This information is up to date as at Thursday 22 January 2015.

muckle LLP

Holiday pay update - questions & answers

Will this issue affect our business/organisation?

Yes, if:

- your business/organisation employs workers or employees who are paid certain payments (such as allowances, commission or overtime) in addition to their basic pay; **AND**
- you only pay employees their basic pay during their holidays, not their "normal pay" (i.e. you don't factor into the holiday pay the different additional payments received during a normal working week) thus underpaying employees and workers whilst they are on holiday.

So how will this issue affect our business/organisation?

You will be affected in 2 keys ways. First, you will need to consider whether, how and when to amend the way you calculate holiday pay going forward. Second, you may need to deal with employees who bring (or at least threaten to bring) claims for backdated underpayment of holidays...further comment on these issues is given below.

What, exactly, is 'normal pay'? (i.e. what sort of additional payments should be factored into an employer's calculation for holiday pay?)

"Normal pay" is "that which is normally received". This is a matter of fact determined on a case by case basis (assessed against what actually happens in practice, not necessarily what may be written in a contract or policy). The case law has indicated that payments will be included in "normal pay" where:

1. the payments are directly linked to the performance required by the employment contract;
2. the payments have a sufficient degree of permanence; and
3. if it is not clear, it is assessed by analysis of a representative period.

Clients have asked whether the following type of payments and allowances should be regarded as 'normal pay'.

1. **Overtime payments** – Yes, if the employee is required to work any overtime offered by the employer (even if there is no guarantee of being offered overtime). However, based on the current cases, if the overtime is genuinely voluntary (i.e. there is no guarantee that overtime will be offered and there is no requirement to accept it, if offered) it does not need to be included. However, in practice it is very difficult to make a distinction between when it is voluntary and compulsory. Also, it is conceivable that even such voluntary overtime will in future be considered as part of a week's pay. If your business/organisation has large amounts of voluntary overtime, this is something which you should review now.
2. **Commission payments** – Yes, if the commission payments are contractual and intrinsically linked to work done. This point was determined by the case of Lock v British Gas Trading Ltd 2012. This case is due to be heard again by the employment tribunal early next year, following the European Court confirming that commission payments could be considered to be normal pay for the purposes of calculating holiday pay;
3. **Discretionary bonus payments** – This is a grey area and currently no case law is conclusive in this regard. It's reasonable to expect a test case in the near future but for now, a careful analysis of any particular scheme will need to be undertaken to see if a bonus could be regarded as normal pay. Much will depend on the history of the scheme and how/when the payments are calculated. It is thought that bonuses which are paid to everyone regardless of performance would not be regarded as normal pay, but a bonus paid on say weekly performance criteria would be normal pay.
4. **Tips** – No, unless the tips are operated through a tronc or are used to top up pay so to ensure the National Minimum Wage requirements are met, in which case they may constitute normal pay.
5. **Shift allowances** – Yes, such an allowance would be considered to be normal pay;
6. **Productivity allowances** - Yes, such an allowance would be considered to be normal pay;
7. **Attendance allowances** – Yes, such an allowance would be considered to be normal pay;
8. **Travel time allowance** – Yes, such an allowance would be considered to be normal pay;
9. **Regional weightings allowances** - Yes, such an allowance would be considered to be normal pay;
10. **Car mileage or overnight stay allowances** – No, such payments should be regarded as expense payments not 'normal pay' unless the payments are routinely given regardless of whether or not an employee is in fact incurring the expense.

Does this assessment of "normal pay" relate to all holiday pay?

The above assessment, strictly speaking, relates to the payment of the 4 weeks of leave granted by the European Working Time Directive **(ED)** NOT the extra 1.6 weeks of leave granted by the Working Time Regulations **(WTR)** or any additional contractual entitlements. However, in the interests of simplicity, it could be easiest to treat all holiday pay the same. Otherwise, you may end up having to do multiple calculations each time holiday is taken. This information is up to date as at 21 January 2015.

If we operate any of the above types of payments/schemes what are our next steps?

You will first need to calculate the extent of any historic liability by establishing what payments have been made to individuals whilst on holiday and what payments should have been made. You will then need to consider when and how (if at all) to pay any backdated liability and how to deal with the issue going forward. (See below for further comments on this).

How do I calculate our liability?

As mentioned above, any historic liability is the difference between the pay the employee received whilst on holiday and the pay the employee should have received as their normal pay. This may be a fixed sum each week or vary from week to week. If the difference in payment varies from week to week normal pay will be calculated using a reference period (see over page). NB Remember this liability is limited to the 4 weeks of leave granted by the ED NOT the extra 1.6 weeks of leave granted by the WTR (see below) – it may also not apply to all employees given the limits currently placed on backdating (see below),

If pay varies from week to week, what is the reference period?

This is most likely to be a 12 week reference period as established in the Employment Rights Act 1996. This means you work out holiday pay by averaging out the pay received in the 12 weeks immediately before the holiday taken. For seasonal workers or sectors which experience peaks of production, for example, this would mean that holiday pay during one time of the year could be massively different to another time.

Can the reference period be changed to avoid the distorting affect of seasonality etc?

Possibly, yes, but this is largely untested. In the case of Williams v British Airways the Advocate General did suggest that it is possible to either take account of the specific period that the worker was on holiday, to calculate the average hypothetical earnings, or to find an earlier period to calculate average earnings. This comment suggested that a business could look to an alternative reference period, however, this comment was only given as opinion and it did not ultimately form part of the judgment.

Reference periods should be determined on a case by case basis. If a 12 week reference period was not fully representative of pay received over the course of, say, 6 months or a year then the period could potentially be extended or moved. Ultimately the reference period must reflect normal working patterns. This may mean to accommodate peaks and troughs in overtime or commission payments, for example, the reference period could be 6 – 12 months or the average overtime from the previous holiday year could be used. Although the European case law has indicated this could be a legitimate manner of proceeding, there is little in the way of direct cases on the issue.

However, if the method of calculation is reasonable and consistent across the workforce, it is unlikely employees will challenge this particularly given the claim fee of £160.

The Government taskforce set up by the Department of Business, Innovation and Skills to consider the impact of the decision on employers is likely to consider this and whether a change in the law is necessary.

How far back in time do we need to go when calculating the liability?

The Bear case effectively says no more than the current holiday year. This is because the judge in Bear says any claim (which needs to be brought as an unlawful deductions claims) must be brought within three months of the last in a series of deductions. Although not entirely certain, the case law indicated that the first 20 days of leave are the ED days and, the last 1.6 weeks are the WTR days. Thus when an employee receives pay for the 1.6 weeks' WTR leave, it is arguable that this breaks the series of deductions resulting in an employee not being able to go back more than year. Although the judge in Bear allowed an appeal on this point, the union representing the employees in Bear (Unite) has announced it will not appeal further. Some commentators have suggested it will not be long before a further challenge is made.

Perhaps to deter or limit such a challenge the Government has announced it has laid legislation before parliament to limit back dated claims to two years. It is not clear why two years has been chosen or when this runs from. In any event, the legislation will come into force on 1 July 2015 (applying to claims filed for deductions from pay thereafter) so we may see a flurry of activity before then from employees and their representatives. Now appears to be as good a time as any to address this issue if you perceive there to be a liability for your organisation.

Could the back dating of claims be limited if the series of deductions is broken by paying the correct amount of holiday at any given time?

It would appear that this could be possible, but the Bear judgment is based on any backdating being limited if there is no unlawful deduction within a period of 3 months. So, for example, paying the correct amount of holiday pay in between two incorrect payments for holiday taken does not under Bear break the series of deductions. This remains an uncertain area and highlights the need for employers to take a forensic, individual by individual approach to calculating their liability. We appreciate this will be a time consuming exercise but it is the only way to value historic liability with any certainty.

Can or will the series of deductions be broken by any other approach?

May be. Some employers already run a contractual limitation on when holidays can be taken to account for seasonality or peaks in productivity. This arrangement may well limit claims from being made. Employers also have the right under the WTR to reject requests for holiday (by following appropriate procedures), but it is difficult to see how this provision could be used safely without exposing the employer to other types of claims (e.g. constructive dismissal claims) - especially if the reason to refuse holiday is to help avoid claims.

So what should we do about our liability? (i.e. what are our options?)

The options are varied and one approach will not fit all. The approach you take will depend on what the liability is, the nature of your work force (for example, are unions involved?) and your appetite for risk. For all employers we recommend that, at the very least, they identify the possible liability (as explained above) and make appropriate budgetary contingencies. After that your options and considerations include:

1. Do nothing – you could sit tight and do nothing further (perhaps waiting to see if the chain of deductions is broken). This may mean the liability of back dated claims is not crystallised. It also means your method of calculating holiday pay could remain a live problem in the future.
2. Do something – this could include reviewing and revising current practices so that, going forward, the right approach to paying holiday is implemented. It is likely that consultation with staff and obtaining their consent will be required if contractual provisions and practices need to be renegotiated and ultimately varied. You may consider, for example increasing basic pay in return for employees working any overtime required for no additional pay.

By taking this action you will crystallise claims and, effectively, flag to employees the fact a back dated claim may exist. You may therefore want to think tactically about this sort of review. For example, could you offer a one-off payment for the possible claims which exist subject to signing a settlement agreement and agreeing a new way of calculating holiday or revised contractual terms.

Or you may not want to confront this issue in such an obvious way, perhaps preferring to discreetly amend holiday pay calculations going forward and seeing whether employees pursue backdated claims within the three month period they have to bring claims.

How should I calculate holiday pay on termination of employment?

If you calculate all holiday pay the same (i.e. ED and WTR leave is calculated in the same way) then holiday pay calculations on termination should be like any other holiday pay calculations. If you are using a reference period to calculate holiday pay, e.g. a 12 week period, the 12 weeks will be the 12 weeks immediately before the termination date.

If you wish to calculate holiday pay by applying different pay rates for ED and WTR leave (see our comments above) a commercial approach would be:

1. Identify how much accrued but untaken holiday remains at the termination date.
2. Identify how many accrued but untaken days fall within the ED entitlement of 20 days (if any).
3. Identify how many accrued but untaken days fall within the WTR entitlement of 1.6 weeks.
4. For accrued but untaken holidays falling within the ED 20 days' entitlement you will need to calculate holiday in the manner detailed above (i.e. inclusive of overtime and similar payments). For accrued but untaken holiday falling into the 1.6 weeks WTR entitlement this holiday pay may be based on a week's basic pay albeit subject to the existing rules and mechanism for calculating a week' pay in accordance with the Employment Rights Act 1996.

Does this issue have any impact on pension entitlements or payments?

Possibly, yes. This is because the definition of "qualifying earnings" used in auto-enrolment schemes is likely to be wide enough to include holiday pay. Also, how existing scheme rules define pensionable pay may also be affected by holiday pay which, in turn, could result in pension contributions having to be revised.

In addition to these concerns, it is foreseeable, for example, that the result of employees earning holiday pay which factors in overtime payments may result in their earnings triggering entitlements to auto-enrolment.

In the first instance we suggest you contact your pension advisers for further assistance in this regard.

Presidential guidance

The President of the Employment Tribunals has now issued a Practice Direction on the handling of claims of unpaid holiday pay in light of Bear v Fulton and ors. The Practice Direction permits a claimant (who has previously presented a holiday pay claim) to apply to amend the claim and to add further complaints of alleged underpayment arising after the presentation of the original claim. This is provided if the further claims could not have been included in the original claim. From the claimant's point of view this would mean they would not have to pay further fees for new claims.

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