
PRACTICE NOTE

PN 203/18

Date: 24 May 2018

TERMINATION PAYMENTS

Introduction

This Practice Note is intended to provide clarity in relation to the income tax and National Insurance treatment of lump sum payments and other benefits received by an employee on or in relation to the cessation of their employment.

This Practice Note replaces PN 89/01.

Background

“Termination Payment” is a term often used to refer to a lump sum paid to an employee when their employment ceases, or to a director when they leave office.

It should be noted that not all payments referred to as termination payments in agreements, documentation or correspondence between an employer and employee, or company and director, fall within the definition of “termination payments” from an income tax perspective. The detailed circumstances of each case need to be carefully considered.

Section 48A(6) Income Tax Act 1970 defines a “termination payment” as:

“...a payment which is made, whether in pursuance of any legal obligation or not, either directly or indirectly in consideration or in consequence of, or otherwise in connection with, the termination of the holding of any office or employment or any change in its functions or emoluments, including any payment in commutation of annual or periodical payments (whether chargeable to tax or not) which would otherwise have been made as aforesaid but does not include any payment which is otherwise chargeable to income tax”.

Section 48A brings “termination payments” as defined above into the charge to income tax and allows up to £30,000 of any qualifying payments to be free of income tax.

It is important to note that the definition excludes any payment which is otherwise chargeable to income tax. Such payments, when made on termination or change in function of an office or employment, will not qualify for the purposes of section 48A.

Section 48B Income Tax Act 1970 extends section 48A to payments made on redundancy, so the first £30,000 of these payments will also be free of income tax.

Income Tax Treatment

Liability to income tax depends on the nature and purpose of the termination payment. A termination payment can be made up of various elements (e.g. unpaid salary, holiday pay, benefits, bonuses, payment in lieu of notice ('PILON'), non-contractual payments etc.) It is, therefore, necessary to identify each element of the termination payment in order to apply the correct tax treatment.

Broadly, any payments that may be defined as "income derived from the annual profits or gains of or in respect of or from any profession, trade, employment, or vocation" under section 2 Income Tax Act 1970, or a benefit in kind provided by reason of employment under sections 2G-KA Income Tax Act 1970, whether contractual or otherwise, are subject to income tax. Any balance up to £30,000 then qualifies for income tax relief under section 48A.

The income tax relief on up to £30,000 may only be applied once per employment or office.

A termination payment as defined in section 48A is, effectively, a payment genuinely made in relation to the loss of an employment or an office and includes any redundancy payment or payment made on the termination of employment where there is no contractual right to that payment.

Any payments made in return for services or as a reward for past services, whether contractual or otherwise, are subject to income tax and include:

- a payment made as compensation for losing the right to a payment or bonus that would otherwise have been taxable;
- a payment where the employer gives notice of termination to an individual and informs the individual that they need not work to the termination date and pays wages attributable to the notice period in a lump sum, this in effect being an advance payment of wages; and
- a PILON where there is a contractual right to the payment or, where there is no contractual right to a PILON, but the payment of a PILON instead of giving the contractual notice period is customary, habitual or expected practice.

Concession for New Residents

By concession, the Assessor will not pursue any liability to income tax in respect of a termination payment where a new resident receives a lump sum termination payment in respect of an employment outside the Isle of Man.

The concession only applies where the payment falls within the definition of "termination payment" contained in section 48A, the employment ceased within one month after the commencement of residence and the termination payment is made within three months of that date.

National Insurance Treatment

National Insurance Contributions ('NIC') are chargeable on "earnings" (e.g. any remuneration or profit derived from an employment), whether contractual or otherwise. For example, even though not contractual, the vast majority of payments described as "ex-gratia" made to employees derive from their employment, and are therefore subject to NIC.

In order to be outside the scope of "earnings" a payment must derive from something other than the employed earner's employment or office.

Any payment made on redundancy is specifically outside the scope of earnings. This is the case even if the redundancy payment is contractual, customary or expected.

A "termination payment" is not defined for NIC purposes, but compensatory payments paid on cessation of employment are the equivalent from an NIC perspective.

A compensatory payment arising solely from the loss of an office or employment does not derive from that office or employment, so would not be within the scope of the charge to NIC. However, where there is contractual right to a payment (e.g. holiday pay, bonus, PILON etc.), or the making of a payment is compulsory, habitual or expected, and that payment is made as part of a termination payment, it will be subject to NIC.

Similarly, if the employment is ended by a compromise or settlement agreement in full and final settlement of all entitlements and claims arising from the contract, the amounts arising under the contract will be subject to NIC.

If the payment made exceeds the amounts arising under the contract and the additional amount does not derive from the employment, the excess will be accepted as a compensatory payment and not subject to NIC.

If an employee is placed on "gardening leave" before their employment ceases, the salary they were entitled to be paid during the period of gardening leave is earnings even if it is paid as part of a compromise or settlement agreement.

See the Appendix for examples of how payments that may be made when an employment ceases are treated for income tax and NIC purposes.

Enhanced Termination Payments

The Assessor is aware that in some cases enhanced termination payments are being made in order to benefit from the £30,000 income tax relief and to avoid any charge to NIC.

These often involve a payment being made to a director, either when they leave a company or when the company has ceased to operate and is about to be wound up.

The director in receipt of the termination payment has received very little - often no - remuneration for their services whilst they were a director of the company, and so the compensatory payment is completely disproportionate to the loss.

The Assessor will take the view that a payment made in such circumstances is not a termination payment for the loss of office as a director. In such a case the payment will be a payment for the services provided by the director whilst they were in office. On that basis, the full amount of the payment would be subject to both income tax and NIC as remuneration derived from the office.

For the avoidance of doubt, companies making payments in these circumstances should report the payments through the normal employer ITIP and NIC reporting systems.

The nature of a payment made to a director on their retirement or the winding-up of the company can be reviewed in the light of contemporaneous evidence and other relevant supporting documentary evidence, if the paying company or receiving director request this.

Depending on the facts of the case, the Assessor may accept that the payment made is not remuneration derived from the office.

Additionally, if the Assessor becomes aware that contractual entitlements to payments of earnings for income tax and NIC purposes are waived, but the employee or office holder subsequently receives a payment of an equivalent value that is not fully chargeable to income tax and NIC, this will be challenged and may not be accepted.

Employment Tribunal Awards

Please see PN 204/18 for further details in relation to payments made as a result of a hearing with the Isle of Man Employment Tribunal.

Reporting Payments Made on Cessation of Employment or Office

It is the responsibility of employers and employees or office holders to correctly report payments made on cessation of employment or office for income tax and National Insurance purposes, and to pay the income tax and National Insurance liabilities at the correct time.

An employer must report payment of all earnings and taxable benefits, plus the amount of any termination payment that is in excess of £30,000, through their payroll within the normal reporting timescales, deduct income tax and NIC as appropriate from these payments and provide the employee with the necessary forms (e.g. payslip, T9, T14 etc).

Employees should declare all contractual payments, taxable benefits and the amount of any qualifying termination payments in excess of £30,000 received on their income tax return for the year in which the payment is made.

If the employer or employee do not correctly report the amounts to the Assessor at the correct time, they may be charged penalties for non-compliance and late payment.

Nicola Guffogg
Assessor of Income Tax

This Practice Note is intended only as a general guide and must be read in conjunction with the appropriate legislation. It does not have any binding force and does not affect a person's right of appeal on points concerning their own liability to income tax and or national insurance.

Comments and suggestions for improvements of issued Practice Notes and suggestions for future Practice Notes are always welcome.

Appendix - Examples

Termination in Accordance with Contract - Employer Terminates

Miss B has a contract of employment which entitles her to:

- a weekly salary of £750 (annual £39,000);
- a bonus of 5% of annual salary;
- annual leave of 4 weeks;
- 4 weeks' notice; and
- PILON.

On 1 March 2018 Miss B is given notice that her employment is to cease with immediate effect and she is given a payment of £10,000 which her employer refers to as a "termination payment".

Miss B has 2 weeks of accrued unused annual leave at that date.

The payment received will be subject to income tax and NIC as follows:

Payment		Amount	Notes
Accrued annual leave	2 weeks x 750	1,500	Contractual - Subject to ITIP and NIC
PILON	4 weeks x 750	3,000	Contractual - Subject to ITIP and NIC
Bonus	5% x 39,000	1,950	Contractual - Subject to ITIP and NIC
Additional Payment		3,550	No liability to income tax or NIC
	Total	£10,000	

Termination in Accordance with Contract – Employee Resigns

Mr W has a contract of employment which entitles him to:

- a weekly salary of £750 (annual £39,000);
- annual leave of 4 weeks;
- 4 weeks' notice; and
- PILON.

On 1 February 2018 Mr W gives notice of his resignation. He has no accrued annual leave, so his anticipated last day in work is 28 February 2018.

Mr W's employer decides that they would prefer he did not attend the office during his notice period, so they place him on gardening leave with effect from 1 February 2018.

On 28 February 2018 Mr W receives £10,000 which comprises his salary for February whilst on gardening leave and £7,000 that his employer refers to as a "termination payment".

Provided that the Assessor is satisfied that the £7,000 is not made in recognition of past services or as a thank you, is not in any other way derived from Mr W's employment and is not artificial, she will accept it as a "termination payment".

The payment received will be subject to income tax and NIC as follows:

Payment		Amount	Notes
February 2018 salary – gardening leave	4 weeks x 750	3,000	Contractual - Subject to ITIP and NIC
Additional Payment		7,000	No liability to income tax or NIC
	Total	£10,000	

Termination via Compromise Agreement - 1

Mr A is contractually entitled to:

- an annual salary of £150,000;
- a bonus of 5% of annual salary;
- 3 months' notice period;
- 3 months' PILON; and
- healthcare cover.

Mr A's employment is terminated without notice, which is not in accordance with his contract. Mr A has accrued unused annual leave of £500 at that date.

A compromise agreement has been made in full and final settlement of all entitlements and claims arising from the contract, including what is referred to as a termination payment, of £200,000.

The compromise agreement is in full and final settlement of all entitlements and claims under the contract, so all amounts that would be due under the contract will be subject to income tax and NIC.

Any excess is accepted as a compensatory payment which will qualify as a "termination payment" for income tax purposes.

The payment received will be subject to income tax and NIC as follows:

Payment		Amount	Notes
Contractual PILON		37,500	Contractual - Subject to ITIP and NIC
Yearly Bonus	5% x 150,000	7,500	Contractual - Subject to ITIP and NIC
Accrued Holiday Pay		500	Contractual - Subject to ITIP and NIC
Payment in lieu of healthcare cover		1,000	Contractual - Subject to ITIP and NIC
Additional Payment		153,500	No liability to NIC No liability to income tax on first £30,000, excess reportable and subject to ITIP.
	Total	£200,000	

Termination via Compromise Agreement - 2

Mrs C is contractually entitled to:

- an annual salary of £260,000 (£5,000 per week);
- 4 weeks' paid holiday; and
- 3 months' notice.

Mrs C's employment is terminated without notice, which is not in accordance with her contract. Mrs C has 2 weeks of accrued unused annual leave at that date.

A compromise agreement of £200,000 has been made in full and final settlement of all entitlements and claims arising from the contract, including what is referred to as a termination payment.

The compromise agreement is in full and final settlement of all entitlements and claims under the contract, so all amounts that would be due under the contract will be subject to income tax and NIC.

Mrs C's employer has no established practice of making a PILON, so no part of the payment can be considered to be the employer making an expected PILON as part of the full and final settlement.

Any excess is accepted as a compensatory payment for NIC purposes and will qualify as a "termination payment" for income tax purposes.

The payment received will be subject to income tax and NIC as follows:

Payment		Amount	Notes
Accrued Holiday Pay (2 weeks)	2 x 5,000	10,000	Contractual - Subject to ITIP and NIC
Additional Payment		190,000	No liability to NIC No liability to income tax on first £30,000, excess reportable and subject to ITIP.
	Total	£200,000	