Terminations factsheet

For many, the tax-exempt figure of £30,000 immediately comes to mind when taking into consideration the tax treatment of a payment in relation to the termination of employment. As we know, this is no longer the case, as it cannot be assumed that the £30,000 exempt threshold automatically applies.

In 2018, HMRC introduced changes that would affect the treatment of tax and National Insurance Contributions (NIC) on all termination payments made to an employee. Also coming into effect from 6 April 2020, was employers' Class 1A NICs on any termination payment made over the £30,000.

What is a termination payment?

A termination package is a settlement agreement which is made up of both contractual and non-contractual payments. What the payment is for, will determine if it is liable to tax or can be included in the tax free threshold of £30,000.

What is normally included in a termination payment?

A termination package may include;

- Pay in Lieu of Notice (PILON)
- Untaken holiday pay
- Bonus/Commission
- Redundancy pay
- Ex-Gratia/compensation
- Cash equivalent of benefits

Post-Employment Notice Pay

The introduction of Post-Employment Notice Pay (PENP) which states that all Pay In Lieu of Notice (PILON) and payments derived from the contract of employment (payments that do not fall inside section 403 of ITEPA), ensured that these figures would be fully subject to normal PAYE deductions.

Whilst the £30,000 tax free allowance still stands, what can be included is now restricted to:

- Statutory redundancy pay
  - Tax year 2020-2021 – capped at £538 per week of employment after a 2-year period, maximum claim is £16,140
- Relevant termination awards (RTA) – subject to section 403 ITPEA 2003
  - RTA's are payments or benefits that are received (directly or indirectly) in connection with the termination of a person's employment, but which is not other wise subject to tax.

The new rules make it clear that any monies paid to an employee that would have been received if the employment had not been terminated, are now subject to PAYE, and do not fall within the £30,000.

The introduction of the PENP rules are primarily to simplify and reform the treatment of PILON payments. The tax and NIC treatment has, since 6 April 2018, no longer been dependent on whether a contractual PILON is made, or whether PILONs are made under a custom or practice established by the employer. Instead, a complex formula must be applied by the employer/former employer to calculate the PENP. The outcome of this calculation is always taxable and liable to Class 1 NICs.

Continued overleaf

Working example of PENP

Paul's contract is being terminated on 1st July 2020. He has worked for a company for 14 years and has a monthly salary of £2,500. He has a contractual taxable PILON of one months' notice, however as he has worked for the company for more than two years, he is statutorily entitled to 12 weeks (84 days) notice.

Termination payment

- PILON = £2,500
- Termination payment = £10,000
- Total Payment = £12,500
- BP = 2,500
- D = 84 (the amount of days' notice should be paid for)
- P = 30 (June is the last period)
- T = 2,500 (PILON)
- 2,500 x 84 / 30 = 7,000 – 2,500 = 4,500

Payment to be made

- PILON: 2,500.00 – Tax and NICable as per PAYE
- PENP: 4,500.00 – Tax and NICable as per PAYE
- RTA (Relevant Termination Award): 5,500.00 – Tax and NIC free (under the £30,000 tax free allowance)

PENP – the formula

((BP × D) ÷ P) – T

'BP' is the employee's basic pay in respect of the last pay period of the employment ending before the trigger date. (The trigger date is the day that notice is given, if no notice is give, the trigger date is the last date the employee was employed)

'D' is the number of calendar days in the post-employment notice period.

'P' is the number of calendar days in the employee's last pay period.

'T' is any payment, or benefit received in connection with the termination of a person's employment, which is chargeable to income tax.

Implementation of Class 1A NICs on termination payments

From 6 April 2020, the National Insurance Contributions (NICs) rules affecting termination payments calculated on the amount chargeable to income tax under section 403 of ITEPA 2003 (Income Tax and Earnings Act 2003 i.e the excess of £30,000) are now be subjected to employer Class 1A NICs. In simple terms, if the payment is not made under section 403 and it exceeded the £30,000 allowance, the employee is liable to tax above this amount and the employer would be liable to Class 1A NICs.

Reporting Class 1A NICs on termination payments

Class 1A NICs for termination payments must not be confused with those Class 1A NICs due on expenses and benefits provided to employees. Whilst Class 1A NICs on benefits must continue to be reported via a P11D(b), Class 1A NICs for termination payments are reported via Real Time Information (RTI) and are due in year. This means that software systems have been updated to accommodate this change. The payroll system will have an updated element so that when payments are made that exceed the £30,000 tax free threshold, Class 1A NICs for termination payments are calculated at the rate of 13.8%. This amount is then reported on the next RTI Full Payment Submission (FPS) and included in your PAYE payment for that period.

For employers who payroll their benefits in kind (BiKs), a P11D(b) will still need to be completed to capture any Class 1A NICs due on these benefits. The feature of reporting Class 1A on termination payments via a FPS must not be used for this.

Working example of Class 1A NICs on termination payments

Sue's contract is being terminated on 1st August 2020. She is being paid a termination package of £50,000. £5,000 is being paid as PILON and it has been calculated that £7,500 is PENP. The balance of £37,500 is being paid as a relevant termination award under section 403 ITEPA.

Termination payment

- £30,000 Tax and NIC free to the employee – No employer NICs due
- £7,500 Tax due to the employee. Employer Class 1A NICS due @ 13.8% reported and paid via RTI

Produced by The Chartered Institute of Payroll Professional policy and research team.

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