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Preparing for the new Termination Payment Rules

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Preparing for the new Termination Payment Rules

The termination of an employee's employment contract is a common occurrence in the life of most businesses. The reasons can be varied but when the employee exits, frequently a settlement agreement is offered by the employer to ensure there is no possibility of future legal action against them by the departing employee.



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Employment lawyers and HR teams are well acquainted with the routine dance involved in the negotiation of settlement agreements. However, it is important to note that HMRC has decided to make some changes which will affect some of the steps taken when negotiating exit payments.

Tax free termination payments have always been a source of angst for HMRC. The Income Tax (Earnings & Pensions) Act 2003 (ITEPA) permits payments to be made tax free up to £30,000.

HMRC have, for many years, tried to erode this 'privilege' of a tax free payment being made because, of course, there is nothing worse for the tax man than to see payments being made when they do not take their slice of tax.

Their train of thought can be seen in the HMRC/HM Treasury consultation paper issued as far back as 2015, on the then proposed changes to the tax regime on termination payments.

The consultation concluded in October 2016 and proposed a number of changes, including a complex system of tax free payments permitted according to length of service. The aim was, of course, to make it harder to make tax free payments and to increase the tax take. The current provisions are a much watered down product of those proposals.

These have been enacted in law by the Finance (No. 2) Act 2017 and will come into force on 6 April 2018.

What is changing and why?

For many years, employment lawyers have been asking their clients for copies of contracts of employment in order to see if there is a PILON clause in the contract.

A PILON sounds like something painfully unpleasant but, as all employment lawyers and HR professionals know, it is simply an acronym for 'payment in lieu of notice'.

Frequently, but not always, employers and their lawyers have inserted PILON clauses into contracts of employment to ensure that if an employee's employment is terminated with immediate effect, they have the contractual right to pay in lieu of notice.

This has always been particularly important when dealing with senior employees who have post-contractual restrictive covenants.

Including a PILON clause means that any payments made in lieu of notice are always taxable. They constitute contractual payments and so are treated as 'earnings' (under s.62 of ITEPA) rather than a termination payment (under s.401 of ITEPA).

However, PILON clauses are often absent from employment contracts. In those circumstances, there is a prospect of treating the monies that might have otherwise been considered notice, as being compulsory in nature and, therefore, payable under the £30,000 exemption.

Utilising the £30,000 tax free exemption has also been a potential option to consider where there has been a 'wrongful dismissal' and there are legitimate grounds to argue that an employee has been dismissed in breach of their contractual notice period.

These new measure introduced by the Finance (No. 2) Act 2017 eliminate the scope for the £30,000 exemption to be applied to monies that are, in effect, payments in respect of notice.

From 6 April 2018 onwards, any sums paid in respect of notice periods that are not worked (whether in part or in whole), will need to be clearly accounted for and will always be taxable - regardless of whether there is a PILON clause in the employment contract or not.

Deemed PILON payments will be both taxable under the appropriate tax code (from April 2018) and subject to employers' and employees' Class 1 NI contributions (from April 2019) and an employer will be required to pay these sums in 'real-time', as part of the employer's standard payroll return.

The £30,000 tax free exemption will continue to exist, but may only be applied once notice has been clearly accounted for. In practice, it will, therefore, only apply to either redundancy payments and/or termination payments that are truly *ex gratia* and compensatory in nature.

Other changes

As of 6 April 2018, foreign service relief on termination payments for UK residents has also been abolished. So employees who are UK residents in the tax year in which their employment is terminated will no longer be entitled to a further exemption for termination payments if they have performed some of their duties abroad.

The legislation also codifies into law the decision in *Moorthy v HMRC* [2016], which clarified that injury to feelings awards were taxable and were not akin or comparable to personal injury awards which remain tax free as compensatory damages.

With effect from April 2019, it is also expected that employers' Class 1A NI contributions will be chargeable on any part of a termination payment that exceeds the £30,000 tax free limit. However, whilst expected, that change is still subject to confirmation.

Conclusion

As ever, there are bound to be a number of employers who get caught out by these changes. The consequence for some employers will be an increase in the cost of termination payments to employees and one hopes this will not result in an increase in workplace conflict.

It is to be hoped that HMRC will be satisfied with these changes and will cease to attack the tax free termination payment limit and perhaps even increase it from the £30,000 figure where it has been stuck for so many years.

The tax free termination payment regime provides an invaluable system by which employers and employees can bring an employment relationship to an end with some degree of dignity and satisfaction for both parties; that is of social and economic value to all concerned.

Employment, Immigration & Pensions

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We pride ourselves on the provision of timely and relevant advice; often our clients require that advice urgently. Our team of highly experienced and skilled employment lawyers offer a responsive, personable and practical approach based on a real understanding of our clients and their businesses and sectors.

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