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Upper Tribunal decides on correct tax treatment of bonus clawback payments

Akash Nawbatt discussed the recent Upper Tribunal ruling in *Martin v Revenue and Customs Commissioners* concerning the tax treatment of bonus clawback payments with Nicola Laver from Lexis Nexis' News Analysis.

What issues did the case raise?

The case involved two principal issues. First, whether a partial repayment of a Signing Bonus under a clawback clause reduced the employee's earnings in the year the bonus was received. Second, whether the repayment constituted negative earnings in the year it was made which gave rise to a right to deduct under s128 ITA.

What are negative earnings?

The phrase "negative earnings" refers to an item (typically a payment by an employee to his employer) which is brought into account in computing the total amount of earnings within the definition of taxable earnings and which reduces the amount of taxable earnings from what it would otherwise have been. However, not every payment made by an employee to his employer constitutes negative earnings nor is a connection between the payment and the contract of employment necessarily sufficient. The Tribunal, in *Martin*, had to determine what was the correct approach to determining whether a payment by an employee qualified as negative earnings.

What did the Tribunal decide?

Mr Martin's earnings for 2005/2006 were not reduced by the £162,500 payments he made to his former employer in 2006/07 and he was not entitled to amend his 2005/2006 tax return to reflect the 2006/2007 payments. The full amount of the Signing Bonus was

- (i) earned by the time of its payment on 25 November 2005
- (ii) "general earnings" for the 2005/2006 tax year and
- (iii) required to be treated as "taxable earnings" in that year.

However, the payments in 2006/2007 did give rise to negative earnings in that later year. The Upper Tribunal concluded that the payments arose directly out of Mr Martin's employment and therefore constituted negative earnings.

The true character of the repayment was not damages for breach of contract; rather, it was a straightforward contractual payment to restore to his employer part of the consideration it had paid for a commitment (to work a minimum 5 year period) which it did not in fact receive in full.

How did this vary from the approach taken by the First-tier Tribunal (Tax Chamber)?

Although the Upper Tribunal reached the same conclusion as the First-tier Tribunal it adopted a different approach. The First-tier Tribunal construed “negative” earnings in ITEPA without reference to the predecessor legislation and purported to give a new meaning to what it described as “the extraordinarily undefined notion of “negative earnings”. Whereas the Upper Tribunal considered that ITEPA had not brought about a change in the law and that a payment made by an employee can be brought into account (i.e. is negative earnings) in determining taxable earnings only where the same payment, made prior to ITEPA, would have been brought into account in determining the amount of taxable amounts. Consequently when deciding whether a payment made by, rather than to, an employee his negative earnings, the question remains whether the payment arises directly out of the employment or for some other reason, i.e. whether it would have qualified as what the Upper Tribunal called “negative emoluments”.

What does the decision add to the meaning of ‘negative earnings’?

The decision clarifies that the approach to ascertaining whether a payment by an employee is negative earnings is essentially the same approach to ascertaining whether a payment to an employee is earnings. Ultimately, the question remains whether the payment arises directly out of the employment or for some other reason. The decision gives some helpful examples of factual scenarios either side of what can often be a very fine line between emoluments which are from an employment and those which are not.

However, as the Upper Tribunal emphasised, each case will require a detailed consideration of the terms of the particular contract pursuant to which the payment is made in order to understand the true character of the relevant payment.

Is there anything employers and employees can do to ensure that clawed-back payments are not treated as liquidated damages?

It is critical that careful consideration is given when drafting clawback clauses to the specific circumstances in which the repayment obligation arises. The clawback clause should clearly identify the trigger for and purpose of any repayment and consideration should be given as to whether the quantum of any repayment could be said to be a pre-estimate of loss arising from any breach of contract.

Akash's principal areas of practice are employment law and employment-related tax and sport litigation. He is recommended as a leading junior for employment by Chambers UK and the Legal 500 and as a leading junior in tax by Chambers UK. For more information on Akash's latest case highlights or Devereux's leading tax team, please contact our practice managers on 020 7353 7534 or email clerks@devchambers.co.uk. Follow us on twitter on [@devereuxlaw](https://twitter.com/devereuxlaw).