LAW PUNDITS

Compromise Agreements and its Relevance

LP Learn Material

Compromise agreements

Where an employee has potential claims against the employer under the Employment Rights Act 1996 or other employment legislation, or where the employee would otherwise have a claim for breach of contract, a compromise agreement can be entered into by the employee and employer to end the employment on the terms set out in that agreement. (There are a few instances under employment law when claims cannot be ended with a compromise agreement). Key managers/shareholders may sign compromise agreements if they leave employment when the employing company is sold.

By entering into a compromise agreement the employer has certainty that the employee will have no claim in the future against the employer.

Among other things, the compromise agreement will deal with all payments and benefits owing or agreed to be paid to the employee.

Whilst the compromise agreement is signed on termination, not all payments and benefits within it will necessarily fall within ITEPA 2003, Part 6, Chapter 3, which is a specific set of provisions dealing with payments and benefits on termination. All the considerations set out in:

- How could a termination payment be taxed
- Termination payments taxed as earnings, and
- Termination payments qualifying for the £30,000 exemption

are relevant here. In practice, most compromise agreements will include some element of compensation and it is this element which often requires the most analysis.

As with all termination payments, the tax treatment will follow the component parts. A comprise agreement will either set out all payments and benefits individually or have one global compensatory sum. In both cases, the employer should keep records of the discussions about, and the basis of, each payment to enable the employer to justify and defend any challenge. If a global sum is used in the first place the employer will need to analyse it to work out how to tax it. If HMRC enquires into the tax treatment of a payment, the employer will need evidence to show what the global sum was made up of. Good practice is to set out payments and benefits individually.

HMRC often challenge the tax treatment of termination payments in compromise agreements. HMRC will consider the payments to see whether the correct label has been given to the payment. Officers are specifically directed to do this both generally and particularly in respect of payments labelled as compensation.
References: EIM12805, EIM13005

Compensation payments--risk of challenge on tax status

These are most vulnerable to attack as they will fall into ITEPA 2003, Part 6, Chapter 3 and benefit from the £30,000 exemption at ITEPA 2003, ss 403-404 and also are payable completely free of national insurance contributions (NIC). Enquires may be opened into payments which have already been taxed to income tax purely to recover the NIC.
References: ITEPA 2003, ss 401-404A

The compensation payment may be made for one or a combination of reasons. For example, it could be damages for breach of contract (ie failure to give proper notice), or damages paid to settle claims that were brought under the Employment Rights Act 1996 (ERA 1996).

Since ITEPA 2003, Part 6, Chapter 3 only applies if the sum in question is not otherwise taxable, HMRC will look to the contract terms which governed the employment to form a view as to whether the compensation is truly that, or whether it is taxable (normally under ITEPA 2003, s 62, s 225 or s 394) because it relates to a contractual right or has its source in the terms of the employment. Examples of this are given by HMRC in its Employment Income Manual (at EIM13924).

References: ITEPA 2003, s 401(3)

EIM13924

Where the compensation is in respect of an ERA 1996 claim, HMRC will look through the payment to determine its source and tax it accordingly.

HMRC will also look closely at the quantum of any compensation payment or benefit and if it exceeds what HMRC believes would be payable as damages then it will consider whether any part is, in substance, paid for some other reason such as:
References: EIM12852

- a terminal bonus for services
- a payment on retirement
- a contractual payment
- a restrictive covenant, or
- a customary payment

HMRC expects employers to apply something called the '*Gourley* principle' when determining quantum of damages; this is the principle that a person must not be placed in a better or worse position than if the contract had actually been carried out . In addition, HMRC expects employers to consider how the damages should be mitigated in the particular circumstances. Mitigation is the reduction of the damages to take account of surrounding factors. See the example below in respect the likelihood of new employment.
References: British Transport Commission v Gourley [1955] 3 All ER 796

EIM13070

In practice, this often does not happen. If, for example, an employee is terminated without proper notice, and there is no pay in lieu of notice clause in his employment contract, the employee will have a claim for breach of contract for failure to give notice. The employee will often expect to be paid the gross amount of salary and benefits during this period, regardless of whether such amount falls within the £30,000 exemption. If an employer tries to reduce this amount under the *Gourley* principle, or to mitigate to take account of the likelihood of the employee finding new employment quickly, the employee may not sign the compromise agreement. In such circumstances, the employer may agree to pay the gross amount as damages as the only way to reach an agreed settlement. In such circumstances, the employer will need appropriate records to help defend the quantum of the payment and to show that is not payment for anything else.

Significant compensatory sums which are truly ex-gratia are the hardest to defend. In these cases it helps to work backwards and show how the facts indicate that all the payment cannot have been for any reason that would give rise to a tax charge.

Particular areas to note in the context of compromise agreements

Restrictive covenants and repayment clauses

Restrictive covenants are undertakings given by employees during employment or on termination which restrict their conduct or activities.

Where the termination has resulted in a breach of the employment contract, any restrictive covenants contained in that contract will no longer be enforceable.

The compromise agreement may reproduce restrictive covenants which were in the employment contract. HMRC confirms in SP 3/96 that as long as these are no more than the ones that were in the employment contract in the first place and no payment is made by the employer to the employee specifically to enter into them, then HMRC will not seek to attribute any value to the giving of such covenants. If a value was attributed it would be taxable under ITEPA 2003, s 225.

Repayment clauses

Additionally, by agreeing in the compromise agreement not to pursue claims, the employee is giving an undertaking that restricts conduct. HMRC does not seek to attribute value to that undertaking unless the agreement includes a specific sum in respect of that undertaking.

Compromise agreements may contain a repayment clause which provides that if, despite the agreement, the employee does later initiate proceedings before a tribunal or court then any sum paid under the compromise agreement must be repaid to the employer. In normal cases, HMRC does not argue that such a clause means that a sum is being attributed to the undertaking not to pursue claims. HMRC explains that in virtually all cases, the sum paid under the agreement can be fully attributed to settlement of the claims.

Legal fees

There is no charge to tax on certain legal costs paid by the employer on behalf of the employee. To be paid tax free, the following must be fulfilled:
References: ITEPA 2003, s 413A

- the payment must meet the whole or part of the legal costs of the employee in connection with the termination, and
- the termination of the employment results in a compromise agreement between the employer and employee, which provides for payment to be made by the employer directly to the employee's lawyer, or
- the payment is made pursuant to a court or tribunal order

From 1 March 2013, references in ITEPA 2003, s 413A(3) to 'compromise agreement' will be replaced with references to 'settlement agreement'. This amendment seeks to revert to the position under ESC A81 (upon which ITEPA 2003, s 413A is based) and ensure that legal fees paid under settlements agreed under ACAS dispute resolution procedures and equality legislation enacted in 2010 are also included within the scope of the income tax exemption.
References: SI 2013/234, art 3

ITEPA 2003, s 413A(3)

It remains important to ensure the compromise agreement fulfils all the necessary employment law requirements (such as including a statement that the employee has sought legal advice and naming the legal adviser) and that the compromise agreement sets out what is to be paid and that it is paid directly to the lawyer.

Payment after termination

Payments under compromise agreements which are paid after the P45 is issued are taxed using an 0T (zero tax) code. Essentially, this taxes the payment as if it was paid in the first week or month of the tax year but without any personal allowances. As a result, large taxable payments will be taxed at a combination of basic, higher and additional tax rates and more tax will be collected at source. The individual must report the termination payment in their self-assessment and will pay more tax or can claim a repayment if the tax calculated through the operation of the 0T code is more or less than the actual tax liability.
References: SI 2003/2682, reg 37

In certain circumstances, (normally where small payments are concerned) the employee will be better off if he receives the payment before the P45 so that he can benefit from the personal allowances.

Tax indemnities

Most compromise agreements have an indemnity from the employee to the employer for PAYE and primary (employee) class 1 NICs which the employer is later assessed to pay. (In most cases an employer cannot recover secondary (employer's) class 1 NIC from an employee, (SSCBA 1992, Sch 1, para 3A)). Indemnity protection is good to have but, in practice, is costly to enforce. If there is any doubt as to the tax position of a compromise agreement, it is open to the employer to withhold the tax and seek clearance under the non-statutory business clearance procedure.

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