[2021] UKUT 165 (TCC)

Appeal number: UT/2020/000207

NATIONAL INSURANCE CONTRIBUTIONS – limited liability partnership- employees' bonus scheme – bonuses paid after employees had become members of partnership – whether employed or self-employed earnings- Social Security Contributions and Benefits Act 1992 ss 3 & 6 - Social Security (Contributions) Regulations 2001 Reg 3 (5) & (6)

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

CHARLES TYRWHITT LLP

Appellant

- and -

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

TRIBUNAL: Sir Julian Flaux, Chancellor of the High Court
Judge Timothy Herrington

Sitting in public by way of remote video Microsoft Teams hearing, treated as taking place in London, on 25 June 2021

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

Laura Poots, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Charles Tyrwhitt LLP ("the LLP") appeals against a decision by the First-tier Tribunal ("FTT") (Judge Nicholas Paines QC) released on 21 June 2020 (the "Decision"). The appeal related to a decision of the respondents ("HMRC") concerning bonus payments paid to five members of the LLP (the "Individuals") under what was referred to as a Long Term Incentive plan, or LTIP. While the Individuals had all been employees of the LLP, they were admitted to the LTIP, which provided for bonuses which were to be calculated by reference to the profits of the LLP across a period of time. The Individuals later became members of the LLP and each of them received a bonus payment in accordance with the terms of the LTIP, after they had become a member of the LLP. The amount of the bonus payment was calculated by reference to the profits of the LLP across a period when that Individual was an employee.

2. The broad issue before the FTT was whether those bonus payments were earnings derived from the Individuals' employment for the purposes of National Insurance Contributions ("NICs.") HMRC had decided that the bonus payments were earnings derived from employment with the result that they were subject to Class 1 primary and secondary NICs. The LLP contended that that the bonus payments were not earnings derived from employment and were instead received in the Individuals' capacity as members of the LLP with the consequence that the payments fell to be taxed and assessed for NICs as self-employed earnings. The amount of NICs in issue is in the order of £1 million.

3. The FTT upheld HMRC's decision and found that the bonus payments received were earnings derived from employment.

4. Permission to appeal against the Decision was given by Judge Paines in the FTT on 17 October 2020.

The Facts

5. References to numbered paragraphs in parentheses, [xx], unless stated otherwise, are references to paragraphs in the Decision.

6. The FTT made findings of fact at [5] to [19]. We can summarise those findings which are relevant to the issues we have to decide as follows.

7. The LLP is a limited liability partnership that carries on business as a retailer of clothing. As of August 2012, the LLP had three members, two of which were the designated members of the LLP, namely the founders of the business, Mr Peter Higgins, and Mr Nicholas Wheeler. By April 2014 there were a further seven members, including the Individuals.

8. The LLP set up bonus schemes for senior employees in 2008. Each Individual became a senior employee of the LLP prior to 2010. In that capacity, they were members of one or other of two bonus schemes ("Scheme A" and "Scheme B", together the "Schemes").

9. In 2010, the Individuals received letters setting out terms of their respective schemes (the "Scheme Letters") which were in identical terms.

10. Both Schemes shared the following features:

(1) Both were intended for "directors and other senior managers", as expressly stated in the Scheme Letters.

(2) The Board of the LLP recorded that it "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 LLP] over the medium to long term."

(3) The Schemes used the concepts of a base year and a calculation period. The base year for Scheme A was the year to 31 July 2010 and the calculation period was the base year plus a further period ending on a "long stop date" ("Long Stop Date"). The Long Stop Date depended on whether the employee exercised an option to receive the bonus early.

(4) The bonus was to be calculated by reference to the difference between the LLP's "earnings before tax" ("EBT") in a "base year" and the average EBT across a "calculation period", multiplied by a multiple of seven and by a calculation percentage that differed for each employee.

(5) Eligibility for the bonus depended on the employee still being an employee on a particular date or having left otherwise than as a "bad leaver". A "bad leaver" included someone who resigned before a specified date. The original wording of this provision meant that a person whose employment terminated because of becoming a member of the LLP might technically be a "bad leaver" and lose their entitlement to bonus.

(6) As a result of the proposal to promote certain employees to become members of the LLP, a letter was issued to the Individuals (three were dated 20 July 2012 and two were dated 1 July 2013) to make changes to the Schemes ("Amendment Letters"). The Amendment Letters explained that the changes were being made "So that the change in status from being an employee to becoming a member does not affect eligibility under the existing LTIP Scheme".

(7) The Amendment Letters contained a new schedule of terms. Among other things, they contained a revised definition of "Appointment". That term originally referred to the employee being in the employment of the LLP and stated the capacity in which they were employed. The revised term continued to give 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 [LLP]". "Appointed" was to be construed accordingly. The eligibility clause continued to empower the board to deem senior employees or full-time directors eligible for the Schemes, but entitlement to receive a bonus then depended on still being "Appointed" on 31 January 2014, unless the recipient was a "Good Leaver" (as newly defined) or a (newly introduced) "Early Leaver". A new clause provided that the LLP would make the appropriate tax and NIC deductions depending on whether the payee was an employee (within s.230 of the Employment Rights Act 1996) or a member of the LLP as at the time of payment.

11. The Individuals in Scheme A received their bonus payments in the 2013/2014 tax year, in which they were not employees, having become members of the LLP on 1 August 2012. The Individuals in Scheme B also received their payments in the 2013/2014 tax year. This was a tax year in which they had initially still been employees of the LLP. They became members of the LLP on 4 August 2013.

12. The LLP originally accounted for Class 1 NICs on the basis that the bonus payments were earnings derived from employment. After receiving new advice, the LLP submitted claims on 20 January 2015 to HMRC for repayment of those NICs. On 5 July 2017, HMRC rejected the claims for repayment and decided under s.8 Social Security Contributions (Transfer of Functions, etc) Act 1999 that the LLP was liable to pay primary and secondary Class 1 NICs in respect of the bonus payments to each Individual, in the years of receipt.

The legislative framework

Limited Liability Partnerships

13. A limited liability partnership is a corporate body created pursuant to the Limited Liability Partnerships Act 2000 ("LLPA"). Although a limited liability partnership is a body corporate, in many respects their features are equated with those of an unincorporated general partnership subject to the terms of the Partnership Act 1890 rather than a company incorporated under the Companies Acts. Section 4 (4) of the LLPA is particularly relevant in this case. It provides:

> "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."

14. As we shall see later, a limited liability partnership is taxed in the same way as a general partnership and its members are treated as if they were partners in such a partnership.

NICs

15. Liability for NICs is governed by the Social Security Contributions and Benefits Act 1992 ("SSCBA").

16. Under s 6(1) SSCBA, Class 1 NICs are payable where 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…"

17. Section 122 SSCBA defines employment as including "any trade, business, profession, office or vocation and "employed" has a corresponding meaning".

18. Section 3(1) SSCBA defines "earnings" and "earner", by reference to "employment" as follows:

> "(1) In this Part of this Act and Parts II to V below—
>
> (a) "earnings" includes any remuneration or profit derived from an employment; and
> (b) "earner" shall be construed accordingly."

19. S.2(1) SSCBA defines "employed earner" and "self-employed earner" as follows:

> "(1) In this Part of this Act and Parts II to V below –
>
> (a) "employed earner" means a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including an elected office) with earnings and
> (b) "self-employed earner" means a person who is gainfully employed in Great Britain otherwise than in employer earner's employment (whether or not he is also employed in such employment)."

20. S. 2(3) SSCBA defines "employed earner's employment" as follows:

> "Where a person is to be treated by reference to any employment of his as an employed earner then he is to be so treated for all purpose of this Act; and references throughout this Act to employed earner's employment shall be construed accordingly."

21. Partners, including the members of an LLP not classified as employees for tax purposes, are liable to pay Class 2 and Class 4 NICs, on the basis that each partner is deemed to be carrying on as a separate trade part of the partnership's business: see ss11, 15 SSCBA and ss.852, 863 of the Income Tax (Trading and Other Income) Act

2005 ("ITTOIA"). To be liable to Class 2 NICs as self-employed earners, partners must be "gainfully employed otherwise than in employed earner's employment": see ss.2(1)(b), 11, and 15 SSCBA.

22. Part 2 of the Social Security (Contributions) Regulations 2001 (the "Regulations") provide for the assessment of earnings-related NICs by reference to "earnings periods". Pursuant to Regulation 2 of the Regulations, broadly speaking, the amount of earnings-related contributions payable are to be assessed on the amount of such earnings paid, or treated as paid, in the earnings period specified in the Regulations.

23. Regulations 3 (5) and (6) of the Regulations makes provision for the situation where employment in respect of which the relevant earnings are paid has ended as follows:

> "(5) Where –
>
> (a)the employment in respect of which the earnings are paid has ended;
>
> (b)the employment in respect of which the earnings are paid was one in which, during its continuance, earnings were paid or treated… as paid at a regular interval; and
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> (c)after the end of the employment, a payment of earnings is made which satisfies either or both of the conditions specified in paragraph (6),
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> the earnings period in respect of such payment of earnings shall… be the week in which the payment is made.
>
> (6) the conditions referred to in paragraph (5) of the payment is –
>
> (a) by way of addition to a payment made before the end of the employment; and
>
> (b) not in respect of a regular interval."

Income Tax

24. As set out further below, there is some overlap between the concepts relevant to determining liability for NICs and the concepts relevant to determining liability under the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") or ITTOIA.

25. Section 1(1) ITEPA provides that the Act imposes a charge to income tax on, inter alia, "employment income", employment being defined (s.4(1)) as including employment under a contract of service.

26. Section 6(1) ITEPA provides for the charge to tax on employment income which is defined as "general earnings" and "specific employment income" as defined by s 7 ITEPA. Broadly speaking, "general earnings" are "earnings" as explained in s 62 ITEPA, that is (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 s 9 ITEPA. In the case of general earnings, it is the "net taxable earnings from an employment in the tax year".

28. Section 17 ITEPA 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".

29. Section 18 ITEPA provides that general earnings consisting of money are received at the earlier of the time at which payment is made or on account of the earnings or the time when a person becomes entitled to payment of or on account of the earnings.

30. The profits of an LLP are taxable in the hands of the partners or members as profits of a trade, profession or vocation under ITTOIA. Under s 7 ITTOIA, tax is charged on the profits of the "basis period" for a particular tax year.

The Decision

31. At [53] and [54] the FTT set out the LLP's arguments in support of its contention that the Individuals received their bonus payments in their capacity as members of the LLP and not as employees:

> "53. In summary, Mr Southern submits that the [Individuals] - 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.
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> 54. Mr Southern developed the argument by way of five submissions:
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> (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)."

32. At [67] the FTT directed itself that it must properly identify the source of the payments, or, to use the terminology from the relevant case law the "correct schedule", being a reference to the old schedular basis of the charge to income tax which was based on the source of the income concerned. The FTT then said:

> "When I do that, however, I am persuaded by [HMRC] 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.)"

33. At [68] the FTT referred to the authorities on the "from employment" question cited to it and said that they amply justify a prima facie conclusion that the bonus payments in this case were earnings "from" the Individuals' employment. The FTT tested that conclusion by considering what the outcome would have been if the Individuals had not become LLP members but had instead received the bonuses by virtue of being good leavers or by remaining as employees and concluded that there was no doubt that in those circumstances the payments would have been regarded as additional remuneration from the employment.

34. At [69] the FTT summarised HMRC's arguments, namely (i) the Schemes were conceived 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 (ii) the Schemes were only ever open to employees and the 2012 amendments were designed to prevent incumbent employees losing the benefits on becoming members rather than expanding the scheme to include members and (iii) the calculation periods under the Schemes were periods when the Individuals were employees.

35. The FTT set out its reasoning as to why it rejected the LLP's counter-arguments to HMRC's position, as set out at [53] and [54]. It said this at [70] to [74]:

"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.
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> 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…

Grounds of Appeal and issues to be determined

36. The LLP was granted permission to appeal on the basis that it was arguable that the Individuals qualified for the bonus – in the event that happened – by virtue of being members of the LLP (and, as the FTT expressly found, no longer its employees), with the consequence that the payments had to be characterised as shares of profits.

37. The LLP contends that the conclusion of the FTT embodies three errors of law as follows:

> (1) The FTT's determination is inconsistent with s 4(4) LLPA which provides that a member of an LLP shall not be regarded for any purpose as employed by the LLP. "For any purpose" means what it says, except as qualified by special rules. On this basis the prima facie identification would have been with self-employed earnings, rather than – as the FTT concluded at [74] with employment income.
>
> (2) The FTT failed to have regard to changes in the taxation of employment earnings introduced in 1989 – for NIC purposes, earnings are characterised as employed or self-employed earnings by reference to the employment status of the individual when they are paid, not when they are earned.
>
> (3) The distinction between contingent and non-contingent payments is fundamental in identifying factors connecting payments to employment income or self-employed profits. Contingent payments, to which there is no vested legal entitlement, cannot be earnings before payment. By the time the amounts became payable, the context in which they were paid had changed.

38. In our view, the essential issue to be determined is whether the source of the bonus payments was a self-employment source at the time of the payment, because the Individuals had by then changed their status by becoming members of the LLP. If the LLP is right in its analysis, the payments concerned would fall to be treated as distributions of profits from the LLP.

Discussion

39. Before turning to the issues in dispute, it is helpful to state some basic points of common ground between the parties, as helpfully identified by Ms Poots in her skeleton argument:

> (1) Before the Individuals became members of the LLP, each of them was an employee of the LLP as a matter of general law.
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> (2) For the period during which the Individuals were employees, each of them was an "employed earner" with an "employed earner's employment" as those terms are defined in the SSCBA: see [17] to [20] above.
>
> (3) When the Individuals became members of the LLP, they ceased to be employees as a matter of general law.
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> (4) At that point, the Individuals ceased to be "employed earners" and became "self-employed earners", as defined in s 2(3) SSCBA: see [20] above.

40. It is common ground that the classification of the payments for NIC purposes will be the same as the income tax classification.Thus, in determining whether remuneration was "derived from" an employment, as provided for in s 3(1) SSCBA, the principles to be applied are the same as those found in the income tax authorities dealing with the question of whether earnings are "from" an employment. As we observed at [27] above, that statutory question is now contained in s 9 ITEPA. We now turn to the authorities to which we were referred on this question.

41. We start with *Mitchell and Edon v Ross* [1962] AC 813. That case involved a number of National Health consultants who had both NHS and private income. The Special Commissioners decided that the income derived from their part-time appointments from the NHS, which it was accepted were offices within the meaning of Schedule E to the Income Tax Act 1918, could nevertheless be assessed as part of their professional earnings under Schedule D on the basis that the consultants carried on one profession and not two, and the Schedule E appointments were merely incidental to the single profession.

42. The House of Lords held that the scheme of the Income Tax Acts demanded that each source of profit should be assessed under the appropriate schedule and in accordance with that schedule alone; and that accordingly the profits arising from the part-time appointments were assessable under Schedule E, not Schedule D, and the attendant expenses must be deducted under the rules applicable to Schedule E, and not under the rules of any other schedule. Lord Radcliffe said this at page 838:

> "Before you can assess a profit to tax you must be sure that you have properly identified the source or other description according to the correct schedule: but, once you have done that, it is obligatory that it is charged, if at all, under that schedule 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."

43. This principle was correctly identified by the FTT at [67] as the starting point for its analysis, as mentioned at [32] above. The historic schedular basis of charging income tax having been reformed, the relevant question is whether the bonus payments are assessable as "employment income" under ITEPA or profits of a trade under ITTOIA.

44. As Ms Poots observed, there is a long line of authorities dealing with whether something constitutes earnings from an employment. We were referred to a review of those authorities to be found in *HMRC v Smith & Williamson Corporate Services Ltd* [2016] STC 1393 at [11] to [29]. The Upper Tribunal in that case recognised that the authorities show that there are several ways of understanding the test contained in the statutory words:

> (1) A distinction is to be drawn between an emolument which is derived "from being or becoming an employee" on the one hand, and an emolument which is attributable to something else on the other hand. If an emolument is not paid as a reward for past services or as an inducement to enter into employment and provide future services but is paid for some other reason, then the emolument is not received "from the employment": *Shilton v Wilmhurst (Inspector of Taxes)* [1991] STC 88 per Lord Templeman at 91.
>
> (2) To be a profit arising from employment, the payment must be made by reference to the service the employee renders by virtue of his office, and it must be something of a reward for services past, present or future: *Hochstrasser (Inspector of Taxes) v Mayes* [1959] 3 All ER 817, per Viscount Simonds at 821.
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> (3) Citing Lord Radcliffe in *Hochstrasser* at page 823:
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> > "…while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee."
>
> (4) There must, in actual fact, be a relevant connection or link between the payments to the employees and their employment: *Kuehne + Nagel Drinks Logistics Ltd v HMRC* [2012] STC 840 at [33], per Mummery LJ, a case which also dealt with the language of the NIC legislation.
>
> (5) The statutory test requires a sufficient causal link to be established between the payment and the employment. A payment can be characterised as "from employment" if it derives "from being or becoming an employee" and "is not attributable to something else such as a mark of esteem or a desire to relieve distress": *Kuehne + Nagel* at [50] and [51], per Patten LJ

45. The FTT had in mind the relevant authorities when analysing whether the bonus payments were derived from the Individuals' employments: see [68] as referred to at [33] above.

46. In *Kuehne + Nagel* Mummery LJ made it clear that it is for the FTT to determine as a question of fact whether the payments concerned were remuneration from employment having evaluated the evidence: it was for the FTT to consider all relevant documents and oral evidence and to make findings of primary fact and proper inferences of fact, to which it must then apply the tax legislation, as interpreted by the courts. It is not the task of appellate bodies to re-decide or second-guess the primary facts, their proper function being limited to questions of law, such as whether the FTT interpreted the law or rule incorrectly, or made perverse findings of fact not supported by the evidence or reached a conclusion that was plainly wrong: see [34] and [46] of Mummery LJ's judgment.

47. We were referred to a number of authorities dealing with the position where the remuneration in question is received after the relevant employment has ceased.

48. *Bray (Inspector of Taxes) v Best* [1989] STC 159 concerned a trust established by a company to buy shares in the company on behalf of its employees. In 1979, following a takeover, the employees were re-employed by the parent company. Shortly before the re-employment, the trustees wound up the trust and distributed the proceeds among eligible employees. In tax year 1979-1980, the taxpayer employee received payments. It was conceded that the relevant payment was one derived from the taxpayer's former employment. The question for the House of Lords was whether it was an emolument *for* the year of assessment in which the charge was raised. Lord Oliver concluded that this was a question of fact to be decided in light of all the circumstances of the particular case (at page 167j-168b). He said that describing a payment as a reward for services, which is necessary 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". Since the employment had ceased in 1979/80, there was no source from which emoluments arose in the year of assessment and there could be no charge to tax.

49. The result in *Bray v Best* was reversed by provisions in the Finance Act 1989**.** Sections 17 and 18 ITEPA, referred to at [27] and [28] above, is the successor legislation in that regard.

50. In our view, neither *Bray v Best* nor ss 17 and 18 ITEPA are relevant in this case. As Ms Poots submitted, the analysis in *Bray v Best*, and the changes made to income tax on emoluments, all relate to the question of which year the emolument was *for*, and when those emoluments were to be taxed. They do not in any way affect the question of whether an emolument was *from* the employment. Indeed, as explained above, Lord Oliver's analysis of whether an emolument was *from* the employment is part of (and consistent with) the long line of authorities which led up to *Kuehne + Nagel* and *Smith & Williamson.* The intention of the legislation which reversed *Bray v Best* was to provide (i) that emoluments which would be *for* a year of assessment in which the person no longer held the employment were to be treated as emoluments *for* the last year in which the employment was held and (ii) that income

tax under Schedule E would be charged in the year of receipt of the emoluments, even if those emoluments were *for* a different year.

51. Therefore, in this case, the bonus payments can be taxed as employment income notwithstanding the fact that they were received after employment had ceased. Section 17 and 18 of ITEPA have no effect on the question which we need to determine which is whether those payments were derived from the Individuals' employment with the LLP.

52. *RCI Europe v Woods (Inspector of Taxes)* [2004] STC 315 ("*RCI Europe*") 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.

53. As the FTT observed at [48] that case is relevant to the present one as regards the interpretation that Lightman J gave to the definition of an employed earner in section 2 (1) SSCBA, as set out at [19] above. Section 4(4) SSCBA, 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).

54. Having held that the payments to the ex-employee were taxable under section 313, Lightman J dismissed an argument that the payments nevertheless did not fall within s 4(4) SSCBA. The argument was that the payments did not fall within s 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.

55. Rejecting that argument, Lightman J observed at [36]:

> "Section 2(1)(a) is a definition section with no specific temporal requirements. The definitions in s 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 e.g. 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…."

56. The judge added at [40]:

> > "Common-sense demand that in s 4 (4) the reference to employed earner is read as a reference to the status in relation to which the payment is received. Section 4 (4) lays down no specific temporal requirements. The reference to an "employed earner" cannot be a reference to the individual's status at the time the sum is

> paid. I should add that such a construction 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."

57. Mr Southern submitted that Lightman J was confining his remarks to the operation of ss 2 and 4(4) SSCBA in conjunction with a provision such as s 313 of the 1988 Act. We do not agree. In our view, it is clear, as the FTT recognised at [70], that the analysis applies to earnings for NIC purposes more generally. As Ms Poots submitted this can be seen from the fact that the taxpayer's argument was based on s 2 (1), a definition section which applies generally in the statute.

58. Finally, in *HMRC v Forde and McHugh Limited* [2014] UKSC 14, the facts were that a company had established a retirement benefit scheme to provide relevant benefits to its employees and directors. The trust provided that, upon a member's retirement trustees were to apply the accumulated fund in providing the member with a pension for life or such other relevant benefits as they might agree with him. On the member's death the trustees were to realise the accumulated fund and apply the net proceeds to or for the benefit of a defined discretionary class of beneficiary. A director, Mr McHugh, became a beneficiary of the trust and informed the trustees that he wished them to exercise their discretion in favour of his wife in the event of his death. The company transferred Treasury Stock to the scheme for Mr McHugh's benefit. He received no relevant benefits from the scheme. He had no vested interest in the assets of the scheme at the time the Treasury Stock was transferred into the scheme because he had not yet reached his retirement age.

59. The issue before the Supreme Court was whether the transfer to the scheme was a payment of earnings to or for the benefit of Mr McHugh within the meaning of s 6 SSCBA with the result that NICs were payable in respect of those earnings. The question was whether the company had paid earnings to or for the benefit of Mr McHugh when it made the transfer to the trust at a time when Mr McHugh's interest in the assets of the trust was only a contingent one which might have been defeated by his death before his specified retirement age.

60. Lord Hodge said this at [16]:

> "If one gives words their ordinary meaning, it is clear that a retired earner receives "earnings" in respect of his employment in the form of deferred remuneration when he receives his pension. So too does an earner when he receives his deferred bonus. In each case I would characterise the payment from the trust or escrow fund as deferred earnings. It follows that the payment into the trust or escrow fund would not be earnings."

61. As Ms Poots submitted, this example illustrates that a payment received after employment ceased can still be earnings.

62. At [17], Lord Hodge made it clear that earnings are paid when the employee receives them. He said that the use of the word "earnings" points the reader towards

what the employee obtains from his employment. Looking to what the earner receives avoids the counter-intuitive result.

63. Lord Hodge observed at [18] that at the time of the transfer all Mr McHugh had was a contingent right: the transfer gave him only the entitlement to a future pension or "relevant benefits" once a condition – his reaching retirement age – had been purified. In that regard, he was assisted by the case of *Edwards v Roberts* (35) 19 TC 618. He said this at [20]:

> "*Edwards v Roberts* …assists in this case not because it is correct to equate "earnings" in NICs legislation with "emoluments" in income tax legislation but because of its application of the general law in relation to a contingent interest and its focus on what an employee receives. In that case an employee received a salary and also, if he remained in employment for more than five years, a right to receive at the end of a subsequent financial year part of the capital of a trust fund into which his employer paid a proportion of its annual profits. Lord Hanworth MR stated (p 638):
>
> "[U]nder these circumstances there could not be said to have accrued to this employee a vested interest in these successive sums placed to his credit, but only that he had a chance of being paid a sum at the end of six years if all went well."

64. Applying the principles of these authorities in this case:

(1) The primary question is whether the source of the bonus payments is the employment of the Individuals by the LLP. That is primarily a question of fact to be determined by the FTT having evaluated the evidence and applying the principles derived from the authorities summarised above. That determination is not to be disturbed on appeal unless the FTT has misinterpreted the law, made perverse findings of fact not supported by the evidence or reached a conclusion that was plainly wrong: see *Mitchell & Edon, Smith & Williamson, Kuehne + Nagel).*

(2) Earnings are subject to tax as employment earnings consequently, where, as in this case, a right to receive the earnings was contingent on the satisfaction of certain conditions, the earnings are not subject to NICs unless and until the conditions are satisfied and the earnings are paid to the employee. Insofar as the earnings were derived from employment, in this case the NICs were payable when the bonus payments were made (*Forde and McHugh, Edwards v Roberts*).

(3) The fact that the employee receives the earnings after his employment has ceased, as in this case, does not affect the position. The liability for NICs will arise by reference to the week in which the payment is made and the earnings will be treated as an addition to a payment made before the end of the employment (*RCI Europe).* See also on this point Regulation 3 (5) and (6) of the Regulations, as set out at [23] above.

65. It is only the application of the first of these principles that is in dispute on this appeal. As we said at [38] above, the question is whether the FTT erred in not

concluding that at the time the payments were made, they had a self-employment source because at the time of the payment the Individuals were members of the LLP with the consequence that they were received by the Individuals in that capacity.

66. Mr Southern submits that the FTT erred in its conclusions for the following reasons:

> (1) The amendments to the Schemes made in 2012 were part of a process whereby the Schemes were evolving to permit members of the LLP to benefit from the Schemes. The individuals were functioning as de facto members of the LLP and the result of the alterations was that benefits under the Schemes were payable to members of the Schemes whether at the time of payment they were employees or had become members of the LLP by the time the right to the payments had crystallised. The amendments to the Schemes specifically envisaged that members of the Schemes could receive payments under the Schemes in their capacity as members of the LLP.
>
> (2) The Individuals' rights under the Scheme had not crystallised by the time they ceased to be employees of the LLP. Accordingly, the combination of two factors, namely that employees had at the time of payment become members of the LLP and the rights under the Schemes did not crystallise until that event had occurred, meant that the payments were attributable not to their status as former employees but their new status as self-employed members of the LLP.
>
> (3) Furthermore, it was legally impossible for the Individuals who had become members of the LLP to receive payments from the LLP in their capacity as employees. That was the result of the operation of s 4(4) of the Limited Liability Partnerships Act 2000 which provided that a member of a limited liability partnership "shall not be regarded for any purpose" as employed by the partnership. Support for that proposition is to be found in *MacKinlay v Arthur Young McClelland Moores & Co* [1989] STC 898 ("*Arthur Young*"). There were no specific rules in this case which affected that general proposition.
>
> (4) An employee who becomes a partner in his firm crosses a Rubicon. There is a tranche – a cut, a caesura – between his former position and the new status which he enjoys. He no longer has employment earnings but instead a share of profits.
>
> (5) It is of no consequence that the bonus payments were computed retrospectively by reference to calculation periods in which the Individuals were employees. The employment of the individuals concerned in the years in question provided the measure the benefit ultimately received. However, it did not provide the source of those benefits.

67. In our view the bonus payments were received by the Individuals in their capacity as former employees of the LLP in accordance with the contractual rights that they had acquired under the Schemes before they became members of the LLP. Accordingly, those payments were derived from their employment. As Lightman J said [40] in *RCI Europe,* whether a person is an "employed earner" is to be read as a reference to the status in relation to which the payment in question is received. Thus, in this case the payments were received by reference to rights which the Individuals

acquired as employees and those rights were not affected by the fact that they had become members of the LLP by the time the payments were received. All that had happened in the meantime was that the terms of the Schemes had been altered so that they would not lose those rights simply because they became members of the LLP.

68. We agree with the FTT when it said at [73] that it does not 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. As the FTT said, the payment was not made solely by virtue of their each being an LLP member: it was made by virtue of their being a member of the LLP who had complied with all the conditions of a scheme open only to employees.

69. It follows that we reject Mr Southern's analysis of the effect of the amendments made to the Scheme in 2012. That analysis is inconsistent with the FTT's findings of fact in that regard. The FTT made a clear finding at [67] that the payments were earnings "from" the Individuals' employment. In our view, that is a finding that the FTT was fully entitled to make based on the evidence of the terms of the Schemes that was before it.

70. In particular, there is nothing in the documentation that suggests that the terms of the Schemes changed to the extent that members of the LLP were entitled to join the Schemes and benefit from them in that capacity. As described at [10 (2)] above, the terms of each Scheme was to incentivise "directors and senior management". As mentioned at [10 (6)] above, the letters to the Individual setting out the proposed amendments to the Scheme made it clear that the changes were being made so that the change in status from being an employee to becoming a member would not affect eligibility under the existing Scheme. In other words, the intention was that an employee would not lose his right to a payment under the Scheme were it subsequently to crystallise, notwithstanding the fact that by the time of the payment he had ceased to be an employee of the LLP. He could still qualify to receive a payment if he was at that time a member of the LLP. There is nothing in the amendments that were made that suggests that they went any further than that. In particular, there was no change to the effect that a member of the LLP as opposed to a director or senior manager became eligible to participate in the Schemes in that capacity. The amendment to the definition of "Appointment" referred to at [10 (7)] above simply recognised that at the time the payment was made the recipient might have a different status to that which he had at the time that he joined a Scheme.

71. Neither was there any evidence before the FTT that the LLP had agreed with the Individuals that when they received the payments they would do so as an addition to their profit share as members of the LLP, rather than as additional remuneration that had become due to them in their capacity as employees of the LLP because of their rights under the Schemes having crystallised. Nor, it seemed, was there any evidence before the FTT to support Mr Southern's submission that the Individuals were operating as "de facto" members of the LLP before they were formally admitted as members.

72. We do not consider that the fact that the Individuals' rights under the Schemes had not crystallised by the time they became members of the LLP can have any effect on their pre-existing contractual rights in the absence of any agreement to change those rights. What happened in this case was the same as the position in *Edwards v Roberts*. There was no right to receive any payments under the Schemes until the relevant conditions had been satisfied, but once those conditions were shown to have been satisfied then any payments made would derive from the employment of the Individuals, whether the payments were received whilst they were still employees or after they had left their employment. We therefore agree with the FTT's conclusion at [72] that the fact that the payments remained contingent and provisional until after the relevant employment had ceased makes no difference.

73. Nor do we accept that s 4(4) LLPA affects the position. All that section does is to preclude a member of a limited liability partnership from also being an employee of the partnership at the same time. As Ms Poots submitted, a conclusion that a payment is derived from a former employment does not involve any conclusion that the recipients are to be regarded as continuing to be employees. Furthermore, Mr Southern accepted that the general provision of s 4(4) LLPA took effect subject to any specific rules to the contrary. In our view, Regulations 3 (5) and (6) of the Regulations fall into that category. Those Regulations make it clear that earnings received in respect of an employment after the employment has ceased are to be treated as an addition to a payment of earnings made before the end of the employment.

74. It follows that *Arthur Young* does not assist Mr Southern. That case 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 before the House of Lords 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 passage in the speech of Lord Oliver at page 900, 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."

75. Mr Southern also relies on the observation of Lord Oliver at page 904 that what a partner receives out of the partnership funds falls to be brought into account in ascertaining his share of the profits of the firm, except in so far as he can demonstrate that it represents a payment to him in reimbursement of sums expended by him for partnership purposes in the carrying on of the partnership business.

76. Mr Southern submits that these passages are authority for the proposition that any payment out of the firm's assets to a partner of the firm must be regarded as a distribution of profits unless it is a reimbursement of expenses. Accordingly, the payments made to the Individuals in this case, because they were made at a time when they were members of the LLP must be regarded as a distribution of the profits of the LLP. .

77. We reject that proposition. It ignores the obvious point that not all a partner's dealings with the firm of which he is a member must be regarded as being carried out in his capacity as a member of the firm. Indeed, Lord Oliver makes that very point at page 903 of *Arthur Young* where he refers to the example of sums being received by a partner in a quite different capacity, for instance, as the landlord of premises let to the partnership or for goods supplied from an independent trade carried on by a partner. We can test the matter further by the following example. Suppose an employee of a partnership leases a property to the partnership. The employee subsequently becomes a partner in the firm, but the partnership continues to lease the property and pay rent to the former employee. It cannot be said that the change of status of the landlord from employee of the partnership to a partner in the firm can without more re-characterise the rent received as a distribution of profits in the firm to the partner. The rent is paid to the partner in his capacity as a landlord.

78. That is precisely the position in this case. At the point at which the bonus payments were made, the Individuals had two different relationships with the LLP as follows. First, each Individual had a relationship by virtue of being a former employee of the LLP who had subsisting contractual rights with the LLP. Those contractual rights gave rise to the right to receive a bonus payment when the conditions of the Scheme of which he was a member had been satisfied, an event which occurred after the Individual had left his employment with the LLP. Secondly, the Individual had a relationship with the LLP as a member of the LLP, which arose after he left the LLP's employment.

79. The payments which the Individuals received were in their capacity as former employees, as found by the FTT. As *RCI Europe* establishes, the fact that those payments were made after the employment relationship from which they were derived has ceased does not prevent the payments concerned being derived from employment. By virtue of the operation of Regulation 3 (5) and (6) of the Regulations, those earnings are to be regarded as an addition to a payment of earnings made before the end of the employment and accordingly are liable to employer's NICs calculated by reference to the amount of the payments concerned.

80. Consequently, the source of the payments did not change because of the Individuals becoming members of the LLP prior to the conditions for the making of

the bonus payments to them being satisfied. The FTT was right to conclude at [74] that the matters advanced by Mr Southern did not displace the prima facie identification made based on the evidence before it of the bonus payments being derived from employment.

Disposition

81. The appeal is dismissed.

Signed on Original

SIR JULIAN FLAUX **JUDGE TIMOTHY HERRINGTON**

UPPER TRIBUNAL JUDGES

RELEASE DATE: 12 July 2021