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# STOP PRESS- A Taxing Compromise for Employees

On 6 April 2011, new rules on PAYE will come into force which will completely overhaul the way you can deal with taxation of (taxable) termination payments. Under these rules, the current ability to tax post-termination payments at basic rate (even if the individual is a higher rate tax payer) will be removed and any payments made to employees who have left employment will be charged to code 'OT' (i.e. where income is taxed and the employee's personal allowance is not considered), meaning that income tax will be deducted at a higher rate.

**Before 6 April 2011**

Currently, any payments made to employees who have already left employment and have subsequently received their P45 are charged to code 'BR', whereby the employer deducts income tax on any payments at the basic rate. Where such payments are in excess of the basic rate threshold, the employee must account for this in their tax return at a later date. This system is relatively simple for employers to administer and allows employees who fall within the higher rate tax band to enjoy a tax holiday on any employment related termination payments.

**After 6 April 2011**

From 6 April 2011, the tax holiday for higher rate employees will be retracted. Employers will be required to deduct income tax at a higher rate on all payments made to ex-employees once their P45 has been issued. It will then be the employee's responsibility to reclaim any tax which has been overpaid through their tax returns.

**Which Payments are Covered?**

All payments made to employees after receiving their P45, are covered. Examples of such payments might include a termination payment, accrued holiday pay, shares transferred on the exercise of an option or a vesting of shares.

**Check Your Compromise Agreements**

The most common type of payment affected by the new rules will be termination payments which often form part of a compromise agreement between the employer and employee. It is standard to include (and employee advisers often insist on) a specific reference in those agreements to any balance over the tax-free £30,000 threshold being taxed at basic rate only. This will not be possible going forward and care needs to be taken in relation to any transitional agreements which are signed before the new rules but provide for payment afterwards. Therefore, it is crucial to ensure that any compromise agreement which provides for a termination payment to be made after 5 April 2011, specifies that the balance of any ex gratia termination payments over £30,000 is subject to the deduction of tax at the applicable, or an unspecified, rate (which will in fact be the higher rate) rather than basic rate.

### What Other Impact will the Rules Have?

The tax rate bands will be operated on a weekly basis, i.e. all deductions of tax will be calculated on a 1 week basis. Therefore, any payments made to employees after leaving employment in excess of £2,884 will be subject to tax at the rate of 50%. As the tax threshold for the 50% rate is currently £150,000, those employees earning less than this will be disadvantaged and will have to apply for a tax rebate for any tax which has been over-deducted under PAYE.

### What Should Employers Do?

Employers should consider carefully any payments made to employees once their P45 has been issued. This includes ensuring that any compromise agreements are worded accordingly (as detailed above) and take account of the new rules.

Employers may also wish to revise their current procedure for making payments on termination. Whereas in the past, payments have generally deliberately been made post-termination in order to maximise the tax efficiency, it may now be advisable to consider making some payments, where feasible, before the issuance of a P45. This would mean that tax is deducted on a monthly basis and such deductions take into account the employee's personal allowance.

This may not be possible in all circumstances such as where shares vest after the issuance of a P45 or the employer is taking advantage of the £30,000 allowance for termination payments but it is something which is likely to be raised by employees. It should be noted that there is no specific rule which says that the £30,000 allowance only applies if the termination payment is made post-termination but HMRC have traditionally been suspicious of payments made before employment terminates, specifically as to whether they actually represent some sort of contractual (and therefore taxable) emolument of employment, like a loyalty bonus. However, under the new regime, we may find employees pushing for such payments to be made before the P45 where this would result in advantageous tax treatment for them.

### Where are the New Rules?

The new rules for employers are set out in the HM Revenue and Customs 'Employer Further Guide to PAYE and NICs' or '*CWG2(2011)*'. The legislation is expected to be contained within this year's Finance Act which is not in final form, but HMRC are advising that it is 99.9% certain that it will go ahead and in readiness for this, they have published final guidance and are telling employers to prepare for the changes in advance.

If you would like to discuss any aspect of this alert or require further information on the matters referred to, please contact:


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