ITEPA and discrimination payments

Charles Wynn-Evans reviews two important recent authorities on whether compensation for unlawful discrimination can be paid tax free

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'Clarifying the basis for, and the nature of, a payment to be made to an employee to settle their claims can be crucial in determining the proper tax treatment to be applied.'

The correct tax treatment of a payment made by an employer to a current or former employee to settle a claim related to that individual's employment can be of considerable significance. The extent to which a payment can be made without deduction of income tax can affect the level of settlement agreed between the parties. Applying an incorrect tax treatment can expose the employer not only to a liability for which it may not have budgeted, but also to costs and penalties for late payment of tax. There is also an increased risk of HM Revenue and Customs (HMRC) conducting a wider PAYE audit of the employer's payroll compliance.

Termination payments

For time almost immemorial, the first £30,000 of a termination payment has been exempt from income tax pursuant to ss401 and 403 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA). Perhaps unsurprisingly, this exemption has never been subject to the automatic inflation-based re-rating which has latterly applied to the limits on certain employment tribunal awards such as for unfair dismissal.

There are circumstances in which the £30,000 exemption does not apply. Examples include termination payments made:

- as a reward for past services (which constitute earnings taxable under s62 of ITEPA);
- pursuant to the exercise of a contractual pay in lieu of notice provision (per *EMI Group Electronics Ltd v Coldicott* [1999]); and
- in consideration of the employee agreeing to new restrictive covenants (s225(3) of ITEPA).

Such payments will generally be taxable in the usual way.

Payments in connection with injury

A payment made in connection with the death of an employee or 'on account of injury to, or disability of, an employee' is exempt from income tax under s406 of ITEPA. This raises the issue of how far this provision can properly apply to any injury to feelings component of settlement payments and to employment tribunal awards for discrimination. This further exemption can therefore be important in negotiating settlements of employees' claims of discrimination and indeed personal injury.

Awards for injured feelings

The employment tribunal can award compensation for injury to feelings in cases of unlawful discrimination pursuant to the combined effect of ss119(1) and 124(6) of the Equality Act 2010. The question which arose in *Timothy James Consulting Ltd v Walton* [2015] was whether such compensation for injury to feelings is tax free under s406(b) of ITEPA.

In this case, the employment tribunal had made various awards to

the claimant for constructive unfair dismissal and harassment. These included an award of £10,000 for injury to feelings, which the employment tribunal grossed up (following the well established principle in *Shove v Downs Surgical plc* [1984]) on the basis that the award would be taxable. The respondent employer appealed, *inter alia*, against the grossing up of this award, arguing that it was not subject to tax.

Prior authorities

In agreeing with the employer that the payment was not taxable and therefore should not have been grossed up, Singh J explored the prior authorities in some detail. In *Orthet Ltd v Vince-Cain* [2004], the Employment Appeal Tribunal (EAT) had relied on a number of factors as indicating that injury to feelings awards were tax free which included the following:

- the possibility of an award for injury to feelings being taxable was not mentioned in the leading case on the issue, *Vento v Chief Constable of the West Yorkshire Police* [2002];
- in *Vento*, it was considered correct to determine injury to feelings awards by analogy with damages for 'pain and suffering, disability and loss of amenity' in personal injury claims, which are not taxable;
- in *Essa v Laing Ltd* [2004], Pill LJ had noted that 'while there is a difference between "injury to health or personal injury" and "injury to feelings", the two are not inconsistent, may overlap and injury to feelings may contribute to injury to health';
- the guidelines of the Judicial Studies Board did not mention tax; and
- the concept of 'injury to or disability of the employee' includes mental and physical injury, so injury to feelings (which, when *Orthet* was decided, was the term used under s66(4) of the Sex Discrimination Act 1975 and carried 'the dictionary definition of "hurt" and humiliation') fell within its scope.

Somewhat more controversially, in terms of their authoritativeness, the EAT also referred in its reasoning to the views of the Equal Opportunities Commission (as it then was) and guidance issued to tribunal chairmen.

In the later case of *Oti-Obihara v Commissioners for HM Revenue and Customs* [2010], HMRC conceded that:

> To the extent that any part of the settlement payment comprised damages for injury to the appellant's feelings as a consequence of discrimination, then that is not taxable under section 6 ITEPA 2003, nor is it taxable under section 401 ITEPA as a termination payment even if it is paid on the occasion of the termination of the employment contract.

Orthet and *Oti-Obihara* were not, however, followed in *Moorthy v Commissioners for Her Majesty's Revenue and Customs* [2014], where the EAT considered that, in the context of a payment made on termination of employment:

> It is clear that ITEPA section 406 does not encompass payments for injury to feelings.

The EAT in that case in effect drew a distinction between an award for injury to feelings and for a disability caused by alleged discrimination. Unless there was a medical injury or disability, it considered that an injury to feelings payment in connection with the termination of an employee's employment could not fall within s406 of ITEPA. It was therefore taxable under s401 of ITEPA and the £30,000 exemption would engage just as it would for any other constituent elements of a termination payment.

EAT's decision

In *Timothy James Consulting*, Singh J preferred the reasoning in *Orthet* when construing what is meant in s406 of ITEPA by the phrase 'injury… to any employee'. He noted that the provision is not qualified by the words, 'in connection with the termination of employment'. In his analysis, this meant that compensation for any injury to an employee will fall within the s406 exemption. He considered it of no importance that the 'side-note' to s406 of ITEPA refers to an 'exception for death or disability payments and benefits'. Therefore the question became whether the concept of 'injury' in this context can extend to injury to feelings or is confined to:

> … physical injury, or at least personal injury of the kind that can be the subject of a claim for negligence.

Singh J was satisfied that he should follow *Orthet* in preference to *Moorthy* in concluding that s406 of ITEPA applies to awards for injury to feelings.

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Comment

Quite apart from its being in conflict with the tax authorities such as *Moorthy*, this decision has not been universally welcomed. The most cogent criticism is that hurt feelings such as distress or anger should not be considered to constitute an 'injury' in the absence of a mental condition amounting to a psychiatric illness. In practical terms, it is particularly unsatisfactory that this EAT authority

directly contradicts the avowed HMRC position in its Employment Income Manual, consistent with *Moorthy*, that an award for injury to feelings due to a discriminatory termination of employment falls to be taxed under s401 of ITEPA. In other words, it is treated as taxable apart from the £30,000 exemption provided by s403 of ITEPA. It will be interesting to see if future appellate decisions in either the taxation or employment sphere revisit this issue and the conflict in the case law.

At least there appears to be no controversy over the contention that compensation for injury to feelings unconnected with the termination of employment is tax free.

At least there appears to be no controversy over the contention that compensation for injury to feelings unconnected with the termination of employment is tax free. HMRC accepted this position in *Walker v Adams* [2003] and records it in its Employment Income Manual. As HHJ McMullen QC noted in *Orthet*, such a payment cannot be earnings as it does not arise from the recipient acting as an employee and it cannot be a termination payment within s401 of ITEPA since employment continues.

Earnings or discrimination compensation?

Clarifying the basis for, and the nature of, a payment to be made to an employee to settle their claims can be crucial in determining the proper tax treatment to be applied. In *Mr A v The Commissioners for Her Majesty's Revenue & Customs* [2015], the First Tier Tribunal (FTT) was asked to consider the tax status of a payment made under a compromise agreement. Was it taxable as 'earnings' under s62 of ITEPA or tax free because it was made to settle a potential race discrimination claim?

The dispute concerned a £600,000 payment made to an employee by the bank for which he formerly worked. HMRC argued that it was chargeable to tax on earnings from employment because it was designed to make good shortfalls in salary and bonus. In contrast, the employee argued that the sum was compensation for his threatened race discrimination claim and therefore free from tax. The claim that was settled was that he had suffered unfair treatment in receiving low or no bonuses over several years and no salary increases.

HMRC disputed that race discrimination was the reason why the bank made the payment. It argued that where compensation for discrimination is awarded by reference to earnings (whether before or after termination of employment) then the amount relating to earnings is taxed under ss62 and 401 of ITEPA. HMRC did not argue that the payment was in any way 'in connection with' the employee's termination of employment so as to fall within the provisions of s401 of ITEPA.

FTT's decision

The FTT concluded that:

> If an employment tribunal were to award damages for discrimination (whether calculated by reference to earnings or whether they included injury to feelings) these are recompense for the right not to be discriminated against under statute. They are paid because the employer has breached a statutory obligation not to treat the employee in a detrimental way due to his race. They are treated in like manner to a tort claim.

The payment was not earnings because it was not made:

> ... in return for the employee's services but because it has been determined

> that the employer has acted unlawfully by discriminating against the employee.

Payment made in settlement of a claim is to be taxed in the same way as the claim which it settles.

That said, the reason for the payment remains crucial and the FTT addressed what the employee needs to demonstrate to show that a payment is compensation for discrimination rather than constituting earnings. It considered that it did not need to be satisfied that there would have been a successful claim at the employment tribunal. However, it did need to be satisfied that the reason for the payment was to settle a discrimination claim and not to pay back money to which the employer thought the employee was contractually entitled.

The FTT rejected HMRC's argument that the employee needed to show proof that he was treated differently because of his race. It was necessary:

> ... to produce sufficient evidence from which it may be inferred that the reason why the payment was made was to compensate for an actual or potential action for discrimination.

The FTT noted various aspects of the factual matrix that it had to evaluate. In evaluating the evidence to ascertain the nature of the payment, the drafting of the relevant compromise agreement, which was in standard and very wide terms, was considered to be of little relevance. The parties' conduct, actions and correspondence were the evidentially probative issues. That the employee believed the payment to be for discrimination or could set out various instances of discrimination did not necessarily mean that the payment was referable to his potential discrimination claim. On the particular facts, the FTT did not consider that he had unwittingly emphasised the discrimination aspects of the matter to improve the tax situation. Rather, it was because his claim was based on discrimination that the tax issue arose.

As for the bank, the FTT considered that it would:

> ... be in a position to assess the strengths of its position in any threatened litigation... would act in a way that would best serve its interests and preserve its reputation [and] would be unlikely to make any explicit admission that it had racially discriminated against an employee.

Accordingly, the FTT accepted that the payment was made to settle the threatened claim for race discrimination and which the bank did not wish to defend. It was:

> ... not necessary to apportion what component of the payment related to merits of the discrimination claim and what related to any other of the various possible reasons. Such components only arise as a result of a claim in respect of which, if judgment had been given by the relevant tribunal in favour of the appellant, the resulting sum which would have been awarded would not have been taxable.

Comment

In reaching its decision in favour of the employee, the FTT conducted a thorough analysis of the history of his claims and the basis on which they were settled. This reinforces the need for the parties to negotiate settlement agreements and those dealing with a challenge from HMRC to the agreed tax treatment to be ready to put forward cogent evidence to support their position.

Practical issues

In a settlement, the employer may not be willing to agree to make a tax-free payment for injury to feelings or personal injury in addition to a generic £30,000 termination payment. It may fear that this is a tacit admission of discrimination or personal injury, even if the terms of settlement are, in principle at least, confidential.

In cases where allegations of breach of contract and discrimination are intertwined, there may be uncertainty about the proper tax treatment of compensation. A pragmatic answer for employers to the uncertainties presented by such cases is to include appropriate tax indemnity provisions in settlement agreements, to the extent that such an indemnity can be enforced. Nonetheless, careful consideration of the proper tax structuring of settlements of employment claims remains crucial, as these two cases demonstrate. ■

Mr A reinforces the need for the parties to negotiation of settlement agreements and those dealing with a challenge from HMRC to the agreed tax treatment to be ready to put forward cogent evidence to support their position.

Mr A v The Commissioners for Her Majesty's Revenue & Customs [2015] UKFTT 189 (TC)

EMI Group Electronics Ltd v Coldicott [1999] EWCA Civ 1868

Essa v Laing Ltd [2004] EWCA Civ 2

Moorthy v Commissioners for Her Majesty's Revenue and Customs [2014] UKFTT 834 (TC)

Orthet Ltd v Vince-Cain [2004] UKEAT/0801/03

Oti-Obihara v Commissioners for HM Revenue and Customs [2010] UKFTT 568 (TC)

Shove v Downs Surgical plc [1984] ICR 532

Timothy James Consulting Ltd v Walton [2015] UKEAT/0082/14/DXA

Vento v Chief Constable of the West Yorkshire Police [2002] EWCA Civ 1871

Walker v Adams [2003] STC (SCD) 269