SQUIRE SANDERS

CLAWBACK: A TAX LOSS OR LOST TAX?

The increased inclusion of clawback provisions in bonus and share plans has, to date, been undertaken with a view that an employee is going to struggle to get any credit from HMRC for a clawed back amount. Sometimes, the clawback provisions have expressly taken this understanding into account and have only required a repayment of the net amount, thereby accepting that the tax originally paid to the taxman is lost.

However, as of 27 December 2012 (when the First-tier Tribunal's decision in Julian Martin v HMRC was published), this reluctant admission that the clawback payment is of no significance in the world of tax may no longer be necessary. The Tribunal allowed an amount which had been clawed back by an employer under a contract to be deducted from earnings received that year which, on that occasion, created a tax loss which could be claimed in either that tax year or carried back a year. Employers and employees alike will no doubt be interested in this one…

Should I Stay or Should I Go?

Mr Martin entered a new employment contract which provided for a £250,000 "signing on bonus" to be paid at the time he signed. However, if he were to leave employment within the next five years, the contract provided that the relevant proportion of that bonus was to be repaid by Mr Martin (gross). Surprise, surprise, Mr Martin left employment before the five years were up and, as a result, had to repay £162,500 of the bonus.

Mr Martin advanced three main arguments as to why he should benefit from a smaller tax bill as a result of that clawback. Two were dismissed by the Tribunal. First, a person's tax return didn't have a mistake in it just because he had to repay money. Secondly, if you want the payment to be treated as a loan, jolly well write it as a loan. Don't just ask the Tribunal to now treat the money as paid under an entirely different structure, simply because that interpretation gets you to where you want to be!

The argument that convinced the Tribunal rested on an "unclear principle" in the employment tax legislation on which there was, "astonishingly", no guidance in the legislation itself (their words, not ours). The concept was that of "negative taxable earnings" – whatever they are and however you calculate them. The (relatively short) judgment makes interesting reading, particularly given the lack of any relevant case law, and sees the Tribunal trying to make sense of the legislation. They ultimately concluded that they could "barely think of a more obvious example" of negative taxable earnings than that presented by Mr Martin and his payment to his employer of £162,500. The long and short of it was therefore that the repaid £162,500 was not itself a loss but it could be deducted from other income receipts in the same tax year which, due to income of roughly £140,000 in that year, meant:

- there was no income tax for the year of the repayment because the deduction reduced the income to nil; and
- because there were surplus negative taxable earnings, there was a £22,500 tax relief claim.

So What Next?

Before we all get carried away, remember this is a First-tier Tribunal decision. Not a court. And, of course, HMRC can (and quite possibly will) appeal the decision. Nevertheless, it is a big step towards clarifying the tax treatment of amounts repaid pursuant to clawback provisions – which is itself very welcome. It may be that HMRC will now be forced to directly address the issue of clawback and how the tax position should be dealt with, or it may be that Parliament now deals with the issue in the form of new or amended legislation. Whichever route is adopted, the clarity that will be provided falls within that old saying, "better late than never".

This decision throws up the interesting scenario where the deduction from income in the year that the clawback is enforced shelters income which would otherwise be taxed at a higher rate than the rate that the bonus itself was originally taxed at.

For example, let's say that in January 2011 a bonus of £25,000 is paid on top of a salary of £120,000. The marginal rate of tax would have been 40%, so the tax on the bonus would be £10,000. Now assume that, in 2014, the full amount of the bonus is subsequently clawed back pursuant to a contractual requirement when the base salary is £170,000. Without the relief for the clawed back amount, the employee's top rate of tax (post April 2013) would be 45% – on £25,000 of the base salary. However, taking the clawed back amount into account as negative taxable earnings, there won't be any income charged at 45% (because the 45% threshold is no longer achieved). As a result, the ability to take into account the repayment when computing the tax liability means a tax bill that is £11,000 lighter (which is also £1,000 more than the tax bill originally levied on the bonus…).

Finally, don't forget that the draft Finance Bill 2013 contains legislation which introduces a cap on the relief that this kind of loss would give rise to. As a result, from April 2013, the relief is limited to £50,000 or 25% of income, whichever is the greater. Unless the employee has non-employment income in the year that the clawback is operated, presumably the £50,000 cap will apply as the clawback has itself reduced income to below zero. Still £50,000 of loss relief is better than none at all, right?

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