Pre-April 2018 injury to feelings termination payment not subject to tax

10/05/2018

Tax analysis: Following the Court of Appeal's decision in Moorthy v HMRC, Alice Carse, barrister at Devereux Chambers, examines the ramifications for employers and employees involved in compromising claims which involve allegations of unlawful discrimination.

Moorthy v Revenue and Customs Commissioners [2018] EWCA Civ 847

What is the significance of this decision?

The Court of Appeal determined that a payment for injury to feelings made to an employee pursuant to a settlement agreement is not subject to tax under the relevant provisions of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003). This affects employers and employees involved in compromising claims which involve allegations of unlawful discrimination. However, in light of the amendments made to the exemption for payments made for injury to an employee with effect from 6 April 2018 (as discussed below), the decision will have only historic significance.

What were the relevant facts?

In March 2010 Mr Moorthy's employer terminated his employment. He began proceedings in the Employment Tribunal alleging unfair dismissal and age discrimination. The proceedings were settled by way of a compromise agreement as part of which Mr Moorthy received a payment of £200,000. The compromise agreement described the £200,000 as 'compensation for loss of office and employment' made in full and final settlement of the Employment Tribunal claim and any other claims which the parties might have against each other 'arising out of or connected with the employment or its termination'. There was no allocation of the settlement amount to different heads of claim.

The main issues before the Court of Appeal were whether the £200,000 settlement sum was subject to income tax under ITEPA 2003 and whether any part of the £200,000 was taken out of the charge to income tax by ITEPA 2003, section 406, which provides an exemption for a payment or benefit provided to an employee 'on account of injury to…an employee'. In particular the Court of Appeal had to consider whether a settlement payment made in respect of injury to feelings fell within the ITEPA 2003, s 406 exemption.

What was the 'taxability issue'? What did the court decide?

The taxability issue was whether any part of the £200,000 settlement sum was subject to income tax as employment income under ITEPA 2003, Pt 3, Ch 3.

The Court of Appeal upheld the decisions of the First-tier Tax Tribunal and Upper Tribunal (UT) and found that the entire £200,000 fell within ITEPA 2003, s 401(1)(a) as a payment or benefit which was received directly or indirectly in consideration, in consequence or otherwise in connection with the termination of Mr Moorthy's employment.

What was the 'exemption issue'? What did the court decide?

The exemption issue was whether any part of the £200,000, specifically any sum payable for injury to feelings, was taken out of the charge to income tax by ITEPA 2003, s 406 which provides an exemption for a payment or benefit provided to an employee 'on account of injury to…an employee'.

Having reviewed the authorities, the Court of Appeal held that an award of damages for injury to feelings caused by unlawful discrimination fell within the natural meaning of the exemption in ITEPA 2003, s 406 (as it then stood). It therefore overturned the decision of the UT.

Sums paid to an employee under a compromise (now settlement) agreement in respect of compensation for injury to feelings were, prior to the 6 April 2018 changes to ITEPA 2003, s 406, exempt from the charge to income tax. As a result, Mr Moorthy did not have to pay income tax on £30,000 of the settlement sum, having agreed with HMRC that this sum could be attributed to compensation for injury to feelings.

How did the court view the relevant authorities on ITEPA 2003, s 406?

The Court of Appeal gave short shrift to the decision of the High Court in *Horner v Hasted* [1995] STC 766 both in finding it to be of 'virtually no assistance' on determining the meaning of 'injury' under ITEPA 2003, s 406 and finding the reasoning to be brief and unsatisfactory.

The decision in *Orthet Ltd v Vince-Cain* [2004] IRLR 857 EAT, [2004] All ER (D) 143 May, in which the EAT determined that an award of damages for injury to feelings was not subject to income tax was considered but criticised and found to be of little or no assistance, save for HHJ McMullen QC's consideration of the meaning of 'injury or disability of the employee'.

The Court of Appeal was less critical of the reasoning in *Timothy James Consulting Ltd v Wilton* [2015] IRLR 368 EAT, [2015] All ER (D) 70 (Apr), in which Singh J sitting in the Employment Appeal Tribunal determined that an award of damages for injury to feelings was not subject to income tax. The Court of Appeal stated that the UT was right to be critical of the reasoning in *Orthet* but should have paid more attention to the points made by Singh J in *Timothy James* including his criticisms of *Horner* and his focus on the language of ITEPA 2003, s 406 itself.

How does this decision add to our understanding of the meaning of 'injury' in the context of termination payments?

The Court of Appeal preferred the natural meaning of 'injury', treating injury to feelings under the Equality Act 2010 (EqA 2010) as comparable to physical and psychiatric injuries.

The judgment does not apply to any payment made in respect of injury to feelings outside of the statutory regime under EqA 2010.

What are the practical implications of the decision?

Prior to 6 April 2018 awards for injury to feelings do not need to 'grossed up' to take account of the incidence of income tax.

When dealing with HMRC as to the tax treatment of pre-6 April 2018 termination payments and settlement agreements in circumstances where an employee alleged unlawful discrimination as part of several claims, employees are likely to push for larger proportions of settlement sums to be apportioned to injury to feelings. It may well be that HMRC will view apportionment in termination payments and settlement agreements prior to 6 April 2018 with a critical eye, especially in cases where a much larger sum has been apportioned to injury to feelings than would be recovered in front of an Employment Tribunal.

Would the outcome be any different now, given the recent changes to the taxation of termination payments?

From 6 April 2018, awards for or payments in respect of injury to feelings are fully taxable because ITEPA 2003, section 406, has now been amended by section 5(7) of the Finance (No 2) Act 2017 so

that injury includes psychiatric injury, but does not include injured feelings. This may lead to attempts to apportion sums paid on termination and settlement of dispute between injury to feelings and psychiatric injury in cases where personal injury is or will be pleaded.

What subsidiary issues were considered?

One subsidiary issue, the effect of EqA 2010, s 124(6) was considered. This provision states that awards of compensation in the Employment Tribunal for unlawful discrimination are to correspond with an award which could be made by the County Court, the importance of consistency between the two jurisdictions having been emphasised by the Court of Appeal in *De Souza v Vinci Construction* (UK) Ltd [2017] EWCA Civ 879, [2017] All ER (D) 69 (Jul). Mr Moorthy contended that there was a risk of inconsistency if Employment Tribunals were required to gross up awards for injury to feelings. The Court of Appeal held that this challenge was misconceived because the amount received by a claimant would be the same in the Employment Tribunal or County Court due to the operation of EqA 2010, s 124(4).

Interviewed by Max Aitchison.

The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.