Termination of employment: when is a payment tax free?

Employment Tax | Personal tax



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We consider a case involving a substantial payment made to a former employee to settle proceedings in the Employment Tribunal.

Key Points

What is the issue?

In a settlement agreement, Ms Mathur's former employer agreed to pay her £6 million less any PAYE and National Insurance due in exchange for her dropping claims of misconduct. She submitted her tax return on the basis that none of the £6 million was taxable.

What does it mean to me?

The Upper Tribunal's focus was on the Income Tax (Earnings and Pensions) Act 2003 s 401(1), which brings into the scope of income tax any payments 'received directly or indirectly in consideration or in consequence of … the termination of a person's employment' (ITEPA 2003 s 401(1).

What can I take away?

The case should serve as a reminder that most payments made following the termination of an employment will be taxable (either on normal principles or as a result of s 401).

One of the issues that has regularly featured in the case law concerning employment tax is the taxation of payments received by former employees. When I first practised in tax in the 1990s, the focus was typically on whether a payment qualified as a tax-free payment in lieu of notice, or at least one where the first £30,000 would be exempt. It is notable that not only has the scope of that exemption been restricted over the years, but also that the £30,000 threshold has remained somewhat static since 6 April 1988.

The reduced value of the £30,000 exemption has meant that there are fewer payment in lieu of notice cases reaching the tribunals. Instead, there are more cases in which taxpayers have sought a complete exemption. The latest such case is *Mathur v HMRC* [2024] UKUT 38 (TCC), which was recently decided by the Upper Tribunal.

The facts of the case

Ms Mathur was employed by a UK company which was a member of an international banking group. In 2015, the banking group reached a settlement with the New York State Department of Financial Services following the latter's investigation into the manipulation of the interest rates of unsecured interbank lending. As part of the settlement, the banking group was ordered to terminate the employment of certain employees (including Ms Mathur) who had allegedly played a role in the misconduct. Ms Mathur's employment was terminated a week later.

In the employer's letter to Ms Mathur, it offered compensation for loss of employment of just over £82,000. A few months later, Ms Mathur commenced a

claim in the Employment Tribunal covering complaints in relation to her (now previous) employment, as well as in relation to the termination itself.

The next year, Ms Mathur and her former employer took part in a mediation meeting and a settlement agreement was signed the following morning. In exchange for dropping her claims, the employer agreed to pay Ms Mathur £6 million less any PAYE and National Insurance due. (The parties agreed that the first £30,000 was exempt from any tax liability.) The employer applied PAYE and National Insurance to the balance, with the proviso that it would co-operate with Ms Mathur in any attempt she made to recover any surplus from HMRC. In addition, the employer made a payment of £400,000 direct to Ms Mathur's lawyers to cover her legal expenses and any VAT thereon.

Ms Mathur submitted her tax return on the basis that none of the £6 million was taxable, thereby claiming a refund of the tax deducted. (It is unclear whether she made a parallel claim for the National Insurance.) HMRC opened an enquiry into the return and, in its closure notice, amended the return so as to ensure that the £6 million (minus the £30,000) was taxable.

Ms Mathur appealed against the closure notice to the First-tier Tribunal, which dismissed her appeal. Ms Mathur then appealed against the First-tier Tribunal's decision to the Upper Tribunal.

The legal questions for the tribunal

The Upper Tribunal's focus was on section 401(1) of the Income Tax (Earnings and Pensions) Act 2003. That brings into the scope of income tax any 'payments or other benefits which are received directly or indirectly in consideration or in consequence of or otherwise in connection with the termination of a person's employment'.

There was no doubt that the sum paid to Ms Mathur's lawyers was exempt from tax. This was because of an express exemption conferred by s 413A.

Ms Mathur first argued that the £6 million was not received in consequence of or otherwise in connection with the termination of her employment and that the First-tier Tribunal's decision to the contrary arose from it reading those words too widely.

Secondly, it was argued that the bulk of the £6 million related to a discrimination claim that addressed the ‘sustained campaign of discrimination that [in Ms Mathur’s view] had been suffered by [Ms Mathur] over many years’. Ms Mathur argued that she had a moral claim against her former employer which she was able to convert to cash in order to allow her former employer to avoid the embarrassment of the claims being public.

Finally, Ms Mathur argued that, given its findings, the First-tier Tribunal should have made an apportionment between the element of the payment which was connected with the termination and the element that related solely to the allegations of the previous discrimination.

The Upper Tribunal’s decision

The appeal was heard by Mr Justice Miles and Judge Rupert Jones.

In respect of the first ground of appeal, the Upper Tribunal confirmed that s 401 is to be interpreted broadly (a point actually conceded by Ms Mathur’s Counsel). In particular, the use of the words ‘otherwise in connection with’ means that there does not need to be a causal link between the termination and the payment, a factual connection is sufficient.

The First-tier Tribunal had expressly found that the termination was central to the claims made in the Employment Tribunal which were settled by the agreement reached. It did so by noting that the termination was the ‘trigger and catalyst’ for the claims in the Employment Tribunal and the subsequent settlement of those claims.

Furthermore, it was noted that, under s 413A, the payment to the lawyers could be exempt only if made ‘exclusively in connection with the termination of the employee’s employment’. It was not logical that that payment to the lawyers could be in connection with the termination of Ms Mathur’s employment but for the £6 million she received somehow to be not so connected.

In respect of the second ground of appeal, the Upper Tribunal addressed the First-tier Tribunal’s dismissal of Ms Mathur’s argument that the payment was exclusively connected to the allegations of the previous discrimination (and had no connection with the termination). Again, mindful of the need to identify an error of law (or a

perverse finding on the evidence), the Upper Tribunal in fact considered that the First-tier Tribunal's findings 'were rational and supportable'. It also made the point that the First-tier Tribunal 'had the benefit of seeing and hearing the Appellant give evidence'. It continued by concluding that there was sufficient evidence to justify the First-tier Tribunal's conclusions and that the tribunal gave reasonable and sufficient reasons for its findings. In other words, the Upper Tribunal addressed every conceivable complaint that Ms Mathur could have made against the First-tier Tribunal's decision and decided that none was applicable.

In relation to the final ground of appeal (apportionment), the Upper Tribunal noted that apportionment had not been argued by Ms Mathur when the case was before the First-tier Tribunal. Nor did she put forward any evidence to support any such apportionment. In other words, Ms Mathur's case before the First-tier Tribunal had been on an 'all or nothing' basis.

The Upper Tribunal ruled that it was not open for her to challenge the question of quantum for the first time in the course of an appeal in the Upper Tribunal.

Commentary

The outcome of the case did not come to me as any surprise. When reading the facts, it is difficult to believe that there was no factual connection between the termination and the settlement. I am more than prepared to accept that Ms Mathur had experienced discrimination over many years which she somehow endured and chose to pursue her moral claim only after her employment was terminated. In other words, I can accept that there was a possibility that the First-tier Tribunal would have allowed Ms Mathur's appeal.

On the other hand, it did not seem unreasonable for the First-tier Tribunal to have found that there was in fact such a connection (given the broad scope of s 401). As the Upper Tribunal commented, the reality of Ms Mathur's first ground of appeal was that it was 'a disguised challenge to the First-tier Tribunal's factual findings and evaluative judgments'. Absent of any error of law, it was difficult to see how the First-tier Tribunal's decision could be set aside by the Upper Tribunal.

It should, of course, be remembered that the First-tier Tribunal might have been able to reach a different decision. In other words, not every post-termination

payment will be in connection with the termination.

For example, as the Upper Tribunal was aware, in *Crompton v HMRC* [2009] UKFTT 71 (TC) a former member of the Territorial Army received a compensation payment for the financial losses he suffered as a result of failings by army selection boards. The Special Commissioner (the hearing took place shortly before the abolition of the Special Commissioners and the decision was issued shortly afterwards – hence the FTT reference) had reached the factual conclusion that Mr Crompton's compensation was not connected with his leaving the army. (See my article in the September 2009 issue of *Tax Adviser*.)

However, first it is fair to say that the facts of the case were very different and, more importantly, the Upper Tribunal's role is not to retry the case but simply to decide whether the First-tier Tribunal's conclusion was legally sustainable.

What to do next

I do not suppose that this case will make its way to the Court of Appeal. It should serve as a reminder that most payments made following the termination of an employment will be taxable (either on normal principles or as a result of s 401). However, in exceptional cases (as illustrated by *Crompton*) it will be possible to demonstrate the lack of connection between the payment and the termination.

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