Employment

Changes to tax on termination payments What you need to know

The way in which tax and National Insurance (NI) contributions are calculated on termination payments is changing. This note summarises the changes.

Background

The Finance (No 2) Bill 2017 includes details of some of the proposed changes to the rules on the tax and NI treatment of termination payments. These provisions were originally included in the Finance Bill 2017 but were removed in order to get the Bill passed before the general election. The changes are due to start coming into force at the beginning of the next tax year.

Redundancy payments

The £30,000 tax exemption will remain, and statutory and contractual redundancy payments will continue to benefit from it (but see below in relation to payments in lieu of notice). Compensation for unfair dismissal, however, will not automatically fall within this exemption.

Payments in lieu of notice

From 6 April 2018, post-employment notice pay (ie pay in lieu of notice) will be fully taxed as general earnings, whether the payment is contractual or not. This means that all payments in lieu of notice will be subject to tax and to employee's and employer's NI contributions. The draft legislation includes complex provisions for calculating post-employment notice pay, which are beyond the scope of this note. The balance of the termination payment above post-employment notice pay is then subject to the normal rules regarding termination payments, including the £30,000 exemption, and is taxed accordingly.

Employers' NI

All termination payments above the £30,000 threshold will be subject to employer's NI on the excess above £30,000 from 6 April 2020. The existing employee NI exemption will be retained, even if the payment exceeds £30,000.

Abolition of foreign service relief

The foreign service relief (FSR) exemption will be abolished from April 2018 for UK resident employees (except in relation to seafarers). FSR wholly or partly exempts non-contractual termination payments from tax where an employee has worked abroad for part of their employment. From April 2018, a more limited 'exception in certain cases of non-UK based employment' will apply. This means that the whole termination payment will be brought into charge if the employee has had earnings subject to UK tax at any point during their employment.

Exemption for injury

Payments for injury to feelings will fall outside the exemption for termination payments relating to death, injury or disability (where there is no financial cap), except where the injury amounts to a psychiatric injury or other recognised medical condition.

Future changes

It is proposed that HM Treasury will have the power to increase or decrease the £30,000 exemption.

A word of caution

These provisions are still in draft and further changes may be made before they come into effect.

What employers need to do

Employers will need to consider these changes in advance of them coming into force, as they are likely to increase the cost of any proposed settlement. In particular, they should look at the timing and, if possible, ensure that the payment falls under the current rules. The changes are also likely to impact on individuals; if they receive lower net payments than at present, they may look to employers to make up the difference.

Where a redundancy programme straddles the start of the next tax year, employees may receive a different net termination payment depending on whether payment is made before or on or after 6 April 2018 and employers will need to consider how to deal with this.

Employers should also think about amending contracts of employment to include contractual payments in lieu of notice (PILON) where they do not already contain them. This is because there will be no tax advantage after next April to not having a contractual PILON. Including such a clause means that the employer will not be in breach of contract by making a PILON, which means that the employee will still be bound by post-termination provisions, such as restrictive covenants. In addition, a contractual PILON can be limited to basic pay only so that benefits will not have to be paid for what would have been the notice period, which will reduce the cost to the employer.

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