THE TAX EFFECTS OF REDUNDANCY

What you need to know Termination payments

To be entitled to exemptions and reliefs on a termination payment it needs to be shown that the payment is not taxed as employment income under the general rules.

The most well-known relief under the provisions which govern the taxation of employment income is the £30,000 exemption available under section 403 ITEPA 2003. For the exemption to apply HMRC must be satisfied that the payment is due to redundancy.

• If any redundancy payment is less than £30,000 then it is exempt. If the payment is more than £30,000 then the first £30,000 is exempt.

• If payments are received in instalments rather than as one lump sum the earliest payments up to £30,000 will be exempt rather than any later ones.

• If payment is made in a mix of both cash benefits and non-cash benefits (the value of which is treated as its 'cash equivalent'), the £30,000 exemption is set off first against the cash benefits and then the non-cash benefits.

Foreign Service

Where a redundancy payment is made to an individual who has had a period of time in foreign service in relation to the employment, no tax will be charged as long as the foreign service was three-quarters or more of the whole period of service; or if the service exceeded 10 years, the whole of the last 10 years; or if the service exceeded 20 years, half or more that period of time.

Statutory redundancy pay

An employee who has worked continuously for an employer for two years or more is entitled to statutory redundancy. Statutory redundancy pay is not taxable.

Statutory redundancy pay is calculated based on a combination of age, length of service and weekly salary as follows:

• Half a weeks' pay for each complete year of service between age 17 and 21
• 1 weeks' pay for each complete year of service between age 22 and 40
• 1 and a half weeks' pay for each complete year of service between age 41 and 65

Note that:

• Service longer than 20 years does not count
• A week's pay cannot exceed a specified figure or cap (£450 for 2013/14).
• Redundancy payments are not treated as earnings, therefore no NIC is due.

So, by way of example, an employee aged 45, who earned £500 a week and worked for the company for 10 years, would be entitled to:

12 (i.e. 4 years at a rate of 1.5 weeks' pay and 6 years at a rate of 1 weeks' pay so total of 12 weeks pay) x £450 (gross weekly salary of £500 is capped at £450) = £5,400.

The maximum statutory redundancy payment is £13,500.

Statutory redundancy is tax free but counts against the £30,000 termination payment threshold.

Payments in lieu of notice

A payment in lieu of notice (or 'PILON') is not defined in tax legislation. Instead it is a term that can be used to describe payments made in a wide variety of circumstances. In order to determine the tax treatment of a PILON it is necessary to determine whether the payment will be taxed as income from employment under the general rule as explained above. A payment that is made after termination of employment will not qualify as a PILON.

• Where the contract provides only for notice, but not for a payment if due notice is not given, then any payment where notice is not given will not be treated as a contractual right – instead the payment is one for breach of contract. As such this would not be a payment derived from employment and would fall within the £30,000 exemption. National Insurance contributions will not be due on such a payment.

• If the employer is not obliged to make a payment but reserves the right or discretion to do so if due notice is not given, HMRC will regard the payment as being within the terms of the contract, will treat it as originating from employment, and it will not qualify for the £30,000 exemption. National Insurance contributions will be due.

• If the employee is given ‘gardening leave’ then the employee, in effect, remains employed throughout the notice period and the payments are taxable as emoluments from employment, and National Insurance contributions will be due.

It appears that HMRC feels that to the extent that employment rights are formalised, fewer PILONs will enjoy the more favourable tax treatment.

Share option schemes

A right to purchase company shares normally lapses on the day employment ceases. However, in some cases, depending on the contractual basis on which the share option scheme has been established, there may be a right to purchase for a period after the employment ends, provided the employer agrees.
Pension considerations

When an individual is going through a planned redundancy process, i.e. one where there is time to undertake some financial planning with, or perhaps without, the co-operation of the employer, there are a number of opportunities:

Topping up a pension arrangement

Clearly a large capital payment would be attractive to many individuals, even if it will suffer income tax and possibly National Insurance. However, if an individual is prepared to consider sacrificing the excess over and above the £30,000 tax free payment then this can be paid into a pension scheme by the employer. For this to be tax-deductible for the employer, it would need to satisfy the 'wholly and exclusively' test. Broadly speaking, this would be undertaken in an identical manner to a bonus sacrifice.

Even if the employer is not willing to consider such a course of action, there is still an opportunity for the individual to plan. Since A-Day, redundancy payments in excess of the £30,000 tax-free ceiling are deemed to be Relevant UK Earnings and, as such, can be used to justify a personal contribution to a registered pension scheme. If an individual receives a redundancy payment of £60,000 which is not liable to NICs then the net amount received would be £48,000 assuming the excess over the £30,000 is all liable to tax at 40%.

Based on the £60,000 gross and £48,000 net figures mentioned in the preceding paragraph, if a personal pension contribution of £24,000 were made this would gross up to £30,000 at basic rate tax. This would only leave the individual with £24,000 in their own hands. However, in due course the higher rate income tax refund of £6,000 would be received thus replenishing the cash held by the individual to £30,000. This would leave them in the same position, albeit after a time delay, as if the £30,000 taxable element of the redundancy payment had been sacrificed.

Any such planning will need to take account of the annual allowance limits if an annual allowance charge is to be avoided. Although the annual allowance has been reduced to £50,000 for tax years 2012/13 and 2013/14, the carry forward provisions, which enable advantage to be taken of any unused annual allowance over the three immediately preceding tax years, should mean that an annual allowance charge can be avoided in most cases.

Where the contribution exceeds the annual allowance, including any carry forward, the individual is subject to income tax on the excess contribution.

Individuals should also bear in mind the lifetime allowance (generally £1.5m for the tax years 2013/14 and £1.25m in 2013/14). If the value of the individual's accrued pension rights when he takes his benefits exceeds this, the individual is subject to a recovery tax charge.

Social Security benefits available after termination

On redundancy a number of social security benefits are available.
For both voluntary and involuntary redundancy Jobseeker's Allowance will be paid from the start. It is worth noting that leaving a job voluntarily (ie resigning) will mean that no Jobseeker's Allowance is paid for six months.

Many State benefits are means tested. Therefore receiving a lump sum redundancy payment is treated for means testing as savings, and as such can affect the level of benefit received.

**Jobseeker's Allowance**

For those who have paid the required number of National Insurance contributions this is paid for a maximum of six months from the date of redundancy and is not means tested. The Jobseeker's Allowance (2013/14) for under 25 year olds is £56.80 per week, and for those 25 and over it is £71.70 per week. After 6 months income-based Jobseeker's Allowance is available but this is means tested.

**Support for Mortgage Interest (SMI)**

For those receiving income-based Jobseeker's Allowance, the government will help pay the interest on a mortgage through Support for Mortgage Interest (SMI). The benefit doesn’t begin until 13 weeks after claiming benefits and is time limited to two years. Help is available under SMI in respect of interest on up to £200,000 of the mortgage and is generally paid direct to the lender.

No help is available with the capital element of the mortgage nor can SMI be used to pay for investments (including life insurance) linked to the mortgage.

The views expressed in this summary are reached from our own research. Henwood Court cannot accept responsibility for any decisions taken as a result of reading this document and investors are recommended to take independent professional advice before effecting transactions. The price of stocks, shares and funds, and the income from them, may fall as well as rise. Past performance is not necessarily a guide to future returns.