Appeal numbers FTC/35/2013 and FTC/57/2013

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 Signing Bonus "earnings"; whether repayment "negative Taxable Earnings" – Yes – appeal dismissed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and –

JULIAN MARTIN

Respondent

Tribunal: Mr Justice Warren, Chamber President

Sitting in public in London in the Rolls Building on 7 February 2014

Adam Tolley QC, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, on behalf of the Appellants
Philip Ridgway, counsel, instructed by FSPG Chartered Accountants , on behalf of the Respondent

Introduction

1. This is an appeal by the Appellants ("**HMRC**") and a cross-appeal by the Respondent ("**Mr Martin**") against a decision of Judge Nowlan and Mr Agboola ("**the Tribunal**") released on 27 December 2012 ("**the Decision**"). Mr Adam Tolley QC appears for HMRC; Mr Philip Ridgway appears for Mr Martin.

The facts

2. The facts are straightforward and common ground. They are set out in [6] to [15] of the Decision. In summary:

    a. Mr Martin and another individual were existing employees of a company called JLT Risk Solutions Ltd ("**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.

    b. A contract was entered into between Mr Martin and JLT on 7 November 2005 with an effective date of 1 November 2005 ("**the Contract**"). Clauses 2.2 and 4.4 are important. I set them out in Annex 1 to this Decision, together with Clause 10.1.c which is referred to in Clause 4.4. As can be seen from Clause 4.4, Mr Martin was to receive (and did receive) a signing bonus (defined as the "Signing Bonus"); its amount was £250,000. There was also an obligation to make repayment in certain cases of termination of employment. The basis for repayment was simple:

it was a time-apportioned proportion of the amount of the Signing Bonus according to the unexpired part of the 5 year period referred to in Clause 2.2.

c. Clause 9 imposed various restrictive covenants on Mr Martin during his employment and after it had terminated.

d. Clause 10 conferred on JLT the liberty to terminate the Contract (i) on 6 months' notice in the event of Mr Martin suffering various degrees of ill-health, mental problems and bankruptcy or (ii) immediately if he was convicted of a serious criminal offence or was guilty of certain forms of misconduct.

e. On 25 November 2005, JLT paid Mr Martin 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 Mr Martin received a net sum of £147,500 in respect of the Signing Bonus.

f. Mr Martin's relevant pay slip showed the salary, the gross Signing Bonus, and the various deductions, and indicated the relevant net receipt. The Tribunal was shown Mr Martin's tax return for the year 2005/2006 which returned the receipts simply as taxable remuneration in the relevant year.

g. On 2 August 2006, Mr Martin 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 in a letter dated 5 October 2006. The terms of that letter are of some importance. I consider it in a moment. As a result, Mr Martin became liable to pay to JLT under Clause 4.4 the sum of £162,500.

h. On three occasions, in October and December 2006 and on 16 January 2007, Mr Martin made payment to JLT totalling £162,500.

The 5th October 2006 letter

3. The letter of 5th October 2006 under JLT's letterhead came from Ms Audrey Byrne described under her signature as "HR Consultant". It appears from the first paragraph of the letter that Mr Martin had had conversations with a Mr Hedley of JLT following receipt of his letter of resignation. I do not know the contents of those conversations. Matters appear to have been dealt with in a sensible manner. Ms Byrne stated that, with effect from 16 October 2006, JLT would like Mr Martin to serve the remainder of his notice period on "garden leave". Although Mr Martin's notice was due to expire on 1 August 2007, an earlier release date of 31 December 2006 (referred to in the letter as "the Termination Date") had been mutually agreed. It was also agreed that the repayment calculation under the Contract would be based on a termination date of 1 August 2007 (giving rise to the figure of £162,500) but so that Mr Martin would be obliged to make actual payment to JLT of that amount by 7 January 2007.
4. The letter pointed out that, until the Termination Date, Mr Martin continued to owe duties to JLT as an employee. He was reminded of his duties of confidentiality and of the restrictions both during and after termination of his employment. There is no mention in that letter of any breach of contract by Mr Martin.

The Legislation

5. The legislation relevant to this appeal is mainly found in the Income Tax (Earnings and Pensions) Act 2003 ("**ITEPA**"). Although the material provisions of ITEPA have been amended from time to time, nothing turns on these

amendments. Also relevant to this appeal is section 128 Income Tax Act 2007 ("**section 128 ITA**") or its predecessor, section 380 Taxes Act 1988, on which Mr Martin relies to carry back his alleged losses to the 2005-6 tax year. Again, nothing turns on the change of wording between these provisions. I set out in Annex 2 the provisions of significance to the current appeal. I mention, but do not need to set out, the provisions in Part 2 ITEPA which impose the charge to tax on employment income and set out how the amount charged to tax for a tax year is to be calculated and who is liable for the tax charged. I have also been referred to a number of provisions in the Taxes Management Act 1970, but I do not need to set these out either.

The Tribunal's decisions

6. Mr Martin brought two appeals before the Tribunal. The first related to the tax year 2005/06 and the second to the tax year 2006/07. Mr Martin raised three distinct (alternative) contentions:

    a. His earnings for 2005/06 were reduced by the sum of £162,500 so that the true amount of earnings received under the Contract was only £87,500. This was the amount on which he was taxable. The Tribunal dismissed this contention. This decision is the subject of Mr Martin's cross-appeal.

    b. The payments in 2006/07 gave rise to negative earnings in that year which in turn gave rise to a right to deduct under what is now section 128 ITA. The Tribunal accepted this contention. This decision is the subject of HMRC's appeal.

    c. The Signing Bonus was in reality a loan and as such would have similar consequences, other than in relation to the imputed interest element, for

Mr Martin's tax liability as under his first contention. The Tribunal dismissed this contention. Mr Martin does not appeal from this decision.

The Issues

7. The issues on the present appeal have been identified by the parties as follows:

   a. **Issue 1:** Whether part of the Signing Bonus, although "earnings" at the time of its receipt, ceased to be "earnings" when repaid to JLT on the basis that it had not been earned thus rendering Mr Martin's tax return for the year of receipt incorrect and so amenable to amendment and giving rise to a repayment of tax. [This is the way the issue is put by Mr Martin and, given his acceptance that the Signing Bonus constituted "earnings" when received, more accurately captures the dispute than HMRC's formulation namely whether the Signing Bonus was "earnings" at the time of its receipt, or only constituted "earnings" once each component of it was earned, such having occurred only by effluxion of time].

   b. **Issue 2:** Whether any "negative taxable earnings" for the purposes of section 11 ITEPA must, in and of themselves, be "taxable earnings" within the meaning ascribed to that term by section 10 ITEPA.

   c. **Issue 3:** Whether the statutory phrase, "negative taxable earnings", means "a contractual reversal, under the terms of employment, of what had constituted earnings" (as was held by the Tribunal: see [60] of the Decision) or whether (as HMRC contend) it refers to cases where the full amount of "general earnings" which fall to be considered as "taxable earnings" pursuant to Chapter 4 or 5 of Part 2 ITEPA, as applicable, is a negative amount, taking into account any relevant negative "general earnings".

d. **Issue 4:** On a true construction of the Contract, and in particular clause 4.4, whether the Payments were "general earnings" or an amount by way of liquidated damages.

8. The phrase "negative taxable earnings" does not appear in the legislation. In the context of Issues 2 and 3, the parties use it, I think, to refer to an item (typically a payment by an employee to his employer) which is brought into account in computing the total amount of earnings within the definition of TE and which reduces the amount of TE from what it would otherwise have been. The phrase is not, or at least not always, used to describe the end result *ie* "where TE is negative".

Issue 1: the Signing Bonus as "earnings"

9. Mr Martin accepts that the Signing Bonus constituted "earnings" at the time when it was paid. I think that he is right to do. The Contract was a new employment contract creating mutual rights and obligations. One of JLT's obligations was to pay the Signing Bonus. Mr Martin's obligations included (i) his obligation to serve JLT for at least 5 years, the proviso to Clause 2.2 precluding his giving a termination notice which would expire before that time had expired and (ii) the restrictive covenants entered into by him under Clause 9. The Signing Bonus was an "emolument of employment" under section 62(2)(c) ITEPA alternatively fell to be treated as earnings under section 225 (payment for restrictive undertakings). Viewed as payment for (i), this conclusion is supported by the decision of the House of Lord in *Cameron v Prendergast* [1940] AC 549 (as to which see paragraph 60a. below).

10. Mr Ridgway submits, however, that when Mr Martin's employment terminated following his giving notice, contrary to the terms of Clause 2.2, the sum which fell

to be repaid (but which he had already received) ceased to be, or to put it another way can be seen retrospectively never to have been, "earnings". His self-assessment tax return although correct when completed, therefore contained an error which he was entitled to correct to show the true amount of his earnings – that is to say the sum received less the sum repaid (ignoring any questions of interest). In effect, the Signing Bonus is to be seen as accruing over the 5 year period during which Mr Martin had agreed not to serve a notice terminating the Contract.

11. Mr Ridgway attaches importance, of course, to the word "repay" in Clause 4.4. It is right to note, however, that "repay" is not being used in the sense of an obligation to return a traceable part of the original payment. It means no more and no less than that Mr Martin is obliged to pay to JLT a sum of money calculated in a certain way although it recognises that the payment is being made because JLT will not have received all of the benefit which it expected to receive as a result of making payment of the Signing Bonus.

12. Mr Ridgway also attaches importance to the letter of 5 October 2006. This, he says, was the culmination of negotiations. It was a negotiated compromise which resulted in an amendment to the Contract and a waiver of the breach of Clause 2.2. This reinforces the appreciation that the repayment of part of the Signing Bonus meant that the sums repaid had not been "earned" and that Mr Martin's return could properly be amended.

13. As to that, there was, no doubt, a negotiated compromise with Mr Martin ceasing to be employed under the Contract with effect from 31 December 2006 but with the quantum of his repayment obligation being calculated taking the date of expiry of the notice which he had given (1 August 2007). I do not consider that this can

have any impact on the result. I do not accept that this consideration lends support to a conclusion that the sums paid had not been earned. Indeed, quite the reverse: I do not understand how an employer and employee could enter into an agreement (*ie* the variation of the Contract in the present case) in a later tax year which would result in "earnings" which had correctly been included in a tax return for an earlier year ceasing to be "earnings" for that earlier year. I see this particular submission of Mr Ridgway as no more than an assertion of the result for which he contends.

14. Mr Ridgway points out that in order to be taxable, an amount must be both received and earned. Income tax can therefore anticipate earnings so that, if a person is taxed on something which he does not subsequently earn, that person can amend his or her return (within the statutory time-limit) to account for any error. An error will occur, he says, if an amount has been received and taxed but not earned. As well as the possibility of correction under section 9ZA Taxes Management Act 1970 ("**TMA**") there is the possibility of correction for error or mistake. And if the payment and repayment are made in the same tax year, a taxpayer may net off the two payments and return the amount actually earned in the tax year. That is all perfectly correct subject to this: the correction (and the set off in the last case) all depends on the repayment resulting in something which has been treated as earned not in fact being earned. In the present case, the issue is whether the repayments made by Mr Martin did, in fact, result in part of the Signing Bonus not being "earned".

15. Tax is imposed under the charging provision (section 9 ITEPA). So far as concerns general earnings for a particular year, the amount on which tax is charged is the "net taxable earnings from an employment in that year". The net

taxable earnings are defined in section 11 (to which I will come in more detail later); one component of the definition is the taxpayer's "taxable earnings". Taxable earnings are defined in section 10(1) which states that they are to be determined in accordance with Chapters 4 and 5 of Part 2. For present purposes, it is necessary to refer only to section 62, the relevant parts of which are set out in Annex 2 below. As I have noted in paragraph 8 above, the Signing Bonus was either an "emolument of employment" under section 62(2)(c) ITEPA or, at least in part, fell to be treated as earnings under section 225 (payment for restrictive undertakings).

16. Section 15 is concerned with tax years when a taxpayer is resident, ordinarily resident and domiciled in the UK. Mr Martin was so resident, ordinarily resident and domiciled. Section 15(3) as it stood for the tax years relevant to the present appeal is also set out in Annex 2 below. Where a person receives an amount of "earnings" in a tax year, it is taxable in the year of receipt (a) whether the earnings are "for" that year or "for" some other tax year and (b) whether or not the employment is held at the time when the earnings are received. Paragraph (b) recognises that an amount might be received when an employment is not held, for instance a payment received before the employment is taken up or after it has come to an end.

17. All income must have a source to be taxable; accordingly, employment income must be earned in a year in which the employment is held; and, as already noted, income must be received before it is taxable. These two aspects (earnings and receipt) are dealt within in section 16 to 19. These four sections are introduced by section 14(2): sections 16 and 17 are stated to "deal with the year for which

general income is earned" and sections 18 and 19 are stated to "deal with the time when general earnings are received".

18. Sections 16 and 17 are also set out Annex 2 below. The foundation is set out in section 16(2): general earnings earned in, or otherwise in respect of, a particular period are to be regarded as general earnings for that period. And so (see section 16(3)) if that period consists of the whole or part of a single tax year, the general earnings are regarded as being "for" that tax year and (see section 16 (4)) if that period consists of the whole or parts of two or more tax years, there is to be a just and reasonable apportionment in order to establish for which years the general income is to be regarded as "for".

19. Section 17 deals with cases where general earnings would otherwise fall to be regarded as being "for" a tax year in which the employee does not hold the office. It operates by treating the earnings as being "for" a different year in which the employment did subsist. This reflects the source doctrine mentioned in paragraph 17 above.

20. Section 18 is also set out in Annex 2 below. Mr Ridgway relies on the wording of Rule 1 and its use of the words "on account of". He correctly observes that this acknowledges the fact that money can be received in advance of, that is to say on account of, earnings which have not yet been earned. But that does not tell us when any particular payment is on account of earnings rather than a payment of an amount which has already been earned.

21. Mr Ridgway has referred to *Edwards v Roberts* (1935) 19 TC 618. This was a case of a contingent payment. It was held that a payment subject to a contingency is not earned until the contingency is satisfied. There needed to be, in that case, a proper examination of the facts to ascertain precisely what right the taxpayer had

in the fund which had been set aside and which might become payable to him: as Lord Hanworth MR put it "It really comes back to a question of fact and the interpretation of the agreement". That being so, I do not propose to go into the facts of the case. It is enough to say that the facts are materially different from, and provide me with no guidance to the correct answer in, the present case.

22. Mr Ridgway seeks to bring the present case within the contingency analysis which applied in *Edwards v Roberts*. He summarises his case this way: When Mr Martin commenced his employment he received a Signing Bonus of £250,000. The entitlement to this sum was contingent upon his working for JLT for five years. In effect for each month he worked he could keep 1/60th of it. If he left before that he had to repay a proportion of it. He was taxable under section 15 on the receipt of earnings, that is to say on £250,000. The full amount was taxable as it had been received. It was a sum paid on account of earnings. As the entitlement accrues over the five years and is contingent upon him working the full five years, it is treated under section 16(4) ITEPA as earnings of that period on a just and reasonable basis. This would be 1/60th for each month of the five years. When Mr Martin resigned in year 2, he was obliged to repay a proportion of the Signing Bonus; it then became apparent that this sum had not been earned and his tax return, based on the receipt of earnings that had subsequently not been earned, was incorrect. He amended his return in accordance with section 9ZA, TMA 1970 to take account of the fact that he had been overtaxed.

23. Mr Tolley submits that, on its true construction, the Contract does not operate in the way that Mr Ridgway suggests. It is not, according to Mr Tolley, correct to say that the Signing Bonus accrues, or is to be treated, as accruing over the 5 year period. The Signing Bonus was a one-off payment given, as is expressly

provided, in return for entering into the Contract, observing its terms and the giving of the restrictive covenants. Mr Tolley agrees, indeed he asserts, that the consideration for the Signing Bonus went beyond merely signing the contract: it is important that it included an agreement by Mr Martin to continue his employment when he might otherwise have left. I would add that it is important also that it also included the other obligations imposed on Mr Martin by the Contract. Mr Tolley submits that the second sentence of clause 4.4 of the Contract does not operate in such a way that the Signing Bonus, or any part of it, can validly be regarded as "unearned" by the time of its receipt by Mr Martin. Mr Martin's right to the full amount of the Signing Bonus accrued from the moment he provided consideration for it, *ie* by entering into the Contract and making the promises contained in it. And so Mr Martin's right to the Signing Bonus was fully vested when he received it on 25 November 2005.

24. Further, he submits that it is not a tenable view that the words, "shall be obligated to repay", in the second sentence in clause 4.4 of the Contract could produce a construction of the clause as a whole whereby the right of Mr Martin to payment of the Signing Bonus by JLT was somehow contingent upon any event occurring after the date of the Contract. If JLT had failed to pay the Signing Bonus, Mr Martin would have had a cause of action to recover its amount; and, it having been paid in fact, the money was at his full disposal.

25. Accordingly, the full amount of the Signing Bonus was (i) "earned" by the time of its payment on 25 November 2005 (ii) "general earnings" for the 2005/06 tax year and (iii) required to be treated as "taxable earnings" in that year.

26. The Tribunal's conclusion was that the Signing Bonus constituted earnings and that Mr Martin's earnings for 2005/06 were not reduced by the payments which he

made in October 2006 to January 2007. They reached that conclusion for very much the reasons which Mr Tolley now advances (as recorded above). They regarded the Signing Bonus as being made to secure Mr Martin's commitment to tie himself to JLT for the 5-year period. As they put it at [40] and [41] of the Decision:

> "40. 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."

27. My conclusion is the same as that of the Tribunal and I accept Mr Tolley's submissions. I agree with what the Tribunal said in [40] (although I should not be taken as agreeing or disagreeing with what the Tribunal said in [41]). I add this. The Tribunal concluded at [28] of the Decision that the obligation to make any repayment under Clause 4.4 would be most likely to arise, if it arose at all, if and only if Mr Martin gave a termination notice in breach of Clause 2.2. The other situations when an obligation to pay might arise (summary dismissal and termination of employment by statute or operation of law) were unlikely to occur in the 5-year period. I do not disagree with that. Nonetheless, there are other situations where the Contract might come to an end without any obligation to repay coming into effect. Thus in case of death or determination on notice by JLT (other than in cases of fraud *etc*, ill health, insanity), there would be no obligation to refund. In these events the Contract says precisely nothing about repayment: it

does not need to say anything because nothing will be repayable. The structure of the Contract is that repayment is expressly dealt with, but only in the case of certain events. The Contract is not structured so as to give Mr Martin an accruing right to payment of a bonus with payment on account being made of the full amount at the beginning of the 5-year period; and, if it had been structured in that way, the Contract would have needed to make provision for the immediate payment of the balance in the cases where, under the Contract as in fact signed, there is no obligation to repay. This supports my conclusion that the £162,500 payments by Mr Martin to JLT in the period October 2006 to January 2007 do not reduce the amount of earnings properly to be contained in his 2005/06 tax return and do not entitle him to amend that return to reflect the payments.

28. Accordingly, Mr Martin's cross-appeal is dismissed.

Issues 2, 3 and 4: "negative taxable earnings" as "taxable earnings"; "negative taxable earnings" and any requirement for a contractual reversal; and "general earnings" or an amount by way of liquidated damages.

29. Although Issues 2, 3 and 4 are identified as separate issues by the parties, they are closely related and can be taken together. These issues all go to establishing the amount of "net taxable earnings" as defined in section 11, another section which is set out in Annex 2 below. As will be seen, I do not address the questions which arise on this appeal, following the rejection of Mr Martin's cross-appeal, in precisely the way which Issues 2 to 4 put them.

30. Both TE and DE are perfectly comprehensible concepts. Taking DE first, this means the deductions which are allowable under section 327(3) to (5) when calculating the amount by reference to which a taxpayer's chargeable employment

income is to be assessed. The starting point is to work out TE and then to deduct the allowable deductions: in other words, the concept of TE does not already include within it the allowable deductions even though TE stands for "taxable earnings". Nothing turns on the detail of the deductions; they include matters such as expenses and pension contributions.

31. It is not difficult to see conceptually how TE-DE might be negative. Where that is the case, "net taxable earnings" are to be taken to be nil. What is not so easy to see is how TE by itself might be negative. There is no definition in ITEPA or elsewhere of what it is for TE to be negative. The very concept of "earnings" being negative is not an easy one to grasp. The Tribunal struggled with it, Mr Ridgway and Mr Tolley have, I think, struggled with it and I have certainly struggled with it. This is because the ordinary concept of "earnings" is something which moves from the employer (or sometimes from a third party) to the employee. Looking at section 62 ITEPA, which explains what is meant by earnings, it is not at all easy to see how there could ever be a negative amount arising under any of the specific matters mentioned in subsections (2) and (3). As to this, see further at paragraph 33 below.

32. Arriving at a proper understanding is not helped by the fact that section 11(3) envisages that loss relief under what is now section 128 ITA may be available where TE is negative. Loss relief is available where a person makes a loss in his employment. It is, once again, not entirely easy to grasp what such a loss could be if it is different in kind, as it must be, from an excess of deductible expenses over taxable earnings, that is to say where DE exceeds TE.

33. Understanding the concept of negative TE is made the greater by the following consideration. If TE is negative, this means, applying the words of the definition

of TE, that the total amount of taxable earnings from the employment in the tax year is negative. In turn, "taxable earnings" are defined (so far as relevant to the present case) in section 15(2) as the full amount of general earnings received in the relevant tax year. Accordingly, if TE is negative, the total amount of general earnings received in the tax year must be negative. Under section 7(3), "general earnings" are in effect earnings which fall within section 62 and any amount treated as earnings by the provisions referred to in section 7(5). It can be seen, therefore, that the principal focus of "general earnings" is on something which an employee receives from the employer; the focus is on what I will refer to as positive general earnings, a concept which presents no difficulties at all. Correspondingly, I will refer to the full amount of positive general earnings received in a tax year as the positive taxable earnings.

34. Just as positive taxable earnings represent positive general earnings of the employee for a relevant tax year, so too negative taxable earnings must, in my view, envisage payments which are made (rather than received) by the employee for the relevant tax year. I will refer to such payments as negative general earnings. In the present case, Mr Martin's case involves the proposition that the payments which he made to JLT are negative general earnings and negative taxable earnings as I have explained them.

35. The Tribunal made the point that positive and negative taxable earnings are taken together in order to arrive at TE, observing that this may seem obvious. However, there appears to have been a suggestion at some stage in these proceedings that the total of the payments made by Mr Martin, £162,500, resulted in a negative figure for TE of £162,500. That is not correct: that figure (if Mr Martin's case is correct) falls within what I have called negative taxable earnings. The amount of negative

TE, that is to say "the total amount of any taxable earnings" is the difference between positive taxable earnings and negative taxable earnings. Further, TE is to be ascertained as a figure from which DE is deducted. It follows that, if TE is negative, there is nothing from which DE can be deducted. The only way of obtaining relief for expenses will therefore be through a loss claim under section 128 ITA but that will be available only in exceptional circumstances under section 11(3)(b). It would not be correct first to work out the amount of positive taxable earnings, next to deduct expenses from that amount and finally to deduct the negative taxable earnings: this would, in effect, give greater relief for expenses than would be allowed if DE is deducted from TE.

36. This point is not without importance. It demonstrates that negative taxable earnings are not only relevant when they produce a result where TE is negative. They are also relevant in arriving at the end figure for TE even if that remains positive. Thus, suppose that a taxpayer's positive taxable earnings are £100 and his negative taxable earnings are £80. This will result an amount for TE of £20. In contrast, suppose that the figures are £100 for positive taxable earnings and £120 for negative taxable earnings. This will result in a situation where TE is a negative figure of £20, so that employment loss relief may be available under section 128 ITA.

37. There is no explanation in the legislation of what it means for TE to be negative or of what items of expenditure by an employee could be brought into account in making a determination of TE. In my terminology, there is no explanation of the concept of what could amount to negative general earnings or negative taxable earnings.

38. To gain an understanding of those matters, it is, I consider, relevant and helpful to consider the position under the law as it stood prior to ITEPA. A taxpayer's liability under Schedule E was a function of his emoluments with allowance being made for certain deductions against those emoluments. There was no express mention of the possibility that emoluments might be negative (or anything resembling that possibility) and there was no express mention of the possibility of a payment by an employee reducing the total amount of his emoluments (in contrast with deductions being allowed from those total emoluments in calculating the employee's tax liability).

39. Employment loss relief was provided by section 380 Taxes Act 1988. This was a portmanteau section dealing with losses in "any trade, profession, vocation, or employment". Its provisions were amended in ways which are not material for present purposes. It was replaced, so far as concerns employment income, by section 128 ITA. Neither side knows of any authority which has considered how section 380 Taxes Act 1988 or section 128 ITA might operate so as to give rise to a loss in the context of employment. HMRC did publish some guidance on the operation of section 380: this was referred to by the Tribunal at [50] of the Decision. I do not set it out again although the guidance gave two examples, stating that the loss had to

> "arise 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)."

40. Similar, but not identical, guidance dealing with section 128 ITA is to be found in HMRC's manuals at EIM 32866. It adds, before giving the same examples, a requirement that "The employee must be contractually obliged to suffer a part of

the employer's losses". This additional requirement is not supported by any authority. Mr Ridgway says that it does not reflect the law. I do not understand Mr Tolley to support it as an accurate reflection of the law. I agree with Mr Ridgway's submission.

41. Mr Ridgway submits that the prevailing practice of the Inland Revenue and now HMRC at the time when ITEPA 2003 was being drafted was to allow the repayment of income tax suffered on earnings which, due to contractual terms, were subsequently repaid to the employer. He says that this practice represented the law but its mere existence meant that the matter was never tested in the courts. He has referred to *British Railway Board v Franklin* [1993] STC 487 which covered a situation where an employee was required under his employment contract to repay sick pay which he had received by way of loan in the event that he received a payment of damages. The practice which was discussed in that case was rather different from the rather wider practice which Mr Ridgway suggests existed at the time. One thing which is clear is that the question whether payment by an employee to his employer had to be paid under a contractual obligation was not addressed. The existence of the Inland Revenue practice meant that it did not need to be. I do not gain any help from that case in resolving the issues in the present case.

42. Although there is uncertainty about the extent to which payments made by an employee to his employer could have been taken account of in ascertaining a taxpayer's taxable emoluments (corresponding to TE in section 11 ITEPA) in contrast with identifying payments giving rise to a right of deduction (corresponding to DE in section 11 ITEPA), it is common ground that there were at least some payments which could have constituted what can be referred to as

negative emoluments. Importantly, HMRC accept that, had the proviso to Clause 2.2 of the Contract not been included in that Clause, the payments which Mr Martin made would have fallen to be deducted in ascertaining his total emoluments from his employment by JLT. And they also accept, unsurprisingly in the light of that concession, that absent the proviso the payments by Mr Martin would have been taken account of in ascertaining TE under section 11 ITEPA. It is because, and only because, the payments are seen by HMRC as liquidated damages for Mr Martin's breach of contract in serving a notice within the Initial Period that they say the payments do not fall to be taken into account. I will come to the case law on which HMRC rely to justify this difference of treatment in due course, at which stage I will reach a conclusion as to whether the payments made by Mr Martin would have been what I have called negative emoluments.

43. Before I do so, however, I wish to say something about the nature of ITEPA. Although it is not a pure consolidation Act, its preamble describes it as

> "An Act to restate, with minor changes, certain enactments relating to income tax on employment income…. and for connected purposes."

44. In my view, section 11 ITEPA did not bring about a change in the law. I consider that a payment by an employee to his employer qualifies as negative general earnings if, but only if, it would have qualified as what I have called negative emoluments. My reasons for reaching that conclusion appear in the following paragraphs.

45. It has not been suggested that there is any type of payment which would, under the pre-ITEPA legislation, have fallen within the concept of negative emoluments as I have described them but which does not now, under ITEPA, fall within the concept of negative general earnings.

46. It is in theory possible, however, that section 11, with its express recognition that TE can be negative, has resulted in certain payments being recognised as negative taxable earnings when they would not, under the old law, have been recognised as negative emoluments. But the basis, and the only basis, for this interpretation of ITEPA, is that the words "where TE is negative" in section 11(3)(a) have brought about a change in the law. Such a change could not, in my view, be described as a "minor change" within the preamble to ITEPA. It would be a significant change, significant because the change would not be limited to occasions of loss relief where TE is negative. As well as that, the change would result in a payment reducing the total amount of taxable earnings when it would not have reduced the total amount of taxable emoluments even in cases where the end position is not one of overall loss. It is, to my mind, very surprising that a significant change of this sort could be effected by those few words which, on any view, are obscure in their meaning.

47. Viewing, as I do, ITEPA against its purpose as expressed in the preamble, I am entitled to take into account the pre-exiting law and to see section 11 as making explicit that which was previously implicit in the pre-existing legislation. My view, therefore, is that TE can be negative only where, under the pre-existing law, the payment which is said to amount to negative general earnings would have featured in the calculation of emoluments. In other words, what I have defined as negative general earnings and as negative emoluments are to be given the same meanings.

48. It might, however, be argued that contrary to HMRC's view, it was never possible for there to be negative emoluments in the sense in which I have described them. If that were right, it would mean that there could never have been a loss in an

employment within section 380. In those circumstances, one should not strain, I consider, to give section 11(3)(a) ITEPA content since the only relevance of TE being negative is that it gives rise, potentially to an employment loss claim (now under section 128 ITA rather than under section 380). It should be accepted that section 11(3)(a) would then be devoid of content. This does not mean that the draftsman has acted under a mistake (namely, that it was possible to have negative emoluments under the old law). Rather, he was simply expressing that which was implicit in the old legislation, namely that there could be occasions where an employment loss might arise.

49. I add this. As already noted (see paragraph 37 above), negative taxable earnings are taken into account in determining TE and this is so even if TE remains positive. The impact of negative taxable earnings is not restricted to circumstances where TE is negative and is therefore of importance even where there is no question of employment loss relief being available. If negative taxable earnings can include payments of a type which would not have been taken into account under the old law in the calculation of total emoluments, then the driver, and the only driver, for this change in the law is section 11(3)(a). If section 11(3)(a) had not been included in section 11, I do not think that it could sensibly be maintained that a payment by an employee could be taken into account in calculating TE which could not have been taken into account in calculating total emoluments. It seems to me that to allow a provision intended to deal with loss relief to have such an important impact even in cases where there is no loss would be a classic case of the tail wagging the dog.

50. In any case, further consideration of the interaction between section 11 ITEPA and section 380 Taxes Act 1988 (now 128 ITA) only goes to reinforce the conclusions which I have reached. Before ITEPA was enacted, employment loss relief was found in section 380 Taxes Act 1988. An employment loss could arise only where there were what I have described as negative emoluments (subject always to any contrary statutory provision or to the limited cases where excess deductions were capable of giving rise to a loss, neither of which is relevant to the present case).

51. When ITEPA came into force, employment loss relief remained to be dealt with under section 380, the wording of which remained unchanged. If a payment before ITEPA would not have counted as negative emoluments but the same payment after ITEPA would have counted as negative general earnings, then the type of payments which could give rise to an employment loss within section 380 would have changed. There is nothing inherently wrong with that. Thus, if section 11 had defined TE in such a way that it was clear that a payment of a particular type made by an employee would be brought into account in calculating (and so as to reduce) TE when that payment would clearly not have been a negative emolument, then no doubt section 380 would have to be read as including any negative TE which resulted from that payment. But where matters are not clear in that way, it seems to me that, reading section 11 in the context of the (pre-existing) section 380 and taking account of the nature of ITEPA as a consolidating Act with minor changes, the correct approach is to treat negative general earnings as no different from negative emoluments. The subsequent restatement of employment loss relief in section 128 ITA does not, in my judgment, have any impact on these conclusions.

52. My conclusion is that a payment made by an employee can be brought into account in determining TE only where the same payment, made prior to ITEPA, would have been brought into account in determining the amount of taxable emoluments. Section 11(3)(a) has not brought about a change in the law.

53. This conclusion is consistent with the tax law rewrite explanatory notes to ITEPA, to which Mr Ridgway has drawn my attention. These explained that ICTA did not spell out the method for calculating the income chargeable to tax under section 19 Taxes Act 1988. They also explained that sections 11(2) to (4) simply reflected the way that the amount of income chargeable to tax was calculated under the pre-existing legislation although the focus of that observation was perhaps on deductions rather than on negative earnings. I agree with Mr Ridgway when he says that section 11 was designed to articulate the operation of the existing legislation and practice rather than creating something new.

54. I turn now to what would have counted as negative emoluments under the pre-ITEPA law and negative general, or taxable, earnings under ITEPA.

55. It is clearly the case that not every payment which an employee makes to an employer is negative general earnings. This is not a matter of dispute. To give an obvious example, the repayment of money which a cashier had stolen from their employer's till would not be such an item. The mere existence of an employment relationship is not enough.

56. Nor is a connection between the payment and the contract of employment of itself necessarily sufficient. A claim for an account of profits alternatively for damages where an employee misuses his employer's trade secrets or acts in breach of a restrictive covenant during the course of his employment can be said to arise out of the contract of employment: it certainly has a connection with it. But no-one

would suggest that a payment pursuant to an order for an account of profits or damages would entitle the employee to assert that the payment was negative general or taxable earnings.

57. The correct approach, in my view, is to establish the attributes of positive taxable earnings and to see which of those are, or might with suitable adjustments, be made, applicable to the particular payment which is said to be negative taxable earnings. If an attribute is not applicable and cannot, by making suitable adjustments, be made applicable to that particular payment, then that attribute can be left out of account.

58. Let me show what I mean by giving an example. For a payment to be positive taxable earnings it has at least these two attributes: first it has to be received by the employee and secondly it has to be received in the relevant tax year (see section 15(2) and (3)(b)). As to the first attribute, a payment which is said to be negative taxable earnings will not, of course, be received by the employee at all: it will be paid by him. But to count as negative taxable earnings, a payment by the employee must I think, be paid to the employer (although I suppose, reflecting *Shilton v Wilmshurst*, (as to which see below) there may be circumstances where a payment to a third party would qualify). As to the second attribute, making the appropriate adjustment, the payment must be made, rather than received, in the relevant tax year; payment in a different year will not result in the payment being negative taxable earnings for the year in question.

59. Just as an amount received after the termination of an employment may still be earnings from that employment, and so chargeable as employment income, the same must be true in reverse of negative earnings, so that a payment by employee

to employer after the employment had terminated can be taken into account in calculating TE. HMRC accepts that to be the case.

60. In relation to earnings received by an employee, or a former employee, section 16 ITEPA makes provision for establishing the tax year to which the earnings relate (that is to say whether earnings are 'for' a particular year). In relation to earnings for a tax year after the termination of employment, the position is covered by s 17(3) ITEPA. There are no equivalent provisions for "negative earnings". In a case where there are negative taxable earnings, the correct approach must be to identify the tax year that the negative earnings were "for" (along similar lines to those in s 16 ITEPA) and allow losses accordingly under s 128 ITA. There does not appear to be any statutory provision which would expressly apply in such a case. HMRC accepts these propositions too.

61. In the present case, the first two payments were made by Mr Martin while he was still employed; the third payment was made after the Termination Date. If that third payment was negative earnings, then, applying the above propositions, it would fall to be treated as having been made "for" the tax year in which the employment terminated.

62. Some fine distinctions have been drawn in the cases between payments which are and are not emoluments. Let me mention a few of them:

    a. *Cameron v Prendergast* (see paragraph 9 above). A director of a company was minded to resign. His fellow directors asked him not to do so, saying that he would be paid £45,000 if he acceded to their request. It was held that an agreement not to cease giving his services as a director necessarily

involved an agreement to continue to render those services. The money so paid was a profit from his directorship and liable to income tax.

b. *Shilton v Wilmshurst* [1991] 1 AC 684. This case concerned a transfer of Mr Shilton, a well-known professional footballer, from Nottingham Forest FC to Southampton FC in August 1982. He agreed with Nottingham Forest to the transfer subject to an agreement by Nottingham Forest to pay him £75,000. He also agreed with Southampton that he would play for them on the basis of an agreed salary and other terms; that agreement provided for a payment by Southampton of £80,000. Mr Shilton was assessed to income tax on the total of those two amounts. He accepted a liability to tax on the £80,000, which was paid to him by Southampton at a time when he was employed by Southampton. He challenged the assessment in relation to the £75,000 paid by Nottingham Foreest. The Court of Appeal had held that, to be chargeable under the then charging provision, section 181 Taxes Act 1970, an emolument must be referable to the performance of services by the employee under his contract of service. This was not the case in relation to the payment made by Nottingham Forest.

   The House of Lords reversed the decision of the Court of Appeal. It was held that an emolument was chargeable to Schedule E income tax as being "from" employment if the payment in question had been made to taxpayer for a reward for past services, or and an inducement for him to agree to become, or to remain, an employee. In the case of a payment by a third party (Nottingham Forest in that case) it was not necessary to show (contrary to the Court of Appeal's decision) that the person making the

payment had any interest in the performance of the services to be undertaken by the employee under his contract of employment (with Southampton in that case). Accordingly, the payment of £75,000 was an emolument of his employment with Southampton. As Lord Templeman put it at p 689B-D:

> "Section 181 is not confined to "emoluments from the employer" but embraces all "emoluments from employment"; the second must therefore comprehend an emolument provided by a third party, a person who is not an employer. Section 181 is not limited to emoluments provided in the course of employment; the section must therefore apply first to an emolument which is paid as a reward for past services and as an inducement to continue to perform services and, secondly, to an emolument which is paid as an inducement to enter into a contract of employment and to perform services in the future. The result is that an emolument 'from employment' means an emolument 'from being or becoming an employee….. 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". The task of determining whether an emolument was paid for being or becoming an employee or was paid for another reason, is frequently difficult and gives rise to fine distinctions…"

The only issues in that case, by the time it reached the House of Lords, were whether an emolument could come from a third party or not; and if it could, whether the third party needed to have an interest in the performance of the service to be provided under the contract of service. It was not suggested that the payment of £75,000 would not be an emolument because it lacked some other characteristic necessary before a payment could count as an emolument.

c. *Henley v Murray* [1950] 1 All ER 908. The taxpayer was employed under a service contract determinable at the earliest on 31 March 1944. He was requested (as a result of a requirement from the trustee for debenture holders) to leave service. He did so on 6 July 1943, it being agreed that he

would be paid £2,000 being an amount equal to that which he would have received under his service contract if he had served until 31 March 1944. It was held that the sum was payable in consideration of the abrogation of the service contract; it was not a profit from his employment in respect of which he was assessable to income tax (there being no special relevant statutory provision for treating such payments as emoluments or taxable earnings). Sir Raymond Evershed drew a distinction between a case (such as *Cameron v Prendergast*) where the contract persists and the case before him, adding this in relation to the former sort of case:

> "Though the right of one party to call on the other for performance of its terms may be modified, or, indeed, wholly given up, still the corresponding right to require payment either of the whole remuneration or of some less figure is preserved and is still payable under the contract."

d. *Dale v de Soissons* [1950] 2 All ER 460. Under the terms of his service contract, the taxpayer was entitled to a salary and commission. The contract was to run for a period of three years. The employer was entitled to terminate the contract at the end of the first or second year of the contract on three months' notice. In that event, the taxpayer would become entitled to the payment of a lump sum by way of compensation for loss of office. The employer exercised its right to terminate at the end of the first year and paid the taxpayer the amount due under his service contract. It was held that, since the taxpayer was entitled to receive the compensation payment under the terms of his contract in the event, which had happened, of the employer exercising its right of termination, the compensation was a profit arising from his employment and therefore taxable. The issue was essentially one of construction of the relevant

clause in the contract. Was it, as the taxpayer argued, essentially a sum paid in consideration for the cancellation of the rights under contract which the taxpayer would otherwise have had (as in *Henley v Murray*)? Or was it part of the remuneration which the taxpayer was entitled to get under, and received from, his service contract? As Sir Raymond Evershed MR observed at p 461B, "Cases of this character are never easy, and the line between those in which the taxpayer has succeeded and those in which he has failed may be described as "a little wobbly""; but he went on to hold that the contract before him resulted in the payment being taxable. He adopted the reasoning of Roxburgh J at first instance:

> "In the present case the taxpayer surrendered no rights. He got exactly what he was entitled to get under his contract of employment. Accordingly, the payment, in my judgment, falls within the taxable class…"

63. One sees in these authorities that the search is for the reason for which the payment in question is made. The cases show that a distinction is to be drawn between those where the payment flows from the implementation of the contract (as in *Dale v de Soissons*) and those where the payment arises as the result of the abrogation of the contract (as in *Henley v Murray*). Mr Tolley suggests that there is a material distinction between cases where the payment arises as a result of something which one or other of the parties is permitted to do in accordance with the terms of the contract (again as in *Dale v de Soissons*) and a case which involves a breach of contract. *Henley v Murray* does not, however, establish that such a distinction is material. It did not involve breach: there was no breach of contract in the parties to it agreeing to vary its terms, indeed going so far as to abrogate it.

64. When it comes to ascertaining whether a payment made by, rather than to, an employee is negative general earnings, the search must again, in my view, be for the reasons for which the payment was made. The question, I consider, remains whether the payment is from the employment – or to use what is perhaps a better phrase in the context of a payment by, rather than to, an employee, whether the payment arises directly out of the employment – or for some other reason. In answering that question, the correct approach reflects what I have suggested in paragraph 57 above: having identified (in accordance with the authorities discussed above, so far as they go) what it is that makes a payment to an employee a payment of positive general earnings, it is necessary to consider how the factors identified might then be applied to a payment by an employee to see whether the payment constitutes negative general earnings. Importantly, just as the total abrogation of the contract in *Henley v Murray* meant that the payment in that case was not an emolument (and did not arise from the employment) so too a payment by an employee to his employer arising as the result of an arrangement which totally abrogates the contract of employment will not, in my judgment, constitute negative general earnings.

65. I now apply that approach to two contrasting examples. Suppose that, in *Henley v Murray*, it had been Mr Henley who wanted to terminate his service contract early and that, assuming he had no right to terminate it, he had entered into an agreement with his employer bringing an end to his employment in consideration of a payment by him equivalent to the estimated cost of recruiting a successor; and suppose that he had paid that amount to the employer before he left service. The payment would not, in my view, be negative general earnings because it would not be from or arise out of the employment. It would not even arise, I consider,

out of the contract of employment although it would, of course, have been payable only because of the existence of the contract of employment. It would, instead, have arisen from something outside the employment and the employment contract, namely an agreement, abrogating the employment contract, about the terms on which Mr Henley would cease to be employed and be released from his employment contract.

66. Next, suppose that in the present case the proviso to Clause 2.2 had not been included in the Contract. Mr Martin would then have been able to serve the notice of termination which he actually served without there being any question of a breach of contract. Payments due under Clause 4.4 would then, in my judgment, have arisen from the employment in such a way as to amount to negative emoluments (under the old law) and as negative taxable earnings under section 11 ITEPA. Such payments would be analogous (in reverse) to the payments in *Dale v de Soissons*. Whether or not HMRC's guidance (as set out above) is entirely accurate, the payments would, to use the words of the guidance, have "arisen directly from the conditions of the employment". HMRC accept that this conclusion is correct: they accept that, absent the proviso, the payments by Mr Martin would have been taken account of in ascertaining the amount of taxable earnings within the definition of TE under section 11 ITEPA (and indeed under the old law in ascertaining the amount of any loss for the purposes of section 380 Taxes Act 1988).

67. The presence of the proviso makes all the difference according to HMRC. On their case, the payment obligation arising under Clause 4.4 when Mr Martin served notice is a provision for the payment of liquidated damages for Mr Martin's breach of contract in serving a notice within the Initial Period. In

contrast with the counterfactual example in the preceding paragraph, the actual facts of the present case give to a situation which is analogous (again in reverse) to *Henley v Murray*.

68. So, into which category does the present case in fact fall? Is it closer to a case of abrogation or is it closer to a case of contractual obligation in the absence of any breach? As judges have said on previous occasions, fine lines have been drawn between cases falling one side or other of the line between emoluments which are from an employment and those which are not. The same is true in deciding whether a payment can count as negative general earnings. It is necessary, therefore, to embark on a more detailed consideration of what the Contract actually means and, in particular, to understand how Clause 2.2 operates and the nature of the payments to be made by Mr Martin under Clause 4.4 as a result of his serving notice to terminate his contract.

69. It has to be said that Clause 2.2 and Clause 4.4 do not sit together entirely comfortably. Without the proviso to Clause 2.2, there would be no difficulty: Mr Martin would be able to serve notice of the requisite length at any time; if he were to do so, he would become liable to make payment under Clause 4.4 of the amount calculated in accordance with the formula found in the clause, his obligation being to pay within 7 days of the termination of the employment.

70. The inclusion of the proviso gives rise to some areas of difficulty relating to the interpretation of both Clauses 2.2 and 4.4. They include the following three principal areas. The first is whether it imposes a contractual obligation on Mr Martin not to serve a notice during the Initial Period or whether it simply renders invalid a notice which is expressed to expire during the Initial Period (or perhaps postpones its effective date until the end of that period). In either case, the

proviso, I should note, was clearly inserted for the benefit of JLT; it would be open to JLT to waive it. The second is whether, in the light of the proviso, a premature notice is nonetheless effective to terminate the Contract since paragraph (a) of Clause 4.4 seems to envisage that such a (premature) notice will do so. The third is whether, assuming Clause 2.2 creates the contractual obligation which I have just mentioned, Clause 4.4 is a liquidated damages provision as HMRC suggest.

71. Reading the two clauses together, the position is, in my view, as follows:

    a. Clause 2.2 imposes a contractual obligation on Mr Martin not to serve a notice expiring within the Initial Period.

    b. If he does so, in breach of contract, it is not clear whether the Contract automatically comes to an end, leaving JLT with its rights under Clause 4.4 and, possibly, a claim for any damage over and above the sum due under that Clause which it could establish or whether JLT would be entitled to hold Mr Martin to his contract. I use the word "possibly" since, if HMRC are correct in saying that Clause 4.4 is a liquidated damages provision, the recoverable loss may be limited to the liquidated sum.

    c. What is clear, in my view, is that it would be open to JLT to accept the notice as effective and to allow the provisions of the contract concerning termination to take effect.

    d. It would also be open to Mr Martin and JLT to agree adjustments, whether as to amount or timing, in the payments falling due for payment under Clause 4.4.

72. This last point may be of some significance. On the actual facts of the present case, Mr Martin and JLT made an agreement which resulted in different payments from the payment which Mr Martin was obliged to make under Clause 4.4. It might be said, therefore, that the differences have an impact on the tax consequences of the payments: in other words, even if payments made strictly in accordance with Clause 4.4 would have been negative taxable earnings, the actual payments in Mr Martin's case were not because, in effect, the Contract was abrogated. I do not think that such an argument is correct. The differences between what Mr Martin actually paid and what the Contract provided for were not major. They reflected the mutual interests of the parties so that Mr Martin obtained an earlier date for the release from his employment and JLT obtained earlier payment of the sum owing than it would otherwise have obtained. Those differences did not, I consider, result in the relevant attributes of the payments actually made being materially different in character. Accordingly, if payments made strictly in accordance with the Contract would have been negative taxable earnings, then so too the actual payments made would have been negative taxable earnings.

73. The correct tax treatment of the payments made by Mr Martin turns, therefore, in my view on the correct tax treatment of the payments which he was obliged to make under Clause 4.4 in the light of the treatment by JLT of the notice of termination. In my judgment, such payments arose directly from Mr Martin's employment and were made for the purposes of the employment. Although fine distinctions have, as already mentioned, been drawn in the cases concerning payment to an employee, the distinction which HMRC seeks to draw between the

counterfactual situation considered at paragraph 66 above and the actual facts of the case is so fine, in my judgment, as to be almost invisible.

74. In reaching that conclusion, I have formed the view that Clause 4.4 is not properly to be seen as a liquidated damages provision. The true character of a payment under that provision is not damages; rather, it is a straightforward contractual provision to restore to JLT part of that which it has paid for a commitment which it will not in fact receive in full. The position is no different, in my view, from the counterfactual situation just mentioned under which Mr Martin would be entitled to serve a notice.

75. But even if that is stating matters too strongly in favour of Mr Martin, the proviso to Clause 4.4 was, as already explained, clearly inserted for the benefit of JLT. JLT could waive its provisions and treat the notice as effective to terminate the Contract; it did not have to treat Mr Martin's conduct as a breach of contract and assert a claim for damages even if Clause 4.4 is capable of being seen as a liquidated damages provision. Thus, if Mr Martin had sought a waiver of the proviso before serving his notice and if the waiver had been granted, there would be no question of any breach of contract by him. Nor, in my view, could that case properly be seen as one of total abrogation of the Contract as in *Henley v Murray*. The position is the same, in my judgment, where Mr Martin serves a notice in breach of the proviso but JLT elect to treat the notice as valid.

76. Mr Tolley submits, however, that on the facts of the present case the service by Mr Martin of the notice was a repudiatory breach of contract which was accepted by JLT: Mr Martin's primary obligation under the Contract was discharged and a secondary obligation to pay damages arose. He relies on [31] of the Decision. But the Tribunal said nothing there about repudiation of the Contract or the

acceptance of the notice as the acceptance of a repudiatory breach bringing about an end to the Contract. What the Tribunal did say was that "….. once JLT accepted the early notice…..it does follow that [Mr Martin's] employment was terminated, and also clear that Clause 4.4 applied so as to render [him] liable to refund £162,500". That is not language describing repudiatory breach: indeed, I see it as more consistent with the view that JLT simply accepted the notice as effective and waived the breach rather than attempting to hold Mr Martin to his contract and requiring him to continue to serve (failing which he might then be in repudiatory breach).

77. There was no cross-examination of Mr Martin at the Tribunal hearing about the issue of breach of contract and what actually passed between him and JLT. The Contract and the 5 October 2006 letter were in the list of documents provided by HMRC which they were proposing to rely on at the hearing. As Mr Ridgway submits, the documents in the appeal bundle before me are therefore the evidence which was made available to the Tribunal and on which it made its findings. As to those documents, I do not consider they are indicative of the payments made by Mr Martin being properly categorised as damages for breach of contract at all, let alone damages for a repudiatory breach. I accordingly reject Mr Tolley's submissions based on an allegation of repudiatory breach.

78. The Tribunal also added that, although Mr Martin had breached Clause 2.2, that did not make the liability under Clause 4.4 secondary: the most important element of Clause 4.4 was "to ensure the reversal of the residual fraction of the Signing Bonus if [Mr Martin] indeed breached Clause 2.2 and gave early notice of resignation". Whilst I agree with HMRC's submission that "contractual reversal" is not the correct test to apply to establish whether a payment amounts to negative

taxable earnings, the purpose of the payment is, nonetheless, a relevant consideration in considering whether it arises from the employment or is made for the purposes of the employment.

79. I also agree with Mr Ridgway that the payments were not secondary in the sense in which Mr Tolley uses the word, that is to say the replacement of the primary obligation of service by Mr Martin under the Contract. As Mr Ridgway submits, Clause 4.4 was an intrinsic part of the Contract: it recognised that Mr Martin might resign before the end of the Initial Period; the Clause makes direct reference to that and provides for the consequences. There was, he says, no secondary obligation on Mr Martin to pay in the event of an early termination notice; it was a primary obligation which went to the very root of the Contract. Viewed in the context of the Contract as a whole, Clause 4.4 governs the very thing that the Contract was designed to achieve, namely to ensure the continued services of Mr Martin and was not a pre-estimate of loss.

80. Accordingly, I agree with the conclusion of the Tribunal although I have adopted a rather different approach. The Tribunal did not consider the predecessor legislation, which I consider to be of great importance, but instead seems to have felt free, indeed obliged, to give a new meaning to what it described as "the extraordinarily undefined notion of "negative earnings"" considering "this forfeiture to be the most obvious example" of such a beast. I do not consider that this approach is one which should be adopted in future.

Disposition

81. Accordingly, HMRC's appeal is dismissed. I should add that, although I have explained what I think is the correct approach to the interpretation of section 11

and of the meaning of TE in particular, my actual decision turns critically on an interpretation of the Contract. It does not, and is not intended, to give any particular guidance about the application of that approach to different facts.

Mr Justice Warren, Chamber President

22 September 2014

Release date: 22 September 2014

Release date

ANNEX 1
Relevant provisions of the Contract

"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 [Mr Martin] 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.]

"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 [Mr Martin] the signing bonus described in the Schedule ("the Signing Bonus") [an amount of £250,000] together and at the same time as [Mr Martin's] first salary payment. In the event that before expiry of the Initial Period, any of the following occurs:

(a) [Mr Martin] serves written notice of termination of his employment or otherwise terminates his employment (other than by reason of death);
(b) [Mr Martin's] employment is terminated by [JLT] in circumstances falling within clause 10.1.c hereof; or
(c) [Mr Martin'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 [Mr Martin] shall be obligated to repay to [JLT] an amount calculated on the basis below within seven (7) days of the termination of his employment.

[Mr Martin] acknowledges and agrees that [JLT] may set off against or deduct any amounts owing to [Mr Martin] under this Agreement amounts of Signing Bonus falling to be repaid pursuant to the aforegoing:

$$\frac{(a)}{(b)} \times c$$

Where a = the number of working days remaining until the expiry of the Initial Period from the last day of [Mr Martin's] employment

Where b = 1300 days [*ie* 5 years of 260 working days]

Where c = the Signing Bonus"

"10.1.c Notwithstanding the provisions of clause 2.2 above, if [Mr Martin] at any time ... is convicted of a serious crime or any criminal offence involving dishonesty or fraud or is guilty of any other misconduct bringing [Mr Martin] or [JLT] or any member of the Group into disrepute (such issue to be determined in the reasonable opinion of the Board) or is guilty of any wilful breach, gross misconduct or negligence or continued neglect of the provisions of this Agreement;

[JLT] may by written notice given to [Mr Martin] terminate the Appointment ... for any reason specified in sub-clause 10.1(c) above, without any period of notice and without payment and allowances (other than remuneration and benefits accrued up to the date of termination. ..."

ANNEX 2

MATERIAL PROVISIONS OF ITEPA

Section 7 (meaning of "employment income", "general earnings" and "specific employment income")

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

(2) "*Employment income*" means-

(a) earnings within Chapter 1 of Part 3; [this includes section 62: see below]

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

(c) …….]

(3) "*General earnings*" means –

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

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

excluding in each case any exempt income.

……

(4) subsection (2)(b) or (3)(b) refers to any amount treated as earnings under –

(a) …..

(b) Chapters 2 to 11 of Part 3 (the benefits code), or

(c) Chapter 12 of Part 3 (payments treated as earnings) or

(d) …….

Section 9 (amount of employment income charged to tax)

(1) The amount of employment income which is charged to tax under this Part for a particular tax year is as follows:

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

…….."

Section 10 (meaning of "taxable earnings" and "taxable specific income")

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

(2) "Taxable earnings from an employment in a tax year are to be determined in accordance with Chapters 4 and 5 of this Part.

(3) ……

Section 11 (calculation of "net taxable earnings")

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

TE – DE

where

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

DE means the total amount of any deductions allowed from those earnings under provisions listed in section 327(3) to (5) (deductions from earnings: general) [these are what can be referred to as expenses]

(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 exceptional cases where the amount calculated under subsection (1) is negative.

……

Section 15 (earnings for a year when employee UK resident)

(1) This section applies to general earnings for a tax year for which the employee is UK resident except that, in the case of a split year, it does not apply to any part of those earnings that is excluded.
[Subsection (1A) gives the definition of excluded earnings which is not relevant to this appeal].

(2) The full amount of any general earnings within subsection (1) which are received in a tax year is an amount of "taxable earnings" from the employment in that year.

(3) Subsection (2) applies: -
(a) whether the earnings are for that year or for some other tax year, and
(b) whether or not the employment is held at the time when the earnings are received.

……

Section 16 (meaning of earnings "for" tax year)

(1) This section applies for determining whether general earnings are general earnings "for" a particular tax year for the purposes of this Chapter.

(2) General earnings that are earned in, or otherwise in respect of, a particular period are to be regarded as general earnings for that period.

(3) If that period consists of the whole or part of a single tax year, the earnings are to be regarded as general earnings "for" that tax year.

(4) If that period consists of the whole or part of two or more tax years, the part of the earnings that is to be regarded as general earnings "for" of those tax years is to be determined on a just and reasonable apportionment.

[(5) This section does not apply to any amount which is required by a provision in Part 3 to be treated as earnings for a particular year].

Section 17 (treatment of earnings for year in which employment not held)

(1) This section applies for the purposes of this Chapter in a case where general earnings from employment would otherwise fall to be regarded as general earnings for a tax year in which the employee does not hold employment.

(2) If that year falls before the first tax year in which the employment is held, the earnings are to be treated as general earnings for that first tax year.

(3) 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 the last tax year.

(4) [Deals with benefits in kind and is not relevant.]

Section 18 (receipt of money earnings)

(1) General earnings consisting of money are to be treated for the purposes of this Chapter as received at the earliest of the following times-
Rule 1
The time when payment is made of or on account of the earnings.
Rule 2
The time when a person becomes entitled to payment of or on account of the earnings.
Rule 3
[not relevant]
……

(5) Where this section applies-
(a) to a payment on account of general earnings, or
(b) to sums on account of general earnings,
it so applies for the purpose of determining the time when an amount of general earnings corresponding to the amount of that payment or those sums is to be treated as received for the purposes of this chapter.

Section 62 (earnings)

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

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

(a) any salary, wages or fee,

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

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

……..

Section 225 (payments for restrictive undertakings)

(1) This section applies where –

(a) an individual gives a restrictive undertaking in connection with the individual's current future or past employment, and

(b) a payment is made in respect of

(i) the giving of the undertaking, or

(ii) the total or partial fulfilment of the undertaking

…….

(2) The payment is to be treated as earnings from the employment for the tax year in which it is made.

……

(8) In this section "restrictive undertaking" means an undertaking which restricts the individual's conduct or activities….

MATERIAL PROVISION OF INCOME TAX ACT 2007

Section 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").

……"