INCOME TAX–Tax avoidance scheme –Dividend from new company instead of bonus: whether Ramsay jurisprudence applies–Schedule E and meaning of emoluments from employment–Schedule F and meaning of dividend or distribution–Class 1 National Insurance Contribution

Neutral Citation Number: [2010] UKUT 251 (TCC)

Case No: FTC/08/2009
FTC/11/2009

IN THE UPPER TRIBUNAL (TAX AND CHANCERY)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 7 July 2010

Before :

MR JUSTICE ROTH and JUDGE CHARLES HELLIER

- -

Between :

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Appellants/ Cross-Respondents**
- and -	
PA HOLDINGS LIMITED	**Respondent/ Cross-Appellant**

- -
- -

Malcolm Gammie QC (instructed by **General Counsel and Solicitors to HM Revenue and Customs**) for the **Appellants/Cross-Respondents**
Stephen Brandon QC and Rory Mullan (instructed by **Speechly Bircham LLP**) for the **Respondent/Cross-Appellant**

Hearing dates: 16, 17, 18 and 19 February 2010

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Decision

Mr Justice Roth and Judge Charles Hellier:

1. This is an appeal and cross-appeal against the decision of the First Tier Tribunal (Tax Chamber) concerning arrangements whereby financial benefits were paid to employees of PA Holdings Limited ("PA"). The First Tier Tribunal ("FTT") held that:

   i) those payments were to be treated as emoluments from employment within section 19 and Schedule E of the Income and Corporation Taxes Act 1988 ("ICTA");

   ii) those payments also constituted dividends or distributions within section 20 and Schedule F of the ICTA;

   iii) pursuant to section 20(2) ICTA, those payments were accordingly not chargeable to income tax pursuant to Schedule E under regulation 80 of the Income Tax (Pay as You Earn) Regulations 2003;

   iv) those payments were earnings within the terms of sections 3 and 6 of the Social Security Contributions and Benefits Act 1992 ("SSCBA") and thus subject to liability for Class 1 National Insurance ("NI") contributions.

2. The Commissioners for Her Majesty's Revenue and Customs ("HMRC") appeal against points (ii) and (iii) above. PA cross-appeals against points (i) and (iv) above. Before the FTT, the appeal against HMRC's decisions regarding NI contributions was brought both by PA and an individual employee of PA, Mr Kully Janjuah, apparently on the basis that the decisions named both the employer and employee to whom it applies. However, the appeal was decided on principle and the decision of the FTT does not concern matters particular to Mr Janjuah whose position was in all respects allied to PA. Only PA and not Mr Janjuah bring this further appeal, but that did not have any effect on the argument or the issues for decision.

The Facts

3. We summarise the relevant facts as found by the FTT, which received a significant body of both documentary and oral evidence.

4. PA was, in the relevant years, a company whose subsidiaries and branches provided consultancy services. The FTT described it as employee-owned, in that its shares were held by employees or by trusts for the benefit of employees ("employee trusts"). PA was resident in the United Kingdom, where slightly over half of its staff were based.

5. PA's policy was to pay median salaries and to award its employees generous individual bonuses. Each year, it paid a substantial proportion of its profits into employee trusts from which awards were made to employees under discretionary bonus schemes. Employees had no contractual entitlement to benefits under these schemes and the bonus that an employee received reflected his or her efforts, the efforts of the part of PA in which he or she worked and the profitability of PA as a whole.

6. In 1999, Ernst & Young proposed an arrangement to PA that was described by the FTT as being "to re-route" bonuses awarded to UK resident employees, so that they were paid as dividends of a UK resident company and thus taxed as distributions. After discussions with professional advisers and the introduction of some modifications, the scheme was implemented. The overall effect of the scheme was that, rather than receiving a bonus of £1, each employee received 99p in dividends and 1p in share redemption proceeds.

7. These arrangements were put into place for the 1999 accounting year. A deed establishing a new employee benefit trust was executed on 16 December 1999 appointing as trustee a Jersey based company selected by PA, Mourant & Co Trustee Ltd ("Mourant"). Like the FTT, we refer to this trust as "the 1999 ET". Very shortly thereafter, PA transferred £24,600,050 to Mourant for payment into the 1999 ET. In January 2000, Mourant adopted what was called the "PA Holdings Limited Restricted Share Plan" for making awards from the 1999 ET to eligible employees.

8. Mourant also decided to establish a company called Ellastone Limited ("Ellastone") and its shares were issued to nominees of Mourant. Ellastone was originally a Jersey incorporated company but senior members of PA's staff were appointed directors of Ellastone on 27 January 2000 and Ellastone became UK resident at that time (with a result that its dividends could fall within Schedule F rather than Schedule D).

9. On 4 February 2000, Mourant transferred almost all the funds paid by PA into the 1999 ET to Ellastone as a capital contribution. On 16 February 2000, 24 million 1p preference shares in Ellastone were subscribed by Mourant at par and issued to its nominee. By resolution passed on 13 March 2000, Mourant (on the basis of recommendations from PA) granted individual awards of beneficial interests in almost all those preference shares to a list of employees and the nominee was instructed to hold those shares for the listed employees. Not all employees received an award. On 24 March 2000, Ellastone declared a dividend of 99p on each 1p preference share from the profits represented by the capital contribution. The dividend was paid to the nominee on 28 April 2000 and thence transmitted to the award holders (to the extent of their interests therein). On 19 November 2000, Ellastone redeemed the preference shares for 1p each and the redemption proceeds were transmitted to the eligible award holders.

10. Essentially the same steps were repeated for the 2000 and 2001 years, save that a failure properly to register the preference shares in the name of the nominee was retrospectively corrected by an action in the Royal Court of Jersey.

11. The awards of beneficial interests in the preference shares to employees were made by Mourant under the terms of the Restricted Share Plan. Under the rules of the Plan, an employee who was granted an award of shares was to receive an award certificate, had a beneficial interest in the number of preference shares awarded to him, and became entitled to all distributions made on the shares while held by the nominee. The shares were to be transferred to employees at the end of a defined restricted period. An employee would forfeit his interest in the shares and the relevant distributions if he ceased in relevant circumstances to be an employee. The terms of the Plan meant that if an employee left employment before the payment of a dividend

or share redemption proceeds, he would not receive and would have no entitlement to those monies.

12. The stated purpose of the 1999 ET was “to motivate and encourage employees in the performance of their duties by the provision of bonuses and incentives and other rewards at the discretion of the trustees.” The payment of £24,600,050 to Mourant was recorded as “staff costs” in PA's accounts. The employees paid nothing in cash or in kind for the awards, aside from their services as employees. The FTT found that PA’s objective in the arrangements was to benefit individual employees and the receipt of the shares and the dividends were presented by PA to its employees as part of the payment of bonuses.

13. Prior to 1999, PA paid sums for bonuses to another employee benefit trust, referred to as “the 1995 ET”. The trustees of that trust awarded bonuses in accordance with formulae established by PA. The formulae applied in the same way to UK resident and non-UK resident employees. Where appropriate, the sums paid were subject to deduction of income tax under PAYE and to the payment of NI contributions. In January 2000, when the 1999 ET arrangements were being set up, presentations were made to UK resident employees (for present purposes we use the words “UK resident” to include those who were UK ordinarily resident) inviting them to choose between receiving a bonus for 1999 from the 1995 ET or from the 1999 ET. Most chose to receive a bonuses from the 1999 ET, and the few who did not remained - along with all those who were non-UK resident - potentially eligible under the 1995 ET.

14. Four days before their decision to make awards of shares, Mourant received from PA a list of recommended share awards for the employees who had elected for the 1999 ET. The list specified, in relation to each of some 1400 employees, a precise number of shares. The total number of shares was 23,757,869. A document before us showed a comparison between the 1998 cash awards and the 1999 share awards which suggested an implicit value of each share award as £1. The FTT found that the list of recommendations was calculated in accordance with the formula used in previous years and used for the 1995 ET. Mourant questioned PA's staff about the recommendations and changed some of them. The FTT found that Mourant genuinely exercised its own discretion.

15. The 1p preference shares had almost no rights. The articles of Ellastone, which as noted above was established under Jersey law, indicate that the shares carried no voting rights and no right to share in any surplus on a winding up; that they carried the rights to receive only one dividend *if* one was declared, and of an amount to be determined by the directors, but had no rights to enforce the declaration of a dividend save that it was to be paid in priority to any payment on other shares.

16. The payment of the dividends was part of an overall scheme that was derived from a proposal put forward to PA by Ernst & Young but then modified by PA in a number of ways. As noted above, the proposal was to “re-route” bonuses awarded to employees as dividends of a UK resident company so that they were taxed as distributions. Notwithstanding the modifications, and the introduction of Mourant as an independent trustee exercising its own discretion, it seems clear that the FTT considered that this remained the purpose of PA in making the arrangements. The

arrangements accordingly constituted a scheme in which each of the steps was planned, anticipated and carried out in sequence. As the FTT put it, the links between the various steps were never broken: paras 64-73. The FTT also found that the capital contribution made by Mourant to Ellastone was made without any conditions attached of a kind that would lead to the conclusion that the monies were impressed with a trust.

17. When Ellastone paid the dividends on the preference shares, the dividends were paid to a nominee as the registered owner. The nominee made the payments to the award holders. The payments were made after the deduction of 25% income tax (the basis for which was not explored before us or discussed by the FTT in its decision). It is implicit in the arrangements that to the extent that Mourant remained the beneficial owner of any preference shares, either in relation to the approximately 250,000 shares not awarded or in respect of shares forfeit under the terms of the Restricted Share Plan, Mourant was entitled to receive the related dividends, although we understand that it generally waived that right.

The statutory provisions

18. As indicated above, the relevant statutory provisions concerning income tax are set out in sections 19 and 20 ICTA. Section 19(1) enacts Schedule E, which provides, insofar as material:

> "Tax under this Schedule shall be charged in respect of any office or employment on emoluments therefrom …."

19. Section 20 concerns Schedule F, and provides insofar as material:

> "(1) The Schedule referred to as Schedule F is as follows-
>
> 1. …income tax under this Schedule shall be chargeable for any year of assessment in respect of all dividends and other distributions in that year of a company resident in the United Kingdom which are not specially excluded from income tax, and for the purposes of income tax all such distributions shall be regarded as income however they fall to be dealt with in the hands of the recipient.
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> …
>
> (2) …no distribution which is chargeable under Schedule F shall be chargeable under any other provision of the Income Tax Acts."

20. "Distribution" in relation to a company receives an extended definition under section 209 ICTA. It is sufficient to quote part of that definition as set out in the first three sub-paragraphs of section 209(2) and sub-section 209(4):

> "(2) (a) any divided paid by the company, including a capital dividend;"

> (b) …, any other distribution out of assets of the company (whether in cash or otherwise) in respect of shares in the company, except so much of the distribution, if any, as represents repayment of capital on shares or is, when it is made, equal in amount or value to any new consideration received by the company for the distribution;
>
> (c) … , any redeemable share capital or any security issued by the company in respect of shares in or securities of the company otherwise than wholly for new consideration, or such part of any redeemable share capital or any security so issued as is not properly referable to new consideration; …
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> (4) Where on a transfer of assets or liabilities by a company to its members or to a company by its members, the amount or value of the benefit received by a member (taken according to its market value) exceeds the amount or value (so taken) of any new consideration given by him, the company shall, … be treated as making a distribution to him of an amount equal to the difference."

21. As regards NI, the relevant liability is for Class 1 contributions under the SSCBA. Section 6(1) imposes liability for such contributions -

> "Where in any tax week earnings are paid to or for the benefit of an earner over the age of 16 in respect of any one employment of his which is employed earner's employment…."

22. The relevant definitions are set out in section 3(1) which provides:

> "(a) "earnings" includes any remuneration or profit derived from an employment; and
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> (b) "earner" shall be construed accordingly."

The FTT Decision and the Issues on Appeal

23. It is accepted by PA that the interest in the shares received by the employees constituted emoluments from their employment, but it is effectively common ground that pursuant to section 140A ICTA since they were conditional shares this award was exempt from income tax. It is also not in dispute that the 1p redemption proceeds were chargeable to tax under Schedule E. The battleground concerns the treatment of the payments of the dividends in respect of those shares.

24. The FTT held that the same considerations applied in determining whether the dividends fell within Schedule E for the purpose of income tax as in determining whether they were earnings for the purpose of Class 1 NI. It held that those payments were properly regarded as emoluments or earnings from the employees' employment with PA. It reached that conclusion essentially on the basis of the test set

out in *Hochstrasser v Mayes* [1960] AC 376, (1959) 38 TC 673, but indicated that it would reach the same result on the basis of the *Ramsay* line of authority relied on by HMRC. It held that the payments were also "distributions" falling within Schedule F, and that pursuant to section 20(2) they fell to be charged under Schedule F not Schedule E. As there is no equivalent provision to section 20(2) addressing receipts of a dual nature under the SSCBA, the FTT held that the payments accordingly attracted liability for Class 1 contributions.

25. There are essentially three questions for consideration on these appeals:

i) Are the dividends to be regarded as coming from the employees' employment within the terms of section 19 ICTA (and section 3(1) of the SSCBA)?

ii) Do those payments constitute dividends or "other distribution[s]" within the terms of section 20 ICTA?

iii) If the answer is yes to (i) and (ii), how do those provisions interact?

26. The appeal of HMRC challenged the FTT's conclusion as regards Schedule F on the basis of the *Ramsay* line of authority. In summary, it was contended that, properly characterised, the payments were emoluments from the employees' employment, and that it was therefore wrong to apply a different characterisation for the purpose of section 20. The appeal of PA challenged the FTT's conclusion that the dividends were to be treated as earnings from the employees' employment, essentially on the basis that the FTT failed correctly to apply *Hochstrasser v Mayes*, in particular in the light of the House of Lords decision in *Abbott v Philbin* [1961] AC 352, (1960) 30 TC 82.

Discussion

(1) The Ramsay principle

27. The progeny of the landmark decision of the House of Lords in *WT Ramsay Ltd v IRC* [1982] AC 300, (1981) 54 TC 101, has been a series of decisions by the House of Lords and Privy Council, each drawing on its predecessors and developing what is by now a clear line of authority. The decisions are further and fully analysed in the recent judgment of Arden LJ (with whom Keene and Sullivan LJJ agreed) in *Astall v HMRC* [2009] EWCA Civ 1010, [2010] STC 137. We see little benefit in lengthening this judgment by quoting extensive passages from these various decisions and we think that the principles which they establish can be set out as a series of propositions:

i) The jurisprudence following *Ramsay* did not introduce a special doctrine peculiar to tax law. It represents the application in the tax field of established principles of broad, purposive statutory interpretation, rejecting formalism in fiscal matters: *IRC v McGuckian* [1997] 1 WLR 991, per Lord Steyn at 1000, Lord Cooke at 1005.

ii) The approach involves giving the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then determining whether the actual transaction (which might involve considering the overall effect of a number of elements together) answers the statutory description: *Barclays Mercantile Business Financial Ltd v Mawson* [2004] UKHL 51, [2005] 1 AC 684, (2004) 76 TC 446, per Lord Nicholls at [32].

iii) Revenue statutes are in general concerned with the characterisation of the entirety of transactions which have a commercial unity rather than individual steps into which such transactions may be divided: *Carreras Group Ltd v Stamp Commissioner* [2004] UKPC 16, [2004] STC 1377, per Lord Hoffmann at [8].

iv) Composite transactions do not cease to have a commercial unity only because they contain a commercially irrelevant contingency, deliberately included to create an acceptable risk that the scheme might not work as planned: *IRC v Scottish Provident Institution* [2004] UKHL 52, (2004) 76 TC 538, per Lord Nicholls at [23].

v) The approach is not limited to a composite transaction. It can apply to “a single multi-faceted transaction which on its face operated in a particular way but which when examined against the facts of the case does not operate as a transaction to which the statute was intended to apply”: *Astall*, per Arden LJ at [42].

vi) However, whether the statutory provision under consideration is concerned with a single step or a broader view of the acts of the parties depends upon the construction of the language in its context: *MacNiven v Westmoreland Investments Ltd* [2001] UKHL 6, [2003] 1 AC 311. Hence, “the purpose must be discernable from the statute: the Court must not infer one without a proper foundation for doing so”: *Astall* per Arden LJ at [44].

vii) Accordingly, the mere fact that a transaction is designed for no commercial purpose other than obtaining a tax advantage is not in itself sufficient ground to interpret the application of the statute to the transaction, or an element within it, so as to deny that advantage: *MacNiven*.

28. Counsel for PA submitted that there is less scope for application of this approach to the charging provisions in the ICTA as they have an established interpretation that already reflects a purposive approach. We reject that submission. Since the *Ramsay* line of authority establishes general principles of construction in the tax field, we consider that they apply as much to the interpretation of the charging provisions as to any other statutory provisions. Indeed, it would be both artificial and inappropriate to exclude them. It may be that some of the earlier authorities foreshadowed what can conveniently be described as the *Ramsay* approach, but that does not render that approach inapplicable.

(2) Section 19(1) and Schedule E

29. We accordingly apply the *Ramsay* approach in considering the application of section 19. In our view, on the factual findings of the FTT, there is a clear commercial unity in the arrangements described above. The interests in the shares were received by the employees not only by reason of their being employees of PA but also to motivate and

encourage them in the performance of their duties as employees. The receipt of the shares and of the dividends were presented by PA to its employees as part of the payment of their bonus for that year. Although the FTT did not explicitly so find, it is implicit, and was accepted by Mr Brandon QC on behalf of PA, that there was an expectation that the directors of Ellastone (who were PA senior staff) would declare the 99p dividend shortly after Mourant awarded the shares. The dividend was fully funded by the payment by PA to Mourant. The FTT found that there was an "unbroken link" between the payment by PA to Mourant and the receipt of the dividends by the employees (paras 71 and 83). In our judgment, that conclusion is amply supported on the facts.

30. There is obvious risk in seeking to paraphrase the concise statutory language in section 19(1). Applying a purposive construction, we consider that it is intended to cover payments which, on a realistic view of the circumstances in which and the reasons why they are made, would sensibly be regarded as coming "from" the recipient's employment. In some cases, the facts will be closer to the borderline than in others. Looking at the payment of the dividends in the present case in their overall context, we have no doubt that that they satisfy this test. The FTT was accordingly correct to reach that conclusion, albeit as a secondary ground of its decision: para 73.

31. We reach the same conclusion if the matter is considered only on the basis of the test in *Hochstrasser v Mayes*, which was the primary approach adopted by the FTT. Indeed, as regards the interpretation of the statutory wording, the earlier cases on Schedule E that were relied on seem to us entirely consistent with the *Ramsay* approach although expressed in pre-*Ramsay* language. In *Hochstrasser v Mayes*, the taxpayer entered into a voluntary housing assistance scheme offered by his employer, ICI. An employee who entered into an agreement under that scheme and purchased a house was in effect guaranteed against depreciation in the value of the house if he was transferred by ICI to another part of the country, since in that event, on a resale of the property, ICI would pay the employee any loss suffered as against the original purchase price. Mr Mayes bought his house for £1850 and was transferred elsewhere by ICI some three years later when he sold the house for £1500. The £350 loss was duly paid to him by ICI and the Crown sought to tax that under Schedule E as earnings from his employment.

32. In the House of Lords, Viscount Simonds stated (at AC 387-388, TC 705):

> "Upjohn J., before whom the matter first came, after a review of the relevant case law, expressed himself thus in a passage which appears to me to sum up the law in a manner which cannot be improved upon. 'In my judgment,' he said, 'the authorities show this, that it is a question to be answered in the light of the particular facts of every case whether or not a particular payment is or is not a profit arising from the employment. Disregarding entirely contracts for full consideration in money or money's worth and personal presents, in my judgment not every payment made to an employee is necessarily made to him as a profit arising from his employment. Indeed, in my judgment, the authorities show that to be a profit arising from the employment the payment must be

> made in reference to the services the employee renders by virtue of his office, and it must be something in the nature of a reward for services past, present or future.' In this passage the single word 'past' may be open to question, but apart from that it appears to me to be entirely accurate."

33. Viscount Simonds proceeded to state that "the issue turns … upon whether the fact of employment is the causa causans or only the sine qua non of benefit, which perhaps is to give the natural meaning to the word 'therefrom' in the statute." He held that the question "is one of substance, not form", and as regards the circumstances of the housing agreement stated (at AC 389-390, TC 706):

> "There is nothing express or implicit in the agreement which suggests that the payment is a reward for services except the single fact of the relationship of the parties, and it is clear enough … that that fact alone will not justify such a conclusion. On the other hand, there is the significant fact that the salary earned by the employee compares favourably with salaries paid by other employers not operating a housing scheme, and is the same whether or not he takes advantage of the housing scheme. This at once suggests that there is some other reason for the payment than services rendered or to be rendered."

34. On that basis, Viscount Simonds upheld the decision of Upjohn J and the majority of the Court of Appeal that the payment did not arise "from" his employment. Lords Radcliffe and Cohen agreed with Viscount Simonds' reasoning, although adding their own as well, and Lord Keith of Avonholme also agreed. Lord Radcliffe said (at AC 391-392, TC 707-708) that the meaning of the statutory words:

> "is adequately conveyed by saying that, while it is not sufficient to render a payment assessable that an employee would not have received it unless he had been an employee, it is assessable if it has been paid to him in return for acting as or being an employee. It is just because I do not think that the £350 which are in question here were paid to the respondent for acting as or being an employee that I regard them as not being profits from his employment.
>
> The money was not paid to him as wages. The wages of employees are calculated independently of anything which they get under the housing scheme, and the ICI salaries compare favourably with salaries paid by other employers in the chemical industry who do not operate a housing scheme. We are bound to say on the facts found for us that the source of the £350 was the housing agreement into which the respondent had entered on June 1, 1951, and that the circumstance that brought about his entitlement to the money was not any services given by him but his personal embarrassment in having sold his house for a smaller sum than he had given for it."

35. Whether or not analysis is assisted by the use of Latin expressions for causation (as to which see Megarry J in *Pritchard v Arundale* [1972] Ch 229 at 237-238, and Lord Simon in *Brumby v Milner* (1976) 51 TC 583 at 613), the question to be answered is essentially one of fact, considered in the light of all the circumstances. Here, the FTT found that the dividends, which were in substantial amounts, were on proper analysis to be regarded as paid with regard to the services performed by the recipients as employees of PA, albeit that the immediate source of the payments was their shareholding in Ellastone. In the light of all the findings of fact, as set out above, we not only see no basis for disturbing that conclusion but we entirely agree with it. We note, in particular, that the policy of PA was to pay median salaries supplemented by generous individual bonuses, that the 1999 ET was offered to employees as an alternative arrangement to the 1995 ET, that the express aim of the 1999 ET was "to motivate and encourage employees in the performance of their duties", and that the benefit to employees who subscribed to the 1999 ET was clearly in the dividend that would result if they were awarded a shareholding, which dividends were funded by PA through a very substantial payment. Accordingly, the test set out by Upjohn J is satisfied.

36. PA submitted that this conclusion is precluded by the House of Lords decision in *Abbott v Philbin*. There, an employee was among those offered by their employing company in 1954 the option, at a price of £1 per 100 shares, to purchase 2000 shares in the company at the then prevailing market price of 68s 6d per share, such option to exercisable at any time within 10 years. The option would also expire on the death or retirement of the employee. The employee purchased the option (for £20), and in 1956 applied for and was allotted 250 shares at the option price. By then the market price had risen to 82s per share and he was assessed to tax under Schedule E for the 1955-56 tax year on the difference between the then market price (82s) and the option price paid (68s 6d) plus the price of the option for those 250 shares.

37. The assessment was upheld at first instance and in the Court of Appeal, but the majority of the House of Lords allowed the taxpayer's appeal. However, that case was conducted on the basis of the Crown's contention that the issue of the shares gave rise to a profit from the taxpayer's employment because the grant of the option itself was not a taxable profit. The latter aspect was accordingly the main focus of the speeches of in the House of Lords, where the majority held that award of the option was in itself a potentially valuable right, capable of being turned into money. On that basis, the Crown's case failed.

38. It was only as a secondary matter that the question of potential relevance to the present appeal was considered, namely whether the benefit on the subsequent issue of the shares could in any event be considered a profit deriving from the taxpayer's employment. As to that, Viscount Simonds, said (at AC 367, TC 118):

> "The taxable perquisite must be something arising "therefrom," i.e., from the office, in the year of assessment. I do not want to embark on the notoriously difficult problem as to the year to which for the purpose of tax a payment should be ascribed, if it is not expressly ascribed to any particular year. But I do not find it easy to say that the increased difference between the option price and the market price in 1956 or, it might be, in

> 1964 in any sense arises from the office. It will be due to numerous factors which have no relation to the office of the employee, or to his employment in it. The contrast is plain between the realised value, as it has been called, of the option when the shares are taken up (though the realisation falls short of money in hand) and the value of the option when it is granted. For the latter is nothing else than the reward for services rendered or, it may be, an incentive to future services. Unlike the realised value it owes nothing to the adventitious prosperity of the company in later years. On this ground also I should reject the claim of the Crown."

39. Lord Radcliffe expressed the matter as follows (at AC 379, TC 125-126):

> "The claim to tax the advantage obtained in the year 1955-56 is not claimed by the Revenue if the right view is that the option itself was taxable in 1954-55. Even if there were no taxable subject in the earlier years I should regard the 1955-56 claim as failing on its own terms. The advantage which arose by the exercise of the option, say £166, was not a perquisite or profit from the office during the year of assessment: it was an advantage which accrued to the appellant as the holder of a legal right which he had obtained in an earlier year, and which he exercised as option holder against the company. The quantum of the benefit, which is the alleged taxable receipt, is not in such circumstances the profit of the service: it is the profit of his exploitation of a valuable right. Of course, in this case the year of acquiring the option was only the year immediately preceding the year in which, pro tanto, it was exercised. But supposing that he holds the option for, say, nine years before exercise? The current market value of the company's shares may have changed out of all recognition in that time, through retention of profits, expansion of business, changes in the nature of the business, even changes in the market conditions or the current rate of interest or yield. I think that it would be quite wrong to tax whatever advantages the option holder may obtain through the judicious exercise of his option rights in this way as if they were profits or perquisites from his office arising in the year when he calls the shares."

40. Mr Brandon for PA relied on the reasoning in these passages as applicable to the present case. He submitted that they establish a principle that if the income flows from a distinctly enforceable legal right, then it is derived from (and in respect of) that right and not from the employment which led to the grant of that right. However, we do not regard the speeches of Lords Simonds and Radcliffe as seeking to lay down such a general proposition. In the first place, they can hardly be regarded in these passages as seeking to depart from the statements of general principle they had enunciated in *Hochstrasser v Mayes* only seven months before. Secondly, as the earlier case established, the question is fact sensitive. In *Abbott v Philbin,* once the company had granted the option, any subsequent benefit derived by the employee on

the issue of shares was dependent on the movement in the company's share price and the time or times when the employee chose, in his absolute discretion, to exercise his option rights: he could of course have done so in stages, seeking the issue of shares at different points in the 10 years up to the total 2000. Although it would be artificial to regard that benefit (or varying benefits in the different years) as being paid as "a reward for services", applying the *Hochstrasser v Mayes* test, those circumstances are far removed from the present case.

41. We should add that although PA sought to rely also on the speech of the third Law Lord forming the majority, Lord Reid, in our view he did not directly address this secondary issue. The reasons which he gives for over-ruling the Scottish case of *Forbes's Trustees* concerned the findings of the Court of Session that the grant of an option could not be regarded as something that can be turned to pecuniary account, in part because an option agreement was not unconditional in that the taxpayer had to pay the companies the par value of the shares when he applied for them. Disagreeing with that view, Lord Reid held that if the condition was one with which the taxpayer can easily and immediately comply, that does not constitute an obstacle to turning the option to pecuniary account, whereas it might be otherwise if the condition was one which cannot be immediately complied with. Lord Reid then distinguished the case of *Salmon v Weight,* saying (at AC 375, TC 123)

> "There the servant had no enforceable right at all until he got his shares. He got his shares because the company chose to give him something then, to give him a perquisite when the shares were issued. But in this case the appellant getting his shares did not flow from any voluntary act of the company when the shares were issued. It flowed from the company's voluntary act in the previous year when they gave him an option by which they were thereafter bound. It would, I think, require some peculiar circumstances to make a mere expectation capable of being turned to pecuniary account."

42. We do not regard the penultimate sentence in that passage, when read in its context, as expressing a conclusion that the issue of shares on the exercise of the option by the employee could not independently be regarded as a profit deriving from his employment. But if such weight can be placed on this single sentence, it is in any event subject to the same observations by reference to the facts of *Abbott v Philbin* as set out above regarding the quoted passages from the speeches of Lords Simonds and Radcliffe.

43. We have considered *Abbott v Philbin* at some length because it was the mainstay of PA's case on the question of earnings. In our judgment, it provides no support for PA's appeal, nor does it undermine the FTT's reasoning based on *Hochstrasser v Mayes* or, indeed, the application to the facts of this case of the general approach set out in the *Ramsay* jurisprudence.

44. PA advanced the further argument that if the payment came from two sources, then it could not be a profit "from employment" for the purpose of Schedule E. On that basis, it was submitted that if the payments received by the employees came from the shares in Ellastone they could not be emoluments from the employees' employment.

45. This proposition regarding a "double source" relied on Lord Reid's statement in *Laidler v Perry* [1966] AC 16 at 30, 42 TC 351 at 363:

> "... in the end we must always return to the words in the statute and answer the question -- did this profit arise from the employment? The answer will be "no" if it arose from something else."

And in *Brumby v Milner* (1976) 51 TC 583 at 613, Lord Simon appeared to affirm Lord Reid's approach.

46. Although PA did not refer to it directly, there are echoes of this in Lord Templeman's speech in *Shilton v Wilmshirst* [1991] 1 AC 684 at 693, [1991] STC 88 at 94, where he said:

> "I prefer the simpler view that an emolument arises from employment if it is provided as a reward or inducement for the employee to remain or become an employee and not for something else."

47. *Laidler v Perry* concerned £10 vouchers given to over 2000 employees at Christmas. But we do not regard Lord Reid's dictum as laying down a rigid, "double source" test. Significantly, he said later in his speech (at AC 32, TC 364):

> "The real question appears to me to be whether these vouchers can be said to be *mere personal gifts*, inspired not by hope of some future quid pro quo from the donee but simply by personal goodwill appropriately signified at Christmas time. That is a question of fact" [our emphasis]

48. Similarly, Lord Morris said (at AC 34, TC 365) that although the impulses of generosity and of kindly and seasonal goodwill were not lacking from the employer, there was manifest "that form of gratitude which is 'a lively sense of future favours'" so that the company would prosper and be advantaged. The vouchers were received by the employees in their capacity as employees and because they were employees. Lord Hodson applied the formulation approved in earlier cases (at AC 35, TC 366): "is it in the nature of a personal gift or is it remuneration?"

49. Accordingly, we consider that the passage from Lord Reid's speech on which PA relies should be read on the basis of this antithesis and in the context of the Commissioners' findings that the vouchers were not gifts rather than as an abstract statement of principle of universal application. There is no basis for imposing the strictures of a "double source" test on the simple words of the statute.

50. Far from questioning this approach, the decision of the House of Lords in *Brumby v Milner* strongly supports it. There, each of the Law Lords agreed with or adopted the judgment of the Court of Appeal, delivered by Russell LJ, which in turn specifically approved the approach of Megarry J in *Pritchard v Arundale*, where he said that there were not several questions involving the decision into which of several compartments a receipt was to be fitted, but only one question: "that is to say, whether it is shown …

that the receipt had the taxable quality of remuneration or reward for services." Russell LJ continued (at 608):

> "Cases in the books have tended to treat the question as one in which, if there was not merely a payment on personal grounds ..., it must be reward for services, and vice versa: but those were cases in which the facts made it necessary that it should be one or the other, and they are not inconsistent with the true situation that in every case there is the one question ..."

51. In *Brumby* the payments had arisen because of the termination of a trust and it was contended that the payments had arisen from the decision to wind up the trust and not from employment. Looking at all the circumstances, including the genesis of the trust as a scheme to reward employees' services, it was found that on proper analysis the payments came from employment. Given the House of Lords' endorsement of Russell LJ's judgment, we do not consider that Lord Simon, in the dictum upon which PA relies (para 45 above), was espousing a contrary approach.

52. In *Wilcock v Eve* (1994) 67 TC 223, Carnwath J cited Lord Reid's statement in *Laidler v Perry*, quoted above, and those of Lord Kilbrandon in *Brumby v Milner*, and observed (at 232) that it must be recognised that in most of these borderline cases the problem is that there is more than one operative cause for a payment, and that inevitably there is then an element of judgement in deciding on which side of the line the payment falls.

53. The authorities require attention to the statutory words. The only statutory question is, as Megarry J said, whether the emolument comes from employment. Answering that question is not to be constrained by the mechanistic application of statements found in the case-law. In some situations, the formulation of an antithesis between one source and another may clarify the process of reaching a decision: for example, finding that a payment is made out of love and affection to a person who happens to be an employee makes it clear that it does not come from employment but from something else; in other situations, the facts may indicate that there is more than one operative cause for the payment and a judgement falls to be made as to whether the employment cause predominates; and in yet other cases, there may be precursor causes for payment, in which event the use of the contrast is not helpful since the conclusion that a payment comes from a particular source will not preclude its coming also from employment.

54. In the present case, drawing a contrast between a receipt from employment and a receipt from the preference shares is of no assistance because the two sources are not opposed to one another when, as the FTT found, the cause of the dividend was the employment: the arrangement including the dividend was made with the object of motivating and encouraging employees in the performance of their duties as employees.

(3) *Section 20(1) and Schedule F*

55. HMRC argued that once the payment was characterised as income from employment for the purpose of Schedule E under section 19, that characterisation must equally apply when considering section 20. If that is the reality of the payments for a

particular tax consequence, as Mr Gammie QC put it in his skeleton argument, "the reality cannot then be denied by reverting to a formalistic analysis that treats each transaction within the series or combination of transactions comprising the composite whole as having its own separate tax consequences".

56. However, although ostensibly attractive, this submission diverts attention from the statutory wording that governs the position. The characterisation of the transaction for the purpose of section 19 is precisely that: it is not a 'once and for all' recasting of the transaction for all other statutory provisions. Nor does the fact that sections 19 and 20 are adjacent charging provisions for income tax alter the approach. It might be otherwise if these sections, and thus Schedules E and F, were mutually exclusive. But section 20(2) expressly envisages that facts which give rise to a distribution chargeable under Schedule F may also fall within one of the other charging provisions, and provides which provision should then prevail.

57. Accordingly, we consider the wording of section 20(1). Is the payment derived from this composite transaction a dividend or "other distribution" within Schedule F? The answer depends upon the interpretation of that statutory provision with regard to the factual context. There is nothing in that provision which suggests that no enquiry is permitted into whether or not something is a distribution if that something is part of a composite transaction designed to deliver employment income or indeed any other form of income or benefit. For example, a composite transaction might be one which takes place in the course of a trade with no motive other than to make a profit: the language of section 20(1) does not suggest that if the resulting composite trading profit would be assessable under Schedule D, it is not to be assessed under this provision. The only items excepted from the charge are those "specially excluded from income tax". It seems to us that the plain purpose of the section is to *require* a consideration of whether or not a dividend has been paid or distribution made and, if it has been, to tax it.

58. Mr Gammie referred to the discussion of the meaning of "dividend" by Robert Walker J in *Memec plc v Commissioners of Inland Revenue* (1998) 71 TC 77 at 103-104. In a judgment upheld by the Court of Appeal, Robert Walker J accepted that the meaning of "dividend" in the ICTA was the ordinary businessman's understanding (as previously expressed by Harman J in *Esso Petroleum v Ministry of Defence* [1990] Ch 163, 166) of "a payment-out of a part of the profits for a period in respect of a share in a company." However, that case concerned the UK-Germany Double Taxation Convention and, as Robert Walker J noted, the term of art in the statutory provisions dealing with Schedule F income is "distribution", which is "elaborately defined" in sections 209ff of the ICTA. Thus the question is not whether the payments were simply dividends, but whether or not the payments fell within the meaning of "distribution" in section 209, purposively construed.

59. Section 209(2) brings within the meaning of "distribution" a wide range of transactions by which value passes from a company in respect of shares in, or securities of, the company. Sections 209ff are the basis for the provisions which tax the recipient on the receipt of the distribution (section 20), deny the payer any deduction for the distribution (section 337 (3) and later section 330 (7A)), and which in the past charged ACT on the making of the distribution. They are not provisions

providing principally for a narrow exemption or relief from tax but are written widely to catch transactions which have two principal characteristics.

60. The first characteristic is that the making of the distribution results in the incurring of a cost by, or the passing of value from, a company. That is evident from: (i) the ordinary businessman's idea of a "dividend" included in section 209(2)(a); (ii) the words "out of assets of the company ... except so much ... as …is, when it is made, equal … to any new consideration received" in section 209(2)(b); (iii) the reference to issue of securities "otherwise than wholly for new consideration" in section 209(2)(c); (iv) the inclusion of the payment of interest exceeding a reasonable commercial return for the use of the principal secured by the securities in section 209(2)(d); (v) the restriction in section 254(6) on the meaning of new consideration received; and (vi) the provision in section 254(9) that a distribution is to be treated as being out of assets of the company if the cost falls on the company.

61. The second characteristic is that the passing of value must be in respect of some share in, or security of, the company. That is evident from: (i) the ordinary businessman's understanding of a "dividend" included in section 209(2)(a); (ii) the words "in respect of shares" in section 209(2)(b) and (c); (iii) the focus on the issue of redeemable shares or securities in section 209(2)(c); and (iv) the words "in respect of securities" in section 209(2)(c), (d), (da) and (e). Moreover, "in respect of shares" and "in respect of securities" are given an extended meaning for this purpose in section 254(2) and (12).

(a) Was a cost incurred by or did value pass from the company?

62. The question whether, in relation to a distribution, value has passed from, or a cost has been incurred by, a company is analogous to the question whether expenditure has in reality been "incurred" for the purpose of the Capital Allowances Acts. In *Barclays Mercantile Business Financial Ltd v Mawson ("BMBF"), Ensign Tankers (Leasing) Ltd v Stokes* [1992] 1 AC 655, and *HMRC v Tower MCashback LLP 1* [2010] EWCA Civ 32, that question arose in the context of expenditure funded by circular cash movements and non-recourse loans. In each case, arrangements had been made as part of a commercial unity to fund the expenditure through the circular flow of funds.

63. In *Ensign*, the taxpayer borrowed on non-recourse terms from the vendor of the film: it was found not to have incurred the expenditure so financed; in *BMBF*, the taxpayer borrowed money which flowed through a number of companies and back to the lender: it was found to have incurred the expenditure; in *Tower*, the part of the payment at issue was sourced by a series of circular transactions giving rise to non-recourse loans on somewhat uncommercial terms: it was held that expenditure had been incurred. In each case, the courts gave consideration to the detail of the terms of the loan and the ways in which the moneys had moved to determine whether in reality the taxpayer suffered the burden of making the payment.

64. In the same way, in the present case, we consider that the receipt of the monies by Ellastone that it used to pay the dividends is not to be ignored, but that it is necessary to consider whether the funds belonged to Ellastone in the context of the arrangement as a whole: only if they belonged to Ellastone can it be said to have expended them in

making the payments. Approaching the matter in that way, the fact is that the monies did belong beneficially to Ellastone - and not just momentarily. Ellastone was expected to pay dividends, and it was highly likely that it would do so but it was not bound to do so. The funds belonged to Ellastone just as the monies borrowed by *BMBF* and *Tower* belonged to those companies despite the expectation, intention and reality that they would immediately dispose of the funds. On that basis, Ellastone's payment of those monies by way of the dividends caused it to incur an economic burden or cost. The components of the composite transaction put it in a position to undertake that burden but do not mean that the cost of these payments was not a cost to Ellastone.

(b) Were the payments "in respect of shares"?

65. We consider that the FTT was clearly correct to regard the dividends as being paid "in respect of" the redeemable shares awarded to the employees. Those are wide words which do not point to consideration of the reason for or source of the payment. But are the redeemable shares properly to be regarded as "shares" for the purpose of section 209? As Mr Gammie emphasised, these were very thin shares: they carried only the right to be considered for a single dividend and then to receive that dividend if that consideration was successful; they carried no right to notice of normal meetings, or to vote or to capital. Is that what the ICTA intends by a "share"?

66. The "debenture" in *Carreras* lasted only about two weeks. The Privy Council held that it was not, in the circumstances, the kind of instrument envisaged by the words "issues…debentures…in exchange for shares" in the Jamaican statutory provisions granting an exemption from transfer tax when shares were exchanged for debentures. But as Lord Hoffmann emphasised, part of the process of statutory construction is to determine whether a broad or narrow approach to the statutory language is appropriate. The context of the Jamaican transfer tax provisions is very different from section 209 ICTA. Section 209 is principally an adjunct to provisions to charge distributions to tax. Section 209 is written widely to catch the products of human ingenuity designed to avoid a transaction being the payment of a dividend. It does not afford a narrow relief, but is intended, through the breadth of its definition of "distribution", to bring such classes of activity within the scope of the charge to tax. Hence, the payment of profit-related or unreasonably high interest on debt and the under value sale to a member, each speak of transactions whereby, by reference to some formal relationship, value is passed from the company to its member(s).

67. A distinction between shares with substantial rights and those with lesser rights is expressly made elsewhere in the legislation: for example in the definition of "ordinary share capital" in section 832 ICTA, and its use in the definition of subsidiary in section 838. The absence of a reference to section 832, or a like provision, and the provisions relating to securities (whose rights may be very limited and transient) show that the possession of substantial rights, such as voting rights or rights in a winding up, are not prerequisites of the nature of the shares for a payment in respect of them to constitute a "distribution". In that context, the purpose of the legislation is to embrace anything which can formally be said to be a share or security. The preference shares here pass that test.

(4) *Section 20(2)*

68. Once the payments are properly characterised as dividends or distributions within the meaning of section 20(1), section 20(2) appears to provide in unambiguous terms that if they are chargeable under Schedule F they shall not be chargeable under Schedule E. The FTT found that the position was clear, and we respectfully agree.

69. Mr Gammie sought to escape this conclusion by arguing that in reality the dividends represented the payments on account of emoluments previously awarded when Mourant exercised its discretion to determine the award of shares to employees. He submitted that by the award of shares Mourant effectively promised to procure the payment of cash to employees in the future, such that the payments of the dividends were payments on account of assessable income. On that basis, the payments would fall within section 203B as payments by an intermediary of PA such that PA falls to be treated as making the payments for the purpose of PAYE.

70. It is not clear that this argument forms part of HMRC's Grounds of Appeal. But leaving that formality aside, we consider that, for all its ingenuity, the argument is misconceived. Critical to this argument is the correct appreciation for the purposes of Schedules E and F of the action of Mourant. Whatever Mourant gave to the employees could constitute an emolument only if it was capable of being turned to pecuniary account. The only thing that the employees had after Mourant did what it did was their shares. There is no finding or evidence recorded by the FTT that Mourant gave any other promise to the employees. There may indeed have been an intimation by PA or an expectation by the employees that a dividend would be paid, and that would be reflected in the value of the shares. This is a commonplace for many shares. But such an intimation or expectation does not in consequence itself become a separate emolument. The subsequent payment of the dividend was not "on account of" the grant of the shares, and there was nothing else of which it could be on account. Section 203B (1) therefore does not apply.

(5) *The SSCBA*

71. For PA it was submitted that payment of the dividends could not be "remuneration … derived from employment" if they were dividends in respect of the shares paid by Ellastone. However, this was essentially a repetition of the argument advanced as regards Schedule E. We see no basis on which to give section 3 SSCBA a different interpretation in that regard from section 19 ICTA. Nor does the wording "in respect of" in section 6(1) SSCBA advance the matter. That simply reproduces the formulation in section 19(1) ICTA; and in any event, "in respect of" is, if anything, a wider concept than "from".

72. The FTT held that the fact that the earnings were dividends of a kind that came within the scope of a "distribution" in Schedule F ICTA did not preclude them from being subject to Class I NIC, since there is no equivalent in the SSCBA as regards the dual nature of receipts to section 20(2) ICTA. Subject to the question whether the dividends were correctly to be regarded as "earnings" within section 3, we did not understand PA to challenge this conclusion which, in our view, is clearly correct.

(6) *Trust*

73. In their Grounds of Appeal, HMRC sought to argue that the payment by Mourant to Ellastone was impressed with a trust such that Ellastone never acquired beneficial ownership of the monies. That argument was rejected by the FTT, and would have required consideration of the evidence presented before the FTT, which expressly accepted the evidence of the witnesses save only where it was directly contradicted by the contemporary documents. In the course of the hearing, Mr Gammie, in our view very properly, abandoned that argument.

Conclusion

74. In conclusion, therefore, and for the reasons set out above, both the appeal by HMRC and the cross-appeal by PA are dismissed.

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