[2020] UKFTT 0272 (TC)

TC07756

Appeal number: TC/2018/00589

National Insurance contributions – limited liability partnership – employees' bonus scheme – bonuses paid after employees had become members of partnership – whether employed or self-employed earnings

FIRST-TIER TRIBUNAL
TAX CHAMBER

CHARLES TYRWHITT LLP **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE NICHOLAS PAINES QC

Sitting in public at Taylor House, Rosebery Avenue London EC1R 4QU on 21 October 2019

David Southern QC, instructed by RSM UK Tax and Accounting Ltd, for the Appellant

Paul Marks, litigator, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. Charles Tyrwhitt LLP carries on business as a retailer of shirts and other items of clothing. Unusually for a business of its size (with some 900 staff), it is structured as a limited liability partnership. This appeal under section 11 of the Social Security Contributions (Transfer of Functions) Act 1999 relates to a decision of HMRC concerning bonus payments paid to five members of the LLP under what was referred to as a Long Term Incentive Plan, or LTIP. The five recipients had all been employees of Charles Tyrwhitt prior to becoming members, and they had been admitted to the LTIP while they were employees. HMRC decided that the payments were subject to Class 1 primary and secondary National Insurance contributions (NICs) as earnings of employed earners. It is not in dispute that the five recipients were members of the partnership at the time that they received the bonus payments, and that the profits of an LLP are self-employed earnings in the hands of the members for tax and National Insurance purposes. However, their bonus entitlements were calculated by reference to profits of Charles Tyrwhitt earned at a time when all of them were employees.

2. The issue in brief is whether the bonus payments were (as Charles Tyrwhitt contends) fixed amounts of profits to which the recipients were entitled as members of the partnership or (as HMRC contend) deferred remuneration in respect of their earlier periods of employment. I am asked to decide this issue, but not to compute any liabilities consequent on my decision. The bonuses were substantial and the amount of NICs in issue is of the order of £1 million.

3. The bonuses were paid to two of the members on 1 May 2013 and to three others on 30 November 2013. At that time Charles Tyrwhitt accounted for income tax under PAYE and for primary and secondary employed earners' NICs; this, as Mr David Southern QC who appeared for Charles Tyrwhitt pointed out, excludes any possibility that avoidance of NIC liability formed part of the motivation for what was done. Subsequently Charles Tyrwhitt received new advice on the correct tax and NIC treatment of the payments and, in January 2015, claimed repayment from HMRC of the employed earner's NICs, maintaining that the payments fell to be taxed and assessed for NICs as self-employed earnings. In consequence HMRC opened enquiries into Charles Tyrwhitt's partnership tax returns; these were concluded with a refusal of repayment dated 5 July 2017, upheld on review on 12 January 2018. Charles Tyrwhitt appealed.

4. I have concluded, for the reasons I give below, that HMRC's decision was correct.

The facts

5. Charles Tyrwhitt was incorporated as a limited liability partnership under the Limited Liability Partnerships Act 2000 in October 2003. It is currently governed by a membership deed which took effect on 1 August 2012, as amended by a letter dated 4 April 2014. The founders, Mr Peter Higgins and Mr Nicholas Wheeler, are the designated members and are also described in the deed as "Key Members", and have particular powers. As at August 2012, Mr Higgins, Mr Wheeler and a company called

Wheeler Higgins Ltd were the only members. At the time of the amendment letter there were a further seven members, including the five former employees whose NIC liability is in issue in this appeal.

6. Those five joined Charles Tyrwhitt as senior employees at points in time prior to 2010. In that capacity they were members of one or other of two bonus schemes, referred to in argument as scheme A and scheme B. The schemes had been set up in 2008, but each of the five received a letter from Mr Wheeler formalising the terms of their respective schemes; in four cases the letter was dated 28 January 2010 while in the fifth case it was dated 2 August 2010. In it Charles Tyrwhitt is referred to as "the Company". The terms of both schemes were significantly amended subsequently, as I shall go on to describe.

7. The two employees in scheme A were Mr Greg Hodder, Charles Tyrwhitt's Managing Director and Mr Mark Higgins, its Operations Director. Mr Hodder was at that time engaged under a contract of employment dated 25 March 2009, which provided "BONUS & LTIP. You shall be eligible to participate in the Company's Executive Bonus and LTIP Plan". Mr Higgins had been a member of the LLP, but had reverted to employee status in 2009. His terms of employment were retrospectively agreed in a jointly signed letter of February 2011, which included the statement "you are a member of the Executive Long Term Incentive Plan".

8. The 2010 letters were in identical terms and included the following:

> As part of its ongoing responsibilities the board of directors of the Company (the Board) has reviewed the incentive arrangements for the directors and other senior managers.
>
> The Board considers it is important both that the interests of the directors and senior management are aligned with Members and that the directors and senior management are incentivised to build the value of the Company over the medium to long term. Consequently, a long-term incentive plan (LTIP) was adopted by the company. It was, and still is, intended that participation in the LTIP will be limited to the directors and other senior managers.
>
> … the Board considers it prudent to set down in writing the terms of the LTIP. These terms, including further information on the performance target to be attained, is set out in the Schedule to this letter.

9. Mr Hodder and Mr Higgins countersigned their respective letters to confirm their consent to them. Each of them was defined in his schedule as "the Employee" and their respective job titles and home addresses were noted. The terms of their schedules were identical, except that different calculation percentages were used in their respective bonus calculations.

10. The scheme employed the concepts of a base year and a calculation period. The base year in their case was the year to 31 July 2010 and the calculation period was the base year plus a further period ending on the "long stop date". The long stop date depended on whether the employee exercised an option to receive bonus early. If so,

the long stop date was 31 July 2012; otherwise it was 31 July 2013. The option could only be exercised during a 30-day period following the auditing of the LLP's accounts for the period to 31 July 2012.

11. The calculation was based on the difference between Charles Tyrwhitt's earnings before tax in the base year and its average earnings before tax in the remainder of the calculation period, multiplied by a multiple of seven and by a calculation percentage that differed for each employee.

12. Clause 6 governed eligibility for the bonus. It entitled the board to deem any senior employee or full time director of Charles Tyrwhitt or a group company eligible for a bonus. To remain eligible, an employee had to remain employed by Charles Tyrwhitt or a group company on 30 November (or, if earlier, the date of auditing of the accounts) in 2012 if he exercised the option or 2013 if he did not, or alternatively to have left otherwise than as a "bad leaver". A bad leaver was someone who had been dismissed for breach of his service agreement (unless the dismissal was found to be wrongful or unfair) or had either resigned in breach of his service agreement or had resigned before the long stop date except in circumstances of injury, disability, ill-health, death or redundancy.

13. One of the consequences of clause 6 as originally drafted was that a person whose employment terminated as a result of becoming a member of the LLP might technically be a "bad leaver" and lose his entitlement to bonus. Mr Higgins and Mr Hodder received identically worded letters dated 20 July 2012, varying the terms of the LTIP in the context of "preparations for certain key personnel to become Members of the Company". The letter referred to the LTIP (erroneously, it seems, describing it as having been set out in a letter of 28 February 2012; there is no letter of that date in the papers). It continued

> We are currently making preparations for certain key personnel to become Members of the Company. So that the change in status from being an employee to becoming a member does not affect eligibility under the existing LTIP Scheme, we have made corresponding changes to its terms.
>
> I ask you to review the Schedule below which sets out these revised terms….

14. The new schedule of scheme terms differed from the old in various respects; one of these was a revised definition of their "Appointment" which gave their job titles and added the words "irrespective of his status from time to time whether it be as an employee … or as a member, of the Company". "Appointed" was to be construed accordingly.

15. The eligibility clause continued to empower the board to deem senior employees or full time directors eligible for the scheme, but entitlement to receive a bonus now depended on still being "Appointed" – in the extended meaning of the term – on 31 January 2014, unless the recipient was a "Good Leaver" (as newly defined) or a (newly introduced) "Early Leaver". An Early Leaver was an employee whose Appointment terminated before 31 January 2014 but after 6 April 2013 if he had exercised the early

payment option or after 30 November 2013 if he had not, subject to the proviso that he was not a Bad Leaver or a Good Leaver. A new final clause provided that Charles Tyrwhitt would make the appropriate tax and National Insurance deductions depending on whether the payee was an employee (within section 230 of the Employment Rights Act 1996) or a member of the LLP as at the time of payment.

16. Mr Higgins and Mr Hodder became members of the LLP on 1 August 2012. Both exercised their options to have a long stop date of 31 July 2012; their bonuses were paid to them in May 2013; this was earlier than the date – 31 January 2014 – on which they definitively fulfilled the conditions of entitlement, but nothing turns on that; they had reached a point at which leaving would have made them Early Leavers. The payments were made in the 2013/2014 tax year, in which they were not employees.

17. The employees in LTIP scheme B were the Finance and IT Director, Mr Tony Bennett, the E-Commerce Director, Mr Luke Kingsnorth and the Buying Director, Mr Nick Reed. Mr Reed had been employed since April 2007 under a contract of employment that said "You shall be eligible to participate in the Company Bonus Plan". It then gave details of a bonus that was subject to the Company achieving its budget. Mr Bennett's contract dated February 2009 used the formula "BONUS & LTIP. You shall be eligible to participate in the Company's Executive Bonus and LTIP Plan". He and Mr Reed received letters of 28 January 2010 that were identically worded to those received by Mr Higgins and Mr Hodder. Mr Kingsnorth was employed under a contract dated 6 October 2009 which entitled him to a budget-related bonus. His letter formalising the scheme terms, identically worded to those of 28 January 2010, was dated 2 August 2010. His calculation period may have different from those of the others, but nothing turns on that.

18. The main difference in the original scheme B schedules of terms, compared to those of scheme A, is that they did not give the option of receiving bonus by reference to results as at 31 July 2012: the "long stop date" was 31 July 2013. Their eligibility clause required them to be employed as at 31 January 2014, or to have been a "good leaver".

19. The three employees also received letters identically worded to the letters of 20 July 2012 received by Mr Higgins and Mr Hodder; their letters were dated 1 July 2013. Their revised schedules of terms contained the same revised definition of "Appointment", the same revised eligibility clause and a similar final clause about tax and NI deductions at the time of payment. The definition of an Early Leaver in their case was an employee whose employment terminated before 31 January 2014 but after 30 November 2013 otherwise than as a Good or Bad Leaver. They became members of the LLP on 4 August 2013 and received bonus payments on 30 November 2013 – the date after which any voluntary departure would have made them Early Leavers. The payments were made in the 2013/2014 tax year; this, as Mr Paul Marks for HMRC pointed out, was a tax year in which the three had initially still been employees.

The legislative framework

Limited Liability Partnerships

20. Limited Liability Partnerships (LLPs) were created by the Limited Liability Partnerships Act 2003. They are taxed in the same way as "traditional" partnerships. Unlike traditional partnerships, their members have limited liability for the debts of the partnership and, in consequence, the partnership has legal personality as a corporation in its own right. Section 4 of the Act deals with membership of an LLP; section 4(4) provides

(4) A member of a limited liability partnership shall not be regarded for any purpose as employed by the partnership unless, if he and the other members were partners in a partnership, he would be regarded for that purpose as employed by the partnership.

21. The reference to "partners in a partnership" is to a traditional partnership, so the effect of the subsection is that a member of an LLP is not an employee of it unless the circumstances are such that he or she would be regarded as an employee of a traditional partnership. It has often been held that, in the law of England and Wales, a person cannot at the same time be an employee of a partnership and a partner in it; the reasoning is that an employee of a partnership is the employee of all the partners, and one cannot be an employee of oneself. (The position may be different in Scotland, where "traditional" partnerships do have legal personality; this may account for the conditional language of section 4(4), given that the 2003 Act also extends to Scotland.)

22. *Clyde & Co v Bates van Winkelhof* [2014] UKSC 32 has left it open whether in the law of England and Wales a person can have a contract of service with a partnership at the same time as being a partner in it (see paragraph 29 of the judgment), though in *Reinhard v Ondra LLP* [2015] EWHC 26 (Ch) Warren J held himself bound to "proceed on the basis that that a person cannot be an employee of the firm in which he is a partner". I do not need to decide the abstract question of whether it is possible in England and Wales to be simultaneously a member and an employee of a partnership or an LLP. Nothing in the materials I have seen supports the suggestion that the "LTIP 5" (as they have been nicknamed) remained employees after becoming members of the LLP, and HMRC have not asserted that they did. HMRC's case is based on the proposition that the bonuses were deferred remuneration attributable to their former employment status. I find as a fact that, as at the date of payment of the bonuses, they were members of the LLP and not its employees.

National Insurance contributions

23. Liability for National Insurance contributions is governed by the Social Security Contributions and Benefits Act 1992. Confusingly, section 122 of it (interpretation) defines "employment" and "employed" as including any trade, business, profession, office or vocation, with the result that it covers both employment and self-employment in the everyday meaning of those terms; section 3 defines "earnings and "earner" by reference to any remuneration or profit derived from an employment (in the wide,

section 122 sense). However, section 2 (categories of earners) defines an "employed earner" as a person who "is gainfully employed in Great Britain" under a contract of service or in an office. Any one else who is gainfully employed in Great Britain is a "self-employed earner". It is possible to be both at the same time (section 2(5)).

24. Section 6 makes the earnings of an employed earner subject to primary and secondary Class 1 NICs; they are payable without regard to the person's earnings in respect of any other "employment" (in the wide sense). The criterion is that "in any tax week earnings are paid to or for the benefit of an earner over the age of 16 in respect of any one employment of his which is employed earner's employment". The earner is liable for the primary contributions and the "secondary contributor" (usually the employer) is liable for the secondary contributions, but provisions in schedule 1 to the Act require the secondary contributor to pay both contributions, recovering the amount of the primary contribution from the earner. Profits of a self-employed earner, by contrast, are subject to Class 2 contributions under section 11 and Class 4 contributions (payable along with income tax in accordance with schedule 2) under section 15.

Income Tax

25. It was common ground between the parties that liability for employed earner's or self-employed earner's NICs is intended to follow liability for income tax on earnings under either the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") or the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA").

26. Section 1(1) of ITEPA provides that the Act imposes a charge to income tax on, inter alia, "employment income", employment being defined (section 4(1)) as including employment under a contract of service. Section 6 provides for the nature of the charge to tax: it does so by way of specifying that the charge is a charge to tax on "general earnings" and "specific employment income" and by cross-referring to various other provisions. For the purposes of ITEPA the bonus payments to the LTIP 5 are classed as general earnings, defined (section 7(3)) as earnings within the definition in section 62 and other amounts treated as earnings under various provisions. The definition of earnings in section 62 is wide, embracing

(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.

27. The amount of employment income charged to tax "for" a particular tax year is governed by section 9. In the case of general earnings, it is the "net taxable earnings from an employment in the tax year"; these are calculated under section 11 by taking the (gross) "taxable earnings from an employment in the tax year" and subtracting allowable deductions. The gross taxable earnings from an employment in a tax year are to be determined, for United Kingdom resident employees, under sections 15 to 19.

28. In the case of the general earnings for a tax year of a wholly United Kingdom resident employee, "the full amount of any general earnings … which are received in a tax year is an amount of "taxable earnings" from the employment in that year" (section 15(2)); this is so whether or not the employment is held when the earnings are received (section 15(3)).

29. Section 16 then returns to the concept of earnings "for" a tax year, specifying that general earnings that are earned "in, or otherwise in respect of" a particular period are general earnings for that period (and, if the period is a tax year, for that tax year). Section 17 applies in a case where general earnings from an employment would otherwise fall to be regarded as general earnings for a tax year in which the employee does not hold the employment; it specifies (inter alia) that "if that year falls after the last tax year in which the employment was held, the earnings are to be treated as general earnings for that last tax year". The section is the successor to legislation introduced to reverse the result of *Bray (Inspector of Taxes) v Best* [1989] STC 159, which I discuss below.

30. Finally, so far as presently relevant, section 18 provides that general earnings consisting of money are received at the earlier of the time at which payment is made of or on account of the earnings or the time when a person becomes entitled to payment of or on account of the earnings. The bonus payments in this case were paid prior to 31 January 2014 when entitlement formally crystallised; if they are taxable as earnings, the dates of payment prevail over the date of entitlement, but those dates were in any event ones at which the LTIP 5 were members of Charles Tyrwhitt LLP and (as I have found) had ceased to be its employees.

31. The profits of a partnership, including an LLP, are taxable in the hands of the partners or members as profits of a trade, profession or vocation under ITTOIA. (This is subject to special rules for salaried members of LLPs, which neither party suggested were relevant in this case.) Under section 7 of ITTOIA, tax is charged on the profits of the "basis period" for a particular tax year. The basis period is in general the period of 12 months ending with the accounting date that falls in the tax year (section 198); the accounting date is the date in the tax year to which accounts are drawn up (section 197). Unlike the provisions of ITEPA, which were heavily discussed, the provisions on ITTOIA were not the subject of detailed submissions. I note that the legislative provisions provided to me included section 4 of ITTOIA, which provides that a receipt or credit item falling within both Part 2 of ITTOIA and Part 2 of ITEPA (employment income) is dealt with under ITEPA, but neither party suggested that that provided an answer in this case.

Case-law

32. The authorities relied on by the parties fell into three broad categories: authorities on the "source" principle of income taxation; authority on the interpretation of the relevant tax and National Insurance legislation; and authorities both on the taxation of partners and on the sometimes difficult borderline between employee and partner status.

33. As regards the last of those categories, I have already referred to the *Clyde & Co* and *Reinhard* cases. I was also taken to *Tiffin v Lester Aldridge* [2012] EWCA Civ 35, a case on section 4(4) of the Limited Liability Partnerships Act that preceded *Clyde & Co,* and reference was made in closing to *Williamson & Sowden v Briars* UKEAT/0611/10/DM, which I read after the hearing. I do not need to discuss these two authorities given my conclusion at paragraph 22 above that the five recipients of bonus payments had the status of members of the LLP, and not employees, at the time they received the payments. I do, however, need to discuss the authorities on the source principle and on the interpretation of the legislation. Before doing so, I shall note the authority that Mr Southern relied upon concerning the taxation of partners.

34. *MacKinlay (Inspector of Taxes) v Arthur Young McClelland Moores & Co* [1990] 2 AC 239 [1989] STC 898 concerned the practice of the taxpayer firm of paying the removal expenses of partners and staff who moved to work at a different office at the firm's request. The issue was whether removal expenses paid to partners were a deductible expense of the firm, given that the removal expenses of a sole trader in similar circumstances would not be a business expense; it was held that the removal expenses were not deductible. Mr Southern relied on the following preliminary passage in the speech of Lord Oliver (with whom the other members of the House agreed), allowing the Revenue's appeal:

> Before turning to the facts of the instant case, I ought, perhaps, to say a word about the position, both generally and in relation to income tax of partners in a firm. A partner working in the business or undertaking of the partnership is in a very different position from an employee. He has no contract of employment for he is, with his partners, an owner of the undertaking in which he is engaged and he is entitled, with his partners, to an undivided share in all the assets of the undertaking. In receiving any money or property out of the partnership funds or assets, he is to an extent receiving not only his own property but also the property of his co-partners. Every such receipt must, therefore, be brought into account in computing his share of the profits or assets. Equally, of course, any expenditure which he incurs out of his own pocket on behalf of the partnership in the proper performance of his duties as a partner will be brought into account against his co-partners in such computation. If, with the agreement of his partners, he pays himself a 'salary', this merely means that he receives an additional part of the profits before they fall to be divided between the partners in the appropriate proportions. But the 'salary' remains part of the profits.

The "source" principle

35. Mr Southern placed reliance on the "source" principle – broadly, the principle that income is only taxable if it emanates from a taxable source, and that it is taxed in accordance with the rules applying to the source in question. He began with the reminder in *Ashraf v HMRC* [2018] UKFTT 97 (TC) (paragraphs 22-27) that the United Kingdom tax system was at its inception a purely schedular system (one that identifies separate types of income and taxes each separately) and that it still identifies separate types of income for computational purposes. The extract quotes Tiley on *Revenue Law* on the consequences of this approach, in particular that "Where income falls within a

Part/Schedule, it falls to be computed in accordance with the rules in that Part/Schedule and no other", quoting *Mitchell and Edon (Inspectors of Taxes) v Ross* [1962] AC 813 (discussed further below), and explains that the references to Parts are, in the current legislation, to Parts 2 to 5 of ITTOIA and Parts 2, 9 and 10 of ITEPA.

36. Mr Southern's survey of the authorities began chronologically with *Fry (Inspector of Taxes) v Salisbury House Estate Ltd* [1930] AC 432, which concerned lettings of commercial and residential accommodation together with the provision of heating, lighting, cleaning and similar services. The Revenue contended that, in addition to the tax due under the then schedule A, the taxpayer companies were liable for tax on all their income, less expenses, under schedule D, subject to an allowance for the tax charged under schedule A. This stance involved the assertion that the companies were liable to tax under schedule D as well as schedule A in respect of their letting income.

37. Rejecting this assertion, Lord Dunedin said, in the first of two passages on which Mr Southern relied:

> … the cardinal consideration in my judgment is that the Income Tax is only one tax, a tax on the income of the person whom it is sought to assess, and that the different Schedules are the modes in which the Statute directs this to be levied…. That tax is to be levied on the income of the individual whom it is proposed to assess, but then you have to consider the nature, the constituent parts, of his income to see which Schedule you are to apply.

38. Lord Atkin reviewed the schedules and concluded

> My Lords, nothing could be clearer to indicate that the Schedules are mutually exclusive; that the specific income must be assessed under the specific Schedule; and that D is a residual Schedule so drawn that its various Cases may carry out the object so far as possible or sweeping in profits not otherwise taxed.

39. *Salisbury House* was discussed in *Mitchell and Edon v Ross*, which concerned the tax position of medical consultants who were at the same time engaged in private practice and as hospital consultants in the (then relatively newly formed) NHS. The consultants maintained in effect that they were engaged in a profession of medical consultants and that their NHS appointment, which was necessary to them in order to give them the status of consultants, was merely part of their overall professional activity. They accepted that their NHS salaries were properly taxed under schedule E, but maintained that the expenses of the NHS practices, insofar as not deductible under the less generous schedule E rules, could be set against their private fee income as part of the expenses of the overall professional activity.

40. In a passage relied on by Mr Southern, Lord Radcliffe said

> My Lords, in my opinion this conception is untenable. I think that it is contrary to what the Income Tax Act itself requires, and I think it inconsistent with those rules about the structure of the taxing system and its necessary implications which we conveniently associate with the speeches made in this House in *Fry v*

Salisbury House Estate Ltd…. Generally speaking, the five Schedules of taxable categories are distinguished from each other by distinctions as to the nature of the source from which the chargeable profit arises…. Before you can assess a profit to tax you must be sure that you have properly identified its source or other description according to the correct Schedule: but, once you have done that, it is obligatory that it should be charged, if at all, under that Schedule and strictly in accordance with the Rules that are there laid down for assessments under it. It is a necessary consequence of this conception that the sources of profit in the different Schedules are mutually exclusive. This is what Viscount Dunedin said in the *Salisbury House* case when he accepted the proposition that "when income is dealt with in the proper Schedule the same income cannot be dealt with again under another Schedule." Also it is what Lord Atkin said: "… the dominance of each Schedule A, B, C and E over its own subject-matter is confirmed by reference to the sections and rules which respectively regulate them in the Act of 1842. They afford a complete code for each class of income dealing with allowances and exemptions, with the mode of assessment and with the officials whose duty it is to make the assessments."

41. As Mr Marks pointed out in respect of the *Salisbury House* case, both these cases are about the impermissible mixing of sources – in *Salisbury House*, imposing a charge to tax under schedule D to income which had also been charged to tax under schedule A, and in *Mitchell and Edon* seeking relief under schedule D in respect of expenses incurred in earning income taxed under schedule E. But alongside the prohibition on mixing sources is the requirement described by Lord Radcliffe as that of properly identifying a source or other description according to the correct Schedule (or, nowadays, Part of an Act).

42. The next case relied on, *Bray (Inspector of Taxes) v Best* [1989] STC 159 concerned the need (under the then law) for the source to exist in the year of assessment. The directors of a family-owned company had established two trust funds for employees of the company in the late 1950s and early 1960s. In 1977 the company was sold to Fisons plc and it was anticipated that the company's employees might be transferred to employment by Fisons, resulting in the classes of beneficiaries of the trusts disappearing or being merged into a larger group. The trustees accordingly decided to wind up the trusts, which they did by altering the classes of beneficiaries to those who had been employees of the company at 31 December 1975 (for one trust) or 1977 (for the other) and requiring the trustees to pay out the fund to, or purchase annuities for, those classes.

43. In the result, the employees were transferred to Fisons on 1 April 1979. The trustees proceeded to determine the allocation of the trust funds between the eligible ex-employees, a process that was completed in early 1980. The issue was whether the ex-employees were chargeable to income tax on the receipts. Tax under the then schedule E was chargeable, in the case of persons resident in the United Kingdom, on any emoluments from an office or employment "for" a chargeable period (defined as a year of assessment). For this purpose the Inspector had allocated the receipts proportionately to each year of a recipient ex-employee's service or, in the alternative, to the final year.

44. Lord Oliver (with whom the other members of the House agreed) said that the provisions taxing emoluments "for" a period

> … underline the annual nature of income tax. For an emolument to be chargeable to tax under schedule E, not only must it be an emolument *from* an employment but it must be an emolument *for* the year of assessment in respect of which the charge is sought to be raised. [His emphasis]

45. He then set out the taxpayer's argument, which accepted that the receipts were emoluments "from" the employment but maintained that the only chargeable period "for" which they could be said to have been paid was the year 1979/1980 – after the employment had ceased. Lord Oliver added that "It is a well-established principle deriving from the nature of income tax as an annual tax that a receipt of entitlement arising in a year of assessment is not chargeable to tax unless there exists during that year a source from which it arises". He cited textbook authority for the proposition that

> … most types of income are classified by reference to the source from which they come. From this it was held to follow that if a taxpayer ceased to possess a particular source of income, he could not be taxed on delayed receipts from that source unless they were referable to, and could be assessed in respect of, a period during which he possessed the source.

46. Lord Oliver proceeded to discuss the argument of the Crown; this relied on the Special Commissioners' finding that the payments were a reward for the ex-employees' services and reasoned that, in the absence of a specified period, they must have been "for" the chargeable periods during which the ex-employees had rendered those services. That argument failed for reasons that it is unnecessary to go into in depth, given that the result of *Bray v Best* has been reversed by what is now section 17 of ITEPA. Crudely summarised, Lord Oliver's reasoning was that describing a payment as a reward for services – which is necessary in order for it to be an emolument "from" employment – does not amount to a finding that it was "for" the chargeable periods in the period of employment. On the facts, the payment in question was decided upon and made in 1979/80 and there was no ground for treating as being "made for or in respect of any other period".

47. The result in *Bray v Best* was reversed by provisions in the Finance Act 1989; section 17 of ITEPA is their successor. Mr Marks relied on section 17 in the case of the scheme A recipients; in that of the scheme B recipients he relied, under section 15(3), on the fact that the bonus was received in a tax year in which they were, for the early part, employees. Mr Southern retorted that section 17 is predicated on the sums in issue being general earnings from employment; it does not assist in deciding whether they are.

The interpretation of the tax and National Insurance legislation

48. *RCI Europe v Woods (Inspector of Taxes)* [2003] EWHC 3129 (Ch) [2004] STC 315 concerned the chargeability of NICs in respect of payments made to an ex-employee of RCI Europe in return for his agreeing to remain bound by covenants not

to compete with his ex-employer's business. It is relevant to the present case as regards the interpretation that Lightman J gave to the definition of an employed earner in section 2 of the Social Security Contributions and Benefits Act 1992 (see paragraph 23 above).

49. Another provision of that Act, section 4(4), provided in its then form that "there shall be treated as remuneration derived from an employed earner's employment any sum paid to or for the benefit of an employed earner" which was taxable under section 313 of ICTA 1988 (a provision dealing with payments made in return for covenants not to compete). Lightman J held that the payments to the ex-employee were taxable under section 313 for reasons it is unnecessary to go into; he then dismissed an argument that the payments nevertheless did not fall within section 4(4) of the 1992 Act.

50. The argument was that the payments did not fall within section 4(4) because they were not "paid to or for the benefit of an employed earner"; that was because section 2 defined an employed earner as "a person who is gainfully employed" and the ex-employee was no longer gainfully employed at the time the payments were made. Rejecting the argument, Lightman J observed that

> Section 2(1)(a) is a definition section with no specific temporal requirements. The definitions in sections 2(1)(a) and (b) are categories of "earner". The term "earner" is in turn defined by section 3(1) as a person in receipt of "remuneration or profit derived from an employment". Accordingly "employed earner" includes any person who receives remuneration derived from an employment. Remuneration can obviously be derived from an employment even if the employment has already ceased to subsist when the remuneration is received eg his last month's salary. Section 2(1) is merely defining the status of an employed earner and spelling out the qualifications for such status. The words "who is" do not add anything to this meaning of the section read with their omission: they are plainly not intended to have any such temporal significance as Mr Prosser attaches to them….

51. After referring to other provisions of the 1992 Act that referred to employed earners in a sense that plainly included people who had ceased employment, the judge added, in a passage relied on by Mr Southern, that the taxpayer's interpretation

> … is scarcely consistent with the scheme envisaged by section 4(4). Section 313 of the 1988 Act brings into charge under schedule E payments made before, during or after employment. Section 4(4) provides for the treatment of any and all of such payments as earnings, and not merely payments made during the period of employment.

52. Despite that tailpiece to the judge's reasoning, I do not consider that his construction of section 2 of the 1992 Act was confined to the operation of that Act in conjunction with a provision such as section 313.

Submissions

53. In summary, Mr Southern submits that the LTIP 5 – none of whom fell in any category of "Leaver" – received the payments in their capacity as members of the LLP and not that of employees. They were not entitled to the payments at any time while they were employees because at that time further conditions of entitlement – either remaining appointed or becoming a Good or Early Leaver – still needed to be satisfied. They had become members of the LLP by the time they received the payments, and only satisfied the conditions of entitlement by virtue of being members.

54. Mr Southern developed the argument by way of five submissions:

(1) The status of being a member of an LLP is in general an absolute bar to receiving employment income from the LLP. In oral submissions he explained the significance of the qualification "in general": the exception was where entitlement as an employee had arisen prior to becoming a member.

(2) The accrued bonus payments in this case remained contingent and provisional until all requirements for payment had been satisfied. That only happened after the employees had become members; no prior entitlement had arisen here.

(3) There are no special legal provisions which would apply in this case to require the bonus payments paid to the LLP members to be characterised for tax purposes as employment income.

(4) When the bonus payments were received the recipients were ensconced as members of the LLP and could only receive the payments as a share of trading profits.

(5) The payments were wrongly accounted for by the LLP as payments of employment expenses. The only substantial tax effects of [re]classifying the payments as a distribution of profits would be the consequent saving of class 1 secondary NIC which would have been paid in error and that other consequential amendments would be minor and readily calculable (though he also acknowledged in oral submissions that the profits of the LLP would increase to the extent that the bonus payments would no longer be an allowable deduction).

55. Mr Southern amplified these submissions in writing and orally. He supported the first submission by reference to the source doctrine, referring to the *Ashraf*, *Salisbury House*, *Mitchell* and *Arthur Young* cases which I have discussed. He said that the case-law raised two related questions: what was the legal nature of the payments when received, and what was their source – general earnings under ITEPA or trade profits under ITTOIA? His answer was that, when entitlement crystallised and the payments were made, the only source to which they could be attributed was self-employment earnings, relying on Lord Oliver's analysis in *Arthur Young* and section 4(4) of the Limited Liability Partnerships Act.

56. In support of the second submission, Mr Southern made two distinct points: first, that the schemes were so constructed that entitlement did not arise until 31 January 2014 unless the scheme member left as a Good or Early Leaver or on health grounds. Secondly, the purpose of the schemes was not only to reward performance during the

calculation period but also to reward and incentivise long term commitment; it did not follow from the fact of calculation by reference to the results of a period that the payments were a reward for services in that period. Payment was dependent on continuing to work in the business for a yet further period, subject to exceptions where that was prevented for reasons outside the scheme member's control. Subject to those exceptions, the bonus might be payable either as employment or self-employment income, depending on the recipient's status when the rights crystallised.

57. Developing his third submission, Mr Southern discussed *Bray v Best* and *RCI Europe.* He described the history of the reversal of *Bray v Best* by the Finance Act 1989, effected by the twin devices of substituting the year of receipt for the year in which income was earned and at the same time providing for prospective or retrospective taxation of income received before or after the period of employment. He submitted that the purpose of section 17 of ITEPA was to prevent non-taxation of golden hellos and goodbyes, not to move receipts from one head of taxation to another. There was, he said, no scope for it to deem employment to exist in a later year where in that year the individual is a partner in the firm that formerly employed him. He supported that by submitting (correctly in my view) that the operation of the section is predicated on the receipts in question being general earnings from employment.

58. In similar vein, Mr Southern disputed the relevance of the *RCI Europe* case, pointing out (again correctly) that it concerned the application of the 1992 Act to income which had, in his words, a "special notional source" because it was deemed to be a schedule 3 emolument under section 313 of ICTA 1988.

59. Mr Southern's amplification of submission 4 covered similar ground to submission 2, together with discussion of the *Lester Aldridge*, *Clyde & Co* and *Reinhard* cases. He reiterated that the character of the receipt under the schemes at issue was established when entitlement arose and the payment was received; as by that stage the individuals had become members of the LLP, the amount paid was and could only be included in their shares of profits for the year of receipt, though he accepted that "if the payment had been, for example, arrears of salary, that would by contrast have been employment income". He concluded his survey of the four cases by concluding that "status as a member of an LLP is an absolute bar to classification as an employee". I think that may go too far in the light of some of the discussion in *Clyde & Co*, but at all events I am with him to the extent of holding that the LTIP 5 ceased to be employees on joining the LLP.

60. Mr Southern amplified his point that the recipients of bonus had no crystallised entitlement during the period when they were employees in a detailed written submission that rehearsed all the possible outcomes and asserted that, as at the date each became a member of the LLP, there were criteria that were yet to be satisfied. Mr Marks largely accepted that that was so, though he did put forward a possible set of circumstances in which the scheme B recipients might have acquired an entitlement earlier than the date on which they in fact became members. That was the perhaps unlikely contingency that the LLP's accounts to 31 July 2013 had been audited before the three employees ceased to be employees on 4 August 2013. Even then, their

entitlement to receive payment would have remained dependent or their remaining appointed or becoming "Good" or "Early" Leavers.

61. Mr Marks challenged Mr Southern's proposition that the status of the five as members of the LLP at the time of payment was an "absolute bar" to their receiving the payments as remuneration for their past employment. He emphasised the connection between the LTIP scheme and the five recipients' former employment, focussing on the provisions of ITEPA and of the Contributions and Benefits Act.

62. Mr Marks submitted that the LTIP schemes were an aspect of the five scheme members' terms of employment – an "addendum" to their contracts of employment. He referred to: Charles Tyrwhitt's statement of the purpose of the scheme in the 2010 letters (see paragraph 8 above); the clauses on eligibility for entry into the scheme (paragraphs 12 and 15 above), which meant that only employees could be admitted (and prior to the 2012 amendments only employees could receive bonusses); and the fact that the calculation periods were periods during which each of the five was an employee, a fact which he described as being of paramount importance. He contrasted the LTIP terms, giving rise to a bonus calculated retrospectively by reference to the firm's performance during their employment with a distribution of current profit between partners.

63. Mr Marks also referred to the payslips that had accompanied the payments, which he said would not have been appropriate for partnership drawings but contained all the usual particulars of a payment to an employee. (This was a point that had been relied on in HMRC's skeleton argument, not drafted by Mr Marks, as affecting the outcome of the case. I do not consider that it could; the fact that a particular tax treatment was applied begs the question of whether it was correct.)

64. The skeleton argument also referred to the provisions of the Contributions and Benefits Act that I have discussed earlier in this decision, submitting that the test for liability for Class 1 contributions was whether the payment was derived from employment as an employed earner. This is arguably too compressed; the combined requirements of sections 3 and 6 are that the payment is derived from employment (in the wide section 122 sense) and is in respect of employed earner's employment. It referred to case-law illustrating the breadth of the concept of an emolument (*Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376 and *Hamblett v Godfrey (Inspector of Taxes)* [1987] STC 60) and to *Bray v Best* and *RCI Europe*. It submitted that the payments met the criteria for being general earnings from employment and for liability to Class 1 NICs.

65. In that connection Mr Marks contrasted the outcome contended for by Mr Southern with the outcome that would have ensued if the five had qualified for the bonus after ceasing employment on the same dates as the five in fact ceased employment, but did so as Good Leavers or on health grounds rather than on promotion to LLP membership. There would then, he maintained, have been no real dispute that the payments were taxable as employment earnings: in the case of scheme A members they would have been taxable in the year of receipt by virtue of being received in a tax year in which the employment had subsisted, while in the case of the scheme B

members they would have been taxable in the year before by operation of section 17 of ITEPA.

66. In reply Mr Southern retorted that Charles Tyrwhitt's obligation under the LTIP was to pay to the five scheme members sums from the LLP's profits, conditionally on the five satisfying the scheme conditions of entitlement; the calculation was the same whether the five were employees or partners at the time of payment, but they could not be said to be being paid in respect of employment as employed earners in circumstances where the entitlements vested as a result of their status as partners.

Decision

67. I agree with Mr Southern as to the approach to sources mandated by the *Salisbury House* and *Mitchell and Edon* cases: the "schedules" (as I shall for brevity continue to describe them) are mutually exclusive and I must, in Lord Radcliffe's words, "properly identify [the] source or other description according to the correct schedule"; this involves applying the terms of the "schedule" to the characteristics of the receipt. When I do that, however, I am persuaded by Mr Marks that the payments *prima facie* satisfy the criteria of being both earnings from employment within section 62 of ITEPA and earnings in respect of employed earner's employment within section 6 of the Contributions and Benefits Act. (This is subject to considering the consequences of the recipients' change of status before the payments became due; I do that below.)

68. Though the nature of the payments in *Bray v Best* as earnings from employment was conceded by the taxpayer, the authorities on the "from employment" question that Lord Oliver went on to consider amply justify a *prima facie* conclusion that the LTIP payments were earnings "from" their employment. One can test the matter by considering, as Mr Marks did, what the outcome would have been if the five had not become LLP members but had instead received the bonuses by virtue of being Good Leavers (or indeed by virtue of remaining employees in January 2014). I have no doubt that in those circumstances the payments would have been regarded as additional remuneration for their employment.

69. Mr Marks understandably emphasised the aspects of the LTIP schemes that connected them with the LTIP 5's particular status as employees: in particular, the letters of 2010 and 2012 demonstrate their conception as schemes for employees, designed to make up for some of the consequences of the senior employees not being LLP members and accordingly not sharing in the profits in that other capacity; the schemes were only ever open to employees and the 2012 amendments were presented as being designed to prevent incumbent members losing the benefits on promotion to LLP membership rather than signalling an expansion of the schemes to ones for employees and members alike. In that connection Mr Marks also stressed the fact that the calculation periods under the schemes were, in fact, periods when the LTIP 5 were employees.

70. Mr Southern's counter-argument was as I have set out above. His fifth submission at paragraph 54 above amounted to stating the consequences of acceptance of the first to fourth submissions, and I do not need to address it separately – though I

have wondered whether the result he contends for is in Charles Tyrwhitt's overall financial interest, given that it involves the bonuses ceasing to be a deductible expense of the LLP. I accept his second submission. As to his third, I accept that neither section 17 of ITEPA nor section 2 of the Contributions and Benefits Act have the effect of requiring the bonus payments to be characterised as employment income, though I would add that, for the reasons given by Lightman J in *RCI Europe*, the fact that the five had ceased to be employed earners by the time the bonuses were paid to them is not an obstacle to Class 1 NICs being payable if (as I go on to hold) they were paid in respect of employed earner's employment. As to the fourth, it is certainly correct that the LTIP 5 were members of the LLP at the time of payment. I do not accept that in consequence they could only receive the payment by way of a share of trading profits, and my acceptance of Mr Southern's first submission is qualified. I think it best to deal with both those submissions together.

71. It would plainly be an over-statement to say that any payment by an LLP to a member is by way of a share of trading profits, as Mr Southern acknowledges by his qualification "in general". In *Arthur Young* Lord Oliver referred to the possibility of a partner receiving sums "in a quite different capacity", for instance as landlord of premises occupied by the partnership. Though Lord Oliver's conclusion was that the payment of rent to him or her would still be a partnership expense, it must equally follow that his or her receipt of rent would not be the receipt of a share of profit.

72. Mr Southern's acceptance that, in the case of a member who is an ex-employee, payments of arrears of salary are an exception seems to me to be a (correct) acceptance that being an ex-employee of a partnership is another example of a "different capacity". I think he would also (and in my view has to) accept that, to fall within the exception, the payment does not have to be overdue; an example would be sales commission for an ex-employee's final month of employment which contractually fell due at the end of the month following. I infer, from his insistence on the bonus payments here having remained contingent and provisional, that he would draw a distinction between payments that are unconditionally due at the conclusion of employment (even if only payable later) and ones which (as here) do not become unconditionally due until afterwards. My difficulty is that I do not see why the law requires a distinction to be drawn at that point.

73. At the time the LTIP 5 became LLP members, it was indeed uncertain whether they would satisfy the conditions of entitlement; there were, moreover, a number of sets of circumstances in which they might satisfy them. It is probably true that the only set of circumstances that it lay within their sole power to bring about were those of remaining a member until they could become Early Leavers (and avoiding behaviour that might trigger an involuntary termination as a Bad Leaver), but I cannot see why that affects the character of the payment made to them. I can see that the most common (though not the only) example of a payment by an LLP to a member is a share of profits; and I can see that, in tax law, shares of profits are by definition paid to members. But it does not seem to me to follow that a payment that is received by a member is, thereby, necessarily characterised as a share of profits, even if it was by being a member that the entitlement was established. The payment was not made solely by virtue of their each being an LLP member: it was made by virtue of their being an LLP member who had

complied with all the conditions of a scheme open only to employees. And, as I have said, it could have been received otherwise than by virtue of their being LLP members.

74. For these reasons I conclude that the matters advanced by Mr Southern do not displace the *prima facie* identification of Part 2 of ITEPA as the "correct schedule" by reason of the fact that its terms describe the bonus payments in this case, nor the conclusion that they fall within section 6 of the Contributions and Benefits Act. I must therefore dismiss this appeal.

Postscript

75. I have dealt with the arguments presented to me, but it has occurred to me that there may be a shorter route to the same result. The remuneration of an employee of an LLP is a matter of contractual obligation between the LLP in its capacity as a legal person and each employee; the profit shares of members of the LLP are a matter between the members from time to time (no doubt normally, as in this case, set by the membership deed or an equivalent document). When the five employees became members it was, as far as I can see, open to all concerned to agree that the five would surrender their contractual rights against the LLP to a prospective LTIP bonus, in return for equivalent fixed amounts of additional profit share. Mr Southern did not suggest that that was done, and my untutored reading of the letter of 4 April 2014 varying the membership deed does not suggest to me that it was.

76. In the absence of that, it seems to me that the payments must as a matter of law have been made in satisfaction of the LLP's contractual obligations under the LTIP agreements, which Mr Marks was correct in my view to classify as an aspect of the five's terms of employment. The final clause in the revised LTIP schedules (paragraphs 15 and 19 above) would not undermine that conclusion as the clause is at best equivocal as to the deductions that would be required in the event that the five were LLP members at the time of payment. I do not, however, base my decision on this line of reasoning, as it was not tested with counsel.

77. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

NICHOLAS PAINES QC

TRIBUNAL JUDGE

RELEASE DATE: 25 JUNE 2020