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Calculating holiday pay - the current position

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Introduction

The calculation of holiday pay has in recent years become a major issue of concern for employers, with a series of cases indicating that the approach allowed under UK law of basing holiday pay on basic pay only did not comply with the requirements of European law.

This Inbrief considers the current legal position, the implications for employers and some options employers can consider to minimise the risks.

The Working Time Regulations

The European Working Time Directive 2003 (the "Directive") requires that workers have a minimum of four weeks' paid leave per year ("EU Statutory Leave"). This is implemented in the UK by the Working Time Regulations 1998 (the "Regulations"). The Regulations also grant employees an additional 1.6 weeks' paid leave per year ("Additional Statutory Leave"). This means that the statutory minimum entitlement for a UK worker is 5.6 weeks, which is 28 days for a full time worker. This entitlement can include bank holidays. Some employers will also offer workers contractual holiday on top of this statutory entitlement. In practice, employers rarely distinguish between different types of holiday. Instead, employers tend to give workers a total holiday entitlement in their contract of employment which is paid in the same way in all cases.

The Regulations state that workers should be paid a "week's pay" for each week of statutory leave calculated in accordance with the Employment Rights Act 1996 ("ERA"). The provisions in the ERA relating to a week's pay are complicated. They make a distinction between employees who have "normal working hours" and those who do not, and currently use a 12-week period for calculating average pay for employees without normal hours. Many employers have relied on certain provisions in the ERA to allow them to pay basic pay only for periods of holiday, without including additional elements such as overtime (other than guaranteed overtime which must be included), bonus and commission.

The Regulations provide that EU Statutory Leave must be taken in the holiday year in which it falls due and that any leave untaken at the end of a leave year is forfeited. So, under the Regulations, payment in lieu of untaken EU Statutory Leave should only be payable for the final year of employment. Other types of holiday may be carried over depending upon the circumstances (such as whether there is a contractual right to do so). This position has been altered somewhat by case law, so that in some situations the entitlement to EU Statutory Leave may be carried over into subsequent holiday years. These situations include where an individual has been wrongly characterised as self employed (following the case of *King v The Sash Window Workshop Limited*) or where the worker has been unable to take holiday due to maternity leave or illness.

Employees can claim that underpaid holiday is an unauthorised deduction from wages. Such claims normally need to be brought within three months of when the deduction was made. However, case law has established that if there has been an unbroken series of such underpayments, employees can potentially bring a claim for the whole series. Such a claim could go back for a number of years. Some cases suggest that this can only be done if there is less than three months between each underpayment. The Government also changed the law on 8 January 2015 to prevent claims made on or after 1 July 2015 from going back for more than two years. Following the case of *King v The Sash Window Workshop Limited* it is possible that these limitations may be incompatible with EU law. This is discussed in more detail below.

ECJ cases on holiday pay

In 2011 the European Court of Justice ("ECJ") stated in the case of *Williams v British Airways plc* that the Directive requires workers to receive their "normal remuneration" for EU Statutory Leave and that payments "intrinsically linked" to the performance of the tasks which the worker is required to carry out under his or her contract of employment form part of that normal remuneration. This suggested that the Regulations were inconsistent with the requirements of the Directive because the wording in the ERA could result in payments such as overtime and commission being excluded, even when they formed part of a worker's overall pay.

This case was followed by the decision in *Lock v British Gas Trading Ltd* in which the ECJ applied the principles set out in *Williams* to determine that a sales consultant's commission payments should be taken into account for the purposes of calculating pay for EU Statutory Leave.

In the 2017 case of *King v The Sash Window Workshop Ltd*, the ECJ held that where a worker has been prevented from taking annual leave because it was unpaid, the worker is entitled upon termination of employment to be

paid for any untaken annual leave that accrued during the employment. There is no limit to the amount of leave which may be carried over in this case because the employer must “bear the consequences” and pay a worker their basic entitlement under the Regulations. The ECJ also confirmed that a worker does not have to have taken the leave in order to be paid for it. This case has potentially significant implications for employers who may have wrongly categorised individuals as being self– employed, as these individuals could now pursue claims for unpaid holiday going back potentially many years to the introduction of the Regulations in 1998.

Importantly, these cases relate only to how an employee should be paid for EU Statutory Leave - i.e. the four-week minimum entitlement. They do not affect pay for Additional Statutory Leave or contractual holiday, which are not governed by EU law.

Current position under UK law

The current position in the UK, other than in Northern Ireland, is covered by the EAT’s judgment in *Bear Scotland Ltd v Fulton* which has been clarified by subsequent developments.

The EAT’s key rulings in the *Bear Scotland* case were as follows:

- In accordance with the Directive and the ECJ decisions in *Williams and Lock*, workers are entitled to "normal remuneration" when they take EU Statutory Leave. This should include non-guaranteed overtime - i.e. overtime which the employer has no obligation to offer but which the worker is obliged to work if requested. The judge commented that normal remuneration is that which is "normally received" and payment has to be "made for a sufficient period of time to justify that label".
- The Regulations should be read in line with the EU law position by altering references in the Regulations to certain sections of the ERA which had allowed non-guaranteed overtime to be excluded from holiday pay.
- Claims alleging underpayment of holiday pay as a series of unlawful deductions from wages will be time-barred if there is a break of at least three months between successive underpayments. Further, workers cannot retrospectively designate whether or not a holiday was part of their four-week EU Statutory Leave entitlement so as to enable them to bring a claim within three months of the last in a series of relevant deductions. The EAT also appeared to suggest that EU Statutory Leave would be the first four weeks' leave taken in the holiday year.

The EAT gave the parties permission to appeal the above findings to the Court of Appeal, but perhaps surprisingly neither party opted to do so.

In 2015, the *Lock* case was remitted back to the tribunal for their decision in light of the ECJ ruling. The tribunal held that the Regulations should be interpreted so as to include commission payments in holiday pay for EU Statutory Leave. The tribunal decided it could overcome the present incompatibility between EU and UK law by “reading in” wording to the Regulations which provide for commission (if part of normal remuneration) to be included in holiday pay calculations. In reaching its decision the tribunal endorsed the decisions in *Williams* and *Bear Scotland*. The EAT dismissed an appeal by British Gas in February 2016 and upheld the tribunal's decision. A further appeal by British Gas was dismissed by the Court of Appeal in July 2016. In the Court of Appeal's view, it was possible to add wording to the Regulations in this way but it limited it to the specific type of results-based commission. Permission to appeal to the Supreme Court was refused.

There have been further developments surrounding the calculation of holiday pay following the decisions in *Lock* and *Bear Scotland*. In 2017 in the case of *Dudley Metropolitan Borough Council v Willets*, the EAT clarified that purely voluntary overtime pay (i.e. overtime which is neither guaranteed by the employer nor compulsory for the employee to work if asked), out of hours standby payments and call-out payments should be included in the calculation of a worker's holiday pay relating to EU Statutory Leave. This would be the case even in the absence of any obligation on a worker to accept the offer of overtime or to participate in the employer's on-call rota.

The approach in *Willets* has recently been clarified in *Flowers and Others v East of England Ambulance Trust* in which the Court of Appeal held that non-guaranteed and voluntary overtime pay should be included in the calculation of a worker's holiday pay as long as the overtime is worked with sufficient regularity and paid over a sufficient period of time. It is not clear what constitutes a sufficient amount of time or regularity but the EAT in *Willets* did agree with the first instance judge that overtime worked one in every four or five weeks would be sufficiently regular to count as "normal remuneration".

The position in Northern Ireland is slightly different from the rest of the UK. Northern Ireland has its own equivalent versions of the Regulations and the ERA. When ruling on a case brought under those pieces of legislation, the Northern Ireland Court of Appeal (“NICA”) considered but declined to follow the EAT’s decision in *Bear Scotland*. The case is *Chief Constable of the Police Service of Northern Ireland* and *Northern Ireland Policing Board v Alexander Agnew and others* and the NICA found in particular that a gap of more than three months in a series of unlawful deductions from wages would not end the series. Nor would the series necessarily be ended by a lawful payment, if for example, the lawful payment was still calculated on basic pay but there had been no additional payments, such as overtime or allowances, in the period to be taken into account.

The NICA also disagreed with the EAT’s view that EU Statutory Leave would be the first leave taken in the holiday year. Rather, it found that each day of leave should be distributed proportionately between each type of leave. So, if as in this case the individuals had thirty days holiday a year of which twenty were EU Statutory Leave, eight were Additional Statutory Leave and two were additional contractual leave, each day of leave should be attributed to all three types of leave in those proportions.

The decision of the NICA does not bind the British employment tribunals, which should follow the *Bear Scotland* ruling. Employers in Northern Ireland should have regard to the *Agnew* case – particularly as the two-year backstop on claims does not apply in Northern Ireland. But other UK employers should not ignore the *Agnew* decision altogether**.** It is worth bearing in mind that there is no statutory

wording underpinning the *Bear Scotland* findings that a break of more than three months ends a series of deductions and that EU Statutory Leave is taken first. It is possible that the Court of Appeal of England and Wales will agree with the NICA if it comes to consider the matter.

Implications of the current position

The courts have set down a general principle that pay for EU Statutory Leave should be based on an employee's "normal remuneration". The case law over the last few years has confirmed that the following payments should be included in the calculation of holiday pay:

- Compulsory, voluntary, guaranteed or non-guaranteed overtime;
- standby payments;
- emergency call-out payments;
- "charge hand" supplements (i.e. payments for taking on supervisory duties);
- incentive bonus – this consisted of a fixed element relating to personal attendance which was paid weekly and a performance element paid monthly if the employees' team met certain performance targets and attendance requirements;
- "acting-up" allowances;
- shift premiums;
- a `radius allowance'- a payment made when the employee had to travel more than eight miles to a construction site (but only the taxable part of this payment made for time spent travelling and not the non-taxable element relating to travel costs);
- travelling time payments - a payment similar to the radius allowance based on the time the employee had to spend travelling to a construction site; and
- commission and similar payments.

Conversely, the following should not be factored in to the calculation of a worker's holiday pay for the purposes of the Regulations:

- Benefits in kind
- Expenses incurred by the worker in performing the work under the contract of employment (e.g. travel expenses). This should not be confused with allowances, the taxable part of such allowance being required to be included in the calculation.
- Bonuses which are not linked in any way to a worker's performance under the contract and one-off bonuses (e.g. a general staff bonus payable regardless of individual performance/service)

Based on the current position - and subject to further case law developments - tribunals will consider the facts of the particular case in detail when considering whether certain payments should be included in holiday pay. This is likely to include looking at the following factors:

- whether the payments amounted to "normal remuneration";
- whether the payments are "intrinsically linked" to the performance of the tasks which the worker is required to carry out under the contract;
- the regularity and certainty of the payments;
- whether the payments are exclusively intended to cover occasional or ancillary costs (in which case they should be excluded from the calculation of holiday pay);
- whether the payments relate to the professional status of the employee e.g. relating to seniority, length of service or professional qualifications (in which case they should be included in the calculation of holiday pay); and
- whether the Regulations (as amended by previous decisions) allow for such payments to be included and, if not, whether the tribunal can amend the Regulations and/or the ERA to do so.

In relation to discretionary annual bonuses, it is not clear what approach tribunals will take, particularly where the bonus has varied from year to year and has an element based on collective rather than individual performance.

The current 12-week averaging period may produce very different results depending on when a bonus, commission or other intermittent payment is made. It is possible in light of the

Court of Appeal's purposive interpretation of the Regulations in *Lock* that a tribunal may conclude that it has the power to read additional wording into the Regulations in a particular case to provide for a different reference period. Particularly as the government has announced that the reference period will be increasing to 52 weeks from 6 April 2020.

Outstanding Questions

Whilst the decisions in *Bear Scotland* and *Lock* and subsequent developments have been helpful in clarifying the law surrounding holiday pay, there are still some areas of uncertainty:

- Which days of an employee's total entitlement of 5.6 weeks' leave (including EU Statutory Leave and Additional Statutory Leave) are deemed to constitute the EU Statutory Leave entitlement? There have been suggestions in recent cases that it is up to the employer to determine which type of leave is taken and when. There have also been suggestions that EU Statutory Leave will be taken first, before Additional Statutory Leave. There has been no definitive ruling on this issue to date.
- What is the correct reference period for commissions, bonuses etc? As discussed in this Inbrief, inconsistencies can arise if the 12 week reference period under the ERA is used to calculate holiday pay, because of variable remuneration such as commissions and bonuses. Employees could seek to boost their holiday pay entitlement by taking holiday immediately after a bonus/ commission payment has been made. There was a suggestion by the Advocate General in *Lock* that a 12 month reference period would be more appropriate and as part of its 'Good Work Plan', the government has laid regulations before Parliament increasing the reference period for calculating holiday pay from 12 to 52 weeks. This will not come into effect until 6 April 2020. But an employment tribunal may decide to take a purposive approach to the Regulations by "reading in" a new reference period before that date.
- What is the effect of the ECJ decision in *King v The Sash Window Workshop Limited* on limitation periods?

What should employers do now?

Employers should now:

- Pay EU Statutory Leave based on 'normal remuneration' in line with the decisions in *Bear Scotland, Lock* and *Willets*. It would be risky for employers to do nothing and continue to base holiday pay upon basic pay only. Workers may raise grievances or bring claims about any future holiday pay if they believe they are being underpaid.
- Try to reach a compromise position with employees on what will happen with holiday pay in relation to the areas of uncertainty identified above, which could include making changes to pay practices, holiday rules and/or rules on overtime (as discussed further below). This would require consultation with employees and is likely to require their agreement if contractual terms are being altered.
- Consider amending employment contracts and/or holiday policies to make it clear that EU Statutory Leave is the first leave taken in the holiday year. This will make it more difficult for employees to argue that there has been a series of deductions from holiday pay going back a number of years, as leave taken towards the end of the holiday year will be Additional Statutory Leave or contractual leave which has been paid correctly.

How should employers assess their exposure?

Employers particularly concerned about their current position would be well advised to undertake an audit to determine the following:

- Whether their employees receive payments which are currently excluded from the calculation of pay for EU Statutory Leave. If so whether, based on the factors outlined above, a tribunal is likely to consider that such payments should be included in the calculation of holiday pay. This will allow employers to assess the risks and place a reserve in their accounts, if necessary, in relation to the potential costs associated with additional holiday pay.
- How they may respond to any future increase in costs associated with holiday pay. This could include attempting to change working practices or reducing contractual holiday to limit any liability. In addition, how the employer would administer any change - e.g. what systems it would need to calculate holiday pay appropriately and whether it would treat pay for EU Statutory Leave differently from other holiday.
- Whether large payments such as overtime, bonus or commission tend to be made at certain times of year and, if so, whether the employer can alter the rules on taking holiday or even the holiday year so that this period does not fall within the calculation period for EU Statutory Leave.
- The holiday practices of employees, to establish to what extent there is generally a break of more than three months between payments for EU Statutory Leave. This will allow employers to assess the risk and place a reserve in their accounts if necessary in relation to potential past liabilities.
- Whether, for those employers who TUPE transfer staff in and out, special consideration should be made for any potential liability or exposure to claims for historic underpayment of holiday pay or failure to pay holiday pay at all which may include indemnities in commercial terms.
- Whether there could be further cost implications because the Regulations apply to workers not just employees (e.g. partners in LLPs, freelancers and agency workers). For example, employment agencies may seek to increase their costs.
- Review arrangements with independent contractors to assess the risks of these individuals having been wrongly categorised as self-employed and therefore the potential risk of claims for unpaid holiday pay.

How might Brexit affect holiday pay?

It is unlikely that Brexit will affect the basic right to paid holiday provided by the Regulations, although the Government may in future wish to amend the right (if it is able to under whatever relationship is agreed with the EU). Various decisions of the ECJ discussed in this Inbrief are unpopular with UK businesses, such as the fact

that holiday pay should be based on all aspects of a worker's normal remuneration and not just basic salary alone. The Government might choose to tweak these laws to make them more commercially acceptable, such as by retaining a right to paid holiday based on basic pay whilst limiting rights to accrue and carry over holiday.

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