INCOME TAX - payments on retirement or removal from office - availability of "top-slicing" relief - meaning of "made in pursuance of an obligation incurred" - case that "obligation" included provision made during employment for early retirement rejected - history of legislation examined - appeal dismissed

THE SPECIAL COMMISSIONERS

LAWRENCE MICHAEL O'BRIEN Appellant

- and -

DAVID R WILLIAMS

(H M INSPECTOR OF TAXES) Respondent

Special Commissioner: MR M S JOHNSON

Sitting in Manchester on 26 April 2000

Mr S Wild, Accountant, for the Appellant

Mr J Hamer, of the office of the Solicitor of Inland Revenue, for the Respondent



DECISION

1. Mr Lawrence Michael O'Brien is a retired bank manager. He retired aged 52 on 31 July 1995. He received on 1 August 1995 a lump sum of £42,919 paid to him by his employer, The Royal Bank of Scotland. It is common ground that that payment was taxable, as a payment on retirement or removal from office or employment, pursuant to section 148 of the Income and Corporation Taxes Act 1988 ("the 1988 Act"), to the extent that it exceeded the exempt sum provided by section 188(4) of the 1988 Act. What is in dispute is the availability of a claim for relief from tax in respect of the balance of the lump sum payment, pursuant to Schedule 11 of the 1988 Act, as provided by section 188(6).

2. Paragraphs 4 to 7 of Part I of Schedule 11 of the 1988 Act were repealed by the Finance Act 1988, except in relation to those cases where a notice is given pursuant to Paragraph 12 of Part II of that Schedule. If such a notice is given, then Part I of the Schedule, with the insertion of additional paragraphs set out in Part II, applies to provide the relief which the Appellant seeks. Paragraph 12, however, provides that such notice can only be given:

"Where a payment [taxable under section 148 of the 1988 Act] is made in pursuance of an obligation incurred before 10 March 1981 ... " (emphasis supplied).

In that case, the giving of such a notice affords relief from tax corresponding to that available prior to that date.

3. The Appellant contends that the payment he received on 1 August 1995 was made in pursuance of an obligation incurred before 10 March 1981, because his employment commenced before 10 March 1981 and it was always envisaged between him and his employer that in the circumstances that happened, he would receive the payment. The Respondent disagrees, and says that, even if this were true, the payment would not for purposes of section 148 have been made in pursuance of an obligation incurred before 10 March 1981. So the task before me is to determine the applicability or otherwise of Paragraph 12 in this case.

4. The 1988 Act is a consolidating act. In interpreting it, I of course need to examine the actual language of the act itself. However if the language of the consolidating act is unclear and ambiguous, it is in order for me to look at earlier repealed legislation as an aid to interpretation, on the basis of the presumption that a consolidating act is not intended to make substantial alterations to the law. The expression "obligation incurred" is capable of a very wide and general meaning, and, indeed, that is how the case has been argued before me on behalf of the Appellant. However just as the word "interest"fell to be interpreted by the House of Lords in Gartside v IRC [1968] AC 553 in a sense more restricted than that which might be understood by the man in the street (see [1968] AC at page 602, per Lord Reid, and at page 617, per Lord Wilberforce), so too, considered against the background of earlier legislation, might "obligation incurred". The question is, does that expression have the wide meaning for which the Appellant contends? Or does it, as Lord Wilberforce said in the Gartside case at the reference mentioned, need to be placed "in a setting" if precise conclusions are to be founded upon its use?

5. I have come to the view that it is so unclear what the expression means that I am not only entitled, but indeed need to, look at the legislative history of the provision I am considering in order to discern its scope.

6. The history of Paragraph 12 of Schedule 11 of the 1988 Act is as follows. Prior to the Finance Act 1960 ("the 1960 Act"), payments made at the end of an employment which escaped a charge to tax as an emolument of the employment were not brought into charge to tax at all. In Comptroller General of Inland Revenue v Knight [1973] AC 428 at 433 (Privy Council), Lord Wilberforce explained the distinction between those payments made at the end of employment which before 1960 attracted tax as emoluments and those payments which escaped tax altogether, in the following words:

"Questions as to the taxability of payments received by employed persons at the end of their employment have frequently come before the courts; they have often been described as difficult, borderline and depending on narrow distinctions. Two

propositions are accepted as common ground in the present case. First, where a sum of money is paid under a contract of employment, it is taxable: even though it is received at or after the termination of the employment: see for example Henry v Foster (1932) 16 Tax Cas 605. Secondly, where a sum of money is paid as consideration for the abrogation of a contract of employment, or as damages for the breach of it, that sum is not taxable: see for example Henley v Murray [1950] 1 All ER 908, 31 Tax Cas 351".

7. Section 37 of the 1960 Act made chargeable to income tax under Schedule E sums received in connection with the loss of an office or employment, subject to the exemptions specified in section 38 of the 1960 Act. However section 37(6) provided:

"(6) This section does not apply to any payment made before 6 April 1960, nor to any payment, whenever made, being -

(a) a payment made in pursuance of an obligation incurred before that date; or

(b) a payment made in respect of a termination or change which took place before that date, not being a payment made in commutation of annual or periodical payments;

but subject as aforesaid this section applies to payments made before as well as after the commencement of this Act".

8. It is important, I think, for the purposes of the present appeal, to bear in mind that section 37(6) was enacted against the background that sums paid under a contract of employment, even those received at the termination of employment, were already taxable as emoluments of the employment. For instance, in Henry (Inspector of Taxes) v Foster (1932) 16 Tax Cas 605, referred to in the passage from the Knight case mentioned above, the Respondent was a company director who under the articles of association of the company was entitled on leaving office to receive a sum by way of compensation for loss of office equal to the total remuneration he had received in the preceding five years. In the Court of Appeal, Lawrence LJ explained the basis on which that sum was taxable as follows (16 Tax Cas at 632):

"In my judgment, the determining factor in the present case is that the payment to the Respondent, whatever the parties may have chosen to call it, was a payment which the company had contracted to make to him as part of his remuneration for his services as a director. It is true that payment of this part of his remuneration was deferred until his death or retirement or cessor of office, and that in the articles it is called "compensation for loss of office". It is, however, a sum agreed to be paid in consideration of the Respondent accepting and serving in the office of director, and consequently is a sum paid by way of remuneration for his services as director".

9. The new charging provisions of the 1960 Act applied only to payments "not otherwise chargeable to income tax" - section 37(2). People were well aware that many sums paid on the occasion of the termination of employment were already treated as subject to income tax, so that the "obligation incurred" referred to in section 37(6)(a) could not refer to obligations to pay those sums, already taxable. The "obligation incurred" must have meant an obligation of a kind which would not already give rise to a charge to tax in respect of the sum paid, being an obligation giving rise to legally-recognised rights and duties (the expression does

not cover the situation in which an ex gratia payment is made: see Mercer v Pearson (Inspector of Taxes) [1976] STC 22).

10. Sections 37 and 38 and Schedule 4 of the 1960 Act were consolidated in sections 187 and 188 and Schedule 8 of the Income and Corporation Taxes Act 1970 ("the 1970 Act"). Section 187, corresponding to section 37 of the 1960 Act, stated, in section 187(6):

"(6) This section does not apply to any payment made in pursuance of an obligation incurred before 6 April 1960".

11. The next development was contained in section 31 of the Finance Act 1981 ("the 1981 Act"). That section amended and simplified section 188 and Schedule 8 of the 1970 Act. One of the Schedule 8 exemptions had been that payments made otherwise than as compensation for loss of office could qualify from exemption from tax to the extent that the standard capital superannuation benefit exceeded the tax free threshold. That relief was abolished. Further the "top-slicing" relief, which had been complex and open to manipulation, was simplified. The new rules applied where an employment was terminated after 6 April 1981, being the factor determining the date of receipt of income. However Budget Day that year was 10 March. Section 31(7) accordingly provided:

"(7) Where a payment is made in pursuance of an obligation incurred before 10 March 1981, the person chargeable to tax in respect of it may, by a notice in writing given to the inspector within six years after the year of assessment in which the payment is made, elect that Schedule 8 to the [1970 Act] shall have effect in relation to the payment as if this Act had not been passed".

12. 1988 was both the year when the tax acts were again consolidated and the year in which, by the Finance Act 1988, "top-slicing" relief was abolished for the future. However the presumption that there was no intention to repeal the relief retrospectively was confirmed firstly by Part I of Schedule 11 providing relief in respect of pre-6 April 1988 payments, and secondly by making Part II as well as Part I apply in respect of pre-10 March 1981 obligations, should the benefit thereof be claimed. By section 188(6) of the 1988 Act, relief therefore remains available from the charge to tax under what is now section 148 of the 1988 Act, to the extent that Schedule 11 applies. Parts I and II together of Schedule 11 contain the provisions for relief formerly contained in Schedule 8 of the 1970 Act and referred to in section 31(7) of the 1981 Act.

13. I now turn to consider the factual basis on which this appeal rests. For the purposes of the appeal, the following facts are agreed:

13.1 The Appellant’s employment commenced with The Royal Bank of Scotland on 13 March 1962 and terminated on 31 July 1995;

13.2 On 1 August 1995 the Appellant received a termination payment of £42,919 which falls within the provisions of section 148 of the 1988 Act and qualifies for an exemption under section 188(4). Any balance in excess of the exempt amount is assessable under Schedule E for the year 1995/96.

14. The Appellant himself gave oral evidence and produced certain documents. On the basis of this evidence, I make the following additional findings of fact:

14.1 The Appellant's employment was pursuant to terms which included provisions for pension and redundancy payments following the termination of employment;

14.2 Those provisions were applicable to all employees of The Royal Bank of Scotland and were incorporated by reference into individual contracts of employment. Copies of the provisions were held at each bank branch, included in "staff manuals" which were available for employees to consult;

14.3 The contents of the "staff manuals" were continually updated, and incorporated inter alia the fruits of trade union negotiations with the employer, intended by union, employers and employees to be contractually binding between employer and all bank employees belonging to the union. The Appellant was a union member throughout his employment;

14.4 The Appellant was employed for the term of 45 years or until the age of 60, whichever came first. As he was aged 19 when first employed, his expected retirement date would have been his sixtieth birthday, i.e. 28 January 2003;

14.5 However the threat of redundancy manifested itself 12 months or so before the termination of his employment in 1995. In the months before his retirement, the Appellant consulted the "staff manual" to see what payment he would become entitled to under the terms of his contract when he retired. He had not hitherto had occasion to consult the manual for that purpose, and could give no evidence as to what retirement/ redundancy terms the manual had previously contained;

14.6 The termination of the Appellant's employment was in accordance with "staff manual" provisions as those provisions stood on 1 October 1992. No earlier versions of such provisions were produced in evidence;

14.7 The provisions of October 1992 included a formula for calculating a lump sum payment receivable by employees who might take early retirement or be made redundant. According to that formula, at Page Q13 of the "staff manual", the payment was to be calculated in the amount of so many weeks' pay for so many years of service before retirement;

14.8 The Appellant retired after 33 years of service, and applying the formula in the "staff manual", received a lump sum payment calculated in the amount of 1/52nd of his annual salary multiplied by 79, being the number of weeks applicable under the formula to service of between 30 and 34 years, i.e. £42,918.31, or £49,919 rounded up to the nearest pound.

15. On behalf of the Respondent, whose case was very helpfully presented by Mr Hamer, I was urged to dismiss the appeal on the initial ground that it had not been proved that an "obligation" dating from prior to 10 March 1981 existed. It was submitted that, even if the Appellant had received a payment pursuant to an obligation incurred by the employer, the evidence before me was limited to such obligation as it existed in the mid 1990s. Reference was made to Grant v Watton (1999) 71 Tax Cas 333 at 353 on the meaning of "incurred". There was, said Mr Hamer, no evidence of an obligation dating from over ten years earlier. Secondly, if I nevertheless were to accept that the employer had been obliged prior to 10 March 1981 to make the payment on the eventual retirement of the Appellant, Mr Hamer submitted that I should not interpret "obligation" in the sense contended for by the Appellant. The "obligation" referred to in Paragraph 12 of Schedule 11, said Mr Hamer, is the obligation to pay the sum, once the redundancy decision

has been made. That decision dated in this case from no earlier than the mid 1990s.

16. Mr Wild, who represented the Appellant very ably, submitted that the Appellant was employed under a contract of employment prior to 10 March 1981 which entitled him to a payment on his being made redundant, and that therefore the payment was made in pursuance of an obligation incurred before that date, namely the contract. He also submitted that, by the time of the 1988 Act, there would be no purpose in including Part II of Schedule 11 unless the "obligation incurred" bore that meaning, because if the phrase related merely to the quantification of the payment and the liability to pay the quantified sum, by 1988 there would in practice be no such obligations which remained outstanding, so that Part II of Schedule 11 would then be otiose.

17. Although I appreciate that the expression "made in pursuance of an obligation incurred before 10 March 1981" is capable of bearing the meaning put upon it by the Appellant, I cannot accept that such is its meaning in the 1988 Act. If the expression did bear that meaning, then the Appellant would as I see it virtually have to concede that the payment was taxable as an emolument of his employment. I am in no doubt that the £42,919 received on 1 August 1995 was what both parties, employer and employee, regarded as properly due to the Appellant by virtue of his employment at the time he stepped down. Both parties appreciated that the Appellant's employment might not last until age 60, and they had made anterior provision for a termination payment, dependent upon years of service achieved by the date of termination, in order to cater for the contingency of early termination of the employment.

18. I am not however required to decide whether or not the payment constituted an emolument of the Appellant's employment. This case comes before me on the basis that it is agreed that section 148 of the 1988 Act applies. The payment received is therefore agreed not to be taxable under section 19 of the 1988 Act as an emolument of employment. Schedule 11 operates only in relation to payments which are not so taxable. The payment cannot therefore have been made on the basis of an obligation all along contained in the Appellant's contract of employment. The Appellant cannot in my judgment undermine the agreement that section 148 applies by showing that the payment was made in such circumstances that one would expect tax to be charged in respect of it under section 19.

19. I should add that there was before me a letter dated 20 July 1998, written to the Appellant's representatives by The Royal Bank of Scotland, stating that in 1981 a similar agreement to that evidenced by the "staff manual" provisions of October 1992 would have been in place covering payments for individuals leaving in a redundancy situation. In the light of the agreement that section 148 nevertheless applies to the payment in this case, I do not see that the assertion in that letter, vague and untested as it is, provides any acceptable evidence of the tax position as to such payments.

20. The question remains, what does the phrase "made in pursuance of an obligation incurred before ... " connote? The answer to this lies, I think, in the background to sections 37 and 38 of the 1960 Act, because the 1970, 1981 and 1988 Acts in my judgment simply adopted and continued the phrase as contained in section 37(6)(a). What the phrase connoted is payment pursuant to an obligation which would be insufficient to enable one to say that the payment amounted to an emolument of the employment, but which would, apart from the exemption, attract a charge to tax under the new provisions. It would on one

view be unfair for the payments under such obligations to attract tax, seeing that they would have arisen on the basis that the payments were not taxable.

21. Similarly, prior to Budget Day1981, obligations might have been entered into to make payments the amount of which was arrived at having regard to the taxation provisions as they stood before that date. So the tax position in relation to these payments is preserved, subject to the election provided by section 31(7).

22. The Appellant questions the necessity for Paragraph 12 of Schedule 11 of the 1988 Act in the above circumstances. The argument runs that, by 1988, the effect of section 31(7) of the 1981 Act, being in the nature of a transitional provision, would be spent. Therefore, the Appellant says, Paragraph 12 must have in contemplation something other than that provision. However the 1988 Act is a consolidating act. It is in my view clear that the 1988 Act is not intending to amend the pre-existing law in the respect in dispute. It would be no part of the function of the 1988 Act to omit any part of the previous law being thereby consolidated which might continue to have effect.

23. It is not difficult to envisage situations (albeit hypothetical) in which taxpayers might still be placing reliance on section 31(7). Under that sub-section, the election is to be made within six years after the year of assessment in which the payment is made. If such an election were made towards the end of the time allowed, one can readily see that, as viewed in 1988, the transitional provision might continue to be of practical value. So the 1988 Act should include it.

24. There being no acceptable evidence of an obligation incurred before 10 March 1981, I accordingly reject the Appellant's arguments that the circumstances of his case bring him within the ambit of Paragraph 12. In formal terms, this means that I uphold the decision contained in the letter dated 16 July 1999 of the Officer in Charge, Inland Revenue Wales and Midlands Cardiff 4, that "top-slicing" relief pursuant to Schedule 11 of the 1988 Act is not available to the Appellant, because the termination payment received by him from The Royal Bank of Scotland was not made in pursuance of an obligation incurred before 10 March 1981. I decide that the Appellant is liable to pay tax on the basis that no such relief is available to him, and I therefore dismiss the appeal.

MICHAEL JOHNSON

SPECIAL COMMISSIONER

Released 27th June 2000

SC 3120/1999