Analysis

Murphy: earnings and settlement agreements

Speed read

In *Murphy*, the Court of Appeal overturned a decision from the Upper Tribunal which held that 'profit' in ITEPA 2003 s 62(2)(b) means net profit rather than gross profit. Whether a payment to an employee is taxable employment income therefore requires a two-stage analysis: first, is the payment from the employment, and second, is it an allowable deduction under ITEPA 2003 Part 5. The decision reminds practitioners of the need for clarity as to how payments under settlement agreements are expressly characterised within the agreement itself.

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In *HMRC v Murphy* [2022] EWCA Civ 1112, the Court of Appeal overturned the Upper Tribunal's decision that the profit received by a taxpayer under a settlement agreement was reduced by the sums that he had paid away to his legal representatives and legal expenses insurer, and hence that only the net profit under the settlement agreement was brought within the scope of the charge to employment income under Part 2 of ITEPA 2003. The Court of Appeal confirmed that 'profit' within ITEPA 2003 s 62(2)(b) means the gross profit received by an employee and that the only deductions which can be made from that sum are those allowed under the allowable deductions listed in ITEPA 2003 s 327.

Background

Mr Murphy had been one of a number of claimants who began litigation against the Metropolitan Police Service in respect of unpaid overtime and other allowances alleged to be due to them under their contract of employment. They entered into a damages based agreement with solicitors and counsel to act for them. They also took out an insurance policy protecting them against the risk of adverse costs orders. The claim was settled for an agreed sum plus recoverable costs, which did not include the sums due to the legal representatives or insurer. Those sums were therefore paid by the taxpayer out of the principal settlement sum, and the settlement agreement provided for a mechanism for those to be paid.

The Metropolitan Police Service applied PAYE to the entire agreed settlement sum (but not the recoverable costs) on the basis that those sums were from the taxpayers' employment. The taxpayer appealed on the basis that the sums were not from employment, and that the sums paid away to the legal representatives under the damages based agreement and to the insurer did not form part of the 'profit' received under the settlement agreement. The First-tier Tribunal rejected the taxpayer's appeal. Judge Guy Brannan cut through the taxpayer's argument, noting simply that the sums paid under the damages based agreement were employment income which was paid away in discharge of the taxpayer's liability under that agreement. The need to pay that away did not alter the underlying character of the sums received under the settlement agreement. The taxpayer appealed to the Upper Tribunal, which allowed the appeal on the basis of the 'profit' issue. That argument therefore fell to be decided by the Court of Appeal.

Does profit mean net or gross?

Before both the Upper Tribunal and Court of Appeal the taxpayer's argument rested on a dictum of Lord Denning in *Hochstrasser v Mayes* [1960] AC 376, and an analysis of cases that arose from repayment of expenses incurred by an employee.

In *Hochstrasser*, the taxpayer had received £350 as compensation under a housing agreement with his employer. Lord Denning agreed with the other members of the House of Lords and went on to say that the employer had not received 'any profit therefrom' the payment because it was no more than an indemnity for a loss that the employee had suffered.

It was argued that the approach of the courts to the reimbursement cases, and the reasons given as to why the repayment of expenses did not constitute employment income, allowed the court to identify that such payments were only brought within the charge to employment income where the employee made a net profit from the payment which reimbursed them for their own expenditure. The two cases relied on by the Upper Tribunal were *Pook v Owen* [1970] AC 244 and *Donnelley v Williamson* [1982] STC 88.

In each of these cases the employee had been reimbursed for expenses incurred. The court had to determine whether payment of those expenses was a reward for the employee's services, and hence whether the payment was 'from' the employment. In *Pook v Owen*, the court had held that where a doctor received partial reimbursement of travelling expenses, both the sums reimbursed and the balance which the doctor had paid out of his own pocket, those were sums from the doctor's employment but that they were expenses necessarily incurred in the performance of his duties. *Donnelley v Williamson* was a much simpler case, in which the court held that where a schoolteacher was reimbursed for her out of pocket expenses incurred at out of school activities, that was not a payment from her employment.

The taxpayer argued that the manner in which the courts had analysed the reimbursement of expenses in each of these cases revealed an underlying principle that where a payment to an employee is a 'profit' rather than any of the other terms in ITEPA 2003 s 62, it is therefore necessary to determine whether the employee receives a net benefit from the payment. The Upper Tribunal agreed with the taxpayer's analysis of these decisions, and further held that the sums paid by the taxpayer to his legal representatives and legal expenses insurer did not form part of the taxpayer's net profit because they had

been 'necessarily incurred' in order to receive the sums under the settlement agreement.

The Court of Appeal's decision

The Court of Appeal disagreed with both bases of the Upper Tribunal's decision: that Lord Denning had intended to emphasise that the employee in *Hochstrasser* had not made a 'profit' or that any general principle as to the meaning of 'profit' could be drawn from the reimbursement cases. Wherever a distinction was drawn, it was between reimbursement of expenses incurred in performance of the employee's duties, and the payment of expenses which the employee had incurred on their own account. Payment of the former to the employee was not a payment from employment, as it was not a reward for the employee's services. Payment of the latter was, on the other hand, a reward for the services rendered by the employee. The Upper Tribunal's analysis of these cases had found a gloss on the statutory test which was not there.

In doing so, the Court of Appeal clarified that 'profit' in s 62(2)(b) is a reference to 'a material benefit derived from a property, position, etc; income, revenue', rather than requiring a fiscal analysis of a taxpayer's income and outgoings. The words in s 62 are meant to capture any payments made to an employee by their employer, rather than implicitly importing any further restriction on the sums that are intended to be brought into the scope of an employee's gross taxable income. It accepted the submission that s 62 was a provision which should be read widely.

The principal settlement sum that the taxpayer had received under the settlement agreement was held to be from the taxpayer's employment; it retained the character of a reward for the taxpayer's services. The present case was therefore on all fours with *Eagles v Levy* [1934] 19 TC 23, in which the taxpayer received a sum out of which he was obliged to pay his own legal representatives. The fact that the taxpayer was liable to pay those sums as a result of the payment did not affect the reason that the payment had been made in the first place.

Comment

The simple outcome of the Court of Appeal's decision is to restore the two-stage analysis of whether employment income is taxable:

- first, to determine whether or not the payment is 'from' employment; and if so,
- second, to apply the statutory deductions regime to determine whether it can be deducted in calculating the employee's net taxable earnings.

The effect of the Upper Tribunal's decision was that the statutory deductions regime fails to control whether or not a particular expense may be deducted from otherwise taxable employment income, as demonstrated by the fact that the Upper Tribunal's characterisation of the sums paid to the legal representatives and legal expenses insurer as having been 'necessarily incurred' is strikingly similar to the general test for deductibility of expenses under ITEPA 2003 s 336 but did not require a strict application of the wealth of principle that has built up in how to apply that test.

The decision is a welcome reminder that the nature of payments made under settlement agreements is a matter of substance not form. It also provides a refreshing simplicity to what is, on any view, a tortured area of the law when dealing with the question of whether a payment is 'from' the employment or not.

The factor which is likely to be given greatest weight when determining the character of payments made under a settlement agreement, and in particular whether those payments are 'from' employment is the nature of the underlying liability in dispute. In Mr Murphy's case, that led to a clear answer as to whether the payments were payments from his employment; the litigation was about his entitlement to sums that would have constituted part of his taxable earnings if they had been paid in the manner and at the time that Mr Murphy alleged they should have been. However, there will be many cases where the answer is not so clear; the facts of *Taylor v Provan* [1975] AC 194 are a clear reminder of that. It is unlikely that structuring the settlement agreement in any particular way will affect the character of the payments made under it. Indeed, if a party structures an agreement in such a way as to capture payments being made out of the settlement sum as 'costs', it is likely that HMRC may well seek to enquire into the substance of that agreement. They would likely seek to do so to see whether the sums paid really are 'costs' or whether they are more properly characterised as 'earnings'; a label applied in an interparty dispute by those parties will likely be of limited significance to HMRC when assessing the proper character of the payment.

Having said that, the decision also reminds practitioners that where a payment made under a settlement agreement is made in respect of various different matters, it is necessary to specify with precision what each part of the payment is for. Although the Court of Appeal held that the present case was on all fours with *Eagles v Levy*, the difference between the two settlement agreements reminds those acting on behalf of litigants of the clarity needed in drafting settlement agreements. In *Eagles v Levy*, the case was settled with no provision made for costs at all in the settlement agreement, whereas in *Murphy* the inter partes costs were paid separately from the principal settlement sum (i.e. paid in addition to the principal settlement sum) and there was no argument at any time that the inter partes costs were taxable as employment income; they were clearly not a reward for the taxpayer's services and therefore were not from the taxpayer's employment. It is possible to carve up a single composite payment made under a settlement agreement, and it is important to consider the tax position for each element separately to ensure that the client is insulated against any argument that sums which were paid in respect of one non-taxable item were in fact paid in respect of another which is taxable.

Finally, the context in which the decision arises also demonstrates the manner in which employers can best deal with these payments. The mechanism in the settlement agreement for the payment of tax was for the employer to apply PAYE to the sums and then to cooperate in any subsequent challenge brought by the employee to the taxability of those sums. In doing so, the Metropolitan Police Service kept itself free of litigation surrounding the nature of the payment that it made; although the status of the sums received which were to be paid under the damages based agreement and to the insurer were in dispute at the time the settlement agreement was entered into, the settlement agreement itself neatly ensured that the onus for challenging any assessment to tax remained with the individual taxpayers themselves. That agreement set the framework for what followed. It is a salutary reminder to be cognisant of the potential for litigation when making payments under a settlement agreement and to ensure that the responsibility for challenging any adverse assessment is expressly dealt with as part of that agreement. ■

The authors appeared for HMRC in HMRC v Murphy.

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- Cases: *HMRC v K Murphy* (24.8.22)