

Taxation of termination payments

This newsletter provides an overview of the law in this area. Call us for a complete understanding of how it may affect your particular circumstances.

What are termination payments?

Termination payments are severance payments to employees on termination of their employment. They can arise in a number of ways, for example, in connection with:

- Dismissal or constructive dismissal.
- Redundancy.
- Retirement.
- Departure because of disability.

Termination payments must be taxed correctly

- HM Revenue & Customs (HMRC) can recover unpaid tax, national insurance contributions (NICs), penalties and interest from the business if termination payments are not taxed correctly.
- A business should consider both income tax and NICs. In addition to employee's NICs, the business must pay employer's NICs on payments that constitute earnings from employment. This can add significantly to the costs of settlement.
- If the business does not deduct tax or NICs from a termination payment it will be generally liable for the tax and NICs not deducted, plus interest and penalties. A failure to deliver PAYE returns on time (or at all) may lead to more penalties.
- Both the business and its former employee will want the termination payment to be legitimately structured to:
 - reduce the tax liability; and
 - increase the certainty that no future liability will arise.

How much of the termination payment is taxable?

How much of a termination payment is taxable will depend on the nature

If you would like to discuss any of the matters raised in this newsletter please contact:-

Jane McKee
jmk@blackgraf.com

Tel: 020 7586 1141

The information in this newsletter is not meant as a substitute for advice on particular issues and is written in general terms. You should seek specific advice before taking any action based on the information in this newsletter.

Black Graf LLP 100 Baker Street London W1U
6WG

Black Graf LLP is a Limited Liability Partnership registered in England and Wales registration no: OC334046. Any reference to a partner is to a member of Black Graf LLP. Authorised and regulated by the Solicitors Regulation Authority no: 488394

www.blackgraf.com

This newsletter outlines the law as it stands at the date of writing in August 2015.

and amount of the payment. Payments fall into a number of categories including:

- **Sums that the employee was contractually entitled to or that were connected with, past or future service.** These are generally taxable in full and include:
 - salary payments;
 - contractual bonus or commission;
 - contractual payments in lieu of notice (PILONs); and
 - automatic PILONs.
- **Consideration for entering into restrictive covenants.** This is taxable in full.
- **Non-contractual payments made as a result of the termination and redundancy.** The first £30,000 is tax-free. These include:
 - damages for wrongful dismissal and payments on account of damages;
 - compensation for unfair dismissal;
 - compensation for discrimination made in connection with the termination to compensate for financial loss;
 - payments of statutory and non-statutory redundancy; and
 - non-contractual benefits in kind provided on termination.
- **Payments where termination results from a disability or from a discrimination claim not connected to the termination.** These are tax-free without limit.
- **Share options and share awards.** Employees may be entitled to exercise share options and receive share awards either before or at some point after termination. The tax and NICs liabilities will depend on a number of factors, including:
 - whether the scheme is HMRC approved;
 - the length of ownership; and
 - the reason for cessation of employment.

A cash cancellation or compensation payment will be fully taxable.

- **Employer contributions to registered pension schemes.** These may be made tax free, subject to the annual contribution limit, provided that they do not represent sums to which the employee was

contractually entitled.

National Insurance Contributions

NICs are generally payable for all termination payments that the employee is entitled to under their employment contract. HMRC may argue that NICs are payable where there is an established practice of making termination payments, even where there is no express contractual right.

Tax-free benefits that can be provided to employees

Provided that payment is made directly to the provider of the service, the following services can be made available to an employee without attracting tax:

- Legal fees in connection with a compromise agreement.
- Outplacement counselling.
- Re-training.

