

## Section 123 payments

### Are they truly compensation?

#### **Compensatory payments under Section 123 of the Employment Relations Act 2000 have become commonplace. However, recent IRD audits of settlement agreements have highlighted the risks associated with indiscriminate tax-free payments**

By far the majority of personal grievances are settled by negotiation or at mediation. Generally they are documented in a Record of Settlement signed-off by a mediator from MBIE. This not only records the full and final nature of the settlement, but also means that any breaches of the settlement are immediately enforceable in the Employment Relations Authority.

Because genuine compensatory payments are not taxable, there is a real attraction to employers paying as much settlement moneys under this heading as possible and therefore avoiding having to pay tax. Compensatory settlements are also attractive to employees for the same reason.

However, if the settlement includes lost wages and contractual obligations, such as payment of notice periods, then these payments will attract PAYE.

The Inland Revenue Department has issued a public ruling about payments under the Employment Relations Act for humiliation, loss of dignity and injury to feelings. Where these payments are genuinely made under the Employment Relations Act they are not income and therefore do not attract PAYE.

Out of Court settlements can similarly include payments for humiliation, loss of dignity and injury to feelings. These are made in return for the employee surrendering their rights under the Employment Relations Act. The Public Ruling states that there should be no difference in the tax treatment of payments dependent on whether

or not the parties used the Employment Relations Authority or Employment Court. A payment can be for humiliation, loss of dignity, injury to feelings of the employee whether the Authority or Court are involved or not.

However, the Ruling cautions against shams. Shams include excessive allocations for compensation or characterising a payment as being compensation for humiliation when, in reality, it is for lost wages.

IRD has search powers to access documents for the purposes of collecting any tax or carrying out any function lawfully conferred on the Commissioner. Where the Commissioner has some doubt about the amount attributed to compensatory payments, they may ask the parties to an agreement what steps they took to objectively evaluate the amount of the compensatory payment. This is regardless of whether or not the settlement was signed by a mediator under the Employment Relations Act.

IRD can also enquire whether a personal grievance has been raised; whether the employer acted fairly and reasonably; how the compensatory amount was assessed and whether it is consistent with comparable cases.

IRD can request supporting documentation, such as copies of personal grievance letters and evidence of how the compensatory amount paid was assessed against comparable cases. If IRD forms the view that the payments have not been genuine then there is a very real risk to the employer. This includes a requirement to pay the tax component on the compensatory payment, along with penalties and interest.

If IRD enforces this, then the employer may need to advise the other party to the settlement that the payment has been assessed by IRD as taxable. This may create issues for the other party as it can impact their overall tax position. Eligibility for family support and payment for child support, student loans etcetera

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will be impacted. Imagine having to inform a disgruntled ex-employee not only that the terms of the Record of Settlement they thought were confidential have become known to IRD but, worse, that their tax position has been negatively impacted.

The Chief Employment Court Judge has issued guidance on the amount of compensation a successful personal grievant should expect to receive. Low-level damages may range as high as \$10,000.00. Moderate damages span between \$10,000.00 and \$40,000.00 and significant damages justify payments over \$40,000.00. Employers making compensatory payments would be wise to reference the Court's guidance and to consult with their financial advisors on the potential tax ramifications of making such payments.

**Want to know more?**

If you have any questions about Section 123 payments, please contact our specialist [Employment](#) Team.