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The Taxation of Certain Compensatory Payments to Employees

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Introduction

There have been a number of interesting Tax Appeals Commission (TAC) determinations in recent years dealing with the interaction between s123 of the Taxes Consolidation Act 1997 (TCA 1997) and other relieving sections in TCA 1997, including ss192A TCA 1997 and 613 TCA 1997. In this article we examine the relevant legislation, Revenue (and HMRC) guidance and two of these TAC determinations. Some of the practical issues arising for tax practitioners in this area are considered.

Background

Section 123 TCA 1997 is a very broad charging provision that applies to:

> *"any payment (not otherwise chargeable to income tax) which is made…either directly or indirectly in consideration or in consequence of, or otherwise in connection with, the termination of the holding of an office or employment or any change in its functions…".*

Where an *ex gratia* payment is taxable under s123 TCA 1997, a number of reliefs are provided for by s201 and Schedule 3 TCA 1997 that can apply to relieve some or all of the payment from income tax. Depending on the circumstances, this may be a partial relief only, and the relief is subject to a lifetime limit of €200,000.

There are certain other provisions of TCA 1997 that can fully relieve "compensatory payments" made by an employer to an employee. For example, provided that certain conditions are met:

- s192A TCA 1997 provides full income tax relief for payments made as compensation for claims under a "relevant Act" (ie, employment legislation); and
- s613 TCA 1997 provides full relief for capital payments that are made by way of compensation for "any wrong or injury suffered by an individual in his or her person or in his or her profession".

However, s192A(5) TCA 1997 provides that where a payment falls within s123 TCA 1997, relief under s192A TCA 1997 cannot apply. Given the broad nature of the s123 TCA 1997 charging provision, a similar principle applies in the context of availing of relief under s613 TCA 1997 (albeit, unlike s192A TCA 1997, s613 TCA 1997 does not have a specific sub-section in this regard). It can, therefore, be difficult for practitioners to advise on the application of either s192A TCA 1997 or s613 TCA 1997 where, for example, an alleged breach of employment law arises during an employment but ultimately the employment is terminated and the claim relating to the alleged breach of employment law is settled around the time that the employment is terminated.

In such circumstances the question arises regarding whether the mere fact of the payment being made pursuant to a compromise agreement entered into contemporaneously with the termination of the employment (albeit stemming from an alleged breach of employment law that arose before the termination of employment) could mean that relief under s192A TCA 1997 does not apply. This is discussed in more detail below.

Also relevant in the context of the recent TAC determinations is the application of s192A(4) TCA 1997, which provides that the exemption therein will, subject to satisfying various conditions, also apply to payments under an "out of court" settlement that has been agreed between an employee and his or her employer in place of a formal hearing of a "relevant authority". Some of the conditions to be met in this regard are set out below (s192A(4) TCA 1997):

- The agreement must be "evidenced in writing" and must not be between "connected persons".
- There is a requirement that the claim would have been a bona fide claim under a "relevant Act" had it been made to a "relevant authority". Revenue guidance on s192A TCA 1997 (Tax and Duty Manual Part 07-01-27, "Exemption from Income Tax in Respect of Certain Payments Made under Employment Law", hereafter "the Guidance") expands on this to provide examples of what factors could be used in considering whether a claim is bona fide, including that "there are sufficient grounds for the claim; the claim is within the scope of a 'relevant Act'; the claim is made within specified time limits, etc" (para. 4).
- The settlement must be in respect of a claim that is "evidenced in writing".
- The claim is likely to have been the subject of a recommendation, decision or determination by a relevant authority that a payment be made to the person making the claim.
- The payment must not exceed the maximum amount that could have been awarded under relevant legislation by the "relevant authority".

Revenue Guidance

Before looking at the TAC determinations, it is important to consider the Guidance.

Interaction between ss123 and 192A TCA 1997

The Guidance provides some very limited commentary on this point, but the examples therein make it clear that the exemption under s192A TCA 1997 does not apply to a payment (however described) in respect of the termination of an office or employment (chargeable to tax under s123 TCA 1997), for example, a payment in respect of a claim made under the Unfair Dismissals Acts 1977–2015.

The Guidance was updated in March 2023, and it is interesting that a particular example (that clearly highlighted a set of facts where s123 TCA 1997 and s192A TCA 1997 applied in parallel to different payments) has been deleted from the Guidance. The now deleted example in the prior version of the

Guidance involved an employer that was found to have both (1) unfairly dismissed an employee and (2) breached its obligations under the Terms of Employment (Information) Act 1994. In this example the employee was awarded €1,290 in respect of the employer's breach of the Terms of Employment (Information) Act 1994. This amount was stated to qualify for the exemption under s192A TCA 1997, notwithstanding the fact the employee was also unfairly dismissed. A payment of one week's gross wages in lieu of notice was also made to the employee in respect of his or her unfair dismissal, and this amount was found to be taxable under s123 TCA 1997.

This example in the earlier version of the Guidance was helpful in that it highlighted that, although payments under the employment legislation that are in respect of a termination of an employment are taxable under s123 TCA 1997, a part of an employee's claim may relate to other breaches of the employment legislation, which are not related to that termination, and that portion of a claim can be exempt under s192A TCA 1997.

The above example was removed from the Guidance, and although some new examples have been included, it is interesting that none of these address a situation where s192A TCA 1997 relief is sought on a portion of a payment made on the termination of an employment. Notwithstanding this, the Guidance still includes commentary on the apportionment of a settlement payment in the context of determining whether s192A TCA 1997 relief may be available (as discussed in further detail below).

The settlement agreement/claim

The Guidance acknowledges that many disputes concerning the infringement of employees' rights and entitlements, or of employer's obligations to employees, are settled by agreement. In addition, the Guidance helpfully confirms that the employee does not need to engage an external adviser to prepare written documentation on his or her behalf and that there is no requirement for the statement of claim to have been formally submitted to a relevant authority, provided that all other conditions set out above are met.

However, the Guidance is somewhat unclear in that it states that:

> "[t]he format of the employee's original statement of claim, which must be evidenced in writing, and the details required to be included in same, will vary depending on the facts and circumstances of each individual case. However, such written documentation may reasonably be expected to include information such as the nature of the claim, the nature of the relationship between the parties involved, a high-level summary of the allegations and the impact of same." (para. 4)

In addition, the Guidance paraphrases one of the conditions to avail of s192A TCA 1997 relief in an out-of-court settlement situation as follows: "the original statement of claim by the employee is evidenced in writing" (para. 4).

The reference in the Guidance to an "original statement of claim" seems to imply a higher degree of formality than the relevant legislative provision, which requires that the "claim" must simply be "evidenced in writing". In the authors' view, the legislative requirement is merely that there is written evidence of the claim (e.g. through written correspondence regarding the issues) and not that there is a prescribed formal statement of claim or a prescribed form of submission of a claim. Clearly, in most cases, a taxpayer would be required to engage an external adviser in order to formally document a claim or, indeed, lodge a claim. In this regard, in the authors' view, the Guidance creates some confusion as to the precise requirements in this regard.

Apportionment of the claim

The Guidance states:

> "In considering if the exemption provided for in section 192A TCA 1997 applies in respect of an out-of-court settlement, due regard must be had to all terms and clauses included within any written agreement between the parties involved. This includes any terms which attribute or apportion the settlement payment between different elements of the claim…". (para. 5)

However, importantly, the Guidance further states:

> "Where the agreement does not clearly attribute the payment to any specific element of the claim, the classification and consequential tax treatment of the payment must be determined having due regard to the full facts and circumstances of the case and the terms of the agreement reached between the parties." (para. 5)

Thus, it appears that Revenue's view is that although apportionment is preferable, lack of apportionment should not, in and of itself, be fatal. That said, the authors' view is that clear apportionment is invariably preferable, albeit that apportionment in and of itself will not ensure exemption under s192A TCA 1997, and any amount attributed to claims for breaches of employment law arising during the employment (which are unconnected with termination of the employment) must be supported by the overall facts and circumstances.

HMRC Guidance

The equivalent guidance from the UK's HMRC deals with compensation received by an employee for distress caused by an employer's actions and states that:

> "if this element of the payment can reasonably be attributed solely to discrimination occurring before the termination of employment, it should be accepted as not connected with the termination".

In addition, it states that:

> "where an employee enters into a settlement agreement with their employer, best practice is for the agreement itself to set out what each element of the termination payment relates to. If there is no such attribution – such as where a single, non-divisible compensation payment is made by an employer 'in settlement of all claims' – the facts need to be examined and a reasonable apportionment agreed as to the amount of compensation paid for different elements. If the agreement relates in part to termination of the employment, the onus will be on the taxpayer to show that the payment is not connected to the termination."[1]

Accordingly, it appears that in the UK:

- a payment for distress can fall outside the scope of the UK equivalent of s123 TCA 1997 where the payment can be attributed to distress due to discrimination occurring before a termination; and
- even where a compromise agreement does not clearly state what portion of a payment relates to each element, it is possible to apportion the payment based on the facts.

This analysis is supported by recent UK Court of Appeal case law (*Moorthy v HMRC* [2018] EWCA Civ. 847), which found that the tax treatment of compensation for discrimination depends on whether the discrimination is connected with the termination. In this case the alleged discrimination arose in the context of the termination of the employment itself, and the compensation was therefore held to be taxable. The court held that this was due to the wide scope of s401 of the Income Tax (Earnings and Pensions) Act 2003, which is the UK's equivalent to s123 TCA 1997. Whilst UK case law is not binding in Ireland, the UK courts' decisions have persuasive authority in Ireland.

Recent TAC Determinations

Recent determinations of the TAC have caused some confusion on the application of ss192A and 613 TCA 1997 to payments made under a compromise agreement entered into contemporaneously with the termination of an employment.

153TACD2020

In this case the taxpayer alleged that €80,000–€150,000 of an €180,000 settlement should be subject to relief under s192A/s613 TCA 1997 on the basis that it should be regarded as representing damages for defamation, victimisation and injury to professional reputation, which was not subject to income tax. The taxpayer noted that the defamation claim pre-dated any claim in relation to the termination of his employment and stated that he had intended to institute proceedings against his employer for defamation but that this was obviated by the execution of the compromise agreement. The employer denied the claims.

As part of a compromise agreement, the employee agreed to resign from his employment with the employer, and the employer agreed to pay the employee €180,000 "in full and final settlement of all claims or entitlements (including the Employee's claims that he has been defamed and victimised)".[2] In addition, it was agreed that the payment of €180,000 would be made "without admission of liability on the part of the Employer".[3]

Revenue argued that the full amount was subject to tax under s123 TCA 1997 (subject to any relief due under s201 TCA 1997) and that the payment did not meet the statutory requirements of s192A TCA 1997. In addition, Revenue argued that it was clear from the terms of the compromise agreement that the payment did not represent damages for defamation or injuries suffered (the consequence of that being that s613 TCA 1997 would not be applicable).

The TAC ruled against the taxpayer in this case and made the following points in relation to the taxpayer's claim.

The payment was made "without the admission of liability"

The compromise agreement said that the payment was made "without the admission of liability on the part of the Employer". The Appeal Commissioner noted that the taxpayer was legally represented at the time of entering into the compromise agreement and therefore placed significant emphasis on the "without admission of liability wording", stating:

> "[w]here the Appellant agreed to withdraw his allegations and to accept the payment without admission of liability on the part of his employer, I am satisfied that the correct legal characterisation of the payment is that the payment was made directly or indirectly in connection with the termination of the Appellant's employment". (para. 22)

In the authors' view this statement is certainly unhelpful, and the legislative basis for it is unclear – perhaps the Appeal Commissioner's view was that the "without admission of liability" wording went to the bona fides of the claim. However, in the authors' experience, it is standard practice for a compromise

agreement to be drafted on the basis that there is no admission of liability. In the authors' view this (of itself) should not have an impact on the application of relief (under s192A TCA 1997) where it can be evidenced that a portion of the payment was in settlement of an alleged breach of employment law that was unconnected with the termination of the employment (assuming that all other requirements for relief are met).

The compromise agreement did not split out the payment

The compromise agreement did not split out the payment between what was alleged to be in compensation for the "defamation or victimisation" and what was for the termination of the employment but simply said that the €180,000 was in full and final settlement of all or any claims or entitlements against the employer.

The Commissioner stated:

> "Based on the terms of the Compromise Agreement, it is not possible to conclude that the payment or part thereof comprised damages for defamation or injury to reputation as alleged by the Appellant. It follows that it is not possible nor is it necessary to identify a basis for apportionment of the monies as contended by the Appellant." (para. 19)

Thus, the Commissioner in this case clearly placed some emphasis on the fact that the claims were not apportioned in the compromise agreement. As noted above, although the Guidance is clear that it is preferable to include an apportionment of claims in a compromise agreement, it also accepts that lack of apportionment should not be fatal. Notwithstanding this, and the fact that other Commissioners did not place the same emphasis on this point (see below), tax practitioners should look to ensure that where s192A TCA 1997 is being relied on, claims are appropriately apportioned in the compromise agreement. However, it should be noted that, practically, employers may be unwilling to apportion an element of a payment to a breach of employment law in a written agreement in circumstances where they are not admitting any liability for such claims.

No statement of claim had issued

The TAC found that s192A TCA 1997 could not apply as no statement of claim had issued (para. 15). The Commissioner referred to s192A(4)(a)(iii), TCA 1997 noting that the section refers to the retention of a statement of claim.

Section 192A(4)(a)(i) TCA 1997 clearly provides that the exemption under s192A TCA 1997 can apply in respect of a payment made under a written agreement in circumstances where, had the claim not been settled by agreement, it is likely to have been the subject of a recommendation, decision or determination by the relevant authority. In our view, and as noted above, although it is important that there is evidence that a claim exists, this should not need to be in any official or prescribed format nor submitted to any "authority".

However, this TAC determination could be viewed as suggesting that a written "statement of claim" must involve a formal issuance of proceedings in all cases in order for relief under s192A TCA 1997 to be available. This is unhelpful and, in our view, if this was the intent of the TAC, is a misinterpretation of the relevant legislation, by seeking to introduce new criteria for the application of s192A TCA 1997 in settlement situations. That said, it would still be necessary that there be some correspondence in writing from the party asserting the claim that sets out the nature of the claim.

It is appropriate to mention that this determination has been requested for case stated to the High Court, and if it proceeds to the High Court, we look forward to seeing the High Court judgment in due course.

115TACD2021

This determination also related to the tax treatment of a settlement payment of €180,000. The taxpayer's main submission in the case was that he was entitled to relief under s613 TCA 1997. He argued that a portion of a payment made to him in a settlement agreement was compensation for defamation (damage to reputation). He also argued that he was subject to victimisation and discrimination by his former employer.

The employee had a contractual entitlement to €55,000 and argued that relief applied to some portion of the balance of €125,000 (with senior counsel noting that €80,000 would be a conservative figure for the taxpayer's defamation claim). Revenue argued that the entire payment was taxable under s123 TCA 1997.

The Commissioner found that €55,000 of the payment was in respect of the termination of his employment (albeit contractual) and the balance was in respect of the other "claims" referred to in the compromise agreement, noting that none of the €125,000 fell within s123 TCA 1997. This in itself was an interesting finding, as the Commissioner allocated no portion of the payment to an ex gratia termination payment – the €55,000 was entirely contractual.

The Commissioner found that s613 TCA 1997 could not apply as he felt that there was no (or insufficient) evidence that the taxpayer's good name was undermined and therefore the payment was not "compensation or damages for any wrong or injury suffered by an individual in his or her person or in his or her profession" but instead found that s535(2)(a)(iii) TCA 1997 applied to the non-contractual portion of the payment.

Section 535(2)(a)(iii) TCA 1997 extends the concept of a disposal and provides that there will be a disposal, for capital gains tax purposes, where a capital sum is received "in return for forfeiture or surrender of rights, or for refraining from exercising rights…". The Appeal Commissioner noted that the taxpayer had a right or chose in action to sue his former employer and that right fell within the definition in s535 TCA 1997 – i.e. the employee, in compromising the claim, disposed of his right to sue.

This was, in the authors' view, an unusual finding, particularly in circumstances where (at least from what can be seen in the determination) it is not clear that the taxpayer had an opportunity to make submissions on s535 TCA 1997 before the TAC. More worryingly, it also seems to set an inappropriately high bar for the application of the s613 TCA 1997 exemption.

The result was that the €125,000 amount was not subject to income tax but was subject to capital gains tax.

For completeness, we note that this determination has not been requested for case stated to the High Court.

Key Takeaways

Given the recent TAC determinations, including those discussed above, on ss192A and 613 TCA 1997, there are a number of issues that, in our view, require clarification to assist tax practitioners in advising on these matters. As regards 153TACD2020, clarity from Revenue would be welcome on certain issues arising from this case, including, in particular:

- Where a compromise agreement includes standard "without admission of liability" language, this does not mean that relief under ss192A and 613 TCA 1997 will be automatically unavailable.

- Even where a compromise agreement does not explicitly apportion a payment to various elements of a claim, relief pursuant to ss192A and/or 613 TCA 1997 can still apply to a portion of a payment where it can be evidenced that a portion relates to a breach of employment law that occurred before (and separate from) the termination of the employment. Clearly, in many situations there is (or can be) payment(s) made both in relation to an alleged breach of employment law during the employment and in the context of a termination of the employment. This would be in line with the position adopted in the UK.

  It is helpful that certain of the TAC cases, including 115TACD2021, clearly demonstrate that not all payments made under a compromise agreement are within s123 TCA 1997. It would also be helpful if Revenue could re-insert an example in the Guidance addressing a situation where s192A TCA 1997 relief is available on a portion of a payment made on the termination of an employment.

- To satisfy the legislative requirement that the claim “is evidenced in writing”, it would be sufficient (notwithstanding the observations of the Commissioner) for the employee making the claim to prepare a letter to his or her employer summarising the claims. The authors would welcome this clarification, given that there appears to be no legislative requirement for the claim to be submitted to a relevant authority in the context of s192A TCA 1997 relief being applied to an out-of-court settlement – and the updated Guidance acknowledges this point.

As regards 115TACD2021, it is helpful that this determination identified that a portion of a payment under a settlement agreement may not be subject to income tax where it can be shown that there was a potential claim arising during the employment and a portion of the payment is attributable to that claim. It should be noted that there was no apportionment of the alleged claims in this case, but this did not impact the Commissioner’s finding that he could attribute a portion of the payment to an alleged claim. It should be noted that TAC determinations are based on the individual facts in each case.

However, it is unhelpful that:

- As a practical matter, the case was decided on the basis of the application of s535 TCA 1997, when this section does not appear (based on a review of the determination) to have been argued by either side.
- The determination denies s613 TCA 1997 relief on the basis that the taxpayer did not have sufficient evidence to prove this claim. In our view, and based on a review of the determination, this sets a very high bar for the application of s613 TCA 1997 relief – particularly in circumstances where there was a senior counsel’s opinion to support the claim in question.

Given the author’s comments above on the position adopted by the Appeal Commissioners in these cases, and in particular that some of the statements made in or by the TAC do not have a legislative/legal basis (and contradict the Guidance), it will remain difficult for practitioners to advise on the application of ss192A and 613 TCA 1997 where an employment has also been terminated until such time as clarification from Revenue is issued.

In the authors’ view it would be prudent for practitioners to adopt the following approach, where possible, when advising on the application of ss192A and 613 TCA 1997 to payments made pursuant to a termination/compromise/settlement agreement:

- Ensure that payments prescribed in the agreement are appropriately apportioned between the different elements of a claim and that there is sufficient contemporaneous evidence to support such apportionment.

- Consider whether the standard “without admission of liability” wording is required in the particular case and, where possible, remove this wording from the agreement. Although, in the authors’ view, the inclusion of this wording should not impact the availability of relief, given the above, the better course of action may be to exclude the wording where possible, pending further guidance from Revenue.

- Ensure that there is sufficient evidence that a bona fide claim existed. In the authors’ view it should be sufficient, for example, for the employee making the claim to prepare a letter to his or her employer summarising the claims (for the purposes of s192A TCA 1997).

- It is important to note that determinations are solely based on the facts of each case. It is unclear in the authors view if these determinations would withstand scrutiny if considered by the High Court.

1. See https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim12965.
2. Paragraph 6 of 153TACD2020 (quoting clause 3.1 of the relevant compromise agreement).
3. Paragraph 6 of 153TACD2020 (quoting clause 3.7 of the relevant compromise agreement).