Date: 15 October 2015

Simplification of the Tax and National Insurance Treatment of Termination Payments

Response to Consultation

BLAKE MORGAN

PUBLIC

Simplification of the Tax and National Insurance Treatment of Termination Payments

Response to consultation

Organisation: Blake Morgan LLP

Address: New King's Court, Tollgate, Chandler's Ford, Eastleigh, Hampshire SO53 3LG

Blake Morgan LLP is a leading full-service law firm working across Southern England and Wales with over 130 partners, 1000 staff, and offices in Southampton, Oxford, London, Cardiff, Reading and Portsmouth. It is recognised as a top-tier firm in Employment law. This response is prepared by Blake Morgan's Employment Pensions Benefits and Immigration Team which has 40 specialist Employment lawyers.

INTRODUCTION

It is our view that, where it applies, the current tax exemption of £30,000 ('the exemption') provides a good mechanism for the effective conciliation and settlement of what would otherwise be expensive and time-consuming employment disputes, to the satisfaction of both the employer and employee.

1 DO YOU AGREE THAT THE DISTINCTION BETWEEN CONTRACTUAL AND NON-CONTRACTUAL TERMINATION PAYMENTS SHOULD BE REMOVED?

1.1 No.

1.2 The Background to the Consultation at **1.2** sets out the current general principle that "*the elements of a termination payment that are from the employment or that an employee is contractually entitled to, are subject to tax and National Insurance Contributions (NICs) in the same way as other payments of salary. Conversely the elements of any termination payment that are not from the employment are only liable to income tax on the amounts exceeding £30,000*". This demonstrates that the current system of taxation is relatively straightforward and easy to understand.

1.3 The current position is logical: Firstly, termination payments due under the terms of the employment contract (even if exercised under a contractual discretion) are treated in the same way for tax purposes as they would have been during employment. Secondly, termination payments which are ex-gratia or compensatory in nature (together with contractually enhanced redundancy payments) enjoy tax relief. The new proposals as set out in the Consultation would result in strange and potentially unfair anomalies, for example the tax free payment of outstanding holiday pay on termination, but only in certain circumstances.

1.4 Although the Office for Tax Simplification (OTS) Interim Review of Employee Benefits and Expenses in August 2013[1] identified the general area of employee benefits and expenses as being complicated and ripe for review, it noted that the specific topic of termination payments was only a real issue for some people. It commented that "the policy for the exemption has become muddled". When it recommended "reviewing the level of the exemption", it is clear from the context (**p8, p59**) that the OTS was envisaging an increase to it, combined with "rethinking the restrictive NICs exemption, and clearer HMRC guidance".

1.5 When it was introduced, the purpose and extent of the exemption was clear. The OTS observed in its final report[2] that it is mainly through HMRC practice and (to a lesser extent) case law that changes in how the exemption is applied have developed. Whilst it may be right to review the taxation of termination payments, the OTS itself observed that its work has "***not pointed the way to an obvious single answer as to how the system should be changed***" (**p35**, our emphasis). One of the main improvements suggested in the 2013 report is "for HMRC to issue clearer guidance on what qualifies for exemption".

1.6 We have a real concern that the main purpose of removing the distinction is to reduce the exemption (see Q5 below), and that the means of achieving that will confuse and contradict well-established legal principles and introduce an entirely new arrangement which will be no less complex.

1.7 We consider that the current level of the exemption provides a valuable means for settling disputes, and would strongly resist any reduction of it. Indeed we suggest there is a strong argument that the exemption should be increased to reflect the erosion of its value since 1988 and the changes in the workplace and patterns of work since that date. The current arrangements can be conclusively shown to be working satisfactorily and, in appropriate circumstances, can benefit employees at all levels of the workforce.

1.8 If (which we do not accept) there is widespread misunderstanding that the £30,000 exemption applies to all termination payments, then it would be a straightforward exercise to clarify to employers and payroll staff through published guidance the difference in the tax treatment of contractual and non-contractual payments.

2 DO YOU AGREE THAT REMOVING THE DIFFERENT TAX AND NICS TREATMENT OF DIFFERENT TYPES OF PILONS WILL HELP REMOVE COMPLEXITY FOR TERMINATION PAYMENTS?

2.1 No.

2.2 The current position is that PILONs paid under a term of the contract (whether by exercise of a stated discretion or otherwise) are fully taxable. If there is a breach of the notice provisions, then the only route for an employee is to pursue a claim for damages in accordance with

---

1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227088/ots_employee_benefits_interim_report.pdf

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/339496/OTS_review_of_employee_benefits_and_expenses_final_report.pdf

well-established contractual principles, and in those circumstances damages will only be paid for loss of income for the relevant notice period. The Consultation wrongly implies that this is somehow disingenuous (**3.3**: "*there have been cases where employees and employers argue that a PILON is actually a payment for breach of contract*"). In fact it reflects the well-established legal position that damages paid to compensate for breach of contract are not treated the same as payments under a term of the employment contract.

2.3 We do not agree that those who benefit from this distinction are generally those who are better advised and better paid. It depends solely on the terms of the person's contract. The most that can be said about an advantage to those who are better paid is that they are likely to negotiate and benefit from longer notice periods to reflect the extent of responsibilities within such jobs. In fact it is often those who are better paid who must pay tax in full on a PILON, because the employer will provide a contractual PILON clause to ensure it does not breach the contract and lose the benefit of restrictive covenants.

2.4 There are essentially only two types of PILON. The "*different types of PILONs*" referred to have been created by HMRC to extend the circumstances where a PILON is considered contractual: for example 'Auto PILONs'. However, such challenges (if not settled) have to be determined by making findings of fact in each case in legal proceedings. In those circumstances HMRC is in no different position to any other organisation or individual as to whether to accept the risk and uncertainty of litigation. We also refer to the OTS final report, in which firstly HMRC's position that employers must undertake a 'critical assessment' of the payment in 'Auto-PILON' cases is rightly criticised and recommended for review (**p54**); and secondly it is acknowledged (at **p35**) that "*in the vast majority of cases, employers are not trying to get out of paying tax*".

2.5 We have a further serious concern: this is that the proposals indicate that compensation for breach of contractual notice provisions would fall within the 'new' exemption for wrongful dismissal (**4.38**). The effect of this would be to reinstate the distinction between contractual and non-contractual PILONs, and it is therefore hard to understand how the new proposals will make any difference to PILONs.

3 DO YOU THINK THAT THE INCOME TAX AND NICS TREATMENT OF TERMINATION PAYMENTS SHOULD BE ALIGNED?

3.1 As discussed above, our view is that the current tax law and practice in respect of termination payments is broadly clear, and therefore any attempt to align income tax and NICs should not be done at the expense of maintaining that clarity (although certain specific anomalies could be addressed – see para 4.1). Also, we think that any attempt to address such alignment in the context of termination payments should be undertaken as part of a much wider review about income tax and NICs generally, which is a wide ranging and complex area.

4 DO YOU THINK THAT ALIGNING THE INCOME TAX AND NICS TREATMENT OF TERMINATION PAYMENTS WILL MAKE TERMINATION PAYMENTS EASIER TO ADMINISTER AND EASIER TO UNDERSTAND?

4.1 We can see benefits of aligning tax and NICs for this purpose, for example in the area of protective awards (under section 189 of the Trade Union and Labour Relations (Consolidation) Act 1992) and payments in lieu of protective awards, which benefit from the

exemption, but on which NICs are fully payable. The difference in treatment can be a source of confusion.

5 THE GOVERNMENT WOULD LIKE TO EXPLORE WHAT LEVEL THE THRESHOLD FOR THE TERMINATION PAYMENT TAX AND NICS EXEMPTION SHOULD BE SET AND WOULD WELCOME VIEWS

5.1 As already stated, our view of the current threshold of £30,000 is that it provides a valuable incentive for both employer and employee to achieve an effective conciliation and settlement of what could otherwise be an expensive and time-consuming employment dispute.

5.2 The threshold has remained at £30,000 since 1988, which at the time was significant and helpful. The OTS Interim report (2013) noted that "at today's prices, it should be £71,000". We are concerned that the Government's proposals may result in considerable further erosion of the exemption's value which has already been frozen for some 27 years.

5.3 We consider that if the Government pursues its intention to remove the difference between contractual and non-contractual payments, the level of the exemption should not be reduced below £30,000, and as previously stated, we would support an increase. If the purpose is to make arrangements less complex, it does not follow that the exemption should be reduced.

5.4 There may be some benefit in linking the exemption to length of service, but we stress that introducing that change does not justify a reduction in the overall level of the exemption either. For example, the exemption could be £5,000 per year of service, up to a maximum of six years' service.

5.5 We consider the £6,000 and additional £1000 per year of service cited in Examples 2 and 4 to be too low. The exemption must be set at a level which is valuable to both sides, and should not depend on very long service. (We further note that Chris and Ali's situations in Examples 3 and 5 would be the same under the current position – contractual payments taxable in full).

5.6 If the threshold is set too low, employees will be more inclined to pursue a claim in an Employment Tribunal (ET), potentially resulting in wasted time and expense on both sides. This is because there will be no route by which the employer can propose a meaningful tax-free payment to resolve contentious issues. We stress, in support of what we have already set out above, that the increased cost to employers and the Government in respect of ET proceedings should not be underestimated.

6 DO YOU BELIEVE THAT A RELIEF BASED ON LENGTH OF SERVICE AND THOSE WHO ARE BEING MADE REDUNDANT WOULD BE EASIER FOR EMPLOYERS TO ADMINISTER?

6.1 See Q5 above regarding length of service.

6.2 We do not agree that a relief based on redundancy would make it easier for employers to administer. Firstly, it is not always clear, even in case law, when a redundancy situation arises. Secondly, the Government proposes to introduce two 'new' exemptions for payments in connection with wrongful or unfair dismissal and compensatory payments in cases of discrimination. This means that employers will not only need to consider whether a payment reflects a redundancy situation, but also whether it is compensation for wrongful dismissal,

unfair dismissal, or discrimination. These are same questions employers must consider now, and will be no easier.

7 DO YOU THINK THAT STRUCTURING THE RELIEF BASED ON LENGTH OF SERVICE AND REDUNDANCY WILL BE EASIER FOR EMPLOYEES TO UNDERSTAND?

7.1 See Q5 above regarding length of service.

7.2 For the same reasons outlined in Q6 above, we do not think that a relief based on redundancy will be easier for employees to understand.

QUESTIONS 8 – 16

We do not propose to answer questions 8-16, except to observe that we agree with maintaining the existing exemptions specified, and that the current exemptions for legal costs and outplacement counselling should be maintained (Q15) because they provide valuable help to employees at a time when they have lost their job.

17 DO YOU THINK THAT THERE SHOULD BE A FINANCIAL CAP, ABOVE WHICH INCOME TAX (AND POSSIBLY NICS) SHOULD BE PAYABLE IN CASES OF UNFAIR OR WRONGFUL DISMISSAL?

17.1 It is not clear whether this question is suggesting that payments in wrongful or unfair dismissal cases could be entirely exempt from tax.

17.2 If the question is asking whether payments for unfair or wrongful dismissal should be exempt from tax up to a certain level, rather than taxable on the full amount, we agree that they should.

17.3 This reflects the current position that an award made by an ET for a successful wrongful or unfair dismissal claim will be tax free up to £30,000. It also supports the effective conciliation and settlement of such claims.

18 DO YOU THINK THAT THERE SHOULD BE ANY DIFFERENTIATION IN TERMS OF A FINANCIAL CAP WHERE PAYMENTS HAVE BEEN SETTLED BY A TRIBUNAL OR AN ARRANGEMENT BETWEEN AN EMPLOYEE AND EMPLOYER?

18.1 No.

18.2 The current regime requires an employee to pay a fee of between £250 and £1200 to pursue a claim in the ET. If the benefit applies only where an ET claim has been brought, this will undermine the principle on which ET fees are based, and could result in needless litigation. If the benefit only applies only where there is an arrangement between an employee and employer, it could put undue pressure on an employee not to pursue an ET claim.

19 DO YOU THINK THAT THERE SHOULD BE A FINANCIAL CAP, ABOVE WHICH INCOME TAX (AND POSSIBLY NICS) SHOULD BE PAYABLE IN CASES OF DISCRIMINATION?

19.1 It is not clear whether this question is suggesting that compensatory payments for discrimination could be entirely exempt from tax.

19.2 If the question is asking whether compensatory payments for discrimination should be exempt from tax up to a certain level, rather than taxable on the full amount, we agree that they should.

19.3 We find the proposals in relation to compensation for discrimination unclear. The current position for discrimination is straightforward, that payments in connection with termination are taxable above the exemption, with the exception of injury to feelings (where there is an established scale of awards, which will not usually exceed £36,000). The position is the same whether the payment is as a result of an award made by a tribunal, the settlement of ET proceedings before a hearing, or the settlement of claims before any proceedings are issued. It is our view is that this position should continue.

19.4 We consider that it would be wrong to treat payments in connection with discrimination differently from payments in connection with an unfair dismissal claim. This is because a difference in treatment will inevitably encourage speculative allegations of discrimination, with all the disadvantages this will cause, in what is an important, complex and sensitive area for public policy and the judiciary.

20 DO YOU THINK THAT THERE SHOULD BE ANY DIFFERENTIATION IN TERMS OF A FINANCIAL CAP WHERE PAYMENTS HAVE BEEN SETTLED BY A TRIBUNAL OR AN ARRANGEMENT BETWEEN AN EMPLOYEE AND EMPLOYER?

20.1 No.

20.2 Please see the reasons outlined at 18.2 above.

15.10.15
Blake Morgan LLP
New Kings Court
Tollgate
Eastleigh
SO53 3LG
www.blakemorgan.co.uk
(Ref: RVC)