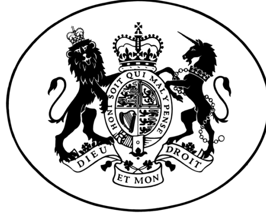

TC02132

Appeal number TC/2009/15862

Employees' bonus payments – whether entitlement to cash or to shares – s 18 & 686 & Part 7 of ITEPA 2003 – s 42 of Companies Act 1985 – tax avoidance scheme – purposive interpretation of statutes – Ramsay & PA Holdings considered - appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

SLOANE ROBINSON INVESTMNENT SERVICES LIMITED
(formerly Sloane Robinson Investment Management Limited)
Appellant

- and -

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

TRIBUNAL: JUDGE MALACHY CORNWELL-KELLY
GILL HUNTER

Sitting in public at 45 Bedford Square London on 5, 6 & 7 March 2012

Mr Julian Ghosh QC and Ms Elizabeth Wilson instructed by Grant Thornton for the taxpayer

Mr Timothy Brennan QC instructed by the Solicitor and General Counsel for HMRC for the Crown

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DECISION

Introduction

1 This case concerns an award of shares made to four individuals, Hugh Sloane, Richard Chenevix-Trench, George Robinson, and Mark Haworth ("the Employees") who were also the directors and the principal shareholders of the Appellant. The shares were in two companies, SRIM Performance ("S1") and SRIM Performance 2 ("S2"), controlled as to 999 shares by the trustee of an employee benefit trust and as to the remaining one share by the appellant through a nominee shareholder. The two companies were subsequently liquidated and the Employees received the proceeds of the liquidation in cash.

2 In form, the appeal is that of the Appellant as employer against PAYE determinations and NIC decisions as follows:

(i) Decisions under section 8 of the Social Security Contributions (Transfer of Functions) Act 1999 dated 28 November 2008 that the Appellant was liable to pay class 1 National Insurance Contributions for the period 6 April 2003 to 5 April 2004 in respect of the Employees totalling £3,312,003.10, and

(ii) A determination under regulation 80 of the Income Tax (Pay As You Earn) Regulations 2003, also dated 28 November 2008 and for the same period, that the Appellant was liable to pay £9,599,957.27 in respect of emoluments paid to the Employees.

3 Both the issues of fact and law arising in the appeal are contested. In summary the issue of fact is whether the Employees' emoluments were in cash and then converted into shares in S1 and S2 as the Crown contend, or whether the shares were directly allocated to the Employees as the taxpayer contends; the issues of law concern the correct analysis of the facts as either disclosing the payment of emoluments fully liable to PAYE and NIC in the usual way, or as disclosing an award of shares dealt with under Part 7 of the Income Tax (Earnings and Pensions) Act 2003.

Facts

4 We received a substantial amount of documentary evidence, including papers produced in response to a Production Order issued by the Tribunal on the application of the Crown on the final day of the hearing, and the oral evidence of one of the Employees, Mr Mark Haworth, whose witness statement was made in May 2011. We saw Mr Haworth as basically an honest witness doing his best to recall the detail of events some seven or eight years earlier, but his recollection was at times uncertain and some of his responses to cross-examination were evasive; he conceded moreover that he had not been closely involved in the evolution of the share dividend schemes the subject of this appeal. Fortunately, the contemporary records have been available to clarify areas in regard to which Mr Haworth's evidence was imprecise or equivocal.

5 Mr Haworth no longer works for the Appellant and is based now for his work in New York. We accept that he had no pecuniary interest in the outcome of the appeal. We also received a brief expert report from Mr Stuart Davis. We find the following facts proved, at least on the balance of probabilities.

6 The Employees were traders in a hedge fund and were in principle entitled to be remunerated by a basic salary, supplemented by a bonus representing a share of the overall profits remaining after all other claims on the business had been met. Since the Employees were, at the material time, also the only directors of their employer and the key profit generators, they effectively negotiated among themselves the distribution of the profits by way of the bonuses, and allocations to each of them were agreed upon. These negotiations took place each year based on the results for the previous year and were apt to be delicate affairs.

7 The relative performance of the participants was of course important, as was the factor that Messrs Sloane and Robinson were the founders of the business which provided the context in which the profits were made. There was, moreover, an underlying entitlement in the case of two of the Employees – Richard Chenevix-Trench and Mark Haworth - to bonuses (which, once the actual bonuses for the

year had been worked out, were formally waived to avoid a situation in which the Employee in question was entitled to a bonus on two accounts).

8 Dividing up the amount available for bonuses proceeded on the basis of a specific number of points being agreed for each person; once the individual's number of points had been settled, they were then translated to what Mr Haworth called the "bottom line", i.e. its monetary value. Each person could then use his points as he wished: he could take their value in cash, he could allocate their value to a charity or he could put their value into a tax scheme or a trust. The bonus of any individual could be split between these options, or taken in the form of one of them alone. Although our witness Mr Haworth was also a shareholder, he said that the dividends from his 10% holding were not important in terms of his share of profits.

9 On 17 September 2003, Robson Rhodes invited the Appellant to start thinking about how to minimise the tax burden on the profits being generated in the course of that year, and the process was begun with a paper to the Board on 30 September. On 3 November, an interim bonus payment was made to the Employees according to percentages of the profits available for distribution. The figures were: Hugh Sloane, 27% (net bonus £196,975.88); George Robinson, 15% (net bonus £109,431.05); Richard Chenevix-Trench 27% (net bonus £196,975.88); Mark Haworth 15% (net bonus £109,431.05). The Board minute of 29 October preceding these payments simply recorded, under the heading "interim bonus":

> Angela Moon advised that they needed to be calculated and then would be paid by BACS.

10 There is no discussion of the amounts or proportions of the Appellant's profits to be taken into account. When final cash bonus payments were made in April and June 2004, the percentage allocations between the four Employees were the same, and the Appellant accepts that these "points", or percentage allocations, are in fact decided by the directors at the start of each accounting year.

11 By mid-December 2003, the Chancellor's autumn statement had been made and digested and the Appellant's Board had met to give initial approval to exploring some tax-saving schemes being proffered by Robson Rhodes, and a meeting between them and the Appellant was envisaged for January in the New Year. By early January 2004, Robson Rhodes were putting in place arrangements for the trustees of the Appellant's employee benefit trust, Bank of Bermuda Trust (Guernsey) Limited, to provide a corporate director and secretary for S1.

12 On 8 January, Robson Rhodes asked the Appellant's in-house lawyer:

> Please let me have a schedule of award recipients and amounts as soon as possible as this will affect the share structure and fixed dividend amount we put in place for [S1]. Although it would be possible to change this later, this would lose vital time.

13 The lawyer replied that she was not able at that point to send details of the amounts and awardees until she knew what form a dividend scheme would take – as they had been the previous year, or with the permutations that she had discussed with Robson Rhodes, because "This will affect the allocations". On the same date, S1 was formally incorporated in England & Wales as an unlimited company. By 12 January, Robson Rhodes were still keen to know the split saying, in an email to the company lawyer:

> Although a rough split of awards would be helpful, this can wait if necessary. It would be helpful however to know the size of the bonus pool for the dividend scheme and whether any individuals other than the four directors will be included.

14 At that time, a scheme had already been worked out by Robson Rhodes for dealing with at least part of the remuneration for the Employees for the financial year ending 28 February 2004[1] and, if possible, subsequent years. It involved delivering shares to the Employees, subject to forfeiture in certain circumstances, for example if the Employee left the company within 12 months, was in breach of any requirement imposed on him by the FSA, or indeed at the absolute discretion of the directors.

[1] In 2004, the Appellant's financial year ended on 29 February.

15 The value of the shares would be represented by investments held by S1, and their ultimate value would depend on how the investments fared. The Employees would have "some element of certainty" however, in that a fixed dividend would be paid and only after that could the discretionary forfeiture provisions operate. The Appellant would capitalise S1 and request the trustee to invest in low risk securities such as Treasury stock and other low risk investments. The plan was that S1 would be seen to operate independently of the Appellant, and neither it nor the Employees would retain control of the funds subscribed.

16 On 14 January, a resolution of the Board of the Appellant with regard to this scheme was passed, which included as the last item:

> That a committee comprising Hugh Sloane and George Robinson be established to take such steps as appropriate to implement the arrangements including determining the levels of bonus awards to be made.

17 Before the decision was made, Robson Rhodes expanded on the possibilities in a further email to the Appellant's in-house lawyer on 15 January:

> Turning to the options open to the directors, I just wanted to expand on the possibilities a little for you. The options fall into the three categories of a straight bonus payment, the dividend scheme and a contribution to the [employee benefit trust]. Planning for the £50m should I think be looked at in the round when deciding on which combination of these routes to take. A limiting factor is of course the size of the income tax shelter still available to the directors which I understand is around £20m.
>
> Choosing to make a straight bonus payment would create taxable income for the directors which may be set against their income tax shelters. This leaves only the national insurance as a cost. Taking into account the deduction available against corporation tax in [the Appellant], making a bonus payment gives rise to an NI leakage of 9%. So, for example, if bonuses of £11m are paid, the tax leakage would be about £1m. The directors should take a view on how much NI they are willing to pay over when other options (namely dividend scheme and [employee benefit trust]) are available.
>
> The dividend scheme would avoid NI altogether and give rise to a taxable dividend in the hands of the directors which could be covered

> by their income tax shelters. The outcome would be that the value could be extracted from [the Appellant] tax free.

18 By 19 January, the Appellant's in-house lawyer confirmed that "the size of the bonus pool for the dividend scheme is £14.5 million split as follows: Hugh Sloane 3.5, Richard Chenevix-Trench 6, George Robinson 2.5 and Mark Haworth 2.5." An internal communication at Robson Rhodes noted that "we now have numbers, but no confirmation as to date", and on 20 January they emailed the Appellant: "the next steps are to alter the standard memo and articles that [S1] was established with to allow the company to pay a fixed dividend". A further email exchange between the Appellant and Robson Rhodes on 22 January dealt with the "paper flow, money flow and timelines". On 28 January, the articles of S1 were altered to provide:

(i) The 1,000 shares to be divided into one voting 'A' share of £1 and 99,900 non-voting 'B' shares of one penny each;

(ii) The 'B' shares were to be entitled to a fixed dividend of 93% of their subscription value by 28 May 2004;

(iii) The 'B' shares were liable to forfeiture if the holder: before 31 December 2005 ceased to hold office or employment with the Appellant or within its group otherwise than by reason of death; sought to transfer, charge etc., the shares without the consent of the 'A' shareholder; or was in breach of any obligation imposed by the FSA.

19 These alterations were not filed at the Companies Registry,[2] but the 'A' share was issued to Bermuda Trust (Guernsey) Limited as trustee of an employee benefit trust on 29 January and the Appellant wrote to that company the same day:

> As you are aware, we are proposing to introduce new remuneration arrangements for certain of our group employees. Details are set out in the Board Paper enclosed entitled "Summary of Proposed New Remuneration Arrangements".

The Board Paper referred to the plan described at paragraphs 14 and 15 above.

[2] We address the significance of this below.

20 The implementation of the dividend scheme continued. On 13 February, Robson Rhodes gave detailed instructions to the Appellant how to proceed, including the issue by S1 of the 'B' shares to the Appellant:

> Once the B shares have been issued to [the Appellant], [the Appellant] is then in a position to hold a board meeting to discuss and agree the allocation of the B shares among its employees. Draft minutes are attached in which you will need to complete the allocations. Based on previous information given to us, we suggest an allocation as follows, but you are of course free to choose an alternative allocation: Hugh: 3,500 shares; Richard: 6,000 shares; George & Mark: 2,500 shares each.

21 On 16 February, the Appellant notified Robson Rhodes that they had decided not to go ahead with the employment benefit trust scheme that year, but wished instead to set up a second dividend scheme for the benefit of the directors, adding that "the amount to go into this scheme will be £9.5m"; this scheme was to become S2. On the same day, the Appellant wrote to the directors of S1 with a request to subscribe for the 'B' shares and undertaking to make payment of £14,500,202 on issue, and asking them to "consider our request that these be applied in making investments which are low risk, but nevertheless give the company the chance to realise a capital gain on the amount invested". The cash amounts to go into the S1 and S2 schemes had thus been ascertained and, as we have seen, the proportions in which the Employees were to share the amounts in S1 had already been fixed on 19 January.

22 The formation of S2 then followed the same pattern as S1, and S2 was formally incorporated on 19 February with the same corporate director and corporate secretary and a share capital of £1,000 initially divided into 1,000 shares of £1 each. Meanwhile, Robson Rhodes enquired whether the Appellant had yet got round to having a board meeting to award the shares in S1. On 24 February, the firm requested "a schedule of award recipients and amounts in order to put in place the share structure and fixed dividend amount" for S2; this was specified by the Appellant on 25 February as: Hugh Sloane 2,000,000, Richard Chenevix-Trench 5,000,000, George Robinson 1,000,000 and Mark Haworth

1,500,000, making up the £9,500,000 mentioned in the communication of 16 February.

23 The share awards by the Appellant for shares in S1 were formally recorded on 25 February: to Richard Chenevix-Trench 6,000 shares; to Hugh Sloane 3,500 shares; to George Robinson 2,500 shares, and to Mark Haworth 2,500 shares. The forfeiture provisions of the articles were repeated, that exercisable on the Appellant's absolute discretion being effective between 1 and 25 March 2005. The Appellant's Board minute of 25 February authorising these awards was as follows:

> The meeting considered the appropriateness of bonus payments for the period ended 28 February 2004 and in particular the extent to which individual and company targets had been met. The meeting was of the view that certain employees of the company had made a significant contribution to the success of the company and their reward and retention remained a key issue for the company. Accordingly, it was agreed that bonus awards would be made for the period ended 28 February 2004.
>
> The meeting then considered which employees should receive a bonus and the quantum of that bonus. The meeting considered it appropriate to make the bonus awards in the form of shares in S1 . . .

24 The text of this minute had been provided by on 13 February as one of the "next steps" then to be taken. Robson Rhodes were notified on 26 February and commented: "The [S1] process is now complete, the next step would be payment of fixed dividends in May". The process was not entirely complete because neither Mr Haworth nor Mr Chenevix-Trench had signed waivers of their basic contractual entitlement to bonuses. In Mr Haworth's case that was done in early March but the waiver was, on advice, dated 15 February. We accept that, as far as Mr Haworth himself was concerned, there was no intention to deceive and that he thought that acting on the advice of professionals as to the dating of the document must be in order.

25 On 26 February, S2's capital had been reorganised into one 'A' voting share of £1 and 99,900 'B' non-voting shares of one penny each. Again the 'A' share was

issued to the trustee, Bermuda Trust (Guernsey) Limited, and the rest to the Appellant so that they could be awarded to the Employees. The fixed dividend was to be 95% of the subscription value of the 'B' shares held on 24 June and payable by 9 July. The S1 pattern was followed with awards of shares in S2 by the Appellant on 12 March: to Hugh Sloane 2,000 shares; to Mark Haworth 1,500 shares; to Richard Chenevix-Trench 5,000 shares, and to George Robinson 1,000 shares. The same forfeiture provisions were attached as before - except that the date of 31 December 2005 was advanced twelve months - and the board minutes as to the matter were in the same terms as those recorded for S1. The basic bonus waivers signed by Messrs Haworth and Chenevix-Trench were of course effective in relation to these shares also. The legal title to the 'B' shares was never vested in the Employees, who had only a beneficial entitlement to them; the Appellant remained the legal owner of the shares.[3]

26 The implementation of the dividend scheme was thus complete, save for the payment of the dividends in May and July 2004, and the investment of the funds subscribed. A spreadsheet produced at around the end of the Appellant's financial year, 28 February, recorded the total amount of profit available for distribution, showing each of the Employees' shares in it in the same proportions as hitherto, and the cash allocations for S1 and S2 corresponding to the shareholdings of each Employee in the two companies. The Employees' cash allocations for their shareholdings thus aligned with the shareholdings, were however in slightly different proportions to those in which they shared the profits overall, indicating that each had made an individual choice of the amount of his basic allocation to be put into the dividend scheme.

27 The Notes to the Appellant's Report and Accounts for the year ended 29 February 2004, dated 29 June 2004, contain the following sentence under the heading 'Directors' Emoluments':

---

[3] Under section 421B of the 2003 Act, a beneficial interest in shares had the same effect as a legal interest for the purposes of the relevant legislation.

> Included in directors' emoluments are awards of shares in [S1 and S2] to the value of £24,000,000, [i.e. £14,500,000 + £9,500,000] of which £9,500,000 was unallocated and included within accruals at 29 February 2004.

5 28 The £24,000,000 was shown elsewhere in this document as employees' remuneration, with the explanation "Staff costs include £24,000,000 in respect of performance related benefits provided to key employees". In the corporation tax computation for the year, the same sum was itemised as "share awards".

29 Initially, the investment of funds in S1 and S2 was to be at minimal risk, 10 which Mr Haworth took to mean "cash or near cash products", but under the twin influences of desire by the Employees to maximise their gains yet further, and advice from tax counsel, the policy was modified on 5 March to allow medium risk investments. The portfolios of S1 and S2 were each composed as to 65% of fixed interest government securities or bank deposits, with the remaining 35% in 15 relatively small but volatile investments in Asian emerging market shares. Over the short periods of investment which were involved, these apparently riskier securities however showed very little change: for S1, a 0.75% gain in sterling terms (1.87% in US dollars), and for S2 the figures were -0.23% and 2.14% respectively.

20 30 The investment policy was in principle controlled by the trustee holder in each instance of the 'A' share, but in practice the Employees and especially Mr Haworth (either in their capacity as equitable holders of the 'B' shares or as directors of the Appellant)[4] exercised a substantial influence over what investments were made by means of "recommendations" - which were actually 25 solicited by the trustee.

31 Mr Haworth played a central role in recommending investments – he could not give an example of any investment actually made which he had not recommended – and it was one which caused him no little anxiety; he felt under greater pressure than in a number of his other responsibilities in the Appellant company, noting

[4] They were of course the same people.

that "we had in all cases carefully followed and written up the investments and debated them regularly". The other three Employees were, according to Mr Haworth, broadly comfortable with what he was doing though they were not always in agreement as to strategy. There were no fixed plans for S1 or S2 after the intended payment of the fixed dividends, other than to retain them as investment vehicles until such time as the tax situation became clearer.

32 The scheme involved, in principle, the risks posed by the forfeiture provisions being put into effect and an employee losing everything but, because of the complete identity between the Employees and the directors of the Appellant, the risk effectively amounted to the four of them falling out before the scheme had been accomplished, a risk which Mr Haworth estimated at 1-2 %; by contrast, he saw the opportunity to make further gains in the investments held by the two companies in the two or three months involved, saying that it was his natural instinct to do so and that the ideas for what to buy came from him and his team; the other three Employees were broadly content that that was so.

33 Mr Haworth described his approach to the schemes thus:

> What I did understand was that, as at the date the shares [in S1 and S2] were notified and awarded to us, what I was getting (and what I wanted) was that part of my bonus in shares instead of cash (and that this part was paid entirely in shares and at no stage consisted of cash). The fact that I was to receive part of my bonus by way of a share award was precisely why I had been worried about the risk and reward ratio of shares versus cash.
>
> Of course, having had the shares instead of cash I would never have sought any additional cash bonus under the Service Agreement in respect of that part of the bonus, and I don't see how I could properly have done.

34 Before the fixed dividends had been paid, alarm and despondency followed the issue by the Inland Revenue on 7 May of a press release stating that the Finance Bill would contain provisions under which "schemes designed to avoid income tax and NI contributions using employment-related securities have been stopped" as of that date. Robson Rhodes advised on 10 May that "we are reviewing what to do to fix the proposed changes". By mid-May, action was proposed in the

form of changes to the articles of S1 and S2 to avoid a tax charge falling on the 'B' shareholders if the fixed dividend was paid. Tax counsel was again consulted and by 24 May the Appellant's in-house lawyer was writing to Robson Rhodes:

> The directors would really like to unravel this whole restricted share plan and would like to speak to someone at your end about how this can be done and quickly (the original payout date was 28 May and there could well be commitments that need to be met).

35 The solution adopted by general agreement and after advice from Robson Rhodes was to liquidate S1 and S2. All the Employees chose to receive cash rather than a share of the investments held by the companies. The fixed dividend dates were amended to 11 February 2005, so that they would fall due after the liquidation had been completed. The process was commenced in June and was largely completed in August when payments out were made by the liquidator to the four Employees, the final payments being made in November 2004. Although they did not hold legal title to the shares which remained vested in the Appellant the Employees were, at the request of Robson Rhodes to the liquidator, paid direct and not through the Appellant. The totals paid out were: from S1 £14,413,755 and from S2 £9,454,852 or, respectively, 99.4% and 99.5% of the amounts subscribed by the Appellant.

36 Mr Haworth ended his written evidence with this statement:

> We were offered a choice of receiving cash or a share of the underlying equities in the liquidation. I chose cash principally because I thought it would be more straightforward, particularly in relation to the fact the fact that I continued to work for [the Appellant] managing similar portfolios.

Mr Haworth added in oral evidence that the other Employees had also taken cash in the liquidation.

37 As noted above, we received an uncontested valuation report by Mr Stuart H Davis whose experience included work in the Estate Duty Office from 1966 to 1980, Grant Thornton as the senior national consultant on estate planning and share valuation from 1980 to 2005; Mr Davis is an associate of the RICS and a

member of the Society of Share and Business Valuers. Mr Davis gave it as his expert opinion that for the purposes of sections 421 and 423 of the Income Tax (Earnings and Pensions) Act 2003 the value of the B shares in S1 and S2 was diminished by the forfeiture provisions affecting them, which have been referred to above.

The legislation

38 The Income Tax (Earnings and Pensions) Act 2003 section 18 (receipt of money earnings) provides, so far as relevant:-

> 18 *Receipt of money earnings*
> (1) General earnings consisting of money are to be treated for the purposes of this Chapter as received at the earliest of the following times-
> Rule 1
> The time when payment is made of or on account of the earnings.
> Rule 2
> The time when a person becomes entitled to payment of or on account of the earnings.
> Rule 3
> If the employee is a director of a company and the earnings are from employment with the company (whether or not as a director) whichever is the earliest of –
> (a) the time when sums on account of the earnings are credited in the company's accounts or records (whether or not there is any restriction on the right to draw the sums);
> (b) if the amount of the earnings for a period is determined by the end of the period, the time when the period ends;
> (c) if the amount of the earnings for a period is not determined until after the period has ended, the time when the amount is determined.

(Section 686 makes parallel provision for the purposes of the PAYE regulations.)

39 Section 62 provides:-

> 62 *Earnings*
>
> (1)This section explains what is meant by "earnings" in the employment income Parts.
>
> (2)In those parts "earnings", in relation to an employment, means-

(a) any salary, wages or fee,

(b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or

(c) anything else that constitutes an emolument of the employment.

5 (3) For the purposes of subsection (2), "money's worth" means something that is-

(a) of direct monetary value to the employee, or

(b) capable of being converted into money or something of direct monetary value to the employee.

10 (4) Subsection (1) does not affect the operation of the statutory provisions that provide for amounts to be treated as earnings (and see section 721(7)).

40 Section 421B defines "employment-related securities":-

15 421B *Application of Chapters 2 to [4A]*

(1) Subject as follows (and to any provision contained in Chapters 2 to [4A]) those Chapters apply to securities, or an interest in securities, acquired by a person where the right or opportunity to 20 acquire the securities or interest is available by reason of an employment of that person or any other person.

(2) For the purposes of subsection (1)—

(a) securities are, or an interest in securities is, acquired at the time when the person acquiring the securities or interest 25 becomes beneficially entitled to those securities or that interest (and not, if different, the time when the securities are, or interest is, conveyed or transferred), and

(b) "employment" includes a former or prospective employment.

30 (3) A right or opportunity to acquire securities or an interest in securities made available by a person's employer, or by a person connected with a person's employer, is to be regarded for the purposes of subsection (1) as available by reason of an employment of that person unless—

35 (a) the person by whom the right or opportunity is made available is an individual, and

(b) the right or opportunity is made available in the normal course of the domestic, family or personal relationships of that person.

(4) ….

…

(8) In this Chapter and Chapters 2 to [4A]—

"the acquisition", in relation to employment-related securities, means the acquisition of the employment-related securities pursuant to the right or opportunity available by reason of the employment,

"the employment", in relation to employment-related securities, means the employment by reason of which the right or opportunity to acquire the employment-related securities is available ("the employee" and "the employer" being construed accordingly unless otherwise indicated), and

"employment-related securities" means securities or an interest in securities to which Chapters 2 to 4 apply (ignoring any provision of any of those Chapters which limits the application of the Chapter to a particular description or descriptions of employment-related securities).

41 Section 423 defines "restricted securities":-

423 *"Restricted securities" and "restricted interest in securities"*

(1) For the purposes of this Chapter employment-related securities are restricted securities … if—

(a) there is any contract, agreement, arrangement or condition which makes provision to which any of subsections (2) to (4) applies, and

(b) the market value of the employment-related securities is less than it would be but for that provision.

(2) This subsection applies to provision under which—

(a) there will be a transfer, reversion or forfeiture of the employment-related securities, or (if the employment-related securities are an interest in securities) of the interest or the securities, if certain circumstances arise or do not arise,

(b) as a result of the transfer, reversion or forfeiture the person by whom the employment-related securities are held will cease to be beneficially entitled to the employment-related securities, and

5 (c) that person will not be entitled on the transfer, reversion or forfeiture to receive in respect of the employment-related securities an amount of at least their market value (determined as if there were no provision for transfer, reversion or forfeiture) at the time of the transfer,
10 reversion or forfeiture.

(3) This subsection applies to provision under which there is a restriction on—

(a) the freedom of the person by whom the employment-related securities are held to dispose of the employment-
15 related securities or proceeds of their sale,

(b) the right of that person to retain the employment-related securities or proceeds of their sale, or

(c) any other right conferred by the employment-related securities,

20 (not being provision to which subsection (2) applies).

(4) This subsection applies to provisions under which the disposal or retention of the employment-related securities, or the exercise of a right conferred by the employment-related securities, may result in a disadvantage to—

25 (a) the person by whom the employment-related securities are held,

(b) the employee (if not the person by whom they are held), or

(c) any person connected with the person by whom they
30 are held or with the employee,

(not being provision to which subsection (2) or (3) applies).

42 Section 425 exempts the acquisition of certain “employment-related securities” which are also “restricted securities” (subject to the election of the
35 employer and employee):-

425 *No charge in respect of acquisition in certain cases*

(1) Subsection (2) applies if the employment-related securities—

(a) are restricted securities, or a restricted interest in securities, by virtue of subsection (2) of section 423 (provision for transfer, reversion or forfeiture) at the time of the acquisition, and

(b) will cease to be restricted securities, or a restricted interest in securities, by virtue of that subsection within 5 years after the acquisition (whether or not they may remain restricted securities or a restricted interest in securities by virtue of the application of subsection (3) or (4) of that section).

(2) No liability to income tax arises in respect of the acquisition, except as provided by—

(a) Chapter 3 of this Part (acquisition by conversion),

(b) Chapter 3C of this Part (acquisition for less than market value), or

(c) Chapter 5 of this Part (acquisition pursuant to securities option).

(3) But the employer and the employee may elect that subsection (2) is not to apply to the employment-related securities.

(4) An election under subsection (3)—

(a) is to be made by agreement by the employer and the employee, and

(b) is irrevocable.

(5) Such an agreement—

(a) must be made in a form approved by [the Commissioners for Her Majesty's Revenue and Customs], and

(b) may not be made more than 14 days after the acquisition.

43 Section 426 imposes a charge to tax on the occurrence of “chargeable events”, and section 427 defines “chargeable events”:-

427 *Chargeable events*

(1) This section applies for the purposes of section 426 (charge on occurrence of chargeable event).

(2) Any of the events mentioned in subsection (3) is a "chargeable event" in relation to the employment-related securities.

(3) The events are—

(a) the employment-related securities ceasing to be restricted securities, or a restricted interest in securities, in circumstances in which an associated person is beneficially entitled to the employment-related securities after the event,

(b) the variation of any restriction relating to the employment-related securities in such circumstances (without the employment-related securities ceasing to be restricted securities or a restricted interest in securities), and

(c) the disposal for consideration of the employment-related securities, or any interest in them, by an associated person otherwise than to another associated person (at a time when they are still restricted securities or a restricted interest in securities).

(4) For the purposes of this Chapter there is a variation of a restriction relating to the employment-related securities if any restriction in relation to them is removed or varied.

44 Section 42(1) of the Companies Act 1985, as it was at the material time, provided:-

42 *Events affecting a company's status*

(1) A company is not entitled to rely against other persons on the happening of any of the following events-

(a) the making of a winding up order in respect of the company, or the appointment of a liquidator in a voluntary winding up of the company, or

(b) any alteration to the company's memorandum or articles, or

(c) any change among the company's directors, or

(d) (as regards service of any document on the company) any change in the situation of the company's registered office,

> if the event had not been officially notified at the material time and is not shown by the company to have been known at that time to the person concerned, or if the material time fell on or before the 15th day after the date of official notification (or, where the 15th day was a non-business day, on or before the next day that was not) and it is shown that the person concerned was unavoidably prevented from knowing of the event at that time.

Submissions for the taxpayer – Mr Julian Ghosh QC

45 The Appellant's case in essence is that the Employees were remunerated in shares, not cash, and the regime that taxes shares in such circumstances (that is, Part 7 of the 2003 Act) is applicable to these shares. Thus, under Part 7, the acquisition of shares, and the disposal or variation of rights in or relating to the shares, are events which of themselves trigger a specific legislative response: whether a calculation of a charge to tax, or an exemption from tax. That, it is argued, is the "essential nature and the purpose of the scheme", citing Toulson LJ in *Mayes v R&C Comrs* [2011] STC 1269 at 1292. Where tax avoidance or commerciality is relevant to a calculation or to an exemption, the regime will say so, sections 446A, 446E, 446K, and Chapter 4, being cited as examples.

46 The Appellant submits that in this case the shares awarded to the Employees were "employment-related securities" within the meaning of section 421B, and "restricted securities" within the meaning of section 423(2). As such, the Employees' acquisition and disposal of the shares is chargeable to income tax as prescribed by Part 7, section 417. And in this case, section 425 prescribes that the acquisition of the shares by the Employees is exempt from tax. The exemption applies because the shares are "restricted securities" on acquisition. In principle, a charge to income tax could be imposed at a later stage, but only if a "chargeable event" occurs within section 427. And, as the Crown accepted, there is no such chargeable event in this case.

47 The Crown's contention that the directors did not receive shares, but cash, is said to be unsustainable because, in the Appellant's submission, at no stage until the liquidation took place was the cash unreservedly at the disposal of the

Employees, in the sense intended by Walton J in *Garforth v Newsmith Stainless Ltd* 52 TC 522, at 529; at no stage did the Employees, either individually or together, have voting control and the Employees even needed consent to request a change of investment strategy. See also *Aberdeen Asset Management plc v CRC* [2012] UKUT 43 (TCC) at [82], where the same issue had arisen.

48 The transactions could not properly be analysed as a composite transaction where the employees get cash applying the *Ramsay* and *Furniss* line of cases (even supposing such an analysis relevant to a regime such as Part 7 of the 2003 Act). The proceeds of the liquidation could not, moreover, be described as consideration for services. The respective values of S1 and S2 and the proceeds obtained by the Employees on their liquidation were not a function of the services provided to the Appellant by the Employees, but rather the value of the investments within each of S1 and S2 - which were themselves the result of Mr Haworth's efforts. Put another way, the liquidation proceeds had the character of the fruition of a shareholder's rights on the destruction of a company in the hands of each of the Employees, not the character of a reward for past services and should be taxed as such: *HMRC v PA Holdings Ltd* [2011] EWCA Civ 1414, paragraphs 39-43.

49 In regard to the *Ramsay* and *Furniss* line of cases, the Appellant submitted that, in essence, the approach of the courts was that the taxpayer should be taxed on the transaction that he had wanted to effect, and that the actual steps which had been taken should be analysed on that basis; in this case, the outcome – the liquidation of S1 and S2 – was not what the taxpayer had wanted. The following summary of the case law was advanced:-

> (i) Transactions which have a "commercial unity", by reference to the relevant documents and the intentions of the parties, so that the transactions are properly viewed as a single composite transaction, are taxed as to their combined net effect: *WT Ramsay v IRC* [1981] STC 174 at 180c-f, per Lord Wilberforce, and *BMBF v Mawson* [2005]

STC 1, paragraph 32; *IRC v. Scottish Provident Institution* [2005] STC 15, at [19].

(ii) In particular, a combined series of *transactions* with a tax avoidance motive which form a composite scheme, designed to
5 produce a deductible loss within TCGA 1992, Section 2(2), are to be taxed according to their combined composite effect:

> To say that a loss (or a gain) which appears to arise at one stage in an individual process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was
> 10 bought, and planned as, a single continuous operation, is not such a loss (or gain) as the legislation is dealing with is … well within the judicial function.

- *W T Ramsay Ltd v. IRC* [1981] STC 174, per Lord Wilberforce at 182b-c; and see Lord Templeman *Eilbeck v Rawling* [1980] STC 192
15 at 202, approved by Lord Wilberforce as "impressive" in *Ramsay* at 180j-181a.

(iii) Thus, as part of a tax scheme, to purport to sell gilts where there is a 95% chance that the gilts purportedly sold to the purchaser would be reacquired under a separate option, is not to give the purported
20 acquirer an "entitlement" to those gilts: *IRC v SPI* [2005] STC 15, at [19]. And at [22-23] it is emphasised that even if there is a risk that the scheme may not unfold as intended, it is still necessary for the court see that risk in the context of what was planned as a whole – there can be no genuinely unforeseen element if the case is to be
25 brought within the *Ramsay* approach.

(vi) It is irrelevant that the composite transaction may also fructify a legitimate business (non-tax avoidance) commercial end: *Furniss v Dawson* [1984] STC 153 at 166-167, per Lord Brightman. Thus, for so-called linear transactions, inserted steps may only be ignored if

those steps have a sole tax avoidance purpose and there is an "... *expectation that [a scheme set in motion] will be ... carried through, and no likelihood in practice that it will not.*": *Ramsay* at 180f-g, per Lord Wilberforce.

5

(v) The test is whether one or more transactions are properly treated as a combination of transactions, intended to operate as such, and the question is whether it "*is reasonable to assume that all steps would, in practice, be carried out ...*" *Ramsay* at 183d per Lord Wilberforce; and further at 180d-e:

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> It is the task of the Court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.

15

(vi) In ascertaining whether or not a transaction is indeed a composite transaction to be taxed according to its combined or net effect, the Court must ignore a prospect of the scheme not proceeding to fructification or any other contingency inserted by the parties as a means to circumvent the application of the *Ramsay/Furniss* doctrine: *Scottish Provident* at paragraphs 16, 23, 24, 26.

20

50 In consequence, identifying the relevant transaction which is preordained becomes decisive: *Barclays Mercantile Business Finance Ltd v Mawson* [2005] STC 1, at [37-38]. Similarly, *Mayes v RCC* [2011] STC 1269 requires also that close attention is paid to the scheme of the statutory provisions in point to see whether, having regard to the events which have actually occurred, those provisions were intended to be applied to them. In this case, the fact of the unexpected and undesigned liquidation negates the possibility of analysing the sequence of events a single whole.

25

51 In this case, the decision to award shares to the Employees, and the subsequent transactions which in the event were undertaken in furtherance of that decision, cannot aptly be described as any sort of self-cancelling scheme, nor as a preordained series or combination of transactions intended to operate as such, so
5 that the individual transactions can be disregarded and only the series or combination itself regarded. In particular, during the lifetime of the companies they had an investment strategy, so that money was not unreservedly at an Employee's disposal and demonstrates that risk and reward was borne by the Employees in their capacity as shareholders and not as recipient of cash.

10 52 It is accepted by the Appellant that there was a plan to extract funds by way of a dividend, and if the scheme had been followed through as planned it might have been arguable that it fell within the *Ramsay* doctrine. But the dividend itself was dependent on the performance of various investments that affected the quantum of profits, so that it cannot be said that the receipt was in cash value rather than
15 shares. More fundamentally, there was no dividend.

53 The plan was changed and the company liquidated, which shows that on no view can the liquidation proceeds be viewed as cash to which the Employees were entitled from the Appellant. The liquidation which occurred, as an action of the shareholders and in which cash was received, cannot operate to transform the
20 initial award of shares to them into an award of cash. Put another way, the true or relevant transaction was indeed the receipt of shares which gave the shareholders a choice as to how to extract money from the company after implementation of the investment strategy. It was not the passing of cash to the Employees and the liquidation itself was in statutory terms a non-chargeable event.

25 54 Section 42 of the Companies Act 1985 is not relevant to the Revenue's position, because S1 was not relying on the un-notified change in its articles as against them. Alternatively, any reliance by the Revenue on the articles of S1 was in assessing the tax and had been at a point after they had become aware of the un-notified change to them and they had not been prejudiced by the lack of

official notification. The taxpayer was thus entitled to rely on the altered articles as, in accordance with the expert evidence, reducing the value of the shares in the hands of the Employees for the purposes of section 243.

55 The consequences for the appeal are therefore that since there is no amount of employment income under section 62 or otherwise, there is no PAYE liability on the Appellant; as for NIC, there is no liability on the acquisition and disposal of the shares, because the payment of "securities, restricted securities… and gains arising from them" do not count as earnings for the purposes of section 3 Social Security Contributions and Benefits Act 1992: paragraph 1 Part IX of Schedule 3 to the Social Security (Contributions) Regulations 1979. Nor is there any NIC liability by virtue of regulation 22 of the Social Security (Contributions) Regulations because there is no charge under Part 7.

Submissions for the Crown – Mr Timothy Brennan QC

56 The issue between the parties is whether the bonuses are taxable as earnings, or whether they escape income tax altogether. The argument that the Appellant and the Employees achieved tax-free status for the bonuses is that money was put into S1 and S2, the individuals were awarded shares in those companies and then got the money out again when the companies were put into liquidation. Taking a step-by-step approach to this composite transaction, the bonuses are said to have been awarded by way of shares, and not by way of money.

57 The awards of the shares are said to escape tax because of the effect of section 425 (tax exemption on acquisition, award of restricted securities) and because there was no later chargeable event on the liquidation. Section 425 forms part of Part 7 (employment related securities) which makes provision for taxation (and exemption) of awards of securities, options, and incentives of various kinds. The Crown submitted that the clear purpose of Part 7 is to provide tax advantages for awards of shares (generally, if not necessarily, in the employer's enterprise or a part of it) as a means of retaining and incentivising employees. It is no purpose of

Part 7 to provide a tax-advantaged wrapper for bonuses decided, denominated, paid, received and enjoyed in money. The Appellant claims that its case is simple, and that the employees were remunerated in shares, which engages Part 7 only. This is to ignore why the rewards were paid to the employees, and to invest Part 7 with a function which it does not have.

58 It is agreed that if the bonuses escape tax because of the effect of section 425, they also escape NIC. The appeal does not depend on a stark choice between whether the employees were remunerated in shares, or whether they were remunerated in cash. The statutory question is whether (and if so when) the employees received earnings chargeable under section 62. If they did, Part 7 is simply irrelevant.

59 The Crown's argument was that at the core of the Appellant's case lies the fundamental error of confusing an award of earnings with the mechanism or process for its delivery. The whole purpose of the exercise which the Appellant undertook was to reward the employee with money. Money went into the scheme at the beginning and came out at the end. Construing the statutory provisions purposively and applying them to the transactions viewed realistically, what the individual received was an award of money. The facts show that the bonuses were awarded in accordance with a previously agreed distribution of surplus profits and were ascertainable in money terms. Following that stage, the Employees chose how the money to which they were entitled should reach them; they were therefore entitled to the monetary sums involved before the shares derived from those sums were awarded to them.

60 This approach has now received the very recent endorsement of the Court of Appeal in *HMRC v PA Holdings Ltd* [2011] EWCA Civ 1414. In that case employees, who would otherwise have been awarded bonuses in money, received shares instead and were then paid dividends in money. The issue was whether the money was taxable under Schedule E (emoluments) or under Schedule F

(distributions). The award of the money was distinguished from the mechanism for its delivery. Accordingly, the Court of Appeal held:-

- The facts must be subjected to a realistic appraisal, at [4].
- It is necessary to look at all the circumstances of the case in order to determine whether income receipts are emoluments or profits from employment, at [35].
- The court is not to be restricted to the legal form of the source of the payment but must focus on the character of the receipt in the hands of the recipient, at [37].
- A *Ramsay* approach is not even necessary, at [66].
- The insertion of the steps (which there created the form of dividends or distributions) did not deprive the payments of their character as emoluments, and the award of the shares and the declaration of the dividend were, in reality, not separate steps but the process for delivery of the bonuses, at [68].

61 The court went on at [66]-[70] to look at the transaction 'through *Ramsay* eyes', holding that the insertion of the steps which created the form of dividends or distributions did not deprive the payments of their character as emoluments. The employer had decided that its employee should receive a bonus and (money having gone through the trustee, etc.) those employees received a bonus. That was the beginning and end of the matter - at [70].

62 There must be a realistic appraisal of the facts: *Tower MCashback LLP v HMRC* [2011] 2 WLR 1131, [2011] UKSC 19, per Lord Walker at [80]. A realistic appraisal of the facts requires rejection of the suggestion that the 'award' of shares in S1 and S2 was anything other than a wrapper for the value of the bonuses. Insofar as the amount which came out of the wrapper was numerically less than went in, this was an acceptable cost of the scheme. The cash received by the employees was a profit arising from the employment because it was made in reference to the services they rendered by virtue of their employment (or office) and was in the nature of a reward for past, present or future services: *PA*

Holdings at [23] per Moses LJ, referring to *Hochstrasser v Mayes* [1959] Ch 22, at 33.

63 The Tribunal should not be seduced by the form in which the payments reached the employees but should focus on the *character* of the receipt in the hands of the recipients: *PA Holdings* at [37] and [39]. The rewards which the employees received were for their services as employees (or directors) during the relevant year. The substance and purpose of the payments - *PA Holdings* at [59] - was remuneration. The process started with the decision of the Appellant to pay bonuses and ended with the receipt of the bonuses, ultimately in the form of distributions on winding up of the two companies.

64 That there were investments during the time the machinery of the scheme was operating does not require the conclusion that the character of what came out is different from the character of what went in. As to the purpose of Part 7, it is to be remembered that its provisions reflect three different legislative purposes:-

- first, there is Parliament's recognition that it is good for the economy and for social cohesion, for employees to own shares in the company for which they work;
- second, that if arrangements of this sort are to act as effective long term incentives, the benefits which they confer have to be made contingent, in one way or another, on satisfactory performance;
- third, it is the legislative purpose to eliminate opportunities for unacceptable tax avoidance - if there is any theme in Part 7 it is one of anti-avoidance and the closing down of perceived tax loop-holes;

– see *Gray's Timber Products v HMRC* [2010] UKSC 4, per Lord Walker at [5]-[7] and Lord Hope at [56].

65 Part 7 may be expected to give rise to rational outcomes, exempting from tax and imposing charges to tax in accordance with the broad statutory purposes identified. With that guidance from the Supreme Court in mind, it would be a

particularly odd result if in a case which does not involve any aspect of encouraging employee participation in the relevant enterprise, and which does not involve any realistic incentives contingent on satisfactory performance (long term or otherwise), Part 7 were instead to have the result that tax avoidance is not eliminated, but on the contrary is facilitated.

66 Provision of the shares in S1 and S2 was, in each case, nothing more than the mechanism for delivery of bonuses. Bonuses were being paid as rewards for employment and (in relation to two employees) pursuant to contract. As *PA Holdings* demonstrates, that was apt to engage section 62 and the conventional charge on earnings. Part 7 had nothing to do with it.

67 The decision in *PA Holdings* is enough to dispose of this appeal but, if it is necessary to do so, what was described by Moses LJ as 'familiar anti-avoidance jurisprudence' gives rise to the same result. He drew attention to the principles summarised by Arden LJ in *Astall v Revenue and Customs Commissioners* [2009] EWCA Civ 1010, [2010] STC 137:

> The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. [32]

68 In the words of Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46, at [35]:

> The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically. (cited by Arden LJ at [36]).

69 In the present case, the insertion of the steps which created the form of (ultimately) distributions in liquidations did not deprive the payments of their character of emoluments. It is necessary to consider the overall effect of the

scheme; even though it comprised a number of elements they were intended to operate together. As Moses LJ described it in *PA Holdings*, at [68]-[70]:

> The award of the shares and the declaration of the dividend were, in reality not separate steps but the process for delivery of the bonuses.
>
> This is the approach which led to the conclusion that the transfer of platinum sponge to directors as a bonus was "earnings" and not "payments in kind" for the purposes of the Social Security (Contributions) Regulations 1979. The court looked at the substance of the transaction (see *NMB Holdings Ltd v Secretary of State for Social Security* (2000) 73 TC 85, 125). The arrangements whereby the directors could immediately sell the platinum sponge for cash, to the bank which held the sponge, stamped the transaction as something different from "payments in kind" exempt from the Social Security legislation (see the endorsement of the court's approach and conclusion by Lord Hoffmann in *MacNiven* [68]).
>
> Similarly in *DTE Financial Services Limited v Wilson* (2001) 74 TC 14, a composite transaction consisted of three stages, the purchase by an employer of a contingent reversionary interest in a trust fund in a sum equivalent to the intended bonus, the assignment of that interest to the employee and the payment of the cash sum by the trustee when the interest fell into possession. Viewed, as Jonathan Parker LJ put it, "through Ramsay eyes", the company decided that its employee should have a £40,000 bonus and the employee got that bonus [41]. 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.

70 Mr Brennan accepted, however, that he could not point to any *Ramsay* type case in which all the events that in fact occurred had not been envisaged at the outset, but he argued that the unplanned liquidation did not alter the overall operation of the scheme because, at the end, the Employees got what it was intended that they should to get.

71 The Appellant has argued that under Part 7, where tax avoidance is relevant to a calculation or to an exemption, the statutory regime will say so. Such an approach begs the question whether Part 7 was ever engaged in the first place. The Appellant does not address the point that there was a reward for services in employment in the first place, nor the underpinning of the decision in *PA Holdings* that there is an important distinction between the reward for employment and the mechanism for delivering it.

72 The Tribunal should not take a step-by-step approach to arrangements designed and intended to operate as a whole, which is an approach the parties themselves did not intend or take. It can make no difference of principle that the Appellant started with a dividend scheme and then altered the arrangements in response to legislative action, and decided to liquidate the companies so as to achieve the same result.

73 Tax (and NIC) is payable by reference to the date of payment. This is governed by section 18 (receipt of money earnings) and section 686 (PAYE). Accordingly, although it may have been earlier, Rules 2 and 3 have the effect that the very latest date at which the payments fell into charge (for the purposes of tax, PAYE and NIC) is the date on which the Appellant awarded the shares and in doing so undertook the commitment to operate the (relevant) share scheme in favour of the Employees. The Appellant wanted to reward its employees with bonuses. It set up arrangements to do so and put cash into the arrangements. The arrangements operated, and the directors got cash.

74 With regard to section 42 of the Companies Act 1985 and the failure by S1 to file notice of its change of articles, Mr Brennan submitted that because its share structure was intrinsic to the nature of a company, any alteration of that kind is necessarily relied on by the company where dealings with its shares are concerned. Although he accepted that HMRC had not been prejudiced by the omission to file notice of the change, Mr Brennan argued that the company was

nonetheless not entitled to rely on it as against them because the Revenue did not know of it at the material time i.e. when the shares in S1 were allocated.

Conclusions-

5 *Section 42 of the Companies Act 1985*

75 Taking this last point first, we are of the view that the wording of the section made it plain that the purpose of this provision was to protect persons dealing with a company from prejudice resulting from alterations to the company's statutes which they had had no means of knowing had taken place.

10

76 In this instance, the Revenue accept that they have in fact suffered no prejudice on account of S1's failure to give official notice of the change in its articles. In our interpretation of the section, the "material time" when the knowledge or otherwise of the matter is relevant is the time at which the liabilities 15 under appeal were determined - which, it is common ground, were substantially after the Revenue had acquired actual knowledge of the position. To accept that the "material time" referred to in section 42(1) was that contended for by Mr Brennan – i.e. when the shares were allocated - would be to give the provision a narrow construction which appears to us to be unrelated to the purpose which it is 20 evidently intended to serve. We therefore reject the Crown's submission with regard to section 42.

Sections 18 and 686 of the 2003 Act

77 These provisions, if applicable to the facts of the case, effectively pre-empt the 25 issues which arise in connection with the share dividend schemes. The Rules given by these sections lay down the times at which earnings consisting of money are to be treated for tax purposes as received. The first option is when a payment is *made* of or on account of the earnings; the second is when the employee becomes *entitled* to payment of or on account of the earnings; and the third option 30 relevant here is when sums on account of the earnings are *credited* in the

company's accounts or records (whether or not there is any restriction on the right to draw the sums).

78 The question therefore arises: was the relevant part of the Employees' bonuses which went to finance the shares awarded to them in S1 and S2 paid, credited or the entitlement to it established before the Employees' interest in the shares was created? Our findings of fact above make it clear that the regime which the Employees, as directors of the Appellant, had put in place for themselves in their capacity as employees was to agree a precise division of profits between them. The Appellant has accepted – paragraph 10 - that these allocations were decided at the beginning of each accounting year.

79 The proper inference to be drawn from these facts is that these allocations were based on a decision made by the four Employees as directors of the Appellant, in regard to themselves as employees, and which created a contractual entitlement each enjoyed as an employee *vis-a-vis* the Appellant to the corresponding share of final profits in that year. The allocations of profit were thus due to the Employees as the fruits of their employment and were received in that capacity, but it was up to each Employee to decide to direct his entitlement to ascertained sums of money (that is, either a part or the whole of the total to which he was entitled) to whatever destination he chose for it: the employee benefit trust, a donation to charity, a cash payment to his bank account, and so on.

80 The accounting year in question in this case ended on 28 February 2004. An interim distribution of profits by way of bonuses had taken place in November 2003 – paragraph 9 – in accordance with the agreed allocation and it is clear that, as the final figures for the year came in, each individual Employee was entitled to draw his share down in whatever way he chose.

81 By early January 2004 – paragraph 11 - the joint decision had tentatively been made to divert some part of these entitlements into the share dividend scheme under appeal, but no precision had yet been given to that intention - paragraphs 12, 13 and 16. By 19 January, however, both the overall sum to be drawn from

the profit pool had been ascertained and the actual amount that each Employee would put into S1 was settled – paragraph 18. The position with regard to S2 was that the total to be drawn down from the bonus pool was ascertained on 16 February – paragraph 21 – and the exact allocations within S2 were fixed on 25 February – paragraph 22. The formal awards of the shares in the two companies were declared on 25 February and 12 March for S1 and S2 respectively.

82 The nature of these transactions derived from the underlying bonus pool in respect of which each Employee already had an established entitlement is confirmed by the note in the Appellant's accounts that "staff costs included £24,000,000 in respect of performance related benefits provided to key employees" and the precise monetary valuation of the share awards of the directors' emoluments – paragraphs 27 and 28.

83 We conclude therefore that the Employees had become entitled to the monetary sums allocated to them for the shares in S1 and S2 no later than 19 January and 25 February 2004 respectively and were liable to income tax on them as earnings under Rule 2. The evidence is not precise as to how or when the monies in question were credited to the account of each Employee, but it cannot have been later than the dates mentioned in connection with Rule 2 for the sums to have been available for the schemes; there was therefore a liability established pursuant to Rule 3(a) no later than 19 January and 25 February 2004. It is common ground that liability for NIC is then the same in either case.

Ramsay

84 Both parties addressed the Tribunal on the basis of the *Ramsay* and *Furniss* jurisprudence and we need to consider its relevance in the present context. It is conceded that this was indeed a tax avoidance scheme and Mr Brennan contended that, if Part 7 had on a proper interpretation of the facts been brought into play, it could be analysed in *Ramsay* terms, and he argued that the insertion of the steps which created the form of distributions in the liquidations did not deprive the payments of their character of emoluments. As we have concluded, the sums of

money which were diverted into S1 and S2 did indeed have the character of emoluments and earned income: does it therefore follow that we are at liberty to look at the entirety of the events that occurred from the setting up of the companies to their liquidation, and reach a conclusion relating to the character of the sums received in the liquidation?

85 It is true that there was throughout a "commercial unity" to the operation. It was designed as a single operation for a specific purpose and, albeit that it was constrained to adopt different means to attain the objective of conveying part of the Employees' bonuses to them than those at first envisaged, the course of events in S1 and S2 throughout did not change their character. Their character was that of a mechanism or mechanisms designed to deliver earnings to which the Employees had become entitled. Why then should it not be subject to the composite transaction analysis developed in this line of jurisprudence?

86 It is no disrespect to the careful submissions of counsel on this issue if we decline to be drawn into debating at any length the still evolving basis of this line of authority. The conclusions which we have already reached, and which we reach under the next heading, make it unnecessary to go beyond the observation - hopefully not too simplistic - that the cases do not on our reading of them include any example of a composite transaction or series of transactions in which a decisive feature of them was not at least envisaged as a possibility at the outset.

87 Thus, as in *Scottish Provident*, contingencies which might or might not occur may be inserted into the overall scheme without it thereby escaping the *Ramsay* analysis. As Lord Nicholls noted at [23]:

> We think that it would destroy the value of the *Ramsay* principle of construing provisions such as section 150A(1) of the 1994 Act as referring to the effect of composite transactions if their composite effect had to be disregarded simply because the parties had deliberately introduced a commercially irrelevant contingency, creating an acceptable risk that the scheme might not work as planned. We would be back in the world of artificial tax schemes, now equipped with anti-*Ramsay* devices. The composite effect of such a scheme should be considered as it was intended to operate and without

> regard to the possibility that, contrary to the intentions and expectations of the parties, it might not work as planned.

88 There is no evidence that the possibility of liquidation was even considered in the instant cases, still less that it was factored into the schemes as an anti-*Ramsay* device. It was, on the contrary, the result of a salvage operation when the legislation in point was changed in the budget of 2004. The liquidation was genuinely unforeseen, unplanned, and indeed unwanted until the point was reached at which it was recognised as the only way out the situation offering a chance of saving the schemes' purpose of conveying the earnings to the Employees free of tax. As Mr Brennan accepted, there seems to be no reported instance in which such an unexpected and unplanned change of course has featured in a *Ramsay*-analysed composite transaction. It must be for a higher jurisdiction than this to make that further step in the application of the *Ramsay* doctrine, if indeed it is to be made at all.

Part 7 of the 2003 Act

89 The case for the application of part 7 of the 2003 Act was forcefully pressed by Mr Ghosh, on the basis principally that the facts would admit of no other course. The case, he said, was inevitably one in which the Tribunal must recognise that the Employees had a distinct legal character as such and, until awarded the shareholdings they received in S1 and S2 by the Appellant, they had nothing. They therefore had received shares, or a beneficial interests in shares, and must be taxed under the provisions of Part 7 designed explicitly for such a case.

90 Although we have found that the Employees were entitled to monetary amounts, and that those amounts had been credited to them in the books of the Appellant before an interest in the shares of S1 and S2 arose, we must address this alternative argument on the basis that those findings are unable to be sustained. We look principally for guidance to the very recent decision of the Court of Appeal in *PA Holdings*. There, in a scheme a good deal more complex that that

in this case, the taxpayer employer had wished to pay its employees discretionary annual bonuses. The company's employees had no contractual right to the bonuses, though a clear expectation that they would be paid in accordance with criteria which had been published to them.

91 The taxpayer company had devised a scheme under which the bonus pool available for all the employees was transferred to a company, in whose shares a trustee was authorised to grant a beneficial interest to employees and to pay dividends from the shares to them; the shares were to be transferred to the employee at the end of a defined period. Employees who had left the employer's service before payment of the dividend forfeited their beneficial interest in the shares and thus the dividend that went with it. It was found as a fact that the dividend payments received by the employees were received by them as emoluments in their hands, representing earnings for work done as employees. The finding however was overlaid by a further finding that the receipts were also dividends in the employees' hands and should be taxed as such.

92 Moses LJ, giving the unanimous judgment of the Court, recognised the following principles:

- In every case, the question must be asked whether the payment is in return for acting as or being an employee [35].
- The court is not restricted to the legal form of the source of the payment but must focus on the character of the receipt in the hands of the recipient.
- The paramount question is always one of interpretation of the statutory provision in point.
- The appraisal of the facts must be realistic and the construction of the statute purposive.
- Once it is concluded that the payments in the hands of the recipients are earnings from employment, there is no room for the application of

statutory provisions which characterise objectively different payments differently.

- The award of the shares and the declaration of the dividend were, in that case, in reality not separate steps but the process for delivery of the bonuses.

93 It is difficult to see how this case could be distinguished from *PA Holdings*. The sums eventually paid in the liquidation to the Employees were, to all intents and purposes, the same sums as had been paid into the two companies by the Appellant at the outset – paragraph 35. The Employees received what they expected to receive, and from the Appellant's viewpoint the bonuses had been distributed in accordance with the agreed amounts drawn down from accumulated profit in order to capitalise the companies. It is unnecessary for us to express any view on the purposes for which the provisions of Part 7 of the 2003 Act were enacted, because it suffices to say that in these circumstances they cannot apply to a situation which is already covered by sections 18 and 686 of the Act.

94 A word should be added about the fact of the investment activity undertaken in the companies. We have recorded what actually took place – paragraphs 29 to 31 - and it remains to evaluate it. Our assessment of the investment activity that took place was that it was essentially cosmetic, and that no significant risk was ever contemplated in regard to it.

95 That is because: (i) the capital invested was to be there for two or three months at the most, and there could be no real prospect in that time frame of increasing the sums invested without the risk of significant loss, which would have defeated the object of the whole exercise to pay fixed dividends – paragraphs 15 and 29; (ii) Mr Haworth was very anxious about how it was to be done and felt under greater pressure in doing it than he did in regard to his other responsibilities with the Appellant, where he was responsible of course for very much greater amounts being invested – paragraph 31; (iii) the three others were said to be broadly comfortable with the investments, but they debated them regularly, evidently

keeping a close eye on what were in effect their bonuses – also paragraph 31; (iv) all the Employees took cash in the liquidation, suggesting that they had never had any real interest in investment as such, and no further use was made of the companies – paragraphs 31 and 36. The fact of the money being invested by S1 and S2 does not therefore change the fundamental analysis of what took place, and it does not alter the conclusion that S1 and S2 were merely money-box companies serving an essentially mechanical purpose.

96 For these reasons, the appeals do not succeed. No applications were made as to costs, but the parties are at liberty to make an application within thirty days of the release of this decision.

Appeal rights

97 This document contains the 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 no 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.

MALACHY CORNWELL-KELLY
TRIBUNAL JUDGE

RELEASE DATE: 16 July 2012