

# Changing taxes on termination payments



CLIENT ALERT

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Employers need to understand the different tax implications of pilon clauses, golden goodbyes, payments for garden leave and unfair dismissal compensation. HM Revenue & Customs (HMRC) recently announced an important change to the tax on termination payments.

Currently tax is deductible at the basic rate (20 per cent) from any taxable element in a termination payment after an employee's P45 has been issued. Employees must then account to HMRC for any further income tax due if they are higher earners.

### New system

From 6 April 2011, employers making the same termination payment will have to deduct income tax at the appropriate rate for that particular employee – 20 per cent, 40 per cent or 50 per cent, as appropriate – rather than the basic rate.

It appears the new system will operate differently from the way commentators have suggested. Even for employees who earn less than £150,000 a year, any amount of a termination payment in excess of one twelfth of their salary (in other words £12,500 for a salary of £150,000) will be subject to tax deducted at the rate of 50 per cent if the payment is made in a lump sum. The employee will have to reclaim any over-paid tax at the end of the tax year. It looks like the only way of mitigating this is by making the payment in two or more instalments in different tax months, or before issuing the P45.



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## **Accountability**

It is likely to be the employer, rather than the employee, that is accountable to HMRC if income tax and National Insurance Contributions (NICs) are not deducted at the appropriate rate from a termination payment, and the employer who will be liable for any interest or penalties due. The employer would need to recover the tax and NICs from the employee.

A compromise agreement may contain a tax indemnity clause, making the employee liable for any unforeseen tax due. But relying on such clauses is not ideal. Enforcing an indemnity may be costly and it is not easy to recover under-paid tax and NICs from ex-employees, especially if they've already spent the termination payment. It is in the interests of both employers and employees to structure termination payments properly to reduce the risk of future unplanned tax liabilities.

## **Which payments?**

Termination payments arise in a number of circumstances, usually in connection with:

- *dismissal (actual or constructive)*
- *redundancy*
- *retirement*
- *the end of an employment contract because of ill health or disability*
- *confidentiality and post-termination restrictions in employment contracts.*

The fact that a payment is made under a compromise or other settlement agreement is irrelevant for tax purposes.

## **How much is taxable?**

Unfortunately, determining the tax due on termination is difficult because there are so many types of payments made. Broadly there are only three ways in which the components of a termination payment can be taxed. These are as:

1) *general earnings, under section 62 of the Income Tax (Earning and Pensions) Act 2003 (ITEPA), to which income tax and NICs are applied;*



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*2) payments for termination of employment, under sections 401 to 403, with the first £30,000 being exempt and income tax (but no NICs) due on any sum in excess of this;*

*3) payments on termination of employment because of death or injury/disability, under section 406, with the whole amount being exempt from income tax and NICs.*

## **General earnings**

Employers often have difficulty distinguishing between general earnings (section 62) and termination payments (section 401). This is partly because many payments made when the contract terminates - rather than because it is terminated - are classified as general earnings and fall under section 62, which can feel counter-intuitive.

As a general rule of thumb, any element that is contractual or has its origin in the contract of employment will be general earnings, attracting full income tax and NICs. This includes clauses that provide for a compensation sum to be paid by the employer if the contract is terminated early, such as a pay in lieu of notice (Pilon) clause.

## **Fully taxable**

Common components in termination packages that are likely to be general earnings and taxable in full are payments:

- *for “golden goodbyes” and terminal bonuses;*
- *for periods of “garden leave”;*
- *in lieu of holidays;*
- *for confidentiality and other restrictive covenants;*
- *in lieu of notice where there is an express Pilon clause or where such a payment is customary or automatic.*

## **Exemptions**

Components that are likely to fall within sections 401 to 403, making the first £30,000 exempt, are:

- *damages for wrongful dismissal;*
- *compensation for unfair dismissal;*
- *redundancy payments;*
- *compensation for discrimination.*

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