

Taxing times

Spencer Keen outlines some valuable guidance about the tax treatment of termination payments

IN BRIEF

► *Moorthy v HMRC* [2014] UKFTT 834 (TC): a helpful review of the most recent authorities on the taxation of termination payments.

Mr Moorthy received a payment of £200,000 in a compromise agreement after he was made redundant from his employment as executive director of operations with Jacobs Engineering UK Ltd (Jacobs) on 12 March 2010. He claimed that the £200,000 was not taxable because it had been paid to settle a discrimination claim.

HM Revenue & Customs did not accept that the entire settlement was tax free. HMRC argued that, with the exception of £60,000, the whole sum was taxable as a termination payment under s 401 of the Income Tax (Earnings and Pensions Act) 2003 (ITEPA 2003). HMRC accepted that £60,000 was exempt from tax because, according to them, £30,000 was specifically exempted as a result of s 403 of ITEPA 2003 and another £30,000 was exempted because it represented compensation for injury to feelings. As a result, on 13 August 2013 HMRC issued a closure notice indicating that Moorthy's self-assessment had been amended to include £140,023 of taxable income. Moorthy appealed the amendment.

Moorthy made a claim in the employment tribunal that he was selected for redundancy on grounds of his age contrary to the Employment Equality (Age) Regulations 2006 (SI 2006/1031). He sought declarations that he had been unfairly dismissed and that his dismissal was on grounds of age. He also sought basic and compensatory awards, compensation for financial loss, an award for injury to feelings and interest.

Mediation

During a mediation, Moorthy stated that he was claiming damages from Jacobs

on the basis that he would have continued working for the company until his retirement, aged 65 and that he had taken all reasonable steps to mitigate his loss. He argued that he would not have been fairly dismissed for a non-discriminatory reason. He claimed damages for injury to feelings in the upper bracket set out in *Vento v Chief Constable in West Yorkshire* [2002] EWCA Civ 1871, [2003] IRLR 102.

The mediation resulted in Moorthy being offered £200,000 by Jacobs by way of compensation for loss of office and employment. This was without admission of liability and in full and final settlement of the 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". The compromise agreement did not allocate the sums between the different heads of claim made by Moorthy.

The compromise agreement also dealt with the question of tax. It stated that the first £30,000 would be paid to Moorthy without deduction of income tax and that the balance would be subject to tax at the rate of 20%. Under the agreement Jacobs explicitly refused to give a warranty as to the taxable status of the payments

made under the agreement. Moorthy on the other hand gave a tax indemnity to reimburse Jacobs should any further tax fall due. Moorthy received £100,000 from his employer on or around the 9th April 2011 and the remainder in the 2010 to 2011 tax year.

On 31 January 2012 Moorthy completed his tax return online. Following this, on 14 February 2012, his solicitor wrote to HMRC setting out why he considered that the £200,000 was not taxable. After several rounds of correspondence HMRC issued the disputed tax return reducing Moorthy's taxable income by £60,000.

Appeal

Moorthy appealed. On 22 November a reviewing officer stated that he considered that the whole of the payment was taxable, subject only to the £30,000 threshold. The officer was of the view that the additional £30,000 related to the injury to feelings was taxable in full since the "alleged discrimination took place as part of the process of termination".

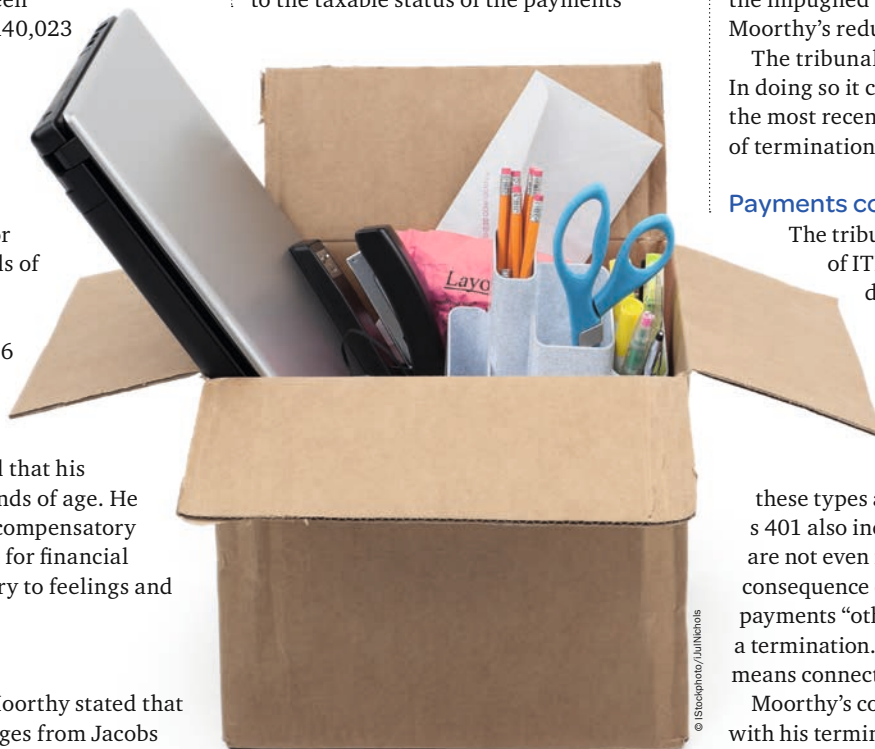
Before the First-Tier Tax Tribunal Moorthy relied on *Oti-Obihara v HMRC* [2010] UKFTT 568 (TC), [2011] IRLR 386 and *Orhet v Vince Cain* [2004] IRLR 857, [2004] All ER (D) 143 (May). He suggested that, as a result of these cases, he had an expectation when he signed the compromise agreement, that the payment of £200,000 was not taxable. He also argued that the payment was not taxable since it was made to protect Jacobs' reputation and that the payment was not connected with the redundancy because the impugned selection exercise pre-dated Moorthy's redundancy.

The tribunal dismissed his arguments. In doing so it conducted a helpful review of the most recent authorities on the taxation of termination payments.

Payments connected to termination

The tribunal observed that s 401 of ITEPA 2003 is very widely drawn. Not only does it catch payments made directly in consideration of a termination, or directly in consequence of a termination but also indirect payments of these types as well. In addition to this, s 401 also includes payments which are not even in consideration of, or the consequence of, termination but are payments "otherwise in connection" with a termination. "Otherwise" in this context means connected "in any way".

Moorthy's complaints were all connected with his termination. The unfair dismissal



claim was self-evidently bound up with the termination. The discrimination claim was expressed, by the claim form, to be a claim for “unlawful dismissal on the grounds of age”, and he had not alleged that he had been discriminated against before the redundancy process had started. His claim for injury to feelings related to the period of discrimination and so was “connected with” his termination. Finally, his claim for interest, being based on these claims, was connected with his termination as well.

The tribunal rejected as irrelevant the argument that the payment was made to Moorthy either partly or entirely because of Jacob’s desire to protect its reputation or to compensate him for discrimination, injury to feelings, redundancy and/or financial loss. The payment could be for any or all of those things but because it was made “directly or indirectly in consideration or in consequence of, or otherwise in connection with” the termination of his employment it fell within s 401 of ITEPA 2003.

In reviewing the authorities the tribunal rejected the relevance of a number of earlier decisions. The tribunal doubted in particular whether the decisions in *Oti-Obihara* and *Orthet v Vince-Cain* were correct. The claim in *Orthet* concerned a claim for exemption under s 406 of

ITEPA 2003. The tribunal held that the Employment Appeal Tribunal in *Orthet* appeared to have misunderstood the exemption under s 406 of ITEPA 2003 because they misread it as applying to a claim for injury to feelings when it did not. Section 406 applied where, on the facts of a given case, the discrimination causes a disability that reduces the employee’s ability to perform his job.

In concluding the tribunal stated that the statue was “plain”. It rejected, perhaps unsurprisingly, Moorthy’s argument that his non-selection for the alternative work during the redundancy process was not connected with his termination. It also rejected the assertion that the parties had agreed the amount of the settlement on the understanding that it was tax free. There was, the tribunal said, no basis in fact for this submission, particularly when the agreement itself contemplated that further tax might be payable. In any event, Jacobs’ belief that the payment was tax free could not determine the tax treatment.

Conclusion

Applying its conclusions on the law, the tribunal determined that HMRC had wrongly allowed £60,000 of the compromise sum to be tax free.

First, it held that s 404 requires payments made in respect of the employment to be aggregated. The £30,000 tax free threshold is set against payments and other benefits received in earlier years before those received in later years. Since s 309(3) states that statutory redundancy payments are included in the calculation of the £30,000 exemption, HMRC had also failed to take into account the statutory redundancy payment of £10,640 which Moorthy had received in the 2009 and 2010 tax years.

Second, the tribunal also held that HMRC should have disallowed the £30,000 exemption in respect of injury to feelings in its entirety.

As a consequence the tribunal assessed Moorthy’s taxable income as £180,640 and Moorthy’s self-assessment was amended to show a taxable income £180,640 rather £140,023. By appealing Moorthy had increased his taxable income by £40,617. Although this was obviously unsatisfactory for Moorthy, the tribunal’s decision provides some valuable guidance about the tax treatment of termination payments.

NLJ

Spencer Keen is a barrister at Old Square
(keen@oldsquare.co.uk; www.oldsquare.co.uk)