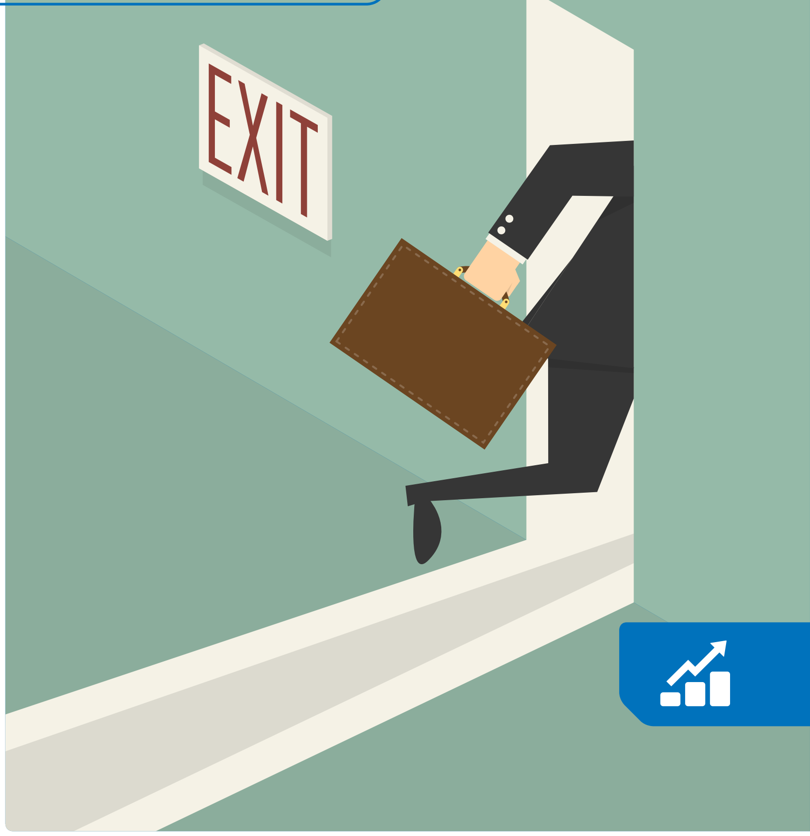

Business Partners
FINANCIAL MANAGEMENT SERVICES

Termination payments

New rules are coming into force on 6 April 2018.

The tax treatment of termination payments can be complex, not least because a termination package typically comprises several different elements, which may be treated differently for tax and national insurance purposes.

In a bid to simplify matters, the rules for taxing payments made on the termination of someone's employment are changing from 6 April 2018.

The rules introduce a new approach and reclassify some payments currently benefitting from the £30,000 exemption as earnings (with the result that benefit of the exemption is lost).

The £30,000 exemption will remain; but its scope will be more limited than at present.

A new class 1A national insurance contribution (NIC) charge will be introduced from 6 April 2019 (one year later than originally planned) on taxable termination payments in excess of £30,000.

The new rules will remove much of the ambiguity surrounding payments in lieu of notice (PILON), which from 6 April 2018 will generally be taxed as earnings, regardless of whether there is a contractual entitlement or customary expectation to the payment.

Earnings or termination payment?

Payments made on termination of employment may be taxed either as earnings or as termination payments benefitting from the £30,000 threshold.

This remains the case under the new rules, although the boundary has moved, as has the method for determining whether a payment falls into the earnings camp or the termination payments camp.

New rules – new approach

Under the new rules, payments made on the termination of an employment may be taxed either as earnings or as a termination payment benefitting from the £30,000 threshold. However, there is a new approach to determining which side of the fence the payment falls.

Broadly, the approach is to look at the earnings the employee would have received during the notice period – had the employment continued – and compare it to the payments made on termination (adjusting for certain exempt items).

The termination payment is taxed as earnings up to the level of the earnings that the employee would have received had the employment continued, with any excess over this amount taxed as a termination payment benefitting from the £30,000 threshold.

The first stage is to identify the amount of the termination award which does not benefit from the threshold and is taxed as earnings.

A **termination award** comprises payments or other benefits received directly, indirectly or in consequence of the termination of employment.

Having identified the termination award, the next step is to identify the **relevant termination award**.

This is the termination award excluding redundancy payments or an approved contractual payment, which is no more than the amount that would've been due had a redundancy payment been payable.

The relevant termination award is then compared to the **post-employment notice pay** to determine the extent to which the termination award is taxed as earnings and the amount, if any, which benefits from the £30,000 exemption.

The calculations can be complex and we can provide help to ensure all elements of the award are dealt with correctly.

Termination payments

Post-employment notice pay

The new rules introduce the concept of post-employment notice pay.

This is essentially the benchmark by which termination awards are judged to see what side of the divide they fall.

To calculate this amount, we apply a formula which takes into account:

- basic pay for the employment in respect of the last pay period before the employee was given notice (or before the end of the employment where no notice was given)
- the number of days in the last pay period
- the number of days in the post-employment notice period
- the total payment or benefits received in connection with the termination.

Basic pay includes overtime, bonuses, commission, gratuities, allowances, amounts received in connection with the termination, amounts treated as earnings and benefits-in-kind taxed as earnings, plus amounts treated as employment income in relation to securities and share options.

To apply the formula correctly, it is important all elements are taken into account. We can help you determine the amount of the post-employment notice pay.

Determining the tax treatment

From 6 April 2018, the approach adopted by the new rules is to compare the payments on termination of employment to what the employee would have received if they stayed in the job.

The following rules apply to determine the amount taxed as earnings and that, if any, which benefits from the £30,000 exemption.

Rule 1

If the post-employment notice pay in respect of the termination is greater than or equal to the total amount of the relevant termination awards in respect of the termination, all the relevant termination awards are taxed as general earnings and do not benefit from the £30,000 exemption.

Rule 2

If the post-employment notice pay in respect of the termination is less than the total amount of the relevant termination awards in respect of the termination, but is not nil, the part equal to the post-employment notice pay is taxed as general earnings.

£30,000 threshold

Although various alternatives were proposed during the consultation phase, the tax-exempt threshold remains at £30,000.

This is where the relevant termination award is more than the post-employment notice pay, with the excess being treated as a termination payment and taxable only to the extent it exceeds £30,000.

Class 1A national insurance

A new class 1A (employer-only) national insurance charge is due to be introduced from 6 April 2019 and will apply to termination awards taxed as termination payments if they exceed the £30,000 threshold.

Example

Paul's employment is terminated on1 June 2018 without notice. Under the terms of his contract he is entitled to three months' notice. His salary is £60,000 a year.

On the termination of his employment, he receives a non-contractual PILON of £15,000 and a compensation payment for loss of office of £60,000. He also receives statutory redundancy pay of £2,445.

Paul is paid monthly and was paid £5,000 (gross) on 31 May 2018 in respect of May 2018. The post-employment notice period is three months.

The termination award is £77,445 and the relevant termination award is £75,000 (PILON of £15,000 plus compensation for loss of office of £60,000).

Applying the formula, the post-employment notice pay is £15,000 ((£5,000 x 3)/1) - £0).

The relevant termination award (£75,000) is more than the post-employment notice pay (£15,000).

Consequently, £15,000 (equal to the post-employment notice pay) is taxed as general earnings (and liable to class 1 NICs), leaving £60,000 to be taxed which, together with the statutory redundancy pay, is eligible for the £30,000.

£32,445 (the excess above £30,000) is taxed as a termination payment. If the termination had taken place after 6 April 2019, the employer would be liable for class 1A NICs on £32,445.

Planning ahead

The new rules are less generous than the current rules and it may be beneficial to terminate an employment before 6 April 2018 rather than just after.

For example, where the employee receives a non-contractual PILON – and where there is no expectation that a PILON will be made – prior to 6 April 2018, the payment will be taxed as a compensation payment and benefit from the £30,000 exemption.

However, from 6 April 2018 it will be taxed as earnings to the extent that the termination award does not exceed the post-employment notice pay.

Under the new rules, the higher the post-employment notice pay, the more of the termination award is taxed as earnings.

The post-employment pay can be affected by irregular items, such as overtime or bonus if they are paid in the last pay period. Planning ahead can prevent distortions to the post-employment notice pay.

Looking further ahead, the new employer-only class 1A charge will come into effect from 6 April 2019.

Where a termination award is likely to exceed post-employment notice pay by more than £30,000, it may be beneficial to advance the termination date to before 6 April 2019 to save class 1A NICs.

We're happy to advise on termination payments.