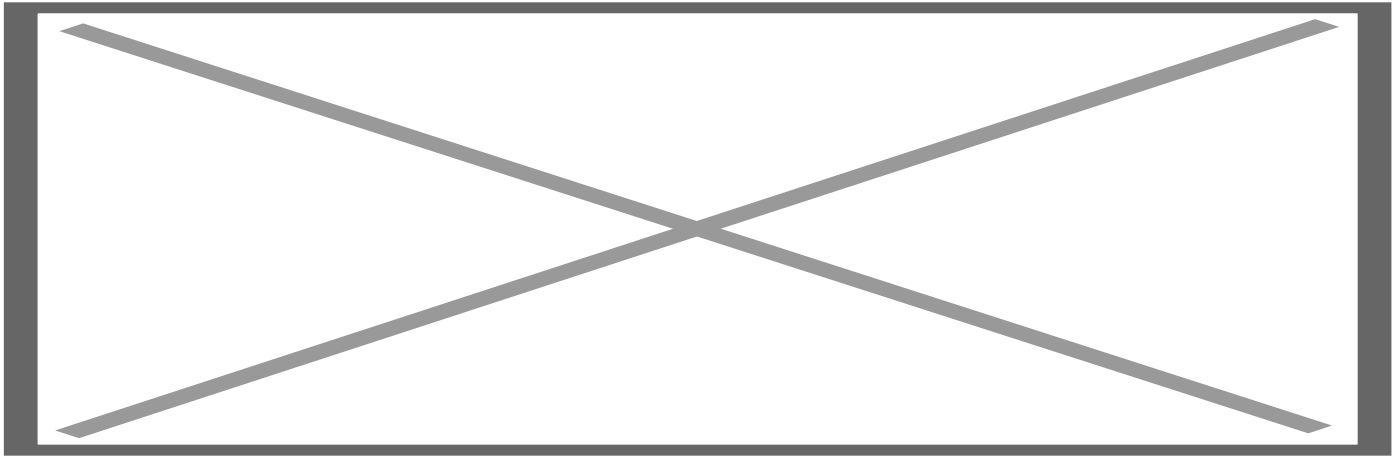


# Termination Payments

Employment Tax

Tax voice



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Mark Groom analyses the implications of the changes to the termination payments rules and introduces us to a raft of new acronyms – RTAs, PENPs

The new tax and NIC treatment of termination payments will not actually bite until April 2018 (and we are not quite out of the woods yet in terms of final legislation). The period of grace is welcome – at least one out of the three main Finance Bill changes recognises that employers need time to adjust.

## The Changes in Outline

Before looking at the legislation, the key changes from April 2018 are to be as follows:

- “Post-Employment Notice Pay” (effectively, Payments in Lieu of Notice determined in accordance with a prescribed formula) will be fully taxable and subject to Class 1 NIC
- Termination payments will be subject to a new (employer’s) Class 1A NIC charge to the extent they exceed £30,000
- Primary Class 1 NIC on termination payments is not proposed
- Foreign Service Relief is withdrawn

I understand that consideration is being given to Regulations (not yet published) which may provide for the Class 1A NIC to be payable at the time of payment of cash benefits included in the termination package; and at the normal due date for Class 1A NIC in the case of non-cash benefits. If so, employers agreeing to provide, say, private medical insurance continuing many years post-employment, will need to ensure those individuals do not fall off their Class 1A radars.

If the above sounds simple, wait until you see the legislation! I stress that what follows is based on draft provisions which are subject to change; I have therefore focussed only on what I believe are the current core policy intentions. We will need to pick up any changes and/or final points of detail in a subsequent edition of

ETV.

## Summary of the draft Finance Bill Clauses

Central to the scheme of the legislation, is the identification of the total amount of the relevant termination awards (RTA), and the calculation of the post-employment notice pay (PENP) under new s402D. RTA will be taxable under s402B and subject to Class 1 NIC, but the taxable amount of RTA will be limited to PENP where this is lower than the total amount of RTA.

RTA is defined as a termination award other than a redundancy payment (or so much of an approved contractual payment up to the amount which would have been due if a redundancy payment had been payable).

The formula for PENP is provided by s402D(1) as follows:

$$\text{PENP} = \frac{(\text{BP} \times \text{D}) - \text{T}}{\text{Y}}, \text{ where PENP} \geq 0 \text{ and,}$$

BP = the employee's "*basic pay*" from the employment for the year ending with the "*trigger date*"

D = the number of days in the "*post-employment notice period*"

Y = 365<sup>1</sup>

T = In short, the total of the payments/benefits made in connection with the termination of employment which have been taxed elsewhere in ITEPA (e.g. contractual PILON, restrictive covenants, EFRBS).

As regards basic pay, where the period since the employment started and ending with the trigger date is less than a year, the BP is the basic pay in that shorter period and Y is the number of days in that shorter period. Also, subject to the rules in s402D(5),(6),(7), where employees are paid weekly or monthly and there are whole numbers of weeks and months in the period, the fraction can be calculated in weeks or months.

Just a few more definitions to go, and then we can look at some numbers...

**"Basic pay"** – essential for the calculation of PENP, s402D(8) defines basic pay as the employment income of the employee from the employment, but disregarding overtime, bonuses, any amount received in connection with the termination of employment, and any amount treated as earnings under the benefits code. Please note that for this purpose, basic pay also includes any amount which the employee has given up the right to receive (e.g. a salary sacrifice or bonus waiver) which would have fallen within this list, had he not done so. However, this does not mean that termination payments cannot be sacrificed in exchange for pension contributions. However, it does mean that the calculation of basic pay for the purposes of PENP will be based on notional pay prior to salary sacrifice amounts.

**"Post-employment notice period"** – essential for calculating the number of days in the numerator, when determining the fraction of BP that constitutes PENP, s402E(2) defines this as the period beginning at the end of the last day of the employment, and ending with the "*earliest lawful termination date*".

**"Earliest lawful termination date"** – s402E(4) defines this as the last day of the period which is equal in length to the "*minimum notice*", and begins at the end of the trigger date.

**"Minimum notice"** – s402E(6) defines this as the minimum notice required to be given by the employer to terminate the employee's employment in accordance with the law and contractual terms effective:

- (a) where the termination **is not** a notice case, immediately before the employment ends, and
- (b) where the termination **is** a notice case, immediately before the notice is given.

“**Trigger date**” – s402E(7) defines this as:

- (a) if the termination is not a notice case, the last day of the employment,
- (b) if the termination is a notice case, the day the notice is given.”

Gasp! I think we can now construct a few examples to help visualise how this will work in some of the most common scenarios:

## Example 1: Contractual PILON

Say an employee’s termination package consists of £10,000 compensation for loss of office and a contractual PILON of £15,000 in respect of a contractual notice period of three months. The employee’s base pay is £60,000 for the year up to when the employer terminates the employment without notice. The statutory notice period is 4 weeks. So, in this example:

Minimum Notice = 4 weeks (28 days)

BP = £60,000

T = £15,000 (already taxable under s62 as contractual)

RTA = £25,000 (the total termination award)

D = 28

Y = 365

PENP =  $\frac{(\pounds60,000 \times 28)}{365} - \pounds15,000$

= £4,602.74 - £15,000

so, taken as NIL

RTA is greater than PENP, so the amount chargeable under s420B (and so s62) is limited to PENP which is NIL. The £10,000 will be taxable under s403, subject to the £30,000 exemption.

## Example 2: Actual termination package exceeds PENP(i)

Now, say, an employee’s package includes:

- £1,000 statutory redundancy payment,
- £3,000 ‘compensation payment’

The employee has been in this employment for just over two years and the employment contract does not mention notice at all. In the last year, he was paid £150 for 20 weeks and £250 for 32 weeks (excluding overtime, commission, etc). The employment is terminated with immediate effect.

Minimum Notice = Two weeks (this is the statutory minimum corresponding to one week for each year of service).

BP = 20 x £150 + 32 x £250 = £11,000

T = NIL (no parts of the package are taxable elsewhere in ITEPA)

RTA = £3,000

$$\text{PENP} = \frac{11,000 \times 2}{52} - 0 = \text{£}423.08$$

RTA = £3,000 which is greater than PENP, so the amount chargeable under s420B is limited to PENP, which is £423.08. This will be taxable under s402B (and so s62) subject to both PAYE and class 1 NIC, while the remaining £2,576.92 will fall within S403 and can thus benefit from the £30,000 exemption.

### **Example 3: Actual termination package exceeds PENP(ii)**

Now, say, an employee's package comprises a single compensation payment of £45,000 payable under a compromise agreement, no amount of which is taxable elsewhere under ITEPA.

The employee has been in this employment for just over two years and the employment contract provides for six months' notice with no PILON clause. His basic pay was £75,000. The employment is terminated with immediate effect.

$$\begin{aligned} \text{BP} &= \text{£}75,000 \\ \text{T} &= \text{NIL (no parts of the package are taxable elsewhere in ITEPA)} \\ \text{RTA} &= \text{£}45,000 \\ \text{PENP} &= \frac{75,000 \times 6}{12} - 0 = \text{£}37,500 \end{aligned}$$

RTA = £45,000 which is greater than PENP, so the amount chargeable under s420B is limited to PENP, which is £37,500. This will be taxable under s402B (and so s62) subject to both PAYE and class 1 NIC, while the remaining £7,500 will be taxable under s403 subject to the £30,000 exemption.

### **Example 4: Sacrificing an element of the termination package**

Say, an employee is on a 6 month notice period, earning £80,000 basic pay per annum. There is no PILON clause in his contract. The employer wishes to terminate the contract with immediate effect and is prepared to make a termination payment of £70,000, consisting of £40,000 PILON and £30,000 compensation.

The employee waives £50,000 of the termination payment and the employer agrees to make a contribution into the employee's pension plan instead. Since only small contributions to the plan were made in the last few years, there is no problem with the Annual Allowance.

$$\begin{aligned} \text{BP} &= \text{£}80,000 \\ \text{T} &= \text{NIL} \\ \text{RTA} &= \text{£}20,000 (\text{£}70,000 \text{ less } \text{£}50,000 \text{ sacrificed}) \\ \text{PENP} &= \frac{\text{£}80,000 \times 6}{12} - 0 = \text{£}40,000 \end{aligned}$$

RTA is lower than PENP so the full amount of RTA i.e. £20,000 is treated as earnings under s402B.

### **Example 5: Salary sacrifice from basic pay**

An employee has a pre-sacrifice gross (notional) salary of £120,000. Of this, she sacrifices £5,000 in respect of extra holiday and £5,000 in respect of private medical insurance (PMI), leaving post-sacrifice gross salary of

£110,000. She has a contractual notice period of six months but the employment is terminated with immediate effect (no PILON clause). She receives a ‘compromise payment’ of £70,000 and the employer will keep providing PMI for the six months after the termination date.

BP = £120,000 (the two sacrifices must be added back to basic pay)

T = 0

RTA = £72,500 (£70,000 + 6m of PMI worth £2,500)

PENP =  $\frac{£120,000 \times 6}{12} - 0 = £60,000$

12

RTA = £72,500 which is greater than PENP, so the amount chargeable under s420B is limited to PENP, which is £60,000. This will be taxable under s402B (and so s62) subject to both PAYE and class 1 NIC, while the remaining £12,500 will be taxable under s403 subject to the £30,000 exemption.

The permutations are endless, and we could go on with many more examples. I trust those provided above are sufficient to illustrate the basic mechanics for now, subject to any further changes in legislation that might be announced.

## Foreign Service Relief

In abolishing Foreign Service Relief, HMRC appears to consider that the existence of the UK’s many Double Tax Agreements solves all the problems relating to employees with international careers. This is unlikely to be the case, unless a short earnings period is adopted, because in most instances the OECD model applies a “last 12 months of working” analysis. Rather, there is a significant risk of mismatching because of the potential conflict between domestic and treaty sourcing periods.

The current draft law would require employers for each termination payment to look back over an employee’s entire career and find out whether they ever had UK taxed earnings. However, for employees who are not resident and not working in the UK immediately prior to payment, there may be no UK host employer required to apply PAYE to any payments made. Therefore, UK tax is only likely to be paid if the employee regards part of the payment he has received as attributable to UK service and reports it via self-assessment. He may well not do so, especially if his country of residence is applying a shorter sourcing period in line with the OECD model. So adopting a sourcing period over the whole employment period could render the law completely unenforceable and risk bringing it into disrepute.

For UK employees, who have some foreign service, whether or not they have returned to the UK by the time of payment, the employer will need to apply the UK tax treatment to the entire termination payment. This may well result in the majority of the payment being subject to UK tax at source, since treaty relief cannot normally be anticipated under RTI. With an international dimension to their career, the employee will often also have to pay tax at source in another jurisdiction on the same payment. This can result in them receiving only a small percentage of their termination payment, just at the time they lose their employment. To claim relief for foreign tax as a credit under a DTA, a UK resident individual would have to file a UK tax return and may have to wait months for a refund.

## Conclusions

Considerable additional complexity appears to have been necessary to achieve a relatively intuitive end objective. There are many new definitions and calculations to perform with the potential for many practical

challenges to arise.

Although this is over a year away, and further changes to the draft legislation will need to be assimilated, many employers will need the coming year to review and renew long established redundancy policies and/or union agreements. The largest redundancy programmes could easily be in contemplation now, and may spread around 6 April 2018. Advance thought will need to be given to the various issues created by differential tax/NIC treatment arising on terminations one side or the other.