Schedule E, Case II – US citizen seconded to UK firm and becoming UK resident – Tax equalisation agreement for employer to bear non-US tax – Part of emoluments when resident attributable to performance of UK duties and part not – Whether UK tax paid by employer wholly "in respect of the performance of duties in the United Kingdom" or to be apportioned – ICTA s.19(1) – Appeal dismissed

THE SPECIAL COMMISSIONERS SpC 00286

NATALIE PERRO Appellant

- and -

BERYL CHRISTINE MANSWORTH

(INSPECTOR OF TAXES) Respondent

Special Commissioner: THEODORE WALLACE

Sitting in London on 30 and 31 August 2001

Aparna Nathan, instructed by Ernst & Young, chartered accountants, for the Appellant

Bruce Carr, instructed by the Solicitor of Inland Revenue, for the Respondents

DECISION

1. This appeal concerns the treatment under Schedule E Case II of United Kingdom income tax paid by a United States firm on account of taxable emoluments of a US citizen employed by that firm for a period while resident in the United Kingdom and working from here. The Appellant was based in London from July 1997, when she became resident in the UK; however she was working abroad for nearly half of her time so that her emoluments while based in the UK fell to be apportioned between those "in respect of duties performed in the UK" and those not.

2. The UK tax was deducted by the associated UK firm under section 203C of the Taxes Act 1988. The Appellant was contractually entitled to have the UK tax paid by her employers under a tax equalisation scheme which was designed to put her in the same overall position as regards income tax as if she had remained located in the United States.

3. I was informed that the treatment of such tax equalisation payments has been a lengthy bone of contention and that other multi-national organisations have similar schemes.

4. Miss Perro was employed by Ernst and Young LLP in New Jersey, being an associate director of Ernst & Young International. She is a US citizen and is ordinarily resident in the United States. I was told that as a US citizen she is subject to US tax on her world income subject to double taxation relief, but that because UK tax rates are higher, full relief is not available.

5. In July 1997 she was assigned to the London office for 2-3 years as Director of Global Lotus Services "to architect, build, operate and support the EYI Global Lotus Notes environment." She was required to travel extensively in Europe, North America, Asia/Pacific and elsewhere.

6. She arrived in London on 16 July 1997 when she became resident in the UK for tax purposes. Her work schedule was clearly heavy since in the year to 5 April 1998 she took only three days' holiday and worked on all but one weekend each month. Between 16 July 1997 and 5 April 1998 she worked on 245 days, 137 in the UK and 108 abroad. 77 days of the 108 were in the USA; she also worked in Singapore, Paris, Netherlands and Switzerland.

7. In accordance with Extra-Statutory Concession A 11 she was not charged to UK tax prior to 16 July, the date when she became resident. This appeal does not concern any income before that date.

8. Her emoluments fell to be split between those in respect of duties performed in the UK and those not.

9. In accordance with the Inland Revenue Statement of Practice 5/84, the emoluments from 16 July 1997 attributable to UK duties have been apportioned on the basis of working days, so that 137/245 is attributable to UK duties and 108/245 to non-UK duties. No problem arises out of that.

10. The dispute concerns what is to be apportioned. It is common ground that the UK paid on her emoluments is itself an emolument, see Hartland v. Diggines [1924] AC 289, 10 TC 247.

11. The Revenue contention is that the payment of UK tax pursuant to the tax equalisation scheme was "in respect of duties performed in the UK" both on the wording of the documents and as a matter of law and was therefore fully taxable without apportionment.

12. The Appellant contended that the payments were indistinguishable from her other emoluments; it was argued that on the contract between the Appellant and her employer they were not attributed either expressly or by implication to UK duties and that they fell to be apportioned along with the other emoluments so that only 137/245 was assessable under Case II.

The Statute

13. Section 19(1) of the Income and Corporation Taxes Act 1988 (as amended in 1989) provides as follows:

"(1) The Schedule referred to as Schedule E is as follows –

SCHEDULE E

1. Tax under this Schedule shall be charged in respect of any office or employment on emoluments therefrom which fall under one or more than one of the following Cases –

Case I: any emoluments for any year of assessment in which the person holding the office or employment is resident and ordinarily resident in the United Kingdom, subject however to section 192 if the emoluments are foreign emoluments (within the meaning of that section);

Case II: any emoluments, in respect of duties performed in the United Kingdom, for any year of assessment in which the person holding the office or employment is not resident (or, if resident, not ordinarily resident) in the United Kingdom, subject however to section 192 if the emoluments are foreign emoluments (within the meaning of that section);

Case III: any emoluments for any year of assessment in which the person holding the office or employment is resident in the United Kingdom (whether or not ordinarily resident there) so far as the emoluments are received in the United Kingdom;

and tax shall not be chargeable in respect of emoluments of an office or employment under any other paragraph of this Schedule;

."

The other paragraphs of section 19(1) are not material to this appeal.

14. Case I has no application because the Appellant was not ordinarily resident on the UK.

15. Case III depends on remittances. It was common ground that the Appellant remitted no emoluments from abroad. The Revenue did not contend that the payments of UK tax constituted receipt of an emolument in the UK for the purposes of Case III..

The facts

16. There was no oral evidence. There was a statement of agreed facts. Although there was no formal contract of employment, there was a letter dated 9 July 1997 on behalf of the Appellant's employer, Ernst & Young LLP, summarising arrangements for the Appellant's assignment to London, to be signed by the Appellant; I assume that this was accepted by the Appellant although the copy exhibited was unsigned. There was an EYI Position Description and a letter by the Chief Information Officer addressed to third parties stating the Appellant's position. There was also a section from Ernst & Young's booklet "Expatriate Program Policies and Procedures Temporary Guidelines – December 1995", referred to in the letter of 9 July.

17. The letter stated that the assignment to the London Office was expected to be 2-3 years when the Appellant would return to the USA.

18. Under "Compensation" the letter stated that the base salary would be $128,800 from 1 July with adjustments on the same basis and at the same time as if she had remained in the United States. It stated that there would be a monthly goods and services allowance of $1726 while in London to cover cost of living excluding rent and utilities, a lump sum payment of $1926 with the first pay check after moving into permanent housing, a sundry allowance of $5000 upon transfer to cover incidental expenses of moving and reimbursement of relocation expenses including shipping and storage.

19. Then appeared provisions headed "Income Taxes" as follows,:

"Hypothetical Taxes: You will be subject to the firm's policy on hypothetical income taxes during your assignment. During the year, your salary will be reduced by an estimated hypothetical amount. After you tax returns are filed annually, a final theoretical tax on base salary, plus any non-firm income, will be calculated. The difference between your estimated hypothetical and your final theoretical tax will result in a tax settlement payment due you (due the firm).

Actual Taxes: The firm will pay all actual U.S. and foreign taxes. When an actual tax payment is required, you should contact Louisa Palmer, at 212/773-5979 or Tom Chen, at 212/773-1337 to request an advance."

20. It was then stated that compliance with US and foreign tax law was considered a mandatory obligation of her assignment. Various other provisions covered home leave insurance, professional development, loss on sale of car and holidays. The letter concluded by asking Miss Perro to sign and return a copy if she was in agreement.

21. Annexed were six pages headed "Section 5 Tax Equalisation" from the booklet referred to at the start of the letter. This started as follows:-

"**Section 6**

Tax Equalisation

It is the policy of the firm that U.S. employees working overseas will pay no more income tax as a result of relocating overseas than they would have paid if they stayed at home, nor will the individual receive a benefit as a consequence of paying less income tax. An individual working overseas will be charged an amount equivalent to the U.S. federal, state and social security taxes which they would have paid had they remained in the U.S. This policy is called tax equalisation, and the tax charged to the individual is called the hypothetical tax.

Calculation of Hypothetical U.S. Tax

Hypothetical U.S. tax is designed to be approximately equivalent to the U.S. federal, state and social security tax an average U.S. counterpart would pay. Hypothetical tax includes the following components:

Hypothetical income

⁰ Base pay (after 401(k) contribution and flex credits)

⁰ All non-firm income, deduction and losses reported on the U.S. tax return for the year, with the exception of a loss on rental of principal residence

⁰ Group term life insurance

⁰ Less: Alimony and other adjustments funded by the individual

Deductions

Greater of:

Standard deduction, or

Actual deductions as reported on the tax return and funded by the individual, including mortgage interest and real estate tax on a principal residence, plus hypothetical state tax

U.S. federal and state taxes are computed based on the individual's exemptions and filing status used on the actual U.S. tax return."

22. The next few paragraphs covered state and local taxes which vary from state to state, non-firm income including spouse's earned income and social security tax. There then appeared the following:

"**Procedures for Tax Equalisation Settlement**

At the beginning of the assignment, an estimated hypothetical federal and state tax will be calculated based on firm income only. The individual's semi-monthly compensation will be reduced by 1/24 of the amount each pay period. Actual social security tax will be withheld on all amounts paid by the U.S. firm, plus base salary paid by the foreign affiliate, up to the maximum required. After the actual tax returns are prepared, a final hypothetical tax will be calculated using amounts from the tax return as filed. The difference between the estimated hypothetical and the final hypothetical will result in an amount due the employee/(due EY).

Sample Calculation of Final Hypothetical Tax

Base salary ($60,000 less 401(k) of $6,000) $54,000

Non-firm income 2,000

Hypothetical income $56,000

Greater of;

Standard deduction $6,500

Actual itemised deductions 4,000

(6,500)

Personal exemptions ($2,500 x 2) (5,000)

Taxable income $44,500

[Final] Hypothetical U.S. Tax

Federal $ 7,390

State 1,335

Social Security 4,590

Total $13,315

Assuming that the individual has estimated hypothetical tax withheld of $9,000 and social security tax withheld of $4,600, he/she would receive a reimbursement from Ernst & Young of $285 ($9,000 plus $4,600 less $13,315, equals $285).

Reimbursement of U.S. and Foreign Taxes

An individual will be reimbursed for the total U.S. (federal and state) and foreign taxes incurred on taxable income (firm compensation and non-firm income) during any year (or part year) in which an individual is working overseas. In addition, an individual will be reimbursed for any excess taxes incurred on assignment-related income received in a post-assignment year.

When an individual is required to pay foreign or U.S. income taxes, such as estimated or final payments, they should request reimbursement from the International Human Resources department. U.S. taxes will be reimbursed in U.S. dollars and deposited in the individual's U.S. bank account. Foreign taxes will generally be reimbursed in foreign currency. Proof of payment is required (tax receipts or copies of tax returns) for all such payments."

23. Next there appeared paragraphs dealing with interest and penalties, excess foreign tax credits and the claiming of foreign source earned income benefits. Finally it was stated that sales taxes, excise taxes, petrol and car registration taxes and non-income related miscellaneous taxes would not be reimbursed.

24. The Appellant's initial self-assessment return for 1997/98 was submitted in January 1999 and apportioned part of the UK tax payment to 128 days on overseas duties out of 245 working days. A notice of enquiry followed with a letter stating the Revenue's position in outline.

25. Ernst & Young provided extensive details and schedules in a letter of 12 May including 108 days overseas in place of 128 days. They provided amended returns (a) on the Appellant's basis and (b) on the Revenue basis.

26. The return on Appellant's basis showed £76,215.99 from P60 payments (Box 1.8) and £34,566.00 other payments (Box 1.10) and £24,522.05 UK tax as having been deducted (Box 11). Foreign earnings not taxable in the UK were shown as £48,834.51 (Box 1.31).

27. Accompanying schedules showed that the figure of £76,215.99 in Box 1.8 was obtained by adding the UK tax paid to the salaries paid in the UK and in the US and then deducting the UK tax claimed as overpaid (£5,921.06); the salaries were from 16 July 1997 although this was not stated. A lower figure appeared on the Revenue basis because on that basis only £454.65 tax was overpaid.

28. The Box 1.10 figure consisted of relocation expenses of £42,566 less the maximum £8,000 allowed on change of residence under Schedule 11A, paragraph 24(g).

29. The Box 1.31 figure of £48,834.51 was obtained by adding together the UK tax due or the equalisation figure (£18,600.99) and £92,181, which was the net remuneration before the UK tax, and multiplying the total by 108/245 (the proportion of days worked overseas).

30. The tax due (the equalisation figure) was the tax on the remaining 127/245 after deducting the personal allowance.

31. The Revenue basis applied 127/245 to the £92,181 alone and only added the UK tax figure afterwards. This produced a lower Box 1.31 figure of £40,634.89: and of course a higher figure subject to UK tax. Not only was the tax equalisation figure not apportioned between UK and overseas duties but the resultant higher UK tax figure represented an increased emolument.

32. The effect of the different bases appears in this table:

Revenue's Method Appellant's Method

Net Earnings 92,184 92,181

Gross Up Method 2 <u>18,601</u>

92,181 110,782

<u>Less</u> Earned abroad

Non UK days 108

Total days 245 (40,635) (48,835)

and Gross Up Method 1 24,067 _____

Assessable 75,613 61,947

Less PAs/corres paymts 4045 (4,045) (4,045)

Taxable 71,568 57,902

Tax thereon £24,067.20 £18,600.80

Submissions

33. Miss Nathan said that the payments of tax were emoluments, whether the tax was UK or overseas tax. They formed part of the global emoluments for the period from 16 July 1997 being no different in kind from salary, benefits in kind and any other emoluments and should be treated no differently being apportioned on the same basis. She submitted that the global emoluments were not divisible into duties performed in the United Kingdom and elsewhere. The UK tax paid was not in its entirety "in respect of duties performed in the United Kingdom" within the words of Case II.

34. Miss Nathan submitted that there was no difference between the tax equalisation payments and the discharge of any other liability. Hartland v Diggines [1926] AC 289; 10 TC 247 applied to the discharge of any debt of an employee, see Richardson v Worrall [1985] STC 693 at 717 and Glynn v Commissioner of Inland Revenue [1990] STC 227, a decision of the Privy Council on a case when the employer undertook the primary liability to pay school fees.

35. When deciding whether the payments were wholly "in respect of the performance of duties performed in the United Kingdom" without apportionment, it was necessary to look first at the contract. She submitted that, unless the payments were expressly or impliedly in respect of the duties in the United Kingdom or this could be inferred from the facts, the emoluments had to be apportioned on a time basis.

36. She said that the agreement between the Appellant and her employer did not allocate any part of her emoluments to any particular duties : it did not earmark any part to UK duties. Although the UK tax equalisation payment varied with the proportion of working days in the UK, it was nevertheless part of her global emoluments. Her assignment was global and involved extensive travel.

37. Miss Nathan submitted that payments of US or Singapore tax under the tax equalisation arrangement would fall into apportionment; UK tax should do so also.

38. She said that Varnam v Deeble [1985] STC 308, Platten v Brown [1986] STC 514, Coxon v Williams [1988] STC 593 and Leonard v Blanchard [1993] STC 259 all supported time apportionment.

39. Mr Carr, for the Revenue, said that the starting point must be the wording of section 19. It was not relevant that the duties were of an international nature, provided they were performed in the United Kingdom.

40. The payment of UK tax arose because of the performance of duties in the United Kingdom. The issue was whether a payment in respect of that tax could be anything other than "an emolument in respect of duties performed in the United Kingdom."

41. The tax equalisation payment varied with the performance of duties in the United Kingdom and was linked with the discharge of the liability for the tax. There was no logical reason why the equalisation payment should not be in respect of the performance of duties in the UK when it was calculated by reference to the time spent in the UK performing those duties.

42. He said that the Appellant's basis in effect resulted in double apportionment because on both bases the UK tax due was calculated on a figure after apportionment. The Appellant wished to apportion not only the basic net earnings but also the tax on the UK element. The tax was based on apportioned emoluments, it was illogical to apportion the tax also by adding it in before apportionment.

43. Mr Carr said that the question was not whether there was a special category of emolument which was outside a process of apportionment, but simply whether any emolument or part thereof was "in respect of duties performed in the United Kingdom.

44. The decision of the Court of Appeal in Taylor v Provan [1975] AC 194; 49 TC 579, which concerned the reimbursement of travel expenses paid to a director to come to the UK in order to perform duties here, showed that there is a category of emolument to which time apportionment is not appropriate; the touchstone is the wording of the statute, see Russell LJ 49 TC at page 596. Although the decision of the Court of Appeal was reversed in the House of Lords that was on another ground and Lord Morris agreed that the travel expenses were emoluments in respect of duties performed in the UK, see page 607.

45. It was immaterial that the obligation to the Appellant arose out of the agreement. It was unrealistic to treat the tax equalisation payments as indivisible.

46. Mr Carr said that the Appellant's argument placed undue emphasis on contractual attributions and was open to abuse. In any event he submitted that when analysed the agreement here was in reality an undertaking to pay UK tax in respect of duties performed in the United Kingdom..

47. In reply, Miss Nathan said that there was no sufficient link between the performance of the duties in the UK and the payment of tax. UK tax law did not require equalisation payments to be borne by the employer. Here the overpaid tax was repayable to the employer not the Appellant. There was no link in the contract and none in fact.

48. She said that the words "in respect of duties" in section 19 were very similar to those considered in Varnam v Deeble "attributable to duties".

49. In Taylor v Provan it was possible on the facts to identify clearly emoluments which were in respect of UK duties: the taxpayer was reimbursed for travelling to the UK to perform duties here. In the present case there was a global salary for an international assignment under which no part of the emoluments could be attributed to any place of performance.

Conclusions

50. Both parties are agreed that the payments of tax by the Appellant's employer were emoluments. This would have been the position even if the Appellant had not been contractually entitled to have the payments made or reimbursed.

51. In my judgment it is immaterial that they were labelled "tax equalisation payments" as between the Appellant and her employer and that the employer was to shoulder the burden of the UK tax without deducting it from the salary to which she was contractually entitled.

52. The documents made no specific reference to UK tax as opposed to "foreign taxes" generally and did not attribute the UK tax paid to the performance of UK duties. In that sense Miss Nathan was correct in saying that the payments were not expressly in respect of duties performed in the United Kingdom.

53. It is quite another matter to say that they were not impliedly or in fact "in respect of" such duties. It is an inescapable fact that the tax was only payable because of the performance of duties in the United Kingdom and the amount of the tax depended on the proportion of her emoluments attributable to those duties. She went to work in the UK on the basis that as a UK resident she would be liable to Case II tax on emoluments for her UK duties. That was the law. Her employer undertook to pay or reimburse that tax. Whether it was implied that tax "in respect of" her UK duties would be paid or whether it was merely so paid in fact matters not. It was still "in respect of" the performance of those duties.

54. It seems to me that Miss Nathan's only real argument was that based on the similarity in wording between section 19 and that in the Finance Act 1977, Schedule 7, paragraph 2 considered by the Court of Appeal in Varnam v Deeble. There the court had to construe the words, "attributable to duties performed in the United Kingdom." Browne-Wilkinson LJ said this at page 312,

"The statutory words require an attribution to be made on some basis and, in the absence of other indications, in my judgment the attribution falls to be made by reference to the taxpayer's contractual right to emoluments for the work performed. If the contract specifically allocates part of the remuneration to the overseas duties, then for the purposes of paragraph 2(1) that part will be the emoluments attributable to such duties, subject to the ceiling provisions of paragraph 4. If, as in the present case, there is no express contractual allocation, the contractual right of the employee to remuneration would be the remuneration for the days on which such duties were performed, the total remuneration being apportioned on a time basis under the Apportionment Act 1870."

55. The passage from Browne-Wilkinson LJ above was cited and followed by Hoffman J in Platten v Brown and by Knox J in Coxon v Williams. In the latter case Knox J said that Varnam v Deeble is,

"very clear authority for the proposition that in applying paragraph 2(1) of Schedule 7 to the Finance Act 1977 a time apportionment basis is correct unless

the relevant contract provides a different allocation of remuneration than a time apportionment one."

At page 600 Knox J distinguished between administrative provisions in a contract of services regulating the time to be devoted to the employment, such as the number of days to be worked and holidays, and "a provision in a contract which attributes part of a salary to particular periods of employment." It was the latter which had to be found for the time apportionment basis in Varnam v Deeble to be displaced.

56. Not one of those cases concerned the treatment of payments of UK tax calculated by reference to emoluments which had already been apportioned. Furthermore although the words "attributable to" are similar to "in respect of" they are not the same and their context was different. The 1977 provision which has been repealed was for a deduction when 30 qualifying days were spent outside the United Kingdom.

57. No doubt it was because of this that Miss Nathan did not suggest that Vernam v Deeble and the cases following it were determinative of this case.

58. In Taylor v Provan the Court of Appeal considered a submission that the reimbursement of the air fares to the UK were not all "in respect of duties performed in the United Kingdom" within Case II of Schedule E. Russell LJ giving the judgment of the Court said this,

"We can only say that, inasmuch as they were only paid for the purpose of enabling the taxpayer to perform such of his duties as required his presence in the United Kingdom, they must all come within the quoted phrase in Case II, and we see no justification for any apportionment."

The House of Lords decided for the taxpayer on a wholly different ground but Lord Morris said at page 607 that he considered that the payments were "emoluments ‘in respect of’ his duties performed in the United Kingdom,"

59. I can see no logical basis for drawing a distinction between payments to enable duties to be performed in the UK and payments resulting from the performance of duties in the UK. If anything the argument in the latter case is stronger.

60. The appeal is dismissed.

THEODORE WALLACE

SPECIAL COMMISSIONER