



Cabinet Office



HM Revenue  
& Customs

# **Taxation of Efficiency Compensation Payments**

## **Policy Guidance**

**(August 2025)**



## Summary: Taxation of EC is the Department's Responsibility

- This guidance sets out how departments should apply the correct tax treatment to efficiency compensation payments made to employees upon dismissal.
- Departments are responsible for assessing and applying the appropriate tax treatment at the point of payment, in line with PAYE requirements.
- The first £30,000 of efficiency compensation is generally exempt from income tax, in line with Section 403 Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) [see Appendix A].
- Any amount above £30,000 is subject to income tax and Class 1A (employer's) National Insurance Contributions (NICs) only.
- Payments made due to injury or disability may be fully exempt from tax under Section 406 of ITEPA 2003 [see Appendix A], where the requirements of the legislation and case law are met. This must be supported by medical evidence with each case assessed individually.
- Departments must clearly separate efficiency compensation from other payments such as redundancy or ex gratia elements or any elements that are taxable as earnings such as outstanding holiday pay, contractual payments in lieu of notice or Post Employment Notice Pay (PENP).
- Individual cases should be assessed on their own merits. Where uncertain, departments should seek advice from HMRC using their [Non-Statutory Clearance Service](#), with the employee's consent.
- Departments should review any potential reappointment implications, including repayment of compensation where applicable.
- Updated internal payroll processes and stakeholder coordination are essential to ensure compliance and consistency across government.



## 1. Purpose and Scope

- 1.1 This document provides guidance for government departments on the correct tax treatment of efficiency compensation payments made to employees upon dismissal.
- 1.2 Departments are responsible for assessing and applying the appropriate tax treatment at the point of payment, in line with their obligations under PAYE Regulations. Historically, employees have had to seek tax rebates directly from HMRC, due to employers not applying tax exemptions at the point of payment.

## 2. Departmental Responsibility for Tax Assessment

- 2.1 Departments must ensure:
  - 2.1.1 Payments are correctly categorised and taxed at the source.
  - 2.1.2 Efficiency compensation is separated from other dismissal-related payments (e.g. redundancy, ex gratia, contractual payments in lieu of notice or Post Employment Notice Pay).
  - 2.1.3 Tax exemptions are correctly applied where applicable.



## 3. Treatment of Lump Sum Efficiency Compensation

- 3.1 When issuing a lump sum payment, departments must:
- 3.1.1 Separate the portion attributable to efficiency compensation from other elements of the payment (e.g., redundancy or ex gratia payments or any elements that are taxable as earnings such as outstanding holiday pay or contractual payments in lieu of notice).
  - 3.1.2 The first £30,000 of an efficiency compensation payment is generally exempt from tax under Section 403 ITEPA 2003 [see Appendix A].
  - 3.1.3 Amounts exceeding £30,000 are subject to income tax and Class 1A (employer's) National Insurance Contributions (NICs) only.
  - 3.1.4 Where an employee has a disability or injury that prevents them from carrying out their duties and the termination payment is made wholly due to this, then the payment may be fully exempt from tax under Section 406 ITEPA 2003 [see Appendix A for the conditions of the exemption and requirements under case law]. This must be supported by medical evidence with each case assessed individually.
  - 3.1.5 Ex gratia payments may be taxable depending on their nature and should be assessed separately.
  - 3.1.6 Any payments of earnings that are also made as part of the final termination payment will be subject to tax and Class 1 National Insurance Contributions like normal salary. These include outstanding salary, holiday pay, contractual payments in lieu of notice or Post Employment Notice Pay.



## 4. Tax Exemption for Disability or Injury-related Dismissals

- 4.1 Under Section 406 of ITEPA 2003, if the employee has a disability or injury that prevents them from carrying out their duties and the termination payment is made wholly due to this, then the payment may qualify for this tax exemption [see Appendix A for full details].
- 4.2 To qualify for this exemption, the following criteria must be met:
- 4.2.1 The dismissal must result from a disability or injury that prevents the employee from undertaking the duties of their employment (this does not include the normal process of ageing).
- 4.2.2 Departments should review medical evidence which must confirm the exact nature of the disability / injury at the point of termination of employment; and it must be clear that the nature of the disability/injury prevented the employee from carrying out the specific duties required under their employment.
- 4.2.3 Essentially, there must be a loss of physical or mental health which has rendered the employee incapable of carrying out the duties which they previously performed. This can either be:
- a sudden loss of health which the employee is afflicted with at a particular time; or
  - the culmination of a process of deterioration of physical or mental health caused by chronic illness, which results in a continuing incapacity to perform the duties of employment.



- 4.2.4 The termination payment must be made solely because of the disability/injury and due to nothing else. For example, if any part of the payment is in reward for services or due on termination regardless of the cause, then it won't be on account of the disability and therefore that part is not eligible for tax relief under the S.406 exemption.
- 4.2.5 The tax exemption decision must rely on fully documented assessments.
- 4.2.6 Departments must assess each case individually; exemptions must not be assumed.

## 5. Individual Case Assessments and HMRC Referral Process

- 5.1 Each case must be evaluated on its own merits.
- 5.2 Departments should:
  - 5.2.1 Assess whether the payment qualifies for tax exemption or is taxable.
  - 5.2.2 Seek advice from HMRC under their [Non-Statutory Clearance Service](#) where it is unclear whether the Section 406 tax exemption applies or not, using the official referral form.
  - 5.2.3 Obtain explicit employee consent before making referrals.



- 5.3 The referral form must include:
  - 5.3.1 The reason for dismissal.
  - 5.3.2 Breakdown of the payment and classification rationale.
  - 5.3.3 Medical evidence that confirms the exact nature of the disability or injury and the impact this has on the employee's ability to carry out the employment duties required for their role.
  - 5.3.4 Decision manager's rationale for proposed tax treatment.
- 5.4 Without employee consent, referrals to HMRC cannot proceed. In such cases, if the decision manager has any doubt that the Section 406 exemption can apply, then any amount of the payment above £30,000 should be subject to tax and Class 1A (employer's) National Insurance only.
- 5.5 HMRC will not need information that confirms the identity of the employee. Medical evidence can be redacted to conceal the employee's identity if you wish.
- 5.6 HMRC will provide a clearance response only where the department has genuine uncertainty about how the legislation applies to the circumstances. If the referral is just seeking reassurance on treatment that the decision maker believes is correct, then HMRC may not provide a response.



## 6. Reappointment Following Efficiency Compensation

- 6.1 Departments must consider the implications of reappointment post compensation.
- 6.2 Key considerations include:
  - 6.2.1 Whether a repayment mechanism should apply if the individual returns to a government service shortly after dismissal.
  - 6.2.2 Whether the original payment should be reviewed or partially returned.
- 6.3 Additional guidance may follow, subject to policy review.

## 7. Implementation and Further Support

- 7.1 Departments should update payroll processes and internal policies to comply with the tax legislation.
- 7.2 Advice should be sought from HMRC under their [Non-Statutory Clearance Service](#) where there is genuine uncertainty about how the legislation applies to the circumstances.
- 7.3 Departments can seek further advice on this, or any other tax issue from the [Tax Centre of Excellence](#) by emailing [tax.coe@justice.gov.uk](mailto:tax.coe@justice.gov.uk).





## 8. Case Study Examples: Tax Treatment of Efficiency Compensation

This section presents real-world scenarios to illustrate how departments should assess efficiency compensation cases and apply the appropriate tax treatment, including Section 406 ITEPA 2003 exemptions where applicable.

### Scenario 1

Job holder off work for over 2 years on account of low mood, stress and anxiety following a workplace incident. Occupational Health recommendations (mediation and offer of CBT) were implemented by the employer, which the job holder engaged with, and the employer had attempted to support a return to work, including agreeing to a change of responsibilities. Nevertheless, the employee did not feel able to return to work. Following the department's absence policy, the absence was deemed unsustainable and the decision was taken to dismiss this individual under limited efficiency with compensation.

#### Tax advice as follows:

- The main driver for dismissal is that the business could not sustain the level of absence.
- The criteria under s406 states: in the usual case where the injury/disability has caused the termination, it is important to ensure that the medical condition and its employment consequences are considered by reference to the situation at the point of termination of employment and not at any other time. For example, evidence of a medical condition existing two years before termination is not determinative.
- Whilst the individual is unfit for work due to ongoing workplace stress and anxiety, a long-term solution and successful return to work requires business rather than medical intervention.

**Decision:** No exemption under s406(b) ITEPA 2003. Termination exemption of £30k under s401 ITEPA 2003 is still available.



## Scenario 2

Job holder suffers from lifelong depression, complex PTSD, and physical impairments including hearing loss, neuropathic pain, and mobility issues caused by Guillain-Barre Syndrome and osteoarthritis. Despite multiple workplace adjustments, including a Workplace Adjustment Passport and private therapy, the psychological barriers, particularly complex PTSD, remain significant and are not expected to resolve. Occupational Health and GP reports confirmed the individual is unfit for work and unlikely to return in the foreseeable future. The department concluded that all reasonable adjustments had been exhausted, and the absence remained unsustainable. Dismissal followed with 100% compensation.

### Tax advice as follows:

- Termination is clearly due to severe, ongoing physical and mental health conditions which prevent the employee from carrying out the duties of their role.
- The Occupational Health evidence and GP confirmation indicate a continuing incapacity and a prognosis that the condition will persist indefinitely.
- Criteria under s406 ITEPA 2003 are met: there is a clearly identified disability and the termination was solely due to this condition.

**Decision:** Exemption under s406(b) ITEPA 2003 applies. Efficiency compensation can be made without deduction of tax or Class 1 NICs.



## Appendix A

This appendix provides relevant legislative references from the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) that underpin the tax treatment of efficiency compensation payments.

### **Section 403: Charge on payment or other benefit where threshold applies**

- (1) The amount of a payment or benefit to which this section applies counts as employment income of the employee or former employee for the relevant tax year if and to the extent that it exceeds the £30,000 threshold.
- (2) In this section “the relevant tax year” means the tax year in which the payment or other benefit is received.
- (3) For the purposes of this Chapter (but see section 402B(3))-
  - (a) a cash benefit is treated as received -
    - (i) when it is paid or a payment is made on account of it, or
    - (ii) when the recipient becomes entitled to require payment of or on account of it, and
  - (b) a non-cash benefit is treated as received when it is used or enjoyed.
- (4) For the purposes of this Chapter the amount of a payment or benefit in respect of an employee or former employee exceeds the £30,000 threshold if and to the extent that, when aggregated with -
  - (a) other payments or benefits in respect of the employee or former employee that are payments or benefits to which this section applies, and



- (b) other payments or benefits in respect of the employee or former employee that are payments or benefits -
    - (i) received in the tax year 2017-18 or an earlier tax year, and
    - (ii) to which this Chapter applied in the tax year of receipt,

it exceeds £30,000 according to the rules in section 404 (how the £30,000 threshold applies).
- (5) If it is received after the death of the employee or former employee -
  - (a) the amount of a payment or benefit to which this section applies counts as the employment income of the personal representatives for the relevant year if or to the extent that it exceeds £30,000 according to the rules in section 404, and
  - (b) the tax is accordingly to be assessed and charged on them and is a debt due from and payable out of the estate.
- (6) In this Chapter references to the taxable person are to the person in relation to whom subsection (1) or (5) provides for an amount to count as employment income or, as the case may be, in relation to whom section 402B (1) provides for an amount to be treated as an amount of earnings.

#### **Section 406:     Exception for death or disability payments and benefits**

- (1) This Chapter does not apply to a payment or other benefit provided -
  - (a) in connection with the termination of employment by the death of an employee, or
  - (b) on account of injury to, or disability of, an employee.
- (2) Although “injury” in subsection (1) includes psychiatric injury, it does not include injured feelings.



## Appendix B

**There are 2 tests that must be met for the exception to apply** (supported by the [\*High Court decision in Hasted vs Horner\*](#)):

1. There must be an identified medical condition that disables the employee or prevents the employee from carrying out the duties of their employment (this does not include the normal process of ageing). The employer should:
  - a. review medical evidence which must confirm the exact nature of the disability/injury at the point of termination of employment; and
  - b. it must be clear that the nature of the disability/injury prevented the employee from carrying out the specific duties required under their employment

Essentially, there must be a loss of physical or mental health which has rendered the employee incapable of carrying out the duties which they previously performed. This can either be (reference [\*HMRC Statement of Practice 10 \(1981\)\*](#)):

- a sudden loss of health which the employee is afflicted with at a particular time; or
  - the culmination of a process of deterioration of physical or mental health caused by chronic illness, which results in a continuing incapacity to perform the duties of employment
2. The termination payment must be made solely because of the disability/injury and due to nothing else. For example, if any part of the payment is in reward for services or due on termination regardless of the cause, then it won't be on account of the disability and therefore that part is not eligible for tax relief under the S.406 exception.