Oury Clark Quick Guides:

Oury Clark

Taxation of Termination Payments

Employment: H20

There is a generous tax exemption available which allows up to £30,000 to be paid to an employee tax free as part of a severance payment on termination of their employment.

However, please note that payments in lieu of notice (PILON) are fully taxable and subject to both employee and employer National Insurance Contributions (NICs) regardless of whether there is a PILON clause in the contract of employment.

The Rules

Termination payments can, essentially, be split into two parts:

- The first is post-employment notice pay (PENP). PENP is the amount of basic pay an employee would have earned had the employee worked his or her notice period in full and is taxable as earnings. Similarly, if there is a contractual PILON, the payment will be treated as earnings. So, where an employer makes a PILON pursuant to a discretionary contract, the payment will be taxable as earnings.
- The second is the remaining balance of the termination payment. The balance of the payment is tax free up to £30,000. Any excess over £30,000 will be subject to income tax and employer (Class 1A) NICs.

If the PENP is **equal to or greater** than the entire termination payment, then the £30,000 exemption does not apply, and the entire amount is fully taxable.

If the PENP is **less than** the entire termination payment, the portion of the payment that exceeds the PENP will be tax free up to £30,000. The remainder of the payment is treated as taxable earnings.

- **Examples of Payments which can fall within the £30,000 exemption:**
- Statutory redundancy payments are always within the £30,000 exemption.
- The following payments are examples that **can** fall within the £30,000 exemption to the extent they are not caught by PENP:
- Enhanced redundancy payments, whether due under contract or discretionary, so long as they are genuinely paid in respect of redundancy and not in relation to past or future service.
- Ex gratia payments.
- Damages for wrongful dismissal and payments on account of damages.
- Compensation for unfair dismissal or other breach of statutory rights.
- Non-contractual benefits in kind provided on termination.

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Disclaimer: This note does not contain a full statement of the law and it does not constitute legal advice. Please contact us if you have any questions about the information set out above.

How to calculate PENP

The calculation of PENP differs depending on a number of factors.

The basic formula is: ((BP x D) ÷ P) – T, where:

- BP is the employee's basic pay in respect of the last pay period of the employment ending before the trigger date.
- D is the number of days in the post-employment notice period (broadly the unworked period of notice.)
- P is the number of calendar days in the employee's last pay period.
- T is amounts (other than holiday pay and termination bonuses) that are paid on termination but are taxable as earnings, subject to some exceptions.

Note that D is calculated by reference to the notice that the employer must give (by contract or law). This may be different from the period of notice that the employee must give.

This is a complex area and there are detailed requirements. It should also be remembered that, in addition to the tax considerations outlined above, there are legal requirements connected with termination of employment.
An employer should therefore ensure they take advice on both the tax and the employment law aspects of this complex issue.