relevant termination award of £9,500 benefits from the £30,000 exemption and 100% NICs exemption.

Example 5: 3 month notice; partly worked contractual PILON based on pre-salary sacrifice salary; no cash allowances

On 1 July, Charlotte is given notice that she will be made redundant. Her employment

contract has a 3 month notice period so her employment will end on 30 September. Charlotte is required to work 6 weeks' of her notice until 10 August. Charlotte is paid monthly and her monthly gross basic salary is £3,750 per month. Charlotte participates in a salary sacrifice arrangement and sacrifices £250 per month so Charlotte's pre-salary sacrifice salary is £4,000 per month. Charlotte does not have any routine allowances. Charlotte receives a termination payment of £16,000 including £4,000 statutory redundancy payment and a PILON (based on pre-salary sacrifice salary) of £6,710 (£4,000 + (£4,000 x 21/31). The relevant pay period is June which has 30 days.

Under the legislation Charlotte's PENP is £90 ((£4,000 x 51)/30) - £6,710). However, by HMRC concession on the basis that (i) the relevant pay period is a month; (ii) Charlotte's salary is paid by 12 equal monthly instalments; and (iii) the post employment notice period is not a number of whole months, the figure of 30.42 can be substituted for the figure of 30 meaning that Charlotte's PENP is zero. The whole of Charlotte's termination payment of £16,000 therefore benefits from the £30,000 exemption and 100% NICs exemption.

Example 6: 12 weeks' notice; no PILON clause; salary sacrifice arrangement but PILON is calculated on pre-salary sacrifice salary; no cash allowances

On 17 July, Mary is told that she is being dismissed. She has to leave her job immediately without working her notice. Her employment contract has a 12 week notice period. Mary is paid monthly and her monthly gross basic salary is £3,750 per month. Mary participates in a salary sacrifice arrangement and sacrifices £250 per month so Mary's pre-salary sacrifice salary is £4,000 per month. Mary receives a termination payment of £24,000 including £4,000 statutory redundancy payment. The relevant pay period is June which has 30 days.

Mary's relevant termination award is £20,000 (£24,000 - £4,000).

Under the legislation Mary's PENP is £11,200 (£4,000 x 84)/30). However, by HMRC concession on the basis that (i) the relevant pay period is a month; (ii) Mary's salary is paid by 12 equal monthly instalments; and (iii) the post employment notice period is not a number of whole months, the figure of 30.42 can be substituted for the figure of 30 meaning that Mary's PENP is £11,046

This means:

- PENP of £11,046 is subject to tax and NICs in full.
- Statutory redundancy payment of £4,000 benefits from the £30,000 tax exemption and 100% NICs exemption.
- The balance of the relevant termination award of £8,954 benefits from the £30,000 tax exemption and 100% NICs exemption.

Example 7: 6 months' notice; PILON clause; salary sacrifice; no notice period worked; no cash allowances

On 31 October, David is told that he is being made redundant. He has to leave his employment immediately without working his notice. His employment contract provides for 6 months' notice and there is a PILON clause calculated by reference to basic salary. David is paid monthly and his monthly gross basic salary is £6,000 per month. David participates in a pension salary sacrifice arrangement under which he sacrifices £1,000 gross per month so his monthly pre-salary sacrifice pay is £7,000. David receives a termination payment of £50,000 including £5,000 statutory redundancy payment and a contractual PILON of £36,000 (based on £6,000 per month) plus £6,000 contribution into his pension.

David's relevant termination award is £45,000 (£50,000 - £5,000). The £6,000 pension contribution is ignored.

David's PENP is £6,000 ((£7,000 x 6)/1)) - £36,000.

This means:

- PILON of £36,000 is subject to tax and NICs in full.
- PENP of £6,000 is subject to tax and NICs in full.
- Statutory redundancy payment of £5,000 benefits from the £30,000 exemption and is not subject to tax or NICs.
- £25,000 of the relevant termination award benefits from the £30,000 tax exemption and 100% NICs exemption.
- £14,000 of the remainder of the relevant termination award is subject to income tax but not NICs.
- No tax or NICs are deducted from the pension contribution.

What are the implications of the new rules?

The new rules have the following implications:

- From 6 April 2018, there is no tax disadvantage in having a PILON clause for basic salary in the contract.

- If the employee works out their full notice or is put on garden leave for their full notice, the new rules do not apply.

- In those situations where the new rules apply, the employer will need to ensure any settlement agreement makes clear that the employer will deduct income tax and employee NICs from PENP.

- Employers will need to calculate the PENP for each employee whose employment is terminating, including those employees whose contracts of employment contain a PILON clause. Employees are likely to want to see this calculation before signing any settlement agreement.

- If the PILON is contractual, however, there are two scenarios where the PENP is likely to be zero. This depends on how the contractual PILON is calculated and will still need to be checked in every case.

Scenario 1

The PENP is likely to be zero if:

- There is a contractual PILON based on a number of whole months;

- There is no salary sacrifice arrangement in place (or PILON is calculated on the basis of pre-salary sacrifice salary);

- No standard cash allowances are paid (or PILON is calculated taking those allowances into account); and

- The unworked period of notice is in a number of whole months.

Scenario 2

The PENP is likely to be zero if:

- There is a contractual PILON based on a number of weeks;

- There is no salary sacrifice arrangement in place (or PILON is calculated on the basis of pre salary pre salary sacrifice salary);

- No standard cash allowances are paid (or PILON is calculated taking those allowances into account).

Specific situations?

There are a number of situations where employers may want to seek specific advice:

- There are anti-avoidance provisions which allow HMRC to ignore any arrangements which are designed to reduce PENP. HMRC has confirmed that they would not seek to apply these provisions where the employee asks for some or all of the relevant termination award to be paid into his or her pension as an employer contribution, even if this reduces the amount which is subject to tax and NICs as PENP Often, rather than requesting that some or all of his/her relevant termination award is paid into pension, an employee may request that some or all of his/her PILON is paid into pension as an employer contribution. Whilst this is possible if a valid salary sacrifice arrangement is implemented prior to the termination of the employee's employment, the PENP rules means that generally it will not result in any tax savings and, depending on the circumstances, it may reduce the amount which is eligible for the £30,000 tax exemption so such a request should generally be refused.

- Where the employee has received no pay in the period immediately before notice was given (or if no notice was given in the period immediately prior to the termination date) (because for example the employee had exhausted their entitlement to both company and statutory sick pay), it is unclear whether that period can be used for the purposes of calculating PENP. The issue is whether a period only constitutes a pay period if the employee has actually received pay in that period. HMRC has indicated in no names correspondence that in those circumstances they accept that PENP is is zero (on the basis that the BP would be zero). However, employers may want to seek specific guidance from HMRC on this point.

- If an employee's employment is terminated summarily without notice or pay in lieu of notice, there is an argument that the PENP is zero since the employer is not obliged to give any contractual or statutory notice so there is no unworked notice period. Whilst HMRC appears in theory to accept this, in practice, if a relevant termination award is paid to the employee it may be difficult to convince HMRC that the employer was entitled to dismiss the employee summarily. It will all depend on the specific circumstances of the case. The more cautious approach is for employers to calculate PENP and apply tax and NICs to it but employers may want to seek guidance from HMRC.

- If an employee's employment is terminated summarily without notice or pay in lieu of notice (and an employment tribunal does not subsequently overturn the dismissal), HMRC accept that the PENP is zero. The employer is not obliged to give any contractual or statutory notice and therefore there is no unworked notice period. It is important, however, that the facts are consistent with the summary dismissal and this is reflected in any settlement agreement.

For further information on this subject please contact:

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