Neutral Citation Number: [2022] EWCA Civ 1112

Case No: CA-2021-000033

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)
MR JUSTICE MICHAEL GREEN AND
UPPER TRIBUNAL JUDGE GREENBANK
[2021] UKUT 152 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 04/08/2022

Before:

LORD JUSTICE LEWISON
LORD JUSTICE NEWEY
and
LADY JUSTICE ANDREWS

- -

Between :

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Appellant**
- and –	
MR KEITH MURPHY	**Respondent**

- -
- -

Joshua Carey and Sam Way (instructed by **HMRC**) for the **Appellant**
Michael Collins (instructed **on direct access**) for the **Respondent**

Hearing date: 14 July 2022

- -

Approved Judgment

This judgment was handed down by the Judge remotely by circulation to the parties' representatives by email and release to The National Archives. The date and time for hand-down is deemed to be 10.30am on 4th August 2022.

Lady Justice Andrews:

INTRODUCTION

1. This appeal concerns the meaning of the term "profit" as it is used in s.62(2)(b) of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") which defines "earnings" for the purpose of the employment income parts of that Act. That section provides, so far as is material, as follows:

> "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."

2. The issue arises in this context. The Respondent, Mr Murphy, was a police officer employed by the Metropolitan Police Service ("the Met"). Mr Murphy was one of a group of police officers who commenced a group litigation action against the Met in the High Court on 19 December 2014, in respect of overtime and certain other allowances to which they claimed to be entitled. A small number of other police officers subsequently joined in the litigation as additional claimants. All the claims were for statutory debts alleged to arise under the Police Regulations 2003, and related to duties performed by the claimants whilst working for the Met. The Met denied that it was liable to make any of the payments claimed.

3. In order to fund the legal proceedings, the claimants entered into a Damages-Based Agreement ("DBA") with solicitors and counsel, which provided for payment of a "success fee" calculated as a percentage of any sum payable by the Met to settle the claim, or damages awarded by the court. The "success fee" was payable in addition to any costs recovered from the Met. Each of the claimants also entered into an insurance contract with an insurer named Temple Legal Protection Ltd ("Temple") by which, in return for a premium, Temple insured them against the risk of having to pay the Met's legal costs if they lost all or part of their claim.

4. On 5 May 2016, the Met entered into a settlement agreement with the claimants, by which, without making any admission of liability, the Met agreed to pay the claimants £4.2 million (defined as the "Principal Settlement Sum") plus "Agreed Costs" in full and final settlement of their claims. These two amounts were collectively referred to in the settlement agreement as "the Global Settlement Sum". "Agreed Costs" were defined as the legal costs and disbursements of the claimants' solicitors and counsel

as assessed by the High Court or agreed with the Met. They did not include the success fee payable under the DBA, or the insurance premium.

5. Clause 8.1 of the settlement agreement provided that:

> "Other than the Agreed Costs, the Parties shall each bear their own legal costs in relation to the Dispute and this agreement."

6. Clause 3.3 of the settlement agreement set out the mechanism for payment of the Global Settlement Sum. The claimants' solicitors were to raise an invoice for the success fee of £1.2 million addressed to their clients, but stated to be payable by the Met. The invoice would identify how much of the success fee was payable to the solicitors and how much was payable to counsel. The Met was then required to pay the success fee directly to the solicitors. The insurance premium was to be deducted from the balance of the Global Settlement Sum and paid directly by the Met to Temple.

7. The Met would then pay an apportioned amount to each of the claimants from the balance of the Global Settlement Sum, as designated in a spreadsheet. To the extent that those sums represented a share of the Principal Settlement Sum, they would be subject to the withholding of income tax and national insurance contributions. Clause 3.3(c) of the settlement agreement made it clear that the Met proposed to treat the whole of the Principal Settlement Sum as subject to PAYE and to deduct tax accordingly. However, the Agreed Costs would be paid without making any such deduction.

8. The Met duly applied PAYE to Mr Murphy's apportioned share of the Principal Settlement Sum, including the part representing his share of the success fee and insurance premium. Mr Murphy filed his 2017 tax return on the basis that none of the Principal Settlement Sum was his income for that year. The tax return was made following correspondence between Mr Murphy's advisers and HMRC, in which HMRC stated that the Principal Settlement Sum was not income of the 2017 tax year, and should be spread over the period in respect of which the underlying claims were made. HMRC subsequently raised discovery assessments for the tax years 2009 to 2016, which assessed Mr Murphy on his apportioned share of the Principal Settlement Sum, including the success fee and insurance premium, and to interest.

9. Mr Murphy appealed against the discovery assessments on the basis that his apportioned share of the success fee and insurance premium was not his earnings. The First-tier Tribunal dismissed the appeal. Judge Brannan found that the payment of the success fee and insurance premium arose from Mr Murphy's employment. The Principal Settlement Sum constituted a payment in settlement of a claim for unpaid allowances and overtime, which it was accepted would have been taxable earnings if they had been paid by the Met in the first place. It was common ground that the sum payable in respect of Agreed Costs was not taxable earnings (since it was not derived from Mr Murphy's employment), but the Principal Settlement Sum did not include a payment in respect of costs. This was made clear by clause 8.1 of the settlement agreement. Clause 3 of the settlement agreement made no difference to the character of the payment, as it was merely a mechanism for the discharge of the claimants' obligations to third parties using the settlement monies. Therefore the entirety of the Principal Settlement Sum was taxable as employment income.

10. Judge Brannan gave Mr Murphy permission to appeal. Before the Upper Tribunal it was common ground, as it was before this Court, that the Principal Settlement Sum (and specifically the component reflecting the success fee and insurance premium) could only be regarded as "earnings" within s.62 of ITEPA if it fell within the expression "any other profit… obtained by the employee" in s.62(2)(b) of ITEPA. The Upper Tribunal identified two issues which needed to be resolved, namely:

    i) Whether the alleged profit was derived from the employment as required by the definition of general earnings in s.9 (2) of ITEPA (the "from" issue); and

    ii) What is the meaning of "profit" in s.62(2)(b); in particular, whether it refers to 'gross' profit or 'net' profit and, if the latter, what items can be taken into account in computing the net profit for these purposes? (the "profit" issue).

    They held that the First-tier Tribunal fell into error because the judge only addressed the "from" issue.

11. The Upper Tribunal decided that even if the Principal Settlement Sum could be regarded as derived "from" the claimants' employments on the grounds that it was paid to compensate them for the Met's failure to pay sums due under their employment contracts, it was necessary to go on to consider the amount of the Principal Settlement Sum that should properly be regarded as a "profit" that the claimants obtained from their employment within the terms of s.62(2)(b).

12. The Upper Tribunal concluded, at [81], that the success fee and insurance premium should be deducted in the calculation of the net profit received, on the basis that those payments were necessarily incurred in order to obtain the payment derived from the employment. They said that it made no difference to their analysis that the claimants chose to fund the litigation by means of a DBA. They allowed the appeal, set aside the decision of the First-tier Tribunal and re-made the decision, holding that Mr Murphy did not make a "profit" within s.62(2)(b) ITEPA to the extent that the Principal Settlement Sum was paid in discharge of the success fee and insurance premium, and that those amounts should not be treated as earnings under s.62.

13. HMRC appeals to this Court on the following grounds:

    i) Ground 1: the Upper Tribunal was wrong to hold that the case law supported a proposition that the focus of the courts in these cases is on whether or not the employee can properly be said to have made an overall or net profit as well as whether a payment is derived "from" the employment;

    ii) Ground 2: the UT was wrong to hold that *Eagles (Inspector of Taxes) v Levy* [1934] 19 TC 23 supported a view that if the taxpayer in that case had received an amount in respect of his costs but had been necessarily obliged to pay the costs in order to receive the settlement sum, he would not have paid tax on the settlement sum to the extent of the amount of the costs;

iii) Ground 3: it was not open to the UT to make a finding of fact that the success fee and insurance premium were liabilities which Mr Murphy 'had to incur' and were 'necessarily incurred' to obtain a payment derived from his employment;

iv) Ground 4: the UT was wrong to hold that it was necessary to consider whether the success fee and the insurance premium should be deducted to determine whether the payment to Mr Murphy of the Principal Settlement Sum amounted to "profit" within s.62(2)(b) ITEPA 2003.

14. For the reasons set out below, I would allow this appeal on Grounds 1, 2 and 4; it is unnecessary to consider Ground 3.

THE STATUTORY FRAMEWORK

15. Part 2 of ITEPA establishes a charge to income tax on "employment income", which (so far as is material to this appeal) is defined by s.7(2)(a) as including "earnings within Chapter 1 of Part 3". The definition of "earnings" in Chapter 1 of Part 3 is the definition in s.62 to which I have already referred.

16. The commentary on s.62 in Note 13 of the Explanatory Notes to ITEPA explains that the word "earnings" has replaced the term "emoluments" which was used in earlier tax legislation. To a large extent the definition of "earnings" follows the previous definition of "emoluments" in s.131(1) of the Income and Corporation Taxes Act 1988, which stated that "emoluments" includes "all salaries, fees, wages, perquisites and profits whatsoever." The reference at the end of s.62 to "anything else that constitutes an emolument of the employment" was intended to ensure that the pre-existing case law would apply to bring into the definition anything that previously constituted an "emolument" which is not expressly covered by the categories of payment identified in the new definition.

17. The one significant departure from the previous definition is that the words "all… perquisites and profits whatsoever" have been replaced by "any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth". The Explanatory Note states that the words "any gratuity or other profit or incidental benefit of any kind" are simply the modern equivalent of the references to "all perquisites and profits whatsoever", but the words "if it is money or money's worth" are new, and were designed to reflect the fact that it was now accepted that only money or money's worth fell within the scope of s.131 of the 1988 Act.

18. S.9 of ITEPA identifies the amounts of employment income charged to income tax, and relevantly provides as follows:

"(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 the year.

> (3) that amount is calculated under section 11 by reference to any taxable earnings from the employment in the year (see section 10(2)).”

19. The expression “general earnings” which is used in s.9(2) is defined in s.7(3)(a) as including “earnings within Chapter 1 of Part 3”. (Other types of earnings falling within the definition are immaterial to this appeal.)

20. Section 10(2) of ITEPA provides that: ““taxable earnings” from an employment in a tax year are to be determined in accordance with Chapters 4 and 5 of this Part.” Chapter 5 is concerned with the position of non-UK resident employees. Where the employee is a UK resident, as Mr Murphy is, the relevant provisions of Chapter 4 (ss.14 and 15(2)) make it clear that “taxable earnings” are the full amount of that person’s general earnings for the relevant tax year.

21. Section 11 of ITEPA defines the expression “net taxable earnings” and relevantly reads as follows:

> “(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).”

22. Thus the statutory scheme contemplates that *all* earnings from a person’s employment are taxable, subject only to the allowable deductions provided for by the provisions listed in s.327 (all of which are in Part 5 of ITEPA). The question whether a payment amounts to “taxable earnings” from the taxpayer’s employment is therefore entirely separate from the question whether a deduction is to be allowed against taxable income. Whilst it is only the “net taxable earnings” from a person’s employment which are chargeable to income tax by virtue of s.9(2), the expression “net taxable earnings” is a defined expression which takes into account those types of expenditure which Parliament has expressly stipulated may be deducted.

23. As Mr Carey, on behalf of HMRC, pointed out, s.62 is a definition section which is widely drawn; it is not concerned with the question whether a deduction is available for a cost incurred in obtaining employment income. It is designed to capture the taxpayer’s entire earnings from his employment from which permissible deductions can then be made. Seen from this perspective, it would make no sense if the word “profit” in s.62(2)(b) were to be given a meaning that involved making a deduction from the payment received by the taxpayer, all the more so if that deduction would not be permitted under Part 5 of ITEPA. The success fee and insurance premium would not be permissible deductions under those statutory provisions.

THE "FROM" TEST

24. Not all payments which are made by an employer to an employee are taxable as earnings "from" the latter's employment. The payment must be a reward for the services provided by the employee. The correct approach to determining whether a payment meets the "from" test is illustrated by *Hochstrasser (Inspector of Taxes) v Mayes* [1960] AC 376. The taxpayer, Mr Mayes, worked for a large company ("ICI") which required its staff to be prepared to work wherever it required. ICI operated a scheme to facilitate transfers to a different location, by which it agreed to provide an interest-free loan to employees to assist in the purchase of a house. If, in due course, the employee wished to sell or let that house, they had to give ICI the option to buy it at a fair value. If that offer was refused the employee could sell it on the open market. In either case, provided the house was kept in good repair, ICI would pay compensation for any capital loss in the value of the house on resale.

25. Mr Mayes took advantage of that scheme and purchased a house for £1,850 with the assistance of a £300 loan from ICI. When he was transferred to a different location, he sold the house for £1,500 and ICI paid him £350 as compensation. He was assessed to income tax on that sum. The issue on appeal was whether the £350 was a profit from his employment. The House of Lords upheld the decisions of the majority of the Court of Appeal and Upjohn J that it was not.

26. The Crown contended that the payment was taxable because it was received by the employee "as such", and no other consideration was given for it than the services under his employment. Mr Mayes' counsel contended that this proposition was too wide, and the issue turned on whether the payment was made by way of remuneration for the employee's services. If it was not, it was not a payment derived "from" his employment even if he only qualified for the payment because he was an employee of ICI.

27. The leading speech was delivered by Viscount Simonds. At p.388, he quoted with approval the analysis of Upjohn J at first instance:

> "it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money's worth and personal presents, in my judgment not every payment made by an employer to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgment, the authorities show that to be a profit arising from the employment *the payment must be made in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services…"* [Emphasis added].

Viscount Simonds went on to state (at p.389) that it was for the Crown to establish that a payment made under the housing agreement was a reward for the employee's services. The addition of the words "as such" added nothing to the proposition. There was nothing express or implicit in the housing agreement which suggested that the payment was a reward for services, other than the employer/employee relationship of the parties, which was not sufficient.

28. Lord Radcliffe, in his concurring speech, said at pp.391-392 that:

> "it is not sufficient to make a payment assessable that an employee would not have received it unless he had been an employee, it is assessable *if it has been paid to him in return for acting as or being an employee."* [Emphasis added].

29. Lord Denning stated that tried by the touchstone of common sense – which he immediately described as "rather a rash test in a revenue matter" – this was a plain case. He said that no-one coming fresh to the matter could regard the money as a profit from the employment. Mr Mayes did not make a profit, he made a loss, and even if he had made a profit from the sale of the house it would not have been taxable. Lord Denning accepted that if an employer, by way of reward for services, agreed to indemnify his employee against his personal losses on the stock exchange, the payments under the indemnity would be taxable, but that was because the payment would be "a straight reward for services". By contrast, he characterised the situation in the present case as one in which Mr Mayes had incurred a loss in consequence of his employment and his employers indemnified him against it. He rejected the Crown's broad definition of "profits of an employment", and concluded at p.397:

> "Was this £350 received by Mr Mayes a "profit" from his employment? I think not, *for the simple reason that it was not a remuneration or reward or return for his services in any sense of the word."* [Emphasis added].

30. The Upper Tribunal sought to place some reliance on Lord Denning's analysis at paragraph [53] of their decision, but read in context I do not consider that his speech provides any support for their approach to the meaning of "profit". It is clear from the final paragraph of Lord Denning's speech that he was applying the same test as the other members of the House, namely, whether the reimbursement of Mr Mayes' loss on the sale of the house was a remuneration or reward or return for his services. In my judgment, that is also true of the earlier passages.

31. When he observed that Mr Mayes did not make a profit, he made a loss, and that even if he had made a profit it would not have been taxable, I do not understand Lord Denning to have been suggesting that a payment could not be a "profit from employment" unless the employee made a net gain from the employer's payment. He was not there using the word "profit" in the sense in which it was used in the (then) statutory definition of "emolument". Rather, he was illustrating the absence of any connection between the financial outcome of the sale of the house (be that a capital loss or a capital gain) and the services rendered by Mr Mayes to ICI as their employee. If Mr Mayes had made a profit from the sale of the house, in the sense of receiving more money from the purchaser than he had paid for it, it would not have been taxable as income, because that 'profit' could not have been characterised as remuneration derived from his employment.

32. Lord Denning went on to draw a distinction between a situation in which the employee suffers a financial loss in consequence of his employment, and the employer compensates him for that loss, and the situation in which the employee incurs a loss which is unconnected with his job and the employer makes good the loss *as part of his remuneration*. Again, the key point that he made was that in order to be

taxable as income from employment, the payment by the employer must form part of the employee's remuneration for his services.

THE CASES ON REIMBURSEMENT OF EXPENSES

33. Lord Denning's observations appear to me to be consistent with the cases concerning the tax treatment of money paid by an employer to an employee by way of reimbursement of expenditure which the employee has been required to incur for the purposes of carrying out their duties. Some of those cases were relied on by the Upper Tribunal and were also cited to us.

34. As Mr Carey pointed out, there are two means by which a payment reimbursing an expense paid by an employee can fall out of account in the calculation of net taxable income, namely:

    a) The payment of the reimbursement may not be treated as earnings at all, as it is not an emolument from employment; alternatively

    b) The payment of the reimbursement may be accounted for as earnings, but a deduction may be allowed for the expense under s.334 ITEPA.

35. Three cases were cited to us: *Pook (Inspector of Taxes) v Owen* [1970] AC 244; *Taylor v Provan (Inspector of Taxes)* [1975] AC 194 and *Donnelly (Inspector of Taxes) v Williamson* [1982] STC 88. *Donnelly v Williamson* was an example of the first type of case, where Walton J held that an allowance paid to a teacher in partial reimbursement of the costs of her attendance at out-of-school activities was not an emolument from employment, because it was not a reward for her services. *Taylor v Provan* was an example of the second type of case, where the "from" test was satisfied, but a majority of the House of Lords held that, on the facts, the expenses met the statutory test for deduction of allowable expenses under a precursor to s.334 ITEPA. *Pook v Owen*, upon which Mr Collins, on behalf of Mr Murphy, placed most reliance, was a slightly odd case in which some members of the constitution decided it fell within the second category, and some decided that it fell within both categories, whereas one decided it fell within neither.

36. In *Pook v Owen* a doctor received a fixed-rate contribution from his employer towards the expenses of travelling from his home (where he ran his GP surgery) to a hospital, whenever he was on "stand-by" duty and answered an emergency call. The issue which was initially raised was whether the doctor was entitled to deduct those payments from his taxable income under the statutory provisions that applied to travelling expenses. The argument concerned both the reimbursed sums *and* the balance of the travel expenses, which the doctor had to pay out of his own pocket.

37. It had been established in *Ricketts v Colquhoun* [1926] AC 1 that the cost to an employee of travelling between their home and their place of work is not a deductible expense, whereas expenses which the employee is obliged to incur in the performance of their duties (such as the cost of travel between two places of work) would be deductible. In reliance on that authority, the Crown argued that Dr Owen was not necessarily obliged to incur the travel expenses, and that they were not incurred in the

performance of his duties, as he only had one place of work for these purposes, namely, the hospital. It was only when the case reached the Court of Appeal that the further argument was raised on Dr Owen's behalf that the reimbursed portion of the expenses did not form part of his income (and thus the "from" test was not satisfied). If that was right, the question whether he was necessarily obliged to incur the expenses for the performance of his duties did not arise.

38. The House of Lords, by a majority (Lords Guest, Pearce and Wilberforce) found for the doctor on the basis that, on the facts as found, he had two places of work, he was performing his duties as an employee when travelling between them, and the travel expenses were necessarily incurred in the performance of his duties. Lords Donovan and Pearson dissented on that issue. However, Lord Guest and Lord Pearce also held that the reimbursements by the hospital did not form part of the doctor's taxable income, and Lord Donovan agreed on that issue. Lord Pearson concurred in their legal analysis of when reimbursed expenditure would (and would not) meet the "from" test, though he dissented on its application to the facts of the case. Lord Wilberforce was the only member of the House who expressed no view on that issue.

39. Lord Guest referred to the passages in the speeches of Viscount Simonds and Lord Radcliffe in *Hochstrasser v Mayes* which I have quoted earlier in this judgment. He then stated at p.256A:

> ".. if the proper test is whether the sum is a reward for services, then, in my view, the travelling allowances paid to Dr Owen are not emoluments. To say that Dr Owen is to that extent "better off" is not to the point. The allowances were used to fill a hole in his emoluments by his expenditure on travel. The allowances were made for the convenience of the employee to allow him to do his work at the hospital from a suitably adjacent area. In my view the travelling allowances were not emoluments."

40. On the question whether the reimbursed expenses were "emoluments", Lord Pearce rejected the Crown's submission that they were "perquisites", commenting that:

> "it would be a wholly misleading description of an office to say that it had a very large perquisite merely because the holder had to disburse very large sums out of his own pocket and subsequently received a reimbursement or partial reimbursement of those sums. If a school teacher takes children out for a school treat, paying for them out of his (or her) own pocket, and is later wholly or partially reimbursed by the school, nobody would describe him (or her) as enjoying a perquisite. In my view, perquisite has a known normal meaning, namely, a personal advantage, which would not apply to a mere reimbursement of necessary disbursements. There is nothing in the section to give it a different meaning. Indeed the other words of the section confirm the view that some element of personal profit is intended." [p.259B-D.]

41. Lord Donovan held that, on the footing that the travelling expenses paid to Dr Owen simply reimbursed what he had spent (or part of what he had spent) on travelling in performance of his duties, they should not be regarded as emoluments of his

employment. However, that would not be good enough to establish that he could deduct the non-reimbursed portion of the expenditure from his taxable earnings, because in order to do so he would have to demonstrate that the expenses were *necessarily* incurred in performance of those duties.

42. After stating that tax is charged "on the full amount of the emoluments" from the office or employment, Lord Donovan referred to the statutory definition of "emoluments" as including "all salaries, fees, wages, perquisites, and profits whatsoever". He stated that this definition gave "no impetus towards the view that it covers sums paid to an employee simply in reimbursement of expenses incurred in carrying out his duties." The same was true of the dictionary definition of "emolument" [p.260B-C].

43. In his dissenting judgment (at pp 265H-266C) Lord Pearson drew a distinction between the position of an employee who is paid (or reimbursed) by his employer the cost of travel between his home and work, and the situation where the employee incurs an expense in performing the duties of his employment and has it reimbursed to him. In the former case, he said, the employee *is better off financially by the amount of the reimbursement or allowance,* and the reimbursement or car allowance is a "perquisite, a profit, an emolument", whereas in the latter situation there is no benefit – no profit or gain - to the employee. He does not receive any emolument. [Emphasis added].

44. It is clear from Lord Pearson's speech, and, indeed, all the other speeches in which a distinction is drawn between (a) reimbursement of expenses incurred in performance of the employee's duties, and (b) the payment of expenses otherwise incurred, in return for the employee's services, that the whole amount of any payment falling within the latter category would be treated as taxable in the hands of the employee. In other words, once the "from" test is satisfied, the entire payment is taxable as income, and the question whether any deductions can be made against that income will depend solely upon whether the case falls within one of the statutory categories of allowable deductions.

45. In *Taylor v Provan* the reimbursement of the taxpayer's travelling expenses was undoubtedly an "emolument" because of the application of the benefits code. Although he sought to argue the contrary, the argument received short shrift. The issue before the House of Lords turned on whether he could make a deduction under the relevant statutory provisions for expenses "necessarily incurred in performance of the duties of his office", and on the facts of the case it was held that he could (because, as in *Pook v Owen*, he had more than one place of work).

46. The only relevance of the case to the present appeal is that there was some discussion of the true ratio decidendi of *Pook v Owen*. Lord Reid admitted that he had some difficulty in reconciling it with *Ricketts v Colquhoun,* but attempted to do so on a factual basis. Lord Simon, Lord Salmon and Lord Wilberforce (a member of the constitution in *Pook v Owen*) considered that it fell into the category of case where the employee had two places of work and was obliged to travel between them in order to carry out his duties. They therefore treated the aspects of the speeches which addressed the "from" issue as obiter dicta. There is nothing in any of the speeches in *Taylor v Provan* which suggests that *Pook v Owen* was concerned with the concept of

'net' profit or that its ratio depended upon whether the taxpayer had made a 'net gain' from the payment of the expenses.

WAS THE UPPER TRIBUNAL'S ANALYSIS CORRECT?

47. The Upper Tribunal referred at [61] to the passages in the judgments of Lord Guest and Lord Donovan in *Pook v Owen* which I have quoted earlier in this judgment, and stated that in reaching the conclusion that the reimbursement of expenses was not an emolument, both passages suggested that "a key question is whether the employee has made an overall (i.e. net) profit". They went on to state that these passages, and a passage taken from Walton J's judgment in *Donnelly:*

> "demonstrate that the courts are looking to see whether the employee actually received a profit or benefit over and above the reimbursed expenses in addition to analysing the source of the payment made by the employer".

48. I consider this to be a misinterpretation of the authorities, none of which was concerned with the meaning of the word "profit" in the statutory definition of "emolument". The courts were not looking to see whether the employee received a benefit *over and above* the reimbursed expenses; they were looking to see whether the reimbursed expenses were properly to be treated as part of his remuneration, i.e. whether they conferred a financial benefit upon him in return for his services. None of the passages cited provides any support for the approach taken by the Upper Tribunal, and there was no intention in any of those cases to provide a further gloss on the "from" test or to depart from the approach taken in *Hochstrasser v Mayes*.

49. In determining whether a payment by the employer to the employee is an "emolument" or "earnings" from employment, the sole question is whether the payment is a reward for their services as an employee. If the employee is obliged to incur an expense out of their own pocket in order to carry out their duties, and the employer subsequently makes a reimbursement of that expense, he is not, in any sense, *rewarding* the employee for the provision of their services. By making good a loss which the employee has incurred for the purposes of doing their job, the employer is not conferring any financial benefit upon them. Similarly, if the employer makes good a loss which the employee has incurred outside the context of their employment, but *not* by way of remuneration for their services, but under some entirely separate arrangement, as in *Hochstrasser v Mayes*, the payment does not fall within the scope of the definition of "earnings" even if, in order to take advantage of that arrangement, the payee has to be an employee of the person making the payment. But if a financial benefit *is* conferred on the employee in return for their services, the whole of that benefit is treated as taxable income, subject only to deductions which are allowable under the relevant statutory provisions.

50. One of the definitions of the word "profit" in the Oxford English Dictionary is "a material benefit derived from a property, position, etc; income, revenue. Frequently in plural". In my judgment that is the sense in which the word is being used in the definition of "earnings" in s.62(2)(b) of ITEPA. Once the "from" test is satisfied, then the only deductions that are permissible are those which are stipulated in Chapter 5 of ITEPA.

51. The Upper Tribunal rightly found at [77] that the payment of the Agreed Costs was not a reward for services. Although their reasoning is not entirely clear, they do not appear to me to have found that the elements of the Principal Settlement Sum which represented the success fee and insurance premium were not a reward for services; on the contrary, their reasoning seems to be premised on the assumption that they were, although there is no clear finding either way. The re-made decision is that Mr Murphy did not make a "profit" within s.62(2)(b) to the extent that the Principal Settlement Sum was paid in discharge of the success fee and insurance premium. However, if and to the extent that the Upper Tribunal did find that the "from" test was not met, they were plainly wrong, because the whole of the Principal Settlement Sum represented a payment in respect of sums alleged to have fallen due under the claimants' employment contracts, out of which certain liabilities incurred by the claimants to their lawyers and insurers were to be defrayed. Clause 8(1) made it clear that the legal responsibility for paying the lawyers and insurers remained that of the claimants.

52. Mr Collins contended that the Upper Tribunal were right to find (at [83]) that there was no difference in kind between the legal costs incurred by Mr Murphy and the other claimants and the success fee and insurance premium. As the Tribunal stated at [82], all those sums were incurred for the same reason – to progress the claim against the Met. Mr Collins submitted that they were necessarily incurred by the claimants in order to achieve payment of the sums which ought to have been paid by the employer under their contracts of employment, and therefore those costs fell to be deducted from the Principal Settlement Sum.

53. Mr Collins accepted that, on this analysis, any shortfall between the sums reimbursed as "Agreed Costs" following an assessment by the court and the actual costs incurred would also fall to be deducted from the Principal Settlement Sum in order to work out what the taxable "profit" was. Indeed, when it was put to Mr Collins that the expenses incurred by Mr Murphy in travelling to the solicitors' office to attend meetings and give instructions might also be characterised as expenses that were incurred by him in order to recover the monies due from the employer, he did not shrink from the proposition that these too would be deductible in order to reach the "profit", irrespective of whether Mr Murphy chose to travel to and from the office by taxi or by public transport.

54. However, and fatally for Mr Murphy's case, none of those costs or expenses were incurred by Mr Murphy in the performance of his duties as a police officer. There is nothing in the authorities to support the proposition that costs or expenses incurred (even *necessarily* incurred) in order to recover sums due from the employer by way of remuneration can be deducted from those sums in order to reach a taxable "profit". In fact, the authorities seem to me to suggest the contrary. It is only if the expenditure is necessarily incurred in the performance of the employee's duties that it qualifies for deduction, but the question whether it can be deducted from "earnings" is entirely separate from the anterior question of whether a payment made by the employer represents "earnings" in the first place. The approach adopted by the First-tier Tribunal is in line with the statutory scheme, whereas the approach to ascertaining what is a "profit" adopted by the Upper Tribunal seems to me to be entirely at odds with that scheme.

55. The situation in this case is essentially on all fours with the decision in *Eagles (Inspector of Taxes) v Levy* [1934] 19 TC 23. In that case, the taxpayer brought

proceedings for unpaid remuneration from his former position as managing director of a company. The case settled on terms that he should receive an agreed sum of £45,000. Counsel for the company stated in court when announcing the terms of the settlement that the sum was "a comprehensive sum; there are no costs on either side in the matter". The taxpayer therefore had to pay his own costs out of the lump sum he received. Finlay J held that because the agreed sum did not represent or include costs, but (on the contrary) costs were deliberately excluded from it, the whole of the £45,000 represented remuneration for the taxpayer's services, and was taxable. The costs could not be deducted. On the approach taken by the Upper Tribunal, that case would have been incorrectly decided.

56. The Upper Tribunal sought to distinguish *Eagles v Levy* on the basis that the settlement agreement in the present case expressly contemplated that the success fee and insurance premium would be paid by the Met directly to the solicitors and insurers. However, that is not a legitimate basis for drawing a distinction; as the First-tier Tribunal judge pointed out, clause 3 was purely a mechanism for payment, which did not alter the character of the Principal Settlement Sum. The obligation to make those payments remained with the claimants under clause 8(1).

57. The UT erred in law in concluding at [76] that in *Eagles v Levy* Finlay J "would have regarded the legal costs as deductible where the taxpayer was 'necessarily obliged to incur them in order to obtain the payment'." As Mr Carey submitted, that finding confused two separate issues raised in that case. First, Finlay J held that he was bound by *Ricketts v Colquhoun* (and a series of other authorities) to hold that the element of costs within the settlement payment was 'not a sum which can be deductible as being a sum which the Respondent was necessarily obliged to incur' – those authorities all being concerned with the issue whether an expense was or was not necessarily incurred in the performance of the employee's duties. Having decided that the payment of the legal costs was not of that character, Finlay J then addressed the question whether the settlement amount was an agreed sum to cover and include costs, and concluded that it was not.

58. In the present case, unlike *Eagles v Levy*, the employer did agree to pay some legal costs, but left the claimants to pay the balance out of the fruits of the settlement. The Agreed Costs were accounted for separately in the settlement agreement, and treated differently from the Principal Settlement sum. The payment of the Agreed Costs was separate from the damages/compensation element of the settlement and was plainly not a reward for the services of Mr Murphy. However, the success fee and insurance premium were not treated separately; they were to be paid from the Principal Settlement Sum. The mechanism of payment by the Met on the taxpayers' behalf directly to the payees did not change the character of the Principal Settlement Sum as a reward for the taxpayers' services.

59. The position in this case was no different from any other case in which the taxpayer is left to defray some or all of his costs and disbursements in the litigation out of the damages or compensation he receives. If, as in the present case, he is paying those costs and disbursements out of money which represents his taxable income from employment, the whole of the money which represents his taxable income remains taxable. Therefore the Met was right to deduct PAYE from the whole of Mr Murphy's share of the Principal Settlement Sum.

60. Lest it be thought that this produces an unfair result because the question whether a payment is taxable or not depends on the structure of the settlement agreement and the label put on the payment, I would emphasise that the question whether a payment is taxable is a matter of substance, not form. If in substance the agreement involves an obligation on the part of the employer to make payment or reimbursement of costs or expenses which are unconnected with the payee's services as an employee, that element will not be taxable as "earnings". But in this case the parties chose to enter into an agreement by which only part of the settlement sum fell into that category, and the rest represented payments which, had they been made when it was alleged they fell due, would have been taxable as part of the employees' income.

61. Those payments did not cease to be taxable in full because the recipients had to use some of the money to pay the balance of what they owed their own lawyers and the premium due to the insurers. I do not regard this as giving rise to any unfairness. Moreover, there was evidence that the amount of the settlement was increased by £200,000 in recognition of the fact that the Principal Settlement Sum would be taxable. Whilst that does not affect the legal analysis, and played no part in my conclusion, it does provide a degree of comfort that the end result has not disadvantaged Mr Murphy.

CONCLUSION

62. For the above reasons I would allow this appeal, set aside the decision of the Upper Tribunal and restore the decision of the First-tier Tribunal.

Lord Justice Newey:

63. I agree.

Lord Justice Lewison:

64. I also agree.