

A sense of déjà vu

Uneasy about the tax and National Insurance implications of termination payments? **Nicole Neville** knows the feeling, but her explanation of the rules and conditions should have readers thinking that they already know them.

It's first thing Monday morning and I'm just passing through reception when my boss's secretary beckons me over: 'He wants to see you urgently. Be warned, he's in a sombre mood.'

Oh dear, this does not bode well. My boss is such a jovial person. He can always find a 'positive' in even the most dire of situations. I'm apprehensive, but try to shrug it off and put a bright smile on my face as I walk into his office. His demeanour does nothing to assuage my fears. He is tense and the serious expression on his face makes me uneasy.

'Nicole, there is no easy way of saying this.'

A tingle of fear spreads through me. My hands feel clammy. The smile falls from my face.

He continues: 'I've been told by the chief executive officer that we need to cut costs. I'm terribly sorry, but the decision has been made that we will, regrettably, be terminating your employment.'

I break into a cold sweat, this cannot be happening! How am I going to pay the mortgage? How will I pay my credit card bills?

'We will of course need to discuss your termination package. But maybe you need some time to come to terms with the situation?'

I stare blankly. I am struck dumb and my breathing is laboured. This cannot be happening. I want to turn and run but stay rooted to the spot.

Key points

- Some termination payments are fully exempt from both income tax and National Insurance.
- A termination payment that is a reward for services is taxable in full.
- Payments to a pension scheme and statutory redundancy payments are fully exempt.
- Does an employee have a contractual entitlement to a termination payment?
- A £30,000 exemption from income tax applies only to a genuine ex gratia payment.
- A payment to an employee on their retirement will be treated as made from an employer financed retirement benefit scheme.
- Post-employment notice pay is treated as earnings and subject to income tax and National Insurance.



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Don't be alarmed

'Beep, beep, beep...'

There is an interminable buzz in my ears. It is drowning out the feeble attempts of my boss and his secretary to comfort me. The buzzing gets louder ... beep, beep, beep.

I jump up, blink several times and look around in the semi-darkness. I am not at work, but in the comfort of my home. My employment is not being terminated. It was all just a dreadful nightmare, which fortunately ended when my alarm went off.

A huge sense of relief washes over me. Never have I been so delighted to be so brutally woken from my slumber as I was this morning.

I go downstairs to the kitchen to pour myself a strong coffee so I can clear my head and face the day. Son glances up briefly from his bowl of coco pops and mumbles: 'Looking a bit rough.'

Husband, being somewhat more tactful, enquires 'Everything all right dear?'

I sit down at the kitchen table and tell them about my terrible dream and then go on to say: 'I'm dreading going to sleep tonight. What if this awful dream recurs? What if my sleep is constantly disrupted by these night terrors?'

'Well,' says Husband trying to put a positive spin on things: 'I think you woke up at the worst time, your boss was just about to tell explain your termination package. I bet that would have been good.'

'But think of the taxes,' grunts Son.

I am still feeling troubled, and find that this conversation is not helping.

Son looks up from his cereal bowl and says: 'The best thing to do is face your fears. You should talk through all eventualities, then if you have this dream again you will be better prepared to deal with it.'

Wow, I don't think I have ever heard Son string so many words into one sentence in his life.

'That is good advice,' says Husband. 'What termination package might you be offered?' he asks optimistically.

Exempt payments

So here I am, the morning after the night before, facing my fears discussing termination payments with the family.

‘Some termination payments are fully exempt from both income tax and National Insurance,’ I start.

Son looks up hopefully.

‘This would include payments made on death, injury or disability of the employee.’

‘So, if you trip over the cable of your computer at work and are so badly injured you cannot do your job anymore, the resultant termination payment is tax free?’

I feel myself breaking out into a cold sweat again – and I thought last night’s dreams were bad enough.

I quickly move on: ‘Also, payments made into a registered pension scheme are completely free of tax.’

‘Now that would be good,’ says Husband. ‘But we’d have to wait until you retire to get our hands on the cash. I was hoping we could use the money to go on that skydiving holiday I have always dreamed of.’

I wonder whether I should remind him that we are discussing a hypothetical situation.

I continue: ‘A statutory redundancy payment is also fully exempt. This is an amount that must be paid under employment law and will be a fixed sum for each year of service.’

Taxable payments

Husband pipes up: ‘Doesn’t your employment contract give you the right to receive a termination payment?’

Son is leaping out of his chair. ‘Where is your employment contract; let me check?’

‘No need to bother Son, I have no contractual entitlement to any termination payment. And if I did, it would be fully taxable,’ I respond calmly.

Son resumes his slouch position and continues shovelling cereal into his mouth.

‘But you have worked so hard for the firm,’ says Husband. ‘Wouldn’t they want to give you something extra as a reward for all your efforts?’

‘If I were given a termination payment that was a reward for services, then the payment would be fully taxable; subject to both income tax and National Insurance contributions, just like my normal salary.’

‘If I want to plan this holiday, I’d need to know our budget.’ says Husband single mindedly.

I am getting a little concerned about his enthusiasm not just for the skydiving, but also regarding the termination of my employment.

‘Have any other members of staff at a similar level to you been made redundant recently? Have they received a termination payment? Maybe the firm customarily makes these payments to staff at your level? So how much would you reasonably expect to receive?’

‘I don’t know of anyone at my level who has had their employment terminated.’

That question has got me panicking again. Why have I been targeted in particular?

I pull myself together, this was just a dream, not a premonition. I respond: ‘If I had a reasonable expectation of receiving such a payment, then I would be taxed on this amount as normal earnings.’

Son comments, ‘I am sure the firm would be disappointed if you left, particularly if you were to go and work for a competitor. Maybe they would make you a payment if you agreed not to work for any competitor for a fixed period?’

I blink and stare wide-eyed. Who has taken Son and replaced him with this kind thoughtful boy? What a lovely sentiment.

‘That type of payment is called a restrictive covenant. That would also be taxable in full as normal earnings.’

Facing my fears is really helping. I am feeling much calmer.

Partly exempt payments

‘There is one further category of termination payment,’ I continue: ‘Payments that are only partly taxable. This will apply if the payment is a genuine ex gratia payment. This means that the employer is under no obligation to make this payment and does so entirely voluntarily. Then the entire payment is exempt from National Insurance and the first £30,000 is exempt from income tax. But the statutory redundancy payment will reduce this tax-free amount.’

“The statutory redundancy payment itself is exempt. But it reduces the tax-free amount on the ex gratia payment.”

Son is looking a little confused.

‘Let me give you an example,’ I say getting into my stride.

‘I’ll write it down,’ volunteers Husband and goes over to the whiteboard on the kitchen wall and wipes it clean. There goes this week’s shopping list.

‘Let’s say I were to receive a £60,000 ex gratia payment along with a £5,000 statutory redundancy payment.’

Husband writes down the information:

Ex gratia payment	£60,000
Statutory redundancy payment	£5,000

I continue: ‘The statutory redundancy payment itself is exempt. But it reduces the tax-free amount on the ex gratia payment. So £35,000 would be subject to income tax.’

Husband writes up the workings:

	Amount £	Taxable £
Ex gratia payment	60,000	
Less: tax free (£30,000 – £5,000)	<u>25,000</u>	
		35,000
Statutory redundancy payment		exempt
Subject to income tax		<u>£35,000</u>

‘And none of it would be subject to a National Insurance liability,’ I conclude.

‘Will the income tax be collected through PAYE?’ asks Husband.

‘Yes,’ I reply. ‘If the payment is made before I receive my P45, the income tax would be deducted using my tax code. But if it is made after my P45 is issued then an OT code will be used.’

‘One-twelfth of the basic and higher rate bands are allocated against the taxable payment without any personal allowance.’

I go over to the whiteboard and jot down the applicable income tax rates:

- The first £2,875 ($1/12 \times £34,500$ basic rate band) will be taxed at 20%.
- The next £9,625 ($1/12 \times £115,500$ higher rate band) will be taxed at 40%.
- The excess over £12,500 (£2,875 + £9,625) will be taxed at the additional rate of 45%.

“ If the payment is made to a retiring employee then it is treated as if it were made from an employer financed retirement benefit scheme.”

The calculation will be as follows.

Taxable	Tax liability £
£2,875 @ 20%	575
£9,625 @ 40%	3,850
22,500 @ 45%	10,125
Total tax to be deducted	£14,550

‘I will certainly need to factor this in to our holiday budget,’ grumbles Husband.

Retirement plans

Son is looking thoughtful. ‘If you are offered a generous termination payment why don’t you just take the opportunity to retire? You are getting on a bit.’

The Son I know (and love?) is back. I take a deep breath before I reply.

‘If the payment is made to a retiring employee then it is treated as if it were made from an employer financed retirement benefit scheme (EFRBS). Such a payment would be fully taxable.’

‘So, the first £30,000 would not be exempt?’ asks Son.

‘That’s right,’ I reply.

Husband tactfully interrupts: ‘Your mother is far too young to consider retiring’, before moving the conversation along.

‘So, we can summarise the tax treatment of termination payments as follows,’ and proceeds to write up an impressive table on the whiteboard.

Exempt from IT Exempt from NIC	Subject to IT Subject to NIC	Partly subject to IT Exempt from NIC
● On death, injury, disability	● Contractual payment	● Ex gratia payment
● Into registered pension scheme	● Reward for services	
● Statutory redundancy pay	● Reasonable expectation	
	● Restrictive covenant	
	● To retiring employee	

The family are surprisingly good students!

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Giving notice

Husband puts the pen down: 'But, aren't we getting a bit ahead of ourselves? Don't you have a three-month notice period? So, you'd have to keep working for the next quarter.'

'Yes, that's correct, and I would pay income tax and National Insurance as normal during the notice period.'

'Didn't Uncle Johnny go on garden leave when he was made redundant?' asks Son. 'What was that all about? I didn't see him mow the lawn once.'

'Well Uncle Johnny was leaving to work for a competitor. His old employer was concerned that he might take some of their clients with him, so they put him on garden leave. This is where the employee is still paid his wages during his notice period but is sent home to "work on his garden". Amounts paid during this period are fully taxable.'

I have always fancied a vegetable patch in the back corner of the garden, I muse.

'Might you get a PILON?' enquires Husband.

Son looks confused.

'A PILON (a payment in lieu of notice) is a payment made to an employee when their employment is terminated without notice, instead of the employee working through a notice period and receiving pay in the normal way.'

So, if the firm decided to terminate my employment and did not want me to work my notice period I am likely to receive a PILON.'

'We could bring forward the date of the skydiving trip,' says Husband.

Post-employment notice pay

I am concerned that I am replacing my fear of termination with my fear of falling out of the sky. I move on swiftly, 'Let's say, for example, that I have a basic annual salary of £144,000.'

Son's eyes widen.

'And my employment contract entitles me to a three-month notice period. If my employer wanted to terminate my contract immediately they might pay me a termination payment of, say, £90,000.'

Some of this termination payment would be classified as post-employment notice pay (PENP). This is the amount of basic salary that I would have earned if I were employed throughout my notice period.'

I can hear the cogs turning in Son's head as he calculates that with a £144,000 basic salary I would earn £12,000 per month and therefore my PENP would be £36,000 – being three months at £12,000. He writes this up on the whiteboard.

'The PENP is treated as earnings and subject to income tax and National Insurance. The remaining £54,000 (£90,000 – £36,000) will be treated as an ex gratia payment.'

'And some of that will be covered by the £30,000 exemption and will be totally tax free,' continues Son as he writes it up on the whiteboard.

Planning point

Termination payments made to a retiring employee will be treated as if made from an employer financed retirement benefit scheme and these will be subject to income tax and, if applicable, National Insurance contributions.

	£	£
<i>Fully taxable</i>		
Post-employment notice pay (£12,000 x 3)		36,000
<i>Partly taxable</i>		
Balance (£90,000 – £36,000)	54,000	
Less: Exemption	(30,000)	
		<u>24,000</u>
Chargeable to income tax		<u>£60,000</u>
Only the PENP of £36,000 is subject to National Insurance.		

I drain my coffee mug and praise Husband and Son: 'Well done, you are now both experts on the tax treatment of termination payments. I feel so much better for having talked this through with you both. But I really must hurry – you know how I hate being late for work on Monday mornings.'

A sense of déjà vu

As I travel into work, I reflect that 'facing my fears' has indeed helped. I feel upbeat and positive and ready to start my working day. What have I got to worry about?

I greet the security guard and walk towards my desk. I am intercepted by my boss's secretary. She has a serious expression as she takes me to one side.

'The boss wants to see you urgently. He's quite insistent that you go straight into his office. Be warned, he's in a sombre mood.'

Now I really am apprehensive. I try to shrug it off and put a bright smile on my face as I walk into my boss's office. His demeanour does nothing to assuage my fears. He is tense and the serious expression on his face makes me uneasy.

'Nicole, there is no easy way of saying this... I need you to stand in for Steve; he's had an accident – apparently he broke his leg on a skydiving holiday. I have never understood what on earth makes people want to throw themselves out of a plane? Anyway, we need someone to lecture on termination payments and the CEO suggested you. Maybe you need some time to come to terms with the situation. I'd like to have given you a bit more notice, but the weather looks good for the next few days so maybe you'd like to take some time out; perhaps sit in the garden, read the lecture notes and bring yourself up to date on the subject?' ●

Author details

Nicole Neville is a senior tutor at Tolley Exam Training. She can be contacted on 020 3364 4500 or examtraining@lexisnexis.co.uk.



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