SOME PITFALLS IN THE TAX TREATMENT OF COMPENSATION PAYMENTS

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Introduction

It is a common misconception that, as a result of the House of Lords' decision in *British Transport Commission v* Gourley [1956] A.C. 185, UK compensation payments are not subject to income tax. Nothing could be further from the truth.

Whilst it is the case that some compensation payments are not subject to income tax because they are capital in nature (or because they benefit from a specific exemption), there have been cases in recent years where HMRC have successfully sought to treat compensation receipts calculated by reference to lost earnings or incurred expenses as employment or trading income (and therefore subject to income tax). These cases appear to suggest an increasingly aggressive predilection on HMRC's part to characterise such compensation receipts as income, with the result that the risk of challenge in this area cannot be discounted.

Moreover, even where the capital nature of a payment is clear, the £500,000 cap on the concessionary treatment offered under ESC D33, together with the lack of judicial authority on the scope of the CGT exemption in s.52 TCGA 1992, mean that it is always wise to seek clearance from HMRC, particularly in regard to large compensation receipts.

The *Gourley* principle

In *British Transport Commission v Gourley*, the claimant, who had suffered serious personal injuries in a railway accident, was awarded damages of £37,720 in respect of actual and prospective loss of earnings. It was agreed between the parties that this award itself was not taxable, presumably because the receipt was recognized to be capital in nature. Capital gains tax had not yet been introduced.) However, it was also recognized that, if the claimant had earned the sum in question through his professional activities, he would have had to pay income tax (and surtax, as it then was) on the amount.

[1] Paying the full amount of damages over to the claimant would thus place him in a better position than he would have been in apart from the accident, so the House of Lords held that the award should be adjusted downwards to take account of the tax he would have suffered on the earnings, leading to an alternative award of £6,695. This adjustment of a non-taxable damages award in light of tax that would have been suffered in the absence of the wrong has become known as the *Gourley* principle.

However, with the passage of time, the fact that the damages award in *Gourley* was recognized as non-taxable *before* the House of Lords reached its decision has become somewhat obscured. It is now not unusual for the *Gourley* principle to be described as somehow *rendering* compensation awards exempt from income tax, as though the principle itself binds HMRC.[2] However, this is to put the cart before the horse. The *Gourley* principle does not *make* compensation awards exempt from income tax, but rather provides for such an award to be adjusted in circumstances where the award itself is *already* exempt under the applicable tax legislation. *Gourley* is thus not a tax case at all, but merely an outworking of the general legal principle of *retitutio in integrum* – namely, that a compensation award ought to be assessed by reference to what the injured part has really lost, and ought not to make him better off than he would have been had he not suffered the wrong in question.[3]

Most importantly, though, the *Gourley* principle does not bind HMRC. HMRC are required to collect whatever tax may be due on a compensation award or settlement under the relevant tax legislation, regardless of whether or not an adjustment has been made under *Gourley*.[4] It is thus entirely possible that a damages award or settlement could be adjusted downwards under *Gourley*, and that HMRC could subsequently seek to tax the adjusted award in the hands of the successful claimant. The danger of mis-applying the *Gourley* principle is that claimants may end up under-compensated by having their awards not only adjusted on account of tax but then actually taxed as well.

This is why, in *Stoke-on-Trent City Council v Wood Mitchell & Co Ltd* [1980] 1 W.L.R. 254, the Court of Appeal recommended that the *Gourley* principle not be applied in circumstances where the tax treatment of a compensation award is uncertain. In that case, which concerned a compensation settlement for business disruption on the compulsory acquisition of land, Roskill LJ stated at 259:

> *Since the purpose of decisions such as those in British Transport Commission v. Gourley [1956] A.C. 185 and West Suffolk County Council v. W. Rought Ltd. [1957] A.C. 403 was to secure that a successful plaintiff or claimant did not get more by way of damages or compensation than would have been received by him in the absence of his injuries or of the compulsory acquisition in question, as the case might be, it seems somewhat strange that the principle underlying those decisions should be able to be invoked by the acquiring authority [the defendant] in order to produce the result that the claimants, in the absence of any assurance from the Inland Revenue that no attempt would be made to levy tax upon this sum, stood in peril of receiving considerably less than that which they would have received had their capacity to earn continued unaffected by compulsory acquisition. In such circumstances the more natural course, which would avoid any risk of injustice, would be for the*

> *claimants to receive the full sum, leaving the question of liability to tax, if any, to be adjusted thereafter between the claimants and the Inland Revenue.*
>
> *We take the view that the principles laid down in West Suffolk County Council v. W. Rought Ltd. can only be applied if after examination of the relevant statutory provisions it is clear beyond peradventure that the sum in question would not be taxable in the hands of the claimants. If that is clear, then it would be wrong to require the acquiring authority to compensate the claimants beyond the amount of the loss which the claimants would in truth suffer. But if it is not, then it seems to us unjust that in a doubtful situation the acquiring authority can get the benefit of a reduced payment while leaving the claimants exposed to the risks we have mentioned. Considerations of abstract justice might be thought to suggest that the claimants should receive the full sum and then in due course account to the Inland Revenue for any tax properly chargeable upon that amount.*

It is therefore necessary to establish the treatment of a compensation payment under the relevant tax legislation before considering any adjustment under *Gourley*.

HMRC's efforts to characterise compensation payments as income

There is a general principle (see *London and Thames Haven Oil v Attwooll* [1967] Ch. 772) that compensation payments are to be treated for income tax purposes in the same way as that which they are compensation for. The *Attwooll* case itself concerned a receipt which was found to be taxable as trading profits, but the principle set out therein by the Court of Appeal is not limited to trading profits.[5] Diplock LJ stated at 815:

> *Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so*

> *received, <u>the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation</u>. It may arise from a primary obligation under a contract, such as a contract of insurance, from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a charter-party, or unliquidated, from an obligation to pay damages for tort, as in the present case, from a statutory obligation, or in any other way in which legal obligations arise.*

This principle was echoed by Lord Woolf in *Mairs v Haughey* [1994] 1 A.C. 303 at 319:

> *It is inevitable that if a payment is made in substitution for a payment, which might, subject to a contingency, have been payable, that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made. There will usually be no legitimate reason for treating the two payments in a different way.*

Attwooll and *Mairs* both involved compensation for failure to receive a sum of money, but the same principle applies equally to compensation for an incurred expense: the nature of a compensation payment, for tax purposes, mirrors that of the payment it replaces.[6] However, in *Attwooll* itself at 816, Diplock LJ cautioned against confusing the nature of a compensation payment with its mode of assessment:

> *The method by which compensation has been assessed in the particular case does not identify what it was paid for; it is no more than a factor which may assist in the solution of the problem of identification.*

In practice, distinguishing the nature of a compensation award from its method of assessment is not always a straightforward exercise, as the following cases from recent years reveal.

In *A v HMRC* [2015] UKFTT 189 (TC), an employee brought a race discrimination claim against his employer. HMRC argued that the settlement payment received represented arrears of wages that should have been paid and therefore was taxable as employment income. The Tribunal rejected this argument, finding instead that the payment was compensation for the statutory tort of discrimination, and therefore was not subject to income tax. Judge Raghaven stated at [81]:

> *If an Employment Tribunal were to award damages for discrimination (whether calculated by reference to earnings or whether they included injury to feelings) these are recompense for the right not to be discriminated against under statute. They are paid because the employer has breached a statutory obligation not to treat the employee in a detrimental way due to his race. They are treated in like manner to a tort claim. It could be said that where the complaint is of underpayment of remuneration that the damages would not have arisen if were not for the fact the claimant was an employee but it is clear that it is not enough. That sort of wide test of causation (a "but for" test) is insufficient (see Hochstrasse [sic] v Mayes). When we pose the question: "Why did the employee receive the payment?" the answer is not that it was in return for the employee's services but because it has been determined that the employer has acted unlawfully by discriminating against the employee. Where damages are calculated by reference to under-paid earnings, while the discrimination may have manifested itself through the way in which the employee was remunerated, the damages arise not because the employee was under remunerated but because the under payment was discriminatory. An award in these circumstances cannot in our view be described as a reward for services. The award is paid for some reason other than the employment and is not earnings.*

However, in *Pettigrew v HMRC* [2018] UKFTT 240 (TC), HMRC successfully argued that a compensation payment received by a part-time employment tribunal judge in settlement of a discrimination claim against the Ministry of Justice was taxable as employment income. The taxpayer argued that the compensation payment was damages for the statutory tort of breach of the Part Time Workers (Prevention of Less Favourable Treatment) Regulations 2000. However, HMRC maintained that, notwithstanding the discrimination claim, the employment was a sufficiently substantial reason for the settlement payment, such that it qualified as an emolument of the judge's employment under s.62 ITEPA 2003 and should be taxed as earnings. The Tribunal accepted this view, with Judge Kempster stating at [99] (emphasis added):

> *[E]ven though the prompt for MoJ to make the Payment was the settlement of claims stood behind the Miller litigation, the methodology and quantification of the Payment was to remedy the underpayments in the period April 2010 to December 2013 under the contract of employment; there was a simple calculation of differences between what Mr Pettigrew was actually paid at the time and what a salaried judge comparator would have earned for the same duties performed. I agree with Mr Stone's comment that Mr Pettigrew had concentrated on the mechanism for the Payment rather than the reason for it being paid. <u>Even if the Miller litigation was one reason for the Payment, that does not displace the employment relationship also being another reason; one would then apply the test in Kuehne + Nagel: was the employment a sufficiently substantial reason for the payment? For the reasons set out at [70-71] above, I am sure that the employment was a sufficiently substantial reason for the Payment</u>.*

As decisions of the First-Tier Tribunal, both *A v HMRC* and *Pettigrew* carry only persuasive authority in future cases, but in January 2020 HMRC updated their Employment Income Manual to reflect the decision in *Pettigrew*. EIM12965 now reads:

> *Section 62 [ITEPA 2003] may also apply to any payments in respect of amounts which the employee would have been entitled to but for discrimination. In Pettigrew v HMRC (2018 TC*

06473) a part-time judge received compensation for unequal pay because he had been underpaid compared to full-time colleagues. Applying Mairs v Haughey (1993 BTC 339), the First-Tier Tribunal found that the compensation should derive its character from the nature of the payment it replaces (which would have been an emolument from the employment) and was therefore earnings. The same treatment would apply to other types of discrimination.

The former version of this guidance (which stated that compensation payments for discrimination are only taxable under s.401 ITEPA 2003, and then only when connected with termination of the employment) still appears at EIM12966, but carries the following health warning:

The guidance at EIM12965 has now been updated to clarify that compensation payments may be taxable under provisions other than s401 ITEPA 2003 in certain circumstances.

The wording of the previous guidance (copied below for reference) does not accurately reflect HMRC's view of the legislation in that it states that compensation payments for discrimination can only be taxable under s401 ITEPA 2003. It should not be relied upon for payments made after 5 April 2021.

These statements together evidence HMRC's future intention to characterise compensation payments for lost earnings due to workplace discrimination as employment income.

Another example of HMRC's appetite for taxing certain compensation awards as income is seen in the case of *Ghadhavi v HMRC* [2018] UKFTT 600. Here seven brothers received compensation from a bank that that had mis-sold them certain interest rate hedging products which had resulted in the failure of their property letting business. The taxpayers argued that the payment was compensation *for* the mis-selling which had occurred, that the method of calculating the payment (by reference to revenue expenses incurred) does not determine its nature, and that the redress received should be regarded as a capital receipt and therefore exempt from tax (see [37]-[39]). Although the Tribunal acknowledged that the compensation could in a sense be said to be "for" the mis-selling, it accepted HMRC's view that the compensation was actually for various revenue expenses incurred by the taxpayers as a result of the mis-selling, such that the compensation should be characterised as a post-cessation revenue receipt of the business under the *Attwooll* principle (see [63]-[65]).

Continued uncertainty regarding capital compensation receipts

Nor is the uncertainty regarding the tax treatment of compensation payments limited to settlements or awards that may be characterised as income. Even if a receipt is plainly capital in nature, the tax treatment can be far from clear. Although it has long been recognised that a right of action is an "asset" for capital gains tax purposes, with the result that sums derived therefrom are subject to tax under s.22 TCGA 1992[7], HMRC's extra-statutory concession D33 long meant that sums derived from rights of action not connected with property escaped taxation all together. However, since 2014, HMRC have imposed a limit of £500,000 on the concession, requiring specific clearance to be sought in respect of greater amounts.

It is also possible that many compensation payments that are capital in nature may be exempt from CGT by statute. Section 51(2) TCGA 1992 reads as follows:

> *It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.*

Whilst this exemption is unlimited as to amount and plainly is only applicable to wrongs suffered by individuals, its scope remains highly uncertain. HMRC's interpretation of this provision is set out in paragraph 12 of ESC D33:

> *The words 'in his person' are to be read in distinction to 'in his finances' but they embrace more than physical injury so that*

> *distress, embarrassment loss of reputation or dignity may all be suffered 'in the person'. Compensation or damages for unfair or unlawful discrimination suffered 'in the person' and for libel or slander (in Scotland defamation) would thus be included. Similarly the words 'in his profession or vocation' refer to compensation or damages suffered by an individual in his professional capacity such as unfair discrimination, libel or slander (in Scotland, defamation) as distinct from 'in his finances'...*
>
> *The exemption is extended by concession to such compensation received by an individual in his trade or employment.*[8]

In practice, it can at times be difficult to distinguish wrongs suffered by individual "in his person" or "his profession" from wrongs suffered "in his finances". Furthermore, the validity of this distinction remains questionable at best. There are very few judgments touching on the meaning and scope of s.52(2) TCGA 1992, and apparently none more from sources more authoritative than the First-Tier Tribunal. The provision was considered (obiter) in *Ghadavi*, where Judge McKeever stated at [71]:

> *The Appellant submitted that the payments fell within Section 51(2) of the TCGA which provides 'It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.'. <u>This provision applies to damages for personal injury or defamation</u>. It has no application in the present case* (emphasis added).

It was considered again in *Robinson v HMRC* [2019] UKFTT 483 (TC), where Judge Bedenham stated at [56]:

> *<u>I agree with the observations made in Gadhavi v HMRC [2018] UKFTT 600 at [71] that s 51(2) TCGA 1992 applies to damages for personal injury and defamation (although there may also be other causes of action that can be said to arise from 'wrong[s] or injury suffered by an individual in his person or vocation</u>').*

> *In my view, a payment made for settlement of a claim that was brought under a provision relating solely to fair value for shares cannot be said to be damages/compensation for "any wrong or injury suffered by an individual in his person or in his profession or vocation" such as to bring the payment within the exemption provided for in s 51(2) TCGA 1992. This is so regardless of the motives behind the commencement of the claim and/or the motives behind settling the claim* (emphasis added).

In addition to carrying only persuasive authority, neither of these judgments goes further by way of analysis or explanation than to repeat HMRC's view on the scope of s.51(2) as set out in paragraph 12 of ESC D33.

Where does this leave us?

The possibility of the *Attwooll* principle being used to characterise compensation payments as income receipts, together with the uncertainty surrounding the treatment of payments that are clearly capital in nature, have rendered HMRC clearances in respect of such payments arguably more necessary than ever before. The recent consequentials hearing in *Rihan v Ernst and Young Global Ltd* accentuates the difficulties now facing many successful claimants.

The main proceedings in *Rihan* ([2020] EWHC 901 (QB)) involved a negligence claim brought by a former audit partner in an accountancy firm against the parent firms of his former employer. The claimant alleged that his former employer had colluded with an overseas regulator and a client who were pressuring him to conduct an audit unethically. He argued that the employer had breached a duty to take reasonable steps to prevent him suffering financial loss by reason of their failure to conduct the audit ethically and without professional misconduct. The court acknowledged an incremental extension of the employer's duty of care (see [600]-[635]), found that the duty had been breached (see [673]-[760]), and awarded the claimant damages for loss of earnings in excess of USD 10 million (see [778], [888]).

The tax treatment of this damages award came to the fore at the subsequent consequentials hearing ([2020] EWHC 1380 (QB)). The claimant argued that the loss of earnings award could be subject to income tax or to CGT, and if the latter, that HMRC could not be relied upon to accept that s.51(2) TCGA 1992 applied (see [11]-[12]). He therefore argued that the award should be grossed up (by reference to his worst-case tax position) in order to protect him from the risk of under-compensation, should the award prove to be taxable. The defendants, on the other hand, argued that the damages award was plainly capital in nature and exempt from tax under s.51(2) TCGA 1992. Moreover, as the lost earnings would have been subject to tax had the claimant received them, the defendants argued that the award should be reduced under the *Gourley* principle (see [17]-[19]).

Kerr J accepted that the tax treatment of the damages award was unclear. He stated at [22]-[24]:

> *Subject to two qualifications, I prefer the claimant's submissions on this issue for the following reasons. First, the tax position is uncertain…*
>
> *Discussion about the nature of the injury done to the claimant could occupy many pages of skeleton arguments in contested tax proceedings. No clear authority (the claimant's two tax cases are not on all fours) elucidates "any wrong or injury suffered by an individual in his person or in his profession or vocation" in the TCGA section 51(2). It is not clear whether HMRC is right to differentiate damages "suffered … in a professional capacity such as unfair discrimination, libel or slander …" from damages suffered "'in his finances'".*
>
> *There was a further debate between the parties about whether HMRC might grant relief from CGT. It is common ground that the first £500,000 of damages is exempt from CGT but there is*

> *a difference over whether amounts above that sum may be granted relief. For the avoidance of doubt, I regard that issue too as unpredictable, except in relation to the first £500,000.*

In light of the uncertain tax position and the Court of Appeal's approach in *Stoke on Trent City Council*, Kerr J declined to apply the *Gourley* principle to reduce the damages award. He stated:

> *"The interest of the successful receiving party in avoiding under-compensation prevails over that of the unsuccessful paying party in avoiding over-compensation, provided suitable undertakings are given to prevent any over-compensation once the tax position is known."*

He then ordered the claimant to seek a ruling from HMRC concerning the tax treatment of the award, and the defendant to pay the grossed-up sum sought, with the tax element to remain in court until the tax position was clarified.

Kerr J's approach had the advantage of ensuring that the successful claimant could move on with his life without concern for the tax position as ultimately determined by HMRC and without the additional burden of having to seek further sums from the defendant should the award turn out to be taxable. An alternative approach, of course (and perhaps one better suited to a settlement scenario), would be to seek a ruling from HMRC and to require the defendant to gross up the claimant in respect of any tax ultimately found to be payable on the compensation sum.

The most significant result of the *Rihan* litigation from a tax perspective, however, is the High Court's affirmation (i) that the tax treatment of such a compensation award is uncertain; (ii) that the scope of s.51(2) TCGA 1992 is unclear, with the correctness of HMRC's interpretation (as set out in CG13030 and in paragraph 12 of ESC D33) remaining untested; and (iii) that the concessionary treatment of capital compensation in excess of £500,000 is unpredictable. This ruling accentuates the importance of seeking clearance from

HMRC as to the proper tax treatment of compensation payments, and also of taking steps to protect the claimant's interests in the meantime.

A recognition of the limitations of the *Gourley* principle, together with an awareness of HMRC's increasing appetite for characterising certain compensation payments as income and of their published views on the limited scope of the exemption in s.51(2) TCGA 1992, should help practitioners to take appropriate steps to protect clients against the risk of unpleasant tax surprises in the aftermath of receiving a compensation sum.

Endnotes

1. See *British Transport Commission v Gourley* [1955] A.C. 185 at 197 per Earl Jowett:

   The trial judge awarded the respondent the sum of £37,720 in respect of loss of earnings actual and prospective, and in arriving at this sum paid no regard to the fact that had the respondent been able by his activities in his profession as a civil engineer to achieve the earnings represented by the sum of £37,729 he would have had to pay a large amount in respect of income tax and surtax on the amount of such earnings. The trial judge, at the request of the appellants, made an alternative assessment of £6,695, which represented the sum he would have awarded if he ought to have taken into account in assessing damages the tax which the respondence would have had to pay if he had in fact earned by his professional activities the sums lost. It was agreed by counsel on both side – and I think rightly agreed – that the respondent would incur no tax liability in respect of the award of £37,720, or alternatively of £6,695.

2. See, for example, FT Adviser (10 January 2018):
   https://www.ftadviser.com/your-industry/2018/01/10/q-a-when-does-tax-apply-to-compensation/

   "*It is generally accepted practice that compensation for loss of earnings should be claimed in respect of the net loss after tax. The employee should be put back into the same financial position that they would have been in, had they worked – that* *is, the loss of net pay. The compensation payment will then be treated by HM Revenue & Customs as exempt in the hands of the recipient. This is known as the Gourley principle…*"

3. See Gourley at 203 per Earl Jowett:

"*I see no reason why in this case we should depart from the dominant rule or why the respondent should not have his damages assessed upon the basis of what he has really lost, and I consider that in determining what he has really lost the judge ought to have considered the tax liability of the respondent.*"

(See also 207 per Lord Goddard on the injustice of over-compensation by *not* taking tax into account when assessing damages).

4. See HMRC's Employment Income Manual at EIM13070, which considers the example of a damages award against an employer who failed to give proper notice of termination to an employee. It is calculated that the employee would have received gross pay of £2000 during the notice period had proper notice been given, but it is recognized that a damages award of £2000 would place the employee in a better position than if the contract had been performed. The damages award is therefore adjusted down to £1500 under the Gourley Principle. EIM13070 then states:

"*It is important to recognise that the £500 adjustment to the sum of damages is not a deduction of tax and must not be dealt with as such. The actual payment made to the employee (£1,500 above) must be considered under the normal taxation rules for that termination payment… What is actually paid is taxed, under the appropriate tax law. If the parties make mistakes in this process that leave a party out of pocket, that is a matter for the parties to remedy between themselves*" (emphasis added).

See also EIM13995, which states:

"*The Gourley principle is to do with the calculation of damages under non-tax law and is not a matter than HMRC can become involved with.*"

See also *MacGregor on Damages* (20th edition) at 18-010:

"*The bare proposition, sometimes stated, that damages are not subject to tax on income is entirely false… Whether damages are taxable turns upon the nature of the loss for which they are awarded and upon the complexities of the Income Tax Acts, the annual Finance Acts, and any other relevant taxing legislation.*"

5. As was recognised by Judge Kemptser in *Pettigrew v HMRC* [2018] UKFTT

240 (TC) at [78]: *"[T]he principle expressed by the Court of Appeal [in Attwooll] is not limited to taxation of trading profits.*"

6. See *Donald Fisher (Ealing) Ltd. v. Spencer* [1989] S.T.C. 256 (CA); see also *Deeny v Gooda Walker* [1996] 1 W.L.R. 426 (HL) at 436 per Lord Hoffmann.
7. See *Zim Properties Ltd v Proctor* [1985] STC 90 (Ch).
8. See also HMRC's Capital Gains Manual at CG13030, which sets out the same position.