TC02614

Appeal number: TC/2012/02864

INCOME TAX – SAYE share option scheme – paragraph 37(a) Schedule 3 Income Tax (Earnings and Pensions) Act 2003 - whether PAYE should have been deducted- Appellant allowed self-assessment credit for PAYE that should have been deducted - management buy-out - special terms for management shareholders - Appellant accepting takeover offer made to non-management shareholders - whether options exercised pursuant to a "general offer" for all share capital with result that PAYE should not have been deducted - no - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

HEMA TAILOR **Appellant**

- and -

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

TRIBUNAL: JUDGE GUY BRANNAN
JOHN ROBINSON

Sitting in public at Bedford Square, London WC1 on 28 February 2013

Anne Redston, Counsel, instructed by Simplification Made Simple Limited, Chartered Certified Accountants, for the Appellant

Gill Cawardine, presenting officer, HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Miss Tailor ("the Appellant") appeals against a closure notice amending her self-assessment tax return for 2007 – 08. The amendment included a SAYE share option gain of £8,410 in her assessable income.

2. The gain arose in respect of the management buyout ("MBO") of the Appellant's employer, Enterprise plc ("Enterprise" or "the employer"). It is common ground that this gain was chargeable to income tax.

3. The issue in the appeal is whether, as the Appellant argues, the gain should have been dealt with under PAYE or, as HMRC argue, taxed under the Appellant's self-assessment tax return. This distinction is important because, as we shall see, if the employer fails properly to account for PAYE, the Appellant, in her self-assessment tax return is nevertheless, given a credit for the PAYE that should have been deducted. Because no PAYE was deducted in this case, and HMRC accepted that PAYE could not now be recovered from the employer, if the Appellant's argument is correct, she would have no liability to income tax in respect of the gain.

4. In short, the issue whether or not PAYE should have been deducted turns on whether the Appellant exercised her SAYE share option following "a general offer to acquire the whole of the issued share capital of [Enterprise] or…to acquire all the shares in the company which are of the same class as the shares in question obtained under the scheme." As we shall also see, the statutory maze through which the tribunal must journey before coming to the relevant provision is very involved.

Evidence

5. The Appellant provided a witness statement but was not called upon to give oral evidence at the hearing. There were four bundles of documents produced the tribunal containing the rules of the SAYE share option scheme, the offering circular containing the terms of the offer for the shares of Enterprise and correspondence between the parties.

The facts

6. The facts in this appeal were not in dispute.

The Appellant's share option gain

7. The Appellant was employed by Enterprise at all times material to this appeal. She saved in Enterprise's SAYE share option scheme from February 2005 to May 2007.

8. At this stage it is perhaps worth giving a few words of explanation about SAYE share option schemes.

9. The relevant statutory provisions relating to SAYE share option schemes are contained in Income Tax (Earnings and Pensions) Act 2003 ("ITEPA"). We shall come to the detailed statutory provisions regulating SAYE share option schemes later, but for present purposes SAYE share option schemes have the following general features. These schemes are usually open to all employees who have been employed by a company. The relevant legislation sets out provisions which must or, in some cases, may be included in the scheme rules, which are approved by HMRC.

10. Employees who participate in a SAYE share option scheme are required to save certain amounts under a SAYE savings contract with a bank or building society. The lump sum resulting from the savings contract can be used to buy shares in the employer if the employee chooses to exercise his/her options after three, five or seven years, depending on the terms of the options in question.

11. Under an approved SAYE share option scheme, the employee does not pay income tax or National Insurance contributions on: the grant of options, any bonus or interest received under the savings contract, any benefit derived from being able to buy shares at a discounted price and any increase in the market value of the underlying shares between the date on which the option was granted and exercised. Capital gains tax may be payable on a subsequent disposal of the shares acquired on the exercise of the share options.

12. As we shall see, the statutory provisions usually prohibit the exercise of options within three years of the date of grant. However, there is an exception to this three year limit which permits options to be exercised early in the event of a change of control of a company resulting from a "general offer". The statutory provisions (paragraph 37 Schedule 3 ITEPA) allow the rules of a company's SAYE share option scheme to permit exercise of options within the three-year limit in these circumstances. Where an employee exercises options within the three-year limit. In these circumstances, whilst early exercise of the option is permitted, the gain is liable to income tax. It is this exception to the three-year limit which lies at the heart of this appeal.

13. In May 2007 an MBO took place in relation to Enterprise. As a result of the MBO and the takeover offer made to non-management shareholders, Enterprise ceased to be a listed company and therefore could no longer operate an approved SAYE share option scheme (paragraph 19 Schedule 3 ITEPA). The Appellant had, therefore, participated in the SAYE share option scheme for less than three years.

14. The company used to make the MBO was a company called Kirk Newco plc ("KN"), a company which was associated with the 3i Group plc, a well-known private equity firm ("3i"). We shall set out the details of the MBO and the offer to the shareholders of Enterprise in greater detail below.

15. KN agreed to pay a bonus to Enterprise employees in order to "top up" the amounts saved under their savings contracts so that the employees would have sufficient savings to exercise the share options at the option price. The bonus payments were subject to PAYE and National Insurance contributions. The tax treatment of the bonus payments is not in dispute.

16. The Appellant used her net bonus, plus her SAYE savings, to exercise her share options and pay the option price. The shares in Enterprise acquired on the exercise the options were then immediately sold to KN pursuant to the offer made by KN to buy all the non-management shares in Enterprise. All this happened within three years of the date of grant of her options and therefore it is now common ground that her gain was subject to income tax.

17. The difference between the share option exercise price and the price at which the Appellant sold her Enterprise shares to KN resulted in a gain of £8,410.

18. In the Appellant's self-assessment tax return for 2007 – 08, she included the above share option gain as a capital gain on which no tax was due. We saw correspondence between the Appellant's tax adviser and HMRC discussing whether the gain was a capital gain. However, the Appellant accepted that the treatment in her self-assessment tax return was incorrect and this point was no longer in dispute. As already explained, the gain was subject to income tax.

19. On 3 November 2009, HMRC opened an enquiry into the Appellant's 2007 – 08 self-assessment return. After correspondence between HMRC and the Appellant's tax adviser, HMRC issued a closure notice on 4 October 2011 amending the Appellant's return to charge the Appellant's share option gain of £8,410 to income tax. The Appellant appealed against this closure notice and the appeal was notified to the tribunal on 20 December 2011.

20. Initially, one of the grounds of appeal was that the share option gain was either completely exempt or subject to capital gains tax. As explained above, this ground of appeal has been abandoned. The Appellant's tax adviser raised the PAYE issue in a letter to HMRC dated 5 September 2011 and it was also mentioned in HMRC's reply of 4 October 2011.

21. We were informed that the Appellant's tax adviser filed and served amended grounds of appeal on 31 August 2012 (the Further Particulars of Grounds of Appeal provided to us were dated 21 August 2012). These amended grounds of appeal set out reasons why the Appellant considered the gain should have been taxed under the PAYE system.

The MBO and the acquisition of the shares of Enterprise

22. We have derived much of the detail in relation to the MBO and the acquisition of the shares of Enterprise from the offering circular, dated 23 March 2007 containing the terms of the recommended cash offer by KN for Enterprise ("the offering circular"). We have not attempted to summarise all the arrangements relevant to the

MBO and the share acquisition, but only those which we consider to be material to the issues before us and which were relied upon by the parties in argument before and at the hearing. None of these facts was in dispute, save as regards certain valuation issues in relation to the consideration offered to the management team in respect of their shares in Enterprise – a matter to which we shall return.

23. Prior to May 2007, Enterprise was a public limited company. The shares in which were listed and traded on the London Stock Exchange. The ordinary shares in Enterprise constituted its only class of share capital.

24. On 8 November 2006, Enterprise announced that it had received an unsolicited approach from 3i and that two of Enterprise's directors, Owen McLaughlin and Neil Kirby, had been authorised to explore terms for a management buyout. The independent directors of Enterprise rejected initial offers by 3i, which fell below the price of 605 pence per Enterprise share.

(a) The Acquisition Agreement

25. On 23 March 2007, the management team of Enterprise (other than Owen McLaughlin) and the Kirk Newco Group (comprising Kirk Holdco, Kirk Finco 1, Kirk Finco 2 and KN) entered into the Acquisition Agreement ("the Acquisition Agreement").

26. KN was a newly incorporated company which had been formed for the purposes of making the public offer to Enterprise's shareholders and was a wholly-owned subsidiary of Kirk Holdco.

27. Upon completion of the Acquisition Agreement (and the Investment Agreement – see below), following the public offer for the Enterprise becoming unconditional, Kirk Holdco was owned by the management team, 3i investors (various investment funds with which 3i was associated), certain employee trusts and the Owen McLaughlin Trust.

28. Under the Acquisition Agreement, the management team (excluding Owen McLaughlin) agreed with the Kirk Newco Group, conditional upon the offer to the Enterprise shareholders becoming unconditional (and KN becoming registered as a holder of more than 25% of the issued share capital of Enterprise), that KN would acquire 1,111,812 Enterprise shares owned by the management team in consideration for the issue of KN loan notes ("First Exchange Notes"). The offering circular stated that the management team would receive an amount of loan notes per Enterprise share, which was "approximately equal to the aggregate of the cash offer price" under the offer to the public shareholders of Enterprise.

29. Immediately subsequent to the above exchange, the management team were to exchange their First Exchange Notes by way of put and call options for an equal amount of loan notes issued by Kirk Finco 2 ("Second Exchange Notes").

30. Immediately subsequent to that exchange, the management team were to exchange their Second Exchange Notes by way of put and call options for an equal amount of loan notes issued by Kirk Finco 1 ("Third Loan Notes").

31. Immediately subsequent to that exchange, the management team were to exchange their Third Loan Notes by way of putting call options for combination of Kirk Holdco B Ordinary Shares and Kirk Holdco Preference Shares.

32. By this rather circuitous route KN acquired the management team's holding of shares in Enterprise whilst the management team eventually became shareholders in Kirk Holdco. The purpose of the various exchanges of shares and/or loan notes was not explained, but we assume that the intention was that the management would obtain rollover relief under section 135 Taxation of Chargeable Gains Act 1992 on the quadruple "roll" into, ultimately, Kirk Holdco shares, thereby avoiding triggering a disposal for capital gains tax purposes. At no stage did the Acquisition Agreement envisage the management team exchanging their shares and/or loan notes for cash.

(b) The Investment Agreement

33. The Investment Agreement was also entered into on 23 March 2007. The parties to this agreement were the companies comprising the Kirk Newco Group, Anglo Irish Trust Company Limited (as trustee of the Owen McLaughlin Trust), the management team, the 3i investors and 3i Investments (a wholly-owned subsidiary of 3i).

34. The Investment Agreement provided that the management team would, pursuant to the Acquisition Agreement, subscribe for 8,961,096 Kirk Holdco B Ordinary Shares at an aggregate subscription price of £896,138 and 5,830,334 Kirk Holdco Preference Shares at an aggregate subscription price of £5,830,334. In addition, three members of the management team agreed to subscribe for Kirk Holdco Preference Shares using the proceeds of sale of Enterprise shares in the offer to public shareholders of Enterprise which they acquired from the exercise of share options pursuant to Enterprise's share schemes.

35. The Investment Agreement also provided that the management team gave certain warranties and undertakings to the 3i investors. The management team and Kirk Holdco also agreed that neither Kirk Holdco nor any of its subsidiaries would do certain things in relation to the conduct of the business without the prior consent of the 3i investors. Each member of the management team agreed to be bound by certain restrictive covenants in favour of Kirk Holdco and the 3i investors.

36. In addition, the Investment Agreement gave certain additional rights to Owen McLaughlin and/or the Owen McLaughlin Trust.

(c) The Offering Circular

37. The offering circular set out the terms of the offer to the public shareholders of Enterprise in respect of their shares. The shares in Enterprise consisted of a single class of issued ordinary shares of five pence each.

38. KN offered 605 pence in cash for each share in Enterprise.

39. The offer extended to all shares in Enterprise unconditionally allotted or issued (including to satisfy the exercise of options granted under the Enterprise SAYE share option scheme) before the date on which the offer ceased to be open for acceptance. In other words, if an employee who held options pursuant to the SAYE share option scheme exercised his/her options before the closing date of the offer the shares so acquired could be sold to KN on the terms of the offer.

40. The offer was expressed to be made in respect of all Enterprise shares other than the 1,111,812 Enterprise shares, which KN had conditionally agreed to acquire from the management team pursuant to the Acquisition Agreement. Thus, the offer comprised in the offering circular was explicitly not made to the management team in respect of their 1,111,812 Enterprise shares.

41. The offer was conditional, *inter alia*, upon the passing of a resolution on a poll at an Extraordinary General Meeting of "independent" Enterprise shareholders (i.e. shareholders other than the management team, those acting in concert with them and certain other persons) approving the Acquisition Agreement and the Investment Agreement and certain other arrangements.

42. The offering circular described the arrangements with the management team described above. Under the Acquisition Agreement the management exchanged their 1,111,812 Enterprise shares for loan notes in KN which were "approximately equal to the aggregate of the cash price under the Offer multiplied by their number of Enterprise shares."

43. The Acquisition Agreement provided that the management team would subscribe for 8,961,096 Kirk Holdco B Ordinary shares at a subscription price of £896,138 and 5,830,334 Kirk Holdco Preference shares at a subscription price of £5,830,334.

44. Under the Investment Agreement, the management team agreed to subscribe for further Kirk Holdco shares using the proceeds of sale of their Enterprise shares in the offer which the team acquired from the exercise of options pursuant to the Enterprise share schemes. Thus the management team were to receive 605p cash for their share option scheme shares which they agreed to apply to the acquisition of Kirk Holdco shares.

45. The offering circular made it clear that the requirement of approval at an Extraordinary General Meeting was to satisfy Rule 16 of the Code (see below). We shall explain the role of the Code and of the Panel, which administers the Code, in greater detail later in this decision.

46. The offering circular noted that Rule 16 of the Code prohibited, except with the consent of the Panel, arrangements with shareholders if there were favourable conditions attached which were not being extended to all shareholders. The offering circular further stated that the Panel had agreed, in relation to the Acquisition Agreement and the Investment Agreement, to allow the offer to be made to the public shareholders of Enterprise, notwithstanding the fact that the opportunity to participate in the arrangements comprised in those Agreements was not be extended to all Enterprise shareholders, provided the resolution was passed by the independent shareholders at the Extraordinary General Meeting.

47. The offer for the non-management shares went unconditional and KN acquired control of Enterprise in May 2007.

(d) Correspondence between HMRC and Enterprise

48. We were provided with correspondence between HMRC and Enterprise dating from 2010. By a letter dated 29 June 2010, HMRC had enquired of Enterprise whether, as a result of the takeover, the scheme approval was formally withdrawn by HMRC. If so, HMRC asked Enterprise to advise the date that approval was withdrawn and to provide a copy of the formal notice of withdrawal.

49. HMRC's letter was passed to the company secretary, Mr Birch, who replied on 6 August 2010. He stated:

> "The Enterprise plc Sharesave Plan was adopted on 8 November 2004…. There were three separate offers to employees under the Plan: in November 2004, October 2005 and October 2006. In March 2007 an offer was made by Kirk Newco to acquire the entire issued share capital of Enterprise plc. Kirk Newco plc was the vehicle used by a private equity backer and management buyout team to take the Company private. Shareholders and share option holders accepted the offer; share option holders exercised their options and accepted the offer and Enterprise plc delisted from the Stock Exchange and was renamed and re-registered as a limited company.
>
> HMRC's shares and securities unit were consulted as to the process and guidance was sought on the tax treatment of the exercise since circumstances had meant that the exercise took place within three years of the date of grant. The HMRC guidance was reflected in our own guidance to employees. I am not aware however whether HMRC have formally withdrawn approval since I do not have a copy of the formal notice of approval."

50. HMRC requested copies of the guidance referred to in Mr Birch's letter and this was provided by Mr Birch in a letter to HMRC dated 20 August 2010. His letter read as follows:

> "Further to your letter dated 17 August 2010, I would clarify that the relevant correspondence on the matter at the time of the Management Buy Out in 2007 was between the Share Schemes unit in Parliament Street, London, and Deloitte and Touche as the Company's advisor.

> I attach a copy of an e-mail which was forwarded to me at the time by Deloitte, the originator of the e-mail was George Parker of HMRC Share Schemes. The e-mail explains the HMRC position re: income tax collection.
>
> I subsequently engage directly with Mr Parker on the telephone. I was at a loss to understand why the Company could not collect the tax due at the point of exercise via the payroll. To my mind this would have been a common-sense approach for all parties and I was told that this was not possible and that employees would need to be instructed to declare the event on their self-assessment forms."

51. The e-mail from Mr Parker of HMRC to which Mr Birch refers read as follows:

> "I note that the Company is subject to a General Offer, which is likely to become unconditional at the end of April 2007. Following this change of control, the Shares will continue to be listed, however, after a short period will no longer meet the requirements of Paragraph 19 Schedule 3. This will be a "disqualifying event," under Paragraph 42 (2) Schedule 3.
>
> HMRC will not automatically withdraw approval; it is for the Company to decide whether or not it wishes to apply for approval to be withdrawn. This is normally only a consideration if Options have been held for more than 3 years since the Date of Grant. HMRC withdrawing approval effectively preserves the income tax relief, which may be due under Section 519. I note that the first grant of Options, which may become exercisable, occurred in February 2005 and so there is no question of income tax relief being due whether or not HMRC withdraws approval.
>
> Any income tax due will be collectable under Self-Assessment and not through the payroll by operation of PAYE (and NIC). The reason being that Section 701 (2) specifically excludes from the definition of an "asset" any shares acquired by the employee… Under a Scheme approved under Schedule [sic]. It follows that if the Shares are not assets they cannot be Readily Convertible Assets and so the question of the operation of PAYE and deduction of NIC does not arise.
>
> I look forward to receiving a copy of the letter. The Company intends to issue to Option Holders explaining the effect of the transaction on their Options."

The statutory provisions and relevant scheme rules

52. Ms Redston very helpfully took us on a guided tour of the relevant statutory provisions. It is not necessary to set these provisions out in full. They were not in dispute. A summary of the provisions should serve to set out the background to the dispute.

53. Most of the relevant provisions are found in ITEPA and all references to statutory provisions are to that Act, unless otherwise noted.

54. Section 471 makes it clear that Chapter 5 applies to any "employment-related securities option "i.e. a securities option acquired by a person where the right or opportunity to acquire the securities option is available by reason of employment.

55. Section 472 defines "associated persons" as including the person who acquired the employment-related securities option on the acquisition.

56. Section 473, referring to the exemption in Section 475, makes it clear that when an employee is granted an option no income tax charge will usually arise – the charge, if any, may arise on the exercise of the option. Section 473 also notes that special rules apply to share options acquired under an approved SAYE option scheme.

57. Section 476 provides that if a "chargeable event" (as defined in Section 477) occurs in relation to an employment-related securities option, the taxable amount counts as employment income of the employee for the relevant tax year. However, Section 476 (6) states that the section is subject to Section 519 in relation to approved SAYE share option schemes so that no charge usually arises in respect of the exercise of the share option by an employee.

58. Section 477 provides that where a share option is exercised and shares acquired which are worth more than the amount paid to the option, this is a "chargeable event" which is taxable as income.

59. Usually, the employer is required to apply PAYE to chargeable events (Section 700, applying Sections 684 – 691 and 696).

60. Section 696 provides that if any PAYE income of an employee is provided in the form of a "readily convertible asset", PAYE should be applied to the increase in value. For these purposes, a "readily convertible asset" includes shares (Section 702).

61. Importantly, Section 701 sets out various exclusions from the requirement to apply PAYE by excluding certain types of property from the definition of "asset" for the purposes of the definition of "readily convertible asset". In particular, Section 701 (2)(c)(i) contains an exclusion for "any shares acquired by the employee (whether or not as a result of the exercise of a right to acquire shares) *under* a scheme approved under Schedule 3" (i.e. approved SAYE share option schemes) [emphasis added]. Thus, if the Appellant acquired her Enterprise shares *under* the Enterprise SAYE share option scheme Enterprise was not under an obligation to deduct PAYE.

62. Section 519 provides that no income tax liability arises in respect of the exercise of share option scheme. If the taxpayer exercises the option in accordance with the provisions of an approved SAYE option scheme and one of two conditions is met.

63. The first condition is that the option is exercised on or after the third anniversary of the date on which it was granted. In this case, the Appellant exercised her options before the third anniversary.

64. The second condition is that the option is exercised before the third anniversary of the grant and is exercised otherwise than by virtue of a provision included in the

scheme, *inter alia*, under paragraph 37 of Schedule 3. In other words, if within three years of obtaining the option it is exercised by virtue of provision included under the scheme as described in paragraph 37, the exercise of the option will still be chargeable to income tax.

65. Paragraph 37 Schedule 3, the statutory provision at the heart of this appeal, provides as follows:

> "(1) The scheme may provide that share options relating to shares in a company may be exercised within 6 months after the relevant date for the purposes of sub-paragraph (2), (4) or (5).
>
> (2) The relevant date for the purposes of this sub-paragraph is the date when—
>
> (a) a person has obtained control of the company as a result of making an offer falling within sub-paragraph (3), and
>
> (b) any condition subject to which the offer is made has been satisfied.
>
> (3) An offer falls within this sub-paragraph if it is—
>
> (a) a general offer to acquire the whole of the issued ordinary share capital of the company, which is made on a condition such that, if it is met, the person making the offer will have control of the company, or
>
> (b) a general offer to acquire all the shares in the company which are of the same class as the shares in question obtained under the scheme.
>
> (4) The relevant date for the purposes of this sub-paragraph is the date when the court sanctions under section 899 of the Companies Act 2006 (court sanction for compromise or arrangement) a compromise or arrangement proposed for the purposes of or in connection with a scheme for the reconstruction or amalgamation of the company.
>
> (5) The relevant date for the purposes of this sub-paragraph is the date when the company passes a resolution for voluntary winding up.
>
> (6) The scheme may provide that share options relating to shares in a company may be exercised at any time when any person is bound or entitled to acquire shares in the company under sections 979 to 982 of the Companies Act 2006 (takeover offers: right of offeror to buy out minority shareholder).
>
> (7) For the purposes of this paragraph—
>
> (a) "share options" means share options granted under the scheme; and
>
> (b) a person is to be treated as obtaining control of a company if that person and others acting in concert together obtain control of it.
>
> (8) This paragraph has effect subject to paragraph 30(1)(b) (options must not be capable of being exercised later than 6 months after bonus date)."

66. It will be seen that paragraph 37 is essentially a permissive provision. It allows the scheme rules of a company to contain the provisions set out therein. Enterprise's scheme rules contained a rule (Rule 7.1) to this effect. Rule 7.1 provided as follows:

> "7.1 If:
>
> 7.1.1 any person or group of persons acting in concert obtains Control of the Company [i.e. Enterprise] as a result of making
>
> 7.1.1.1 a general offer to acquire the whole of the issued ordinary share capital of the Company (whether or not including any relevant Treasury shares within the meaning of section 428(2A) of the Companies Act 1985), which is made on a condition such that if it is satisfied the person or group of persons will have Control of the Company; or
>
> 7.1.1.2 a general offer to acquire all the issued Shares [i.e. fully paid ordinary shares of Enterprise] (whether or not including all any relevant Treasury shares within the meaning of section 428(2A) of the Companies Act 1985) (or such of them as are not already owned by it and-or by any of its subsidiaries)….
>
> 7.1.2 and person becomes entitled or bound to acquire Shares under Sections 428 to 430 of the Companies Act 1985; or
>
> 7.1.3 under Section 425 of the Companies Act 1985, the court sanctions a compromise or arrangement proposed the purposes of or in connection with a scheme for the reconstruction of the Company or its amalgamation with any other company or companies,
>
> then the Board shall serve notice. Upon each Option Holder (or his personal representatives) notifying him of such facts and an Option Holder (or his personal representatives) may subject to Rule 5.1 (other than. Rule 5.2.1) exercise any subsisting Option by the earlier of the expiry of the Appropriate Period defined in Rule 7.3 below and the expiry of the Option Period. Any option which is not so exercised shall lapse unless Rule 7.2 below applies."

67. Thus, Rule 7.1 essentially incorporated the provisions of paragraph 37 into the Rules of Enterprise's SAYE share option scheme.

68. Thus, to cut a long statutory story short, the early (i.e. within the three year period from the date of grant of the option) exercise of an option may be permitted by the scheme rules in the case of a "general offer" (and was so permitted by Enterprise's scheme rules) but the gain accruing to the option holder is subject to income tax.

69. It was common ground between the parties that the effect of Regulation 185 (6) of the Income Tax (PAYE) Regulations 2003 SI 2003/3682 when read with Section 59 B Taxes Management Act 1970 that PAYE that should have been deducted by the employer liability is "tax treated as deducted" for the purposes of self-assessment. In other words, the employee receives a credit under self-assessment for PAYE, which should have been deducted.

70. Thus, if PAYE should have been deducted by Enterprise in respect of the option gain but was not so deducted, the Appellant cannot be assessed on that gain under the self-assessment rules. Conversely, if Enterprise was not required to deduct PAYE the Appellant is liable to income tax under self-assessment.

Arguments of the parties

Arguments for the Appellant

71. Ms Redston, appearing for the Appellant, argued that the Enterprise shares acquired by the Appellant were not acquired "under" the Enterprise SAYE share option scheme. In order for the shares to be acquired "under" the SAYE share option scheme, the exercise of the options must have been permitted by, and in accordance with, the rules of the scheme.

72. If the MBO was a "general offer" within the meaning of Rule 7.1 (which, as we have noted, echoes the provisions of paragraph 37 Schedule 3) then the share option gain arose "under" the rules of the scheme; if there was no general offer the gain fell outside the exceptions to PAYE treatment provided by Section 701.

73. As Ms Redston acknowledged (as did HMRC), there is no statutory definition of the term "general offer".

74. Ms Redston referred to HMRC's guidance in their Employee Share Schemes User Manual ESSUM 36210 which sets out HMRC's view of the expression "general offer" in relation to paragraph 38 Schedule 3 (provision in almost identical terms to paragraph 38 dealing with exchanges of share options). The guidance reads as follows:

> "There is no statutory definition of "general offer", so the phrase must be given its normal meaning – there must be an "offer" and it must be "general". These features will not be satisfied if the acquiring company obtains control by acquiring holdings of shares privately from selected shareholders, possibly at different times in different prices. The essential features are that the acquiring company makes an offer, *on precisely the same terms, to all the shareholders of the relevant class or classes.*" (Emphasis added)

75. In HMRC's skeleton argument, the guidance in ESSUM 36210 was referred to but the wording of the guidance was paraphrased so that it referred to the acquiring company making an offer, "to all the shareholders of the relevant class or classes on the same terms." In other words, the more restrictive adverb, "precisely", was omitted.

76. Ms Redston considered that the guidance in ESSUM 36210 was correct: there was no general offer in this case because the management had been offered different terms. She argued that this interpretation of "general offer" was supported by The Takeover Code ("the Code") in which the expression "general offer" is used, particularly in relation to Rule 9. Ms Redston argued that "general offer" in paragraph 37 Schedule 3 should be construed in the light of the Code.

77. The Code is promulgated, administered and supervised by the Panel on Takeovers and Mergers ("the Panel"). The Panel was established in 1968 and is the regulator in respect of takeover offers for UK companies. It is a self-regulatory body,

composed of persons professionally involved in takeovers, such as bankers, brokers and lawyers, as well as shareholders.

78. Rule 9 requires a person who (either alone or together with persons acting in concert) acquires 30% or more of the voting rights of a public company to launch what is known as a mandatory Rule 9 bid for the outstanding shares. Rule 9 of the Code refers this mandatory bid as a "general" offer. The Code requires that a "general offer" must be made in cash or be accompanied by a cash alternative (e.g. loan notes) of at least equal value for each class of shares.

79. Ms Redston argued that, in the case of Enterprise, the offer to the non-management shareholders was not a "general offer". Instead, the transaction was governed by Rule 16 of the Code as the offering circular recognised i.e. it was a "Special deal with favourable conditions".

80. In relation to HMRC's argument that the value of the First Exchange Notes acquired by the management was the same as the value given to the other ordinary shareholders, Ms Redston put forward three arguments. First, the complex arrangements involving the shares owned by the management team had to be looked at in the round i.e. the various agreements involving the management team had to be taken into account. The sale of the management team's shares was part and parcel of the MBO structure and was different from the simple cash offer made to non-management ordinary shareholders.

81. Secondly, by virtue of the various exchanges and the put and call options, the management team acquired Kirk Holdco B Ordinary Shares and Kirk Holdco Preference Shares. These were not publicly traded and their true value was a matter of speculation. In any event, non-management shareholders were not given any access to these shares.

82. Finally, the test in regulation 37 and Rule 7.1 of the scheme rules was that the shares had to be sold by way of a "general offer" and an offer under Rule 16 was not a general offer.

83. Ms Redston argued that, in terms of the purpose of regulation 37, it made sense that the rules of a SAYE share option scheme should permit an early exercise of options where a general offer was made. However, the same policy reasons did not extend to an MBO where the management of the company were parties to changing the lifespan of the scheme.

Arguments for HMRC

84. Mrs Cawardine argued that in considering whether an offer was a "general offer", the correct approach was to consider the offer as a whole. It was not correct to say that an offer was not a "general offer" just because some shareholders received consideration in different forms. HMRC's view was that the acquiring company had to make an offer to all shareholders of the relevant class or classes on the same terms and, for example that the acquiring company was not obtaining control by acquiring

shares privately from different groups of shareholders at different times and at different prices.

85. Although the arrangements in respect of the MBO were complex, Mrs Cawardine argued that KN had made an offer of 605p for all the Enterprise shares albeit that 605p was paid in cash in some instances and in exchange for loan notes which became Kirk Holdco shares in others. Any timing difference between the acceptance of the Acquisition Agreement and Investment Agreement arrangements and the closing of the acceptances of the cash offer were not material. Thus, in HMRC's view the buyout would meet the requirements for a "general offer": it was an offer for all the shares made at the same time for everyone at the same price.

86. Mrs Cawardine noted that under the Acquisition Agreement the management exchanged their 1,111,812 Enterprise shares for loan notes in KN which were "approximately equal to the aggregate of the cash prize under the Offer multiplied by their number of Enterprise shares."

87. The Acquisition Agreement, Mrs Cawardine noted, stated that the management team would subscribe for 8,961,096 Kirk Holdco B Ordinary shares at a subscription price of £896,138 and 5,830,334 Kirk Holdco Preference shares at a subscription price of £5,830,334. Thus, in exchange for the management team's 1,111,812 Enterprise shares the management team received Kirk Holdco shares worth (£896,138 + £5,830,334) £6,726,472, which was equivalent to 605p per Enterprise share.

88. Mrs Cawardine also noted that under the Investment Agreement, the management team agreed to subscribe for further Kirk Holdco shares using the proceeds of sale of their Enterprise shares in the offer which the team acquired from the exercise of options pursuant to the Enterprise share schemes. Thus the management team were to receive 605p cash for their share option scheme shares which they agreed to apply to the acquisition of Kirk Holdco shares.

89. Mrs Cawardine also noted that the cash offer to non-management shareholders was conditional upon the passing of a resolution to approve the Acquisition Agreement and the investment Agreement.

90. Finally, Mrs Cawardine noted that it was not clear on what basis the Share Scheme Adviser, in his e-mail of 4 April 2007, accepted that the arrangements were a "general offer".

Discussion

91. It seems to us that there are two issues to consider. First whether the Appellant exercised her option in circumstances where KN had acquired control of Enterprise as a result of making a “general offer”. The second issue is whether, if a “general offer” was made, it was an offer to acquire the whole of the issued ordinary share capital of Enterprise (Rule 7.1.1.1 of the scheme rules and paragraph 37(3)).

Was it a General Offer?

92. It is a curious feature of tax legislation that some statutory provisions are the subject of considerable litigation between HMRC and taxpayers, whilst others are not. In the former category, one thinks of "by reason of employment" or "allowable loss". The words "general offer", although having featured in the statute book for almost four decades, fall into the second category – an expression which has slumbered for many years with minimal disturbance from the courts and this Tribunal, at least until this appeal. The parties were unable to find any judicial authority on these words and we, too, have found none.

93. It is also an unusual feature of this appeal that HMRC find themselves in the position of arguing that PAYE should not have been applied to the payments made to the Appellant. Normally, HMRC are very keen that PAYE should be applied to payments to employees for the obvious reason that it is easier to collect tax from the employer than it is to chase after various employees who may well have spent their earnings.

94. Be that as it may, it was common ground that this case turned on whether PAYE should have been deducted by Enterprise in 2007. If PAYE should have been deducted, but was not, both parties accepted that the Appellant has no further liability to income tax under self-assessment: see paragraphs 67-70 above.

95. Both parties also accepted that there was no statutory definition of the expression "general offer".

96. We accept Ms Redston's argument, however, that the Code is relevant to the interpretation of the expression "general offer" in paragraph 37 Schedule 3. Paragraph 37 is quite plainly dealing with a public takeover bid. The Code is the regulatory framework dealing with such transactions. Paragraph 37 is not to be construed in a vacuum – the Code is part of the relevant regulatory background against which these words must be considered and the use of the term “general offer” can shed light on its use in tax legislation.

97. That being said, we find that the Code and, in particular, Rule 9 of the Code contains no express definition of the words "general offer". In any event, of course, there was no suggestion that the circumstances of this case fell within Rule 9 i.e. where a bidder has acquired a 30% (or more) stake in the target company and is forced by the Code to make a mandatory Rule 9 bid.

98. In fairness, we did not understand Ms Redston to be arguing that Rule 9 did apply in this case but rather that Rule 9 shed some light on the meaning of the words "general offer". In truth, we do not think that Rule 9 – although it does in a number of places (particularly in the Notes to Rule 9) refer to a "general offer" – sheds much light on the meaning of those words, save by analogy with the facts of this case.

99. More relevant, in our view, is the very first General Principle set out in the Code. It is perhaps worth explaining that the Code is a principle-based set of rules

which are, broadly, to be interpreted and applied in accordance with the spirit rather than their strict letter. General Principle 1 states:

> "All holders of the securities of an offeree company of the same class must be afforded equivalent treatment; moreover, if a person acquires control of the company, the other holders of securities must be protected."

100. In our experience, in relation to facts such as those in the present case, General Principal 1 requires that shareholders of the same class of shares should receive the same offer and that shareholders of different classes of shares should receive comparable treatment.

101. Rule 16 constitutes a derogation from General Principle 1 in the case of a management buy-out. It recognises that a bidder will only make an offer for the target company if it has special arrangements and incentives in place to ensure that the management of the target stays with the company. Fairness is achieved by the dual safeguard not only that the arrangements must be approved by the non-management shareholders but must also be recommended by the target's independent directors having taken independent advice.

102. Rule 9 is relevant in the sense that it underpins the general equality/equivalence principle. Rule 9 requires that a bidder who has acquired 30% or more of the voting rights of the target company (which will often be a de facto controlling stake) must make a general offer to the remaining shareholders at the highest price that it has paid in the previous 12 months. Thus, those shareholders who had previously delivered to the bidder a controlling position and those shareholders to whom the Rule 9 offer must be made are given equal treatment in the sense that the general offer must at least give the remaining 70% of shareholders a share in any control premium previously paid in building up the 30% stake as well as, importantly, the same opportunity to exit the target company.

103. In our view, the offer made to the non-management shareholders of Enterprise by the offering circular was a "general offer". The fact that the special arrangements with management shareholders required non-management shareholder approval under Rule 16 does not, in our view, prevent the offer being a "general offer" to the non-management shareholders.

104. It is not necessary for an offer, in order to be a "general offer", to be made to all the shareholders of the target company. Indeed, in the case of a mandatory Rule 9 bid, the offer will usually be made only to those shareholders whose shares are not already owned by the bidder or by those acting in concert with the bidder. It is clear from Rule 9 (and the notes to Rule 9) that an offer to such (non-bidder) shareholders is regarded by the Code as a "general offer". It is an offer made generally to the outstanding (non-bidder) shareholders and is "general" in the sense that it is not made to a smaller or discrete group of shareholders of that wider class.

105. Likewise, in the present case the offer was made to all shareholders who were not members of the management team. The special arrangements for the management

team, reflected in the Acquisition and Investment Agreements, were required by Rule 16 of the Code to be recommended by the independent directors and to be approved by the non-management shareholders. By analogy with Rule 9, the offer made to the shareholders who did not benefit from the special arrangements made with the management team is a general offer in the same way that a mandatory Rule 9 offer would be made to shareholders who were neither part of the bidder's 30% holding nor in concert with the bidder. In a Rule 16 situation such as this, it is almost, in a very broad sense, as though the management team shareholders are assimilated with bidder. So it seems to us that a general offer is made if it is made to the generality shareholders who are not either party to special arrangements (Rule 16) or to "outstanding" shareholders who are not part of the bidder's existing holding or concert party (Rule 9) and is not made to some smaller or more discrete constituency.

106. Parliament has chosen not to define the term "general offer". In our view this was not accidental. It is very much a term which takes its colour from market practice and the circumstances of each takeover. The definition offered above seems to us appropriate in the circumstances of this case, taking account of the analogy with Rule 9. In the light of the huge variety of different types of offers that are made for public companies and in widely differing circumstances, it does not seem to us wise to attempt an all-purpose definition of "general offer" or to go beyond what is required in the circumstances of this case.

107. We note, in this context, that Mrs Cawardine was, when asked by the Tribunal, unable to explain why the guidance regarding the meaning of "general offer" contained in ESSUM 36210 was not being applied in this case. Even if we accepted (which we do not – see below) that the Acquisition Agreement and the Investment Agreement should, in some sense, be treated together with the offer comprised in the offering circular as one overall offer to the ordinary shareholders of Enterprise, the "offer" to the management team was plainly not made on "precisely" the same terms (the requirement contained in the guidance) as the offer made to the non-management shareholders. The management team, as a result of the various exchanges, would never receive cash as a result of the offer. The non-management shareholders would always receive cash and nothing but cash. The fact that the non-cash consideration received by the management team may, arguably (see below), have had broadly the same value as the cash consideration received by the non-management shareholders hardly constitutes "precisely" the same terms.

108. In any event, taking the various rights and obligations specified in the Acquisition Agreement and the Investment Agreement into consideration, it is very hard to reach any definite conclusion that the consideration received by the management team was the same as the consideration received by the non-management shareholders and we decline to reach such a conclusion.

109. Moreover, as noted above, an offer made in Rule 16 circumstances is effectively a derogation from the principle of equivalence contained in General Principle 1. Rule 16 seeks to achieve fairness for non-management shareholders in the manner described above but does not set out to achieve equal or equivalent treatment. It is

hard then to see how special terms given to management shareholders in a Rule 16 management buy-out would ever satisfy the terms of the ESSUM guidance.

110. Nonetheless, whether or not HMRC applied its published guidance is not determinative of this appeal. The question whether the offer made to non-management shareholders of Enterprise in this case was a "general offer" is a question of statutory interpretation, not one of interpretation of HMRC guidance.

111. For the reasons given above, we conclude that the offer made by KN for Enterprise in the terms of the offering circular was a "general offer".

112. That conclusion does not, however, determine this appeal.

Was it an offer for all the issued share capital?

113. Paragraph 37 Schedule 3 is specific in its language. Rule 7 of Enterprise's scheme rules, reflecting paragraph 37, is in similar terms. The point here is that the "general offer" must be an offer either:

- "to acquire the whole of the issued ordinary share capital of [Enterprise], which is made on a condition such that, if it is met, the person making the offer will have control of the company, or

- a general offer to acquire all the shares in [Enterprise] which are of the same class as the shares in question obtained under the scheme."

114. In this case, Enterprise had only one class of issued share capital. Therefore, the shares obtained under the SAYE share option scheme were obviously shares of the same class (i.e. ordinary shares of 5p each) and therefore the issued ordinary shares constituted the whole of Enterprise’s issued share capital.

115. The offer made by KN in the offering circular was, in its terms, an offer addressed only to the non-management shareholders. It specifically excluded the 1,111,812 ordinary shares owned by the management team. It was, therefore, not on offer to acquire the whole of Enterprise's issued ordinary share capital nor was it an offer to acquire the whole of the same class of ordinary shares (i.e. the shares obtained under the SAYE share option scheme).

116. We do not accept the argument put forward by Mrs Cawardine that the arrangements under the MBO (i.e. reflected in the Acquisition Agreement and the Investment Agreement) should be lumped together with the offer embodied in the offering circular and treated as one overall "offer". In the first place, those agreements were not, unlike a typical takeover offer, a unilateral (albeit conditional) offer made to the shareholders of Enterprise. The Acquisition Agreement and the Investment Agreement were negotiated conditional agreements which had been concluded on the same day that the offer to the Enterprise shareholders was made by means of the offering circular. They were not offers, but rather conditional contracts. It is true that any agreement represents an offer and an acceptance of that offer, in

accordance with the basic law of contract: but we do not think it can fairly be said that, conditional contracts having been concluded, those contracts can be described as "offers".

117. We put this point to Mrs Cawardine in the course of her argument and she accepted, albeit perhaps hesitantly, that neither the Acquisition Agreement nor the Investment Agreement could not readily be regarded as an "offer". At least, it was evident that she was unable to explain how those agreements could be considered to be an "offer" or part of an "offer".

118. We accept that this is, in some senses, a strange result. It would lead to the conclusion that a mandatory Rule 9 bid would not be a general offer satisfying the conditions laid down in paragraph 37. By definition, a Rule 9 bid is made to the shareholders of the target company in circumstances where the offeror (and those acting in concert with the offeror) controls 30% or more of the voting rights of the target company. In those circumstances, a Rule 9 bid could not be an offer to acquire the whole of the issued ordinary share capital of the target nor could it be an offer to acquire all the shares in the target of the same class as the SAYE share option scheme shares. Nonetheless, the language of paragraph 37 Schedule 3 and Rule 7 of the scheme rules is perfectly plain.

119. Moreover, paragraph 37 Schedule 3 is not the only tax provision dealing with a "general offer". Since 1965 the capital gains tax rollover provisions, dealing with exchange of shares for securities (shares or debentures) in another company, have provided for rollover relief to be available where the offeror company issues shares or debentures in exchange for shares in the target company as a result of a "general offer". However, there is no requirement in these rollover provisions (now contained in section 135 Taxation of Chargeable Gains Act 1992 ("TCGA")) that the general offer be made to acquire the whole of the issued ordinary share capital of the target or all the shares in the target company of the same class of the SAYE share option scheme shares. Instead, so far as relevant, section 135 provides:

> "Where company B issues the shares or debentures in exchange for shares as the result of a general offer –
>
> (c) made to members of company A or any class of them (with or without exceptions for persons connected with company B), and
>
> (d) made in the first instance on a condition such that if it were satisfied company B would have control of company A….)

120. This wording clearly contemplates an offer being made ("with or without exceptions") otherwise than for the whole of the issued share capital all the whole of a class of shares. Although section 135 and paragraph 37 Schedule 3 both deal with a "general offer", paragraph 37 is plainly a more restrictive provision: the offer must be for all the issues shares or all the shares of the relevant class. The contrast with section 135 TCGA is striking and, we must assume, was intended by Parliament.

121. It is not clear to us why this should be so. For example, there appears to be no good reason why, as explained above, a mandatory Rule 9 offer should be excluded

from the terms of paragraph 37. Nonetheless, the language of paragraph 37 is explicit. It is not possible, in this case, to construe the words "all the issued ordinary share capital" or "all the shares in the company which are of the same class as the shares in question obtained under the scheme" as meaning all those shares other than the shares which were acquired under the Acquisition Agreement.

122. Accordingly we have concluded that although the offer contained in the offering circular was a “general offer”, it was not an offer to acquire the whole of the issued ordinary share capital of Enterprise or to acquire all the shares in Enterprise which are of the same class as the shares in question obtained under the scheme for the purposes of Rule 7 of the scheme rules or paragraph 37 Schedule 3.

Decision

123. It follows, therefore, that the Appellant did not acquire her Enterprise shares *under* the Enterprise SAYE share option scheme and that, for the reasons explained above, PAYE should have been deducted by Enterprise in respect of the SAYE share option gain. It was common ground that if Enterprise should have deducted PAYE but failed to do so the Appellant could not be charged under the self-assessment regime in respect of that gain.

124. The appeal must therefore be allowed.

Rights of Appeal

125. This document contains full findings of fact and reasons for the decision. Any dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

GUY BRANNAN
TRIBUNAL JUDGE

RELEASE DATE: 27 March 2013