

Croner Briefing

Is a payment for injury to feelings taxable?

In previous Tribunal cases it was decided that section 406 of the Income Tax (Earnings and Pensions) Act 2003 (“ITEPA”) provided that sums paid to employees under a settlement agreement for ‘injury to feelings’ was exempt from income tax. However, the recent case of *Moorthy v Commissioners of HM Revenue and Customs* has decided these payments are not exempt from tax.

BACKGROUND

The facts of the case were that Mr Moorthy worked for his employer until 2010, when he was made redundant. Mr Moorthy consequently claimed age discrimination and unfair dismissal at the Employment Tribunal. However, prior to any hearing, a settlement was reached with his employer for the sum of £200,000, which was labelled compensation for “loss of office and employment”. The employer treated the first £30,000 of this sum as exempt from tax (by section 403 of ITEPA) and then deducted tax and the basic rate for the remainder of the sum.

Consequently, Mr Moorthy submitted a tax return whereby he treated the entire sum as a tax free payment. However, HMRC considered the sum was subject to income tax, therefore Mr Moorthy appealed to the First-Tier Tribunal (“FTT”). However the FTT found that the payment was made “in connection with the termination of his employment” and as such, was subject to tax, pursuant under section 401, to which, section 403 provides that for these types of payments, the first £30,000 is exempt from tax, however any sum in excess of this threshold is not.

ON APPEAL

Mr Moorthy appealed again, this time to the Upper Tribunal, arguing that the payment was made “on account of injury to an employee” and therefore exempt from tax under section 406(b) of ITEPA.

The Upper Tribunal did not agree with Mr Moorthy and found that the entirety of the settlement sum came within section 401 of ITEPA as it was paid in connection with the termination of his employment; therefore it was subject to tax pursuant to section 403. The Upper Tribunal held that this section is still applicable for payments which include non-pecuniary sums, which can encompass a sum for injury to feelings.

The Upper Tribunal outlined that section 406 of ITEPA was intended to apply to payments made for ‘injuries’ which resulted in a change in duties or income or termination of employment. Therefore, this was not the circumstance in this case, as that had not occurred. Accordingly, the previous similar cases which decided that a sum paid for injury to feeling to an employee fell within section 406 of ITEPA were wrongly decided.

Therefore, the Upper Tribunal have provided helpful guidance as to the circumstances where section 406 of ITEPA applies for payments made for ‘injury’, in that unless the injury caused the termination of employment, change of duties or income the payment will be subject to tax.

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