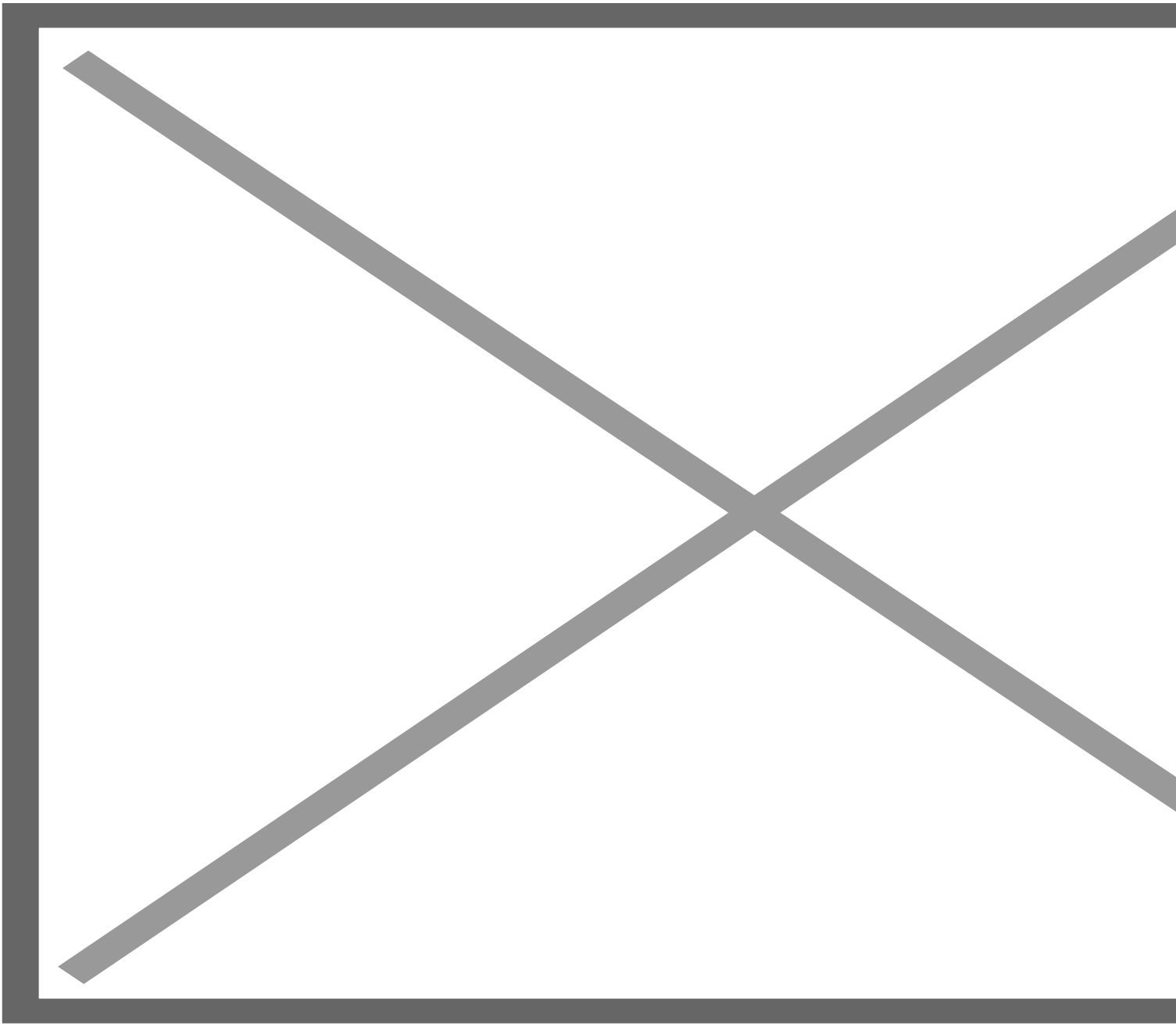
Smiley’s People

Employment Tax



01 March 2016

Keith Gordon discusses the Upper Tribunal’s decision on the tax treatment of an incentive payment made to a group of employees in *HMRC v Smith & Williamson Corporate Services Ltd* and *HMRC v Patrick Smiley*

Key Points

What is the issue?

HMRC considered a goodwill payment to attract a team of investment managers as constituting employment income

What does it mean to me?

The case confirms that client relationships and connections are not themselves assets, even if they might in some circumstances be turned to account

What can I take away?

The judge concluded that any goodwill belonged to the team's former employers. What the team members held (being the personal relationships) could not be transferred

HMRC's antipathy towards goodwill is renowned among advisers. There have been frequent attempts to challenge taxpayers' assertions that goodwill has been transferred, most famously in the case of Balloon *Promotions Limited v HMRC* (2006) SpC 524, a decision that marks its first decade this month. The apparent response by HMRC to its defeat in Balloon Promotions is not to appeal against the special commissioner's decision, but to remain hostile to assertions of goodwill in other cases, as if the hearing had never happened.

Of course, if the statute is to give a better tax treatment were a payment categorised as goodwill, it is natural to assume that taxpayers will arrange their affairs to take advantage of this or argue that there has been a transfer of goodwill. The joined cases of *HMRC v Smith & Williamson Corporate Services* and *HMRC v Patrick Smiley* [2015] UKUT 0666 (TCC) show how such an argument is deployed.

The facts of the case

Although the judgment is relatively long, the facts of the case can be quite simply stated. One arm of the Smith & Williamson Group undertook asset management. It sought to increase the funds under its management by attracting an existing team of investment managers, headed by Patrick Smiley. That team had worked together for various institutions, including latterly a private bank.

There was no dispute that the team members became employees of Smith & Williamson under contracts of employment. However, by a separate contract, Mr Smiley and his team co-members were entitled to what became known as a 'goodwill payment' to be shared among the team members. This was payable in consideration for the team delivering the client relationships from the private bank to Smith & Williamson: in other words, the agreement of the private bank clients to transfer the responsibility for managing their investments to Smith & Williamson. A separate company within Smith & Williamson made the goodwill payment.

Smith & Williamson and Mr Smiley treated the goodwill payment as capital in nature. However, HMRC considered it to constitute employment income, from which income tax and National Insurance contributions (NICs) should have been deducted. The Revenue sought to revise Mr Smiley's relevant tax returns and issued determinations against Smith & Williamson in relation to the amounts that should have been paid as PAYE and National Insurance.

The First-tier Tribunal (FTT) allowed the taxpayers' appeals, but HMRC appealed against the decision to the Upper Tribunal.

The Upper Tribunal's decision

The judge, Mr Justice Warren, considered the principal issue to be whether the goodwill payment constituted earnings from an employment. It was accepted that the conclusion on this would determine the liability to NICs, if any.

Following the House of Lords' decision in *Shilton v Wilmshurst* [1991] STC 88, Warren J noted that the charge to what was Schedule E embraced all emoluments from the employment, whether or not they were made by the employer, so that payments from third parties could also count.

In reaching their decision in Shilton, their lordships reviewed several other leading authorities. In particular, it was noted in *Hochstrasser (HM Inspector of Taxes) v Mayes* (1959) 38 TC 673 that to be employment income a payment had to have been caused by the fact of the employment. It was not sufficient for HMRC to show simply that the payment would not been made but for the employment; a closer causal link had to be established.

On the subject of goodwill, Warren J noted the non-tax case of *Asprey & Garrard Ltd v WRA (Guns) Ltd* [2001] EWCA Civ 1499. In that case, Mr William Asprey, a member of the Asprey family which had previously owned the shares in the claimant company, was a former employee of that company. As noted by Peter Gibson LJ in that case, any goodwill arising from Mr Asprey's work for the claimant company belonged to it. The logical conclusion was that any new business conducted by Mr Asprey could not properly associate itself with that goodwill. It was considered that, bar any restrictive covenants, there was nothing to prevent Mr Asprey making use of any personal contacts that he had established during his previous employment. Warren J recognised that this clearly confirmed the distinction between goodwill and personal contacts.

A key observation made in the case at the FTT was that Mr Smiley's team did not own the client connections, either collectively or individually. Warren J considered that this confirmed his view that relationships were not in themselves assets, even if they might in some circumstances be turned to account. Warren J recognised that, had the team been carrying on a business rather than been employees of a trading company, those client relationships might have formed part of an asset – being the goodwill of that business.

Towards the end of a long judgment, Warren J considered that the FTT judge had made errors of approach. In particular, he had been wrong to interpret the facts by reference to the parties' (Smith & Williamson's and the team members') perceptions, rather than by considering them objectively. These errors permitted Warren J to remake the decision.

In doing so, the judge retraced his way through the case law he had already discussed, notably *Shilton*. In essence, he considered the payment to be given in return for a service provided – the procuring or assistance in the procuring of clients for Smith & Williamson. Further, the judge considered that the contracts providing for the goodwill payment could not be realistically severed from the employment contracts themselves.

Adopting the approach taken in Asprey and in *Kirby v Thorn EMI plc* (1987) 60 TC 519, Warren J considered that what was provided to Smith & Williamson could not be equated with goodwill. In particular, he noted that the goodwill, if any, belonged to the team's former employers and what the team members held – being the personal relationships – could not be transferred.

In conclusion, the judge held that the goodwill payment had arisen from the team members' employments. Therefore, HMRC's appeals were allowed.

Commentary

The difficulty when reading any judgment is that it will usually explain the facts in a way that will support the judge's eventual conclusion. Indeed, when reading Warren J's decision notice, it seemed inconceivable to me that the goodwill payments could have been considered anything other than taxable as employment income. Reading this decision alone prompted the question as to why the contrary was ever argued.

In such cases, it is illustrative to refer to the original decision of the FTT. There, the tribunal was specifically, at the behest of counsel for Smith & Williamson, directed to the question as to whether the team had an asset to sell. Further, the FTT judge held that there was no such asset, for the reason that the team members could not sell the client connections. However, the FTT proceeded to treat the goodwill payment as capital in nature because it had concluded (wrongly) that it could be severed from the employment relationship.

One area where the question of goodwill has been hotly contested concerns the incorporation of businesses. HMRC's latest tactic has been to revise the rules to make the goodwill argument less attractive. However, there are undoubtedly cases arising from earlier years that are likely to require resolution in due course.

The *Smith & Williamson/Smiley* case deals with a different issue and will not resolve all outstanding cases. However, it is likely to give succour to HMRC in its attempt to come in from the cold on goodwill.

Further information

Read Keith's article 'Half-baked' on the non-tax Sofra case.