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Case Nos: CA-2022-002223; CA-2022-002238; CA-2022-002242; CA-2022-002243; CA-2022-002244; CA-2022-002246

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
MR JUSTICE LEECH AND UPPER TRIBUNAL JUDGE TIMOTHY HERRINGTON
[2022] UKUT 00200 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 15/12/2023

Before:

LORD JUSTICE LEWISON
LADY JUSTICE FALK
and
SIR LAUNCELOT HENDERSON

- -

Between:

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS ("HMRC")	**Appellants**
- and –	
(1) BLUECREST CAPITAL MANAGEMENT LP (2) BLUECREST CAPITAL MANAGEMENT LLP (3) BLUECREST CAPITAL MANAGEMENT (UK) LLP (the "Partnership Respondents")	**Respondents**

And Between:

(1) ANDREW DODD (2) LEDA BRAGA (3) SIMON DANNATT (4) MICHAEL EDWARD PLATT (5) JONATHAN WARD (the "Individual Partner Appellants")	**Appellants**
- and –	
THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS ("HMRC")	**Respondents**

- -
- -

Jonathan Peacock KC, John Brinsmead-Stockham KC and Edward Hellier (instructed by **Slaughter and May**) for the **Individual Partner Appellants** and the **Partnership Respondents**
Rupert Baldry KC, Thomas Chacko and James Kirby (instructed by **HMRC Solicitors' Office and Legal Services**) for **HMRC**

Hearing dates : 14th, 15th and 16th November 2023
- -

Approved Judgment

This judgment was handed down remotely at 2.00pm on 15th December 2023 by circulation to the parties or their representatives by e-mail and by release to the National Archives.

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Sir Launcelot Henderson:

Introduction

1. BlueCrest Capital Management is one of the world's largest investment management businesses. It was founded in 2000 by Michael Platt ("Mr Platt") and William Reeves. During the period with which these appeals are concerned, running from 2008 until 2014, BlueCrest carried on its business in the United Kingdom through three partnerships, which broadly operated in succession: first, a limited partnership called BlueCrest Capital Management LP ("BCM LP"); next, a limited liability partnership ("LLP") called BlueCrest Capital Management LLP ("BCM LLP"); and then, after the migration of BCM LLP to Guernsey in April 2010, another LLP called BlueCrest Capital Management (UK) LLP ("BCM (UK) LLP"). Except where it is necessary to distinguish between them, I will refer to the UK business of the firm, and to the three partnerships collectively, as "BlueCrest".

2. In April 2008, a pilot phase of a "Partner Incentivisation Plan", or "PIP", was introduced on a voluntary basis for some of the senior partners in BlueCrest. This phase operated for the accounting period of BCM LP ending on 30 November 2008.

3. From its inception, the PIP had both a genuine commercial purpose and a perceived fiscal advantage for the participating partners.

4. The commercial purpose, which was explored in evidence before the First-tier Tribunal ("FTT") and is reflected in their unchallenged findings of fact, was (in short) to incentivise the partners to remain with BlueCrest, in a highly competitive market, for periods of between six months and three years; to discourage excessive risk-taking; and to permit account to be taken of the partners' subsequent performance before awards under the PIP were finalised. In bare outline, these objectives were to be achieved by exchanging a proportion of the partner's prospective share of profit in the partnership business for a deferred entitlement, which was both contingent on the satisfaction of specified conditions and wholly discretionary, to a corresponding award of so-called "special capital" made to him by a newly introduced corporate partner. Meanwhile, the corporate partner would be allocated initial shares of profit equivalent to those forgone by the individual participating partners, and it was then in practice obliged to invest those shares, after retention of a sum sufficient to satisfy its expected liability to corporation tax and expenses, in the special capital from which final awards to the relevant partners might in due course be made.

5. During this pilot phase, the corporate partner was a limited company incorporated in England and Wales in April 2008 called Special Capital Limited ("SCL"). SCL became a partner of BCM LP by a Deed of Adherence on 30 April 2008.

6. The perceived fiscal advantage of the PIP lay in the difference between the marginal rate of income tax (then 40%) which the partner would otherwise have been liable to pay on his prospective share of profits diverted to the corporate partner, and the rate of corporation tax (then 28%) payable by the corporate partner on the profits reallocated to it. If, and when, an award of special capital was later

made to an individual partner, it was expected that this would escape liability to income tax in the partner's hands for two separate reasons. First, it would be a receipt of capital, not income; and secondly, even if it had the character of income, the receipt would not be derived from a taxable source.

7. The second phase of the PIP operated for BlueCrest's accounting period ending on 30 November 2009. Participation was now open to a wider group of senior personnel than before, and on an opt-out basis, with the result that participation was the default position. By this stage, BlueCrest had also undergone some organisational changes:

    a) a new corporate partner, ABM Avon Limited ("Avon"), joined BCM LP by a Deed of Adherence on 27 November 2008;

    b) in December 2008 the business of BCM LP was transferred as a going concern to BCM LLP; and

    c) although SCL remained a partner of BCM LP, and then a member of BCM LLP, by late 2009 Avon had taken over the main role of facilitating the PIP, and the residual special capital held by SCL had been transferred to Avon.

8. Apart from those changes, the second phase operated in substantially the same way as the pilot, but with one important difference. Unlike SCL, Avon was willing to retain only 15%, rather than 28%, of its initial allocation of profits representing the contributions to the PIP of the participating members. This meant that, for every 100 of partnership profits allocated to Avon, 85 instead of 72 would be available to be invested in special capital and made the subject of future final awards. The reasons why Avon was able to proceed in this way remain obscure, in the absence of any relevant findings by the FTT; but presumably Avon had been able to arrange its tax affairs so that its trading profits were subject to an effective rate of corporation tax of only 15% or less. Whatever the reason may have been, the attraction to BlueCrest was obvious. For every 100 that was contributed to the PIP, the amount of special capital available for future final awards would be substantially greater than under the previous arrangements with SCL.

9. The third, and last, phase of the PIP began with the first accounting period of BCM (UK) LLP, which was extended to end on 31 December 2010, and continued for subsequent annual accounting periods until the end of 2014. With effect from February 2010, participation in the PIP became mandatory for all individual members of the LLP, with some immaterial exceptions. The PIP did not, however, become obsolete after the end of 2014. To the contrary, the evidence was that it continued to operate thereafter across the global BlueCrest businesses, but the UK fiscal benefits which I have mentioned were effectively countered by remedial legislation in the Finance Act 2014 ("FA 2014") concerning excess profit allocations to non-individual partners: see sections 850C to 850E of the Income Tax (Trading and Other Income) Act 2005 ("ITTOIA 2005"), inserted by FA 2014 section 74 and schedule 17, para 7(3).

10. Throughout the three phases of the PIP with which we are concerned, the participating partners fell into three main groups, comprising (a) discretionary

traders, (b) systematic traders, and (c) others who fulfilled various supporting or "back office" functions. Broadly speaking, discretionary traders were engaged in the active management of investment portfolios, while systematic traders performed investment management services based on algorithmic trading.

11. Between 2010 and 2015, HMRC opened enquiries into the relevant tax returns of BCM LP, BCM LLP and BCM (UK) LLP, as well as into the returns of Mr Platt and other individual participants in the PIP, including Andrew Dodd, Leda Braga, Simon Dannatt and Jonathan Ward. In due course, those enquiries led to the sending of closure notices whereby HMRC sought to give effect to their primary case and to their alternative case.

12. HMRC's primary case was, and remains, that, having regard to the PIP arrangements as a whole, the profit share initially allocated to the corporate partner/member (i.e. SCL or Avon) is properly chargeable to income tax as the separate profit shares of the participating individual partners in the proportions in which they were intended to benefit from those allocations by final awards, or "re-allocations", of special capital. This result is said to follow from a realistic application to the undisputed facts of section 850 of ITTOIA 2005, which states that:

> "(1) For any period of account a partner's share of a profit or loss of a trade carried on by a firm is determined for income tax purposes in accordance with the firm's profit-sharing arrangements during that period.
>
> …
>
> (2) In this section … "profit-sharing arrangements" means the rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade."

It is implicit in this argument that, if it is correct, the individual profit shares allocated to SCL or Avon cannot simultaneously be treated as profits which are subject to corporation tax in the hands of the corporate partner or member. HMRC accordingly accept in principle that, if their primary argument succeeds, all necessary adjustments must be made to ensure that there is no double taxation of this nature.

13. If HMRC's primary case fails, their alternative case is, and again remains, that the re-allocations of special capital received by Mr Platt and the other individual participants in the PIP, at the final stage of the scheme, are chargeable to income tax in their hands *either* (a) as income not otherwise charged to income tax under section 687 of ITTOIA 2005, *or* (b) under the rules relating to the sale of occupational income ("SOI") contained in Chapter 4 of Part 13 of the Income Tax Act 2007 ("ITA 2007").

14. Section 687 of ITTOIA 2005 materially provides that:

> "(1) Income tax is charged under this Chapter on income from any source that is not charged to income tax under or as a result of any other provision of this Act or any other Act.
>
> …
>
> (4) The definition of "income" in section 878(1) does not apply for the purposes of this section."

Section 689 then states that the person liable for any tax charged under section 687 "is the person receiving or entitled to the income".

15. Procedurally, HMRC's primary case was given effect by amendments to the self-assessment returns of the three partnerships (which were required to state the profit allocations made to the partners). HMRC's alternative case was given effect by (alternative) amendments to the personal self-assessment returns of the individual partners concerned. It has been common ground throughout that, if the primary case succeeds, then neither section 687 nor the SOI rules can apply to charge to income tax the final re-allocations of special capital to the individual partners. Thus, the appeals of the partnerships, which have been generally referred to as "the PIP appeals", and the appeals of Mr Platt and the other four individual partners mentioned above, generally referred to as "the IP [*Individual Partner*] appeals", in substance raise a series of alternative arguments derived from the same factual background, and they have at all stages been heard together.

16. The linked appeals were heard by the FTT (Judge John Brooks) over some four weeks in November 2019, together with related appeals concerning a structure established in the Cayman Islands in 2007 ("the Cayman appeals") which for present purposes may be ignored. The FTT released its decision ("the FTT Decision") on 17 July 2020: see [2020] UKFTT 298 (TC). The FTT Decision is very lengthy, running to some 220 pages and 459 paragraphs. The paragraphs which deal with the PIP appeals run from [252] to [337], while those dealing with the IP appeals run from [338] to [457].

17. In summary, the FTT decided against HMRC on the PIP appeals, but in favour of HMRC on the first of its alternative arguments, with the result that the IP appellants were chargeable to income tax under section 687 of ITTOIA 2005 on the amounts of their final PIP awards. On that basis, it was strictly unnecessary for the FTT to deal with HMRC's second alternative argument under the SOI rules, but since the matter had been fully argued Judge Brooks helpfully went on to consider it, concluding that on this issue too HMRC were entitled to succeed. It was in this context that the FTT found, at [437], that "although the PIP arrangements clearly did have a commercial purpose, the retention and incentivisation of partners, they also had as a main object the avoidance or reduction of liability to income tax". That finding is no longer challenged by the IP appellants.

18. Both sides then appealed to the Tax and Chancery Chamber of the Upper Tribunal ("the UT") (Leech J sitting with UT Judge Timothy Herrington), which released its decision ("the UT Decision") on 22 July 2022: see [2022] UKUT 200 (TCC), reported at [2022] STC 1696. The UT reached the same overall conclusions as the FTT. On the PIP appeals, it held that the FTT had misdirected itself in law, but

then decided to remake the decision with the same result. On the IP appeals, it held that the PIP awards made to individual partners had the character of income, and that the FTT had rightly identified the source of the awards as the decision of the corporate partner in each case to re-allocate the special capital and make the award final. The UT then dealt, *obiter*, with the SOI issue, and again upheld the decision of the FTT, for similar reasons.

19. Both sides now pursue second appeals to this court, with permission granted by the UT. Permission to appeal on a third ground was refused to the IP appellants by the UT, and that refusal was upheld by Lewison LJ on a renewed application. HMRC were represented before us by Rupert Baldry KC and Thomas Chacko, as they were below, and by James Kirby, who did not appear below. The partnerships and the IP appellants were represented by Jonathan Peacock KC, John Brinsmead-Stockham KC and Edward Hellier, none of whom appeared below.

The facts in more detail

20. For a full account of the facts, it is necessary to refer to the FTT Decision at [253] to [307] for the PIP appeals, and [340] to [399] for the IP appeals. A helpful summary of the FTT's findings of fact relevant to the PIP appeals is also given by the UT at [20] to [43] of the UT Decision. In the selective and abbreviated account which follows, I will focus on the areas which seem to me most significant, drawing mainly on the UT's summary. Unless otherwise stated, paragraph references are to the UT Decision.

The nature of the partnership business

21. The skills, reputation and performance of BlueCrest's discretionary and systematic traders were "a key to the success of the Partnership": [26]. In the hedge fund industry, "very high levels of reward" are needed "to secure the highest quality talent available". Those working in the sector are "inherently mobile", so effective strategies were also needed to attract and retain key members of staff, "with the reward received by individual partners being key to that attraction and retention": [27].

Remuneration of partners before the PIP

22. Before the PIP began in 2008, the profit allocations and drawings of partners were determined by the partnership management, with the final decision being made by the board of the general partner of BCM LP. For discretionary traders, their performance over the year would be reviewed, generally by reference to their individual profit and loss accounts for the portfolios they managed, and their total reward would be calculated by using a standard methodology: [29]. For systematic traders, and for partners performing non-investment functions, there was a more "subjective" assessment of their contribution, but after discussion and review by senior staff the final decision would again be made by the board of the general partner: [30].

23. Importantly, before the PIP "there were no contractual provisions which enabled the Partnership to defer payment or to require partners to invest their own profits into BlueCrest funds or to claw back profit allocations after they had been made":

[31]. This gave rise to difficulties when profit allocations were made to certain traders who had made profits in 2006 and 2007, but when they made significant losses in late 2007 and 2008, the partnership had no recourse against them. It also became necessary to divert performance fees from profitable funds to compensate other traders who had performed well, even though overall no performance fees were received by the partnership because the relevant funds remained below their high-water mark: *ibid*.

The purpose of the PIP

24. The PIP was introduced to deal with these issues: [32]. It was "a bespoke piece of tax planning developed by Ernst & Young LLP", who informed BlueCrest in a "question and answer" format that it had been used by a number of hedge funds since 2003/04 and on at least one occasion had been considered by HMRC but not challenged by them. However, the possibility of challenge remained, although in the view of Ernst & Young the PIP did not constitute "aggressive tax planning" and it had "a genuine commercial underpinning": [33] and the FTT Decision at [272].

25. The tax partner in Ernst & Young who introduced BlueCrest to the PIP was Robin Aitchison, who gave oral evidence to the FTT. He described how the PIP was intended to work in terms recorded in the FTT Decision at [269-70]:

> "Mr Aitchison proposed offering partners the prospect of a greater share in its capital by the introduction of a corporate partner into BCM LP which, like all partners, could be awarded a portion of the profits by way of discretionary allocation. The corporate partner could then re-invest those profits back into the business as a capital contribution, to be called "special capital" in order to distinguish it from ordinary capital. This could then be used to invest in a BlueCrest Fund or Funds. Although this would reduce the profits available for allocation to the other partners those partners could be made eligible for consideration for potential discretionary awards by the corporate partner of special capital in BCM LP if that is what it recommended. Under the proposed plan the awards that were to be made by the corporate partner to the other partners would not be an allocation of profits of BCM LP but an award of capital from the corporate partner."

The role of the corporate partner

26. As recommended by Mr Aitchison, the corporate partner was independent of, and not controlled by, BlueCrest. Both SCL and Avon were ultimately controlled by a trust company. The objects of SCL included participation in incentivisation and retention strategies for the individual partners: [35]. As I have already explained, SCL entered into a Deed of Adherence on 30 April 2008, the material terms of which are set out in the FTT Decision at [276]. In short, SCL was entitled to be allocated income profits in accordance with the Limited Partnership Deed "in the absolute discretion of the General Partner", and upon receipt of any such profits, or drawings on account of them, it agreed to consider contributing all or part of

those amounts to the partnership as special capital "less UK corporation tax considered likely to be due on the … profit allocation and reasonable expenses": see clause 2.4. This was the arrangement which, in simplified terms, enabled SCL to contribute 72% of its gross profit allocation back to the partnership as special capital: [35].

27. The FTT recorded the evidence of Andrew Dodd, a senior BlueCrest executive and chief financial officer, that he considered it important for the partners "to feel that there was objectivity, fairness and a degree of separation between BCM LP and the corporate partner", and "this was achieved by the utilisation of an independent corporate partner in the administration of the plan and the making of awards": [274] of the FTT Decision. (It is convenient to mention here that the FTT typically recorded the evidence of witnesses without expressly saying whether or not it accepted that evidence. The parties have sensibly agreed that acceptance should be presumed in the absence of any contrary indication.)

28. As I have said, Avon subsequently took over the role of corporate partner because it was able to contribute 85% of its profit allocation back into the partnership as special capital: [35]. The FTT heard evidence from Andrew Beverly, who was a founding member and director of Avon, but his evidence apparently did not explain on what grounds Avon was content to retain only 15% of its gross profit allocations.

The partnership deed provisions relating to special capital

29. The FTT reproduced the relevant provisions of the BCM LLP Partnership Agreement, to which both SCL and Avon were parties, at [283] of the FTT Decision. The UT provided a summary at [37] to [39].

30. Clause 7.4(A) provided that members may, with the agreement of "the Board" (i.e. the managing board of the LLP), make "further contributions" separate from their ordinary capital, either in cash or in specie. Such further contributions would then be credited to the member's Special Capital Account, and could be invested, at the discretion of the Board, in such assets (including interests in BlueCrest Funds) as the Board might determine ("Investment Assets"). The clause continued (with my emphasis):

> "Subject as hereinafter provided, the monies standing to the credit of a Special Capital Account (and any Investment Assets acquired with any such monies) shall be held *exclusively for the benefit of the relevant Member and only the relevant Member shall be entitled to such monies, any Investment Assets acquired with such monies and the proceeds of realisation of any such Investment Assets, and no other Member shall have any interest in such monies or such Investment Assets save as specifically provided for in this Agreement or as agreed in writing with the relevant Member."*

I comment that the Agreement could hardly have provided more explicitly that special capital contributed by a member should remain in the sole and separate beneficial ownership of the contributing member, even if it were invested in other

BlueCrest Funds, and even if it were intended to be later used (in the case of special capital contributed by the corporate member) to make PIP awards to individual partners.

31. Clause 7.4(B) enabled any member to withdraw special capital credited to his Account on three months' notice to the Board.

32. Clause 7.4(C) then provided for the re-allocation of special capital by any member (including, of course, a corporate member) following the receipt of a recommendation from the Board (again with my emphasis):

> "Subject to the provisions below any Member who has Special Capital credited to his Special Capital Account may, in its sole and absolute discretion, decide (following, and only following, the receipt of a recommendation from the Board that such Member should consider a reallocation of such interest in such Special Capital) that all or part of the interest of such Member in any Special Capital (and accordingly in any Investment Asset acquired with such Special Capital) should be reallocated to any other Member or Members so that such other Member or Members will, following such reallocation, become beneficially entitled [thereto] and shall give notice of any such decision to the Board provided that no such reallocation shall be made by any such Member prior to the expiry of the period of six months following the date upon which the Special Capital was contributed to the Partnership and used (either directly or indirectly) to acquire the relevant Investment Assets … ".

33. I observe that this (like its similar predecessor in the BCM LP Agreement, and its successor in the BCM (UK) LLP Agreement) was the key provision which enabled PIP awards to be made by the corporate partner in favour of individual members. It should be noted that (a) the corporate partner's power to do so was, on the face of it, an unfettered discretion, but (b) it could only be exercised following the receipt of a specific recommendation from the Board, and (c) the minimum period of six months for such exercise ensured that the member in receipt of the re-allocation would have been obliged to remain in service for at least that long since the partners' shares of profit for the year were first decided.

34. The profit allocations of partners were originally determined by the Board, but after the introduction of the PIP, a PIP Recommendations Sub-Committee (the "PRSC") was established, which made non-binding recommendations to the corporate partner that certain partners should receive a provisional indication of a potential future award of special capital: [40].

The eligibility conditions for awards of special capital

35. The conditions which an individual partner had to satisfy to be eligible for a final award of special capital are most conveniently seen in the provisional award letters sent by the corporate partner to the partner in question. We were taken by Mr Baldry KC to a sample set of documents relating to the award made by SCL in 2009 to an individual partner, Mr Florent Chermat. In a letter to him dated 14

April 2009, SCL informed Mr Chermat that BCM LLP had made an initial recommendation for an award of a specified amount to be made in his favour by way of a re-allocation from the special capital held by SCL in the "Incentivisation Pool" on or after 1 August 2009, defined as "the Vesting Date". It was emphasised that the recommendation was non-binding, and although SCL would take it into account, SCL would "retain absolute discretion over the Incentivisation Pool".

36. Mr Chermat was then told that he would forfeit the right to be considered for such re-allocation if, on or before the Vesting Date, (a) a Notice of Removal was served on him under clause 17.1 of the LLP Agreement (save for a notice under sub-clause 17.1(i)), (b) he served a notice of resignation, or (c) he became an Outgoing Partner under clause 18 (save in the case of his death or permanent incapacity). Clause 17.1 provided for the removal of an individual member upon conviction of a criminal offence and in various other specified cases of misconduct, while sub-clause 17.1(i) also enabled a Notice of Removal to be served "in the event that the Board considers the service of such notice to be in the best interests of the Partnership". Clause 18 contained a list of events upon the occurrence of which membership would cease, and made provision for the rights of the Outgoing Member in such circumstances. In cases of that type, Mr Chermat was told that he would be treated as a Non-Forfeiting Outgoing Member, and he would automatically be entitled to re-allocation of the underlying Investment Assets attributable to his provisional award of special capital.

37. For present purposes, the important point is that the triggering of an event of forfeiture was largely, if not entirely, within the member's control, and there were express exceptions for the member's death, permanent incapacity or expulsion in the best interests of the partnership. It may also be questioned whether the member really had a vested right to be considered for re-allocation which was capable of being forfeited. Although the point was not explored in any detail, it seems to me the correct analysis might well be that, in the specified circumstances, the right to be considered never arose at all, because it remained subject to conditions precedent which were never satisfied.

The operation of the PIP in practice

38. The UT summarised the FTT's findings on how the PIP operated in practice in [41], which I will set out in full:

> "41. The FTT also made findings in relation to the way the PIP operated in practice and, in particular, how the total rewards of individual partners were determined: see [290] to [298]. In summary:
>
> (1) The PRSC received from the Executive Committee of the Partnership the proposed total rewards which it had decided were appropriate for the individual partners in question. Based on these proposals, the PRSC would consider what awards of Special Capital to recommend to the Corporate Partner. When the PIP was first implemented, and for a time thereafter, the ratio of the size of the potential award of Special Capital which would be recommended to the Corporate Partner to the

discretionary profit allocation which a partner would receive varied. However, from 2010 onwards the ratio was approximately 2:1.

(2) The PRSC was made up of Executive Committee members of the Partnership and Mr Andrew Beverley of Avon. The Board of Avon would decide whether it would accept the recommendations of the PRSC and thus which provisional indicative awards to make to the individual partners. If Avon (or before it SCL) adopted the PRSC's recommendations individual partners would be provided with a non-binding, provisional indication of a discretionary award of Special Capital to be made by the Corporate Partner which was often referred to as a "provisional award". This sum would become final after a "deferral period" and at a date in the future and it was frequently described as a "final award". It would take the form of a reallocation of a fractional interest in the investment assets held by the Partnership.

(3) The eligibility of a partner for a final award of Special Capital would depend on the fulfilment of a number of "eligibility conditions" which included his or her continuing to be a partner. It was for Avon as the Corporate Partner to decide whether to make such a final award at the conclusion of the deferral period having been provided with a second recommendation from the PRSC which would have considered a number of factors including the partner's performance over the intervening period, whether or not they had submitted a resignation, and their level of risk taken in the market and current P&L account (if a portfolio manager).

(4) The provisional, indicative awards of Special Capital made by Avon would only be made final after the deferral period had expired. The deferral period was initially a period of six months. Over time, a variety of deferral periods was used across the BlueCrest business. This ensured that should a partner leave they would automatically breach the eligibility criteria or "forfeit" the possibility of an award being made final.

(5) The length of the deferral period was determined so as to ensure that there was always a significant amount at stake for each individual partner, if they were to resign or commit a breach of any of the eligibility conditions stated in their provisional award letters (which would lead to the forfeiture of a final award and any future awards or, if the relevant partner had incurred losses, would lead to the receipt of a final award which was less than the amount of the provisional, indicative award).

(6) The Partnership would decide as a business matter how much of its anticipated profit distribution it wished to be subject to the PIP arrangements. Avon would then be asked to make an advance drawing on account of its expected allocation of profits, and would subscribe the amount of this advance as Special Capital. Avon's Special Capital Account was credited with the advance when these contributions were made and would also be credited when gains were subsequently realised on assets acquired using Special Capital (although gains would only be recognised in the Partnership's accounts on realisation). The Partnership would then recommend the levels of Special Capital awards to be made to individual partners. These recommendations from the Partnership to Avon were made by the PRSC, on which Mr Beverley sat as an independent member, to make sure that the decision making of the Partnership was consistent and met Avon's own principles. Mr Beverley saw himself "to some extent" as "a sort of independent conscience."

(7) The recommendations of the PRSC were generally applied by Avon but there were a number of instances when that was not the case as follows:

(i) On 10 May 2010 Avon increased the amount of a final award over the recommended amount pointing out to the Partnership that the recommended award was less than the indicative award and clarified that this was not for a good reason.

(ii) On 11 October 2011 Avon pointed out to the Partnership that it was minded not to accept a recommendation to make an award to a person who was no longer a partner and that recommendation was accepted.

(iii) On 1 September 2011 Avon noticed inconsistencies in the proposed forfeiture conditions between the letter of recommendation to Avon and in the draft indicative award letter to the participant. These inconsistencies were resolved satisfactorily and an award was made".

39. Although I will not reproduce it, it is also helpful to refer to the FTT Decision at [301] which sets out a table describing the full PIP cycle for the financial year of BCM (UK) LLP beginning on 1 January 2012. This table formed part of the evidence of Catherine Kerridge, who was BlueCrest's head of tax from 2007 to 2017. There is one minor error to note in the table: in box 3, the date of crystallisation of the performance fees due from the BlueCrest-managed funds to the partnership was 31 December 2012, not 21 December.

40. A relatively small, but nevertheless significant, proportion of provisional PIP awards were never made final. According to Mr Dodd, about 16% in number, and

2 to 3% in value, of the UK provisional awards fell into this category, because of the departure of the partner concerned or later losses being incurred: see the FTT Decision at [303]. The assets attributable to these non-awards stayed in the beneficial ownership of the relevant corporate partner as special capital, and helped to offset BlueCrest's "netting risk" exposure: *ibid* at [304].

The commercial benefits of the PIP

41. The UT summarised the FTT's findings at [43], as follows:

> "The FTT then recorded the commercial benefits of the PIP arrangements at [305] to [307]. In summary:
>
> (1) Individual partners were incentivised to remain with the Partnership on an ongoing cycle and to continue to deliver returns for investors.
>
> (2) The Partnership was now protected to some extent against downside risk from an individual trader's negative P&L in the next year because it was now possible for potential awards of Special Capital to be adjusted (or, indeed, not be made at all) in the light of subsequent performance, with the Special Capital remaining in the Partnership instead.
>
> (3) This conditionality and adjustability also meant that: (a) the Partnership was protected against "netting risk" since it was now possible to adjust downwards the potential award of Special Capital to one trader (who had made losses) in order to free up Special Capital which could be used to reward a second trader (who had made back those losses but in circumstances where no performances fees would be earned); and (b) traders who had received provisional indications of PIP Awards, but who subsequently had a negative P&L, were no longer incentivised to take risky bets to try to make back the losses.
>
> (4) The fact that the Special Capital associated with future PIP Awards was generally invested in BlueCrest-managed funds created alignment between the interests of individual partners (who would want the funds in which the Special Capital was invested to perform well) and investors in BlueCrest-managed funds (and it also increased the AUM of the Partnership and therefore the management fees earned). This alignment was attractive to potential investors.
>
> (5) The PIP gave the Partnership additional bargaining power when it came to negotiating the departure terms of partners who had given, or were considering giving,

> notice to leave the business (since the possibility of receiving the potential award would be forfeited), and encouraged them to leave on good terms, due to the prospect of a severance payment".

The scheme of partnership taxation in the UK

42. There is no disagreement about the basic scheme of partnership taxation in the UK, so I can deal with it briefly. All types of partnership, including LLPs, are generally treated for income and corporation tax purposes as transparent, and are therefore taxed on a "look-through" basis. Thus, section 848 of ITTOIA 2005 provides that "Unless otherwise indicated (whether expressly or by implication), a firm is not to be regarded for income tax purposes as an entity separate and distinct from the partners", and section 847(1) defines a "firm" collectively as "persons carrying on a trade in partnership". In the case of LLPs, which as a matter of general law have a separate corporate identity, section 863 of ITTOIA 2005 specifically provides that:

> "(1) For income tax purposes, if a limited liability partnership carries on a trade, profession or business with a view to profit –
>
> (a) all the activities of the limited liability partnership are treated as carried on in partnership by its members (and not by the limited liability partnership as such),
>
> (b) anything done by, to or in relation to the limited liability partnership for the purposes of, or in connection with, any of its activities is treated as done by, to or in relation to the members as partners, and
>
> (c) the property of the limited liability partnership is treated as held by the members as partnership property."

43. The way in which a partnership's trading profits are to be calculated is set out in section 849:

> "(1) If-
>
> (a) a firm carries on a trade, and
>
> (b) any partner in the firm is chargeable to income tax,
>
> the profits or losses of the trade are calculated on the basis set out in subsection (2) or (3) as the case may require.
>
> (2) For any period of account in which the partner is a UK resident individual, the profits or losses of the trade are calculated as if the firm were a UK resident individual."

44. I have already set out the relevant provisions of section 850: see [12] above. The crucial point is that, for any period of account, an individual partner's share of a profit or loss of the trade carried on by the firm is determined for income tax

purposes "in accordance with the firm's profit-sharing arrangements during that period", and those arrangements are defined as "the rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade."

45. In the case of the corporate partners, it is necessary to look at section 1262 of the Corporation Tax Act 2009 ("CTA 2009") which is drafted in materially similar terms to section 850 of ITTOIA 2005. (For the first accounting period in issue on these appeals, the relevant provisions were contained in section 114 of the Income and Corporation Taxes Act 1988 ("ICTA 1988"), but although drafted in slightly different terms, it is common ground that nothing turns on the differences.) As for income tax purposes, LLPs that carry on a trade or business with a view to profit are treated for corporation tax purposes in the same way as general partnerships: see in particular section 1273(1) of CTA 2009, which corresponds to section 863(1) of ITTOIA 2005.

46. For a general summary of the correct approach to the legislative scheme of partnership taxation in the years under appeal, reference may also be made to my judgment (with which Newey and Sharp LJJ agreed) in *HMRC v Vaines* [2018] EWCA Civ 45, [2018] STC 297, at [14] – [18] and [21].

Partnership capital, partnership assets and "special capital"

47. As Nourse LJ explained in *Popat v Shonchhatra* [1997] 1 WLR (CA) at 1371, repeating what he had said at first instance in *Reed v Young* (1983) 59 TC 196, 215, [1984] STC 38, 57:

> "The capital of a partnership is the aggregate of the contributions made by the partners, either in cash or in kind, for the purpose of commencing or carrying on the partnership business and intended to be risked by them therein. Each contribution must be of a fixed amount. If it is in cash, it speaks for itself. If it is in kind, it must be valued at a stated amount. It is important to distinguish between the capital of a partnership, a fixed sum, on the one hand, and its assets, which may vary from day to day and include everything belonging to the firm having any money value, on the other …"

This passage was approved by the House of Lords in *Reed v Young*: see the speech of Lord Oliver of Aylmerton at [1986] 1 WLR 649, 654. It is common ground that the same principles are equally applicable to an LLP: see *Whittaker and Machell on the Law of Limited Liability Partnerships* (5th Edition, 2021) at para 16.5.

48. It is just as important to distinguish between the assets of a partnership or LLP, which are in principle available to meet the claims of its creditors, and assets which are the separate property of individual partners, which (at least for limited partners and members of LLPs) in general are not. Thus, in the context of the present case, it seems clear that when a share of profits was allocated to a partner (whether individual or corporate) and credited to the partner's distribution account, the share ceased to be partnership property and became the separate property of the partner.

Similarly, when a partner (whether individual or corporate) made a contribution of so-called special capital, the explicit provisions of the relevant partnership agreements make it clear that the amounts standing to the credit of the partner's Special Capital Account, and any Investment Assets acquired with it, remained the separately owned property of the partner, and did not in any sense become partnership property, or partnership capital.

HMRC's primary case

49. With these preliminaries, I can now turn to HMRC's primary case.

The decision of the FTT

50. The FTT's consideration of what it called "the PIP issue" runs from [308] to [335] of the FTT Decision. After setting out the relevant legislation, the FTT prefaced its treatment of the substantive issue by quoting long passages from the judgments of David Richards LJ and myself in the then recent decision of the Court of Appeal in *Rossendale Borough Council v Hurstwood Properties (A) Ltd and others* [2019] EWCA Civ 364, [2019] 1 WLR 4567 ("*Rossendale (CA)*"). That was not, strictly speaking, a tax case, but it concerned an artificial and discreditable scheme to avoid the imposition of non-domestic rates on the owner of unoccupied business premises (or "hereditaments" in the language of rating law), by leasing the premises to special purpose vehicle ("SPV") companies controlled by the owners which were then voluntarily wound up or allowed to be struck off the register of companies as dormant companies and so dissolved. On claims by the local authorities to recover non-domestic rates from the defendant lessors, the local authorities contended that (a) the court could pierce the corporate veil of the SPVs so that the defendants would be treated as the true owners of the hereditaments, and (b) alternatively, that the Local Government Finance Act 1988 should be given a purposive interpretation so that "owner" in section 45(1)(b), which was defined in section 65(1) as "the person entitled to possession" of the hereditament, meant someone with a "real" entitlement to possession, which in the circumstances would be the defendants and not the SPVs.

51. It was held unanimously in this court that neither argument could succeed, with the consequence that the claims had to be struck out. The local authorities then appealed on both issues to the Supreme Court, which allowed their appeal on the interpretation of section 45(1)(b), but dismissed it on the corporate veil issue: see [2021] UKSC 16, [2022] AC 690 ("*Rossendale (SC)*").

52. For present purposes, it is enough to say that, in the passages from my judgment quoted by the FTT, I took the view, wrongly as it later turned out, that the leases to the SPVs, which were admittedly not sham, conferred the right to legal possession of the premises on the SPVs, and that the SPVs were therefore the "owners" of the hereditaments within the meaning of sections 45(1)(b) and 65(1) of the 1988 Act. I held that the legislation in question did not admit of a purposive interpretation based on the *Ramsay* line of authorities (*WT Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300), because in this context "possession" meant the immediate legal right to possession which, as a matter of real property law, became vested in the SPVs once the leases were executed. The Supreme Court disagreed, holding that, in the unusual circumstances of the case, it would

defeat the purpose of the legislation to identify "the person entitled to possession" in section 65(1) as the person with the immediate right to legal possession of the property, and that Parliament cannot have intended that expression to "encompass a company which has no real or practical ability to exercise its legal right to possession and on which that legal right has been conferred for no purpose other than the avoidance of liability for rates": see the judgment of Lord Briggs and Lord Leggatt JJSC (with whom the other members of the court agreed) in *Rossendale (SC)* at [48] and [49]. The court went on to explain, at [59], that:

> "The landlord, as grantor of the lease, will be the owner, because the landlord will not by the grant of the lease have transferred to the lessee a real entitlement to possession."

53. Returning to the present case, the FTT agreed at [319] with the submission of Malcolm Gammie KC, who then appeared with Michael d'Arcy for the appellant partnerships, that the approach adopted by this court in *Rossendale (CA)* was relevant, because although the present case does not concern a fundamental principle of land law, it "does involve a fundamental principle of partnership law and, as such, … HMRC are not entitled to substitute some different agreement to that arrived at by the parties concerned which was clearly a commercial agreement entered into to achieve a commercial purpose."

54. At [320], the FTT recorded Mr Gammie's argument that the partnerships' case under section 850 of ITTOIA 2005 was "straightforward": after the admission of SCL and subsequently Avon as partners, and the allocation to them of a share of the profits under the relevant partnership agreement, their share was brought into charge to corporation tax, and the post-tax share was kept as special capital in the partnership before being transferred to the individual partners pursuant to the recommendations of the PRSC and an exercise of discretion by the board of the corporate partner.

55. By contrast, Mr Baldry KC for HMRC argued for a purposive construction of section 850 to be applied to the facts viewed realistically as a whole. Mr Baldry rejected the suggestion that HMRC were seeking to tax the partners as if they were employees.

56. The FTT then considered more case law (the decisions of the Supreme Court in *RFC 2012 plc (formerly the Rangers Football Club) v Advocate General for Scotland* [2017] UKSC 45, [2017] 1 WLR 2767 (*"Rangers"*), and the decision of the Privy Council in the New Zealand case of *Hadlee v Commissioner of Inland Revenue* [1993] AC 524 ("*Hadlee*")), before stating its conclusions, quite shortly, at [333] to [335]:

> "333. However, in the case of a partnership, a provisional award, such as under the PIP, is not an allocation of profits but drawings from a partnership which is not within the scope of tax. The taxation of partners is in relation to the profits of the underlying trade and the division of profits as agreed between the partners. As such I am unable to derive [*any*] assistance from *Rangers* in this case where it is necessary to consider what the partners actually received under the PIP.

> 334. It is apparent from the PIP arrangements that it was not a share of the profits that the partners received or had credited to their accounts but special capital credited to the corporate partner, SCL and/or Avon, which it agreed to transfer to the partners …
>
> 335. The Partnership profits, i.e. the profits that were agreed to be allocated were, in fact, allocated by [*the relevant Partnership*] to SCL and Avon and were correctly brought into charge to corporation tax with the post-tax share of the profits of the corporate partners being invested in partnership assets as special capital which formed the basis of the awards made to individual partners under the PIP."

The decision of the UT

57. HMRC advanced two grounds of appeal before the UT. The first was that the FTT failed to apply section 850 of ITTOIA 2005 to the facts viewed realistically because it wrongly interpreted the "profit-sharing arrangements" in section 850(2) as a fixed legal concept analogous to the property rights in *Rossendale*. The second was that the FTT wrongly distinguished *Rangers*: [48]. In support of the first ground, HMRC argued, in particular, that "the rights to share in the profits" for any accounting year "were not limited to the allocation of profits in the Partnership Deed but included their rights under the PIP arrangements by which they ultimately received a further allocation of profits": [49]. In support of the second ground, HMRC submitted that the awards made to individual partners under the PIP "formed part of the reward for their valuable services and were in reality rewards for their work", with the result that the reasoning of the Supreme Court in *Rangers* applied to the transfers of special capital made to the partners, in the same way as it would have done in an employment context: [51].

58. The UT summarised the partnerships' response to HMRC's case in 12 numbered sub-paragraphs at [52], before embarking on their careful and detailed discussion of the grounds of appeal which ran from [53] to [92].

59. The UT first discussed the principles of partnership taxation, correctly pointing out at [56] that the division of profits at the second stage "is purely a matter of agreement between the partners" and bears no necessary relation to their respective contributions to the partnership. This was important when considering the position of Avon as a corporate member: the fact that its only business was to administer the PIP, and it made no other contribution to the running of the partnership business, was irrelevant in the absence of any challenge by HMRC to the genuineness of the PIP arrangements.

60. The UT then discussed the *Ramsay* approach, with particular reference to the decision of the Supreme Court in *Rossendale (SC)* which, of course, post-dated the FTT Decision. The UT held that the FTT's conclusion, based as it was on the reasoning of this court in *Rossendale (CA)*, could not stand, and that a "broader inquiry was required": [64]. The FTT had erred in law, and the error was clearly material. It was therefore necessary for the UT to exercise its powers under section 12 of the Tribunals, Courts and Enforcement Act 2007 to set aside the decision of

the FTT on the PIP issue. However, because none of the evidence before the FTT was disputed, and sufficient facts had been agreed or found by the FTT, the UT decided to remake the decision on the basis of those facts, rather than remitting it to the FTT: [65].

61. The UT then directed itself on the nature of its task, in an important passage which I will set out in full:

> "66. We are also satisfied that for each period of account we must construe the ambit or scope of the term "the firm's profit-sharing arrangements" in section 850(1) and [*(2)*] of ITTOIA 2005 by ascertaining the purpose of that provision and then applying it realistically to the facts as agreed between the parties and found by the FTT. Mr Baldry submitted that the purpose of section 850 was to ensure that the profits of a partnership (as calculated in accordance with s 849 of ITTOIA 2005) were allocated to those partners who in real terms had the right to share in those profits for the period in question. He also submitted that to give effect to the proper purpose of section 850 it was necessary to examine all of the arrangements between the individual partners and the Partnership including the PIP. Subject to one point, we accept both of these submissions.
>
> 67. The FTT found that the Partnership entered into the PIP for commercial reasons and not only for tax avoidance purposes: see [267] and [268]. But we also accept Mr Gammie's submission that we cannot disregard the arrangements under which the Corporate Partner became a partner in the Partnership and was allocated a profit share. Likewise, we cannot ignore the conditions which typically had to be satisfied before a provisional award became a final award or treat them as window-dressing. The evidence before the FTT showed that 16% of provisional awards (representing 3% of awards made by value) were in fact forfeited because the conditions which the partners were required to meet were not satisfied.
>
> 68. In our view, therefore, this is not the type of case which Lords Briggs and Leggatt described in *Rossendale* at [11] where it is open to the Tribunal to disregard transactions or elements of a transaction which have no business purpose and have as their sole aim the avoidance of tax. On the other hand, however, this does not mean that the *Ramsay* principle has no application in this case. If we were to take the view that the Corporate Partner was no more than a conduit and that either as a matter of contractual construction or because of the way in which the Partnership operated the PIP in practice (or both), the right to share in the profits of the Partnership remained in the hands of individual partners, it would be open to us to conclude that their PIP Awards formed part of the profit-sharing arrangements of the Partnership. Having decided that the *Ramsay* approach applies, therefore, we now consider the profit-sharing

> arrangements of the Partnership (including the PIP) realistically and as a whole."

In the course of argument before us, Mr Baldry accepted that there was nothing wrong with the UT's self-direction in the last sentence of [68].

62. After recording HMRC's submissions in some detail at [69] to [71], the UT said at [72] that they accepted many of them, including (in particular) "that the Corporate Partner had no function other than to distribute Special Capital to individual partners, that individual partners had an expectation that they would receive their final PIP awards and that the Corporate Partner had in most cases a contractual obligation to give effect to those expectations unless the forfeiture conditions were satisfied". The UT then set out its reasons for so concluding in six numbered sub-paragraphs:

> "(1) We accept that the Corporate Partner was introduced into the Partnership for the sole purpose of administering the PIP and that the Corporate Partner had no other business purpose and made no other commercial contribution.
>
> (2) We are also satisfied that the evidence before the FTT established that individual partners had an expectation that they would receive a final award unless the forfeiture conditions were satisfied. Moreover, as Mr Dodd's evidence demonstrated, there was a clear understanding that although in theory both the PRSC and the Corporate Partner had discretion, a provisional PIP Award would always be made final unless the forfeiture conditions were satisfied.
>
> (3) Where a contract confers a discretion on one party the exercise of which may adversely affect the interests of another party, it will generally be an implied term that the discretion may only be exercised in good faith and not arbitrarily, capriciously, or irrationally: see *Braganza v BP Shipping Ltd* [2015] 1 WLR 1661. We therefore accept that it was an implied term of the Partnership Deed that the Corporate Partner would not exercise the discretion in clause 7.4(C) except in good faith and not arbitrarily, capriciously or irrationally.
>
> (4) We also accept that a failure by the Corporate Partner to exercise the relevant discretion at all would have been capricious and that an exercise of discretion to reject the recommendations of the Board without good reason or to reallocate Special Capital to those partners who had not received a provisional award or to reallocate it to itself would have been arbitrary, irrational or capricious.
>
> (5) We therefore accept that in practice the Corporate Partner was bound to exercise its discretion to give effect to the PIP Awards unless the forfeiture conditions were satisfied. Moreover, the evidence before the FTT established that in

> practice reallocations were made in accordance with recommendations made to the Corporate Partner, except in a few cases (where a mistake had been made or there was a good reason for departing from the recommendation).
>
> Finally, we accept that when the Corporate Partner drew monies on account of profits prior to an allocation of a profit share in accordance with clause 7.4(C), the amounts drawn were earmarked for payments to be made in respect of awards to individual partners in due course."

63. I would observe that the UT's references to there being a contractual obligation to give effect to expectations and to a provisional award "always" being made final unless the forfeiture conditions were met, and to the corporate partner being "in practice" bound to exercise its discretion in those circumstances, do not in my view fully reflect the FTT's more nuanced findings. In particular, one of the purposes of the PIP was to address the problem of the lack of recourse against partners who made profits and then made losses. My understanding is that a provisional award could not only be forfeited if the eligibility conditions were not met, but it could also be reduced where losses had been incurred: see the UT Decision at [41(5)], quoted at [38] above.

64. Nevertheless, the UT then said, at [73], that they were not satisfied that the rights of individual partners under the PIP should be treated as rights to share in the profits of the partnership. The UT gave three main reasons for reaching this conclusion:

> "74. First, although SCL and Avon were introduced to the Partnership to administer or give effect to the PIP and they had no other commercial function, the FTT found that the PIP was intended to solve a business issue: see [267]. Moreover, we agree with Mr Gammie that the scheme of partnership taxation takes no account of how much an individual partner has contributed to the success of the business of the partnership. Section 850 of ITTOIA 2005 simply allocates the profits of the partnership for tax purposes to the partners in accordance with the terms of the agreement under which they have agreed to share the profits. In our judgment, therefore, the fact that the Corporate Partner made no commercial or business contribution to the Partnership's profits is of no consequence. The Corporate Partner performs a different but nevertheless commercially important role.
>
> 75. Secondly, there was no suggestion that the Corporate Partner was not intended to be a genuine partner and that it was not intended to enjoy the rights or be bound by the obligations contained in the Partnership Deed. Mr Baldry did not suggest that the relationship between the Corporate Partner and the other partners was a sham and the FTT made no finding to that effect. Furthermore, there was no suggestion that profit allocations made to the Corporate Partner were held in any way by the Corporate Partner on trust for individual partners or in a fiduciary capacity (and this issue is the subject of detailed

> consideration in the separate decision referred to at [44] above.). We are satisfied, therefore, that until the Corporate Partner exercised its discretion to make a final PIP Award to a partner, that partner did not have a right or entitlement to it.
>
> 76. Thirdly, it does not follow that all of the amounts allocated as a profit share to the Corporate Partner in respect of a particular accounting period were used to fund awards to individual partners in respect of the accounting period in which the profits in question were earned. If a provisional PIP Award did not become final because the eligibility conditions were not met, the relevant assets would be retained by the Corporate Partner and became available to satisfy future awards made in future accounting periods. This raised the most difficult question for HMRC's case. If the Corporate Partner had no right to share in the profits and the individual partner had forfeited his or her rights to receive them, who was entitled to share them and on what basis?
>
> 77. HMRC's primary case was that profits which a partner had forfeited should be treated as allocated between the other partners in proportion to their awards. HMRC's alternative case was that the Corporate Partner would be taxed on any excess allocation. We find neither of those arguments compelling. Neither outcome arises out of the contractual arrangements which only contemplated the allocation of Special Capital to those partners who had received a final PIP Award reflecting their individual contributions. There was no contractual entitlement to an additional bonus simply because other partners had forfeited their PIP Awards. We, therefore, agree with Mr Gammie and the FTT that to allocate forfeited profits in the way suggested by HMRC would involve rewriting the contractual arrangements between the parties."

65. It is convenient to mention here that Mr Baldry submitted that the UT's description of HMRC's case at [77] reflected a misunderstanding by the UT. HMRC's position was that the forfeited profits should be treated as allocated to the partner who had forfeited them, on the basis that it was their profit share. He further submitted that this would include the 28% retained by SCL to meet its tax liability, but not the 15% retained by Avon on the basis that it was akin to a fee (a distinction that we found hard to follow).

66. The UT then observed, at [78], that there are limits to the application of the *Ramsay* doctrine, citing the dictum of Patten LJ in *Brain Disorders Research Limited Partnership v HMRC* [2018] EWCA Civ 2348, [2018] STC 2382, at [32]:

> "Although the *Ramsay* approach to construction has undoubtedly involved the courts in looking at the commercial realities of the transaction and ignoring financial components of a scheme which are circular or have no purpose other than to produce a tax loss in order to identify whether and, if so, which

> parts of the transaction engage the relevant tax provisions, it does not enable the courts to fix the taxpayer with a contract which under the scheme it does not have. The actual transactions remain the same."

67. Finally, the UT concluded their discussion of HMRC's first ground of appeal at [79]:

> "79. We consider that to bring the PIP within the profit-sharing arrangements of the Partnership would go beyond those limits in the present case. It would be necessary to fix the taxpayer, in this case the Partnership, with a contract to which its members did not agree. In our view, the correct contractual analysis is that the individual partner has no right to share in the profits of the Partnership at the time when allocations were made to the Corporate Partner and that the terms of the Partnership Deed which allocated those profits to the Corporate Partner must be respected. It is also our view that the contractual effect of the PIP and the way in which it was operated in practice do not change that position. When profits were allocated between the partners under the Partnership Deed, each individual partner had a legitimate expectation that his or her provisional PIP Award would be made final unless they failed to meet the eligibility conditions. Individual partners only had a right or entitlement to receive their PIP Awards once they were entitled to withdraw the Special Capital. Even adopting a purposive construction of section 850 of ITTOIA 2005, the PIP did not form part of the profit-sharing arrangements of the Partnership. We therefore dismiss Ground 1 of the PIP Appeals".

68. The UT then dealt with Ground 2 at [80] to [91], concluding that neither *Hadlee* nor *Rangers* would assist HMRC's primary case even if Ground 1 were rejected.

HMRC's grounds of appeal to this court

69. HMRC pursue four grounds of appeal, which may be summarised as follows:

Ground 1: the UT did not properly construe section 850 of ITTOIA 2005 and/or failed to take a realistic view of the arrangements when answering the question of what the rights to share in the profits of the partnership were when the PIP was being used.

Ground 2: even if the UT was in general right on the application of section 850, there were some early years with short forfeiture periods when a sum would have gone through the whole PIP process before final profit allocations were made to the partners. In such cases, the allocation to the corporate partner could only realistically be seen as an allocation to the individual partners who had in fact already received the money. The same would apply even if the corporate partner received an interim profit allocation shortly before paying away the special capital.

Ground 3: acquiescence in part of a partner's reward being paid to a third party for the partner's conditional benefit does not alienate that reward for partnership tax purposes any more than it does in employment taxation.

Ground 4: even if the general operation of the PIP does not represent a diversion of income within the principle of *Rangers*, the initial rounds of the PIP were different, when senior partners were asked how much of their bonus they would like routed through the PIP. Those voluntarily diverted sums remained allocations to the partners concerned.

70. I observe that grounds 1 and 3 are substantially similar to HMRC's two grounds of appeal in the UT, while grounds 2 and 4 are of a subsidiary nature and relate only to some of the early iterations of the PIP. As the oral argument developed, it soon became clear that the issue at the heart of the case is the proper construction of section 850, and its realistic application to the facts. So that is where I shall begin.

Ground 1: The proper construction of section 850 of ITTOIA 2005 and its realistic application to the facts

71. A crucial part of the background is the general scheme of partnership taxation. As I have explained, it requires the actual profits of the partnership for the relevant accounting period to be allocated between the partners in accordance with their profit-sharing arrangements during that period. The definition of profit-sharing arrangements in section 850(2) is framed in terms of the *rights* of the partners to share in the profits, and their *liabilities* to share in the losses, of the trade. For a corporate partner, the equivalent provision is section 1262(4) of CTA 2009.

72. It is important to recognise that there is nothing optional or provisional about this process of allocation. The full amount of the profits (or losses) for the period must be divided between the partners, in accordance with their rights (or liabilities) to share in them. Furthermore, there is no requirement that the partners should have actually received their allocated shares. What matters is the partner's entitlement to it, even if (for example) the partner is contractually obliged to plough it back into the business. Nor, as I have said, is there any necessary correlation between the size of a partner's share and the nature or value of the partner's contribution to the business. In principle, it is open to the partners to agree the shares in which the profits will be divided between them, and tax law normally follows and respects such agreement. The fundamental protection for HMRC is that 100% of the profits must be allocated pursuant to section 850 (or, in the case of a corporate partner, section 1262 of CTA 2009), and each allocated share will then (for a trading partnership) be taxed as trading income of the entitled partner in the relevant year, under section 5 of ITTOIA 2005 for an individual partner and section 35 of CTA 2009 for a corporate partner.

73. With these basic provisions in mind, it seems to me impossible to escape the conclusion that, during the years when the PIP operated, the agreed division of the trading profits of the relevant partnership was between the individual partners and the corporate partner, in the shares finally determined by the Board. Those were the shares to which the partners (including the corporate partner) were legally entitled, and those were the shares on which they were in principle taxed as trading income in the year of distribution. There has never been any suggestion that the

PIP arrangements were sham, or that the steps in the scheme involving the corporate partner could somehow be disregarded because they were artificial and devoid of any purpose other than tax avoidance. On the contrary, the PIP arrangements had a genuine commercial purpose as well as a tax mitigation purpose, and there is no challenge to the FTT's findings on the commercial benefits of the scheme as summarised in the UT Decision at [43].

74. In my judgment, there is no way in which those commercial benefits could have been delivered without the involvement of the corporate partner, or the mechanism of special capital, and I can see no answer to Mr Peacock's simple submission for the partnerships that the steps in the scheme involving special capital cannot denature, or alter the correct characterisation of, the allocation of profits, because those steps essentially concerned the use to which the corporate partner put its own post-tax income from the partnership. To treat the profits allocated to the corporate partner as, in some metaphorical version of reality, the disguised profits of the participating individual partners, would in my view be to rewrite the agreement between the parties and to replace it with something quite different. A reconstruction of this nature would also ignore the commercial substance of the conditions which had to be satisfied to qualify for a final award of special capital, and the unchallenged evidence that a significant proportion in number and value of provisional awards of special capital never became final.

75. I fully accept that the PIP scheme must be critically examined as a whole, and that the statutory concept of a "right" to share in the profits of the partnership's trade in section 850(2) of ITTOIA 2005 is not in principle immune from a *Ramsay* approach which might, in an appropriate context, give it a broader meaning than an enforceable legal entitlement, which is what I take to be the normal connotation of a "right". But any wider approach of that nature could only be justified if, as in *Rossendale*, the statutory purpose of the relevant provision can be safely identified, and the wider meaning, when realistically applied to the facts, is needed to prevent the frustration of Parliament's intention in enacting it. That is where, in my view, HMRC's supposedly purposive approach to the construction of section 850 breaks down. The purpose of section 850 is to determine the shares of the partners in the actual profits of the partnership trade for the relevant accounting period, and this can only be done by examining the rights of the partners, including the corporate partner, to share in them. There is nothing illusory, or unreal, about the share allocated to the corporate partner, and it cannot therefore be simultaneously treated as consisting of separate slices of profit allocated to the participating PIP partners in addition to their direct shares.

76. The unreality of HMRC's approach is illustrated, to my mind, by their acceptance that, if it is adopted, the corporate partner cannot be charged to corporation tax on its allocated profit share. This concession may be tactically prudent, but I cannot discern any principled basis for it. The corporate partner was undoubtedly allocated its share, and the PIP arrangements were predicated on the fact that the corporate partner would then be liable to corporation tax in respect of it, at a lower rate than the top rate of income tax payable by the individual partners. Rates of income tax and corporation tax are, of course, set by Parliament, and if the former are significantly higher than the latter, that must be taken to reflect Parliament's intention. It follows that, if a partnership arranges its affairs so that a substantial

proportion of its profits is payable to a corporate partner, and the arrangement is genuine and has a real commercial purpose, HMRC cannot complain and their remedy, if the arrangements are considered objectionable, is to procure a change in the law as happened in 2014.

77. There was some discussion at the hearing before us whether a "right" to share in profits for the purposes of section 850 could extend to rights which were future or contingent, and (if so) how such rights should be valued. Although the discussion was inconclusive, and I would not wish to express a firm view, my provisional inclination would be not to rule out the possibility that such rights might in some way be relevant, but to stress that in practice there would probably be little scope for taking them into account, because the entirety of the partnership's trading profits has to be allocated between the partners in Year 1, and not at any future date. I therefore find it hard to see how, for example, on HMRC's case, a contingent expectation of an award of special capital, up to three years in the future, could properly be taken into account when the profits are allocated in Year 1, even assuming that it is properly to be characterised as a "right" at all. But the point does not need to be resolved, since the fatal objection to such an analysis is that, on any realistic view, it would not be a right to share in the partnership's profits, which is what section 850 requires, but rather a right to share in future special capital beneficially owned by the corporate partner and funded by the corporate partner's own post-tax profits.

78. For all these reasons, I am satisfied that the UT was correct to conclude that the PIP arrangements did not give the participating individual partners any rights to share in the profits of the partnership within the meaning of section 850, purposively construed. I would therefore dismiss HMRC's appeal on Ground 1.

Ground 2: Does it make a difference if the final PIP award was made before final allocations of profit were made to the partners?

79. As I have explained, this is a subsidiary ground of appeal which builds on the fact that in some of the early iterations of the PIP with short forfeiture periods (typically six months), the PIP process was concluded by the making of final awards of special capital *before* the partnership's allocation of profits for the relevant accounting period was finalised. This argument does not appear to have been run below, but no objection was raised by the partnerships to our considering it.

80. In their written submissions, counsel for HMRC identify four rounds of the PIP, including the initial pilot phase, where the chronology followed this pattern. Thus, taking the pilot phase, which was based on BlueCrest's accounting period running from 1 December 2007 to 30 November 2008, letters of provisional award under the PIP were sent to the participating partners by SCL (the corporate partner) on 2 June 2008, indicating a short deferral period until 1 August, and final awards were notified, again by SCL, on 31 January 2009. However, the accounts of BCM LP, showing the allocation of profits between the individual partners and SCL, were not signed off until 25 March 2009. In the three later rounds of this type, between 2009 and 2011, the pattern was similar, but there were also rounds during those years where the trading accounts were signed off before the PIP awards were finalised. For accounting periods from 2011 onwards, there was only one PIP round each year and the timetable followed the pattern set out in the table at [301]

of the FTT Decision, with only the shortest deferrals coming to an end at the same time as the partnership accounts were finalised, and the longer deferrals coming to an end later.

81. The short argument advanced by HMRC is that, in the relatively few cases of this type, the individual partners received their final PIP awards, having satisfied the relevant contingencies, before the final allocations of the partnership's trading profits were made and recorded in the accounts. It seems that the corporate partner was enabled to do this by using drawings from the partnership to fund the acquisition of special capital, followed by an interim allocation of profit before the accounts were finalised. On any realistic view, it is said, it would be artificial to regard the profit-sharing arrangements for the year as including the allocation to the corporate partner of sums already received by the individual partners.

82. The argument has a superficial attraction, but I am unable to accept it. In the absence of any argument that the arrangements were sham, the profit allocations in the accounts must in my opinion be respected, as must the acquisition of special capital by the corporate partner with money borrowed from the partnership, and the application of that special capital to make final PIP awards, funded by an interim allocation of profit. The fact remains that the sums received by the individual partners through the PIP were shares of special capital belonging to the corporate partner, and not shares of the partnership's trading profits. I would therefore dismiss this ground of appeal.

Grounds 3 and 4: The principles in Rangers and Hadlee.

83. It is convenient to consider these two grounds together, as they both seek to apply principles derived, in different fiscal contexts, from (a) the decision of the Supreme Court in *Rangers* and (b) the decision of the Privy Council in *Hadlee*. I can deal with both grounds shortly, because in my view neither case throws light on the real issues in the present case which concern the taxation of partnerships in the UK. Like ground 2, these grounds assume that HMRC's first and primary ground of appeal has been dismissed.

84. *Hadlee* was a case about the diversion of partnership profits, but it arose in the context of a different scheme of partnership and income taxation from that in the UK. The question on the appeal, as stated by Lord Jauncey of Tullichettle (who delivered the advice of the Board) at 529, was "whether an assignment by a partner of a part of his share in a professional partnership is effective to transfer the tax liability in respect of the income assigned from the partner to the assignees". The taxpayer was a partner in a firm of chartered accountants in Christchurch, and in January 1981, shortly before the end of the partnership's business year, he assigned a percentage of his share in the partnership to the trustees of a family trust which he had established earlier the same day. Despite the assignment, he was then assessed to tax on the whole of his partnership income for the relevant tax years. The New Zealand law of partnership was broadly similar to that of the UK, and the partnership was treated as transparent for tax purposes. Affirming the decisions of both the lower courts, the Privy Council upheld the assessments and dismissed the taxpayer's appeal.

85. As Lord Jauncey explained at 530, the principal charging section was section 38(2) of the Income Tax Act 1976, which provided for the payment of income tax "by every person on all income derived by him during the year for which the tax is payable". The courts below had approved, and applied, the dictum of Henry J in *Spratt v Commissioner of Inland Revenue* [1964] N.Z.L.R. 272, 277 that:

> "No taxpayer can, by way of assignment, escape assessment of tax on income resulting from his personal activities – such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it."

86. *Spratt* was a case of an employee, but later authority had applied Henry J's dictum to partners, and this extension was endorsed by the New Zealand Court of Appeal in *Hadlee*. At 533, Lord Jauncey cited with "complete agreement" the principle stated by Richardson J that:

> "There is no justification in principle for differentiating between salary and wage earners and professionals whose income is the product of their personal exertion. In either case the person whose personal exertion earns the income derives the income."

It followed that, because no income-producing proprietary interest had been assigned by the taxpayer, he was unable to escape income tax on the whole of the income derived from his personal exertion as a partner.

87. UK tax law contains no general charging provision equivalent to section 38(2) of the Income Tax Act 1976, and the facts of the present case are also far removed from the relatively simple attempt by Mr Hadlee to divest himself of part of his share of partnership income. I agree with the UT, who said at [90] that the position in New Zealand "is quite different from the UK system of partnership taxation under which a partner is taxed by reference to his right to share in the profits of the partnership for the accounting period in question regardless of whether that income has been generated by personal exertion or not." *Hadlee* is therefore of no direct assistance in the present context.

88. *Rangers* was a case about employment income, not partnership taxation. It concerned a tax avoidance scheme for executive officers and footballer employees of the Rangers Football Club, and it is (relevantly) authority for the proposition that sums payable in respect of an employee's remuneration to the trustees of an employment benefit trust were taxable as the earnings of that employee, whether or not he received them. The leading judgment, with which the other members of the court agreed, was delivered by Lord Hodge JSC. Having reviewed the statutory scheme of employment income in the UK, and the circumstances in which receipt by the taxpayer (for example, of benefits in kind) is required if remuneration is to be taxable, Lord Hodge concluded at [59]:

> "Parliament in enacting legislation for the taxation of emoluments or earnings from employment has sought to tax remuneration in money or money's worth. No persuasive rationale has been advanced for excluding from the scope of this tax charge remuneration in the form of money which the

> employee agrees should be paid to a third party, or where he arranges or acquiesces in a transaction to that effect. Having adopted this purposive construction of the legislation, I turn to apply it to the facts of this appeal."

89. One of the authorities which Lord Hodge reviewed was *Hadlee*, which he regarded as supporting his view on the taxability of remuneration paid to a third party: see the summary of his conclusions at [58(v) and (vi)]. Having outlined the issue in *Hadlee* at [50], Lord Hodge there said:

> "While the relevant provision of the New Zealand statute was worded differently from the United Kingdom legislation, the latter, by its emphasis on emoluments arising from a taxpayer's employment, adopts a similar concept of the tax charge. It supports the view which I have reached that a charge to income tax on employment income can arise when an arrangement gives a third party part or all of the employee's remuneration."

90. In rejecting HMRC's corresponding second ground of appeal to the UT, the UT said at [91]:

> "Finally, we do not consider *Rangers* to be authority for the wide proposition that an individual cannot escape tax on the income which they derive from their personal exertion by having it paid to another person. The case is authority for the narrower proposition that an employee cannot escape tax on his employment income by having it paid to another person. But in any event, PIP Awards were not made solely to reward the personal exertions of the individual partners. The PIP was intended to reward individual partners. But it was also intended to facilitate the Partnership's commercial purpose of ensuring the retention and incentivisation of individual partners by discouraging them from leaving to join competitor firms or engaging in inappropriately risky investment behaviour and aligning the Partnership's interests with those of the funds it managed. We therefore reject Ground 2 of HMRC's appeal".

91. I agree with the UT that it is not legitimate to seek to extrapolate from *Rangers* a wide proposition in the form stated by the UT. Under UK tax law, partnership income is taxed on a quite different basis from employment income. Partners are taxed on their agreed shares of the profits of the partnership, whereas employees are taxed on the emoluments and other income derived from their employment. The statutory regimes applicable to employment income on the one hand, and trading income on the other hand, have separate origins in the old Schedule E, and Cases I and II of Schedule D, respectively; and even today they are the subject of separate provision in the elaborate codes contained in the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003") for employment income and ITTOIA 2005 for trading income. The principle which Lord Hodge derived from *Hadlee* was transplanted by him from its original New Zealand context to illuminate the relevant provisions of the UK employment income regime. This was appropriate and helpful, because section 32(8) of the New Zealand statute had much in

common with the prime focus of UK employment tax law on whether emoluments derive *from* the taxpayer's employment, or from something else. Against that background, it is easy to see that an employee cannot escape liability for tax on the earnings derived from his personal exertions as an employee, whether or not he receives them himself. But Lord Hodge was careful to confine his reliance on *Hadlee* to the context of UK employment taxation, and I can see no warrant for extending it, by a sort of reverse analogy, to the context of UK partnership taxation, merely because *Hadlee* was a case about partnership tax in New Zealand.

92. Moreover, as the UT rightly recognised at [90] and [91], quoted above, the PIP served an independent commercial purpose in the interests of the partnership as a whole, as well as providing a reward to individual partners, and there is anyway no necessary link between a partner's right to share in the partnership's profits and his personal exertions.

93. For these reasons, I am unable to accept HMRC's general submission that the principles in *Hadlee* and *Rangers* apply to UK partnership taxation. Since grounds 3 and 4 both depend on a positive answer to that submission, albeit in the case of ground 4 only in relation to the initial rounds of the PIP in 2008 and 2009, it must also follow that neither ground can be sustained, with the result that these grounds too must in my judgment be dismissed.

Overall conclusion on HMRC's appeal

94. I have now considered HMRC's four grounds of appeal, and I have concluded that each of them should be dismissed. Accordingly, I would dismiss HMRC's appeal.

HMRC's secondary case: the Partnerships' appeal

(1) The "miscellaneous income" issue: section 687 of ITTOIA 2005

Introduction

95. On the assumption that HMRC's primary case has failed, the question here is whether the final PIP awards to individual partners are taxable in their hands under section 687(1) of ITTOIA 2005 as "income from any source that is not charged to income tax under or as a result of any other provision of this Act or any other Act". If the answer is yes, there is no dispute that the recipient partner is the person liable for the tax charged under section 687, as "the person receiving or entitled to the income": see section 689. I have already set out the relevant provisions of section 687 at [14] above. The section forms part of Chapter 8 of Part 5 of the Act, which is headed "Miscellaneous Income".

Facts

96. The FTT made some further findings of fact which were relevant to the IP appeals, in addition to the lengthy findings which they had already made in relation to the PIP appeals. For present purposes, it is enough to refer to the further findings at [343] to [350] of the FTT Decision. According to Mr Platt's evidence, the PIP in its original form was "just copying" the "bonus deferral programme" of the J P Morgan Group, under which "a percentage of pay was deferred". Mr Platt

explained that this was "extremely effective" in ensuring people did not leave the business, and he saw it as a way to "lock my people in": [343]. Mr Dodd also confirmed in his evidence that the PIP and its tax implications were explained to new recruits, one of whom described it, in an email to him in 2012, as "the tax scheme used for bonuses": [350].

The statutory background

97. The UT correctly observed at [109] that section 687(1) of ITTOIA 2005 formed part of the Tax Law Rewrite Project, and was designed to replace the residual charge to income tax previously contained in Case VI of Schedule D. The most recent iteration of the previous charge was contained in section 18 of ICTA 1988, as amended, which charged tax under Case VI "in respect of any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedule A or by virtue of ITEPA 2003 as employment income, pension income or social security income". At our request, we were shown the Explanatory Notes for Chapter 8 of Part 5 of ITTOIA 2005 prepared by the Rewrite Project, which confirmed that the Chapter was based on section 18 of ICTA 1988, and explained (at para 2628) that Schedule D was "the residual Schedule into which income falls for income tax purposes if neither ITEPA nor another Schedule of ICTA applies to it", and (at para 2629) that "Case VI is itself the residual Case under Schedule D". It was further explained, in para 2632, that the charge under Chapter 8 was restricted to "amounts that are "income" on first principles", or in other words that "they are "annual profits or gains" under section 18(1) of ICTA, as that phrase has been interpreted in the case law, and are not profits or gains of a capital nature. …"

98. In the light of this background, it was common ground before us, as it was in the Tribunals below, that section 687(1) was intended by Parliament to have the same scope as the earlier legislation, and that the authorities relating to Case VI of Schedule D (which go back many years) remain relevant to its interpretation. On this last point, see too (although we were not referred to it) *R (Derry) v Revenue and Customs Commissioners* [2019] UKSC 19, [2019] STC 926, at [10] and [84] to [90].

Authorities

99. In *Jones v Leeming* [1930] AC 415, the issue was whether the profits derived by the taxpayer, with three other persons, from the sale of two options to purchase rubber estates in the Malay Peninsula were subject to tax under Case VI of Schedule D, it having been found on a remitter to the General Commissioners (whose role was similar to that of the FTT) that the transaction was not an adventure in the nature of a trade, which would have meant that the profits were taxable under Case I of Schedule D. The House of Lords held that the profits were not in the nature of income, but were an accretion to capital, with the result that they were not taxable under Case VI either.

100. In an influential passage, Viscount Dunedin said at [422]:

> "Now, Case VI sweeps up all sorts of annual profits and gains which have not been included in the other five heads, but it has been settled time and again that that does not mean that anything

> that is a profit or gain falls to be taxed. Case VI necessarily refers to the words of Schedule D, that is to say, it must be a case of annual profits and gains, and those words again are ruled by the first section of the Act, which says that when an Act enacts that income tax shall be charged for any year at any rate, the tax at that rate shall be charged in respect of the profits and gains according to the Schedules.
>
> The limitations of the words "profits and gains" were pointed out by Blackburn J long ago in the case of *Attorney General v Black* (1871) LR 6 Ex 308, 309, when he said that profits and gains in Case VI must mean profits and gains ejusdem generis with the profits and gains specified in the five preceding Cases. And then there came the memorable and often quoted words of Lord Macnaghten in the *London County Council* case [1901] AC 26, 35, when he begged to remind people "that income tax is a tax on income". The only question, therefore, here was – Was there in any sense income? It is quite true that, as the Counsel for the Crown said, the word "annual" does not mean something that recurs every year, but none the less the receipt must be of the nature of income."

101. *Leeming* is thus authority for two key propositions, which have never been doubted: (a) to be taxable under Case VI (and now under section 687) the receipt "must be of the nature of income", and (b) it must be of the same type (in Latin, "ejusdem generis") as, or analogous with, some other head of charge to income tax. Although Viscount Dunedin's formulation apparently confined the search for an analogous head of charge to the other cases of Schedule D, I think it is now reasonably clear from the wording of section 687, if it was not clear before, that the necessary analogy may be found in any head of charge under the Income Tax Acts, including at least those specified in the latest version of section 18 of ICTA 1988 which section 687 replaced.

102. A further requirement, implicit in the wording of section 687, is that the income must arise from an identifiable source in the relevant tax year. This follows, in my judgment, from the opening words of subsection (1), which impose the charge to tax on "income *from any source* that is not charged to income tax …". The need for this requirement to be satisfied was arguably left open by Viscount Cave in *Brown v National Provident Institution* [1921] 2 AC 222, 242, where he referred to Case 6 as a "possible exception" to the general rule that "an assessment for a year requires a taxable subject-matter in that year", commenting "This may be so". But any doubt on the point was in my opinion removed by the express wording of section 687(1). That was evidently the view of the Upper Tribunal (Zacaroli J and Judge Guy Brannan) in *Kerrison v Revenue and Customs Commissioners* [2019] UKUT 8 (TCC), [2019] 4 WLR 8, ("*Kerrison*") at [70], although they left the point open because it was not necessary for them to decide it.

103. Before us, neither side displayed any enthusiasm for investigating the further question whether the issue of the proper characterisation of the final PIP awards as being of a capital or an income nature was one of law or of fact, or a mixture of the two. Counsel said that an anthology of citations supporting almost any view on

the topic could probably be found, and it would not be fruitful to spend time on it. Nevertheless, it seems to me that the question cannot be ignored, however difficult it may be to answer. My own view, which has not been tested in argument and which I therefore state with some diffidence, is that the question is in principle one of law, to which there can be only one correct answer in any given factual situation. It is not a question of evaluation, or of mixed fact and law, for the tribunal of fact, whose decision could then only be challenged as erroneous in law on the limited grounds explained in *Edwards v Bairstow* [1956] AC 14.

104. This was certainly the conclusion reached by the House of Lords in *Beauchamp v F W Woolworth Plc* [1990] 1 AC 478, where the issue was whether a currency exchange loss was of an income or capital nature, and thus whether it was deductible, or not, in a computation of the taxpayer's trading profits. The authorities were reviewed by Lord Templeman (with whom the other members of the court agreed) at 491-2, leading him to conclude at 492G:

> "On principle, and in the light of the judicial pronouncements which I have cited, the question involved in the present case is one of law, and was rightly so dealt with by Hoffmann J, who held that the commissioners had misdirected themselves".

The Court of Appeal, by contrast, had taken the view that the question was one of fact, and that the determination of the commissioners could not be shown to be erroneous in law on *Edwards v Bairstow* principles.

The decisions of the FTT and the UT

105. The FTT dealt with the miscellaneous income issue at [401] to [428] of the FTT Decision. After citing lengthy extracts from the authorities, including several which I have not thought it necessary to mention, the FTT stated its conclusions with comparative brevity at [416] and [424] to [427]. At [416], it held that there was no difficulty in identifying the source of the awards, namely "the decision of the company, be it SCL or Avon, to pay the awards". It then gave its reasons for rejecting a contention, which is no longer pursued, that the imposition of a charge under section 687 would amount to double taxation, before turning to the question whether an analogous head of charge could be found in the Taxes Acts. The FTT held that it could, accepting Mr Baldry's submission for HMRC that "the essential nature of the award was a deferred discretionary bonus which …was analogous to something taxed by the legislation": see [425] and [426].

106. The FTT continued, at [427]:

> "As [Mr Platt] said in evidence … the decision to introduce the PIP was to implement a type of deferred bonus award scheme similar to that of JPM. However, as it is not paid to an individual as an employee it cannot be taxed as such. Neither, given my conclusion in the PIP Appeals, is it taxable as partnership profits. However, as the award of Special Capital is analogous to a taxable bonus then, subject to the issues of its source and whether there was double taxation, I consider that it is to be regarded as income and is taxable under section 687(1) ITTOIA."

107. The FTT did not deal explicitly with the separate question whether the awards were of the nature of income, but it was clearly aware of the need for this condition to be satisfied from its review of the authorities. No doubt it took the view that, if the awards were comparable with a deferred discretionary bonus paid to an employee, they would necessarily have an income character. And the FTT did also expressly say, in [427], quoted above, that the award "is to be regarded as income".

108. The UT's relevant reasoning on the miscellaneous income issue is at [109] to [127] of the UT Decision. The UT began by confronting the issue whether the PIP awards were of an income nature, although (like the FTT) they seem to have conflated it with the allied question of whether the awards were analogous to another head of charge (i.e. the ejusdem generis issue). They concluded, at [115], that the FTT had been "entitled to find that the PIP Awards fell within Case VI and were analogous to the other cases in Schedule D". They found support for this conclusion in the decision of Rose J (as she then was) in *Manduca v Revenue and Customs Commissioners* [2015] UKUT 262 (TCC), [2015] STC 2002, before concluding at [117]:

> "*Manduca* shows that if a payment is made to an employee as a reward for services it is taxable under Case VI even if it is not paid pursuant to a contract for employment. In the present case the payment was a reward for services. Although we have found that individual partners did not have the right to receive PIP Awards as part of the profit-sharing arrangements of the Partnership, this does not prevent those awards falling within Case VI. The FTT found that the PIP was intended to reward individual partners for their contribution to the success of the Partnership, because of the services they provided and to incentivise them for the future. In our judgment, the FTT was also entitled to find that these services were *eiusdem generis* with the services listed within the other Cases in Schedule D."

109. I would respectfully observe at this point that the UT's approach to this issue was in some respects flawed. Apart from the conflation of the questions of income nature and analogous head of charge, they proceeded on the basis that the issue was whether the FTT had been entitled to find as it did, rather than whether the FTT had been right in law to do so, and they also seem to have assumed that the necessary analogy had to be found in the other Cases of the old Schedule D, rather than anywhere else in the Taxes Acts, or indeed in any other Act.

110. The UT then turned to the question of source. At [118], they recorded the submission of counsel for the partnerships that the source of the awards was the distribution of partnership property, and that partners are not taxed on the way in which they choose to distribute partnership property between themselves. Once the corporate partner had reinvested its share of the profits in special capital, it was said, those profits became capital assets, and any dealings with them were on capital account. The UT then reviewed a number of cases, including the decision of the Supreme Court in *Shop Direct Group v Revenue and Customs Commissioners* [2016] STC 747 and the decision of the UT (Proudman J and Judge

Bishopp) in *Spritebeam Ltd v Revenue and Customs Commissioners* [2015] UKUT 75 (TCC), [2015] STC 1222 ("*Spritebeam*"), before noting at [124]:

> "The principal issue in *Spritebeam* was whether the receipts by Company C were taxable at all, given that it had no enforceable right to receive payment under the loan arrangements. But it provides clear authority for the proposition that the source of a particular payment may be a decision taken by a party on whom a discretion has been conferred by trust or contract. *Spritebeam* is also authority for the proposition that the required connection between the taxpayer and the source need not be limited to legal rights provided that there is a legal obligation to make the payment".

111. The UT continued:

> "125. We have found that that the Corporate Partner had a contractual obligation to give effect to the expectations of the IP Appellants that they would receive a final award of Special Capital unless they failed to meet the eligibility criteria. The decision of the Corporate Partner to reallocate or transfer Special Capital to the IP Appellants was, therefore, capable of being the source of the PIP Awards made to them (as the FTT found). Moreover, the fact that the IP Appellants did not have a contractual right to payment but only to ensure that the Corporate Partner exercised its discretion fairly and without acting arbitrarily or capriciously did not, in our judgment, prevent the FTT from finding that there was a sufficient connection between each PIP award and the Corporate Partner's decision.
>
> …
>
> 127. In our judgment, the FTT was right to identify the source of each [*of the*] PIP Awards as the decision of the Corporate Partner rather than the underlying trade of the Partnership. Moreover, we consider *Shop Direct* (and both *Stainer's Executors* and *Cheney's Executors*) to be distinguishable for the following reasons:
>
> > (1) We have found that the profit-sharing arrangements of the Partnership did not include the PIP and that the terms of the Partnership Deed which allocated profits to the Corporate Partner must be respected. It follows that each PIP Award of Special Capital which the Corporate Partner reallocated or transferred to the IP Appellants did not represent profits from the trade of the Partnership but represented awards made to them at the discretion of the Corporate Partner. Mr Gammie cannot have it both ways.
> >
> > (2) One of the principal reasons why we rejected HMRC's case on the application of the *Ramsay* doctrine was that it was

impossible to say for certain that individual partners had a right to share between them all of the profits allocated to the Corporate Partner. This analysis also served to break the connection between the trade of the partnership and the source of the payments.

(3) The analogy which Mr Gammie drew between the PIP and a partner who makes withdrawals of capital from the partnership is not exact and may be apt to mislead. Where a partner who reinvested his or her profit allocation back into the partnership and then later withdrew it as capital, we might well accept that the ultimate source was the partnership trade. But in the present case the profits were allocated to the Corporate Partner who re-invested those profits. It then exercised a discretion to transfer those profits to the IP Appellants. There was, therefore, a second and entirely separate stage before the IP Appellants withdrew their capital. Unlike Mr Gammie's partner in the solicitor's firm the IP Appellants had no right to withdraw their Special Capital unless the Corporate Partner made a decision to re-allocate it to them and made their PIP Awards final.

(4) Further, each PIP Award did not involve the withdrawal by partners of retained profits reinvested as capital but the transfer of a partnership interest by one partner (the Corporate Partner) to another partner. Mr Gammie attempted to meet this argument by relying on the fact that the members of the partnership hold the assets on trust for the partnership as a whole and, in the present case, this must include the Special Capital. In our judgment, this is not an answer (or at least a complete answer). Even though the Partnership holds funds in its bank account on trust for the partnership as a whole, this would not prevent one partner from assigning to another his or her rights to the funds in that bank account. Likewise, where partner A sells his partnership interest to partner B, the source of the payment by partner B is not the underlying trade of the partnership but the transfer of the partnership interest."

Grounds of appeal

112. The partnerships pursue two grounds of appeal on this issue:

(1) The first ground is that the subject matter of the PIP awards comprised partnership assets resulting from the accumulation of post-tax partnership profits, and therefore represented a re-allocation of partnership assets between partners. The UT thus erred in law in concluding that the awards were annual profits taxable as income.

(2) The second ground is that, even if the PIP awards can be regarded as having the character of "annual profits" from the perspective of an individual partner who benefits from that re-allocation of partnership assets, the UT erred in law in

concluding that the corporate partner's decision to make the award amounted to its "source" (as that term is properly understood for income tax purposes) and as a result converted the transfer of assets comprised in the award into income chargeable to tax under section 687(1).

In essence, therefore, the first ground challenges the UT's conclusion that the awards had the character of income, while the second ground challenges its conclusion that the awards had a taxable source in the decision of the corporate partner to make them.

Discussion

113. In considering the first ground of appeal, I begin with a point that is not disputed. The partnerships accept that the PIP awards have the nature of "annual profits" within the meaning of Case VI of Schedule D. In *Kerrison*, the UT identified this as the first requirement which had to be satisfied if a receipt was to fall within the charge to tax in section 687(1) as miscellaneous income. It is true that the content of this requirement does not take the enquiry very far. As Rowlatt J explained in *Ryall v Hoare* [1928] 2 KB 447 at 454-455, the word "annual" in this context denotes only "calculated in any one year", and "annual profits or gains" mean "profits or gains in any one year or in any year as the succession of years comes round". Nevertheless, the potential for annual recurrence, coupled with the need to calculate the profits in any one year, are at least pointers to the awards having the quality of income.

114. Secondly, Rowlatt J said (*ibid* at 454) that " "Profits or gains" in Case 6 refer to the interest or fruit as opposed to the principal or root of the tree". The homely metaphor of fruit of the tree has often proved helpful in the search for a guiding principle to distinguish capital from income receipts, and unlike Lord Macnaghten's celebrated dictum in the *London County Council* case, cited in this context by Viscount Dunedin in *Leeming*, it has the advantage of not being circular. That is not to say that there is no value in the reminder "that income tax is a tax on income". Apart from anything else, it serves to distinguish the proper scope of Case VI, and now section 687, from isolated transactions of a capital nature which do not amount to an adventure in the nature of a trade. It also reflects the fact that the distinction between capital and income receipts is sometimes easier to recognise than to define, and that in reaching a conclusion there is a place for the intuitive common sense of judges or tribunals well versed in tax law. Although the question is in my view ultimately one of law, I do attach some significance to the fact that in the present case both the expert tribunals have had little difficulty in concluding that the awards were of an income nature, even if some of their reasons for doing so are left to be inferred or could perhaps have been more clearly articulated.

115. Thirdly, it is in my view necessary to stand back and examine the commercial reality of the PIP scheme as a whole. So viewed, the economic substance of the matter is that the final PIP awards constituted a form of deferred and contingent reward to the participating partners for their work in the relevant accounting period of the partnership. This assessment of the underlying reality of the arrangements is reinforced by, but not dependent upon, the further findings of fact by the FTT summarised at [96] above. Although, as I have sought to explain, this view of the

facts cannot support HMRC's primary case, because (put shortly) it cannot be reconciled with the actual machinery which the parties adopted to implement the PIP scheme, it is in my judgment entirely legitimate to rely on an overall assessment of this nature when answering the question whether the awards were of an income nature.

116. It is also at this point that the need for an analogy with some form of taxable income becomes relevant, and the latter requirement is in turn satisfied by the realistic view taken of the scheme as a whole. The payment of deferred remuneration to an employee, perhaps in the form of a deferred bonus, is self-evidently derived from his employment and is of a quintessential income nature, taxable now as employment income under ITEPA 2003 and previously under Schedule E. In substance, the PIP arrangements were a way of providing part of a partner's intended share of the partnership's trading profits in the form of a contingent right to special capital, which the partner would then be entitled to cash in at short notice. The link between the award and the partner's work for the partnership is made explicit by the conditions to which the award was made subject, including notably the continuation of the partner in service throughout the deferral period. In my view, these features of the PIP arrangements are amply sufficient to provide an analogy with deferred awards of employment income, and thus to bring the PIP awards within the proper scope of section 687. If the partnership was the tree, the deferred PIP award was part of the fruit which the partner derived from his membership of the partnership and his exertions on its behalf during the relevant accounting period. To tax the award under section 687 is appropriate because it reflects the underlying economic reality of the arrangements, and the way in which they were perceived by the parties.

117. I add the obvious point that it is important not to be mesmerised by the word "capital" in the phrase "special capital". The phrase is no more than a label, no doubt deliberately chosen to give the impression that a partner's special capital, and in particular the special capital of the corporate partner, was a form of partnership capital, and that its transfer would be analogous to a transfer of partnership capital or assets properly so-called. In fact, special capital was nothing of the sort. It remained throughout in the sole beneficial ownership of the partner concerned, and although it had to be used for the benefit of the partnership in specified ways, it was neither partnership capital in the strict sense nor an asset of the partnership.

118. For these reasons, I conclude that, as a matter of law, the PIP awards had the character of income, and I also consider that the ejusdem generis requirement is clearly satisfied. Furthermore, to the extent that these requirements may have been matters for the evaluation of the FTT and/or the UT, I consider that they were each fully entitled to conclude as they did. It therefore only remains to consider whether the awards had a "source" in the tax year in which they were made.

The "source" requirement

119. The UT discussed this question at [118] to [127] of the UT Decision. Its conclusion was stated in a single sentence at the beginning of [127]:

> "In our judgment, the FTT was right to identify the source of each [*of the*] PIP Awards as the decision of the Corporate Partner rather than the underlying trade of the Partnership."

120. In reaching this conclusion, the UT considered a number of authorities, including the decision of the UT in *Spritebeam* and the earlier decision of the Court of Appeal in *Cunard's Trustees v Commissioners of Inland Revenue* (1946) 27 TC 122 ("*Cunard*"). The UT said, at [122]:

> "Mr Baldry submitted that the FTT was correct to find that the source of the PIP Awards made by the Corporate Partner was its decision to pay the awards (or, more properly, reallocate or transfer Special Capital to them on the recommendation of the Partnership). He relied on *Spritebeam Ltd v HMRC* [2015] STC 1222. That case concerned a tax avoidance scheme which was intended to avoid tax credits arising under a loan relationship. Company A lent money to Company B but instead of Company B paying interest to Company A, Company B issued irredeemable preference shares equal in value to a commercial rate of interest on the loan to Company C. The Upper Tribunal considered a number of authorities in which discretionary payments were treated as the source of income including *Cunard's Trustee v IRC* [1946] 1 All ER 159 and drew the following conclusion at [68]:
>
> "The conclusion we draw from the authorities to which we have referred is that it is immaterial that the recipient cannot enforce payment; what matters is whether there is an obligation on the payer to pay… in the trustee cases the beneficiaries, individually, could not enforce the payment of any particular sum to themselves; but the trustees were under an enforceable obligation to exercise their discretion and make a payment to one or more of the beneficiaries as circumstances required."

121. In *Cunard*, the trustees of a will were directed to hold the residuary estate of the testatrix on trust to pay the income to her sister during her life, with power to supplement the income from capital if the income alone was insufficient to enable the sister to live in the same degree of comfort as she had during the testatrix's lifetime. This power was exercised by the trustees, and the sister was then assessed to income tax under Case III of Schedule D and to surtax on the whole of the payments made to her, including the supplements from capital. The main argument for the taxpayer was that "the payments in question, having been made out of capital at a time when the residue had not been ascertained, were not [*her*] taxable income": see 130-131. The leading judgment was delivered by Lord Greene MR, with whom Morton and McKinnon LJJ agreed. After holding that the will, properly construed, authorised the application of capital in this way from the date of the testatrix's death, and not merely from the date when the administration of the residuary estate was completed, Lord Greene continued, at 132:

> "The payments, therefore, in my opinion, were properly made and at the moment of payment became income of the recipient, Miss McPheeters … [*her*] title to the income arose when the trustees exercised their discretion in her favour and not before. *At that moment a new source of income came into existence [my emphasis]*. The payments came to Miss McPheeters under the express terms of the will and not by virtue of what I may call the quasi-interest enjoyed by a residuary legatee pending completion of administration …"

122. Lord Greene went on to deal with further arguments that the payments were not taxable under Case III of Schedule D because (a) they were not annual payments, and (b) they were discretionary and therefore voluntary payments which the taxpayer could not claim as of right (see 133). The answer to the first point was that the payments were capable of recurrence on a yearly basis, even if they varied in amount, while the second argument also failed for the reasons which Lord Greene gave at 133-134:

> "It was suggested, however, that the Rule does not extend to mere voluntary payments. But the payments here were of a totally different character. They were not voluntary in any relevant sense, but were made in the exercise of a discretion conferred by the will out of a fund provided for the purpose by the testatrix. It is true, of course, that the trustees had an absolute discretion whether to make a payment or not. But the question whether they should do so is one which they were bound to take into their consideration. … The money, when received by Miss McPheeters, was received by her through the joint operation of the will and the exercise of their discretion by the trustees."

123. *Cunard* was relevantly a case about Case III of Schedule D, but there is no reason to suppose that what Lord Greene said is not equally capable of application for the purposes of Case VI or section 687. I therefore see no difficulty in holding that a source for the final PIP awards may be found in the exercise by the corporate partner of its discretion whether or not to follow the recommendations of the Board and make the awards, especially as it is common ground that the discretion was not unfettered and had to be exercised in accordance with the principles of the *Braganza* case.

124. Finally, I would respectfully endorse the distinctions drawn by the UT at [127(3)] of the UT Decision, which for convenience I will repeat:

> "The analogy which Mr Gammie drew between the PIP and a partner who makes withdrawals of capital from the partnership is not exact and may be apt to mislead. Where a partner who reinvested his or her profit allocation back into the partnership and then later withdrew it as capital, we might well accept that the ultimate source was the partnership trade. But in the present case the profits were allocated to the Corporate Partner who re-invested those profits. It then exercised a discretion to transfer those profits to the IP Appellants. There was, therefore, a second

> and entirely separate stage before the IP Appellants withdrew their capital. Unlike Mr Gammie's partner in the solicitor's firm the IP Appellants had no right to withdraw their Special Capital unless the Corporate Partner made a decision to re-allocate it to them and made their PIP Awards final."

125. For all these reasons, I conclude in agreement with both Tribunals below that the source requirement is also met, with the result that the partners who received final PIP awards are liable to income tax thereon under section 687 of ITTOIA 2005. I would therefore dismiss the partnerships' first ground of their appeal.

(2) The "Sale of Occupational Income" Issue: Chapter 4 of Part 13 of the Income Tax Act 2007

126. If the other members of the court agree with my conclusions so far, the failure of the partnerships' first ground of their appeal means that it is unnecessary to consider ground 2, which challenges the second and alternative limb of HMRC's secondary case. It is enough for HMRC to succeed on either ground for that appeal to be dismissed.

127. In my view, it would be unwise for us to embark upon an examination of ground 2 in circumstances where its resolution is not necessary to the disposal of the appeal. Anything which we said on the subject would inevitably be obiter, and although we heard full argument on it, I am satisfied that at least some of the issues to which it gives rise are far from straightforward. They are therefore better left for determination in a case where their resolution matters to the outcome.

128. The only point I would wish to make is that, by declining to deal with ground 2, we should not be taken to endorse either the reasoning or the conclusions (likewise obiter) which the FTT and the UT reached upon it.

Disposal

129. I would therefore dismiss both HMRC's appeal and the partnerships' appeal.

Falk LJ:

130. I agree.

Lewison LJ:

131. I also agree.