Appeal number: TC/2016/05395

INCOME TAX – payment of "loyalty bonus" by platform service provider to investors - whether liability to deduct tax - whether loyalty bonus payments "annual payments" - held not pure income profit - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

HARGREAVES LANSDOWN ASSET MANAGEMENT LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE THOMAS SCOTT

Sitting in public at Taylor House, Rosebery Avenue, London on 27 and 28 November 2017

John Tallon QC for the Appellant

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

DECISION

Introduction

1. This appeal relates to assessments issued to Hargreaves Lansdown Asset Management Limited ("HL") on 14 September 2016 under section 957 of the Income Tax Act 2007. The assessments relate to the 13 quarterly accounting periods between 1 April 2013 and 30 June 2016.

2. The only issue in the appeal is whether certain payments made by HL to its investors during those periods required HL to deduct and account for sums representing income tax on the payments because they were "annual payments" for tax purposes.

Background

3. HL is a well-known "platform service provider". This means that its business is to provide a platform for the distribution to investors of investment products offered by different fund providers, and to provide administration services to investors.

4. In 2013, HMRC announced that from April 2013 it expected financial intermediaries making certain payments to investors to deduct basic rate tax at source from such payments, with investors being expected to declare any higher rate liability on the payments in their returns.

5. HL did not accept that this obligation applied to the payments which it made to investors. Given the substantial number of investors receiving such payments, and the relatively small amounts per investor, HMRC and HL reached an agreement, intended to avoid the necessity of multiple appeals. Under that agreement, HL would retain an amount equal to the basic rate of income tax on the payments to investors, and HMRC would then assess HL for that amount under section 957 of the Income Tax Act 2007.

6. That is what was done, and, as a result, although HL is the appellant in this appeal, the substantive issue between the parties is whether or not the payments in question are "annual payments" within section 683 of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005").

Legislation

7. For the relevant periods, the applicable legislation, so far as relevant, is as follows.

8. The basic charging provision, in section 683 ITTOIA 2005 (Chapter 7 of Part 5), states as follows:

"683 **Charge to tax on annual payments not otherwise charged**

(1) Income tax is charged under [Chapter 7 of Part 5] on annual payments that are not charged to income tax under or as a result of any other provision of this Act or any other Act.

…

(3) The frequency with which payments are made is ignored in determining whether they are annual payments for the purposes of this Chapter."

9. The obligation to deduct at source is found in section 901 of the Income Tax Act 2007 ("ITA 2007") as follows:

"901 **Deduction from annual payments made by other persons**

(1) This section applies to any payment made in a tax year if-

(a) it is a qualifying annual payment, and

(b) the person who makes it is not an individual.

…

(4) If the person who makes the payment has no modified net income for the tax year the person by or through whom the payment is made must, on making it, deduct from it a sum representing income tax on it at the basic rate in force for the tax year in which the payment is made."

10. Section 899 ITA 2007 provides as follows:

"899 **Meaning of "qualifying annual payment"**

(1) In this Chapter "qualifying annual payment" means an annual payment that meets the conditions in subsections (2) to (5).

(2) The payment must arise in the United Kingdom.

(3) If the recipient is a person other than a company, the payment must be-

(a) a payment charged to income tax under-

… (iv) Chapter 7 of Part 5 of [ITTOIA 2005] (annual payments not otherwise charged) …"

11. Chapter 15 of Part 15 of ITA 2007 provides for persons who have made "section 946 payments" to make returns of those payments, and to collect income tax in respect of them. Section 946 ITA 2007 provides as follows:

"946 **Payments within this section**

The payments within this section are-

…

(b) a payment from which a UK resident company is required to deduct a sum representing income tax under-

… (iv) section 901(4) (annual payments made by persons other than individuals) …"

12. The assessments in this appeal were made under section 957 ITA 2007, which states as follows:

> "957 **Assessments in other cases**
>
> (1) This section applies if an officer of Revenue and Customs thinks-
>
> (a) that there is a section 946 payment which should have been included in a return under this Chapter and which has not been so included, or
>
> (b) that a return under this Chapter is otherwise incorrect.
>
> (2) An officer of Revenue and Customs may make an assessment, to the best of the officer's judgment, on the person who made the return, or should have made one."

Evidence

13. I considered various documents dealing with HL's business and its relationship with its investors, with a particular focus on the payments which are the subject of this appeal. I also considered documents and evidence dealing with the regulatory position regarding those payments. I heard evidence from, and questioned, Mr Ben Lundie, who is "Head of Vantage Development" within the HL group. Mr Lundie is responsible for managing HL's relationships and commercial negotiations with external fund management groups and companies offering products in which HL's clients might invest. I found Mr Lundie to be an entirely credible and reliable witness.

The regulatory changes in April 2014

14. It is first necessary to summarise certain regulatory changes regarding payments to investors which are relevant since the payments in this appeal were made both before and after those changes. The changes were made as a result of a consultation and review (the "FCA Review") carried out by the Financial Conduct Authority ("FCA").

15. In April 2013 the FCA published Policy Statement PS13/1, titled "Payments to platform service providers and cash rebates from providers to consumers". Included within that Policy Statement was the text of the FCA's Notification to the European Commission justifying the proposed reforms. That contained the following passage which is helpful background in this appeal, and which stated, so far as relevant, as follows:

> "**Key characteristics of platforms**
>
> 14. Platforms are internet-based services used by advisers and retail clients to manage and administer investments online, offering a single view of the retail client's invested portfolio. They are normally investment firms and comprise a web based portal which can be accessed by either retail clients or advisers to execute investment transactions. Platforms are seen as a convenient channel through which investments can be arranged and then held in one place (for example to provide a single valuation for an entire portfolio) ….

> 16. In the UK, platforms have in the past generally been funded by payments from product providers. These payments, commonly referred to as 'rebates' in the UK, are a proportion of the fund manager's annual management charge (AMC) paid by the retail client. As a result, many platforms (including those used via an advice process as well as D2C platforms) have been able to market their services at no explicit cost to the retail client. In contrast, some other types of platform charge retail clients a separate fee for their services and any cash rebate is generally paid into the retail client's cash account."

16. The reference to a "D2C" platform is to a "direct to consumer" promoter, such as HL.

17. The FCA concluded that this fee structure created risks for investor protection and hindered transparency. Accordingly, it changed its rules from April 2014 with the effect that, subject to certain transitional arrangements, cash rebates by platform providers to investors would only be permitted if (broadly) a rebate received by a platform from a fund manager was passed on in full to the investor in the form of additional units in the relevant fund or, subject to conditions, in cash. Platform providers would no longer be able to retain a share of the annual management charges paid by the investor to the investment provider, but would be obliged to charge their clients a direct fee for their services.

18. These changes were implemented in the FCA's "Conduct of Business Sourcebook", with which HL was obliged to comply. The relevant provisions (the "New Rules") stated as follows:

> "**Requirement to be paid through platform charges**
>
> … a platform service provider must:
>
> (1) only be remunerated for its platform service (and any other related services it provides) by platform charges…
>
> Examples of remuneration that should not be accepted by a platform service provider include…a share of an annual management charge…
>
> **Providing additional units or payment in cash to a retail client**
>
> [This rule] does not prevent a platform service provider receiving a share of an annual management charge from an authorised fund manager if the platform service provider passes that share on to the retail client in the form of:
>
> (1) additional units; or
>
> (2) cash, provided that it does not offset or appear to offset any adviser charges or platform charges."

Findings of fact

19. On the basis of the documentary evidence and of the witness evidence of Mr Lundie I make the following findings of fact.

20. HL's primary business is to present and explain a range of investment products offered by investment providers to retail investors and to help their clients to invest in their chosen products. It also provides nominee and custodian services, administrative services and financial advice and information. This platform of services is collectively referred to as the Vantage Service.

Position before April 2014

21. In common with many other platform service providers, prior to the New Rules HL did not charge clients an explicit fee for its services. Instead, HL earned its profit by retaining a share of the annual management charge levied by investment providers and in part "rebated" to HL.

22. Annual management charges or AMCs are monthly fees paid (or more accurately borne) by investors to investment providers in return for managing their investment in a given fund. A typical AMC (subject to what is said at [29]) would be 1.5% of the value of an investor's shares or units in a fund. In the retail market, AMCs are generally collected directly from the relevant fund rather than being paid by an investor as a separate fee. In addition, investment providers usually impose an initial "entry" charge when investors first invest in a particular fund.

23. As discussed below, HMRC do not accept that the AMC is paid by the investor; rather, they say it is paid by a fund entity to the fund provider.

24. HL was able to use its size (in terms of number of investors and value of assets under management) to negotiate lower AMCs with investment providers on behalf of HL clients. This often also included a reduction of the entry charge to nil. In practice, investment providers would usually prefer to implement the reduced rate for AMCs not by creating a new class of share for HL clients but by "rebating" part of the AMC to HL.

25. In order to pass on to investors part of the benefit of any reduced AMC, HL would pay to investors a "loyalty bonus" (the "Loyalty Bonus"). It is such payments, both before and after the New Rules, which are the subject of this appeal. The remainder of the "rebate" on the AMC paid to HL by the investment provider would be retained by HL as its profit.

26. HMRC contend that the term "loyalty bonus" is incorrect, and that in fact such payments are properly described as "trail commission": see further [35].

27. I considered contracts between HL and various investment providers which were agreed by the parties to be a representative sample. Those contracts all showed that the amount "rebated" to HL was calculated as a percentage of the AMC paid or borne by the investors in the relevant fund operated by that investment provider.

28. In the period before the New Rules HL had complete discretion over the size of the Loyalty Bonus paid to investors in a particular fund. That decision was typically taken by Mr Lundie. His evidence, which I accept, was that such a decision would

take into account the rates being offered by competitors; the popularity of the fund (for a popular fund HL might decide to pay a higher Loyalty Bonus to beat the competition), and HL's views of the prospects for a particular fund (a fund regarded as promising might be made more attractive to investors by a larger Loyalty Bonus).

29. The contractual relationship between HL and its investors in relation to the Loyalty Bonus is discussed in detail below in the context of the tax analysis. It is, however, helpful to mention at this stage the criteria which HL applied in deciding whether to pay a Loyalty Bonus. In order to receive a Loyalty Bonus, a client had to satisfy two basic criteria. The first was that they retained the relevant investment at the end of any given calendar month. The second was that they had paid, or borne, the AMC in respect of that investment. Prior to 1 March 2014 it was also necessary that the investment had been held for a full calendar month, and that the value of the holding was at least £1,000.

The New Rules

30. The New Rules incorporated transitional provisions for investments made before 6 April 2014 and which did not undergo material change after that date. Those rules enabled platform service providers such as HL to continue to retain any part of an AMC rebated by an investment provider until 6 April 2016.

31. Both before and after April 2014 investment providers typically offered both 'bundled' and 'unbundled' share classes within a fund. Unbundled (or 'clean') share classes levied a lower AMC than bundled (or 'inclusive') share classes. In response to the New Rules, HL began to add more unbundled share classes to its platform, and to increase the Loyalty Bonus in respect of bundled share classes. The aim was to enable HL to offer bundled and unbundled share classes with the same effective net AMC. During the period relevant to this appeal, a typical AMC for an unbundled share class was 0.75%. For a bundled share class, with a higher AMC of, say, 1.5%, HL might typically have negotiated a rebate of that AMC with the investment provider of 0.85%, and passed on all but 0.1% to the client as a Loyalty Bonus.

32. For all new investments after 6 April 2014, and for all investments after 6 April 2016, the New Rules applied. Under those rules any rebate of an AMC received by HL from an investment provider had to be passed on in full by HL to its client. The effect of this was that the Loyalty Bonus equalled the entirety of any rebate negotiated by HL. Investors would pay a platform fee to HL, based on the value of their funds under management. The terms and conditions of the Vantage Service from 1 March 2014 provided that the annual fee was 0.45% for funds up to £250,000, reducing in tiers until the charge was nil for funds in excess of £2,000,000.

33. The Loyalty Bonus was paid by HL crediting cash to the relevant client account, and once that cash had reached a minimum amount (£10) reinvesting that cash into shares or units within the investor's portfolio. If an investor had sold all his investments with HL, or died, before the £10 threshold had been reached, the Loyalty Bonus would be passed on in cash.

HMRC Practice

34. On 25 March 2013 HMRC published Revenue and Customs Brief 4, titled "payments of trail commission" ('Brief 04/13'). This explained HMRC's considered view on "the tax treatment of payments of 'trail commission' passed on to investors in collective investment schemes".

35. The Brief stated as follows:

> "This Brief…concerns the tax treatment of payments made to investors in a Collective Investment Scheme, insurance policy or other investment product, by fund managers, fund platforms, advisers, or any other person acting as an intermediary between the fund and the investor.
>
> In particular, it concerns cases where all or part of any trail commission paid by the fund manager to other intermediaries is then paid to (or used to meet the liabilities of, or provide a benefit to) the investor. This typically happens as a result of an agreement between the investor and the fund platform, although it could be as a result of an agreement between the investor and their adviser or the fund manager.
>
> Such payments typically originate from the annual management charge paid by the Collective Investment Scheme to the fund manager.
>
> HMRC understands through its discussions with industry that industry have generally considered such payments not to be taxable in the hands of the investor.
>
> HMRC however considers that these payments are taxable and this brief sets out HMRC's views on how payments from trail commission should be taxed…
>
> The payments made to investors are (in tax terminology) 'annual payments' and therefore subject to Income Tax in accordance with S683 Income Tax (Trading and Other Income) Act 2005.
>
> A consequence of this is that the payers are under an obligation to deduct basic rate Income Tax, in accordance with Chapter 6 Part 15 Income Tax Act 2007, from the payment of trail commission and to account for this to HMRC. The investors should then account for any higher or additional higher rate tax due through their Self Assessment tax return."

36. The Brief explained that liabilities in respect of past payments would not be pursued by HMRC, taking into account that HMRC had "in some cases advised investors that such payments are not taxable" and "may possibly have given unclear advice" to those making the payments.

37. HMRC also published a "Technical Note" as background to Brief 04/13. This explained HMRC's technical analysis of the "annual payments" issue and set out HMRC's view that the (then) pending regulatory changes would not affect HMRC's analysis.

The meaning of "annual payment"

38. It is agreed between the parties that if the Loyalty Bonus payments were "annual payments" then they would also satisfy the conditions to be "qualifying annual payments" within section 899 ITA 2007. HL would then have an obligation to deduct basic rate tax under section 901 as HMRC contend.

39. Section 683 ITTOIA 2005 imposes the charge on "annual payments" not otherwise charged but does not define the term. The predecessor legislation to section 683 did not define the term either, though an indication to its interpretation can be found to an extent in the previous language, which referred to "interest, annuities and other annual payments", and, following the separate taxation of interest, "any annuity or other annual payment".

40. The meaning of the term is to be found in case law. For the purposes of this appeal, the leading authorities, which I have considered in reaching my decision, are *Inland Revenue v Whitworth Park Coal Limited* [1959] UKHL TC 38 531; *Campbell v Inland Revenue* [1970] A.C.77; *Re Hanbury (Deceased)* (1939) 38 TC 588n; *Moss' Empires v Inland Revenue* [1937] 3 All ER 381, and *Inland Revenue v National Book League* [1937] Ch 488.

41. I observe in passing that, particularly given the continuing relevance of the term in modern legislation, it is surprising, and by no means helpful, that the most recent of these cases (*Campbell*) was decided some fifty years ago.

42. The authorities establish that an annual payment is a payment which has four characteristics, as follows:

(1) It must be payable under a legal obligation.

(2) It must recur or be capable of recurrence, although the obligation to pay may be contingent.

(3) It must constitute income and not capital in the hands of the recipient.

(4) It must represent "pure income profit" to the recipient.

43. In this appeal, HL accept that the Loyalty Bonus payments constitute income in the hands of investors. There is therefore no need to consider that issue.

44. I now turn to the three criteria in dispute in this appeal, and consider their application to Loyalty Bonus payments made before and after the New Rules.

Payable under a legal obligation

HMRC arguments

45. HMRC submit that for all periods under appeal the Loyalty Bonus payments were made by HL under a legal obligation. The obligation, say HMRC, is found in the terms and conditions which governed the Vantage Service, and which were part of the contract between HL and investors. The terms and conditions incorporated various

"fact sheets" and online information, and together these made clear the entitlement to the Loyalty Bonus.

46. The fact that HL's payment of a Loyalty Bonus might have depended in whole or part on the receipt by HL of a "rebate" from the relevant investment provider was not relevant to the proper analysis of the contractual relationship between HL and the investor.

47. Although the terms and conditions stated that HL "may amend or remove the levels of discount at any time", the level of a bonus payment could not be changed with retrospective effect.

48. Under the New Rules, the legal obligation on HL was even clearer, because under the FCA rules the amount of any "rebate" received by HL had to be passed on in full by HL to the investor.

HL arguments

49. Mr Tallon submitted that there was nothing in the relevant terms and conditions or associated documents which gave rise to a bilateral contract between HL and an investor in relation to a Loyalty Bonus. That was because an investor made no promise to do anything.

50. Accordingly, Mr Tallon argued, a legal obligation could arise only if there could be shown to be a unilateral contract. HMRC would need in that regard to establish an offer by HL which an investor accepted by conduct.

51. Mr Tallon acknowledged that in order to receive a Loyalty Bonus an investor needed to both do something (pay the relevant AMC for that month) and to forbear from doing something (not to sell his investment by the month end). However, he argued, even where an investor satisfied these requirements, no *legally enforceable* obligation arose on the part of HL to pay the Loyalty Bonus. That was because the terms and conditions of the Vantage Service made it clear that the level and frequency of Loyalty Bonus payments were totally at the discretion of HL and could be varied at any time.

52. Put simply, said Mr Tallon, any acts or acts of forbearance by an investor gave him no enforceable right to payment of a Loyalty Bonus, but only the right to be eligible for a payment, should HL in its discretion decide to pay it.

Discussion

53. The requirement that a payment must be made under a legal obligation in order to be an annual payment is set out in a number of authorities. In *Whitworth Park Coal,* Jenkins LJ in the Court of Appeal (affirmed by the House of Lords) stated as follows (38 TC 531 at 548):

> "The payment in question must fall to be made under some binding legal obligation as distinct from being a mere voluntary payment: see

> *Smith v Smith* p191, per Lord Sterndale MR, at page 197, and Warrington LJ, at page 202…"

54. The case law does not elaborate on the meaning of "binding legal obligation", though it clarifies that the obligation may be imposed by contract, court order or statute, and contrasts a mere gift or voluntary payment.

55. I approach the question by considering whether HL had a contractual obligation to pay the Loyalty Bonus during the periods of this appeal to an investor who satisfied the relevant criteria communicated by HL to the investor.

56. In my judgment the assessment of the existence or absence of a binding obligation should not take place in a vacuum. It takes account of the context and the conduct of the parties as well as the bare documentation. In a commercial context, such as this appeal, I take into account the guidance given by Lord Clarke in the Supreme Court decision in *RTS Ltd v Molkerei Alois Muller GmbH and Co KG* [2010] UKSC 14, at [45] as follows:

> "The general principles are not in doubt. Whether there is a binding contract between the parties, and, if so, upon what terms depends upon what they have agreed. It depends not upon their subjective state of mind, but upon a consideration of what was communicated between them by words or conduct, and whether that leads objectively to a conclusion that they intended to create legal relations and agreed upon all the terms which they regarded or the law requires as essential for the formation of legally binding relations. Even if certain terms of economic or other significance to the parties have not been finalised, an objective appraisal of their words and conduct may lead to the conclusion that they did not intend agreement of such terms to be a pre-condition to a concluded and legally binding agreement."

57. The terms and conditions of the Vantage Service for April 2013 (the first of the periods under appeal) included the following statements:

> "A4- Loyalty Bonus
>
> [HL] may amend the level and frequency of loyalty bonus payments at any time. The amount of loyalty bonus payable by [HL] on each fund is published on our website and is available on request. The method of calculating loyalty bonuses and the loyalty bonus we pay on each fund is available on request.
>
> A7- Amendments
>
> We can amend these terms, including our fees and charges, by giving you reasonable notice of the change…
>
> We will give you at least 30 days' notice of any change to these terms that may be detrimental to you, unless we are required to make the change sooner (for example, for regulatory reasons) …
>
> We may amend or remove the levels of fund discount at any time."

58. The terms and conditions which took effect from 1 March 2014, and which continued in force for the period after the New Rules, contained similar provisions relating to amendments to terms, and stated as follows:

> "A4- Loyalty Bonus
>
> You may be entitled to a Loyalty Bonus if you invest in certain investments. Loyalty Bonuses are calculated according to the value of the relevant investment as at the end of each month.
>
> The level of Loyalty Bonus payable is available on each investment's factsheets.
>
> For units purchased before 1 April 2014: Loyalty Bonuses are paid in cash into each Account and you may withdraw, invest or use this cash to settle fees. The level of Loyalty Bonus paid on each fund and the frequency of payment is entirely at our discretion and may be amended at any time.
>
> For units purchased, or transferred to us, on or after 1 April 2014: (a) Loyalty Bonuses are paid in units, (b) Loyalty Bonuses will be paid into each Account and will be re-invested on a monthly basis into units in your largest eligible investment (by value) on reaching a cumulative total of at least £50, (c) Where there are restrictions on buying your largest holding, [HL] may choose an alternate holding at its discretion…
>
> A42-Definitions
>
> … "Loyalty Bonus" means a benefit you may be entitled to receive depending on the funds in which you have invested, as explained in Section A4…"

59. "Factsheets" for the period before the New Rules and agreed by the parties to be representative expressed the Loyalty Bonus as a percentage of funds invested, and showed it both as a separate percentage and as a reduction to the net AMC for that fund.

60. Representative factsheets for the period after the introduction of the New Rules showed the annual charges for a fund and an "ongoing saving from HL" expressed as a percentage. It was stated that "in some cases the ongoing savings are provided by our loyalty bonus".

61. Although there are certain inconsistencies and ambiguities in the drafting, in my judgment this language is apt to describe an offer by HL to pay a stated amount as a Loyalty Bonus at the end of a month capable of acceptance by an investor who satisfies the criteria HL has set for that month. The investor is on notice that the amount and frequency of the Loyalty Bonus may be amended by HL, but there is no express or implied indication in the documents construed as a whole that this could be done with retrospective effect. So, at the end of any given month, HL would be bound

to pay the Loyalty Bonus to an investor who satisfied the criteria set by HL, and that would not be not a matter of choice or discretion for HL.

62. Mr Tallon argued to the contrary, and placed considerable emphasis on the statement in the "Amendments" section of the terms and conditions that HL "may amend or remove the levels of fund discount at any time". That right, he submitted, existed quite independently of the general right to amend the terms of the Vantage Service on giving reasonable notice or, where a change would be detrimental to an investor, on giving 30 days' notice.

63. I regard this as placing far too much weight on a single sentence in the terms and conditions, and as ignoring the overall context and conduct of the parties. That is particularly unwarranted where that sentence by no means makes it clear that the right might operate with retrospective effect. In my judgment an investor would have understood the Loyalty Bonus to be a mechanism by which his net cost of investing in a fund could be reduced by investing through HL's platform. That indeed was HL's commercial aim. He would not have understood it to be a mechanism by which his net cost of investing might be reduced, but only if HL did not change its mind. He would have appreciated that the "loyalty" element arose from the requirement to continue to stay invested with HL, and to be charged the relevant AMCs, to continue to receive the payment. He would (or should) have understood that the amount of the Loyalty Bonus could be changed by HL, but not with retrospective effect.

64. This interpretation of the overall agreement between HL and its investors is consistent with the evidence given by Mr Lundie. He confirmed in questioning that if an investor satisfied the published criteria for a particular month, HL would always have paid him the Loyalty Bonus. That is not surprising given the negative consequences for investor relations had HL rewarded "loyalty" by rowing back from its side of the bargain. As Mr Lundie expressed it, if an investor had met the criteria he was entitled to the Loyalty Bonus and HL "would not renege".

65. For the period following the introduction of the New Rules (subject to the transitional rules) it is even clearer that the Loyalty Bonus payments were made by HL under a binding legal obligation. That is because under the FCA's Conduct of Business Sourcebook (paragraph 6.1E.10R) HL was obliged to pass on the full amount of any rebate from an investment provider. Mr Lundie stated in his Witness Statement as follows:

> "Hargreaves Lansdown considers the rebate claimed from Investment Providers on behalf of clients (in respect of new investments post 5 April 2014 and all investments post 5 April 2016) to belong to its clients. Our role is simply to pass on the rebate (ie the Loyalty Bonus) from the Investment Provider to the client. I understand from our compliance team that the FCA take the same view."

66. I conclude that, taking all the evidence and the commercial context into account, the Loyalty Bonus payments were paid under a binding legal obligation for all periods under appeal for the purposes of the criteria relevant to an "annual payment".

Capable of recurrence

67. The characteristic of recurrence in relation to an "annual payment" has been very broadly expressed in the relevant authorities.

68. I refer again to the judgment of Jenkins LJ in *Whitworth Park Coal*, at page 829:

> "The payment in question must possess the essential quality of recurrence implied by the description "annual". But that description has been given a broad interpretation in the authorities. For example, in *Smith v Smith* at page 201, Warrington LJ said
>
> "Again the fact that the payment is to be made weekly does not prevent it being annual provided the weekly payments may continue beyond the year."
>
> See also the case in the House of Lords of *Moss' Empires, Ltd v Commissioners of Inland Revenue* [1937] AC 785, where the payment in question fell to be made under a guarantee by the appellants of the payment of a fixed preferential dividend at a specified rate on the ordinary shares of another company, and were therefore in their nature contingent. At pages 793-4, Lord Macmillan said:
>
> "At your Lordships' Bar it was argued for the appellants that the payments were not annual payments inasmuch as they were casual, independent, not necessarily recurrent, and throughout subject to a contingency. This argument commended itself to Lord Moncrieff, but I am unable to accept it. There was a continuing obligation extending over each and all of the five years to make a payment to the trustees for the shareholders in the event of the company earning no profits or insufficient profits. The fact that the payments were contingent and variable in amount does not affect the character of the payments as annual payments…
>
> At pages 795-6, Lord Maugham said:
>
> "… 'annual' must be taken to have, like interest on money or an annuity, the quality of being recurrent or capable of recurrence…""

69. I note also that section 683(3) ITTOIA 2005 states that the frequency with which payments are made is ignored in determining whether they are "annual payments".

70. Mr Tallon made two arguments in support of his submission that the Loyalty Bonus payments were not capable of recurrence. His first argument was that the payments could not be recurrent because they were not paid under a legal obligation. That argument falls away given my determination that the payments were made pursuant to a binding legal obligation.

71. Mr Tallon's alternative submission was that the necessary feature of recurrence was not satisfied because HL could reduce the amount of a Loyalty Bonus to zero. Recurrence requires that the *obligation* must remain even if the *payment* is contingent in either amount (because of a formula) or arises only on satisfaction of a condition

encapsulated in the terms of the continuing obligation. In short, he submitted, if an offer could be withdrawn at any time, the necessary feature of recurrence was lacking.

72. The decision in *Moss' Empires* was cited in support of this proposition. However, while that case did concern a continuing obligation where payment was contingent throughout, I find nothing in the judgment to indicate that every annual payment must satisfy that criterion.

73. I find no support in the authorities for the distinction proposed by Mr Tallon. Nor do I see any persuasive reason to adopt such a restriction in light of the discernible purpose of the recurrence characteristic as part of the "annual payment" criteria. The authorities identify the characteristic in the context of establishing that a payment is not a "one-off" payment in the nature of capital, but has the "quality" of a payment which will or may recur. The approach proposed by Mr Tallon would rob the words "capable of" of any substantive meaning, and would effectively extend the first characteristic so that it became necessary to establish a continuing binding legal obligation, with the minimum period of such continuance at large.

74. The Loyalty Bonus payments were not only "capable of recurrence", but they did recur, over many months and for the periods in this appeal. They are not prevented from being recurrent by depending on a contingency, and, per *Smith v Smith*, were not prevented from being annual because they were made monthly provided they might continue beyond a month.

75. I therefore find that the Loyalty Bonus payments for all periods under appeal have, in Lord Maugham's words, "the quality of being recurrent or capable of recurrence".

Pure income profit

76. I have found that the Loyalty Bonus payments were paid under a legal obligation and were capable of recurrence. It is agreed that the payments were income in the hands of investors. Therefore, if the payments were "pure income profit", the appeal will fail.

The concept of pure income profit

77. The requirement for the receipt to be pure income profit lies at the heart of what is meant by an "annual payment". It is therefore critical to understand the underlying rationale which led the courts to lay down this principle. It does not focus on the position of the payer, and in particular does not depend on an element of gratuity or bounty on the part of the payer. Rather, it is driven by the application of the deduction at source mechanism to annual payments. Under that mechanism someone other than the taxpayer (namely the payer) must collect and discharge all or part of the taxpayer's liability for the receipt. That mechanism would operate improperly if the payment comprised anything other than a *gross* receipt of the payee. The rather archaic phrase "pure income profit" is no more than shorthand for this principle.

78. In the House of Lords judgment in *Whitworth Park Coal*, Lord Radcliffe sets the concept in its proper context as follows (38 TC 531 at 575):

> "Neither the Acts nor the Courts have supplied any definition of these words "other annual payment". There is authority for saying that the "category is quite a limited one": In *re Hanbury*, 20 ATC 333, at page 335. There is ample authority for saying that not all payments that are made annually are annual payments under Case III: *Earl Howe v Commissioners of Inland Revenue*, 7 TC 289; *Hill v Gregory*, 6 TC 39. The reason for limitation lies in the fact that for the Courts Case III annual payments have been inseparably associated with payments from which tax is deductible…and it has been thought to be inconsistent with the idea of tax being deducted at the source at the standard rate to allow within the Case payments that are likely to be gross receipts of the payee and not "pure income profit"."

79. When the payee is a trader, then at least in principle the concept is easy to grasp. In *Earl Howe v Commissioners of Inland Revenue*, Scrutton LJ provided this much quoted example (7 TC 289, at page 303):

> "It is not all payments made every year from which Income Tax can be deducted. For instance, if a man agrees to pay a motor garage £500 a year for five years for the hire and upkeep of a car, no one suggests the person paying can deduct Income Tax from each yearly payment. So, if he contracted with a butcher for an annual sum to supply all his meat for a year, the annual instalment would not be subject to tax as a whole in the hand of the payee, but only that part of it which was profits."

80. The question becomes more difficult where, as in this appeal, the recipient is not a trader. According to Lord Donovan in *Campbell* (45 TC 427 at page 475):

> "One must determine, in the light of all the relevant facts, whether the payment is a taxable receipt in the hands of the recipient without any deduction for expenses or the like—whether it is, in other words, "pure income" or "pure profit income" in his hands, as those expressions have been used in the decided cases. If so, it will be an annual payment under Case III. If, on the other hand, it is simply gross revenue in the recipient's hands, out of which a taxable income will emerge only after his outgoings have been deducted, then the payment is not such an annual payment…The test makes it necessary to decide each case on its own facts."

81. Particular difficulty may arise where the payment is received by a non-trader subject to what the cases have termed a condition or counter-stipulation.

82. Mr Tallon helpfully stated that he did not dissent in any material terms from the description of the basic principle set out in HMRC's statement of case. That statement is as follows:

> "Pure income profit can be described in a number of ways. At its most basic it is essentially income that is received without the person in receipt of that income having to do anything in return ie no outgoing/expense has been incurred for receipt of the income.

> The principle was established by the House of Lords in the case of *CIR v Corporation of London (as Conservators of Epping Forest)* (1953) 34 TC 293, in which Lord Reid used the example of whether the income would have to appear in a profit and loss account set against outgoings in order to describe the principle. It being the case that if the income did not so appear, it would be pure income profit. Lord Reid also stressed however that the "quality and nature of the payment" is important over and above whether it appears in a set of accounts.
>
> This was expanded upon by Lord Donovan in *Campbell v IRC* [1970] AC 77 who said that what constitutes pure income profit will involve consideration of a number of questions:
>
> (a) Do those in receipt of the payment have to do anything in return?
>
> (b) Is it pure "bounty" on their behalf?
>
> (c) Did the payer make some counter-stipulation or receive some counter-benefit?"

HL arguments

83. Mr Tallon submitted that the Loyalty Bonus payments are not pure income profit because HL pays them only where an investor both does something and forbears from doing something. The investor must pay the relevant AMC for the month in question. Indeed, the Loyalty Bonus is a discount on the AMC (or following the New Rules the whole of the AMC) so cannot arise without it. The investor must also forbear from selling his investment before the end of the month.

84. These, Mr Tallon argued, were clear conditions or counter-stipulations which disqualified the Loyalty Bonus from being pure income profit. The decisions in *National Book League* and *Campbell* supported this analysis.

85. Mr Tallon pointed to HMRC's categorisation of credit card "cashback" payments as not being annual payments and argued that Loyalty Bonus payments were strikingly similar in nature and quality to such payments.

86. For payments under the New Rules, the position was even clearer. Any rebate of the AMC obtained by HL from the fund provider must be paid over in full in additional units or in limited circumstances cash to the investor. Any rebate is therefore impressed in HL's hands with a *Quistclose* trust.

HMRC arguments

87. Ms Poots relied on *Campbell* as authority that payment of a sum subject to a condition or counter-stipulation does not necessarily render the payment pure income profit.

88. All an investor must do to receive the Loyalty Bonus is to hold the relevant investment at the end of the month. HMRC do not accept that payment of the Loyalty Bonus is dependent on the investor paying the AMC for the month in question. That is

because in HMRC's view the AMC is not paid by the investor at all. It is paid by the fund entity to the fund provider. HMRC's position on this is set out in Brief 04/13.

89. In short, submitted Ms Poots, the investor does not have to do anything which would result in a deduction from the Loyalty Bonus. It is pure income profit in his hands.

Discussion

90. I agree with Ms Poots that the effect on the pure income profit analysis of the presence of a condition or counter-stipulation has developed over the years. The Court of Appeal in *National Book League*, relying in particular on statements in the *Epping Forest* case, appeared to support the view that a condition or counter-stipulation would prevent a payment from being pure income profit. At the least, that was how the Court of Appeal in *Campbell* (particularly Lord Denning MR) read their decision.

91. However, the House of Lords in *Campbell* made it clear that this was so only where the condition or counter-stipulation related to the provision of goods or services by the payee: 45 TC 427 at 462 per Viscount Dilhorne. The decision in *Epping Forest* may have turned on its particular facts and deriving any general principle from it in this respect would be unjustified. While a condition or counter-stipulation would prevent a payment from being "pure bounty" it would not *necessarily* prevent it from being pure profit: Lord Upjohn at page 471. As Lord Donovan explains in the passage set out at [81] above, each case turns on its facts.

92. Because each case does indeed turn on its facts the authorities provide limited assistance in determining this appeal. In particular, many of the authorities concern payments which were held not to be pure income profit because they were either made in return for services or were impressed with an obligation on the payee to do something with the payment. *Campbell, Hanbury, National Book League* and *Moss' Empires* all fall into this category. A more recent example is *Essex County Council v Allam* [1989] STC 317. The Loyalty Bonus payments lack this feature.

93. So, what, if anything, must an investor do or not do in order to receive a Loyalty Bonus?

94. Mr Tallon submitted that an investor must forbear from doing something in order to receive a Loyalty Bonus, because he must not withdraw his investment with HL by the end of the relevant month. Prior to 1 March 2014 it was also necessary that the investment had been held for a full calendar month, and that the value of the holding was at least £1,000.

95. In *Campbell*, Lord Donovan gives three examples of payments which are made pursuant to a contractual obligation on the part of the payee but which nevertheless (in his opinion) represent pure income profit: see 45 TC 427 at pages 473 to 474. In summary, they are an annuity purchased from an investment company, the sale of intellectual property for an annual sum, and the surrender by an employee of a film company of all his existing rights to remuneration in return for a percentage of the

takings from certain films. What is striking about these examples is that they are all *ejusdem generis* with the predecessors to section 683 which referred to interest, annuities and other annual payments. In my judgment that is a signpost to the primary intent and purpose of section 683, which is to identify a category of payments where the payee has satisfied his substantive obligations at the outset of the contract or agreement. The payee of the annual payments has indeed done something in order to receive those payments, but he has done it at the outset. He has typically made an outright transfer of an asset or right on stated terms, and in return need do nothing more of substance to remain entitled to the agreed annual payments. I do not go so far as to say that section 683 is restricted to payments of this type, but I do consider that in assessing whether a payment is pure income profit it is helpful to approach the question with this in mind.

96. In this appeal, as in the examples given by Lord Donavan in *Campbell*, once the investor has made his investment in a fund through HL at the outset he need do nothing more of substance in order to satisfy the non-withdrawal "condition" and receive the relevant Loyalty Bonus. In my judgment the requirement to maintain the investment (or maintain it at a minimum level) does not suffice to prevent the Loyalty Bonus from being pure income profit.

97. Mr Tallon also submitted that an investor had to do something to receive the Loyalty Bonus, because he had to pay the AMC for the relevant fund for the month in question. Ms Poots submitted that the investor did not in fact pay the AMC.

98. I must therefore determine whether an investor did pay an AMC and, if so, whether that deprived an applicable Loyalty Bonus of its character as pure income profit. In making that determination I have taken account of all the facts and circumstances, and the terms of the bargain as presented by HL to its investors. The labels attached to the various payment flows are relevant but by no means determinative. The authorities establish that it is the character or nature of the payment which determines whether it is pure income profit.

99. In my judgment, in general terms an AMC would be likely to be understood by a typical investor to be a cost he would have to bear each year in order to invest or remain invested in a particular fund. HMRC say that understanding is wrong.

100. Ms Poots submitted that in fact the AMC is an amount paid by a *fund entity* (such as a unit trust, investment trust or OEIC) to the *fund provider* which administers the fund assets. HMRC's understanding is that the AMC is "taken from or paid by" the fund entity and is not paid by the investor. The fund provider, said Ms Poots, may pay a platform provider such as HL an amount which is referred to as a "rebate" of the AMC, but in fact, although calculated as a percentage of the AMC, it is not a rebate but a commission for promoting that fund to investors. The Loyalty Bonus is also a misnomer, say HMRC, as it is actually "trail commission" and not a bonus at all.

101. In argument Ms Poots submitted that while an investor is "affected or burdened" by the AMC, that is only reflected in the value of the fund investment. The position is

no different, HMRC argued, to any expense borne by a company in which one invests. The contract between HL and its investors, said Ms Poots, imposed no obligation to pay the AMC, and that showed that it is not the investor who pays it.

102. I confess to finding HMRC's analysis surprising. Indeed, in what I assume is a slip of the pen I note that HMRC's statement of case sets out a "factual summary" which includes the statement:

> "The fund provider levies an initial charge when the investor makes an investment and then raises annual management charges on the investor".

103. HMRC offered no evidence in support of their general analysis of the various payment flows, or their correction of their conventional descriptions. I have therefore considered the evidence available in the appeal. HMRC's skeleton argument sets out HMRC's understanding that "the AMC is taken from, or paid by, the Fund Entity, and it is not paid by the Investor". In support of that proposition it cites a section from Mr Lundie's witness statement and the terms of the Application Forms for various funds which HL offers its investors.

104. The relevant section from Mr Lundie's witness statement is as follows:

> "AMCs are monthly fees payable by Investors to Investment Providers in return for managing their investment in a given fund. Before the introduction of the New Rules, Investment Providers would generally levy AMCs of around 1.5% of the value of an investor's shares (or units) in a fund. In the retail market, AMCs are generally collected directly from the relevant fund (without an investor being required to make a separate payment). In addition, Investment Providers usually levy an initial charge when the Investor first invests in the relevant fund."

105. The Application Forms cited by HMRC as supporting their analysis all contain materially similar language. Taking a typical example, the wording states, so far as relevant:

> "**Charges**
>
> The charges you pay are used to pay the costs of running the Fund, including the costs of marketing and distributing it. These charges reduce the potential growth of your investment.
>
> **One-off charges taken before or after you invest**
>
> Entry charge 5.00%
>
> Exit charge None
>
> Any charges shown are the maximum that might be taken out of your money before it is invested.
>
> **Charges taken from the Fund over a year**
>
> Ongoing charges 1.43%
>
> **Charges taken from the Fund under certain specific conditions**

Performance Fee None"

106. Mr Tallon submitted that there was ample evidence to establish that the AMC was a cost borne by the investor, although the detailed mechanic did not entail paying it as a separate amount. The evidence showed that the bargain presented to investors by HL was that the Loyalty Bonus would reduce the net cost of the AMC, and was therefore entirely dependent on it. In addition to the Terms and Conditions set out above, Mr Tallon referred to the documentation prepared for investors by HL, and, in relation to generally understood industry practice, the FCA Review.

107. In relation to the effect of the New Rules, HL sent to its clients a document titled "Changes to the Vantage Service Explained". Relevant extracts from that document stated as follows:

> "**What is changing for fund investors?**
>
> Fund managers are launching new versions of their funds with reduced annual management charges- typically around 0.75% a year or less. Charges have historically been around 1.5%, so this is a significant reduction. We call these new funds 'unbundled' funds.
>
> The [Table headed "Significantly reduced fund charges"] illustrates how annual management charges of some of the funds available through Vantage will fall. Please note, it takes account of loyalty bonuses but not the new Vantage tariff. The combined effect of these super-low fund charges and our highly competitive tariff means that overall most clients will pay less than they do today…
>
> **Will I still receive loyalty bonuses in my account, and how will they be paid?**
>
> In some cases you will receive discounts in future through buying funds with significantly lower annual management charges rather than receiving a separate loyalty bonus. However, some funds will still provide discounts through loyalty bonuses. Many of the existing fund units you already hold will also attract much higher loyalty bonuses…
>
> Most investors will notice little change in the way they manage their Vantage account. The annual management charge made by the fund manager will continue to be paid within the fund as it is today and will be reflected in the fund price…
>
> **Loyalty bonus**-loyalty bonuses are discounts on fund annual management charges that we give you when you invest through us."

108. Mr Tallon cited the extracts set out at [15] and the following extracts from the FCA Policy Statement PS 13/1 as being consistent with HL's analysis of general industry practice:

> "1.11 We are proceeding with our ban on cash rebates for non-advised platforms, in line with the ban previously consulted on in the advised

> market, to prevent these payments being used to disguise the costs of the platform charge…
>
> In the UK, platforms have in the past generally been funded by payments from product providers. These payments, commonly referred to as 'rebates' in the UK, are a proportion of the fund manager's annual management charge (AMC) paid by the retail client…
>
> The receipt of rebates by platforms from product providers and rebates of product charges in cash to retail clients can severely restrict market access to low cost investments that do not pay a rebate to the platform…"

109. Having considered the evidence put forward by the parties, and all the facts and circumstances, I have reached two conclusions. First, although the AMC is not paid as a separate fee by an investor, it is a compulsory charge directly borne by him as a term of investing through HL. Secondly, HL consistently and clearly presented the Loyalty Bonus to investors as a method of reducing or discounting the net cost of investing in a fund through HL.

110. The mechanism by which an AMC was charged to an investor and the relationships between the different fund flows were far from transparent to an investor. Indeed, that was a large part of the FCA's rationale in imposing the New Rules. However, an investor would or should have understood that the AMC would be charged against his fund investment, and would be effectively reduced by the Loyalty Bonus. He would or should have understood that following the New Rules the fund structures and money flows would change, but in net terms he should be no worse off, and might be better off, by remaining invested through HL.

111. Ms Poots referred to the decision in *HMRC v Landsdowne Partners Limited Partnership* [2012] STC 544 as demonstrating a distinction for tax purposes between investment fees being paid and being borne. However, the facts and issues in that case are so far removed from this appeal that the decision provides no useful guidance in relation to the analysis of the Loyalty Bonus payments.

112. I am not persuaded by HMRC's submission that the AMC is no different from any other expense borne by an entity in which an investment might be made. The end result is indeed reflected in the value of the investor's holding in both cases, but if an investor buys shares in a company directly he is not usually charged an annual fee for the privilege of acquiring the shares and continuing to hold them.

113. The language used in the documentation relating to the AMC can only sensibly be read as indicating that the AMC is an annual charge to investors for investing in a fund. The mechanic for collecting that charge does not alter the burden and responsibility on the investor to bear the charge. The evidence submitted by Ms Poots as supporting HMRC's alternative view in fact does nothing of the sort. The section referred to in Mr Lundie's witness statement describes AMCs as "monthly fees payable by Investors to Investment Providers in return for managing their investment

in a given fund." The Terms and Conditions list the AMC under "charges you [the investor] pay" as a charge "taken from the Fund".

114. Does the conclusion that the AMC is borne by an investor have the effect that a Loyalty Bonus is not pure income profit?

115. As the authorities indicate, each case turns on its facts, and the issue is the nature and quality of the Loyalty Bonus payments.

116. In my judgment, the evidence makes it plain that the nature and quality of a Loyalty Bonus payment is that it is not a "profit" to an investor, but a reduction of his net cost. It is quite unlike an annuity payment or interest in respect of which a recipient need do nothing but sit back and receive the payments. The assertion by HMRC that an investor does not need to pay or bear an AMC to receive a Loyalty Bonus and that there is nothing in the contract between HL and investors to impose the AMC ignores the plain terms on which HL offers and permits investment to be made. The terms and conditions, and indeed the marketing material, could scarcely make it plainer that in investing through HL in a particular fund, a schedule of charges will apply. Investment on terms that HL would meet what I have found (and HMRC assert) to be a binding legal obligation to pay the Loyalty Bonus each month, but without the recipient being charged the applicable AMC, is not an option, and would be a commercial nonsense. Yet that in substance is what HMRC say occurs when a Loyalty Bonus is received, because it is "pure income profit".

117. HMRC's analysis seeks to recharacterize and unpick the various payment flows taking place on a fund investment in order to isolate the Loyalty Bonus and treat it as pure profit. That approach is not the way to establish objectively the nature and quality of the payment; the Loyalty Bonus is a mechanism for reducing net cost, nothing more and nothing less.

118. I make no comment on HMRC's published practice of treating credit card "cashback" payments as not being annual payments.

119. The conclusion I have reached that Loyalty Bonus payments are not pure income profit applies to payments both before and after the New Rules for the periods in the appeal. The FCA obligation on HL to pay on a payment from a fund provider in full to an investor does not in my judgment affect the nature or quality of the Loyalty Bonus.

Decision

120. The Loyalty Bonus payments in this appeal are not pure income profit and are therefore not annual payments. The appeal is allowed.

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.

THOMAS SCOTT
TRIBUNAL JUDGE

RELEASE DATE: 8 MARCH 2018