

black & white paper

Payments for hurt and humiliation

Over the last few years, the tax treatment of payments for hurt and humiliation has become an area of focus for Inland Revenue, with many public sector entities receiving amended PAYE assessments.

Under section 123 of the Employment Relations Act 2000, where the Employment Relations Authority or the Employment Court determines that an employee has a personal grievance, the Authority or the Court may provide for a compensation payment for humiliation, loss of dignity, or injury to feelings.

A personal grievance is defined as a grievance in relation to unjustified dismissal, discrimination, sexual harassment, racial harassment, duress associated with union membership, or an unjustified action by the employer that results in the employee being disadvantaged. Essentially, the definition requires some form of wrong-doing or unjustified action by the employer.

Public Ruling BR Pub 06/05 states that payments that are genuinely and entirely for compensation for humiliation, loss of dignity, or injury to feelings are non-taxable. This ruling applies regardless of whether the compensation is determined by the Courts or in an out-of-court settlement.

However, payments for lost income, redundancy entitlements, or exit inducements are taxable and subject to PAYE. Simply classifying a payment as being for hurt and humiliation and getting the settlement agreement signed by an independent mediator does not make the payment non-taxable.

The role of the mediator is to help the parties to resolve their dispute, not to determine who is right or wrong. It is also not the mediator's role to determine an appropriate level of compensation for hurt and humiliation.

If Inland Revenue investigated an out-of-court settlement, the parties involved would have to prove that the employee had a genuine personal grievance (as defined), and that the amount paid to the employee was reasonable based on the level of compensation awarded by the Courts.

Most of the amounts awarded by the Courts for hurt and humiliation are under \$10,000, and only a small percentage are over \$15,000.

In an investigation, any payments over \$10,000 are likely to attract attention from Inland Revenue. In general, it would be very difficult to convince Inland Revenue that any payments over \$20,000 were not at least partially taxable. Tax liabilities may also exist in relation to smaller payments. In cases where there is no evidence of a genuine personal grievance, Inland Revenue could consider the entire payment to be taxable.

Where there is no genuine personal grievance or the payment is considered to be excessive, Inland Revenue will often seek to "gross-up" the payment to calculate the PAYE liability. As a result,

Top three things you need to know:

- The tax treatment of any out-of-court settlements may be challenged by Inland Revenue.
- It would be very difficult to convince Inland Revenue that any payments over \$20,000 are not at least partially taxable.
- Employers who are aware of this issue will generally try to limit any out-of-court settlements to around \$10,000

Where to go for more information:

- You can find the Auditor-General's report on *Severance Payments in the Public Sector* on www.oag.govt.nz. You can also email reports@oag.govt.nz to request a hard copy.
- You can find Public Ruling BR Pub 06/05 on www.ird.govt.nz
- You can find the Employment Relations Act on www.legislation.govt.nz
- Contact Jason Biggins, Tax Director, on 021 222 4001 or jason.biggins@auditnz.govt.nz if you have specific queries.

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the total liability for the employer, including interest and penalties, can be as much as the payment made to the employee.

About three years ago, Inland Revenue wrote to all district health boards and local authorities, asking for details of any payment for hurt and humiliation. A large number of these entities received amended PAYE assessments as a result of this approach.

Entities in other sectors have also received amended PAYE assessments as a result of investigations or voluntary disclosures.

Despite this activity, we continue to see large payments for hurt and humiliation, and employers who believe that they have no tax liabilities as long as they have a settlement statement signed by a mediator. As a result, it appears that the tax treatment of payments for hurt and humiliation will continue to be an area of focus for Inland Revenue for some years to come.

Given the success of Inland Revenue's approach in the local government and health sectors, it is likely that the same approach will be repeated and applied to other sectors.

When we find hurt and humiliation payments over \$20,000 as part of our audit work, we usually recommend that the entity review its policy for out-of-court settlements and consider making a voluntary disclosure to Inland Revenue.

Employers who are aware of the issue will generally try to limit any out-of-court settlements to around \$10,000. Some employers take a harder line and make a payment for hurt and humiliation only if instructed to by the Courts.

Unfortunately, many employers remain unaware of the potential tax liabilities associated with these payments.

Health sector

In November 2005, Inland Revenue wrote to all district health boards requesting details of any payment for hurt and humiliation in the last two years. A number of these entities received amended PAYE assessments as a result of this approach.

Central Government and Crown entities

Large payments for hurt and humiliation tend to be less common in this sector. However, a reasonable number of entities have made voluntary disclosures and received amended PAYE assessments for these payments.

Tertiary education institutions

The tax treatment of payments for hurt and humiliation has been a significant issue in investigations in the tertiary education sector. However, unlike other sectors, Inland Revenue has not yet taken a sector-wide approach to investigating these payments.

Local Government

Inland Revenue wrote to all local authorities in 2006, asking for details of any payment for hurt and humiliation in the last two years. A large number of local authorities received amended PAYE assessments as a result of this approach.

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