TC01778

Income Tax - Scheme to remunerate controlling directors so as to secure deductions for Corporation Tax purposes, whilst avoiding PAYE and National Insurance liabilities - Dividends paid from specially formed company - Hearing after the First-tier and Upper-tier Tribunal decisions in PA Holdings Ltd v. HMRC but prior to the decision of the Court of Appeal in that case - Decision delayed until after publication of Court of Appeal judgment - Appeals on both the PAYE and National Insurances issues dismissed

FIRST-TIER TRIBUNAL **Reference no: SC/33016/2009**

TAX

MANTHORPE BUILDING PRODUCTS LIMITED

Appellant

-and-

THE COMMISSIONERS FOR HER MAJESY'S REVENUE AND CUSTOMS

Respondents

Tribunal: HOWARD M. NOWLAN (Tribunal Judge)
MOHAMMED FAROOQ

Sitting in public in Birmingham on 5 to 8 September 2011

Dougal Powrie of Powrie Appleby LLP on behalf of the Appellant
Malcolm Gammie QC on behalf of the Respondents

DECISION

Introduction

1. This was a broadly similar case to the case of *HMRC v. PA Holdings Ltd* [2011] EWCA Civ 1414, that has recently been heard by the Court of Appeal. In other words it was a case where an attempt was made to remunerate directors in a manner that would enable the Appellant to obtain a deduction for Corporation Tax purposes for the cost of the effective remuneration, whilst simultaneously endeavouring to avoid PAYE and National Insurance contribution ("NIC") liabilities by procuring that the payments were made as dividends paid by a specially formed company, thus attracting tax at the lower relevant rate for dividends, and no liability for either employee or employer NIC contributions.

2. The essence of the scheme was that the Appellant, the employing company, resolved to implement a bonus plan for Mr. and Mrs. Pochciol, the husband and wife who between them were the ultimate controlling shareholders of the Appellant, and the key directors of the Appellant, the Appellant's holding company and a second subsidiary of that holding company.

3. Under the scheme, the Appellant formed a UK resident unlimited company called Manthorpe Investment Services ("Manthorpe Investments"). The Appellant itself always held the voting shares in Manthorpe Investments. It made a capital contribution of £1,050,000 to Manthorpe Investments and then subscribed 10,000 1p shares which carried the right to a priority dividend of anything between nil and £1,000,000, payable on or shortly after 30 September 2004. The Appellant's bonus plan envisaged that if the Appellant's sales for August and September 2004 reached or exceeded £1,000,000 (a 4.4% increase on the sales for the comparable period of 2003) Mr. and Mrs. Pochciol would respectively receive £800,000 and £200,000 as their entitlement under the bonus plan. Were the targets not achieved they would receive the lower, so called "guaranteed", amount of £875,000, rather than £1,000,000, between them. The 1p shares were then transferred to Mr. and Mrs. Pochciol in the ratio 80/20. The intention of this transfer of the 1p shares to Mr. and Mrs. Pochciol was that the bonus plan would be effected via the share rights of Manthorpe Investments. If the sales targets were achieved, dividends would then be paid in the amounts of £800,000 and £200,000 to Mr. and Mrs. Pochciol, whereas if the targets were not achieved it was envisaged that there would be a priority repayment of capital on the 1p shares, or a redemption of those shares, for the aggregate amount of the guaranteed bonus figure of £875,000. The targets were in fact achieved and the dividends of £800,000 and £200,000 were paid.

4. At the hearing before us in September 2011, it was implicit that deductions had been conceded for Corporation Tax purposes for the cost of the payment that the Appellant had made technically to Manthorpe Investments, but indirectly to fund the dividend payments. It was claimed that the sales targets to which the entitlement to the dividends was subject gave Mr. and Mrs. Pochciol the incentive to enhance the Appellant's profits, and the payments in any event reflected the great contribution that each of Mr. and Mrs. Pochciol made to the success of the company. It was not disallowed as being a distribution since it was not distributed as a dividend of the Appellant.

5. Whilst it had obviously originally been believed by the relevant advisers to the Appellant that the Income Tax treatment of the scheme would be based on a different analysis, when the case came before us, after the decisions of the First-tier and Upper-

tier Tribunals in the *PA Holdings* case, the Appellant's contention had changed. Consistently with the conclusions of the First-tier Tribunal, which the Upper-tier Tribunal had effectively endorsed, in the *PA Holdings* case, the Appellant conceded that the dividend payments by Manthorpe Investments were remuneration of Mr. and Mrs. Pochciol for Income Tax purposes. Since, however, they were also dividends, and since section 20(2) Taxes Act 1988 provided that "no distribution which is chargeable under Schedule F shall be chargeable under any other provision of the Income Tax Acts", it was contended, consistently with the two decisions in *PA Holdings*, that this tie-breaker section precluded taxation of the dividends as remuneration, and thus eliminated any liability on the part of the Appellant to deduct and account for tax under the PAYE machinery.

6. The feature that the two Tribunals in the *PA Holdings* case had concluded that the reality that the payments were remuneration meant that they were earnings for NIC purposes, and since section 20(2) Taxes Act applied only for Income Tax purposes and not for NIC purposes, it followed that the payments were liable for NIC employee and employer contributions. The Appellant contended that neither Tribunal had given sufficient attention to the NIC issues, and that we should conclude that there was no liability for NIC contributions. In any event, it was hoped that in the appellant's cross-appeal to the Court of Appeal in the *PA Holdings* case, the Court of Appeal might reverse the NIC findings of the First-tier and Upper-tier Tribunals.

7. At the end of the hearing before us, and because everyone knew that the *PA Holdings* case was shortly to be heard by the Court of Appeal, we had canvassed the issue of whether we should give our decision prior to the Court of Appeal hearing, or whether it would be more practical to defer writing our decision until the outcome of the Court of Appeal hearing was known.

8. Mr. Gammie, on behalf of the Respondents, had contended that there were significant differences between the two cases, in particular in the respect that he claimed that the Appellant had conferred a right to bonuses in general terms either in a Board resolution of the Appellant or in letters written by the Appellant to the two directors, such that there was a charge to tax and a liability for PAYE at one of various earlier points prior to the dividends being paid. Since the dividend mechanism was on this approach just one way of discharging a more general liability to pay bonuses, it was suggested that the liability for PAYE tax had clearly arisen. It followed that even if the Court of Appeal upheld the appellant's contention in the *PA Holdings* case that section 20(2) eliminated the PAYE liability, we should nevertheless hold that the Appellant was liable for PAYE tax in this case.

9. Whilst at the close of the hearing we had not reached a conclusion as to whether we should write our decision immediately or await the Court of Appeal decision, we subsequently decided that we were not convinced by the argument just referred to in paragraph 8 above, and that it was therefore more sensible to await the Court of Appeal decision. We accordingly issued Directions, indicating that we would defer our decision until after the issue of the Court of Appeal decision, and after each of the parties in this case had had an opportunity to consider whether they wished to make any further representations to us in the light of the Court of Appeal decision. We have only recently been informed that neither party wished to make further representations, and accordingly we now give our decision.

10. The judgment of the Court of Appeal makes our decision in this case extremely simple. Although for various reasons we will record the facts of this case in more detail, will give our decisions on three other bases on which this case might equally be decided, and record one observation on the outcome of this case that we consider to

be of some significance, the decision that we will now record based on the Court of Appeal's decision on the non-application of section 20(2) Taxes Act (albeit given in the Introduction to this Decision) in fact represents the totality of our relevant decision on this particular basis of arriving at our decision, and little or no further record or reasoning is material to this basis of reaching and explaining our decision.

11. Our decisions on the PAYE issue and the NIC issue are as follows:

- The Appellant in this case has already conceded that in a realistic sense the dividend machinery was just a mechanism to deliver remuneration, and that the only defence therefore to liability on the part of the Appellant for PAYE tax was the feature that section 20(2) was the tie-breaker that eliminated the PAYE liability, and required the dividends from Manthorpe Investments to be taxed simply as dividends.
- Quite apart from that concession on the part of the Appellant, we would unhesitatingly have reached the conclusion that the dividend payments were in reality remuneration. In this regard, the findings of the two Tribunals in the *PA Holdings* case in any event admitted of no other possible conclusion, and we agree with Mr. Gammie to the extent at least that the facts of this case were yet more consistent with this conclusion than the facts in the *PA Holdings* case.
- It follows therefore from the fact that the Court of Appeal has allowed HMRC's PAYE appeal in the *PA Holdings* case; has concluded that the only charge to Income Tax in the *PA Holdings* case was to tax on employment income, and that section 20(2) Taxes Act is irrelevant and that it provides no exemption from PAYE liabilities, that the present Appellant's contention which relies entirely on the application of section 20(2) collapses.
- We also dismiss the Appellant's NIC appeal. The Court of Appeal has endorsed the findings of the two earlier Tribunals in the *PA Holdings* case to the effect that the NIC conclusion is based, not on the application of the detailed rules in relation to shares, but on the simple proposition that the dividends were simply earnings for NIC purposes. That was Mr. Gammie's contention in this case, and in the light of the fact that the Court of Appeal has endorsed just this analysis of the NIC issue that the two earlier Tribunals had reached in the *PA Holdings* case, and in the light of the fact that we anyway agree with this analysis, the Appellant's NIC appeal is dismissed.

12. Whilst we consider that the decision in this Appeal, certainly on the PAYE point, is a foregone conclusion such that a detailed decision is almost superfluous, we will summarise the facts and some findings of facts in some detail. This is firstly because our assumption may be wrong, and the Appellant may wish to appeal against our decision and it would obviously be unsatisfactory for us to have barely recorded any of the facts. Secondly, as we indicated in paragraphs 8 and 10 above, there are three other grounds on which we might have decided the PAYE element of this Appeal. Whilst these three other approaches would appear now potentially to be relevant only if there was a further, and a successful, appeal to the Supreme Court from the Court of Appeal decision on the section 20(2) issue in *P.A. Holdings*, or if the Appellant itself in this case took an appeal to the Supreme Court and secured a finding that the decision of the two Tribunals in the *P.A. Holdings* case had been correct on the section 20(2) issue, we still consider that we should at least provide the findings of fact, and perhaps less relevantly give our decisions on the PAYE issue by reference to those alternative lines of reasoning. The three other possible grounds on which this Appeal on the PAYE issue might have been decided were:

- Mr. Gammie's contention that the bonus plan conferred a general right to bonuses, in fact satisfied by the so-called dividend mechanics, but nevertheless a general right which could have been enforced by the two directors by the simple receipt of cash payments, and that this occasioned a PAYE liability when the right was granted, and not one vacated on any analysis by section 20(2) Taxes Act;
- the contention, also advanced by Mr. Gammie that although the wording that accompanied the payment of £1,050,000 made by the Appellant to Manthorpe Investments suggested that Manthorpe Investments could do as it wished with the money contributed, in fact the terms of the Appellant's 12 August Board Minute indicated that Manthorpe Investments would be told to deal with the monies in such a manner that enabled it to pay the £1,000,000 to Mr. and Mrs. Pochciol, should the targets be met, as was virtually bound to be the case. Accordingly Manthorpe Investments received no profit when the capital contribution was ostensibly made to it. In reality it was a paying agent, which was handed money by its controlling shareholder that it would have to apply in discharging a pre-existing commitment. On this approach, there was neither a profit, nor were the dividends in reality dividends;
- thirdly, there is the second approach that the Court of Appeal dealt with in the *P.A. Holdings* case, namely that on applying the *Ramsay* principles, now generally taken to require the notion of judging the facts realistically and interpreting the law purposively, the PAYE liabilities should have been confirmed by reference to that analysis, quite apart from the earlier elements of the Court of Appeal judgment, related to the proper application of the charge to tax of the payment as remuneration altogether precluding taxation as a dividend, such that section 20(2) was never engaged.

13. As we have also indicated, there is also an observation that we will make on the effect of this decision. This has nothing to do with our decision and, somewhat oddly, HMRC resisted the approach that we mentioned. Nevertheless we will record it.

The evidence

14. In the hearing before us, evidence was given by Mr. Caister (who acted at the time essentially as the Finance Director of, or the financial adviser to, the Appellant), Mr. and Mrs. Pochciol, and by Mr. Neal, the partner in the firm of solicitors, Freeth Cartwright LLP, who had given the advice in relation to the scheme, and provided the scheme documentation.

15. It is unnecessary to record the evidence given by each witness. We will record the relevant evidence in summarising the facts generally. We regarded all the witnesses as honest and entirely trustworthy.

The facts in more detail

16. The Appellant was an impressive company. Its business had been commenced many years ago in Mr. Pochciol's garage. Its business was now a reasonably substantial manufacturing business, producing products such as loft windows, and supplying those products mainly to the large building materials supply companies. As we have already indicated, the Appellant's holding company owned a second subsidiary that undertook the business of supplying sophisticated machined products to aero-engine manufacturers, its principal customer being Rolls-Royce. The Appeal did not involve that company in any way, though it is worth having recorded the

impressive businesses that Mr. and Mrs. Pochciol had plainly both had a major hand in creating from very small beginnings. We record that Mrs. Pochciol played an active role in the business of the Appellant and we were entirely convinced by the general proposition that both Mr. and Mrs. Pochciol deserved, and had more than earned, everything in fact received by them.

The bonus plan

17. Mr. and Mrs. Pochciol had over the years received many letters offering tax schemes. Mr. Pochciol had been unenthusiastic about such approaches, and his and his wife's remuneration had been dealt with in a fairly conventional manner.

18. Mr. Pochciol had considerable faith in one of the partners of the Appellant's solicitors, Freeth Cartwright, who he had known for many years. When this partner indicated that Freeth Cartwright had recently been joined by an individual, Mr. Neal, who was fully conversant with a scheme that had been approved by counsel, and that purported to give the dual advantages of a Corporation Tax deduction, along with the Income Tax and NIC implications of a dividend (i.e. materially less tax and no NIC chargeable in respect of the payment), Mr. Pochciol asked Mr. Caister to look into the proposed scheme.

19. Mr. Neil attended an initial meeting with Mr. Caister, where he explained the scheme. Little evidence was given about this meeting, and we were not shown the slide show that was apparently provided.

20. In order to give a clear summary of our understanding of the scheme, and the way in which it was meant to work, we will describe generally the essence of the bonus plan. In giving this summary, we are recording our general understanding of how the scheme was meant to work. We are specifically not, at this stage, seeking to decide the precise nature of any rights conferred by the Appellant on Mr. and Mrs. Pochciol, and we are ignoring the technical rights attaching to the shares of Manthorpe Investments. We will address relevant points in relation to the nature of the rights granted, and the share rights in due course.

21. The obvious basic intention of the bonus plan was that:

- the Appellant would form the special purpose unlimited company, Manthorpe Investments;
- the Appellant would always hold the few voting or Ordinary Shares in that company;
- the Appellant would subscribe 10,000 1p shares whose rights would permit the directors to pay aggregate dividends on the 10,000 shares of any amount up to £1,000,000 on 30 September 2004;
- the Appellant would make a capital contribution to Manthorpe Investments of £1,050,000;
- The two key directors of the Appellant, Mr. and Mrs. Pochciol, would then be told that the 10,000 1p shares would be transferred to them in the 80/20 ratio, and they would be told that between them they would get guaranteed bonuses of £875,000, essentially by the mechanism of the redemption of the shares. If however the Appellant's sales for the months of August and September reached £1,000,000, the directors would receive the aggregate dividend of £1,000,000 in place of the somewhat lower redemption amount. There was a condition in the bonus award that each Director would receive nothing if he or she was not employed by the Appellant at the end of the two-month period

designated for comparing the current year performance of the company with the previous year's performance over the same two months.

- It was clear that Mr. and Mrs. Pochciol were informed that the tax expectation was that if the targets were met and the dividend was paid, then the dividend would be taxed just at the lower rates applicable to a dividend, rather than as employment income. Accordingly PAYE tax would not be deductible and there would be no NIC liabilities. It was suggested that if the targets were missed, then the redemption amount would be taxed as employment income, without the benefit of the various savings applicable to the dividend.

22. From the perspective of the Appellant itself, the expectation was that because the Appellant would not be paying a dividend, but would be instituting a scheme designed to benefit key employees, and moreover a scheme that would contain performance targets that would allegedly benefit the company, the company would secure a Corporation Tax deduction for the cost of the scheme, i.e. the cost of putting Manthorpe Investments in the position to be able to pay the dividend. The Appellant did secure a deduction for Corporation Tax purposes for the cost of the scheme, and that was not in issue before us.

The first further basis of challenge mentioned in paragraph 12 above - The nature of the rights actually granted to Mr. and Mrs. Pochciol

23. There were two Board meetings of the Appellant held for the purpose of considering the scheme, one on 9 August 2004, and the other on 12 August. The Directors present were Mr. and Mrs Pochciol, with Mr. Caister, Mr. Neil and a Mr. Garrod from the accountants Mazars, being in attendance at both meetings.

24. There was considerable discussion during the hearing in relation to the proposition that the Minutes of the two meetings did not look like realistic minutes. They had been drafted by Mr. Neil and not even submitted as drafts until 10 September. Rather more relevantly, the Minutes were drafted in unfortunate terms in that they concentrated first and foremost on emphasising the bonus points, indicating how 87.5% of the "bonus pot" would be guaranteed, subject only to the participating directors remaining in employment until the end of the 2-month period during which the performance target was to be judged (August and September), with the other 12.5% of the "bonus pot" being payable if the targets were met. The Board Minutes were, by contrast, reticent about or ambiguous in relation to the presently more relevant issue of whether a general bonus was promised, or whether there was just a commitment to implement the particular scheme being promoted by Freeth Cartwright.

25. Without actually referring to the wording of the first Board Minute, it is worth mentioning that it paid no regard to the mechanics of what was fairly obviously the intended scheme. It referred to the guaranteed element of bonus, and the performance related element, but there was no indication about any separate company, special share rights or dividends. The first meeting reached no conclusion and observed that there would have to be a further meeting, which there was on 12 August.

26. The Minutes of the meeting on 12 August are more relevant, and ignoring the first two paragraphs about directors' interests etc, the Minutes read as follows:

> ***"New Bonus Plan for Key Employees***

3.1. The Chairman reported that the meeting was further to the Board meeting of 9 August at which it was discussed whether the Company should implement a new bonus plan ("the Plan") with the purpose of rewarding and incentivising selected employees. He noted that the previous meeting had concluded that a further discussion of the Plan would be needed before making a decision on whether or not to implement it.

3.2. It was agreed that the Company has performed very well recently, and that the aim of introducing the Plan is to give key employees an incentive to ensure that this level of performance is maintained and improved. The plan does this by giving them part of the bonus as guaranteed in recognition of past performance and to encourage them to continue to perform well in future, and part being performance-related.

3.3. The Plan was then discussed in more detail. The payment of the guaranteed bonus element is subject to the employee remaining in employment with the Company until the Plan concludes (i.e. that meant to the end of the two-month period of August and September 2004 during which the company's sales would be compared with those for August and September 2003, with the target being that sales in the later period needed to exceed those of the earlier period by 4.4%). *Subject to that, there is a guaranteed payment which is equal to 87.5% of the sum allocated to each participant under the Plan. The remaining 12.5% will be payable only if the performance target is satisfied – this was discussed in more detail later. The split between the guaranteed element of 87.5% and the performance-related element of 12.5% was discussed and it was agreed that this is an appropriate split to provide the necessary incentive to these key employees.*

3.4 It was agreed that the Plan would provide a strong incentive to key people to make sure that the Company's excellent performance is continued. It was agreed that adopting the Plan was in the best interests of the Company, and accordingly IT WAS RESOLVED that the Company should implement the Plan.

3. Performance target and period for the Plan

4.1. There was a general discussion of what measure should be used for the performance target and what level of target should be set. There was also a discussion of the period over which the Plan should operate. It was agreed that the performance target must use a measure which is relatively straightforward and which will bring out the best in the participants; also it must be an objective measure which can be determined without ambiguity and relatively quickly. After discussion it was agreed that the best performance target to use would be the Company's total sales.

4.2. The period over which the Plan should operate was also discussed. It was decided that the period of the months of August and September 2004 was an appropriate period to measure performance for the purposes of the Plan, and that the bonuses under it should therefore be paid at the end of September 2004.

4.3. There was a lengthy discussion about the performance of the Company so far this year and in comparison to the same period last year. The performance in July this year was a record level of sales and this was

significantly up on last year (£600,000 compared to £537,000) However, performance for May had been less good at almost exactly the same level as the previous year (£517,000 in each case) and also May 2004 had fallen some £40,000 short of the budgeted performance for that month. After then, performance in June had been good and as noted above performance for July had been outstanding.

It was discussed and agreed that the aim of the Plan was to ensure that this strong performance continues, but it was noted that the target for the Plan should be both demanding but also realistic and achievable. It was noted that the actual performance on sales for the months of August and September 2003 had been a total of approximately £956,000. August is traditionally a weak month. It was therefore agreed that the aim should be to substantially out-perform the comparable period last year which would continue with this year's overall good performance. After some discussion it was agreed that a suitable target would be total sales of £1m for the combined months of August and September 2004, an improvement of 4.4% on last year's performance. IT WAS RESOLVED that this should be the performance target for the Plan.

44. There followed a discussion about the selection of the employees to take part in the Plan. The Meeting decided that the following employees would be invited to take part in the Plan and that the following amounts should be allocated to each of them under the plan.

Name	***Amount Allocated***
Paul Pochciol	*£800,000*
Carol Pochciol	*£200,000*

5. Plan Mechanics

5.1. It was reported to the meeting that the company's solicitors, Messrs. Freeth Cartwright LLP, had advised that the objectives of the Plan could be achieved by creating a subsidiary company (the "Plan company") and transferring shares in the Plan company to the participants in the Plan. The terms of the shares would be such that they could be redeemed for the guaranteed bonus amount in September 2004, which would give participants the security of knowing that they have an absolute entitlement to that amount, subject only to a requirement that the shares be forfeit if they cease to be employed before that date. The performance-related incentive would be achieved by declaring a dividend of the full 100% of the Plan amount should the performance target be hit; in those circumstances the redemption option would not be available.

It was discussed and agreed that this would be the best way of implementing the Plan.

5.2. It was discussed and agreed that the total amount which would be paid out under the Plan should the performance target be hit, should be transferred to the Plan company by way of a capital contribution which may be used as distributable reserves for the purposes of the dividends which are payable

should the performance target be hit. It was agreed that an additional £50,000 should be paid in this way to provide a buffer against the possibility that the investments might decline in value. The investment posture to be taken for these funds was discussed and it was agreed that the Plan company should be instructed that these funds must be actively managed with a view to maximising the return but that asset selection must take account of the fact that these funds will need to be made available for payment out at the end of September 2004.

6. Adoption of the Plan

Following these discussions and after careful consideration it was decided that it would be in the best interest of the Company to adopt the Plan in the terms agreed previously. Accordingly, any Director was authorised and instructed to take the necessary steps to implement the Plan including:-

6.1. instructing the Company's solicitors, Messrs. Freeth Cartwright LLP, to incorporate the necessary companies for use in the Plan and to prepare all the necessary document to set up the Plan;

6.2. the transfer of £1,050,000 into the Freeth Cartwright LLP client account to be used for capital contribution referred to at paragraph 5.2 above with an additional £17,625 to pay the fees in setting up the Plan; and

6.3. the transfer of the appropriate numbers of shares in the Plan company to the participators named in paragraph 4.4 above.

6.4. to commission Mazaars accountants and the investment Management arm of Freeth Cartwright LLP to provide services related to the Plan.

6.5. any Director was authorised to execute any necessary documents on behalf of the Company to implement the Plan.

7. Closure

There being no further business, the Chairman declared the meeting closed."

27. The other documents that have a bearing on any rights that Mr. and Mrs. Pochciol may have had to bonuses in any form are the identical letters (the relevant figures of award apart) that the company wrote to both Mr. and Mrs. Pochciol. These letters was again drafted by the solicitors, and they had a slight aura of unreality to them, inevitably because the directors who had resolved to implement the scheme on 12 August were Mr. and Mrs. Pochciol. Not least because the following letter (the one to Mr. Pochciol) , dated 18 August was actually signed on behalf of the company by Mr. Pochciol, and written to himself personally, the opening phrase cannot have come as much of a surprise. The letter sent to Mr. Pochciol read as follows:

"Bonus Plan for Key Employees

I am delighted to tell you that you have been selected by the Board of Directors of the Company to take part in the Company's Bonus Plan for key employees.

The Bonus Plan is designed to recognise your contribution to the Company's success, and to give you the promise of additional rewards providing a performance target is reached. The Board considers that the target is demanding but achievable, and considers that your personal contribution to reaching it will be essential. Your selection to participate in the Bonus Plan recognises this. This letter is to tell you about the performance target that has been set and your participation in the Bonus Plan.

Performance Target

The performance target set by the Board of Directors of the Company is that the Company must achieve sales totalling £1,000,000 in the months of August and September 2004.

The figure that will be used to determine whether this target has been achieved will be the Company's sale figures for the months of August and September 2004, produced on a consistent basis with previous sales figures.

How the Bonus Plan Works

Please be aware that if you cease to be employed by the Company for any reason whatsoever (or notice has been given to terminate your employment) before you receive payment under the Bonus Plan, your participation will cease immediately and you will receive nothing.

The Bonus plan has two parts. Firstly, you have been awarded a guaranteed minimum bonus, in recognition of your past performance and to show the Company's appreciation of the key role you will play in its success in the future. The guaranteed minimum bonus will be payable at the end of September 2004 subject only to the employment condition previously mentioned. Your guaranteed minimum bonus is £700,000.

The second part of the Bonus Plan will be awarded only if the performance target is hit. Your additional performance-related bonus is £100,000.

The Bonus Plan works by awarding you shares in an unlimited company created specially for the Bonus Plan. Your minimum bonus is guaranteed by making the shares redeemable for that amount at the end of September 2004. If the performance targets are hit, a dividend will be paid to you of the entire bonus amount of £800,000 and if paid this will replace the redemption option.

Amounts payable under the Bonus Plan will be sent to you by TT. Please contact me immediately if you have any queries on anything arising from this letter.

Yours sincerely,"

Our decision on the first further issue referred to in paragraph 12

28. Having now recorded in full the more relevant of the two Board Minutes and the key letter that dealt with the grant of right to some form of bonus to Mr. and Mrs. Pochciol, we will now consider whether the right interpretation of the 12 August Board Minute, and the letter of 18 August was that Mr. and Mrs. Pochciol had general rights to bonus in any form, with the dividend scheme just being the one method of discharging that commitment, or whether the guarantee was only that they would receive the transfer of the 10,000 1p shares, coupled either with the dividend or the priority reduction of capital or share redemption.

29. While we agree with Mr. Gammie's contention that the Board minute and the letter were extraordinarily ambiguous, and that an objective reader, unaware of the background, would have concluded on reading the early sections of both the Board Minute and the letter that the Appellant might indeed have contemplated simply paying cash itself to satisfy either the guaranteed or the profit-related elements of the bonus, we actually conclude that this was not what was intended. We consider that the apparent broad impression created by the early sections of both the Minute and the letter were in fact entirely qualified by the closing paragraphs or paragraph that indicated that the only mechanic for delivering the promised amounts was via the Manthorpe Investments scheme. This is just made clear by the terms of the two documents, but it is more the surrounding facts that put the matter beyond doubt. The originating cause of the whole scheme was clearly the decision to adopt the Freeth Cartwright scheme, and there was no doubt that that scheme was only meant to be operated in the way in which it was operated. We accordingly conclude that, had the Court of Appeal confirmed the section 20(2) analysis adopted by the two Tribunals in the *PA Holdings* scheme, then we would have concluded that the point raised in the first bullet point in paragraph 12 above was not made out. There was clearly a commitment that Mr. and Mrs. Pochciol had rights, following the adoption of the plan and the terms of the letter addressed to them, but we conclude that those rights were just that the Appellant should procure the dividend or reduction of capital payment envisaged by the Freeth Cartwright plan. The right to something that, when received, would have been taxed only as a dividend (on the assumption that the Court of Appeal had confirmed the Tribunals' decisions in *PA Holdings*) would not have attracted tax on any different basis. Accordingly on Mr. Gammie's first point, we would have decided that point in favour of the Appellant.

The second basis of challenge mentioned in paragraph 12 above

The relationship between the intended operation of the scheme and the actual share rights of Manthorpe Investments, and the related issue of whether a capital contribution was in fact made to Manthorpe Investments, and whether its payments of £800,000 and £200,000 to Mr. and Mrs. Pochciol were indeed dividends

30. We note firstly that there was a considerable miss-match between the expectations of the scheme and the actual share rights of Manthorpe Investments.

31. It was quite clear that the expectation of the scheme was that a dividend would only be paid to Mr. and Mrs. Pochciol if the sales targets were achieved, and that if the targets were not achieved, they would receive the £875,000 between them on a reduction of capital or redemption of the 10,000 1p shares. They were also told that the redemption of shares would be taxed as employment income, and that only the dividend would attract the more beneficial treatment as a dividend.

32. Whilst this was the clear way in which the scheme was meant to work, there was actually nothing in the share rights attaching to the 10,000 1p shares that would preclude the payment of a dividend of £875,000 to Mr. and Mrs. Pochciol, or indeed a

dividend of £1,000,000 to Mr. and Mrs. Pochciol, even if the targets were not achieved. For the share rights simply indicated that the directors could pay whatever dividend they chose, of up to £1,000,000 on 30 September and there was no reference to targets or any other condition. It was clear therefore that the plain intention of the scheme was that the Appellant would procure that the directors of Manthorpe Investments would declare dividends only to the extent that it was envisaged under the scheme that dividends should be paid.

33. We might also observe that as Mr. and Mrs. Pochciol between them were the controlling shareholders of the Appellant's holding company and the directors of the Appellant, it was they who could very simply have changed the share rights of Manthorpe Investments. Accordingly the whole notion that there was any reality to the sales targets, in the sense that Mr. and Mrs. Pochciol would only receive the lower amount of £875,000 if the targets were not achieved was fictitious in the sense that that was only achieved because they would voluntarily act to adhere to the expectations of the scheme. The share rights of Manthorpe Investments, let alone the feature that Mr. and Mrs. Pochciol could procure anything they wished, meant that the whole target notion was unrealistic.

34. The yet more significant factor is the feature that because everyone was going to operate in accordance with the expectations of the scheme, and not in accordance with the strict share rights, it was inevitably the case that if the bonus targets were achieved, then Manthorpe Investments was going to have to pay the £1,000,000 to Mr. and Mrs. Pochciol. Indeed Minute 5.2 of the Board Minutes of the Appellant dated 12 August made it absolutely clear that Manthorpe Investments would be instructed to ensure that the interim investment of the £1,050,000 paid to it was dealt with so as to recognise *"the fact that these funds will need to be made available for payment out at the end of September 2004"*.

35. Whilst we have decided that the Appellant did not confer rights to direct cash bonus payments from the Appellant itself by the terms of the Board Minutes and the letters, one of which we quoted in paragraph 27 above, we do attach great significance to the facts that the directors of Manthorpe Investments were obviously going to make payments to Mr. and Mrs. Pochciol only in accordance with the terms and expectations of the bonus plan, and that Manthorpe Investments was going to have to pay £1,000,0000 to Mr. and Mrs. Pochciol on 30 September if the targets were achieved. It is our decision that this undermines the claim that there was a genuine capital contribution made to Manthorpe Investments, and that Manthorpe Investments had realised a profit which it could, if it chose, declare as dividend. We agree with Mr. Gammie that the letter accompanying the payment to Manthorpe Investments of the £1,050,000, which said that *"Manthorpe Investments could do whatever it wanted with the capital contribution"* was not true. It was in total conflict with the instruction that was to be given to Manthorpe Investments that £1,000,000 of the £1,050,000 *"will need to be made available for payment out at the end of September 2004"*.

36. We accordingly consider that when we interpret the facts realistically, as we are required to do, the reality was that as regards at least £1,000,000 paid to Manthorpe Investments, Manthorpe Investments was just a paying agent to discharge a commitment that its controlling shareholder had undertaken. Having regard to the liability that Manthorpe Investments had got to discharge on behalf of its controlling shareholder, we conclude that it had a profit, only to the extent of any excess over the matching liability that in reality it had got to discharge. Accordingly the £1,000,000 was not a capital contribution; there was no profit to that extent, and the so-called dividends were not in fact dividends paid out of profits, but the discharge of the

liability on the part of the contributor that in reality Manthorpe Investments had got to meet.

37. This decision is not material in the light of the Court of Appeal's decision, but had the Court of Appeal confirmed the section 20(2) conclusion reached by the two Tribunals, we would still have concluded that any contention geared to the treatment of dividends was irrelevant in this case, because in reality there was no dividend.

38. We might mention one other point that further confirmed the way in which the parties acted in order to conform to the expectations of the scheme, whilst altogether disregarding the reality and the terms of the share rights. For some reason, Mr. and Mrs. Pochciol were prevailed upon to transfer their 10,000 1p shares back to the Appellant at the end of the further period of 2 years, and before the second dividend potentially payable on those shares might be paid. They were told to transfer the shares back for £6,000, and that was said to be their value. This point is of little significance so we will not summarise the share rights, and the reality. We will simply record that it was perfectly obvious that the shares were worth considerably more than £6,000, and that there was not the slightest genuine reason why they should be sold for that figure. We consider this a further example, therefore, of the way in which Mr. and Mrs. Pochciol were simply instructed to do something thought appropriate by the promoters of the scheme. This may have conformed to some feature of the planning underlying the scheme, but it paid no regard to reality, and to the true value of the shares, or indeed any reason why they should have been transferred, and further supports the whole fictitious nature of these transactions.

The Targets

39. There was considerable discussion about the reality of the targets. Mr. Gammie made the points that by the time the scheme was officially sanctioned (12 August), the sales figures for the first half of August would have been known. Furthermore since in 11 out of the 12 months of 2004, the sales exceeded those for the previous year, it was reasonably clear that the sales in the chosen two-month period would be very likely to exceed those in the two-month period of the preceding year by the required 4.4%.

40. For the Appellant it was contended that the sales target figure was nevertheless genuine, and that had the target not been achieved, then Mr. and Mrs. Pochciol would receive the lesser sum between them of £875,000. As we have already indicated, this emerged from the terms of the bonus plan, albeit that it was not particularly inevitable if one paid regard actually to the rights attaching to the 10,000 shares.

41. We also accept that Mr. Pochciol regarded the target as a genuine one, and almost certainly agreed with the suggestion advanced in argument that had the target not been met towards the end of September, he would probably have sought means to accelerate sales. The suggestion advanced was that he would have arranged for employees to come in over the weekends so as to accelerate the delivery of orders, and get those orders into the September sales figures, so that the target might nevertheless be achieved.

42. Whilst we have no doubt that Mr. and Mrs. Pochciol were both essential contributors to the success of the company, we consider that the sales target was nevertheless futile, and certainly inserted only for one or another taxation purpose. As we understood matters, Mr. Pochciol's main role was as the engineer who evolved designs for the products that the company manufactured, and the main way in which he might increase sales and profits in reality was to devise and then perfect new products. For her part, Mrs. Pochciol's role in terms of being in charge of the

marketing teams was more to solicit new customers amongst the major building supply companies. We did not understand her to be attending to telephone orders on an order-by-order basis. The material facts, therefore, in relation to the reality of the sales target was first that the main roles of Mr. and Mrs. Pochciol had very little to do with the somewhat uncontrollable issue of whether existing customers would happen to place orders in the two-month period, or whether the occasional new customer would place an order. Far more relevantly, however, the only way in which it was suggested that either Mr. or Mrs. Pochciol could actually influence whether the target was achieved or not was to arrange for workers to come in on an overtime basis over weekends in order effectively to accelerate October supplies into the latter part of September. As a mechanism for enhancing turnover or profitability for the company as a whole, this would have been both futile (in that it would only shift orders from one month to another), and counter-productive in that it would involve extra costs in achieving something artificial, so that it would actually reduce profits.

43. Our conclusions in relation to the chosen targets are accordingly that:

- they were genuine in the limited sense that if they had not been achieved, we accept that it was the intention that Mr. and Mrs. Pochciol would have been said, under the terms of the scheme, not to be entitled to the last 12.5% of the total award;

- the targets were futile from a genuine business point of view, and were almost certainly inserted in order to support some tax contention, most probably the Appellant's need to claim a Corporation Tax deduction;

- the targets had been set so that the very great likelihood was that they would be achieved; and finally

- even if the targets had not been achieved, there was nothing (artificial compliance with the terms of the bonus plan apart) to prevent Mr. and Mrs. Pochciol procuring the payment of £1,000,000 to themselves on 30 September, whether that be in discharge of some implicit liability as paying agent or, failing that, as dividend. The share rights would have permitted the payment of anything that ranked as profit, up to £1,000,000, to be paid to the holders of the 10,000 shares, as dividend on 30 September 2004, whatever the terms of the bonus plan.

The third possible basis of challenge mentioned in paragraph 12 above - the second approach adopted by the Court of Appeal

44. The third basis on which we might have decided this case on the PAYE issue is the alternative basis shortly considered by the Court of Appeal in the *PA Holdings* case, namely on a *Ramsay* basis of applying the law, interpreted purposively, to the facts, analysed realistically. This approach entirely tallies with the approach that we have already considered in relation to the slightly more technical issue of whether we regarded the payment to Manthorpe Investments to be a true capital contribution, and the receipt of that amount as a profit that could be paid as dividend by Manthorpe Investments.

45. The Court of Appeal paid relatively little regard to this issue in the *PA Holdings* case, though all three judges concurred in the statement that the case could equally have been decided on this basis. The final words of Lord Justice Moses' judgment were as follows:

"In the instant appeal PA decided that its employees should receive a bonus, Mourant identified which of the employees, from the list provided by PA, should receive a bonus and those employees received a bonus. That, to adopt the dismissive terms of Special Commissioner de Voil in DTE, was the beginning and end of the matter. It is, in my view, the beginning and end of these appeals."

Beyond the fact that we would have considered the present case one where the above conclusion was if anything somewhat more obvious, we simply record that we could have decided this case on this basis, rather than by reference to the section 20(2) conclusion reached by the Court of Appeal.

The NIC issues

46. The Appellant advanced arguments in relation to the NIC contribution liability, geared to the particular provisions that deal with shares. By contrast the Respondents contended that the NIC issue was much simpler, in that as soon as the conclusion had been reached that the so-called dividends ranked as remuneration for income tax purposes because of the overall reality of the source and origin of the payments, it naturally followed that for NIC purposes, the so-called dividends simply ranked as earnings, just as if a direct cash bonus had been paid. It view of the fact that this conclusion inevitably follows from the income tax conclusion, and in view of the facts that the two Tribunals and the Court of Appeal in the *P.A. Holdings* case have reached these conclusions, all on the same fundamental reasoning, our decision is that the payments paid on or shortly after 30 September 2004 to Mr. and Mrs. Pochciol were indeed earnings, and that NIC employer and employee contributions were due in respect of them.

The observation in relation to the PAYE issue

47. We mentioned in the Introduction that we would repeat a point that we had made during the hearing, to the effect that even if the Appellant lost this appeal, in a perverse way it would still half win it. This observation is probably relevant in relation to both the PAYE and the NIC points, and it relates of course to the issue of the absence of any calculation on a grossed-up basis.

48. The very simple point that we make is that if Mr. and Mrs. Pochciol's Income Tax affairs for the relevant period are still open so that the dismissal of this appeal means that any Income Tax charged on the dividend analysis will be refunded by HMRC, it will then follow that it is the Appellant and not Mr. and Mrs. Pochciol that will be liable for the PAYE tax and the employer and employee NIC liabilities. Those are presently assessed by reference to the amount that should have been deducted on paying bonuses, so that very roughly the amounts are £400,000 in PAYE tax (at the 40% rate of £1 million) and say £100,000 in PAYE contributions. Had those amounts been deducted from the initial payments, Mr. and Mrs. Pochciol would have had in hand only the aggregate net sums of approximately £500,000. As it is, then will have £1 million (indeed the full £1,000,000, if the tax on the dividend is refunded, and therefore actually more than they would have had in hand, had the scheme succeeded), and whilst the Appellant will have to pay the PAYE tax and the NIC contributions, those sums will at least be calculated by reference to the £1 million and not to the very much higher sum that would have had to be paid in the first place if Mr. and Mrs. Pochciol were to be left with the £1 million that they now have.

49. We accept, with Mr. Gammie, that the Appellant may well have a legal right to recover from Mr. and Mrs. Pochciol the PAYE tax and even possibly the employee NIC contributions that should have been deducted from their income. In reality

however it is presumably inconceivable that that right will be exercised in this case. Accordingly unless HMRC is to advance the understandable, but somewhat extraordinary, contention that the Appellant's failure to seek to enforce the right just mentioned constitutes yet a further benefit of employment, chargeable to tax, it would appear that our conclusion is right. In other words, the Appellant loses this appeal, but in a sense it has still half won it.

Right of Appeal

50. This document contains full findings of fact and the reasons for our decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) Tax Chamber Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

HOWARD M. NOWLAN (Tribunal Judge)

Released: 25 January 2012