TC02460

Appeal numbers: **TC/2010/2791**
TC/2011/3869

INCOME TAX - Liability of employee under his employment contract to refund a proportion of a taxable Signing Bonus when the employee gave notice to resign prior to the end of the period for which the employee had committed to remain an employee - whether repayment "negative Taxable Earnings" - Appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

JULIAN MARTIN **Appellant**

-and-

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

TRIBUNAL: JUDGE HOWARD M. NOWLAN
JOHN AGBOOLA

Sitting in public at 45 Bedford Square in London on 10 and 11 December 2012

Philip Ridgway, counsel, on behalf of the Appellant

Christiaan Zwart, counsel, on behalf of the Respondents

DECISION

Introduction

1. This was an interesting case. The Appellant, then an employee of JLT Risk Solutions Ltd ("JLT"), agreed with JLT to enter into a new employment contract under which he received a "Signing Bonus" of £250,000 for committing to work for JLT for at least 5 years. Under the contract he was potentially liable to repay a fraction of that bonus under a formula if he gave early notice to terminate his employment in breach of his 5-year commitment. When he did give such early notice and became liable to repay £162,500 under the formula HMRC denied any relief for the fact that much of the taxed bonus had been repaid. This case accordingly involved two Appeals and three contentions designed in varying ways to secure that no tax was ultimately borne on the element of the bonus that had been refunded.

2. The case was difficult in two respects. The first was that if the Respondents' contentions were correct, and the Appellant was properly taxed on the whole of the Signing Bonus, and entitled to no relief when he had to pay back significantly more than half of it, he actually ended up considerably worse off than if he had received no Signing Bonus in the first place. HMRC appeared to concede that this result was "hard" in that they went to some (quite unnecessary) lengths, and referred to a number of cases, to assert that it was Parliament not HMRC that enacted the law, and that it was simply HMRC's duty to apply it. We naturally accepted this, and we accepted that, even though HMRC had some discretion as to when to enforce the strict law and when not to do so in the exercise of their general powers of management of the taxation system, we in the First-tier Tribunal had no jurisdiction in relation to the exercise of that discretion.

3. The second respect in which the case was difficult was that of the three contentions advanced on behalf of the Appellant, one (in fact the one on which we decide that the Appellant wins this Appeal) involved the application of a principle in the current law of employment taxation in relation to which there was no judicial authority and astonishingly no guidance in the legislation itself.

4. We made the point during the hearing that we were fully aware that, whilst there was some merit in our endeavouring generally to arrive at fair decisions and to apply the law in a manner that accorded with common sense, it was quite wrong for us to arrive at a rogue decision simply because we might consider that the Appellant would be unfairly prejudiced by a correct decision that dismissed his Appeal. Equally (another point raised by this Appeal), it was immaterial that with a different structure a similar economic effect could have been achieved by the parties to that sought in the present case without there being any risk of the Appellant suffering tax on receipts that had to be repaid to JLT.

5. In view of the point made in paragraph 3, we accept that our decision cannot be immune from challenge and HMRC may seek to appeal against it. We do however consider that our decision is based on what we believe to be a sensible and correct application of the unclear principle in the legislation to which we have referred, and

not in any way one designed to twist the law in order to confer on the Appellant some relief that we merely consider to be just.

The facts

6. The facts were relatively simple and not in dispute, albeit that there was some contention as to how the provisions of the relevant Executive Employment Contract ("the Contract") should be interpreted.

7. The Appellant and another individual were existing employees of JLT and for some reason in late 2005 JLT must have concluded that it was important to seek to ensure that both employees were "tied in" and committed to remain employed. They thus induced both employees to enter into new employment contracts, one of the features of which was the endeavour to achieve that objective for a five-year period.

8. The Contract with the Appellant, entered into on 7 November with an effective date of 1 November 2005, contained the following terms dealing with termination and notice:

> *"2.2 The Appointment shall commence on and with effect from the Effective Date and unless terminated earlier pursuant to clause 10 hereof, the Appointment shall continue until terminated by either party giving to the other written notice of its wish to terminate this Agreement always provided that any such written notice given by [the Appellant] shall not expire before the fifth anniversary of the Effective Date (the Initial Period). The notice period is as stipulated in the Schedule to this Agreement.* [The notice period stipulated in the Schedule was 12 months.]

9. Clause 4 dealt with remuneration, the first three sub-clauses specifying the fixed remuneration, the possibility of that being varied from time to time, and the possibility of discretionary bonuses. Of present relevance, Clause 4.4 provided as follows:

> *"4.4. In consideration for the Executive entering into this Agreement and abiding by its terms in particular giving the undertakings set out in clause 9 hereof [JLT] agrees to provide to [the Appellant] the signing bonus described in the Schedule ("the Signing Bonus")* [an amount of £250,000] *together and at the same time as [the Appellant's] first salary payment. In the event that before expiry of the Initial Period, any of the following occurs:*
>
> *(a) [the Appellant] serves written notice of termination of his employment or otherwise terminates his employment (other than by reason of death);*
> *(b) [the Appellant's] employment is terminated by [JLT] in circumstances falling within clause 10.1.c hereof; or*
> *(c) [the Appellant's] employment terminates pursuant to statute or operation of law (which includes any objection under the Transfer of Undertakings (Protection of Employment) Regulations 1981),*
>
> *then [the Appellant] shall be obligated to repay to [JLT] an amount calculated on the basis below within seven (7) days of the termination of his employment.*

[The Appellant] acknowledges and agrees that [JLT] may set off against or deduct any amounts owing to [the Appellant] under this agreement amounts of Signing Bonus falling to be repaid pursuant to the aforegoing."

The basis for the refund of the Signing Bonus was simple in that it provided for the Signing Bonus to be retained and refunded according to the fractions of the 5-year period that had elapsed, and that had yet to pass, as at the effective date of termination, all calculated on a daily basis by reference to working days. An example was given indicating that if termination occurred halfway through the period, then £125,000 would have to be refunded.

10. Clause 10 conferred on JLT the liberty to terminate the Appellant's contract on 6 months' notice in the event of the Appellant suffering various degrees of ill-health, mental problems and bankruptcy. Clause 10.1.c (the paragraph cross-referred to by Clause 4.4.c) conferred on JLT the liberty to terminate the Appellant's contract immediately in the event that the Appellant was convicted of a serious criminal offence or was responsible for some form of wilful breach or grossly negligent conduct.

11. On 25 November 2005, JLT paid the Appellant his first salary payment and the £250,000 Signing Bonus. Both were treated as emoluments and paid under deduction of PAYE and employee's NIC. The deductions meant that the Appellant received a net sum of £147,500 in respect of the Signing Bonus.

12. As was fairly obvious from the PAYE and NIC deductions just mentioned, the Appellant's relevant pay slip showed the salary, the gross Signing Bonus, and the various deductions, and indicated the relevant net receipt. We were also shown the Appellant's own tax return for the year 2005/2006 which returned the receipts in a similar manner, i.e. simply as taxable remuneration in the relevant year, with a "nil" entry in the box that enquired whether any beneficial loans had been made.

13. On 2 August 2006, the Appellant and the other employee who had received a similar Signing Bonus wrote to JLT giving formal notice of their intended resignation, giving 12 months' notice to expire on 1 August 2007. JLT replied on 5 October, indicating implicitly that they had accepted the notice. Specifically they said that until 31 December 2006 the Appellant would remain "on gardening leave", though theoretically on call. The letter then indicated that it had been agreed that the employment, and entitlement to basic salary, would terminate on 31 December 2006 (rather than on the expiry of the notice period), though it was conceded that the fraction of the Signing Bonus to be repaid (repaid 7 days after the termination date, and thus on 7 January 2007) would be calculated by reference to the date when the 12 months' notice would theoretically have expired, i.e. on 1 August 2007. The Appellant's liability thus became a liability to repay £162,500 on or before 7 January 2007.

14. The detail of this is immaterial but we were told that the Appellant sold shares in JLT on 3 occasions, in October and December 2006 and on 16 January 2007, and he applied the proceeds in repaying the £162,500.

15. We were given no detailed information in relation to the other employee who resigned on the same date, but we were told that in some way he settled his obligation to repay Signing Bonus by selling shares or options or perhaps forfeiting options. Whatever the detail, and nothing much was made of this point, we were told that the other employee did not suffer the problems encountered by the Appellant, to which we now turn.

The two appeals and the Appellant's three distinct submissions

16. The effect of having had to repay £162,500 of the £250,000 Signing Bonus was that in retrospect the Appellant had retained only £87,500. The Appellant therefore sought to bring an error or mistake claim for the tax year 2005/2006, claiming that although the full Signing Bonus had initially been taxed in that year, in retrospect it emerged that that taxation had anticipated the receipt of income that had not in fact been "earned" in the year, and that had later emerged never to have been earned. On account of the fraction in Clause 4.4 of the Agreement, the realistic position was that in the tax year 2005/2006, the only element of the Bonus that had been earned by the end of the tax year 2005/2006 was approximately 5/60ths of the Bonus (i.e. the fractional accrual between 1 November 2005 and 6 April 2006). By the time the employment had been terminated in the following tax year, the contingencies had all been resolved and it emerged that the ultimate income earned in respect of the Signing Bonus had been £87,500 (the rest having been returned, and thus "not earned"), so that the appropriate treatment was to reduce the assessment for the 2005/2006 tax year by £162,500.

17. It seems that this claim was discussed and debated for some considerable period, but when HMRC finally rejected the claim mentioned in the previous paragraph, the Appellant appealed against that decision, and sought (either before or after commencing the first Appeal) to advance a new argument. The new argument eventually led to the second appeal, namely one for the tax year 2006/2007. The essence of this second contention was a claim that the liability under the Contract to repay £162,500 occasioned "negative TE" or "negative taxable earnings" of the type contemplated by section 11 Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") in the year 2006/2007, and that insofar as the negative TE exceeded the ordinary salary of the same employment in the period, the resultant loss could be offset against other income of the period or carried back for one tax-year. Section 380 Taxes Act 1988 was the original section that provided for such loss relief, but it happens that the loss relief provision was re-enacted in section 128 Income Tax Act 2007, and that it is possible that in this case the earlier provision and the re-enacted provision might both affect the Appellant's claim. Since the two provisions were identical in effect, we were asked to ignore this detail.

18. Whilst there is a four-year period for the making of "error or mistake" claims of the type required in order to mount the first appeal for the 2005/2006 tax year, HMRC pointed out in relation to the second contention just mentioned that the claim for relief against other income or by carry-back had to be brought within 12 months of the end of the tax year in which the claimed loss arose. Since the claim had not been made within that period and there was no statutory latitude to extend the period for making the claim, the claim could not be brought. In addition, HMRC claimed on various grounds, which we will need to consider below, that the claim would have been

unsound even if it had been made in time. Essentially it was argued that there was no "negative income", and that what had happened was that the Appellant had appropriated taxed income (or perhaps the proceeds of the share disposals) in discharging some liability that of itself occasioned no "negative income". Accordingly no relief would anyway have been due.

19. At an early point in the hearing, and in response to a question that we posed to the Respondents, the Respondents relented in relation to the "out of time" point. They conceded that even where no statutory provision enabled an appeal to be brought out of time, HMRC could permit an appeal to be brought out of time if there were exceptional circumstances. They added that in order that the point of principle in this case might be resolved on cogent substantive grounds rather than rendered irrelevant by a timing point, they would accept that the second appeal for the loss claim in the tax year 2006/2007 could be brought.

20. We might add, though this will anticipate some of the points that we will amplify in our decision, that we consider that both parties, and in particular the Respondents, actually made a wrong assumption in relation to the second claim, i.e. the claim that the liability to repay £162,500 occasioned "negative TE". It seemed to us that the parties treated that claim as one inherently and wholly involving a claim for loss relief under the two provisions mentioned in the last two sentences of paragraph 17 above. We admit that the provisions in section 11 ITEPA dealing with "negative TE" are somewhat obscure, but it seems to us that sense can only be made of them if some payment made by an employee that ranks as "negative TE" is first set against other receipts from the same employment of ordinary taxable salary, i.e. "positive TE", such that to the extent of positive TE, the effect of negative TE is simply to reduce "net TE", or reduce "net TE" to nil. The provisions about "loss relief" are therefore only material to the extent that negative TE exceeds positive TE from the same employment in the tax year. The Appellant had received approximately £140,000 salary in the tax year 2006/2007. Accordingly, if the point just made is correct, the first effect of there being negative TE of £162,500 in the same tax year would have been to set the negative TE against the positive TE of £140,000 and to reduce the "net TE" for the year to nil in respect of the particular employment. The loss relief provisions, and their short period for the making of the claim, therefore applied only to the loss element, namely the excess £22,500. Whether this is right or not is now academic so far as the waived time limit point is concerned. The same issue will however be relevant when we consider the proper interpretation of section 11 ITEPA and how that interacts with the loss relief provisions.

21. As we have indicated, HMRC rejected the claim that the repayment of £162,500 generated any sort of "negative TE", initially on both procedural (timing limit) and substantive grounds. This led to the Appellant advancing its third contention.

22. The third contention was that the reality was that the payment of the Signing Bonus should be analysed as a loan, with the following tax implications. First, during the subsistence of the loan, the Appellant should have suffered tax on the imputed interest element, i.e. on the beneficial element of the loan. Secondly the bonus should be treated as being "earned" only to the extent that elements of the

£250,000 became "uncontingent" during tax years, i.e. to the extent that the repayment obligation contained in clause 4.4 of the Contract was reduced by virtue of the Appellant having remained in employment during the period. As the bonus was truly "earned" the Appellant should be treated as receiving emoluments, such that PAYE tax and NIC should be charged on the "earned" bonus, and a corresponding amount of loan should be reduced. We did not explore the resultant mechanics of how the tax would be collected, and how a corresponding portion of the notional loan would either be waived or repaid. Obviously the feature that in a full tax year the appropriate net receipt of bonus would only be, say, £25,000, whereas £50,000 of the loan would have to be discharged, occasioned a slight complication, but this was relative detail. Finally the annual tax charge on the beneficial loan would progressively diminish as the loan itself reduced.

23. It seemed to be common ground between the parties that the economic effect of the provisions in this case might well have been achieved by adopting some sort of loan approach, but equally obvious that we could not govern the outcome of the appeal by treating some different structure as having been selected by the parties. The Appellant contended, however, that the definition of "loan" in the provisions dealing with the tax charge on beneficial loans did refer to "credit of any form", and since there were contingent liabilities to repay the non-earned elements of the Signing Bonus, the loan analysis could be addressed even on the present facts.

Our decision

24. We consider that the clearest way to set out our decision will be first to reach some conclusions on the effect, under the Contract, of the giving of the termination notice, notwithstanding the provision in Clause 2 to the effect that no notice given by the Appellant should expire prior to the fifth anniversary of the Effective Date of the Agreement.

25. Rather than then set out the respective contentions of the parties on all points before indicating our decisions, we consider it clearest to deal with each of the Appellant's three contentions, in the order 1,3 and 2, giving sufficient indication of the parties' contentions on each point, our interpretation of the law, and then our decision on that point, prior to turning to the next contention.

The effect of the Contract on the premature service of notice by the Appellant

26. It was agreed between the parties that the Notice given by the Appellant on 1 August 2006 to terminate his employment at the expiry of a 12-month notice period was given in breach of Clause 2.2 of the Contract. Since the stipulated notice period, when given by the Appellant, was of 12 months, and since no notice given by the Appellant was meant to expire until 1 November 2010, it followed that if the Appellant was to comply with Clause 2.2, notice to terminate should not have been given prior to 1 November 2009.

27. The point just made was debated at some length during the hearing, and it occurs to us that this point could theoretically have some bearing on each of the three contentions advanced by the Appellant.

28. Before considering such potential relevance, we first address the practical point and indeed the rather odd point that in all likelihood the Appellant's obligation to repay the "residue element" of the bonus payment under Clause 4.4 was far more likely to arise if, and only if, the Appellant gave an early termination notice in breach of Clause 2.2. For the possibility of there being a liability to make a repayment under Clause 4.4 in any other situation was virtually non-existent. After all, if (as was possible) JLT gave 12 months' notice to terminate the Appellant's employment at any time, either because there was no work for him to do or because they preferred some other candidate, there would be no obligation on the Appellant to repay anything. Equally if JLT gave the 6-month notice relevant in the context of ill-health, insanity or bankruptcy, the Appellant had no obligation to repay anything. If the Appellant had only given notice after 1 November 2009, there would be no obligation to repay anything. Accordingly the only circumstances where there would be an obligation on the Appellant to repay the "residue element" of the bonus would be:

- some termination of the employment occasioned by the Appellant in breach of Clause 2.2;
- the somewhat unlikely circumstance of "termination by operation of law or statute"; or
- the doubtless equally unlikely circumstance of the Appellant being guilty of a serious crime, or responsible for wilful breach of the Contract or gross negligence.

29. We next make the observation (a point of some significance to the Appellant's first contention) that it appeared, understandably, to be very important to JLT to secure the commitment contained in Clause 2.2 that the Appellant would remain an employee until 1 November 2010. The whole point of the Contract, and certainly the payment of the Signing Bonus, was to seek to achieve some confidence that JLT would have the services of the two relevant employees for a considerable period.

30. Whilst we do not doubt the significance of the point just made, we also believe that JLT would have assumed that it would be either pointless or impossible to seek to bind the Appellant to the Clause 2.2 commitment if he decided that he no longer wanted to work for JLT. We have no doubt that JLT would have seen the Appellant's obligation to repay a fractional part of the Signing Bonus, were he minded to breach Clause 2.2 and to contemplate resigning at an early point, as the only practical mechanism that might ensure that the Appellant would refrain from resigning. Whilst, therefore, the Respondents were correct to suggest that the Appellant's early notice did breach Clause 2.2, we certainly do not conclude that this rendered Clause 4.4, and the obligation to repay the Signing Bonus, irrelevant. Indeed, the reason why we considered the various circumstances in which the repayment obligation might in fact bite in paragraph 28 above was that those circumstances indicated that, beyond providing for a repayment obligation in one or two far-fetched circumstances, the one situation at which Clause 4.4 and its repayment obligation were really, and practically, directed was precisely the present situation of early resignation in breach of Clause 2.2. That was fundamentally what JLT wished to prevent, and what they hoped to achieve essentially by the contingent obligation imposed on the Appellant by Clause 4.4.

31. Our two conclusions in relation to the application of the Contract, and Clause 4.4 in particular in the circumstances of this Appeal, are as follows. First, once JLT accepted the early notice given by the Appellant, as in practice they were virtually bound to do, it does follow that it was by virtue of that notice that the Appellant's employment terminated, and also clear that Clause 4.4 applied so as to render the Appellant liable to refund the £162,500. Our second conclusion is that although the Appellant breached Clause 2.2, this did not render the liability under Clause 4.4 irrelevant or secondary. We consider that just as the Signing Bonus was initially paid in the effort to secure the long-term employment of the Appellant, so the most important feature of the Clause 4.4 repayment obligation was to ensure the reversal of the residual fraction of the Signing Bonus if the Appellant indeed breached Clause 2.2 and gave early notice of resignation. For, just as the Signing Bonus had in retrospect failed to secure the very thing for which the payment had initially been paid, so when the employment terminated early, the fractional residue of the Signing Bonus had to be reversed or paid back under the terms of Clause 4.4.

Our decision on the Appellant's first contention

32. The Appellant's first contention was that an error had been made when paying and reporting (in the Appellant's tax return) the total amount (£250,000) of the Signing Bonus in the 2005/2006 period since only 5/60ths of the Bonus had been "earned" in that period. The very notion of "earnings" was that emoluments should be "earned absolutely" in order to count as "taxable earnings". It was not sufficient that earnings might be contingent, or that there should be some future event or circumstance that might render emoluments received refundable. The contingent liability under Clause 4.4 of the Contract meant that the balance of the Signing Bonus would only be earned as time passed with the Appellant remaining in employment. Moreover since during the period 2006/2007 the contingencies had all been resolved, and it had become clear that £162,500 fell to be refunded, and only £87,500 retained, the appropriate adjustment for the period 2005/2006 was to reduce the income initially returned for that year by £162,500.

33. The Appellant drew our attention to the fact that several of the key sections of ITEPA, in particular sections 6,7,9,11 and most obviously 18 referred to "earnings", and it was claimed that the ordinary meaning of when something was "earned" supported the contention summarised in the previous paragraph. Reference was also made to the HMRC Manual references in EIM 42320 and 42350 that applied to the special rule in section 18 for directors that something credited to a director in the employing company's accounts was to be treated as having been "received", and to the statement in the Manual that this treatment did not apply to any accounts recognition of contingent receipts until the contingency had been fulfilled.

34. HMRC contended that "earnings" were defined to mean "any salary, wages, fee or anything else that constituted emoluments" by section 62 ITEPA and that the Signing Bonus plainly fell within the definition of emoluments. The measure of the charge for a tax year was the "net taxable earnings for the period". Section 15(2) provided that "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 18 provided that money payments should be treated as received at the earliest point provided by that section, one of those points being "the time when a payment was

made of or on account of earnings." Accordingly in this case "emoluments", or "earnings" had been received in the full amount of £250,000 in the year 2005/2006, and they had properly been included amongst the "net taxable earnings" for that year.

35. It seemed that HMRC's counsel also suggested that, even if the notion of "earnings" required that in some sense earnings had to be "ultimately earned or accrued in an uncontingent manner by reference to the final circumstances affecting entitlement", the Signing Bonus was still correctly treated as "earned in the 2005/2006 period". This was because the Signing Bonus was paid in return for the Appellant signing the Contract.

36. HMRC also made the points that JLT and indeed the Appellant had dealt with PAYE and the Appellant's personal tax return for the period 2005/2006 on the basis that the full £250,000 was rightly included in net taxable earnings for the period. Furthermore, when an error or mistake claim was made what had to be shown was that the initial tax return had contained an error, and not that circumstances arising in some later period indicated that the originally correct return should be amended.

37. Our decision in relation to the Appellant's first contention is that the Respondents' contentions just summarised are correct.

38. We were taken to a considerable number of reported cases, all of which we considered to be irrelevant. Insofar as cases distinguished between payments to induce someone to become an employee and cases for giving up some existing position, such cases were plainly irrelevant. In this case, the two recipients were in any event already employees, and the payments received by them were payments for remaining employees, and thus clearly emoluments. There was no conceivable ground for suggesting that the payments were referable to some personal relationship distinct from the employment, and so cases dealing with that topic were again irrelevant.

39. We also agreed with the Respondents that the references in the Manuals to which we referred in paragraph 33 above, concerning debits in the accounts for contingent payments, were irrelevant. HMRC contended that they were irrelevant because they dealt only with directors, and the Appellant was not a director. We phrase our explanation for those references in the Manual being irrelevant on a somewhat different basis. We say that they refer simply to the third category of receipt, that related to something being debited in the company's accounts. When they then address the distinction between something debited, reflecting an entitlement, and something debited in the sense of a mere provision for something that might be payable depending on some future calculation or event, we consider that the "savings" in the Manual merely qualify in a sensible manner what is meant by something being credited to the director. The phrase cannot encompass a mere cautious provision that something might become due. We do not in any event consider that some contingent liability to repay something **actually paid** either to a director or to any other employee would prevent the payment from being "earnings" in the period of actual payment, or indeed that the references in the Manual have any bearing on emoluments actually paid.

40. We would also slightly re-phrase the way in which HMRC said that the Signing Bonus had been "earned in every sense of the word" by saying that the full payment was in return for the Appellant having signed the Contract. We say that what the payment was made for was to secure the commitment by the Appellant and the other employee to tie themselves to the company for the 5-year period. The plan may not have worked, and Clause 4.4 was the acknowledgment that at the very least the plan would have to be backed up by a mechanism to ensure forfeiture of the bonus if the plan did not work. But at the outset, JLT sought and obtained that crucial commitment, and that in a realistic sense was what they paid for.

41. The fundamental reason why we dismiss the first Appeal, however, is that we do agree with HMRC that when something that on any test constitutes "emoluments" and thus "earnings" has actually been paid, it has thereby been received by the employee and is properly treated as earnings for the period of receipt, and properly included in "net TE" or "net taxable earnings" for the period.

Our decision on the Appellant's third contention

42. We are dealing with the third contention before the second because we consider it relatively easy to dismiss this contention. The third contention was that the payment of the Signing Bonus was in substance a loan, with the implication that as time elapsed:

- period-by-period the obligation to repay the loan would be waived whilst the Appellant remained an employee (or portions of the loan would have been repaid and set-off against payments of extra salary) and the whole loan would be waived (or again matched by repayment and extra salary payment) if employment ceased in circumstances that would have involved no liability on the Appellant to make any repayments under the present drafting of Clause 4.4;
- loan waivers or salary payments would be taxed when given or paid;
- the beneficial interest element of the interest-free loan would be taxed, the benefit progressively reducing as the loan itself was re-paid or waived; and
- if the employment terminated in circumstances in which there would have been a liability under the present drafting of Clause 4.4 to re-pay Signing Bonus, the then balance of the loan would be repaid by the Appellant.

43. We dismiss this contention because it simply does not tally with the facts. We accept that some sort of loan-based structure might have been agreed between the parties instead of the Starting Bonus payment actually adopted. It would have been roughly along the lines just summarised in the previous paragraph and thought would have had to have been given to the way in which, as each portion of loan would have been waived, PAYE deductions would have been made to reflect the fact that the amount of loan being waived would have been the gross figure of £50,000 per tax year, whilst the net receipt on the implicit receipt of salary would have been of approximately half that amount.

44. The reason, as we have said, why we now reject this contention is that it is perfectly clear that the payment of the £250,000 in late November 2005 was an outright payment. There might have been (indeed there were) circumstances in

which some amounts of the Bonus would have to be paid back, but it is totally unrealistic to say that the amount paid in late November was the advance of a loan. The Appellant's counsel pointed out that the imputed loan interest provisions treated any provision of credit as a loan, but in the present case it is still unrealistic to assert that the Appellant was any form of debtor to the extent of £250,000 after the payment had been made. There was a possibility of having to pay something in the future, or indeed to "repay part of the Signing Bonus", but the Appellant was not a debtor in respect of the entire "residue element" of the Signing Bonus.

45. We were referred to the case of *Williams (HMIT) v. Todd* [1988] STC 676, in which HM Revenue had loaned money to one of its Inspectors to assist in the purchase of a more expensive house when the Inspector was moved from a District Office in Wigan down to London. Notwithstanding that HM Revenue's scheme for assisting with house purchase was referred to as an "advance of salary scheme", on the reasoning that the loan was progressively to be reduced by future deductions from net salary, it was clear in this case that there actually was a loan. Were the Inspector to leave the service of HM Revenue, he had to repay the balance of the loan, and the initial documentation reflected the loan reality. Indeed before the General Commissioners, the then appellant (the Inspector) had conceded that there was a loan and that he had only been seeking to avoid the tax charge on imputed interest by saying that the beneficial loan derived from the obligation to assist with house purchase on a compulsory move to a new area, rather than from employment as such. Before the High Court, the further contention that the payment was just "advance salary" was rejected on the ground that there really was a loan.

46. The case of *Williams (HMIT) v. Todd* is not however any sort of authority for the proposition that something paid as salary can, and should, be analysed to be loan. It is authority for the proposition that a loan is a loan. And in the present case, there was no loan. A different structure might have involved a loan, but the structure adopted did not.

47. We mentioned that the interpretation that we gave to the Contract, and the significance of the feature that we considered Clause 4.4 to be central to JLT's presumed objective of securing a commitment on the part of the Appellant to remain an employee for the 5-year period could have some bearing on all three of the Appellant's contentions. At this point we ignore the second contention, but so far as the first and third are concerned, we make the following point. The way in which we regarded the Signing Bonus as being paid in return for the crucial long-term commitment, and the reality that the loan approach had not been adopted both reflect the feature that the outright payment of the Signing Bonus, and the absence of any loan notion were more consistent with JLT's presumed objective than the loan structure might have been. We accept that the substantive economic effect might have been similar (though both the detailed money movements and the tax implications would have been slightly different), but we still consider that in terms of superficial impression the structure chosen did more to emphasise the importance of tying the Appellant to the long-term commitment, and largely seeking to achieve this by the Clause 4.4 provision concerning forfeiture of the residue of the Signing Bonus for failure to honour the commitment.

The Appellant's second contention

48. The Appellant's second contention, namely that the repayment of £162,500 in the year 2006/2007 was a payment of "negative earnings" by the Appellant was one that could not have been advanced under the original Schedule E rules, in which there was no notion of "negative salary". Under section 11 ITEPA there is clearly the notion that "taxable earnings" can be "negative". Although section 11 gives little guidance as to precisely what is contemplated by "negative earnings", section 11 is the only provision that directly refers to "negative taxable earnings", and we therefore need to quote it in full, as follows:

> *"**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 earning 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).*
>
> *(2) If the amount calculated under subsection (1) is negative, the net taxable earnings from the employment in the year are to be taken to be nil instead.*
>
> *(3) Relief may be available under [section 128 of ITA 2007] (set-off against general income) –*
> *(a) where TE is negative, or*
> *(b) in certain exceptional cases where the amount calculated under subsection (1) is negative.*
>
> *(4) If a person has more than one employment in a tax year, the calculation under subsection (1) must be carried out in relation to each of the employments."*

49. Whilst we will need to revert to section 11, we need first to quote the opening sub-section of section 128 Income Tax Act 2007, and an excerpt from the Manual indicating the circumstances where HMRC suggested that loss relief should and should not be given. We might say that we consider it odd that the definition of "negative TE" might be found not in the provision (section 11) that clearly refers to it, but in a section entirely dedicated to providing the relief (i.e. against other profits or by carry-back to the prior year) that can be obtained for "negative TE", but it was certainly HMRC's contention that we should take the provision of section 128 into account in interpreting section 11. As we indicated in the introduction, both parties actually seemed initially to treat all relief for "negative TE" to be claimable only

under section 128 or its predecessor, ignoring the implicit relief in the calculation of "positive TE" itself.

50. We need only quote the first sub-section of the current relief provision, namely section 128, since the other sub-sections refer just to the form of relief available for whatever ranks as an employment loss. It reads: -

> ***"128. Employment loss relief against general income***
>
> *(1) A person may make a claim for employment loss relief against general income if the person –*
>
> *a. is in employment or holds an office in a tax year, and*
>
> *b. makes a loss in the employment or office in the tax year (the "loss-making year").*"

The extract from the Manual that we need to quote is as follows:

> ***"Employees***
>
> *Relief for losses in an employment or office is under ITA 07/ S128 and not under the trade loss relief provisions in ITA 07 / S72. However, an employee's title to the relief should not be admitted unless the loss arises directly from the conditions of the employment (for example, a departmental manager remunerated by a percentage of the profits of their department and responsible for a corresponding percentage of any losses, or a commercial traveller responsible for bad debts arising from orders obtained by him or her).*
>
> *A deduction from earnings for expenses cannot exceed the earnings from which it is deductible. There is no such limitation in the case of capital allowances because relief is given via CAA01 and not via the legislation for expenses. Information on claims by employees for a loss generated by capital allowances is at EIM 36890."*

51. We start by noting that notwithstanding that the notion of "negative TE" is a fairly recent statutory addition to the long-standing Schedule E rules, there appears to be no definition or statutory guidance as to what can constitute "negative TE".

52. We also repeat that it seems odd that the definition of "negative TE" might be deduced from the section, section 128, that deals only with the relief that can be claimed when an employee has a loss resulting from "negative TE", and not what "negative TE" is in the first place.

The interpretation of section 11 ITEPA

53. Turning now to section 11, the first obvious point is that there is the notion that something can rank as "negative TE". Section 11(3)(a) is otherwise meaningless, as is the notion of being able to set an employment loss off against various items of income and indeed capital gain under later provisions.

54. The next obvious point is that the "calculation under sub-section (1)" referred to by section 11(2) is the calculation of simply deducting expenses from income. Accordingly sub-section (2) clearly refers just to the situation where expenses exceed income, whereupon "net taxable earnings" are treated as nil. It does not refer to the case where TE itself is negative. This is made clear first by the point that "negative TE" does not result from the calculation of deducting expenses from income anyway, and from the fact that the contrast between paragraphs (a) and (b) of sub-section (3) would otherwise be meaningless.

55. One consequence of the point just made and the obvious distinction between the two paragraphs of sub-section (3) is that save in exceptional circumstances no relief will be given for the situation where deductions exceed income, though relief may be available where TE is itself negative. Our understanding during the hearing was that both parties agreed with what seemed to us to be this obvious interpretation.

56. The next point of interpretation which seems inevitable, albeit not made particularly clear by section 11, is as follows, and is best illustrated with two examples. If an employee's positive salary in a tax year from one employment is, say, 100, and the employee has to pay something (whatever that might be) that is acknowledged to be "negative earnings" in an amount of 110, the result is that the "net taxable earnings" will be "minus 10". Accordingly no tax will be paid on the salary, since the 100 out of the 110 will eliminate the "positive TE", and the relief sought under section 128 will simply be for the excess 10. It naturally also follows that in the second example if the positive salary was 100 and the "negative earnings" were of the more obvious figure of, say, 20, the result would then be that the "net taxable earnings" from the employment would be 80. No loss would then arise and there would be no occasion to make any claim under section 128.

57. While section 11 does not specifically confirm the points made in the previous paragraph, it seems to us that they must be reasonably self-evident. We repeat the point that we mentioned in paragraph 20 above, to the effect that the parties seemed to have assumed that if the payment made by the Appellant in the period 2006/2007 had counted as "negative earnings", the whole £162,500 would have been the subject of a claim under section 128. The fact, however, that the Appellant had received other taxable salary in the same period of roughly £140,000 seemed to result in the "net taxable earnings" being reduced to nil in 2006/2007, with the section 128 claim being confined to the £22,500, rather than £162,500.

58. As we understood matters during the hearing, we believe that the parties, and in particular the Respondents, eventually agreed with the conclusions summarised in paragraphs 56 and 57.

59. We turn now to the more difficult question of the type of payments that constitute "negative TE".

60. The Respondents' counsel made the point that as "negative TE" meant "negative taxable earnings", whatever "negative TE" might be it had to consist of "taxable earnings". As the Appellant's counsel observed, this seemed to be a quite extraordinary suggestion because "negative TE" would obviously have to be something that flowed from the employee to the employer, and the notion that any

such flow of money could be taxable earnings appeared to be ridiculous. Whilst we are going to question the examples of "negative TE" contained in the Manual that we quoted (see the second quotations in paragraph 50 above), the two examples do at least presuppose payments being made "to" the employer. Nothing else can make sense. Indeed, if any sense can be made out of the fact that "negative TE" means "negative taxable earnings", the most obvious conclusion is that the phrase must mean "a contractual reversal, under the terms of employment, of what had constituted taxable earnings".

61. Since therefore we must interpret the notion of "negative TE" with no statutory assistance (at least from section 11), we can only give it the meaning that seems to us to be the most natural.

62. In the present case, the Appellant received a Signing Bonus of £250,000 for committing to remain in employment for a 5-year period, always subject to the liability in the same contract to repay to the employer what we have termed the "residual element" of the Signing Bonus if he terminated his employment prior to the end of the 5-year period. That liability and the precise amount to be repaid was fixed by the employment contract that provided for the payment to be made in the first place. Indeed the commitment to make the initial payment and the contingent liability to refund part of it were all contained in the one sub-clause. Furthermore that sub-clause even contemplated the set-off of other salary payments owed to the employee against amounts of Signing Bonus liable to be refunded. The initial payment was made to secure the commitment; the liability to refund the payment was designed to induce the Appellant to satisfy his commitment, and the liability to repay resulted from the Appellant's failure to honour the commitment. Accordingly he had to "repay the relevant proportion of salary", he had to "reverse the salary payment", and since this obligation was all contained in the very employment contract, and the very sub-clause, under which the Signing Bonus had been paid, we can barely think of a more obvious example of "negative TE".

63. We fail to see that this conclusion produces any sort of unduly beneficial result, and consider that it more accords with the substance of the provisions than the one contended for by HMRC. The Appellant had argued, in supporting his first contention, that he only "earned" the Signing Bonus on a period-by-period basis and provided he remained an employee. There was some merit and reality to that submission and the only reason why the Appellant's first contention failed was because (ignoring attribution to tax years) the Signing Bonus was clearly "an emolument", all emoluments rank as earnings, the taxable earnings for the period 2005/2006 under section 15(2) were the "general earnings **received** in the tax year", and earnings actually paid were treated as "received". Accordingly a receipts basis took precedence over any form of more general attribution on "an earnings basis" to periods in which the Bonus might more naturally have been said to have been earned. Where however the notion of "negative TE" can reverse the way in which the receipts basis takes precedence over a normal earnings basis, if and only if the "earnings" are ultimately ***"not earned"***, we cannot see that that result breaches any principle. It only gives relief for something that in retrospect was not earned, and the liability to make the repayment arises directly under the employment contract.

64. As we have said, we find it odd that we should seek to derive the notion of what ranks as "negative TE" by referring to section 128 rather than section 11, but the Respondents contended that this was a helpful approach and we will now consider both the terms of section 128 and the related provisions in the Manual.

65. The only point added to the debate by section 128 is the notion that "the [claimant] must make a loss in the employment". This reference to "making a loss" may account for why the Manual gives the two examples included in the quote above, where the employee was making a loss, almost in the sense of participating in the employer's loss. We agree first with the submission of the Appellant's counsel that the notion in the examples in the Manual that the employee only suffers a loss when the employee shares the employer's loss is firstly completely absent from anything in either section 11 or section 128, and secondly it pre-supposes a type of profit and loss sharing structure somewhat akin to partnership. We share the doubt as to whether the person engaged on these terms would necessarily rank as an employee at all.

66. It seems to us, however, that the reason why section 128 focuses on the employee "making a loss" is that the claim under section 128 applies only to the excess "negative TE" over "positive TE", and where there is such an excess, there is quite naturally "a loss". In our example in paragraph 56 above, where the "negative TE" had been 110, and the positive salary 100, the loss was 10, and there was simply a loss because the 110 exceeded the 100. In the other example, where the "negative items" were of only 20, the negative items would simply have reduced the positive and left the employee with "net taxable earnings" of 80, no "loss", and nothing to claim under section 128. This, in our view, is why section 128 obviously focuses on "the claimant making a loss in the employment".

67. Whilst we remain bemused by the two examples of loss-sharing referred to in the extract from the Manual, we have no difficulty with the other implicit requirement mentioned in the Manual, namely that the loss must derive directly from the conditions of the employment. That is plainly the case in the present Appeal. We also accept that this point about the loss deriving from the conditions of the employment accords with our own notion that "negative TE" must be a fairly restricted notion. In other words if an employee receives a salary of 100, and is then sued for some form of breach of contract, and damages of 50 or 150 are awarded to the employer, there is no way in which the 50 would reduce the net taxable earnings, or the 150 produce a loss of 50. If a cashier earns salary of 100 and steals 50 from the employer or customers, and the employer brings a civil action in addition to any criminal proceedings, there is again no question of the net taxable earnings being reduced. We agree that negative earnings must be in the nature of the repayment of earnings, owing under the terms of the contract, and most obviously reversing payments that had initially been received subject to contingencies that were eventually not fulfilled.

68. We need finally to refer to two final grounds on which the Respondents contended that the repayment of the £162,500 ought not to be regarded as "negative TE".

69. The first was the argument that "negative TE" had to be something paid during the currency of the employment, and that it could not be paid on its termination. We

can see no basis for this suggestion. We also note that where the initial emoluments (i.e. the Signing Bonus) were paid to secure the continuance of the employment, and the employment terminates, occasioning a contractual obligation to repay part of the emoluments, it is inevitably at the point of termination that the repayment will have to be made. We can see nothing contrary to principle in this, and indeed nothing that suggests any principle to the effect that negative TE can only arise during the currency of the employment. For quite different reasons we have already accepted that damages sought from an employee on termination of employment would not rank as negative earnings, but this is for a quite different reason and has no bearing on the contractual repayment, due under the very sub-clause under which the payment was initially made.

70. The other point that the Respondents made was that the repayment was an application of income, and not a deduction from income. We entirely accept that if a person is entitled to salary, and the entitlement is applied in the subscription of shares and the shares fall in value, the person's taxable salary is the amount of the entitlement. It is not the lower amount, or the nil amount, that the shares might later be worth, nor indeed is it the higher amount if the shares have gone up in value. We consider that cases reflecting this principle are irrelevant in this Appeal. This was a case of the contractual forfeiture of something initially paid on a contingent basis, all under the terms on which payment was made, and we consider this forfeiture to be the most obvious example of the extraordinarily undefined notion of "negative earnings".

Our decision in summary

71. In summary our decision is that:

- the Appellant's first contention fails because the receipts basis takes precedence over any earnings notion, and the Appellant received the full £250,000 in 2005/2006;
- the Appellant's third contention fails because it did not apply to the clear facts of the present case; but
- the Appellant's second contention succeeds, such that the net taxable earnings from the relevant employment in the period 2006/2007 were reduced to nil, and the excess "negative TE", i.e. roughly the £22,500, should have qualified for relief under whichever of the two loss-relief provisions (section 128 or its predecessor) was the appropriate provision.

NIC implications

72. We were not addressed in relation to any NIC implications that might arise in this case, but we were told that in practice HMRC had indicated that NIC adjustments would be made if our decision was in favour of the Appellant. We make no observation on whether that was technically correct or not.

Right of Appeal

73. This document contains full findings of fact and the reasons for our 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.

HOWARD M. NOWLAN
TRIBUNAL JUDGE

RELEASE DATE: 27 December 2012