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HM Revenue & Customs and HM Treasury consultation on Simplification of the Tax and National Insurance Treatment of Termination Payments.

Response from the Employment Lawyers Association

16 October 2015

HM Revenue & Customs and HM Treasury's consultation on Simplification of the Tax and National Insurance Treatment of Termination Payments.

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INTRODUCTION

1) The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent claimants and respondents in courts and employment tribunals. It is not ELA's role to comment on the political or policy merits or otherwise of proposed legislation, rather it is to make observations from a legal standpoint. Accordingly in this consultation we do not address such issues. ELA's Legislative and Policy Committee consists of experienced solicitors and barristers who meet regularly for a number of purposes including to consider and respond to proposed new legislation.

2) The Legislative and Policy Committee of ELA set up a sub-committee under the chairmanship of Stephen Levinson of Keystone Law to consider and comment on the consultation paper from the HM Revenue & Customs and HM Treasury on the Simplification of the Tax and National Insurance Treatment of Termination Payments that was published on 24 July 2015. Its report is set out below. A list of the members of the sub-committee is in Appendix 1 to this response.

3) Our comments are only addressed to those non-policy questions we considered it appropriate to address.

Executive Summary

A. There are serious concerns raised by the proposals in this paper that require a great deal of further thought before any changes are made.

B. There would be merit in removing the the current distinction for tax and national insurance contributions (NICs) purposes between payments made under a contractual term relating to payment in lieu of notice (PILON) and payment of the equivalent sum also related to a period of notice (but not in pursuance of a contractual term).

C. However removing the different treatment of tax and NICs of different types of PILONS would substantially increase the costs of termination for employers.

D. The suggestion that the tax exemption should be restricted to redundancy situations and/or based on length of service is misconceived and unfair and would not clarify the position for employers or employees.

E. The proposals in relation to employees who resign does not address constructive dismissal situations which is a serious oversight.

F. The current law relating to the taxation of injured feelings is not as clear as Government believes it to be and requires further consideration.

G. It is our majority view that the foreign-service tax exemption provisions should be removed but all other exemptions to taxation are justifiable and should remain in place.

H. The provisions relating to exemptions referable to discrimination divided our committee. The majority wish to preserve the status quo believing it to be a legitimate support for the protections against particular unlawful and prohibited objectionable conduct and that the change would discourage settlements. For others their serious concerns at the potential for abuse of those protections arising from the ramifications of allowing payments which are referable to discrimination to enjoy materially different tax treatment from those that are not, leads them to want to remove the distinction.

Finally as an initial point we wish to say generally that whist we accept the desirability of simplicity and clarity in the law the argument for change based on the obvious fact that those who are better paid and better advised are often able to structure their affairs to greater advantage would seem to be a trite statement of such general application that it has no particular force in this area of law rather than any other. It seems to be a particularly ironic point for the OTS to make as it will always apply until HMRC produces a taxing scheme so simple that no-one at all needs external advice to operate it. As we indicate below a number of the proposed changes will only create more complexity and therefore increase those concerns identified by the OTS

Question 1: Do you agree that the distinction between contractual and non-contractual termination payments should be removed? Please provide reasons for your answer.

4) We make two preliminary points.

5) First, that sums which do not represent “earnings” are charged to tax to the extent that they exceed £30,000. The exemption was fixed at this level with effect from the tax year 1988-89, and has not been increased since then and has been dramatically eroded by inflation. Had it been increased by reference to the retail prices index the figure would now exceed £70,000. The failure to increase that amount is a policy decision on which we express no opinion, but we draw attention to it as part of the context in which these questions arise.

6) Secondly the term ‘contractual termination payments’ is imprecise and may be inaccurate. The dividing line is between, on the one hand

   payments which are or are derived from, or represent earnings from the employment (sums paid for acting as, or being or becoming an employee)

   and on the other hand

   payments which do not have such a character because they represent compensation for loss of the benefits of the contract of employment, or for compensation for breach of a statutory or common law right associated with employment.

7) Sums of the former character are taxed as earnings and attract Class 1 primary and secondary NICs. Sums of the latter character which are paid in connection with termination of employment are taxed as earnings to the extent they exceed £30,000 but do not attract

NICs. Sums of the latter character which are not paid in connection with termination (such as some compensation for discrimination in employment) escape tax and NICs altogether.

8) That said, we agree that the current distinction for tax and NICs purposes between payments made under a contractual term relating to a PILON and payment of the equivalent sum also related to a period of notice (but not in pursuance of a contractual term) has no substantial justification and should be removed.

9) At the start of employment, the employer will often reserve the right summarily to terminate employment on making a PILON. This has advantages for the terminating employer: he can dismiss summarily without being in breach of contract (and can thus preserve any restrictive covenants in the contract of employment); and he avoids any issues with "garden leave". Such provision is more likely to be included in the contracts of senior employees.

10) The distinction for tax and NIC purposes arises from the decision of the Court of Appeal in *EMI Group Electronics Ltd* v *Coldicott* [2000] 1 WLR 540. The court drew the distinction between a contractual PILON and a non-contractual PILON. The former was part of the terms on which the employee agreed to serve the employer and attracted tax and NIC. The latter was damages for breach of contract and was not taxable under £30,000 and did not attract any NIC. In that case, two groups of employees of the same employer, dismissed at much the same time, were taxed differently on termination.

11) While the distinction was justified on the state of the authorities, and is not difficult to understand or administer, it makes little sense. In each case, the payment is made by reference to the amount of contractual notice to which the employee is entitled. In our view, the taxable character of such a payment ought to be the same whether or not a right to terminate on making such a payment was reserved by the employer at the start of employment.

12) The distinction between a 'contractual and non-contractual' PILON can give rise to the further difficulty in the light of HMRC's occasional expression of view that an "auto-PILON" is taxable as earnings. We understand this term to refer to a payment which, while not made under the express terms of the contract of employment, is nonetheless the type of payment routinely made to employees in such circumstances. HMRC have been known to suggest that such a payment arises under a variation of the contract of employment (under "custom and practice"), and is taxable as a contractual PILON. This argument does give rise to potential uncertainty. Removal of the distinction between contractual and non-contractual PILONs would remove this uncertainty too.

Question 2. Do you agree that removing the different tax and NICs treatment of different types of PILONs will help remove complexity for termination payments? Please provide reasons.

13) We agree that removing different tax and NICs treatment will reduce complexity and that (on balance) reducing complexity is desirable. The present system imposes income tax and Class 1 primary (employee) and Class 1 secondary (employer) NICs on contractual PILONs, but not on damages and non-contractual PILONs. This distinction makes little commercial sense.

14) Imposing Class 1 primary (employee) and Class 1 secondary (employer) NIC on all termination payments would substantially increase the cost to employers of terminating

employment, potentially decreasing flexibility in the workforce. It is not obvious that the "New exemption proposal" foreshadowed at para 4.3 and 4.16-4.21 of the consultation paper would extend the NIC exemption to employers. In our view, it should do so.

Question 3: Do you think that the income tax and NICs treatment of termination payments should be aligned? Please provide reasons.

15) We have assumed this question relates to a wider ambit of payments than Question 2 which we took to relate only to PILON payments.

16) On that assumption our answer is no.

17) The system at present distinguishes clearly between the payments that are subject to income tax only and the payments that are subject to income tax and NICs. Compensation payments (i.e. non-contractual payments) are currently not subject to NICs at all. If the £30,000 tax relief on compensation payments were abolished and tax relief became based on years of service, it will decrease the amount of tax relief available for many employees at a time of particular financial hardship. If we assume that employers often decide to pay severance amounts on the basis of the overall cost to them rather than the net benefit to the employee then imposing NICs in addition to tax on the amount above the new tax relief threshold will further decrease the net amount the employee receives. It would represent a "double whammy" for many employees in terms of the net termination payment they receive.

18) It will also impose an additional financial burden on employers who will have a larger NICs bill, particularly where making a large number of redundancies at one time, for example. It is hard to believe that this would not affect the amount of the severance payments on offer, to the obvious detriment of the staff affected. The employees this is most likely to affect prejudicially are lower earners for whom the £30,000 tax relief and the fact that NICs are not paid on compensation is proportionately the most significant. Likewise an increased NICs burden on termination payments will increase the cost of terminating employment and settling cases for all employers, but will be a more significant burden for small employers.

19) In addition, the aligning of tax and NICs would not produce the desired simplification. The result of such an approach would be that the NICs bill (both employee and employer) on the termination payment would depend on that employee's length of service, the reason for termination and (according to the Consultation document) what other payments, contractual or not, are made to the ex-employee at the same time. It might be argued that if the employer has already had to calculate the tax liability on a formula as complex and open to error as that suggested, then applying NICs to the taxable amount is little extra burden. All the same, this is still clearly more complicated than the current regime, even before the proposal in the Consultation document that one's ultimate tax bill may be revisited if the employee obtains fresh employment with the same employer within 12 months.

20) As the purpose of tax relief on termination payments is firstly to assist employees at a time of hardship and secondly to make it easier and cheaper for employers and employees to reach a settlement, thereby avoiding their disputes reaching an employment tribunal, we do not see the merit in applying NICs to such payments. While it would increase HMRC revenues, it would go nowhere towards either of the stated fairness or simplification objectives of the Consultation exercise. The paper does not contain any evidence of employers having particular difficulties with the current distinction in any event.

21) Finally on this point the question takes a short term view. The real answer may well lay in the wider ranging tax/NIC simplification review.

Question 4. Do you think that aligning the income tax and NICs treatment of termination payments will make termination payments easier to administer and easier to understand. Please provide reasons for your answer.

22) At one level it would make it marginally easier to understand – if the payment is taxable, it is NICable. However, that implies that determining the taxable figure accurately in the first place is simplified and that is clearly not the case. To the extent that the employer miscalculates the tax, the NICs will obviously also be wrong, compounding the burden of correction on both the HMRC and the employer (and prospectively also the employee). In addition the employer would need to have regard to the various factors affecting the applicable NIC rate, such as the deductions made in the year to date, contracted-out status, etc. That it would be easy (if tax and NICs were aligned) to determine whether a severance payment was NICable would not make it easy to determine at what precise rate. As a result alignment would be simpler superficially only, in reality being no fairer and clearly more complex for the employer to administer. This would not help the stated objective of allowing the parties earlier clarity on the ultimate net payment.

23) Overall we do not think that the current distinction between tax and NICs makes either particularly difficult to administer and understand. For this reason and the reasons stated above in answer to Q3 we do not think the treatment should be aligned, whilst acknowledging that aligning the tax treatment of the two would make matters simpler we do not think the present distinction is sufficiently complex to justify the change.

Question 5. The government would like to explore what level the threshold for the termination payment tax and NICs exemption should be set and would welcome views. Please provide reasons for your answer.

23 Deciding the threshold level of the exemption should depend on the Government's underlying aims for reform.

24 It appears the Government may be contemplating a far lower maximum threshold than £30,000. Pat, the employee in Example 2 (paragraph 4.20 of the consultation paper) would need 26 years' service before she could benefit from £30,000 relief. The class of individuals who attain such long service is small and declining, and it is our experience that the lower paid and more vulnerable are most typically least likely to obtain such long service. Setting such a high service requirement to benefit from a material level of relief would therefore go contrary to the government's expressed aim of ensuring that the exemption is fair to those who are lower paid and more vulnerable.

25 Given the expressed aims for reform set out in paragraph 3.5 of the consultation paper, we think there is no need to reduce the current £30,000 maximum amount of the exemption. Instead, the focus should perhaps be on how the exemption applies. We have in mind also the continued erosion of the exemption mentioned in paragraph 5.

26 Whilst we accept this is a policy issue on which we do not offer a view we believe the Government is bound to consider the background. The exemption has been in place for 55 years. It was last uprated to its current £30,000 level 27 years ago, in 1988/89. If the exemption threshold had been inflation-adjusted since then, it would now stand at over

£70,000. Given the statement in the consultation paper that the Government accepts that the exemption in some form has merit, for the reasons already mentioned, an objective observer might ask why the amount has not been inflation-adjusted regularly, or at certain times, since 1988/89. The Government may therefore wish to give thought to setting a maximum threshold at a higher level than the current £30,000 limit (subject, of course, to another of the government's stated aims that it must be affordable to the Exchequer).

Question 6. Do you believe that a relief based on length of service and those who are being made redundant would be easier for employers to administer. Please provide your reasons

Limiting relief to redundancy situations

27 We do not accept this proposition.

28 The original taxing provisions of what is now s401 Income Tax (Earnings and Pensions) Act 2003 (ITEPA) brought into charge (and then exempted up to £5,000) payments "not otherwise chargeable to tax". The exemption was not limited to just redundancy terminations, and indeed, the statutory redundancy scheme was only introduced 5 years later. The provisions applied to payments made on termination which are not, or not clearly, remuneration or deferred remuneration under the tax rules and this approach carries through to the current day. The proposal to tie relief to redundancy situations is therefore a very significant narrowing of the existing relief.

29 We think the Government's proposals to limit relief to those who are being made redundant will not be easier for employers to administer, for the following reasons:

- The current regime does not limit the termination circumstances in which the exemption applies. Our experience is that employers do not find this element of the regime complicated. The fact that the exemption applies regardless of the termination context makes it easier for employers to understand and administer.

- A large number of dismissals happen simply because people don't get on. This is particularly an issue in smaller workplaces. The fact that people don't get on often doesn't mean there is fault on either side – it is simply that the individuals are not "a good fit" in that working environment. There is no reason to distinguish these sorts of terminations from redundancy situations.

- It will increase the difficulty for employers if the exemption is confined to redundancy situations in the technical sense specified in section 139 of the Employment Rights Act 1996 (ERA). A considerable body of case law has built up over the years about what is meant by "redundancy" under s139 ERA. Employers will have to form an opinion as to whether a particular termination is within the definition of redundancy in s139 ERA, in order to decide whether tax relief can be applied. There will often be situations which are not clear cut. For example, business reorganisations can often be redundancy situations. However, this isn't the case where, for example, the overall amount of work that needs to be done doesn't diminish and the employer is instead introducing new ways of performing the same jobs. It would surely not be right for a person made redundant to have the benefit of the proposed

exemption, but not someone whose dismissal was the result of a reorganisation which did not technically amount to a redundancy.

• Limiting the exemption to redundancy situations is likely to distort behaviours. The government says in paragraph 3.3 of the consultation paper that employees and employers attempt to change the nature of their termination benefits under the current regime. The same will likely occur under the proposed regime - employers and employees may be pressured to shoehorn termination situations into a redundancy situation, or worse, simply mislabel the termination as a redundancy when it is not actually the case. We envisage HMRC having similar difficulties to those mentioned in paragraph 3.3 in determining whether a termination was genuinely for redundancy.

<u>Relief based on length of service</u>

30 General points:

- the Government will need to consider whether introducing a length of service requirement for the exemption is indirectly discriminatory.
- Use of a length of service criterion may be unfair. The consultation suggests that using length of service will reward long serving, lower paid employees. However, in our experience, those who are most vulnerable (and therefore arguably in more need of tax relief) often have far less service: it is counterintuitive that they should be penalised using a length of service regime.

31 Tying relief to length of service will not be easier for employers to administer, because:

- It will be an additional calculation - something that is not necessary under the current regime.
- It will not always be easy to calculate someone’s relevant length of service. In the modern workplace, individuals may work for employers in a number of different capacities at different times of the relationship – for example, as employees, casual workers, self-employed, on zero-hour contracts etc. Employers will have difficulties working out which periods of engagement under these different arrangements count towards the length of service requirement.
- The amount of the exemption available to each employee will depend on that employee’s personal circumstances. Employers will therefore have to work out the relevant tax relief for each individual separately, and make sure that that is taken into account in any settlement documentation. In a redundancy exercise involving more than a few employees, this will be very administratively burdensome. In contrast, under the current regime, an employer knows that each terminated employee is entitled to the same relief up to the £30,000 maximum and can use standardised documentation.

Question 7: Do you think that structuring the relief based on length of service and redundancy will be easier for employees to understand? Please provide reasons.

32 No.

33 The definition of redundancy is not easily understood by employees. In our experience, individuals are often confused about whether or not their termination is technically a redundancy. In many cases, they assume that being dismissed by their employer constitutes a redundancy, notwithstanding that the circumstances described in section 139 of the Employment Rights Act 1996 have not arisen. For completeness, we note that some employers also struggle with the definition of redundancy (or seek to apply the label in circumstances where it is not correct, in order to soften the perceived impact of a dismissal and for the employee to benefit from a statutory redundancy payment).

34 Although length of service may be easy to calculate for some employees, for others it will not be straightforward – for example, where they have become employed by their current employer as a result of a TUPE transfer or have moved around between group entities and do not have employment documentation which accurately reflects their length of service. In comparison to the current system (which draws no distinction based on length of service) the proposed new system appears to us to be more difficult for employees to understand

Question 8: Are there any alternative ways that the income tax and NICs exemption could be structured that would better meet the government's stated aims as set out at 3.5 of this document? Please provide details with your answer.

<u>Alternative 1</u>

35 One possible view is that the government's stated aims of simplicity, certainty, affordability for the Exchequer and fairness as between different categories of employees (in particular, those who can afford legal or tax advice and those who cannot) would be met if a blanket approach were applied to termination payments – i.e. so that all payments are taxed as earnings and no distinction is drawn between different categories of payment. We note, however, that the stated aims at 3.5 of the consultation paper refer to fairness in a very limited context – "so that those who are better paid and better advised (because they are able to afford to pay for advice) do not receive a more favourable tax and NICs treatment than those who are lower paid." There is no general reference to overall fairness in the government's stated aims but we understand this to be a relevant factor, given that the consultation paper assumes that an exemption will be available and sets out proposals based on targeting those considered most in need. That being the case, any approach which involved removing the exemption on a blanket basis, although possibly achieving the aims stated at 3.5, would not achieve the broader objective of benefiting those most in need.

36 We also consider that removal of the exemption would remove some of the incentive for employees and employers to reach settlement in relation to any potential disputes arising on termination of employment.

<u>Alternative 2</u>

37 Although the Government has identified that the current system is complex and gives rise to uncertainty, we think there is a case for saying that the taxation of termination payments arising outside of an employment tribunal is now relatively well understood, having been in place for many years.

38 The Government's consultation paper does not identify that the current system is unaffordable for the Exchequer so, on the assumption that this is not a current concern, we think that one proposal which would achieve the aims stated in 3.5 of the consultation paper would be to leave the current system in place and make changes only in relation to the taxation of tribunal awards (which we agree involves a complex approach that is difficult to understand, particularly for litigants in person).

Alternative 3

39 To remove complexity from the proposed approach, we think that any available relief should not be linked to length of service. If the government wishes to define specific categories of termination in respect of which the exemption would apply, we would suggest that fairness would be better achieved by adopting a scope wider than just redundancy.

40 In particular, we would suggest that consideration should be given to the following reasons for termination: (i) redundancy; (ii) capability; (iii) payments made in settlement of a statutory or contractual claim.

41 We note, however, that any approach which involves limiting the category of employees who may benefit from the exemption gives rise to the risk of avoidance (e.g. manipulating the label applied to a termination in order to seek to benefit from any available tax exemption).

42 The proposed categories set out in this paragraph also risk excluding a common reason for termination – i.e. some other substantial reason (often arising in circumstances such as a personality clash between senior individuals or a breakdown in the working relationship). In this scenario it is difficult to attribute any "fault" to the employee and it is therefore hard to see why an employee who is dismissed for some other substantial reason would be any less deserving of a tax exemption.

43 This may then lead to the conclusion that all termination circumstances other than misconduct should qualify (perhaps only misconduct justifying summary dismissal, to avoid uncertainty). Relatively few cases fall into this final category (and fewer still where termination payments other than strictly contractual payments would be made (the taxation of which is currently clear)). Trying to identify "no-fault" dismissals therefore captures almost all dismissals.

Question 9: Are there any alternative approaches that you can think of that will prevent payments of salary being disguised as a termination payment? Please provide details with your answer

44 The question presupposes that salary being disguised as a termination payment is a regularly encountered issue. We do not believe that it is and we do not therefore consider that there is a need to identify methods through which payments of disguised salary should be tackled. In our view the consultation paper poses a problem that is sufficiently rare that in the absence of cogent evidence it does not justify any change.

Question 10: Please can you provide details of the types of payments and people who receive termination payment who would be affected by the anti-avoidance provisions? Please also state which anti-avoidance provisions you are referring to.

45 The consultation document states that the government does not intend to provide tax relief to those who choose to resign. A distinction must be drawn here between employees who resign without cause (and where the concept of compensation should not therefore validly arise) and those who resign with cause, for example those who contend that they have been constructively dismissed. We believe it would be inequitable to debar employees who have been constructively dismissed from the tax and NIC reliefs available to employees who have been expressly dismissed.

46 The consultation document also states that the Government does not intend to provide tax relief to those working under a fixed-term contract. We presume and recommend that this restriction will be limited to circumstances in which the contract terminates in circumstances intended/envisaged at the outset. We do not believe there is any reason to disentitle fixed-term workers from tax relief where the reason for that differentiation is their status alone particularly given that expiry of a fixed-term contract constitutes a 'dismissal' in law.

47 It is suggested, the Government intends to recover tax and NICs on termination payments where the individual is reengaged in the preceding 12 months to do a similar job. We recommend that this expressly excludes circumstances where the employee is reengaged by reason of a later TUPE transfer or other acquisition that affects his employment with a subsequent employer or which results in their reengagement (or subsequent consultancy arrangements) through 'accidental' means. The Government will also need to carefully consider, and provide practical guidance, of what is meant by "similar" in these circumstances. For example is it limiting its views to employment relationships or including subsequent short-term consultancies as often occurs for example after work in central government or the NHS. There is a danger here of impairing flexibility. We propose that the similarity is adjudged by reference to remuneration rather than role. We also consider that the imposition of a blanket 12 month repayment period may result in employees being required to repay a potentially significant sum of tax and/or NICs in circumstances where they have been out of work for a lengthy period of time and may not consequently have the means to do so. We therefore consider that a remission or phased repayment scheme will need to be considered in such cases. This proposal seems to bring with it a bundle of complexities.

Question 11: Do you think that the exemption for injury or disability should be maintained? Please provide reasons for your answer.

48 We agree that some exemption for payments made on account of injury or disability should be maintained. Such payments have a compensatory element, are likely to be controlled by the market, do not relevantly represent rewards from employment and should not therefore be diminished by tax. Those who are injured or disabled are in a materially different position on the termination of employment from able-bodied people. The exemption affords some recognition of that fact.

49 Despite the view expressed at paragraph 4.41 of the consultation document, we do not consider that existing legislation puts it beyond doubt that payments “paid in relation to injury of feeling and where there was discrimination prior to the termination are not subject to tax or NICs…” On the contrary, we believe that such payments are properly taxable.

50 Insofar as the government’s view is based on *Timothy James Consulting Ltd* v *Wilton* UKEAT/0082/14 [2015] IRLR 368 we consider that case was clearly wrongly decided in holding that the award for ‘injury to feelings’ (though the correct statutory term is ‘injured feelings’) was not taxable. As explained in Harvey on Industrial Relations and Employment Law (Div. BII para 241) the conclusion is completely inconsistent with the language of the legislation and particularly with the statutory history, to which the Employment Appeal Tribunal was not referred.

51 It is our view that if Government decides that an exemption for ‘injured feelings’ should be introduced or maintained, it should be done expressly, and that it should make clear that any element of compensation for disappointment, outrage or anger is separate from compensation for injury to the person. But in our view, many types of dismissal give rise to such feelings. Other than maintaining or achieving consistency in the tax treatment of payments made to those whose employment continues and those where employment terminates, there is no coherent basis for giving tax-free compensation for such awards in the context (only) of discrimination and other statutory torts. As we suggest below, this requires consultation on specific options.

52 Further, we believe that the review should not overlook how this exemption for ‘injured feelings’ might relate to s 51(2) of the Taxation of Chargeable Gains Act 1992 (TCGA 92). Insofar as a payment is exempted from income tax (which generally takes precedence over capital gain tax), it may still fall within the charge to capital gains tax. Where a payment has a capital character, rather than income or revenue, and is exempted from s 401 ITEPA as a termination payment, s.51 (2) TCGA means it may escape tax altogether.

53 Section 51(2) provides

It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.

54 HMRC’s note on Extra Statutory Concession D33 makes it clear that it includes within the scope of s 51(2) payments made:

> *because of any wrong or injury suffered by the individual personally rather than because of any financial loss e.g. for physical injury, distress, embarrassment, loss of reputation or dignity, unfair or unlawful discrimination and for libel or slander (in Scotland, defamation).*

55 Another difficulty with the government’s thinking is that the result may go wider than intended. In the employment jurisdiction ‘injured feelings’ include the whole range of responses to statutory torts, from being upset or put out, to mental illness. In our view, there should be specific consultation over what should be the conditions to qualify for

tax-free compensation. As well as addressing the requirements of relevant European directives, at issue is whether tax-free compensation should be given to payments for any injured feelings caused by dismissal; or to injury to feelings, irrespective of severity, caused by statutory torts (maintaining fairness between those who receive such payments during employment and those who receive them on termination), or restricted so that only genuine impairments of physical or mental condition arising from the statutory torts should qualify.

56 If the exemption were not so confined, then payment in respect of any type of hurt or injured feelings would attract the exemption. In particular, that would include a payment made in respect of genuine distress and hurt feelings in response to a wrongful or unfair dismissal, yet such a payment is not recoverable as damages since 1909 when the House of Lords decided *Addis* v *The Gramophone Company Ltd* [1909] AC 488. To extend a tax exemption to all forms of injured feelings would be to create a new head of tax exemption, and an avenue of tax avoidance in the employment area.

Question 12. Do you agree that by removing the requirement to differentiate between the different elements of payments made in connection with injury or disability will provide simplification? Please provide reasons for your answer.

57 We find it difficult to understand how s 406 could be further simplified. It provides:

This Chapter does not apply to a payment or other benefit 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.

58 Leaving aside any subtlety inherent in a difference between “in connection with” and “on account of” we see no difficulty in distinguishing between on the one hand, death as the reason for a payment or benefit, and on the other, injury or disability as the reason. There is no need for simplification, other than, perhaps, removing the difference of terminology.

Further, as s 401(1)(a), (b) and (c) define the scope of Chapter 3 of Part 6 of ITEPA, the Parliamentary intention in referring to ‘termination’ in connection with death in s 406(a) is apparent: it recognizes that s401(b) and (c) could never be relevant to payments in connection with death.

59 If something else is intended by Question 12, that is not apparent from the consultation document.

Question 13: Do you think that there should be a cap on the amount of tax and NICs relief that is provided where the payment is connected with injury or disability? If so please provide reasons and suggested amounts.

60 No we do not think there should be a cap on the amount of tax and NICs relief where a payment is on account of injury or disability. This would not make the existing regime in this respect either fairer or simpler.

61 This exemption is used primarily where an individual will not be able to work in their own occupation or possibly at all again due to serious illness or injury. In many of the cases

our members have dealt with the individual will never work again. Regardless of the long-term prognosis, however, they usually face the prospect of financial hardship if and when their employment terminates and are therefore (at a moral level at least) very worthy cases for tax relief. They are in a different position from employees who have not suffered the pain or loss of enjoyment/amenity of the injury or disability and whose prospects of re-employment are likely to be far greater. The “fairness” objective should not therefore extend to treating employees who are injured or disabled in the same way as those who are not. In particular, we anticipate that there will be few if any cases where the receipt of compensation without tax would represent any form of windfall to the employee, i.e. a payment exceeding his losses.

62 As the largest awards and settlements are likely to go to those who are most seriously disabled or injured and/or have the longest period to go prior to retirement a cap in these circumstances would penalise those who face the greatest hardship. Therefore if the tax relief is intended to assist those who face the greatest hardship, applying a cap would not achieve this aim.

63 In addition, future financial loss in these circumstances is usually calculated on a net basis as it is in a personal injury claim. In personal injury cases compensation for the injury itself and the resulting financial loss is also calculated on a net basis and is awarded tax-free with no cap. We see no principled reason for the tax treatment of compensation on account of disability or injury in these circumstances to be treated any differently. We appreciate that in theory the absence of a cap on tax-free injury/disability compensation could be used as a means to get money to the employee or ex-employee which should properly be taxed. However, we do not consider this to warrant the imposition of a cap. First, the Consultation paper makes no suggestion that this is part of the Government’s thinking or a problem in practice. Second, this device would require the connivance of the employer, which clearly faces its own problems if HMRC disallows the payment later. Third, to the extent that such sums are funded by the employer’s employment liability insurer, they will be limited (not gratuitously large) in any event. Fourth, the tax exemption in these cases is often a significant factor in enabling employer, employee and (on occasion) permanent health insurer (PHI) to reach a deal which gives a measure of financial security to the injured/disabled employee and avoids litigation. This must be good for the public purse, not to mention avoiding the strain of litigation on the disabled employee. Income and/or a lump-sum from a privately-held permanent health insurance or long-term disability policy (for example of the sort which partners pay individual premiums for) is paid out tax-free so imposing tax on payments which are made as a result of a PHI policy held by an employee would also result in an unprincipled difference in treatment.

64 The Consultation paper does not expressly address the issue of tax on compensation for injury to feelings. At present the law on this seems inconsistent and the subject of conflicting decisions between HMRC and the employment tribunals. It currently appears that compensation for injury to feelings in connection with a discriminatory termination may be taxable while that for an earlier discriminatory act is not. That is not always an easy distinction to make and so is not a satisfactory position for employers or their advisers (or indeed for employees). An additional complexity is the sometimes very blurred line between injury to feelings and actual injury, though the Government does not suggest in the Consultation paper that this has been the subject of particular confusion or abuse in practice. We believe that this is because payments for injury to feelings are

to some extent self-disciplining – often refused by employers for fear that they amount to an admission of discrimination and generally limited to the employer's estimate of the appropriate *Vento* band (on the basis that if the compensation materially exceeds what a tribunal might reasonably award, there must be an inference that it is actually payment for some other reason). While guidance on the conflict above would be helpful, we do not consider there to be any need for a statutory cap on injury to feelings compensation either.

Question 14: Do you think that the foreign-service exemption should be removed? Please provide reasons for your answer.

65 Yes, we think it should be removed.

66 If the aim of the consultation is to simplify the tax on termination payments but to maintain some tax relief for those suffering financial hardship on termination of their employment, the removal of this relief will achieve the objective of simplifying the system (the application of this exemption is complicated) and is likely to affect only a relatively small number of employees who in general will have been well-remunerated in their work. There is an argument that their having worked abroad for long enough to trigger the application of foreign service relief might put them at a disadvantage in the domestic employment market but we consider this weak given that the relief is available even if the employee was already working in the UK at the time of his termination. That may put him in a better financial position than a peer dismissed from the same job at the same time for the same reason, which may clearly be seen as unfair.

67 We note the statement in the consultation paper that if the exemption were removed then territorial limits for termination payments would be adopted, in line with all other payments of employment income. We would welcome an explanation and illustration of this point and the extent of any changes to the current position which are proposed.

Question15: Do you think any of the other exemptions should be maintained. If so, which ones? Please provide reasons for your answer.

<u>Legal costs</u>

68 We think the legal costs exemption (s413A ITEPA 2003) should be retained.

69 It is a requirement that employees receive independent legal advice (or equivalent) to waive validly their statutory employment claims under a settlement agreement. The removal of the legal costs exemption could act as a disincentive to employees seeking legal advice. Such a mismatch between the tax regime and the statutory employment rights regime is undesirable.

70 Further, a practice has built up over time that employers will pay for, or make a contribution to, the cost of an employee's legal advice on termination. This legal costs payment (made direct to the employee's adviser) is understandably viewed as something separate to any termination payment received the employee. If the legal costs exemption were removed, employees would suffer income tax on their termination payment, in respect of a service, rather than a payment, that they had received.

71 The consultation paper raises a concern that the legal costs exemption is used to pay for legal advice with the sole purpose of reducing tax and NICs liability for employees and employers. However, our experience is that legal costs can vary, not so much because of advance tax planning, as because of the difficulty employees face in obtaining appropriate termination packages from their employers. The situation involving Chris, the employee in Example 3 (paragraph 4.20) who has a contractual right to a large termination payment regardless of the reason for his dismissal, is very rare. It is far more common for employees to struggle to get an appropriate termination payment and in consequence incur significant legal costs. Removing the separate legal costs exemption could therefore have a harsh impact on employees through no fault of their own.

72 The Government's fear is that the legal costs exemption unfairly advantages employees who are better paid and advised. In our experience, the legal costs incurred by employees become higher when either:

- the employee has complex pay arrangements; or
- the employer is initially reluctant to offer satisfactory termination terms, so giving rise to a dispute.

Outplacement costs

73 We think the outplacement costs exemption (section 310 ITEPA 2003) should be retained.

74 This is a valuable exemption for employees who lose their jobs. If the exemption were removed, employees would suffer an income tax charge on a service, rather than a payment, that they receive.

75 Further, without outplacement help, many employees will be out of work for longer periods, possibly putting more pressure on the public purse.

Contributions to registered pension schemes

76 We think the contributions to registered pension schemes exemption (s408 ITEPA 2003) should be retained.

77 This too is a valuable exemption for employees who lose their jobs. This exemption accords with the government's aim to encourage individuals to make provision for their own retirement.

78 Further, given that the taxation of pension contributions and pension receipts may change considerably over time, there seems little merit in changing the rules about termination payments into registered pension schemes, rather than reviewing it as part of a more holistic review of the general pension taxation regime.

Question 16: Do you agree that any payments that would usually be exempt from income tax and NICs should remain exempt (subject to the usual rules) when made as termination payments? Please provide reasons for your answers.

79 Yes. Given the Government's aims to simplify the regime and make the tax and NICs treatment of payments easy to understand and administer, we think it sensible to have a consistent tax and NICs treatment for payments that would usually be exempt from income tax and NICs, when such payments are made as termination payments.

Question 17: Do you think there should be a financial cap, above which income tax (and possibly NICs) should be payable in cases of unfair or wrongful dismissal? Please provide reasons for your answer.

80 The consultation paper does not ask whether we agree that payments for unfair or wrongful dismissal should be treated differently from other termination payments. Instead, it asks only whether we agree that there should be a financial cap, above which such payments are taxable. For completeness, however, we confirm that it is our view that if the Government were to proceed with the proposal of linking any tax exemption only to redundancy, payments in respect of unfair and wrongful dismissal should benefit from a separate exemption. Some of our members are of the view that there is no reason to treat such payments differently from any other termination payments for which an exemption is available – for example, if redundancy-related payments were to benefit from an exemption set at a particular level, there is an argument (particularly if the government's aim is simplicity) for saying that unfair dismissal and wrongful dismissal payments should be subject to an identical exemption.

81 Question 18: Do you think that there should be any differentiation in terms of a financial cap where payments have been settled by a tribunal or an arrangement between an employee and employer? Please provide reasons for your answer.

82 We think that there are advantages and disadvantages to differentiating between employment tribunal awards and arrangements between an employee and employer, but on balance it would be better to differentiate.

83 The disadvantage of failing to differentiate between the two types of payment is that there would be significant scope for avoidance. For example, provided that an employer was not concerned about admitting liability in a settlement agreement, it would be in its (and the employee's) interests to label any payment under a settlement agreement as being made in settlement of an unfair dismissal claim. Unless HMRC intended to police such arrangements and test the merits of any threatened claim in respect of which a settlement payment had been made, it would be unable to prevent such avoidance.

84 The disadvantage of treating the two types of payment differently is that employees may be incentivised to take their claim all the way to a Tribunal in order to benefit from the more favourable tax treatment that would apply to any compensation awarded. However, they are likely only to take such a risk in circumstances where they feel (or have been advised) that the merits of their case are strong. In such circumstances, they may as part of any settlement negotiations ask their employer to gross-up the relevant settlement payment to put them in the same position as they would have been in had the damages been awarded by a Tribunal. This could make negotiations more protracted, and calculation of termination payments more complex.

85 We note that the need to differentiate between the two types of payment only arises if the government chooses to treat compensation payments for unfair dismissal and

wrongful dismissal differently from other payments made on termination of employment. As set out in response to question 17 above, the majority of our committee are of the view that simplicity may be best achieved by aligning all termination payments (or all termination payments in respect of which the Government believes that an exemption should be available).

Question 19: Do you think there should be a financial cap, above which income tax (and possibly NICs) should be payable in cases of discrimination? Please provide reasons for you answer.

86 We are seriously concerned at the potential ramifications of the current proposals and its impact on allowing payments which are referable to discrimination to enjoy materially different tax treatment to those that are not. We believe that such a position may encourage employees to allege that they have been discriminated against in order to avail themselves of more favourable tax and NICs treatment. Whilst we recognise that payments referable to injured feelings are often categorised as tax-free and that this has not in our view resulted in a significant number of complaints of discrimination that may not otherwise have arisen, the position at present is softened by the availability of the £30,000 general threshold, a sum that the published statistics suggest the majority of termination payments do not exceed. Should that threshold be removed, or be materially reduced for non-discrimination based termination payments, the prospect of a tax free sum becoming available through reference to discrimination will, we believe, significantly increase the attraction of a discrimination allegation or claim.

87 This risk has caused some of our members to say that they consider that an approach should be taken that mirrors (exactly or materially) the treatment of payments that are not referable to discrimination. Others would not want to undermine the very important protections and prohibitions against all forms of discrimination, harassment and victimisation because of protected characteristics.

Question 20: Do you think that there should be any differentiation in terms of a financial cap where the payments have been settled by a tribunal or an arrangement between an employee and employer? Please provide reasons for your answer.

88 On balance no, although there are conflicting points of view.

89 Some argue that if termination payments can attract tax free status simply by the existence of an agreement between the employer and employee that there is an allegedly discriminatory element we consider that there will be a financial incentive for employees to raise potentially meritless complaints of discrimination in order to avail themselves of more favourable tax and NICs treatment on termination. There will presumably be no independent arbiter, once the dispute has been settled and the payment made, of how legitimate that allegation was. We also envisage circumstances in which an employer may be put under pressure to either accept (contrary to its own belief) that there was discrimination or to instead "top up" the shortfall that the employee will otherwise suffer on the taxation of the payment due to them.

90 The other point of view is that only allowing payments that are both referable to discrimination and also awarded by an employment tribunal to enjoy enhanced tax treatment may encourage employees to continue with employment tribunal complaints to a full hearing in order to secure the judgment that will entitle them to the more favourable

tax treatment they seek. This does not sit comfortably with the government's aim to decrease the volume of litigation coming before employment tribunals through early dispute resolution. In addition the proposal to impose the differentiation would also be inconsistent with the proposals in relation to wrongful and unfair dismissal compensation.

12 October 2015

APPENDIX 1

Members of the Sub-Committee

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