



Neutral Citation Number: [2008] EWCA Civ 393

Case Nos: A2/2007/1874 & A2/2007/1931

**IN THE SUPREME COURT OF JUDICATURE**  
**COURT OF APPEAL (CIVIL DIVISION)**  
**ON APPEAL FROM THE EMPLOYMENT APPEAL TRIBUNAL**  
**MR JUSTICE ELIAS**  
**UKEAT/0644/06/MA & UKEAT/0367/06/MAA**

Royal Courts of Justice  
Strand, London, WC2A 2LL

Date: 22/04/2008

**Before :**

**LORD JUSTICE PILL**  
**LORD JUSTICE MAURICE KAY**  
and  
**LORD JUSTICE LLOYD**

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**Between :**

<b>ENFIELD TECHNICAL SERVICES LIMITED</b>	<b><u>First Appellant</u></b>
<b>- and -</b>	
<b>RAY PAYNE</b>	<b><u>First Respondent</u></b>
<b>- and -</b>	
<b>BF COMPONENTS LIMITED</b>	<b><u>Second Appellant</u></b>
<b>- and -</b>	
<b>IAN GRACE</b>	<b><u>Second Respondent</u></b>

(Transcript of the Handed Down Judgment of  
WordWave International Limited  
A Merrill Communications Company  
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Official Shorthand Writers to the Court)

**Mr Marcus Pilgerstorfer** (instructed by **Nat West Mentor Services**) on behalf of the **First Appellant** and (instructed by **Messrs Rice-Jones & Smiths**) on behalf of the **Second Appellant**  
**Mr Stephen Roberts** (instructed by **Berry Smith LLP**) for the **First Respondent**  
and

**Mr Thomas Kibling** (instructed by **Bar Pro Bono Unit**) for the **Second Respondent**

Hearing date: 26 February 2008  
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Judgment  
As Approved by the Court

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## Lord Justice Pill :

1. This is an appeal against a judgment of the Employment Appeal Tribunal, Elias J (President) presiding, handed down on 25 July 2007. The EAT dismissed an appeal by Enfield Technical Services Limited (“Enfield”) against a decision of an Employment Tribunal sitting at Reading (the Chairman sitting alone) on 25 October 2006 whereby Enfield’s submission that Mr Ray Payne’s contract of employment with them was tainted with illegality was rejected.
2. In the same judgment, the EAT allowed an appeal by Mr Ian Grace against a decision of an Employment Tribunal held at Brighton on 10 April 2006 which decided that Mr Grace did not qualify for the right not to be unfairly dismissed. The Tribunal held that the contract under which he was employed by BF Components Limited (“BF”) was not enforceable by reason of unlawful performance. There had been an earlier hearing before a differently constituted Tribunal but there is no need to mention it further.
3. The EAT heard the two appeals together “because each raises the question of how the doctrine of illegality falls to be applied in two separate unfair dismissal cases”. In the Summary of their decision, the EAT stated:

“These two appeals consider the circumstances in which contracts will be considered illegal so as to preclude an employee from making claims for unfair dismissal.”

Section 94(1) of the Employment Rights Act 1996 (“the 1996 Act”) gives employees a right not to be unfairly dismissed. Another issue, which is not the subject of appeal, was also considered by the EAT.

4. In October 1998, Mr Payne began working for Enfield as a catering equipment engineer. He expressed a wish to work as a sub-contractor. In November 1998, Enfield sent to Mr Payne what was termed a sub-contractor’s contract. It contained an undertaking that Mr Payne would work exclusively for Enfield and would receive no sickness or holiday pay. The Inland Revenue made enquiries about Mr Payne’s status. By letter dated 22 September 2004, the Revenue expressed the view that while the matter was not clear-cut, they were prepared to accept Mr Payne’s status as one of self-employment, or a contract for services. In a letter to a third party in 1999, Enfield had stated that Mr Payne was an employee. In March 2006, Enfield dispensed with the services of Mr Payne and he alleged unfair dismissal, claiming to have been an employee.
5. Mr Grace began working for BF in June 2002. He answered an advertisement for work in commercial sales, services to be provided on a self-employed basis. Until 23 September 2003, he was paid a daily rate of £120 gross for which he invoiced BF, a process instigated by BF. He did not receive holiday pay or sick pay. His work for BF was his only work. He paid his own tax and National Insurance contributions.

6. About 10 weeks after his work for BF had begun, Mr Grace was told that the company would like to keep him on and offered him an annual salary of £18,000, plus commission. He refused the offer, which he perceived as a pay cut, preferring to continue working at the daily rate and did so for almost a year. During August 2003, BF told Mr Grace that they were liable for his tax and National Insurance since he was, to all intents and purposes, an employee. He was told that unless he signed a contract of employment, he would be dismissed. Having reasonably consulted ACAS about the terms of the proposed contract, he signed employment particulars on 19 September 2003 under which he was to receive an annual salary of £25,000. His work did not change. Mr Grace's employment was terminated on 12 January 2004.
  
7. To be able to make a claim for unfair dismissal, Mr Grace had to establish a continuous period of employment for a period of not less than one year (section 108 of the 1996 Act). When he applied to the Employment Tribunal, BF successfully claimed that he did not qualify because he had regularised his position as an employee only in September 2003. The Employment Tribunal accepted that the suggestion for payment at a daily rate had first come from BF but once he was offered and refused a contract of employment, and opted to retain self-employed status, he was a party to the illegal performance of a contract and could not claim unlawful dismissal. In the alternative, any period of employment was interrupted by Mr Grace's insistence on being treated as self-employed between 21 August 2003, when BF delivered their ultimatum, and 19 September 2003 when Mr Grace signed the employment particulars.
  
8. The EAT summarised the findings of the Employment Tribunal in Mr Grace's case. Until September 2003, the parties represented to the Revenue that Mr Grace was self-employed when in fact he was at all times an employee, working under a contract of employment. Mr Grace had knowledge of the arrangement and actively participated in it. Until September 2003, Mr Grace was engaged in an illegal contract which could not be relied on for the purpose of establishing continuity of employment. The Employment Tribunal concluded at paragraph 21:

“Applying the *Salvesen* test [post] to the question of what constitutes “knowledge” we conclude that Mr Grace knew what was being done even though he may not have known that it was illegal.”

9. The Employment Tribunal's findings in Mr Payne's case, at paragraphs 13 to 16 of their determination, were:

“. . . it is clear that it was not an illegal contract, nor tainted with illegality. The fact is that the Claimant [Mr Payne] at the onset of the engagement made a choice that he would prefer to be treated as self-employed. Arguments could be raised in support of self-employment status or employment status and generally the matter is never cut and dried but must depend upon various characteristics and background details. Indeed the Inland Revenue said that it was a finely balanced matter (D28). In the Tribunal's view, just because a document had been prepared by the Respondent [Enfield] . . . and signed by the Claimant purporting to support the case for self-employment, does not

render the contract illegal.

The dividing line between self-employment and employment status can often be blurred and in the Tribunal's experience it is a regular occurrence that the Inland Revenue will scrutinise arrangements of purported self-employment status to see whether it falls on that line or on the line of employment status. In the event, facts generated by the Respondent and signed by the Claimant were put before the Revenue arguing that the reality was self-employment.

The Tribunal finds that there is nothing inherently illegal regarding the contract. The parties were arguing that the factual situation should be interpreted as one of self-employment as opposed to employment status. Furthermore, the parties were complying with Inland Revenue guidelines at the time that if somebody is self-employed, tax would be deducted at source at 18% and there was a CIS certificate in place.

In the Tribunal's view the Respondents in pursuing this rather vestigial argument of illegality were motivated by the unfairness, as they see it, of the Claimant having his cake and eating it, by urging upon the Respondents at the inception of his arrangement a self-employed position and then when the engagement ceased and it suited him, to change his stance to maintaining he was an employee. The situation in the Tribunal's view comes nowhere near the circumstances where the contract could be determined to be illegal."

The Employment Tribunal went on to consider carefully all the features of the relationship and concluded that Mr Payne was an employee of Enfield.

10. Having considered the authorities, the EAT stated:

"46. In none of these cases has the contract been held to be illegal merely as a consequence of the fact that the parties in good faith and without misrepresentation wrongly characterised their relationship with the result that the wrong tax regime was adopted. That is a relatively common occurrence. Tribunals frequently have to determine whether someone ostensibly employed under a contract for services has in fact been subject to a contract of service. Such cases typically involve the employee resiling from the arrangement he originally made."

11. Applying those principles in Mr Payne's case, the EAT accepted that there had been knowledge and participation in the scheme by Mr Payne and agreed with the Employment Tribunal that there had been no misrepresentation. The EAT held:

"However, it would be absurd if a contract were held to be

illegal because the parties in good faith thought that it could legitimately be considered to fall into one legal category whereas in fact it fell into another” (paragraph 51).

“. . . It would be extraordinary if adopting the wrong characterisation - wrong in the sense that it was not the view of the court subsequently charged with determining the matter - could place the parties outside the law’s protection. It would be even more offensive in circumstances, as here, where the Revenue is informed of the nature of the relationship and accepts the legal characterisation adopted by the parties” (paragraph 52).

12. The EAT did not find Mr Grace’s case as clear. At least by August 2003 the employers had made it plain that it was their strongly held view that he should be treated as an employed person. However, at no stage had Mr Grace sought to misrepresent the facts of the relationship to the Revenue. When first employed, he understood that the relationship could be characterised as one of self-employment and some features were more consistent with that view. Allowing his appeal the EAT concluded:

“56. We accept that on occasions where the parties have sought to claim self-employed status knowing that this was not sustainable then it might be legitimate to infer that they are seeking to misrepresent the true nature of their relationship. It is not, however, the mischaracterisation of the legal status which is the relevant misrepresentation; it is the implicit representation about the underlying facts of the relationship. The only evidence of that here is the finding that he continued to want to be treated as self-employed even after the company had told him that in their opinion he plainly was not. He was unwilling to accept their analysis, albeit only for a short period while he considered the employer’s offer. The Tribunal say that he thereafter knew that the status had been wrongly described. More accurately it seems to us that he knew that this is what his employers were representing. We do not think that his further exploration of the new position adopted by the company can be said to constitute a misrepresentation of the facts of the relationship such as to render the contract illegal.”

13. The EAT cited the underlying principle stated by Lord Mansfield in *Holman v Johnson* (1775) 1 Cowp 341 at 343:

“No court will lend its aid to a man who founds his cause of action upon an immoral or illegal act. If, from the plaintiff’s own stating or otherwise, the cause of action appears to arise ex turpi causa, or the transgression of a positive law of this country then the court says he has no right to be assisted.”

14. For the appellants, Mr Pilgerstorfer submits that the present contracts come within the third category of cases defined by Peter Gibson LJ in *Hall v Woolston Hall Leisure Ltd* [2000] IRLR 578, at paragraph 31:

“That is where a contract, lawful when made, is illegally performed and the party knowingly participated in that illegal performance.”

Mr Pilgerstorfer submits that in both these cases there was illegal performance and the employees participated in it. The EAT have wrongly put a gloss on the doctrine by requiring it to be established that the employee made a misrepresentation of the facts of the employment relationship, and that he must have known he was making a misrepresentation of the true position, that is, he must have been acting in bad faith.

15. I would accept that, in both cases, the employee did actively participate in the scheme under consideration though, in Mr Grace’s case, the initiative for payment at a daily rate had come from BF, who subsequently changed their approach. The issue is whether there was, on the facts, an illegal performance. Non-compliance with revenue statutes, if submitted on behalf of the appellants, constitutes illegality in law. Such breach, even if the parties do not know it is a breach, and even if they could not reasonably have known it is a breach, amounts to illegality. Proof of moral culpability is not required. Even if the belief that the contract is one of services and not of service is based on specialist legal advice, what is subsequently found to be a contract of employment has been unlawfully performed and is not enforceable, it is submitted.
16. The appellants rely on the potential tax advantages of being self-employed. Even if there is every intention to pay tax as a self-employed person, the tax regime may be more favourable because of the more generous approach to business expenses for the self-employed and because of the possibility of deferred payment of tax.
17. The unattractiveness of a person first seeking the benefits of self-employed status and then claiming to have been an employee is mentioned by Mr Pilgerstorfer. In *Salvesen v Simons* [1994] IRLR 52, in the EAT, Lord Coulsfield referred to the moral dimension, at paragraph 19:

“. . . It is not necessarily inequitable that persons who seek to take advantage out of the tax system, misguidedly or otherwise, should not be entitled to be treated as if they were employed under a normal contract of employment.”

However, Mr Pilgerstorfer does not claim that to be the rationale of the *Holman* rule, which is the offence against public policy. The principle, as stated by Lord Gough of Chieveley in *Tinsley v Milligan* [1994] 1 AC 340, “is not a principle of justice; it is a principle of policy whose application is indiscriminate and so can lead to unfair consequences as between the parties to litigation. Moreover, the principle allows no room for the exercise of any discretion by the court in favour of one party or the other”. As Ackner LJ accepted in *Young and Woods v West* [1980] IRLR 201, it would not be contrary to public policy to allow an employee to resile from the agreement.

18. Mr Pilgerstorfer relies on the recent decision of the EAT, Underhill J sitting alone, in *Daymond v Enterprise South Devon* [UKEAT/0005/07] handed down on 6 June 2007. Citing *Salvesen*, Underhill J stated, at paragraph 12:

“ . . . where an employee has made a positive choice to operate arrangements which have the effect of depriving the Revenue of payment to which it is entitled, contracts giving effect to those arrangements will be unlawful notwithstanding that the employee may genuinely have believed them to be lawful. The position might be different where the initiative came from the employer; but these are not the facts of that case.”

19. At paragraph 23(3) Underhill J stated:

“But even where – surprisingly – they [employees] can show that they were not seeking such advantages [perceived tax advantages] I see nothing objectionable in the law taking the view that workers who actively choose to employ sophisticated arrangements of this kind must take the consequences of their actions, whether they appreciated those consequences or not.”

20. The facts in *Salvesen* were that a salary of £12,200 was split and paid as £10,000 for salary and £2,200 as a “management fee” paid to a partnership (Jonor Services) the employee operated with his wife, which would invoice the employer for the management fee. The only services were those of the claimant under the contract of employment. He thought what he was doing was lawful.

21. Holding the contract unenforceable, Lord Coulsfield stated, at paragraph 13:

“[The payment] was not truly a payment to Jonor Services at all, but was a diversion of part of the [employee’s] remuneration, so we cannot escape the conclusion that there was here a misrepresentation to the Revenue, and, to that extent, a fraud upon the Revenue.”

22. In *Hall*, the contract of employment was tainted with illegality because of the employers’ mode of paying wages to the employee, in which the employee, having queried it, acquiesced. She was permitted to bring a sexual discrimination claim. The employers’ alleged performance was not causally linked with that claim and, in any event, there was no active participation by the employee in the illegal performance.

23. In both *Hall* and *Salvesen*, analysis was required of whether the employee participated in the scheme. That problem does not arise for the appellants in the present case; Mr Payne and Mr Grace plainly participated in the respective schemes.

24. Considering *Salvesen* and *Daymond* in the present case, the EAT stated, at paragraph 44:

“ . . . the parties were representing that services had been

provided by a partnership or company when in fact that was false.”

That was also the position in *Miller v Karlinski* [1945] 62 TLR 85, a decision of this court cited by the EAT at paragraphs 30 and 31, where the claimant received his remuneration partly by way of salary and partly for what were termed “travelling expenses” when they were not.

25. In his judgment, Elias J analysed the above and other authorities in some detail. I agree with his analysis and with the statement, at paragraph 43:

“In our judgment the essential feature of all the cases where there has been found to be illegality is that the parties have knowingly entered into arrangements which have to their knowledge represented the facts of the employment relationship to be other than that they really were.”

I have already cited the general conclusion of the EAT at their paragraph 46. I agree with their further statement, at paragraph 49 that, while the decision in *Daymond* was correct, the width of Underhill J’s remarks at paragraph 12, cited at paragraph 18 above, was too broad. Elias J stated:

“We do not consider that the authorities, or *Salvesen*, support the proposition that if the arrangements *have the effect* of depriving the Revenue of tax to which they were in law entitled then this renders the contract unlawful. For reasons we have given, in our judgment there must be some form of misrepresentation, some attempt to conceal the true facts of the relationship, before the contract is rendered illegal for the purposes of a doctrine rooted in public policy.”

26. A decision as to whether a relationship is one of employment or whether the person performing the services is self-employed will often be very difficult. Circumstances are infinitely variable. The issue is, as Elias J with his extensive experience of employment work put it at paragraph 46, one which is “relatively common”. A number of factors will be involved and the relationship between them and the weight to be given to each of them in the particular case will need to be assessed. Predictions as to the side of the line on which a particular relationship will be held to fall are notoriously difficult to make.
27. For present purposes, I am prepared to assume that there could be tax advantage for the respondents in claiming to have self-employed status. I do not accept that, of itself, such advantage renders a contract subsequently found to have been a contract of employment unlawfully performed. I do not accept that a characterisation of the relationship held to be erroneous necessarily prevents an employee subsequently claiming the advantages of being, or having been, an employee.

28. A contract of employment may, as the cases show, be unlawfully performed if there are misrepresentations, express or implied, as to the facts. An obvious example occurs when what is in fact taxable salary is claimed to be non-taxable expenses. That is, however, distinguishable from an error of categorisation (as in the present cases) unaccompanied by such false representations, even if the employee had claimed the advantages of self-employment before the dispute arose. I accept that there are limits to that principle and that the circumstances in which a miscategorisation is made may amount to misrepresentation and bad faith which would deprive the employee of the right subsequently to claim the benefits of employment.
29. This is not a case of ignorance of the law providing a defence. A genuine claim to self-employment, unaccompanied by false representations as to the work being done or the basis on which payment is being made, does not necessarily amount to unlawful performance of a contract of employment.
30. In my judgment, the EAT correctly held that the contracts of employment considered in this case were not unlawfully performed. I have cited their findings in Mr Payne's case, with which I agree, at paragraph 11 of this judgment. Until corrected by the finding of the Employment Tribunal in the present case, the Revenue themselves were prepared to accept that Mr Payne was self-employed. In Mr Grace's case, the case for self-employment was, on the facts, less strong. Remuneration at a daily rate paid gross was, however, instigated by the appellants and some features normally present in a contract of employment were absent. The Employment Tribunal found, correctly, that Mr Grace actively participated in the scheme but they also found that he acted in good faith and made full disclosure to the Revenue. It was subsequently held that he was an employee but his conduct did not amount to unlawful performance of his contract of employment. The EAT were also entitled to hold that the legal test applied by the Employment Tribunal in Mr Grace's case was not the correct one.
31. I agree with the EAT that the Employment Tribunal in Mr Grace's case were also in error in their alternative finding that Mr Grace was unlawfully performing his contract of employment during the few weeks between the ultimatum and his signing the contract. That finding was inevitably influenced by their main finding about the illegal character of the arrangement with BF. Having previously acted in good faith, Mr Grace was entitled to time in which to consult ACAS in what had become a complex situation, especially as the contract submitted to him was not a straightforward one.
32. I would dismiss these appeals.

**Lord Justice Maurice Kay :**

33. I agree.

**Lord Justice Lloyd :**

34. I agree that these appeals should be dismissed. The importance of the issue leads me to

add some comments of my own.

35. In each appeal the Respondent, applicant to the Employment Tribunal, was held to have been an employee during a period when, at the time, he was treated by himself and his employer as self-employed. This incorrect treatment of the relationship will have had the result that income tax at the basic rate will not have been deducted by the employer under the PAYE system, as it should have been, but will have been accounted for by the employee in his own tax return. Thus the Inland Revenue will have received the tax later than it should have done. There could have been a further loss to the Revenue if the employee claimed the deduction of expenses allowable under Schedule D which would not have been allowed under Schedule E, but there is no finding that this happened. There might also have been a shortfall in the amount paid in respect of National Insurance Contributions, but there is no finding as to that either.
36. Mr Pilgerstorfer for the Appellants submitted, correctly, that the employer, in paying the employee his remuneration under the contract gross rather than subject to deduction of tax under PAYE, was in breach of its statutory obligations in respect of tax, and he is entitled to submit that the different (and incorrect) treatment of the tax liability was a consequence of the treatment of the employee as self-employed which was known and intended by both parties. On that basis, he submitted that the contract between the parties was illegal, in the sense that it was performed illegally, and that the consequence is that the employee cannot enforce it by a claim for unfair dismissal.
37. I agree with Pill LJ that the EAT, chaired by Elias J, President, was correct to hold that it is not sufficient, in a case of this kind, to show that the employer's fiscal obligations were not complied with, and that the employee knew of the facts which led to this, namely the mischaracterisation of the relationship as being not one of employment, and participated knowingly and actively in that mischaracterisation. In a case of this kind there must in addition be a misrepresentation, express or implied, to the Revenue as to the facts if the contract is to be tainted by illegality of performance. That was the case in *Miller v Karlinski* (1945) 62 LT 85 and in *Salvesen v Simons* [1994] IRLR 52, as well as in other cases cited to us.
38. In *Hall v Woolston Hall Leisure Ltd* [2000] IRLR 578 this court held that, if the illegality relied on is in the performance of the contract, the employee is not affected unless he or she knows of the facts which render the performance illegal and also participates actively and knowingly in the illegal performance. In that case the illegality was on the part of the employer alone, in using false documents; Mrs Hall knew of that, because the documents included her payslips, but she did not participate in the illegality. The employer misrepresented the position to the Revenue, to the knowledge of the employee, but the employee did nothing herself. The case was therefore unlike *Miller v Karlinski* and *Salvesen v Simons* where both parties participated in a misrepresentation to the Revenue, in the one case that a sum claimed as expenses was properly so claimed, whereas in fact it was just part of the employee's salary, and in the other case that a sum was properly payable to a partnership consisting of the employee and others, on the basis that the partnership had rendered some service to the employer for which it was properly entitled to be paid. The requirement of knowing participation does not require that the employee should realise that what is being done is illegal, but it is necessary that he or she should know of the facts which

make it illegal.

39. In the present cases, neither the employer nor the employee has been found to have made any misrepresentation to the Revenue. For a time the Revenue accepted Mr Payne's position, after enquiry, as being one of self-employment. Eventually a contrary position was taken, on the basis of the proper analysis of the facts which had been disclosed. It does not seem to me that, in such a case, if in the end it is agreed, or decided, that the contract is or was one of employment, with the result that, during the relevant period, fiscal obligations have not been properly performed, that fact is sufficient to render the contract illegal, so that the employee cannot enforce either the contract or his or her statutory rights based on having been employed under it.
40. Mr Pilgerstorfer relied in this respect on Lord Mansfield's reference in *Holman v Johnson* (1775) 1 Cowp 341 to "the transgression of a positive law of this country", but it seems to me that this submission placed far too much weight on a phrase expressed in general terms. The principles relating to the effect of illegality have developed considerably since 1775, and I do not find it useful to resort to Lord Mansfield for points of detail.
41. In terms of more recent authority, Mr Pilgerstorfer's strongest reliance was on the decision of the EAT (Underhill J) in *Daymond v Enterprise South Devon* UKEAT/0005/07. That decision is, as regards its reasoning, clearly inconsistent with the analysis adopted by the EAT in the decisions under appeal. It is the one case which clearly supports Mr Pilgerstorfer's submissions on the appeals. Whether or not the actual decision was right is irrelevant for present purposes, and I say nothing on that either way. But I agree with Pill LJ in endorsing the EAT's observations about *Daymond*. In my judgment what the EAT said in paragraph 49 of the decisions under appeal, cited by Pill LJ at his paragraph 25, correctly sets out the law on this point.
42. It was also part of Mr Pilgerstorfer's argument that the EAT was wrong to add a requirement of misrepresentation because this only relates to fiscal illegality. He argued that the principles as to the effect of illegality ought to be of general application. I agree with that proposition, but I do not see that the EAT's decision offends against it. How it would apply in practice will depend on the facts of each case, and in particular on the nature of the illegality involved. There might well be cases concerned with other types of illegal performance where it would be relevant to consider whether a misrepresentation has been made, for example to a regulatory authority, as to the relevant facts.
43. These reasons, and those expressed more fully by Pill LJ, lead me to conclude that the appeals should be dismissed.