

THE TAX TREATMENT OF TERMINATION PAYMENTS: A SHORT REVIEW

by Michael Thomas

In the present economic climate the tax treatment of termination payments is a timely topic. This is also an area where HMRC is frequently known to attack clients' self-assessments. Accordingly, it is also something to watch out for during the due diligence exercise on a company acquisition. This article aims to address the fundamental themes. It does not purport to state the relevant law fully, which the textbooks do very well. When advising in this area, the details, such as the NICs position, should not be overlooked.

The issue is typically whether the termination payment is taxable as earnings or only under s.401 ITEPA (formerly s.148 ICTA). If the latter tax treatment applies, the first £30,000 is exempt, and the payment is not subject to Class 1 NIC. The tax at stake in any one case is therefore very limited. Whilst in absolute terms this is a good thing, it does mean that the employer will not want to devote significant resources to fighting HMRC. The result is that correspondence tends to be dealt with piecemeal, whereas a more comprehensive response at an early stage generally tends to be a better strategy. In consequence, HMRC is likely to become firmly entrenched in its own position, and stalemate is the probable result – with the employer then faced with the unattractive choice of having to pay HMRC to settle or the lawyers to fight, the costs of which will be irrecoverable should it succeed before the Tribunal. It is worth taking extra care at the outset to ensure that the chances of a future dispute are minimised. In short, the advice is simple: terminate the employment first and agree the financial settlement afterwards.

To explain why this is the best approach it is necessary to review the relevant law. There are essentially three main kinds of payment that might make up a termination award. The first kind is a redundancy payment, which is a payment to reduce hardship. Such payments are not fixed by reference to earnings. HMRC will not normally challenge the status of an enhanced redundancy payment provided that it is computed by reference to the statutory formula. Accordingly, redundancy payments do not need to be discussed further here. The key distinction is between the second and third kinds of payment – earnings and damages for breach of contract.

The test is essentially a legal one: is the payment made under the contract, and therefore earnings, or is it damages paid in compensation for a breach of the contract, in which case it is not earnings? However, commercially and economically these two kinds of payments can appear quite similar, hence the scope for dispute in this area. Nevertheless, when cases have come to court the distinction between earnings and damages has become apparent.

Starting with what is earnings, any right to a payment under the employment contract is an inducement to work and therefore earnings. A right to be paid for working a notice period is clearly earnings. Similarly, if the contract gives the employee the right to receive a *payment in lieu of* (working the) *notice* (period) (a "PILON") then that is earnings, even if it is paid on termination. It does not matter that the right to be paid is dependent upon an exercise of discretion by the employer, because payment is made under the contract rather than as compensation for its

breach. Discretionary PILON payments are therefore taxable as earnings. The chief authorities in this area are *EMI v. Coldicott* [1999] STC 803 CA and *Richardson v. Delaney* [2001] STC 1328. In *EMI* a discretionary PILON was held to be taxable as earnings. In *Richardson* a payment agreed in lieu of notice which brought the contract to an end by mutual consent was taxable as earnings. It was central to Lloyd J's reasoning that there was no breach of contract (see e.g. at p.1342g-j). More recently, in *SCA Packaging Ltd v. HMCE* [2007] EWHC 27 (Ch.) employees who had the benefit of notice periods in their contracts were made redundant. A memorandum agreed by the employees' trade union, which was supplemental to their employment contracts, gave the employees the right to be paid in lieu of notice in the event that their employments were terminated. The relevant employees were made redundant and agreed to the PILONs being made. Lightman J quite correctly decided that these payments were earnings because "[t]he payments were made under and pursuant to the provisions in their contracts of employment." The source of the payments was the employment contract itself rather than any right to damages.

On the other side of the line, where a contract is terminated in breach, for example because the employer fails to honour a notice period and, if appropriate, does not make a PILON, any settlement of damages is not earnings. Economically, there may not be much difference, because damages will typically be calculated by reference to what would have been earned during the notice period; although an employer should reduce the damages by reference to the Gourley principle to take account of the non-taxable damages being equal to what would have been earned after tax. It is precisely this commercial similarity which tends to lead to disputes with HMRC.

The key to identifying a payment of damages is to find a breach of contract followed by a resulting negotiation of the award. In theory, the employee is under a duty to mitigate his loss, but in a termination situation, unless the notice period is particularly long, this is unlikely to have a practical impact. Another consequence of a breach of contract is that the employee is no longer bound by, for example, the confidentiality obligations in the employment contract. These will need to be reinstated in a damages award and the employee will normally require a payment to accept them, which is not taxable as earnings on general principles¹. The authority to cite to HMRC is *Cerebus Software v. Rowley* [2001] IRLR 66, which illustrates that a termination payment following a breach of contract is damages even if the employer had a right to make a PILON which it did not exercise.

Finally, it might be asked what can be done on a practical level to ensure that a termination payment is truly damages. First, the employer should make sure that it breaches the employment contract, most obviously by breaching a notice period and not agreeing to pay any PILON. However, the employer must be happy to lose the benefit of confidentiality and other obligations in the employment contract. Secondly, the employer should not offer any money until the employment has been well and truly terminated so that there is no room for confusion. Preferably the former employee should claim for compensation and this claim should then be settled. Thirdly, the correspondence should make clear that the claim is one for damages. The employer might, for example, raise the issue of the duty to mitigate. Fourthly, the compensation agreement should be suitably drafted. A time gap will also help so that HMRC cannot argue that negotiations must have taken place in advance of

termination, which of course they should not. Finally, employers should beware a blanket policy towards payments because of the risk of HMRC arguing for an implied contractual term that PILONs will be paid. This is not an attractive argument but it should be borne in mind.

In summary, the distinction between damages and earnings is a legal one which depends upon whether there is a breach of contract. In practice, this may not always appear so clear because of the facts, so the message to employers is to avoid creating room for argument by ensuring that the tax treatment of a termination process is managed properly from the outset.

¹ Although note the potential application of s.225 ITEPA (restrictive covenants).