CHAPTER 15

INTRODUCTION TO EMPLOYMENT INCOME & BENEFITS

15.1 Employment Income

The Income Tax (Earnings & Pensions) Act (ITEPA) 2003 taxes income from **employment** as well as other income such as that from **pensions and from certain social security benefits**. An "employment" in this context includes any employment under a contract of service as well as apprenticeships and services for the Crown. Employments also cover "office holders" such as directors. The Act simply refers to all employees and directors as "employees". ITEPA 2003, s.4 ITEPA 2003, s.5

Employment income generally falls under two main categories – these are "**general earnings**" and "**specific employment income**". ITEPA 2003, s.6

"General earnings" are the most prevalent and consist of remuneration paid in **normal monetary form** – i.e. cash – as well as certain **non-monetary rewards** such as taxable benefits. The definition of "general earnings" extends to certain other payments such as sick pay, payments to non-approved pension schemes and payments for restrictive covenants. In essence, "general earnings" covers payments made to the employee **as a reward for services rendered**. ITEPA 2003, s.7(3)

"Specific employment income" broadly covers payments made to the employee by his employer which are **not part of the usual remuneration package** and is defined as "any amount which **counts as employment income** excluding any exempt income". We shall deal with exempt income in later chapters. ITEPA 2003, s.7(4)

Income which "counts as employment income" is divided into three being: ITEPA 2003, s.7(6)

a) income which is not earnings or "share related";
b) "share related income; or
c) any other enactment (i.e. employment income which is taxable but which doesn't "fit" any of the other categories).

"Non-share related" income broadly encompasses **termination payments** and employer contributions to non-approved pension schemes.

"Share related" income covers profits and gains made by employees from various **share option and share incentive schemes** offered by the employer.

We will deal with each of these in later chapters.

15.2 Definition of "earnings"

"Earnings" are defined within s.62 ITEPA 2003 as: ITEPA 2003, s.62

a) any salary, wages or fee;
b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth;
c) anything else that constitutes an emolument of the employment.

Broadly speaking, "earnings" are **cash remuneration** or any form of payment of **direct monetary value,** or which can be **converted into cash**. This will cover obvious forms of payment such as salaries and bonuses, but will also cover **tips and gratuities** received in the course of carrying out one's employment duties or payments in the form of cash vouchers or premium bonds which can be surrendered for cash.

The definition of "earnings" does not specifically cover benefits in kind (eg company cars, cheap loans, living accommodation, etc.) as such remuneration is neither cash nor of direct monetary value. However, the provision of such benefits is brought within the charge to income tax by the "Benefits Code". We shall look at benefits in detail in later chapters.

15.3 "Emoluments" of the employment

There is a significant body of case law to determine the existence of an "**emolument**" of an employment. This term was part of the old statutory provisions and was specifically retained in ITEPA 2003 to ensure that the case law was still applicable. ITEPA 2003, s.62

"Emoluments" of an employment are chargeable to tax under s.62. The key words here are "**of the employment**". Just because a payment is made by an employer to an employee, it does not automatically follow that the payment is from the "employment".

For a payment to be treated as being "from an employment", the payment must generally be made **in return for services** (past, present or future).

In the case of *Hamblett v Godfrey (1987)* an employee of a government agency (GCHQ in Cheltenham) was offered £1,000 as compensation for agreeing to give up her rights to join a trade union. The employee contended that the payment was not an emolument from her employment as it was not being made in return for services.

The Courts disagreed and found the payment to be a taxable emolument. The right to join a trade union is part and parcel of "**acting or being an employee**". The payment was too closely linked to the employer–employee relationship for it to be treated as anything other than an emolument.

In *Shilton v Wilmshurst (1991),* a footballer (England goalkeeper Peter Shilton) transferred from Nottingham Forest to Southampton football club. As the player was under contract to Nottingham Forest, the club agreed to pay Mr Shilton £75,000 to agree to the transfer. Again the question arose as to whether this payment arose "from the employment".

Mr Shilton contended that the payment was made to him by his former employer in connection with the termination of his employment (such termination payments being tax free up to £30,000). The Revenue argued that the payment was a reward or inducement flowing from the services he was about to offer to Southampton FC.

The Courts agreed with the Revenue and found the payment to have arisen **from Mr Shilton's employment** (therefore fully taxable). Mr Shilton had received payment "**to remain or become an employee**" – the payment was to **induce** the player to become an employee of Southampton FC and for no other reason.

Similarly in *Glantre Engineering Ltd v Goodhand (1983),* an inducement payment to persuade an accountant to leave Ernst & Young (as is now) and join a small engineering firm was held to be an emolument as it was paid by reference to services "to be performed" for the new company.

In *Mairs v Haughey (1993),* an employee moved from a government owned company to a new private company, and in return for accepting the new employment he received the following:

(i) £4,506 paid by the government owned company as compensation for the employee giving up his rights under their redundancy scheme; and
(ii) £1,300 from the new company as an "ex gratia" incentive to join.

The Courts held that the latter was taxable being an inducement payment referable to services to be performed. However, compensation payments for loss of redundancy rights were not within the definition of an emolument.

15.4 Amount of employment income charged to tax

S.9 ITEPA 2003 deals with **how much** of a taxpayer's income is chargeable to income tax for a particular tax year. ITEPA 2003, s.9

In the case of "general earnings", the amount charged to tax is the "**net taxable earnings**" from the employment in the tax year. "Net taxable earnings" are "taxable earnings" less any **deductions allowed from those earnings** under the "expenses provisions" within the Act. ITEPA 2003, s.11

Employees receive tax relief in respect of any expenses "**wholly, exclusively and necessarily**" incurred in doing their job. We shall look specifically at employment expenses in a later chapter.

Net taxable earnings can therefore be broadly summarised as:

	£	£
Cash remuneration:		
Salary, bonus etc		X
Other emoluments which have direct monetary value		X
Non cash remuneration:		
Benefits		X
Taxable earnings		X
Less: allowable deductions:		
Employment expenses	X	
Other deductions	X	
		(X)
NET TAXABLE EARNINGS		**X**

15.5 The "receipts" basis

S.15 ITEPA 2003 deals with general earnings (cash plus benefits) of an employee resident ordinarily resident and domiciled in the UK and tells us that… ITEPA 2003, s.15

> "The **full amount** of any general earnings …which are **received** in a tax year is an amount of "**taxable earnings**" from the employment in that tax year".

Therefore the way we tax an individual's employment income is on a "**receipts basis**". This means that employees and directors will be taxed on their employment income **when it is received**.

The rules for taxing earnings are slightly different for employees who are either resident, or ordinarily resident or domiciled outside the UK, and these will be covered in a later session.

The date of receipt of earnings consisting of money is the earlier of two dates: ITEPA 2003, s. 18

1) the time when **payment is made;** or Rule 1

2) the time when a person becomes **entitled to payment** Rule 2

Therefore if an employee or director becomes **entitled** to a payment before he or she is physically paid the money, the date of entitlement is treated as the date of receipt and the payment is taxed at that point. In practice this distinction is not particularly important, as for most of us the date of entitlement and the date of physical receipt are usually the same.

Where the receipts basis becomes important is with regard to the taxation of **bonuses**. Consider a company which draws up accounts for the year ended 31 December 2009. On the 28 April 2010, the annual general meeting is held and the board of directors of the company sign-off the accounts and agree the profits of the year just ended. At this point the company is in a position to determine the bonuses due to its employees.

An employee receives a bonus at the end of April 2010 in respect of work carried out by him in the year which ended in December 2009. For employment income purposes, the employee is taxed on his bonus not in the period in which the bonus was earned, but instead **on the date the bonus is physically received**.

As such this bonus is taxable at the end of April 2010, and therefore goes into the employee's tax computation for 2010/11.

This is a general principle and there are always occasional exceptions. Certain **special rules exist for company directors** but in most cases the normal receipts basis will apply.

In relation to company directors, the date of receipt is the **earliest** of either of the above two dates, and; ITEPA 2003, s.18

Rule 3

a) when sums on **account** of his earnings are **credited** in the company accounts; or
b) at the **end** of the company's accounting period if the earnings have been determined **by the end** of that period; or
c) at the date the earnings are **determined** if that date falls **after** the end of the company's accounting period.

Illustration 1

Mr Matthews is a company director earning £60,000 per annum. He is entitled to an annual bonus based on the company's results for each year ending on 31 December.

At their Board Meeting on 25 March 2011, the Board agree the draft accounts and determine Mr Matthews' bonus in the sum of £25,000. This is paid to Mr Matthews on 30 April 2011.

Although the date of physical receipt is 30 April 2011, as Mr Matthews is a director, we need to consider Rule 3 in s.18 ITEPA 2003. Mr Matthews' earnings were determined after the end of the company's accounting period, therefore rule (c) above applies. The date of "receipt" for employment income purposes is therefore 25 March 2011 and the bonus will be taxable in 2010/11.

15.6 Taxable benefits

Benefits are very important as far as your exam is concerned. By benefits we mean non-cash remuneration. Many employees receive such benefits as part of their overall remuneration package. ITEPA 2003, s.63

These benefits often include the use of a **company car**, the use of company provided **accommodation**, or a cheap **loan**. **Private medical insurance** or contributions by the employer to the employee's **pension scheme** are also very common benefits, as is the provision of a **mobile phone** along with associated telephone calls. The majority of these benefits are taxable in the hands of the employee. There are certain benefits which are exempt from tax and we shall deal with these later.

For taxable benefits, we need to determine the **"cash equivalent"** of each particular benefit. Essentially we are allocating a cash figure to each taxable benefit and thereafter we will tax that cash equivalent as if it was an additional amount of earnings.

15.7 Measuring the benefit

Benefits are chargeable to tax if they are either:

(i) specifically charged within the Benefits Code; or
(ii) "employment-related" benefits under s.201 onwards ITEPA 2003.

We shall look at specific benefits within the Benefits Code in later sessions, but first we will examine the rules for taxing **employment related benefits**.

An employment related benefit is a benefit provided either for an **employee**, or for a member of the employee's **family or household**, by reason of the employee's employment. Therefore, a taxpayer cannot avoid being taxed on the provision of a benefit simply by directing his employer to provide the benefit to, say, his wife rather than himself. ITEPA 2003, s.201

This means, for example, if by reason of Jack's employment, Jack's wife or son are provided with a company car or other benefit, it is Jack who will be charged to income tax on the cash equivalent of that benefit.

S.203 ITEPA 2003 tells us that "the **cash equivalent** of an employment related benefit **is to be treated as earnings** from the employment for the tax year in which it is provided", and .. ITEPA 2003, s.203

> "The cash equivalent of an employment-related benefit is the **cost of the benefit** less any part of that cost **made good by the employee** to the persons providing that benefit".

Under s.204 ITEPA 2003, "the cost of an employment related benefit is the **expense incurred in, or in connection with, the provision** of that benefit". ITEPA 2003, s.204

This means that, for example, if an employer wishes to provide a benefit to an employee in the form of, say, private medical insurance, and the cost to the employer of paying the premium is £500, the cash equivalent – i.e. the amount charged to tax – is £500. The fact that it might cost the employee more than £500 to obtain the same level of medical cover is irrelevant – we simply look at **what it cost the employer to provide the benefit**.

Amounts **paid by the employee** to the employer towards the provision of the benefit can be **deducted** from the cash equivalent. Therefore if the employee reimburses the employer's full cost, the taxable benefit will be zero.

Every benefit provided by an employer to an employee which has a cash equivalent, must be **reported to the Revenue** by the employer on a **special form** called a **P11D**. The employer should complete a form P11D for each employee who has received taxable benefits, and these forms should be **submitted** to the Revenue **no later than 6 July after the end of the tax year.** The P11D tells the Revenue the amount of the cash equivalent of each benefit. A copy is given to the employee to enable him to complete his own tax return.

In the case of certain benefits, it is very difficult to establish exactly what is the cost to the employer of providing the benefit. In such cases special rules exist to help us calculate the cash equivalent. Special rules are in place for calculating company car and fuel benefits, accommodation benefits, cheap loans and instances where an employer lends an asset to an employee. We shall take a look at these various special rules later.

15.8 Pepper v Hart

The concept of the **"cost of providing"** a benefit was the subject of a leading and extremely important tax case heard by the House of Lords in 1993. The case of ***Pepper v Hart*** concerned a private, fee-paying school. Just before the start of term, the school had some surplus places, which it had been unable to sell. The school therefore allowed some of the **schoolmasters** to **send their own children to the school** to be educated at a **subsidised price**.

HMRC and the schoolmasters both agreed that a benefit had arisen. This was because an employee or members of his family or household were being provided with a benefit (i.e. cheap education) by reason of the schoolmasters' employment. There was no dispute that a benefit had arisen.

The argument was about how to determine the "cost to the employer" in providing the education to the children involved. Each side put forward an alternative way of establishing the cost to the school of providing the benefit.

HMRC argued that we should first take the total cost of running the school for the year. This figure should then be divided by the number of pupils in the school to give an average cost of providing education per student. From this average cost, we deduct the fees actually paid by the schoolmasters and the difference is the taxable benefit. HMRC therefore **argued that "cost of providing"** as per the legislation **actually meant the "average" cost**.

The taxpayer put forward an alternative suggestion. He argued that we first calculate the cost of running the school for its **normal fee paying pupils** (i.e. not counting those students receiving subsidised education). Next we calculate the cost of running the school for **all the pupils**, this time including the additional children who had paid reduced fees. The **difference** between these two figures is the additional cost incurred by the school in providing these extra places.

Therefore the cost of providing each additional place is this figure divided by the number of extra places. From this we deduct the fees paid by the schoolmasters and the difference is the taxable benefit. What the **taxpayer** was advocating was a "**marginal" cost method** as opposed to HMRC's average cost method.

The House of Lords on a majority decision found in favour of the **taxpayer** and decided that the **marginal cost method** was the correct way of calculating the cash equivalent in this instance.

The case of *Pepper v Hart* has particular relevance when it comes to calculating the benefit in respect of **"in-house benefits"** as we shall now illustrate.

Illustration 2

A flight is about to leave from London Heathrow airport to JFK New York. The flight will cost the airline £20,000. The plane has 100 seats. This means that the average cost to the airline is £200 per seat. Assume that all but one of the seats have been sold to normal fee paying passengers. A few minutes before the flight is due to leave, the airline offers this spare seat to one of its employees for the bargain price of £10.

There is a benefit arising to the employee because the employee is receiving a benefit – i.e. a very cheap flight – by reason of his or her employment. The cash equivalent will be the cost to the airline of providing that one heavily subsidised seat to one of its employees.

Following *Pepper v Hart* we do not take the average cost per passenger of £200. Instead we consider the marginal cost. This will be the extra cost to the airline of flying that one extra passenger over to New York.

This extra cost should be negligible – presumably it costs more or less the same to fly 100 passengers to New York as it does to fly 99. There will be a few additional costs such as one extra in-flight meal or an extra newspaper which should be covered by the £10 paid by the employee.

As a result following the principle established by *Pepper v Hart*, where an employee is using goods or services manufactured or provided by his employer, the marginal cost is effectively zero giving rise to a taxable benefit of nil.

15.9 Lower paid employees

ITEPA 2003, s.216

Certain chapters of the Benefits Code do not apply if those benefits are provided to an employee who defined as a **lower paid employee** and who is **not a director of a company**. These excluded benefits include company cars and vans, cheap loans, certain share related benefits and certain expenses payments.

A lower paid employee is one earning less than £8,500 in the tax year.

In order to establish whether an employee earns more or less than £8,500, we need to take account of **cash earnings** (including expense reimbursements) and any payments **treated as earnings**, for example under the **Benefits Code**. We also need to add in any amounts received under the special rules for intermediaries (see Chapter 27). We then need to deduct "authorised deductions" as listed in s.218(4) which include payroll giving and certain pension contributions.

ITEPA 2003, s.218

To test if an employee is lower paid (earnings less than £8,500 in the tax year):

	£
Cash earnings (including reimbursed expenses)	X
Payments treated as earnings (eg Benefits)	X
Earnings from intermediaries	X
	X
Less: authorised deductions (s.218(4))	(X)
TEST HERE	X

Note that for the purposes of the test, we include expense reimbursements but do not deduct general business expenses (eg travel etc) which are allowable under the expenses rules, as these are not in the list of authorised deductions.

If the resulting figure at the bottom is £8,500 or more, we do not have a lower paid employee. In this instance, all benefits and expenses payments will be taxed in the normal way. The above test is designed in this way to prevent a company paying an employee a cash salary of £8,499 and "topping-up" his remuneration package with a number of non-cash benefits and expenses.

If an employee is a lower paid employee, taxable benefits will still need to be reported to HMRC but this time on a form P9D as opposed to form P11D.

It is more common for an employer to provide benefits to employees who are not lower paid employees nor directors, and we will concentrate on these for the rest of this course.

15.10 Pension income and social security income

Parts 9 and 10 of ITEPA 2003 deal with the taxation of pension income and social security income.

Income from pensions is generally taxable. This will include the State Pension and any pension income paid by a former employer whether in the UK or abroad.

If a taxpayer is resident and domiciled in the UK and receives income from an overseas pension, only 90% of the pension income arising is taxable. This "10% deduction" rule also applies to overseas government pensions paid in the UK. ITEPA 2003, s. 575(2) ITEPA 2003, s.617

Many social security benefits paid to UK taxpayers are exempt from tax. Such exempt sources include bereavement payments, child benefit, council tax benefit, housing benefit, disability living allowances and working tax credits and child tax credits. ITEPA 2003, s.677

There are however, still a significant number of social security benefits which are taxable under ITEPA 2003. These include employment and support allowance, job seekers allowance, statutory maternity pay and statutory sick pay. ITEPA 2003, s.660

Example 1

Bruno works for Online Tutors Limited (OTL). Which of the following are taxable under ITEPA 2003?

a) Salary
b) Performance Related Bonus
c) M&S voucher from employer
d) Dividend on shares in OTL
e) Interest free loan from OTL
f) Profit from one-off consulting job for ABC plc

Example 2

Chris and Dean work for Online Tutors Limited. Their earnings are as follows:

	Chris	*Dean*
	£	£
Salary	6,000	5,000
Bonus	1,000	Nil
Benefits (cash equivalent)	1,400	2,800
Business expenses reimbursed	200	600

Which of them is a lower paid employee?

a) Chris only
b) Dean only
c) Both of them
d) Neither of them

Answer 1

	Employment income?
a) Salary	✓
b) Performance Related Bonus	✓
c) M&S voucher from employer	✓
d) Dividend on shares in OTL	X (Dividend income)
e) Interest free loan from OTL	✓
f) Profit from one-off job	X (Miscellaneous income)

Answer 2

The answer is **B**

	Chris	*Dean*
	£	£
Salary	6,000	5,000
Bonus	1,000	Nil
Benefits	1,400	2,800
Expenses	200	600
TEST	8,600	8,400
"Lower paid"	NO	YES

Dean would therefore **not** be taxable on the benefits.