

Injury to feelings compensation: taxable or excepted?

February 24, 2016

Moorthy v. HMRC [2010] UKUT 13 (TCC)

In the long-running case of *Moorthy*, the Upper Tribunal has held that an injury to feelings compensation payment made in connection with a termination of employment was taxable as a termination payment under section 401 of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA 2003). In doing so it has upheld the decision of the First-tier Tribunal but, controversially perhaps, disagreed with past decisions of the Employment Appeal Tribunal (EAT).

There has been some understanding previously that it is open to parties to reduce the level 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 £30,000 of the ex gratia payment exempt from tax) to injury to feelings. However, *Moorthy* is an important reminder that parties may not do this where that payment is made in connection with the employee's termination.

In March 2010, Mr *Moorthy*, a senior employee in the local government team of an engineering contractor, was dismissed by reason of redundancy and received a statutory redundancy payment. He then commenced proceedings in the Employment Tribunal for unfair dismissal and direct age discrimination. His claim related solely to his dismissal and there were no allegations of discrimination predating his selection for redundancy. The claim was settled by an ex-gratia payment of £200,000, as compensation for loss of office and employment, and there was no apportionment between different heads of loss.

In February 2012, Mr *Moorthy* informed HMRC that he believed that the payment was not taxable and HMRC opened a formal enquiry. In August 2013, HMRC issued a closure notice, stating that the payment of £200,000 was taxable under section 401, save for £30,000, which fell under the statutory threshold (although it allowed a further £30,000 tax free element "by concession"). Mr *Moorthy* appealed HMRC's decision.

Upholding the decision of the First-tier Tribunal, the Upper Tribunal has found that the key issue to be determined is whether there is a connection between the payment and the termination of employment. If there is, then the payment will be subject to tax under section 401.

The Upper Tribunal also considered whether the payment could fall within the exception in section 406 ITEPA 2003, which excepts payments in connection with the termination of employment by death of an employee or on account of injury to, or disability of, an employee. The Upper Tribunal, relying on the case of *Horner v. Hasted* [1995] STC 766, held that injury, like death and disability, means a medical condition for the purposes of the section. Accordingly, Mr *Moorthy's* injury to feelings in the context of the discrimination claim did not fall under the exception in section 406.

Comment

The key point to take from this decision is that parties need to be very careful to appropriately apportion settlement

payments to reflect compensation for pre-termination discrimination. If they fail to do so, it is highly likely that the whole sum (above the first tax-free £30,000) will be deemed subject to deductions for tax under section 401.

Employers should apply the Upper Tribunal's interpretation, rather than the EAT's, when deducting tax from a compensation payment, or risk HMRC seeking under-deducted tax from them directly.

Whilst the Upper Tribunal's decision on the meaning of injury is binding on the First-tier Tribunal, it is not binding on the EAT. Accordingly it is hoped that the Court of Appeal will rule on this issue to resolve the conflict.

Your Key Contacts



Gilla Harris

Partner, London

D +44 20 7320 6960

gilla.harris@dentons.com



Sarah Beeby

Partner, Milton Keynes

D +44 20 7320 4096

M +44 7584 204819

sarah.beeby@dentons.com