Murphy’s Law

Employment Tax



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Keith Gordon reviews the Upper Tribunal’s decision in a case that considers the taxation of payments made to resolve an employment dispute

Key Points

What is the issue?

Following the settlement of a claim made by Mr Murphy against the Metropolitan Police, HMRC considered that he was liable to pay income tax in respect of the full amount received, including those elements relating to the success fee and the insurance premium.

What does it mean for me?

The taxation of these payments was a concern of the parties to the original litigation with the Met. There are similar concerns in the context of the new IR35 rules and in VAT cases, where a disputed tax treatment often has to be resolved by the parties to a contract themselves and not involving HMRC.

What can I take away?

Anyone advising an employee in a future case should follow the approach taken by Mr Murphy and ensure that any settlement agreement separately quantifies the additional litigation costs being paid for.

It is well known that the rules for obtaining a tax-allowable deduction from employment income are particularly restrictive. The underlying policy reason for this can be explained on the basis that employers can usually be expected to cover costs incurred by their staff.

Therefore, subject to the relatively common exceptions such as reimbursed travel expenditure and fees for professional memberships, it will usually be the case that what an employer pays will be taxed as a receipt of the employee. As with all ‘general rules’, however, this short cut cannot be relied upon as a hard and fast rule. A potential exception was the subject matter of the recent Upper Tribunal decision in Murphy v HMRC [2021] UKUT 152 (TCC).

The facts of the case

Mr Murphy was a police officer serving with the Metropolitan Police (‘the Met’). He and a number of colleagues made claims against the Met in relation to the alleged underpayment of overtime and other allowances. Shortly before a three day trial was due to commence, those claims were settled by the Met. Part of the amounts received from the Met were discharged in the payment of a conditional fee to the officers’ lawyers (a success fee) and an insurance premium paid to cover any adverse costs that the officers might have been required to pay to the Met (had the matter proceeded to trial). (There were also additional legal costs reimbursed by the Met, but those were agreed to be non-taxable.)

So far as the payments made to Mr Murphy and his former colleagues are concerned, HMRC considered that the individuals were liable to pay income tax in respect of the full amount received, including those elements relating to the success fee and the insurance premium. On the other hand, Mr Murphy considered that the portion attributable to the success fee and the insurance premium was not taxable. The First-tier Tribunal agreed with HMRC. Mr Murphy took the case to the Upper Tribunal.

The Upper Tribunal's decision

The case came before Mr Justice Michael Green and Judge Ashley Greenbank.

The Upper Tribunal considered that the starting point of the discussion was Income Tax (Earnings and Pensions) Act 2003 s 62(2). That breaks the definition of 'earnings' into three categories:

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.

It was common ground that para (a) was not engaged in the present case.

In addition, HMRC accepted that, within para (b), the success fee and insurance premium did not fall within the scope of 'any gratuity' or 'incidental benefit'. Furthermore, HMRC accepted that para (c) was merely a sweep-up provision so as to preserve the effect of the pre-2003 case law. Thus, as the Upper Tribunal concluded, the case turned on the meaning of 'other profit' within para (b).

The Upper Tribunal then turned to the case law, which shows the need for a payment to derive 'from' the employment. In particular, the Upper Tribunal focused on a summary of the principles as set out in the Court of Appeal's decision in Kuehne & Nagel Drinks Logistics Ltd v HMRC [2012] EWCA Civ 34, including the rule that there must be a sufficient causal link between the employment and the payment. The mere fact that the payment would not have been made had the recipient not been an employee was necessary but not sufficient to bring the payment into the charge to tax.

Although the question as to whether a payment is ‘from’ an employment is ultimately a value judgment for a tribunal to make on a case by case basis, the Upper Tribunal considered that the more pertinent issue in the present case was the application of the word ‘profit’.

The closest equivalent case was that of Eagles (HM Inspector of Taxes) v Levy (1934) 19 TC 23, where a former director received a sum from a company and was not entitled to any deduction for his costs. The First-tier Tribunal relied upon that decision in the present case.

However, as the Upper Tribunal pointed out, in Levy the settlement reached between the company and Mr Levy expressly excluded any reference to costs. In the present case, however, the settlement with the Met expressly provided for part of the sum paid to refer to the legal and insurance costs now in issue.

In the Upper Tribunal’s view, that was a fundamental distinction between the two cases. Furthermore, the Upper Tribunal interpreted the Levy judgment as saying that, if costs had been expressly provided for in the settlement, that element would not have been subject to income tax.

The Upper Tribunal also relied on the case of Hochstrasser v Mayes [1959] 38 TC 673, in which an employer reimbursed an employee £350 for the loss incurred on the sale of his house when he was transferred by the employer to another part of the country. Although this case is usually cited as a leading authority in respect of the meaning of the word ‘from’, Mr Murphy’s counsel referred the Upper Tribunal to a concurring judgment by Lord Denning, which took issue with the concept of £350 being any form of profit at all, and instead said that it was no more than a payment indemnifying the employee for a loss.

Those two cases made it clear why it was common ground that some of the legal costs could not be subject to tax – they were not payments for Mr Murphy having been, being or becoming an employee; nor did they constitute any element of profit. However, the Upper Tribunal considered that the same logic applied to the elements of the settlement payment that related to the success fee and the insurance premium. Even if the payments were ‘from’ the employment, the Upper Tribunal felt more confident that they still fell outside the scope of the meaning of the word profit.

The Upper Tribunal therefore allowed Mr Murphy’s appeal.

Commentary

This was a case where the Upper Tribunal overturned a decision from an experienced First-tier Tribunal judge. Furthermore, one of the questions at the heart of the decision (whether or not a payment is ‘from’ an employment) has been variously described as one where it is ‘often difficult to draw the line’, ‘not an easy question to answer’ and where ‘there is an element of value judgment’. Indeed, on this very point, the Upper Tribunal felt the need to consider that it might have been wrong and reinforced its decision by turning to the question of ‘profit’, which is something that has had very little attention over the years and indeed was the subject only of a minority judgment, albeit by Lord Denning in the House of Lords.

In addition, the closest case to the present (Levy) was decided the other way, but there was one subtle but fundamental factual distinction between the two cases.

It is clear, therefore, that this was a finely balanced case, but I consider that the right result has been reached. At the very least, it is a sensible outcome.

The background facts also reveal that the taxation of these payments was a concern of the parties to the original litigation with the Met. In most cases where X pays money to Y, X has no interest in whether the payment is taxable. However, where for example X is (or was or will be) Y’s employer, X will have a direct interest in the potential tax treatment because X might well be liable to HMRC for any shortfall if the tax treatment applied proves to be incorrect. There are similar concerns in the context of the new IR35 rules and in VAT cases, where a disputed tax treatment often has to be resolved by the parties to a contract themselves and not involving HMRC.

Given the finely balanced nature of this case, it is hard to criticise the Met for taking a cautious approach, even though it had been shown specialist tax counsel’s advice to the effect that the success fee and insurance premium were not taxable.

It therefore applied PAYE and National Insurance to the whole of the payment, leaving it for the individual employees to self-assess the payments in a different fashion and to recoup any additional tax back from HMRC.

In this case, no harm was done, particularly because the Self Assessment system allowed the taxpayers to assert their own view of the law. However, it does demonstrate that there will be many commercial situations where a particular tax

position is adopted so as to favour the party with the greater bargaining power, rather than to reflect the actual legal position. In my view, that is unfortunate.

What to do next

What has clearly distinguished the present case from that of Levy is the fact that the disputed costs were clearly quantifiable and represented the true commercially agreed amounts payable in respect of the success fee and insurance premium. The Levy case demonstrates that a different outcome would be reached in a case where the payment made to an employee does not get broken down into its respective components.

Accordingly, subject to any possible appeal by HMRC to the Court of Appeal, anyone advising an employee in a future case should follow the approach taken by Mr Murphy and ensure that any settlement agreement separately quantifies the additional litigation costs being paid for.

What the present case does not address, however, is the situation where the parties to the litigation quantify those additional litigation costs, but that quantification process reflects only an estimate of those costs rather than the actual figures. Will a court or tribunal adopt the Murphy approach in such a case (provided that the quantification is not unreasonable) or will that bring the case back into the Levy category? Given Murphy’s Law – often abbreviated as if anything could go wrong, it will go wrong – it is probably best not to risk it.