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Case Notes

HMRC v E.ON UK PLC – Stick to the Test

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The Court of Appeal handed down its judgment in *HMRC v E.ON UK plc* [2023] EWCA Civ 1383 on 28 November 2023. HMRC succeeded in their appeal against the decision of the Upper Tribunal (**"UT"**) and the original decision of the First-tier Tribunal (**"FTT"**) was upheld.

The key message from the judgment is set out by Falk LJ at [48]: when considering the question of "earnings", the only test one has to consider is that set out in s.9/s.62 of ITEPA 2003 and s.3(1) of SSCBA 1992:

> "It bears emphasis that there is a single statutory question: whether the amount in question is earnings "from" employment."

For anyone with any familiarity of employment tax, that is of course a deceptively simple question.

In both the decisions below and in the Court of Appeal, a large amount of the discussion focussed on determining the *ratio* in *Tilley v Wales* [1943] AC 386 (i.e. the binding point of law determined by the court), as well as the so-called "replacement principle". *Tilley v Wales* was a case concerning commutation of an accrued pension entitlement - the commutation was held not to be earnings. E.ON UK was seeking to argue that this decision also applied to (or ought to be extended to) future pension entitlements as well but this was rejected.

The "replacement principle" is as follows: where one receives a payment in replacement of something else, the payment ought to be taxed in the same manner as the thing replaced. This was derived from *Mairs v Haughey* [1994] 1 AC 303, albeit it arguably overlaps with the reasoning in *Tilley v Wales* itself.

What the *E.ON UK* decision confirms is that the "replacement principle" is not a free standing rule; if it has any application it is simply a tool (and a limited one at that) to determine whether a payment is "from" employment or something else. To suggest this principle could be anything more than guidance was realistically never up for grabs given that this simply reflects what Chadwick LJ stated in *EMI Group Electronics Ltd v Coldicott (Inspector of Taxes)* [2000] 1 WLR 540. However, even the attempt to apply this principle as guidance failed.

The underlying facts

The case concerned "Facilitation Payments" that were paid to many of E.ON's employees. However, the payment to a sample employee, Mr Brotherhood, was used as the subject for the tax appeal. By way of background: E.ON was making changes to a defined benefits pension scheme for its employees. This was referred to as the DB Scheme in the decisions but actually comprised two categories or sub-schemes (retirement balance and final salary) - see the FTT at [16].

The "Facilitation Payments" were made by E.ON, following prolonged discussions with trade unions, as part of an "integrated package" -see the FTT at [76] to [83] - and were summarised by Falk LJ as follows:

> "The package comprised a two year pay deal, a commitment not to make further changes to pension arrangements for five years, certain other commitments (for example in relation to the extent of outsourcing) and a "Facilitation Payment". The Facilitation Payment, unlike other elements of the package, was available only to members of the DB scheme. It amounted to 7.5% of salary, subject to a minimum of £1000. Employees were warned that, if they did not agree to the changes, they would receive neither the Facilitation Payment nor the pay rises."

The changes to the DB Scheme did not affect accrued entitlements only future ones. If employees wished to retain their future benefit accruals (above a certain level) they would be required to make additional contributions. Further, the option to purchase additional benefit levels above 40% was removed. It was open to the employees to receive their Facilitation Payment either in cash or as an addition contribution to the DB Scheme.

Tilley v Wales and the "replacement principle"

Tilley v Wales concerned payments totalling £40,000 paid to a director in 1937. The payments were made (i) to reflect a reduction in salary from £6,000 to £2,000 a year, and (ii) to commute an accrued right to a pension of £4,000 per year for 10 years. The House of Lords held that the element of the £40,000 reflecting the reduction in salary was taxable as employment income whereas the element referable to the commutation of a pension was not. The reasoning in relation to the non-taxability of the pension commutation was based on the earlier House of Lords case of *Hunter v Dewhurst* (1932) 61 TC 605 which held that a payment by a company for a release from its "contingent obligations" to pay a pension under a company's articles of association was not taxable as earnings.

The more recent case of *Mairs v Haughey* was an appeal from the Court of Appeal of Northern Ireland. It concerned a payment to Mr Haughey of £5,806 of which £4,506 was found by the Special Commissioner to be in return for Mr Haughey giving up a contingent entitlement to be paid an enhanced redundancy payment if he were made redundant. This was in the context of the privatisation of Harland & Wolff Plc, the shipbuilder. The Court held that the payment was not a benefit (within what is now s.201 ITEPA) on the basis that it was "fair bargain" (discussed further below) but the question remained whether it was earnings. Lord Woolf, giving the only substantive judgment, held that it was not earnings.

First, he held that the whole of the £5,806 could not be treated as an inducement to become or remain employed (i.e. the Special Commissioner was entitled to apportion). Second, he held the following:

> "It is inevitable that if a payment is made in substitution for a payment which might, subject to a contingency, have been payable that the nature of the payment which is made in lieu will be affected by the nature of the payment which might otherwise have been made. There will usually be no legitimate reason for treating the two payments in a different way.
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> As already indicated, payment made to satisfy a contingent right to a payment derives its
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> character from the nature of the payment which it replaces. A redundancy payment would not be an emolument from the employment and a lump sum paid in lieu of the right to receive the redundancy payment is also not chargeable as an emolument under Schedule E."

Since the redundancy payment itself would not have been earnings it therefore followed that the sum of £4,506 - which was paid in lieu of such a possible payment - would not be either. Of course, it would have been taxable under what is now s.401 ITEPA 2003 but on the facts of *Mairs v Haughey* there would have been no tax since the apportioned £4,506 was below the then taxable threshold of £5,000.

The decisions below

The appellate story of *E.ON UK* can be summarised as follows:

(1) FTT decision [2021] UKFTT 156 (TC)

The taxpayer relied on *Tilley v Wales* and *Mairs v Haughey* and argued three alternative points: namely that that the Facilitation Payment was intended to replace any of the following:

(i) payments from the DB Scheme;

(ii) salary to allow the employee to make pension contributions; or

(iii) pension contributions which E.ON otherwise would have made.

The FTT at [11] agreed with HMRC that the "replacement principle" was, if anything, simply a useful guide as to whether a payment was from employment. Further, at [107] the FTT rejected the submission that the ratio of *Tilley v Wales* applied to the removal/alteration of future pension rights. In terms of the taxpayer's analysis, the FTT accepted point (ii) but found that this did not lead to the result that there was no earnings:

> "119. However, in Mr Bradley's submission, it did not follow from that analysis that the Facilitation Payment was not taxable. Instead, on receipt by the member, the Facilitation Payment was earnings, and as such taxable and subject to NICs in his hands. If the employee subsequently used the Facilitation Payment to make pension contributions, he would obtain tax relief at that point.
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> 120. Again, I agree with Mr Bradley. There are two steps here: the first is that the Facilitation Payment could be characterised as replacing the employee's earnings. If, as a

second step, the employee decides to use his earnings to make higher contributions to his retirement balance, he will obtain tax relief at that point. But he had a choice: he could instead reduce his pension contributions and retain the whole of the Facilitation Payment."

The FTT then went on at [125]-[134] to consider what the Facilitation Payment was "from". It concluded that the payment was an inducement to provide future services on different terms and was part of an "integrated package" and the Facilitation Payment could not be separated from the rest of the package. Whilst the FTT noted that there was the loss of an option to purchase additional benefit levels above 40%, this did not prevent the Facilitation Payment being "from" employment since it was only necessary for employment to be a "substantial cause". In any event, on the facts, Mr Brotherhood had never used the option.

(2) UT decision [2022] UKUT 196 (TCC)

The taxpayer's argument remained largely the same before the UT, albeit this time emphasising that the Facilitation Payment replaced E.ON's pension contributions.

Whilst the UT accepted at [36] that the "replacement principle" was "not an overarching principle but a guide which is helpful in some circumstances but not in others", the UT found that the FTT had erred in law in that it:

(i) Wrongly distinguished between compensation for accrued pension rights versus compensation for future pension rights and had read the ratio of *Tilley v Wales* too narrowly "such that it only encompassed accrued rights". In particular, at [62] it held:

> "We see no difference in principle between the characterisation of sums paid in respect of loss of accrued pension rights on the one hand, and sums paid in respect of a diminution in the practical value of expected future benefits on the other. In both cases the sum is from something else, and not from employment."

(ii) Incorrectly approached the question of what the payment was "from". At [83] the UT held that the FTT's process of evaluation in focusing on the reason for the payment being a reward for future service (and possibly the loss of the option to purchase additional benefit) "wrongly omitted that a reason, or an alternative reason for the payment was to compensate for adverse changes to the recipient's pension arrangements". In addition, at [95] the UT found that the FTT erred in its approach to the integrated package:

> "we consider that the fact the *package* might have a pension source was wrongly discounted because of the FTT's legal misapprehension that compensation in respect of changes to pension expectations could not in principle amount to an alternative source to employment for the payment."

In light of the above, the UT set aside the FTT decision and remade it. At [109] it concluded that the Facilitation Payment was not "from" employment since it was from "something else" – namely the adverse changes to rights and expectations in relation to Mr Brotherhood's pension arrangements.

The Court of Appeal decision

Falk LJ gave the lead judgment with which Nugee LJ (who also gave a short judgment) and Lewison LJ agreed. The core of Falk LJ's reasoning was that:

> (1) *Tilley v Wales* did not apply to the "expectation of a future pension" and therefore there was no error of law – see [43]-[47]. Whilst the point about the ratio of *Tilley v Wales* being restricted to commutation of accrued pension rights was apparently conceded by the taxpayer in oral submission, the taxpayer still maintained that it was authority for a broader principle (not spelt out). This argument of the taxpayer (as recorded) is hard to understand given that "authority" has to be based on ratio.
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> (2) The UT was right to find that the FTT made no error in relation to its approach to the replacement principle – see [48].
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> (3) The FTT was entitled to find that the Facilitation Payment was part of an integrated package – see [51].
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> (4) Insofar as the FTT had erred in failing to address that the Facilitation Payment was paid only to DB Scheme members (as opposed to other employee) this was not material – see [52].

In short, once the ratio of *Tilley v Wales* was properly delineated (and it is difficult to see how it could have been said to apply to any expectation of future pension as a matter of binding ratio), there was no realistic route for E.ON to succeed given the usual difficulties in attempting to unravel findings of the FTT on appeal. Reading Falk LJ's judgment, one is left wondering how the UT got it so wrong.

The most thoughtful passage in the decision is at [59] of Nugee LJ's judgment, where he commented on the UT's finding that the FTT had overlooked changes to the pension arrangements as a possible "source" for the Relevant Payments:

> "The difficulty I have with this is that this is presented as an alternative to the FTT's conclusion that the payment was made in exchange for the relevant employees agreeing to a change in their future terms of employment, as if they were mutually exclusive. But that seems to me a false dichotomy. I do not see any reason to doubt that the payment was made as compensation for the adverse changes to the pension scheme going forwards, not least because it was only paid to the members of the DB scheme. But this is no more than another way of saying that it was paid as an inducement to the members to agree to a change in their future terms of employment, the relevant change being the adverse change to the DB scheme. So to say that the payments were compensation for the adverse changes being made to the pension scheme or in exchange for agreeing to a change in future terms of employment is not to my mind to say two different things, but is to say the same thing in two different ways."

This is the key insight as to why the Facilitation Payment was taxable. Making a payment in exchange for changing an employee's future terms of service (including pension) will invariably be earnings because it is a payment to induce the continuation of employment (albeit on different terms). The fact that the terms for future employment could not be changed without consent (or at the very least without a dispute) does not detract from this and is not sufficient to prevent the payment being "from" employment.

s.201 - The can of worms that did not bark in the night-time

One point for practitioners to note is that HMRC did not seek to argue (in the alternative) that the Facilitation Payment would in any event be caught under s.201 ITEPA as a "benefit" provided by reason of employment.

The advantage of this argument from HMRC's perspective is that provided it could be shown that there was a benefit, it would automatically be treated as "by reason of employment" insofar as the payment came from the employer (which was the case here). The cash equivalent would then automatically be treated as earnings "from" the employment under s.203(1). This would obviously avoid questions concerning *Tilley v Wales* and the "replacement principle". However, presumably HMRC were concerned to avoid introducing a further difficult area of argument which is whether the Facilitation Payment was a "benefit".

As referred to above, the question of what constitutes a "benefit" was answered by the Court of Appeal of Northern Ireland at an earlier stage of *Mairs v Haughey* – [1992] STC 495 which was then followed more recently in *Apollo Fuels v HMRC* [2016] STC 1594. In *Mairs v Haughey* the employee was offered either redundancy (and in one sense his right to the old redundancy scheme had therefore "accrued") or work under a new contract under a less generous redundancy scheme plus 30% of what he would have been entitled to under the old redundancy scheme. Leaving aside the question of whether it was earnings (which went on to the House of Lords) it was found that the payment was not a "benefit" since it was a payment for a fair bargain (the giving up of a contingent right to a payment under the old redundancy scheme).

On the facts of E.ON, the employees were "giving up" more generous rights (for future periods) under the old pension arrangements albeit it was actually unclear whether their consent was required. Was this a "fair bargain" in the *Mairs v Haughey* sense?

Instinctively the answer *ought* to be no. However, this would involve extrapolating from *Mairs v Haughey* that the "fair bargain" rule should only apply to accrued rights as opposed to merely the right to future work under the existing terms of a contract. The reasoning in *Mairs v Haughey* on the point is very thin and simply focused on the facts before it. However, viewing the Facilitation Payment as a benefit is consistent with the approach, as recognised in *Mairs v Haughey*, that where (assuming one has a benefit) any "making good" under s.203(2) cannot be satisfied by the supply of services by the employee – see *Stones v Hall* (Inspector of Taxes) [1989] STC 138. In other words, if making good cannot entail an obligation to carry out future work why should a "fair bargain" recognise future pension benefits flowing from future employment as being something that the employee can give up in return for a lump sum without it constituting a benefit?

s.401 - A payment for a change in earnings?

On the facts here this was not a viable line of challenge for HMRC. Given the sums of tax and NICs involved in relation to Mr Brotherhood (who presumably was representative of other employees), the £30,000 threshold was nowhere near being reached.

Leaving this aside, the argument under s.401 ITEPA is probably one that is less obvious to practitioners given that most would think of it as a provision only applying where there is some form of connection with a termination of employment. However, s.401 applies not just to termination of employment but also where there is a change in the earnings or duties from a person's employment. The earnings in question in this case would be the reduced employer's contribution to the DB Scheme (which is what the taxpayer at least was arguing). Whilst no income tax would have arisen as a result of the exemption under s.308 ITEPA had such a contribution been made, this does not prevent the contributions from being considered as earnings. However, again this would depend on demonstrating that the Facilitation Payment was a "payment" or "other benefit".

Does s.401 only apply to payments/benefits that are "beneficial" in the *Mairs v Haughey* sense? The short answer is "no" (probably!) due to the deeming that exists in s.402(1) which asks whether the payment etc received would give rise to an amount of taxable earning if one were to assume that it was received for performing the duties of the employment (subject to limited exceptions).

Comment

Overall, the result should not be surprising; there is an earnings charge where an employee receives a payment as part of a wider deal whereby, going forward, their pension will accrue on less generous terms. As Nugee LJ stated, this was a payment made as an inducement for a change of employment terms and is therefore "from" the employment. Once the ratio of *Tilley v Wales* was confined to its proper limits, there was no convincing basis to argue for the payment being anything other than earnings. However, it does highlight the dangers for taxpayers relying on so-called "rules" which emerge from the case law. As this case shows, "rules" are at best guidance or 'a rule of thumb' and one should always be concerned to consider the wording of the statute as a whole.

If the taxpayer had succeeded, the result would have been surprising. As the FTT pointed out at [120], the taxpayer had a choice as to whether to make a contribution themselves. What was in effect being argued by the taxpayer was that the Facilitation Payment should be treated as free from tax *regardless* of whether the employee subsequently contributed the monies to the DB Scheme (and thus enjoyed relief under s.188 of FA 2004). Indeed, on the taxpayer's case, they would be entitled to a tax free receipt *as well* as a deduction if a contribution were made. This does not appear to have troubled the UT (and was not commented on by the Court of Appeal) but it does seem to be a sensible reality check.

HMRC also had an alternative point that they could have run under s.201 (and on other facts with bigger quantum, s.401). This again shows the potentially overlapping nature of charges for employment income tax and the difficulty in demonstrating that payments (unless for accrued rights) can escape tax. However, until the UT decision, HMRC were presumably sufficiently confident in their basic case on earnings such that they believed there was no need to raise other points.