
TERMINATION OF EMPLOYMENT - TAX CONSEQUENCES

Background

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Background

The various potential elements of a settlement are many and varied, and each need to be considered to assess the tax that may arise - unfortunately, HM Revenue & Customs (HMRC) do not accept that all payments on termination of employment are automatically taxed as termination payments, with the benefit of the termination payments exemptions (such as the £30,000 exemption and the foreign service exemption). Elements that need to be considered include:

- damages for wrongful dismissal;
- redundancy payments;
- compensation for unfair dismissal;
- compensation for discrimination;
- damages for injury to feelings;
- damages for personal injury;
- “ex gratia” payments

Both income tax and national insurance contributions (NICs) need to be considered in each case. Employers are liable to pay employer's NICs on payments which constitute general earnings from employment, and this can add significantly to the costs of settlement, as employer's NICs are currently paid at 12.8%.

It is important that the termination payment is taxed correctly as HMRC can recover unpaid tax and NICs, penalties (up to 100% of the tax liability) and interest from the employer (who has some rights of recovery against the ex-employee) or income tax and national insurance from the ex-employee.

In addition, following changes to HMRC rules, from April 2010, employers will no longer be able to “catch up” with PAYE errors and underpayments. Payments will need to be dealt with on time and accurately. At the moment, provided that all is sorted by the end of the tax year, few penalties and interest arise from errors made and resolved during the year. From April 2010, each monthly PAYE return will need to be correct to avoid penalties and interest. One “late” payment a year will be allowed, but subsequent late payments (including catch up payments on errors) will be subject to penalties of between 2% and 12% of the income tax and/or NICs involved.

The following all apply to compromise agreements and settlements, and assume that the ex-employee is UK domiciled and resident.

Taxation

HMRC follow the order of priority in statutory provisions governing the tax treatment of payments and assess each element of any settlement as follows:

- does the payment fall within the category of general earnings, or is it a benefit of the employment?¹ (fully taxable)
- if not, is the payment for a restrictive covenant? (fully taxable)
- if not, is the payment in respect of a non-approved retirement benefit scheme? (fully taxable)
- if not, is the payment a payment taxable under the taxation of termination payments provisions?² (first £30,000 tax exempt; other exemptions also available)

If a payment is capable of being categorised as both a termination payment and general earnings, it will be taxed as general earnings rather than a termination payment. The £30,000 exemption is only available where the payment cannot fall into any other taxable categories.

HMRC will not take the view that all payment under a compromise agreement should be regarded as termination payments - for example, damages in respect of unpaid notice are taxable as general earnings. In fact, the termination payments tax provisions only apply if the termination payment cannot be taxed under any other provision of the Taxes Acts.

HMRC are examining termination payments much more carefully than previously, where any benefit is claimed under s410-416 ITEPA.

General earnings

Earnings include any salary, wage or fee, any gratuity or other incidental benefit of any kind obtained by an employee consisting of money or money's worth, and anything that constitutes an emolument of the employment. Employment is not exhaustively defined in tax legislation, but includes employment under a contract of service or of apprenticeship, or in the service of the Crown. Directors and office holders are also considered to be in employment for tax purposes.

Earnings must derive from employment but need not be paid directly by the employer, and do not need to be paid directly to the employee (for example, where the employer settles debts of the employee - a particular pitfall where the employer settles the employee's tax liability).

Employee's and employer's NICs are payable on earnings received by employed earners from their employment; in general, they will be payable on all termination payments to which the employee is entitled under their contract of employment.

Restrictive covenant payments

Where new restrictive covenants are agreed at termination, some element of the termination payment will need to be allocated to act as consideration for the new covenants. This element of the payment will be fully taxable³ and so a separate allocation

¹ Parts 2 to 4 Income Tax (Earnings and Pensions) Act 2003 (ITEPA)

² sections 401 to 416 ITEPA

³ sections 225 & 226 ITEPA

must be made to ensure that HMRC do not have the opportunity to argue that the whole payment is taxable by imputing an element of consideration to the severance compensation generally.

There is some indication that HMRC may consider that a confidentiality clause constitutes a restrictive covenant; whilst this is debatable, it may be useful to allocate specific consideration to a confidentiality clause - particularly where the payment will be part-taxable in any case as it exceeds £30,000.

Non-approved retirement benefit

Payments made to non-approved retirement benefit schemes are fully taxable⁴ and cannot qualify for the termination exemptions; HMRC takes a very wide view of what constitutes a “scheme” for these purposes and may consider any “arrangements” to make payments to ex-employees over the age of 50 to be a “scheme” so that the payment will be fully taxable.

Minto (SpC 625) – a chartered surveyor on long-term stress-related sick leave was made redundant; part of the settlement included the transfer to him of a permanent health insurance policy taken out by his employer, so that the monthly payments to the claimant would continue. The continuing benefit was held to be a taxable pension payment, and not part of a settlement in respect of stress damages (as contended by the claimant).

It is important to be clear in any documentation what the purpose of a payment is, particularly where the ex-employee is over 50, and to show that the compensation is appropriate to that purpose.

Note that payments to approved pension schemes are exempt from tax (provided that they are within the limits for payments to such schemes) and provided that it is capable of being regarded as part of the ex-employee’s retirement benefits, or where the loss of employment is due to ill health.

Termination exemptions - general

These apply to payments that are not taxable under any other provisions, principally the three above. The best known exemption is the £30,000 exemption, under which the first £30,000 of the aggregate qualifying payments on termination is exempt from tax. Note that this will be the case even where payments are spread over more than one tax year - only one £30,000 exemption per employment termination is available.

Can be wide-ranging – see Resolute Management Services Ltd (SpC 710): an individual resigned her employment when she recognized that the task for which she had been recruited had been completed. As a result, she forfeited a potential redundancy benefit (assessed at around £150k). The company, considering that she had done “the right thing” decided to make her an ex gratia payment of £150k, and deducted tax at the basic rate from £120k. HMRC argued that the amount was general earnings and fully taxable.

The Special Commissioners agreed with the company that the amount was not general earnings (it had no connection with services rendered etc) but was, instead, earnings in connection with the termination of employment – the fact that it was a pure gift did not take it outside s401, as the provisions of that section are very wide. The reason the gift was made was because she had terminated her employment, and so it was paid in connection with that termination.

⁴ sections 386 and 224 ITEPA

The other two exemptions are the foreign service exemption and the death/disability exemption.

Termination exemptions - foreign service

The foreign service exemption applies to payments in respect of employments that included an element of foreign service; this has to be reasonably substantial foreign service, as the employee must have been resident and ordinarily resident outside the UK during that service - usually, the employee must have been outside the UK for at least two years.

The whole amount is exempt from tax if the foreign service element was:

- 75% or more of the whole period of employment; or
- all of the last ten years of employment (where the total employment exceeded 10 years); or
- half of the employment period (where that employment exceeds 20 years), provided that includes at least ten of the last 20 years

For example:

A is employed for 35 years, of which 19 years have been spent overseas; he receives a qualifying payment on termination.

- if those 19 years were the first 19 years of service, followed by 16 years in the UK, the payment is not fully exempt (but may be partially exempt, see below), as although more than half his employment has been overseas, that does not include 10 of the last 20 years.

- if he serves 10 years in the UK, then 19 years overseas, then 6 years in the UK, the payment will be fully exempt, as he has been overseas for more than half his employment and for more than 10 out of the last 20 years.

There is a partial exemption available where the foreign service element was not enough to exempt the entire amount. This is calculating by deducting the £30,000 exemption from the payment and then pro-rating the remainder between the UK and foreign service.

For example:

In the first example for A above, if he receives £100,000, the exempt amount due to foreign service is:

$$(100,000-30,000) \times (19/35) = \text{£}38,000$$

and A will also receive the £30,000 general exemption.

Strictly, where the payment is partially exempt, the employer should tax the entire amount and the ex-employee recover the tax on his return at the end of the tax year. In practice, HMC will generally allow the employer to make that that element of the payment tax-free, on application.

Note that it is generally good practice to agree the tax position in advance with HMRC if the foreign service exemption (full or partial) is to be relied upon. This is done by contacting the employer's PAYE office to set out the position and request confirmation that the payment can be made without full/partial deduction of tax. The response from HMRC is not binding but, once agreed, HMRC are unlikely to review their decision unless circumstances change materially.

Termination exemptions - death, injury or disability

Payments on account of disability are exempt from tax; whilst this sounds helpful, the conditions that need to be satisfied are reasonably strict.

Note that the definition of disability is *not* the same as in the Disability Discrimination Act 1995. For tax purposes, a disability is an “incapacity to fulfill the duties and responsibilities of an office or employment ... due to a sudden affliction or the culmination of a process of deterioration of physical or mental health caused by a chronic illness (but not ... aging)”.⁵

For a qualifying payment to be exempt the tests in *Harner v Hasted* [1995] STC 766 must be satisfied:

- the ex-employee must have a relevant disability (total or partial impairment in ability to perform the functions or duties of the employment); and
- the employer must make the payment on account of the disability of the ex-employee, not merely in connection with the termination of the employment

The payment must be *only* on account of disability and so cannot be described as being on account of potential employment claims, even where the disability is the reason for those claims.

In practice, a separate amount should be allocated to the payment on account of disability and it should be specifically separated from any other (realistic) payments being made in respect of settlement of employment or other claims. The employer must confirm that the payment is being made on account of disability.

In order to allow the exemption, HMRC will require medical evidence confirming the nature of the disability, which must make it clear that the disability prevented the ex-employee from carrying out the specific duties of employment. It is advisable to agree with HMRC that the payment will be exempt from tax prior to the payment being made.

Note that HMRC will refer certain disability cases to their technical division, principally where the ex-employee is above normal retirement age for that occupation, or where the payment on account of disability is over £250,000.

Payment elements

Payments in lieu of notice - contractual

Payments of contractual PILONs are fully taxable as earnings; they will not qualify for any termination exemptions in s401-416 ITEPA.

Where the compromise agreement includes mutual agreement to early termination, and the employment contract included a PILON clause, HMRC will generally tax at least a portion of the payment as earnings - even if the employer has not invoked the PILON clause directly.

HMRC may also attempt to tax PILON payments where the employee has threatened to resign without actually doing so - the argument seems to be that the employee has waived the breach and reached agreement with the employer and so no damages are due.

Where the clause is discretionary, HMRC accepts that the payment may be regarded as damages and so within the scope of the termination exemptions. There needs to be an identifiable breach of contract (this can be difficult to establish with confidentiality clauses) and the payment should not be substantially the same as would be paid on a contractual PILON.

PILONs - customary/automatic

If HMRC can establish that there is an implied contractual right to a PILON, such a payment will be fully taxable. This is one area where HMRC has started to back down from an aggressive stance on these payments and concedes that it will now be rare that “custom” will imply a contractual right to a PILON. However, they do interpret “contract” rather widely, and will check the staff handbook, any side letters, appointment letters, union agreements and redundancy agreements.

Nonetheless, if a payment is an automatic response to any period of unworked notice⁶, where there is no genuine assessment of whether to make the payment, it will still be fully taxable. HMRC appear to be checking whether payments are individually negotiated and take into account mitigation and net, not gross, loss.

PILONs - damages

Where there is no contractual or automatic right to a PILON, and this can be proved to HMRC’s satisfaction, then a payment of a PILON is regarded as a payment of damages and will potentially qualify for the termination exemptions in s401-416 ITEPA.

Contractual termination payments

Almost all payments made as a result of an obligation in the employment contract are fully taxable as general earnings - even where the payment, if made ex-gratia, would qualify for the termination exemptions in s401-416 ITEPA.

HMRC considers payments made according to established custom in the same way, even though there is no express contractual entitlement to the payment (cf: *Corbett v Duff* 23 TC 763 - the Football League regulations permitted a payment of a lump sum on termination of a footballer’s contract; this was held to be taxable as being made according to established custom even though there was no contract between the footballer and the club).

The only exception to this rule is where the contractual payment is specifically for redundancy (see below for more detail); such payments qualify for the termination exemptions in s401-416 ITEPA. Note that the contract must expressly state that it is to be paid only in respect of redundancy - a payment to be made on termination for any reason will not qualify for the exemption, even if the payment is in fact made on redundancy (*Dale v de Soissons* 32 TC 118).

Benefits in kind

Including - for example - use of a company car, medical insurance etc. These are valued in the same way that they would have been valued during employment, for tax purposes

(usually, either the cost to the employer of providing the benefit or the market value of the benefit). If contractual, these are fully taxable. If non-contractual, then the payment is within the termination exemptions in s401-416 ITEPA.

Share options and shares

Tax-approved share option schemes may permit the exercise of options on termination of employment, but this usually restricted to a “good leaver”, often including redundancy. A compromise agreement entered into for reasons of redundancy should make it clear that the post-termination exercise provisions are available as a result of redundancy (if they are available) to preserve any tax benefits under the scheme.

Where share options are not approved, any permitted exercise will be fully taxable, and subject to income tax and possibly NICs on the difference between market value and the exercise price, in the same way as during employment.

Note that, where an election was made for the employee to pay any employer’s NICs arising on exercise, this election will still apply if the exercise occurs post-termination.

Where exercise is not permitted (regardless of whether the scheme was tax approved or not), and a compensation payment is negotiated for the cancellation of the options, that payment will be subject to income tax and NICs⁷ and will not qualify for the termination exemptions in s401-416 ITEPA.

Redundancy compensation

Statutory, non-contractual and contractual redundancy payments all qualify for the termination exemptions in s401-416 ITEPA, provided that they are genuinely on account of redundancy⁸.

Compensation for unfair dismissal and general payments in settlement of claims/waiver
These payments all qualify for the termination exemptions in s401-416 ITEPA⁹ unless taxable in full under one of the earlier provisions (eg: as a PILON).

Awards for unfair dismissal

Both the basic and compensatory awards will be within the termination exemptions in s401-416 ITEPA.

If the ex-employee’s net loss exceeds the maximum compensatory award then the approach should be that the ex-employee is awarded the maximum and the employer deducts PAYE on the excess over £30,000.

Compensation for discrimination and breach of other statutory employment rights

If termination is caused by the discrimination, then the termination exemptions in s401-416 ITEPA will apply to the compensation. However, if there is not a direct correlation, the payment may be fully taxable, depending on the nature of the payment. This is an area where it is advisable to get a determination from HMRC, as there is very little guidance from HMRC on the point, although in practical terms, they will usually agree that the payment relates to the termination and qualifies for the termination exemptions in s401-416 ITEPA.

⁷ s477(3) ITEPA

⁸ as defined in s139 ERA

⁹ HMRC Statement of Practice 3/96

Protective awards are generally within the termination exemptions in s401-416 ITEPA, as HMRC have not accepted that they are not compensatory payments.

Payments relating to unlawful deductions and similar ERA/Equal Pay Act claims will generally be fully taxable as these represent arrears of pay and are therefore “earnings” for tax purposes.

Compensation for injury to feelings

This is not generally taxable - although HMRC have been known to attempt to dispute the point. Note that the *Vento* guidelines should be considered, as HMRC are likely to challenge payments for injury to feelings that are in excess of the guideline amounts in settlements.

The recent case of *A v HMRC* (SpC 734) was a case in point and illustrates the care needed with settlements: an investment advisor resigned after receiving a final written warning in disciplinary proceedings in respect of breaches of bank compliance. A admitted the breaches, but believed that the proceedings were a sham to intimidate him for whistleblowing over recruitment processes and that he had no option but to resign to protect his reputation. He claimed compensation for unfair dismissal and dismissal on the grounds of protected disclosure, seeking compensation for injury to feelings and damage to reputation (inter alia). The claim settled on mediation for £250k on withdrawal of the ET claims, which were held to be by reason of dismissal (£175k for damage to reputation and £25k for injury to feelings). HMRC did not accept that the payment was taxfree.

A claimed that the payment was for damage to reputation (on the “sham” disciplinary proceedings) and was not taxable employment income in connection with termination; his resignation did not cause the damage to his reputation and so the damage was not connected with termination of employment. HMRC contended that the compensation agreement made it clear that the payment was by reason of dismissal.

The Special Commissioners held that the compensation – apart from that allocated to injury to feelings – was directly connected to the termination of employment and so counted as employment income subject to the £30k exemption. There was no persuasive evidence of the “sham” nature of the disciplinary proceedings, and the agreement demonstrated a direct link between the compensation and the termination of employment.

The Commissioners held that the amount on account of injury to feelings (which would be outside the scope of tax) should be limited to £10,000 as the circumstances on which the claimant was basing his claim “lacked objectivity” and he could in fact have continued to work with the bank.

Legal costs

Payment of the ex-employee’s legal costs by the employer is exempt from tax¹⁰ provided that certain conditions are met:

- the fees must be paid directly to the solicitor;
- the costs must be incurred solely in connection with termination; and
- the payment must be a term of the compromise or severance agreement

Note that this does not cover other advisers’ fees directly, although these could be covered if paid by the solicitor as a disbursement.

Costs payments made under court order are also exempt from tax.

VAT is due on legal fees, but cannot be recovered by the employer, as the services were not provided to the employer.

Gourley Principle/grossing up

“A person must not be placed in a better or worse position than if the contract had actually been carried out”¹¹.

Payments, particularly of damages, which are either fully exempt or within the termination exemptions in s401-416 ITEPA need to be adjusted to ensure that the ex-employee receives the award intended.

In general, such damages are calculated by reference to the pay and benefits which the employee would have received if the contract had been properly performed.

Accordingly, a payment calculated on gross pay and benefits - if exempt or partially exempt - will place the ex-employee in a better position than if the amount had been received during employment, when it would have been subject to income tax and NICs (via PAYE).

To satisfy the Gourley principle, such payments are adjusted downwards to account for notional taxes - note that the adjustment is *not* a payment of tax and does not need to be accounted for to HMRC. The tax rules above will still apply to the payment, and so this needs to be taken into account when considering both the level of payment and any adjustments that need to be made.

Where the payment will actually be taxed, no downwards adjustment should be made. However, taxable (and partially taxable) compensation awards calculated on the basis of *net* earnings will need to be adjusted upwards - grossed up - to ensure that the ex-employee receives the correct net amount after tax has been deducted (either under PAYE or via the tax return).

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¹¹ HMRC interpretation of British Transport Commission v Gourley (1955) - EIM13070

SUMMARY

Consider each element of any payment in following order:

- is it general earnings?
 - includes:
 - salary payments
 - contractual bonus or commission payments
 - gardening leave payments
 - contractual/automatic PILON
 - taxable share option exercises
 - if so, it is fully taxable. If not:
- is it consideration for restrictive covenants? If so, it is fully taxable. If not:
- is it a payment to a non-approved retirement benefit scheme? If so, it is fully taxable. If not:
- is it a payment in connection with termination of employment?
 - includes:
 - redundancy scheme payments
 - non-contractual PILON
 - compensation for unfair dismissal
 - damages for wrongful dismissal
 - discrimination compensation connected with termination
 - non-contractual benefits in kind paid on termination
 - if so, the first £30,000 is exempt from tax. Some/all of the remainder may be exempt if it relates to foreign service or is paid on account of disability.

If an element of the payment does not fall within these categories, it is unlikely to be taxable, particularly:

- injury to feelings
- legal costs paid by employer
- personal injury damages
- exercise of tax-approved share options within time limits

Adjust payments - on Gourley principle:

- increase if taxable and calculated on net earnings
- decrease if not taxable and calculated on gross earnings