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TAXATION OF DISABILITY PAYMENTS

Important Exemption

A payment on account of a disability is tax free under section 406 of Income tax (Earnings and Pensions) Act 2003 and free of National Insurance Contributions.

What constitutes a disability?

This is not the same as the usual statutory definition you might have seen in the Disability Discrimination Act 1995 and is in fact broader in scope. HMRC defines a disability as *"an incapacity to fulfil the duties and responsibilities of an office or employment ... due to a sudden affliction or the culmination of a process of deterioration of physical or mental health caused by a chronic illness (but not due to the normal process of ageing)"*.

The courts have said that this means a total or partial impairment in the employee's ability to perform the functions or duties of the employment.

But is the payment on account of a disability?

In order for the exemption to apply, the employer must make the payment solely on account of the employee's disability. This is the current view of HMRC, in spite of a court ruling that the payment must be made partly or solely on account of the disability.

What does this mean for termination payments?

If a termination payment is stated to be made, for example, on account of the employee's potential employment claims, such as unfair dismissal and/or disability discrimination, then even if the underlying reason for the payment is that the disability gives rise to such claims, HMRC does not regard the payment as being made solely on account of a disability.

How do you solve this?

In order to avoid this difficulty and to claim the tax exemption, termination payments should therefore be expressly divided into two amounts – one on account of disability alone and the other in respect of the waiver of claims against the employer. Provided the payment on account of waiving claims is realistic, the payment on account of a disability should be sufficient for HMRC to allow the tax exemption to apply.

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