[2021] UKUT 0152 (TCC)

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

Appeal number: UT/2020/0093

BETWEEN

KEITH MURPHY **App**

-and-

THE COMMISSIONERS FOR
HER MAJESTY'S REVENUE AND CUSTOMS **Respon**

TRIBUNAL: **MR JUSTICE MICHAEL GREEN**
JUDGE ASHLEY GREENBANK

Sitting in public by way of remote video hearing treated as taking place at The Royal Courts of Justice, Rolls Building, Fetter Lane, London on 26 March 2021

Michael Collins, counsel, instructed by Fraser White, Chartered Accountants, for the Appellant

Joshua Carey, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1.
This is an appeal by Mr Keith Murphy from a decision of the First-tier Tribunal (Judge Guy Brannan) (the "FTT") released on 11 November 2020 (the "FTT Decision"). The respondents are the Commissioners for Her Majesty's Revenue and Customs ("HMRC").

2.
Mr Murphy was a police officer with the Metropolitan Police Service (the "Met"). The matter before the FTT concerned the tax treatment of certain payments made by the Met for the account of Mr Murphy and a number of other police officers pursuant to a settlement agreement in respect of claims brought by the officers for alleged unpaid overtime and other allowances. The disputed payments related to certain legal expenses and the costs of insurance against liabilities to pay the legal costs of the Met if the claim were to be unsuccessful.

3.

The FTT decided that Mr Murphy was subject to income tax on the amounts received from the Met pursuant to the settlement agreement that were applied to make the disputed payments. This was on the basis that such amounts were employment income. Mr Murphy now appeals to this Tribunal with the permission of the FTT.

Relevant legislation

4.
It will assist our explanation if we first set out the legislative background to this appeal.

5.
The charge to income tax on employment income is contained in s6 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). It provides, so far as relevant:

6 Nature of charge to tax on employment income

(1) The charge to tax on employment income under this Part is a charge to tax on—

(a) general earnings, and

(b) specific employment income.

The meaning of "employment income", "general earnings" and "specific employment income" is given in section 7.

(2) The amount of general earnings or specific employment income which is charged to tax in a particular tax year is set out in section 9.

…

6.
Section 6 ITEPA therefore charges income tax on "general earnings" and "specific employment income". The concept of "specific employment income" encompasses amounts which count as employment income under certain specific regimes, such as the rules relating to securities and securities options and the disguised remuneration rules. It is not relevant for present purposes.

7.
The definitions of "employment income" and "general earnings" are found in s7 ITEPA. It provides as follows:

7 Meaning of "employment income", "general earnings" and "specific employment income"

(1) This section gives the meaning for the purposes of the Tax Acts of "employment income", "general earnings" and "specific employment income".

(2) "Employment income" means—

(a) earnings within Chapter 1 of Part 3,

(b) any amount treated as earnings (see subsection (5)), or

(c) any amount which counts as employment income (see subsection (6)).

(3) "General earnings" means—

(a) earnings within Chapter 1 of Part 3, or

(b) any amount treated as earnings (see subsection (5)),

excluding in each case any exempt income.…

…

8.
Subsection (5) contains references to amounts which are treated as earnings, for example, under the rules relating to agency workers or workers under arrangements made by intermediaries or the benefits code. It is not relevant for present purposes.

9.
Subsection (6) concerns amounts which are treated as specific employment income. It is also not relevant for present purposes.

10.
The amount of general earnings which is charged to tax in a particular tax year is set out in s9(2) ITEPA:

9 Amount of employment income charged tax

…

(2) In the case of general earnings, the amount charged is the net taxable earnings from an employment in the year.

11.
The "net taxable earnings" of an employee is given by a formula which is set out in s11(1) ITEPA:

11 Calculation of "net taxable earnings"

(1) For the purposes of this Part the "net taxable earnings" from an employment in a tax year are given by the formula—

TE − DE

where—

TE means the total amount of any taxable earnings from the employment in the tax year, and

DE means the total amount of any deductions allowed from those earnings under provisions listed in section 327(3) to (5) (deductions from earnings: general).

…

12.
The meaning of "earnings" for these purposes is found in s62 ITEPA. It provides:

62 Earnings

(1) This section explains what is meant by "earnings" in the employment income Parts.

(2) In those Parts "earnings", in relation to an employment, means—

(a) any salary, wages or fee,

(b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or

(c) anything else that constitutes an emolument of the employment.

(3) For the purposes of subsection (2) “money’s worth” means something that is—

(a) of direct monetary value to the employee, or

(b) capable of being converted into money or something of direct monetary value to the employee.

(4) Subsection (1) does not affect the operation of statutory provisions that provide for amounts to be treated as earnings (and see section 721(7)).

Facts

13.
We have set out below a summary of the facts which are relevant to this appeal. It is drawn largely from the FTT Decision (FTT [5]-[24]). The facts were not in dispute before the FTT or before us.

14.
On 19 December 2014, Mr Murphy and other police officers commenced group litigation proceedings in the High Court against the Met for unpaid overtime and other allowances (“hardship allowances”). A number of other police officers were added as claimants at a later stage. We refer to Mr Murphy and the other claimants in the legal proceedings together as the “Claimants”.

15.
To fund the legal proceedings against the Met, each of the Claimants entered into a Damages-Based Agreement (the “DBA”) with a firm of solicitors, Simons Muirhead & Burton (“SMB”), and Jonathan Davies of Counsel. Under the terms of the DBA, SMB and Jonathan Davies agreed to act as solicitors and counsel respectively for the Claimants in return for a “Success Fee” which was calculated as a percentage of any sum paid by the Met to settle the claim or any damages awarded to the Claimants by the High Court. The percentage was originally set at 40%, but was subsequently reduced by agreement to 30% and the maximum amount by reference to which the fee operated was capped at £4 million.

16.
Each of the Claimants also entered into an insurance contract with Temple Legal Protection Limited (“Temple”). Under the terms of the insurance contract, Temple insured the Claimants against the risk of having to pay the Met’s legal costs if the Claimants lost all or part of their claim in return for a premium.

17.
The Met denied any liability for the overtime or hardship allowances claimed by the Claimants.

18.
On 5 May 2016, the Met entered into a settlement agreement (the “Settlement Agreement”) with the Claimants. We summarize the main provisions of the Settlement Agreement below.

The recital to the Settlement Agreement, under the heading “Background” stated as follows:

The Claimants lodged a claim in the Queen's Bench Division … on 19 December 2014… claiming pay for unpaid overtime, an entitlement to receive the [hardship allowances] and a declaration regarding the entitlement to the payment of unpaid overtime and [hardship allowances]. The Defendant disputed that the Claimants were entitled to any part of the Claim. A three-day liability trial is scheduled to take place as early as 9 May 2016 (the “Dispute”). The Parties wish to settle the Dispute and have agreed terms for the full and final settlement of the Dispute and wish to record those terms of settlement, on a binding basis, in this agreement.

Under clause 3.1 of the Settlement Agreement, the Met agreed to pay the Claimants the sum of £4.2m (which was referred to as the “Principal Settlement Sum”) plus Agreed Costs in full and final settlement of the “Settled Claim”. It was in the following form:

3.1 In exchange for the Claimants agreeing to the full and final settlement of the Settled Claim, the Defendants shall pay to the Claimants a total sum of:

(a) £4.2 million (“Principal Settlement Sum”); plus

(b) Agreed Costs.

The “Settled Claim” was defined in clause 1 as “the claims for payment of [the hardship allowances] from the period of 1 April 2012 until the date of issue of the claims; and the claims for declarations regarding the entitlement to the payment of unpaid overtime and [the hardship allowances]; and any claim for the payment of overtime from the date of issue of proceedings until the date of settlement; and any claim for the payment of [hardship allowances] from the date of issue of proceedings until the date of settlement.”

“Agreed Costs” were defined (also in clause 1) as “the legal costs and disbursements plus VAT of the Claimants’ solicitors and counsel as assessed by the court or as agreed with the Met”.

The aggregate of the Principal Settlement Sum and the Agreed Costs was referred to in the agreement as the “Global Settlement Sum” (clause 3.2).

Under clause 3.3 of the Settlement Agreement, the Met agreed to pay the Global Settlement sum in the following manner:

The Defendant [the Met] agrees to pay the Global Settlement Sum as follows:

(a) the Firm [SMB] will raise an invoice in the total sum of £1,200,000 ("being the Success Fee") addressed to the Claimants but stated to be payable by the Defendant, which will identify the amount payable to the Firm and to counsel as agreed with the Claimants pursuant to the funding arrangement in place with the Claimants. Only once the Defendant has received this invoice will it pay the Success Fee by electronic transfer to the Firm's office account … within 12 days of the date on which this agreement is signed by both Parties or the Defendant receives the invoice, whichever is later;

(b) from the balance of the Global Settlement Sum, the Defendant will deduct £50,000 representing the insurance premium payable to Temple Legal Protection Limited (“Temple”) pursuant to an insurance contract between each of the Claimants and Temple. The Defendant will agree to pay this sum to Temple within 12 days of the date on which this agreement is signed by both Parties or the Defendant receives a letter from Temple confirming the amount of the insurance premium due, whichever is later;

(c) from the remaining balance of the Global Settlement Sum, the Defendant will pay to each of the Claimants as contained in an Apportionment Spreadsheet sent to the Defendant by the Firm, such sums to be subject to the withholding of income tax and National Insurance contributions. For the avoidance of doubt, the said withholdings are to be made on the basis of the Principal Settlement Sum and not the balance of the Global Settlement Sum. The payments to be made pursuant to this clause 3.3(c) are to be made in the first monthly payroll which follows receipt by the Defendant of the Claimants' Apportionment Spreadsheet.

As can be seen from the above, under clause 3.3(c) of the Settlement Agreement, the Met proposed to treat the whole of the Principal Settlement Sum as being subject to income tax and National Insurance contributions and to deduct tax accordingly. Under clause 7.1, the Met agreed to co-operate with any of the Claimants, who disputed the Met's proposed tax treatment. Clause 7.1 was in the following terms:

7.1 The Defendant agrees to provides prompt co-operation with any of the Claimants listed in Schedule 1 to this agreement or their representatives in the event that any of the Claimants wish to dispute the Defendant's proposed tax treatment of the Principal Settlement Sum, such co-operation to include, non-exhaustively, providing access to relevant paperwork at no cost to the Claimant(s) and answering questions raised by the Claimant or their representatives or Her Majesty's Revenue & Customs ("HMRC") relating to the taxation of the Principal Settlement Sum. Such co-operation to be provided by or on behalf of the Defendant promptly and without unreasonable delay.

Under clause 5.1 each party released the other party from all claims in relation to the dispute and the Settled Claim.

Clause 8.1 dealt with costs and provided:

8.1 Other than the Agreed Costs, the Parties shall each bear their own legal costs in relation to the Dispute and this agreement.

No admission of liability to pay overtime or hardship allowances was made by the Met (clause 11).

19.
The Principal Settlement Sum was apportioned between the Claimants on the basis of length of service since 20 December 2008 (overtime claim) and 1 April 2012 (hardship allowances claim). No distinction was made between those Claimants who were entitled to overtime and those who were not because they were not inspectors.

20.
The FTT also referred to a memorandum dated 29 April 2016 from SMB to the Claimants. This memorandum was written in advance of the settlement of the claims pursuant to the Settlement Agreement and discussed the advantages and disadvantages of the proposed £4.2 million settlement amount. In paragraph 4, the memorandum stated:

However, the Met has informed us that it will tax the entire amount of the settlement sum (i.e. it will tax the success fee) and after that, it will deduct the success fee which is payable to your legal team. This approach is less tax efficient for you. This would decrease the size of the pot available to the Claimants. We have told this to the Met and in reply the Met has increased its settlement offer to £4.2 million plus costs.

We sought independent tax advice from a tax specialist Barrister …. The tax Barrister has advised that the success fee and legal costs are not taxable. In effect, his position reflects your legal team's position and this is good news. We have sent this advice to the Met. However, what it risks is that the Met may decide to reduce its offer from £4.2 million to £4 million plus costs if it decides to follow the tax advice and NOT tax the success fee. If this does happen, the Executive Committee has authorised me to confirm that they recommend you agree to settle at £4 million plus costs.

21.
Mr Murphy filed his 2017 tax return on the basis that none of the Principal Settlement Sum was his income for that year.

22.
The tax return was made following correspondence between Mr Murphy's advisers and HMRC in which HMRC stated that the Principal Settlement Sum was not income of the 2017 tax year and should be spread over the period in respect of which the claims were made.

23.
HMRC opened an enquiry into Mr Murphy's tax return but on 12 March 2018 issued a closure notice making no amendments to the return. Also, on 12 March 2018, HMRC raised discovery assessments for the tax years 2009 to 2016. The discovery assessments assessed Mr Murphy to income tax on his apportioned share of the Principal Settlement Sum (without deducting a share of the Success Fee and insurance premium) and to interest.

24.
Mr Murphy appealed to the FTT against the discovery assessments on two grounds. The first ground was that the payment of Mr Murphy's apportioned share of the Success Fee and insurance premium was not his earnings. The second ground was not pursued before the FTT.

The FTT Decision

25.
Having reviewed the relevant authorities, the FTT defined the question before it as whether the payment of the Success Fee and the insurance premium arose from Mr Murphy's employment or from something else (using the language of Lord Reid in Laidler v Perry (Inspector of Taxes) [1965] 2 All ER 121 ("Laidler") at p124) (FTT [51]).

26.
The FTT decided that the payment of the sums in respect of the Success Fee and the insurance premium arose from Mr Murphy's employment and not from something else and accordingly that those amounts were taxable as employment income (FTT [52], [58]). On that basis, it dismissed Mr Murphy's appeal.

27.
The FTT's reasons for its conclusion were based primarily on the terms of the Settlement Agreement.

It was clear from the definition of "Settled Claim" that the claims for unpaid overtime and hardship allowances were made by the Claimants against their employer. If those payments had been made by the Met, they would have been taxable as employment income. The payment of the Principal Settlement Sum and the Agreed Costs was made in satisfaction of that claim (FTT [53]).

Whilst it was agreed between the parties that the amount paid in respect of Agreed Costs was not taxable as earnings because it was paid “in respect of something else – i.e. the costs incurred in the action” (FTT [54]), it was clear from clause 8.1 of the Settlement Agreement that the payment of the Principal Settlement Sum did not include any amount in respect of costs, but rather was a payment in settlement of the claim for unpaid overtime and allowances (FTT [55], [56]). The FTT drew some parallels with the judgment of Finlay J in Eagles v Levy (1934) 19 TC 23 (“Eagles”) in this respect (FTT [57]).

The full amount of the Principal Settlement Sum was therefore taxable as employment income. The fact that part of that sum (the Success Fee) was then “paid away” to discharge the Claimants’ own liabilities to the solicitors and counsel under the DBA did not affect that treatment (FTT [58]). The same analysis applied to the payment in respect of the insurance premium (FTT [59]).

The Grounds of Appeal

28.
Mr Murphy appeals to this Tribunal. In summary, his grounds of appeal are that the FTT erred in deciding that the payments of the Success Fee and the insurance premium were Mr Murphy’s earnings for the purposes of s62 ITEPA. His grounds of appeal make three points in support of this position.

First, the FTT erred in finding that the Success Fee and the insurance premium arose “from” Mr Murphy’s employment. The Success Fee and the insurance premium arose from the litigation with the Met and the Settlement Agreement and not Mr Murphy’s employment with the Met.

Second, the FTT erred in not having due regard to the comments of Lord Denning in Hochstrasser (Inspector of Taxes) v Mayes [1960] AC 396 (at p396-7) (“Hochstrasser”) to the effect that a payment to an employee in respect of a liability incurred in consequence of his employment did not give rise to a “profit” for the employee.

Third, the FTT erred in finding that no part of the Principal Settlement Sum was in respect of costs i.e. the Success Fee and the insurance premium (FTT [56]). In doing so, the FTT failed to have proper regard to the comments of Viscount Simmonds in Hochstrasser (at p390) that the question of whether an employee receives a profit from their employment is a matter of substance and not form.

The parties’ submissions

The appellant’s case

29. Before us, Mr Collins made four main submissions.

First – and as his principal argument – Mr Collins said that, to the extent that Mr Murphy was obliged to make payments in respect of the Success Fee and the insurance premium, he cannot be regarded as having made a “profit” within s62(2)(b) ITEPA. In this respect, the payments made in respect of the Success Fee and the insurance premium were no different from the payments in respect of the Agreed Costs. Mr Collins relied on the judgment of Lord Denning in Hochstrasser and Finlay J in Eagles in support of this submission.

Second, the payments made by the Met on account of the Success Fee and the insurance premium arose from the Claimants’ participation in the litigation and the Settlement Agreement and not “from” Mr Murphy’s employment with the Met.

Third, the FTT's application of the decision of Finlay J in Eagles was wrong. In Eagles, Finlay J accepted that if the agreed sum covered the taxpayer's costs and expenses, then that amount would not be subject to tax. The amount of the Principal Settlement Sum used to discharge the Success Fee and the insurance premium was intended to cover the Success Fee and the insurance premium.

Fourth, the fact that the Met increased the amount of the Principal Settlement Sum (by £200,000) to reflect the fact that the Claimants would bear the risk of any dispute with HMRC regarding the tax consequences of the payments made under the Settlement Agreement was not relevant to the question of whether the payments made in respect of the Success Fee and the insurance premium should be treated as earnings.

HMRC's case

30. In summary, Mr Carey's submissions supported the FTT Decision.

The Success Fee and the insurance premium were the Claimants' own liabilities. They were not incurred because of the Claimants' employment. They were incurred because the Claimants decided to enter into the DBA. The fact that the Claimants chose to pay away these amounts from the Principal Payment Sum did not detract from the fact that the Principal Payment Sum was received by the Claimants under the Settlement Agreement as a profit from their employment.

In contrast to the payment for the Agreed Costs, the payments on account of the Success Fee and the insurance premium arose from the employment and not "from something else" (Laidler, A v HMRC [2015] STFD 678). Unlike the Agreed Costs, the payments on account of the Success Fee and the insurance premium were not free-standing amounts.

The FTT did not err in finding that the Principal Settlement Sum did not include amounts in respect of the Success Fee and the insurance premium. The effect of the Settlement Agreement was to provide a payment mechanism for the Success Fee and the insurance premium. It did not change the character of the receipt of the Principal Settlement Sum.

Discussion

31. It is common ground between the parties that the amounts paid under the Settlement Agreement can only be regarded as "earnings" within s62(2) ITEPA by virtue of s62(2)(b) as any "other profit… obtained by the employee". In particular, HMRC accept that s62(2)(a) ITEPA (salary, wages or fee) does not apply to these payments, nor do the references in s62(2)(b) to "any gratuity" or "incidental benefit". Furthermore, the parties agree that the purpose of s62(2)(c) ITEPA (emoluments) is simply to ensure that the pre-ITEPA case law continues to apply.

32. The question for us is therefore what is the "profit" for the purposes of s62(2)(b) that Mr Murphy and the other Claimants should be treated as obtaining from their employment as a result of the settlement with the Met? It seems to us that that question requires us to address two issues.

The first is whether the alleged "profit" is derived "from" the employment as required by the definition of general earnings in s9(2) ITEPA. We refer to this question as the ""from" issue" in this decision notice.

(We note in passing that the wording used in s62(2)(c) ITEPA is whether an emolument is an emolument "of" the employment. However, the older cases to which s s62(2)(c) is intended to permit reference refer to emoluments "from" an employment. The FTT found (FTT [61]) that nothing turns on this distinction. We agree.)

The second is the meaning of “profit” in s62(2)(b); whether it refers to “gross” profit or “net” profit; and if “profit” is a reference to net profit, the items that can be taken into account in computing the net profit for these purposes. We refer to this question as the ““profit” issue” in this decision notice.

33. The FTT reached its decision by reference to the “from” issue. It did not address the “profit” issue other than as part of its analysis of the judgment of Finlay J in Eagles, to which we turn later in this decision notice. In our view, the FTT’s failure to consider the “profit” issue led it into error.

34. We have set out below our analysis, from which the points at which we differ from the FTT will be apparent.

The relevant case law

35. We will begin with the case law authorities.

36. We were referred by the parties to various authorities. We do not intend to embark upon a comprehensive review of them all. We have, however, in the paragraphs below, briefly discussed the main authorities to which we were referred and identified the key points of principle that we take from them.

The “from” issue

37. The vast majority of the judgments in the cases to which we were referred addressed the “from” issue – i.e. whether the alleged “profit” is derived “from” the employment. These included Laidler, Shil ton v Wilmshurst (1991) 64 TC 78, Kuehne & Nagel Drinks Logistics Ltd v HMRC [2012] EWCA Civ 34 (“Kuehne & Nagel”), and A v HMRC. Those cases focus on determining whether the relevant payment is from employment or from a non-employment source.

38. Extracts from the judgments in those cases (and others) are summarized by the FTT in the FTT Decision (FTT [40]-[50]). The FTT referred, in particular, to an extract from the judgment of Patten LJ in Kuehne & Nagel (Kuehne & Nagel [49]-[53]) in which he summarized the position as follows.

49. The issue on this appeal is whether the payments constituted “earnings from an employment”: see s9(2) ITEPA. It is conceded that they were “earnings” as defined in s62(2) if they were from the employment. On that basis, they were clearly an “other profit or incidental benefit” or an “emolument”. It is also accepted that their taxability under s.401 as a payment made on the termination of employment only arises if they are not within the s9 charge: see s401(3).

50. What constitutes an emolument or other benefit from an employment has been the subject of judicial analysis for almost 100 years. As Mummery LJ has explained in his judgment, our task is to apply the statutory test to the facts found and not to apply some other test based on a gloss: see e.g. Hochstrasser v Mayes [1959] 38 TC 673 per Lord Radcliffe at p707. But some gloss is inevitable because it is accepted that it is not enough merely to show that the payment was received as an employee and would not have been received if the individual had not been an employee. Something more must be established. This has been expressed in terms of the difference between causa sine qua non and causa causans but it does, on any view, require a sufficient causal link to be established between the payment and the employment.

51. The ways in which that necessary link has been described and analysed in the earlier cases does, I think, have to be respected even though the ultimate question is whether the “from” question can be answered in the affirmative. Neill LJ in Hamblett v Godfrey [1986] 59 TC 694 at p. 726 G-H describes those explanations as valuable and authoritative. And what the cases, I think, show is that the

question of taxability involves one being able to characterise the payment as one “from employment” if it derives “from being or becoming an employee" and is not attributable to something else such as a mark of esteem or a desire to relieve distress. I take this formulation from Lord Templeman in Shilton v Wilmshurst [1991] 64 TC 78 at p105 G-I because this is how the words “from employment” were construed and that decision is, I believe, binding on us in that respect. The same test was adopted by Lord Reid in Laidler v Perry [1965] 42 TC 351 at p363 and by Lord Kilbrandon in Brumby v Milner [1976] 51 TC 583 at p614.

52. It must follow from this that, in order to satisfy the s9 test, one must be able to say that the payment is from employment rather than from a non-employment source. This has certainly been the approach of the courts in most of the decided cases, examples of which are:

(i) Viscount Simonds in Hochstrasser v Mayes at p705/706 “often difficult to draw the line and say on which side of it a particular case falls”;

(ii) Lord Wilberforce in Brumby v Milner at p612 “not an easy question to answer”;

(iii) Lord Diplock in Tyrer v Smart [1979] STC 34 at p36c-d: “determination of what constitutes his dominant purpose”; and

(iv) Carnwath J in Wilcock v Eve [1994] 67 TC 223 at p232A: where there is more than one operative cause “there is an element of value judgment in deciding on which side of the statutory line the payment falls”.

53. This process of evaluation requires the fact-finding judge to make findings of primary fact based on the evidence as to the reasons and background to the payment and then to apply a judgment as to whether the payment was from the employment rather than from something else. To this extent, I agree with the appellants so far as they submit that having determined the causes of the payment that process of characterisation must then follow. The interpretation of the words "from employment" by the House of Lords in the cases referred to makes that an inevitable step in answering the statutory question. Although this is the only question (see Russell LJ in Brumby v Milner at p608), it still has to be answered.

39. We would adopt that summary.

The “profit” issue

40. In contrast to the “from” issue, there were no authorities, which directly addressed the “profit” issue – i.e. the meaning of “profit” and whether it is gross or net.

41. On this question, Mr Collins relies primarily on two cases in support of his submission that, to the extent that Mr Murphy was obliged to make payments in respect of the Success Fee and the insurance premium out of the Principal Settlement Sum, he cannot be regarded as having made a “profit” within s62(2)(b) ITEPA.

Eagles v Levy

42. The first is the decision of Finlay J in Eagles.

43. In Eagles, the taxpayer brought an action in the High Court in respect of unpaid remuneration from his position as managing director. The action was settled upon terms that £45,000 was to be paid by the employer to the taxpayer. The Inland Revenue assessed the taxpayer on the payment of £45,000 as employment income. The taxpayer argued that the payment of £45,000 was an agreed sum

to cover his claim for remuneration and his costs and expenses and that the amount of those costs and expenses was not assessable to income tax. The General Commissioners found in favour of the taxpayer and reduced the assessment by the amount of the taxpayer's costs. They did not give reasons. Finlay J allowed the Inland Revenue's appeal.

44. Finlay J's reasoning would appear to be as follows:

There were two possible bases on which the General Commissioners could have found in favour of the taxpayer:

either the costs were allowable deductions which the taxpayer was necessarily obliged to incur; or

the costs were included in the settlement sum of £45,000 and so that element of costs was not taxable.

If the reason was that the costs were an allowable deduction (i.e. (a) above), the General Commissioners were wrong. The costs were not an allowable deduction.

If the reason was that the costs were included in the settlement sum (i.e. (b) above), on the facts, the General Commissioners were again wrong. On the facts, the costs were not included within the settlement sum.

45. As part of that reasoning, Finlay J accepted (at p30) counsel for the taxpayer's submission (at p29) that if the taxpayer had been "necessarily obliged to pay the said costs in order to obtain the payment of the remuneration due to him" then the decision of the General Commissioners would have been supportable.

46. Finlay J reached his conclusion that the costs were not included within the settlement sum on the basis of a statement made by counsel in the previous proceedings that "The sum of £45,000 is a comprehensive sum; there are no costs on either side in the matter" which Finlay J construed as meaning that the parties had deliberately excluded costs from the settlement sum "with rather meticulous care". He said this (at p31):

It seems to me that, when one reads that, one sees that it is quite definite that there is a sum of £45,000 and that, as plainly as possible, costs are excluded from that so as to form no part of it. After all, one cannot entirely neglect this aspect of the matter. If now I were to hold that £5,000 or £6,000, or whatever it was, was costs of the action, that would mean that the directors pro tanto were paying the costs. That seems to me to be exactly what great pains were taken to prevent. I think, therefore, accepting as I do accept – and this point is the only point which gives me the least difficulty – the test which [counsel for the taxpayer] put to me, and taking, as I do, the view that this was a question of fact upon which, if there was evidence, the Commissioners were entitled to find, I arrive at the conclusion that on the materials before them they could arrive only at one conclusion, which is that this £45,000 did not to any extent represent costs but, on the contrary, was a sum from which costs were, with rather meticulous care, excluded. It therefore results that I am unable to think that the decision of the Commissioners can be supported on either of the grounds, on one of which they must be taken to have made it, and the appeal of the Crown is allowed.

47. We agree with Mr Collins that there is an assumption behind Finlay J's reasoning, and his finding that costs were not part of the settlement sum, namely that if they were, that amount would not have been taxable. If they were taxable as part of the settlement sum, there would have been no need to make that factual finding.

48. In our view, it is implicit in the reasoning of Finlay J in Eagles that it is the net sum after costs have been deducted that is taxable. If the taxpayer had received an amount in respect of his costs but had been necessarily obliged to pay the costs in order to receive the settlement sum, he would not have paid tax on that amount.

Hochstrasser v Mayes

49. The second case on which Mr Collins relies is Hochstrasser.

50. Hochstrasser concerned the taxation of a payment of £350 made by an employer to an employee to compensate the employee for the loss on a sale of his house on moving to a different job with the same employer. The payment was made under a separate housing agreement with the employee and not under his employment contract. The House of Lords decided unanimously that the payment was not taxable as employment income.

51. Most of the members of the House of Lords decided the case on the basis that the £350 compensation payment was paid to the employee under the housing agreement. It was not paid as a reward for services and it was not therefore a profit “from” his employment. The employment was not “the causa causans” of the payment, but only “the causa sine qua non” (see Viscount Simmonds at p389, Lord Cohen at p395). Most of their Lordships therefore decided the case by reference to the “from” issue and did not address the “profit” issue.

52. Mr Collins referred us, however, to the speech of Lord Denning who approached the issue rather differently. He said this (at p396-7):

My Lords, tried by the touchstone of common sense - which is, perhaps, rather a rash test to take in a revenue matter - I regard this as a plain case. No one coming fresh to it, untrammelled by cases, could regard this £350 as a profit from the employment. Mr. Mayes did not make a profit on the resale of the house. He made a loss. And even if he had made a profit, it would not have been taxable. How, then, can his loss be taxable, simply because he has been indemnified against it? I can readily appreciate the case which was put in argument - namely, that if an employer, by way of reward for services, agrees to indemnify his employee against his losses on the Stock Exchange, the payments which the employee received under the indemnity would be taxable. But that would be because the losses were his own affair and nothing to do with his employment: the payments of indemnity would there be a straight reward for services. This payment of £350 was nothing of that kind. It was a loss which Mr. Mayes incurred in consequence of his employment and his employers indemnified him against it. I cannot see that he gets any profit therefrom. If Mr. Mayes had been injured at work and received money compensation for his injuries, no one would suggest that it was a profit from his employment. Nor so here, where all he receives is compensation for his loss.

53. Later cases tend to refer to the judgments of the other members of the House of Lords without reference to Lord Denning’s speech. However, we agree with Mr Collins, that Lord Denning’s focus on the actual profit that the employee made from the payment, and his distinction between a payment made by way of compensation for losses incurred in consequence of the employee’s employment and payment made to compensate an employee for losses “which were his own affair and nothing to do with his employment” is instructive. Although Lord Denning did not address the issue in terms of whether the measure of profit was gross or net, he was clear that on the facts of the case that there was no profit at all.

Other cases

54. We also derive some assistance from two of the cases which deal with reimbursement of expenses.

55. The first of those cases is Pook (HM Inspector of Taxes) v Owen (1969) TC 571.

56. Pook v Owen involved a doctor in general practice, who also held part-time appointments as an obstetrician and anaesthetist at a hospital. He received a payment from his employer reimbursing him for the costs of travelling between his home and the hospital. He argued that the payment was not taxable as an emolument or, in the alternative, that the payment was deductible from his earnings (under the provisions that are now contained in s336 and s337 ITEPA).

57. The only issue that is relevant for our purposes is whether the payment was an emolument. However, the process of determining a ratio from judgments of the members of the House in Lords on that issue is complicated by the fact that the judgments also address the question as to whether the payment was an allowable deduction under the statutory provisions, with different members of the House of Lords reaching differing conclusions on the two issues.

58. Lord Guest and Lord Pearce found that the payment was not an emolument and was deductible. Lord Guest said this (at p589):

The facts in that case [Hochstrasser] were widely different from the present, but if the proper test is whether the sum is a reward for services, then, in my view, the travelling allowances paid to Dr. Owen are not emoluments. To say that Dr. Owen is to that extent "better off" is not to the point. The allowances were used to fill a hole in his emoluments by his expenditure on travel. The allowances were made for the convenience of the employee to allow him to do his work at the hospital from a suitably adjacent area. In my view, the travelling allowances were not emoluments.

59. Lord Donovan agreed that the payment was not an emolument (although he did not agree that the payment was deductible under the statutory provisions). He said this (at p593):

It is also interesting to notice the decision of the Court of Appeal in Reg. v Postmaster General (1878) 3 Q.B.D. 428. There an ex-employee of a private concern, whose business had been taken over by the Postmaster General, was entitled to receive from him compensation based on his past emoluments from the private employer. He used to receive from him travelling and subsistence allowances which yielded him a small profit. It was held that this profit was part of the ex-employee's emoluments. No one suggested that the allowances were, as a whole, part of the claimant's "emoluments". On the footing that the travelling expenses paid to Dr. Owen simply reimbursed what he had spent (or part-of what he had spent) on travelling in performance of his duties, I do not think they should be regarded as emoluments of his employment...

60. Lord Wilberforce decided the case on the basis that the expenses were deductible. Lord Pearson dissented: he considered that the expenses were not deductible and because of that they were emoluments.

61. As we have mentioned above, the relevant issue for our purposes is whether the payment was an emolument. A majority of the House of Lords found that the reimbursement of expenses properly incurred was not an emolument. In reaching that conclusion, the extracts from the judgments of Lord Guest and Lord Donovan both suggest that a key question is whether the employee has made an overall (i.e. net) profit. On the facts of Pook v Owen, there was no profit from the employment because the amount of the payment from the employer was equal to the expenses incurred by the employee (and so there was no emolument).

62. The second case is the decision of Walton J in Donnelly (Inspector of Taxes) v Williamson [1982] STC 88.

63. This case involved a teacher who received a payment reimbursing her for the expenses of travelling to out of school functions which did not form part of the duties that she was obliged to perform under her contract of employment. Walton J held that the payment was not an emolument on the basis that the payment was not received by the teacher "for acting as an employee" (p93g) (i.e. on the basis of the "from" issue). However, he went on to consider the earlier authorities, including the judgments in Pook v Owen. He concluded that the ratio of the majority (Lords Guest, Pearce and Donovan) was that "repayment of expenses is not an emolument" and that this conclusion was "unassailable" (at p97b-c). In the context of an allowance that was paid for the use of a car, the question was "whether the allowance… in question was intended as a genuine estimate of the cost to the taxpayer of undertaking the journeys that she did take, or whether on the other hand, it included an element of bounty" (at p97e). If there was an element of bounty involved, then this would be a benefit that would be taxable; but, if the intention was only to reimburse expenses that had been genuinely incurred, then there was no real benefit, no profit, and so the reimbursement would not be taxable.

64. Even though these cases are concerned with reimbursement of expenses, they demonstrate that the courts are looking to see whether the employee actually received a profit or benefit over and above the reimbursed expenses in addition to analysing the source of the payment made by the employer.

Application to the facts of this case

65. We should now turn to the application of these principles to the facts of this case.

The Settlement Agreement

66. Our starting point is clause 3.1 of the Settlement Agreement. Under clause 3.1, the aggregate of the Principal Settlement Sum and the Agreed Costs (i.e. the Global Settlement Sum) is paid to the Claimants in full and final settlement of the Settled Claim i.e. the claim for unpaid overtime and hardship allowances.

67. The Global Settlement Sum is defined in clause 3.2 to include the Principal Settlement Sum and the Agreed Costs. The Global Settlement Sum is then applied under clause 3.3 to meet the payments in respect of Success Fee (clause 3.3(a)) and the insurance premium (clause 3.3(b)) before being divided between the Claimants in the agreed proportions (clause 3.3(c)).

68. In terms of the structure of the Settlement Agreement, unlike the Agreed Costs, the Success Fee and the insurance premium are not separately identified as part of the Global Settlement Sum. Also unlike the Agreed Costs, the Success Fee and the insurance premium are discharged by direct payments to SMB, counsel and Temple under the terms of clause 3.3. The Settlement Agreement does not directly address this point, but we must assume that the Claimants were left to settle the Agreed Costs out of the amounts allocated to them under clause 3.3(c) or their other resources. These differences are driven by the facts that, at the time of the execution of the Settlement Agreement, the amount of the Agreed Costs had not been determined and that, under the terms of the DBA, the Claimants were obliged to procure the direct payment of the Success Fee to SMB and counsel.

69. In terms of the economic substance, however, no real distinction can be made between the Agreed Costs, and the Success Fee and the insurance premium: they are all amounts that the

Claimants had to meet out of the Global Settlement Sum; and they are all amounts which the Claimants had to incur in order to pursue the claim and obtain the settlement.

The FTT's analysis

70. The FTT recorded in the FTT Decision that it was common ground that the amount paid in respect of the Agreed Costs was not taxable as employment income because it was paid in respect of "something else", namely the costs incurred in the case (FTT [54]). It then distinguished the payments in respect of the Success Fee and the insurance premium and the payment in respect of the Agreed Costs on the grounds that the Principal Settlement Sum from which those amounts would be discharged "did not include a payment in respect of costs" relying on clause 8.1 of the Settlement Agreement and parallels which it drew from the decision of Finlay J in Eagles (FTT [56] and [57]).

71. As we have mentioned above, the definition of the Global Settlement Sum did not include a specific amount in respect of the Success Fee or the insurance premium. However, we can see no other reason to distinguish the payment in respect of Agreed Costs from the payments made in respect of the Success Fee and the insurance premium on either of these grounds.

First, the Agreed Costs, the Success Fee and the insurance premium were all costs incurred in the action. The only difference is that the payment for Agreed Costs is an unascertained (at the time of the agreement) amount added to the fixed element of the agreed settlement sum (the £4.2m) whereas the Success Fee and the insurance premium are ascertained amounts and have to be discharged out of the fixed element of the agreed settlement sum.

Second, in our view, the reliance upon Eagles is misplaced.

This is not a case like Eagles where there was no requirement to pay the legal costs out of the settlement sum. Although, unlike the Agreed Costs, they were not separately identified as constituent elements of the Global Settlement Sum, the Met was expressly obliged to discharge the Success Fee and the insurance premium out of the Global Settlement Sum (in clause 3.3(a) and (b)). The Success Fee and the insurance premium were not excluded from the Global Settlement Sum "with meticulous care".

In any event, on the reasoning of Finlay J in Eagles, he would have regarded the costs as deductible in computing the amount on which the taxpayer was liable to tax, if the taxpayer had been "necessarily obliged" to pay the costs in order to receive the settlement sum. In this case, the Claimants had to incur the Agreed Costs, the Success Fee and the insurance premium to obtain the settlement sum.

Our approach

72. The traditional approach of the courts when faced with cases in which employees have incurred expenditure or a loss and seek to argue that a corresponding amount received from their employers should not be treated as their earnings has been to approach the question by reference to the "from" issue and ask whether the payment that is received from the employer is derived "from" the employment (whether as a "reward for services" or "for being or becoming an employee"), or from "something else".

73. That approach can be applied most naturally in cases where the employer makes a separate payment over and above the normal amounts of salary or wages to compensate the employee for a specific liability or cost that the employee has incurred (i.e. the reimbursement cases). In such cases, where the taxpayer is successful in arguing that the amount is not earnings, the analysis applied by

the courts is that the employee is being paid an amount which the employee would not have received but for the fact that he or she is an employee; however, the amount is not a reward for services but for something else – such as compensation for travel costs (in Pook v Owen or Donnelly v Williamson) or a loss incurred on moving house to take up employment (Hochstrasser) – and so is not regarded as earnings.

74. As we have discussed, in our view, the reimbursement cases demonstrate that the focus of the courts in these cases is also on whether or not the employee can properly be said to have made an overall profit (i.e. a net profit) from their employment as a result of the payment from their employer. That is the "profit" issue.

75. With the exception of Eagles, the cases do not address circumstances in which an employee incurs a liability or cost which the employee seeks to deduct in computing the employee's earnings from an amount received from an employer which would otherwise demonstrably be regarded as derived "from" employment. However, in cases where s62(2)(b) ITEPA applies to such a payment, in our view, the court must also have regard to the "profit" issue in computing how much of that payment can properly be regarded as earnings. These cases will necessarily be limited to cases to which s62(2)(a) ITEPA is not in point.

76. That leads to the more difficult question as to what is the test for determining whether an amount can be taken into account in computing the amount of profit which the employee obtains from a particular payment for the purpose of s62(2)(b) ITEPA. In the cases to which we have referred, the judges have used different terminology to express the connection to the employment that a payment must have in order to be taken into account for this purpose. In Hochstrasser, a reimbursement case, Lord Denning employed a distinction between a loss or expense which was the employee's "own affair and nothing to do with [the employee's] employment" as opposed to a loss or expense incurred "in consequence of [the employee's] employment". In Eagles, a case concerning deduction of costs from an otherwise taxable payment of earnings, Finlay J would have regarded the legal costs as deductible where the taxpayer was "necessarily obliged" to incur them in order to obtain the payment.

The Agreed Costs

77. In the present case, the amount that the Claimants receive from their employer is the Global Settlement Sum. The parties are agreed that in so far as this payment is made in respect of the Agreed Costs it is not taxable. This is on the grounds that the payment is of an amount over and above the amount that is paid to compensate the Claimants for the unpaid overtime and hardship allowances (the Principal Settlement Sum) and it is not a reward for services because it is for "something else" i.e. the costs incurred in the action against the Met. On that basis, the Global Settlement Sum is not earnings "from" an employment to the extent that it compensates for the Agreed Costs.

78. In any event, even if the amount of the Global Settlement Sum that is paid by the Met to compensate the Claimants for the Agreed Costs were to be regarded as derived "from" the Claimants' employment (for example, because the claim which gives rise to the payment arose from the Met's failure to make payments due to the Claimants' under their employment contracts), the Claimants could not be regarded as making a "profit" within s62(2)(b) to that extent. In the words of Lord Guest in Pook v Owen, the payment of the amount in respect of the Agreed Costs did not make the Claimants "better off", it was used "to fill a hole in [their] emoluments". This analysis is consistent with the way Lord Denning viewed the payment in Hochstrasser.

The Success Fee and the insurance premium

79. In our view, the same analysis can be used in respect of the other legal costs incurred by the Claimants.

80. Even if the Principal Settlement Sum can be regarded as derived "from" the Claimants' employments on the grounds that it was paid to compensate them for the Met's failure to pay the overtime and hardship allowances due under their employment contracts, it is then necessary, in our view, to go on to consider the amount of the Principal Settlement Sum that should properly be regarded as a "profit" that the Claimants obtained from their employment within the terms of s62(2)(b) and which is therefore taxable as employment income – and, in particular, whether the payments of the Success Fee and the insurance premium should be deducted to arrive at the net profit to be taxed.

81. We consider that payments such as the Success Fee and the insurance premium, which are necessarily incurred in order to obtain the payment derived from the employment, should be deducted in the calculation of the net profit received by the Claimants. The Claimants only incurred these costs because the Met had not paid the full amounts that they were owed for their employment. They were costs which the Claimants had to incur in order to obtain the payment. The DBA was the way that the Claimants' chose to fund their litigation. We cannot see that it makes any difference that the fees were paid pursuant to a DBA rather than any other funding arrangement. The insurance premium was also a payment that the Claimants had to make for the litigation to be feasible.

82. Mr Carey says that the payments made under the DBA and in respect of the insurance premium were payments in respect of the Claimants' own liabilities by which we take him to mean they were the Claimants' "own affair" and "nothing to do with their employment" to use the phrase of Lord Denning in Hochstrasser. We disagree. For the reasons that we have given, the Agreed Costs, the Success Fee and the insurance premium were all incurred for the same reason – in order to progress the claim against the Met for the unpaid overtime and hardship allowances.

Conclusion

83. In the present case, there is no reason to distinguish between the various categories of costs. Each of the Agreed Costs, the Success Fee and the insurance premium were necessarily incurred by the Claimants in obtaining the Global Settlement Sum.

84. The parties agreed that the part of the Global Settlement Sum that was paid to compensate the Claimants for the Agreed Costs was not derived "from" employment. As regards the remainder of the Global Settlement Sum, the only "profit" within s62(2)(b) ITEPA that the Claimants obtained from the settlement was the amount of the Principal Settlement Sum less the aggregate of the Success Fee and the insurance premium.

85. We therefore agree with Mr Collins that the amount of employment income on which Mr Murphy should be taxed is the proportion of the Principal Settlement Sum to which he was entitled less a proportionate share of each of the Success Fee and the insurance premium.

Other grounds of appeal

86. Our conclusion on this issue – which was essentially the second ground of Mr Murphy's appeal – decides this appeal in favour of Mr Murphy. We have addressed issues which touch upon the other grounds of appeal in passing, but we do not need to address them separately and do not do so.

Decision

87. For the reasons we have given, in our view, the FTT erred in its approach to the treatment of the Success Fee and the insurance premium by failing to consider the “profit” issue. That error was an error of law. We set aside the FTT Decision on that basis.

88. We will remake the decision. Mr Murphy did not make a “profit” within s62(2)(b) ITEPA to the extent that the Principal Settlement Sum was paid in discharge of the Success Fee and the insurance premium and those amounts should not be treated as earnings of Mr Murphy under s62 ITEPA.

89. We allow this appeal.

Signed on Original

MR JUSTICE MICHAEL GREEN **ASHLEY GREENBANK**

UPPER TRIBUNAL JUDGES

Release date: 29 June 2021