Thorntons

Calculating post-employment notice pay

There are two formulas which an employer should use to calculate PENP and which is the correct one to use, will depend on how often the employee is paid, whether their notice period is expressed in weeks or months and whether any part of their unworked notice period is in whole months. The two formulas as are follows:

Formula 1

The basic formula for an employee who is paid monthly, whose contractual notice period is expressed in months and whose employment is terminated with immediate effect or whose unworked periods of notice is a whole number of months is: BP x D – T, where:

- BP is basic pay for the last pay period to end before the day notice is given (assuming notice is given) or the last pay period to end before employment is terminated (if notice is not given) – please see further below.
- D is the number of months in the post-employment notice period, broadly the unworked period of notice.
- T is the amount (other than holiday pay and termination bonuses) paid on termination but taxable as earnings. Most commonly, T will cover contractual PILONs or cases whether PILON has been already been paid subject to the appropriate deductions for tax and NI.

<u>Basic pay</u>
Basic pay for the last pay period is defined as employment income <u>disregarding</u> overtime, bonuses, commissions, gratuities, allowances, termination awards, benefits in kind, amounts treated as earnings, and amounts that count as employment income (such as share-based employment income). However, basic pay <u>includes</u> amounts that would have been received absent a salary sacrifice arrangement.

Example
Employee A is paid £3,000 monthly (basic pay) and has a 3 month notice period (no contractual PILON). A works one month of the three month notice period. A's employer makes an RTA of £10,000.

Applying the formula BP x D - T: £3,000 x 2 months – nil = £6,000.
As PENP is less than the RTA, £6,000 is treated as earnings and the balance is taxable as under section 403.

However, if part of the termination award is a statutory redundancy payment, the RTA is reduced accordingly. For example, if the termination award comprises a statutory redundancy payment of £5,000 and an ex gratia payment of £5,000, RTA will be £5,000. As PENP is greater than RTA, the entire RTA (£5,000), would be treated as earnings.

Formula 2

A more complicated formula is applied if the employee is not paid monthly or the employee's notice period or unworked period of notice is not expressed in months. Here the formula is (BP x D)/P – T, where:

- BP is as set out in formula 1.
- P is the number of days in the "pay period". "Pay period" is not defined in the legislation and therefore should be given its ordinary meaning.
- D is as set out in formula 1.
- T is as set out in formula 1.

Example

Employee B is paid £1,000 fortnightly (basic pay) and has an 8 week notice period (no contractual PILON). B serves 3 weeks of the 8 week notice period. B's employer makes an RTA of £5,000.

Applying the formula (BP x D/P) - T results in: (£1,000 x 35 days) / 14 days – nil = £2,500. Therefore, £2,500 of the RTA is taxable as earnings.

<u>What if the contract includes a contractual PILON clause?</u>
Under the pre-6 April 2018 rules, where a contractual PILON was paid, it was taxed as earnings. That treatment continues after 6 April 2018 and if all that is paid on termination is a contractual PILON, a PENP calculation is not needed (since there is no RTA).

However, if there is an RTA and a contractual PILON is paid, employers must carry out the PENP calculation. While in many cases PENP will be nil in these circumstances, that will not always be the case as the following example illustrates:

Example

Employee D earns £10,000 a month (30 day pay period) and has a 12 week notice period. Here, the notice period is not expressed in months. Accordingly, the more complex (BP x D)/P – T formula applies. The employer exercises contractual right to dismiss without notice and pays PILON equal to 12 weeks' salary (£120,000/52.1 x 12 = £27,639).

Applying the formula (BP x D/P) - T results in: (£10,000 x 84 days) / 30 days - £27,639 = £361.

Therefore, £361 of the RTA is taxable as earnings.