

# Employment Tax Update



by Simon Newsham, Partner

## Taxation of Payments in Settlement Agreements

In the recent First-tier Tribunal (FTT) case of *Mr A v HMRC* [2015] UKFTT 189, the FTT held that a settlement payment made under a compromise agreement arose purely from a potential discrimination claim and, therefore, was not taxable as earnings from his employment.

### Key Issue

Mr A worked as a trader in the London office of a European bank.

The key issue surrounded the correct tax treatment of a £600,000 payment which was included as part of his compromise agreement.

The taxpayer argued it was not taxable as earnings because it was compensation in relation to a threatened race discrimination claim regarding his unfair treatment in receiving very low or no bonuses over several years and no increase in his base salary.

HMRC contended the £600,000 payment was fully taxable as earnings from his employment because it was made in order to make good shortfalls in his bonuses and salary and, therefore, fell squarely within the ambit of section 62 of the Income Tax (Earnings and Pensions) Act 2003.

### Analysis

The FTT referred to the case of *Hochstrasser v Mayes* (1959) 38 TC 673 and noted the correct test was whether or not the payment constituted a reward for services past, present or future.

The FTT further noted that a settlement under a compromise agreement should be treated in the same way as an award by an Employment Tribunal and the key question was '*Why did the employee receive the payment?*'.

Where damages are calculated by reference to an underpayment of employment earnings and, in particular, where the discrimination has manifested itself through the adverse remuneration of an individual, the damages can be regarded as arising not because the employee was underpaid, but because the underpayment itself was discriminatory.

Accordingly, for Mr A to succeed, he had to establish that the payment was made by his employer in order to settle a discrimination claim and not in order to pay money which the Bank considered that Mr A was entitled to pursuant to his service agreement. Nonetheless, it was not necessary for Mr A to prove actual racial discrimination.

### Decision

The FTT concluded that the Bank had not wished to defend a discrimination claim through the Courts and, therefore, the payment had been made in order to settle such potential claim.

Rather interestingly, the FTT rejected the Bank's contention that part of the payment represented an additional 2005 bonus, on the basis that the payment had only been made solely after the race discrimination questionnaire had been served by Mr A's solicitor.

## Takeaway Point

This decision may yet be appealed by HMRC and, whilst a decision by the FTT does not create a legally binding precedent, it nonetheless provides a useful illustration of the approach to be taken in relation to settlement payments.

The FTT clearly thought the focus should be upon the reason **why** the payment was made (i.e. to avoid a race discrimination claim) rather than what it represented (i.e. underpayments of salary and bonuses). Since the FTT found that it was purely compensatory in nature, it could not represent employment earnings and, therefore, could not be taxable.

The decision also provides a useful reminder that parties to settlement agreements should try to ensure that all payments are sufficiently labelled and analysed in order to avoid any confusion and potential litigation at a later date.

## Want to get in touch?

If you would like to discuss more about this decision and/or need any employment tax advice, please contact Simon Newsham at New Quadrant Partners on 020 7430 7176 or you can email him at [simon.newsham@nqpltd.com](mailto:simon.newsham@nqpltd.com)

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