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# Are you correctly taxing termination payments to employees for disability?

Termination payments made to employees on account of disability are completely free of tax and National Insurance contributions (NICs). They are not subject to the £30,000 cap that normally applies to tax-free termination payments.

HMRC's restrictive interpretation of what qualifies as a disability payment has been successfully challenged in a recent case.

## Background

*Nicky Howard-Ravenspine v The Commissioners for HM Revenue & Customs* involved an employee who suffered from ill-health and for some time received benefits under the employer's permanent health insurance (PHI) scheme. The PHI provider became reluctant to continue making regular payments and, as a result of this, the employer met the employee to discuss termination of employment due to ill-health. As part of this, it was suggested that the employee should receive a lump sum payment funded by the insurer. The employee entered into a settlement agreement with her employer and was paid the following:

1. Outstanding salary
2. A payment in lieu of accrued but untaken holiday, and
3. A payment "as compensation for loss of office and termination" (the Severance Payment)

The first two payments were accepted to be employment income for the employee and were paid through PAYE subject to income tax and NICs as normal. It was the Severance Payment that caused disagreement with HMRC as to how it should be taxed.

## Scope of the disability exemption

The employee had documentation which showed that approximately £80,000 of the Severance Payment related to the settlement of the PHI claim. She claimed that this part of the Severance Payment (the Disability Payment) should be fully exempt from tax under the 100% exemption for termination payments for disability.

HMRC disagreed and instead argued that in order for the Disability Payment to benefit from the disability exemption, it should pass its interpretation of the two-limbed test set out in the case of *Hasted v Horner*:

- There must be an identified medical condition that disables or prevents the employee from carrying out the duties of employment; and
- the payment must be made on account of that disability and on account of nothing else.

HMRC agreed that the first test had been satisfied but not the second. Even though it was clear from other documents produced by the employer that the Disability Payment was paid on account of disability, HMRC's view was that the payment had to be wholly on account of disability and nothing else to benefit from the disability exemption.

HMRC maintained that the Disability Payment was also made on account of other matters. They noted that the settlement agreement did not specify the Disability Payment was on account of disability and also that it was tied up with the termination of the employment in an overall Severance Payment for termination generally.

The Tribunal disagreed with HMRC's interpretation and pointed out that the legislation needed to be construed purposively. The purpose of the disability exemption is to exempt from tax any payment which is made on account of a disability, irrespective of whether other payments are being made to the employee as part of the same deal. It was enough to provide compelling evidence that the

Disability Payment element of the overall Severance Payment was on account of disability even if the Severance Payment itself was paid and/or described as being as compensation for loss of office with no reference to disability.

HMRC's manual is likely to change to reflect this judgment.

### Key takeaways

This case serves as a reminder as to the importance of accurately describing in a settlement agreement what the particular elements are being paid for, although in this case the Tribunal looked at the underlying factual circumstances.

In addition, three other points are also relevant:

- First, large lump sum payments can often push employees into higher tax brackets than had they received payments in the normal course. Employers awarding and employees accepting bonuses and additional benefits increasingly need to assess this as the tax system becomes more complicated.

The particular issue in this case was that a taxable Disability Payment had the knock-on impact of the employee having to repay child benefit, where repayment starts once taxable income of £50,000 is received in any year. Indeed it was HMRC contacting the employee to claw back child benefit that led to the Tribunal case.

- Secondly, while this disability payment was treated as tax-free, employers should be careful that any payment for which 100% exemption is claimed really is for disability and HMRC is known to consider these payments closely on PAYE audits.
- Finally, there are also other specific tax provisions which can treat insurer-funded disability payments, including lump sum payments, as fully taxable and so not able to benefit from the termination payments regime at all. It is not clear from this case why these other provisions did not apply here, but they could easily do so, and advisers should not assume that all payments like this can be taxed as successfully as this employee was able to achieve.

To discuss this further please contact Nicholas Stretch or Desiree de Lima.

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