[2017] UKFTT 495 (TC)

TC05949

Appeal number: TC/2014/03502
TC/2014/03503

CORPORATION TAX – grant of share options to employees by an employee benefit trust – whether accounting debit arising under IFRS2 deductible as a trading expense of the employing companies – yes – whether that debit was capital in nature – no – whether s1038 or s1290 of the Corporation Tax Act 2009 prevents a deduction from being available – no – decision in principle accordingly

FIRST-TIER TRIBUNAL
TAX CHAMBER

NCL INVESTMENTS LIMITED **Appellants**
SMITH & WILLIAMSON CORPORATE SERVICES LIMITED

- and -

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

TRIBUNAL: JUDGE JONATHAN RICHARDS

Sitting in public at The Royal Courts of Justice, Strand, London on 15 to 17 May 2017

Jolyon Maugham QC, instructed by the Appellants, for the Appellants

Julian Ghosh QC and Jonathan Bremner, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. The appellant companies, Smith & Williamson Corporate Services Limited ("SWCS") and NCL Investments Limited ("NCLI" and, together with SWCS, the "Appellants") are appealing against closure notices that HMRC have issued in respect of their accounting periods ended 30 April 2010, 30 April 2011 and 30 April 2012.

2. In each of those accounting periods, the Appellants claimed deductions against trading profits corresponding to accounting debits that appeared in their income statements relating to the grant of share options to their employees. HMRC have raised four arguments as to why those amounts are not deductible and, after finding primary facts and setting out the law, I will analyse these arguments in separate sections:

(1) As Issue 1, HMRC argue that the expenses in question were not incurred wholly and exclusively for the purposes of the Appellants' trades with the result that s54 of the Corporation Tax Act 2009 ("CTA 2009") prevents the expenses from being deductible. (In part, this argument involved HMRC asserting that, because of the particular nature of the accounting debits arising in the Appellants' accounts, the expenses were not "incurred" at all in the necessary sense).

(2) In the alternative, as Issue 2, HMRC argue that the expenses were capital in nature and thus not deductible under s53 of CTA 2009.

(3) In the alternative, as Issue 3, HMRC argue that s1038 of CTA 2009 prevents a deduction from being available.

(4) In the alternative, as Issue 4, HMRC argue that s1290 of CTA 2009 prevents a deduction from being available.

3. The Appellants have asked me to make a "decision in principle" as to how Issues 1 to 4 should be resolved as they considered that the parties could agree matters of quantum between themselves. HMRC have not objected to that suggestion and I will therefore follow it.

Evidence

4. For the Appellants, I had factual evidence from Kevin Stopps, the co-Chief Executive Officer of Smith & Williamson Holdings Limited, the Appellants' parent company. I also had expert evidence on accounting matters from David Chopping, a chartered accountant and partner in Moore Stephens LLP.

5. HMRC relied on expert accounting evidence from David Henworth, a Fellow of the Institute of Chartered Accountants who works for HMRC.

6. All witnesses were cross-examined and I considered that they were reliable and honest. Both experts were fully conscious of their duty to give their opinion evidence dispassionately. I also had evidence in the form of an agreed bundle of documents.

Facts

7. The primary facts set out at [8] to [41] were either agreed or determined by me. In the "Discussion" section of this decision, I will also make further secondary findings of fact relevant to the issues arising in this appeal.

The group structure and the grant of the options

8. At all times material to their appeals, the Appellants were members of a corporate group of companies (the "Group") whose ultimate parent is Smith & Williamson Holdings Limited ("SWHL"), a company incorporated in England & Wales. The Group carries on a professional services business that includes the provision of tax and accountancy services and, through a separate division, wealth management services.

9. The Appellants employ staff pursuant to contracts of employment. They then make those staff available to other companies in the Group in return for a fee (the "Management Charge"). The Management Charge is based on the costs that the Appellants incur in employing the staff marked up by an appropriate amount. (The reason why there are two employing companies in the Group is that, prior to 2001, the Smith & Williamson and NCL businesses were in separate ownership. SWCS was the employing company for the Smith & Williamson business and NCLI was the employing company for the NCL business. The businesses merged in 2001, but the two separate employing companies remained.) It is common ground that the activities that the Appellants perform in order to earn the Management Charge constitute a trade for corporation tax purposes.

10. The Group operates a number of share schemes for the benefit of employees. I was not referred to any evidence that suggested that the Appellants, as employers, had any contractual obligation to provide their employees with share schemes and I have, accordingly, concluded that the Appellants were under no such contractual obligation.

11. A list of all relevant plans is set out in the Appendix to this decision, but since little turns on the distinction between the various schemes, I will refer to them together as the "Share Schemes". The Share Schemes (insofar as they related to share options and so are relevant to these appeals) had the following general features:

> (1) By deed dated 6 March 2003, SWHL established an employee benefit trust (the "EBT"). The trustee of that trust (the "EBT Trustee") was a company incorporated in Jersey. The purpose of the EBT was to encourage or facilitate the holding of shares in SWHL by or for the benefit of employees of members of the Group. SWHL constituted the trust by paying the initial sum of £100 to the EBT Trustee. SWHL made further payments to the EBT Trustee from time to time and the EBT Trustee used some or all of these payments to purchase, or subscribe for, shares in SWHL.
>
> (2) The EBT Trustee held the trust fund on trust for a class of beneficiaries that included employees or former employees of any member of the Group

and the Trustees had a broad power of appointment, entitling them to apply capital and income of the trust for the benefit of such beneficiaries as they should select.

(3) Pending the exercise of any power of appointment the EBT Trustee had the power to grant options or awards over shares in SWHL pursuant to the rules of any share scheme established by any member of the Group.

(4) From time to time, SWHL, by resolution of its board would establish a Share Scheme. The precise details of the Share Schemes varied but, insofar as relevant to this appeal, set out a framework for the grant of share options to employees of the Group. That framework covered matters such as which employees were eligible to be granted options (for example the "Company Share Option Plan" envisaged that either SWHL or the EBT Trustee could award share options to employees of their choosing whereas the "Sharesave" scheme envisaged that employees would apply to join the scheme). The framework would also cover the type of share award that SWHL could make (for example, outright awards or the grant of share options) and conditions that employees needed to meet in order to be eligible to receive awards.

(5) When a decision was made to grant a share option to a particular employee or employees, that option was granted by the EBT Trustee. Therefore, an employee's contractual rights in relation to that option were against the EBT Trustee, rather than against SWHL or any other member of the Group. Clause 6.1 of the Trust Deed constituting the EBT required the EBT Trustee to consult with SWHL before exercising its powers (including the power to grant share options pursuant to the rules of any share option scheme) and also to consider the recommendations of SWHL. However, SWHL had no power to require the EBT Trustee to follow those recommendations.

(6) Options that the EBT Trustee granted entitled the holder (subject to "vesting" and other conditions described below) to acquire a certain number of "A" ordinary shares in SWHL for a specified "exercise price". Typically, there would also be "vesting" conditions associated with the grant of the option: it would only "vest" (so that the holder would be entitled to exercise it) if, for example, the employee remained employed by the Group for a certain period of time or if certain performance conditions were satisfied.

12. The options did not give employees any proprietary right over shares. Rather, they gave employees a contractual right (if vesting conditions were satisfied) to acquire shares in SWHL from the EBT Trustee for a specified price. In practice, the EBT Trustee acquired shares in SWHL so that it would be able to satisfy its obligations if options were exercised. However, I was shown little evidence as to <u>when</u> precisely the EBT Trustee would acquire shares. I was not satisfied, on the evidence I saw that, as soon as the EBT Trustee granted an option entitling employees to acquire a certain number of shares, it would immediately acquire that number of shares in SWHL. On the contrary, the evidence I saw suggested that the EBT Trustee

did not at all times hold sufficient shares to satisfy all options that it had granted. For example, the consolidated accounts of the Smith & Williamson Group for the year ended 30 April 2010 indicated that, on 30 April 2010, the EBT Trustee held 5,367,000 shares in SWHL, but that it had granted options over 8,401,609 shares that could potentially become exercisable in just one share scheme (the Smith & Williamson Company Share Option Plan). Nevertheless, the EBT Trustee ensured that, whenever a particular option was exercised, it would hold sufficient shares to satisfy its obligations under that option.

13. Whenever the EBT Trustee granted employees of the Appellants a share option, the Appellants agreed to pay SWHL an amount equal to the fair value of the options granted to their respective employees. That obligation was reflected in an inter-company balance owed by the Appellants to SWHL. Each month, the Appellants would settle the intercompany balance due. This arrangement was referred to in the hearing as the "Recharge" and I will use the same expression in this decision. (Later, I will consider Mr Ghosh's[1] argument that, since the options cost SWHL nothing to grant, the arrangement should properly be characterised as a "charge" rather than a "recharge".) The Appellants passed the cost of the Recharge on to other group companies (with a mark-up) by including it within the Management Charge.

14. Significant numbers of options that the EBT Trustee granted were never exercised either because "vesting conditions" were not satisfied or because the options were "out of the money" when they came to be exercised (i.e. the value of SWHL shares in the period when the options could be exercised was lower than the exercise price of the option). In the year ended 30 April 2010, for example, the Group's consolidated accounts stated that options over 1,134,089 shares had lapsed during that year. In the year ended 30 April 2009, options over 964,122 shares lapsed and in the year ended 30 April 2008, options over 14,400 shares lapsed.

15. Mr Stopps's witness statement contained some evidence on the general commercial purpose of the option schemes as a whole. That evidence was not given from the perspective of the Appellants and so he did not speak to the Appellants' own motivations (as separate companies) for being party to the option arrangements. He did not state that the Appellants were themselves involved in the decision to establish particular share option schemes, or to grant share options to particular employees. He thus did not make any particular distinction in his evidence between the commercial objects of the Appellants and the commercial objects of the Group as a whole (for example, he referred to the "Board" having particular perspectives on the option schemes without making it clear precisely which legal entity's board of directors was being referred to). However, it was clear from his evidence (which was not challenged) that senior management within the Group regarded the option schemes as forming a part of the remuneration package available to employees and as serving the desirable commercial objective of incentivising employees of the Group who were employed by the Appellants.

[1] I will refer throughout this decision to Mr Ghosh's submissions as he made oral submissions at the hearing on behalf of HMRC. In doing so, I mean no discourtesy to Mr Bremner and I recognise that he helped to formulate the submissions that Mr Ghosh made orally.

16. As noted at [11(4)], SWHL determined the rules of the Share Schemes. Given Mr Stopps's evidence, I am satisfied that SWHL established those schemes to incentivise and reward the Appellants' employees. I also consider that SWHL would, in discussions with the EBT Trustee referred to at [11(5)], have communicated its commercial objectives to the EBT Trustee. Since the EBT was established for the benefit of employees of the Group, I have concluded that the EBT Trustee was motivated by a wish to incentivise and reward the Appellants' employees when granting share options. Therefore, the object of both the EBT Trustee and SWHL, when share options were granted, was to incentivise employees of the Appellants as that was considered important to the wider business of the Group which, since it involved the provision of professional services, was particularly reliant on its employees. There was no suggestion that share options were awarded for any ulterior, non-business purpose, nor was there any suggestion that the grant of the options formed part of any tax avoidance or tax mitigation scheme.

17. As I have noted, there was little evidence that the Appellants themselves designed the option schemes, or required options to be granted to particular employees. Rather, the documents I saw indicated that the share option schemes were established by SWHL and operated by the EBT Trustee in consultation with SWHL. However, the Appellants were required to contribute to the costs of Share Schemes (by paying the Recharge). Given the purpose of the Share Schemes at [15] and [16], I consider that the Appellants' object in paying the Recharge would have been to benefit their trade by paying SWHL for the grant of share options to incentivise the Appellants' employees.

The accounting treatment for the Appellants

18. In the three accounting periods that are relevant for their appeals (the accounting years ended 30 April 2010, 2011 and 2012), the Appellants prepared accounts under International Financial Reporting Standards ("IFRS"). The applicable accounting standards dealing with the treatment of share options from the perspective of the Appellants were as follows:

(1) For the Appellants' year ended 30 April 2010, the applicable accounting standard was IFRS2 "Share-based Payment" as supplemented by IFRIC8 "Scope of IFRS2" and IFRIC11 "Group and Treasury Share Transactions".

(2) For the Appellants' years ended 30 April 2011 and 30 April 2012, an amended version of IFRS2 had effect. The amendments to IFRS2 incorporated the provisions of IFRIC8 and IFRIC11 and therefore those two IFRICs were withdrawn.

19. Although the precise detail of the applicable accounting standards varied over the accounting periods that are the subject of these appeals, it was common ground that the applicable accounting treatment of the grant of the options for the Appellants was as summarised at [20] to [36] below. It was also common ground that the Appellants' statutory accounts for all three years complied with the applicable provisions of IFRS.

(a) The recognition of a debit in the Appellants' income statements under IFRS2

20. Even though the EBT Trustee (rather than the Appellants or SWHL) granted share options to employees, and even though the Appellants had no contractual obligation to provide their employees with share options, the grant of share options to the Appellants' employees had accounting consequences for the Appellants.

21. For the purposes of the Appellants' accounts, the grant of share options to the Appellants' employees had to be treated as "equity settled". In the accounting year ended 30 April 2010, this requirement came from IFRIC 11 and arose because the Group, in its consolidated accounts, treated the options as equity settled and IFRIC 11 required this treatment to be applied in the Appellants' solus accounts. In the accounting years ended 30 April 2011 and 2012, the requirement arose under IFRS2 because the Appellants had no obligation to "settle the share-based payment transaction" because it was under no obligation to provide employees with shares or share options (or to procure that they were provided with shares or share options)[2].

22. Under paragraph 7 of IFRS2, an entity that receives goods and services in a share-based payment transaction is required to account for that transaction, including the goods and services received. In the circumstances of these appeals, the Appellants were treated as receiving the services of the employees under a share-based payment transaction that involved those employees being granted share options by the EBT Trustee[3]. IFRS2 therefore imposed an obligation on the Appellants to account for the goods and services received. Since the services that the employees provided to Appellants were regarded as consumed immediately on receipt, paragraphs 8 and 9 of IFRS2 required the Appellants to recognise an expense reflecting the consumption of those services.

23. The treatment set out at [22] had created some controversy within the accounting profession when IFRS2 was being proposed. Prior to the introduction of IFRS2, some within the profession thought that the grant of equity settled share options to employees did not involve an entity incurring any expense that should be recognised in the accounts. Indeed, before IFRS2 was introduced in 2004, there was no accounting standard that would have required a UK company to recognise an expense on the grant of equity settled share options to employees and virtually no company did so. This controversy was recognised in a section of IFRS2 that set out the basis for the conclusions reached in that standard as follows:

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[2] Mr Ghosh invited me to conclude that the Appellants were "prevented" from providing their employees with shares or share options. I will not, however, make this finding. If the Appellants had an obligation to provide their employees with shares or share options, the accounting treatment under IFRS2 would have been different (and the share-based payment transactions would not have been treated as equity settled). However, I do not consider that the Appellants were "prevented" from giving options or shares to employees: they simply had no obligation to do so.

[3] Even though the Appellants made their employees available to other group companies, they were still treated for accounting purposes as receiving the employees' services since the employees were not seconded and the Management Charge that the Appellants charged other group companies built in a margin which demonstrated that the Appellants were actually benefiting from the employees' services.

'There is no cost to the entity, therefore there is no expense'

> BC40 Some argue that because share-based payments do not require the entity to sacrifice cash or other assets, there is no cost to the entity, and therefore no expense should be recognised.
>
> BC41 The Board regards this argument as unsound, because it overlooks that:
>
> a) Every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and
>
> b) The expense arises from the consumption of those resources, not from an outflow of assets.

24. Mr Henworth said, and I agree, that in this passage the International Accounting Standards Board ("IASB") is recognising that, when the EBT Trustee granted share options to employees, the Appellants were not required to "sacrifice cash or other assets" but that nevertheless the Appellants should be obliged to record an expense relating to their consumption of employees' services as part of the share-based payment transaction that involved the options being granted. The rationale for that treatment is that the expense in question is not the sacrifice of cash or other assets, but rather the consumption of services that the employees provided to the Appellants.

25. The next logical question that IFRS2 addressed was how to quantify that expense. IFRS2 recognised that there were practical difficulties in doing this: for example it would be difficult to decide which specific part of an employee's services should be treated as given in exchange for the share options issued. Therefore, IFRS2 concluded that an entity should apply the following approach:

> Given these practical difficulties in measuring directly the fair value of the employee services received, the Board concluded that it is necessary to measure the other side of the transaction i.e. the fair value of the equity instruments granted, as a surrogate measure of the fair value of the services received.

26. It follows, therefore, that any grant of share options by the EBT Trustee to employees triggered an obligation on the Appellants to recognise an expense in their income statements equal to the fair value of the options that the EBT Trustee had granted[4]. That obligation arose whether or not the Appellants had to pay any amount to any other person (such as SWHL or the EBT Trustee) in relation to the grant of those options. Therefore, even if the Appellants were not party to the Recharge

[4] As noted further below, this amount would not necessarily be recognised immediately, but would be spread over a number of accounting periods (and adjusted).

arrangement, their obligation to reflect an expense in their income statements in respect of the fair value of the options granted would have been the same[5].

27. IFRS2 does not itself specify how the fair value of options granted should be calculated. Where, as in these appeals, the options granted were not listed, IFRS2 simply required the Appellants to use an "option pricing model". It was common ground that the Appellants had, in determining the fair value of options granted, used an appropriate option pricing model can be summarised as follows:

> (1) The fair value of each option granted had two components: an "intrinsic value" and an "extrinsic" or "time value".
>
> (2) The "intrinsic value" depended on a straightforward comparison between the market value of a single A ordinary share in SWHL at the time the option was granted and the exercise price under the option. Therefore, if the EBT Trustee granted an employee the right to acquire 100 shares for £1 each at a time when the market value of a single A ordinary share in SWHL was £1.20, the intrinsic value of that option would be £20 (the 20p difference between market value and exercise price multiplied by the 100 options granted). Similarly, if the EBT Trustee granted employees the right to acquire shares for an exercise price of £1, when the market value of a share was £1, the options would have no intrinsic value.
>
> (3) The "extrinsic value" of an option is essentially the value that is generated by the prospect that, over the life of the option, the underlying shares would increase in value. This value can be calculated by statistical or mathematical methods that take into account, among others, the duration of an option (clearly the longer an option is granted for, the greater the chance that the share will increase in value over its life), the volatility of the share, the dividend yield on the share and prevailing market interest rates. Therefore, if in the example set out at [(2)] above, the options were granted when the shares in SWHL had a value of £1, the options would have no "intrinsic value", but might still have an "extrinsic value".
>
> (4) The fair value of the options would <u>not</u> take into account "service conditions" that need to be satisfied before the options vest (such as a condition that the employee granted remains in service for a set period). Rather, the effect of such service conditions is taken into account in the adjustments referred to at [28(4)] below.

28. Having determined the aggregate fair value of the options granted to employees, the Appellants then had to perform a further calculation to determine how much of an expense to allocate to relevant accounting periods. The process for determining this was as follows:

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[5] Although the Recharge arrangement did require the Appellants to make additional accounting entries (not affecting the amount of expense recognised in their income statements) as noted further below.

(1) The Appellants would start with the aggregate fair value of the options issued. To explain the process, assume that the Appellants issued 10,000 options each with a fair value of £1.22, subject to a condition that they vest only if the employee concerned remained in employment in four years' time.

(2) The Appellants would estimate the number of options likely to vest (by, for example, considering expected staff departures over the four-year vesting period). On grant of the options, they might estimate that 80% of options would vest.

(3) Given the estimate set out at (2) the Appellants would initially calculate the total expense to be recognised in relation to the options as 10,000 x £1.22 x 80% (i.e. £9,760). That charge would be spread over the four-year vesting period with the result that, in the accounting period in which the options are granted, the Appellants would recognise an expense of £2,440 (i.e. £9,760 divided by 4).

(4) In subsequent accounting periods, the Appellants would not revisit their initial calculation of the fair value of the options. Therefore, the £1.22 fair value figure would remain fixed. However, the Appellants would revisit their estimate as to the number of options that would vest. For example, in the second accounting period after the options were granted, they might conclude that in fact 82% of the options would vest. In those circumstances, they would conclude that over the first two accounting periods of the arrangement, an aggregate expense of 82% x 10,000 x 2/4[6] x £1.22 (i.e. £5,002) needed to be recognised. £2,440 of that total had been recognised in the first accounting period and therefore, to produce the correct aggregate expense over the first two accounting periods, the balance of £2,562 would be taken as an expense in accounting period 2. The process of adjustment would continue in subsequent periods. By the fourth accounting period (when the share options were due to vest), the Appellants would know the actual number of options that had vested and so the cumulative effect of all the adjustments made is that the aggregate accounting expense recognised took into account only those options that actually vested.

29. If options vested, but were not exercised (for example because the value of the SWHL shares was less than the exercise price under the option), the Appellants were not required by applicable accounting practice to make any adjustment to their accounts. Whether or not employees chose to exercise their options, they had still been given those options and the rationale behind IFRS2 was that the Appellants were consuming the services of employees as part of the transaction that resulted in the options being awarded, whether or not those options were actually exercised.

30. The process set out at [27] and [28] above enabled the Appellants to calculate, for each accounting period relevant to this appeal, the amount of accounting expense that

[6] Since the calculation is a cumulative total over two years of the four-year vesting period of the options

should be reflected as a debit (the "IFRS2 Debit") in its income statement in respect of the grant of share options. It was common ground that the Appellants calculated the IFRS2 Debits correctly, and properly allocated them to accounting periods, in accordance with IFRS.

5 *(b) Other accounting entries relevant to the Appellants*

31. As noted above, the grant of options to the employees required the Appellants to recognise the IFRS2 Debit in their income statements. Principles of double-entry accounting meant that this debit had to be matched by a corresponding credit that would be reflected on the Appellants' balance sheets and this section explains the
10 nature of that credit.

32. Both IFRIC 11 (for the accounting period of the Appellants ended 30 April 2010) and IFRS2 (for the accounting periods of the Appellants ended 30 April 2011 and 30 April 2012) dealt with the situation where a parent company issued share options to employees of a subsidiary. In the that situation, both IFRIC 11 and IFRS2 required the
15 subsidiary to recognise an accounting credit (corresponding to the IFRS2 Debit) on its balance sheet and treat that credit as a capital contribution received from the parent company (the "Capital Contribution"). The rationale for this was that, by issuing share options to employees of the subsidiary, a parent company was providing a benefit to its subsidiary and was in substance making an investment in its subsidiary. In a note
20 to SWHL's accounts for the year ended 30 April 2014 (which explained a change in SWHL's accounting policy in relation to share options), it was acknowledged that the arrangement under which options were granted to the Appellants' employees involved SWHL being regarded, for accounting purposes, as making a capital contribution to the Appellants.

25 33. On the face of it, the treatment set out at [32] might be thought to sit oddly if the subsidiary was party to a recharge arrangement under which it paid the parent the cost of the options that the parent had granted. If a subsidiary was compensating a parent for the cost of granting the options, it might be thought that the parent should not be regarded as making a capital contribution at all. However, IFRS2 (at least in the
30 version that applied to the Appellants years ended 30 April 2011 and 30 April 2012) made it clear that, even if the costs of granting share options were being "recharged", a subsidiary still had to recognise a balance sheet credit in respect of a capital contribution. Paragraph 43D of that version of IFRS2 dealt with the point explicitly:

> Some group transactions involve repayment arrangements that require
> 35 one group entity to pay another group entity for the provision of share-based payments to the suppliers of goods or services. In such cases, the entity that receives the goods or services shall account for the share-based payment transaction in accordance with paragraph 43B… regardless of intragroup repayment arrangements.[7]

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[7] Although this provision applied only to the accounting periods ended 30 April 2011 and 30 April 2012, neither party suggested that the requirements for 30 April 2010 were any different. I have therefore concluded that a similar requirement applied in 2010.

34. Therefore, the Appellants had to adopt a method of accounting that recognised the requirement to recognise the Capital Contribution but also properly dealt with the effect of the Recharge. IFRS2 does not set out any requirements as to how the Appellants account for the Recharge and that, therefore, falls to be determined in accordance with general principles. Moreover, there is no professional consensus as to how the Recharge should be accounted for. Some possibilities are:

(1) to treat the Recharge as reducing the Capital Contribution;

(2) to treat the Recharge as an expense in the income statement; and

(3) to treat the Recharge as a distribution made to SWHL.

There is no consensus as to which of these methods is to be preferred and Mr Henworth's professional opinion, which I have accepted, is that in principle all of the above approaches could be in accordance with IFRS provided that they were consistently applied.

35. I have accepted Mr Henworth's expert evidence that the Appellants adopted a form of the approach set out at [34(1)] and treated the Recharge as reducing the Capital Contribution. The "end result" reflected in the Appellants' accounts for each of the accounting periods was as follows:

(1) The income statement for each of the financial years recorded an IFRS2 Debit.

(2) No Capital Contribution was recognised <u>as at the balance sheet date</u> because the Recharge arrangement meant that the Capital Contribution had been repaid by the balance sheet date. That repayment was effected by the inter-company balance that the Appellants owed the Parent pursuant to the Recharge arrangement. To the extent that the Appellants had not repaid that inter-company balance by the balance sheet date, that inter-company balance would be recorded as a liability on the balance sheet (instead of a liability in respect of a Capital Contribution). To the extent that the intercompany liability had been discharged as part of the monthly settlement programme referred to at [13], no intercompany liability would be recognised, but there would be a corresponding reduction in the Appellants' cash balances.

36. There has been extensive correspondence between the parties as to how precisely the "end result" referred to at [35] was achieved by means of journal entries in the Appellants' book-keeping records. Mr Henworth was able to confirm that the end result set out in the Appellants' accounts was in accordance with IFRS but since, the accounts themselves did not record the journal entries leading to that end result, he was not in a position to confirm what those journal entries were. Mr Chopping's expert evidence did not address the question either: indeed his evidence was concerned largely with the policy and background to IFRS2 and did not deal with the specifics of the Appellants' accounts at all. Mr Stopps's witness statement contained some evidence on the journal entries that were made but he accepted in cross-examination that he could not personally speak to the journal entries that were made and, since he accepted that, Mr Ghosh chose not to cross-examine him on that issue. I

will not, therefore, make any findings as to what journal entries the Appellants actually made. However, the journal entries that were required were as set out at [32].

The accounting treatment for SWHL

37. The parties were not agreed on whether the accounting treatment that SWHL adopted was relevant to the tax position of the Appellants: Mr Ghosh submitted it was of some relevance, whereas Mr Maugham submitted it was not. In this section, I will make findings on the accounting treatment that was required in SWHL's statutory accounts, and the accounting treatment that was adopted. Later sections will consider the relevance or otherwise of SWHL's accounting position.

38. The "end result" shown in SWHL's statutory accounts for the relevant accounting periods was that it recorded a credit on its balance sheet in respect of an equity reserve (reflecting the fact that options had been issued over SWHL's shares) and a debit (an asset) on its balance sheet in respect of the intercompany debt owed by the Subsidiaries pursuant to the Recharge. Of course, to the extent that intercompany debt had been settled, it would be replaced by a different asset on SWHL's balance sheet being the cash received on settlement of the intercompany debt. Mr Henworth accepted that this "end result" was in accordance with IFRS.

39. It was, however, not clear how SWHL had got to the end result in its statutory accounts. Mr Stopps's witness statement suggested that SWHL made the following journal entries in its book-keeping records that led to the end result:

> (1) On grant of the options, it took a debit to its income statement reflecting the fair value of the options granted. That debit was calculated in the same way as the IFRS2 Debit that appeared in the accounts of its subsidiaries. The other side to that debit, applying principles of double-entry book-keeping was a credit to an equity reserve (reflecting the fact that options had been granted over SWHL's own shares).
>
> (2) Since the Recharge arrangement meant that SWHL could recover an amount from the Subsidiaries, it immediately reflected a credit to its income statement (that had the effect of counteracting the debit referred to at (1) above) and took a debit to its balance sheet (the asset reflected by the intercompany debtor).
>
> (3) The net result of the book-keeping entries set out at (1) and (2) led to the "end result" on SWHL's balance sheet.

40. Mr Henworth said in his expert evidence that the journal entries referred to at [39] were not consistent with applicable accounting standards. Rather, he said that, instead of taking the debit referred to at [39(1)] to its income statement, SWHL should have reflected the debit on its balance sheet as an increased investment in its subsidiaries. That would then mirror the treatment in the Appellants who, as noted at [32], were treated by IFRS2 as receiving the Capital Contribution from SWHL. Mr Henworth's opinion was not challenged in cross-examination, and Mr Chopping did not give any evidence on this issue. I have therefore accepted Mr Henworth's professional opinion that, on grant of the options, SWHL was treated for accounting purposes as making an

investment in its subsidiaries (that mirrored the Capital Contribution treated as received by the Appellants). However, I am not suggesting that SWHL's statutory accounts were not prepared in accordance with IFRS as Mr Henworth agreed that the end result (which was all those accounts were required to disclose) was consistent with IFRS.

41. The accounting treatment in SWHL meant that SWHL did not reflect any cost in its accounts relating to the grant of the options. That was because, as the IASB noted in the extracts from IFRS2 referred to at [23] and [24], the grant of the options did not result in SWHL sacrificing any cash or other assets and, since SWHL (as distinct from the Appellants) was not consuming the services of employees, there was no notional expense that needed to be included in its accounts either.

Relevant Statutory Provisions

Provisions relevant to the calculation of trading profits

42. Companies are subject to corporation tax as income on the profits of a trade under the provisions of Part 3 of CTA 2009. Section 46 of CTA 2009 as in force at the relevant times provided as follows:

> **46 Generally accepted accounting practice**
>
> (1) The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for corporation tax purposes.

It was common ground that, since the Appellants drew up accounts under international accounting standards, "generally accepted accounting practice" for this purpose meant international accounting standards as set out in IFRS (section 1127 of the Corporation Taxes Act 2010).

43. Building on the requirement set out in s46, s48 of CTA 2009 also stresses the central importance of accounting entries in determining trading profits as follows:

> **48 Receipts and expenses**
>
> (1) In the Corporation Tax Acts, in the context of the calculation of the profits of a trade, references to receipts and expenses are to any items brought into account as credits or debits in calculating the profits.
>
> (2) It follows that references in that context to receipts or expenses do not imply that an amount has actually been received or paid.
>
> (3) This section is subject to any express provision to the contrary

44. Section 53 of CTA 2009 denies relief for capital expenditure as follows:

> **53 Capital expenditure**
>
> (1) In calculating the profits of a trade, no deduction is allowed for items of a capital nature.

(2) Subsection (1) is subject to provision to the contrary in the Corporation Tax Acts.

45. Section 54 of CTA 2009 contains a restriction on the deduction of expenses in the calculation of trade profits as follows:

5 **54 Expenses not wholly and exclusively for trade and unconnected losses**

(1) In calculating the profits of a trade, no deduction is allowed for—

(a) expenses not incurred wholly and exclusively for the purposes of the trade, or

10 (b) losses not connected with or arising out of the trade.

(2) If an expense is incurred for more than one purpose, this section does not prohibit a deduction for any identifiable part or identifiable proportion of the expense which is incurred wholly and exclusively for the purposes of the trade.

15 *Statutory provisions providing for relief for employee share acquisitions*

46. Part 12 of CTA 2009 contains provisions giving a company relief in respect of certain employee share acquisitions. Part 12 also contains provisions that oust other reliefs where relief under Part 12 is available. Therefore, Part 12 is relevant in this appeal not because the parties are disputing the Appellants' actual entitlement to relief 20 under Part 12, but rather because HMRC consider that Part 12 prevents the Appellants from obtaining relief (in their calculation of trading profit) in respect of the grant of options to employees.

47. Section 1001 of CTA 2009 sets out the Overview of Part 12. Section 1001(1) provides for corporation tax relief to be available "in relation to employee share 25 acquisitions". Part 12 does not, therefore, afford any relief in relation to the grant of employee share options. However s1001(4) provides that Chapter 3 of Part 12 provides for relief if:

(a) an employee or another person obtains an option to acquire shares because of the employee's employment by a company, and

30 (b) shares are acquired pursuant to the option.

Relief under Chapter 3 therefore remains a relief granted when shares are acquired, although the trigger for that relief to be available is that the shares are acquired pursuant to an option.

48. Relevant statutory provisions relating to the Chapter 3 relief were, at the material 35 times, as follows:

Chapter 3

Relief if Employee or Other Person Obtains Option to Acquire Shares

Introductory

1014 Overview of Chapter

(1) This Chapter provides for relief if—

(a) an employee or another person obtains an option to acquire shares because of the employee's employment by a company, and

5 (b) shares are acquired pursuant to the option.

(2) Sections 1015 to 1017 set out the requirements that must be met for relief to be available.

(3) Sections 1018 to 1020 set out how the amount of relief is calculated.

10 (4) Section 1021 sets out how the relief is given….

1015 Basic requirements for relief under Chapter 3

(1) Relief under this Chapter is available to a company ("the employing company") if—

15 (a) a person ("the employee") has employment with the employing company,

(b) that employment ("the relevant employment") is in relation to a business within subsection (2) ("the qualifying business"),

(c) the employee or another person obtains an option to acquire 20 shares because of the relevant employment,

(d) the person who obtains the option acquires shares pursuant to the option, and

…

49. Section 1016 and 1017 of CTA 2009 set out some further conditions that needed 25 to be satisfied in order for the relief to be given. Nothing turns on these conditions for the purposes of this appeal and, accordingly, those provisions are not reproduced.

50. Section 1018 set out how any relief under Chapter 3 should be calculated as follows:

1018 Calculation of relief if shares are neither restricted nor 30 convertible

(1) If the shares acquired are neither restricted shares nor convertible shares, the amount of relief to be given is an amount equal to—

(a) the market value of the shares when they are acquired, less

(b) the total amount or value of any consideration given by any 35 person in relation to the obtaining of the option or to the acquisition of the shares.

51. Having determined the amount of relief that is due, s1021 of CTA 2009 sets out how the relief is given as follows:

1021 How the relief is given

(1) The relief is given for the accounting period in which the shares are acquired.

(2) The amount of relief is allowed as a deduction in calculating the profits of the qualifying business for corporation tax purposes (subject to subsections (3) and (4)).

52. Section 1038 of CTA 2009 deals with the interaction between deductions available under Part 3 of CTA 2009 and other deductions that might be available. At times relevant to this appeal, s1038 read as follows:

1038 Exclusion of other deductions

(1) If relief under this Part is or, apart from condition 2 in section 1009(1), would be available for an accounting period, no other deduction in relation to expenses within subsection (2) is allowed for the purpose of calculating any company's profits for corporation tax purposes for any accounting period.

(2) The expenses within this subsection are the expenses directly related to the provision of the shares.

(3) They include, in a case in which the shares are acquired under an employee share scheme, any amount paid or payable by the employing company in relation to the participation of the employee in the scheme.

(4) But they do not include in such a case—

(a) expenses incurred in setting up the scheme,

(b) expenses incurred in meeting, or contributing to, the costs of administering the scheme,

(c) the costs of borrowing for the purposes of the scheme, or

(d) fees, commission, stamp duty, stamp duty reserve tax, and similar incidental expenses of acquiring the shares.

53. Section 1038 did not, therefore, deal expressly with whether a deduction would be available on grant of an employee share option. However, with effect for accounting periods ending after 20 March 2013 (and thus after the period relevant to this appeal), Parliament changed the law so that deductions associated with the grant of employee share options were expressly dealt with. As amended, s1038 reads as follows:

1038 Exclusion of other deductions

(1) Subsection (2) applies if relief is or, apart from condition 2 in section 1009(1), would be available under this Part.

For this purpose, it does not matter if the amount of the relief is or would be calculated as nil.

(2) Except as provided for by this Part, for the purpose of calculating any company's profits for corporation tax purposes for any accounting period, no deduction is allowed—

(a) in relation to the provision of the shares or to any matter connected with the provision of the shares, or

(b) so far as not covered by paragraph (a) in a case in which the shares are acquired pursuant to an option, in relation to the option or to any matter connected with the option

54. Also for periods later than that covered by this appeal, a new s1038A of CTA 2009 had effect that reads as follows:

1038A Exclusion of deductions for share options: shares not acquired

(1) Subsection (2) applies if—

(a) a person obtains an option to acquire shares and the requirements of section 1015(1)(a) to (c) are met in relation to the obtaining of the option, or

(b) so far as not covered by paragraph (a), a person obtains an option to acquire shares and the obtaining of the option is connected with an option previously obtained in a case covered by paragraph (a) or this paragraph.

(2) For the purpose of calculating any company's profits for corporation tax purposes for any accounting period, no deduction is allowed in relation to—

(a) the option, or

(b) any matter connected with the option,

unless the shares are acquired pursuant to the option.

55. Therefore the revisions to s1038 of CTA 2009 s1038A of CTA 2009 made express provision dealing with expenses relating to the grant of share options (for periods subsequent to those at issue in this appeal) whereas the version of s1038 in force at times relevant to this appeal made no such express provision.

56. Section 1290 of CTA 2009 seeks to ensure that there is broad symmetry between the time at which a company obtains relief for an “employee benefit contribution” and the time at which the employee receives taxable “qualifying benefits” out of that contribution. That result is achieved by the following provisions:

1290 Employee benefit contributions

(1) This section applies if, in calculating for corporation tax purposes the profits of a company (“the employer”) of a period of account, a deduction would otherwise be allowable for the period in respect of employee benefit contributions made or to be made (but see subsection (4)).

(2) No deduction is allowed for the contributions for the period except so far as—

(a) qualifying benefits are provided, or qualifying expenses are paid, out of the contributions during the period or within 9 months from the end of it, or

(b) if the making of the contributions is itself the provision of qualifying benefits, the contributions are made during the period or within 9 months from the end of it.

57. Section 1290 therefore applies to deductions in respect of "employee benefit contributions". That, and other, defined terms are set out in s1291 of CTA 2009 as follows:

1291 Making of "employee benefit contributions"

(1) For the purposes of section 1290 an "employee benefit contribution" is made if, as a result of any act or omission—

(a) property is held, or may be used, under an employee benefit scheme, or

(b) there is an increase in the total value of property that is so held or may be so used (or a reduction in any liabilities under an employee benefit scheme).

(2) For this purpose "employee benefit scheme" means a trust, scheme or other arrangement for the benefit of persons who are, or include, present or former employees of the employer or persons linked with present or former employees of the employer.

…

Discussion of Issue 1 – whether the IFRS2 Debit was "incurred" wholly and exclusively for the purposes of the Appellants' trades

High level summary of the competing arguments

58. Mr Maugham submitted that the Appellants' trading profits had to be ascertained in accordance with IFRS by virtue of s46 of CTA 2009. The IFRS2 Debit was an expense properly recognised in the Appellants' income statements under IFRS2 and was therefore an expense recognised in determining (accounting) profits and as such was prima facie deductible. He accepted that the Appellants still had to establish that the IFRS2 Debit was incurred wholly and exclusively for the purposes of their trades (by virtue of s54 of CTA 2009). However, the requirements of s54 of CTA 2009 had to be applied in the context of a regime where, under s48 of CTA 2009, the IFRS2 Debit was treated as an expense. Therefore, although s54 of CTA 2009 referred to expenses being "incurred", this was not imposing a requirement that the IFRS2 Debit be actually paid as such a requirement would be inconsistent with s48 of CTA 2009 which was plainly intended to afford relief for accounting debits whether or not they resulted in actual payments. Rather, s54 of CTA 2009 was concerned with whether expenses have a duality of purpose. He argued that there was no duality of purpose given that the options were granted solely to remunerate the Appellants' employees and accordingly there was no obstacle to the Appellants obtaining a deduction for the IFRS2 Debit.

59. Even if s54 of CTA 2009 was imposing a separate and free-standing requirement that an expense be "incurred", Mr Maugham argued that on a realistic view of the

facts, the Appellants had incurred the expense (as they had made a payment to SWHL pursuant to the Recharge arrangement).

60. Mr Ghosh accepted that the Appellants' trading profits had to be computed in accordance with IFRS and that, in principle, relief was available for accounting debits. However, he argued that s54 imposed a requirement that the Appellants had "incurred" the expense represented by the IFRS2 Debit and this was not the case since (as the IASB acknowledged), the IFRS2 Debit did not represent any real expense of the Appellants but rather represented consideration that the Appellants had received (the services of employees) that was treated as immediately consumed (and therefore as giving rise to an accounting debit). The IFRS2 Debit, therefore, was a very different kind of debit from those that were deductible for tax purposes. Moreover, the Appellants had no liability to do anything in relation to the share options that resulted in the IFRS2 Debit and the share options in question were granted by the EBT Trustee (and not the Appellants) and that was a further reason why the expense was not "incurred". In addition, since the IFRS2 Debit was the only relevant entry in the Appellants' income statement that could give rise to a deduction, the fact that sums had been paid under the Recharge arrangement was not relevant to the question of whether the IFRS2 Debit had been "incurred".

61. Mr Ghosh also made the separate, but related, argument that since the IFRS2 Debit related neither to money that had actually been spent (or would be spent) and existed only to satisfy the requirements of IFRS2, any incurring of the IFRS2 Debit could not have been wholly and exclusively for the purposes of the Appellants' trades.

Conclusion on Issue 1

62. There was no real difference between the parties on the effect of s46 of CTA 2009. Both were rightly agreed that s46 means that the starting point in computing taxable profits is the company's accounts (provided those accounts are prepared in accordance with generally accepted accounting practice). Therefore, s46 makes it clear that the starting point is that, since the IFRS2 Debit was properly taken into account as a reduction in computing accounting profits, it is deductible for tax purposes unless an adjustment is "required by law".

63. The next relevant provision is s48 of CTA 2009. Mr Ghosh argued that, once the nature of the IFRS2 Debit was properly understood, s48 did not apply to it as the IFRS2 Debit was not actually an expense or, alternatively, that it was not brought into account in calculating profits. I do not agree with that submission. The IFRS2 Debit was properly brought into account in calculating the Appellants' accounting profits by virtue of being recognised in the Appellants' income statements. In the absence of any express provision to the contrary, s48 of CTA 2009 does not require any further examination of whether the IFRS2 Debit satisfies any legal definition of an "expense": the fact that it is validly recognised as a debit in the Appellants' income statement is sufficient for s48 to apply and causes the IFRS2 Debit to be treated as an "expense". I do not accept Mr Ghosh's submission that, by analogy with the decision of this Tribunal in *Stagecoach Group plc and another v Revenue & Customs Commissioners* [2016] UKFTT 120, s48 of CTA 2009 applies only if the IFRS Debit

has the general legal qualities of an expense. *Stagecoach* concerned the statutory loan relationships code which provides, in s307 of CTA 2009, that an item recognised in a company's profit and loss account was deductible only if it "fairly represent[ed]" a "loss" from a loan relationship. Therefore, in that case, it was appropriate for the Tribunal to analyse whether the item did represent a loss. In this appeal, s48 CTA 2009 applies because the IFRS2 Debit is taken into account as a debit in computing accounting profits. No further examination of the nature of the IFRS2 Debit is needed for s48 to apply.

64. Section 54 of CTA 2009 then applies to the "expense" that arises by virtue of the application of s48 of CTA 2009. There is a slight logical oddity in s54. As drafted, it precludes a deduction for "expenses not incurred wholly and exclusively for the purposes of a trade". Read literally, that appears to suggest that if the IFRS2 Debit is not an "expense", it is outside the scope of the prohibition in s54, with the result that there is nothing to prevent it from being deductible under s46. Therefore, in passages of his oral submissions, Mr Maugham argued that HMRC's arguments to the effect that the IFRS2 Debit was not really an "expense" in fact supported the contention that the IFRS2 Debit was deductible. I do not, however, consider that anything turns on this point. As I have found at [63], the IFRS2 Debit is an "expense" (because s48 of CTA 2009 treats it as such). Therefore, the prohibition in s54 is capable of applying to that expense and, in order to decide whether s54 actually applies, I first need to determine what requirements s54 imposes (as a matter of construction) and then need to apply s54, properly construed, to the facts that I have found.

65. As a matter of construction, I agree with Mr Maugham that, in circumstances where the IFRS2 Debit is treated as an expense by s48, it is an expense that is "incurred". Section 54 of CTA 2009 is not imposing a separate, free-standing requirement that the IFRS2 Debit must satisfy in order to be regarded as "incurred" and so deductible. Rather, s54 of CTA 2009 is concerned with identifying the object of expenditure.

66. Section 54 has to be understood in conjunction with the scheme of Chapter 3 of CTA 2009 as a whole. Section 46 makes it clear that the starting point is that profits are to be calculated in accordance with generally accepted accounting practice (subject to any adjustment required or authorised by law). Section 48 supplements that provision by providing that, if a debit is brought into account in calculating accounting profit, it is (unless there is express provision to the contrary) to be treated as an "expense" for tax purposes. The whole flavour of s46 and s48 is that, if a sum is properly reflected as a debit in a calculation of accounting profit, the starting point is that the sum is deductible unless there is a specific statutory rule to the contrary. If Parliament wished to deal with a category of expenses that, although properly recognised as a debit in calculating accounting profits, are not "incurred" in the necessary sense and so not eligible for relief, I consider that it would have spelled this out explicitly and, in particular, would have set out with precision what it meant for an accounting credit to be "incurred".

67. My conclusion at [66] is reinforced by the fact that Parliament would have been aware, when enacting s46 and s48 of CTA 2009 that it was legislating against a

background of court decisions that emphasised the central importance of accounting principles in determining taxable profits. For example, in *Johnston v Britannia Airways* [1994] STC 763, having surveyed authorities on the computation of taxable profits, Knox J said:

5 > The court is slow to accept that accounts prepared in accordance with accepted principles of commercial accountancy are not adequate for tax purposes as a true statement of the taxpayer's profits for the relevant period. In particular, it is slow to find that there is a judge-made rule of law which prevents accounts prepared in accordance with
10 the ordinary principles of commercial accountancy from complying with the requirements of the tax legislation. The latest example of this is *Gallagher v Jones*, but in that case there was no competing method of accounting relied upon as giving a true and fair statement of the relevant profits. As long ago as 1957 Lord Radcliffe in Southern
15 *Railway of Peru Ltd v Owen* said that he would view with dismay the assertion of legal theories as to the ascertainment of true annual profits which were in conflict with current accountancy practice and were not required by some special statutory provision of the Income Tax Acts (see [1957] AC 334 at 360, 36 TC 602 at 645).

20 In CTA 2009, Parliament did not enact specific legislation spelling out when a debit could be taken into account in the calculation of accounting profits but not be "incurred" for tax purposes. Rather, it enacted s46 and s48 to put decisions such as those in *Johnston v Britannia Airways* on a statutory basis. That, I consider, is inconsistent with the word "incurred" having the weight for which Mr Ghosh argued.

25 68. Therefore, inferences from s46 and s48 of CTA 2009 support Mr Maugham's construction of s54. That construction is borne out by the words of s54 itself. Section 54 is concerned to identify expenses that have some duality of purpose (or losses that have no connection with the trade). Section 54(2) emphasises this by permitting a deduction to be given for an identifiable proportion of an expense which, as a whole,
30 has a dual purpose. That further suggests that, when Parliament uses the word "incurred" it does so simply as a participle that takes its colour from the word "expenses" and does not intend to impose a free standing requirement to be applied to accounting debits of the kind for which Mr Ghosh argued.

69. Mr Ghosh argued that some guide to the interpretation of s54 of CTA 2009 could
35 be found in the predecessor provision that was contained in s74(1)(a) of the Income and Corporation Taxes Act 1988 ("ICTA") which read as follows:

> Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sums shall be deducted in respect of –
>
40 > (a) any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation.
>
> …

70. It may well be that, when Parliament used the expression "money wholly and exclusively laid out or expended" in s74 of ICTA, it had in mind a requirement that a deduction was available only if money was "laid out or expended". However, the task of the Tribunal is to construe the CTA 2009 provisions and not those in ICTA. Quite apart from the question of whether the interpretation of s74 of ICTA is any guide to the meaning of s54 of CTA 2009, ICTA contained no analogue of s46 or s48 of CTA 2009[8]. I therefore do not consider that the wording of s74 of ICTA serves as a guide to Parliament's intention in relation to accounting debits in CTA 2009. In a similar vein, Mr Ghosh referred me to some authorities that considered what it meant for sums to be "wholly and exclusively laid out or expended" for the purposes of predecessor legislation on the computation of trading profits (*Lowry v Consolidated African Selection Trust Ltd* 23 TC 259 and *IRC v Niddrie and Behar Coal Ltd* 32 TC 244). However, those authorities dealt with a very different statutory regime that did not accord the accounting measure of profit the status that s46 and s48 of CTA 2009 confer. I did not, therefore, consider that these authorities cast any significant light on the question of whether the IFRS2 Debit was "incurred" in the requisite sense.

71. I therefore do not accept Mr Ghosh's argument that, as a matter of construction, the IFRS2 Debit is prevented from being deductible because it is not "incurred". It is therefore necessary to go on to consider how s54 actually applies given the facts that I have found. That makes it necessary to consider whether the IFRS2 Debit was incurred "wholly and exclusively for the purposes of the trade". In order to determine that question, it is necessary to "look into the taxpayer's mind" and determine the Appellants' object in incurring the expenditure. Having done so, the question is whether the expenditure was incurred in order to enable the Appellants to carry on and earn profits in their trade (see the speech of Lord Brightman in *Mallalieu v Drummond* [1983] STC 665).

72. There is, however, a difficulty in applying Lord Brightman's approach to the IFRS2 Debits at issue in these appeals. Those debits did not themselves reference an actual outlay of cash by the Appellants. Rather, they arose because different legal entities (the EBT Trustee and SWHL) had decided to grant share options. Of course, there was an actual outlay of cash when the Appellants settled the Recharge. However, that was a separate matter from the IFRS2 Debits and indeed settling the Recharge did not involve any entry in the Appellants' income statements. The question, therefore, is how Lord Brightman's approach should be applied to the IFRS2 Debits which arise because of what Mr Maugham termed an "accounting fiction" rather than because of the payment of actual money.

73. It would be an unduly blinkered view of the facts to conclude that the Appellants' object in including the IFRS2 Debit in their accounts was simply to comply with accounting standards. In a sense, all accounting debits are included within accounts in

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[8] Although, after s74 of ICTA was enacted, s42 and s46 of Finance Act 1998 introduced provisions similar to s46 and s48 of CTA 2009. However, the enactment of s42 and s46 of Finance Act 1998 did not cause Parliament to make any amendment to s74(1)(a) of ICTA with the result that it is not clear to me that s74 of ICTA sheds any light on how Parliament intends s54 of CTA 2009 to apply to accounting debits.

order to comply with applicable accounting standards. Having legislated specifically to permit accounting debits to be deductible, I do not consider that Parliament intended to deny a deduction simply because a particular debit is mandatory as an accounting matter. I therefore consider that, in order to apply Lord Brightman's approach to the IFRS2 Debits, it is necessary to consider the circumstances in which the IFRS2 Debits arose.

74. The relevant circumstances are that the Appellants carry on trades that involve employing staff and making those staff available to other group companies. The profits of that trade come from the fact that the Appellants charge a margin over and above their employees' payroll costs. The Appellants' employees operate in a professional services business whose success depends on the availability of skilled and motivated professionals and the grant of share options to those employees is part of their remuneration package. The IFRS2 Debit arises only because options have been granted to the Appellants' employees. Moreover, as noted at [13], the Appellants charge group companies an amount corresponding to the IFRS2 Debit (appropriately marked up) when making employees available to them, and therefore the incurring of the IFRS2 Debit has a direct link with the earning of revenue profits. There is no suggestion that the options were granted, and the IFRS2 Debit thus incurred, for any ulterior motive not related to the Appellants' trades.

75. I also consider that it is relevant that the Appellants were prepared to pay SWHL (under the Recharge arrangement). I agree with Mr Ghosh that any deduction that the Appellants obtain has to be in respect of the IFRS2 Debit and not for sums paid under the Recharge arrangement for the simple reason that the payment of sums under the Recharge did not result in any expense in the Appellants' income statements. I do not think it matters whether the grant of the options involved SWHL incurring any cost (or whether the Recharge arrangement should more accurately be described as a "charge"). The Recharge demonstrates that the Appellants thought that they were obtaining a benefit from the grant of options sufficient to warrant them paying an amount equal to the fair value of those options to SWHL which further suggests that the IFRS2 Debit (which arose only because the options were granted) was incurred wholly and exclusively for the purposes of SWHL's trade. In addition, as noted at [22], the IFRS2 Debit is intended, as an accounting matter, to represent a measure of the value of employees' services that the Appellants consume in return for the grant of share options. The Appellants consume those services in the course of the trades that they conduct.

76. For all of those reasons, I consider that taking a realistic view of the facts, the IFRS2 Debit was incurred wholly and exclusively for the purposes of the Appellants' trades.

77. I have had much pause for thought before reaching the conclusions set out above. There was force in Mr Ghosh's submissions that the conclusion that the IFRS2 Debit is deductible for tax purposes is somewhat surprising as it means that a deduction is potentially available both when options are granted and, under Part 12 of CTA 2009, if shares are issued on exercise of options. However, it seems to me that this result is a consequence of Parliament giving accounting debits such a central role in computing

trading profits. It also seems to me that the fact that Parliament enacted specific legislation (in the amended s1038 and s1038A of CTA 2009 referred to at [53] and [54]) to prevent a deduction from being available when share options are granted to employees lends some support to the proposition that, but for that legislation, a deduction was potentially available.

Issue 2 – whether the IFRS2 Debit is capital in nature

78. The essence of Mr Ghosh's argument was that the IFRS2 Debit was capital in nature because it was a "contra" item to the Capital Contribution that the Appellants were treated as receiving because of the accounting treatment outlined at [32]. He argued that the accounting treatment for both SWHL and the Appellants made it abundantly clear that, when the EBT Trustee granted share options to the Appellants' employees, SWHL was making a capital contribution to the Subsidiaries. Therefore, Mr Ghosh argued that the IFRS2 Debit's nature could only be understood by reference to the Capital Contribution and, properly understood, it was capital in nature.

79. The question of whether particular expenditure is revenue or capital is ultimately one of law. The accounting treatment of expenditure may be relevant to that question, but does not determine it. Still less can the nature of particular expenditure be conclusively determined by an analysis of a "contra" item in a company's accounts (or in the accounts of a different legal entity). Therefore, while I agree that the Appellants were treated for accounting purposes as receiving the Capital Contribution from SWHL, I do not believe that determines whether, as a matter of law, the IFRS2 Debits were capital in nature.

80. I also consider that Mr Ghosh's analysis of the accounting started in the middle of the story, rather than the beginning. He approached matters by noting that the IFRS2 Debit was the "contra" item to the Capital Contribution. However, a better analysis is to note that both the IFRS2 Debit and the Capital Contribution arose only because the EBT Trustee granted share options to employees. Therefore, as with the analysis of whether the IFRS2 Debit was incurred "wholly and exclusively" for the purposes of the Appellants' trades, I consider that it is necessary to consider the circumstances in which the share options were granted, and the nature of the IFRS2 Debit itself, in order to determine whether the IFRS2 Debit is income or capital.

81. Viewed in that way, the IFRS2 Debits are not capital in nature. As noted at [74] and [75], the IFRS2 Debits arose because the Appellants' employees were remunerated with share options and the remuneration of employees has a revenue, not a capital, nature. The IFRS2 Debits arose periodically, they were not "one off" items. The IFRS2 Debits were therefore recurring costs that had a connection with the Appellants' earning of income (not least since the Appellants on-charged the IFRS2 Debits to other members of the Group, at a margin, by way of the Management Charge). In addition, as an accounting matter, the IFRS2 Debits reflect the consumption of employees' services by the Appellants. That also is redolent of the IFRS2 Debits being revenue in nature, and not capital. For all of those reasons, I have concluded that the IFRS2 Debits are not capital in nature.

Issue 3 – Section 1038 of CTA 2009

The competing arguments of the parties

82. Two aspects of s1038 of CTA 2009 are relevant to these appeals. The first question is whether "relief is available" under Part 12 of CTA 2009. If that condition is satisfied, the effect of s1038 is that a taxpayer is denied relief for expenses "directly related" to the provision of shares. That gives rise to the second question, namely whether expenses associated with the options are "directly related" to the provision of shares. Mr Ghosh and Mr Maugham advanced very different theories on what s1038 of CTA 2009 meant and how it should be applied. In the interests of brevity, I will not summarise all of those arguments but will just give a flavour of them.

83. Mr Maugham argued that it was important to keep in mind that Part 12 of CTA 2009 was conferring relief when shares were provided pursuant to options. By contrast, these appeals are concerned with tax relief that the Appellants submit arises in relation to the grant of share options. Given the way in which the accounting expense is calculated and allocated to accounting periods (referred to at [20]to [30]), in each accounting period in which the Appellants claimed tax relief associated with the options, it could not be said that relief was "available" under Part 12. Indeed, in an accounting period in which an option was first granted, it would not be possible to say with certainty whether shares would ever be provided in pursuance of that option (as that would depend on whether the option was exercised in the future). Parliament could not have intended s1038 of CTA 2009 to deny relief for the IFRS2 Debits simply because the relevant options might be exercised in future accounting periods particularly given that the statutory provisions contained no mechanism for adjusting relief available on the grant of share options in earlier accounting periods depending on whether or not shares were ever provided pursuant to the options.

84. Mr Maugham's argument at [83] was therefore that, as a matter of construction, s1038 CTA 2009 was simply not capable of denying relief for an IFRS2 Debit associated with the grant of share options. In the alternative, he argued that, even if s1038 applied, it could only deny relief for expenses "directly related to the provision of the shares". The IFRS2 Debits did not satisfy this requirement (as they arose from the options rather than the provision of shares) and so s1038 could not disallow them.

85. Mr Ghosh noted that s1038 denies other kinds of relief where relief is "available" under Part 12 and that relief could be "available" (under s1015 of CTA 2009) without necessarily being "given" (under s1018 CTA 2009). Therefore, in Mr Ghosh's submission, in all relevant accounting periods, relief was "available" under s1015 of CTA 2009. Since the Debit arose because of the grant of options and the options themselves related to the provision of shares, the Debit was "directly related to the provision of shares" and so fell to be disallowed under s1038. On that construction of s1038, no relief was available on the grant of share options, whether or not shares were provided on exercise of the options.

86. Mr Ghosh submitted that there was another construction of s1038 that led to the same conclusion. If one looks at the "final" accounting period in which an option is exercised, and shares provided, on any view relief under Part 12 is "available" in that

accounting period. Section 1038 makes it clear that, when relief is available under Part 12, no other relief for expenses directly related to the provision of the shares is available in any accounting period. That restriction does not, therefore, simply apply to the "final" accounting period and therefore s1038 can deny relief for an IFRS2 Debit in any accounting period. He accepted that this meant that a taxpayer granting a share option might not know until future accounting periods whether relief was available for an IFRS2 Debit associated with that option. However, he did not accept that this made the relevant provisions unworkable: the taxpayer could potentially claim relief but disclose to HMRC that relief would not be available if the option was subsequently exercised and shares issued. Moreover, there were other examples of situations in which Parliament adopted a "wait and see" approach in determining whether a particular relief was available and he referred to the (now repealed) s77 of ICTA 1988 in this regard. This construction of s1038 is therefore different from that outlined at [85] as it would mean that s1038 denies relief only if the option is subsequently exercised (leaving open the possibility of relief being available for options that were not exercised).

Conclusion on Issue 3

87. I do not accept Mr Ghosh's submission to the effect that relief under Part 12 of CTA 2009 is "available" (so that the restriction in s1038 applies) before shares are actually issued under the option. Parliament has set out, in s1015 of CTA 2009, the conditions that must be met before relief is "available". One of those conditions, set out in s1015(1)(d) is that:

> the person who obtains the option acquires shares pursuant to the option

I do not, therefore, consider that relief can be "available" under s1038 unless and until an option is exercised. Nor do I consider that references in s1018 and s1021 of CTA 2009 to relief being "given" compels a different conclusion. Rather, in s1015 Parliament sets out a set of pre-conditions that must be met before relief is available. Once those conditions are met, s1018 of CTA 2009 explains how much relief is to be given and s1021 explains how that relief is given (for example as a deduction in calculating profits of a trading company).

88. Therefore, despite the ingenuity of Mr Ghosh's submissions, I do not agree with his construction of s1038 of CTA 2009 set out at [85]. I do not consider that the restriction in s1038 of CTA 2009 is capable of applying to restrict expenses associated with the grant of a share option unless and until that option is actually exercised.

89. I prefer Mr Ghosh's construction set out at [86]. If an option is exercised, it is clear that s1038 imposes a restriction on a deduction for expenses "directly related to the provision of shares" in any accounting period. I consider that Mr Maugham overstated matters in submitting that this interpretation would make the legislation unworkable. In any event, since Parliament has quite deliberately provided that, if a share option is exercised, the restriction in s1038 applies in any accounting period, effect has to be given to that statutory provision.

90. The question therefore reduces to a consideration of whether the IFRS2 Debits at issue in this appeal are “directly related to the provision of shares”. I do not consider that they are for the following reasons:

(1) The IFRS2 Debits arise in respect of the grant of options, irrespective of whether shares are provided on exercise of those options. The possibility of options not being exercised was real and not fanciful as noted at [14]. Since the IFRS2 Debits can arise even where no shares were issued, I do not consider that they are “directly related to the provision of shares”.

(2) As an accounting matter, the IFRS2 Debits are intended to measure the consumption of employees’ services by the Appellants. That is not directly related to the provision of shares.

(3) As noted at [25], the accounting standards seek to measure the value of employees’ services consumed by ascertaining the fair value of the options granted. The value of the IFRS2 Debits takes into account a number of factors, some of which are not at all related to the SWHL shares. For example, the extrinsic value of the options takes into account prevailing market interest rates and the duration of the option which have nothing at all to do with SWHL shares. Moreover, the IFRS2 Debit will also take into account the Appellants’ changing estimates of the number of options that will vest, a factor that depends more on patterns of staff turnover than on the provision of SWHL shares.

91. I do not think that the fact that the law in s1038 CTA 2009 was subsequently amended (and s1038A enacted) sheds much light on what Parliament meant by expenses being “directly related to the provision of shares” and therefore my conclusion at [90] disposes of Issue 3. Understandably, Mr Maugham submitted that the change in law suggested that Parliament realised that it had not dealt satisfactorily with relief on grant of share options in the original version of s1038. Mr Ghosh, equally understandably, submitted that the amended legislation demonstrated that Parliament’s intention throughout had been that relief should not be available in respect of the grant of share options. He referred to extracts from Hansard and Explanatory Notes accompanying the amended legislation which suggested that the changes had been made “to put the position beyond doubt”. On balance, I think that Mr Maugham had the better of that argument since the legislative changes were significant and introduced express reference to the position on grant of share options where there had been no such reference previously. However, I do not think that adds much to the conclusion that I have already expressed at [90].

Issue 4 – Section 1290 of CTA 2009

92. It was common ground between the parties that the act of granting share options to employees did not involve employees receiving “qualifying benefits” for the purposes of s1292 of CTA 2009 (largely because s473 of the Income Tax (Earnings and Pensions) Act 2003 provides that the grant of an option to employees does not give rise to an income tax charge for employees).

93. Mr Ghosh submitted that s1290 applied. He argued that the grant of options to employees involved the making of an "employee benefit contribution" as defined in s1291 of CTA 2009. His argument proceeded as follows:

> (1) As a result of the EBT Trustee's act of granting the options, the employees held property (namely the options themselves). Moreover, as a result of granting those options, the EBT Trustee itself held property (namely shares that it acquired to satisfy its obligations under the options).
>
> (2) The options that the employees held form part of an arrangement (the Share Schemes themselves) that was for the benefit of employees generally and, as such constituted an "employee benefit arrangement". The shares that the EBT Trustee held were also held subject to the same "employee benefit arrangement".
>
> (3) Therefore, whether one viewed the relevant "property" as the shares held by the EBT Trustee or the options held by the employees, there was an employee benefit contribution as property was held under an "employee benefit scheme".
>
> (4) In those circumstances, any deduction to which the Appellants were entitled in respect of the grant of the share options was denied, or at very least deferred until qualifying benefits were provided to employees out of the "employee benefit contributions" that had been made.

94. The width of the terms used in s1290 has given me much pause for thought. However, on balance I have concluded that s1290 does not apply in the manner for which Mr Ghosh argued.

95. The first point to note is that s1290(1) and s1290(2) of CTA 2009 apply to deny or postpone a "deduction in respect of employee benefit contributions". The deduction at issue arises in respect of the grant of share options. Therefore, for s1290 to apply, the grant of share options must amount to an "employee benefit contribution" within the meaning of s1291.

96. Section 1291 of CTA 2009 contains the definition of "employee benefit contribution". Perhaps oddly, that definition does not explain what amounts to an employee benefit contribution, but rather sets out the circumstances in which an "employee benefit contribution" is made (namely that there is an "act or omission" that has certain specified results). However, construed in context, it seems as though the "employee benefit contribution" is the "act or omission" that leads to the results specified in s1291(1) of CTA 2009.

97. Therefore, the question is whether, as a result of the grant of the share options either (i) property is held, or may be used, under an "employee benefit scheme" or (ii) there is an increase in the total value of property that is so held or may be used (or a reduction in any liabilities under an "employee benefit scheme").

98. If the "property" is regarded as the options themselves, I do not consider that limb (i) or limb (ii) set out at [97] is satisfied. The options that the EBT Trustee grants to

employees simply embody a set of contractual rights that entitle employees to acquire shares from the EBT Trustee for a specified price. Those options were certainly granted in the context of Share Schemes (that are "employee benefit schemes" as defined in s1291(2)). However, once granted, I do not consider that the options were held, or may be used under an employee benefit scheme (defined as a "trust, scheme or other arrangements for the benefit of persons who are, or include, present or former employees…"). Rather, the options embodied contractual rights that employees held in their own names, absolutely. When the employees received their options, they had received their benefit and those options were no more held "under" an employee benefit scheme after they were granted than was an employees' salary.

99. If the "property" is regarded as shares held by the EBT Trustee, the position is slightly different. The EBT certainly embodied a trust for the benefit of persons who include employees and so is an "employee benefit scheme". However, I do not consider that the fact that the EBT Trustee needed to obtain shares to meet its contractual obligations when options were exercised caused those shares to be held "under" the employee benefit scheme in the necessary sense. Those shares were not acquired to confer a separate benefit on employees, but rather to enable the EBT Trustee to honour the contractual benefit that had already been provided in the form of the option.

100. I was also not satisfied on the evidence I saw that a "result" of granting share options was that the EBT would hold shares in SWHL or an increased value of shares. I have, at [12] explained why I do not consider that the very act of the EBT Trustee granting a particular share option over a number of shares would involve it in acquiring that very number of shares. I have also concluded that significant numbers of share options would lapse. Therefore, if the EBT Trustee granted share options, it would not necessarily need to acquire shares to "cover" those options. For example, employees might fail to meet the vesting conditions or the options might be "out of the money" when they came to be exercised. Even if the options granted vested and were "in the money", other options granted by the EBT Trustee might lapse so that the EBT Trustee might not need to acquire further shares to honour obligations under options that were exercised. In short, I am not satisfied on the evidence that I was shown that there was the necessary causal link between the grant of any particular option and the EBT Trustee's acquisition of shares to conclude that, as a "result" of the grant of any particular option, the EBT Trustee acquired shares or an increased value of shares.

101. The interpretation at [98] to [100] is consistent with the overall purpose of s1290 of CTA 2009. Section 1290 is not seeking to establish a general principle that a company is denied a corporation tax deduction whenever it makes outright payments to employees that are not subject to tax in the employees' hands. If that were the purpose of s1290, it could have been expressed much more briefly. Rather, s1290 is concerned with situations in which an employer incurs expenses in putting property into an arrangement that can be expected (in due course) to result in employees receiving benefits but the corporation tax deduction is taken before employees are subjected to a tax liability on their benefit. That is emphasised by the fact that s1290(2) permits a deduction to be given where qualifying benefits are provided "out

of" employee benefit contributions (suggesting that an employee benefit contribution is something other than an outright transfer to employees). It is also emphasised that by the fact that the definition of "employee benefit arrangement" envisages that there is some sort of intermediary arrangement standing between the provision of property by the employer and the receipt of benefits by the employee. The options arising in this appeal were not within the evident purpose of s1290: as noted above, as soon as the EBT Trustee granted the options, the employees received their benefit (consisting of the option itself) and no further action was needed for them to receive that benefit.

102. My conclusion, therefore, is that s1290 does not apply in the circumstances of this appeal.

Conclusion

103. My conclusion on the various questions of principle is as follows:

(1) On Issue 1 and 2, the IFRS2 Debits were deductible trading expenses of the Appellants.

(2) On Issue 3, s1038 of CTA 2009 does not prevent the IFRS2 Debits from being deductible.

(3) On Issue 4, s1290 of CTA 2009 does not prevent the IFRS2 Debits from being deductible.

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

JONATHAN RICHARDS
TRIBUNAL JUDGE

RELEASE DATE: 14 JUNE 2017

APPENDIX

List of Share Schemes

1. The following Share Schemes are relevant to this appeal:

Scheme name	Adoption Date
Smith & Williamson Company Share Option Plan (approved)	24 June 2003
Smith & Williamson Company Share Option Plan (unapproved)	24 June 2003
Smith & Williamson Sharesave Scheme	24 June 2003
Smith & Williamson Holdings Limited Deferred Option Plan	23 November 2006
Smith & Williamson Holdings Limited Executive Long Term Incentive Plan	24 April 2009
Smith & Williamson Holdings Limited Matching Share Plan	23 April 2009
NCL Replacement Restricted Share Bonus Plan	30 April 2003
NCL Replacement Discretionary Share Option Scheme	30 April 2003
NCL Replacement Unapproved NCL plan	30 April 2003