

Termination payments

A guide to the income tax and social security regime



The income tax and National Insurance Contribution (NIC) treatment of payments has recently undergone some significant changes. In order to assist employers we have outlined, at a high level, the steps to be followed in determining how a termination payment should be subject to income tax and NIC.

Recent and expected changes

- From 6 April 2018, termination payments that would previously have been subject to income tax only if, and to the extent that, they exceeded the £30,000 threshold may no longer qualify for this treatment;
- From 6 April 2018, Foreign Service Relief (FSR) was also withdrawn for UK residents other than seafarers; and
- From 6 April 2020, it is expected that termination payments that benefit from the £30,000 threshold will be subject to Class 1A NIC if, and to the extent that, the threshold is exceeded.

The treatment of termination payments from 6 April 2018

Contractual Payments In Lieu Of Notice (PILONs) made on termination are subject to income tax and NIC as earnings. The Apprenticeship Levy also applies to such payments if the employer is within its scope.

In contrast, under the pre-6 April 2018 regime, non-contractual PILONs and certain other payments could potentially be subject to income tax only if, and to the extent that, they exceeded £30,000 in total.

The pre-6 April 2018 regime continues to apply to termination payments made on or after 6 April 2018 **if** the relevant employment was terminated prior to that date.

However, from 6 April 2018 the income tax and NIC treatment of non-contractual PILONs (and comparable payments) has been brought into line with that of contractual PILONs.

It will be important for employers to be able to demonstrate to HMRC that they have properly considered and correctly applied the new termination payments rules.

How do the new rules work?

Employers will need to identify what payments or benefits provided on termination are subject to the special rules for 'termination awards' and, potentially, benefit from the £30,000 threshold.

In order to do this, it is necessary to **exclude** payments or benefits which are otherwise subject to income tax, or which fall within the scope of a specific exception from the special rules on termination awards.

This is illustrated below with a straight-forward termination package:

	£
Statutory redundancy payment	10,000
Contractual redundancy payment	10,000
Non-contractual PILON	15,000
Payment for additional restrictive undertakings	500
Qualifying legal expenses met by the employer	2,500
Total payments to be made on termination	38,000
Less payment for additional restrictive undertakings (otherwise subject to tax)	(500)
Less qualifying legal expenses (excepted)	(2,500)
Amounts taxable as 'termination awards'	35,000

Once the payments and benefits that are taxed as 'termination awards' are identified, the termination payment rules are applied as set out overleaf.

Step 1: Establish the Relevant Termination Award (RTA)

To calculate the RTA, any statutory redundancy payment should be deducted from the total payments subject to tax as 'termination awards'. This is illustrated below, continuing the example above:

	£
Total 'termination awards'	35,000
Statutory redundancy payment	(10,000)
RTA	25,000

Some employees may be entitled to an 'approved contractual payment' negotiated by their trade union, rather than to a statutory redundancy payment.

Such 'approved contractual payments' should, subject to a cap, be deducted when calculating the RTA.

No other contractual redundancy payments should be deducted.

Step 2: Establish the Post-Employment Notice Pay (PENP)

Broadly, the PENP – calculated according to a formula – is the 'basic pay' that the employee would have received had they worked their notice period in full (separate rules apply where there is no notice period).

For these purposes, the calculation of 'basic pay' adds back any amounts given up under a salary sacrifice arrangement and essentially ignores items like overtime payments, benefits-in-kind, sick pay and share awards.

In calculating the PENP, a reduction is made in respect of any contractual PILON or comparable cash payments or benefits received in connection with the termination which are taxable as 'earnings'.

However, **no** reduction is given in respect of any bonuses payable for termination of the employment, pay in respect of accrued holiday entitlement, or cash payments that are subject to tax under special rules rather than simply as 'earnings' (e.g. payments for restrictive undertakings).

Continuing the example above, if the employee has monthly 'basic pay' of £5,000 and a contractual notice period of three months (which is not worked), the 'basic pay' that would have been earned had that notice period been worked in full would have been £15,000.

In this example, the employee does not receive any other relevant payments on termination that are subject to income tax as 'earnings', and so no reduction is given when calculating the PENP.

The PENP in this example is therefore £15,000.

Step 3: Compare the RTA and the PENP

The final stage is to compare the RTA and the PENP.

In essence, an amount of the RTA equal to the PENP (or the entire RTA if the PENP is larger) will be subject to income tax and NIC as 'earnings'.

Any remaining part of the RTA, together with any statutory redundancy payment (or equivalent 'approved contractual payment'), will be subject to income tax only if, and to the extent that, it exceeds the £30,000 threshold.

Such payments are currently free of NIC, but will be subject to Class 1A NIC from 6 April 2020 if and to the extent that the £30,000 threshold is exceeded.

Concluding the example, as the PENP has been calculated to be lower than the RTA, £15,000 of the RTA will be subject to income tax and NIC (and, potentially, Apprenticeship Levy) as though it were a contractual PILON.

The remaining £10,000 of the RTA, plus the statutory redundancy payment of £10,000 (i.e. £20,000 in total) will benefit from the £30,000 threshold for 'termination awards'.

No further income tax (or, from 6 April 2020, NIC) will be due in relation to the 'termination awards' in this example.

What do employers need to consider?

Understanding the calculations

In many cases, calculating RTA and PENP will be relatively straightforward. However, this will not necessarily be the case.

It will be important for employers to ensure that the correct amounts are included in each element of the calculation and that the correct notice period is applied.

In particular, care should be taken to identify which elements of a termination package are:

- Either subject to income tax under the special rules for 'termination awards', otherwise subject to income tax, or an excepted payment or benefit;
- Included or excluded from 'basic pay' for the purposes of the PENP calculation (e.g. for these purposes cash allowances are generally ignored, but should be taken into account if they have in effect been consolidated into the employee's standard pay); and/or
- Deductible when calculating the PENP.



In addition, determining the correct notice period over which the PENP should be calculated can also be complex as this will depend on the 'minimum notice' to which the employee is entitled and the circumstances in which the termination occurs.

Further complexities can arise depending on the relevant statutory or contractual employment terms, and the specific circumstances of the termination.

Special rules apply to limited-term contracts where no notice clause is included in the contract.

International aspects

The withdrawal of FSR means that individuals who are UK resident on termination will (save for seafarers) need to seek relief from any double taxation taking account of the terms of any relevant double tax treaty.

Note that, for these purposes, individuals will be treated as UK resident for the UK tax year of termination, even if they claim 'split year' treatment.

Employers should also consider potential cash flow disadvantages which might arise for internationally mobile employees from double payroll withholding. This may need to be addressed using Appendix 5 agreements to give effect to relief at source for foreign tax paid.

Assessing the cost of termination packages

Employers should ensure that NIC (and, where relevant, Apprenticeship Levy charges), which arise under the termination payment regime are identified and taken into account when assessing the overall costs associated with termination packages.

The associated NIC costs are expected to become more significant following the introduction of the new Class 1A rules from 6 April 2020.

How KPMG can help

Our experienced multi-disciplinary team of payroll, reward and legal specialists regularly advise employers on the tax treatment of termination packages and the associated withholding and reporting obligations.

Contact us to find out how we can assist in reviewing the tax treatment of termination packages, and calculating the associated PAYE/NIC costs, in cases where the new regime applies.

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