TC01877

Appeal number: TC/2011/06059

INCOME TAX – Whether 'termination payment' included repayment of investment in company EMI scheme – No – Appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

GRAHAM REID **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JOHN BROOKS
ANDREW PERRIN FCA

Sitting in public at Vintry House, Wine Street, Bristol BS1 2BP on 17 February 2012

The Appellant in person

Karen Powell of HM Revenue and Customs, for the Respondents

DECISION

1. Graham Reid appeals against a closure notice issued by HM Revenue and Customs ("HMRC") under s 28A of the Taxes Management Act 1970 on 19 January 2010 and which was upheld by HMRC following a review on 15 June 2010.

2. The circumstances giving rise to the closure notice, which increased Mr Reid's liability to income tax by £12,000, are not disputed. Having had the benefit of hearing from Mr Reid and Mr Ian Johnson, his former colleague, and having read the documents provided by the parties we make the following findings of fact.

Facts

3. On 17 October 2005 Mr Reid commenced employment with RR Richardson Limited (the "Company") as its managing director.

4. On 30 November 2005 he entered into a share option agreement (the "Option Agreement") with the Company under its Enterprise Management Incentive ("EMI") Scheme. This was a qualifying EMI scheme under chapter 9 and schedule 5 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA").

5. Under the terms of the Option Agreement, on payment of £30,000, Mr Reid was granted an option to acquire a maximum of 30,000 ordinary shares in the capital of the Company at the "exercise price" of £nil per share.

6. Although it was not expressly stated in the Option Agreement, when Mr Reid paid his £30,000 he did so on the understanding that it would be refunded to him if he were to cease employment with the Company. Mr Johnson, who paid £30,000 under a share option agreement as part of the Company's EMI scheme also understood that he would receive a refund should he leave the Company. Other former employees of the Company, who had paid £10,000 for an option under the EMI scheme, not only had a similar understanding but had been refunded their £10,000 when their employment ceased.

7. On 9 July 2007 Mr Reid's role within the Company changed. He ceased to be managing director and became the Company's Commercial Director responsible to the Group Managing Director. His contract of employment was revised accordingly.

8. The terms of his revised contract of employment were set out in a letter, dated 4 July 2007, from the Group Managing Director. Under these terms Mr Reid was to receive an annual salary of £80,000 and be entitled to a car allowance of £11,202 per anum. Although there was no reference to the EMI scheme in that letter, Mr Reid received another letter, also dated 4 July 2007 from the Company's Group Managing Director.

9. This letter stated that "in the event that things don't work out" if Mr Reid was to leave the Company within 12 months of commencing the role of Commercial Director it would:

> … honour its contractual commitments for the full six month notice period ie a lump sum payment in lieu of notice, the first £30,000 will be tax free, together with car allowance for the notice period; a lump sum pension contribution for the notice period; permanent health insurance, life assurance and private medical insurance for the notice period or until you are provided with these benefits by a new employer, whichever is soonest.

The letter continued:

> As regards the EMI Scheme as you know there is a mechanism within the scheme rules for valuing the options when someone leaves the business. That being the case I cannot guarantee a refund of your money from the Scheme. You will however receive a payment of £30,000 in lieu of your contribution.

10. By a letter dated 4 January 2008 Mr Reid resigned from the Company with effect from 6 December 2007. The terms on which he resigned were set out in a Compromise Agreement (the "Agreement") made between Mr Reid and the Company on 8 January 2008. It includes the following Clauses:

> 2.2 … The parties have entered into this Agreement to record and implement the terms of the termination of the Employee's [Mr Reid's] employment and the settlement of all actual or potential claims.
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> …
>
> 4.1 The Employer [the Company] shall pay to the Employee without admission of liability the sum of £77,731 (*seventy seven thousand seven hundred and thirty one pounds*) (the **"Termination Payment"**) by way of compensation less any income tax or other sum the Employer is required by law (or entitled under the terms of this Agreement) to deduct. For the avoidance of doubt the Termination Payment includes the Employee's entitlement if any to a Statutory Redundancy Payment in the sum of £930.
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> …
>
> 4.4 The Employer agrees not to make any deduction from the first £30,000 thirty thousand pounds of the Termination Payment on the basis that the parties believe that under normal HM Revenue and Customs rules, the first £30,000 (thirty thousand pounds) of the termination payment may be paid to the Employee tax-free.
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> …
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> 11.4 The Employee represents and warrants that:
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> 11.4.1 the Employee has instructed the Adviser to advise as to whether the Employee has or may have any claims, including statutory claims, against the Employer, any other Group Companies and its or their

> respective directors, officers or employees arising out of or in connection with the Employee's employment or its termination;
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> 11.4.2 the Employee has provided the Adviser with all available information which the Adviser requires or may require in order to advise whether the Employee has any such claims;
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> …
>
> 14.3 This Agreement constitutes the entire agreement between the parties in respect of its subject matter and supersedes all previous agreements and understandings between the parties …

11. The HMRC "rules" to which clause 4.4 refers, regarding the first £30,000 being paid tax free is in fact s 403 ITEPA. The "Adviser" to whom clause 11.4 refers is Alex Monaco of C J Jones Solicitors, London who has certified (at schedule 1 of the Agreement) that Mr Reid has been advised "of the terms and effect of the terms of the Agreement".

12. In accordance with s 403 ITEPA and clause 4.1 of the Agreement income tax of £10,501 was deducted from Termination Payment of £77,731 and on 11 January 2008 the Company paid £67,230 into Mr Reid's bank account.

13. Mr Reid filed his 2007-08 self-assessment tax return on 29 January 2008. As he had understood the Termination Payment to include a refund of the £30,000 he had paid for the option under the Company's EMI scheme, Mr Reid deducted this amount from the total sum received and included the reduced amount in the "Redundancy and other lump sum payment" box on his return. He also stated on the return that £10,501 of tax had been deducted from this payment.

14. On 4 January 2010 HMRC wrote to Mr Reid seeking clarification of the "Redundancy and other lump sum payment" and the tax deducted shown on his return. The enquiry was completed by the issue of the closure notice, on 19 January 2011, which concluded that Mr Reid "failed to return £30,000 taxable income" and was therefore liable to pay a further £12,000 in income tax.

15. This conclusion was upheld following a review by HMRC and Mr Reid was notified of this in a letter from HMRC dated 15 June 2011.

Submissions

16. Mr Reid contends that the Termination Payment includes a refund of the £30,000 he paid for the option under the Company's EMI scheme and that as he had already paid tax on the £30,000 he should not be required to do so again and referred us to the letter of 4 July 2007 which clearly states that he will "receive a payment of £30,000 in lieu of your contribution" to the EMI scheme.

17. However, he accepts that the Agreement does not specifically refer to the EMI scheme explaining that the Company was not willing to include such a clause but, as he wanted to be certain of payment, he had signed the Agreement as it was after having had the benefit of legal advice.

18. Mrs Powell, for HMRC, submits that as it is not mentioned in the Agreement the £77,731 Termination Payment made does not include the £30,000 paid under the EMI scheme. She points to the fact that the Company deducted basic rate tax from £47,731 (being the total sum of £77,731 less £30,000 which was exempt from tax by virtue of s 403 ITEPA) which suggests it was a contractual payment to Mr Reid in accordance with his revised terms of employment.

Discussion and Conclusion

19. The issue for us to determine is whether the Termination Payment made under the Agreement includes a refund of £30,000 paid to the Company by Mr Reid for an option under the Company's EMI scheme.

20. We note that before he signed the Agreement Mr Reid had the benefit of legal advice.

21. The principles by which contractual documents, such as the Agreement, should be interpreted were considered by Lord Hoffman in *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896 at 912-913 where he made the following "general remarks about the principles by which contractual documents are nowadays construed":

> "I do not think that the fundamental change which has overtaken this branch of the law, particularly as a result of the speeches of Lord Wilberforce in *Prenn v. Simmonds* [1971] 1 WLR. 1381, 1384-1386 and *Reardon Smith Line Ltd. v. Yngvar Hansen-Tangen* [1976] 1 WLR 989, is always sufficiently appreciated. The result has been, subject to one important exception, to assimilate the way in which such documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old intellectual baggage of "legal" interpretation has been discarded. The principles may be summarised as follows:
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> (1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
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> (2) The background was famously referred to by Lord Wilberforce as the "matrix of fact," but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.
>
> (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances

in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax. (see *Mannai Investments Co. Ltd. v. Eagle Star Life Assurance Co. Ltd.* [1997] 2 WLR 945

(5) The "rule" that words should be given their "natural and ordinary meaning" reflects the common sense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *The Antaios Compania Neviera S.A. v. Salen Rederierna A.B.* [1985] 1 AC 191, 201:

> ". . . if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense."

22. In December 2011 the Court of Appeal in *Delaney v Pickett* [2011] EWCA Civ 1532, confirmed these principles. Ward LJ said, at [43]:

> "We are regularly referred to and are familiar with Lord Hoffmann's five principles adumbrated in *Investors Compensation Scheme Ltd v West Bromwich Building Society*. We have been told that interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract. The background or matrix of fact includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man. Previous negotiations are excluded. The meaning which a document would convey to a reasonable man is not the same thing as the meaning of its words which are a matter of dictionaries and grammar. If one would conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had."

23. Applying these principles we must therefore only have regard to the terms of the Agreement and not any prior negotiations between the parties to ascertain whether the Termination Payment included a refund of the £30,000 paid by Mr Reid under the Company's EMI scheme.

24. Although it is possible to find some support for Mr Reid's case in the letters of 4 July 2007 which contain his revised contract of employment and what would happen "in the event that things don't work out" under which he would be entitled to a lump sum payment of approximately £30,000 less than the £77,731 he received under the Termination Payment, we are unable to do so as clause 14.3 of the Agreement unequivocally provides that it "constitutes the entire agreement between the parties" and that it "supersedes all previous agreements and understandings between the parties".

25. It is not disputed that there is no reference in the Agreement to the £30,000 paid by Mr Reid under the EMI scheme being included as part of the Termination Payment. However, having carefully considered its terms, in particular those which we have set out above (in paragraph 10) we are unable to find either an implied term in the Agreement or infer that this sum should be included as part of the Termination Payment of £77,731 which under clause 4 of the Agreement was "by way of compensation".

26. In the circumstances we find that the Termination Payment did not include the £30,000 paid by Mr Reid for an option under the Company's EMI scheme and have no alternative but to dismiss the appeal.

27. This document contains full findings of fact and reasons for the 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.

JOHN BROOKS

TRIBUNAL JUDGE

RELEASE DATE: 8 March 2012