



# Taxing termination payments

Employment, pensions & benefits – contentious issues: briefing 14

## Executive summary

A recent change in approach by the Revenue means it is now much harder for employers to make tax free termination payments. The key issue for the employer is whether the payment should be treated as earnings; if it is not, the first £30,000 of the payment will be tax free. The employer should determine whether the contract contains a pay in lieu of notice clause (PILON) and whether the right to make a PILON has been exercised. It should not assume that just because there is no discretion to make a PILON, any termination payment will be treated as damages and attract tax relief.

When employees are dismissed, questions often arise about whether termination payments can be made tax free. Getting the answer right is vital. Following a recent change in approach by the Inland Revenue (the Revenue), it is much harder in practice to make tax free termination payments. Further, if tax is not deducted when it should have been, the Revenue is likely to recover tax from the employer (not the employee) on the whole of the sum paid out.

The basic rule is that employment earnings are taxable in full. Earnings include salary and wages and anything else that is an 'emolument' of employment – such as a bonus. If a termination payment is not treated as earnings, the first £30,000 of the payment will be tax free. The key issue for the employer is whether the payment should be treated as earnings. There are various questions to ask before this can be decided.

## Does the contract contain a PILON?

Payments made under an employment contract are treated as earnings. Tax and national insurance contributions (NICs) are deducted and accounted for in the normal way. Where the contract includes a pay in lieu of notice clause (PILON) and a payment in lieu is made in accordance with it, the termination payment is made under the contract and taxable in full.

## Has the right to make a PILON been exercised?

However, just because a contract contains a PILON does not automatically mean that an employer has chosen to make a payment in lieu under the contract. The courts have found that even where an employer has a right to pay in lieu, it can still choose to terminate in breach of contract. Damages for breach of contract are not treated as earnings and are only taxable if they exceed £30,000, and employers' NICs are not payable.

Deciding whether a payment has been made under the contract in such a case is not easy. The Revenue has recently outlined some of the factors it will take into account in assessing whether such a payment is taxable. These include:

- whether the payment is substantially the same amount as would have been paid under the PILON – if so, the Revenue is likely to decide that the payment is made under the contract and taxable in full;
- whether there are factors that point to the payment being damages, such as a deduction for mitigation, an adjustment to reflect the difference in tax and NIC payments, or the fact that all salary and benefits payable during the notice period are taken into account; and
- any evidence that the employer has decided not to exercise its discretion to make a payment in lieu.

Although all these factors are relevant to whether a termination payment is damages or a PILON, recent experience suggests that it will be difficult to persuade

the Revenue that a payment represents damages where there is a PILON in the contract. The payment is likely to be taxed in full in the absence of clear evidence that a payment is compensation for breach of contract.

## What if there is no PILON in the contract?

It tends to be assumed that if there is no discretion to make a PILON, any termination payment will be treated as damages and attract tax relief. This is no longer a safe assumption.

The Revenue has moved away from simply looking at whether an employer has a contractual right to make the payment. Instead, it considers whether termination payments can be regarded as earnings. This does not depend on whether payments are contractual, but on whether they are 'an integral part of the employer-employee relationship for the workplace... and [have their] source in that relationship and nowhere else'.

What this means in practice is that where an employer makes a PILON as a matter of course (in every redundancy situation for example) the presumption will be that the payment is earnings. Unless the employer can show that this approach is incorrect by relying on the factors outlined above, a termination payment will be taxed in full. This analysis is being applied to all terminations, so if it is an employer's practice to pay in lieu of notice whenever there is an executive termination, there is a substantial risk that the payment will be taxable in full.

## What can be done to minimise liability?

Despite the Revenue's new approach, there are still some steps that an employer can take to protect the tax position.

- Take PILONS out of contracts unless there are good reasons for including them (such as the need to preserve restrictive covenants following an immediate termination of employment or a desire to minimise any termination payment by limiting the payment to salary, excluding the value of bonuses and benefits from the calculation).
- Avoid policies (such as redundancy policies) that give a right or expectation that notice will be paid in lieu.
- As far as possible, structure a termination payment so that there is evidence to show that it should be

treated as damages – such as a deduction for mitigation.

- Alternatively, provide that the payment is to meet a liability that would otherwise arise – such as liability for unfair dismissal or a redundancy payment. Unfair dismissal and redundancy compensation are not earnings, so are tax free up to the £30,000 limit. (It is important to ensure that the employee is waiving such claims at the same time.)
- Take advantage of other tax exemptions if possible – for example, payments made where an employee is dismissed because of disability or ill health can be made tax free (although it will usually be appropriate to obtain Revenue clearance before a payment is made).
- Full documentation of the events surrounding a dismissal and the calculation of the termination payment should be kept to make assessment of the nature of the payment easier.
- If there is any doubt about whether a payment can be made tax free, obtain Revenue clearance to do so in advance. Clearance can be sought by way of a letter to the relevant tax office, explaining the circumstances, the components of the compensation payment and the tax treatment proposed.
- Where a settlement has been reached with an employee, but the appropriate tax treatment cannot be agreed, consider paying money representing the possible tax and employee NIC liability into an escrow account pending determination of the proper tax treatment by the Revenue. Once the Revenue has determined the tax treatment, the monies in the account can be paid either to the employee or in settlement of the tax liability.

Tax treatment of a termination payment obviously depends on the true nature of the payment and not on how it is dressed up. However, these actions should increase an employer's chances of being able to rely on tax exemptions and ensure that it is not penalised if its analysis of the position is incorrect.

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