TC01527

Appeal numbers TC/2010/7178
TC/2010/8806

INCOME TAX — accountant leaving partnerships — whether payments received shares of profit or compensation — in one case share of profit, in other case compensation — appeal allowed in part

FIRST-TIER TRIBUNAL
TAX CHAMBER

AB **Appellant**

- and -

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

Tribunal: Judge Colin Bishopp
John Whiting OBE FCA

Sitting in private in London on 23 August 2011

CD, solicitor, for the Appellant

Nicola Parslow of their solicitor's office for the Respondents

DECISION

Note: in accordance with a direction of the tribunal made before the hearing of the appeals, we sat in private. We have issued a fully anonymised decision, in accordance with r 32(6) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009, in order not to undermine the purpose of a private hearing.

1. These are consolidated appeals by a chartered accountant and tax adviser, to whom we shall refer as AB, against amendments by HMRC to her self-assessment returns for the years ended 5 April 2008 and 5 April 2009. The issue is whether certain payments made to AB on her leaving partnerships of which she had formerly been a member are chargeable to income tax, because they represent AB's shares of profit, as HMRC contend; or are not taxable because they were sums paid as compensation, as AB maintains. There is no dispute about the relevant amounts.

2. AB was represented before us by CD, who is a solicitor and also her partner; he played a part in the relevant events and accordingly gave evidence, as did AB. HMRC were represented by Mrs Nicola Parslow of their solicitor's office; she did not call any witnesses, but placed great emphasis on the documentary evidence.

The facts

3. AB joined a large international firm of accountants, EF, in June 2000, initially as a "partner designate", progressing to "fixed share" partner and then, in April 2006, becoming an equity partner. Her remuneration, like that of the other equity partners, consisted of a notional salary, a share of profits determined by reference to the number of points allocated to her from time to time, a performance award or bonus, and interest on capital. While AB was an equity partner, EF adopted a hybrid corporate and limited liability partnership structure, a development which necessitated some alteration of the arrangements by which partners owned their respective shares of the business and were remunerated, but the essentials of the discretionary elements of the remuneration scheme were unaltered. The performance award was intended to reflect both personal performance and the performance of the office at which the partner was based. The number of points allocated to a partner and the level of his or her performance award were determined on a discretionary basis by a process which was not fully explained to us but which was evidently strongly influenced by the recommendations of local managing partners.

4. AB's unchallenged evidence was that in late 2004 she moved from one of EF's offices to another, of which the managing partner, GH, was national head of tax, her own speciality. The office to which she moved was highly profitable and, she said, had a substantial tax department, while the office she had left had only a small tax department. She told us she had a good relationship with GH, but in about 2006 the office at which she was based was merged with another, which had no tax department, and GH was replaced as managing partner by IJ, whose speciality was not tax. Within a short period, several of the tax partners and staff left, and were not replaced. GH, who remained at the office, retained two assistants; AB's two assistants were among those who left and were not replaced, despite her protests to IJ. Nevertheless, AB said, she continued to work hard,

attracting new clients as well as retaining existing clients. She was working long hours, recording higher chargeable hours than any other partner at her office, collecting her fees efficiently and meeting all of her targets.

5. In the spring of 2007 the process of determining AB's points allocation for the following accounting year began. Despite her performance she was told by IJ that her points would not be increased even though, as she discovered, male partners admitted to equity at the same time as she was had received increases. Soon after she underwent an appraisal, by IJ, in what she considered to be a manner so cursory as to be insulting. She also learnt that a male partner, a contemporary based at the same office, had been allowed to recruit while she had not. Her complaints about what she perceived to be unfair treatment led to a discussion with the regional managing partner, who told her that the reason her points were not to be increased was that she had not built up a team—an explanation she considered extraordinary, since she had been refused permission to recruit a team.

6. These events had an adverse effect on AB's health. In late June 2007 she saw her GP who diagnosed stress and recommended a break from work. On 1 July AB began a prolonged period of sick leave from which, as events turned out, she did not return. While she was absent she saw GH, with whom she had evidently remained on good terms, who told her that before he was replaced as managing partner he had recommended, albeit on incomplete information, that her performance award for the year to 31 March 2007 should be £50,000. In the event she was awarded barely a third of that amount, while other partners, who had earned significantly less for the firm than she had, received performance awards ranging from £65,000 to £105.000.

7. Unsurprisingly, AB came to the conclusion that she could not return to EF if she was to be treated in what she believed to be an unfair manner, and with CD's assistance she wrote to IJ complaining about her treatment, which she ascribed to sex discrimination. The letter made it clear that she did not expect to return, since she broached the subject of the clients she might be allowed to take with her (although she had no other firm to which she could go and did not know when she would be medically fit to return to work), and it ended with a demand for compensation. She did not receive what she regarded as a satisfactory response and decided to consult solicitors (at the time CD was not practising).

8. The solicitors embarked on a course of correspondence with EF (which also instructed solicitors) and in addition began proceedings before the Employment Tribunal on AB's behalf. The essence of AB's complaints, in the correspondence and before the tribunal, was that she had been treated unfairly, in breach of the duty of good faith owed in accordance with EF's partnership agreement, and in breach of the Sex Discrimination Act 1975. She added a complaint of breach of the Equal Pay Act 1970 although, as AB accepted, there were considerable doubts about whether it applied to equity partners.

9. EF's response was to make an unparticularised denial of AB's contentions, without any counter-allegation, and there was then some brief and inconclusive correspondence between solicitors, followed by a meeting at the end of October 2007 attended by AB, CD, a senior EF partner, KL, and an in-house solicitor

employed by EF. Neither of the firms of solicitors instructed by the parties was represented. After what appears to have been some skirmishing in which KL indicated that EF wanted AB to return—with what degree of sincerity is unclear—the parties began negotiating upon the assumption that AB would not return and, AB told us, acceptable terms were quite quickly agreed. AB was to leave the firm on 30 November 2007, and was to receive a payment which was recorded, in the form of a letter from EF's solicitors which AB countersigned on 23 November 2007, as having been paid in settlement of all claims AB might have "arising out of or in connection with [her] partnership and membership of [EF, including any associated organisation] and [her] retirement" as well as "any Statutory Claim as defined in paragraph 5(c) or any other matter whether such claims arise under English or European law". The settlement was expressed to deal with AB's claims against not only EF and associated organisations, but any which might be made against partners or employees. Paragraph 5(c) referred to a variety of legislation, and was evidently a standard list since much of it was of no conceivable relevance to AB's case. AB agreed to, and did, withdraw her Employment Tribunal claim.

10. On the same day—23 November 2007—AB and EF entered into a Retirement Agreement which recited AB's status as an equity partner and that she had agreed to retire from EF on 30 November. The two provisions of the agreement of relevance to these appeals are, first, that it was to take effect subject to AB's entering into a compromise agreement in respect of the claims she had made and, second that "The Retiring Member's [*ie* AB's] Share of Profits (excluding interest) (as defined in the [EF] Members' Agreement) for the period from 1 April 2007 to 30 November 2007 shall be a fixed share of profit of £191,532. This is in full and final settlement of the Retiring Member's entitlement pursuant to clause 6.2 of Part D of the [EF] Members' Agreement … for the period 1 April 2007 to 30 November 2007."

11. The expression "Share of Profits" was a term defined in the Members' Agreement, and included the partner's notional salary, the sum referable to the points allocated to that partner, his or her performance award and interest. AB told us that she realised that because she had worked for only about three months of the 2007-08 accounting year she could not reasonably expect any performance award, and she did not argue during the course of the negotiations that she should do so. The composition of the sum of £191,532 was explained by a letter from EF to AB of 8 November 2007 as

- her "Basic Salary" for the period from 1 April 2007 to 30 November 2007, being 8/12ths of £95,000, ie £63,333
- an "Additional amount" of £170,000, from which was to be deducted an adjustment of £41,801 in respect of AB's capital account

12. The parties agree that the amount of £63,333 is taxable; they also agree that the £41,801 adjustment has no tax consequences. The dispute is over the remaining balance of £128,199 and whether this amount is liable to income tax. In the course of the hearing, Mrs Parslow agreed that if this last amount is not subject to income tax, it is not subject to capital gains tax either and so it would escape tax altogether.

13. It was clear from AB's evidence that the aggregate amount to be paid to her was arrived at not by detailed debate but almost arbitrarily. In her witness statement she said "The discussion amounted to no more than an initial tentative sum being offered, then doubled and accepted." From her perspective, she told us, what she was to receive represented reasonable compensation for the treatment she had suffered, and a sufficient sum to tide her over until she could find another position: in other words she, too, did not regard it as a calculated sum composed of discrete items.

14. Quite soon after she left EF, AB found a position with OP, a smaller firm than EF, though with a substantial presence in London, and she began working as an "employed partner", an intermediate position between fixed-share and equity partners, as early as January 2008. She was told, when she was recruited, that the firm did not admit partners to equity on their joining the firm, but required candidates to work in another capacity for what amounted to a probationary period. Nevertheless, her expectation, she told us, was that she would become an equity partner on 1 July 2008 or, failing that, 1 January 2009. We did not learn what criteria would decide her future progress. AB told us she was able to bring some clients with her from EF, did work for OP's existing clients, and managed to acquire some new clients despite having entered into restrictive covenants with EF which limited her scope for doing so. She was, she said, very busy almost as soon as she joined the firm. Again, she told us, she had high chargeable hours, was winning clients and meeting all her targets.

15. However, after a few months with the firm she was offered, not the equity partnership she expected, but a "guaranteed partnership", to take effect from 1 July 2008, and described by the existing equity partners as a stepping stone to equity. She decided to accept, and entered into an appropriate agreement. The change in status brought with it a modest increase in AB's remuneration. However, she was still subordinate to another, equity, partner, QR, with whom, she said, she always had a rather difficult relationship. In particular, she said, he promised that OP would recruit new staff to assist her, but did not honour the promise.

16. A few months after AB became a guaranteed partner she learnt that OP had made offers of immediate equity partnership to two men, neither of whom was then with the firm. The offers conflicted with what AB had been told, that OP's policy was not to admit partners to immediate equity. In the event, one of the offers was withdrawn, but the other was honoured.

17. AB told us that not only did her relationship with QR not improve, but that he failed to support her when an important client indicated that it wished to instruct AB, but not another of OP's equity partners, ST. Shortly after this incident, she said, the firm's offices were re-organised and, in part because of difficulties caused by ST, she found that she had been allocated a small and inconveniently placed room, inferior to her previous room to the extent that the staff considered she must have been demoted.

18. Relations between AB, QR and ST seem to have deteriorated rapidly in the early part of 2009. On 23 February she was, she said, summoned to a meeting at which she was told abruptly that she was no longer required at OP, and given the

choice between resignation and termination of her partnership. Negotiations about the terms on which she would leave began soon after the meeting. For unconnected reasons CD had renewed his practising certificate and he agreed to represent AB; OP instructed a large city firm of solicitors.

19. On this occasion a settlement was not so quickly achieved. CD instructed a barrister, who advised AB to make a further Employment Tribunal claim, which she did. In the meantime there was correspondence between solicitors about the financial arrangements, correspondence in which OP's solicitors took an initially very firm line, though they did not address the detail of AB's complaints. An initial offer, which AB considered insulting, was rejected but then substantially improved, and eventually the parties came to terms.

20. The agreement ultimately reached, and recorded in what was described as a Settlement Agreement, was that AB would nominally remain a partner until 30 April 2009, but would be on "garden leave" after 31 March. She was to be paid her agreed remuneration from 1 April 2008 to 30 April 2009, less the money she had already drawn, plus two additional amounts, each of £102,500. The first was described as "being equivalent to six months' profit share as a payment in lieu of her six-month notice period". The second was described only as "a further sum", without any elaboration. Clause 4.2 of the agreement provided that the total amount to be paid to AB "will be treated as her profit share in the Firm's accounts for the year to 30 June 2009 and it is agreed that in the partnership tax returns of the Firm the aggregate allocation of taxable profit shown as attributable to [AB] shall be" a sum which, for reasons we did not discover (though we assume it reflected some non-deductible expenditure), was £441 greater than that total.

21. There is no dispute that the first amount of £102,500 is taxable. It is the second amount of £102,500 that we are concerned with in this appeal, though in fact the sum under discussion is actually £102,750. The difference is due to OP's having marginally increased the sum actually paid to AB, we understand because of a slight delay in paying over the monies. Mrs Parslow accepted, as in the case of the disputed EF payment, that if this sum was not liable to income tax, it was also not liable to capital gains tax.

22. The sum to be paid was expressed to be "in full and final settlement of any claims [AB] has or may have against the Firm". There then followed two lists, one of claims which AB had made or intimated she might make, and the other of claims which she was recorded to have contemplated. She undertook also to withdraw her Employment Tribunal claim.

23. As noted above at para 10, a term of the Retirement Agreement concluded in November 2007 between AB and EF was that she should enter also into a compromise agreement. For reasons we did not discover, it was not until June 2009, after she had already left OP, that this agreement was concluded, and that after mediation. As before, it consisted of two documents: a Settlement Agreement dated 18 June and a Compromise Agreement, in the form of a letter from EF dated 2 July, countersigned by AB. The former provided for the payment to her of £50,000 "as a tax-free capital payment", the latter for her abandoning any claim she had or might have against EF, including in particular those she had

made in the Employment Tribunal proceedings. We understand that there is no argument about the tax status of this amount.

24. The Settlement Agreement recorded the fact that AB had made claims and then, at Recital (C), set out EF's response:

> "Save that it has always been acknowledged by the [EF] Parties that the Former Partner was not treated in accordance with her entitlement as a full equity partner in respect of the profit share allocations for the financial year ending 31 March 2007, the Former Partner's allegations are denied by the [EF] Parties."

Discussion

25. We preface this part of our decision by observing that we are conscious that we have heard only AB's side of the story (though corroborated, so far as it was possible for him to do so, by CD) and that we had no evidence from EF or OP, beyond the letters written by them or on their behalf, and the various agreements to which we have referred. No doubt, had they given evidence, the relevant partners of EF and OP would have sought to put the events we have related in a different light. However, there was no apparent impediment to HMRC's calling any of those partners to give evidence had they not accepted at least the thrust of AB's version of events. We found AB and CD to be entirely credible witnesses. Accordingly, in the absence of any basis upon which we could reach other conclusions, what we have set out above represents our findings of fact.

26. The essence of AB's case is that both EF and OP, or more accurately their partners, discriminated against her on the basis of her sex: there was, she said, no other rational explanation of their conduct. She had made claims of sex discrimination in the course of the negotiations and in her Employment Tribunal claims, and neither firm had done more than make a bare denial of the allegations, offering no other explanation of its conduct. She was able to point to male, but otherwise comparable, EF partners who had been treated more favourably than her even though she had performed better than they had. She could not do the same in respect of OP because there were no directly comparable male partners but, conspicuously, there were also no other female partners; there was, though, the example of the direct entrant male equity partner – a status that was denied to her. She was convinced that there was no other explanation for ST's attitude to her, or for QR's failure to support her against ST.

27. HMRC's case is that there is no evidence, beyond AB's belief, that any part of what she received was compensation. AB had entered into each of the agreements providing for her retirement from the two firms after taking legal advice, and each agreement referred to the amounts to be paid as shares of profit, there was no admission of any cause for the payment of compensation, and neither the word "compensation" nor any synonym for it appeared anywhere in the documents. The Partnership Act 1890 provides, by s 24, that partnership profits are to be divided equally among the partners unless they agree otherwise. Here, the partners of both EF and OP, including AB, had agreed otherwise and had recorded their agreement in the documents. The shares so agreed were, by virtue of s 850 of the Income Tax (Trading and Other Income) Act 2005, the shares upon which the individual partners were liable to income tax.

28. AB's case, Mrs Parslow argued, required us to accept that in their partnership accounts two large firms of accountants had described as shares of profit payments which in fact represented something else. Moreover, AB herself had done the same, by describing what she had received as a share of profit in her self-assessment returns, only later seeking to amend those returns.

29. AB told us that she did consider aspects of the tax issues around the payments from EF, as one would expect of a tax specialist accountant. However, she admitted she did not fully address the issues and nor did her advisers at the time: none were partnership tax experts. She did not discuss how the amounts would be described in EF's accounts. She told us she understood that compensation for personal injury would not be taxable but did not expect that EF would agree to describing the payment in those terms. AB explained that her objective at the time was to agree a settlement and "…draw a line under the experience". Negotiating tax and accounting issues would have meant more delay.

30. We recognise that AB initially completed her tax return for 2008-09 on the basis that the £102,500 received from OP was taxable. She later amended her return to treat the amount as non-taxable, partly because of her researching the High Court case of *Zim Properties Ltd v Procter* [1985] STC 90. In fact, we do not regard the manner in which AB completed her self-assessment returns as particularly important; the question for us is not what AB thought the payments represented, but what in fact they represented.

31. Both parties referred us to the decision of this tribunal in *Morgan v Revenue and Customs Commissioners*, *Self v Revenue and Customs Commissioners* (2009, TC00046) which (in common with most of the other cases to which we were referred) we are bound to say we found of limited help since cases of this kind are determined very largely, if not almost entirely, on their own facts. It is, however, worth bearing in mind one observation, at [52]:

> "… in deciding whether payments made by a partnership to an individual partner are profits of the firm, or expenditure which should be deducted from the profits, it is necessary to decide whether the payments were received by the individual partner in his capacity as a partner in the firm and whether that was 'the very justification for the receipt'. What an individual partner receives out of the partnership funds is part of his share of the profits unless he can demonstrate that it represents a payment to him in reimbursement of sums expended by him on partnership purposes or an entirely collateral payment made to him otherwise than in his capacity as a partner."

32. The quotation within that observation is derived from the speech of Lord Oliver of Aylmerton in *MacKinlay v Arthur Young McClelland Moores & Co* (1989) 62 TC 704, a case about a quite different issue.

33. It is undisputed that the burden of persuading us that the disputed amounts represent "an entirely collateral payment"—in this case compensation—rather than profit shares rests on AB. It follows from our findings of fact that we are satisfied that AB was treated unfairly by each of the firms, a conclusion which provides her with the foundation for her argument. However, it is not enough to show unfair treatment alone; AB must satisfy us in addition that the disputed payments are properly to be regarded as compensation for that unfair treatment.

We do not need to explore any other possibility since it is accepted by AB that if the disputed amounts were not payments of compensation each must represent a share of profit.

34. There are, in our view, great difficulties facing AB in persuading us that any part of the payment she received from EF in 2007 represents compensation. First, the Retirement Agreement and the letter which preceded it both described the payment made pursuant to that agreement (leaving aside the capital adjustment) as a share of profit: it was offered and accepted as such. That same agreement expressly contemplated a quite separate compromise of AB's claims, and in due course she received (as HMRC have always accepted and as the Settlement Agreement effectively if reluctantly concedes) a payment of £50,000 as compensation for her unfair treatment. The only realistic conclusion is the two items—her profit share and the compensation due to her—were treated on both sides as discrete items. We do not see, against that background, how it could properly be said that any part of the sum agreed to be paid in accordance with the Retirement Agreement represents compensation.

35. However. the arrangements by which AB terminated her relationship with OP dealt with her departure differently: she was to be paid two sums, each of £102,500 (or, in the event, £102,750). In our view, analysis of these payments leads to a different conclusion. Accepting her evidence as we do, there can be no real doubt that she was treated badly, though we do not think it necessary (or even possible) to decide whether she was so treated because of her sex, or for other reasons. The only interpretation we can place on the agreement AB entered into with OP was that, while OP was unwilling to make any admission, the partners recognised that AB had been treated unfairly, and that compensation had to be paid. Had the "additional sum" been attributable to anything other than compensation it would have been simple to say so; that this course was not adopted, against the background of an Employment Tribunal claim which was withdrawn in consequence of the payment, is in our view a compelling indication that that is precisely what it represented.

36. It does not seem to us that OP's wish to treat the payment, in its own accounts, as a share of profit affects that conclusion. It is consistent with what we deduce to be OP's desire to avoid making an admission. Moreover, while it is a statement of OP's proposed accounting treatment of the payment it is not, in contrast to the wording used in the Retirement Agreement between AB and EF, a statement of what the payment represented.

37. We are accordingly satisfied that the "further sum" of £102,750 paid to AB by OP represented compensation for her adverse treatment, but that no part of the amount paid to her by EF in 2007 was compensation. It follows that the appeal is allowed in respect of the payment made by OP, but dismissed in respect of the payment made by EF.

38. 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.

Colin Bishopp

Tribunal Judge

Release Date: 28 October 2011