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Taxation of termination payments

By Antony Seely

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Summary

'Qualifying termination payments' that an employee receives on redundancy may be free of income tax, up to a limit of £30,000. This applies to statutory redundancy pay – the legal minimum which an employer is obliged to pay an employee – and any ex-gratia payments made by an employer to compensate for loss of employment by reason of redundancy. Only the excess over £30,000 is charged income tax, although a payment that qualifies for the £30,000 exemption is free of National Insurance contributions (NICs), whatever its amount. By itself, statutory redundancy pay is unlikely to exceed £30,000, but it must be included with any other qualifying payments when applying this threshold.

Certain types of termination payment are exempt from income tax – for example, a payment made on the death, disability or injury of an employee. However, at the time of someone being made redundant, it is likely they will also receive payments which are part of their contractual employment pay, and taxed as such: for example, holiday pay, bonuses, arrears of pay or a 'payment in lieu of notice' (PILON).

Over 2013-14 the Office for Tax Simplification (OTS) undertook an inquiry on the tax treatment of employee benefits and expenses. In its final report the OTS recommended certain reforms to the tax regime for termination payments, as "this is an area which gives rise to confusion because many people believe that the first £30,000 of any 'payoff' will be tax-free" and "many employers are unclear about which parts of a termination package qualify for the exemption."¹ In turn HM Revenue & Customs [consulted over summer 2015](#) on proposals to simplify the rules, but also to prevent their manipulation for tax avoidance purposes.

The 2016 Budget confirmed the Government would proceed with this reform, while emphasising that "the first £30,000 of a termination payment will remain exempt from income tax and the full payment will be outside the scope of employee NICs."² Following a [technical consultation](#), draft legislation was published in December that year.³ In turn this provision now forms [s5 of the Finance \(No.2\) Act 2017](#).⁴ It is estimated that this measure will raise just over £400m a year from 2018/19.⁵

There have been concerns that this measure might hit individuals dealing with the wider costs from being made redundant, and that the Government might cut the £30,000 exemption in the future. When this provision was debated at the Committee stage of the Finance Bill, Treasury Minister Mel Stride said, "the Government recognise that losing a job is a challenging time, but we must remain vigilant to opportunities for the tax rules to be manipulated ... [This clause] ... sets out a fair and proportionate set of changes that will continue to protect the vast majority of employees. The first £30,000 of a termination payment will remain tax-free, as will the whole of the compensation payment for discrimination during employment. However, where there were opportunities for manipulation, the loopholes must be closed, and they now will be."⁶

¹ [Review of employee benefits and expenses: final report](#), July 2014 p7

² [Budget 2016](#), HC 901, March 2016 para 1.145-6

³ HMRC, [Income Tax and National Insurance contributions: treatment of termination payments – tax information & impact note](#), December 2016

⁴ For commentary on the new rules see, "Changes ahead", *Taxation*, 15 June 2017 & "Tax on termination payments: what's changing from 2018/19 onwards", *Tax Journal*, 26 January 2018.

⁵ [Spring Budget 2017](#), HC 1025, March 2017 p29 ([Table 2.2 – item ar](#)).

⁶ [HC Deb 11 October 2017 c372](#)

1. Background: the OTS review in 2013-14

'Qualifying termination payments' that an employee receives on redundancy may be free of income tax, up to a limit of £30,000.

This applies to statutory redundancy pay⁷ – the legal minimum which an employer is obliged to pay an employee – and any ex-gratia payments made by an employer to compensate for loss of employment by reason of redundancy. Only the excess over £30,000 is charged income tax, although a payment that qualifies for the £30,000 exemption is free of National Insurance contributions, whatever its amount. By itself, statutory redundancy pay is unlikely to exceed £30,000, but it must be included with any other qualifying payments when applying this threshold.

This rule is established by section 401 of the *Income Tax (Earnings and Pensions) Act (ITEPA) 2003*. Section 403 of the Act specifies the £-value of this threshold. Certain types of termination payment are exempt from income tax – for example, around foreign service and death; these are set out by sections 405-16 of the Act. However, at the time of someone being made redundant, it is likely they will also receive payments which are part of their contractual employment pay, and taxed as such: for example, holiday pay, bonuses, arrears of pay or a 'payment in lieu of notice' (PILON).⁸

HM Revenue & Customs [publish estimates of the Exchequer costs](#) of tax reliefs, and this puts the annual cost of the £30,000 exemption for income tax at £1 billion. It should be noted that this estimate is "particularly tentative and subject to a wide margin of error."⁹

Over 2013-14 the Office for Tax Simplification (OTS) undertook an inquiry on the tax treatment of employee benefits and expenses.¹⁰ Following a period of evidence gathering the OTS published an interim report in August 2013, identifying four priority areas for further study: HMRC administration, travel and subsistence expenses, accommodation benefits, and, termination payments. In the latter case, the OTS found that relatively few employers and employees properly understood the operation of the regime or how the provisions of someone's employment contract affected the amount of tax they paid:

There is a lack of awareness – amongst both large and small employers and employees – about how the regime works in practice, and a very common misconception that the first £30,000 of any termination payment is automatically tax-free ...

⁷ For details of the statutory right to redundancy pay see, [Key employment rights, Commons Briefing paper CBP7245](#), 7 June 2017 pp42-3.

⁸ HMRC, [Employer further guide to PAYE and NICs \(CWG2\)](#), 2018-19 edition (see "Payments you make when an employee stops working for you" para 5.11). Further details are in HMRC's [Employment Income Manual](#) – see from, [para 12800](#).

⁹ HMRC, [Estimated costs of main tax reliefs](#), January 2018. Figure for 2016/17.

¹⁰ OTS press notice, [Tax rules for employee benefits and expenses under review](#), 8 August 2013

Where difficulties arise, it is normally in relation to higher-end payments, particularly in relation to payments in lieu of notice (PILONs). In the feedback from our meetings, the main concern has been that the tax treatment of a departing employee's package is often wholly dependent upon the provisions of his employment contract, as follows:

- employees who have express provisions for a PILON in their contract will be subject to income tax and NICs on the whole of their payment (on the basis that it is taxable as earnings because it is paid in accordance with the contract); whereas
- employees who have no such provision in their contract are more likely to be taxed under section 401 ITEPA, and benefit from the associated £30,000 exemption and completely NICs-free treatment (on the basis that the amount paid is closer to a damages payment, and therefore is not earnings).

This distinction is unfair when the employees rarely have any control over the provisions in their contracts. Well-advised employers are more able to structure their arrangements in a tax effective way, and for their employees to benefit from this.¹¹

The OTS also found that employers had difficulties in applying the £30,000 exemption correctly:

We have been told (not least by HMRC) of employers unaware of the different income tax and NICs treatment of termination payments which fall under section 401 (under which the payments are entirely NICs-free, but only the first £30,000 is free of income tax) ...

Many employers have difficulty over applying the rules surrounding the £30,000 exemption and the extent to which it can be available depending upon the particular circumstances. For example, if an individual is employed by two successive employers who are associated with each other, there is only one £30,000 exemption available to him in relation to all termination payments from those two employers.

The level of the £30,000 exemption itself has been queried, as it has not been increased since 1988 and therefore appears out of date. At today's prices, it should be £71,000.¹²

Some employers and advisers are in favour of an increase to the value exemption, and others have suggested that it could, for example, be linked to length of service in order to give it greater meaning and give more recognition to the contribution that the employee has made to the business. Others feel that the exemption should be extended in full, taking the view that there is no need for the taxation of PILONs at all – whether or not they are in the employment contract – as this payment represents a payment for loss of office.

One suggestion was for a lower limit which would apply to any payment on loss of employment. However, many people have raised with us the idea that a significant increase in the £30,000

¹¹ Office for Tax Simplification, [Review of employee benefits and expenses: interim report](#), August 2013 para 7.2-3

¹² The £30,000 figure was last changed in April 1988 when the retail price index was 417.4. In May 2013 it was 986.3.

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exemption could be linked to imposing NICs above the limit. These are policy issues that are beyond the remit of this review.¹³

The report provided a detailed description of the tax regime for termination payments and the legal difficulties arising from their application, and this is reproduced in an appendix to this paper.

The OTS published a final report in July the following year.¹⁴ In this the OTS argued that the taxation of termination payments was an area “in which confusion and uncertainty are frequent”:

Confusion – because many employees believe that the first £30,000 of any ‘payoff’ will be tax-free, and are surprised and upset when they find that is not the case

Uncertainty – because many employers are unclear exactly how the exemption operates

In the vast majority of cases, employers are not trying to get out of paying tax: they simply want to pay the correct tax and therefore avoid incurring any penalties that might otherwise arise. The complexities in the current system are getting in the way of them being able to achieve this. They have told us that, above all, they would like to see a regime that is clear and easy to administer.

As for the employees, who are after all losing their jobs, the thing they most want is certainty about the value of whatever they are receiving. Receiving a later tax bill or, as is more often the case, having the employer deduct too much tax because it is unsure of the correct tax treatment, is particularly unwelcome as the employee will probably be using the termination payment to subsist on; many clearly feel that not taxing a payoff is a matter of fairness (though this may be qualified in the case of large payments).¹⁵

Although there was a clear need to improve the system, the OTS noted that “the problem we have is that the work we have done has not pointed the way to an obvious single answer as to how the system should be changed”:

Overall, we believe that, subject to certain exemptions, all payments made in connection with a termination of employment should be subject to income tax ... Alongside this, there should be:

- a new income tax relief available in circumstances where the employee qualifies for a statutory redundancy payment, instead of the current £30,000 exemption under section 403 ITEPA 2003; and
- a government review of the existing exemptions, reliefs and reductions which apply to the existing charge under section 401, in order to establish in each case whether they should be retained as part of the wider reform of income tax treatment of termination payments.

These proposals should first be the subject of a formal consultation process in order to establish in more detail how

¹³ [Review of employee benefits and expenses: interim report](#), August 2013 para 7.7-12

¹⁴ OTS press notice, [Simpler rules for accommodation benefits and termination payments recommended](#), 4 August 2014

¹⁵ [Review of employee benefits and expenses: final report](#), July 2014 para 2.1-2

individual taxpayers, businesses and HMRC would be impacted by the reforms if they were introduced. This consultation should also include a review of whether there should also be a reform to the NICs treatment of termination payments, in order to align the two regimes in this area.¹⁶

The OTS noted that there was a case for simply taxing all payments made on the end of someone's employment, but that this would impose a significant burden on the lower paid:

The simplest approach is to tax all payments made on the termination of an employment, whatever their basis. Some employers have told us that they would prefer this approach, on the basis that this would result in a system that is easier to understand and much more straightforward to administer.

We have spent some time looking back at the 1955 Royal Commission on the Taxation of Profits and Income that considered the question of taxing termination payments in the 1950s.¹⁷

Imposing tax on all termination payments appears to have been the preferred approach when the income tax regime which is specific to termination payments was originally introduced in the *Finance Act 1960*. The prime intention behind that legislation was to tax extravagant pay-offs, but also to capture payments of whatever size – as much as anything because it is very difficult to separate excessive payments from the reasonable ones.

However, a flat value income tax exemption was introduced alongside this general charge on the basis that this would exempt from tax the sort of redundancy payments made to manual workers and clerical staff at that time. In 1960 this exemption was set at £5,000, but this has been periodically revised to the present £30,000 (which has remained unchanged since 1988).

These original considerations remain relevant today.

From a pure simplification basis, imposing tax in full on all termination payments is the simplest approach. However, it is likely to have a significant cost impact for some people, particularly those lower paid employees who may more often be the ones receiving smaller termination payments;¹⁸ who are, after all, losing their job.

There is clearly a policy decision to be made here on how payments should be taxed/exempted: such policy matters are in strictness outside the remit of the OTS. Our inclination, though, is that the policy which underpins the current structure is correct.

We therefore consider that, subject to certain exemptions, all payments made in connection with a termination of employment would be subject to income tax. However, we propose that a new income tax relief should be available instead of the current £30,000 exemption under section 403 ITEPA 2003.¹⁹

¹⁶ *op.cit.* para 2.3-5

¹⁷ *Royal Commission on the Taxation of Profits and Income*, Cmd.9474 June 1955 see para 242-52

¹⁸ In that the higher paid who might receive a payoff well above £30,000 are already taxed on the value above £30,000 and thus would see a proportionately smaller change to the net value of their payoff.

¹⁹ *Review of employee benefits and expenses: final report*, July 2014 para 2.10-4

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In December 2014 Treasury Minister David Gauke set out the Government's position on a variety of projects undertaken by the OTS, and on this specific issue said, "I agreed that the current rules are complicated and can result in inconsistent outcomes, but as your report lays out, [this is a complex area] ... Reforms will have far-reaching impacts and will need careful consideration."²⁰

²⁰ [Letter between the Financial Secretary and OTS: competitiveness and other reviews](#), December 2014

2. Consultation on simplifying tax treatment of termination payments

In the Summer Budget in July 2015 the Government confirmed that, following the OTS' work, it would consult on the tax and NICs treatment of termination payments, "to make the system simpler and fairer."²¹ [The consultation](#) was launched on 24 July, and responses were invited by 16 October. As an introduction to the issue, HMRC's paper gave an example of how the tax regime works in practice:

The termination payment [that an employee receives] can be made up of several different elements, even where the employee is made redundant, so the employer is required to look at each element separately. They then must consider whether or not each element should have income tax and NICs deducted.

Example 1

Pat gets made redundant after working for a company for 10 years. Pat gets a termination payment of £13,750. This is made up of:

- £4,750 statutory redundancy
- £5,000 ex-gratia payment for loss of employment
- £3,000 PILON
- £1,000 of holiday pay

Under the existing rules £4,000 (PILON and holiday pay) of the termination payment will have tax and NICs deducted at the employee's marginal rate and the employer will need to pay employer NICs on this part of the payment, as this will be classed as earnings.

The £9,750 (statutory and ex-gratia payment) is within the exemption for termination payments. Because the total of this payment is less than £30,000 there is no liability to income tax, neither is there a liability to employer or employee NICs.

There are various exemptions, reliefs and reductions applying to termination payments in addition to the tax-free threshold. For these exemptions to apply the payment to the employee must not be contractual or salary. If the conditions of the exemption are met then there is no income tax liability even on the elements over £30,000.

These include payments made:

- because of the death, disability or injury of employee;
- under a tax exempt pensions scheme;
- to a registered pension scheme;
- for liabilities and indemnity insurance;
- to HM Armed Forces;

²¹ *Summer Budget 2015*, HC 264, July 2015 para 2.164

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- by a foreign government;
- where the employee has a certain type of foreign service;
or
- in respect of certain legal costs.²²

The Government acknowledged the case, made by the OTS, for a regime “that is easy for employers to administer and for employees to understand”, and given this, it made sense to remove the distinction made between contractual and non-contractual termination payments. Further to this, any new system would have to be affordable, and also be fair, given the evidence that individual employers and employees were manipulating the rules:

HMRC has evidence that some employees and employers attempt to change the nature of their termination payments. This is so the employee can benefit from the £30,000 exemption and the employer isn’t liable for employer NICs. For example there have been cases where employees and employers argue that a PILON (subject to tax and NICs) is actually a payment for breach of contract, so there is no NICs liability and the payment is only taxable on amounts over £30,000.

With such a complex tax treatment of termination payments it is often difficult for HMRC to disprove such claims. These employees are generally those who are well advised (and generally better paid) ... [A new regime] must be fair, so that those who are better paid and better advised (because they are able to afford to pay for advice) do not receive a more favourable tax and NICs treatment than those who are lower paid.²³

Writing in *Taxation* magazine, the editor, Andrew Hubbard, suggested that this “takes us in a wholly new direction”:

There are times – and losing a job is one of them – that are out of the ordinary and where it is wholly appropriate for someone to take advice on the taxation of what is often the single largest sum they will ever receive.

After all, it is standard practice for an employee signing a compromise agreement to take independent legal advice. Getting rid of the need to take tax advice at such a crucial time should not be a design principle for reform in this area.²⁴

Turning back to the consultation paper, while the Government proposed removing any distinction between contractual and non-contractual payments, it stated that there remained “a principled case for providing support in the form of tax and NICs relief when someone loses their job.”²⁵

The paper asked for views on the best approach for designing an exemption, and in particular, on basing its monetary value on someone’s years of service with their employer:

²² [Simplification of the Tax and National Insurance Treatment of Termination Payments](#), July 2015 para 1.3-4

²³ *op.cit.* para 3.3, 3.5

²⁴ “This week: consultation on termination”, *Taxation*, 13 August 2015. See also, “Written in stone”, *Taxation*, 3 December 2015

²⁵ [Simplification of the Tax and National Insurance Treatment of Termination Payments](#), July 2015 para 4.3

This would create a new fairer exemption which will proportionately reward long serving, lower paid employees. Linking the availability of relief to the length of service of the employee would create a simple system that is easy to understand and easy for employers to administer.²⁶

The paper also asked for views as to whether the rules for NICs liability on payments should be fully aligned with the tax rules, and whether any or all of the existing exemptions that apply in addition to the £30,000 exemption – for death, foreign service, etc – should be retained.

In the event HMRC received 109 written responses from a variety of different groups. Respondents included tax advisory firms, employers of all sizes from different sectors, and individuals.²⁷

In his 2016 Budget statement the then Chancellor, George Osborne, announced a number of measures to tackle tax evasion and avoidance, and as part of this, confirmed that the Government would “tighten rules around the use of termination payments. Termination payments over £30,000 are already subject to income tax. From 2018, they will also attract employer national insurance.”²⁸

The 2016 Budget report announced that the Government would “undertake a technical consultation on tightening the scope of the exemption”²⁹ and this was [launched in August 2016](#).

HMRC’s consultation document gave a summary of the changes to be made from April 2018:

From April 2018, the government will:

- Continue to support individuals when they lose their job by ensuring that:
 - the first £30,000 of a termination payment remains exempt from income tax; and
 - any payment paid to any employee that relates solely to the termination of the employment continues to have an unlimited employee NICs exemption.
- Clarify the scope of the exemption for termination payments to prevent manipulation by making the tax and NICs consequences of all postemployment payments consistent.

In order to achieve this, the government will tax and subject to Class 1 NICs any payment that the employee would have received if they had worked their notice period, even if the employee is asked to leave employment immediately or part way through their notice period. This will also remove the confusion about the different rules for payments in lieu of notice (PILONs) by making all PILONs taxable and subject to Class 1 NICs.

²⁶ *op.cit.* para 4.16

²⁷ A full list is given in [Annex B](#) of, *Simplification of the tax and National Insurance treatment of termination payments*, August 2016

²⁸ HC Deb 16 March 2016 c956

²⁹ [Budget 2016, HC 901, March 2016 para 2.26](#)

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- Align the rules for income tax and employer NICs so that employer NICs will be payable on payments above £30,000 (which are currently only subject to income tax).
- Make the following changes to the exemptions for termination payments:
 - remove foreign service relief; and
 - clarify that the exemption for injury does not apply in cases of injured feelings because of the divergence of judicial decisions about this issue.³⁰

HMRC's consultation paper gave more details of the responses received, and the Government's reasons for its approach.

First, in relation to the **different tax treatment for contractual and non-contractual payments**, the majority of respondents supported removing this distinction as it applied to **PILONs**:

Around two-thirds of respondents agreed that removing the different tax and NICs treatment of PILONs would remove complexity because the distinction causes confusion and can result in incorrect tax and NICs being paid. Some respondents thought that the distinction should be removed on principle and the current system is unfair because it gives preferential treatment to those paid non-contractual PILONs.

Others thought that the tax treatment should be based on the circumstance, rather than the form of the payment, i.e. all PILONs should be treated the same. A few respondents highlighted that in their experience PILON clauses in contracts are increasing, meaning that the different treatment is an anomaly with little practical purpose.³¹

By contrast "opinion was fairly split" as to the wider treatment of these two categories:

Support for retaining the distinction between contractual and non-contractual termination payments was slightly higher, on the basis that it was clear and widely understood.

Some stated the distinction should not be removed as it aligned with basic legal principle that something 'contractual' is 'from the employment' and that 'non-contractual' means a payment relates directly to the termination. They argued that any payment explicitly relating to compensation for loss of the employment, such as statutory redundancy payments, should fall under the termination payment rules, whereas anything from the contract or which was customary (such as holiday pay) should be taxed and subject to NICs as earnings in the same way as salary or holiday pay would be taxed during employment.

A number of respondents highlighted that non-contractual termination payments can be a useful negotiating tool when ending an employment, particularly given the tax exemption [and] ... that removing the distinction would impair this.³²

Second, respondents expressed a variety of views as to **preventing manipulation** of the rules:

³⁰ [Simplification of the tax and National Insurance treatment of termination payments - consultation on draft legislation](#), August 2016 p4

³¹ *op.cit.* Part 2A paras 4-5

³² *op.cit.* Part 2A para 8-9

The Government is aware that some employers and employees manipulate the current rules to provide the most favourable tax and NICs outcome by breaking contracts and/or creating circumstances that effectively turn a contractual payment into a non-contractual payment of damages. This can be done by breaching the employee's terms and conditions, for example by not giving minimum notice...

Some respondents said they were unaware of such practices and the current rules sufficed. However, other respondents said they had seen these practices and made a range of suggestions on how best to tackle this form of manipulation. Respondents put forward a number of ideas including a lifetime limit on termination payments to prevent serial abuse. A number of respondents suggested aligning tax and NICs so employers would not be encouraged to breach an employee's contractual terms and conditions. Another idea was that HMRC should provide clearer guidance on what constitutes redundancy under a fixed-term contract and what is compensation for ending employment.³³

Third, there was a general consensus that the **£30,000 exemption** should not be replaced with an exemption based on the employee's length of service:

The vast majority of respondents did not want the existing threshold to be reduced from £30,000. Some suggested that the threshold should be uprated by inflation from when it was set at £30,000 in 1988, or be index-linked in future ...

The consultation also considered whether the exemption should be dependent on length of service. The responses were strongly against such a change, with many respondents raising concerns that this would not support simplification and would be more complex than the current flat rate. Some respondents fundamentally disagreed with the proposition and argued it could be discriminatory for certain individuals such as those who had not been in a job for a long time, who were young, part-time workers and those who had been on a career break. Others were concerned it could inhibit some employees' careers as they could be reluctant to move role.³⁴

In the light of these views, the Government proposed that both types of PILON should be taxed in the same way. Only payments directly related to the termination of employment would be able to use the current exemption, which would remain set at £30,000:

On the basis of responses to PILONs, the government has decided to remove the distinction between the different types. The majority supported removing this distinction and the government believes this change will provide more clarity and certainty. However, it is clear that the general distinction between contractual and non-contractual termination payments is useful and not consistently found to be complex. Removal of the distinction could add new complexity given the need for additional rules to prevent manipulation, therefore, the government has decided to retain that distinction.

Nevertheless, it will ensure that only payments directly related to the termination of the employment may use the exemption. The

³³ *op.cit.* Part 2A para 12-13

³⁴ *op.cit.* Part 2C para 11, 13

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government believes it is fair that any payments that would have been made in the absence of the termination should be taxable and subject to Class 1 NICs ...

In order to determine which post-employment payments (or proportion of a payment) will be subject to the exemption, employers will need to refer (as they do now) to the employee's underlying employment contract and other terms and conditions. Any payment that covers part of the existing contractual entitlement, including the notice period even if the employee does not work it, will be taxed and subject to Class 1 NICs as earnings. Anything that is non-contractual will be the termination payment which will be taxed and subject to employer NICs on any amount that exceeds the £30,000 threshold...

The government has decided to maintain the £30,000 threshold. The government felt there was not a strong enough case to increase the threshold, particularly given the additional Exchequer cost. Maintaining the £30,000 threshold means the majority of termination payments will be free from tax and NICs.³⁵

In addition the liability for employer NICs would be aligned with that for income tax:

The government will also align the employer NICs and income tax treatment ... The government believes that the combination of these changes will remove the incentive to manipulate the rules, and will ensure that the termination payments exemption is there to support those who have lost their job ...

The government recognises that this will impose an additional cost on some employers but the majority of termination payments will continue to be exempt because they are less than £30,000.

The employee NICs exemption on termination payments will remain unchanged to minimise the impact on individuals – a concern that was raised by a number of respondents to the consultation. The government firmly believes that the decision to align only employer NICs strikes the right balance between delivering simplification for employers, and fairness for individuals who are losing their jobs.³⁶

Finally the consultation has asked whether the existing **exemptions – for death, foreign service, etc** – should be amended in any way. The majority of respondents took the view that many of these exemptions were fair, and should be retained. This included the **exemption for termination payments because of disability or injury**, although there were concerns over its potential misuse:

Many respondents were concerned that it may not always be used as intended and that medical advice should be required. It was also highlighted that the use of this exemption could grow if employees and employers sought to bring other payments under the exemption by claiming injured feelings.³⁷

In turn the Government proposed an amendment to clarify its scope:

Recent divergent judicial decisions on this issue mean that the government has decided to make an amendment to clarify that the exemption does not apply in cases of injured feelings. This

³⁵ *op.cit.* Part 2A para 14, para 16, Part 2C para 15

³⁶ *op.cit.* Part 2A para 15, Part 2B para 8-9

³⁷ *op.cit.* Part 2C para 19

reflects what HMRC considers is the correct interpretation of the existing legislation. In order for the exemption to apply there must be an injury or disability of a physical or psychological nature that is sufficient to cause the employee to be unable to perform his or her job properly.³⁸

There were a variety of views as to the case for retaining **Foreign Service Relief** ...

Foreign Service Relief allows termination payments for certain qualifying individuals to be completely exempt from income tax. Employees who receive termination payments while working in the UK but who have worked for their employer outside of the UK for more than 75% of the last 20 years do not have to pay any income tax. If an employee has worked abroad but does not meet the 15 qualifying criteria for a 100% deduction, they may be able to receive a smaller relief which is proportionate to their time worked outside the UK for that employer.

Some argued Foreign Service Relief is a protection for those who work abroad and described it as a vital part of the territorial system. There were concerns that removing the relief could cause inequitable results and reduce mobility.

Others wanted to retain the relief but with significant simplification ... Some felt it should be removed because it is rarely used and some employers do not apply it even when employees meet the criteria. Others commented that the exemption was unfair, providing a lucrative form of remuneration with little rationale.³⁹

... and the Government announced that this exemption would be removed:

The Government believes the Foreign Service Relief has become outdated and unnecessary. A termination payment is normally offered as a lump sum at a single point in time and for this reason, the government will tax the payment as such and from April 2018, Foreign Service Relief will be removed. Today there is a global workforce and this exceptional treatment is no longer justifiable. Those who have worked abroad will continue to benefit from the £30,000 tax-free threshold. This will help achieve the government's aims of a fairer system.⁴⁰

In general there does not appear to have been very much comment in the press or the House on the Government's proposals, although the Chartered Institute of Taxation raised concerns that the new regime would be too complicated:

Colin Ben-Nathan, Chair of CIOT's Employment Taxes Subcommittee, said: "We are disappointed that it seems the Government has not taken greater account of the work of the OTS to encourage simplification of the income tax and NICs treatment of termination payments.

"Instead of a move to simplify we will end up with more complexity, particularly as regards to new rules aimed at taxing non-contractual pay in lieu of notice which presently fall within the £30,000 exemption. These rules extend over seven pages of legislation and, amongst other things, will require employers to

³⁸ *op.cit.* Part 2C para 28

³⁹ *op.cit.* Part 2C paras 21-4

⁴⁰ *op.cit.* Part 2C para 29

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guess an employee's 'expected bonus income' and other benefits by way of bonus that employees 'could reasonably be expected to receive' during the 'default period'."

The CIOT added that the intention to impose employer NIC on termination payments in excess of £30,000 will raise revenue for the Exchequer without there being any balancing increase in the £30,000 income tax exempt threshold which has been unchanged since 1988 ... [It] is also likely to cause confusion among employers as regards when, and to what extent, payments made on the termination of an employment are liable to employer NIC, employee NIC, both or neither.

Colin Ben-Nathan said: "... By imposing an employer-only NIC on termination payments over £30,000 this may make employers more inclined to reduce termination packages to compensate for the additional employer cost. And so the extra revenue accruing to the Exchequer may ultimately be funded by those who will have lost their jobs which surely cannot be the Government's intention".

The CIOT has also called for the Government to rethink its plan to abolish the Foreign Service Relief (FSR) exemption from April 2018. ... Colin Ben-Nathan added: "FSR is as relevant and necessary today as it was when it was introduced. It has worked well over many years to ensure that tax paid on termination payments properly reflects where part or all of the work was undertaken abroad."⁴¹

Writing on the proposals in the *Tax Journal*, Alasdair Friend (Baker & McKenzie) also suggested that while simplification was "the express aim" of the reform, "the eight pages of draft legislation suggest that the opposite might well be the result." Mr Friend also noted the proposal to abolish Foreign Service Relief, although, in contrast to the points made by the CIOT, he commented, "in practice, this was only ever applicable in a very small number of instances."⁴²

The Government provided an update on its plans in the Autumn Statement in November 2016 ...

4.10 Termination payments – As announced at Budget 2016, from April 2018 termination payments over £30,000, which are subject to income tax, will also be subject to employer NICs. Following a technical consultation, tax will only be applied to the equivalent of an employee's basic pay if their notice is not worked, making it simpler to apply the new rules. The government will monitor this change and address any further manipulation. The first £30,000 of a termination payment will remain exempt from income tax and National Insurance.⁴³

... and draft legislation was published the following month.⁴⁴ HMRC's tax and information & impact note gave details of the changes to be made to the law ...

⁴¹ CIOT press notice, [Termination payment rules likely to confuse workers and confound employers, experts warn](#), 25 October 2016

⁴² "Q&A: What's proposed on termination payments", *Tax Journal*, 16 September 2016

⁴³ *Autumn Statement 2016*, Cm 9362, November 2016 p36

⁴⁴ Legislation relating to National Insurance cannot be included in the annual Finance Bill, so that HMRC confirmed at this time these reforms would be included in a future NICs Bill: HMRC, [Draft legislation: termination awards](#), December 2016.

Current law

The termination payments legislation is contained within Chapter 3 of Part 6 of the *Income Tax (Earnings and Pensions) Act (ITEPA) 2003*. There is currently no corresponding NICs legislation to Chapter 3 of Part 6.

Proposed revisions

Legislation will be introduced in *Finance Bill 2017* to amend Chapter 3, Part 6 of ITEPA 2003. The key changes to create the concept of post-employment notice pay are achieved by inserting a number of new sections.

The legislation splits an employee's termination payment into two types of payment: payments that can still benefit from the £30,000 threshold and those that cannot. The legislation works by first identifying any payments that should be treated as earnings and any remainder is then subject to the £30,000 exemption.

The legislation ensures that statutory redundancy payments remain exempt from Income Tax up to the £30,000 threshold.

Foreign service relief is removed through amendment to sections 413 and 414 of ITEPA. It is retained for seafarers.

A new power to vary the threshold upwards or downwards is also provided.

The employer NICs charge on termination payments over £30,000 is achieved through amendment to section 10 of the *Social Security Contributions and Benefits Act 1992*. The amendment specifies that a Class 1A charge will apply to termination payments that count as employment income under section 403 ITEPA, provided the earner also pays Income Tax on that termination payment.

This legislation does not set out the way that the Class 1A charge will be collected as this will be covered in secondary legislation in due course. It is anticipated that this Class 1A charge will arise and be paid in 'real-time', rather than after the end of the tax year, as with other Class 1A charges.

and the anticipated impact on employers and employees:

Impact on individuals, households and families

There is not expected to be any significant impact on individuals or households. The change is not expected to impact on family formation, stability or breakdown ...

Impact on business including civil society organisations

This measure will have no ongoing impact on compliant businesses and civil society organisations who already apply the rules regarding taxation of termination payments correctly. It will only impact on businesses that structure termination payments to reduce the tax and NICs due. All employers will be required to pay employer NICs on payments above the £30,000 threshold that are not subject to an exemption.⁴⁵

⁴⁵ HMRC, [Income Tax and National Insurance contributions: treatment of termination payments – tax information & impact note \[updated\]](#), 4 April 2018

3. Budget 2017 & Finance (No.2) Act 2017

The Government confirmed that it would proceed with this reform at the time of the Budget in March:

As announced at Budget 2016 and confirmed at Autumn Statement 2016, the Government will legislate in Finance Bill 2017 to tighten and clarify the tax treatment of termination payments. This will include making all contractual and non-contractual payments in lieu of notice taxable as earnings and requiring employers to tax the equivalent of an employee's basic pay if notice is not worked.

Legislation will also be introduced in the NICs Bill 2017 to align the tax and employer NICs treatment of termination payments so that employer NICs will be payable on the elements of the termination payment exceeding £30,000 on which Income Tax is due. The first £30,000 of a termination payment will remain exempt from Income Tax and NICs. The changes, including to Foreign Service Relief, will take effect from 6 April 2018.

Following consultation on the draft legislation, the government will include legislation to abolish Foreign Service Relief in Finance Bill 2017-18.⁴⁶

It was estimated that this measure would raise just over £400m a year from 2018/19.⁴⁷

In the days after the Budget this measure was not discussed in the press or in Parliamentary debate in any detail,⁴⁸ although it was mentioned briefly in evidence submitted to the Treasury Committee, as part of [their inquiry on the Budget](#).⁴⁹ As in earlier years, the Committee had invited evidence from the four main professional bodies on the tax measures in the Budget to be introduced in the Finance Bill, and there was some mention of the proposed reforms to termination payments. In their evidence the Institute of Chartered Accountants argued that the reforms "do not offer much by way of simplicity":

The tax treatment of termination payments will be changed and will include making all contractual and non-contractual payments in lieu of notice (PILON) taxable as earnings and requiring employers to tax the equivalent of an employee's basic pay if notice is not worked. The tax and employer NIC treatment of termination payments will also be aligned so that, for example, employer NIC will be payable on the elements of the termination payment exceeding £30,000 on which income tax is due. The first

⁴⁶ HM Treasury, [Overview of tax legislation and rates](#), March 2017 para 1.8. In November 2017 the Government stated it would introduce a separate NICs Bill in 2018 to include this provision relating to employer NICs. The legislation would take effect from April 2019 ([Written Statement HCWS220, 2 November 2017](#)).

⁴⁷ *Spring Budget 2017*, HC 1025, March 2017 p29 ([Table 2.2 – item ar](#)).

⁴⁸ The one PQ on this issue this Session pre-dated the Budget itself: [PO62921, 7 February 2017](#). See also, "Termination payments", [Tax Adviser magazine - Employment Taxes Voice \(issue 2\)](#), March 2017

⁴⁹ The timing of the Election dissolution meant that the Committee did not have time to complete a full report.

£30,000 of a termination payment will remain exempt from income tax and NIC.

Our view is that these changes do not offer much by way of simplicity and are incomplete, which adds to the uncertainty.⁵⁰

The Chartered Institute for Taxation had some concerns as to the drafting of the legislation, if not the reforms themselves:

6.3 Termination payments etc: amounts chargeable on employment income [clause 14]

6.3.1 This measure is intended to bring fairness and clarity to the taxation of termination payments by making it clear that all payments in lieu of notice (PILONs), not just contractual payments in lieu of notice, are taxable earnings. All employees will pay tax and Class 1 NICs on the amount of basic pay that they would have received if they had worked their notice in full, even if they are not paid a contractual PILON. This means the tax and NICs consequences will no longer depend on how the employment contract is drafted or whether payments are structured in some other form, such as damages. In this way, the measure is designed to bring coherence to the tax treatment of termination payments.

6.3.2 On the whole, we think that the legislation will achieve its policy objectives, although the drafting is complex and difficult to follow in places, and can give rise to anomalies. For instance, Class 1A National Insurance is payable by the employer on amounts which are taxable for the employee, yet this Class 1A National Insurance is to be paid in 'real time', unlike other forms of Class 1A which are payable by 22 July following the end of the tax year.⁵¹

Finally, in their submission the Association of Tax Technicians noted their earlier concerns, made in response to the Government's consultation, "that the treatment of Payments in Lieu of Notice as 'earnings' for the purpose of National Insurance would adversely affect employees during a time when they may be feeling particularly vulnerable."⁵²

The *Finance Bill 2017* was published on 14 March, and initially this provision formed [clause 14 of the Bill](#). Following the Prime Minister's announcement, [on 18 April](#), of the Government's intention to call a General Election on 8 June, the House completed all of the remaining stages of the Bill in the Commons on 25 April and the *Finance Act 2017* received Royal Assent on 27 April. With cross-party support the Government removed a series of clauses from the Bill, with the intention of legislating for these at the start of the new Parliament – including this clause.⁵³ In turn this second [Finance Bill](#) was published on 6 September, including this provision.⁵⁴

Subsequently the Government confirmed it would present its first autumn Budget on 22 November, and introduce a Finance Bill after

⁵⁰ Treasury Committee, [Budget 2017 inquiry: ICAEW - written evidence \(B170001\)](#), 19 April 2017 pp6-7

⁵¹ [Budget 2017 inquiry: CIOT - written evidence \(B170002\)](#), 19 April 2017 p9

⁵² [Budget 2017 inquiry: ATT – written evidence \(B17004\)](#), 19 April 2017 para 1.8

⁵³ [HC Deb 25 April 2017 c1013](#).

⁵⁴ specifically [clause 5 of the Bill](#). For details see, [Finance Bill 2017 - Explanatory Notes \(Bill 102 – EN\)](#), September 2017 pp12-15.

this.⁵⁵ The Government published [draft clauses for this Bill on 13 September](#), in line with previous practice in recent years for publishing much of the Bill in draft for consultation,⁵⁶ and this included provision to remove Foreign Service Relief.⁵⁷

Prior to the formal presentation of the Finance Bill, the House has to agree a series of 'Ways and Means' Resolutions, relating to the measures that will be in the Bill. Normally this occurs at the end of the Budget debates that the House has after the Budget statement – as happened on [14 March 2017](#). As the Government's second Finance Bill was a new one, the House approved a second series of resolutions on 6 September, and during this debate there was some mention of the proposals regarding termination payments. Speaking for the Opposition Peter Dowd said:

The proposed measures on termination payments, if they reflect what was before the House before the election, will target sacked workers as a source of revenue. If there is genuine evidence of the abuse of payments in lieu of notice, that needs to be acted on, but the Government have tacked on a power for the Treasury to reduce the tax exemption on termination payments without primary legislation. That would be a U-turn on their previous statements about dropping such plans. If there is no intention to use the power to reduce the exemption, then the measures should be amended so that it can only be updated, not reduced. The Government also heartlessly want to enshrine the taxable status of "injury to feelings" compensation. Even when that reflects HMRC's practice, why is it seen as a priority for legislation?⁵⁸

Speaking for the SNP Kirsty Blackman expressed concern over this change, "because I have not seen any evidence to show that the issue is as significant as the Government are suggesting", and several other Members mentioned the issue in the debate.⁵⁹ Concluding the debate the Financial Secretary Mel Stride responded to these points saying, "the £30,000 tax-free allowance will still be available and statutory redundancy will be tax-free. However, we must face the fact that, while it may be a particularly easy argument to prosecute that we are somehow beating up those who are losing their jobs, the reality is that that situation is being used as a vehicle for tax avoidance, and when the Government find tax avoidance, we will clamp down on it."⁶⁰

The issue was also raised when the Bill received a Second Reading on 12 September – first, by the Financial Secretary to the Treasury when he opened the debate:

Let me now deal with termination payments ...

The current rules are unclear and complicated. Some payments are taxed as earnings, some are only taxed above £30,000, and

⁵⁵ [HM Treasury press notice, 12 September 2017](#)

⁵⁶ [Draft legislation for Finance \(No.2\) Bill, HCWS113, 6 September 2017](#)

⁵⁷ This now forms [s10 of FA2018](#). For details see, HMRC, [Termination payments: removal of foreign service relief \[updated\]](#), 6 April 2018

⁵⁸ [HC Deb 6 September 2017 c206](#)

⁵⁹ [op.cit. c214](#). Other Members mentioning this issue included Wes Streeting (c326), Ruth George (c242), and Steve McCabe (c247).

⁶⁰ [op.cit. cc252-3](#)

others are completely exempt from tax and national insurance contributions. Although most employers use the current rules as intended, the present system allows some to ignore those rules and deliberately manipulate their payments to minimise their tax by exploiting the differential tax treatment. That is clearly not fair. The Bill makes the rules simpler and fairer by recommending that we exempt the first £30,000 of termination payments from tax, while tightening the rules in respect of what is rightly included within such payments.

In last week's debate, some Members raised concerns that the Government would be taxing compensation that is paid to employees when it is proved that they have been discriminated against—for example, after an employment tribunal. I am happy to reassure them.

All compensation awards caused by proven discrimination against someone in employment will remain completely exempt from tax. All that the Bill does in the way of change is close the obvious loophole that enables an employer to treat part of a termination payment, as opposed to a tribunal award, as an "injury to feelings" in order to benefit from the tax exemption. It is HMRC's longstanding position that if an employee claims a tax exemption for injury, it must have actually impaired that employee's ability to work, and the Bill simply reconfirms that position.

Members also raised concerns that the Government intended to reduce the tax-free amount from £30,000. The Bill makes no such provision. If there were ever any desire to reduce the tax-free amount, it would be subject to a statutory instrument and the affirmative procedure, so the House would have to expressly approve any such proposal.⁶¹

Second, Peter Dowd reiterated the Opposition's concerns on this issue in his speech in the debate:

The changes to the tax treatment of termination payments will mean that people who lose their jobs may face higher tax bills when they are least able to pay—people like the thousands of HMRC employees in my constituency, and in others, who are being forced to choose between relocating or being given their P45s ...

No evidence has been produced to show that the proposals will simplify very much. The Government must stop looking to ordinary workers to pay for their mismanagement of the public finances. Instead, they should stop the smoke and mirrors games and get serious on tax avoiders.⁶²

Finally, Ruth George, who had mentioned the issue in the Ways and Means debate, picked up on the Minister's comments:

I was pleased to receive the assurances from the Financial Secretary earlier, with the guarantee that the £30,000 of tax-free money on termination of employment would continue and that there would be no taxation of discrimination compensation payments following a tribunal. However, Ministers need to recognise the ill feeling and hurt feelings that are often caused when an employee is made redundant. Those payments can be genuine and Ministers need to look again at that matter.⁶³

⁶¹ [HC Deb 12 September 2017 c669](#)

⁶² [op.cit. c681](#)

⁶³ [op.cit. c721](#)

These concerns were reiterated when the House debated this provision of the Bill – one of the clauses selected for debate on the floor of the House on [11 October 2017](#). On this occasion the Opposition tabled several amendments – to withdraw provisions allowing the £30,000 threshold and the definition of basic pay used in the legislation to be amended by secondary legislation; and to extend the tax exemption to termination payments made for ‘psychiatric injury’ and ‘injured feelings’. Speaking for the Opposition Peter Dowd said, “the Government seem to have taken a scattergun rather than forensic approach to this matter, affecting everyone regardless of the circumstances”:

The key point is whether people who have been made redundant should have further worries about their financial future vis-à-vis redundancy, and that sets a hare running, whether the Government like it or not.

As for the consultation, the bottom line is that it was at best inconclusive. Many non-vested respondents suggested that it would be appropriate to uprate the threshold, rather than reduce it—I do not necessarily agree, but that was the case—but there is absolutely no evidence of that, which in the current climate will unnerve many people. Therefore, once again, at the last minute, I ask the Minister to withdraw this iniquitous proposal.⁶⁴

However, the Minister opposed each of these amendments, as well as one tabled by Kirsty Blackman for the SNP a formal review of the impact of the change on low-income workers:

Amendment 1 would remove the power to amend the meaning of basic pay for the purposes of calculating post-employment notice pay by regulation. When we consulted on this measure, we listened to responses that asked us to make the basic pay definition more simple. It now excludes overtime, bonuses, commission and tips. However, we introduced this power to allow the Government to act quickly and to remain flexible if there is manipulation in the future ...

Amendment 2 and consequential amendment 3, ... would remove the power to reduce the £30,000 threshold by regulation. Some Members have raised concerns during the debate that the Government intend to reduce this tax-free amount. We have no intention to do so. If we were to do so, we would ...be required to do so by an affirmative statutory instrument ...

Amendment 4 would include injured feelings within the definition of injury ... The reason for [this exclusion] ... is clear: without it, there would be a large loophole ... allowing payments to be routinely reclassified on account of injury to feelings, and without medical evidence, simply in order for people to pay no tax. These things are hard to prove or disprove, and would be difficult for HMRC to police. However, it remains the case that payments on account of an injury to feelings, like any normal termination payment, will qualify for the £30,000 tax exemption ...

Amendment 12, tabled by the hon. Member for Aberdeen North, would require a review of how these changes will affect low-income workers. That is unnecessary because only 85% of the payments are below £30,000. As I have explained, the provisions do not affect awards for discrimination at work, for example. We have also maintained the £30,000 income tax exemption. We

⁶⁴ HC Deb 11 October 2017 c372

have considered the impact on low-income workers throughout, and we will continue to do so.⁶⁵

In the event the House divided on three of these amendments, but they were all negated and the clause agreed without amendment. At the Report stage of the Bill the Opposition moved its amendments regarding the £30,000 threshold and the definition of injury a second time, but they were negated on this occasion as well.⁶⁶

As noted, the Government had intended to include provision to amend the NICs treatment of termination payments in a separate NICs Bill, to take effect from April 2019.⁶⁷ The Bill was also to make provision to reform the structure of Class 2 NICs, paid by the self-employed, but in September 2018 the Government announced it would not proceed with this separate reform.⁶⁸ Consequently in the 2018 Budget the Government confirmed that it would introduce a Bill of smaller scope, to make this change to the NICs treatment of termination payments, as well as the NICs treatment of income from sporting testimonials, from April 2020.⁶⁹

A second Commons Briefing note has more details on this legislation.⁷⁰ During the Committee stage of this legislation, Exchequer Secretary, Robert Jenrick set out the Government's rationale for introducing a new Class 1A NICs charge on termination awards:

Termination awards that are not earnings are currently charged to income tax on amounts that exceed £30,000, and they are currently entirely exempt from employee and employer national insurance contributions. Allowing the difference between the income tax treatment of that income and the employer national insurance treatment to persist would be confusing, and continue to provide an incentive for employers to manipulate final payments to achieve a tax advantage.

[Clauses 1-2] will close that loophole, simplify the tax system, and raise about £200 million in revenue to continue to support the funding of public services in a significant way.⁷¹

The Minister also underlined that the Bill would not make any wider changes to the taxation of redundancy payments, and reiterated the Government's commitment to retain the £30,000 exemption threshold:

[These clauses] do not introduce a NICs liability on the employee ... There remains an unlimited employee national insurance charge exemption on termination awards. Although there is a principled case for greater simplification and alignment by applying employee NICs to that income, the Government have listened carefully to representations made during the consultation, and we believe that our approach strikes the right balance between delivering greater simplification for employers, and fairness to individuals who are undoubtedly in a difficult period of

⁶⁵ HC Deb 11 October 2017 cc 371-2

⁶⁶ [HC Deb 31 October 2017 cc747-54](#)

⁶⁷ [Written Statement HCWS220, 2 November 2017](#)

⁶⁸ [Written statement HCWS944, 6 September 2018](#)

⁶⁹ [Budget 2018, HC 1629, October 2018 para 3.12](#); HMT, [Overview of Tax Legislation and Rates, October 2018](#) para 2.14

⁷⁰ [National Insurance Contributions \(Termination Awards and Sporting Testimonials\) Bill 2017-19, Commons Briefing paper CBP8554](#), 14 June 2019

⁷¹ Public Bill Committee, [Second Sitting](#), 14 May 2019 c33

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their lives: losing their jobs and having to make the necessary adjustments.

Secondly, the clauses do not reduce or seek new powers to change the existing £30,000 threshold, below which termination awards are entirely tax-free and NICs-free. ... That threshold remains generous compared with those of many other countries, including the United States and Germany, that tax income linked to a termination from the very first pound. It will ensure that about 80% of awards are unaffected by [these clauses] ... and that awards made as statutory redundancy pay are untouched. We have no plans to lower the threshold in future. Any future Government who wished to do so would need parliamentary approval ...

Finally, the clauses do not introduce any legislation that goes beyond mirroring the effect of the income tax rules with respect to the scope of the change. Instead, by virtue of the clause, the rules that determine liability to income tax will apply directly in calculating the amount of employer class 1A NICs payable on termination awards above £30,000. Therefore, clauses 1 and 2 simplify the tax system and reduce the incentive for manipulating payments to achieve tax advantage.⁷²

⁷² *op.cit.* cc33-4

4. Appendix: Legal background

Office for Tax Simplification, [Review of employee benefits and expenses: interim report](#), August 2013

Annex G: Termination payments legal background

G.1 This annex sets out the key legislation and HMRC policy which is relevant to the taxation of termination payments. It also outlines some of the complexities of this area which have been highlighted by cases considered by the courts.

Legislation

G.2 A major source of complexity is the interaction between the tax legislation which is specific to termination payments and that which taxes general earnings. This is the case both in relation to income tax and NICs. Income tax treatment

G.3 Sections 401 to 416 of ITEPA are income tax charging provisions in respect of "payments and other benefits which are received directly or indirectly in consideration or in consequence of, or otherwise in connection with...the termination of a person's employment".¹ However, these provisions only apply to a termination payment if no other charging provision applies (s401(3) ITEPA).

G.4 In order to determine which charging provision applies to a termination payment, HMRC policy is that the following questions should be raised in the following order, in line with the order of priority which applies to such payments under ITEPA (HMRC Employment Income Manual EIM12810):

- is the payment or benefit earnings from the employment?
- if not, is the payment or benefit for a restrictive covenant?
- if not, and only if no other income tax charge applies, is the payment or benefit made in connection with termination under sections 401 to 416 ITEPA?

G.5 If none of the above applies then the payment is not connected with the termination and therefore is free of income tax and NICs.

Does the payment fall within general earnings?

G.6 "Earnings" is defined under section 62 ITEPA as including "any salary, wages or fee, any gratuity or other profit or incidental benefit of any kind...or anything else that constitutes an emolument of the employment".

G.7 Due to this wide definition, it is often the case that a termination payment will be taxed as earnings under section 62 ITEPA instead of being subject to section 401.

G.8 The one exception to this rule is redundancy payments, which are taxed under section 401, even where provided for under the employment contract, provided that they are made genuinely on account of redundancy (section 309 ITEPA and HMRC Statement of Practice 1/94). An employer operating a redundancy scheme is able to apply to HMRC for specific clearance that the redundancy payments will be taxed under section 401. However, this type of clearance procedure is not available in relation to other forms of termination payment.

¹ Section 401 also extends to payments and benefits on a change of duties or change in earnings, but such payments would ordinarily be taxed as earnings in practice, for the same reasons described above in relation to termination payments.

Is the payment for a restrictive covenant or does it fall within another charging provision?

G.9 If an employer pays its employee on termination in return for the employee agreeing to new restrictions (for example that he will not act in competition or solicit customers or employees), this payment will be fully taxable under sections 225 and 226 ITEPA and subject to NICs.

G.10 Various other charging provisions may apply to a termination payment, depending upon the nature of the payment itself. Specific rules apply to the taxation of shares and rights to shares, as well as payments in respect of pension schemes and employer financed retirement benefits schemes. Any payments made by a third party may potentially be taxable in full under the “disguised remuneration” legislation in Part 7A of ITEPA 2003, which imposes tax on certain payments made by third parties other than the employer or a member of its corporate group.

Operation of Sections 401 to 416 ITEPA

G.11 Subject to the above, if a payment or benefit does fall within section 401 ITEPA, the first £30,000 of its value will be tax-free and any excess above the £30,000 threshold will be taxed as employment income in the normal way. See the end of this Appendix for a note of how this threshold has increased over time.

G.12 Sections 401 to 416 also include tax exemptions from certain types of termination payment. Broadly, these are:

- certain employer contributions to approved personal pension schemes before 6 April 2006 or to registered pension schemes and employer-financed retirement benefit schemes (ss 405,408 ITEPA);
- payments or benefits provided in connection with the termination of employment on death of the employee, or on account of injury to or disability of an employee (s406 ITEPA);
- payments or benefits provided under certain tax- exempt pension schemes (s407 ITEPA);
- certain payments in respect of employee liabilities and indemnity insurance (ss409,410 ITEPA);
- certain payments and benefits for the forces (s412 ITEPA);
- certain payments made by foreign governments (s411 ITEPA);
- payments or benefits made in certain cases of foreign service (in which case a full or partial exemption may apply) (ss413, 414 ITEPA); and,
- payments for certain legal costs in connection with the termination (s413A ITEPA).

NICs treatment

G.13 NICs are payable in respect of any “earnings” received by “employed earners” from their employment (under section 6(1) of the *Social Security Contributions and Benefits Act (SSC&BA) 1992*).

G.14 For NICs purposes, “earnings” includes “any remuneration or profit derived from an employment” (section 3(1) of SSC&BA 1992). Following case law on this area, HMRC policy is that this includes earnings from previous employment. HMRC policy is that when determining whether a payment is “earnings” for NICs purposes, the principles established for income tax in relation to emoluments will apply.

For NICs, a payment will still be earnings if it derives from the employment (NIM02610). Note, however, that a redundancy payment is free of NICs under regulation 25 and paragraph 6 of Part X of Schedule 3 to the Social Security (Contributions) Regulations 2001.

G.15 Therefore, for both income tax and NICs, the meaning of earnings is broadly similar and most items that are earnings for income tax purposes are also earnings for NICs purpose, but if it is compensation paid in settlement of a claim for damages for breach of contract then it will not be.

Different income tax and NICs treatment for payments falling under s401

G.16 As outlined above, if a payment is not general earnings and it is not taxed under any other income tax charging provision then it will fall under section 401 and be subject to income tax to the extent that it exceeds £30,000. Payments of this kind which exceed £30,000 will therefore have a different income tax treatment and NICs treatment: only the amount which exceeds £30,000 will be subject to income tax, but the whole of the payment will be free of NICs on the basis that it does not constitute "earnings".

Difficulties which arise under this tax regime

Identifying the different elements of a termination package

G.17 A termination payment can often consist of a variety of different elements, such as payment in lieu of notice, restrictive covenant payment, compensation for loss of office, unpaid salary, and non-cash benefits provided after termination, payments into a pension scheme. When determining its tax treatment, each element must be separately identified, and then the circumstances and the basis for it being included in the termination payment must be considered in order to confirm which charging provision applies. Employers often fail to appreciate this when drafting the compromise agreement which sets out the terms of the termination payment. Problems often arise:

- **if each element of the termination payment is not clearly identified in the compromise agreement:** In these circumstances it is possible that the payment will be fully taxable as earnings, without taking account of the background in which the payment is being made (Reid v HMRC [2012] UKFTT 182 and Johnson v HMRC [2013] UKFTT 242); and,
- **if the payment is described in a particular way in the compromise agreement:** If the payment is described in a particular way in the compromise agreement then this can inadvertently impact on its tax treatment, even where the contractual position is not clear (Goldberg v HMRC [2010] UKFTT 346).

Determining whether the termination payment constitutes "earnings"

G.18 As a general rule, a termination payment will be treated as "earnings" if it satisfies a right to remuneration in the employment contract or is otherwise an emolument of the employment. In such cases the termination payment will therefore be subject to income tax and NICs in full under section 62, rather than being able to benefit from the £30,000 exemption under section 401 and the associated NICs free treatment.

However, if instead the payment is damages paid in compensation for a breach of the contract then it should not be earnings and should be subject to section 401. The distinction between these two types of payments is not always clear.

Particular difficulties have arisen in resolving the following questions:

- **does the payment satisfy a right to remuneration in the employment contract?** Where it is unclear what the payment represents or the basis upon which it has been calculated, the courts have had to consider whether or not it was paid as a result of a right under the employment contract (*Carter v Wadman* (28TC41) 1946).
- **what does the employment contract consist of?** In establishing whether the payment satisfies a right to remuneration in the employment contract, it is necessary to identify what the contract itself comprises of. This is not necessarily clear, as the contract may have been amended or supplemented over time, or it may be set out in a number of different documents, depending upon the processes followed by the employer in dealing with their employees' terms.

For example in *SCA Packaging Limited v HMRC* [2007] EWHC 270 (Ch) it was decided that a memorandum between the employer and trade unions representing its employees formed part of their employment contract. HMRC takes the view that the contractual arrangements between employer and employee can extend to a variety of different documents. Many employers are unaware of this.

G.19 Even where the employment contract provides for a payment on termination "for any reason" then the payment is treated as earnings rather than compensation for the termination (*Dale v De Soissons* (1950) (32TC118)).

Treatment of payments in lieu of notice (PILONs)

G.20 Employers often terminate the employment immediately by making a PILON instead of giving the full period of notice, and the tax treatment of this type of payment can raise particular difficulties. If it is made under an express provision in the employment contract then it is taxable as "earnings", for the reasons referred to above. However, if it is not expressly provided for in the contract then the courts have found that its tax treatment is less clear, particularly on the following issues:

- **is a discretionary PILON treated as a contractual payment?** If the employment contract expressly gives the employer discretion to make a payment in lieu of notice, and the employer makes such a payment, then the courts treat the payment as taxable earnings arising from the contract (*EMI Group Electronics Limited v Coldicott* (HMIC) (1999)(71TC455). However, the position is less straightforward where the employer has not exercised its discretion to make the payment and has paid damages instead, as a payment of damages may be taxable under section 401.

In those circumstances, HMRC tends to treat the payment as taxable earnings unless there is clear evidence of it being a damages payment. For example, there would need to have been a clear breach of contract by the employer (which justifies the payment of damages) and the payment should have other characteristics of a damages payment, such as being calculated so that adjustments should be made to reflect the difference in tax treatment between earnings from employment and a damages payment. In practice, this can be very difficult for an employer to demonstrate.

- **is the PILON treated as a contractual payment as a result of custom and practice?** HMRC argued in the past that if an employer has made such payments as a matter of custom and practice then they will generally have resulted in an implied contractual right to receive a PILON, which is therefore taxed as if it had been expressly provided for in the contract (*Corbett v Duff* (1941) 23 TC 763). The courts have held that in fact the threshold is high for custom and practice to imply terms into employment agreements (*Clinton v HMRC* [2009] UKFTT 337 (TC) and *SCA Packaging Limited v HMRC* [2007] WEHC 270). HMRC changed its view on this issue in 2003 on the basis that contracts generally include a right to receive notice (either expressly or through statute) and therefore an implied right to receive a PILON would conflict with this (HMRC Tax Bulletin 63).

- **is the PILON treated as a contractual payment because it is made automatically?** HMRC now considers that if the employer makes a PILON as “an automatic response to a termination” (often referred to as an “auto-PILON”) then it can still be taxable as earnings unless the employer has a procedure for making a genuine “critical assessment” in the making of such payments, so that they are not made automatically (HMRC Employment Income Manual EIM12977). Whilst HMRC continues with this policy, a risk remains for companies who are unable to demonstrate that they operate a “critical assessment” procedure in the making of PILONs in these circumstances. HMRC itself has confirmed that it would like to see legislation to clarify how these types of payments are taxed (See Tax Guide 3/11 of the Institute of Chartered Accountants in England and Wales).

Determining the treatment of payments which are not “earnings”

G.21 As referred to above, payments will only be taxable under section 401 if they have been received in connection with the termination and are not chargeable under any other section. The payment must be made “directly or indirectly in consideration or in consequence of, or otherwise in connection with the termination”. The courts have found that the words “otherwise in connection with” under the legislation should be interpreted very widely and can mean “in any way connected with” (HMRC v Colquhoun [2010] UKUT 431 (TCC)). As a result, many payments which might otherwise appear unconnected with the termination itself will nevertheless be subject to tax under section 401. Employers are often unaware of this and therefore do not anticipate that there will be tax due on the payment to the extent that it exceeds £30,000. Tax can therefore be due on various types of payments, including:

- **payments for distress or damage to reputation:** Unfair dismissal awards are taxed under section 401 on the basis that they are received in connection with the termination of employment. If compensation is paid to an employee, for example for damage to reputation, as part of a payment to settle unfair dismissal claims, the courts have found that this is directly connected to the termination of his employment and, therefore, is subject to tax under section 401 (A v HMRC [2009] UKSPC SPC00734.)
- **payments in relation to discrimination:** The courts have found that a compensation payment made by a tribunal or under a settlement agreement to an employee for discrimination may be taxable under section 401 if the discrimination is the cause of the termination of the employment, but only to the extent that the compensation meets financial loss caused by the termination of the employment (Oti-Obihara v HMRC [2010] UKFTT 568 (TC).)
- **gifts:** Due to the wide drafting of section 401 the courts have had difficulty in finding that a cash gift made on termination will not be considered to be received in connection with the termination of employment, and therefore it will be taxable under section 401 (Resolute Management Services Ltd v HMRC [2008] UKSPC SPC00710).

History of the £30,000 exemption

G.22 Following its introduction in 1960, the value of the exemption was increased steadily over the next two decades, but it has now remained the same since 1988. A summary of its increases is as follows:

- 1960: introduced at £5,000 (s37 FA1960)
- 1978: increased to £10,000 (s24 FA/1978);
- 1981: increased to £25,000 (s31 FA1981); and,
- 1988: increased to the current level of £30,000 (s74 FA1988).

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