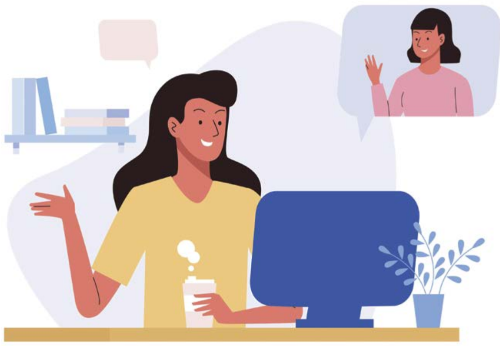
A zoom through redundancy pay

Victoria Cavell takes a look at the taxation of termination payments.



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My friend Ioana calls for our Thursday night Zoom catch-up. She works in marketing in London, and we swapped our weekly meetings at our favourite burger restaurant for Zoom sessions what feels like a lifetime ago. We used to make burgers at home to recreate the good old days with considerable success, but now we just settle for a packet of crisps and a glass of wine as we talk the evening away.

I've been looking forward to tonight all week. Wind-down time arrives – Ioana appears on my screen and she is super excited – she cannot sit still and seems to be bursting to tell me something.

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'I am being made redundant. I am going to get a huge pay-out. I can take some time out. I can go on that holiday I've wanted to take. I might even take a year out. For the first time since university I am actually going to have time … and money … and it's all tax free, right?'

Oh dear. It's going to be a long call as I start to explain: 'It is not that simple…'

Termination payments are an interesting topic and are examined regularly in both ATT papers 1 and 3. It is necessary to delve into the exact make-up of the termination package – what is being paid and why. The nature of each element of the payment will determine whether that element is fully taxable, partly taxable or fully exempt – and each element of the payment can have a different tax treatment.

As I explained to Ioana: 'To work out the tax treatment, we need to break down the termination payment and identify the bits that are fully taxable, then the bits that are fully exempt, and essentially what's left is partly taxable.'

Key points

- To work out the tax treatment of a termination payment it has to be broken down into the taxable and non-taxable elements.
- If a termination payment is contractual, it is taxed in full. If it is not contractual, but there is a reasonable expectation of receiving it, it is still taxed in full.
- Some types of termination payment are exempt from income tax and National Insurance.
- There is also statutory redundancy pay, although employers can also pay non-statutory redundancy or ex gratia payments for compensation for loss of office, the first £30,000 of which is tax-free.

Fully taxable termination payments

Let's start with payments that are fully taxable. If it is contractual, it is taxed in full. Contractual means that within the employment contract there is a legal right to receive the payment. If the employment contract states 'on redundancy, the employer will pay £20,000', then that £20,000 is taxed in full.

If it is not contractual, but there is a reasonable expectation of receiving it, it is still taxed in full. Imagine some employees in similar positions have been made redundant, and each of them has received £10,000, if another employee in a similar position to them is made redundant there is an expectation that they will also receive the same £10,000 – and that £10,000 is taxed in full.

Payments made for services past, present or future are also taxed in full. So, if the employee receives a £4,000 bonus for completing a project prior to leaving, that is a payment for services performed and taxed in full.

Payments in respect of restrictive covenants are another element that would be taxed in full. This is where the employer pays an employee for giving up the right to do something, for example, agreeing not to contact any previous clients for six months following redundancy.

Ioana asked 'what does taxed in full mean?'

This is a good question. Taxed in full means taxed as normal earnings – the same as salary. The payment is charged to income tax through the PAYE system and class 1 National Insurance (primary paid by the employee, and secondary paid by the employer) is due in the same way as for any normal salary payment.

To summarise so far – the following termination payments are taxed in full:

- contractual payments;
- non-contractual payments where there is reasonable expectation they will be received;
- payments in return for services performed past, present or future; and
- payments for restrictive covenants.

Fully exempt termination payments

Moving to the good stuff – the termination payments that are completely tax-free and also free of National Insurance. If there is no charge to income tax, there is no National Insurance.

For most people, the key exempt payment is where the employer pays into a registered pension scheme. Where the employer makes a payment into a pension scheme for the employee it is completely exempt and this is often done in practice.

Also payments for outplacement counselling or retraining are exempt. Being made redundant can be a stressful time, and professional help may be provided to adjust to the loss and help the employee find a new job. The employer may pay for training courses to help build new skills or knowledge that could be used to find a new job, or even self-employment. All of this is tax-free.

Ioana asked: 'So there's no tax if I take a course in how to start my own business?'

I explained there are some conditions to be met, but potentially yes. I saw her eyes light up even more.

In summary, the following termination payments are fully exempt from tax:

- payments into a registered pension scheme;
- outplacement counselling;
- retraining; and
- payments made on the death, injury or disability of the employee.

Partly taxable termination payments

If we strip out what is fully taxable and fully exempt, essentially what is left is partly taxable and partly exempt.

'What other payments could there be?' Ioana asked.

Statutory redundancy pay is a fixed amount for each year of service that employers must pay under employment law. Employers can also pay non-statutory redundancy or ex gratia payments for compensation for loss of office. There is no legal or contractual obligation to pay such amounts and with these redundancy and genuine ex gratia payments, the first £30,000 is tax-free, anything above £30,000 is taxed.

The £30,000 is not a lifetime amount, or an annual allowance, it is per employment and is applied to earlier payments first.

'What if I get to keep my company car?' Ioana quizzed me. I knew she was referring to her company Mercedes that she absolutely adores.

I explain that the termination rules apply to both cash and non-cash payments. If the car is given as compensation for loss of office and outside the contract, the market value of the car will fall within the ex gratia payments with the first £30,000 of the total ex gratia amounts being tax-free. Ioana was absolutely delighted at the thought.

'Do I have to pay National Insurance again on anything over £30,000?' she asked.

This is one of the many quirks in tax. Where payments are taxed in full, they are also charged to class 1 National Insurance. However, whereas ex gratia payments over £30,000 are subject to income tax, there are no class 1 contributions – they are only subject to class 1A which is paid by the employer, not the employee.

> "If Ioana works her notice period and receives her wages as normal, this is taxed in full as earnings."

To recap, the following fall into the partly taxable bucket, with the first £30,000 tax-free:

- statutory redundancy payments;
- non-statutory redundancy payments; and
- any other ex gratia payments including non-cash assets.

Notice periods

Ioana tried to think of anything else she might like to know on this topic of terminations.

'What about my notice period? I have a three-month notice period in my contract?' she asked.

Notice periods are a legal requirement and the minimum period of notice an employer must give an employee is one week for each year worked up to a maximum of 12 weeks. Although this is the legal minimum, it can be longer, so a three-month notice period is reasonable.

Now, as for the tax treatment, that depends on what happens in that notice period.

Working the notice period

If Ioana works her notice period and receives her wages as normal, this is taxed in full as earnings – the same as any normal salary.

Not working the notice period

Ioana might be required specifically not to work her notice period. The employer still honours the notice period and Ioana is still employed until the end of the full three-month period, but she could be asked not to do any work and instead she would be paid to stay at home and 'work on the garden'. This is also taxed in full.

Terminating the employment within the notice period

The employer can terminate Ioana's employment early – asking her to leave before the end of three-month notice period. This is usually accompanied by a payment in lieu of notice (PILON).

If the PILON is contractual, ie the employment contract permits a payment to be made instead of the employee serving the notice period, then again, it is taxed in full.

If the PILON is not within the employment contract then we need to calculate an element of post-employment notice pay (PENP) and tax that in full. This is what would have been paid if the notice period had been worked. Whatever is left of the payment is ex gratia of which the first £30,000 is tax-free.

Let's say Ioana is paid a salary of £60,000, so £5,000 a month. We know her notice period is three months, but what if she worked one month and was dismissed two months early? Her employer pays Ioana £28,000 as a termination payment, but her contract does not allow for a PILON.

For the one month Ioana works, the monthly salary of £5,000 is taxed in full as earnings as normal.

For the other two months not worked, a non-contractual payment of £28,000 has been paid instead. The PENP will be the two months' worth of salary, at £5,000 a month, that Ioana should have received if she had been allowed to work the notice period properly – that's £10,000 PENP. £10,000 is therefore also taxed in full.

Of the £28,000 termination payment, that leaves £18,000 as a genuine ex gratia payment and that falls into that partly taxable/partly exempt bucket. If this was the only payment Ioana received on termination, then the full £30,000 allowance would be available to set against the £18,000, and therefore, nothing else would be taxed.

Ioana was reflective. 'Ok,' she said. 'So not everything is tax-free on termination, but there's certainly potential for some tax-free payments. I shall have to find out exactly what's being offered. Now my next question is, how do I go about starting up my own restaurant? I've been practising making those burgers!'

But that is a whole new conversation for another Thursday night. ●

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