

Important tax changes to the payment of legal fees

Important changes have been announced to the tax treatment of legal fees paid by employers in connection with termination of an employee's employment. These changes will apply to legal fees payments made on or after 6 April 2011.

There are concerns that some legal fees which currently benefit from a tax exemption will cease to qualify. This may affect how employers choose to handle severance arrangements with their employees.

The current position

Employees often take legal advice when negotiating the terms of their exit from an employer, particularly where a settlement arrangement is agreed. Those agreements can come in various forms, including using private settlements, statutory compromise agreements or COT3 agreements via ACAS conciliation. Employers will often make a contribution to the employee's legal fees as part of the agreement. This is particularly common when using statutory compromise agreements, as one of the conditions for an effective agreement is that the employee must obtain independent legal advice on the terms and effect of the agreement.

Certain tax concessions apply if an employer pays an employee's legal costs in connection with advice received in relation to the termination of their employment. Currently these payments are exempt from tax as a result of an HMRC Extra-Statutory Concession (ESC) if:

- the fees are paid directly to an employee's solicitor;
- the costs are incurred solely in connection with the employee's termination of employment; and
- the payment is made under a term of a compromise or severance agreement; or
- a Court or Tribunal order (this includes fees paid directly to the former employee).

The change

From 6 April 2011, payment of legal fees by an employer on an employee's termination of employment will only be treated as free of tax if:

- an order of the Court or Tribunal is granted to that effect; or
- the fees are paid pursuant to a compromise agreement which meets the conditions required by section 203 of the Employment Rights Act 1996 (ERA).

This is significantly narrower than the existing concession. It does not cover private settlement agreements, ACAS COT3 conciliation agreements or compromise agreements which are not made under the ERA. Agreements which are made under the ERA will continue to be covered.

Impact

Employers need to be alive to this change when considering what type of settlement agreement to use. Those wanting to take advantage of the concession will want to use a compromise agreement under section 203 ERA 1996 as the safer option. That agreement would need to satisfy the various conditions required under that legislation in order to be an effective agreement. COT3 agreements and private settlement letters will now be less tax efficient if payment of legal fees is a term of the deal.

So far as statutory compromise agreements are concerned, most are made under section 203 ERA so this is unlikely to be an issue. However, if employers are using a compromise agreement which refers to other legislation, not to the ERA, then there is a risk that the tax concession does not apply. We understand that this issue has been raised with HMRC, which is considering whether to change the draft legislation. HMRC has confirmed that any compromise agreements structured under the rules set out in the Equality Act

2010 will attract the concession but this is not yet reflected in the legislation. However, this does not completely solve the problem. All statutes which set out provisions on how the conditions regulating compromise agreements are satisfied should be referred to in the relevant tax legislation.

Recommendations

If employers wish to continue to make use of the tax concession, they should use a statutory compromise agreement (under s203 ERA). That form of agreement has other advantages, of course, as it acts as a valid waiver of statutory employment claims. If an employer prefers to use some other form of private settlement or ACAS COT3 agreement, any legal fees paid to an employee or their adviser under that agreement will not attract the concession and will therefore be taxable. For those of our clients using our precedent compromise agreement (which refers to s203 ERA), no amendments are needed in light of the changes.

The Employment team have extensive experience advising employers on how best to structure compromise and settlement agreements and would be happy to assist you.

Bernadette Daley

Partner

bdaley@mayerbrown.com

Tel: +44 20 3130 3667

Katherine Fox

Associate

kfox@mayerbrown.com

Tel: +44 20 3130 3169

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