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MBKB Payroll Factsheet - Terminations

What is a termination?

Termination is the term used when an employment contract comes to an end. It can either be ended by an employee or an employer.

Employees can terminate their contract by resigning and an employer can terminate the contract by dismissing an employee. Redundancy is a form of dismissal.

Is the redundancy fair?

In order for a redundancy to be fair, there must be a genuine redundancy situation. This can happen with the closure of a business, a workplace, or a whole department, or when there is a 'diminished need for work of a particular kind.' This can apply where an employer restructures the business, for example an employer may decide to merge two roles into one or divide the work amongst other staff, or perhaps the business has lost a significant contract so the workforce needs to reduce.

If, however, an individual is dismissed for 'redundancy' and then the employer recruits someone to do the same job then it is unlikely to be a genuine redundancy, the exception being if the new recruit is paid significantly less money, which is a legally acceptable reason to make somebody redundant.

Giving notice

A notice period is the length of time between an individual being told they are being made redundant and their last working day.

The minimum length of notice period is based on the length of the employee's service, though the employee's employment contract may state that a longer notice period is required. If this happens the minimum period to apply is the longer of the statutory versus the contractual notice period. The statutory minimum notice periods are as follows:

Length of service	Minimum notice period
1 month to 2 years	At least a week
2 years to 12 years	A week's notice for every year employed
12 or more years	Maximum statutory notice is 12 weeks

Payment in Lieu of Notice (PILON)

If the individual's employment contract includes a PILON clause the employer can end the employee's employment with no notice, but they must then make a payment to cover the notice period the employee would have worked.

When an employer makes a payment in lieu of notice, they must still pay the basic pay that the employee would have received during the notice period. This also includes pension, private health care insurance or other contributions if it's in the employee's contract.

What is a termination payment?

A termination payment is made to an employee when their contract is terminated. What the payment is for, and what it includes, will determine whether it is liable to income tax and/or National Insurance contributions (NIC). A termination payment normally includes elements such as:

- PILON
- Redundancy pay
- Untaken holiday pay
- Bonus / Commission
- Ex-gratia payment / compensation
- Cash equivalent of benefits

When calculating the notice payment it is important to note that if the employee has earned less than usual because they have been furloughed, notice payments must be based on what they would have earned normally, rather than on their furlough pay.

Tax and NIC treatment of termination payments

Until 2018, employers often would give the employee a non-contractual PILON, classing it as a payment for breach of contract and as such, the first £30,000 was exempt from income tax and the whole payment was exempt from NIC. Following the introduction of the Post Employment Notice Payment (PENP) in 2018, this is no longer the case and the tax and NIC treatment of termination payments now falls into three main categories:

- Payments relating to an employee's notice period or which are derived from the contract of employment are taxable in in accordance with the PENP provisions and subject to Class1 NICs.

- A relevant termination award of up to £30,000, which includes the Statutory Redundancy Pay, and compensates the employee for the termination of their employment can be made without being liable to income tax or NICs.

- Any part of the termination payment that exceeds £30,000 is liable to income tax and the employer must pay Class 1A NICs.

What is a relevant termination award?

A relevant termination award is any payment or benefit which compensates the individual for the termination of their employment. With effect from 6 April 2018 if an employer pays a relevant termination award to an employee the employer has to calculate how much of the relevant termination award is Post Employment Notice Pay.

What ia a Post Employment Notice Payment (PENP)?

If an employee has not worked their full notice period, PENP is the amount of income the employee would have received during any period of unworked notice. It was introduced to ensure that income tax and NICs are paid on all PILONs.

If an employee works their full notice period then income tax and NICs will be calculated in the usual way and there is no need to calculate PENP.

If there is a relevant termination award as well as a PILON than a PENP calculation must take place.
The employee's salary, for PENP purposes, is the income the employee would have received during the unworked period of notice, including any amounts given up by the employee as salary sacrifice (i.e. it is the pre-salary sacrifice salary that is used).

Once again it is important to note that if the employee has earned less than usual because they have been furloughed, notice payments must be based on what they would have earned normally, rather than on their furlough pay.

How to calculate PENP

PENP is calculated using the following complex formula:
$((BP \times D) \div P)-T$
BP is the employee's basic pay in respect of the last pay period ending before the 'trigger date'. The trigger date is the day that notice is given, if no notice is given the trigger date is the last day the individual was employed;
D is the number of days in the post-employment period;
P is the number of calendar days in the last pay period;
T is any payment or benefit received in connection with the termination of the employment which is taxable as earnings.
If the amount calculated by the formula is zero or a minus number then the amount of PENP is nil and no additional tax is due.

Example of PENP calculation

At the beginning of June 2020 Joe is told that he is being made redundant. He is paid £3,000 each month. Joe has a notice period of 3 months (92 days) and has worked 17 days of his notice period. No taxable termination payments have been made.

BP =£3,000 per calendar month (before any salary sacrifice)

Notice period is 3 months (92 days) and the period of notice worked is 17 days

D (unworked notice period) = 92 – 17 = 75 days

P (pay period) = one month – notice is given in June so look at May = 31 days

T (contractual payments including PILON) = £0

$((3000 \times 75) \div 31) - 0 = £7,258.06$

PENP = £7,258.06 which is taxable through payroll.

Simplified calculation

There is a simplified calculation which can be used when:

- Employee's pay period is exactly a calendar month;
- Notice period is a whole number of calendar months; and
- The unexpired period of notice is a period of whole calendar months.

When using the simplified calculation the formula is the same but take 'P' to be 1 and calculate 'D' in months rather than days.

More information

You can find more information about termination of employment on the ACAS website.

HMRC's website gives information about the tax and NIC treatment of termination payments.

MBKB has recorded a webcast covering redundancy and termination payments which is available on the PayrockPayroll website.