Taxation of termination: update from the Tax Tribunal

AKASH NAWBATT and CHRIS STONE, Devereux Chambers

Two recent decisions of the Tax Tribunal – Moorthy and Martin – have important implications for employment practitioners negotiating settlement agreements and remuneration clawback mechanisms. What practical lessons can we draw from the cases?

Moorthy v HMRC

Most practitioners should be familiar with the charge to tax on payments made in connection with the termination of a person's employment within chapter 3 of part 6 of ITEPA. It has been a common misconception that it is open to the parties to reduce the incidence of tax on a sum paid to settle a claim with a discriminatory element by attributing all or part of the sum payable by the employer (above the first tax-free £30,000) to injury to feelings. Often settlements include a figure set in accordance with the Vento guidelines according to the severity of the discrimination alleged, capped at around £30,000.

The recent First-tier Tribunal Decision in *Moorthy* is an important reminder of the correct application of the charge to tax and its exemptions. Those acting for employers should remember that the correct application of the tax charge on termination payments is not something that can be left to the employee, as it is against the employer that HMRC will generally seek to enforce the correct application of PAYE. Even where a settlement agreement contains the standard tax indemnity clause, employers will often be reluctant to rely upon it given the hassle of enforcement and risk of non-payment by an ex-employee. It is therefore important that all practitioners understand how the charge to tax is correctly applied.

Mr Moorthy's claim to the employment tribunal of direct age discrimination and unfair dismissal related solely to his dismissal on the grounds of redundancy; there were no allegations of discrimination pre-dating his selection. His claim was settled by payment of £200,000; in the settlement agreement there was no apportionment between different heads of loss. Before the Tax Tribunal, Mr Moorthy argued that the whole sum was not taxable, while HMRC accepted that the first £30,000 was free from tax under s.403 ITEPA and a further £30,000 was free from tax in respect of injury to feelings (a concession that had been made during the enquiry (notwithstanding that it was technically incorrect) and from which it did not seek to resile). The Tax Tribunal found that only the first £30,000 was free from tax and that HMRC had no power to permit a further £30,000 to be paid free from tax in relation to injury to feelings, given there was no warrant for this in the statute.

In rejecting the claim that the whole payment was free from tax, the Tax Tribunal disapproved (correctly) of the previous tax case of *Oti-Obihara* and the EAT judgment in *Vince Cain*, which has long been a source of controversy (see *Harvey on Industrial Relations and Employment Law* at [207.05]).

Vince Cain has been commonly relied upon as authority for the proposition that sums paid in respect of injury to feelings are not taxable. However, that decision was based upon a misunderstanding of s.406(b) ITEPA, which excludes from the charge to tax a payment or other benefit provided 'on account of injury to, or disability of, an employee'. S.406(b) ITEPA does not necessarily encompass payments for injury to feelings. There is no other exception within Chapter 6, which excludes such payments if they would otherwise be caught by the charge to tax under s.401(a) ITEPA. Where the alleged discrimination relates to the termination of employment, it is not therefore open to the parties to reduce the charge to tax by attributing a portion of the settlement monies to injury to feelings. The exceptions to the charge to tax are only those contained in ss.406 to 414A (for example, a sum attributed to legal fees).

Moorthy was concerned with discrimination relating solely to dismissal. A payment that is not connected with termination (for example, compensation for discrimination during employment) will not be caught by s.401 ITEPA and will not fall within the charge to tax unless it constitutes earnings under s.62 ITEPA. Where a payment is made in respect of various matters, some of which may not fall within the charge to tax, the settlement agreement should be clearly worded to attribute sums to various heads of loss.

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Martin v HMRC

Clawback mechanisms are increasingly prevalent, especially in the financial services sector, with regulations being implemented to mandate their use in certain situations. The Upper Tribunal Decision of *Martin* concerned the tax implications of the repayment of a signing bonus under a clawback clause. In 2005, Mr Martin received a signing bonus of £250,000 in return for committing to work for a five-year period. On giving early notice of termination in the 2006/07 tax year, he was required, under the terms of his contract of employment, to repay £162,500, on which he had already paid tax.

The Upper Tribunal concluded that the repayment in 2006/07 did not have the effect of reducing Mr Martin's earnings in the earlier year when he received the signing bonus. However, it considered that it did constitute 'negative earnings' in the year of repayment which was available for set-off against Mr Martin's taxable earnings in that year and to the extent it exceeded those taxable earnings, the balance was available to be used as loss relief against his general income under s.128 ITA.

Whether a payment from an employee to an employer represents 'negative earnings' depends on whether the payment arises directly out of the employment or for some other reason, ie whether it would have qualified as what the Upper Tribunal called 'negative emoluments'. This is essentially the same approach used to determine whether a payment to an employee is earnings. In *Martin*, 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 five-year period) which it did not, in fact, receive in full.

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 that 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.

To avoid clawed-back payments being treated as liquidated damages (which an employee would not be able to deduct), it is, therefore, important 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 thought 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.

KEY:

Moorthy	*Moorthy v Revenue and Customs Commissioners* [2014] UKFTT 834 (TC)
Martin	*Martin v Revenue and Customs Commissioners* [2014] UKUT 0429 (TCC)
ITEPA	Income Tax (Earnings and Pensions) Act 2003
Oti-Obihara	*Oti-Obihara v Revenue and Customs Commissioners* [2010] UKFTT 568 (TC)
Vince Cain	*Orthet v Vince Cain* [2004] IRLR 857
ITA	Income Tax Act 2007