NATIONAL INSURANCE CONTRIBUTIONS – whether payable on restrictive covenant entered into after employment ceased – yes – whether Contributions limited to the case where there is a current employment – no – whether for TA 1988 s.313 a restrictive covenant is given in connection with the holding of the office of director when the office has ceased – yes

THE SPECIAL COMMISSIONERS

RCI (EUROPE) LIMITED - Appellant
- and -
KATE WOODS (HM INSPECTOR OF TAXES) - Respondent

Special Commissioner: DR JOHN F AVERY JONES CBE

Sitting in public in London on 19 and 20 December 2002

Kevin Prosser QC instructed by Slaughter and May for the Appellant

David Ewart instructed by the Solicitor of Inland Revenue for the Respondents

DECISION

1. This is an appeal by RCI (Europe) Limited against a Notice of Decision dated 29 September 1999 that it is liable for primary and secondary Class 1 National Insurance contributions (Contributions) in respect of payments by the Appellant to Mr Julian Haylock totalling £2.2m. The Appellant was represented by Mr Kevin Prosser QC and the Respondents by Mr David Ewart.
2. There was a statement of agreed facts as follows (during the hearing the date of Mr Haylock's ceasing to be a director was agreed and I have included this in the statement below):
    1. Mr Julian Haylock was a director of RCI Europe Limited ("RCI") and employed from April 1984 to 31 July 1994 under a contract of service.
    2. On 22 December 1994, RCI and Mr Haylock entered into a Severance Agreement whereby (inter alia) Mr Haylock agreed by a restrictive covenant to restrict his activities in certain respects following the termination of his employment. In return, RCI agreed to make certain money payments to him.
    3. All payments were made net of deduction of Schedule E income tax.
    4. In the events which happened, RCI made the following money payments to Mr Haylock under the Severance Agreement (as amended by an Addendum dated 3 and 4 March 1997).

Item	Date of Payment	Sum Paid
1	03.01.95	£500,000
2	30.12.95	£500,000
3	03.01.96	£200,000
4	30.12.96	£800,000
5	01.01.97	£200,000
Total		**£2,200,000**

5.
6. Throughout the period during which payments under the restrictive covenants were made (3rd January 1995 to 1st April 1997), Mr Haylock was neither a director or nor employed by RCI.

3. The Severance Agreement provided for post-termination restrictions on Mr Haylock applying from the date of the agreement (22 December 1994) until 31 December 1995, in outline not to be engaged in any competing business of the Appellant and its associated companies, not to solicit their customers, not to employ their employees, not to communicate with any customer or client of theirs, not to be employed by a party to an affiliation agreement with any of them; and two restrictions without any time limit, not to represent that he is associated with the Appellant, and not to use the names or intellectual property of the Appellant or its associated companies. The consideration for those restrictions was payments 1 and 2 in the table above. Mr Haylock could, and did, elect to continue to be bound by the same restrictions for the year 1996, and separately for 1997 for which he was entitled to payments 3, 4 and 5 in the table. The payments were to be made as to £200,000 on or before 3 January 1996, £800,000 on or before 30 December 1996, and similar amounts on or before 1 January 1997 and 30 December 1997 respectively. There was a sixth payment but as it was made in gilts it is agreed not to be subject to Contributions.
4. Mr Haylock was not employed during the term of these restrictive covenants. He was employed again as group managing director of the Appellant from 1 August 1997 by which time it was no longer privately owned, which was the cause of the conflict that led to his leaving.
5. The statutory provisions with which we are concerned are:

   Section 4(4) of the Social Security Contributions and Benefits Act 1992:

   "For the purpose of section 3 above, there shall be treated as remuneration derived from an employed earner's employment any sum paid to or for the benefit of an employed earner which is chargeable to tax by virtue of section 313 of the Income and Corporation Taxes Act 1988 (taxation of consideration for certain restrictive undertakings) otherwise than by virtue of subsection (4) of that section."

   Section 313 of the Taxes Act 1988:

   "(1) Where an individual who holds, has held, or is about to hold, an office or employment gives in connection with his holding that office or employment an undertaking (whether absolute or qualified, and whether

legally valid or not) the tenor or effect of which is to restrict him as to his conduct or activities, any sum to which this section applies shall be treated as an emolument of the office or employment, and accordingly shall be chargeable to tax under Schedule E, for the year of assessment in which it is paid

(2) This section applies to any sum which—

(a) is paid, in respect of the giving of the undertaking or its total or partial fulfilment, either to the individual or any other person; and

(b) would not, apart from this section, fall to be treated as an emolument of the office or employment.

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(4) Where valuable consideration otherwise than in the form of money is given in respect of the giving of the undertaking or its total or partial fulfilment, subsections (1) to (3) above shall have effect as if a sum had instead been paid equal to the value of that consideration.

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(6) In this section—

(a) 'office or employment' means any office or employment whatsoever such that the emoluments thereof, if any, are or would be chargeable to income tax under Case I or II of Schedule E;…."

Section 313 of the Taxes Act 1988

6. In applying section 4(4) of the Social Security Contributions and Benefits Act 1992, the first question is whether the payments are chargeable under section 313 of the Taxes Act 1988. Mr Prosser QC contended that, while he conceded that the first two payments were chargeable, the remainder were not, since they were derived from the separate elections by Mr Haylock to be bound by the restrictive covenants during 1996 and 1997. He contended that the covenants were not given "in connection with his holding" of the office of director of the Appellant, but after he had ceased to hold the office. Section 313 was enacted to deal with cases like *Beak v Robinson* 25 TC 33 where the service agreement provided for an immediate payment in return for a covenant not to compete for 5 years within a radius of 50 miles if he determined the agreement or it was determined by his breach of the provisions.
7. Mr Ewart contended that it was a clear case of a person who "has held" the office. He referred to *Vaughan-Neil v IRC* [1979] STC 644 at 652f where Oliver J said:

"As a matter simply of grammatical construction, it seems to me that these words [in connection with his holding that office or employment] fulfil an adverbial function and qualify not the undertaking but the giving of it."

The undertaking was given pursuant to the termination agreement which was sufficient to connect it with the holding of the office of director. Mr Prosser QC did not dispute this point but said that the covenant was not given in connection with the holding of the office, but in connection with the non-holding of it.

Reasons for decision on section 313

8. Although the covenants were given pursuant to two separate elections by Mr Haylock to continue to be bound by the covenants imposed for the first period after termination of his service agreement, I consider that they were given in connection with his holding that office. They are a continuation of covenants given in relation to the termination of the office, which is a sufficient connection. The reason why the covenants were imposed, and why the Appellant was prepared to pay during the two extension periods, was that Mr Haylock held the office of director. I do not consider that the section is limited to cases like *Beak v Robinson* where the restriction is contained in the service agreement and relates to the period after it is terminated. Whether or not that represents the normal case, there is nothing to prevent the section from applying to covenants imposed in a termination agreement made after the person has ceased to hold the office or employment. The covenant is still given in connection with the holding of the office or employment.
9. Accordingly section 313 applies to all the payments in question. I turn next to the liability to Contributions.

Section 4(4) of the Social Security Contributions and Benefits Act 1992

10. I shall start by setting out the relevant definitions in the Social Security Contributions and Benefits Act 1992:

"'employment' includes any trade, business, profession, office or vocation and 'employed' has a corresponding meaning." (section 122(1))

"…(a) earnings includes any remuneration or profit derived from an employment; and

(b) 'earner' shall be construed accordingly." (section 3(1))

"…(a) 'employed earner' means a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including elective office) with emoluments chargeable to income tax under Schedule E; and

(b) 'self-employed earner' means a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment)." (section 2(1))

It will be seen that employment, earnings and earner are expressions applying to both employment (in the non-defined sense of work under a contract of service, corresponding to income tax under Schedule E) and self-employment (which by including "business" is wider than the income tax equivalent, although class 4 Contributions do not apply to a business), so that the definitions of employed earner and self-employed earner are

necessary to determine which applies, leading to verbose terminology such as "employed earner's employment."

11. Mr Prosser QC contended that one must read the definitions into the legislation with the result that section 4(4) reads:

    "4(4) For the purpose of section 3 above, there shall be treated as remuneration derived from an employed earner's [meaning a person *who is* gainfully employed in Great Britain either under a contract of service, or in an office (including elective office) with emoluments chargeable to income tax under Schedule E] employment [including an office] any sum paid to or for the benefit of an employed earner [meaning as before] which is chargeable to tax by virtue of section 313 of the Income and Corporation Taxes Act 1988 (taxation of consideration for certain restrictive undertakings) otherwise than by virtue of subsection (4) of that section."

12. He contends that an employed earner is someone who is currently employed. If the section were to charge Contributions on former employees it would have needed to say so, as in section 136(5)(c) of the Taxes Act 1988: "'employee'…includes a person who is to be or has been an employee." In support he points out that many provisions of the Social Security Contributions and Benefits Act 1992 look at the person's employment status at the time of payment:

    "Where in any tax week earnings are paid to or for the benefit of an earner in respect of any one employment of his *which is* employed earner's employment and – (a) he is over the age of 16…." (section 6(1))

    "…no primary Class 1 contributions shall be payable in respect of earnings paid to or for the benefit of an employed earner after he attains pensionable age…." (section 6(2))

    These look to the age of the person at the time of payment, not the age at the time it was earned, resulting in Contributions being payable if payment is made after the age of 16 in respect of earnings before that age, and vice versa with payments to a person after pensionable age in respect of earnings before that age.

    He also points to the regulation-making power in Schedule 1 paragraph 8(1)(o):

    "for treating a person's employment as continuing during periods of holiday, unemployment or incapacity for work and in such other circumstances as may be prescribed;"

    This shows that it is a fundamental requirement that a subsisting employment is necessary for Contributions to be payable. It is an important power which was contained in the first section (section 1(3)(c)) of the National Insurance Act 1946. This power has been exercised but only in relation to self-employed earners in Schedule 2 to the Social Security (Categorisation of Earners) Regulations 1978 providing that the (self-) employment shall "be treated as continuing unless and until he is no longer ordinarily employed in that employment."

13. Mr Prosser QC also points out that there are many references in the benefits sections of the Act that are restricted to, or assume that it applies to, persons currently employed, such as: section 28(3) enabling regulations to be made for the purpose of preventing inequalities or injustice to the general body of employed earners or of earners generally; 60(2) deeming contribution conditions to be satisfied where a married employed earner dies as a result of a personal injury; 96 enabling regulations to be made treating a person as the earner's employer for industrial injuries benefit; 102 entitlement to sickness benefit where an employed earner is incapable of work as a result of a personal injury; 116 treating a serving member of Her Majesty's forces as an employed earner (which also applies for Contributions); 117 dealing specifically with persons who have been, or are to be, employed on board ships or aircraft, including in subsection (2)(c) a power to make regulations dealing with Contributions whether or not they are employed earners, and (2)(e) for enabling persons who have been employed to authorise payment of benefits to their dependants; 153(5)(b) power to made regulations directing an employer to provide a person who has been employed by him with a statement relating to statutory sick pay, and subsections (9) and (10) anti-avoidance provisions dealing with for example contracts of service brought to an end for the purpose of avoiding liability for statutory sick pay; 164 dealing with entitlement to maternity pay for a woman who has been an employee;.
14. Mr Prosser QC also points out that Class 1A Contributions are payable by reference to car benefits chargeable by section 157 of the Taxes Act which is restricted to current employments and so there is nothing surprising about the rest of Contributions being limited in the same way.
15. Mr Prosser QC also drew my attention to two textbooks, Tolleys National Insurance Contributions Services (paragraph 28.5) and Butterworths Simon's National Insurance Contribution Service (paragraph 5.96-98) which supported his contentions.
16. Mr Ewart contends that the present tense in the definition of employed earner ("who is gainfully employed") is defining that the person being referred to is employed rather than self-employed and has no temporal significance. Section 313 of the Taxes Act applies in terms to past holders of an office. There would be a big hole in the legislation if Contributions were restricted to payments to current holders. He accepts that it may be right that when applying other sections of the 1992 Act one looks to the employment of the person at a particular time but those sections are not in issue.
17. Mr Prosser QC contends that the second requirement for Contributions to be payable is that each payment must be made in a tax week in which Mr Haylock is in employed earner's employment:

    "Where in any tax week earnings are paid to or for the benefit of an earner in respect of any one employment of his *which is* employed earner's employment a primary and a secondary Class 1 contribution shall be payable…." (section 6)

    He contends that Contributions are not payable on payments made to past or future employees.

18. Mr Ewart again contends that the reference to employed earner's employment is to differentiate it from self-employment. The section is referring to a payment in respect of (a wide expression) any one employment which is employed earner's employment (meaning, and is not

self-employed earner's employment). Mr Ewart with great erudition described the "is" as copulative, to which I have found reference in Fowler's Modern English Usage: "In grammar, used of a word that connects words or clauses linked in sense or connecting a subject and predicate….Typical copular constructions are:…and esp. the type *Canberra* is *the capital of Australia*." In the former Social Security Act 1975 which was consolidated in the 1992 Act the equivalent reference (in section 4(2)) was to "any employment of his *being* employed earner's employment." He contends that it is permissible to look at pre-consolidation enactments where the legislation is ambiguous (Lord Hope in *R v Secretary of State for the Environment ex p. Spath Holme Ltd* [2001] 2 WLR 15, 46) or even in the absence of overt ambiguity, the court finds itself unable to place itself in the draftsman's chair and interpret the provision in the social and factual context which originally led to its enactment (Lord Bingham at p.28F). Mr Prosser contends that as there is no ambiguity one cannot look at pre-consolidation legislation.

19. Mr Prosser QC contends that the third requirement for Contributions to be payable is that there must be an employer in the tax week in which the payment is made:

    "7(1) For the purposes of this Act, the "secondary contributor" in relation to any payment of earnings, to or for the benefit of an employed earner is—

    a. in the case of an earner employed under a contract of service, his employer;…

    (2) In relation to employed earners who—

    b. are paid earning in a tax week by more than one person in respect of different employments; or
    c. works under the general control or management of a person other than their immediate employer,

    and in relation to any other case for which it appears to the Secretary of State that such provision is needed, regulations may provide that the prescribed person is to be treated as the secondary contributor in respect of earnings paid to or for the benefit of an earner."

    He contends that the reference is to earnings which are paid in a tax week (subsection (2)(a)) or to a person who works (subsection (2)(b)), both in the present tense. Mr Ewart contends that one cannot read the section literally because otherwise an unconnected employer at the time of payment by the former employer would be liable for Contributions. The references to "employed earner" and "earner employed under a contract of service" are references to the status by virtue of which the payment of earnings are received. The employer liable for Contributions is the employer in relation to the relevant employment in respect of which the person is an employed earner employed under a contract of service.

20. Mr Prosser QC pointed out that when section 4(4) of the 1992 Act was enacted section 313 itself did not apply to former employees because there was no charge unless the emolument was for a year in which the employment subsisted, see *Bray v Best* [1989] STC 159, so that it was not absurd for Parliament to have limited section 4(4) to existing employees. Mr Ewart did not accept that *Bray v Best* applied and submitted that

section 313 was a freestanding Schedule E charge under paragraph 5 of section 19 in the same way as section 148, see *Nichols v Gibson* [1996] STC 1008. In its original form in section 26 of the Finance Act 1950 it was a charge to surtax on an annual payment, not a Schedule E charge. He also said that the position was reversed for emoluments by paragraph 4A in section 19 at about the same time as section 4(4) was enacted in 1989. Mr Prosser QC in reply pointed out that the Revenue's Manual at SE3602 did not consider the charge to be a freestanding one. Being a normal Schedule E charge like the charge on fringe benefits under section 154, it was restricted to current employees.

21. Mr Prosser QC further contended that the Revenue could not rely on the fact that there are regulations made in 1983 and 1984 under the Social Security Act 1975 that assume that there can be Class 1 Contributions on sums paid after the termination of employment:

    "(a) Where—(i) the employment in respect of which the earning are paid has ended…the earnings period in respect of such payment of earnings shall,…be the week in which the payment is made." (regulation 3(4) of the Social Security (Contributions) Regulations 1979)

    "(1) Where a person is, or is appointed, or ceased to be a director of a company during any year the amount, if any, of earnings-related contributions payable in respect of earnings paid to or for the benefit of that person in respect of any employed earner's employment with that company shall…be assessed on the amount of al such earnings paid (whether or not paid weekly) in the earnings periods specified in the following paragraphs of this regulation.

    (5) Where a person is no longer a director of a company and in any year after that in which he ceased to be a director thereof he is paid earnings in respect of any period during which he was such a director, then…(b) the earnings period in respect of all those earnings shall be the year in which they are paid." (regulation 6A)

    Mr Ewart points out that the basis of the regulations was correct on the wording of the 1975 Act "any employment of his *being* employed earner's employment." If Mr Prosser were right the consolidation Act of 1992 changed the law in a major way. He contends that if the Act is ambiguous it is permissible to construe it by reference to regulations. Lord Lowry in *Hanlon v The Law Society* [1981] AC 124 at 193 sets out a number of propositions derived from cases and textbooks, the first of which is:

    "Subordinate legislation may be used in order to construe the parent Act, but only where power is given to amend the Act by regulations or where the meaning of the Act is ambiguous."

22. Finally, Mr Prosser QC contended that there was no machinery for determining the earnings period relating to the payments, which was consistent with his construction. Regulation 6A quoted above relates to "earnings in respect of any period during which he was such a director" which is not applicable here. Mr Ewart contended that if regulation 6A did not apply then regulations 3 or 4 must apply:

    "(a) Where—(i) the employment in respect of which the earning are paid has ended… (iii) after the end of the employment a payment of earnings is made which satisfies either or both of the conditions specified in the next

succeeding sub-paragraph, the earnings period in respect of such payment of earnings shall,…be the week in which the payment is made; (b) the conditions referred to in the preceding sub-paragraph of this regulation are that the payment is one which is…(ii) not in respect of a regular interval." (regulation 3(4) of the Social Security (Contributions) Regulations 1979)

"…where earnings are paid to or for the benefit of an earner in respect of an employed earner's employment, but no part of those earnings is normally paid or treated under regulation 6 of these regulations as paid at regular intervals, the earnings period in respect of those earnings shall be a period of one of the following lengths—…(b) where it is not reasonably practicable to determine that period under the provisions of the last preceding paragraph…(ii) where the payment is made before the employment begins or after it ends, a week." (regulation 4)

Mr Prosser replied that regulation 3 did not apply because the payments were in respect of a regular interval, and nor did regulation 4 apply because they are paid at regular intervals.

Reasons for the decision

23. It is common ground that a literal construction of these sections is not appropriate. One must identify a relevant employer, so that if a person has two employments the Contributions are paid by the relevant employer and if the person has a new employer that employer is not liable for Contributions (assuming they are payable) on payments made by a former employer. This is clear from section 6(4):

"Except as provided by this Act, the primary and secondary Class 1 contributions in respect of earnings paid to or for the benefit of an earner in respect of any one employment of his shall be payable without regard to any other such payment of earnings in respect of any other employment of his."

24. Mr Prosser QC makes a powerful case that the Act consistently looks to the employment in the tax week in question. It is certainly possible to read the Act in this way. But the context of the wording is important. The defined expressions employment, earnings and earner set out in paragraph 10 above all apply to both employment (in the non-defined sense of work under a contract of service) and self-employment (in the defined sense), and so it is necessary to describe work under the former as employed earner's employment. I therefore agree with Mr Ewart that the purpose of the definition of employed earner is to differentiate between employment (in the non-defined sense) and self-employment, and not to impose any temporal restriction to a person who is currently employed.
25. As there is ambiguity whether the present tense is intended to have a temporal significance I consider that it is permissible to look at the pre-consolidation wording of section 6 "*being* employed earner's employment" to confirm that that is the sense in which the words are used. The existence of Regulations made under the former Act providing for an earnings period after the employment has ceased is in accordance with this interpretation. It is not likely that by changing the wording from *being* to *which is* and leaving the regulations to continue that a consolidation Act

changed its meaning in such a significant way as to exclude liability for Contributions on payments in respect of a former employment.

26. The power in paragraph 8(1)(o) of Schedule 1 has been exercised to deal only with self-employed where it might be difficult to determine whether if there was little or no activity the self-employment was continuing. If it were a fundamental principle that there must be a subsisting employment so that payments made before or after employment were not liable to Contributions it would surely have been exercised in the employment field.
27. On the question whether section 313 of the Taxes Act is a freestanding Schedule E charge or whether it is subject to the Cases of Schedule E it seems to me that Mr Prosser QC is right. It is a case of something being "treated as emoluments" which is the formula used for fringe benefits in section 154 and in many other charges such as sections 134, 144A, 149, 164 and 648. By section 313(6) it applies to an office or employment within Cases I or II of Schedule E which is inconsistent with its being a freestanding charge. Having come to that conclusion I looked for confirmation (not as a aid to construction) at the Income Tax (Earnings and Pensions) Bill currently before Parliament. This Tax Law Rewrite Bill treats section 313 payments as part of general earnings in the same way as other items treated as earnings (the modernisation of "emoluments") to which the Cases of Schedule E apply, and not as specific employment income (the successor to the freestanding charge) which has no territorial limits except in accordance with the terms of the charge. In any case, as *Bray v Best* was reversed at about the same time as section 4(4) of the 1992 Act was originally enacted I do not find this point helpful in deciding whether section 4(4) applies. The fact that other cases of something being "treated as emoluments," such as section 154, are limited to current employments does not mean that all items treated as emoluments are so limited, as is the case with section 160(3) dealing with loans where the employment has terminated.
28. The draftsman of section 4(4) of the 1992 Act had to incorporate payments taxed under section 313 of the Taxes Act into the Contributions legislation. He deliberately excluded payments in kind in section 313(4) because they were not at the time liable to Contributions. He did not make any other changes to a section that applied in terms to a person who holds, has held, or is about to hold an office or employment. If an employed earner were restricted to someone currently employed he would surely have made a further modification to restrict the application of the section rather than merely applying Contributions to "any sum paid to or for the benefit of an employed earner which is chargeable to tax by virtue of section 313." Accordingly I consider that Contributions are payable on the payments in question.
29. As to the earnings period, I agree with Mr Prosser QC that regulation 6A does not apply because the payments are not "earnings in respect of any period during which he was such a director." They are earnings in respect of periods after he ceased to be a director. The payments are made in respect of the periods first from 22 December 1994 to 31 December 1995 and then two periods of a year, 1996 and 1997; they were paid on 3 January 1995 (£500,000), 30 December 1995 (£500,000) in respect of the first period, 3 January 1996 (£200,000) and 30 December 1996 (£800,000) in respect of 1996, and 1 January 1997 (£200,000), being the first payment in respect of 1997. These are neither paid at regular intervals, the December and following January payments being made within a few days of each other followed by an interval of almost a year, nor in respect of a regular interval because the first period exceeds a year, although it might be said that the payments for the following two years were in respect of a regular interval of a year. Accordingly, paragraph 4,

and possibly paragraph 3 (except for the first period), apply and either way the earnings period is a week. I might add that if the payments had been made six monthly it is difficult to see that either regulation would have applied.

30. Accordingly I dismiss the appeal in principle.

J F AVERY JONES

SPECIAL COMMISSIONER

SC3086/02

Authorities referred to in skeletons and not referred to in the decision:

Maradana Mosque v Badi-Ud-Din Mahmud [1967] 1 AC 13

Pocock v Steel [1985] 1 WLR 229

Jones v 3M Healthcare [2002] EWCA 304

Chesterfield Football Club Ltd v Secretary of State for Social Services [1973] QB 583

Vandyk v Minister of Pensions and National Insurance [1955] 1 QB 29

Frankland v IRC [1997] STC 1450

Shilton v Wilmshurst [1991] 1 AC 686

George v Ward [1995] STC (SCD) 230

IRC v Mcguckian [1997] 1 WLR 991

Nichols v Gibson [1996] STC 1015

Dimond v Lovell [2002] 1 QB 216