Taxing News

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Employment Law News

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Employers everywhere, sharpen your pencils and find your calculators. Tax on employment termination payments has changed and you will need to dust off your arithmetic. The objective of the new regime is said to be tax simplification but we'll let you be the judge of whether that has been achieved.

What's changing?

The change relates to taxation of notice periods. As is well-

known, the previous law allowed payments in lieu of notice to be made tax free up to a maximum of £30,000, but only if there is no payment in lieu of notice (PILON) clause in the contract of employment.

This handy little loophole has long eased the situation of employees who've lost a job and also smoothed the path to settlement of employment disputes, by maximising the value of a termination payment in the hands of the departed employee without increasing the cost to the employer. However, it seems that the view of HMRC is that loopholes are there to be closed and so this concession is being removed.

Which employment termination payments are caught by the new rules?

It appears from an HMRC statement that the new rules will only be applied where **BOTH** the termination date **AND** the payment are after 5 April 2018.

How do the new rules work?

The new rules will apply whenever an employee is receiving a payment on termination unless they work/remain employed for the entire duration of the notice period.

For terminations that are caught by the new rules, an amount of pay equivalent to base pay over any unexpired notice period ("Post-employment Notice Pay" or "PENP") will need to be taxed, irrespective of whether or not the employment contract contains a PILON clause.

Unfortunately, the precise mechanism for applying tax under these rules is a bit complex. There are two possible formulae to calculate the PENP and work out the amount of pay that is deemed to be taxable notice pay. In either case you will calculate the employee's basic pay for each day/month then multiply that by the remaining part of the notice period before netting off any taxable sums otherwise payable.

Which one of the formulae you need to use depends on whether the notice period is expressed in weeks or months and what the pay interval for the employees is. Unfortunately most cases will fall into the day-based calculation, which is slightly more complex and is likely to need to be done manually. It may also mean that the total amounts are affected by the number of days in the months over which the relevant time periods fall, which may produce inconsistencies.

How to apply the new rules for employment termination payments?

There are a few tricky pitfalls to watch out for in applying the new rules, including:

- To calculate the PENP you need to use "basic pay" which is just the basic pay for the previous pay period and disregards overtime, bonuses, commission etc. However, you must include any amounts forfeited under salary sacrifice arrangements, such as for childcare vouchers.
- It is not yet clear how the rules work if you have a PILON clause. Probably the right interpretation is that you still have to calculate the PENP to assess how much tax is due but then deduct any taxable PILON payments, to avoid double-counting. This will hopefully be clarified in the guidance, when published.
- It is also unclear what the effect is if the employee has been terminated for gross misconduct and so arguably no notice of termination is due. Again the expectation, as yet unconfirmed, is that if a payment is made in these circumstances then an amount equivalent to the PENP is due to be taxed.
- What if some of the payment is paid into a pension scheme or is otherwise tax-sheltered? Current expectations are that the tax-sheltering will be effective and won't be taxable even if this means that there is a shortfall in tax from the full PENP but, once again, clarification is awaited.

In reality it has taken many years of clarifying legal cases to reach the current position on taxing termination payments which, although complex, is relatively certain. The truth is that, even after guidance has been issued, it is likely to take a similarly long period to shake down the new rules and iron out the unclear wrinkles.

What should employers do now?

- Ensure that you update payroll staff who may process payments and HR personnel who may be providing illustrations of termination payment structures, to ensure that the rules are correctly communicated and applied.
- Update settlement agreement templates to split out the two payments (Termination Award and PENP) and update tax indemnity wording.
- Employers without PILON clauses in their employment contracts should now consider including them. The tax advantage of omitting these clauses historically has been thought to outweigh the disadvantages (which include the risk that termination without notice will not be accepted as validly ending employment). Given the change, there is now no real upside to excluding them.

If you have queries on the above please contact Tom McLaughlin, Partner on TomMcLaughlin@bdbf.co.uk

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