

TAX TREATMENT OF PAYMENTS ON TERMINATION OF EMPLOYMENT

Most employers are aware that in certain circumstances a lump sum payment to an employee on the termination of their employment may be tax-free. Where tax-free treatment is available it is usually capped at £30,000, but unfortunately this has led many employers to believe that all payments made to employees in these circumstances will be tax-free up to £30,000. This is very far from the case and the circumstances in which a termination payment might be treated in this favourable manner for tax purposes are in fact very restricted. The situation has in fact been getting worse in recent years because HM Revenue have tried to interpret the legislation as narrowly as possible and review (frequently in an aggressive manner) all payments of this sort.

The favourable tax treatment referred to above will only be available where the payment is damages or compensation to an employee for loss of rights in respect of their employment. Otherwise the payment is likely to be part of the earnings from their employment and taxable in full including national insurance contribution liability. As a number of different situations can arise in practice, some of these are considered below and a summary of the tax consequences provided.

Resignation

The payments made to an employee whilst serving notice are subject to PAYE in the normal way. This would be the case even if the employee is on "garden leave" during this period. It is of course possible that an employer might decide to terminate the employment at an earlier date by making a payment in lieu of notice ("PILON"). If the contract of employment in question specifically provides for a payment to be made to the employee as an alternative to working notice, then the payment is always subject to PAYE (tax and NIC).

In circumstances where the contract of employment does not give the employer a right to pay out a notice period then any such payment will be non-contractual in nature. Non-contractual PILONs might still be taxable if HMRC is able to show that it is the employer's "custom and practice" to make such payments on the cessation of employment. PILONs are therefore very often open to challenge by HM Revenue whether they are contractual or not.

Dismissal

If an employee is given notice for poor performance (appropriate disciplinary procedures having been followed) then any earnings during the period in which that notice is being worked, will be taxable in the same way as outlined above. In practice many employees in these circumstances will go on garden leave or receive a PILON and the tax treatment is exactly the same as previously described under the heading of resignations i.e. is there a contractual right to receive the sum or not and if not, is it "custom and practice" to make such payments? Where a dismissal is concerned it is probably harder for HM Revenue to argue that an employee has an implied right to receive such a payment if there is no written contractual entitlement. However care should be exercised in respect of the dismissal of owner-managers as HM Revenue will expect that the employer should do everything to mitigate any potential loss and usually this would involve owner-managers being required to work notice periods (generating taxable remuneration) rather than receiving lieu of notice payments (potentially tax-free up to £30,000 assuming no contractual entitlement exists).

Where a summary dismissal takes place because of gross misconduct there will presumably be no entitlement to a termination payment in any event. Sometimes however a payment may be made because of a failure (or perceived failure) to comply with appropriate disciplinary procedures. In these circumstances it should be possible to argue that the payment is damages and thus tax-free up to the limit of £30,000.

Compromise Agreements

Even where poor performance or some degree of misconduct is a factor it is often quite rare for employees, particularly relatively senior ones, to be dismissed. Departure by "mutual agreement" is more common and lawyers are usually employed to draw up compromise agreements under which an employee receives certain payments, usually in return for making certain undertakings, one of which will normally be an undertaking not to pursue any legal action against the employer. Compromise agreements are often very difficult to evaluate from a tax point of view and expert advice will usually be required. HM Revenue look at these carefully to see what the employee has agreed to do in return for the payment. To the extent that they can identify that a compromise agreement is merely enshrining the employee's contractual rights, or that it is a payment in return for giving restrictive undertakings as to future conduct, then they will often argue that the payment under such agreements is taxable or at least partly taxable. All employers should ask a tax advisor to review the wording of compromise agreements before they are finalised.

Redundancy

Redundancy will often offer the best opportunity for a payment to be received tax-free on termination, but it must be a genuine redundancy. Statutory redundancy payments are tax-free, but count towards the £30,000 limit. If the redundancy payment includes anything in respect of restrictive covenants, holiday pay, terminal bonuses and so on, these will all be taxable.

Retirement or Quasi-Retirement

Non-contractual lump sum termination payments made to employees who leave voluntarily at or around or approaching retirement age, are treated by H M Revenue as unapproved retirement benefits and as such are taxable and do not benefit from the £30,000 exemption. This is an example of a situation where a non-genuine redundancy might arise. If tax-free treatment (up to the £30,000 limit) is to be accepted by H M Revenue, then it will be necessary in the first place to demonstrate that it has not been common practice for the employer to make such payments in these circumstances and secondly to demonstrate what the payment was for if it was not an unapproved retirement benefit. This latter requirement is often very difficult to satisfy in practice for older employees.

Tax Deductibility for Employer

In the majority of situations there will be no difficulty for the employer in obtaining a tax deduction against business profits for the cost of an employee termination payment. The basic deductibility of the costs of hiring and firing staff is well established. One area of potential difficulty, however, is where the payment relates to a change in ownership of a business. If the removal of the member of staff in question is closely associated with a transfer of ownership – for example the departure of a director who is also selling his shares – the question may arise as to whether the payment is being made wholly and exclusively for the purposes of the trade or rather to facilitate a change in ownership of the company. In these circumstances a deduction may not be available.

Conclusion

It is probably fairly clear from the above that there are many more possibilities that a termination payment will be taxable than that it will be non-taxable and employers have to proceed on that basis. Failure to operate PAYE will always fall back on the employer in these circumstances, often with an interest and penalty charge included in any late settlement of the PAYE liability. It is worth noting however that if the payment in question is made after the employment is terminated (that is after the issue of a form P45) then the employer only has an obligation to deduct tax at the basic rate. The employee would then have to account for any higher rate liability at a later date through the self-assessment procedure.