

Exploring the taxation of ‘injury to feelings’ termination payments

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Employment analysis: Timothy Brennan QC of Devereux Chambers explores the recent decision of the Upper Tribunal (Tax and Chancery Chamber) (UT) in *Moorthy v Revenue and Customs* and provides some tips on what lawyers should do when advising on the taxation of termination payments which include an element of injury to feelings.

Original news

Moorthy v Revenue and Customs Commissioners [2016] UKUT 13 (TCC), [2016] All ER (D) 08 (Feb)

The UT dismissed the appeal by the taxpayer employee against a decision of the First-tier Tribunal (Tax Chamber) (FTT) which had rejected the taxpayer's challenge to an amendment to his tax return by the Revenue and Customs Commissioners (the Revenue). The tribunal decided, among other things, that the payment made by the employer to the employee to settle his claim for unfair dismissal and age discrimination following the termination of his employment by reason of redundancy fell to be treated as employment income by sections 401 and 403 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003) and was therefore chargeable to income tax under ITEPA 2003, s 6 and 9.

What is the significance of this UT decision?

The UT has decided that a payment made on, or in connection with, termination of employment as compensation for ‘injury to feelings’ in discrimination cases is taxable under the ‘termination’ provisions of ITEPA 2003, Pt 6, Ch 3, ss 401, 403, 406.

What were the relevant facts of the case?

Mr Moorthy was made redundant from his employment on restructure. He complained of unfair dismissal and age discrimination. In addition to basic and compensatory awards for unfair dismissal, he claimed compensation, an award for injury to feelings, and interest. After mediation with his employer, he received an agreed £200,000 in settlement, not allocated to any particular head of claim. The agreement expressly recorded that Mr Moorthy was receiving a sum ‘by way of compensation for loss of office and employment’. HM Revenue & Customs (HMRC) took the initial view that the sum fell within the charge to tax under ITEPA 2003, s 401 as having been paid in connection with termination of employment, but that this was subject to an allowance of £30,000 (which was provided for by ITEPA 2003, s 403, and was clearly correct) and that a further £30,000 was tax free because it was paid, or could be regarded as having been paid, in respect of statutory compensation for injury to feelings. When the matter came before it, the FTT held that its task was to determine the correct amount of tax, and that a sum paid in respect of ‘injury to feelings’ was not exempted by ITEPA 2003, s 406 as having been paid on account of injury to an employee.

What was the important point at the UT?

There were other points argued before the UT, but the most significant point discussed is the issue whether compensation for ‘injury to feelings’ or, to use the current term, ‘injured feelings’ (see the Equality Act 2010, s 119(4) (EqA 2010)) is exempted from tax under the ‘termination’ provisions. The Equality and Human Rights Commission intervened in the appeal and submitted written submissions. The point was regarded as controversial because of two earlier decisions in the Employment Appeal Tribunal (EAT), each open to strong criticism, which had held that such compensation was tax-exempt. In *Orthet Ltd v Vince-Cain* [2005] ICR 374 the EAT had held that all ‘injury to feelings’ awards were tax-exempt, because injury to feelings amounted to an injury to the employee. The reasoning was odd because upsetting someone is obviously not the same as injuring them, but it is also odd because in that case the EAT failed rigorously to apply the proper principles of tax law, but approached the question by looking for indicative ‘factors’ in decisions of the courts which did not address questions of taxability at all, and even in non-judicial opinions of the (then) Judicial Studies Board and the (then) Equal Opportunities Commission. That was quite bad enough, but in *Timothy James Consulting Ltd v Wilton* [2015] IRLR 368 Singh J followed the reasoning of Judge McMullen QC in the EAT in *Orthet*, generously describing Judge

McMullen's observations on the point as 'an important passage which deserves citation in full'. So *Timothy James* constitutes EAT authority that an award for 'injured feelings' is not taxable.

What did the UT decide?

After a careful review of the authorities, not all of which had been cited in *Orthet* and *Timothy James*, the UT (Rose J and Judge Sinfield) dismissed Mr Moorthy's appeal, holding that injury to the feelings of an employee did not amount to injury to the employee. This welcome, if less than startling, piece of reasoning was enough to dispose of the point on taxability of the award under ITEPA 2003, s 401—the exemption under ITEPA 2003, s 406 did not apply. The decision is plainly correct—feeling distressed, upset, disappointed or outraged, however unpleasant, is not being 'injured', in the context of tax provisions taking effect on termination of employment. Indeed, the House of Lords confirmed in the Hillsborough case of *Hicks and another v Chief Constable of the South Yorkshire Police; Wafer v Chief Constable of the South Yorkshire Police* [1992] 1 All ER 690 that in the tort of negligence (where damage is of the essence of the cause of action), suffering a normal human emotion does not give rise to damages—this is because it is not an injury. To say otherwise would be an abuse of language.

Is the clarification on the meaning of 'injury' in the context of termination payments a helpful development?

The clarification is extremely helpful. However, the EAT decisions (generally regarded as binding on the Employment Tribunal) are to the effect that 'injured feelings' awards escape tax. And the UT decision (generally regarded as binding on the FTT) is now to the effect that they do not do so. So a purist's view might be that an Employment Tribunal is bound to find that the payment is not taxable (and that, therefore, it need not be grossed up for tax), but that the FTT is bound by authority to find that it is taxable after all.

The answer to the conundrum is to be found in the legislative history, which was not discussed in any of the cases.

Statutory underpinning for awards of compensation for injury to feelings arising from the statutory torts of sex discrimination and race discrimination was introduced respectively by the Sex Discrimination Act 1975, ss 65(1)(b) and 66(4), and by the Race Relations Act 1976, ss 56(1)(b) and 57(4). Doubtless express provision was made for this head of damage arising from the statutory tort of discrimination precisely because injury to the claimant's feelings is not the same as injury to the claimant himself. The provisions were rewritten in EqA 2010, ss 119(4) and 124(6), relating also to other protected characteristics.

However, the tax charge on 'termination' payments, and the exemption for injury to an employee, reached the income tax code much earlier, in the Finance Act 1960, s 37 (FA 1960). There was an exemption from the charge (s 38(1)(a)) for 'any payment...made on account of injury to or disability of the holder of an...employment'.

This 1960 provision therefore pre-dated any concept of compensation for injury to feelings, and all relevant statutory employment protection. At the date of FA 1960 there was no relevant statutory protection available to an employee concerning termination of employment, nor providing for compensation for detriment due to sex or race discrimination, nor was there any available award for compensation for injury to feelings. Indeed, the decision in *Addis v Gramophone Co Ltd* [1909] AC 488 was already authority for the proposition that an award for injury to feelings, or arising from the manner of dismissal, was not available in a contract action for wrongful dismissal.

The tax provisions were then consolidated successively in:

- o the Income and Corporation Taxes Act 1970, ss 187 and 188
- o the Income and Corporation Taxes Act 1988, ss 148 and 188, and
- o the Income and Corporation Taxes Act 1988, s 148 (as substituted by the Finance Act 1998, s 58(1)) and Sch 11

The provisions were then rewritten in ITEPA 2003, ss 401, 403 and 406.

Accordingly, in 1960 the term 'injury' in the context of taxation of payments on termination of employment cannot have included a statutory (or any other) award of compensation for injury to feelings because no such award was available in law. Neither the subsequent consolidations nor the rewrite could seriously be contended to have effected a change in the

law. Accordingly, the exemption in ITEPA 2003, s 406(b) never did, on its proper construction, extend to exempting such an award from the charge under ITEPA 2003, s 403.

In relation to the current state of authorities in this area, do you have any tips on what lawyers should do when advising on the taxation of termination payments which involve an element in respect of injury to feelings?

Employment Tribunals, and those who practise before them and advise on these issues, will have to take a view as to which line of decisions is correct. There can be no doubt that the UT in *Moorthy* is correct for the reasons given but also because of the compelling legislative history. If the compensation for injured feelings is part of a sum paid in connection with termination of employment, and is in excess of £30,000, it should therefore be assumed that it is taxable. Any other approach involves unacceptable risk.

Accordingly, an employer making a payment of compensation in these circumstances should not rely on the EAT decision in *Timothy James*. The employer should always have careful regard to the incidence of PAYE income tax (not, however, national insurance contributions) on the payment. If he fails to deduct and account for tax, in practice HMRC will pursue the employer, not the employee. And the employee will always get credit for the PAYE in his own tax affairs, so he would be free to argue the issue of taxability with HMRC if he wishes.

Correspondingly, an employee seeking compensation in these circumstances should always seek to have the payment of compensation for injured feelings grossed-up to take account of the income tax that will be payable on the payment.

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