

Taxation of Termination Payments

The phrase ‘taxation of termination payments’ refers to payments in money or benefits which are made by employers to employees when the contracts of employment between the parties are terminated. These payments, which are made as a result of the termination of employment, are subject to provisions contained in the taxation legislation. A redundancy payment, for example, is a termination payment. An ex gratia payment can also be a termination payment: Resolute Management Services Ltd and Haderlein v The Commissioners for Her Majesty’s Revenue and Customs (2008) Spc 00710, 10 April 2008.

Many employers and employees assume that the first £30,000 of any termination payment is automatically exempt from tax under s.401 and s.404 of the Income Tax (Earnings and Pensions) Act 2003 – but this assumption is not always correct.

The payments of lump-sums by employers to employees on termination of employment before retirement are, with exceptions, liable to income tax. The main exception is that the first £30,000 is normally tax-exempt. But such a payment is chargeable to tax if the employee was contractually entitled to it because the payment was classed as earnings: EMI Group Electronics v Coldicott (HMIT) 1999) IRLR 630, Court of Appeal.

Settlements consisting of cash award made by employment tribunals are tax-exempt up to the first £30,000. Regarding the payment of income tax on such awards, the position is that an amount equal to tax that would have otherwise have been paid is deducted in calculating the first £30,000. But in *Manyservice Ltd v Wilson* (1998), the Employment Appeal Tribunal approved the payment of a gross sum for the reason that: ‘This is a well-established practice in which the decision in *Gourley* plays no part.’

A lump-sum payment made by an employer as a result of a compromise agreement made ‘in full and final settlement of all claims’ as compensation for the termination of the contract of employment (but which must not contain any payment in respect of earnings or emoluments) is tax-exempt up to the first £30,000.

A lump-sum payment that is paid as compensation for wrongful dismissal is paid net of tax: *British Transport Commission v Gourley* (1956) AC 185, HL – ‘the *Gourley* principle.’ *Gourley* (1956) was a personal injuries case in which the House of Lords held that damages for loss of earnings should be net of tax. The Court of Appeal confirmed that the same principle applied in wrongful dismissal cases; i.e. damages must be reduced by an amount equal to the tax the employee would have had to pay on them: *Parsons v BNM Laboratories* (1964) 1 QBD 95.

But an example of wrongful dismissal is where an employee is dismissed and given pay in lieu of notice where there is no contractual term that allows the employer to do this. The lump-sum payment would be compensation for breach of contract being a wrongful dismissal. As such, the payment is not taxable as an 'emolument' but comes under s.401, Income Tax (Earnings and Pensions) Act 2003. Any such payment up to the first £30,000 will not be taxable.

A different rule applies where damages exceed £30,000. The leading case is *Shove v Downs Surgical Ltd* (1984) ICR 532 QBD, wherein the Court assessed the claimant's net losses but held that damages were to be paid gross and ordered the gross sum to be paid that, after tax was deducted, would give the claimant the correct net award that would compensate him for his losses. This case authority was confirmed by the Employment Appeal Tribunal in 2008: *Abbey National plc and another v Chagger* (2008).

An award of statutory compensation for 'injury to feelings' made in a discrimination case does not attract tax: *Orthet Ltd v Vince-Cain* (2004) EAT, IRLR 857. Similarly, common-law damages for 'pain and suffering, disability and loss of amenity' in personal injury cases, with which 'injury to feelings' cases are analogous, are not subject to tax.

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