[2018] UKUT 0007 (TCC)

**Appeal number: UT/2016/0193**
**UT/2017/0195**

***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 ITEPA – whether employees to be treated as receiving cash***

**UPPER TRIBUNAL**
**TAX AND CHANCERY CHAMBER**

**CYCLOPS ELECTRONICS LIMITED**
**GRACELAND FIXING LIMITED**

**Appellants**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS**

**Respondents**

**TRIBUNAL: The Honourable Mr. Justice Marcus Smith**
**Judge Timothy Herrington**

**Sitting in public at The Rolls Building, Fetter Lane, London EC4A 1NL on 10 and 11 December 2017**

**Michael Sherry, instructed by Charterhouse (Accountants) Limited, accountants, for the First Appellant and by Haines Watts Farnborough LLP, accountants, for the second Appellant**

**Malcolm Gammie, Q.C. and Laura Poots, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents**

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DECISION

## Introduction

1. This is a decision relating to two appeals, heard together, from the decision (the "Decision") of the First-Tier Tribunal (Tax Chamber) (Judge Jonathan Richards) (the "FTT") released on 12 July 2016, by which the FTT decided that the acquisition of certain loan notes (the "Loan Notes") by various employees (the "Employees") of the two appellants (who we will refer to individually as "Cyclops" and "Graceland"; and together as the "Appellants") gave rise to obligations on the part of the Appellants to account for national insurance contributions ("NICs") and to pay income tax under the PAYE system.

2. Before the FTT, these appeals were lead cases under the FTT's Rule 18 procedure, with more than one hundred appeals designated as related cases which remain stayed before the FTT.

3. In essence, the question to be determined on these appeals is whether, because of the existence of a forfeiture provision in the terms of the Loan Notes, the Loan Notes were "restricted securities" for the purposes of Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). If, as the Appellants contend, the Loan Notes were restricted securities, then by virtue of section 425 ITEPA (and corresponding provisions in the NIC legislation) there was no income tax or NIC payable upon acquisition by the Employees of the Loan Notes. The Loan Notes at issue in Graceland's appeal were redeemed in tax year 2004-05 and Graceland contends that the detailed operation of Part 7 ITEPA means that there was no income tax (or NIC) payable on this redemption.

4. HMRC contend 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 judgment of the Supreme Court in two appeals, *UBS AG v HMRC* and *Deutsche Bank Group Services (UK) Ltd v HMRC* [2016] UKSC 13, [2016] STC 934 (the "*UBS* decision") is that the Loan Notes were not restricted securities and that the acquisition of the Loan Notes by 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. Without prejudice to those contentions, HMRC also contend that, as a result of the Supreme Court's judgment in *RFC 2012 plc (in liquidation) (formerly Rangers Football club plc) v Advocate General for Scotland* [2017] STC 1556 (the "*Rangers* decision"), a case which was published after the Decision, Cyclops and Graceland's respective subscriptions for cash of the Loan Notes prior to their acquisition by the Employees was the first of a pre-ordained set of steps to deliver cash which represented payment of the Employees' money earnings. HMRC contended that the effect of the *Rangers* decision was that the Employees were to be taxed on those sums on the basis that they were money earnings.

5. In relation to Graceland's appeal, HMRC contend that even if the Loan Notes were restricted securities, Part 7 ITEPA did not operate in the way contended for by

Graceland and both income tax and NIC were payable on redemption of the Loan Notes.

## The Facts

*The generic transaction*

6. The FTT made detailed findings of fact at [6] to [59] of the Decision. It is helpful to start by summarising the transactions undertaken by the Appellants in relation to the Loan Notes. This summary represents the facts common to the lead cases agreed between the parties for the purposes of the Rule 18 procedure.

7. The transactions effected were as follows:

(1) An Employee incorporated, or acquired "off the shelf", a company ("NewCo");

(2) The Employee became the sole shareholder and a director of NewCo;

(3) NewCo's authorised (but not issued) share capital included a class of preference shares (the "Preference Shares");

(4) NewCo issued, and the Employee's employer (the "Employer") subscribed for, Loan Notes of £X, in denominations of £10;

(5) The Employer transferred the Loan Notes to the Employee.

8. The key common terms of the Loan Notes were:

(1) The redemption price was a sum equal to £10 for each £10 Loan Note (the "Redemption Price").

(2) There were two redemption periods during which the holder of the Loan Note (the "Noteholder") could give notice to redeem some or all of the Loan Notes. The exact periods and notice requirements varied from case to case, but in general:

(a) The "First Early Redemption Period" began several weeks after the issue of the Loan Notes and lasted for several weeks. During this period the Noteholder could require redemption upon several days' notice.

(b) The "Second Early Redemption Period" began immediately upon the issue of the Loan Notes and lasted for several months. If notice was given in the appropriate form during the Second Early Redemption Period, then redemption was to take place several days after the expiry of that period.

(3) The Loan Notes were immediately repayable at the Redemption Price at the option of the Noteholder, such option only to be exercised by the Noteholder giving notice in writing during the Second Early Redemption Period following the occurrence of certain specific events, including the passing of any resolution for the winding up or dissolution of NewCo.

(4) In the event of the death of the Employee within 365 days of the date of the Loan Note instrument, all Loan Notes which had not been redeemed or converted were to be immediately re-registered with the Employer without compensation for the Noteholder at the date of death. This is the forfeiture provision that is mentioned in [3] above.

(5) If and to the extent that the Loan Notes had not been redeemed during the First Early Redemption Period or notice given during the Second Early Redemption Period, there followed a "Conversion Period". During this period NewCo had discretion to convert each £10 Loan Note into one 10p Preference Share issued fully paid with a share premium of £9.90.

*Cyclops*

9. In relation to Cyclops's appeal, Cyclops was the Employer and Mr. Daniel Yodaiken was the Employee. Mr. Yodaiken was also the sole shareholder and director of Cyclops. Charterhouse (Accountants) LLP brought to Mr. Yodaiken's attention a tax planning opportunity involving the payment of a bonus in the form of Loan Notes. It was explained to Mr. Yodaiken that the intended effect of such arrangements was to ensure that there was no income tax or NIC liability associated with either the receipt of the Loan Notes or their redemption.

10. On 21 May 2004, Mr. Yodaiken took a decision in principle to proceed with the tax planning by taking a bonus in the form of Loan Notes.

11. On 24 June 2004, Cyclops, through Mr. Yodaiken, signed an engagement letter with Charterhouse with agreed fees of £48,000, some of which became due following a satisfactory meeting with tax counsel.

12. On 14 July 2004, a satisfactory meeting with tax counsel took place. It was pre-ordained at that point that the transactions described at [13] below would take place. After that date, but before 1 September 2004, Cyclops determined to pay Mr. Yodaiken a bonus in total of £400,000. Of that bonus, £150,000 was attributable to the year ended 31 March 2004; the remaining £250,000 was attributable to the year ended 31 March 2005.

13. The NewCo that was established was Davissa Ltd ("Davissa"). Cyclops subscribed and Davissa issued Loan Notes with a nominal value of £400,000 for cash on 1 September 2004. Cyclops transferred the Loan Notes to Mr. Yodaiken on 24 September 2004 as to £150,000 in nominal value in consideration of the 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.

14. Clause 9.1 of the instrument constituting the Loan Notes contained the forfeiture provision that is of central relevance in Cyclops's appeal. This 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…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…"

15. The effect of the forfeiture provision was, as the FTT observed at [36] of the Decision, that Mr. Yodaiken's estate would be running a risk if he were to die within the 365-day period specified in the forfeiture provision as the Loan Notes would cease to be owned by Mr. Yodaiken's estate and would be owned by Cyclops. Of course, were the contingency to arise, Mr. Yodaiken's estate would continue to have an indirect interest in the Loan Notes as the sole shareholder in Cyclops.

16. In addition to redemption during the Early Redemption Periods referred to at [8 (2)] above, clause 4.1 of the instrument provided that the Loan Notes might be redeemed by Davissa at its option by payment of their nominal value.

17. Mr. Yodaiken did not exercise his redemption rights, and Davissa converted the Loan Notes to Preference Shares on 18 April 2005. The FTT concluded that any action that Mr. Yodaiken would take following receipt of the Loan Notes was not pre-ordained.

18. At [30] of the Decision, the FTT concluded that the predominant purpose for the transactions described above was to provide Mr. Yodaiken with 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. The FTT found at [31] of the Decision that the transactions also had the effect that Mr. Yodaiken owned all of the shares in a company, Davissa, that held a material cash sum which could be used to undertake new lines of business, but that this was not the purpose or a main purpose of those transactions.

19. At [32] of the Decision, the FTT found that there was no business or commercial purpose for including the forfeiture provision in clause 9.1 of the instrument constituting the Loan Notes and that the provision was commercially irrelevant and designed only to secure the benefit of the tax exemption for restricted securities. The FTT gave its reasons for that conclusion as follows:

> "…. 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 [a partner in Charterhouse'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."

*Graceland*

20. In relation to Graceland's appeal, Graceland was the Employer. There were two Employees: Mr. Paul Darrington and Ms. Vivien Brown. Mr. Darrington was a director of Graceland and held two-thirds of Graceland's issued share capital. Ms. Brown was the other director of Graceland and held one-third of Graceland's issued share capital. Haines Watts, accountants, brought to Mr. Darrington and Ms. Brown's attention a tax planning opportunity whereby, if Graceland provided them with a bonus in the form of a Loan Note containing a forfeiture provision, there was a prospect that the bonus would not be subject to PAYE or NICs.

21. Mr. Darrington and Ms. Brown agreed to implement the scheme and to cause Loan Notes to be issued as a bonus pursuant to that scheme. On 22 April 2004, Graceland entered into an engagement letter with Haines Watts, under which Haines Watts was to receive 10% of the bonus in instalments.

22. On 7 May 2004, a satisfactory meeting with tax counsel took place. It was pre-ordained at that point that the transactions described at [23] below would take place.

23. In relation to Mr. Darrington:

(1) NewCo was PJD Investments Limited ("PJDI").

(2) Graceland subscribed and PJDI issued Loan Notes with a total nominal value of £173,330 on 30 June 2004.

(3) Graceland transferred the Loan Notes to Mr. Darrington on 13 July 2004 as to a nominal value of £80,000 as consideration for services provided to Graceland in the period of account ended on 30 November 2003 and as to a nominal value of £93,330 as consideration for services provided to Graceland in the period of account ended 30 November 2004.

(4) Mr. Darrington gave notice on 10 September 2004 requiring PJDI to redeem £155,000 of his Loan Notes by 13 October 2004.

(5) On 12 October 2004, PJDI paid Mr. Darrington redemption proceeds of £155,000.

(6) Mr. Darrington redeemed a further £7,446 of his Loan Notes between June and November 2008. PJDI was struck off the register of companies on 27 July 2010 and Mr. Darrington received no further payment in respect of the Loan Notes.

(7) It was not pre-ordained that, from the time at which Mr. Darrington received his Loan Notes, he would request redemption of them in the manner that he did.

24. In relation to Ms. Brown:

(1) NewCo was VJB Investments Limited ("VJBI").

(2) Graceland subscribed and VJDI issued Loan Notes with a total nominal value of £86,670 on 30 June 2004.

(3) Graceland transferred the Loan Notes to Ms. Brown on 13 July 2004 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 as to a nominal value of £46,670 as consideration for services provided to Graceland in the period of account ended 30 November 2004.

(4) On 10 September 2004, Ms. Brown gave notice requiring VJDI to redeem £60,000 of her Loan Notes by 13 October 2004.

(5) On 12 October 2004, VJBI paid Ms. Brown redemption proceeds of £60,000.

(6) At the time of the FTT hearing, Ms. Brown continued to hold the balance of £26,670.

(7) It was not pre-ordained that, from the time at which Ms. Brown received her Loan Notes, she would request redemption of them in the manner she did.

25. The forfeiture provision in the instrument constituting the PJDI Loan Notes referred to a contingency, namely the death of Mr. Darrington in the period of 365 days after the date of the instrument. In the event of that contingency, the instrument provided that the PJDI Loan Notes would be registered, or re-registered, with Graceland.

26. The forfeiture provision in the instrument constituting the VJBI Loan Notes referred to a contingency, namely the death of Ms. Brown in the period of 365 days after the date of the instrument. In the event of that contingency, the instrument provided that the VJBI Loan Notes would be registered, or re-registered, with Graceland.

27. As the FTT observed at [58] of the Decision, Mr. Darrington and Ms. Brown took a greater risk of being adversely affected by the operation of the forfeiture provision than, for example, Mr. Yodaiken. That was because, if Mr. Darrington died within the 365-day period, his Loan Notes will be transferred to Graceland, and he held only two-thirds of the shares in Graceland. Similarly, if the forfeiture provision relating to the VJBI Loan Notes were to apply, Mr Darrington would, indirectly, acquire a two-thirds share in the VJBI Loan Notes. The FTT found that 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.

28. The instrument constituting both the PJDI Loan Notes and the VJBI Loan Notes contain the same provisions as regards redemption as the Davissa Loan Notes, as described above.

29. The FTT found that the object of the planning was to ensure that both Mr. Darrington and Ms. Brown received bonuses in a form that was not subject to NICs or PAYE and that neither of them, nor Graceland, PJDI or VJBI, intended that the proceeds of issue of the respective Loan Notes would be used in a commercial venture: see [51] to [53] of the Decision.

30. The FTT also found that the sole purpose of the forfeiture provision in the respective Loan Notes was to enable the Loan Notes to constitute "restricted securities", which was essential if the tax planning was to achieve its desired object. Accordingly, the FTT found that there was no independent business or commercial purpose for including the forfeiture provision in the Loan Notes and that the forfeiture provision was commercially irrelevant: see [54] of the Decision.

**Relevant statutory provisions**

31. Section 6 ITEPA imposes a tax on employment income which, so far as relevant, is on "general earnings". Section 7 defines "general earnings" by reference to section 62 ITEPA which, so far as relevant, provides:

> "(2) …'[E]arnings', in relation to an employment, means -
>
> (a) any salary, wages or fee,
>
> (b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or
>
> (c) anything else that constitutes an emolument of the employment.
>
> (3) For the purposes of subsection (2) 'money's worth' means something that is -
>
> (a) of direct monetary value to the employee, or
>
> (b) capable of being converted into money or something of direct monetary value to the employee."

32. Part 7 ITEPA contains a specific statutory code dealing with "employment related securities". It was common ground that, insofar as they were "securities" at all, the Loan Notes were "employment related securities".

33. Chapter 2 of Part 7 ITEPA deals with "restricted securities". Section 422 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."

34. The definition of "restricted securities" is set out in section 423 as follows:

> "**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."

35. Section 425 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.

…"

36. In most cases, the income tax charge is to be postponed until the point at which restrictions are lifted. That is achieved by a combination of section 426 and section 427, which respectively impose a tax charge on the occurrence of a "chargeable event" and define the concept of a "chargeable event" as follows:

"**426 Charge on occurrence of chargeable event**

(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)."

37. Section 428 ITEPA sets out the amount of any charge arising on a "chargeable event".

38. Sections 430 and 431 ITEPA permit the employer and employee jointly to make elections whose effect is, very broadly, to disapply the exemption set out in section 425 ITEPA, with the result that the receipt of "restricted securities" gives rise to an immediate tax charge, but the subsequent lifting of the restrictions does not give rise to a tax charge.

## The Decision

39. The following issues were before the FTT:

(1) Whether the Loan Notes were "restricted securities" for the purposes of section 423 ITEPA, so that they were exempt from tax under section 425 ITEPA on receipt by the Employee;

(2) If the Loan Notes were not restricted securities, so that they were taxable as earnings on receipt by the Employee, the basis on which the amount of earnings was to be determined; and

(3) If the Loan Notes were restricted securities, whether a redemption of the Loan Notes triggered an income tax charge under Chapter 2 or 4 ITEPA.

40. In relation to the first issue, the FTT analysed with care the Supreme Court's judgments in the *UBS* decision, holding that the correct approach to be followed when construing section 423 ITEPA is to focus on the provisions for forfeiture and to ask whether they have a business or commercial purpose or whether they are commercially irrelevant conditions whose only purpose is the obtaining of the exemption: see [74] of the Decision.

41. The FTT referred at [76] to its earlier findings that there was no business or commercial purpose for the inclusion of the forfeiture provisions within the terms of the Loan Notes; that they were commercially irrelevant; and designed only to secure the benefit of the tax exemption in section 425 ITEPA. Accordingly, the FTT concluded that none of the Loan Notes were "restricted securities".

42. Although the FTT did not consider that it was necessary to look beyond the purpose of the forfeiture provision and consider the wider commerciality or otherwise of the circumstances surrounding the issue of the Loan Notes, for completeness it nevertheless did so. It held at [77] that there was no predominant commercial purpose for the issue of any of the Loan Notes, although it is accepted that the issue of the Loan Notes had commercial effects.

43. Consequently, the FTT held at [82] that no exemption applied for either income tax or NIC purposes when the Employees received their Loan Notes. Therefore, 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.

44. In relation to the second issue, the FTT, having analysed the relevant authorities and applying the approach set out by the Inner House of the Court of Session in *Aberdeen Asset Management plc v HMRC* [2014] STC 438 (the "*Aberdeen* decision"), concluded 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. This was because all of Davissa, VJBI and PJDI held cash balances representing the principal amount of their respective Loan Notes and 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. They had the practical ability to require immediate payment of the redemption proceeds if they wished: see [99] and [102] of the Decision.

45. The FTT held at [103] that it did not matter 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. The FTT regarded the analogy with an employee who receives a payment of salary into a bank account as being 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, the money will be spent.

46. Accordingly, the FTT concluded at [104] 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.

47. On the basis that the Loan Notes were not restricted securities, it was not necessary to consider the third issue, namely the application of Chapters 2 and 4 of Part 7 ITEPA to the redemption. The FTT did, however, set out its views on the application of Chapter 2. In particular, the FTT concluded that (i) redemption was a chargeable event for the purposes of Chapter 2 and (ii) the formula used to calculate the taxable amount should not be interpreted to produce a nil amount.

**Grounds of Appeal**

48. The Appellants challenge the FTT's findings on all three of the issues set out at [39] above. In summary, the grounds of appeal are as follows:

> (1) In respect of the first issue, it was contended that the FTT erred in its conclusion that the Loan Notes were not restricted securities. The Appellants contended that the Loan Notes were issued by real companies for contemplated commercial purposes. The forfeiture provisions were real restrictions with a real possibility of occurrence and would have had a real effect on the value of the securities. That was the purpose of the restrictions, in contrast with restrictions under consideration in the *UBS* decision. The FTT confused the motivation of the Appellants and the purposes of the transactions entered into and confused the motivation of all those involved in the inclusion of the forfeiture provisions with the purpose of such provisions.
>
> (2) In respect of the second issue, it was contended that the FTT erred in concluding that the reasoning in the *Aberdeen* decision was applicable to the circumstances under consideration so as to treat the transfer of the Loan Notes as the payment of earnings of an amount equal to the nominal value of the Loan Notes. The Appellants also contended that the FTT erred in concluding that the recipients of the Loan Notes had the underlying cash unreservedly at their disposal from the time securities were transferred to them. The Appellants contended that the FTT should have concluded that the earnings consisted of the Loan Notes which fell to be valued by reference to market value and were subjected to PAYE only in so far as they were readily convertible assets, by reference to their market value.
>
> (3) In respect of the third issue, it was contended that the FTT erred in concluding that a redemption of the Loan Notes was a disposal for the purposes of section 428 ITEPA and that the formula set out at section 428(3) used to calculate the taxable amount should not be interpreted so as to produce a nil amount.

49. Judge Richards gave permission to appeal on these grounds on 13 September 2016.

50. HMRC contended that the FTT was right in its conclusions on the three issues that were before it for the reasons that it gave in the Decision.

## Discussion

51. We shall deal with the grounds of appeal in the context of the three issues identified above as follows.

*Whether the Loan Notes were restricted securities*

52. In reaching its conclusion that the Loan Notes were not restricted securities, the FTT analysed and applied the judgment of the Supreme Court in the *UBS* decision.

53. There are clear similarities between the *UBS* decision and these appeals, in that they all involve the carrying out of a number of pre-ordained steps designed to enable discretionary bonuses to be awarded in a manner which would minimise the incidence of income tax and NICs. In the *UBS* decision, the pre-ordained steps, as described at [25] of the judgment, involved the following:

> "(1) The bank decided which of its employees would receive discretionary bonuses, and the amount of those bonuses.
>
> (2) Company Z was created in an offshore jurisdiction in such a manner that it was not an associated company of the bank.
>
> (3) A special class of redeemable shares in Company Z was created. As shares, these were "securities" as defined in section 420(1)(a). The shares were subject to a short-term restriction designed to satisfy the requirements of section 423(2).
>
> (4) The restriction involved a contingency which was unlikely to occur but might conceivably do so. In cases where the occurrence of the contingency lay beyond the control of those involved in the scheme, hedging arrangements were entered into so that the employees were compensated in the event of the restriction being activated.
>
> (5) Directly or indirectly, the bank paid the aggregate amount of the bonuses to Company Z as the price of the shares.
>
> (6) The purchaser received the shares and allocated beneficial interests to the employees identified at step (1) in amounts equal to the amounts that the bank had decided to award them as bonuses. Exemption from a charge to income tax on the employees' acquisition of the shares was asserted under section 425(2), on the basis that the shares were restricted securities by virtue of section 423(2).
>
> (7) A short time later, the restriction was removed from the shares.
>
> (8) A short time after that, the employees became entitled to redeem their shares, and many did so. No liability to income tax arose by reason of the redemption.
>
> (9) Some employees who were resident and domiciled in the UK continued to hold their shares for the two years necessary to mitigate a charge to capital gains tax using taper relief. They then redeemed their shares.
>
> (10) In due course Company Z was wound up."

54. As summarised by the FTT at [63] of the Decision, the contingency which was said to make the shares "restricted securities" in the appeal by UBS in the *UBS* decision 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 Company Z 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 the contingency did not occur. In Deutsche Bank's appeal in the *UBS* decision, an employee's shares would be forfeited if, in the period of approximately 8 weeks after the award of the shares, the holder ceased to be employed by Deutsche Bank (other than in specified circumstances).

55. Lord Reed gave the leading judgment with which the other members of the court agreed. He referred at [61] and [63] of the judgment to the principle explained in *Barclays Mercantile Business Finance Ltd v Mawson* [2005] 1 AC 684 that the relevant statutory provision should be given a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description.

56. At [64], Lord Reed referred to this approach proving to be particularly important in relation to tax avoidance schemes as a result of two factors: first, that tax is generally imposed by reference to economic activities or transactions which exist in the "real world"; and secondly, tax avoidance schemes commonly include elements which have been inserted without any business or commercial purpose, but are intended to have the effect of removing the transaction from the scope of the charge. He then quoted with approval (at [66]) the well-known statement of Ribeiro PJ in *Arrowtown Assets* 6 ITLR 454:

> "The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."

57. At [74], Lord Reed observed that Part 7 ITEPA was concerned with particular taxation issues which arise when employees are remunerated in shares and other securities, the purpose of the provisions being in broad terms threefold:

> (1) to promote employee share ownership, particularly by encouraging share incentive schemes;
>
> (2) since such schemes require benefits to be contingent on future performance, creating a problem if tax is charged on the acquisition of securities, to wait and see until the contingency has fallen away; and
>
> (3) to counteract consequent opportunities for tax avoidance.

58. Against that background, and having referred at [75] to the structure of the legislation being based on the exemption of restricted securities from income tax when the securities were acquired but imposed when the restrictive conditions were lifted, subject to a widely drawn exemption from the latter charge, Lord Reed then came to the following conclusion on the scope of the exemption contained in section 425(2) ITEPA at [76] to [78] of the judgment:

> "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 section 425(2), and more specifically the question whether, in section 423(1), the words "any contract, agreement, arrangement or condition which makes provision to which 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 Chapter 2 was introduced partly for the purpose of forestalling tax avoidance schemes self-evidently makes it difficult to attribute to Parliament an 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 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 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.

78. More specifically, it appears from the background to the legislation that the exemption conferred by section 425(2), in respect of the acquisition of securities which are "restricted securities" by virtue of section 423(2), was designed to address the practical problem which had arisen of valuing a benefit which was, for business or commercial reasons, 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 section 423(2) should also apply to transactions having no connection to the real world of business, where a restrictive condition 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."

59. Accordingly, at [85] of the judgment, Lord Reed concluded that the reference in section 423(1) ITEPA 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 provisions having a business or commercial purpose, and not to commercially irrelevant conditions whose only purpose is the obtaining of the exemption.

60. Applying this approach to the transactions at issue Lord Reed, in summary, concluded at [86] to [88] in the *UBS* decision that:

(1) In the UBS appeal, the condition was completely arbitrary and had no business or commercial rationale beyond tax avoidance. Consequently, the condition should be disregarded, with a consequence that the shares were not "restricted securities".

(2) That conclusion was fortified by the fact that the economic effect of the restrictive condition was nullified by the hedging arrangements so that the

benefit to the employee was not truly dependent on the contingency set out in the condition.

(3) In the Deutsche Bank appeal, although "leaver" provisions in employee benefit arrangements often serve a genuine business or commercial purpose, that was not true in relation to the condition in this case because the provision operated only for a very short period during which the possibility that it might be triggered lay largely within the control of the employee concerned. Deutsche Bank 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.

61. As we summarised at [40] to [43] above, the essence of the FTT's reasoning was that the correct approach to be followed when construing section 423 ITEPA was to focus on the question of whether the provisions for forfeiture have a business or commercial purpose or whether they are commercially irrelevant conditions whose only purpose is the obtaining of the exemption. It derived this approach from the application of the conclusion at [85] of Lord Reed's judgment in the *UBS* decision. The FTT's findings of fact that there was no business or commercial purpose for the inclusion of the forfeiture provisions and that those provisions were commercially irrelevant and designed only to secure the benefit of the tax exemption in section 425 ITEPA inevitably led to the conclusion that none of the Loan Notes were "restricted securities".

62. Mr. Sherry, who appeared for the Appellants, submits that in reaching this conclusion the FTT confused the motivation for including the restrictions with their purpose. He submits that the Loan Notes were issued by real companies for contemplated commercial purposes which involved the continuing existence of those companies, in contrast to the position in UBS and Deutsche Bank.

63. Furthermore, he submits, the restrictions imposed on the securities (namely that they were to be forfeit if the individuals to whom they respectively to be awarded were to die within one year of their issue) were real restrictions with a real possibility of occurrence and which would have had significant consequences had the contingency arisen. There was nothing built into the terms of the issue otherwise arranged to offset the real risk of the contingency arising, which was in sharp contrast to the position in the UBS appeal, where the effect of the restriction was hedged so as to rob it of any purpose, and in the Deutsche Bank appeal, where compliance with the bad leaver provisions which only lasted for a short period was entirely (or very largely) within the power of the employees. Those restrictions would self-evidently have had a real effect on the value of the securities. That was the purpose of the provisions, which may be contrasted with the restrictions under consideration in the *UBS* decision.

64. Mr. Sherry submits that, unlike the position in the *UBS* decision, the arrangements in this case were not carefully crafted to fall within the scope of the statutory provisions purely for the purpose of tax avoidance. As regards the references at [78] of Lord Reed's judgment to the need for the transactions to have a connection

to the real world of business, properly applied to these appeals, the correct approach was to consider what would have happened had the taxpayer died, that being a real world event. Whilst there was no rational purpose for the restrictions considered in the *UBS* decision, in the case of these appeals, when viewed objectively, the issuing of Loan Notes which revert to the Employer if the Employee dies within a year makes sense when viewed objectively. The provision had a commercial purpose which was to ensure that the bonus was not paid if the Employee died within a year.

65. Mr. Sherry submits that in the context of the *UBS* decision, it is not surprising that the application of the principle stated at [85] of Lord Reed's judgment led to the conclusion that the forfeiture provisions should be ignored. Those cases can properly be characterised as "cash delivery cases", that is where the sole object of the exercise was to deliver cash into the hands of the relevant employees through a series of pre-ordained steps. In the case of these appeals, pre-ordination ceased when the Employee acquired the Loan Notes and that put them in a different category. What happened after that was not pre-ordained: there were some partial redemptions and some investment by the issuers of the Loan Notes in other businesses, demonstrating that on the facts found by the FTT these were not schemes to deliver cash to the Employees.

66. We are not persuaded by these submissions for the following reasons.

67. We cannot see that the distinction that Mr. Sherry seeks to draw between motivation and purpose can have any significance in the context of these appeals in the light of the FTT's clear findings of fact to the effect that there was no purpose for the arrangements other than to obtain the benefit of the exemption. The basis of the distinction that Mr Sherry sought to draw was that the *motivation* for the inclusion of the restriction was to ensure that the Loan Notes could be received by the Employees in a tax efficient manner and the *purpose* of the provision was to ensure that no bonus was paid if the Employee died within a year the issue of the Loan Notes.

68. There are a number of difficulties with this submission:

(1) First, there was no finding of a purpose to that effect by the FTT and Mr Sherry's submission cannot be made good without flying in the face of the factual findings that the FTT did make. To recap, the FTT found, in relation to Graceland, that at the time that PJDI and VJBI received the subscription monies from Graceland, neither company had any intention of using the money in a commercial venture and, in relation to Cyclops, the effect of the transactions was that Davissa had cash which could be used to undertake a new business but that was not the purpose or a main purpose of the arrangements and in fact no other business was developed.

(2) Secondly, the finding that the FTT made at [32] of the Decision, as set out at [19] above, makes it clear that the evidence did not suggest any business or commercial purpose for the forfeiture provision. Mr. Sherry's submission that the purpose of the provision was to ensure that no bonus was paid if the Employee were to die within the period of the restriction was unsupported by any evidence to that effect. No explanation was given as to why the Employer would want the Loan Notes back if the Employee died in circumstances where

the Loan Notes had been transferred in consideration of services which had already been provided. As Mr. Gammie, Q.C., who, with Ms. Poots, appeared for HMRC, submitted, the restriction was a condition imposed by the issuer of the Loan Notes and not the Employer so it could only ever serve the Employee's purpose, which was to ensure that (s)he received a bonus without any income tax or NICs becoming payable.

(3) Thirdly, we do not consider that the distinction that Mr. Sherry sought to drawn between *motivation* and *purpose* was a real one. We accept that the *effect* of the forfeiture provision was to ensure that no bonus was paid if the Employee died within a year the issue of the Loan Notes, but that was not its purpose. Mr. Sherry was entirely unable to explain the purpose of the provision, save in terms of its effect. We consider that in the case of the present appeals, the *purpose* of the provision was to satisfy the *motive*, which was to avoid a charge to tax.

69. In those circumstances, in our view the FTT was absolutely right to conclude that the purpose of the arrangements was the payment of bonuses and the motivation for those arrangements was to avoid the income tax and NICs that would otherwise arise in respect of those payments.

70. In any event, as the FTT correctly identified following the approach laid down by Lord Reed in the *UBS* decision, when looking at a forfeiture provision in the context of section 423 ITEPA, it is necessary to focus on the purpose for the inclusion of the forfeiture provision, rather than the purpose for which the Loan Notes were issued, so that even if the NewCos had been funded with the intention of carrying on business that cannot affect the question as to whether the Loan Notes were restricted securities. We therefore agree with the FTT's analysis at [77] of the Decision that the fact that the issue of the Loan Notes had commercial effects makes no difference in the absence of any predominant commercial purpose for their issue.

71. We accept that the contingency created by the forfeiture provisions in the Instruments creating the Loan Notes had a greater possibility of occurring than those in the *UBS* decision. However, we do not regard that as being of any significance. Although the death of an Employee would be a "real world" event, it is of no consequence unless the restriction has been inserted for a business or commercial purpose.

72. Finally, since the Employees had control of the respective issuers of the Loan Notes through their directorships and shareholdings, they had a free choice as to whether the restrictions should continue or not, either by removing the restrictions or procuring that the issuer exercised its option to redeem the Loan Notes. As the FTT found, any risk of forfeiture was a risk that the Employee was willing to take in order to seek to obtain the intended tax benefits. As the FTT found, that situation was not materially different in that regard from the facts in the Deutsche Bank appeal in the *UBS* decision. Furthermore, because the Employees had this level of control, the fact that pre-ordination ceased once the Loan Notes had been acquired by the Employees is of no significance.

73. We therefore conclude on the first issue that the FTT correctly identified the relevant principles to be applied in considering the terms of the restrictions, as derived from the judgment of Lord Reed in the *UBS* decision*,* and correctly applied those principles to the relevant facts in these appeals. We therefore find that the Loan Notes were not restricted securities for the reasons that the FTT gave in the Decision.

74. We have come to this conclusion without finding it necessary to consider Mr. Gammie's alternative argument, which was based on an analysis of the Supreme Court's judgment in the *Rangers* decision. This judgment was released after the Decision, and for that reason the Decision makes no mention of it.

75. The *Rangers* decision concerned a tax avoidance scheme pursuant to which the employer had made payments to a remuneration trust for the benefit of particular employees, recommending that the trustee resettle the sum on a sub-trust for the benefit of the employee in question. The trustee would then make a loan to the employee. The central issue in the appeal was whether it was necessary that the employee himself should either receive, or be entitled to receive, the remuneration for his work in order for that reward to amount to taxable emoluments.

76. The Supreme Court held that there was no such requirement, observing that the relevant provisions of section 62(2) ITEPA do not specify the recipient. Lord Hodge, who gave the principal judgment, with which the other members of the court agreed, said at [41]:

> "As a general rule, therefore, the charge to tax on employment income extends to money that the employee is entitled to have paid as his or her remuneration whether it is paid to the employee or a third party. The legislation does not require that the employee receive the money; a third party, including a trustee, may receive it. While that is a general rule, not every payment by an employer to a third party falls within the tax charge. It is necessary to consider other circumstances revealed in case law and in statutory provisions which fall outside the general rule. Those circumstances include: (i) the taxation of perquisites, at least since the enactment of ITEPA, (ii) where the employer uses the money to give a benefit in kind which is not earnings or emoluments, and (iii) an arrangement by which the employer's payment does not give the intended recipient an immediate vested beneficial interest but only a contingent interest…."

77. One of the examples that Lord Hodge gave as falling outside this general rule, as an example of a benefit in kind, was the provision of employment related securities which fell within the scope of Part 7 of ITEPA: see [46] of the judgment.

78. Lord Hodge summarised the position as regards the general rule at [59] as follows:

> "Parliament in enacting legislation for the taxation of emoluments or earnings from employment has sought to tax remuneration paid in money or money's worth. No persuasive rationale has been advanced for excluding from the scope of this tax charge remuneration in the form of money which the employee agrees should be paid to a third party, or where he arranges or acquiesces in a transaction to that effect…"

79. Mr. Gammie submits that, applying this principle to the facts of these appeals, the payment made to NewCo was remuneration in the form of money which the Employee agreed should be paid to a third party (NewCo), and the Employee arranged or acquiesced in transactions to that effect. He submits that in relation to these appeals, the subscription monies for the Loan Notes represented sums which the Employer had agreed should be paid to the relevant Employee by way of bonus but in a manner to minimise tax. Mr. Gammie submits that is exactly the same as the position in the *Rangers* decision, where the amount resolved to be paid by way of remuneration was paid to the employee benefit trust. Therefore, the sums divested by the Employer by subscribing for the Loan Notes as part of the pre-ordained arrangements to pay these bonuses were emoluments of the Employee's employment and fell to be taxed on that basis. He submitted that it was legitimate to look at the composite effect of the scheme as it was intended to operate.

80. We would accept that analysis but for Lord Hodge's specific reference to the fact that the general rule laid down in the *Rangers* decision should not be taken as applying to cases where the employer uses the money to give a benefit in kind which is not earnings or emoluments: in that context Lord Hodge referred specifically to the special rules for securities acquired in connection with employment in Part 7 ITEPA. There is a degree of ambiguity here, in that if employment related securities are provided they are not to be treated as earnings if they are "restricted securities" so that it might be said that the general rule should apply in so far as the securities are held not to be "restricted securities", as we have found to be the case here. However, Lord Hodge's observation at [46] was to Part 7 ITEPA generally, and not specifically to securities which were restricted securities.

81. On that basis, where securities are provided by an employer, the position should be determined by reference to the provisions of Part 7 ITEPA alone, without the need to rely on the principle in the *Rangers* decision. We have approached the question in that fashion in reaching our conclusion at [73] above. Mr. Gammie accepted that an analysis based on the Rangers decision (the payment made to NewCo was earnings) and an analysis based on the *UBS* decision (the transfer of the Loan Notes to the Employee was earnings) produced the same outcome, namely that the Employee is taxable on the amount subscribed by the Employer for the Loan Notes. In those circumstances, the point is academic and we say no more about it.

*Basis of determination of the amount of earnings received by the Employees*

82. It follows from our finding that the Loan Notes were not "restricted securities" 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. It is therefore necessary to consider how to determine the amount of those earnings for tax purposes. The respective positions of the parties on this issue were as follows:

(1) HMRC contended 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, they contend 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) The Appellants contended that the Loan Notes were not money earnings. They were illiquid securities and 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. We were referred to a number of authorities where this question has been considered.

85. In the *UBS* decision, the Supreme Court held that the redeemable shares in those cases which had been issued to the employees were to be treated as shares and not cash. Lord Reed analysed the issue at [90] to [92] of his judgment as follows:

> "90. Since the restrictive conditions attached to the shares do not make provision to which section 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."

86. Lord Reed then concluded at [94] that the restriction on the shares that the employees received should still be taken into account in valuing the shares, even though that restriction had no business or commercial purpose.

87. Lord Reed rejected a further argument that the shares were to be regarded as money on the basis that the commercial reality of the scheme was the payment of cash: in particular, the shares were always intended to be redeemable for cash. He said this at [97]:

> "It may well be that, in an appropriate case, the statutory term "money", construed purposively, might apply to arrangements which, viewed realistically, were no more than disguised or artificially contrived methods of paying cash to employees. For the reasons explained in para 92, however, that approach cannot be applied on the facts of the present appeals. It is also apparent from some of the examples of "securities" given in section 420(1)(b), such as debentures, certificates of deposit, and other instruments creating or acknowledging indebtedness, that the ability to redeem an instrument for cash does not render it "money". Indeed, the implication of section 424(c) is that redeemable shares are included within the scope of Chapter 2."

88. In *Garforth v Newsmith Stainless Ltd* [1979] STC 129, Walton J 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", that conclusion being based upon a finding that payment of the sum standing to the credit of the loan accounts would have been made had the directors demanded payment from the company, so that there was no question of any fetter whatsoever on the making of that payment: at 134d of the judgment.

89. *Garforth* was followed by the Inner House of the Court of Session in the *Aberdeen* decision, where the court considered a composite transaction which culminated in shares in "money box" companies being transferred to a nominee for an employee. The court held that the transfer of shares in a "money box" company to an employee was a "payment" for the purposes of the PAYE provisions. The court's reasoning was set out in the judgment of Lord Drummond Young 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" ….

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 section 203(1) of the Taxes Act. Consequently the cross-appeal by HMRC must succeed.

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*, supra, at paragraph 42, that for the purposes of the PAYE system payment "ordinarily means actual payment: i.e. 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. Perhaps more importantly, it takes one aspect of the complex transaction contained in the Scheme, namely whether an employee has a direct right to payment of the funds paid into the Scheme by the employer, and treats that as determinative of whether there is a "payment" to the employee. Under the *Ramsay* approach, however, the transaction under consideration must be viewed "realistically" (Ribeiro PJ in the *Arrowtown Assets* case, cited above at paragraph [25]). That clearly requires the transaction to be looked at as a commercial whole. In the present case the First-tier Tribunal expressly found that the Scheme was conceived as a whole, to channel money from the appellants to the favoured employees. When such a transaction is viewed realistically, as the unity that it was intended to be, it is apparent that the employee-shareholders had ample power to ensure the beneficial use of the funds that had been transferred by the appellants into the money box companies. The fact that powers conferred by company law might have to be exercised to achieve that purpose if the directors are not compliant does not matter; it is the substance of control, and in particular the ability to use the funds in the companies as a medium of exchange for the benefit of the employee, that is important. In this connection it should be noted that, even if funds are paid into the employee's bank account, the employee will require

to exercise a legal power in order to make beneficial use of them, namely the power to direct the bank how the funds due to him are to be applied, as by writing a cheque or directing a credit transfer. In my opinion there is no material difference between that power and the powers that the employee-shareholders in the present case had to determine the beneficial use of the funds provided by the appellants as employer. This accords with the test applied in *Garforth*, where Walton J held that payment occurred "when money is placed unreservedly at the disposal of directors by a company" (52 TC 529). Nothing is said there about any need for a "clear" or "direct" legal right to payment; Walton J rather considered that it was the practical ability to make use of the funds that was important."

90. It is apparent from this reasoning that Lord Drummond Young placed an emphasis on looking at the scheme as a whole, commercially, and in so doing he concluded that realistically the employee-shareholders had the practical ability to obtain access to the funds, albeit that they had to use the powers they had over the money box companies conferred by company law to ensure the monies were paid to them. He regarded that situation as meaning that the monies had been placed unreservedly at the disposal of the employee-shareholders. The fact that their strict legal rights were represented by shares in a company and the rights attaching to those shares would have to be exercised in order to realise the cash did not matter because it was necessary to concentrate on the substance of the transaction rather than its strict legal form.

91. In the *Rangers* decision, Lord Hodge cautioned against "misplaced reliance on judicial glosses", stating that such misplaced reliance has been evident in the case law in relation to the concept of "payment": see [51] of the judgment. He then referred to *Garforth* at [52] of the judgment in this context, but recognised that the gloss which Walton J placed on "payment" by holding that it covered money placed unreservedly at the disposal of the directors "was a practical and sensible one in the context of the circumstances which he was addressing".

92. In the same context, Lord Hodge referred at [53] to that gloss having been adopted in the *Aberdeen* decision, regarding it as having been "unexceptionably applied" in holding that an employee can be said to obtain the benefit of funds where as a practical matter they may be spent by the employee as he wishes.

93. However, Lord Hodge said at [54]:

"The gloss is no basis for establishing a general rule or "principle" that a payment is made for the purposes of PAYE only if the money is paid to or at least placed unreservedly at the disposal of the employee. Yet it has been so used."

94. Lord Hodge then referred to an example of where the gloss had been misused, overruling the Special Commissioners' decision in *Sempra Metals v HMRC* [2008] STC (SCD) 1062, where it was held that there had been no payment of emoluments or earnings in circumstances where payment had been made to a trust on the basis that no transfer of cash or its equivalent had been placed unreservedly at the disposal of the employees.

95. We turn to the decision of the FTT. As we summarised at [44] to [46] above, the FTT applied the approach set out by Lord Drummond Young in the *Aberdeen* decision and concluded that when the Employees received the Loan Notes, the principal amount of those Loan Notes was placed unreservedly at their disposal, with the result that they received "earnings" in the form of cash and the measure of those earnings was, accordingly, the principal amount of the Loan Notes.

96. Mr. Sherry submits that the FTT erred in that conclusion for the following reasons:

(1) It treated the issue and subsequent transfer of the Loan Notes as the main mechanism by which the Appellants transferred cash to the Employees and ignored the real purpose (as opposed to motive) of the issue of the securities, namely to capitalise, in each case, the issuing company so that it was capable of conducting business going forward.

(2) It failed to recognise the limitations of the concept of funds being unreservedly placed at the disposal of employees, which had been discredited by the Supreme Court in the *Rangers* decision.

(3) By concluding that funds had been put unreservedly at the disposal of the Employees, it had effectively pierced the corporate veil, particularly given the specific findings as to the lack of pre-ordination in respect of the period after the transfer of the Loan Notes. Whilst the Employees might have had the means to access the cash by redeeming the Loan Notes, that is not in itself sufficient to justify treating a transfer of the Loan Notes as a payment of money earnings.

(4) It should have followed *UBS* decision, where Lord Reed rejected the assertion that the employees received cash and not securities and held that the ability to redeem an instrument for cash does not render it "money".

97. We are not persuaded by these submissions for the following reasons.

98. We have previously rejected Mr. Sherry's submissions regarding the distinction between motivation and purpose. Therefore, the FTT did not ignore the real purpose of the issue of Loan Notes. It found the main purpose to be the payment of bonuses to the Employees in a tax efficient manner.

99. In our view Mr. Sherry misunderstands Lord Hodge's observations as regards the glosses put on the concept of "payment" in *Garforth* and *Aberdeen.* Lord Hodge was simply saying that it was wrong to use those glosses to justify a conclusion, such as that reached in *Sempra Metals*, that the concept was restricted to "payment" made to the employee and did not embrace payments made to third parties. Lord Hodge specifically acknowledged that the gloss had been appropriately applied in both *Garforth* and *Aberdeen* on the facts of those cases.

100. Likewise, in our view, the FTT appropriately applied the gloss in this case. In our view, in following the approach of Lord Drummond Young in the *Aberdeen* decision, the FTT properly took into account the Employee's powers as directors and shareholders to ensure that the Loan Notes could have been redeemed at any time in

determining whether cash had been placed unreservedly at the disposal of the Employees. This cannot be criticised as "piercing the corporate veil". The approach does not seek to disregard NewCo as being a separate entity, but recognises that the Employees would need to exercise their rights as directors and shareholders in order to procure that the cash sums held within the relevant NewCo was paid to them.

101. In the light of the FTT's findings that the Employees could have procured that the Loan Notes were redeemed at any time, the fact that the time of redemption and whether it took place at all was not pre-ordained is of no significance, particularly in the light of the FTT's findings that it was not intended that the NewCos would undertake any other commercial transactions. As Mr. Gammie submitted, Lord Drummond Young's analysis in *Aberdeen* was based on the practical control that the employees had over the cash, rather than the precise pre-ordained steps. The question as to when that practical control would be exercised was irrelevant.

102. In our view, the position in relation to these appeals can be distinguished from that in the *UBS* decision. We are not saying that the Loan Notes are not to be regarded as securities, but that the Employees should be treated as receiving money earnings equivalent to the principal amount of the Loan Notes and therefore the restriction in the Loan Notes should not be taken into account in valuing them. It is clear from paragraph [92] of Lord Reed's judgment in the *UBS* decision, quoted at [85] above, that the facts were quite different in that case. The redeemable shares issued in those cases were not wholly represented by cash but by other assets whose value could vary. The underlying asset in this case was cash. Lord Reed recognised at [97] of his judgment, quoted at [87] above, that the term "money", construed purposively, might apply to arrangements which, viewed realistically, were no more than disguised or artificially contrived methods of paying cash to employees. In our view, that is precisely the position in this case.

103. We therefore conclude on the second issue that the FTT was correct, for the reasons it gave, to hold that the measure of the Employees' earnings when they received the Loan Notes was the principal amount of those Loan Notes.

*Whether a redemption of the Loan Notes triggered an income tax charge*

104. Our conclusions on the first two issues are sufficient to dispose of these appeals. Therefore, in view of our clear findings on those issues, there is no need for us to consider the remaining issues any further. We shall therefore say no more about them in this decision.

## Disposition

105. The appeals are dismissed.

**MR JUSTICE MARCUS SMITH** **JUDGE TIMOTHY HERRINGTON**

**UPPER TRIBUNAL JUDGES**
**RELEASE DATE: 17 January 2018**