Hilary Term
[2014] UKSC 14
On appeal from: [2012] EWCA Civ 692

JUDGMENT

The Commissioners for H M Revenue & Customs (Respondents) *v* Forde and McHugh Limited (Appellant)

before

Lord Neuberger, President
Lord Sumption
Lord Reed
Lord Toulson
Lord Hodge

JUDGMENT GIVEN ON

26 February 2014

Heard on 16 January 2014

Appellant	*Respondent*
Richard Bramwell QC Michael Sherry Anne Redston (Instructed by Farrer & Co)	Philip Jones QC James Rivett (Instructed by HM Revenue & Customs Solicitors Office)

LORD HODGE, (with whom Lord Neuberger, Lord Sumption, Lord Reed and Lord Toulson agree)

1. This appeal is the lead case in a number of appeals concerned with the interpretation of the phrase in section 6(1) of the Social Security Contributions and Benefits Act 1992, "[w]here in any tax week earnings are paid to or for the benefit of an earner". It focuses on the meaning of the word "earnings" in that phrase. The context is the payment of an employer's contribution to a Funded Unapproved Retirement Benefits Scheme. Until 2006 such schemes were commonly used to top up sums available through tax-approved pension schemes.

The facts

2. On 11 April 2002 the appellant company (FML) established by trust deed a retirement benefit scheme to provide relevant benefits (as defined in section 612 of the Income and Corporation Taxes Act 1988) to its employees and directors. The trust provided that, upon a member's retirement from service, the trustees were to apply the accumulated fund in providing the member with a pension for life or such other relevant benefits as they might agree with him. On the member's death the trustees were to realise the accumulated fund and apply the net proceeds to or for the benefit of a defined discretionary class of beneficiary. On the same day Mr McHugh, a shareholder and director of FML, asked to become a member of the scheme. He informed the trustees that he wished them to exercise their discretion in favour of his wife in the event of his death. FML made an initial cash contribution to the scheme of £1,000 and transferred to it Treasury Stock with the nominal value of £162,000, both for Mr McHugh's benefit. He has been the only member of the scheme. He has received no relevant benefits from the scheme.

3. When the transfers were made to the scheme Mr McHugh was 54 years old. He had no vested interest in the assets of the scheme because the retirement age under the scheme was defined as meaning:

> "the date between the 50th birthday and the 85th birthday notified to a Member by the Employer as the date on which the Member's benefits will become payable. Such date may be varied from time to time by agreement in writing between the Employer and the Member."

FML specified Mr McHugh's retirement age to be his 60th birthday. But, as HMRC pointed out, he controlled FML and was in a position to bring forward his retirement date for the purposes of the trust deed.

The Issue

4. The principal issue which we address is whether the transfer of the cash and Treasury Stock to the scheme was a payment of earnings to or for the benefit of Mr McHugh within the meaning of section 6 of the 1992 Act. It was agreed that the payment was for his benefit. But was it "earnings" for the purposes of that section?

The prior proceedings

5. FML appealed against HMRC's decision that it was liable to pay Class 1 National Insurance Contributions on the value of the transfer. The Upper Tribunal (Tax and Chancery Chamber) (Floyd J and Judge Avery Jones) heard the appeal at first instance. It delivered a judgment on 21 February 2011 allowing the appeal. HMRC appealed to the Court of Appeal (Arden LJ, Rimer LJ and Ryder J). By a judgment dated 30 May 2012 the Court of Appeal by a majority (Arden LJ and Ryder J) allowed the appeal and restored the decision of HMRC.

6. Before this court Mr Bramwell presented FML's appeal on a much narrower front than the case which had been debated before the Court of Appeal. Until his oral submissions to us, FML's case had been that "earnings" in NIC legislation covered the same ground as "emoluments" in income tax legislation. FML abandoned that position and focused principally on the contingent nature of Mr McHugh's interest in the transferred assets. In short, Mr Bramwell accepted that "earnings" had a wider meaning than "emoluments" in income tax legislation. His submission was that the payment of "earnings" under section 6 of the 1992 Act did not extend to the employer's transfer to a trust of funds or assets in which the earner had at the time of the transfer only a contingent interest. We, and Mr Jones for HMRC, therefore had to address a different argument from that advanced before the Court of Appeal. Counsel for both parties argued their cases very ably.

Discussion

7. The legislative history that lies behind our present system of national insurance shows that Mr Bramwell's change of position was correct: National Insurance Contributions (NICs) have been levied on a basis which is different from the "emoluments" on which income tax has been raised.

8. Mr David Lloyd George, when Chancellor of the Exchequer in 1911, introduced the first compulsory system of insurance against illness and unemployment in the United Kingdom: the National Insurance Act 1911. The Act fixed contributions rates by reference to the level of an employed person's "remuneration" (section 4 and Second Schedule). Lord Beveridge carried out a substantial review of the by then expanded system of national insurance and reported in 1942. The Beveridge Report (Cmnd 6404) was implemented by the National Insurance Act 1946, which established the National Insurance Fund, into which workers, employers and the state were to contribute. Employers and employed persons were required to make weekly contributions into the National Insurance Fund to pay benefits to the earners and their dependants. Contributions were paid in respect of "earnings". In section 78 of the 1946 Act "earnings" were interpreted to include "any remuneration or profit derived from a gainful occupation".

9. The current provision for NICs is contained in the 1992 Act and subordinate legislation. Sections 6 to 9 of that Act provide, in relation to an earner employed under a contract of service, that where in any tax week earnings are paid to or for his benefit, the employed earner shall pay a primary Class 1 contribution and his employer will pay a secondary Class 1 contribution (both subject to specified thresholds). Section 3 of the 1992 Act provides that 'earnings' includes "any remuneration or profit derived from an employment".

10. In my view it is significant that Parliament in the1946 Act, chose to use the word "earnings" rather than "emoluments", which had been a term used in income tax legislation with a definition which had remained substantially unchanged since the Income Tax Act 1842. The latter word had been the subject of judicial interpretation. In particular, in *Tennant v Smith* [1892] AC 150, the case of the Montrose bank manager whose employer gave him free accommodation in a bank house which he was required to occupy, the House of Lords held that the Inland Revenue could not charge income tax on the value of the accommodation because the employee could not convert the benefit into money. The House of Lords held that emoluments were confined to actual money payments and to benefits in kind which were capable of being turned into money by the recipient. See also Lord Reid's explanation of the case in *Heaton v Bell* [1970] AC 728, 744-745.

11. By contrast, from the outset, the word "earnings" in NICs legislation has included benefits in kind which the recipient could not convert into money there and then. Part I of the First Schedule to the 1946 Act, which set out the contribution rates of employed persons, had a rate for earners earning remuneration of under 30 shillings per week and a higher rate for those earning remuneration above that sum. Like the 1911 Act (section 4 and Second Schedule) it treated remuneration, which, as I have said, formed part of the definition of "earnings" in section 78, as including the provision of board and lodging by providing:

> "For the purpose of this and Part II of this Schedule [which set out employers' rates] a person shall be deemed to be earning remuneration at a weekly rate of thirty shillings or less if, but only if, his remuneration does not include the provision of board and lodging by the employer and the rate of the remuneration does not exceed thirty shillings a week, and to be earning remuneration at a weekly rate exceeding thirty shillings in any other case."

12. Since then, primary and subordinate legislation pertaining to NICs has made express provision for benefits in kind to be disregarded when Parliament has not wanted such earnings to be taken into account in the calculation of NICs. In the National Insurance Act 1959, which introduced a graduated pension scheme on top of flat rate benefits, benefits in kind which the recipient could not convert into money's worth were excluded from the calculation of graduated contributions by the device (in section 2(1)) of deeming "remuneration" to include only emoluments assessable to income tax under Schedule E. That arrangement was preserved in the National Insurance Act 1965 (section 4(2)). But in 1975 the basic scheme and graduated scheme were replaced by a new scheme which provided for graduated contributions related to the level of earnings between a lower earnings limit and an upper earnings limit. The link between graduated contributions and emoluments for income tax purposes was abolished. Since then, subordinate legislation has provided for the disregard of, among others, any payment in kind or by way of provision of board or lodging (the Social Security (Contributions) Regulations: SI 1973/1264, regulation 17(1)(d); SI 1975/492, regulation 17(1)(d); SI 1979/591, regulation 19(1)(d); and now SI 2001/1004, para 1 of Part II of Schedule 3 – see para 13 below). In 1985 the upper earnings limit was removed in relation to employer contributions, and since 6 April 2003 employees have been subject to an additional surcharge on earnings above the upper earnings limit (currently 2%).

13. Under the 1992 Act and current subordinate legislation, the Social Security (Contributions) Regulations 2001 (SI 2001/1004) as amended, a similar arrangement of using "earnings" as the basis of calculating liability to NICs and disregarding payments in kind has been maintained. Thus in Schedule 3 to the 2001 Regulations (Part II para 1) it is provided:

> "A payment in kind, or by way of the provision of services, board and lodging or other facilities is to be disregarded in the calculation of earnings."

It is not appropriate to interpret an Act of Parliament by reference to subordinate legislation which was made years after the primary legislation (*Deposit Protection Board v Barclays Bank plc* [1994] 2 AC 367, 397 per Lord Browne-Wilkinson; see also *Hanlon v The Law Society* [1981] AC 124, 193 - 194 per Lord Lowry). But that is not my purpose. I refer to the 2001 Regulations simply to demonstrate that the scheme of NICs legislation by which "earnings" includes non-convertible benefits in kind unless they are disregarded, either expressly or by necessary implication, has existed at least since 1946.

14. As FML accepts the proposition that "earnings" in NICs legislation is not to be equated with "emoluments" in income tax legislation, most of the arguments which engaged the Upper Tribunal and the Court of Appeal fall away. Instead, the debate has focused on whether FML had paid earnings to or for the benefit of Mr McHugh when it made the transfer to the trust at a time when Mr McHugh's interest in the assets of the trust was only a contingent one which might have been defeated by his death before his specified retirement age. As I have said, both parties agreed that the transfer to the trust had been "for the benefit" of Mr McHugh. The question was: was the transfer the payment of "earnings"?

15. On this narrow issue, HMRC's stance before this court was remarkable. Because of the assumptions on which the subordinate legislation had been framed, Mr Jones had to submit that earnings are paid to an earner both when assets are transferred to a pension scheme to be held on a trust and also when payments are made from the trust fund. HMRC looked to the payment and not to what the earner received. HMRC argued that the payment into the trust fund was earnings because it was a sum paid as the *quid pro quo* for past or future services. It was part of Mr McHugh's remuneration. The sum went to a trust fund which was solely for the benefit of Mr McHugh and his wife. Mr McHugh, it was submitted, was immediately better off because he had the hope of receiving the trust fund in the future, and his family would benefit if he did not survive until his retirement age. Payments to him out of the trust fund would as a matter of principle also be earnings when made because they also were payments to him in respect of his employment. On this approach, double-counting was avoided only by Part VI of Schedule 3 to the 2001 Regulations which disregards, among others, payments by way of pension (para 1) and payments by way of relevant benefits pursuant to an unapproved retirement benefits scheme (para 4).

16. There are three reasons why I think that HMRC's argument is wrong. The first and principal reason is that the ordinary man on the underground would consider it to be counter-intuitive that a person would earn remuneration both when his employer paid money into a trust to create a fund for his benefit and again when at a later date that trust fund was paid out to him. The argument would in principle apply also when a company gave an employee a bonus, which was put into a trust or in an escrow fund and was payable at a future date only if the company performed

to a specified level by then: he would earn the bonus twice. I am reluctant to attribute such a view to Parliament absent clear words or necessary implication, of which there are neither. If one gives words their ordinary meaning, it is clear that a retired earner receives "earnings" in respect of his employment in the form of deferred remuneration when he receives his pension. So too does an earner when he receives his deferred bonus. In each case I would characterise the payment from the trust or escrow fund as deferred earnings. It follows that the payment into the trust or escrow fund would not be earnings.

17. Secondly, it is only by looking exclusively to what was paid and ignoring what the earner received that HMRC's view can be sustained. But such an interpretation of section 6(1) of the 1992 Act denudes the word "earnings" of any meaning, so that the phrase "earnings are paid" would amount to "payments are made" in respect of any one employment. Earnings in this context are remuneration derived from the employment. The use of the word "earnings" points the reader towards what the employee obtains from his employment. Looking to what the earner receives avoids the counter-intuitive result.

18. The third and subordinate reason relates to the method of computation. HMRC, by treating the payment into the trust as earnings, fail to take into account the existence of the contingency. If Mr McHugh had died before his retirement date, the trustees would have realised the accumulated fund and paid the proceeds to a member of the defined discretionary class of beneficiary – probably his wife. One must ask: what did Mr McHugh receive through the transfer? It was not the cash and Treasury Stock. The trustees received the assets transferred to them on the trusts of the fund and not unconditionally for Mr McHugh. The transfer gave him only the entitlement to a future pension or "relevant benefits" once a condition – his reaching retirement age – had been purified. It does not matter that Mr McHugh could not immediately convert his entitlement into money because, as I have said, non-convertible benefits in kind are in principle earnings in the NICs legislation. But the hypothetical value to be attributed to Mr McHugh's entitlement would not be the value, at the date of the transfer, of the assets paid into the fund. Rather it would be the value of his contingent right to the trust fund such as it would be at his retirement date. That calculation would not be a simple exercise. The valuer would have to allow for both the contingency of the earner's pre-deceasing the specified retirement date and the uncertainty of the trustees' performance in managing the fund until that date. That would not be the same as the value of the cash and assets in the week in which the transfer was made. HMRC's approach, by treating the payment into the trust fund as Mr McHugh's earnings, fails to address what it was that he received when the transfer was made.

19. In my view therefore the transfer to the trust was not the payment of earnings to or for the benefit of Mr McHugh within the meaning of section 6(1) of the 1992 Act.

20. Having reached this view on the issue which the parties presented in this appeal, I comment briefly on some of the cases to which counsel referred. This case was presented as a test case on the issue of principle. No argument was advanced as to whether a payment into a pension or bonus fund might properly be analysed as a payment out of the earner's salary as in *Smyth v Stretton* (1904) 5 TC 36. Mr Jones stated that HMRC might take that point in an appropriate case. *Edwards v Roberts* (1935) 19 TC 618 assists in this case not because it is correct to equate "earnings" in NICs legislation with "emoluments" in income tax legislation but because of its application of the general law in relation to a contingent interest and its focus on what an employee receives. In that case an employee received a salary and also, if he remained in employment for more than five years, a right to receive at the end of a subsequent financial year part of the capital of a trust fund into which his employer paid a proportion of its annual profits. Lord Hanworth MR stated (p 638):

> "[U]nder these circumstances there could not be said to have accrued to this employee a vested interest in these successive sums placed to his credit, but only that he had a chance of being paid a sum at the end of six years if all went well."

21. HMRC submitted – and the majority of the Court of Appeal accepted - that Collins J had been in error in *Tullett & Tokyo Forex International Ltd v Secretary of State for Social Security* [2000] EWHC (Admin) 350; [2000] All ER (D) 739 because he held that NICs were payable on what the employee receives. For the reasons set out above, I disagree with HMRC's submission.

Conclusion

22. I would therefore allow the appeal and reinstate the judgment of the Upper Tribunal.