Tax on awards for injured feelings

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The EAT has misinterpreted the tax provisions that apply to awards of compensation for injured feelings, wrongly declaring them tax-free, laying a PAYE trap for employers and giving rise to a tax loophole.

Compensation for injured feelings

Awards of compensation for unlawful discrimination based on the familiar protected characteristics in EA ss.5-12 (age, disability, race, sex etc) may include 'compensation for injured feelings' (EA s.119(1), as applied by s.124(6) to awards by employment tribunals). Under the earlier terminology of 'compensation for injury to feelings' this element of compensation for the statutory tort of discrimination first appeared in SDA 1975 and RRA 1976.

Tax on termination of employment

When a payment of compensation is made in connection with termination of employment, that payment will be taxable as employment income (if not already otherwise taxable) to the extent that the payment exceeds £30,000 (ITEPA s.401, s.403 – the termination provisions). This widely drafted residual charge to tax catches any payment made, above the £30,000 threshold, in connection with termination of employment, whether or not there was a legal liability on the employer to make the payment, and whether or not there was any statutory foundation for it.

The paying employer will deduct and account for PAYE on the taxable element of the payment, even where payment is made after the employment has ended (see reg 37 of the PAYE regulations). There is, however, an exemption under ITEPA s.406 from the tax charge: it does not apply to a payment 'provided – (a) in connection with the termination of employment by the death of an employee, or (b) on account of injury to, or disability of, an employee'.

Tax on compensation for injured feelings

The question sometimes arises whether that element of an award by a tribunal (or a compromise) which represents compensation for injured feelings is taxable under the termination provisions, or whether it is taken out of tax by s.406(b) as having been paid 'on account of injury to … an employee'.

In *Timothy James Consulting Ltd* the claimant before the employment tribunal succeeded in a complaint of unlawful sex discrimination under EA 2010. Her award included an element of compensation for injured feelings, initially put at £10,000. The tribunal was persuaded that the total award (which, including other elements, exceeded £30,000) would be taxable in her hands, and therefore grossed up the 'injured feelings' element under conventional *Shove* principles to take account of the tax payable, reaching a gross award of £16,000 for this element. The employer appealed against the grossing-up.

Singh J, sitting in the EAT, reviewed the authorities, none of which, he considered, completely dealt with the point. His view was that the question came down to whether 'injury to feelings' was an 'injury' of the type addressed in ITEPA s.406(b).

In fact, the term 'injury to feelings' does not appear in either relevant statute. The modern statutory question is whether compensation for 'injured feelings' (EA s.119(1)) is exempted from tax because it is provided on account of 'injury to … an employee' (ITEPA s.406(b)).

Nor did things continue well. Singh J's view was that since the exception for a payment 'on account of injury to … an employee' in s.406(b) was not qualified by the words 'in connection with the termination of employment', then, as he saw it, 'any injury to an employee will fall within the exemption'. Leaving aside that the compensation was for 'injured feelings', not 'injury to an employee', there were two other problems with the approach.

First, it was irrelevant that use of the statutory phrase 'on account of injury to an employee' was not immediately

linked to termination of employment. It did not need to be so linked, because the tax charge is imposed in connection with termination of employment; that will be the typical occasion on which the question has to be answered. It is right to acknowledge that the charge can apply, in theory, to payments on other occasions (changes in duties and salary, s.401(b), (c)), but such payments are usually taxable as employment income without resort to s.401; these provisions are there largely for anti-avoidance reasons; for example, preventing avoiding the tax charge by maintaining the employment in existence with trivial duties.

But secondly, in any event, the nature of the occasion on which a payment is made on account of injury (termination of employment, or change of duties etc) says nothing about the nature of the injury itself. The width (or narrowness) of the term 'on account of injury to an employee' remains the same, no matter what the occasion of payment.

The issue before the EAT was not new. In *Orthet* the EAT had expressed an *obiter* view on the subject of taxability, but (see in particular para 33 of that decision) did so on the basis of an unusual approach to legal reasoning which included, among other questionable techniques, attaching weight to the opinions of the Judicial Studies Board and of the EOC. Opinion evidence is not admissible as an aid to statutory construction in the law of England and Wales. Nonetheless, assisted by clearly inadmissible material, the EAT there decided that damages for 'injury to feelings' were not taxable under the termination provisions, without construing the relevant provisions in their technical statutory context.

In contrast, in *Moorthy* the First-tier Tribunal (Tax Chamber) decided that where a compromise payment included an element attributed to 'injury to feelings', in the absence of a (medical) injury or disability there was nothing to exempt the payment from the charge under s.401. It was to be taken into account for tax under the termination provisions.

Singh J decided to follow the approach of the EAT in *Orthet*, describing the observations at para 33 of that decision, as 'an important passage which deserves citation in full'. He held that the award for 'injury to feelings' was not taxable.

The decision in *Timothy James* is clearly wrong on this point. It is inconsistent with the language used and with the statutory history. Being wrong, it lays a PAYE trap for the employer. More than that, it gives rise to a striking unintended consequence.

Upset is not injury

An employee who has been hurt and upset has not, always and in every case, necessarily sustained 'injury'. Of course causing a psychiatric illness to an employee amounts to causing 'injury'. That said, reactions of distress, disappointment, embarrassment, bitterness or outrage which amount to 'injured feelings' could not, in the absence of some impairment of mental condition amounting to psychiatric illness, realistically be described as amounting to 'injury to an employee'. Indeed, the House of Lords confirmed in the Hillsborough case of *Hicks* 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.

Statutory history

The statutory history of the relevant provisions is also inconsistent with the conclusions of Singh J. The term 'injured feelings' in EA 2010 has, as its statutory predecessors, SDA 1975 (s.65(1)(b), s.66(4), for sex discrimination) and RRA 1976 (s.56(1)(b), s.57(4), for race discrimination). Further protected characteristics were subsequently added in other legislation, and the law was rewritten into EA 2010.

But the tax charge on payments made on termination of employment has a longer history. It was introduced by s.37 of the Finance Act 1960, with an exemption from the charge (see s.38(1)(a)) for 'any payment … made on account of injury to or disability of the holder of an … employment'. This pre-dated all relevant statutory employment protection and any concept of compensation for injury to feelings for the statutory tort of discrimination. Accordingly, when the tax charge and its linked exemption were introduced, the concept of compensation for a statutory tort of discrimination causing 'injury to feelings' or 'injured feelings' was unknown to the law. The provision was subsequently consolidated or rewritten in further statutes in ICTA 1970, ICTA 1988, FA 1998 and most recently in ITEPA 2003, maintaining its essential structure.

Furthermore, the decision of the House of Lords in *Addis* was at all relevant times authority for the proposition that an award of damages arising from the manner of dismissal, or for distress, was not available in a contract action for wrongful dismissal. So the term 'injury' in 1960 did not include 'injury to feelings' or 'injured feelings'. It can hardly

'the term "injury" has not developed a new layer of meaning since 1960'

have developed that new layer of meaning in successive consolidations and rewrites.

A PAYE trap

It is, at least, unlikely that HMRC will proceed on the basis that the decision of Singh J is correct. Any employer making a payment of compensation, whether under a tribunal award or by way of compromise, would be well advised to protect himself in relation to PAYE, either by deduction or by insisting on an indemnity in consideration of gross payment. It will, in most circumstances, be the employer to whom HMRC will look for unpaid tax, and the employer who bears the risk of a determination under reg 80 of the PAYE regulations.

An unintended consequence

The cases on injured feelings (*Orthet* and *Timothy James*) deal with a statutory head of compensation for unlawful discrimination. If they are correct, however, there is no reason why a potentially exempt payment could not be made in connection with compensation which has nothing to do with discrimination. Many employees who lose their employment for reasons other than discrimination also suffer feelings of distress, disappointment etc which could be described as 'injured feelings'.

On the reasoning of Singh J in *Timothy James* an employer who (genuinely) makes a payment to his employee on account of the employee's injured feelings arising from termination of his employment should be able to pay him that amount tax free. Only a bold or foolhardy adviser would rely on the decision in that way. An instinctive feeling of reluctance to do so may provide a cross-check on whether the EAT got this decision right.

KEY:

EA	Equality Act 2010
SDA 1975	Sex Discrimination Act 1975
RRA 1976	Race Relations Act 1976
ITEPA	Income Tax (Earnings and Pensions) Act 2003
PAYE regulations	Income Tax (Pay As You Earn) Regulations 2003
Timothy James Consulting Ltd	*Timothy James Consulting Ltd v Wilton* UKEAT/0082/14/DXA
Shove	*Shove v Downs Surgical plc* [1984] ICR 532
Orthet	*Orthet Ltd v Vince-Cain* [2005] ICR 374
Moorthy	*Moorthy v Revenue and Customs Commissioners* [2014] UKFTT 834 (TC), [2015] IRLR 4
Hicks	*Hicks v Chief Constable of South Yorkshire* [1992] 2 All ER 65
ICTA 1970	Income and Corporation Taxes Act 1970, ss.187, 188
ICTA 1988	Income and Corporation Taxes Act 1988, ss.148, 188
FA 1998	Finance Act 1998 s.58(1) (substituting ICTA 1988 s.148 and Sch 11)
Addis	*Addis v The Gramophone Company Ltd* [1909] AC 488