

## CHAPTER 25

### TERMINATION PAYMENTS

#### 25.1 Introduction

Typical termination payments will include **compensation for loss of office**, **redundancy payments**, **damages** for dismissal, **payments in lieu of notice** - "PILONs" - and certain payments made on retirement.

[ITEPA 2003, s.401 - s.416](#)

Termination payments will either be fully taxable, partially taxable, or fully exempt depending on the nature of the payment.

The statutory rules concerning termination payments are contained at Sections 401 onwards ITEPA 2003. To understand the taxation of termination payments we must first remind ourselves of a couple of basic principles.

ITEPA 2003 differentiates between "general earnings" and "specific employment income". "General earnings" are defined in s.7(3) as **earnings and any amount treated as earnings** (such as benefits under the benefits code). "Earnings" are broadly defined in s.62 ITEPA 2003 as salaries, wages and benefits (in money or money's worth), or anything else that constitutes an emolument of the employment.

In a number of decided tax cases it has been held that emoluments are "of the employment" if they are given to the employee **in return for services** performed under the employment contract. Therefore, in general terms, payments made by an employer to an employee which are **not** in return for services performed, will **not be classed as "general earnings"** under ITEPA 2003.

This general principle is important as far as termination payments are concerned, because a termination payment will generally compensate the employee for loss of office rather than being any sort of reward for services performed.

As such, **most termination payments are not regarded as earnings** from an employment and are therefore **taxed in a completely different way** to other earnings such as salaries and bonuses.

Instead, termination payments will generally fall into the category of "specific employment income" and will be taxed under the provisions of s.401 onwards ITEPA 2003.

#### 25.2 Does Section 401 apply?

This is an important question because there are certain **exemptions and reliefs** available within the legislation dealing with termination payments which would not apply if the payment were to be treated as "general earnings" under s.62.

Your starting point should be to **ask yourself whether the termination payment is contractual**. If the employment contract contains a clause under which the employee has a legal right to receive a termination payment, the termination payment will be regarded as earnings from the employment and will be taxed in full.

When there is any doubt about the taxation of a termination payment, HMRC will ask to see the employment contract to see if any reference is made to termination payments. If there is, the payment will be regarded as being made in return for services and will be fully charged to tax.

If the contract is silent and makes no mention of termination payments, if HMRC can prove that there was "**reasonable expectation**" on the part of the employee that he would receive a termination payment, the payment will be taxed in full. It can be difficult for HMRC to prove that an employee expected to receive a termination payment. The Revenue Officer will look back at past practice and previous policy of the employer to see if other employees in a similar position received termination payments.

If a **termination payment is made outside the employment contract** and is totally voluntary - ie, the employee had no expectation whatsoever that he was to receive such a payment - this does **not** mean that the **payment is tax free**. It simply means that the payment will be **taxed under Section 401** which is the section that specifically deals with the taxation of genuine termination payments.

S.401(3) says that "this chapter does not apply to any payment or other benefit chargeable to income tax apart from this chapter". This means that if a payment is charged to tax **somewhere else** in the legislation, Section 401 will **not** apply. For example, if a payment is treated as general earnings from the employment it will be taxed as earnings under the definition in Section 62 which will take priority over Section 401.

This means that Section 401 only applies to non-contractual or "**ex gratia**" payments. Ex gratia here literally means "thank you" - ie, the payment is entirely **voluntary and without any obligation** on the part of the employer.

### 25.3 Fully exempt payments

Certain payments falling within Section 401 are fully exempt from tax.

A **termination payment made on the death of an employee** is fully exempt from tax. Similarly, where the employment has been terminated due to the **injury or disability** of the employee, any subsequent compensation payment is exempt from tax.

[ITEPA 2003,  
s.406](#)

If an **employer** makes a **payment to a registered pension scheme** or approved personal pension arrangements as part of the termination package, this is also **completely free of tax**. Making a termination payment to such pension schemes, rather than to the employee directly, is very effective tax planning and is commonly used in practice.

[ITEPA 2003, s. 408](#)

Finally full exemption from tax is given in instances where the employee has a substantial amount of foreign service. We shall look at foreign service exemptions later on in this chapter.

[ITEPA 2003, s.413](#)

## 25.4 Partially taxable payments

The most important rule as far as termination payments are concerned is the £30,000 rule. Section 403(1) says that termination payments are only charged to tax to the extent they exceed £30,000. This means that the **first £30,000 of a genuine termination payment is tax free**.

[ITEPA 2003, s. 403\(1\)](#)

The £30,000 exemption only applies to payments which are taxable under Section 401. This means that this tax free amount only applies to genuine ex gratia compensation payments such as redundancy or compensation for loss of office. It does not apply where the employee has a contractual right to receive the termination payment.

If more than one termination payment is made to the same employee in respect of the same employment or by associated employers, the £30,000 exemption applies to the aggregate of all payments. If termination payments are staggered so that the employee receives them in different tax years, the £30,000 exemption applies to the earlier payment first.

[ITEPA 2003, s.404\(4\)](#)

If a termination payment exceeds £30,000 so that some of it will be chargeable to tax, that excess must be taxed at source under PAYE. If the termination payment is made **before the employer issues the form P45**, income tax must be deducted from the excess under PAYE using the employee's **tax code**.

If, however, the termination payment is made **after the form P45 has been issued** to the employee, tax is deducted on the excess over £30,000 at the **basic rate of 20% only**.

If an employer is uncertain as to whether the £30,000 exemption applies, he can **apply to HMRC for clearance**. It is extremely important that the employer operates PAYE correctly as it is the employer, and not the employee, who is primarily responsible for paying any tax which has been under deducted.

## 25.5 Foreign service

[ITEPA 2003,  
s.413 & s.414](#)

Exemption from tax can apply to termination payments where the employee has foreign service. Where an employee has worked overseas and that employee receives an "ex gratia" termination payment, one of two things will happen. The termination payment will either be fully exempt from tax, or it will be partially exempt.

The full exemption rules are quite complex. If **foreign service is at least three quarters of total service**, the termination payment is **completely tax free**. Therefore, if an employee has been in service for 10 years, and has spent 8 of those 10 years abroad, foreign service comprises more than three-quarters of total service so the termination payment is fully exempt.

[ITEPA 2003,  
s.413\(1\)](#)

If this rule is not satisfied we move down to test number 2. This says that if **total service has exceeded 10 years and the last 10 years of the employee's service has been spent abroad**, the whole of the termination payment is **exempt from tax**.

If neither test 1 nor test 2 have been satisfied, we finally move on to test number 3. This says that if **total service has exceeded 20 years**, any termination payment is **tax free if at least half of total service has been spent abroad, including 10 of the last 20 years**. These three rules are difficult to remember but they are listed in S.413(1).

If none of the three tests has been satisfied, then only the foreign service part of the termination payment will be exempt from tax.

[ITEPA 2003,  
s.414](#)

### Illustration 1

William was made redundant in March 2011 and he received an ex gratia termination payment of £150,000. William had worked for the company for the last 30 years as below:

		<i>Years</i>
March 1981 to March 1987	London	6
March 1987 to March 2003	Paris	16
March 2003 to March 2011	London	<u>8</u>
Total		<u>30</u>

In order to work out how much of the termination payment is chargeable to tax, we need to apply the three foreign service tests to see whether the termination payment is fully exempt.

The first test is whether foreign service exceeds three quarters of total service. Here the answer is quite clearly "no" because foreign service is 16 years and total service is 30 years.

The second test says that the payment will be fully exempt if total service exceeded 10 years and the whole of the last 10 years was spent outside the UK. Again, this is quite clearly not the case as the last 8 years of William's service was spent in London.

The third test only applies if total service exceeds 20 years which is the case here. There are two more conditions to satisfy, the first being that foreign service must be at least 50% of total service. Foreign service here is 16 years and total service is 30 years so this 50% condition is satisfied. Finally here, we need to check whether foreign service makes up 10 of the last 20 years. If you look back at the last 20 years of William's service, you will see that 8 years have been spent in the UK and 12 years have been spent in Paris so this condition is satisfied.

As **all three conditions in test 3 have been satisfied**, foreign service is "substantial" which means that the **whole** of the termination payment of £150,000 is tax free.

The important thing here is the approach to the question. If you are asked to deal with this in practice, then draw a time line breaking service up into UK and overseas service, then apply each of the 3 tests in order. If **any** of the 3 tests are satisfied, the termination payment is **fully** exempt.

### Illustration 2

If we were to change the example of William very slightly, it will give rise to a significantly different result. Assume William still has 30 years of total service, but instead of originally going to Paris in March 1987 let us now assume that he originally went in March 1989.

		Years
March 1981 to March 1989	London	8
March 1989 to March 2003	Paris	14
March 2003 to March 2011	London	<u>8</u>
Total		<u>30</u>

This will reduce his foreign service from 16 years down to 14 years. We now need to apply the 3 foreign service tests again. The first two tests clearly are still not satisfied. Foreign service is clearly not more than three quarters of total service, and William has not spent the last 10 years outside the UK.

So let us reconsider condition number 3. Total service has exceeded 20 years, however for test 3 to be satisfied, at least 50% of total service must be foreign service. This is not the case here because foreign service is 14 years and total service is 30 years. This is less than 50%. As such, none of the three tests are satisfied which means that the termination payment of £150,000 is not fully exempt.

If the termination payment is not wholly exempt, it must be partly taxable. When dealing with an ex-gratia termination payment, the first £30,000 is always tax free. This leaves a chargeable amount of £120,000. Because part of William's service includes foreign service, we can take a foreign service deduction for the time spent abroad.

[ITEPA 2003  
s.414\(3\)](#)

	£
Termination payment	150,000
Less: exemption	<u>(30,000)</u>
	120,000
Less: foreign service deduction:	
$£120,000 \times \frac{14}{30}$	<u>(56,000)</u>
Taxable	<u><b>£64,000</b></u>

This is chargeable to tax as specific employment income for 2010/11.

## 25.6 Statutory redundancy pay

Redundancy payments fall into two categories, being statutory and non-statutory. Statutory redundancy is an amount which must be paid by the employer to the employee under employment law and will be a fixed amount for each year of service. Employers may also decide to pay an additional payment as further compensation for the redundancy. Both types of redundancy pay are charged to tax, under s.401 ITEPA 2003. This is the case even if a non-statutory payment is contractual. As a result, there will be no tax to pay in respect of a statutory redundancy payment as the maximum payment is currently £11,400, well below the £30,000 limit. However, if an employee receives statutory redundancy pay, this will reduce the £30,000 exemption available to set against any other ex-gratia payment.

The tax treatment of non-statutory redundancy is set out by HMRC in **SP 1/94**.

[SP1/94](#)

Genuine redundancy payments must be distinguished from other payments which would be taxable as earnings under s.62 ITEPA 2003. For example, a payment that is really a terminal bonus, say for meeting production targets or doing extra work in the period leading up to redundancy, is not compensation for redundancy.

## 25.7 Employees approaching retirement age

Termination payments will typically be made to employees who are at or approaching retirement age. If an employee is retiring due to injury or disability and receives a termination payment, that payment is fully exempt. However, **payments made to retiring employees** under normal circumstances are taxable.

[ITEPA 2003,  
s.394](#)

Any payments made to a retiring employee out of an Employers Financed Retirement Benefit Scheme (EFRBS) are taxable in full. This means that the £30,000 exemption will **not** be available. This may also be the case where an employee receives a genuine ex gratia payment that is not within his employment contract and is not expected.

Where the payment is "**on or in connection with retirement**", HMRC may deem the payment to be made out of the EFRBS and hence taxable in full. There has been speculation as to what HMRC mean by the term "on or in connection with retirement". HMRC has said that they will give no "hard and fast" rules as to whether an employee is retiring.

HMRC has accepted that a middle aged employee who moves on to another full time employment is not retiring. As such, if that middle aged employee receives a termination payment, the first £30,000 will be exempt.

However, when a payment is made to an older employee, who is not moving on to full time employment, that employee will be treated as retiring. The payment will therefore be deemed to be from an EFRBS, so the £30,000 exemption will not be available and the payment will be taxable in full.

As a rule of thumb, if you are dealing with any sort of termination payment being made to an employee over the age of, say, 45 years, it must be considered whether HMRC will deem the payment to be made from an EFRBS. Again, HMRC can be approached in advance for clearance as to whether the £30,000 exemption applies or not.

## 25.8 PILONS

Payments in lieu of notice (PILONs) have been the subject of much discussion over recent years.

If a payment in lieu of notice is **referred to in the employment contract**, the Revenue will regard it as a reward for services and will **tax it in full without the £30,000 exemption**. This principle was established in the tax case of *EMI v Coldicott*. In this case, the employment contract reserved a right for the employer to make a PILON on the termination of the employment and this provision was enough to make the payment fully taxable.

HMRC has always regarded payments to employees on "garden leave" as being taxable in full. Garden leave covers situations when the employee is not required to work during his notice period but is instead sent home "to do the garden" whilst still being paid. These payments are taxable in full.

However, where the employer makes a PILON **without** having any **contractual right or obligation** to do so, the **payment is likely to be treated as damages** for breach of contract and is **taxed under Section 401** in the normal way.

HMRC has said that even if the employment contract is silent and makes no provision (discretionary or otherwise) for the employer to make a PILON, a subsequent payment to an employee in place of he/she working during their notice period could still be held to be taxable in full as an emolument of the employment. For example, if the making of a PILON is an automatic response by the employer to a termination of the employment, HMRC are likely to regard the payment as an "integral part of the employer-employee relationship" and will argue that the source of the PILON is the **employment**, thereby making the payment fully taxable. In their view, the fact that the contract may be silent on the point is immaterial.

This is an aggressive view and in practice the facts and circumstances of each case should be reviewed separately on their merits.

If an employer terminates an employment contract without regard to any contractual notice period, he is treated as breaching the contract. If in return for that breach of contract, he makes a payment in lieu of notice to the employee, that payment is treated as a non-contractual payment of damages and is not taxed in full. In these circumstances, the first £30,000 of the PILON will be free of tax.

The taxation of PILONS is a very hazardous area for employers and if they have any doubts they should **seek clearance** before making any payments to their employees. Indeed many employers take the very prudent step of taxing the whole of the payment - i.e. ignoring the £30,000 exemption - and leave it to the employee to argue with the Tax Office as to whether the exemption applies.

## 25.9 NIC implications

Class 1 National Insurance Contributions are paid on earnings from the employment. As far as termination payments are concerned, the National Insurance Contributions Office have said that where a termination payment is made to an employee **under a contractual obligation, this payment will be regarded as earnings for NIC**.

However, where an ex gratia payment is made - i.e. where there is **no contractual obligation** - the **payment will not be regarded as earnings** and will not therefore be charged to NIC. Therefore as a broad rule, where a termination payment is made such that the £30,000 exemption rule applies for income tax, there will be no National Insurance Contributions due.

The £30,000 rule itself does not apply to NIC. NIC is an "all or nothing" charge - i.e. the payment is either fully charged to National Insurance or fully exempt. Therefore where a termination payment is taxed in full, NIC will be levied on the full amount.

Payments from an EFRBS will generally be subject to Class 1 NIC.



Class 1 NIC is levied on both employees and on employers. Employees have an upper earnings limit for Class 1 primary contributions which is currently £43,875 per annum. This means that if a termination payment is made to an employee who earns above this upper earnings limit, if the termination payment is chargeable to NIC, there will only be a 1% additional charge on the employee. However, secondary NICs will be levied on employers in full.

### 25.10 Miscellaneous points

Many termination agreements often incorporate some sort of restrictive covenant. A typical restrictive covenant clause is where the employee promises not to work for a competitor firm for a certain period of time after the termination of his own employment.

[ITEPA 2003,  
s.225](#)

Any such restrictive covenant payments made to the employee are taxed in full and there is no £30,000 exemption. S.225 ITEPA 2003 specifically **deals with restrictive covenants**.

If an employee takes legal action to recover compensation for loss of employment, legal costs recovered by the employee from the employer are taxable under s.401.

However, under ESC A81, there will not be a charge if agreement is reached out of court and any payment of costs by the employer is made directly to a solicitor under the terms of a settlement agreement. In addition, if a dispute goes to court, no charge will be made in any circumstance if the employer pays under a court order

ESC A81

A termination payment need not necessarily be in cash. From time to time, assets are transferred to employees as part of the termination agreement - these are most commonly company cars. Many employers allow employees to keep their company car as part of the termination package. For tax purposes we value the company car at the date of the gift and treat this as a cash payment.

It is possible for the ex-employee to continue to receive certain benefits from the employment even after the employment has terminated. If the benefits are taxable benefits, these continuing benefits are simply taxed in the year of receipt.

The £30,000 exemption is set against cash payments in a tax year in priority to non-cash benefits.

[ITEPA 2003  
s.404\(5\)](#)

The employer may have certain obligations to report termination payments. A one off report needs to be filed by the employer no later than 6 July following the end of the tax year if the termination package exceeds £30,000 and includes non-cash benefits.

Finally if a termination payment is taxable under S.401 (ie, if it exceeds the £30,000 threshold), it is taxed on the "top slice" of a taxpayer's income. This means that it will be taxed **after** dividend income. You may therefore need a 4<sup>th</sup> column in your tax computation.

A summary diagram of the key points on termination payments is included at the end of this chapter.

**Example 1**

Charles is made redundant on 30 November 2010 and receives the following:

	£
Ex-gratia cash payment	50,000
Company car (MV)	8,000
Statutory redundancy pay	5,000
Employer contribution to pension fund	<u>17,000</u>
Total package	<u>£80,000</u>

**Calculate the amount chargeable to tax under s.401.**

**Answer 1**

	£
Ex gratia payment	50,000
Car @ MV	8,000
Statutory redundancy pay	5,000
Pension contribution	<u>Exempt</u>
	63,000
Less: exemption	<u>(30,000)</u>
Taxable 2010/11	<b><u>£33,000</u></b>