



# Compensation Payments – A Tax Perspective

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**Abstract** In this article Tax Partner Pat Sheehan & Tax Manager Karen McEntee examine the benefits of structuring a Settlement Agreement so that the tax liability is minimised. Recipients of compensation payments may be liable to Income Tax, Capital Gains Tax or even Capital Acquisitions Tax on the payment received. Inserting a catch-all phrase such as *“the payment will be made in a tax efficient manner”* does not guarantee that the recipient will obtain the tax relief and exemptions they are entitled to.

Taking appropriate tax advice in advance of signing a Settlement Agreement could substantially mitigate or even eliminate the tax liability associated with the payment to be received under that agreement.

Correctly framing the agreement can ensure that clients obtain the tax reliefs or exemptions that they are entitled to. In this regard it should be pointed out that simply including the phrase, *“the payment will be made in a tax efficient manner”* is not sufficient in such cases.

The recipient of a compensation payment could be liable to Income Tax, Capital Gains Tax or even Capital Acquisitions Tax on the payment received. However, certain exemptions are available and are dealt with in the table below. In addition, in certain cases, the person making the compensation payment may be obliged to operate PAYE on the payment. Failure to do so can give rise to serious financial implications for the payer.

Nature of Exemption	Tax Head of Charge	Comment
Compensation for wrong or injury suffered by an individual in their person or in their profession (e.g. compensation/damages received by the victim of a road accident or libel/slander).	Capital Gains Tax	Without exemption, the payment could be liable to CGT at 25%.
Compensation or insurance proceeds received for damage/destruction of assets where the proceeds are used to restore or replace the asset.	Capital Gains Tax	Without exemption, the payment could be liable to CGT at 25%.
Payments made to employee in connection with breaches or infringements of the employee’s employment rights through, for example, discrimination, harassment, victimisation or employer’s failure to comply with statutory requirements.  The exemption applies in specific circumstances and may include out of Court settlements.	Income Tax	Without exemption, PAYE would have to be operated by employer on the payment.
Ex-gratia termination payments made by an employer on the termination of the office or employment: <ul style="list-style-type: none"> <li>In connection with the death of an employee or</li> <li>On account of injury to or disability of the employee</li> </ul>	Income Tax	Full income tax exemption available where certain conditions met.
Statutory Redundancy	Income Tax	Fully exempt from income tax.

Nature of Exemption	Tax Head of Charge	Comment
<p>Ex-gratia termination payments made by an employer on:</p> <ul style="list-style-type: none"> <li>Terminating the office or employment or</li> <li>Changing the nature or functions of the office or employment</li> </ul> <p>may qualify for partial or total exemption. Employees may claim the higher of the following exemptions:</p> <ol style="list-style-type: none"> <li><i>Basic Exemption:</i> €10,160 plus €765 per complete year of service</li> <li><i>Increased Exemption:</i> €10,000 plus Basic Exemption (provided certain conditions met) minus Present Value of Tax Free Pension Lump Sum</li> <li><i>Standard Capital Superannuation Benefit:</i> Formula applies – the longer the term of service, the more beneficial the calculation of the exempt amount becomes</li> </ol> <p>The employer must operate PAYE on the excess over the exempt amount (marginal rate of tax plus health levy plus new income levy).</p> <p>The employee may in certain cases apply to the Revenue Commissioners for another relief known as Top Slicing Relief, after the tax year end.</p>	<p>Income Tax</p>	<p>Partial or full income tax exemption available.</p>
<p><i>Note: Certain conditions will apply in relation to the above exemptions / reliefs and appropriate tax advice should be sought to ensure that these conditions are met.</i></p>		

### Compensation Payments

Some general observations about compensation payments are as follows:

- It is necessary to examine the exact nature of the payment to determine the tax treatment. It should never be assumed that a compensation payment will be exempt from tax.
- If the payment is made on foot of a Court case, out of Court settlement or otherwise, the Revenue Commissioners may ask to see the relevant legal and supporting documents, when reviewing the tax treatment of the payment.
- Tax advice should always be sought before signing a Settlement Agreement.
- While “pure” compensation payments would not normally be liable to VAT, any agreement signed should be carefully drafted to ensure VAT does not arise.

### Termination Payments

Some general observations about termination payments are as follows:

- Tax planning opportunities are available where, for example, an individual steps down as a director but continues to remain on as an employee or perhaps where a director or employee changes the nature of their duties/functions.
- If a payment is made as part of a contractual obligation in the employee’s contract, then it must be taxed as salary and no exemptions/reliefs are available.
- Compensation awarded by the Labour Court for unfair dismissal or by the Employment Appeals Tribunal (“EAT”) for job loss may qualify for full or partial exemptions. However, an EAT award for loss of earnings is fully taxable.
- Part of the payment up to a maximum of €5,000 may be exempt if it relates to re-training and meets certain conditions.

### Conclusion

Whether you are advising the payer or the payee on a compensation payment, failure to obtain professional tax advice before the Settlement Agreement is signed can give rise to significant tax costs which could potentially have been avoided or taken into account in the negotiations. We would therefore strongly urge solicitors to ensure that their clients obtain appropriate tax advice in such cases.



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