



[2013] UKUT 007 (TCC)
Appeal number: FTC/08/2012

National Insurance Contributions – Class 1 – Payment by employee benefit trust to employee on winding up of the trust following sale of sponsoring company – whether a “gratuity” – no – Social Security (Contributions) Regulations 2001/1004, Schedule 3 Part X paragraph 5 - appeal allowed

**IN THE UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER**

**THE COMMISSIONERS FOR HER MAJESTY’S Appellant
REVENUE & CUSTOMS**

- and -

KNOWLEDGEPOINT 360 GROUP LIMITED Respondents

**TRIBUNAL: Judge Timothy Herrington
 Judge John Walters QC**

Sitting in public in London on 15 and 16 October 2012

Elizabeth Wilson, Counsel, instructed by the General Counsel of Solicitor to HM Revenue and Customs, for the Appellant, the Commissioners of Her Majesty’s Revenue and Customs (“HMRC”)

Sadiya Choudhury, Counsel, instructed by Knights Solicitors LLP, for the Respondent, Knowledgepoint 360 Group Limited (“Knowledgepoint”)

DECISION

Introduction

1. This is HMRC's appeal from a decision of the First-tier Tribunal (Tax Chamber) (the "FTT") allowing Knowledgepoint's appeal (the "Decision") against a decision of HMRC dated 13 November 2009 that Knowledgepoint is liable to pay primary and secondary class 1 National Insurance Contributions ("NICs") for the period 6 April 2003 to 5 April 2004 in respect of cash payments made to one of its employees in October 2003 and February 2004.
2. The payments were made by the trustees of an employee benefit trust following an earlier sale of the shares in Gardiner-Caldwell (Holdings) Limited ("Holdings") the parent company of the group of companies of which Knowledgepoint is a member.
3. The law relating to NICs on such payments was changed with effect from a date shortly after the second of these payments so the matter is to a large extent of historic interest only.
4. Knowledgepoint contend, as was found by the FTT, that the cash payments should be disregarded in the calculation of earnings for the purpose of NICs on the grounds that they were payments in respect of "gratuities" within paragraph 5 of Part X of Schedule 3 to the Social Security (Contributions) Regulations 2001.
5. HMRC contend that this provision has no application to the facts of this particular case and that there is no basis for disregarding the payments in the calculation of earnings. In deciding otherwise, they contend, the FTT erred in law applying the wrong legal test to the wrong facts.

Relevant Facts

6. The parties agreed a Statement of Facts prior to the hearing before the FTT which formed the basis of its findings of fact and is set out in full in paragraph 6 of the Decision with some annotations. Knowledgepoint was previously known as Gardiner-Caldwell Communications Limited ("Communications"), which was the main operating company of the Gardiner-Caldwell group of companies ("the Group"), whose holding company was Holdings.
7. In 1992, an employee benefit trust known as the Gardiner-Caldwell Employee Trust ("No.1 Trust") was set up for the benefit of the employees of Communications and a second employee benefit trust known as Gardiner-Caldwell Employee (No.2) Trust ("No.2 Trust") was set up in 1997. Each of the Trusts had as its trustee a wholly-owned subsidiary of Holdings. This appeal only concerns payments from the No.1 Trust, although it is common ground that the outcome of this appeal will determine the liability to NICs of payment to beneficiaries made by the No.2 Trust as well.

8. The No.1 Trust was established for the purpose of facilitating schemes to encourage employee share ownership in Holdings, of which there were at least three, and also purchase shares from departing employees. Knowledgepoint added further sums from time to time. The No.1 Trust was used purely as part of the mechanism for making the employee share ownership arrangements work properly. There was no specific plan to use the No.1 Trust as a conduit for making cash payments to employees until the sale of Holdings was being considered and there was no hope or expectation of any such payments on the part of employees until that time.

9. In the summer of 2001, Thomson Healthcare plc (“Thomson”) entered into negotiations with Holdings for the purchase of Holdings’ entire share capital and eventually did so for consideration in cash and loan notes of approximately £39 million on 28 December 2001. During the purchase negotiations, it was agreed that the Trusts would cease to be associated with the Group and their funds would not be under the control of the Group or Thomson. Therefore prior to the purchase, the shares of the two companies were transferred to two individuals, Mr Denis Hall and Mr William Gardiner, and the power to appoint new trustees in respect of the No. 1 Trust was removed from Holdings and vested in the relevant trustee company. Mr Gardiner later resigned as a director of the trustee company and was appointed an additional trustee of the No. 1 Trust. The trustees of the No. 1 Trust covenanted not to make any distributions without informing the board of Communications of the proposed distribution and consulting in good faith with a majority of the board as to the proposed distribution.

10. As a result of the sale of the share capital to Thomson and the exercise of share options by employees prior to the sale, there was a large amount of cash in the No 1 Trust. The trustees eventually decided to make cash payments to those employees who had contributed to the success of the Group prior to its sale to Thomson by exercising their dispositive powers which were conferred on them by the Settlor of the No. 1 Trust. In determining the payments to be made, the trustees applied certain criteria. They used Knowledgepoint’s bonus model as a “starting point” for determining the amount of payments but did not do so in a mechanical fashion as some employees received more than they would have purely on the basis of the model. The trustees were sensitive to the possibility of undermining Knowledgepoint’s management if the trustees rewarded employees who had not gone “the extra mile”. Only those who were in employment on 28 December 2001 and had not given their notice as at the date of payment were eligible.

11. The No.1 Trust made payments to employees in October 2002, October 2003 and February 2004. Income tax was deducted from all these payments but no deduction was made in respect of primary and secondary Class 1 NICs for the last two payments and the trustees later claimed repayment of the primary and secondary Class 1 NICs deducted from the first payment. The decision issued by HMRC on 13 November 2009 referred to in paragraph 1 above was in respect of the payments made in 2003 to 2004 to a Mrs V. Adshead (“Mrs Adshead”) as a representative employee of Knowledgepoint. According to this decision, primary and secondary Class 1 NICs should have been deducted from these payments. The FTT found that the directors of

the trustee company acted independently from Knowledgepoint, being careful to separate their trustee director roles from their management role at Knowledgepoint.

12. Prior to making the payments, mindful of their obligation to consult, the trustees sent a letter to the prospective new Thomson nominee director on Knowledgepoint's board, a Mr Noble, outlining the proposals. Mr Noble acknowledged this letter, giving thanks for the consultation and made no further comments. That was the end of the consultation.

13. It is helpful to refer here to the key provisions of the No.1 Trust Deed, which as the FTT found, was in fairly standard form establishing a discretionary trust for the benefit of Knowledgepoint's employees (past, present and future). It contained the following recital:

"The Company wishes to establish this Trust as an employee's share scheme to act as an incentive for its officers and employees and intends to pay to the Trustees the sum of £100 to be held in accordance with the terms of this Trust and from time to time further money, investments or other property may be paid or transferred to the Trustee by way of addition"

14. The key operative provisions were:

"2. TRUSTS

2.1 SUBJECT to the provisions of clause 3 below, the Trustee shall hold the Trust Fund and the income thereof upon such trusts for the benefit of the Beneficiaries or any one or more of the Beneficiaries exclusive of the other or others in such shares and proportions and (where appropriate) subject to such terms and limitations and with and subject to such provisions for maintenance education or advancement or for forfeiture in the event of bankruptcy or otherwise and with such discretionary trusts and powers exercisable by such persons as the Trustee shall from time to time by deed or deeds revocable or irrevocable executed before the Distribution Date but without infringing the rule against perpetuities appoint BUT SO THAT the Trustee shall have power from time to time before the Distribution Date (but without infringing the said rule) to pay or apply the whole or any part or parts of the unappointed capital of the Trust Fund to or for the benefit of such one or more of the Beneficiaries as are for the time being living in such shares as the Trustee in its absolute discretion shall think fit without the necessity for a deed or deeds.

2.2 IF there is any question as to whether an individual is a Beneficiary, and in particular any question of whether a person is an employee or former employee of the company, the Trustee shall refer the question to the Board of Directors or a duly authorised designated Committee of the board of Directors of the company whose written determination of the point shall be final and binding.

2.3 NOTWITHSTANDING any other provisions of this Deed, any property which is comprised in the Trust Fund shall not be applied for the benefit of any person for whose benefit the trusts could not permit it to be applied without Section 13(1) of the Inheritance Tax Act 1984 (5% plus participator) thereby failing to apply to such disposition or payment AND PROVIDED THAT it shall not be applied in such a

way as to cause this Trust to cease to be an Employees' Share Scheme as defined in Section 743 of the Companies Act 1985.

2.4 SUBJECT as aforesaid the Trustee shall have the following powers exercisable at any time before the Distribution Date:

5 2.4.1 power from time to time by deed naming the individual concerned to include in the Beneficiaries any individual except any individual who may for the time being be excluded from the Beneficiaries in exercise of the power in that behalf contained in sub-clause 2.4.2 of this clause;

10 2.4.2 power from time to time by deed naming the individual concerned to exclude from the Beneficiaries any member for the time being of the Beneficiaries either permanently or for any period specified by the Trustee in such deed;

15 PROVIDED THAT these powers shall not be exercised in such a way as to cause this Trust to cease to be an Employees' Share Scheme as defined in Section 743 of the Companies Act 1985.

...

3. TRUST PENDING OF APPOINTMENT

UNTIL and subject to and in default of any appointment under Clause 2

20 3.1 THE Trustee shall pay or apply the income of the Trustee Fund to arise before the Distribution Date to or for the benefit of all or such one or more of the Beneficiaries exclusive of the other or others of them as shall for the time being be in existence and in such shares if more than one and in such manner generally as the Trustee shall in its absolute discretion from time to time thinks *[sic]* fit.

...

25 4. ULTIMATE DEFAULT TRUSTS

SUBJECT as above and if and so far as not wholly disposed of for any reasons whatever by the above provisions the capital and income of the Trust Fund shall be held in trust for such charity or charities as the Trustee shall in its absolute discretion determine.

30 ...

8. DISCRETIONARY NATURE OF THIS TRUST

35 THE provisions of this Trust shall not form part of any Contract of Employment of any Beneficiary and shall not confer upon any person any legal or equitable rights whatsoever (except as discretionary objects of this Trust) and no Beneficiary ceasing to hold the office or Employment by virtue of which he is a Beneficiary shall be entitled to any compensation for any loss or any right or benefit or prospective right or benefit under this Trust Deed which he might otherwise have enjoyed."

15. The Trust Deed also contained the following relevant definition:

“The Beneficiaries

The present and future employees or former employees of the company or any company resulting from the amalgamation or reconstruction of the company and any other individual named as a member of the Beneficiaries by the Trustee in exercise of the powers contained in this Deed from and after the date of such nomination.”

5

Relevant Legislation

10 16. Section 2(1)(a) of the Social Security Contributions and Benefits Act 1992 (SSCBA) defines an “employed earner” as “a person who is gainfully employed in Great Britain either under a contract of service, or in an office (including elective office) with emoluments chargeable to income tax under Schedule E” (since 5 April 2003, ‘general earnings’).

15 17. Section 3(1) SSCBA provides that “earnings” includes “any remuneration or profit derived from an employment” and that “earner” shall be construed accordingly. Section 3(3) makes provision for certain items to be disregarded in the calculation of earnings. Section 6 makes provision for the payment of primary and secondary Class 1 contributions. The primary contribution is the liability of the earner, and the
20 secondary contribution is the liability of the secondary contributor. Section 7 defines a “secondary contributor” in relation to any payment of earnings to or for the benefit of an employed earner, as “his employer”.

18. Pursuant to section 3(3) SSCBA, Schedule 3 to the Social Security (Contributions) Regulations 2001 (SI 2001/1004) (“the 2001 Regulations”) provides
25 that certain items are to be “disregarded in the calculation of earnings for the purposes of earnings-related contributions”. This appeal concerns paragraph 5 of Part X of Schedule 3, which for ease of reference we refer to in this decision as “paragraph 5”. At all material times the items to be disregarded included:

“5. Gratuities and offerings

30 (1) A payment of, or in respect of, a gratuity or offering which satisfies either of the conditions in this paragraph.

(2) The first condition is that the payment –

(a) is not made, directly or indirectly, by the secondary contributor;
and

35 (b) does not comprise or represent sums previously paid to the secondary contributor.

(3) The alternative condition is that the secondary contributor does not allocate the payment, directly or indirectly, to the earner.”

19. The 2001 Regulations consolidate and replace the 1979 Social Security (Contributions) Regulations (SI 1979/591) (“the 1979 Regulations”). Regulation 19(1)(c) of the 1979 Regulations provided:

5 “(1) For the purposes of earnings-related contributions, there shall be excluded from the computation of a person’s earnings in respect of any employed earner’s employment any payment insofar as it is –

...

(c) a payment of, or in respect of, a gratuity or offering –

10 i. where the payment is not made, directly or indirectly, by the secondary contributor and the sum paid does not comprise or represent sums previously paid to the secondary contributor; or

ii. where the payment is not directly or indirectly allocated by the secondary contributor to the earner.”

20. Regulation 19 also provided for the following additional items to be disregarded in the computation of a persons earnings:-

15 “(e) a payment made to or by trustees ... where –

i. in the case of a payment to trustees, the share thereof which that person is entitled to have paid to him, or

ii. in the case of a payment made by trustees, the amount to be so paid,

20 is or may be dependent upon the exercise by the trustees of a discretion or the performance by them of a duty arising under the trust.”

21. Regulation 19(1) (c) and (e) of the 1979 Regulations replaced Regulation 17(c) and (e) of the Social Security (Contributions) Regulations 1975 (SI 1975/492), which replaced Regulation 17(c) and (e) of the Social Security Contributions Regulations 1973 (SI 1973/1264). Regulation 19(1)(e) of the 1979 Regulations was revoked by the

25 Social Security (Contributions) Amendment No.3 Regulations 1987 (SI 1987/1590) reg 2, with effect from 6 October 1987.

22. This analysis of the statutory provisions shows that the key issue to be determined in this appeal is whether the payments made by the trustees of the No.1

30 Trust could be said to be a “gratuity or offering”. It is common ground that the payments concerned were not “an offering”. There is no statutory definition of “gratuity” so we must construe it according to its ordinary and natural meaning, guided by the relevant authorities.

23. If we decide that the payments do not have the character of a “gratuity” that is the end of the matter: we must allow the appeal. If we decide that the payments do have that character we must consider whether either of the conditions in paragraph

35 5(2) or (3) are satisfied; again if they are not we must allow the appeal.

24. We include the reference to Regulation 19 (1)(e) of the 1979 Regulations as it is relevant to the argument advanced by Knowledgepoint that the fact that there is no longer an express disregard for payments made under a discretionary trust does not mean they cannot be disregarded under the provisions of paragraph 5.

5 The Decision of the FTT

25. The starting point for the FTT's consideration of the meaning of "gratuity" was the definition suggested by the Special Commissioners in *Channel 5 TV Group v. Peter Morehead* [2003] STC (SCD) 327 ("*Channel 5*"). It reads as follows (at paragraph 41) :

10 "a gratuity means a voluntary payment given in return for services rendered where the amount of the payment depends on the donor and where there is no obligation on the part of the donor to make the payment."

26. The FTT said this definition might be usefully be clarified by substituting the words "in recognition of services rendered" for "in exchange for services rendered":
15 see paragraph 76 of the Decision.

27. The FTT then directed itself as to how to analyse this definition in paragraph 55 of the Decision as follows:

20 "It can readily be seen that this definition itself breaks down into four elements, the first and last of which appear to cover the same point: it is difficult to see what is added to the concept of "voluntary payment" by the phrase "where there is no obligation on the part of the donor to make the payment". We therefore consider this to be a single composite element of the definition. The second element is the concept of "given in return for services rendered"; and the final element is "Where the amount of the payment depends on the donor ..."

25 28. On the first element the FTT accepted that as the No.1 Trust is a discretionary trust the payments were made entirely voluntarily; even though there would have been a reasonable expectation that payments would be made to employees out of a scheme such as this there was no obligation to do so: for example the trustees could if they felt it appropriate pay the funds to charity. Furthermore, each payment had to be
30 considered independently: each individual could have received either nothing at all, a very large sum of money or somewhere between. In paragraph 65 of the Decision the FTT stated:

35 " To the extent that the trustees have exercised their discretion to fix the payment of each employee at what they consider the correct point in the continuum we consider they have made a voluntary payment to that employee in a situation where there was no obligation to make that payment."

29. Whilst the FTT agreed that the creation of a link between receipt of the payments and continued employment with Knowledgepoint is "an unexpected element of a gratuity", even if the employee remained in employment as and when
40 payments were made the making of further payments was discretionary. This meant that the payment remained voluntary: see paragraph 70 of the Decision.

30. Finally in the first element the FTT did not believe that the employee whose payments were the subject of this appeal, Mrs Adshead, had any expectation that she would receive a payment or other benefit from the No.1 Trust; the most the employees had been led to expect was that there was some possibility of a gratuity of some kind in connection with their past service and nothing more: see paragraph 71 of the Decision.

31. On the the second element, the FTT noted that in the definition suggested in *Channel 5* there was no requirement that the services concerned should have been rendered to the person making payment, so the fact that the No.1 Trust had not received services in return for the payment did not trouble the FTT. The FTT considered, at paragraph 78 of the Decision, that it was unnecessary to carry out an analysis of what services had been rendered and to whom: all that was necessary was that a payment has been made because the recipient has rendered some service for which the payer wishes to show approval or gratitude. In this case the FTT were satisfied that the payments were made to Mrs Adshead because they wished to show approval of her efforts, rejecting HMRC's argument that the payments received were little more than her entitlement under an incentive scheme.

32. On the third element, the FTT found that the trustee directors deciding on the payments did so independently of their status as directors of Holdings and Knowledgepoint without any involvement by the recipients or Knowledgepoint in deciding the amount of the payments.

33. On that basis the FTT was satisfied that the payments were gratuities.

34. The FTT then considered whether the condition set out in paragraph 5 (3) was satisfied. On the basis that all four individuals concerned in making the decisions as to payment were extremely careful to distinguish in their own minds the role and responsibility which they had in relation to the No.1 Trust from their other roles and responsibilities for Knowledgepoint and did so in practice when making the allocation decisions and finding that there was no involvement in these decisions by Mr Noble as a result of the consultation exercise, the FTT had no difficulty in finding that there was no allocation direct or indirect, of any payment by Knowledgepoint: see paragraphs 96 and 97 of the Decision.

35. Finally, the FTT considered whether the condition set out in paragraph 5(2)(a) was satisfied. It was common ground that there had been no direct payment by Knowledgepoint. The FTT concluded that in circumstances where the direct funding of the No.1 Trust by Knowledgepoint, made over a period of nine years was exceeded by a much larger sum received from third parties representing the proceeds of the exercise of share options by employees and the consideration received on the sale to Thomson, it could not be said that Knowledgepoint had thereby indirectly made payment of the much larger sum representing the trust fund as a whole. Consequently, the FTT concluded that the payments made to Mrs Adshead were not made, directly or indirectly, by Knowledgepoint: see paragraphs 108 to 111 of the Decision.

The authorities

36. We were referred to a number of cases for assistance on the meaning of “gratuity” and the related issues that arise in this appeal.

5 37. *Channel 5*, which the FTT relied on, is as far as we are aware the only case which has directly considered the meaning of “gratuity” as it is used in paragraph 5.

38. The facts of the case were as follows. When Channel 5 was established a US Investment Company purchased some of its shares. These shares were sold some years later making a substantial profit. The Managing Partner of the Investment Company, S, who was also a board member of Channel 5, decided to make a payment
10 to E, Channel 5’s Chief Executive in an amount which represented the amount by which the sale price of the investment company’s shares had exceeded the profit which S had wanted to make on the sale and the costs of the sale. S said he wished the payment to go to the people who had contributed most to the creation and value of Channel 5. The Board of Channel 5 agreed with E’s proposal that all Channel 5’s
15 employees should benefit from the payment and that some should go to charities. In due course a payment was made by the investment company to a firm of solicitors for onward distribution by them to the employees. These payments came as a surprise to the employees.

39. The Special Commissioners had to consider whether these payments attracted a
20 liability for primary or secondary Class 1 NICs on the basis that the payments were part of the employees’ earnings. Channel 5 contended that the payments fell within Regulation 19(1) (c) of the 1979 Regulations, which as we have seen is substantially the same as paragraph 5.

40. The Special Commissioners rejected HMRC’s argument that gratuity meant no
25 more than a tip. This argument was based on the definition of the Oxford English Dictionary which stated that the word gratuity was now applied “exclusively to a gift made to a servant or inferior official, a tip”. As we have seen, (see paragraph 25 above) the Special Commissioners gave a wider meaning to gratuity, holding that it covered a voluntary payment given in return for services rendered where the amount
30 of payment depends on the donor. That definition includes, but is not restricted to a tip.

41. On the basis of this definition the Special Commissioners concluded at paragraph 44 of its decision as follows:

35 “Applying that meaning of the word gratuity to the facts of the present appeal we conclude that the payments made by the investor to the employees of the appellant were gifts given in return for the fact that the employees had contributed to the creation and increase in value of the appellant which became a successful investment for the investor. The amount of the gifts depended upon the investor and there was no obligation on the investor to make the payments. The payments were therefore,
40 gratuities within the meaning of reg 19(1)(c).”

42. We observe from the decision that the Special Commissioner were of the view that a payment from an employer to an employee *could* be a gratuity; it was only

prevented from being so where the conditions in (i) and (ii) of Regulation 19(1) (c) of the 1979 Regulations were not met. In paragraph 37 of their decision the Special Commissioners stated that if only payments from non-employers could be gratuities then these conditions would be otiose.

5 43. We also observe that the Special Commissioners made no reference in their decision as to whom the services for which the payment had been made had to be rendered. It is implicit from the decision that the gratitude that was being expressed by the making of the payment was for the services of the employees in helping to make their employer, Channel 5, a success. The investment company benefitted because of the increase in the value of its shares, rather than because of any direct or personal services rendered by those employees to the investor.

10 44. In *Annabel's (Berkeley Square) Ltd and others v. Revenue and Customs Commissioner* [2009] EWCA Civ 361 ("*Annabel's*") the Court of Appeal had to consider whether tips, gratuities and service charges were to be taken into account in calculating an employee's wage for minimum wage purposes. *Annabel's* and other clubs operated tronc schemes for the distribution of tips. Most payments of such charges were by credit or debit card or cheque, so the proceeds were paid into the employer's bank account. The employer calculated what element of these credits represented tips, service charges and gratuities and paid that sum into the troncmasters' dedicated bank accounts. The troncmaster obtained legal title to the tronc moneys and held them on trust to distribute amongst the employees in accordance with a set of rules; rules which the employer had no power to dictate.

20 45. The Court of Appeal held that the payment by the troncmaster to the employee was not also a payment "paid by the employer" to the employee and could not therefore be counted towards the calculation of the minimum wage. At the point of payment, what was paid to the employee was part of a fund constituting in equity the employees' commonly owned property. The employer could not claim that it paid the relevant money to the employee because it was not its money that was so paid. The employer might regard that as hard because the money so paid had derived from money that was once its own. The result, however, flowed from a legitimate and genuine arrangement under which the administration and distribution of service charge money was to be handled exclusively and independently by the troncmaster.

30 46. The Court of Appeal inferred that the establishment of the troncmaster arrangements was for the purpose of taking advantage of the exemption from NICs in respect of gratuities: see paragraph 34 of the judgment, per Rimer LJ. It was observed that the conditions for the exemption were met because the employer did not allocate the payment, directly or indirectly, to the employee so that the alternative condition in paragraph 5(3) would apply. These arrangements implemented the common intention of all concerned that the tips and gratuities initially paid by the customers to the employer would ultimately be used for paying money payments to the employees: see paragraph 50 of the judgment, per Mummery LJ. The reasoning of Mummery LJ, set out in paragraph 51 of the judgment, explains why these payments were not to be treated as payments made by the employer to the employee for the purposes of calculating the minimum wage.

“... the employers initially owned the tips and gratuities paid to them by cheque, or by card. However, they did not retain ownership down to the point when money payments were paid to their employees. The employers ceased to have any legal or beneficial title to or control of the moneys once they had paid them into the tronc bank account. The employers were not legally entitled to operate that account or to require the moneys in the account to be paid back to them. The troncmaster alone was entitled to operate the account. He was bound to do so for the benefit of the employees in accordance with the tronc scheme in force. The moneys in the tronc account then fell to be distributed by the troncmaster not as the employers’ money or as his own money, but as a fund subject to a trust scheme governing the distribution of the moneys to the employees.”

47. *Annabel’s* clearly demonstrates the policy behind paragraph 5. This is that gratuities which are given to a particular employee in recognition of services provided by the employee to the payer are to be treated as not having been paid by the employer so long as either the employer never received the monies at all (which would be the case of cash tips paid directly to the employee and where paragraph 5(2) applies) or where the sums were alienated by the employer upon receipt to a trust or similar arrangement providing for their distribution to the employees concerned pursuant to allocations in which the employer played no part (and where paragraph 5(3) applies).

48. We also observe that this case demonstrates that paragraphs 5(2) and 5(3) provide a mechanism for the payment of gratuities which must be complied with in order for the exemption to apply. This mechanism recognises that the source of payment should not be the employer’s own money or represent monies that the employer has determined as a reward for services rendered to it by the employee, but should represent money that has always been earmarked as a ‘thank you’ for services rendered by the recipient of the payment and where the employer played no part in allocating the payments made.

49. The essential feature that a tip or gratuity represents services rendered by the recipient personally to the payer was recognised in *Calvert v. Wainwright* [1947] 1 KB 526, a well-known case that established the principle that a taxi driver’s tips were assessable to income tax as earnings on the grounds that they were received as a reward for services rendered and therefore arose out of the recipient’s employment, notwithstanding they were not paid by the employer. It would only be personal gifts given on personal grounds other than for services rendered, such as a Christmas gift given by a regular customer to his driver that would escape the link with employment: see pages 528 and 529 of the judgment, per Atkinson J.

50. The fact that payments are made by trustees of an employee benefit trust on the winding up of the trust in recognition of their past services does not mean that the payments are not to be treated as emoluments of employment.

51. In *Brumby v. Milner* [1976] 1 WLR 1096 under a company profit-sharing scheme the trustees of a trust deed with the help of a loan from the company purchased shares in the company to be held in trust for the employees and former employees of the company. When the company merged with a larger company the scheme became impracticable and the trustees reluctantly resolved to determine the

scheme, whereupon the capital of the trust fund became distributable between the current employees and former employees at the discretion of the trustees and was distributed in amounts varying with length of service. It was contended on behalf of an employee that the distribution was not made in order to reward the employees but because the merger had made the continuation of the scheme impracticable and that the distributions were not received by the employees “from” their employment but were received as an incident of the merger. This argument was rejected by Lord Kilbrandon in the House of Lords where he said at page 1101:

“It was submitted that the payment arose not from the appellant’s employment but from the company’s reluctant decision to wind up the profit-sharing scheme. I cannot agree with that. Certainly the money forming the payment became available in consequence of certain events and decisions connected with the structure of the company. But the sole reason for making the payment to the appellant was that he was an employee, and the payment arose from his employment. It arose from nothing else, as it would have done, if for example, it had been made to an employee for some compassionate reason.”

52. The fact that the emoluments were provided by the trustees and not by the company and the fact that the trustees as trustees had no interest in the performance by the taxpayers of their services as employees were not argued to make any difference.

53. We observe that the Court of Appeal in this case, with whom the House of Lords agreed, accepted that from its birth the scheme was intended as an incentive scheme both to encourage and to reward employees in respect of their services as such and payments made during the years before the scheme was terminated were therefore plainly profits from the employment as being rewards for and referable to services. The Court of Appeal held that the termination payment was no different; Russell LJ’s reasoning at 51 TC 583, 609F being:

“It appears to us that the scheme is one scheme based fundamentally on reward for services by employees and the fact that after the final payment there is no more by way of bonus to look for does not relevantly distinguish that final payment. Moreover, there are two particular points which indicate that in truth these final payments are rewards for and with reference to services. First, pensioned ex-employees, who *ex hypothesi* will be such because of the services they have rendered to the company, are brought into the class of recipients. Second, if an employee who is such at the date of determination of the scheme and would otherwise qualify is in the period (up to a year) between then and distribution dismissed for misconduct or incompetence, he is excluded from benefit. Such misconduct or incompetence clearly would be referable to his services, and the deprivation being referable to his services, so should be regarded his entitlement.”

54. On the issue as to whether payments by trustees performing their duties as such can be regarded as voluntary payments we were referred to *Drummond v. Collins* [1915] AC 1011. The relevant facts were that the trustees of an estate from time to time remitted to the mother of the infant beneficiaries of an accumulation trust monies for their maintenance and education. On the question as to whether these sums were assessable to income tax the House of Lords held at page 1017, per Lord Loreburn:

5 “It was argued, however, that these allowances sent from America are not “income” of the children, because they were voluntary payments by the trustees. I do not assent to the proposition that a voluntary payment can never be charged, but it is enough to say that these were not voluntary payments in any relevant sense. They were payments made in fulfilment of a testamentary disposition for the benefit of the children in the exercise of a discretion conferred by the will.”

10 55. In *Cowan v. Scargill* [1985] 1 Ch 270 the High Court affirmed the principle that the trustees of a pension scheme have a duty to exercise their powers in the best interests of the present and future beneficiaries. Megarry J observed at page 287 of the judgment:

15 “When the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question; and the prospects of the yield of income and capital appreciation both have to be considered in judging the return from the investment.”

20 56. As a consequence the Court held that the trade union representative trustees of the mineworkers’ pension scheme were in breach of their duty if they sought to prevent the scheme making investments which were contrary to union policy but which were in the financial interests of the beneficiaries.

57. In other words, the Court held that it was the duty of the trustees to invest the trust’s assets solely in pursuance of the purposes of the trust and thereby maximise the returns for the trust.

25 58. In our view the following principles can be derived from the cases that we have reviewed:

30 (1) A gratuity includes a tip but it can be wider than that. A tip is the most obvious example of a gratuity and the provisions of paragraph 5 are drafted primarily with tips and similar payments in mind.

(2) The following formulations all reflect the characteristics of a gratuity:

35 (a) a gift or present (usually of money) often in return for favours or services, the amount depending on the inclination of the giver: this reflects the definition contained in the 1989 edition of the Oxford English Dictionary;

(b) a voluntary payment given as a token of thanks or recognition for a job well done: see *Channel 5*;

(c) a gift given in return for services rendered where the amount of the gift depended on the donor and where there was no obligation to make the payment: see *Channel 5*;

40 (d) a voluntary gift received in discharge of the recipient’s duties of office: see *Calvert v. Wainwright*.

(3) These formulations share the following characteristics:

- 5 (a) they are payments by a person who has had an interest in the performance of the services: for example the diner in the restaurant receiving good service from his waiter, the customer receiving efficient service from a taxi driver;
- (b) they are payments given to the recipient personally (that is for his own benefit and not for his employer);
- (c) they are personal gestures; and
- 10 (d) they are gifts, for example in the definition suggested in *Channel 5* the words “donor” and “gift” were used: see paragraphs 41 and 43 of the decision.

15 59. None of these formulations reflect the position of trustees, and in particular whether payments made pursuant to the powers in the trust instrument have the character of being voluntary payments or gifts to qualify as gratuities.

Discussion

60. It was common ground between the parties that the definition of “gratuity” formulated in *Channel 5*, which is set out in paragraph 25 above, is a good starting point.

20 61. Ms Wilson is, however, critical of the decision in one important respect. She submits that the definition was wrongly applied to the facts that existed in *Channel 5*. She submits that the payments were made in recognition of the services that the employees concerned rendered to their employer rather than to the investment company who made the payments and therefore cannot be a gratuity, the essential
25 element of which is a reward for services provided to the payer personally. She would therefore characterise the payments concerned as a reward for past services with the same character as a bonus. She submits that the Special Commissioners were wrong in paragraph 44 of their decision to characterise the payments as gifts in return for the fact that the employees had contributed to the creation and increase in value of
30 *Channel 5* which became a successful investment for the investor, whereas in reality the payments were a gift for the services rendered to the employer.

62. Ms Choudhury agrees that the definition in *Channel 5* is the correct starting point and that the FTT’s decision is fully consistent with it. She submits that the payments were made in this case to reward Mrs Adshead in recognition of the
35 services she had provided to her employer which had created and increased the value of the No.1 Trust’s investment in Holdings. She admits that it would be difficult to say that the services concerned were provided to the trustees of the No.1 Trust, but she submits that as a result of those services the value of the Trust’s assets were enhanced, in the same way as in *Channel 5* the value of the investment company’s
40 assets were enhanced as a result of the employees’ efforts. In *Channel 5*, she submits, the Special Commissioners did not find it necessary to decide who the services were

provided to but based their decision on the basis that the services provided had resulted in Channel 5's shares increasing in value. In effect, her submissions amount to saying that a payment will amount to a gratuity where the effect of the services provided to the recipient's employer have resulted in an increase in value of the payer's assets.

63. We reject Ms Choudhury's submissions on this point. In so doing with some regret we have to conclude that the Special Commissioners were wrong in concluding as they did in paragraph 44 of their decision in *Channel 5* that a voluntary payment by a third party who has received an indirect benefit from the provision of the employee's services can amount to gratuity within the ordinary meaning of that word and how it has been interpreted, particularly in *Calvert v. Wainwright*. The essence of a gratuity, as we have identified, is that it is a token of thanks for the services provided directly and personally to the donor.

64. This is reinforced by the statutory provisions of paragraph 5, which through the payment machinery laid down in paragraphs 5(2) and (3) seek to implement the policy behind the provision, as clearly emerges from *Annabel's*, that the exemption should only apply in respect of payments designed to reward the recipient personally for that aspect of his services which constitute a personal service to the person making the payment. Any other payment that the employee receives in the course of his employment must reasonably be characterised as earnings from his employment, akin to a bonus if it is voluntary rather than a contractual payment.

65. Thus there is scope for a gratuity arising in circumstances where an employee in the course of performing his duties provides a personal service to the employer's customers or clients. That was not the position in *Channel 5* and it is not the position in this case.

66. The FTT did not consider this issue at all, as it followed the approach in *Channel 5* and did not consider whether the question as to whom the services were provided was a relevant factor. In our view it was an error of law on the FTT's part not to do so.

67. Our conclusion on this issue is sufficient for us to find that the payments concerned were not gratuities within paragraph 5. However, in case we are wrong on this issue we will consider the question as to whether the fact that the payments were made by trustees acting pursuant to the terms of the No.1 Trust deprives the payments of the character of a gratuity.

68. The question for consideration here is whether the fact that the payments are made by the trustees of the No.1 Trust means that they cannot have the character of a voluntary payment or a gift and the trustees could not be considered to be a donor.

69. Ms Choudhury does not seek to argue that every payment by a discretionary trust to its beneficiaries in the ordinary exercise of their powers is within paragraph 5 as a "gratuity". However, Knowledgepoint relies on the particular circumstances attaching to the payments made by the trustees of the No.1 Trust to contend that they

are within that paragraph because they were made in recognition of the services provided by those employees who had “gone the extra mile” and which had resulted in the increase of the value of the shares held by the No.1 Trust.

5 70. Ms Choudhury submits that there had never been a plan to use the No.1 Trust as a means of rewarding employees with cash payments and it was only decided to do so when Thomson’s offer was implemented. Thus the payments were quite different in character to the awards that were made whilst the No.1 Trust’s purpose was to incentivise employees and had the character of gratuity payments unlike the previous awards made in exercise of the trustees’ discretionary powers. The payments in this
10 case were taken out of the class of discretionary payments usually made by trustees because they were made as a reward for services provided by the beneficiaries.

71. Ms Choudhury also observes that after the circumstances relevant to this appeal, paragraph 5 was amended so as to exclude from the scope of what constituted a gratuity payments made by a trustee (who is not a troncmaster) holding property for
15 any persons who include, or any class of person which include the recipient. If it is right that payments by trustees would not be gratuities this amendment would have been otiose. Likewise, the fact that the specific disregard for payments made by trustees in Regulation 19(e) of the 1979 regulations was not to be found in the 2001 Regulations did not prevent such payments being gratuities within paragraph 5.

20 72. Ms Choudhury accepts that the concept of a gift sits uneasily as a description of a payment made by a trustee. Nevertheless she submits that a gift is only a particular type of voluntary payment, and any type of voluntary payment is capable of constituting a gratuity if the other features are present which she submits is the position in this case. She observes that the Special Commissioners in *Channel 5*
25 concluded in paragraph 41 of their decision that a gratuity was a voluntary payment without explicitly using the word “gift”.

73. Ms Choudhury distinguishes *Drummond v. Collins* on the basis that the payments made there were in exercise of the dispositive power in the trust instrument and the payments made were those always envisaged by the terms of the trust. This
30 contrasts with the position of the No.1 Trust which did not envisage payments of this nature being made until the offer from Thomson materialised and the purpose of the No.1 Trust as an employee share scheme came to an end.

74. Ms Choudhury submits that *Cowan v. Scargill* is irrelevant here; that case concerned the duty of trustees to act in the interests of the beneficiaries without regard
35 to their personal interests and there was no suggestion in the current case that the trustees were not acting in the best interests of the beneficiaries in making the payments to reward employees for their past efforts.

75. Finally, Ms Choudhury submits that *Brumby v. Milner* is of no relevance as it was a case concerning the definition of “emolument”.

40 76. In our view the purpose of the No.1 Trust remained the same throughout its life, including when it made the cash payments to the employees. The purpose of the No.1

Trust was set out in the recital that we quoted in paragraph 13 above, namely to act as an incentive for its officers and employees.

5 77. The trustees were obliged when exercising their discretionary powers to make payments to the Beneficiaries, which as set out in paragraph 15 above constituted the present and future employees or former employees of the Company, to have that purpose in mind. Indeed the proviso to clause 2 of the Trust Deed, set out in paragraph 14 above, prevents the powers being exercised in such a way as to cause the No.1 Trust to cease to be an Employees Share Scheme as defined in Section 743 of the Companies Act 1985. That provision defines an Employees Share Scheme as
10 being a scheme for “encouraging or facilitating the holding of shares or debentures in a company” by employees or former employees or their close relatives. Failure to observe the purpose would deprive Knowledgepoint of the relief afforded to employees share schemes under the Companies Act from the prohibition on companies providing financial assistance for the purchase of their own shares.

15 78. The fact that Knowledgepoint no longer wished to have a scheme for such a purpose inevitably meant that it had to make dispositions out of the trust fund, but in making the payments that the trustees did they were distributing the proceeds of investments that had been held for the purposes of the No.1 Trust, and did so consistently with the stated objective of incentivising employees.

20 79. The situation is therefore on all fours with the position in *Brumby v. Milner* and in our view the fact that that case was concerned with the question as to whether a termination payment was an emolument as opposed to a gratuity in our view makes no difference. The relevant point is that in *Brumby v. Milner* the termination payment was held to be no different in character to the benefits conferred on employees before
25 the decision was taken to wind up the scheme.

80. We therefore reject Ms Choudhury’s submission that the No.1 Trust changed its purpose as a result of the decision that an employee share scheme was no longer required and that this changed the nature of the payments that were made. It was common ground that awards by the trustees exercising their discretionary powers
30 before that decision could not be gratuities and in our view that position did not change thereafter.

81. *Cowan v. Scargill* is also relevant to this issue in that it demonstrates that the trustees of a trust are bound to deal with its assets in a manner consistent with the purpose of the trust and not for any extraneous purpose. Thus the trustees of the No.1
35 Trust had no powers to do anything other than make dispositions which were consistent with the purpose of the trust, in the same way that the trustees of the mineworkers pension fund had no power to do anything other than invest the assets in accordance with the investment powers of the trust so as to maximise the return to beneficiaries.

40 82. It also follows from this analysis that the character of the payments made by the trustees is the same as those made by the trustees in *Drummond v. Collins*; the payments made by the trustees of the No.1 Trust could not be characterised as

voluntary payments in the same way that the payments made by the trustees to the beneficiaries in that case were held by the House of Lords not to be voluntary. We therefore accept Ms Wilson's submissions to the effect that the trustees made the payments in exercise of a dispositive power. Consequently the payments satisfied the gifts made by the settlor (in this case Knowledgepoint) and were not gifts made by the trustees: see the passage from *Drummond v. Collins* quoted in paragraph 54 above.

83. It follows that in our view the FTT was wrong to focus its reasoning entirely on the basis that the payments were voluntary payments because they were made by the trustees in the exercise of a discretion which they exercised having considered the individual circumstances of each employee and entirely on the basis of their own decision without the involvement of any other person. The FTT failed to consider how the nature of the payments could be different when paid by trustees under their dispositive powers as opposed to being voluntary payments, such as those made in the *Channel 5* case.

84. Nor do we accept Ms Choudhury's submission that it is not a necessary feature of a gratuity that it is a gift. Although paragraph 41 of *Channel 5* on which she relies does not mention the word "gift" it does refer to a donor, who must be defined as a person who makes a gift. Furthermore in paragraph 44 of the decision, which sets out the application of the formulation in paragraph 41 to the facts of the case, the Special Commissioners clearly refer to the payments concerned being gifts, and as Ms Choudhury accepts, payments made by trustees under their dispositive powers are not gifts.

85. Neither do we believe that anything turns on the fact that the law was changed specifically to prevent payments made by trustees being gratuities. It may be the case that Parliament believed at the time the amendment was passed that payments by trustees could be gratuities for the purpose of paragraph 5 but at that time that had not been found to be the case.

86. We therefore conclude that the payments made by the trustees of the No.1 Trust on its termination were not gratuities.

87. Consequently, we need to go further to consider whether in the manner in which the payments were made the conditions in paragraph 5 were satisfied. Had we found that the payments were gratuities we would necessarily have had to accept Ms Choudhury's submission and the FTT's reasoning that the payments made were voluntary payments and did not amount to a disposition by the trustees of the No.1 Trust of the bounty of the settlor. In those circumstances for the reasons given by the FTT we would have found that the conditions would have been satisfied.

Conclusion

88. As a result of our conclusion that the payments concerned were not gratuities within the meaning of paragraph 5 of Part X of Schedule 3 to the 2001 Regulations, for the reasons we have given we must allow HMRC's appeal. We will deal with any application for costs in the usual way.

5 **TIMOTHY HERRINGTON**

JOHN WALTERS QC

**UPPER TRIBUNAL JUDGES
RELEASE DATE: 28 MARCH 2013**

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