Taxation of financial loss from discrimination

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L v The Commissioners for His Majesty's Revenue and Customs [2024] UKFTT 001044 (TC)

The tax treatment of damages from (or settlement of) employment disputes involving dismissal – particularly when they involve mixed or overlapping claims in discrimination, dismissal and loss of earnings - is a frequent headache for practitioners.

Not only does the question tend to arise when the parties appear to be at the "finishing posts" in terms of agreeing settlement, but also the guidance from HMRC on the matter falls somewhere between opaque and non-existent. Many readers may share the position of the author: that the necessary forays into tax law have the principal effect of making them grateful for the existence of accountants.

The recent case of L v HMRC in the FTT (Tax Chamber), looking at this question, might therefore seem to be a useful point of certainty. Although the judgment is not authority, being only at first instance, and addresses in detail only one particular question in the area, it nonetheless sets out and considers a number of the relevant principles in one place.

The question the FTT addresses in depth is also an interesting and potential thorny one: how does one treat damages for a claim that the employee was discriminatorily *prevented* from performing work?

Background Facts

L had been issued a closure notice by HMRC amending her self-assessment tax bill, to include £115,900.88 in additional income tax. That unwelcome surprise was the result of HMRC taking a different approach than had been used in her self-assessment to the taxation of a substantial settlement arising from a claim she brought against her employer.

L had been an executive director, and the settlement included amounts relating to the calculation of various potential bonuses, long-term incentive plans, and the value of shares. Part of the Claimant's claim reflected her allegation that her role had essentially been split with

an additional person appointed, which reduced her opportunity to develop business. It was claimed that this was an act of discrimination.

The question the FTT determined in this case was whether the settlement amount which related to that part of her claim was taxable or not.

Legal Background

Practitioners will be familiar with the effect of s.401 ITEPA, which applies a chapter of the Act to "payments and other benefits which are received directly or indirectly in consideration or in consequence or otherwise in connection with […] the termination of a person's employment".

That is, in itself, a departure from the rules that apply to simple earnings, which are defined by s.62 of ITEPA. Although the wording is not found in the section itself, the fundamental question is whether a payment is "from employment".

The FTT sets out and discusses a number of authorities at Paragraphs 56 to 76 which many practitioners who frequently deal with the settlement of claims or compromise agreements my find a useful summary.

Amongst them, the FTT considered the effects of ***Hochstrasser v Mays 38 TC 673***, that a payment being "from employment" is a question of whether the payment is a reward for services past, present or future and that a "but for" connection connecting the payment and fact of employment is insufficient. It also considered ***Kuehne + Nagel Drinks Logistics Ltd v HMRC* [2012] EWCA Civ 34**, that where there are both "employment" and "non-employment" reasons for a payment, the amount is taxable if the employment reason was a "substantial cause".

The Parties' Cases

The fundamental argument put by L in the FTT was that this part of the settlement did not relate to a claim for payment from employment, but in respect of work she *didn't do* because she was prevented from doing so.

HMRC's contention was that the substantive right in the claim was the recovery of employment income to which they were entitled had the employer not acted in a discriminatory fashion and relied on the case of ***Pettigrew v HMRC* [2018] UKFTT 240 (TC)**.

In that case, Mr Pettigrew had been a fee-paid Employment Judge and received payment in respect of a potential claim of less favourable treatment by virtue of being a part-time worker.

The FTT determined that the payment received derived its character from that which it replaces, which were (or would have been) earnings, and were taxable.

HMRC's own argument appears to follow the logic of its own internal manual, which immediately beneath the discussion of ***Pettigrew*** notes**:**

> *"The same treatment would apply to other types of discrimination. If a female employee had been underpaid relative to a comparable male colleague then any resulting compensation for the historic loss of earnings would be taxable as earnings from the employment (however, compensation for the distress caused by this discriminatory treatment might not be taxable – see below)."*

Readers will note that, in spite of the general reference to "other types of discrimination", the other language used in the paragraph might tend to refer to Equal Pay claims in particular and not the myriad other circumstances in which a person may claim for historic loss of earnings through a discrimination claim.

The FTT's Decision

In the course of determining the correct principles, the FTT set out what it considers as the relevant principles to determining whether a payment in settlement of a discrimination claim is taxable. These are set out in full below:

> *(1) Where a global settlement sum has been paid to compromise a number of discrete claims it must be determined whether that single sum can sensibly and realistically be apportioned and attributed to the various components of the claim.*
>
> *(2) Where the payment can be apportioned and attributed each portion of the payment is to be considered separately.*
>
> *(3) Any payment or apportioned part payment which is paid "directly or indirectly in consideration for in consequence of, or otherwise in connection with" termination of employment, the payment will be taxed under section 401 ITEPA.*
>
> *(4) When considering any part of the payment made otherwise than in the circumstances envisaged under section 401 ITEPA and thereby in connection with a period of employment (past, present or future) the critical question is whether the payment is a reward for services of the employee (Hochstrasser, Mairs).*
>
> *(5) Where claims are made under the EqA the critical focus of attention should be whether the payment is made to compensate for actual or potential discrimination or*

"to pay back money which [the employer] thought the Appellant was entitled under [their] service agreement".

(6) Where there are multiple reasons for the payment or apportioned part payment the existence of a non-"from employment" reason will be unlikely to deprive the nature of the payment as "from employment".

The FTT considered ***Pettigrew*** and distinguished it from the case before it, by virtue of the fact that it concerned a claim which related to sums properly payable to him by virtue of his contract (when modified so as to not to be less favourable).

It went on to conclude that the part of the settlement relating to the claim that L's role had been split, depriving her of opportunity, was a payment for reasons which did not include a reason "from employment":

"the heart of this part of the Appellant's claim is not that they were not fairly paid for what work they did but that they were deprived of the opportunity to perform their full role […] compensation for such lost opportunity cannot be directly connected to the employment as it was an employment she never fulfilled because of the discrimination she suffered"

Commentary

The reasoning of this decision does give rise to potential arguments on this question in a significant number of discrimination claims, where a failure to provide an opportunity is often pleaded as a basis of a claim and which may be susceptible to the same analysis. In particular, claims involving discrimination which prevent a promotion would appear relevantly similar.

While few cases will be as clear cut in respect of the loss being a direct result of work the employee was *prevented* from doing, the judgment certainly calls into question the apparently straightforward approach suggested by HMRC's own guidance.

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