

## How to make a payment in lieu of notice

Generally a contract of employment can be terminated by either side giving the appropriate notice to the other party. However, in some circumstances an employer may wish to dismiss an employee without notice and make a payment in lieu of notice instead. This may be appropriate in a redundancy case or where an employee is being dismissed following a capability process.

This XpertHR Professional “how to” guide steers employers through the issues they need to consider when making a payment in lieu of notice.

### The guide covers:

- › What is a payment in lieu of notice?
- › Contractual provision for payment in lieu of notice
- › When is a payment in lieu of notice appropriate?
- › Should a compromise agreement be used with a payment in lieu of notice?
- › When is a period of garden leave more appropriate than a payment in lieu of notice?
- › Confidential information and company property
- › Making the payment in lieu of notice
- › Benefits in kind
- › Payment for holiday entitlement that would have accrued during the notice period
- › Calculation of redundancy payments where a payment is made in lieu of notice
- › Taxation of payments where there is no PILON clause in the contract
- › Taxation of payments made under a PILON clause

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## What is a payment in lieu of notice?

The general rule is that a contract of employment can be terminated by either side giving the appropriate notice to the other party. The length of such notice is generally set out in the contract of employment and must be included in the employee's statement of terms and conditions of employment.

In the absence of a specific contractual clause, the courts will imply a term allowing the contract to be terminated on the giving of "reasonable" notice. Section 86 of the Employment Rights Act 1996 also imposes a minimum period of notice, which will apply if it is longer than that provided for in the contract.

Terminating the contract without giving the appropriate notice will be a breach of contract (unless there is a contractual provision allowing for this) and will give rise to a claim for damages. Damages for breach of contract are based on putting the employee in the position in which he or she would have been if the contract had been performed properly. In the context of dismissal this means that the employee must receive the money that he or she would have received had the employer given proper notice.

Therefore, at its simplest level, a payment in lieu of notice is the payment made by the employer to cover the damages for the breach of contract involved in terminating the contract without giving proper notice.

If the employee is guilty of gross misconduct, the employer is under no obligation to give notice at all and can summarily dismiss the employee. In these circumstances there is no breach of contract and no entitlement to notice pay.

## Contractual provision for payment in lieu of notice

The standard analysis that a payment in lieu of notice is a form of damages for breach of contract does not apply if the contract of employment specifically provides that the employer can terminate it by making a payment in lieu of notice. In such circumstances there is no breach of contract when the dismissal takes effect and the payment is simply a sum due under the contract.

The key advantage of this is that it allows the immediate termination of the contract without affecting the validity of any post-employment restrictions, such as non-competition and non-solicitation clauses. Since these are part of the contract, they generally cannot be enforced by a party that has repudiated that contract through a fundamental breach, such as terminating the contract without notice. A payment in lieu of notice clause (PILON clause) makes it clear that termination without notice is not a breach of contract, provided that the employer makes the correct payment to the employee.

A PILON clause may also define the scope of the payment in lieu of notice in a way that is narrower than the normal calculation of damages for breach of contract, for example by limiting the payment to basic pay only, excluding any non-cash benefits to which the employee would otherwise be entitled. Therefore, it has the advantage of preventing arguments about what should or should not be included in the payment, which can be a particular problem in relation to jobs with complicated remuneration provisions or valuable benefits in kind.

The main disadvantage of a PILON clause is that payments made under it form part of the employee's contractual remuneration and fall to be taxed accordingly (see [Taxation of payments made under a PILON clause](#)).

## When is a payment in lieu of notice appropriate?

An employer should make a payment in lieu of notice when it wishes to terminate the contract of an employee without giving the notice due under the contract, unless the dismissal is in response to gross misconduct on the part of the employee.

When dismissing an employee, the employer must decide whether to dismiss him or her with no notice, partial notice or full notice. In this context, a dismissal

without notice does not mean a dismissal without warning, consultation or discussion. A dismissal out of the blue is highly likely to be unfair and the employer may well be liable for compensation going well beyond payment for the notice period.

Payment in lieu of notice is particularly common in redundancy cases where there has already been consultation prior to the dismissal. Once the employer has taken the decision to dismiss, there is often little value to either the employer or the employee in the employee working out his or her notice, so an immediate cessation of the employment may be appropriate.

A payment in lieu of notice may also be appropriate where dismissal follows a capability process. This may provide for a more dignified exit for the employee than if he or she were to continue to work, and the employer may feel that the contribution from the employee during the notice period is likely to be limited.

Employers should take care to ensure that there is clarity about exactly when the contract of employment ends. The dismissal letter should specify a date that is the last day of employment. The employer should pay the employee's pay and benefits in the normal way up to that date and make a payment in lieu of notice for any sums that would become due in the notice period. In general, a payment in lieu of notice is appropriate only when the contract is ending immediately. Therefore, subject to any restrictive covenants in the contract (for example, limiting the employee's ability to work for a competitor within a fixed period following the end of the employment), the employee will be free to work for another employer during what would otherwise have been the notice period.

Restrictive covenants are likely to be unenforceable if the employer has breached the contract by failing to give proper notice. However, if there is a PILON clause in the contract, the termination will not amount to a breach and the validity of the restrictive covenants will not be affected.

### **Should a compromise agreement be used with a payment in lieu of notice?**

When dismissing an employee with a payment in lieu of notice, the employer should consider whether or not it would be appropriate to seek to enter into a compromise agreement with the employee. If the employer is simply paying the minimum amount due to the employee on termination it is unlikely that the employee would be prepared to sign a compromise agreement in full and final settlement of all potential employment tribunal claims.

However, where the payment in lieu of notice is accompanied by additional payments designed to compensate the employee, over and above his or her contractual entitlement, it is normal to provide for the payment in lieu of notice as part of a compromise agreement. This has the advantage of removing the risk of the employee bringing a claim about the extent to which bonuses, benefits in kind and other elements of the employee's remuneration package should be included.

### **When is a period of garden leave more appropriate than a payment in lieu of notice?**

A period of "garden leave" occurs where the employer gives the employee notice of dismissal and instructs him or her not to come into work during the notice period. In such a case the employee remains bound by the terms of the contract and is unable to work for a competitor. No payment in lieu of notice is required if the employee is on garden leave; the employer simply continues to pay him or her as normal. When the contract eventually ends, the employee remains bound by any post-employment restrictions contained in the contract of employment.

However, garden leave does not achieve the quick, clean break that employers often want. The employee remains on the payroll and part of the headcount. In

some organisations, this can cause delays in hiring a replacement. There are also circumstances in which keeping an employee on garden leave for an extended period can itself be a breach of contract. This is likely to be an issue where the employee's remuneration is highly dependent on performance in the role, for example a sales person earning commission. Employers should include a clause in the contract for such roles specifically authorising the employer to require the employee to remain on garden leave during the notice period.

One circumstance in which garden leave will generally be more appropriate is when the employee has resigned by giving notice and the employer feels that it is not desirable for him or her to work out the notice period. Instructing the employee to remain at home is less likely to cause legal complications than seeking to make a payment in lieu of notice. Even where the contract specifically allows for a termination with a payment in lieu of notice, there is a risk that bringing forward the termination date by making such a payment, without the employee's consent, would constitute a dismissal (rather than a resignation), which could be held to be unfair. Compensation for unfair dismissal in these circumstances would be limited to the basic award, as the employer would already have compensated the employee for all lost earnings up to the date on which the employment would otherwise have terminated.

If an employer makes a payment in lieu of notice to a resigning employee who does not agree to shorten the notice period, there will be a risk of breach of contract (in addition to the risk of an unfair dismissal), unless there is a PILON clause in the contract that specifically applies where it is the employee who has given notice.

## **Confidential information and company property**

An immediate dismissal requires careful handling to ensure minimal disruption and appropriate protection of confidential or commercially sensitive information.

Where the dismissal is not only immediate but also sudden (that is, the employee has not been involved in discussions about possible dismissal), the employer may need to take appropriate steps to protect the business in the immediate aftermath of the dismissal. This may involve disabling the employee's access to the computer system or premises as soon as the dismissal has taken effect and before the end of the meeting to confirm the dismissal. In some businesses it is standard practice to ensure that the employee remains accompanied by an appropriate staff member (often from HR) throughout the period between being informed of the dismissal and leaving the premises.

Where confidential information is an issue, the employer should remind the employee of his or her obligations in respect of confidentiality as part of the written confirmation of dismissal.

The employee may be in possession of property belonging to the employer that must be returned. This may be a company car or laptop, but can also include files and databases contained on memory sticks or saved on the employee's own computer at home. The employer may consider withholding the payment in lieu of notice until this property has been returned or deleted from the employee's own computer. However, if the employee is relying on a PILON clause, it can withhold payment in these circumstances only if this is expressly provided for in the contract. Otherwise, withholding the payment may amount to a breach of contract.

## **Making the payment in lieu of notice**

The employer should always confirm the dismissal in writing, stating clearly the date of the last day of employment. Where the employer is relying on a PILON clause, it is important that it makes the payment at the same time as the dismissal, unless the contract expressly provides for a later or staged payment. The dismissal letter should confirm the amount of the payment, and set out any deductions for tax and national insurance.

The payment in lieu of notice should be clearly identified as such. In [Publicis Consultants UK Ltd v O'Farrell EAT/0430/10](#), the employer made a payment to the employee on termination that was calculated with reference to her notice period, but which was labelled as an "ex gratia" payment. The Employment Appeal Tribunal held that this was not sufficient to discharge the employer's burden of making a payment in lieu of notice.

Where there is no PILON clause, the actual payment is not such an urgent issue and may depend on negotiations between the parties. Where the payment is being rolled up with other payments such as redundancy pay or a payment to reflect compensation for potential unfair dismissal, payment may be dependent on the completion of a compromise agreement, which will dictate the appropriate terms for payment.

## Benefits in kind

A PILON clause can deal specifically with benefits in kind that accrue under the contract, such as the provision of a company car, health insurance and bonuses. The usual position is to provide that the payment will cover basic pay only and that there will be no payment in respect of non-cash benefits that would usually accrue under the notice period.

However, in the absence of a contractual clause regulating this, the default position is that the employee should be compensated for the loss of any benefit under the contract for the duration of the notice that should have been given. Therefore, if the employee has the benefit of the personal use of a company car, the payment in lieu of notice must make provision for this. The employer can either allow the employee to keep the car for the appropriate period or make a payment representing the cost of renting a vehicle for that period of time. The same principle applies in relation to other benefits such as private medical insurance.

In relation to bonuses and commission payments, the position will depend on the wording of the relevant contractual scheme. Some contracts expressly provide that commission and bonuses are not payable during the employee's notice period, and in such circumstances they will not need to be reflected in a payment in lieu. In general, however, the question is the same as with other benefits: what would the employee have received in pay and benefits if the contract had been correctly performed and notice duly given?

## Payment for holiday entitlement that would have accrued during the notice period

Some statutory payments, such as holiday and redundancy pay, will vary depending on the day on which dismissal takes place. Regulation 14 of the Working Time Regulations 1998 (SI 1998/1833) provides for the payment of statutory holiday that an employee has accrued but not taken at the time of dismissal. The payment under reg.14 is specifically based on the actual termination date, not the date on which the employment would have terminated had statutory notice been given (unlike provisions relating to the calculation of a redundancy payment (see [Calculation of redundancy payments where a payment is made in lieu of notice](#)). This means that, even if the giving of proper notice would have given rise to an increased entitlement to statutory holiday, this need not be reflected in the payment of holiday accrued up to the termination date under reg.14.

Entitlement under reg.14 does not vary if the employer makes a payment in lieu of notice to cover the full notice period. It is the actual date of termination that matters, not the date that termination would have occurred if notice had been given, and the employer should calculate payment under reg.14 accordingly.

In addition to statutory rights relating to holiday under the Working Time Regulations 1998, holiday entitlement is also a contractual right. However, while, as a matter of contract, the employee would have continued to accrue holiday over

the course of the notice period, had he or she worked it, this will not necessarily need to be reflected in the payment in lieu of notice. Holiday would have accrued in the notice period, but it could also have been taken by the employee before the contract ended, in which case there would have been no further payment required at the end of the notice period. Where there are alternative options as to how a contract could have been performed, there is a general principle in calculating losses that the party paying the compensation would have performed the contract in the way most advantageous to itself. If the employer is entitled, under the contract, to require the employee to take holiday at specified times, it can be assumed that the employee would have taken holiday accrued during the notice period during the notice period (subject to the requirement in reg.15 of the Working Time Regulations 1998 for the employer to give twice as much notice as the number of days' leave in question, or such requirements for notice that may be set out in the contract of employment or a workplace agreement).

Therefore, in general, the payment in lieu of notice need not reflect holiday that would have accrued beyond the actual date of termination, unless the contract provides otherwise. However, in practice, employers may decide to include this in the payment in lieu to avoid any dispute over the point. Where the employer is negotiating a compromise agreement with the employee, or where negotiations are taking place with a union as part of a redundancy exercise, the calculation dates relating to payment of accrued holiday can form part of the negotiation.

## Calculation of redundancy payments where a payment is made in lieu of notice

Under s.145 of the Employment Rights Act 1996, the entitlement to a statutory redundancy payment is calculated in accordance with the date on which the contract actually ends – either the expiry of notice or the date on which the dismissal takes effect when notice is not given. If the employee would, during the contractual notice period, have reached an anniversary or milestone that would have increased his or her redundancy payment, that entitlement will not arise if the employee is dismissed without full notice and the contract ends before that date.

The exception to this is where the employer has dismissed the employee without the statutory notice required by s.86 of the Employment Rights Act 1996. This is a period of between one week and 12 weeks, depending on the employee's length of service (see [Statutory minimum notice to be given to employees](#) in the XpertHR quick reference section), and is unaffected by any shorter notice period provided for in the contract. For the purposes of calculating a redundancy payment, s.145(5) of the Employment Rights Act 1996 provides that the dismissal date is taken to be no earlier than the day on which the statutory minimum period of notice would have expired.

There is no requirement for the payment in lieu of notice to include the extra statutory redundancy payment that would have arisen if contractual notice had been given, rather than just the statutory minimum notice. The courts will not allow compensation for breach of contract to allow employees to claim for statutory rights for which they do not otherwise qualify ([Harper v Virgin Net Ltd \[2004\] IRLR 390 CA](#)).

This means that, if an employee with five years and 11 months' service is dismissed, the redundancy payment will be calculated based on six years of service because the five weeks' notice required under s.86 would have taken him or her past the anniversary date. If, however, the employee has only five years and 10 months' service, the redundancy payment will be based on just five years, even if the contract requires the employer to give three months' notice of termination. This is because the five weeks' notice required under s.86 would not have taken the employee past the six-year anniversary date.

Where an enhanced redundancy payment is provided for in the contract, and the giving of full notice by the employer would have led to a higher contractual



redundancy payment, for example because the employee would have had longer service, it may be necessary for this to be reflected in the payment in lieu of notice. The contractual redundancy scheme should anticipate that a payment in lieu of notice may be made in a redundancy situation and the terms of the contract should cover how the payment will be calculated in these circumstances.

## Taxation of payments where there is no PILON clause in the contract

If the employer makes a payment in lieu of notice as compensation for the breach of contract involved in not giving the appropriate notice to the employee, it need only make the payment on the basis of net pay. This is because damages for breach of contract are intended to put the employee in the position in which he or she would have been if the contract had been performed. If the employer had given the employee the appropriate notice, the pay that he or she would have received would have been net of tax and national insurance.

The total sum of the payment will count towards the employee's individual tax liability. However, because the payment is compensation for loss of employment, the employee can usually take advantage of a tax allowance of £30,000 (pursuant to s.403 of the Income Tax (Earnings and Pensions) Act 2003). This means, in effect, that the first £30,000 of the payment in lieu of notice is tax free.

This also means that the employer enjoys a windfall in relation to redundancy pay under £30,000 in that it does not need to pay the employee the full gross amount of his or her pay. Some employers choose to cushion the impact of the dismissal on the employee by passing on this windfall to the employee, although there is no legal obligation to do so. This may be a matter of negotiation if the parties are discussing a potential compromise agreement.

Payments in excess of £30,000 will be subject to tax, but not national insurance. Since the employee is entitled to receive the full amount of the net pay that he or she would have received if the proper notice had been given, it may be necessary for the employer to "gross up" the amount of a payment in lieu of notice so that the employee is left with the correct net amount after paying tax on any payment in excess of £30,000.

This means that, in the case of high-value employees, the calculation of the correct payment in lieu of notice can be a complicated matter. Employers should take legal advice on a case by case basis in these circumstances, to ensure that the correct payment is being made. Depending on the circumstances, it may be appropriate for the parties to reach a compromise agreement in which appropriate warranties and indemnities are given in relation to tax liability.

## Taxation of payments made under a PILON clause

If the employer makes a payment in pursuance of a PILON clause, it will be a payment due under the contract and will fall to be taxed in the same way as other contractual benefits given to the employee – the £30,000 tax allowance does not apply. The position adopted by HM Revenue and Customs (HMRC) changes from time to time, but HMRC has been known to treat employers that regularly dismiss with a payment in lieu of notice to be doing so as a matter of contract, even in the absence of a PILON clause. The legal basis for this is doubtful at best as the courts would not imply a PILON clause into a contract that contradicted the express terms relating to notice. However, employers that operate a standard practice of making payments in lieu of notice without the presence of a PILON clause should take detailed advice as to the tax position.

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