ACTIVE PRACTICE UPDATES

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CRANE & JOHNSTON

CHARTERED CERTIFIED ACCOUNTANTS REGISTERED AUDITORS

PLANNING FOR REDUNDANCIES IN 2020/21

How termination payments are taxed.

With redundancies on the rise due to the coronavirus, is it time you understood how termination payments work in 2020?

Beyond the human tragedy of COVID-19 is an economic one.

Swathes of the UK economy have been flatlining and a rising redundancy rate is inevitable – even with the Chancellor's furlough scheme in full swing until the end of October.

No employer will implement compulsory redundancy lightly. It's a legal minefield which requires careful planning, difficult conversations and in recent years – thanks to tax changes – it has become more expensive.

The human resources aspect is a big job in itself. But let's get you briefed up on the tax side of things so that if you are considering making redundancies later in the year, you can start to plan your finances well in advance.

First of all, a word of caution: this is a technical topic.

We'll go through everything in layman's terms to give you an idea of what to expect, but you may need professional advice when calculating how individual packages should be paid and taxed.

If you are seasoned in such matters, you might have a £30,000 tax-free figure in the back of your mind, and at a first glance you are not wrong.

However, new rules were announced back in 2018 and additional changes subsequently came into effect in April 2020.

This changes what counts within the £30,000 allowance, and it's less generous to both you and your employees.

TWO TYPES OF TERMINATION PAYMENTS

For tax purposes, there are two categories of pay that can be made after you terminate an employment contract.

The first is the general employment earnings that an employee would have received if they were still working in the notice period: outstanding salary/wages, payment in lieu of notice (PILON) if relevant, and any holiday pay for instance.

Much of this money is referred to as post-employment notice pay (PENP) and is always subject to income tax and national insurance contributions (NICs).

Prior to 2018, there were exemptions which could appear to be rather arbitrary, coming down to how contracts were worded.

The second category is termination payments. These directly relate to the termination of employment, so they include things like compensation for loss of office.

APPLYING THE TAX

When you pay an employee you are making redundant a final termination sum, this is made up of these two categories of payment we have just described.

If all of the money is classed as PENP or other general earnings, such as benefits-in-kind – like keeping a company car – or accrued holiday pay, the cash value for it is all considered general earnings and taxed accordingly. No £30,000 tax exemption comes into play.

If only some of the final payment is PENP and other general earnings, then this part is taxed as general earnings. But that leaves a further aspect of the payment which the £30,000 tax exemption can be applied against. So up to the next £30,000 of payment is tax-free for both PAYE and NI purposes.

A NEW STING IN THE TAIL

As has long been the case, any excess above this £30,000 would again become subject to income tax for the employee.

Until April 2020, that was the end of the tax liability on this part of the termination payment with no NICs liability arising. This remains the case for the employee.

But from 6 April 2020, class 1A employers' NICs will now be payable on the termination payment in excess of £30,000, making some redundancies far more expensive for the employer than previously, since class 1A NICs will be due at 13.8%.

Unlike other class 1A NICs associated with taxable P11D benefits, which are payable once a year on 19 or 22 July following the tax year-end, this class 1A NICs liability will be deducted through real-time information/PAYE at the time of the termination payment, resulting in additional cashflow pressure.

HMRC will usually charge late payment interest and penalties if it is not paid promptly and correctly.

HOW IT WORKS IN PRACTICE

Hopefully you are still with us, so let's build on this with an example to show how the PENP calculation works.

The calculation

To calculate the PENP, the following statutory formula applies:

PENP = (monthly basic pay (BP) x unworked notice period (D)) divided by the number of days in the last pay period (P).

Basic pay includes any amounts given up in salary sacrifice arrangements, but excludes benefits-in-kind, commissions and bonuses among other payments.

Once this calculation has been done, the value of a contractual termination payment (T), such as a payment in lieu of notice (PILON), will be deducted but this will not include accrued holiday, termination bonuses or 'golden handshakes'.

In practice what this means is that if you are already planning to tax the employee PILON and the value of the PENP is less than this or the same there may be nothing else to do.

If this is not the case, you will need to consider what other payments are being made to the employee and their tax treatment. This is best illustrated through an example.

Example

Charlotte is notified on the 15 November 2020 of your intention to make her redundant, and her last day of employment is agreed as 30 November.

Charlotte's contract states she should receive three months' notice. D is therefore 77 days as her contractual notice period goes up to 15 February 2021.

Charlotte earns £60,000 a year in basic salary, so her monthly 'BP' amount will be £5,000. And her last pay period was the full month of October which was 31 days – the 'P'.

Charlotte will not be paid in lieu of notice but you have instead agreed to pay her £24,000 as an ex-gratia lump sum, plus £10,000 for loss of notice and £2,000 in accrued holiday pay.

In total she will receive £36,000. In order to work out how much she should be taxed on this amount, the statutory formula to work out the PENP needs to be followed.

Applying the formula gives Charlotte a PENP figure of £12,419. As she has not been made any taxable payments in lieu of notice, T is zero and nothing is deducted from this figure. The full £12,419 is therefore taxable as earnings. The £2,000 from accrued holiday pay also remains fully taxable as earnings.

The balance of £21,581 is treated as the ex-gratia payment and it is not subject to any tax as it is under £30,000.

If the numbers were different and the outstanding ex-gratia payment had been, say, £40,000, then further income tax would have been due on the excess above £30,000.

As this transaction happened after April 2020, you would have been liable for an additional 13.8% in class 1A NICs on the £10,000 excess.

LONG-TERM PLANNING

The coronavirus job retention scheme being in place until 31 October should give companies breathing space to ride out the drastic impact of coronavirus on the economy.

But Chancellor Rishi Sunak already concedes that we are in "significant recession" and there are still so many unknowns as the COVID-19 story unfolds.

Therefore, if you think there is a negative outlook for your business, it would be prudent to explore your options now around making redundancies later in the year.

Having read this article we trust you will take away that the pay and tax calculations involved are complicated and there are new terms to get your head around.

You should also be aware that it will have become more expensive to implement some redundancies this year owing to the tax rule changes.

Speak to us about termination payments.