[2016] UKFTT 487 (TC)

TC05237

Appeal number: TC/2014/01035
TC/2014/01832

INCOME TAX, NATIONAL INSURANCE CONTRIBUTIONS – award of bonuses in the form of loan notes – whether those loan notes were restricted securities for the purposes of Part 7 of ITEPA – no – whether employees to be treated as receiving cash – yes – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

CYCLOPS ELECTRONICS LIMITED **Appellants**
GRACELAND FIXING LIMITED

- and -

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

TRIBUNAL: JUDGE JONATHAN RICHARDS

Sitting in public at The Royal Courts of Justice, Strand, London on 6 to 10 June 2016

Michael Sherry, instructed by Charterhouse (Accountants) LLP, for Cyclops Electronics Limited

Michael Sherry instructed by Haines Watts, Accountants, for Graceland Fixing Limited

Malcolm Gammie QC and Laura Poots, instructed by the General Counsel and Solicitor to HM Revenue & Customs, for the Respondents

© CROWN COPYRIGHT 2016

DECISION

1. These are two appeals which were heard together because they give rise to similar questions of fact and law. There are, in addition, several hundred appeals which also raise similar issues which have been designated as "related cases" under Rule 18 of the Tribunal Rules.

2. The two appellant companies who I will refer to as "Cyclops" and "Graceland" undertook a series of transactions which resulted in Daniel Yodaiken, Paul Darrington and Vivien Brown (collectively the "Employees") receiving loan notes (collectively "Loan Notes"). HMRC argue that these transactions gave rise to an obligation on the part of Cyclops and Graceland to account for national insurance contributions ("NIC") and to pay income tax under the pay as you earn system ("PAYE"). HMRC have made determinations under Regulation 80 of the Income Tax (Pay as You Earn) Regulations 2003 (the "PAYE Regulations") and under s8 of the Social Security (Transfer of Functions etc) Act 1999 as summarised in the table set out below. It is against those determinations that the appellants appeal.

Date	Company	Type of decision	Relevant tax year	Amount
17 April 2009	Graceland	Regulation 80	2004-05	£190,000.40[1]
17 April 2009	Graceland	Section 8	2004-05	£45,309.54[2]
17 April 2009	Graceland	Section 8	2004-05	£20,236.45[3]
31 March 2009	Cyclops	Regulation 80	2004-05	£160,000.00
31 March 2009	Cyclops	Section 8	2004-05	£55,871.80

3. It is convenient at this stage to set out an overview of the parties' respective positions which I will consider in more detail later in this decision. In essence:

(1) The appellants argue that, because of the existence of a forfeiture provision in the terms of the Loan Notes, those loan notes were "restricted securities" for the purposes of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). Therefore, by virtue of s425 of ITEPA (and corresponding provisions of NIC legislation) there was no income tax or NIC payable on the Employees' receipt of the Loan Notes.

[1] HMRC accept this has been wrongly calculated and seek to uphold it as to only £98,527.21

[2] HMRC accept this has been wrongly calculated and seek to uphold it as to only £23,919.54

[3] HMRC accept this has been wrongly calculated and seek to uphold it as to only £11,960.46

(2) The Loan Notes at issue in Graceland's appeal were redeemed in 2004-05. Graceland argues that the detailed operation of Part 7 of ITEPA means that there was no income tax (or NIC) payable on this redemption.

(3) HMRC argue that because, inter alia, there was no business purpose for the inclusion of the forfeiture provision in the Loan Notes' terms, the effect of the decision of the Supreme Court in *UBS AG v HMRC ("UBS"); Deutsche Bank Group Services (UK) Ltd v HMRC* ("*Deutsche Bank*") [2016] STC 934 is that the Loan Notes were not restricted securities at all. Therefore, Part 7 of ITEPA did not apply (so s425 of ITEPA could not prevent an income tax and NIC liability arising when the securities were transferred to the Employees). Therefore, the transfer of the Loan Notes to the Employees should be treated for PAYE and NIC purposes in the same way as a payment of cash equal to the principal amount of the Loan Notes.

(4) In relation to Graceland's appeal, HMRC argued that even if the Loan Notes were restricted securities (so that Part 7 of ITEPA did apply), Part 7 did not operate in the way that Graceland asserted it did and both income tax and NIC were payable on redemption.

Evidence

4. HMRC did not rely on witness evidence. For Graceland and Cyclops, I had evidence from the following witnesses of fact:

(1) For Cyclops, from Daniel Yodaiken, director of Cyclops, and from James Edmond, a partner in Charterhouse (Accountants) LLP who advised Cyclops on the transactions

(2) For Graceland, from Paul Darrington and Vivien Brown, directors of Graceland, and from Stephen Edwards, a partner in Haines Watts who advised Graceland on the transactions.

5. Mr Gammie cross-examined all of these witnesses. I considered all of the witnesses to be reliable and honest.

Findings of fact – Cyclops

The relevant transactions

6. In this section, I will set out more detail on the transactions involving loan notes in Cyclops's appeal. In later sections, I will supplement these findings with more detailed findings as to the background and circumstances surrounding those transactions.

7. On 27 July 2004, Davissa Ltd was incorporated in Scotland. Its sole director was Mr Yodaiken. It issued 100,000 ordinary shares of £1 each to Mr Yodaiken of which 1,000 were fully paid up.

8. On 26 August 2004, Davissa resolved to increase its share capital by the creation of 100 million preference shares of 10 pence each and adopted new Memorandum and Articles of Association.

9. On 1 September 2004, Davissa resolved to issue £400,000 in nominal amount of loan notes ("Davissa Loan Notes") to Cyclops. For its part, Cyclops resolved to subscribe £100,000 for Davissa Loan Notes. The subscription and issue took place on the same day and Cyclops paid Davissa £400,000 as consideration for the issue of the Davissa Loan Notes.

10. On 24 September 2004, Cyclops resolved to transfer the Davissa Loan Notes to Mr Yodaiken as to £150,000 in nominal value as consideration for services provided to Cyclops in the period of account ended on 31 March 2004 and as to £250,000 in consideration of services provided in the period of account ended 31 March 2005.

11. On 18 April 2005, Davissa gave notice to Mr Yodaiken that it would be converting the Loan Notes into preference shares. On 26 April 2005, Davissa converted the Davissa Loan Notes into 40,000 preference shares of 1p each.

Material terms of the Davissa Loan Notes

12. The Davissa Loan Notes were constituted by a loan note instrument, executed as a deed, dated 1 September 2004 (the "Davissa Loan Note Instrument").

13. The principal amount of the Davissa Loan Notes was £400,000 and the Davissa Loan Notes carried interest at the rate of 1% per annum. The Davissa Loan Notes were unsecured debt obligations of Davissa and were expressed to rank pari passu with Davissa's other unsecured obligations.

14. Clause 2.7 of the Davissa Loan Notes provided as follows:

> Except as set out in clause 4.2, clause 4.3 and clause 6 the Loan Notes have no fixed term by which they must be redeemed but may be redeemed in whole or in part at such time or times as the Company[4] may in its absolute discretion determine by payment of the Redemption Price.

The "Redemption Price" for these purposes was defined as £10 for every £10 in nominal amount of Davissa Loan Notes.

15. Clause 4.2 of the Davissa Loan Note Instrument set out an exception from the general rule that the holder of the Davissa Loan Notes had no right to require redemption of those loan notes as follows:

> A Noteholder may, by giving written notice during the First Early Redemption Period in accordance with the form set out in the second Schedule to this instrument require some or all of his £10 Loan Notes

[4] The term "Company" in the Davissa Loan Note Instrument was defined as meaning Davissa

> to be redeemed at the Redemption Price within the period of seven days following receipt of the notice by the Company.

16. The "First Early Redemption Period" was defined as "the period of 40 days commencing 30 days after the date of issue of the Loan Note". Therefore, given that the Davissa Loan Notes were issued on 1 September 2004, the First Early Redemption Period began on 1 October 2004 and ended on 9 November 2004.

17. Clause 4.3 set out another exception from the general rule in Clause 2.7 in the following terms:

> A Noteholder may, by giving written notice during the Second Early Redemption Period in accordance with the form set out in the second Schedule to this instrument require some or all of his £10 Loan Notes to be redeemed at the Redemption Price by the tenth business day following expiry of the Second Early Redemption Period.

18. The "Second Early Redemption Period" was defined as "the period commencing on the date of issue of a Loan Note and concluding on the last Business Day of the period of 90 days following the date of issue of the Loan Note". Therefore, the Second Early Redemption period ran from 1 September 2004 to 30 November 2004.

19. Both Clause 4.2 and Clause 4.3 set out a latest date by which the Davissa Loan Notes were to be redeemed following notice given by a noteholder requiring redemption. Neither clause set out an earliest date. Therefore, if a noteholder gave notice of redemption, Davissa was entitled to pay the Redemption Price immediately (if it chose to), although a noteholder could only require payment by the latest date stipulated in Clause 4.2 or Clause 4.3.

20. Clause 6 of the Davissa Loan Note Instrument permitted a noteholder to require early redemption of the Davissa Loan Notes following the occurrence of certain events relevant to the creditworthiness of Davissa (for example if Davissa were declared insolvent or went into liquidation). It was common ground, however, that none of the relevant "trigger events" occurred and therefore this provision is not considered in any more detail.

21. Clause 5 of the Davissa Loan Note Instrument permitted Davissa to convert the Davissa Loan Notes into preference shares. I will not set out the relevant clause in detail since, although the Davissa Loan Notes were ultimately converted into preference shares, that took place in a year of assessment that is not in issue for the purposes of this appeal.

22. Clause 9.1 of the Davissa Loan Note Instrument contained the forfeiture provision that is of central relevance in this appeal. It provided as follows:

> Notwithstanding any other provisions of this instrument or the conditions to which these Loan Notes are subject, in the event of the death of Daniel Yodaiken of [address] during the period of 365 days following the date first above mentioned (being the date this instrument was made) all Loan Notes that are then in issue and have

> not been redeemed, converted or cancelled, shall without compensation for the then registered Noteholders be immediately registered or re-registered with Cyclops Electronics Limited of [address] as the sole registered holder of the Loan Notes and the Register shall be amended as necessary to give effect to this Clause…

Events leading up to, and circumstances surrounding, the Cyclops transactions

23. At all material times, Cyclops carried on a business of buying and selling electronic components which are either obsolete or difficult to find. Because of the nature of those components there is often a considerable interval between Cyclops purchasing them and being able to sell them to a buyer. The amount of profit that it makes is therefore difficult to predict.

24. Mr Yodaiken was, at all material times, the sole shareholder and director of both Cyclops and, following its incorporation, Davissa. When making decisions about Cyclops's business, Mr Yodaiken would consult with other employees of Cyclops, for example Stuart Mellor who was Cyclops's financial controller. However, the final decision on such matters was always made by Mr Yodaiken.

25. Mr Yodaiken held regular meetings with Charterhouse to discuss tax planning options. At one such meeting, on 10 October 2003, Charterhouse outlined a tax planning opportunity involving the payment of a bonus in the form of loan notes. Some further meetings and discussions took place. Mr Yodaiken considered the profitability of Cyclops in its accounting period ended on 31 March 2004 and its anticipated profitability in its accounting period ending 31 March 2005, Cyclops's likely cash requirements and other matters of tax planning. He discussed those matters with Mr Mellor. On 21 May 2004 Mr Yodaiken took a decision in principle to proceed with planning involving the provision of bonuses to him in the form of loan notes. However, by that date he had still not decided how much of a bonus should be paid in this form.

26. On 24 June 2004, Mr Yodaiken, on behalf of Cyclops, signed an engagement letter with Charterhouse under which Charterhouse agreed to provide "advice…in connection with the provision of bonuses in a form anticipated to minimise the amount of Income Tax and National Insurance payable in respect of the bonuses". Section 5.2 of that engagement letter stated that total fees would be £48,000 plus VAT for work on the specific bonus proposal under consideration. Of this £13,500 plus VAT was payable on signing of the engagement letter, a further £16,500 plus VAT would be due following a satisfactory meeting with tax Counsel with the remainder being payable at a later stage. A satisfactory meeting with tax Counsel took place on 14 July 2004 and, from this point, it was pre-ordained that the transactions described at [7] to [10] would take place. Those transactions were devised by Charterhouse and Mr Yodaiken (in his capacity as director and shareholder of Cyclops and Davissa) ensured that requisite board and shareholder resolutions of those companies were passed to enable them to take place.

The purpose and effect of the arrangements

27. In July 2004, Cyclops was considering starting a new business venture that would focus on purchasing excess inventory of its customers. The catalyst for this was that at the time there was a large package of components on the market that Cyclops was considering purchasing. If Cyclops were to start such a business, it would involve a significant cash investment which would be tied up in stock for potentially long periods. Mr Yodaiken therefore concluded that, in order that it would not affect Cyclops's existing business, it was desirable for any new business to be conducted in a separate company.

28. In his witness statement, Mr Yodaiken said that his understanding was that the loan note proposal would enable Cyclops to obtain a deduction for corporation tax purposes equal to the amount of bonuses provided by way of loan notes. In his oral evidence, he accepted that the proposal enabled income tax and NICs to be saved, but he thought that the saving was temporary only and that income tax and NICs would be due if and when he received cash from Davissa.

29. Mr Yodaiken was giving evidence as to his recollection of events nearly 12 years ago and, although I have not accepted Mr Yodaiken's evidence set out at [28], I make no criticism of him. Mr Yodaiken is not a tax specialist. It is quite understandable that he would not be able to remember the precise tax analysis of a transaction that was implemented so long ago. Having considered the contemporaneous documentation, I have concluded that, in 2004, it was explained to Mr Yodaiken that the intended effect of the arrangements was to ensure that there was no income tax or NIC liability associated with either the receipt of the Davissa Loan Notes or their redemption. I was shown a note of a telephone conversation at which Mr Yodaiken was present on 18 October 2004 which I considered explained this. Charterhouse's engagement letter of 24 June 2004 also described the arrangement as "minimising" the amount of income tax and national insurance due and did not suggest that the benefit was simply a deferral of the point at which income tax or NICs became due.

30. I have concluded that the predominant purpose for the transactions described at [7] to [10] was to provide Mr Yodaiken with Davissa Loan Notes in such a way that there would be no material income tax or NIC obligation either when he received those loan notes, or when they were redeemed or converted. Cyclops, Charterhouse and Mr Edmond also intended those transactions to give rise to a corporation tax deduction for Cyclops. However, unlike the income tax and NIC results outlined above, the obtaining of a corporation tax deduction was not an end in itself not least since Cyclops could have obtained such a deduction by paying a bonus in cash. I have reached this conclusion partly because Mr Edmond very fairly accepted in cross-examination that it would have been a straightforward matter for Cyclops to obtain a corporation tax deduction by simply paying Mr Yodaiken a bonus in cash and that Charterhouse would not have been able to obtain a fee of £48,000 plus VAT simply in return for providing advice on the deductibility of a cash bonus.

31. Those transactions also had the effect that Mr Yodaiken owned all of the shares in a company, Davissa, that held a material cash sum and which could be used to

undertake the new business of purchasing excess inventory referred to at [27]. That was a welcome effect of the arrangements that coincided with Mr Yodaiken's and Cyclops's business interests at the time. However, it was not the purpose or a main purpose of those arrangements. If Mr Yodaiken's purpose, or Cyclops's purpose was simply to establish and capitalise a new company to undertake the new business, that could have been achieved by Mr Yodaiken receiving cash from Cyclops and applying that cash in subscribing for shares in a new company. The professional fees involved in such a course of action would have been much lower than those paid to Charterhouse as no loan notes with unusual terms, or detailed tax advice, would be needed.

32. There was no business or commercial purpose for including the forfeiture provision in Clause 9.1 of the Davissa Loan Note. That forfeiture provision was commercially irrelevant and designed only to secure the benefit of the tax exemption in s425 of ITEPA. I have reached that conclusion because Mr Yodaiken accepted in cross-examination that he had no independent reason (whether as a director of Cyclops or in his personal capacity) for wanting the forfeiture provision to be included and it was included purely on Charterhouse's advice. Mr Edmond's evidence did not suggest any business or commercial purpose for the forfeiture provision and, in cross-examination, he explained that the forfeiture provision was essential if the planning was to have the desired result (as it was the forfeiture provision that enabled the Davissa Loan Notes to be "restricted securities"). Moreover, there was no evident link between the forfeiture provision and any aspect of the commercial activities of Cyclops, Davissa or Mr Yodaiken.

33. As events transpired, the proposed business idea involving the purchase of excess inventory referred to at [27] did not go ahead. Some thought was given to the possibility of Davissa making loans to an affiliated company in 2004 or buying a house and letting it to Cyclops so that Cyclops could attract new employees with an offer of subsidised accommodation. In addition, consideration was given to implementing an arrangement under which Cyclops traded as an agent for Davissa in some business lines. However, none of these proposals was implemented. Davissa kept the money it received from Cyclops by way of subscription for the Davissa Loan Notes on deposit with a bank continuously from 1 September 2004 when it received those proceeds until 27 March 2006 when it withdrew part of its deposit to make a loan of £350,000 at a commercial rate of interest to Express Electronics Limited, a company that had been demerged from the Cyclops group earlier in 2007.

Mr Yodaiken's ability to secure redemption of the Davissa Loan Notes

34. Mr Edmond advised Mr Yodaiken that he should not make any decision as to what he would do with the Davissa Loan Notes until he received them. On 18 October 2004, Mr Yodaiken took part in a telephone conference call with Mr Mellor and Mr Edmond to discuss Mr Yodaiken's options in relation to the Davissa Loan Notes. The outcome of that meeting was that, since Mr Yodaiken did not have any personal need of the money that Davissa held, he would not exercise his right to require redemption of the Davissa Loan Notes during the First Early Redemption Period or the Second Early Redemption Period. That decision was taken during, or

shortly after, the telephone conversation on 18 October 2004. Therefore, while, as I have noted at [26] some of the transactions with which this appeal was concerned were pre-ordained, the actions that Mr Yodaiken would take following receipt of the Davissa Loan Notes were not pre-ordained.

5 35. When Mr Yodaiken received the Davissa Loan Notes on 24 September 2004, the Second Early Redemption Period was current and the First Early Redemption Period would start a few days later. Mr Yodaiken could, therefore, have issued an immediate notice requiring redemption of the Davissa Loan Notes under Clause 4.3 of the Davissa Loan Note Instrument. Clause 4.3 specified only a latest date by which 10 the Davissa Loan Notes had to be redeemed. Mr Yodaiken could have used his power as sole director and shareholder of Davissa to procure that Davissa redeemed the Davissa Loan Notes earlier than the latest date, or even immediately.

36. By choosing not to require Davissa to redeem the Davissa Loan Notes, Mr Yodaiken, or perhaps more accurately, his estate, would be running a risk if he were 15 to die within the 365-day period specified in the forfeiture provisions as, in that case, the Davissa Loan Notes would cease to be owned by Mr Yodaiken's estate and would be owned by Davissa. Mr Yodaiken could have eliminated any such risk by requiring immediate redemption of the Davissa Loan Notes. He could also have eliminated that risk by procuring that Davissa agreed to an amendment of the Davissa Loan Note 20 Instrument removing the forfeiture provision. By not taking these steps, he (or his estate) were voluntarily running the risk set out above.

37. There were additional methods that Mr Yodaiken could have employed to secure immediate redemption of the Davissa Loan Notes even after the First Early Redemption Period and the Second Early Redemption Period had expired. For 25 example:

(1) He could have procured that Davissa agreed to amend the terms of the Davissa Loan Notes so as to make them immediately redeemable.

(2) As the sole shareholder of Davissa, he could have put Davissa into liquidation, thereby triggering his right to request early redemption of the 30 Davissa Loan Notes under Clause 6 of the Davissa Loan Note Instrument referred to at [20].

Findings of fact – Graceland

Transactions effected – Graceland

38. The transactions to which Graceland was party involved Graceland subscribing 35 for loan notes in two companies, PJD Investments Limited ("PJDI") and VJB Investments Limited ("VJBI") and transferring those loan notes to its two directors, Mr Darrington and Ms Brown.

39. On 20 May 2004, both PJDI and VJBI were incorporated in England and Wales. Both companies had a share capital of £100,000 divided into 100,000 shares of £1 40 each. Mr Darrington was appointed the sole director of PJDI and subscribed for 100

£1 ordinary shares in PJDI. Ms Brown was appointed as the sole director of VJBI and subscribed for 100 £1 ordinary shares in VJBI.

40. On 29 June 2004, PJDI resolved to approve the creation of up to £173,330 loan notes to be issued to Graceland ("PJDI Loan Notes") and VJBI resolved to approve
5 the creation of up to £86,670 of loan notes also to be issued to Graceland ("VJBI Loan Notes"). For its part, Graceland resolved to subscribe for £173,330 in nominal amount of PJDI Loan Notes and £86,670 nominal amount of VJBI Loan Notes.

41. On 30 June 2004, PJDI issued £173,330 of PJDI Loan Notes to Graceland and VJBI issued £86,670 of VJBI Loan Notes to Graceland. Graceland paid the
10 subscription price due to PJDI and VJBI.

42. On 13 July 2004, Graceland resolved to transfer its holding of PJDI Loan Notes to Mr Darrington:

(1) As to a nominal value of £80,000 as consideration for services provided to Graceland in the period of account ended on 30 November
15 2003; and

(2) As to a nominal value of £93,330 as consideration for services provided to Graceland in the period of account ended 30 November 2004.

43. Also on 13 July 2004, Graceland resolved to transfer its holding of VJBI Loan Notes to Ms Brown:

20 (1) As to a nominal value of £40,000 as consideration for services provided to Graceland in the period of account ended on 30 November 2003; and

(2) As to a nominal value of £46,670 as consideration for services provided to Graceland in the period of account ended 30 November 2004.

25 44. On 10 September 2004, Mr Darrington gave notice to PJDI requiring PJDI to redeem £155,000 in nominal amount of PJDI Loan Notes by 13 October 2004. On 12 October 2004, PJDI paid Mr Darrington redemption proceeds of £155,000.

45. On 10 September 2004, Ms Brown gave notice to VJBI requiring VJBI to redeem £60,000 of Loan Notes by 13 October 2004. On 12 October 2004, VJBI paid
30 Ms Brown redemption proceeds of £60,000.

Material terms of the PJDI Loan Notes and the VJBI Loan Notes

46. The PJDI Loan Notes and the VJBI Loan Notes were constituted by loan note instruments (the "PJDI Loan Note Instrument" and the "VJBI Loan Note Instrument") dated 30 June 2004. The terms of the PJDI Loan Notes and VJBI Loan Notes were in
35 all material respects identical to those of the Davissa Loan Notes set out at [12] to [22] above subject to the following differences:

(1) Both sets of loan notes carried interest at 0.75% per annum of their nominal amount.

(2) The First Redemption Period (under both the PJDI Loan Notes and the VJBI Loan Notes) ran from 30 July 2004 to 7 September 2004. The Second Early Redemption Period under both sets of Loan Notes ran from 30 June 2004 to 28 September 2004.

5 (3) The equivalent forfeiture provision in the PJDI Loan Note Instrument to Clause 9.1 of the Davissa Loan Note Instrument (referred to at [22] above) referred to a death of Mr Darrington in the period of 365 days after the date of the PJDI Loan Note Instrument and provided, that if that occurred, the PJDI Loan Notes would be registered, or re-registered, with 10 Graceland.

(4) The equivalent provision in the VJBI Loan Note Instrument to Clause 9.1 of the Davissa Loan Note Instrument (referred to at [22] above) referred to a death of Ms Brown in the period of 365 days after the date of the VJBI Loan Note Instrument and provided, that if that occurred, the 15 VJBI Loan Notes would be registered, or re-registered, with Graceland.

Events leading up to, and circumstances surrounding, the Graceland transactions

47. At all material times, Graceland's main business was the installation of precast concrete floors on construction sites. It also installs fall protection systems to stop 20 workers on those sites from falling when they are working at height. Mr Darrington, sometimes working with others, invented a number of the products that Graceland installs and those are, in a number of cases, protected by patent registrations. Mr Darrington holds two-thirds of the shares in Graceland and Ms Brown holds one-third of those shares. Mr Darrington and Ms Brown were at the relevant times the only 25 directors of Graceland.

48. Graceland obtains general accounting advice from Haines Watts. Its principal contact at Haines Watts was Graham Goss and at some point prior to 9 March 2004, Mr Goss explained to Mr Darrington and Ms Brown that, if Graceland provided them with a bonus in the form of a loan note containing a forfeiture provision, there was a 30 prospect that the bonus would not be subject to PAYE or NICs. On 9 March 2004, Mr Goss introduced Mr Darrington and Ms Brown to Stephen Edwards who explained the idea in more detail.

49. Mr Darrington and Ms Brown understood that the object of the planning was to enable them to receive bonuses in a form that were not subject to NIC or income tax. 35 On 22 April 2004, Graceland entered into an engagement letter with Haines Watts under which Haines Watts was to receive 10% of the bonus to be provided (plus VAT) in instalments. The first instalment of £10,000 plus VAT was payable on signing of the engagement letter. A further £7,500 plus VAT was payable if Counsel confirmed the accuracy of Haines Watts's analysis of the tax treatment of the 40 proposal. The balance was to be payable when the tax treatment of the bonuses was finalised. By the time Graceland entered into this engagement letter (which committed Graceland to paying at least £10,000 plus VAT in professional fees), Mr Darrington and Ms Brown had agreed that the proposal would be implemented and that, in total

Graceland would provide them with £250,000 in nominal amount of loan notes. The transactions described at [39] to [43] were devised by Haines Watts pursuant to that engagement letter.

50. On 7 May 2004, a satisfactory conference with Counsel took place. From this point, there was no practical likelihood that the steps outlined at [39] to [43] would not take place and those steps were pre-ordained from that point. On 13 May 2004 and 24 June 2004, Stephen Edwards sent Mr Darrington and Ms Brown documents to be signed to implement the proposal.

The purpose and effect of the arrangements

51. Both Mr Darrington and Ms Brown accepted that the object of the planning was to ensure that they received bonuses in a form that was not subject to NICs or PAYE.

52. At the time, Mr Darrington had a number of ideas for inventions that might conceivably be capable of obtaining patent protection. Developing those ideas and exploiting them would involve the expenditure of money. Those ideas ultimately did not proceed and Mr Darrington accepted in cross-examination that it was quite possible that they had been abandoned before PJDI received any cash from Graceland as consideration for the issue of the PJDI Loan Notes. At all material times PJDI simply held the proceeds of issue of the PJDI Loan Notes on deposit with a bank (drawing down on that deposit to fund redemption of those loan notes). I did not consider, therefore, that Mr Darrington, PJDI or Graceland ever formed an intention that PJDI would use the proceeds of issue of the PJDI Loan Notes in a commercial venture.

53. Similarly, Ms Brown did not suggest that, at the time it received money from Graceland, VJBI had any intention of using that money in a commercial venture. There was some brief discussion of the possibility of VJBI purchasing cars and leasing them to Graceland, but that proposal did not go ahead. VJBI also held the proceeds of issue of the PJDI Loan Notes on deposit with a bank, drawing down on that deposit to fund the partial redemption that Ms Brown requested. In 2007, VJBI decided to acquire a property investment business, bought a property (funded in part with cash that it took off deposit) and let that property to a tenant.

54. Mr Darrington, Ms Brown and Mr Edwards all variously accepted in cross-examination that the sole purpose of the forfeiture provision in the VJBI Loan Notes and the PJDI Loan Notes was to enable those loan notes to constitute "restricted securities" which was essential if the tax planning was to achieve its desired object. Even if they had not made those candid admissions, I would have reached the same conclusion as I was not satisfied that there was any link between the inclusion of the forfeiture provisions of the VJBI Loan Notes or PJDI Loan Notes and any business carried on either by Graceland, VJBI, PJDI, Mr Darrington or Ms Brown. There was, therefore, no independent business or commercial purpose for including the forfeiture provision in those loan notes and the forfeiture provision was commercially irrelevant and designed only to secure the benefit of the tax exemption in s425 of ITEPA.

The ability of Mr Darrington and Ms Brown to secure redemption of their respective holdings of loan notes

55. Mr Darrington and Ms Brown were advised that they should not make any decision as to what they should do with their respective holdings of loan notes until they received them. On 13 August 2004, both Mr Darrington and Ms Brown had meetings with Mr Goss and Mr Edwards to discuss their options in relation to their loan notes. Following those meetings, Mr Darrington decided to request redemption of £155,000 of his PJDI Loan Notes and Ms Brown decided to request redemption of £60,000 of VJBI Loan Notes. Mr Darrington and Ms Brown made their decisions at, or shortly following, the meeting on 13 August 2004. Therefore, while I have noted at [50] that certain aspects of the transaction were pre-ordained, it was not pre-ordained that, from the time at which they received their Loan Notes, they would request redemption of them in the manner they did.

56. Both PJDI and VJBI duly paid the redemption proceeds due. Following those redemptions, £18,330 of PJDI Loan Notes remained in issue to Mr Darrington and £26,670 of VJBI Loan Notes remained in issue to Ms Brown. £7,446 of the balance of Mr Darrington's PJDI Loan Notes were redeemed between June and November 2008. PJDI was struck off the register at Companies House on 27 July 2010 and Mr Darrington received no further payment in respect of his PJDI Loan Notes. Ms Brown continues to hold the balance of her VJBI Loan Notes.

57. The conclusions set out at [35] to [37] apply in a similar way to Mr Darrington and Ms Brown as regards their holdings of PJDI Loan Notes and VJBI Loan Notes. However, those conclusions should be understood in the context of the slightly different positions of Mr Darrington and Ms Brown when compared with that of Mr Yodaiken as set out below.

58. The forfeiture provision in the PJDI Loan Notes and the VJBI Loan Notes involved Mr Darrington and Ms Brown taking a greater risk than Mr Yodaiken was taking in connection with the Davissa Loan Notes. That is because if Mr Darrington, for example, died within the 365-day period in which the forfeiture provision was operative, his PJDI Loan Notes would be transferred to Graceland, and he held only two-thirds of the shares in Graceland. Therefore, if the forfeiture provision operated, Ms Brown would, indirectly (by virtue of her shareholding in Graceland), acquire a one-third share in the PJDI Loan Notes. Similarly, if the forfeiture provision in the VJBI Loan Notes applied, Mr Darrington would, indirectly, acquire a two-thirds share in the VJBI Loan Notes. Both Mr Darrington and Ms Brown considered that this risk was worth running in order to secure the tax advantages that the planning was intended to secure.

59. Against that background, since Ms Brown was the sole director and shareholder of VJBI and since Mr Darrington was the sole director and shareholder of PJDI, both of them could have taken similar steps to those outlined at [36] and [37] to secure redemption of their respective holdings of loan notes.

Statutory provisions

60. Appendix One to this decision contains the statutory provisions that are relevant to the income tax aspects of this appeal. Appendix Two contains relevant statutory provisions applicable to NIC.

Whether the Loan Notes are "restricted securities"

61. A central issue in these appeals is whether the Loan Notes were "restricted securities" for the purposes of s423 of ITEPA. The question, therefore, is whether "there is any contract, agreement, arrangement or condition which makes provision to which any of subsections (2) to (4) [of s423] applies".

Deutsche Bank and UBS

62. A large proportion of the parties' respective submissions on whether the Loan Notes were restricted securities were directed at the effect of the decisions in *Deutsche Bank* and *UBS* and other cases relating to the "Ramsay" doctrine. The parties were not agreed on the conclusions that I should draw from these authorities and in this section, I will set out the conclusions that I have drawn from these and related decisions.

63. The *Deutsche Bank* and *UBS* cases both concerned arrangements under which the employing companies rewarded their employees by the provision of shares in a company that were said to be restricted securities for the purposes of Part 7 of ITEPA. To enable the shares to be "restricted securities" and so achieve the desired tax result, they were made subject to a short-term contingency which was unlikely to occur, but might conceivably do so. In *UBS* the contingency related to the performance of the stock market over a three-week period. If the contingency occurred, the employees would be forced to sell their shares for 90% of market value. However, derivatives that the issuing company entered into meant that, if the contingency occurred, the market value of its shares would increase. It was found as a fact that, even if the contingency occurred, the employees would still receive 99.2% of the amount they would receive if it did not occur. In *Deutsche Bank*, an employee's shares would be forfeited if, in the period of approximately eight weeks after the award of the shares, the holder ceased to be employed by Deutsche Bank (other than in specified circumstances).

64. I consider that the Supreme Court's judgment in *Deutsche Bank* and *UBS* sets out, among other issues, the correct approach to construing s423 of ITEPA. At [72] of the reported decision, Lord Reed, with whom all other members of the Supreme Court agreed, introduced the question of construction in the following terms:

> It is necessary now to return to the statutory provisions in issue in the present appeals. Rather than dealing with the arguments in the way in which they were presented, in terms of broader and narrower versions of a 'Ramsay' approach, it seems to me to be preferable to begin with the interpretation of the legislation, and the fundamental question whether it can be given a purposive interpretation going beyond its

literal terms: that is to say, whether a 'Ramsay' approach is possible at all, and if so, the purposive construction on which it is to be based.

65. Having considered the legislation and its background, Lord Reed concluded that a purposive construction was possible in the following passages:

5 [76] It is in the context explained in para [74], and against the background described in para [75], that it is necessary to consider the scope of the exemption on acquisition conferred by s 425(2), and more specifically the question whether, in s 423(1), the words 'any contract, agreement, arrangement or condition which makes provision to which 10 any of subsections (2) to (4) applies' should be construed as referring to 'provision' with a genuine business or commercial purpose.

[77] Approaching the matter initially at a general level, the fact that Ch 2 was introduced partly for the purpose of forestalling tax avoidance schemes self-evidently makes it difficult to attribute to Parliament an 15 intention that it should apply to schemes which were carefully crafted to fall within its scope, purely for the purpose of tax avoidance. Furthermore, it is difficult to accept that Parliament can have intended to encourage by exemption from taxation the award of shares to employees, where the award of the shares has no purpose whatsoever 20 other than the obtaining of the exemption itself: a matter which is reflected in the fact that the shares are in a company which was brought into existence merely for the purposes of the tax avoidance scheme, undertakes no activity beyond its participation in the scheme, and is liquidated upon the termination of the scheme. The 25 encouragement of such schemes, unlike the encouragement of employee share ownership generally, or share incentive schemes in particular, would have no rational purpose, and would indeed be positively contrary to rationality, bearing in mind the general aims of income tax statutes.

30 [78] More specifically, it appears from the background to the legislation that the exemption conferred by s 425(2), in respect of the acquisition of securities which are 'restricted securities' by virtue of s 423(2), was designed to address the practical problem which had arisen of valuing a benefit which was, for business or commercial reasons, 35 subject to a restrictive condition involving a contingency. The context was one of real-world transactions having a business or commercial purpose. There is nothing in the background to suggest that Parliament intended that s 423(2) should also apply to transactions having no connection to the real world of business, where a restrictive condition 40 was deliberately contrived with no business or commercial purpose but solely in order to take advantage of the exemption. On the contrary, the general considerations discussed in para [77], above, and the approach to construction explained in paras [64] and [68], above, point towards the opposite conclusion.

45 66. Having considered counter-arguments to the analysis set out above, in a section headed “Conclusion on purposive construction”, Lord Reed set out the following summary:

> [85] In summary, therefore, the reference in s 423(1) to 'any contract, agreement, arrangement or condition which makes provision to which any of subsections (2) to (4) applies' is to be construed as being limited to provision having a business or commercial purpose, and not to commercially irrelevant conditions whose only purpose is the obtaining of the exemption.

67. Lord Reed then went on to apply this approach to the transactions at issue in the following passages:

> [86] In the UBS case, the condition—whether the FTSE 100 rose by a specified amount during a three-week period—was completely arbitrary. It had no business or commercial rationale beyond tax avoidance. Such a condition is simply not relevant to the application of s 423, if, for the reasons already explained, that section is concerned with 'provision' having a genuine business or commercial purpose. Applying s 423 to the facts, viewed from a commercially realistic perspective, it follows that the condition to which the UBS shares were subject should be disregarded, with the consequence that the shares are not 'restricted securities' within the meaning of that section.
>
> [87] That conclusion is fortified by another aspect of the facts of the UBS case. The economic effect of the restrictive condition was in any event nullified by the hedging arrangements, except to an insignificant and pre-determined extent (namely 0.8% at most—see para [32], above). The fact that what the First-tier Tribunal described as 'a deliberate near miss' was designed into the scheme, rather than a complete offsetting of the risk, is immaterial. Paragraphs [22] and [23] of the opinion in *Scottish Provident*, cited at para [70], above, are in point. As the Committee stated, the effect of the scheme should be considered as it was intended to operate. So considered, the benefit to the employee was not truly dependent on the contingency set out in the condition.
>
> [88] The restrictive condition in the DB case was simpler but equally artificial. 'Leaver' provisions in employee benefit arrangements often serve a genuine business or commercial purpose. But that cannot be said of the condition attached to the Dark Blue shares. The forfeiture provision operated for only a very short period, during which the possibility that it might be triggered lay largely within the control of the employee who would be adversely affected. It had no business or commercial purpose, and existed solely to bring the securities within the scope of s 423(2). Paragraphs [22] and [23] of the opinion in *Scottish Provident* are again in point. DB deliberately included a contingency which created a minor risk, but one which the parties were willing to accept in the interests of the scheme. The scheme should therefore be considered as it was intended to operate, without regard to the possibility that it might not work as planned.

68. Mr Gammie argued that the above passages made it abundantly clear that, in order to decide whether the Davissa Loan Notes, the VJBI Loan Notes or the PJDI Loan Notes were "restricted securities', it is necessary to decide only whether the

forfeiture provision in those loan notes had a business or commercial purpose as set out at [85] of Lord Reed's judgment.

69. Mr Sherry argued that Lord Reed's summary conclusion at [85] needed to be understood both in the context of the paragraphs that went before (in particular those at [76] to [78]) and in the context of earlier decisions of the House of Lords on the Ramsay doctrine. He argued that a broad examination of the facts was required and that account should also be taken of the fact that Parliament, by offering employers and employees the right to make elections in relation to the restricted securities regime (in s425(3), s430 and s431 of ITEPA, had intended there to be a degree of flexibility in the way the restricted securities regime operated. In his submission, none of Davissa, PJDI or VJBI undertook "no activity beyond its participation in the scheme", and none of these companies were "liquidated upon the termination of the scheme" (matters which he argued were significant given paragraph [77] of Lord Reed's judgment). He argued that the forfeiture provisions attaching to the Loan Notes in this appeal were real. They would be triggered on the death of the individuals concerned, an event that was not within their control, they endured for a year (rather than the short timescale in the *UBS* and *Deutsche* appeals). Moreover, the consequences of the restrictions applying were real: the estates of the individuals concerned would cease to benefit from the loan notes and, unlike in the UBS case, there were no hedging arrangements that would insulate the employees or the estates from that consequence.

70. Mr Sherry also submitted that, in paragraph [78] of Lord Reed's judgment, he was essentially putting forward a two stage test: a provision for forfeiture without any business or commercial purpose could be ignored, but only if the relevant transactions had no connection to the world of business. In these appeals, he argued that there was a connection to the world of business: Davissa, PJDI and VJBI were all provided with funds that they either used, or could have used, in real world commercial transactions. Therefore, he argued that the question of "business or commercial purpose" should be informed by the purpose of those companies in obtaining funds.

71. Mr Sherry developed that submission by arguing that the decision in *UBS* and *Deutsche Bank* was not intended to recast the Ramsay doctrine completely. He referred to the well-known statement of Ribeiro PJ in *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 (which was endorsed by the House of Lords in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 654) that:

> ...the driving principle in the Ramsay line of cases continues to involve a rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically.

72. Mr Sherry submitted that this approach to the Ramsay doctrine could be seen in cases going back to *Craven v White* [1989] AC 389 and that in *Craven v White* at 514F of Lord Oliver's speech, the House of Lords had set out four "essentials" for the doctrine to apply namely:

(1) that the series of transactions was, as the time when the intermediate transaction was entered into, pre-ordained in order to produce a given result; (2) that the transaction had no purpose other than tax mitigation; (3) that there was at that time no practical likelihood that the pre-planned events would not take place in the order ordained… and (4) that the pre-ordained events did in fact take place.

73. Mr Sherry submitted that since these four essentials were not present in the circumstances of this appeal the doctrine should not apply.

74. I prefer Mr Gammie's submissions. Lord Reed's judgment is, in my view, setting out the approach that must be followed when construing s423 of ITEPA. That approach involves focusing on the provisions for forfeiture and asking whether they have a "business or commercial purpose" or whether they are "commercially irrelevant conditions whose only purpose is the obtaining of the exemption". It is clear from paragraph [85] of Lord Reed's judgment that the focus is on the provisions for forfeiture (and not on a wider consideration of the commercial purpose of the securities). When Lord Reed applies his own test in paragraphs [86] to [88] he applies it by reference to the forfeiture provisions alone. While he was "fortified" in his conclusions in the *UBS* case by the fact that the hedging arrangements in that case prevented the employees from suffering any real consequence, that was not central to his conclusion.

75. I do not consider that paragraphs [77] or [78] of Lord Reed's judgment are suggesting anything different. While those passages do appear to refer to matters other than the relevant forfeiture provision, it is clear that they are part of the reasoning that he applies in determining what kind of forfeiture provisions Parliament had in mind when enacting s423 of ITEPA. That is made clear by his introductory comments at paragraph [76] of his judgment. I agree with Mr Sherry that the Supreme Court in *UBS* and *Deutsche Bank* were not intending to reverse the previous lines of authority set out in *Craven v White* or *Barclays Mercantile*. However, those authorities do nothing more than echo the conclusion that the Ramsay doctrine is concerned with the approach to statutory construction and the ascertainment of the facts. Of course in construing taxing provisions, or deciding the facts to which statutory provisions apply, it will often be relevant to ask whether particular steps were pre-ordained or not (as in *Craven v White*). However, in *UBS* and *Deutsche Bank* the Supreme Court have formulated the correct approach to the construction of s423 of ITEPA in terms of the "business purpose" of the relevant forfeiture provision and not in terms of whether particular transaction steps were pre-ordained or not.

Conclusion on whether the Loan Notes are restricted securities

76. The effect of my findings at [32] and [54] is that there was no business or commercial purpose for the inclusion of the forfeiture provisions within the terms of the Loan Notes. Rather, those forfeiture provisions were commercially irrelevant and designed only to secure the benefit of the tax exemption in s425 of ITEPA. Those conclusions, together with the conclusions that I have reached on the effect of the decision in *Deutsche Bank* and *UBS* mean that none of the Davissa Loan Notes, the

PJDI Loan Notes or the VJBI Loan Notes were "restricted securities" within the meaning of s423 of ITEPA.

77. As I have noted above, I do not consider that it is necessary to look beyond the purpose of the forfeiture provision and consider the wider commerciality or otherwise
5 of the circumstances surrounding the issue of the Loan Notes. However, for completeness, for reasons I have outlined at [31], [33], [52] and [53], I do not consider that there was a predominant commercial <u>purpose</u> for the issue of any of the Loan Notes although I accept that the issue of those Loan Notes had commercial <u>effects</u>. Nor do I consider that it is relevant that the Employees, Cyclops and Davissa
10 could have made elections under s425(3), s430 or s431 of ITEPA. They did not make such elections precisely because they hoped that the operation of restricted securities regime would produce a result favourable to them.

78. I am fortified in my conclusion by the fact that, although the forfeiture provisions ostensibly would operate for a whole year and depended on "real"
15 contingencies outside the control of the Employees, closer inspection reveals that they effectively had a free choice as to whether to subject themselves to those conditions or not. As I have noted at [35], [36], and [57] to [59], the Employees could at any point have ensured that the forfeiture provisions in their Loan Notes no longer had any real effect. In that sense, whether the forfeiture provisions had any consequence was very
20 much in the control of those individuals and the situation is not materially different in that regard from the facts of the *Deutsche Bank* case.

79. In order for the Loan Notes to be restricted securities, it is necessary that there be a "contract, agreement, arrangement or condition" which "makes provision" for those loan notes to be forfeited in certain circumstances. Given what I have said at
25 [78], the risk of forfeiture of the Loan Notes was not provided for by any "contract, agreement, arrangement or condition"; it was assumed entirely voluntarily.

80. Mr Sherry submitted that the restrictions applicable to the Loan Notes in this appeal are more "real" than those considered in the *UBS* and *Deutsche Bank* cases. For the reasons I have set out at [78] and [79] above, I do not believe that this is the
30 case. However, as I have noted in my analysis of the *UBS* and *Deutsche Bank* decisions, the question is not how "real" the restrictions are, but whether those restrictions were inserted for a business or commercial purpose or not.

81. For all of those reasons, I do not consider that the Davissa Loan Notes, the PJDI Loan Notes or the VJBI Loan Notes are "restricted securities" as defined in s423 of
35 ITEPA. Therefore, the Employees' receipt of the Loan Notes was not exempt from income tax under s425 of ITEPA and was not prevented from giving rise to an NIC charge by Part IX of the SSC Regulations.

The approach to the calculation of the income tax and NIC charges

Outline of the issue to be considered

82. At [81], I have concluded that no exemption applied for either income tax or NIC purposes when the Employees received their Loan Notes. There can be no doubt that the Loan Notes represented "earnings" of the Employees for both income tax and NIC purposes as the Employees received them in the course of their employment and as consideration for services that they rendered as employees and directors of Cyclops and Graceland respectively.

83. However, it is still necessary to consider what precisely is the nature of the "earnings" that the Employees received and the parties had different positions on this issue.

(1) Mr Gammie submitted that, as soon as the Employees received their Loan Notes, they were in a position where they could immediately redeem them and receive a cash sum equal to their principal amount. In those circumstances, he argued that the "earnings" that the Employees received were, in reality, money earnings equal to the principal amount of their Loan Notes and should be subject to PAYE and NIC in just the same way as straightforward payments of cash bonuses.

(2) Mr Sherry argued that, the Loan Notes were not money earnings. They were illiquid securities which contained no fixed provision for redemption. Therefore, the amount of "earnings" had to be determined by valuing those Loan Notes and that PAYE and NIC provisions applicable to the provision of earnings in the form of securities (rather than those applicable to cash payments) should operate.

84. Neither party suggested that the position for NIC purposes was different from that applicable to PAYE and income tax. They therefore were agreed that either the Employees should be treated in the same way as if they had received cash for both income tax and NIC purposes or they should be treated as receiving securities for both income tax and NIC purposes.

Authorities on this issue

85. In this section, I will consider authorities on the above point to which I was referred and an outline of the parties' submissions on the conclusions that I should draw from them. In the next section, I will set out what I consider to be the correct analysis of these authorities and apply them to the facts of these appeals.

86. At paragraphs [90] to [92] of the reported decision in *UBS* and *Deutsche Bank* the Supreme Court considered a similar issue saying as follows:

> [90] Since the restrictive conditions attached to the shares do not make provision to which s 423 applies, it follows that the shares are not 'restricted securities' within the meaning of that section. Is that the 'end

> result', in Lord Brightman's phrase, or is it appropriate to go further and disregard other steps: namely, the use of the bonus funds to buy shares in the vehicle companies, the award of the shares to the employees, and the subsequent redemption of the shares for cash? Those steps were disregarded by the First-tier Tribunal, so that the end result was that the employees were treated as though they had been paid in cash.
>
> [91] In the broad version of its Ramsay argument, the Revenue invited this court to adopt the same approach. The schemes, it argued, were simply vehicles for passing cash bonuses to employees without paying income tax and national insurance contributions. The shares, although genuine, functioned merely as a cash delivery mechanism. They were not designed or intended to have any other function.
>
> [92] In agreement with the Upper Tribunal and the Court of Appeal, I find this argument unpersuasive. In the first place, the employees actually received shares, not cash. Subject to one qualification, the vehicle companies did not hold cash. The qualification is that ESIP held cash during the period prior to 27 February 2004; but the cash was not at the disposal of the employees, since they could not redeem their shares until almost four weeks later. Throughout the intervening period, ESIP's funds were invested in UBS shares. Dark Blue's assets were invested in low-risk investments. In both cases, therefore, the realisable value of the shares depended on the performance of the assets in which the companies' funds were invested, as shares normally do. The amount of cash for which the shares might be redeemed was neither fixed nor ascertainable when the shares were acquired, and was unlikely to be the same as the bonus which had initially been allocated to the employees. In the event, the difference turned out to be modest in the case of the employees who redeemed their shares at the earliest opportunity, but matters could have turned out differently.

87. At [94] of his judgment, Lord Reed concluded that the restriction in the shares that the UBS and Deutsche Bank employees received should still be taken into account in valuing those shares (even though that restriction had no business or commercial purpose and was therefore not sufficient to make the shares "restricted securities").

88. In *Garforth v Newsmith Stainless Ltd* [1979] STC 129 the High Court concluded that there was a "payment" for the purposes of PAYE legislation when money was credited to directors' loan accounts as the sums so credited had been "placed unreservedly at the disposal of the directors".

89. In *DTE Financial Services Ltd v Wilson* 74 TC 14, the Court of Appeal considered a transaction under which directors of a company received the transfer of a contingent reversionary interest in a trust with the contingency being satisfied just two days later whereupon the directors became absolutely entitled to a sum of money. At [42] of the reported decision, Parker LJ (with whom Sedley LJ and Potter LJ agreed) expressed the view that the concept of "payment" in the PAYE legislation is a "practical, commercial concept". Looking at the totality of the arrangements, he concluded that the cash payment that the relevant employees received in respect of the

trust interests that they required was a “payment” of assessable income that was subject to PAYE.

90. Mr Gammie argued that *DTE Financial Services* supported his argument. Mr Sherry submitted that because, in these appeals, it was not pre-ordained that the Employees would receive cash in any particular timescale (still less a timescale as short as the two days involved in *DTE Financial Services*) as a consequence of redeeming their Loan Notes, the decision should be distinguished.

91. In *Aberdeen Asset Management plc v Revenue and Customs Commissioners* [2014] STC 438, the Inner House of the Court of Session considered a composite transaction which culminated in shares in “money box” companies being transferred to a nominee for an employee. One point at issue was whether the transfer of shares to an employee was a “payment” for the purposes of the PAYE provisions. Lord Drummond Young, who delivered the leading judgment concluded that a “payment” had been made. The essence of his reasoning is found in the following passages:

> [34] In considering what amounts to payment for the purposes of the PAYE legislation, it is important in my opinion to bear in mind that money is a medium of exchange. In practical terms, therefore, the crucial question is whether funds have been placed in a position where as a practical matter they may be spent by the employee as he wishes; it is at that point that the employee can be said to obtain the benefit of those funds. If the PAYE legislation is construed purposively it is in my view obvious that it is such a benefit that is to be taxed. For this purpose it is not appropriate to deconstruct the precise legal nature of the employee's rights, drawing fine distinctions according to the methods that he must adopt in order to use the funds for his benefit. The fact that the employee has practical control over the disposal of the funds is sufficient to constitute a payment for the purposes of the legislation.
>
> [35] In the present case the unchallenged findings in fact made by the First-tier Tribunal included the following. The employees who were to be benefited under the Scheme accepted shares in the money box companies on the basis that they formed part of their remuneration package. The employees had control over those companies, if necessary by using their powers and shareholdings to replace any director who might resist their wishes. In practice, however, the directors did exactly what the relevant employee wanted with the funds held by the company, and the funds were actually used to benefit the employee-shareholders in a number of different ways, in each case determined by the employee concerned. The First-tier Tribunal expressly found that the structures put in place operated simply as a means of channelling remuneration from employer to employee, that the assets of the companies, in the form of cash, were 'effectively at the disposal of the employee', and that the facts showed 'unequivocally' that control was vested in the employee who had 'access to the pot of money contained within the corporate money box' (see at [29] above).
>
> [36] In the light of those findings it is very clear in my opinion that the employees had total practical control over the disposal of the funds that

> had been paid into the money box companies. That by itself satisfies the requirements of a payment for the purposes of PAYE legislation, and in particular for the purposes of s 203(1) of the Taxes Act. Consequently the cross-appeal by HMRC must succeed.

92. At [37] and [38], Lord Drummond Young considered the argument that the employees had received shares and not cash:

> [37] The argument for the appellants was that the funds transferred to the companies were not placed unreservedly at the disposal of the employees. The only right that an employee had was ownership of the shares, and he had no clear legal right to the cash. The Scheme came to an end when the shares were issued to the employee, and did not involve transferring any right to the cash to him. In this connection reliance was placed in particular on the statement in *DTE Financial Services Ltd v Wilson (Inspector of Taxes)* [2001] STC 777 at [42], 74 TC 14 at [42], that for the purposes of the PAYE system payment 'ordinarily means actual payment: ie a transfer of cash or its equivalent'. This involves focusing on the legal right enjoyed by the employee; what was required was a right to payment of cash. It was submitted that that followed from a proper analysis of the PAYE legislative code.
>
> [38] In my opinion this opinion reads the word 'payment' too narrowly in the context of the PAYE legislation. It amounts in effect to saying that for payment to occur an employee must have a direct legal 'right', in a very strict sense, to the funds that are paid, and it is not enough that the employee can, by exercising a power that has been conferred upon him, obtain the beneficial use of those funds. That involves a concentration on strict legal form rather than the substance of the transaction, and treats the form as critical.

93. Mr Gammie submitted that, in these appeals, as soon as the Employees received the Loan Notes (if not earlier), cash was placed unreservedly at their disposal. The Employees might have needed to exercise their rights as directors of the issuers of the Loan Notes in order to secure that cash was paid to them immediately but, as Lord Drummond Young noted at [34] of his decision, it is not necessary to deconstruct the precise legal nature of the employee's rights to secure that cash. Therefore, he submitted that Lord Drummond Young's reasoning should be applied.

94. Mr Sherry submitted that there were a number of distinctions between the transaction considered in *Aberdeen Asset Management* and these appeals. For example, in these appeals, the planning in question was not designed to deliver cash or its equivalent to the Employees (since the question of when, or indeed whether, the Employees would receive cash was not pre-ordained). Moreover, whereas in *Aberdeen Asset Management* the FTT concluded (as noted at [31] of Lord Drummond Young's decision) that the sole existence of the "cash box" companies was to hold a pot of cash, that is not the case in these appeals as Davissa, VJBI and PJDI all had the possibility of undertaking commercial transactions and indeed ultimately did so. He also noted that shareholder control of Cyclops and Graceland was in the hands of the Employees (who were also the only directors of those companies). Therefore, he submitted that it was not right to apply Lord Drummond Young's approach to

ascertaining whether cash had been placed unreservedly at their disposal since, even if they had not received Loan Notes, the Employees could have exercised their rights as shareholders to procure that they received cash from those companies equal to the principal amount of the Loan Notes (whether in the form of dividends, repayments of debts owed by the companies or by payment of a cash bonus).

95. Mr Sherry also submitted that paragraph [38] of Lord Drummond Young's decision demonstrated that the Inner House of the Court of Session in *Aberdeen Asset Management* was adopting a wider interpretation of the concept of "payment" than the Court of Appeal had adopted in *DTE Financial Services*. In those circumstances, he argued that I should follow the narrower concept of payment set out in the decision of the English Court of Appeal's decision and that I was not bound by the formulation of the wider concept of payment set out in a decision of the Inner House of the Court of Session in Scotland.

Conclusion as to how the Employees' income tax and NIC charges should be calculated

96. If Graceland and Cyclops had paid cash into the Employees' bank accounts equal to the principal amounts of their holdings of Loan Notes, there could be no doubt that they would have made a payment of cash to the Employees for both PAYE and NIC purposes. In legal form, if cash were paid into their bank accounts, the Employees would acquire a debt claim (or increased debt claim) against their banks. The credit balance of their accounts would be at the Employees' disposal, but they might need to take certain steps to secure payment of that debt claim. For example, if they wished to withdraw cash from their accounts, they would need to give notice to their bank, would probably have to provide appropriate identification and might have to comply with daily transfer limits. If they wished to transfer the balance of their account to someone else as payment for goods or services, they would need to comply with the bank's terms and conditions as to the manner in which they could deal with the debt claim represented by the credit balance on their accounts. Thus, in such a paradigm case of a "payment", the Employees would in legal form be receiving a debt claim (or increased debt claim) which they had an immediate contractual right to turn into cash. However, they would need to take some steps before they could actually turn that debt claim into cash.

97. When the Employees received their Loan Notes they were not in any material respect in a different position from that set out at [96]. On receipt of the Loan Notes, they had an immediate contractual right to require redemption of their Loan Notes at their face value and all of the issuers of the Loan Notes had sums on deposit that were sufficient to enable them to redeem the Loan Notes in full. The issuers of the Loan Notes had the contractual right not to pay the redemption proceeds for a period of time. However, that is not in any material respect a different position from a bank requiring a period of notice before sums can be withdrawn from an account. In any event, the Employees could use their influence as directors and shareholders of the issuers of the Loan Notes to ensure that payment was made immediately as I have found at [35] and [57] and, even after the First Redemption Period and Second

Redemption Period expired, the Employees could still have ensured that their Loan Notes were redeemed immediately as I have found at [37] and [57].

98. I do not accept Mr Sherry's submission that companies that are controlled by their directors should be treated differently. It may well be true that the Employees had a number of options as to how they could have received cash from Cyclops and Graceland. However, before receiving their Loan Notes, they had not actually received anything that needed to be analysed for PAYE and NIC purposes. When they received their Loan Notes, they received something and Lord Drummond Young has set out an approach to the characterisation of what exactly they received. Moreover, I was not shown any authority that suggests a different approach should be applied to companies controlled by their directors.

99. Therefore, applying the approach that Lord Drummond Young set out in *Aberdeen Asset Management*, I consider that, when the Employees received the Loan Notes, the principal amount of those Loan Notes was placed unreservedly at their disposal. Therefore, they received "earnings" in the form of cash and the measure of those earnings was, accordingly, the principal amount of the Loan Notes. "Payment" of those earnings was made for PAYE purposes when the Employees received those Loan Notes.

100. Even without Lord Drummond Young's extensive analysis in *Aberdeen Asset Management*, I would have reached the same conclusion based on *DTE Financial Services*. Given that the concept of "payment" is a "practical, commercial concept", I would have no hesitation in concluding that, when the Employees received the Loan Notes, taking into account the totality of their rights as shareholders and directors of the issuers of those Loan Notes, they received "earnings" in the form of cash and that "payment" of those earnings was made when they received their Loan Notes.

101. I do not agree with Mr Sherry that Lord Drummond Young was adopting a different approach to the question of "payment" than was adopted in *DTE Financial Services*. When Lord Drummond Young comments, in the passage highlighted at [92] that the approach to payment is being read "too narrowly", I consider that he was referring to the arguments of the appellants that he had summarised at [37] of the reported decision, rather than the Court of Appeal's formulation. Even if *Aberdeen Asset Management* is adopting a wider formulation I would still follow it on the basis that I am making a decision as a UK tribunal applying statute law that has effect throughout the UK. Therefore, the fact that *Aberdeen Asset Management* was decided by a Scottish court does not appear to me to detract from its authority as a precedent in these proceedings.

102. I do not consider that the *Deutsche Bank* and *UBS* decisions require me to take a different conclusion from that I have reached at [99]. All of Davissa, VJBI and PJDI held cash balances representing the principal amount of their respective Loan Notes. The Employees had a right to require redemption of the Loan Notes for an amount equal to their par value from the point at which they acquired them and the practical ability to require immediate payment of the redemption proceeds if they wished. As the extracts from the *Deutsche Bank* and *UBS* decisions set out at paragraph [92] of

the reported decision (referred to at paragraph [86] above) demonstrate, the situation in the *Deutsche Bank* and *UBS* appeals was much different.

103. Nor do I consider that it matters that, at the point the Employees received the Loan Notes, they were not pre-ordained to deal with the Loan Notes in any particular way. What is relevant, as is clear from *Aberdeen Asset Management* and *Garforth v Newsmith Stainless Ltd* is that the funds were at the Employees' disposal. The analogy with an employee who receives a payment of salary into a bank account is instructive: such an employee has received a payment of that salary even if he or she has not yet decided whether, and if so how, they will spend that money.

104. For all of those reasons, I have concluded that, when the Employees received their Loan Notes, they received a "payment" of "earnings" in the form of cash equal to the principal amount of those Loan Notes.

Other points

105. The conclusions that I have reached at [81] and [104] are sufficient to dispose of the appeals. However, a number of other points would have been relevant had I reached different conclusions on these issues. For example, if I had concluded that the Loan Notes were restricted securities, the Employees' receipt of the Loan Notes would not be subject to income tax or NIC (because of s425 of ITEPA and Part IX of the SSC Regulations). If I had concluded that the Loan Notes were restricted securities, but did not represent money earnings, it would be necessary to consider how the income tax and NIC provisions applicable to payments in the form of readily convertible assets and other related issues should be applied.

106. I have decided that I will not consider all of these other issues since I do not need to. However, in case this appeal goes further, I will set out, relatively briefly, my views on how Chapter 2 of Part 7 applied on redemption of the PJDI and VJBI Loan Notes.

Application of Chapter 2 of Part 7 of ITEPA on redemption

107. If the Loan Notes were "restricted securities" then, under s425 of ITEPA, there would be no income tax liability on their receipt. Instead, by virtue of s426 of ITEPA, tax would be levied on "chargeable events" in relation to the Loan Notes. A "chargeable event includes", by virtue of s427:

> 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)

108. Mr Darrington and Ms Brown were "associated persons" by virtue of being employees of Graceland. The question, therefore, is whether the above definition embraces a redemption (under which securities are extinguished on payment of a cash sum) or whether it is envisaging a transfer of the securities to another person as part of arrangements under which the securities continue to exist. Mr Gammie argued that the

expression plainly includes a redemption and Mr Sherry, while not explicitly conceding the point, did not make any strong arguments that it does not.

109. I initially entertained doubts as to whether redemptions are covered by the above statutory definition. While a redemption can fairly be described as a species of "disposal", the words in parentheses invite an analysis of whether, at the point of disposal, the securities are still restricted securities. That would be a slightly unusual test to apply in the case of redemptions since, at the point of redemption, a security will cease to exist. Moreover, the tax charge on a "chargeable event" is determined under s428 by reference to concepts of "market value". If Parliament intended to include redemptions as "chargeable events", it might have been expected that it would seek to tax the actual redemption proceeds received.

110. However, on balance, I have concluded that the redemption of the Loan Notes was a chargeable event. As the Supreme Court explained in *Deutsche Bank* and *UBS* the purpose of Part 7 of ITEPA is, amongst others, to defer the tax charge in relation to restricted securities to the point when the risk of forfeiture is lifted or the securities are sold (at which point the securities are easier to value). An employee who sells restricted securities for £100 is in no different economic position from an employee who receives redemption proceeds of £100. In those circumstances, I can see no reason why Parliament should have wished employees receiving redemption proceeds to be in a different tax position from employees selling their securities to third parties.

111. Assuming that a redemption is a chargeable event, the income tax due on that chargeable event is set out in s428 as follows:

428 Amount of charge

(1) The taxable amount for the purposes of section 426 (charge on occurrence of chargeable event) is—

UMV x (IUP – PCP – OP) – CE

(2) UMV is what would be the market value of the employment-related securities immediately after the chargeable event but for any restrictions.

(3) IUP is—

$$\frac{\text{IUMV} - \text{DA}}{\text{IUMV}}$$

where—

IUMV is what would have been the market value of the employment-related securities at the time of the acquisition but for any restrictions, and

DA is the total of any deductible amounts.

…[5]

---

[5] I will not set out the definitions of "PCP", "CE" or "OP" since it was agreed that they were nil in the context of both appeals.

(7) For the purposes of this section each of the following is a "deductible amount"—

…

(b) any amount that constituted earnings from the employee's employment under Chapter 1 of Part 3 (earnings) in respect of the acquisition of the employment-related securities,

112. It was common ground that, in the formula set out in s428(1), "PCP", "OP" and "CE" were all zero. Mr Sherry's analysis of s428 revolved around two propositions:

(1) Firstly, he argued that "UMV" was zero since, immediately after the chargeable event (the time at which UMV had to be determined), the Loan Notes in question had ceased to exist (as they had been redeemed) and their market value at that point was zero.

(2) Secondly, he argued that the market value of the Loan Notes represented "earnings" under Chapter I of Part 3 of ITEPA that the Employees received when the Loan Notes were transferred to them even though s425 of ITEPA prevented those earnings from being subject to income tax. Therefore, in his submission, "DA" in the formula is broadly equal to "IUMV" so that "IUP" is at or around zero. This, in Mr Sherry's submission supplied a further reason why the formula in s428(1) led to a tax charge of nil (or close to nil).

113. Mr Gammie disagreed with both of these propositions:

(1) He argued that the definition of "UMV" involved a hypothesis (as demonstrated by the use of the words "what would be" in that definition). Therefore, UMV should be determined on the basis that the Loan Notes continued to exist.

(2) He argued that, since the purpose of s426 is to bring into account amounts that were not charged on acquisition of the restricted securities, Parliament cannot have intended amounts that did not give rise to an income tax charge to be included within "DA" and so reduce the amount of taxable income arising on the chargeable event.

114. I prefer Mr Gammie's submissions. If Mr Sherry's submissions on "UMV" were correct then, on any redemption of restricted securities, the amount payable on that chargeable event would inevitably be zero. Parliament can scarcely have intended to include redemptions as "chargeable events" but then provide that on all redemptions, the amount of tax chargeable is zero. Therefore, the statute must be construed so as to lead to a result that value employees receive on redemptions is taxed in a similar way to value received following a transfer of securities. Mr Gammie's construction of "UMV" achieves that and, in my view, is consistent with the statutory wording used. I accept, as Mr Sherry submitted, that it is possible to read the hypothesis embraced within the words "what would be" as simply a hypothesis as to the absence of restrictions on the security. However, for the reasons I have given, I do not consider that to be the correct reading.

115. A similar point arises on the definition of "DA". If Mr Sherry were correct then no disposal of restricted securities could ever give rise to significant tax under s428. Having legislated to tax value received following disposals of restricted securities, Parliament cannot have intended this result. Therefore, "DA", and the definition of "deductible amounts" should be construed so as to lead to a result that is consistent with the purpose of the statutory provisions. Mr Gammie's interpretation, that "deductible amounts" is referring only to taxable earnings does this. I note that, in s49 of the Finance Act 2008, Parliament legislated specifically to make it clear that "earnings" to be taken into account in the definition of "DA" did not include "exempt income" as defined in s8 of ITEPA. However, I do not consider that this demonstrates that, prior to 2008 Parliament intended Mr Sherry's analysis to apply. Rather, it is consistent with Parliament noticing that the drafting in s428(7) was, in some respects unclear, and that the true intended meaning should be clarified.

116. I therefore do not accept Mr Sherry's submissions as to how Chapter 2 of Part 7 of ITEPA would apply if the Loan Notes were "restricted securities". However, that is not the end of the matter. If the Loan Notes were "restricted securities", some findings as to market value would be needed in order to apply the definition of "UMV". For example, if the Loan Notes continued in existence, they would still contain no set date for redemption and would confer only limited rights for a holder to require redemption, they would still be issued by an unquoted private limited company and they would still carry a low interest rate. All of those matters might have an effect on market value. In addition, it would be necessary to consider to what extent the rights that Mr Darrington and Ms Brown had in their capacity as shareholders and directors of PJDI and VJBI are to be taken into account in determining the market value of the Loan Notes on the hypothesis set out in s428(2). I have not considered these issues given my conclusion that the Loan Notes are not restricted securities although for completeness I note that any amount chargeable by virtue of s428 of ITEPA would, by virtue of Regulation 22(5) of the Social Security (Contributions) Regulations 2001 be treated as "earnings" for NIC purposes as well.

Application of Chapter 3C of Part 7 of ITEPA on redemption

117. In his skeleton argument, Mr Gammie argued that the redemption of the PJDI and VJBI Loan Notes could have given rise to a charge under Chapter 3C of Part 7 of ITEPA. He did not press those arguments during the oral hearing and, therefore, I have not addressed them in this decision.

Application of Chapter 4 of Part 7 of ITEPA

118. Mr Gammie also argued that, to the extent that the redemption of the PJDI Loan Notes and VJBI Loan Notes did not give rise to a tax liability under s426 to 428 of ITEPA, it resulted in a tax liability under Chapter 4 of Part 7 of ITEPA. Mr Sherry did not accept that this was the case.

119. This question arises only if those Loan Notes are restricted securities (and I have concluded that they are not). Moreover, it arises only to the extent that, even if the Loan Notes were restricted securities, there would not be a charge under Chapter 2 of Part 7 (and I have concluded that there would be a charge under that Chapter,

although questions of valuation mean that it is not possible for me to state exactly how much that charge would be). In those circumstances, I consider that the arguments as to Chapter 4 of Part 7 of ITEPA do not need to be addressed.

Conclusion

120. The appeals are dismissed except insofar as necessary to give effect to the reductions in the Regulation 80 Determinations and Section 8 Decisions which HMRC agree need to be made (as set out in the footnotes to the table at [2] above).

121. 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.

JONATHAN RICHARDS
TRIBUNAL JUDGE

RELEASE DATE: 12 JULY 2016

APPENDIX ONE – RELEVANT STATUTORY PROVISIONS OF ITEPA

All references in this appendix to statutory provisions are to those provisions as in force at the material time or times.

The general charging provisions

1. Section 6(1) of ITEPA is the basic charging provision which provides as follows:

> (1) The charge to tax on employment income under this Part is a charge to tax on –
>
> a) general earnings, and
>
> b) specific employment income.

2. A number of the terms used in s6 are defined in s7 of ITEPA which provides as follows:

> **7 Meaning of "employment income", "general earnings" and "specific employment income"**
>
> …
>
> (2) "Employment income" means –
>
> (a) earnings within Chapter I of Part 3
>
> (b) any amount treated as earnings (see subsection (5)), or
>
> (c) any amount which counts as employment income (see subsection (6))
>
> (3) "General earnings" means –
>
> (a) earnings with Chapter I of Part 3, or
>
> (b) any amount treated as earnings (see subsection (5))
>
> excluding in each case any exempt income.
>
> (4) "Specific employment income" means any amount which counts as employment income (see subsection (6)) excluding exempt income.

3. Section 8 of ITEPA provides that:

> …an amount of employment income is "exempt income" within paragraph (a) (b) or (c) of section 7(2) if, as a result of any exemption in Part 4 or elsewhere, no liability to income tax arises in respect of it as such an amount.

4. The concept of "earnings" is defined in s62 of ITEPA which provides as follows:

(2) … "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

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

5. Sections 6 and 7 of ITEPA therefore identify those sums that are within the scope of the charge to tax on employment income. There are also rules that set out when those sums are treated as received. In particular, s18 of ITEPA provides as follows:

10 **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

15 The time when payment is made of or on account of the earnings.

…

Part 7 of ITEPA – "Employment related securities"

6. Part 7 of ITEPA contains a specific statutory code dealing with "employment related securities". The definition of "employment related securities" is set out in
20 s421B(8) of ITEPA which then refers back to s421B(1) and s421B(2) of ITEPA. I will not set out the provisions in full since there was no dispute that the Loan Notes at issue in this appeal were, insofar as they were "securities" at all, "employment related securities".

7. Part 7 of ITEPA contains different Chapters that deal with different categories
25 of employment related securities and different events that take place in relation to employment related securities. Chapter 2 is the chapter that deals with "restricted securities" and, since many of the provisions of this Chapter are relevant to the issues that fall to be determined in this appeal, I will set out large sections of it.

Chapter 2 of Part 7 of ITEPA – Restricted Securities

30 8. Section 422 of ITEPA sets out the scope of the Chapter as follows:

422 Application of this Chapter

This Chapter applies to employment-related securities if they are—

(a) restricted securities…

at the time of the acquisition.

35 9. The definition of "restricted securities" is set out in s423. It is one of the central statutory provisions at issue in this appeal as the appellants argue that the statutory definition is met, whereas HMRC deny that it is met.

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

(1) For the purposes of this Chapter employment-related securities are restricted securities or a restricted interest in 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

(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, reversion or forfeiture.

10. Section 425 of ITEPA provides that, subject to certain exceptions, there is no income tax charge on the acquisition of restricted securities in the following terms:

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.

…

11. As the Supreme Court explained in the *UBS* and *Deutsche Bank* decisions, the rationale behind the legislation is that, in most cases, the income tax charge is to be postponed until the point at which restrictions are listed. That is achieved by a combination of s426 and s427 which respectively impose a tax charge on the occurrence of a "chargeable event" and define the concept of a "chargeable event".

426 Charge on occurrence of chargeable event[6]

(1) If a chargeable event occurs in relation to the employment-related securities, the taxable amount counts as employment income of the employee for the relevant tax year.

(2) For this purpose—

(a) "chargeable event" has the meaning given by section 427,

(b) "the taxable amount" is the amount determined under section 428, and

(c) "the relevant tax year" is the tax year in which the chargeable event occurs.

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) …

(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).

12. Section 428 of ITEPA sets out the amount of any charge arising on a "chargeable event". Since I have analysed in detail how the provision operates in the context of this appeal, I have set out this provision in the main body of the decision at [111].

13. Section 430 and s431 of ITEPA permits employer and employee jointly to make elections whose effect is, very broadly to disapply the exemption set out in s425 of ITEPA (with the result that the receipt of "restricted securities" gives rise to an

[6] Set out in this section is the version of s426 as it applied after 1 September 2004 and which is therefore applicable to the only potential "chargeable event" at issue in these appeals, namely the partial redemptions of the PJDI Loan Notes and VJBI Loan Notes in October 2004.

immediate tax charge) but the subsequent lifting of the restrictions does not give rise to a tax charge.

PAYE Provisions

General provisions

14. Income tax on employment income tends to be collected by deduction under the PAYE system.

15. Section 684 of ITEPA authorised what was then the Inland Revenue to make regulations with respect to, inter alia, the collection and recovery of income tax on "PAYE income". The combined effect of the definitions set out in s683 of ITEPA, s10(2) of ITEPA and is that the "general earnings" of a UK resident, ordinarily resident and domiciled employee are "PAYE income".

16. The relevant regulations are set out in Regulation 21 of the PAYE Regulations which requires an employer on making a "relevant payment" to deduct tax from that payment. Again, the combined effect of a number of relevant definitions (contained in Regulation 2, 4 and 5 of the PAYE Regulations) is that a "relevant payment" includes a payment on account of "general earnings" defined in s7(3) of ITEPA.

17. It will be seen from the above that the starting point is that the obligation to deduct tax under the PAYE system arises in relation to "payments". Section 686 of ITEPA defines the concept of "payment" in the following terms:

> **686 Meaning of "payment"**
>
> (1) For the purposes of PAYE regulations, a payment of, or on account of, PAYE income of a person is treated as made at the earliest of the following times—
>
> *Rule 1*
>
> The time when the payment is made.
>
> …

18. As the above extract demonstrates, s686 of ITEPA does not set out a comprehensive definition of what a "payment" is. Rather, it is primarily concerned with the question of <u>when</u> a "payment" is to be regarded as made. In the main body of this decision, I address relevant authorities on the meaning of "payment" for these purposes.

"Readily convertible assets" and "employment related securities"

19. The general provisions referred to at [14] to [18] of Appendix One apply in a reasonably straightforward way to payments in cash. However, there are other ways of rewarding employees that do not involve a payment of cash from which it is straightforward for employers to withhold an amount on account of tax. Nevertheless, the scheme of the legislation is that in certain cases that do not involve a payment of cash, there should still be an obligation on the employer to account to HMRC for income tax on the benefit that the employee is receiving and specific provisions are

needed to achieve this. I have not set out these provisions since the effect of my decision is that, when the Employees received their Loan Notes, they were treated for tax purposes as receiving cash and, accordingly, these provisions are not relevant.

20. Regulation 80 of the PAYE Regulations permits HMRC to determine, to the best of their judgment, the amount of income tax for which an employer is obliged to account under the PAYE Regulations. It is against such "Regulation 80 determinations" that the appellants are appealing.

APPENDIX TWO – STATUTORY PROVISIONS RELATION TO NATIONAL INSURANCE CONTRIBUTIONS

1. Section 6 of the Social Security Contributions and Benefits Act 1992 (“SSCBA”) contains the main NIC charging provision relevant in this appeal. Under s6 of SSCBA, primary Class 1 NICs and secondary Class 1 NICs are due when “earnings” are paid to, or for the benefit of, an earner who is over the age of 16. Section 6(4) provides that the primary Class 1 NICs are the liability of the earner (although they must be paid by the employer) and secondary Class 1 NICs are the liability of the “secondary contributor” (which, by virtue of s7 of SSCBA in the context of this appeal is either Graceland or Cyclops in their capacity as employers).

2. The concept of “earnings” is defined in s3 of SSCBA as including:

> any remuneration or profit derived from an employment

3. Section 4 of SSCBA provides for certain sums to be treated as remuneration derived from an employed earner’s employment (with the result that such sums are “earnings” for the purposes of s3 of SSCBA). Section 3(3) and s4(6) of SSCBA permit the Treasury to make regulations that either include, or exclude, amounts from the definition of “earnings”.

4. The Treasury has made regulations that deal specifically with employment related securities in the Social Security (Contributions) Regulations 2001 (the “SSC Regulations”).

5. Pursuant to Regulation 22(5) of the SSC Regulations, any amounts that count as employment income of an employed earner by virtue of Chapter 2 of Part 7 of ITEPA (the provisions relating to “restricted securities”) are treated as “earnings” for NIC purposes.

6. Pursuant to Regulation 22(6) any amounts that count as employment income of an employed earner by virtue of Chapter 4 of Part 7 of ITEPA (the provisions that deal with “post acquisition benefits”) are similarly treated as “earnings” for NIC purposes.

7. The effect of Regulation 22(5) and Regulation 22(6), therefore, is to ensure that amounts that are treated as taxable employment income under Part 7 of ITEPA for income tax purposes are also treated as “earnings” for NIC purposes.

8. Schedule 3 of the SSC Regulations contains provisions that exclude certain amounts from the calculation of “earnings”. While paragraph 1 of Part II of Schedule 3 of the SSC Regulations excludes certain “payments in kind” from the calculation of earnings, it is made clear in paragraph 2(a)(i) of Part II and paragraph 1 of Part III of Schedule 3 that the conferment of a beneficial interest in a “readily convertible asset” as defined in s702 of ITEPA is not excluded from the calculation of “earnings”.

9. Part IX of the SSCA Regulations deals with the mirror image situation to that summarised at paragraph [7] above. Paragraph 9 of Part IX operates to exclude from the calculation of earnings any payment by way of the acquisition of restricted securities where s425 of ITEPA prevents an income tax charge from arising on that acquisition. This provision also, therefore, aligns the NIC treatment with that applicable for income tax purposes as the receipt of a restricted security which does not trigger an income tax liability (because of s425 of ITEPA) does not trigger an NIC liability either.

10. Section 8 of the Social Security (Transfer of Functions etc) Act 1999 permits HMRC to make "section 8 decisions" as to the amount of NIC payable. Section 10 of that Act confers a right of appeal to the Tribunal.